Is 2017 a Game Changer for Japanese Equities?

Kenichi Amaki, Portfolio Manager at Matthews Asia, shares his outlook for Japanese equities.

After a year of contrasting fortunes in 2016, the prospects for the Japanese economy in 2017 are anything but certain. This isn't surprising against a backdrop of the new U.S. president, rising interest rates and inflation, and the likelihood of an increased fiscal stimulus to promote economic growth. However, while I am not one for making predictions about how the Japanese stock market will end in 2017, I believe that this year could be a real game changer for Japanese equities.

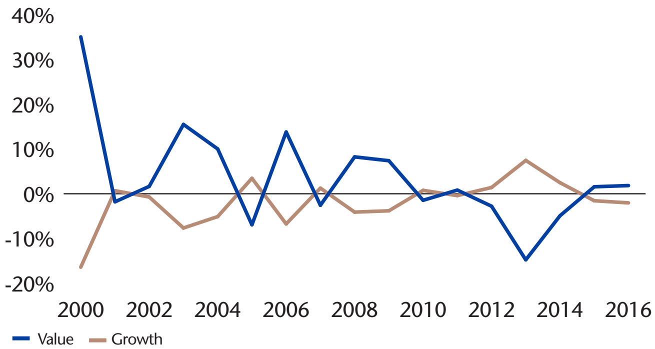
2016—A GAME OF TWO HALVES

In football, there is an age-old analogy of a game consisting of two halves. It is used to illustrate a stark contrast in fortunes, where a team may be winning easily in one half, only to see that lead evaporate in the second half.

For the path of the Japanese stock market in 2016, this figure of speech is a perfect summation of events. So what happened? Firstly, a combination of increased monetary stimulus announced by the Bank of Japan, the surprise election of Donald Trump in the U.S. and the Federal Reserve's decision to raise interest rates in December, led to both a weakening of the yen and a considerable rotation in favor of cyclical, interest rate sensitive equities.

On top of this junk rally, small caps underperformed large caps in the second and third quarters. This was mainly the result of the BOJ's decision to increase its purchases of exchange traded funds (ETFs), which were largely focused on Japan's largest Nikkei 225 stocks; though this was later adjusted to purchase more TOPIX based ETFs.

Figure 1. YoY Outperformance vs. MSCI Japan Index



Value represents the MSCI Japan Value Index; Growth represents the MSCI Japan Growth Index. Past performance is no guarantee of future results. For illustrative purposes only. It is not possible to invest directly in an index.
Sources: Bloomberg, MSCI; data as of December 31, 2016

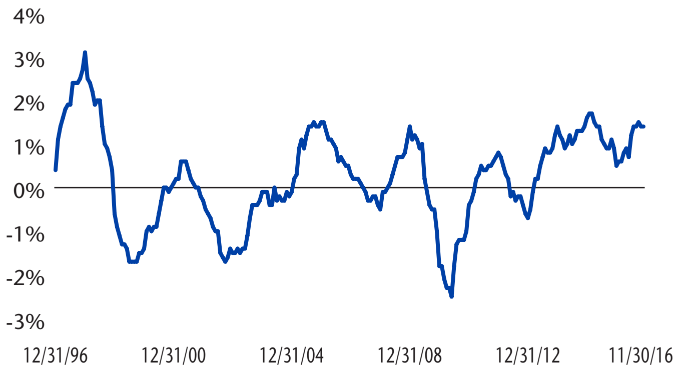
When it comes to investing in Japanese companies, quality is the hallmark of our approach at Matthews Asia. We look for quality names, whether they are value or growth, as long as they are businesses led by competent management teams with established track records that are able to generate a sustainable return on capital over longer periods of time.

In Matthews Asia's experience over the past 25 years, junk rallies tend to be quite transient. For example, some of the strongest recent performers in the MSCI Japan Index have been companies in the marine transport sector that consists of large shipping companies, all of which have been losing money and are heavily indebted—even if shipping rates doubled, these companies will struggle to make meaningful profits.

STRUCTURAL FACTORS SUPPORTING JAPANESE EQUITIES IN 2017

Over the years, the Japanese economy has faced many macroeconomic headwinds. This year, many of them have turned into tailwinds. Improved Purchasing Managers' Indexes (PMIs), accelerating wage growth and the announcement that the Japanese government will expand fiscal spending for the first time in three years all bode well for the strength of the economy.

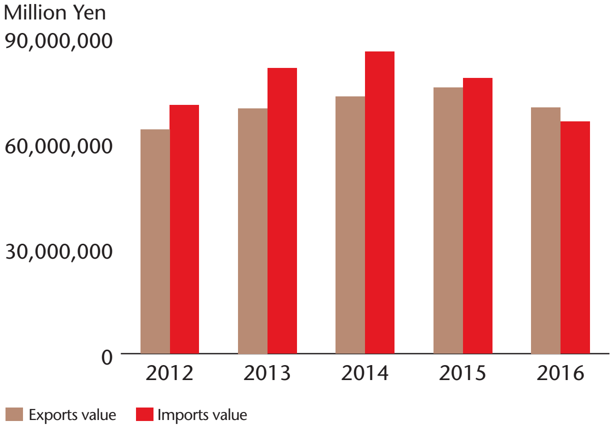
Figure 2. Wage Growth: The Key To Ending Inflation and Boosting Consumption
Morgan Stanley Japan Hourly Wage Growth Indicator



Source: Bloomberg

Assisted by higher export volumes, Japan's economy continued its improvement last year, recording annualized real GDP growth of 1.3% in 3Q 2016. This marked the third quarter in a row in which the economy had expanded owing to a boost in export volumes. However, this was offset by weaker domestic spending, and concerns remain that the benefits of Prime Minister Shinzo Abe's reform efforts have not yet reached the Japanese consumer.

Figure 3. Japan: Imports Falling Faster Than Exports



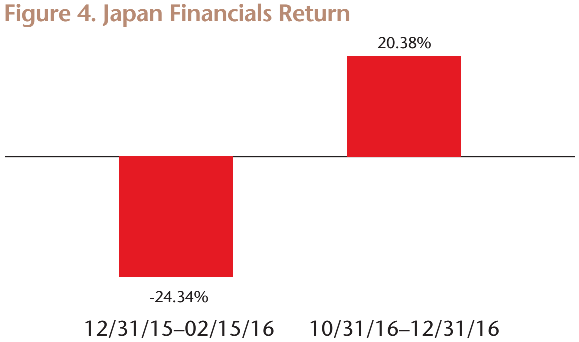
Sources: Ministry of Finance, Bloomberg

So is Abenomics doomed to fail? The goalposts always seem to be moving. Nevertheless, there have been concrete changes in Japan, with an improved labor market and better corporate governance. Then there is inflation. Japan has been stuck in deflation for most of the past two decades and even I anticipated that after few years of positive consumer price index growth, the economy would sink again into deflationary territory. However, in all likelihood, inflation may actually accelerate this year given the weakness of the yen, a potentially inflationary environment in the U.S. (and elsewhere) along with rising commodity prices.

At the margin this is good news for Japanese stocks and is a tailwind that frankly we have not had. It should be supportive of Japanese revenues, trickling down to Japanese earnings and eventually to Japanese shares.

Two areas that are likely to benefit this year are retail and financials. Japanese retail companies underperformed last year, owing to expectations of a return to deflation and price competition amongst retailers. Yet with a change in both currency and inflation expectations, those things might be viewed positively for the retail sector. At the same time, with Japanese wage growth accelerating again, I believe there is room for more consumption this year. This should be good news for retailers. Meanwhile, yield curves have steepened globally, including in Japan, which should be positive for Japanese banks and life assurance companies.

Figure 4. Japan Financials Return

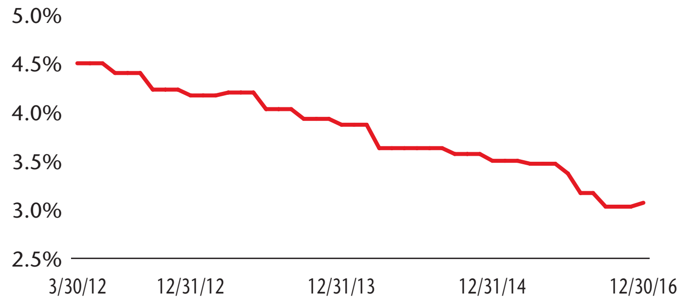


Represents MSCI Japan Financials Index. Past performance is no guarantee of future results. For illustrative purposes only. It is not possible to invest directly in an index.
Source: Bloomberg

In addition, I am bullish on health care for structural reasons. Japan is an aging society, which creates a natural increase in demand for health care. As Japan ages, health care companies can accumulate experience in that market, and export it to other markets around the world.

In Japan, as the labor pool shrinks and becomes more expensive, companies are increasingly seeking to outsource non-core operations, such as human resources, to specialist providers. That's why we believe business-to-business services in areas such as outsourced HR and benefits services still have room to grow.

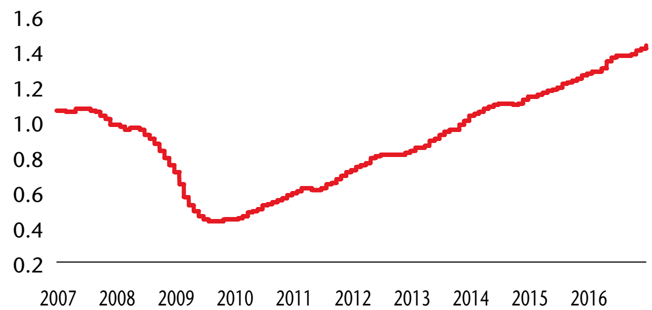
Figure 5. Japan Unemployment



Source: Bloomberg

Figure 6. Job Application Ratio

Data from Jan. 1, 2007 to Dec. 31, 2016



Source: Bloomberg

Thirdly, we are bullish on automation, for example, in robotics. This area will be attractive over the next 10 years because penetration of robotics and other types of automation in China and the rest of Asia is still extremely low compared with more advanced countries, such as Japan, Germany and South Korea. China needs to climb the value chain, now that it is making more high-end technology products, so it needs to improve quality along its entire supply chain. This is especially the case as wages in China and the rest of Asia are rising, making robots more cost-effective in comparison.

Another tailwind for Japanese equities is a weaker yen, at 115–120 per U.S. dollar. The first thing to say is that yen weakness is not a requirement for Japan equities to outperform, but it is helpful owing to its effect on corporate earnings. Prior to the U.S. election it was about 103 to 104 yen to the dollar, and depending on what actually comes out of the Trump White House it could move in any number of different directions. Still, I remain skeptical that it will weaken to as low as 125.

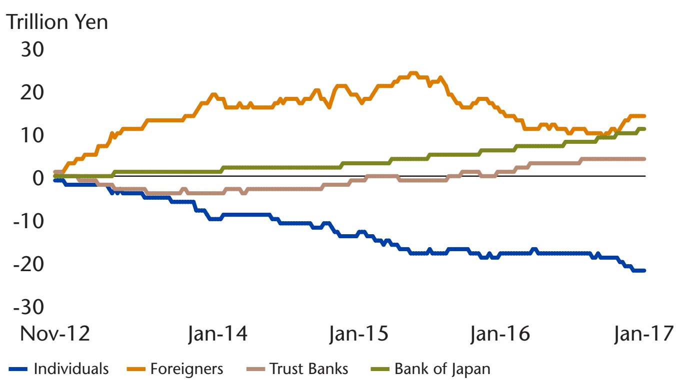
Figure 7. Yen vs. U.S. Dollar
Price of US$1 to yen, Jan. 30, 1987–Dec. 30, 2016

Source: Bloomberg

A final factor to be positive about is fund flows in Japanese equities. This tends to be quite short-term in nature, but there are reasons to be bullish. By the end of October last year, international investors had sold almost two-thirds of what they purchased since the start of "Abenomics." Meanwhile, the Bank of Japan will be buying 6 trillion yen of Japanese equities annually, while corporate share buybacks have been robust, hitting 5 trillion yen in 2016 and can be expected to continue apace this year.

At the same time, domestic pension funds are short of their target allocations for Japan, all of which combined means there is likely to be around 10 to 15 trillion yen of domestic buying into the asset class this year. If international investors change their attitude toward Japan and decide to raise their weightings, it could really propel the market upwards.

Figure 8. Japan Market Flow by Investor Type
Cumulative Purchase of Japanese Equities
Since Prime Minister Abe Took Office



Source: Bloomberg

WHY SMALL CAPS WILL RETURN TO THE FORE

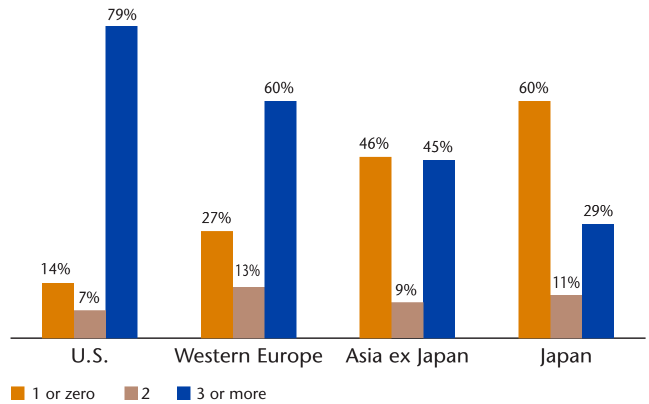
As Japanese macro tailwinds persist in 2017, it is my belief that the anomaly of small cap underperformance last year, which was technically driven, should begin to dissipate.

The majority of underperformance was driven by ETF demand by the Bank of Japan and it is likely that if foreign investors do decide to return to Japan their first foray might be into more liquid larger cap securities. However, ultimately, if the growth trajectory continues in Japan, and the macro tailwinds we have discussed persist, you would expect small caps to normalize and catch up in 2017.

As a result, small caps remain a very important part of our investment approach. Many investors are focused on the top 400 companies, the household names where there is liquidity, familiarity and much sell-side analyst coverage. But the small-cap space offers particularly compelling investment opportunities: Approximately 60% of the roughly 1,500- company universe of small caps has fewer than two analysts covering them.

Many of these stocks are strong and sustainable growing businesses at reasonable multiples relative to their growth and peers, but remain under-covered and under-appreciated. These holdings can develop into market leaders in their respective industries given a long-term investment horizon.

Figure 9. Japan's Alpha Opportunity is in Small Caps
Small-cap coverage in Japan remains thin, less than Asia ex Japan



Source: Bloomberg; data as of June 30, 2016
Western Europe includes France, Germany, Italy Spain, Switzerland and UK. Asia ex Japan is Hong Kong, Singapore, South Korea, Taiwan, India, Indonesia, Malaysia, Mongolia, Pakistan, Philippines, Sri Lanka, Thailand, Vietnam

THE CLOUDS ON THE HORIZON

So far the picture I have painted for Japan in 2017 is broadly a positive one, however there are of course potential risks. The biggest one relates to what will happen in the U.S. with President Trump. While globally, investors so far have adopted a positive view of his fiscal plans to boost growth, sentiment in Japan could prove fragile, especially regarding his protectionist policies.

The key issue is how many of his economic policies he can deliver and how much the Republican Party is willing to compromise on deficit spending. His protectionist policies could have a substantial negative impact on the global economy, while any U.S. policy mistakes causing U.S. economic reversal are also a concern. If the fiscal stimulus underperforms or underwhelms, yet the Federal Reserve continue its hiking cycle it could hamper U.S. growth. Policy mistakes causing deflationary trends would also be a threat to the global economy and remove all the inflationary tailwinds we discussed earlier.

The sentiment of equity investors also remains somewhat dependent on the expectations for the yen. While we have said its weakness is not a requirement for Japanese equities to perform, the risk remains that Japan's perceived status as a safe haven currency could result in renewed strength, if unexpected developments from here lead global investors to adopt a more risk-averse stance.

Other possible risks would be the velocity of increases in U.S. interest rates and a stronger dollar. After the first rate rise in

December last year, it is widely expected three more will follow in 2017. An accelerated pace and a higher number of increases could cause a substantial headwind. However such risk scenarios will inflict pain on all of U.S. trade partners, not just Japan.

DON'T UNDERESTIMATE THE POWER OF STABILITY

Meanwhile unlike many other countries right now Japan has the benefit of political stability, with Abe boasting some of the highest approval ratings among leaders in the developed world, which is a final positive tailwind to end on. He is now in his fourth year, and likely to run for re-election as leader for the Liberal Democrat Party again this year, which he is heavily favored to win. So he could be in office until 2021.

This stability is in stark contrast with other areas in the world, in particular Europe, where many countries are going to the polls this year. And these election results are much less certain. In my view, the market is not appreciating this lack of political risk in Japan.

IT'S ALL ABOUT STICKING TO THE LONG-TERM PLAN

So-called flights from quality in markets can test portfolios. The best are those that shoulder the short-term pain and stick to long-term convictions—and at Matthews Asia, we believe that for those seeking good long-term performance, sticking with good businesses and management is critical.

Japan will always be dominated by discussions about macro, political and regulatory headwinds. These things are outside of our control. What we can control is our analysis of a company and avoidance of those areas of the market that tend to be sensitive to cyclical ebbs and flows.

Yet there remain many strong Japanese companies that represent the real growth story in Japan today: Companies that can capture domestic demand, tap into Asia's ongoing evolution and take global market share. And in our view, there are several reasons to be more optimistic not only for 2017, but further beyond.

Disclosure and Notes

For Institutional/Professional Investor Use Only

The MSCI Japan Growth Index is a free-float weighted equity index.

The MSCI Japan Value Index captures large and mid cap Japanese securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. With 176 constituents, the index targets 50% coverage of the free float-adjusted market capitalization of the MSCI Japan Index.

The MSCI Japan Index is a free float–adjusted market capitalization–weighted index of Japanese equities listed in Japan.

The MSCI Japan Financials Index is a free float-weighted equity index. It was developed with a base value of 100 as of December 31, 1998.

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