Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Limited
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Outlook for Japanese equities in 2018

Upward price pressure may help boost corporate profits

The feel-good factor is back in Japan, but it may not be a one size fits all approach for corporates.

The Japanese stock market had a strong run in 2017, with the TOPIX rising 24% in USD terms[1]. Prime Minister Abe's comfortable re-election in October raised expectations of continued fiscal and monetary stimulus, while improvements in corporate profitability, governance and shareholder return further added to Japanese equities' appeal. The domestic economy also gained momentum, delivering annualised growth of 2.5% in the July-September quarter[2] owing to the global recovery as well as policy supports and reforms.

We continue to hold our constructive outlook for the market in 2018 while at the same time being mindful of risks, as summarised below:

Upside Factors	Downside Risks
● political stability & policy supports ● strong earnings momentum ● reasonable valuations	● global economic slowdown ● rising geopolitical tensions ● sharply appreciating yen

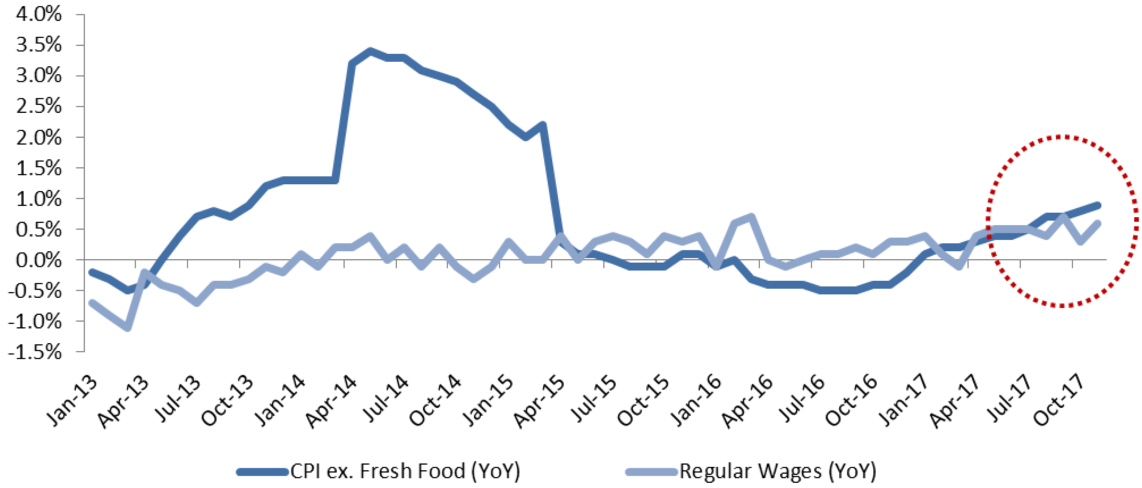
In addition, we believe that the country's return to an inflationary environment could present opportunities as well as challenges for Japanese corporates. Therefore, while many of the positives seen last year are likely to again help drive Japanese equity prices higher in 2018, we may see an increasing disparity in corporate performance owing to this dynamic.

1 Bloomberg
2 Cabinet Office

From Stagnation to Inflation

Although it is still too early to tell whether Japan has finally made a sustained exit from its deflationary state of the past two decades, the indications are that the country is moving in the right direction. CPI ex fresh food was 0.9% in November 2017.

Inflation and Wage Growth in Japan



Source: MIAC, MHLW, compiled by TMAM

This may be below the Bank of Japan's stated target of 2% and over, but with Abe calling for a 3% wage hike in this spring's wage negotiation and a very tight domestic labour market, we could yet see a pickup in wage-push inflation this year. Indeed, we are already seeing an increase in regular wage growth on a YoY basis, as shown above.

Such a scenario could have significant implications for corporates, particularly those with a domestic focus, as rising costs will put profit margins under greater pressure. Only those firms with competitive business strategies and products will likely be able to pass on these higher costs to customers.

One area where we are already seeing a dispersion in margins is in the retail sector. Here, traditional department store groups such as Takashimaya, J. Front Retailing and Isetan Mitsukoshi have higher revenue than smaller, specialty stores such as ABC Mart (footwear), Nitori (furniture) and Ryohin Keikaku (lifestyle products), but the difference in their profitability is striking.

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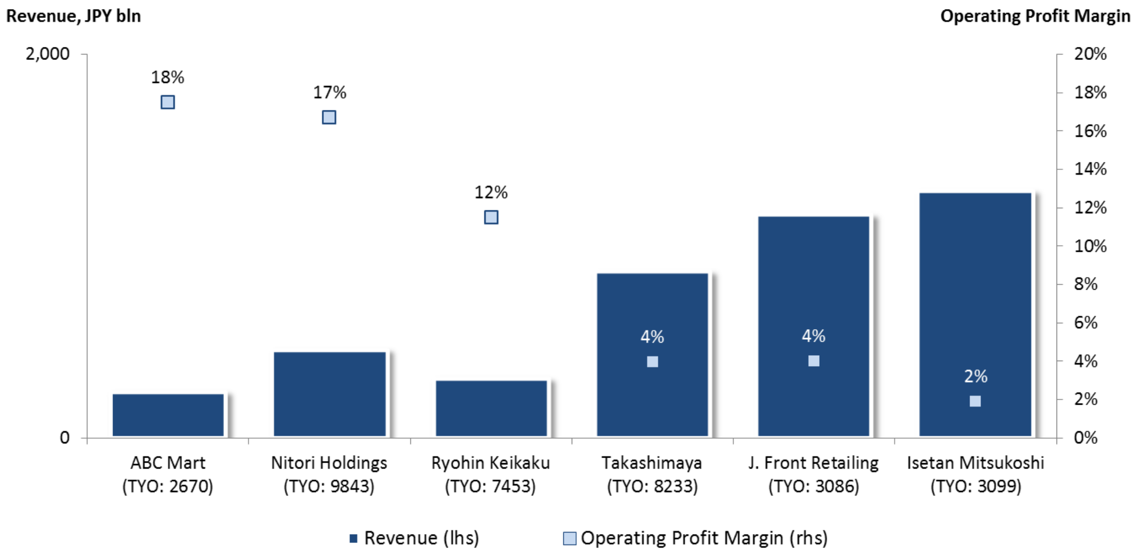
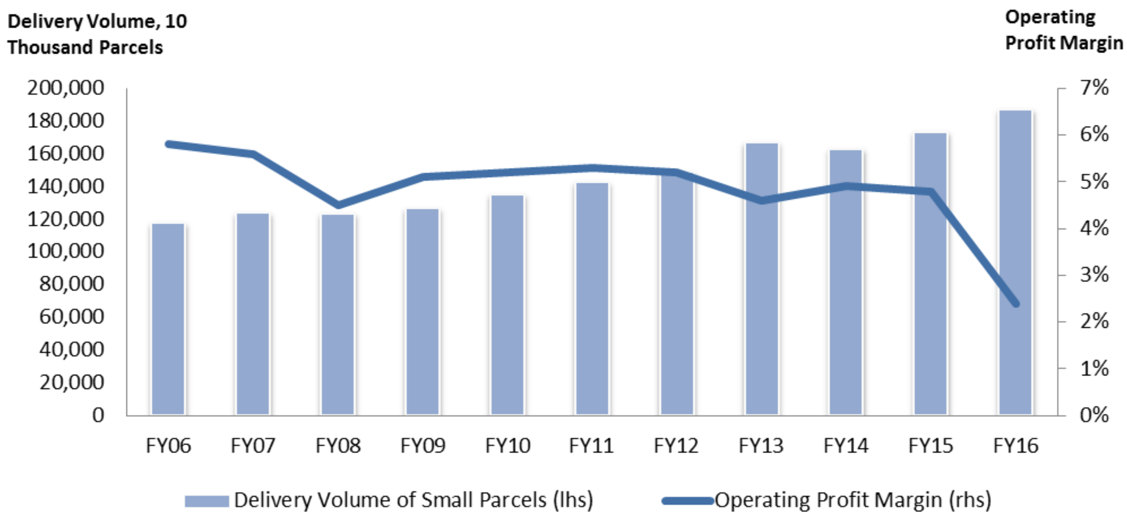
Performance of Selected Japanese Retailers



Source: Bloomberg, complied by TMAM, numbers as reported for the latest fiscal year

Faced with increasing costs, changes are also being seen in the business strategy of corporates in other domestic-oriented sectors, such as logistics. Previously, market share mattered most to delivery companies – often accepting orders with unfavourable terms – but this approach resulted in fierce price competition and margins being eroded as delivery volumes rose.

Yamato Transport's Delivery Volume and Profit Margin

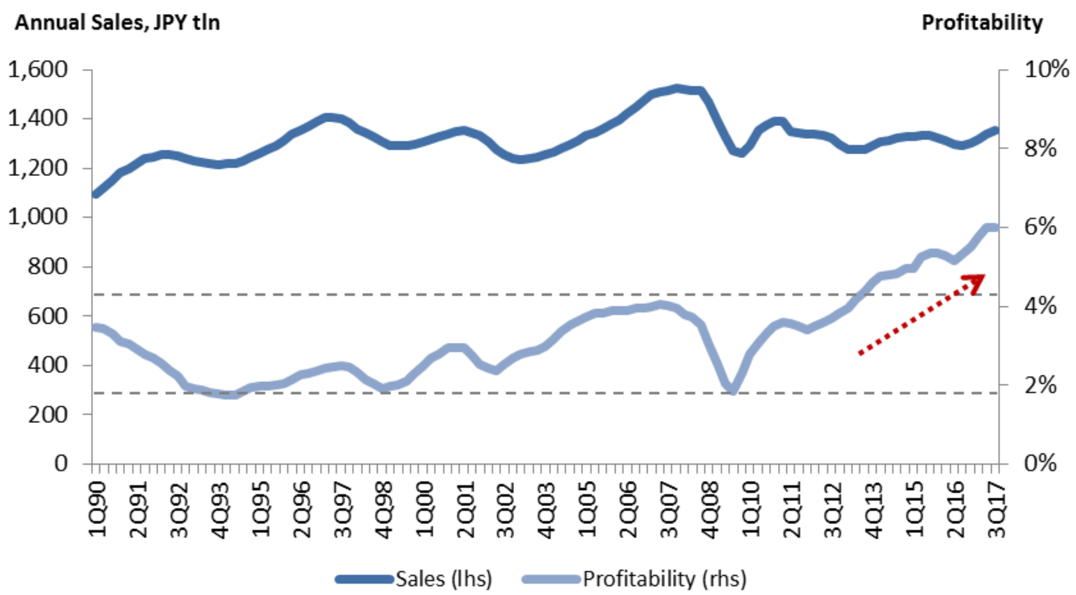


Source: Yamato Holdings (TYO: 9064), compiled by TMAM

Now, amid a labour shortage as well as greater demand for online shopping, the country's biggest couriers such as Yamato and Sagawa are finally having to start raising their prices and limiting delivery volume. This shift in focus to profitability rather than market share and passing on costs to customers is expected to spread to other companies and sectors.

In fact, the recent improvement in corporate profitability as a whole in Japan is set against a backdrop of relatively flat sales growth. The current profit to sales ratio (profitability) has risen to 6%, above the historical range of 1.7 to 4.1%.

Sales and Profitability of Japanese Corporates (ex. Financials)



Source: Ministry of Finance, compiled by TMAM

We therefore feel that rising prices, as well as greater demand from a recovery in private consumption owing to higher wages and more confidence about the Japanese economy, may present an opportunity for some corporates to increase their profits still further in 2018.

Conclusion

We believe that this year could be another exciting year for Japanese equities. We find supporting factors both at the macro and micro level for continued investor interest in the market, but at the same time, we feel that Japan's gradual shift out of deflation brings both opportunities and challenges, especially for corporates.

Rising costs in the form of higher wages will present a new challenge for corporates unused to such change and those unable to adapt will struggle. On the other hand, those corporates that can adapt successfully and raise prices should be able to increase their profits. We therefore expect to see the performance disparity between corporates to continue widening.

As a locally based investment manager, we feel ideally placed to help our clients find attractive investment opportunities in the changing market landscape in Japan.

Tokio Marine Asset Management is a Japan/Asia equity specialist with over 30 years' market experience and approx. $58.4bn AUM (as of November-end 2017).

For more information about the issues raised in this article, please contact Business Development at Tokio Marine Asset Management (London) Ltd.

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