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Tokio Marine Asset Management

Japan - entering a New Era

Hiroyasu Sato, Senior Fund Manager at Tokio Marine Asset Management, explains his continued positive view on Japanese equities.

We believe Corporate Japan has entered a new era with improving economic fundamentals. I would like to address the following three catalysts:

1) Strong corporate fundamentals
2) The emergence of growth stocks
3) Favourable supply-demand conditions

Corporate fundamentals

It is paramount for Japan to breakout from its twenty year deflationary spiral. Despite the Koizumi rally in 2005 and Abenomics rally in 2013, TOPIX is still within a broad downtrend. How can Japan break these downtrends? Abenomics certainly is a game-changer. But we believe that prior to Abenomics, Corporate Japan had already conquered its three demons of excessive debt, surplus labour and subdued ROEs.

First, the days of excessive debt are gone. Prior to its successful deleveraging, weak balance sheets were a bottleneck for aggressive investment. Now free cash flow is at a historical high and corporations have over $2 trillion to invest.

Second, the days of surplus labour are finished. Despite Japan's traditionally inflexible labour market, labour costs have fallen to break-even points not seen since the 1970s. However as labour costs have fallen, the Japanese labour market has tightened. Many managements of retail and construction companies struggle to find workers at current pay levels. Rising wages are a key component of Abenomics. Small to mid-sized non-manufacturers pay approx. 60% of the nation's wages and they are the biggest drivers for wage inflation.

Third and finally, ROEs are back in the game with restored profitability and are likely to reach 10% in 2015. Around 30% of all public companies are forecasted to release historical high earnings.

Significance of growth stocks

Fundamentals and bottom-up research are now more important to the market than ever before. If we look at the beta between PBR and ROE, as well as the simple distribution between the two, it tells us earnings revisions are the key driver to the market and that growth will finally become a leading theme again.

Favourable supply-demand conditions

First, the introduction of NISAs (Japanese ISAs), could be a significant factor. With almost 6million accounts opened and each account having a tax exemption budget of approx.$10,000, this could potentially bring as much as an additional approx.$60bn to markets.

Second is the potential asset allocation shift by the GPIF, the world's biggest pension fund with assets of more than $1trillion. Their current asset allocation is too heavily weighted into low yielding JGBs which would be a risk in an inflationary period. Currently the weighting to domestic equities is 16%, but we believe the GPIF will announce an upwards revision in June.

In Conclusion

After shrinking to protect themselves from deflation for 20 years, we believe that Corporate Japan has succeeded in becoming globally competitive again. We firmly believe that Abenomics can break Japan out of its deflationary spiral and corporates are entering a new inflationary phase, from shrinkage to expansion. We forecast that TOPIX will break its 20 year downtrend.