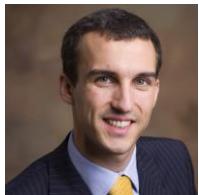




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Archibald Ciganer  
*Portfolio Manager,  
Japanese Equities*

## Japan Equities

# **DON'T WAIT FOR THE MACRO, JAPANESE COMPANIES ARE ALREADY DELIVERING**

### KEY POINTS

- The Japanese corporate sector has recently achieved two significant landmarks—delivering a record level of profits, exceeding the previous high set in 2007, and overtaking the U.S. as the best earnings delivery story of the past decade.
- This reminds us that economic and corporate fundamentals are two very different dimensions for investors to consider, especially in Japan. The surge in earnings provides substance to our belief that Japan remains a compelling cyclical and self-help profits growth story, regardless of its economic growth and inflation profile.
- Central to this belief is the transformation taking place within Japan's corporate sector. In recent years, the Abe government has made corporate reform one of its primary objectives. The fruits of the reform efforts are beginning to reveal themselves, and the impact on company profitability and capital allocation policies has been significant.
- Strong corporate fundamentals continue to highlight that the opportunity in Japanese stocks should not be defined by the Japanese economy. Investors waiting to see stronger domestic growth and the return of inflation are missing what matters most—namely, accelerating company profits underpinned by a corporate governance revolution and a sweet spot in the global economy.

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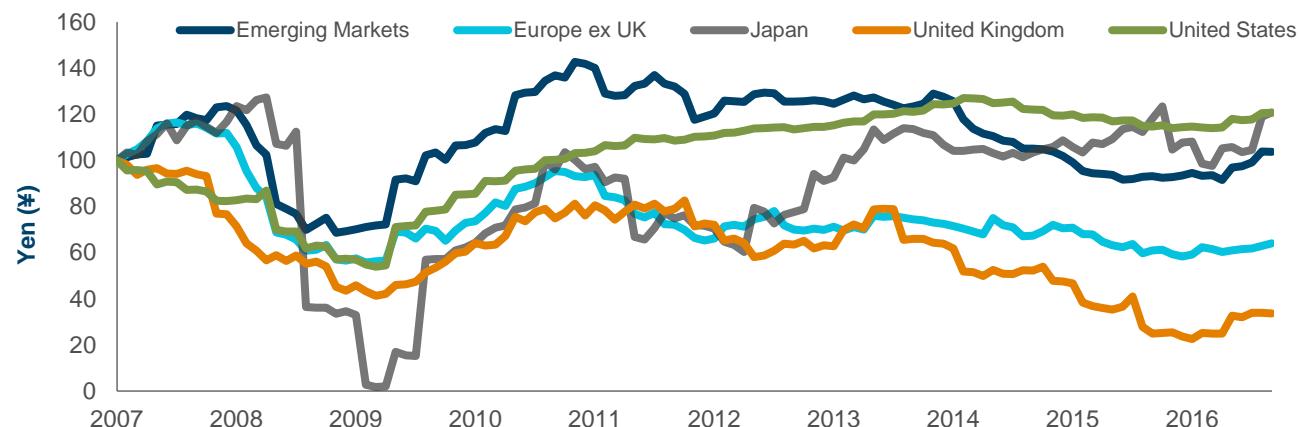
Recent improvement in the Japanese economy—recording a sixth consecutive quarter of growth in the second quarter of 2017—has again raised hopes that, together with an improving global economy and Bank of Japan stimulus, this could be the catalyst for the long-awaited Japanese growth and inflation cycle.

### MILESTONES HIGHLIGHT CORPORATE HEALTH

However, while macro watchers wait for the data to provide comfort, Japanese corporate fundamentals have turned decidedly upward. Indeed, corporate profits have recently achieved two significant milestones—exceeding their own all-time highs, established in 2007, and overtaking the U.S. in delivering the best earnings over the past decade (see Figure 1).

## Figure 1: Japanese Companies Are Delivering Strong Earnings

Earnings Per Share Since Last Cycle Peak (October 2007)



Source: FactSet Economics, as of June 30, 2017.

**Past performance cannot guarantee future results.**

With both dividend and share buybacks also reaching all-time highs, this is a timely reminder that economic fundamentals and corporate fundamentals are two very different dimensions for investors to consider, especially in Japan. The recent surge in earnings provides substance to our belief that Japan remains a compelling cyclical and self-help profits growth story, regardless of its economic growth and inflation profile.

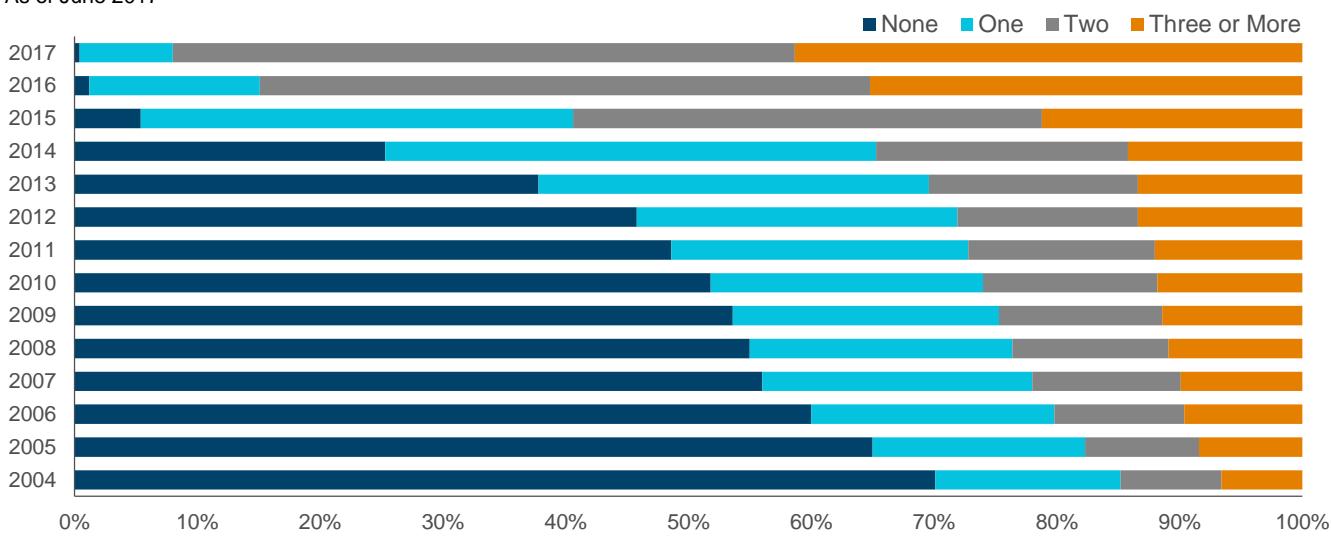
### A TRANSFORMATION IS UNDERWAY

While profits growth is impressive at face value, some observers have been quick to point out that the surge in profits has been driven predominantly by an increase in margins rather than an increase in topline sales. However, margin improvement also identifies a significant transformation occurring within Japan's corporate sector.

In recent years, the Abe government has made corporate reform one of its primary objectives, targeting (both through regulation and incentivized encouragement) improved standards of governance, including the mandatory hiring of external directors (see Figure 2), better returns on equity, and, broadly speaking, higher returns for the providers of capital, namely shareholders.

## Figure 2: Hiring External Directors Is a Rising Trend

As of June 2017



Sources: Corporate Reports, Japan Exchange Group, Empirical Research Partners Analysis. Tokyo Stock Exchange First Section.

## REFORM EFFORTS ARE BEARING FRUIT

The fruits of these reform efforts are beginning to reveal themselves, and the impact on company profitability and capital allocation policy has been significant. This has occurred in the absence of any real significant change in domestic macroeconomic conditions and in spite of modest sales growth. With global economic conditions now showing both stability and modest improvement, double-digit earnings growth is being delivered in Japan in 2017, and forecasts continue to show a superior profits growth outlook in Japan versus Europe and the U.S.<sup>1</sup>

While export growth, a weaker yen, and fiscal stimulus have been early-stage contributors to this corporate profits growth rally, private consumption and business investment have been contributing more recently. With substantial cash sitting on balance sheets—significantly more than other developed market peers—the prospect of this cash being unlocked and used to fund more disciplined investments, or to increase capital returns for investors, remains a positive driver for many Japanese stocks.

## MEANWHILE, ON THE INFLATION FRONT...

In relation to Japan's ongoing struggle with low-to-negative inflation, there are signs that pockets of price inflation may be emerging. With Japan's unemployment rate falling to a 23-year low of 2.8% in June 2017, and with the ratio of jobs to applicants reaching the highest level since 1974,<sup>2</sup> worker shortages are becoming real. While broad-based wage increases remain modest, workers are moving for higher-paid positions, especially in the part-time employee segments of the economy. At some point, as labor market constraints persist amid a backdrop of global economic strength and domestic corporate profits, this may well begin to feed through to a gentle rise in inflation.

However, regardless of the inflation backdrop, strong corporate fundamentals continue to highlight that the opportunity in Japanese stocks should not be defined by the Japanese economy. Those investors waiting to see stronger domestic growth and the return of inflation may miss what matters most—accelerating corporate profits underpinned by a corporate governance revolution and a sweet spot for the global economy, within which Japan's companies operate.

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<sup>1</sup>Thomson Reuters, as of July 2017.

<sup>2</sup>Bank of Japan Data, as of July 2017.

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