JAPAN: EARNINGS MATTER MORE THAN GDP

(From right to left:)

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Much ink has been spilled recently concerning Japan entering into technical recession in the third quarter. Judging by the number of client questions we've fielded about it, many are wondering if this signals the failure of "Abenomics" and the end of the Japanese market rally. We would urge investors to take a deep breath before hitting the panic button. As equity portfolio managers, we only fixate on gross domestic product (GDP) of a nation to the extent that it has a causal impact on what we *really* care about – namely, the level and direction of corporate earnings per share (EPS). After all, as equity shareholders, that's what we are actually entitled to – a fractional share of profits. To paraphrase the great bond investor Bill Gross, you can't buy GDP futures. With regards to earnings, Japan actually has a much stronger trend than its mixed GDP reading might suggest.

EPS vs GDP: Linkages Less Direct Than You Might Think

But wait: shouldn't the economy have an impact on the performance of a company domiciled in that economy? Maybe, but counterintuitively, GDP growth and earnings growth are often less directly correlated than one might expect. This is because corporations are in essence "micro-economies" unto themselves, affected not only by macroeconomics, but equally or more so by trends in their respective industries and end markets, as well as by changes in costs of capital, regulation, management decisions and fluctuations in currency. Adding to the complexity, many large-cap corporations are global, so the economy of one's home country may matter less than the economies of other areas.

Skeptics on Japan are quick to point out that Japan has now entered its third technical recession in less than five years. However, what fewer people know is that corporate earnings in Japan over the same time period have almost doubled by our count.

EPS vs GDP: Japanese EPS Much Stronger Than GDP

We think Japan is a great example of how earnings can be more important than GDP. Skeptics on Japan are quick to point out that, with the slight drop in overall quarterly GDP in Q3, Japan has now entered its third technical recession in less than five years. **However, what isn't discussed nearly as much is that by our count, corporate earnings in Japan over the same time period have almost doubled, surpassing their previous all-time earnings peak (see Chart of the Week, next page)**. Unsurprisingly, the Japanese stock market has also soared during this time period. How is this possible?

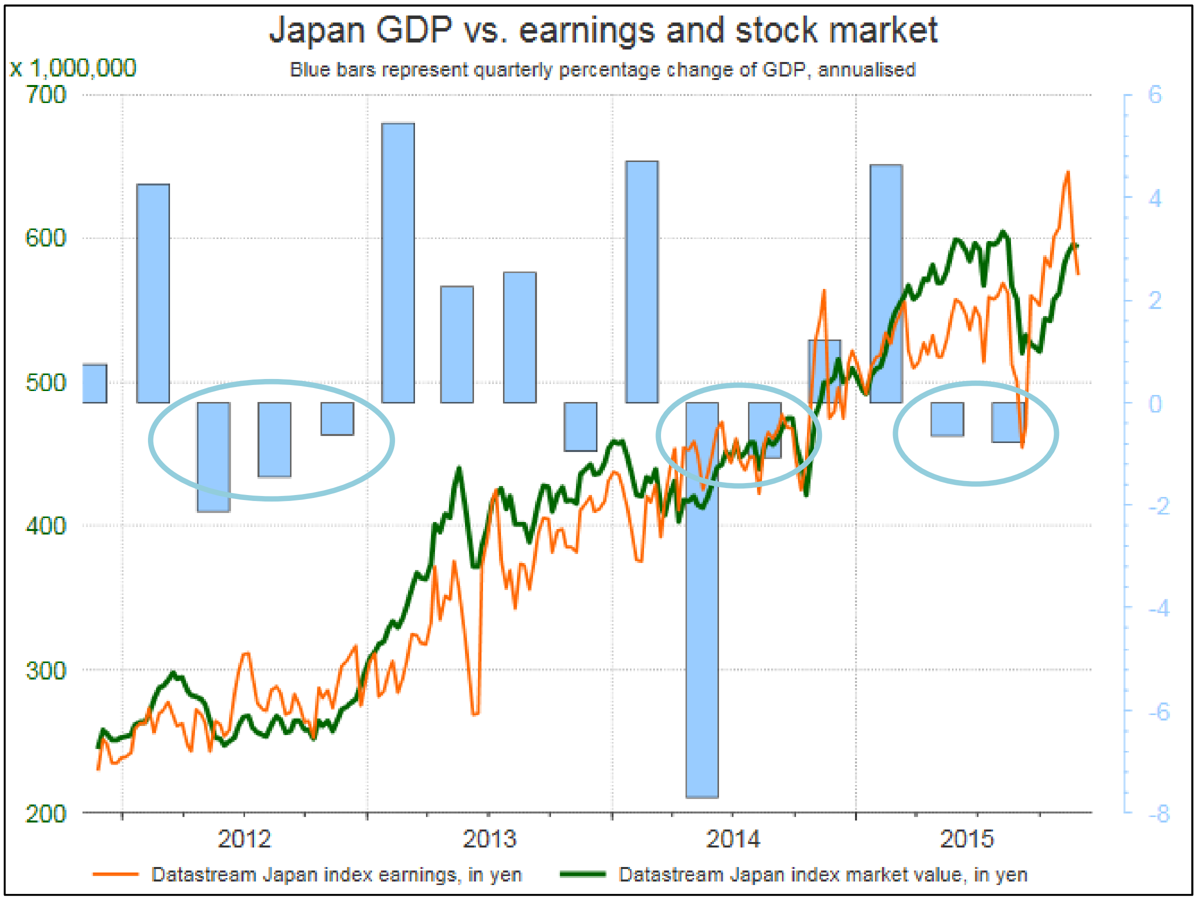
There are many different answers to this question, but one of the more obvious reasons has been the weakness in the yen generated by the Bank of Japan's aggressively easy monetary policy. The near 40% drop in the yen versus the US dollar since late 2012 has given Japanese corporate earnings major translation gains and likely boosted the competitiveness of Japanese exporters to a certain extent, as well. Skeptics point out that this boost in earnings may prove only a one-time windfall. However, we believe that *how* this windfall is spent matters a lot for Japan, a place that has struggled with deflation for decades. If corporate profits are being recycled back into the Japanese economy in the form of increased capital expenditures and wages for workers, as is already starting to happening, we believe a self-sustaining "virtuous cycle" for the Japanese domestic economy may emerge. In fact, in looking at labor tightness, business and consumer confidence measures, and forward-looking indicators such as Purchasing Manager Index (PMI) surveys, we think signs of this virtuous cycle are already starting to emerge. Our recent research trip to Japan reinforced our view that certain areas of the economy are stronger than commonly believed (for more on our trip, see The Weekly View, dated September 15, 2015).

Conclusion: Japan Is On A More Positive Path Than Commonly Believed Or Reported

In conclusion, Japan still faces an uphill battle in its existential fight to exit two decades of deflationary stagnation. However, we believe the nation is currently making more progress than either an elementary glance at GDP trends or news headlines would suggest. On page 3, we have provided a summary grid of common secular "bear case" arguments against the Japanese market and our counterpoints to each.

We believe that aggressive central bank action has granted the Abe regime some breathing room to try and take on some of the necessary "heavy lifting" reforms. While many criticize the rate of reform, we believe that progress on major economic reforms is often measured in decades, not years, and that significant headway has been made in a relatively short period of time. In short, our view is that out of the dozens of different country markets we follow, Japan is where the most legitimate economic and governance reforms are taking place, and corporate earnings are likely to continue to benefit from it.

CHART OF THE WEEK: Japan's Earnings and Stock Market Are Stronger Than Its GDP Would Indicate



Souce: RiverFront Investment Group, Thomson Reuters Datastream. Data as of 11/27/2015. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

In the chart above, the light blue bars show the quarterly percentage change in GDP, annualized, for each of Japan's quarters since 2012 (right hand scale, in %). The 3 blue circles indicate technical recessions, defined as two or more consecutive quarters of negative GDP growth. The orange line (left hand scale) indicates the trend of aggregate corporate earnings of publicly traded large-capitalization Japanese companies, and the green line represents the aggregate market value of those companies, as represented by the Datastream Japan-DS Market index, a market-cap weighted index of 1,003 publicly traded companies, representing a proxy for the total Japanese stock market. As the chart clearly indicates, strong Japanese corporate earnings and stock market returns have occurred over the past four years, despite the mixed macroeconomic fortunes of Japan.

APPENDIX

Since we became bullish on the Japanese stock market back in late 2012, we have consistently encountered skepticism about our views. This is perhaps an understandable byproduct of historical scar tissue among investors; despite a couple false dawns, Japan was one of the world's worst-performing economies and stock markets from 1990–2011, and many investors view Japan with jaundiced eyes. In our opinion, you can see this bias at work in the fact that global fund managers with mandates in developed international markets are currently underweight Japan by more than 6% relative to their benchmarks, according to recent research published by Goldman Sachs Global Investment Research.

Despite Japan's history, we believe that fundamentals have structurally improved since Abe took office in late 2012. In the chart below, we have attempted to distill some of the most common Japan "bear case" arguments we hear from investors and in the press, along with counterpoints for why we continue to think the general consensus on Japan remains too biased towards the negative.

TYPICAL BEAR CASE ON JAPAN	OUR COUNTERPOINT
"Japan back in recession."	Corporate earnings at record highs, real estate values starting to eclipse previous highs, and expanding PMIs territory all suggest a stronger economy rather than a recession.
"Japan has highest debt-to-GDP levels of any developed economy."	Less than 10% of Japanese debt is held outside of Japan. In addition, interest rates close to zero mean low carrying costs for debt.
"Abenomics has failed."	Three years into the "Abenomics" experiment, core inflation is consistently above zero for the first time in 15 years, wages are increasing, Japanese corporations are generating record income, and corporate governance is improving.
"Japan's corporate sector suffers from a terminal case of inflexibility."	Japan is one of the very few economies that currently deserves to be called a reform story, in our opinion. Return on Equity (ROE) for shareholders has improved consistently since Abe took office, and there is a high likelihood that corporate tax rates will be reduced. Potential passing of the Trans-Pacific Partnership has helped abolish "sacred cow" tariffs in agriculture.
"Japanese demographics are among the worst in the world."	Japanese workforce productivity growth, which is among the best in the world post-global financial crisis, has helped offset the negative effects of an aging population. In addition, a credible attempt to bring educated women back into the workforce is starting to gain traction – female labor participation has increased 5% since Abe was elected. Increases in wage gains and low interest rates also mean that the current demographic may spend more of their savings, which would further stimulate the economy.
"China's economic slowdown will spell disaster for Japan."	Actually, the Japanese economy is more correlated to developed country economies such as the US, rather than China, in our opinion.

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