Lazard Insights

Abenomics and the **Japanese Revival**

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Summary

- Japanese equity valuations are at all-time lows despite the Topix Index almost doubling in two years.
- Although western commentators have dismissed Abenomics as a failure, Japanese companies have become more profitable and are acting in the interest of shareholders with rising dividends, buybacks, and return on equity (ROE).
- As the Japanese economy emerges from its low-growth, deflationary slump and corporations normalize, we believe it is critical that investors have a more thorough and in-depth understanding of the complexities of what remains one of the world's largest and deepest equity markets.

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Japan—Cheap and Changing

Since the Japanese market peak in 1989, equity valuations have fallen steadily and currently trend around lows not seen since the early 1980s. In other developed markets where there is modest inflation, similar to Japan, price-to-book ratios are generally around 2 times as compared to Japan's Topix Index price-to-book ratio which is only slightly over 1 (Exhibit 1, top chart). This significant difference suggests that the Japanese market continues to be somewhat fixated with its deflationary past and has yet to embrace the possibility of more secular change. Japanese price-to-earnings ratios tell a similar story. Despite the Japanese market almost doubling since the election of Prime Minister Shinzo Abe two years ago, price-to-earnings ratios remain at their all-time lows as corporate profits have actually been rising on pace with the market (Exhibit 1, bottom chart). In effect, valuations in Japan remain as compelling two years into the launch of Abenomics as they did at the outset.

Corporations in Japan have historically had weak balance sheets and an ongoing need to repay bank borrowings. Recently, however, there has been a substantial improvement in the equity ratio for Japanese companies and are now, on average, on par with their global peers. The long drawdown of resources to pay debt has finally come to an end. The risk that companies will be forced to issue equity to stabilize their business is very low. In fact, extremely cautious corporate CFOs in Japan have led to a massive accumulation of cash on balance sheets. Over 50% of all Japanese companies have net cash on their balance sheets. In other words, these companies are effectively debt free.[1] While this may seem illogical, it was a sensible strategy, since cash's value rises in real terms with persistent deflation. Moreover, the

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psychological effects of having dealt with a deflationary environment for twenty years are likely to linger for some time among corporate CFOs even after Japan's deflation has come to an end. This is why the Abe administration's initiatives to encourage corporations to shift their focus away from balance-sheet strength to profit improvements are so critical. Convincing corporations that deflation has come to an end and effecting a change in behavior is a major force behind revitalizing the private sector.

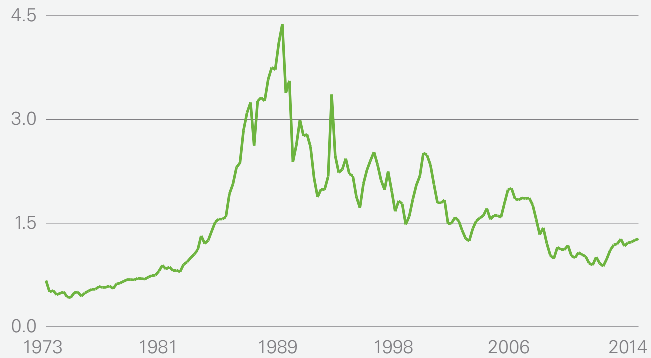
The government is already having some success, as evidenced by the consistent rise in the average stock buybacks by Japanese companies. In fact, aggregate stock buybacks are on pace to almost double the previous fiscal-year peak at close to 7 trillion yen ($60 billion in US dollar terms).[2] This change in attitude among corporate executives coincides with the 2012 election which brought Abe to power. Leading up to the 2012 election, Japan was facing a crossroads to either continue down the path of low growth, persistent deflation, geared for its aging population and gradually fading from the world stage or reclaim its position as one of the world's leading economic powers and a major contributor to world growth and prosperity. Abe clearly ran on a platform embracing the latter, a policy shift which now bears his name—Abenomics.

Despite Abe's desire to push Japan in a new direction, convincing investors that real change is occurring and that the economy is normalizing has been a challenge. For instance, the price-to-book ratio of companies broken down by Tokyo Stock Exchange sectors versus their 10-year median, indicates that stable defensive sectors like services, foods, pharmaceuticals, and land transportation are trading at record-high levels relative to their long-term median, while pro-cyclical reflation sectors, like banks, real estate, and iron & steel are at record lows (Exhibit 2). Clearly not all investors are convinced by Abe's attempts at reform. According to the market, the situation in Japan has not changed and is doomed to continue on its twenty-year past of persistent deflation and little economic dynamism.

Exhibit 1
Japanese Equity Valuations Are Attractive

Japanese Equities Have a Very Low Price-to-Book Value Despite Rising Inflation

Topix Index Price-to-Book Ratio



Price-to-Earnings Ratio Is at All-Time Lows

Topix Index Price-to-Earnings Ratio

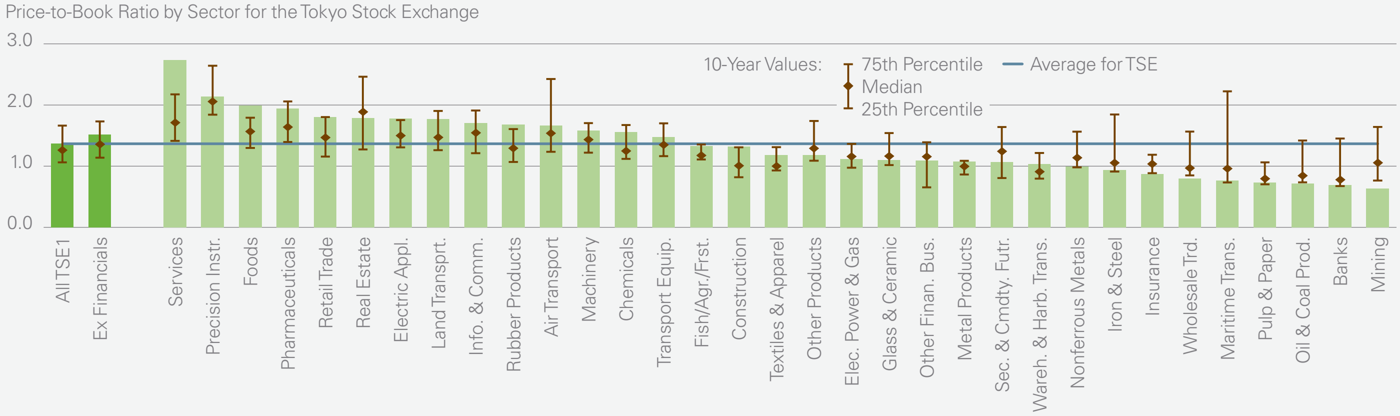
As of 10 February 2015

The index listed above is unmanaged and has no fees. It is not possible to invest directly in an index.

Source: Bloomberg

Exhibit 2
Divergence in Valuation: Cyclical and Defensive Sectors

Price-to-Book Ratio by Sector for the Tokyo Stock Exchange



As of 30 January 2015

Source: Toyokeizai, Nikkei, and IFIS, compiled by Mizuho Securities Quantitative Strategy

Has Abenomics Failed?

An analysis of the last two years paints a very different picture of where Japan is today than where one would surmise by reading the opinion of western commentators or looking at the internal sectors in the market. Exhibit 3 highlights some key indicators in terms of profitability and dividend policy. Corporate earnings have risen precipitously over the last two years and within this trend it is noticeable that domestic-demand focused companies have seen profits rise faster than exporting and globally oriented firms. Clearly, it is more than just a weak currency driving the profit revival in Japan.

Companies have responded to this improved profitability by raising dividends. Historically, Japanese corporations opted to pay a stable dividend rather than one that rises and falls with profitability. However, there has been a change in management thinking regarding their dividend policy, which we believe is almost certainly influenced by the Abe administration's corporate reform initiatives. Similarly, average corporate ROE has doubled in the past two years and is set to eclipse 10% for the first time since the 1970s. The recovery in ROE has two components. The first is due to the managements' focus on their companies' core competence and eliminating businesses which do not cover their cost of capital. The other is the revival of both revenue volume and pricing power, something Japanese firms have not experienced in over twenty years.

The really good news is that some of these newfound profits are finding their way into consumer pocketbooks. Japanese companies pay salaries on an 18-month cycle, 12-month base pay and a 6-month variable bonus paid twice a year. The variable bonus component of pay was up sufficiently (Exhibit 4) to raise overall compensation by 2.7% in 2014. In 2015, wages are expected to grow in both nominal and real terms. This is important because personal private consumption represents 63% of GDP and therefore a bump to GDP is expected due to positive wage news.

A recent development has been the rapid improvement of Japan's net debt to GDP ratio. Rising tax revenues have lowered borrowing costs. Further, better returns on invested pension assets have allowed the government to reduce pension funding with bond issuance. Lastly, the improvement in nominal GDP has raised the denominator in the calculation (reducing overall debt to GDP). In total, Japan has seen a remarkable swing from debt to GDP since Abe was elected. The Ministry of Finance in Japan has been curiously quiet about this, as they would prefer to keep the politicians' feet to the fire and have them remain committed to fiscal reform.

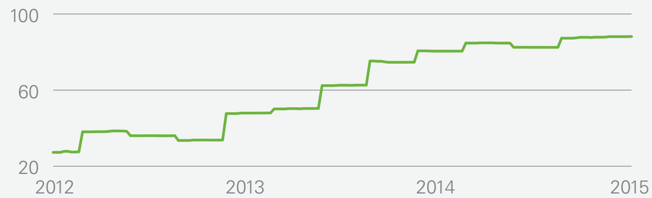
One of the more remarkable success stories of Abenomics has been the rapid rise in women participation in the workforce, which is now at an all-time high. Despite this, the labor market is becoming increasingly tight with unemployment and job offer levels not seen in several years (Exhibit 5). This is feeding through to higher household income levels and improved consumption.

One way to determine if deflation in Japan has ended is to track bank lending. In a persistent deflationary environment, the logical thing to do is to pay down debt which rises in real terms. Hence, in looking at the trends since Abe was elected, bank lending has grown consistently at a 2% pace over the last two years (Exhibit 6). This is an initial indication that individuals and corporations are convinced that deflation is a thing of the past.

Exhibit 3
Japanese Companies Are More Profitable Since the Onset of Abenomics

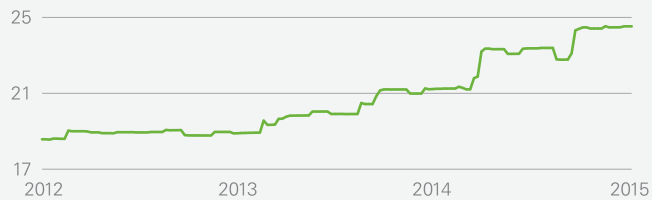
Corporations Earnings per Share Have Doubled

Topix Earnings per Share



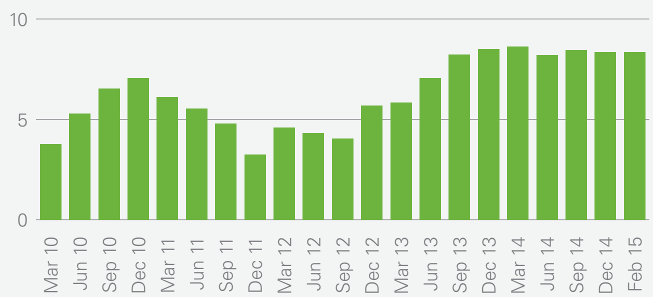
Dividends Have Increased 60%

Topix Dividends per Share



Topix Return on Equity Has Doubled

Topix ROE (%)



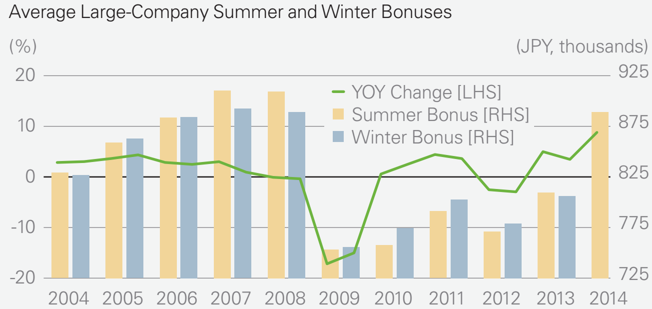
As of 10 February 2015

Data are based on Tokyo Exchange Tokyo Price Index Topix. Earnings data are annual frequency and in yen. Dividends and ROE data are quarterly. The index listed above is unmanaged and has no fees. It is not possible to invest directly in an index. Past performance is not a reliable indicator of future results.

Source: Bloomberg

Exhibit 4
Bonuses Appear to Be Back to Pre-Crisis Levels

Average Large-Company Summer and Winter Bonuses



As of May 2014

Source: Keidanren

Exhibit 5
Abenomics Has Led to Greater Female Labor Force Participation and a Tighter Labor Market

As of 31 December 2014
Source: Bloomberg, Haver Analytics

Third Arrow Reforms and Conclusion

Close to seventy separate pieces of legislation for reforming Japan's economy have been passed since Abe took power, a remarkable legislative performance. We believe one of the primary reasons overseas investors have been negative on the third arrow of reform and Abenomics is because of the lack of a single large and tangible outcome. This was never the intention of the third arrow. The third arrow was always about a series of reforms across a range of sectors of the economy that together would revitalize the nation. On this metric, the pace of the reform initiatives is high. The next phase is to monitor the execution of these reforms in a practical sense.

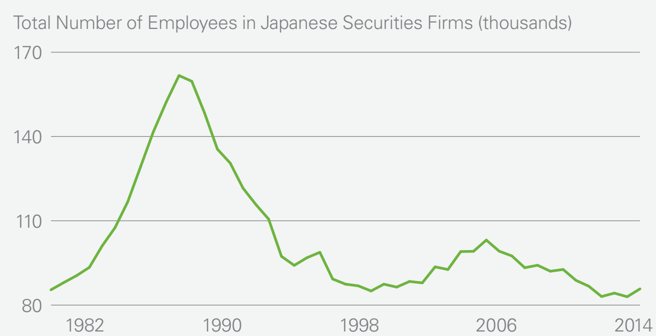
Japanese market valuations are cheap and do not reflect that the country is potentially emerging from its deflationary slump. The implications are profound if a country the size of Japan were to suddenly start experiencing a reflationary economic revival. For the last twenty years the Japanese market has been out of sync with the rest of the world, as evidenced by its low correlation to other developed markets: 0.69 for the period January 1990 to September 2014. By contrast, the correlation of the United States and the United Kingdom with other developed markets is 0.90 and 0.87, respectively.[3] Interestingly, Japan's low correlation includes a large component of global companies which are inevitably linked to the global economic cycles and pure plays on domestic Japanese economic revival offer massive diversification benefits to investors.

In addition to the diversification benefits, the twenty-year slump in asset prices meant that the financial services industry has seen a collapse in employment (Exhibit 7). For years, it has been easy to lump all of Japan into one macro tactical trading-based decision, therefore, on-the-ground research was considered a luxury. Today, with the economy normalizing corporations acting in the interest of shareholders with rising dividends, buybacks, and ROE, and more reform coming, it is critical that investors have a more thorough and in-depth understanding of the complexities of what remains one of the world's largest and deepest equity markets. Like the emerging markets of a decade ago, we believe investors will increasingly find that a dedicated allocation to Japan is the most efficient way to capture this opportunity.

Exhibit 6
Japan Bank Loans Have Grown for Two Consecutive Years

As of 31 January 2015
Source: Bloomberg

Exhibit 7
Coverage of Japanese Equities Is Scarce



As of 30 June 2014
Source: Lazard, Japan Securities Dealers Association

Notes

1 As of 29 May 2014. Source: J.P. Morgan, Bloomberg.

2 As of 29 May 2014. Source: J.P. Morgan, Bloomberg.

3 Data are based on the MSCI World Index, as of 30 September 2014. Source: MSCI.

Important Information

Published on 15 September 2017.