MARKET INSIGHTS

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# Japan outlook: Will Japanese equities jump in the Year of the Rabbit?

## Introduction

*'There is no doubt Japan faces severe challenges. Yet it is hard to avoid the conclusion that today's apocalyptic commentary is overblown. Therein lies the investment opportunity'. (Financial Times, 5 December 2010)*

Japanese equities have long been unloved and under-owned. However, following the announcement of a second round of quantitative easing (QE2) by the US Federal Reserve in November last year, overseas investors have started to buy Japanese equities again, albeit modestly. The boost in market sentiment that resulted from QE2 served to make Japan a more attractive investment choice as Japanese equities are seen principally as a geared play on the global economic recovery.

In this paper, we discuss the factors that may affect the Japanese equity market in 2011 and why Japan is well positioned to benefit from a global cyclical upturn.

## Indicators for outperformance

The fundamentals suggest that Japanese equities should see further healthy outperformance provided robust global economic growth, underwritten by quantitative easing, continues. To assess whether Japan's recent outperformance is temporary or long term we believe investors should keep an eye on three key developments in 2011:

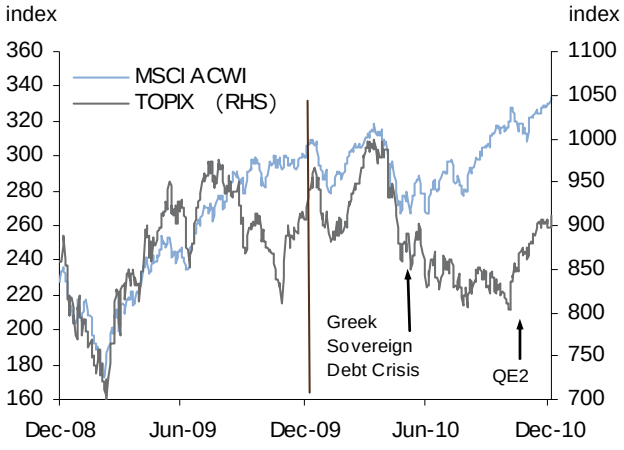
1. The course of the global economic recovery, especially developments in the US economy;
2. The strength of corporate earnings;
3. The attractiveness of market valuations.

The current contrast in monetary policies between Japan and countries in the Asia ex Japan region may also encourage a relatively strong pro-Japanese equities environment in the near term.

## External drivers of Japanese equities

In the short-to-medium term, it is likely that the Japanese equity market will continue to be driven by external factors. We believe that as the visibility of the global economic recovery becomes clearer, Japanese equities will have the potential to outperform their peers. The global economic recovery is very important to the Japanese equity market because the contribution from Japanese exports to the country's GDP is very significant.

Exhibit 1 – **The global equity market (MSCI ACWI) vs. the Japanese equity market (TOPIX)**

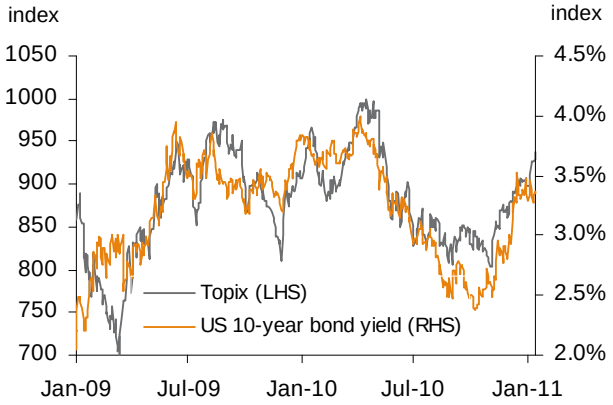



Source: Bloomberg, J.P. Morgan Asset Management. Data as at 4 January 2011

Thanks to the policy efforts of global central banks and governments, such as QE2 in the US, we believe that asset prices and consumer demand should be supported globally in 2011. Any increase in real US interest rates would also help - higher US rates have the potential to prompt a reversal of the US dollar's recent weakness against the Japanese yen.

The US ten-year bond yield can be seen as the proxy for economic growth prospects in the US. As shown in **Exhibit 2**, the correlation between the TOPIX and US long-term interest rates has been quite high. A fall in the value of the Japanese yen, supported by US interest rate rises, should be positive for Japanese equities – a trend that already seems to be underway.

Exhibit 2 – **US ten-year bond yield and TOPIX**

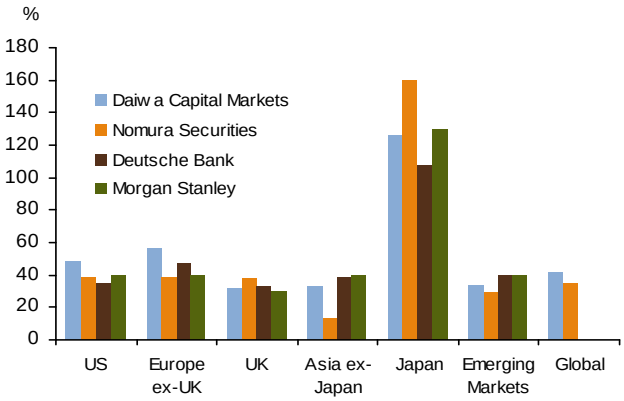



Source: Bloomberg. Data as at 13 January 2011

## Strong corporate earnings

Although Japanese corporate earnings growth was strong in 2010, one of the reasons for the poor relative performance of Japanese equities was concern about the persistent strength of the yen. Japanese companies' earnings-per-share growth for the 2010 calendar year is estimated to have been over 100% year on year, which far exceeds other developed and emerging markets, as shown in **Exhibit 3**. However, this significant corporate earnings growth has so far failed to grab the attention of market participants.

Exhibit 3 – **Global EPS growth forecasts (y/y) for the 2010 calendar year as at January 2011**

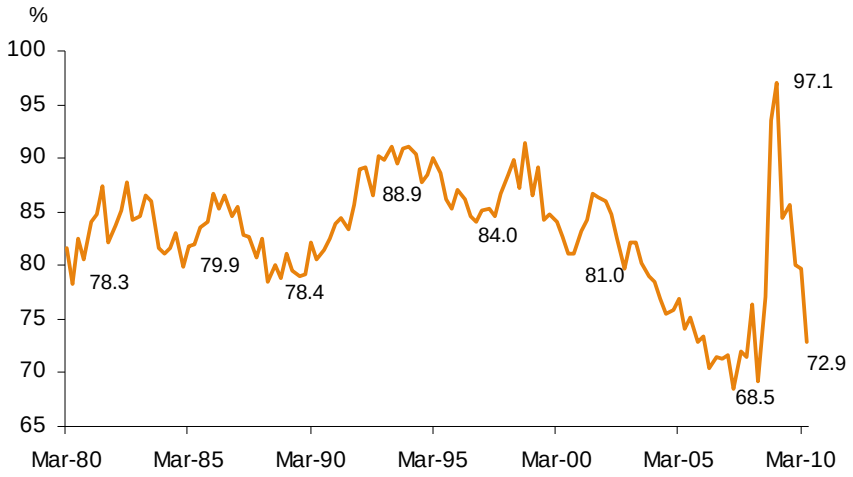



Source: Daiwa Capital Markets, Nomura Securities, Deutsche Bank, Morgan Stanley. The chart is compiled by J.P. Morgan Asset Management.

It should be noted that in the past ten years, Japanese companies have significantly cut costs so that the breakeven ratio (breakeven sales/actual sales) for Japanese large caps has fallen to as low as 72.9%, as shown in **Exhibit 4**. This means that as top-line sales are boosted by overseas demand, there is considerable upside potential for profit growth.

Given this dynamic, the market should be well supported by fourth-quarter 2010 results, followed in early April by the 2010 financial year results. If investors start to gain further confidence in the sustainability of global economic growth during 2011, we believe that Japanese equities, backed by these solid fundamentals, could attract growing attention.

Exhibit 4 – **Breakeven ratio for Japanese large corporations, as at November 2010**

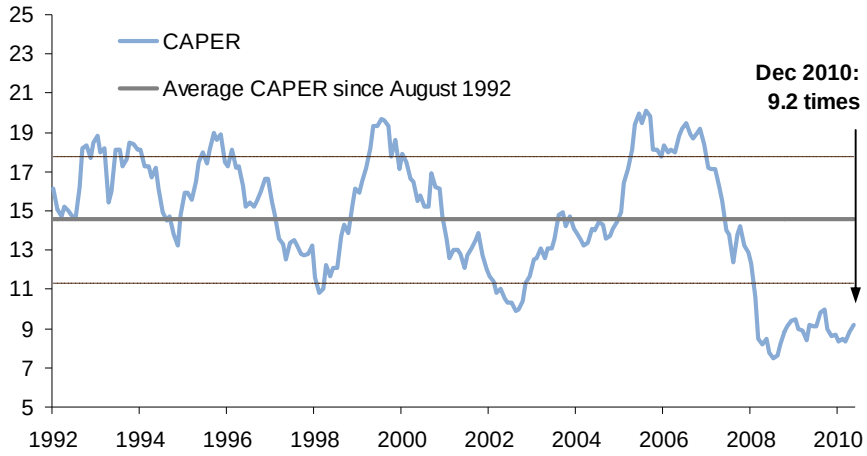



Source: MOF Financial Statements Statistics of Corporations by industry; compiled by Daiwa Securities CM.

## Attractive valuations

Japanese equities are currently significantly undervalued, having been unloved and under-owned for a long time. **Exhibit 5** shows the fall in Japanese equity valuations during the 2007/2008 financial crisis, measured by cyclically adjusted price-to-earnings ratios. Even at the end of 2010, Japanese valuations on this basis remained historically low. Therefore, there is plenty of upside room for Japanese stocks as the global economic recovery progresses. Recently investors have started to pay closer attention to Japanese equity market valuations as they recognise the potential to benefit from a rebound.

Exhibit 5 – **Cyclically adjusted price-to-earnings ratio (CAPER)***




Source: Nomura Securities, J.P. Morgan Asset Management
*Cyclical adjusted price-to-earnings ratio (CAPER) is the price-to-earnings ratio using ten-year average operating profits for all the stocks included in the TOPIX index. The dotted lines indicate the average standard deviation of ±1 for the period from August 1992 to December 2010.

## Japan in context

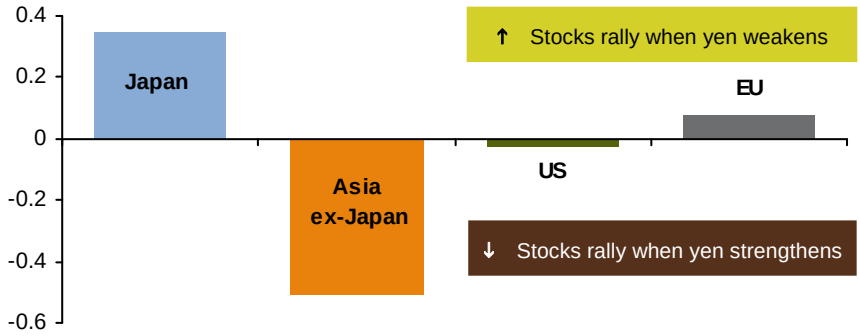
We maintain the view that, over the coming years, economic growth in Asia should continue to be strong. Asian countries are becoming increasingly important customers for Japan, with approximately 60% of exports going to Asia, while continued direct and indirect demand from the US is also important. As Japan is already a mature developed country its economic growth is of course likely to be relatively subdued compared to other Asian countries.

From an equity investment point of view, however, the current contrast in the direction of monetary policies in Japan and countries in the Asia ex Japan region may bring a more pro-Japanese equity environment in the near term. In the Asia ex Japan region, policymakers have unveiled more monetary tightening measures in the first weeks of 2011 and the pace of rate increases may pick up in the first half of the year as core inflation pressures intensify.

In contrast to other Asian countries, Japanese interest rates should remain close to zero in 2011 and inflation is unlikely to be a concern. This situation is likely to weaken the yen, which will provide a boost for Japanese export stocks and help support investor sentiment.

Many Asian currencies are pegged to the US dollar and therefore their value tends to move in tandem with the US currency. Historically movements in the JPY/USD exchange rate have led to a negative correlation between Asian equity markets and the Japanese equity market, as shown in **Exhibit 6**. This suggests that if the Japanese yen depreciates and the US recovery remains strong the environment for Japanese exporters could improve, potentially sparking outperformance from Japanese equities.

Exhibit 6 – **The correlation between JPY/USD and regional stock indices**




Source: FactSet; compiled by Daiwa Securities CM.

## Downside and upside risk scenarios

Understandably, investors may remain doubtful over improvements in the Japanese domestic economy, with issues such as deflation and stagnant consumption still causing concern. However, these issues have been well documented, and are likely to already be well priced into the market.

We therefore see two major risks to our positive outlook for the Japanese equity market in 2011:

1. Policy failure, such as premature monetary tightening by the US and China, which damages the global recovery;
2. A demand shock triggered by another global financial crisis.

However, our current main scenario is that there is very limited risk for a severe global economic recession. Instead we believe the market could potentially receive a boost from a stronger-than-expected US economic recovery. A sharper depreciation in the value of the Japanese yen and any sign of an end to deflation would also be supportive. Such positive surprises could help the Japanese equity market to outperform.

## Themes for 2011

Other potential themes that may draw the market's attention to Japan in 2011 include policy talks on free trade agreements, social security and tax system reform, the Bank of Japan's asset purchasing programme and a tighter domestic labour market. In the short-to-medium term, we believe investors should keep a close eye on these themes as well as the aforementioned indicators as they all have the potential to spark Japanese equity market outperformance.

Japan is currently significantly undervalued so there is great upside potential for investors if Japan becomes the beneficiary of a global cyclical upturn. 2011 is the year of the rabbit according to Japanese tradition – so perhaps it is time for the market to bounce further.