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Stock selection & Abenomics: where will the returns come from in Japan?

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Recent performance

2016 was a mixed year for the Neptune Japan Opportunities and Neptune Japan Institutional funds, with the latter one of the best funds in the IA Japan sector in 2016, returning more that 30%. However, despite their underlying stockholdings being nearly identical, the currency hedge on the Neptune Japan Opportunities Fund saw it underperform given the yen's strength in 2016.

Performance drivers

Both funds did well out of their underlying stockholdings and were a good source of alpha. The majority of multinational companies in Japan dominate their global industry and we are primarily positioned in these companies. They are capable of maximising earnings growth due to their high emerging markets exposure. In Japan, there is also the market's beta, which is Abenomics and the yen, which can either gear up the underlying profits and returns from stocks or clobber them, and 2016 was a case more of clobbering them.

Fund positioning

The funds' holdings are dominated by large, international companies across the industrial engineering and materials sectors. We also have 15% of the portfolios in sectors that directly benefit from the government's fiscal spending. What we do not have are the classic sort of defensive, domestic consumer-orientated stocks. This is because given static wages and a declining workforce, there is not much scope for a consumer boom in Japan, in our opinion.

Drivers of portfolio composition

The profitability of Japanese multinationals is driven by the fact that they are being faced by a structural decline in their domestic market, whilst Japan is also a very expensive place to operate. Therefore, what the companies have done on a strategic basis is invest abroad to obtain growth, as well as to benefit their margins, through lower costs of production. What it means in practice is they are truly global companies. No car company, for instance, has more than a quarter of its sales in Japan; in fact, most have a lot less. In the US, Ford still have 50% of its sales in the

US and Volkswagen, depending on whether you include the UK or not in Europe, has two thirds of its sales still in its domestic market.

The one thing these companies are not, however, is export dominated. Looking at the vehicle manufacturing industry in particular, there has been a shift from roughly 9 million vehicles produced by Japanese companies outside of Japan in 2003, to double that now. Approximately four times the number of vehicles that are exported from Japan are produced and sold outside the country. This has been a consistent feature of Japanese firms over the years whereby, yen strength has come and gone, world economic conditions and natural disasters have come and gone, but the average rate of profits growth achieved by TOPIX companies in yen terms has been positive. If you re-priced that into weaker currencies over that period, like the dollar or sterling, the difference would have been at least 20-25%. You can see that Japanese companies shrugged off the credit crunch recovering far more quickly than any of their non-Japanese rivals and the same happened following the earthquake/tsunami disaster. This is because they have been focused on the growth markets outside of the OECD, maintained strong balance sheets and reinforced their global dominance.

The aim of Abenomics and a weak yen is to try and boost Japanese profits substantially over a five to seven year period, lifting the tax take which begins to eliminate the budget deficit. In addition, it should feed through into the domestic economy more directly via higher wages and higher payments to the staff of the big multinationals, as well as their domestic sub-contractors.

Market overview

In the 1970s, whilst being faced with bankruptcy due to a rise in the price of oil, Japan began to recycle domestic savings into long-term loans to big industrial corporations, which export from Japan; these companies did not have overseas facilities at that stage. They were trying to generate dollars overseas in order to bring them back home to make up the dollar deficit that they had, which was causing an external deficit. At that time, this was referred to as ‘Japaning’ – a term which meant the whole country operated as one to save the country.

This is what had been missing in Japan, but has recently been seen to be making a return. However, the country is now trying to fill a domestic hole, whereby the government has continually spent money, driven by the country’s demographics and slow or no growth in tax receipts. The country has run out of domestic savings, so if they are going to fill this domestic hole and get the economy growing, they have got to look overseas, and the shortest route to that is by dropping the yen, meaning that you artificially boost the yen profits of the big corporations. This is the quickest way to boost tax revenue and in terms of corporate tax, the top 100 companies pay a large share of it.

Government spending has been consistently going up for the past 30 years, driven by the country’s demographics, the cost of pensions and the healthcare system, while GDP has, in comparison to national debt, plateaued. If this was the case in the UK, if our GDP was where it was in 1992, you would not be able to support a welfare state and also maintain the expenditure that we have now. This is the current problem in Japan.

Demographics

The fundamental problem the Japanese have is the structural issue that by 2020 the work force in Japan will be back at 1975 levels in absolute numbers. The percentage of the population that is capable of working and paying taxes is back to where it was in the 1950s. In productivity terms, in order to keep GDP the same nominally, workers have to be 10% more productive by 2020. If they work at a 4% nominal target you need another 22% of GDP per working individual, a 34-35% leap in nominal productivity over five years.

A weak yen

The fundamentals are there for the weakening of the currency, but the yen has got to go a fair way down to balance the books. In nominal terms, we believe that the yen has got to be well over the 200 mark in relative terms to pound sterling.

Political response

The traditional response to try and rectify the problem that Japan faces has been to announce budgets, but spend relatively little of it. When the country faced genuine crisis periods like '08-'09 and the first release of the Three Arrow Programme in 2013, they spent more than they budgeted, and this worked. The last budget, however, was more hot air than actual progress and it was supposed to make only somewhere between 0.4-1.4% GDP difference. It was not enough and we believe they have got to reload and actually spend a lot more money.

There even may be a twist as the GPIF, the state pension fund, is already talking about buying soon to be issued US bonds. This will strengthen the relationship with the US but at the same time if you exchange enough money from yen into dollars, it will have a weakening effect on the yen. Still, when the fiscal year ends on 31st March, Japan will have run a bigger deficit than expected, principally because tax receipts are down due to a slowing domestic economy, so they have had to issue more bonds. This means that they still have not boosted the domestic economy or increased tax revenues.

The state of the Japanese market

The Japanese market is cheap and we believe earnings are massively understated; at least the internal accounting yen rate is at least 10% off where we are now. From the end of 2012, as the worst of the Greek crisis began to fade, most markets began to pick up and re-rate, whereas Japan was left out. In fact, it got cheaper, mainly because earnings kept on going up. Therefore, Japan has stayed a cheap market and the earnings growth in the country is underestimated.

There is also a considerable amount of technical buying power in the Japanese market, with the Bank of Japan, NISA accounts, the GPIF and corporate accounts all buying equities. So there is approximately another 5-7% of the market that is going to get bought up this year irrespective of what foreign investors do. When comparing Japan to the MSCI World Index and the S&P 500 Index, Japan has been left behind. With a start year of 1982, you can see that the MSCI World is up 30 times and the

S&P 500 up 44 times; Japan is up only 3 times. Once people begin to appreciate the strength of the earnings growth, which will continue for several years, and you get the multiple re-rating, then they can go a long way to closing that gap.

Questions

Any parts of the market you are avoiding?
We are avoiding the domestic staples and the bond market proxies. What is becoming ever apparent to us is the appreciation of the change in global fundamentals. If you look at the underlying global economics, it turned way back in the spring of 2016, helped by the oil price remaining at $50. Looking back to 1987 when the markets fell 20%, everybody was predicting 1988 would be a poor year but what was forgotten was the oil price halving in 1985-1986. This gave such a boost to the global economy that it pushed earnings right the way through the late ‘80s and most of the 1990s. It was one reason why 1987 was disregarded and 1988 was actually a remarkably good year for the markets. If for every 1% shift in the rate of global economic growth, the Japanese multinationals can lift their aggregate profits by 3%, then they really are geared into global GDP growth, which is a clear beneficiary of a cheaper oil price.

If they eventually balance the budget, is it likely that the Bank of Japan will simply default on the vast amount of government debt that they owe?
It is a possibility, however, going back to what they did in the 1970s, the national debt as a percentage of GDP in Japan was 6%, while by 1978, it had got it up to 90%. In the ‘80s, because there was a runaway boom in share prices and land prices, the government taxed the increase in asset value that investors and corporates obtained and used that windfall tax to pay down the capital value of the outstanding debts and managed to cut it down to about 40% by 1981-82 as a percentage of GDP. It is becoming increasingly apparent they are thinking along the same lines and that if they can get the equity market, land prices and house prices rolling steadily upwards, then phase two of the plan is to switch the focus to paying off the debt. A proportion of it helps with inflation, however, it appears as if the government are looking for the asset price appreciation to be such that they can tax it to pay down the debt.

The yen has weakened considerably recently versus the dollar and also to sterling. How much do you think that is down to Trump?
It is more a reflection of the very short-term moves, and what they call the non-commercial positions outstanding on the Chicago Board of Trade in foreign exchange futures. What becomes apparent is when investors build up to be long yen, then usually the yen begins to weaken because it is running out of buyers. Conversely, when the yen is short, a big short position is built up then the yen begins to strengthen. Last summer, Japan started building up massive longs in the yen and they were very quick to switch them back into shorts, so the shorts have peaked very early this year and as a result, the yen strengthened marginally. So, in the short term, it just ebbs and flows.

Longer term, going back to the underlying fundamentals, if there is a reduction in workers because productivity is not growing quickly enough, then nominal and real GDP shrinks. If the size of the economy is shrinking, the wealth-generating capacity shrinks, so that tends to weaken the currency over the long term, independent of whether you need it devalue to sort the fiscal problems out or not.

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