

Japan: inflation risk tilts the equity undervaluation to extremes

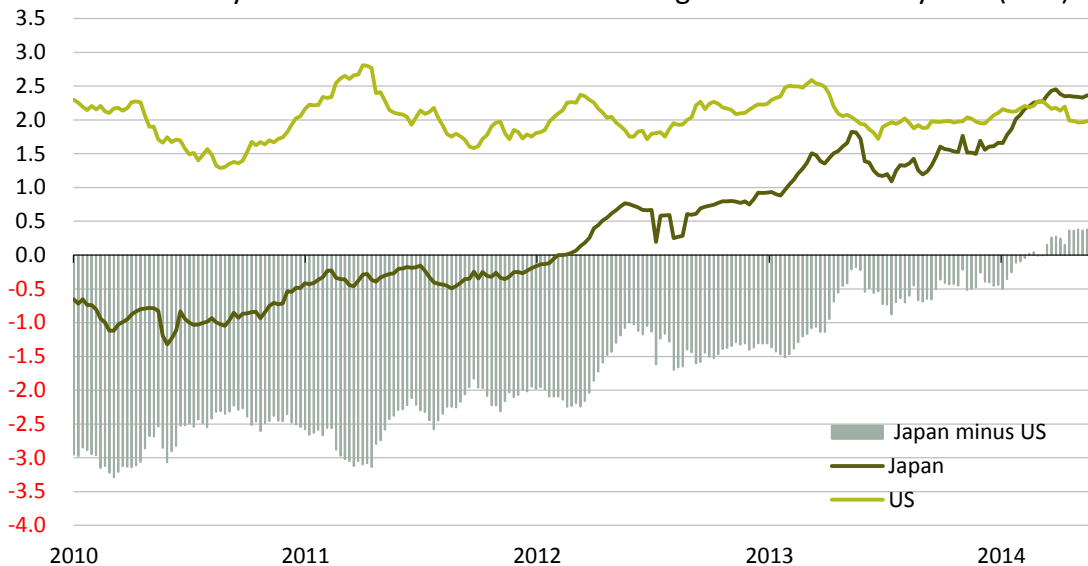
Summary

- Entrenched inflation in Japan is feeding through into rising inflation expectations. Driving it is resilient private sector demand, backed by solid fundamentals.
- The signals underscore bond market bearishness. Bonds yielding less than inflation may divert domestic saving flows to equities, unlocking a potential re-rating of Japanese equities.
- An elevated inflation adjusted equity risk premium suggests a strong undervaluation case for Japanese equities. Higher dividends will help foster the appeal to equities.
- Investors who share this sentiment may consider the following Boost ETPs:
www.boostetp.com/products

Long equities:

1. Boost TOPIX 2x Leverage Daily ETP (2JAL)

Chart 1. Inflation expectations for Japan now exceed that for the US
based on 5-year nominal over inflation-linked government bond yields (in %)



Source: Boost ETP Research, Bloomberg. Data as at 15 June 2014

Inflation in Japan, initially led by rising market prices of imported energy and policy induced yen devaluation, is becoming more entrenched. Driving it are improving private sector domestic demand fundamentals: a balanced fiscal policy sustaining consumer spending and higher financial leverage capacity of Japan's corporate balance sheet that is reviving investment spending of companies.

The effect is higher inflation expectations, which in Japan have exceeded that in the US. As the signals are becoming increasingly bearish for its bond market, the trigger for a potential re-rating of Japan's equity market may come from bond biased investors at home. In seeking equity income as a viable means to hedge against looming inflation

risks, they should set in motion a redirection of domestic saving flows away from bonds and into equities. The appeal of Japanese equities to investors is likely to gain further traction as corporate Japan accommodates the need of a growing base of domestic shareholders with higher, more competitive dividends.

Hovering close to 10%, the inflation adjusted equity risk premium is pointing towards extreme levels of undervaluation, potentially helping to unlock a re-rating of Japanese equities.

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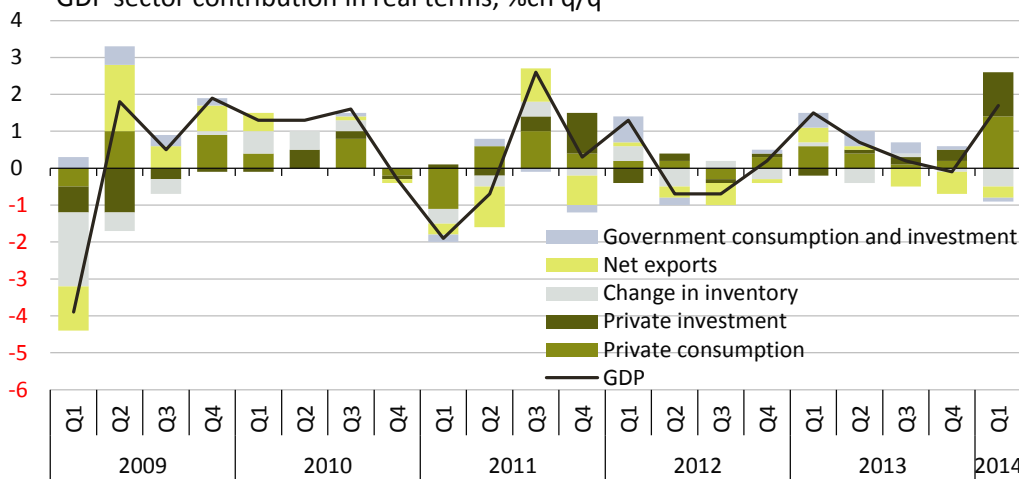
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Limited downside risk to consumer spending

On the back of a steady rise in oil and gas prices and a marked yen devaluation last year, the high energy import costs have helped boost the inflation rate in Japan, initially. However, with the year on year growth rates breaking out of negative territory effectively since

subsequently pushed the economy into recession. Unlike 1997, the government of PM Shinzo Abe is committed to sustain fiscal stimulus sufficiently large so as not to undermine the recovery. The projected budget deficits (as % of GDP) this year, as captured by Bloomberg consensus, is around 8%, which is much larger than the steep cutbacks to public spending implemented in 1997. Furthermore, by explicitly formulating its monetary policy around quantitative targets, the BoJ has put its own credibility on the line. Hence, until inflation becomes sufficiently entrenched in the economy, the BoJ will not renege on its pledge to keep monetary policy exceptionally loose. This in

Chart 2. Japan growth is more domestic demand led than export led
GDP sector contribution in real terms, %ch q/q



Source: Boost ETP Research, Bloomberg. Data as at 31 March 2014

the middle of 2013, the higher energy prices and QE induced FX cost effects may now start to spill over into broader price increases, as demand led pressures have started to built up. For instance, when excluding food and energy, the year on year inflation readings have been rising steadily since October last year.

A lot of emphasis is placed on the accelerating growth rate of consumer prices this year and the parallels drawn from previous sales tax increases that have caused similars spikes. While April's 2.3% spike in Japan's core CPI is evidently distorted by the sales tax increase and is expected to lead to a subsequent adjustment, it is unlikely that it will revert into outright deflation, such as was the case when Japan last implemented a sales tax increase in April 1997. This

itself should nullify the risk of Japan reverting to deflation in the aftermath of the sales tax increase.

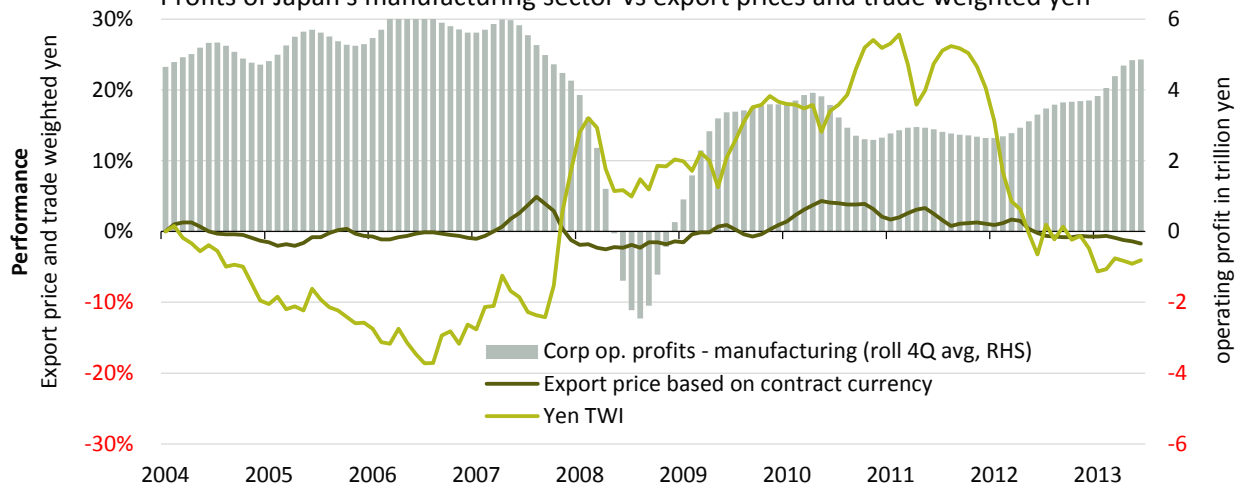
Further evidence pointing towards more entrenched inflation in Japan arrived with the release of last month's GDP numbers which, apart from being the strongest readings of more than 2 years (for Q1 2014, Japanese GDP grew 1.6% Q/Q, or 6.6% annualised), were overwhelmingly domestic demand led (see chart 2). Moreover, the rebound in consumer confidence and uptrend in wages in the month of May suggest that the consumption tax hike has been absorbed without any indication of it having undermined the behaviour of consumer spending.

Underpinning a resilient inflation outlook for Japan is also a corporate sector which, on the back of strong earnings is now more willing to reinvest than in previous years. Starting with earnings as being a key driver for capital expenditures and demand-led inflation, there is a misconception that, without more

This in itself suggests that the necessity of yen depreciation to boost earnings is overstated. In fact, over many decades did corporate Japan keep the price fluctuations of goods quoted in foreign currency relatively suppressed, in an attempt to defend market share. As shown in chart 2, the export price index of

Chart 3: corporate Japan does not require a weaker yen to support profits

Profits of Japan's manufacturing sector vs export prices and trade weighted yen



Source: Boost ETP Research, Japan Ministry of Finance, Bloomberg. Data as at 30 April 2014.

yen depreciation, corporate Japan will struggle to boost its earnings. This is only partly true. For instance, while last year the yen's trade-weighted currency fell by more than 18%, corporate profits of Japan's large-cap stocks (as gauged by the trailing EPS of the TOPIX) rose 69%. Small-cap stocks benefited significantly less however, having risen corporate profits by 10% in the same period (as gauged by trailing EPS of the MSCI Japan Small Cap). On the face of it, it suggests that any unit of currency depreciation will disproportionately benefit the operationally geared companies with sales heavily geared to export markets, i.e. the very large corporations (think Toyota). Nevertheless, there have been plenty of periods where corporate Japan as a whole was able to grow operating profits even while the yen appreciated. As illustrated in chart 3, since 2000, there were 6 calendar years where the yen's trade weighted index (TWI) appreciated or remained flat; in 2002 (+1.4%), in

2003 (+7.23%), in 2004 (+0.1%, i.e. flat), in 2008 (+32%), in 2010 (+7.4%) and in 2011 (+7.2%). Except in 2011 when operating profits from Japan's manufacturing sector fell by 28%, in all of the preceding years where the yen appreciated did Japan's corporate sector enjoy increases in corporate profits. Operating profits were particularly strong in 2002, 2004 and 2010, rising by 71%, 21% and 23%, respectively, while in 2003 these rose by 3%.

corporate goods quoted in the foreign currency has remain relatively stable, unlike the volatile trade weighted currency basket of the yen which since 2004 fluctuated around 20% appreciation and 20% depreciation. Hence, in the same way that a depreciating yen would have helped companies increase market share by lowering the foreign currency price, so would they have suffered from likely market share losses if a yen appreciation forced them to raise the foreign currency price. This shows that Japan's shrinking current account should not be seen as corporate weakness, but rather as management willing to forego taking advantage of shocks unrelated to the business cycle, in an attempt to preserve corporate continuity and make longer-term business planning more aligned to structural, as opposed to cyclical driving forces. Therefore, what will really drive Japan's exports will be volumes which, on the back of a resilient US, a restructuring Europe and rebalancing China, are likely to serve as more reliable indicators for fundamental strength/weakness and that are within the control of management, than the policy induced distortions to

export prices, which are largely beyond the control of management.

Sufficient leverage capacity of companies to fund CAPEX

The final driver helping inflation in Japan to become more entrenched in the economy is the unused capacity by which corporate Japan can reinvest

investments. As shown in chart 2, the last 4 quarters of GDP growth were increasingly led by private sector investment. Driving this has been the painful process

Abe's election victory and its implementation of its three-pronged economic stimulus package.

Chart 5. Real equity risk premium of Japan vs US
12M trailing earnings yield minus real bond yields* (in %)

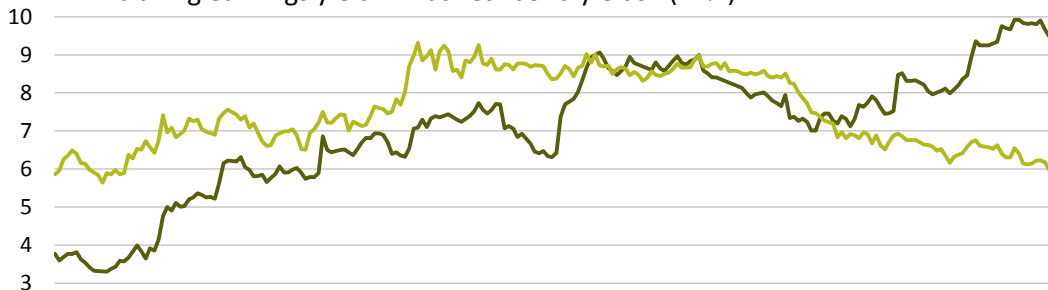
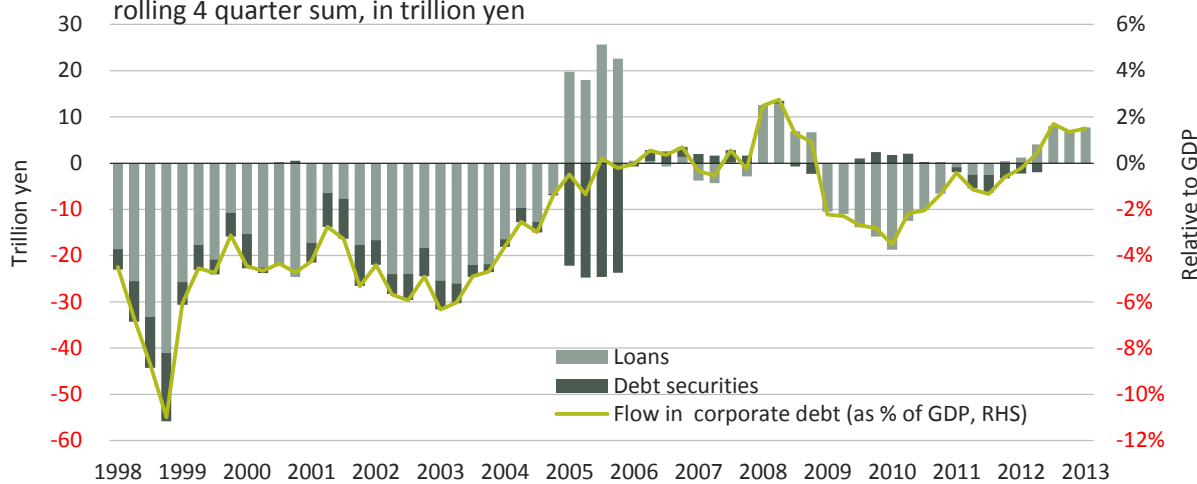


Chart 4: balance sheet re-leveraging finally taking hold of corporate Japan
rolling 4 quarter sum, in trillion yen



Source: Boost ETP Research, Bank of Japan. Data to 31 Dec 2013

by which Japan's corporate sector has deleveraged for more than a decade. The large debts carried on the balance sheet, remnants of the investment splurge undertaken during the late 80s and mid 90s, have forced companies to pay off bank loans and retire (rather than refinance) outstanding bonds to a significantly degree.

The extent of balance sheet deleveraging by Japan's corporate sector was sufficiently large so as to undermine efforts to reflate the economy with QE. For instance, on a rolling 4 quarter basis, the combined cuts to outstanding bank loans and corporate bonds in the period the mid 1990s to mid 2000s ranged anywhere between 3% to 6% of GDP (see chart 4), in the process causing a significant demand vacuum in the Japanese economy (and likely to have been a major contributor to deflation that befell it). By 2005, the debt stock was reduced to such a degree that corporate Japan was looking to relevel. But the 2008 credit crisis, followed by the 2011 Tsunami and Fukushima disaster, have cut short any attempt by Japan's corporate sector to do so. Hence, not until mid 2012 did the the releveraging of Japan's corporate sector resume, just ahead of prime minister Shinzo

Hence, while QE in the period of 2001 to 2006 was discredited for the wrong reasons (i.e. QE failing to reflate the economy amidst an entire corporate sector paying down their outstanding debt obligations), Abenomics may this time succeed as demand for loanable funds by the corporate sector to spur growth in investments and jobs may be sustained longer term on the simple basis that corporate balance sheets are strong.

Longer-term inflation expectations in Japan have begun to point to unusual high levels. Inflation expectations in

Significant potential for Japanese equities to re-rate

Japan have for the first time in over a decade exceeded the inflation expectations of the US (see chart 1 on first page). Based on the difference between nominal and inflation-linked bond yields of 5 year US Treasuries and JGBs, Japan's longer term inflation

expectations, at 2.4% p.a., are approximately 0.4% higher than the US.

Given the markedly lower nominal bond yield of Japan relative to the US (0.2% in Japan vs 1.7% in the US) there is significant downside risk looming in Japanese government bonds. Prolonged deflation previously induced many to hold longer dated JGBs that yielded only a few tenths of a percent in nominal terms but would offer real yields in excess of 1%. However, with inflation expectations brewing above 2%, this no longer makes sense, especially in light of the better yields offered in the equity market. Chart 5 shows how the real equity risk premium of Japan, or the difference between the earnings yield (effectively already a real yield measure since dividend streams tend to grow in line with inflation) and longer term inflation linked bond yields, has risen to almost 10%, and reflects a 2% higher equity risk premium observed in the US. What it means is that relative to bond yields, the inflation outlook, and competing equity markets such as the US, Japanese equities have reached new levels of significant undervaluation.

Given that the yen has failed to extend the depreciation seen in 2013, QE may now largely have been baked into the prices on asset markets. This being the case, the driver for a re-rating of Japanese equities may no longer have to come from foreign investors, nor may it have to come from further yen depreciation. Instead, it may come from Japan's private sector itself, most notably households, who, on the back of rising inflation expectations, should feel compelled to seek equities as the new inflation hedge. In seeking viable alternative to fixed income streams, a competitive dividend yield is required. Dividend yields in Japan currently hover at 1.9%, relatively low when compared to peers in developed markets. Yet since the middle of last year, dividend yields have risen even as Japanese equities rallied. In readying itself to appeal to a new growing shareholder base at home, the increase in dividends may merely be a prelude to far larger more significant dividend increases to come.

All data is sourced from the Bank of Japan, Japan Ministry of Finance and Bloomberg

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