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# A fabulous year
# – Japan's full-scale resurgence is certain to occur in 2015

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## (1) No doubts about strong earnings growth, an end to the trade deficit and a continuation of ultra-easy-money policies

**2015 will be a fabulous year**

A favorable environment on an unprecedented scale, and one that may never happen again, is emerging in Japan. The big drop in oil prices as the yen weakens looks very much like the period from 1981 to 1985, which is when Japan posted its strongest economic growth. Furthermore, there are other positive factors that did not exist in the early 1980s. One is the robust US economy. Other positives are the Japanese government's broad-based support for growth (Abenomics centered on extreme monetary easing) and the extremely low interest rates in Japan (real interest rate is the lowest in the world and negative). The business climate for Japanese companies has improved dramatically. Selling prices for products are higher because of the weaker yen. Costs are lower because of cheaper oil. And production volume is growing. These three favorable developments are almost certain to push fiscal 2015 corporate earnings well above even the record-high earnings of the current fiscal year. Companies in Korea and China, which had posed a big threat to Japan, will face even greater challenges. Overall, there is little doubt that 2015 will be a year when Japanese companies clearly demonstrate to the world their overwhelming strengths.

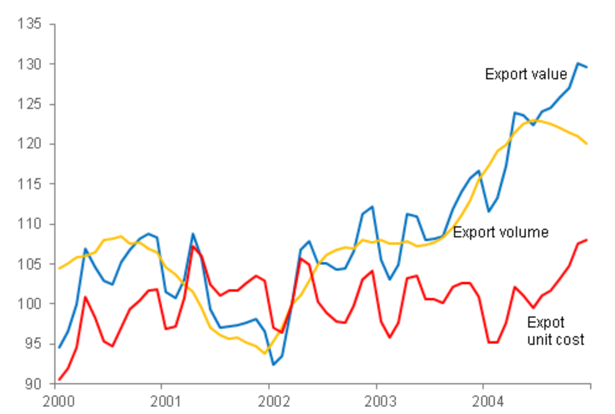
**The reservoir is full: Japanese companies are poised for unprecedented value creation**

People are correct to say that the benefits of Abenomics are not yet visible. There are two reasons. First, unlike during Japan's past economic recoveries, production volume is not rising due to the lack of growth in export volume. Second, real wages are declining because wage increases are not keeping up with rising prices caused by the weaker yen and the consumption tax hike. However, it is wrong to say that we should conclude that Abenomics has run out of gas or that it was a mistake. Benefits of Abenomics are being stored in the form of a dramatic improvement in earnings. In a sense, the reservoir is full but there is still a drought downstream. But sooner or later, a deluge of this stored water is certain to start rushing downstream.

**The shift in Japan's business model has enormously changed its trade structure**

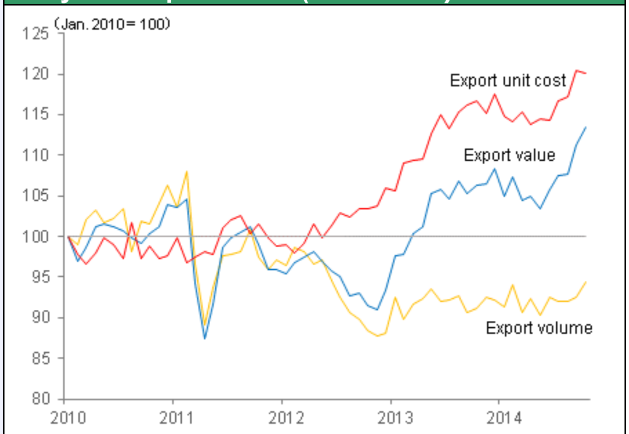
Positive effects of Abenomics, namely the weaker yen, have not appeared because there has been a major change in the country's trade structure at Japanese companies. In the

**Figure 1: Export volume, value and unit cost in the yen's depreciation (since 2000)**




Note: 3month MA, Mar 2002 = 100 when the 3MMA JPY depreciated most for the period
Source: Ministry of Finance, Bloomberg, Musha Research

**Figure 2: Export volume, value and unit cost in the yen's depreciation (since 2010)**

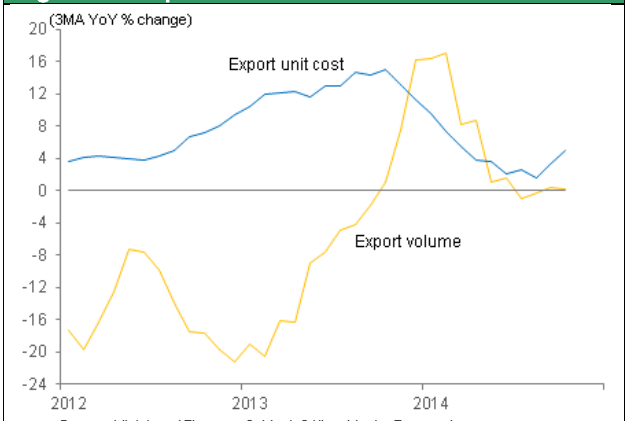



Source: Ministry of Finance, Cabinet Office, Musha Research past, the Japanese economy benefited from a decline in the yen's value because of higher manufacturing output as export volume increased. This created a chain reaction of positive effects on the economy. Figure 1 shows how export volume and prices moved during the yen's previous decline (from 2001 to 2004). As you can see, there was only a small increase in export prices (because companies reduced dollar-denominated prices) and a big upturn in export volume. But during this downturn of the yen, as Figure 2 shows, export prices are up sharply while export volume remains sluggish. Clearly, exporting companies in Japan have reacted to the weaker yen in the opposite way they did 10 years ago.

Japanese companies are no longer using prices to compete. Companies do not need to cut dollar-denominated prices even when the yen weakens. The result has been a big increase in yen-denominated export prices. On the other hand, export volume has not increased as the yen weakened because companies have no desire to engage in price-based competition. There has obviously been a major shift in the business models of Japanese companies. In the past, these companies cut prices to capture market share and create difficulties for competitors in neighboring countries. Now, companies have completed the transition to a business model in which they avoid competition by supplying only products that are superior in terms of technologies and quality. This shift has not produced trade friction. Instead, the new business model has created an environment in which other countries must have the technology and quality of Japanese products that are essential to their own economic growth. President Xi Jinping of China has been a consistent critic of Japan for political reasons but is now seeking closer ties with the Abe administration. The only possible reason is China's immense thirst for Japanese technology.

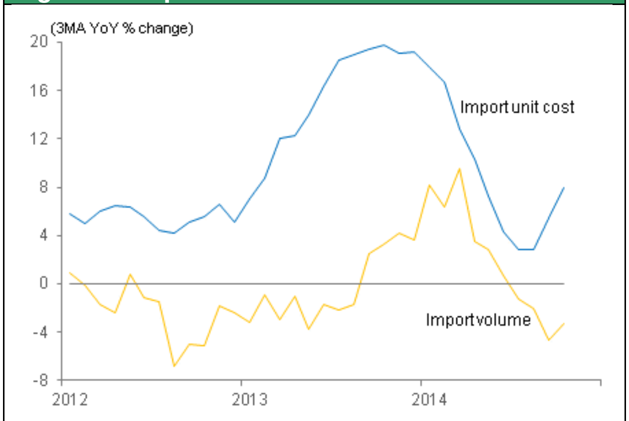
Since the spring of 2014, Japan's imports from China in terms of volume have been decreasing at an annualized rate of more than 2%. Apparently, Japanese companies are moving manufacturing activity back to Japan. In Japan, loans for capital expenditures are increasing to small and midsize companies, which have been competing with Chinese companies. Orders for machine tools are approaching an all-time high (Figures 5 and 6). Toshiba and Micron Technology (Elpida Memory) are expanding their production facilities in Japan. This return of manufacturing to Japan is one more reason that we are likely to see substantial growth in Japan's trade volume. The combination of big increases in yen-denominated export prices and export volume means that we

**Figure 3: Export to China volume & unit cost**



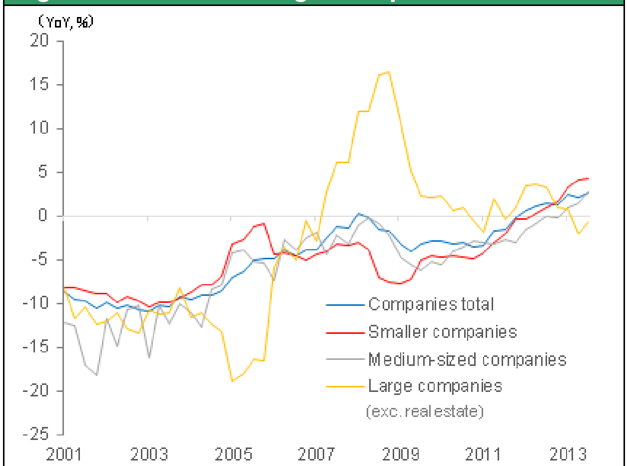

Source: Ministry of Finance, Cabinet Office, Musha Research

**Figure 4: Import from China volume & unit cost**



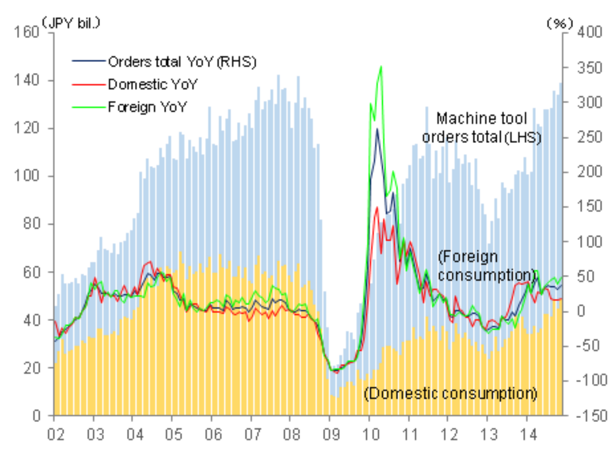

Source: Ministry of Finance, Musha Research

**Figure 5 : Bank lending for capital funds**




Source: BoJ, Musha Research

**Figure 6: Machine tool orders**




Source: Bloomberg, Musha Research

can expect a major upturn in the volume and monetary value of Japan's international trade. This environment is reminiscent of Japan's rapid economic growth period.

**2015 will be the "downstream year"**

All of the benefits I just outlined will probably result in a powerful surge in corporate earnings. In fiscal 2014, earnings are forecast to climb almost 20% to new record high. More growth is foreseen in the next fiscal year. We can expect to see a positive economic impact from higher wages and dividends as well as a high volume of investments and M&A activity. The reservoir that is filled with corporate earnings is finally about to be released for distribution to the real economy. Benefits will probably start to emerge in the first half of 2015.

As these positive effects of the weaker yen surface, the government will probably implement Abenomics even more forcefully and stock prices will probably move even higher. As a result, Japan's economy is likely to be very strong in 2015 and 2016. Amid this economic strength, even the impact of about ¥5 trillion from a consumption tax hike of 2% could probably be absorbed with no difficulty. The delay of the consumption tax increase and the public's vote of confidence in the Abe administration in this month's general election mean that the definite end of Japan's deflation will at last become apparent in 2015.

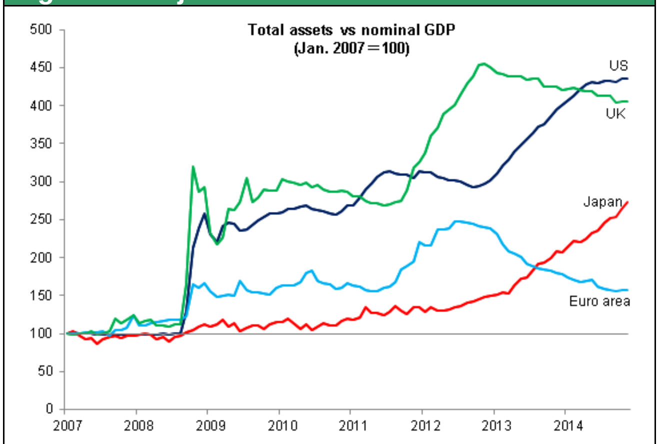
## (2) The scenario for a stock market rally in Japan

No end is in sight for the favorable global investment climate that is fueled by the apparent full-throttle economic growth in the United States. Additionally, the entire world is about to move together for enacting demand creation policies. Three factors will probably push global stock prices higher: 1) worldwide monetary easing, 2) the end of government budget austerity, and 3) higher corporate earnings because of cheap crude oil and low interest rates and wages. Furthermore, the start of US interest rate hikes will probably have only very minor impact and will not spark turmoil in financial markets.

**Three reasons for extra stock market momentum in Japan**

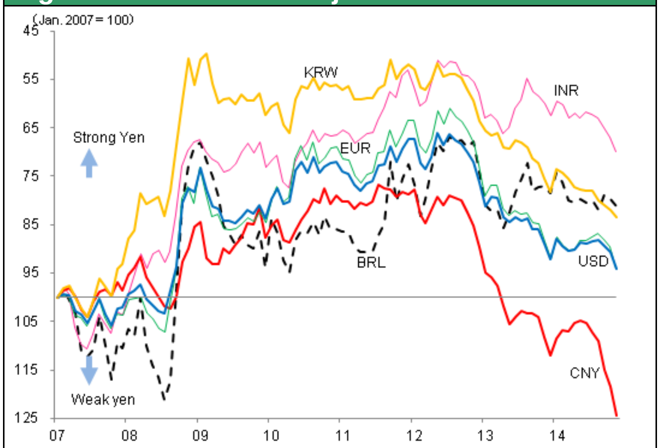
As stocks worldwide rise, investors should focus most of all on Japanese stocks. The reason is that Japan has three reasons that exist nowhere else for extra upward stock market momentum. First is the end of the strong-yen deflation due to Abenomics. Compared with the lowest point during the financial crisis, stock market indexes are up about 150% in the United States and Germany. But in Japan, stocks remained low until November 2012 and even now are up only about 70%. The reason was that the yen was the only major currency that kept appreciating. Under the leadership of Governor Shirakawa, the Bank of Japan alone in the world implemented pessimistic monetary policies while European and US central banks went down the path of monetary easing. The yen's rapid appreciation quickly eroded the competitive edge of Japanese companies in export markets. Moreover, Japan became the only place in the world with deflation. The yen's value doubled in relation to the Korean won, which means that Japanese companies would have to cut their wages in half to remain competitive. Damage from deflation (falling selling prices) was particularly severe for the service sector, which relies on domestic demand, because there were very few places for cost cutting in this sector. Strong-yen deflation weakened all industrial sectors in Japan and made Japan the only economic loser in the world. Now, Abenomics is about to correct the fundamental cause of this problem.

**Figure 7: Major central banks total assets/GDP**




Source: Bloomberg, Musha Research

**Figure 8: FX rates of major currencies vs. JPY**

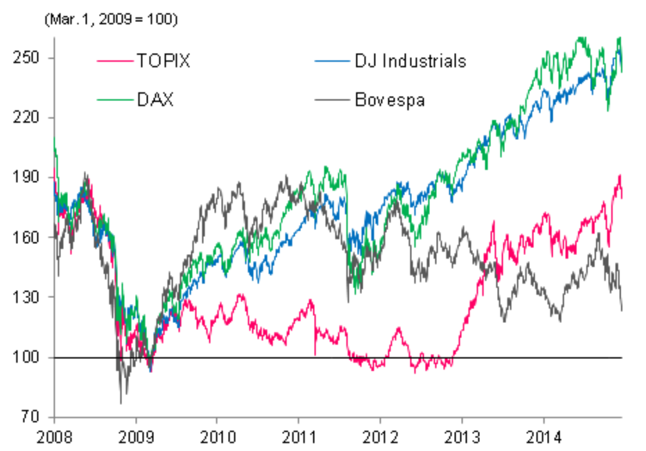



Source: Bloomberg, Musha Research

**Figure 9: Global stock market capitalization**


Source: Bloomberg, Musha Research

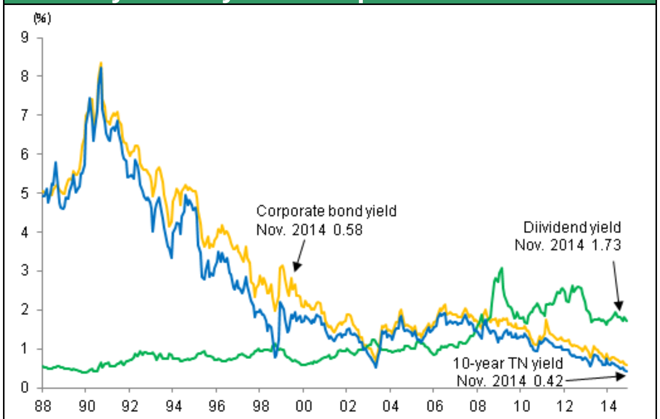
**Figure 10: Stock indices in major countries**




Source: Bloomberg, Musha Research

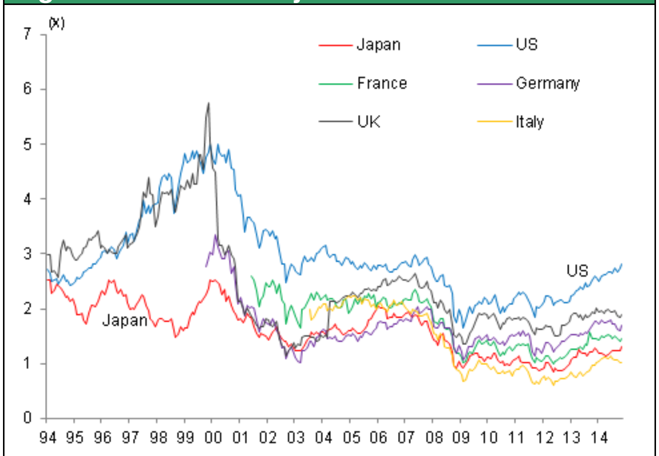
The second reason is that a correction is about to occur that will end the undervaluation of Japanese stocks on a scale that is unprecedented anywhere in the world. Today's income yield for Japanese stocks is 7%. That means companies are generating earnings of ¥7 for every ¥100 of stock prices. These earnings are about ¥1.8 for dividends alone. Purchasing bonds in Japan would give an investor a yield of only 0.6%, which is ¥0.6 for each ¥100. The difference is more than 10 times. Bank deposits yield nothing at all. Despite this income gap, people have not put their money in stocks in Japan. But now an enormous wave is forming that will eliminate this undervaluation.

**Figure 11: Corporate bond yield, dividend yield and 10-year TN yield in Japan**




Source: Bloomberg, Musha Research

**Figure 12: PBR in major countries**




Source: Bloomberg, Musha Research

**A geopolitical environment not seen since the Korean War**

The third reason for additional momentum is the geopolitical environment. Japan was mired in a 23-year economic slump after the asset bubble burst in 1991. The fundamental cause was the US containment policy against Japan. Until about 1990, Japan enjoyed prosperity and its automobile, electronics and other industries became very competitive. Making this possible were the use and improvement of US technologies and the large market shares of Japanese products in the United States. However, the excessive strength of Japan posed a threat to the industrial base of the United States as the world's superpower. US national interests were damaged. The result was Japan bashing that included trade friction, the yen's extreme appreciation and other events. But a complete reversal has now occurred. The reason is that a resurgence of the Japanese economy is vital to US national interests. Allowing Japan to become even weaker would place Asia under the influence of China. Only a strong Japanese economy can contain China and enable the United States to preserve its stature in Asia. As a result, the Japanese economy enjoys a geopolitical tailwind instead of a headwind. Japan's postwar period of prosperity (1950-1990) started with the Korean War. Quickly restoring the health of Japan's economy was critical to winning the war. Today, 60 years later, geopolitical risk is once again increasing. Making Japan's economy more powerful will be essential with respect to two apparently inevitable events: the collapse of North Korea and the establishment of democracy in China. This is why Japan needs to switch from following the United States to advancing to the status of a key component of the so-called Republic of the World (a new world order).

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**Figure 13: Stock price, land price, corporate earnings, employee compensation in Japan**

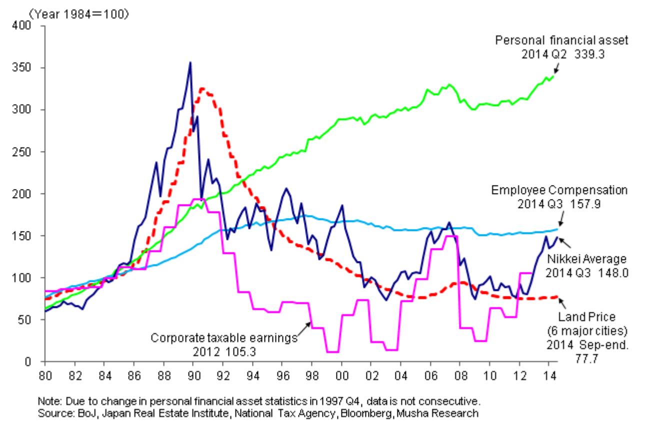
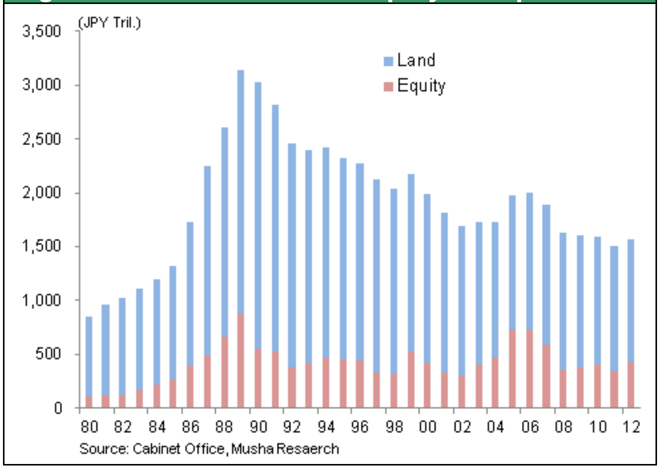



**Figure 14: MV of land and equity in Japan**




Japan has finally advanced to the phase of contributing to global prosperity and ending the country's status as the world's only economic loser.

## (3) Key points about investing in Japanese stocks

**Japanese companies have a sound foundation for growth**

Looking back now, we can say that Japan's lost 20 years were actually 20 years for putting in place the conditions required for growth.

Companies in Japan had four major accomplishments as they faced adversity during these two decades:

1) The most significant progress in the world with streamlining and cost cutting;

2) The development of a business model (unified service model) based on developing advanced technologies and providing solutions;

3) The establishment of global networks that made these companies citizens of the world;

4) The accumulation of a large volume of capital (unprecedented ability to make investments = a balance sheet with ample funds is a decisive condition for progress, as was demonstrated by the success of Fuji Film).

Now that Japan is ending the yen's strength and deflation, the benefits of these accomplishments will emerge in the form of strong earnings growth. We are just now on the verge of seeing these benefits appear.

**Figure 15：Japan's greatest streamlining - ULC trends in major countries**

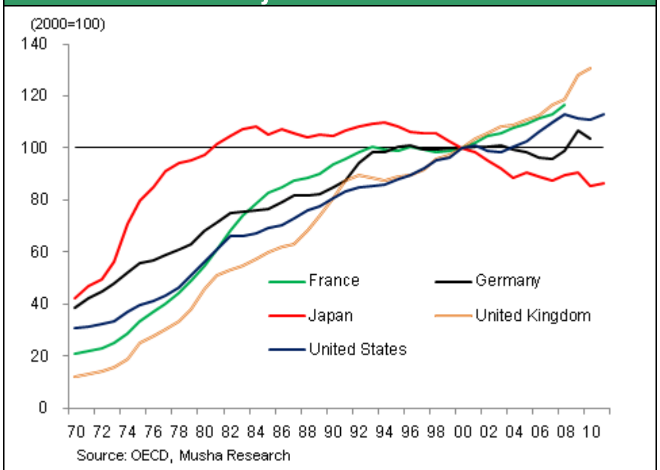
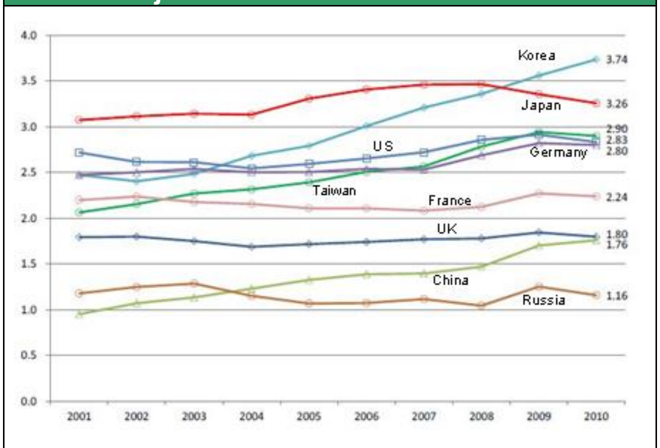



**Figure 16：Gross domestic expenditure on R&D in major countries**




Source: MITI (original data by OECD)

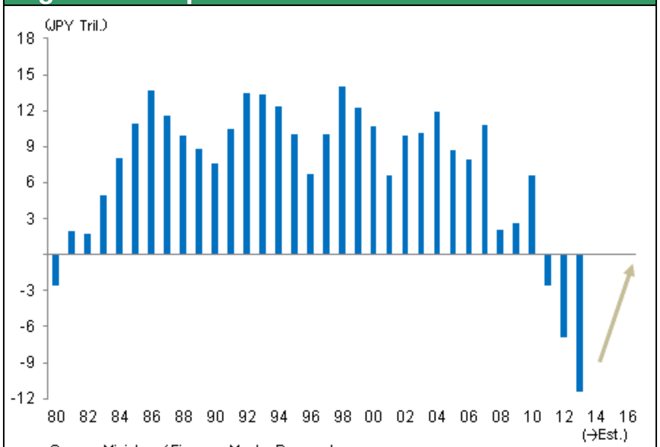
**The unusually favorable supply-demand dynamics for Japanese stocks**

The stock market rally of the century that we believe has started in Japan has probably advanced to the second stage. The rally is likely to be propelled by favorable valuations and supply-demand dynamics of an unprecedented scale. The Japanese government is implementing powerful measures for channeling capital to stocks. One is additional monetary easing (more ETF purchases) by the Bank of Japan. Another is Government Pension Investment Fund (GPIF) reforms that will raise its allocation for Japanese stocks from 12% to 25%. Furthermore, pension funds and other institutional investors can buy more stocks because rising stock prices give them more capacity for risk. We will also probably see foreigners make more short-term and long-term investments in Japanese stocks. Short-term investors are likely to establish positions that take advantage of the abnormal gap between zero-interest funding and the 1.8% dividend yield on stocks.

**Dollar-based purchases of Japanese stocks will start when the yen's decline ends in 2015**

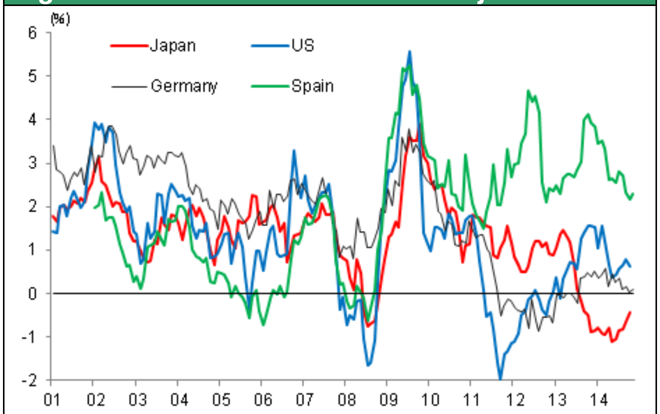
Japan's annualized trade deficit is currently about ¥11 trillion. But signs of a steep decline in this deficit are appearing. If the price of crude oil and LNG fall 30%, there will be an ¥8 trillion decrease in the annual cost of Japan's fossil fuel imports, which is now ¥26 trillion. In addition, the falling volume of imports from China shows that Japanese companies are moving manufacturing back home because of the weaker yen. Rising manufacturing in Japan will probably produce a significant improvement in Japan's trade volume. Furthermore, Japanese companies have avoided reductions to dollar-denominated prices as the yen weakened. The resulting big increase in yen-denominated export prices has sharply increased the monetary value of Japan's exports. Due to these developments, the virtual elimination of Japan's trade deficit is now in sight. Japan's current account surplus is much higher because of improvements in the travel balance and overseas income balance. Moreover, there will probably be larger inflows of capital as investors turn their attention to Japanese stocks and real estate, which are currently the most undervalued in the world. Three forces have come together to generate strong growth in corporate earnings: higher selling prices due to the weaker yen; lower operating costs due to cheaper crude oil; and growth in production volume. Once the yen's downturn has run its course, Japanese investors that have increased overseas holdings will realize that stocks in Japan are more attractive. This may slow down Japan's overseas investments. The yen will probably stop declining in 2015. The end of this downturn will eliminate extreme fears about a government financial collapse triggered by a dangerously oversold yen and sudden increase in interest rates. When the yen stops falling, the Japanese economy will probably be revitalized by the country's greater competitive edge and the end of deflation. Stock prices in Japan are likely to move even higher as a result. As the dollar-denominated market capitalization of Japanese stocks increases significantly, overseas investors will be forced to raise their Japanese stock allocations.

**Figure 17: Japan trade balacne**




Source: Ministry of Finance, Musha Research

**Figure 18: Real interest rates in major countries**




Note: Excluding push up effect of consumption tax hike (BoJ est. 2%) after Apr. 2014 for Japan
Source: Bloomberg, Musha Research

**Investors should focus on three themes**

I. Industries benefiting from the weaker yen and reevaluation of exporters with global operations – 1) rising export prices and volumes, 2) rise in overseas asset values due to the weaker yen (higher equity) = Tourism, agricultural products

II. Industries benefiting from the end of deflation, which means higher margins resulting from growth in selling prices = Domestic-demand, financial services, real estate, construction, transportation

III. Industries benefiting from a higher standard of living and consumer spending in Japan = Retail, entertainment, health care, education

Japan's extremely favorable supply-demand dynamics will first boost stock indexes. Investors will focus their attention on financial services and real estate companies that benefit from rising asset prices and on value stocks (for example, stocks with a high dividend yield).