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BUILT TO LAST

Is this Japanese equity bull market for real?

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ASK TYLER

Japanese Prime Minister Shinzo Abe's bold bet on an early election has paid off. Yesterday, his Liberal Democratic Party (LDP) and its coalition partners scored a thumping victory, securing a "super majority" in both houses of parliament.

While this effectively amounts to a double down on so-called Abenomics stimulus policies, investors were not prepared. In the week prior to the election, funds focused on Japanese equity suffered net outflows of $4.4 billion — the largest negative number since 2002 (the year when EPFR Global began tracking the data).

There are few believers in a sustainable Japanese bull market. And, on the surface, why should there be? Japan faces some serious structural issues — high debt levels, aging demographics, and so on.

But everyone already knows the macro headwinds. Far fewer understand the micro story. Over the past 25 years, Japanese companies faced the twin burdens of chronic deflation and an overvalued currency. What has been the result? Corporate Japan is now extremely lean and efficient. Aggregate Japanese return on equity has been quietly trending upwards and corporate profits just hit a record high relative to GDP. Japanese companies also happen to sit atop USD $4 trillion in cash. That means capex can be radically increased without borrowing.

Japan is also a veritable hotbed of companies at the forefront of several technologies reshaping the global economy — including robotics, electric cars and alternative energy (in the words of one analyst, "they make cool stuff").

Fortunately for the intrepid investor, one does not have to pay up for this growth. Japanese equities are priced at the frontier of value, if not over the edge — deep into bargain territory. The small cap sector in Japan trades below their book value. And, companies have been steadily increasing their dividends, yet payout ratios still average only 25 to 30 percent of earnings.

INVESTMENT IMPLICATIONS

Since Japan's epic bull market peaked in 1989, there have been too many false dawns to name. Now, in one of its best runs since 1949 and longest in nearly 30 years, the Japanese Nikkei 225 index has risen for 13 days. Clearly, the market may be running too hot in the short-term. But, over the medium-term, a synchronized global expansion should support growth and earnings momentum. Perhaps most importantly, the Japanese Yen itself has become dramatically undervalued — the currency is the cheapest it has been in 32 years. In a globalized world, corporate profits typically show a strong correlation with cheaper exchange rates. This is the crucial difference between now and previous Japanese bull markets over the last 20 years, where the Yen was expensive. Those rallies were never built to last. This one will be far more durable.

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