The case for Japanese equities

Summary

We see three factors that potentially support Japanese equities going forward:

Improving earnings outlook amid a strengthening domestic economy and synchronized global expansion.

Currently attractive equity valuations compared to developed market peers.

Continued monetary stimulus from the Bank of Japan and a potentially stable yen.

Japan is experiencing its longest expansion in over 10 years. The country’s economy has grown above-trend for the past five quarters, which has supported corporate earnings growth and prompted upwards earnings revisions. Japan’s competitive exports may leave it well positioned to benefit from the broad-based, synchronized upswing in global growth underway.

Our G7 economies GPS indicator currently shows upside global growth potential relative to consensus expectations, which could support export growth and Japanese corporate profits overseas. Although yen strength is a risk to Japanese equities, growing monetary policy divergence between the Bank of Japan (BoJ) and both the European Central Bank (ECB) and Federal Reserve could continue to put downward pressure on the yen.

Earnings growth trending higher

Source: Thomson Reuters, July 19, 2017. 12m Fwd EPS shown for the MSCI Japan Index. EPS refers to Earnings Per Share. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Equity market responding to stronger fundamentals

Japan’s equity market has responded to these positive economic developments, with the MSCI Japan Index up 11.97% YTD. Earnings revisions accelerated over 4Q16 and 1Q17, outpacing U.S. and European markets, but have since moderated. The earnings outlook remains strong. The year-over-year change in analysts’ 12-month forward earnings estimates for the MSCI Japan Index is currently above the MSCI USA Index and MSCI Eurozone Index, yet Japan trades at a 20% discount to U.S. peers on a 12-month forward price-to-earnings basis.

More shareholder-friendly corporate behavior may also support Japanese equities going forward. Improved corporate governance, investor appetite, and growing corporate earnings alongside record cash balances provide the necessary supply and demand ingredients that could help increase shareholder payouts going forward. Share buyback announcements are down 48% year-over-year so far, but over the last five years 3Q has been the seasonal low point for buyback announcements before rebounding during 4Q.
Focus on monetary policy, not politics

After a strong start to the year, investor sentiment and positioning have reversed course (notably following the recent local Tokyo election loss by Prime Minister Abe’s Liberal Democratic Party). We believe this midyear slump is likely overblown given currently strong fundamentals and attractive valuations, which could provide a favorable entry point for equity investors at this time. There is no credible opposition party to Abe’s government at the national level, which could allow structural reforms under Abenomics to continue. At the same time, the BoJ has continued to purchase domestic equities and government bonds at record levels. Japanese institutions have also increased their risk appetite for equities, adding a further bid to the market, in our view. Attractive valuations and strong fundamentals may outlast any short-term sentiment setbacks.

Bank of Japan accommodation continues… …Which could support equity markets


Conclusion

We see several reasons potentially supporting Japanese equities including currently attractive valuations, improving earnings outlook, and continued BoJ accommodation. Political risks appear overblown, in our view, and strong fundamentals are likely to prevail. We believe Japan’s competitive export position and improving domestic fundamentals may continue to support the earnings growth at home and abroad, while the risks of yen strength currently appear limited as the BoJ’s monetary policy diverges from a normalizing Federal Reserve and a looming step change in the ECB’s monetary stimulus.

Footnotes: ¹Source: Thomson Reuters, July 24, 2017. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. ²Source: Thomson Reuters, July 21, 2017. Japan and U.S. represented by MSCI Japan Index and MSCI USA Index, respectively. ³Source: Thomson Reuters, June 30, 2017.

Abenomics refers to the economic policies advocated by Prime Minister Shinzo Abe and is based upon the “three arrows” of monetary easing, fiscal stimulus, and structural reforms.

Related iShares Funds

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| HEWJ | iShares Currency Hedged MSCI Japan ETF |
| DEWJ | iShares Adaptive Currency Hedged MSCI Japan ETF |

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