Japan: An Encouraging Visit

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Chris Konstantinos and Michael Jones have recently returned from a trip to Asia, most of which was spent in Japan and China meeting with corporate executives, policymakers and economists. This week we focus on Japan in a Q&A format with Chris.

What were your overall impressions?

Things are finally changing in Japan, a place that many associate with chronic lack of change in the corporate sector. Voluntary job turnover, public release of ROE (Return on Equity) targets, a major influx of tourism, robust corporate real estate growth plans, and price increases for consumer goods that stick without volume declines are all examples of interesting themes we picked up on our recent trip. Each one of these points is interesting in isolation, but when viewed together within the context of a broader mosaic, we believe that they point to a profound change in the way Japanese corporations think and how the Japanese consumer consumes. There is a need for patience, however, as “reform” stories often happen in fits and starts; and, there appeared to us to be a discernible difference between "old Japan" and "new Japan" companies with respect to reform. The Bank of Japan's open-ended Quantitative Easing (QE) program is, however, providing ample economic support as Japan slowly reverses 20 years of missteps at the corporate level.

What surprised you the most?

We were surprised by the growth of tourism in Japan, especially from Chinese consumers, which further reinforces the difference between China’s industrial spending decline and its consumer growth. We learned this from meetings with some of Japan's largest food, drug, apparel and discount manufacturers and retailers. Spending by non-residents in Japan, which had stagnated from 2000–2012, has now increased by two and a half times since Abe was elected; it now stands at 2.5 trillion yen, close to 1% of total domestic personal consumption.

With the Summer Olympics being held in Tokyo in 2020 and the overall level of Chinese tourists to Japan as a percentage of total Chinese population still relatively minimal, we expect these positive trends to continue. This tourist spending will manifest itself in higher corporate earnings and will certainly play a money multiplier effect in the general economy, in our view.

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Which of your opinions on Japan were most supported by what you heard from companies and policymakers?

We heard very encouraging things on company reform, inflation, and tightness in the labor market. Corporate governance reform has (finally) passed the tipping point. For decades, Japan Inc. produced among the least shareholder-friendly companies in the world, in terms of transparency and board independence as well as in low ROE compared to other developed nations. Although Japan still has a long way to go, we are now seeing the first legitimate signs of positive change in decades. For instance, we asked some version of the same question to every company we met with: what are your plans for conformance to the government’s new Corporate Governance Code? Notably, most companies we spoke to were in the process of releasing public ROE targets, in many cases for the first time in their history.

Given the cultural importance around the concept of “face” in Japan, we believe that there will be unprecedented pressure for management teams to meet targets now that they are public.

Many also talked about adding outside directors to their board – according to Ministry of Finance (MoF) statistics, 92% of listed companies in the Topix have at least one outside director as of June 2015, up from 74% just one year ago. Admittedly, we detected a definitive reticence in reducing levels of cross-holdings at "old Japan" types of companies such as the banks and property developers, where many of the cross-holdings represent clients of the company. That said, according to data we obtained during our meeting with the MoF, ROE in Japan has increased over 3 percentage points (to roughly 8.5%) from the time Abe was elected in the fourth quarter of 2012; by contrast, the return on equity for the S&P 500 Index has stagnated at around 13.5% over the same period of time.

One anecdote summarizes a key lesson on the inflation and wage front: in a meeting with an executive from one of Japan’s largest food producers, we heard that a recent major price increase on dairy and chocolate went much better than expected — while the company was expecting decreased volume after the price hike, volumes didn’t drop at all. The company is now planning a second round of price increases. In our view, this anecdote suggests that an inflationary mindset is starting to permeate Japan. This mindset is positive for Japan because the major economic issue of the last two decades has been *lack of inflation and its concomitant depression of consumer spending*: as one of our Japanese strategist friends mentioned to us, soda prices in vending machines in Tokyo are the same as they were in 1997!

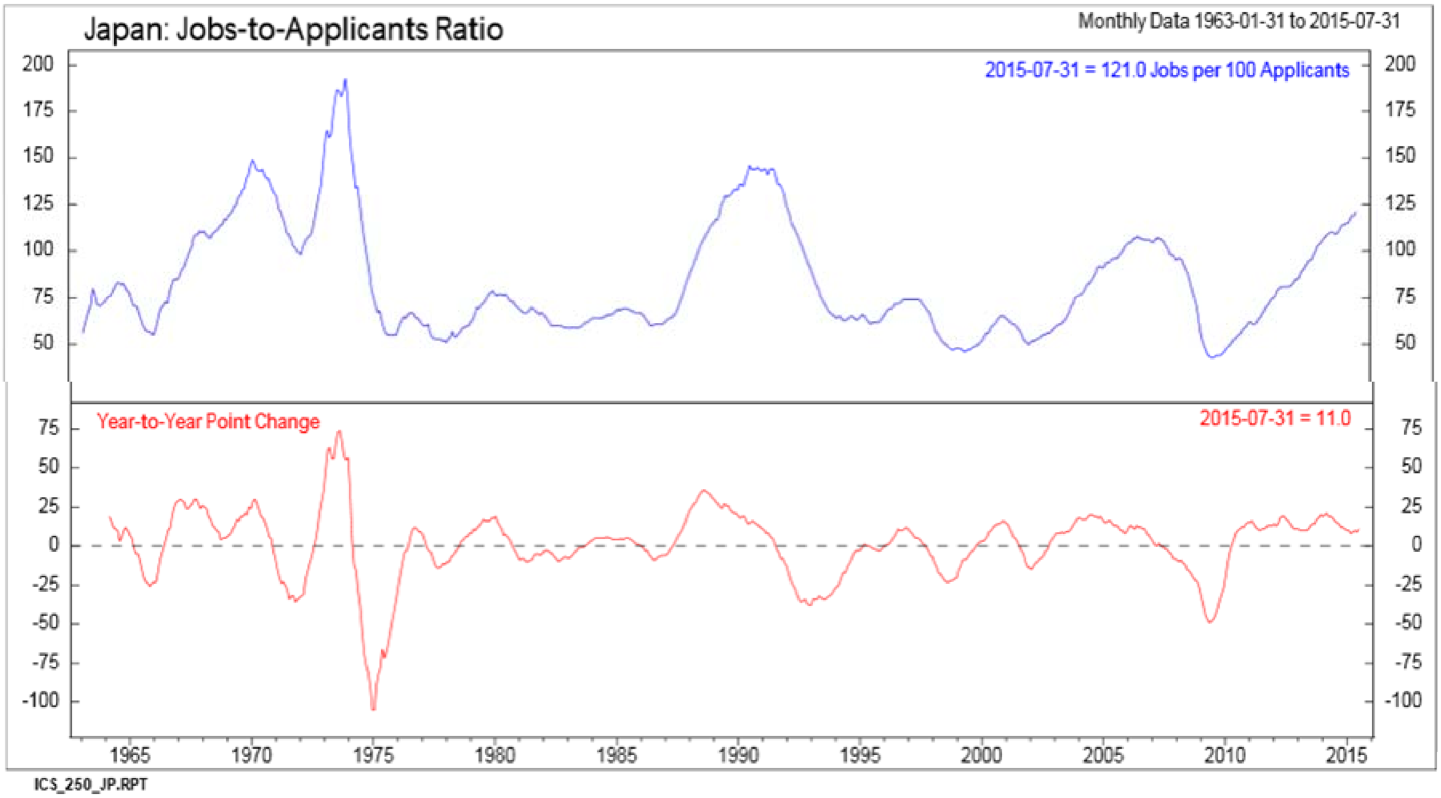
Of course, price increases won’t be digested well if wages aren’t also improving. One large discount retailer with whom we spoke raised wages by 6% over the past year and has still had difficulty finding enough talented associates to hire. In speaking with two major employment agencies, we heard repeatedly that the job market remains strong.
One particularly encouraging data point is that staffing needs for full-time employees is finally starting to improve along with temp and part-time workers. Also, job turnover related to "proactive job changes" is growing rapidly; this is notable because it represents a refutation of Japan's traditional "one employer for life" culture.

Can you touch on some of the challenges that remain and some of the things that concerned you?

Obviously, not all that we heard was positive. We were surprised to discover that, despite very low interest rates and attractive incentives, demand for housing is still lackluster. This point was in direct contrast to the red-hot market dynamics we encountered in commercial property development. We believe this tepid demand for residential has something to do with lack of available credit for part-time workers. Another challenge is that there is now a lack of meaningful further upside to earnings from downward revisions to the yen. The companies we talked to are now baking an exchange rate of 115-120 yen/USD into their guidance. Third, it still appears that small-and-medium size businesses, which tend to be more “old Japan”-style machinery and industrial companies, may be seeing more difficult business trends than larger ones. And lastly, we think that Japanese management teams are still somewhat myopic when it comes to their lack of use of leverage and excess cash on their balance sheet, as well as their insistence on looking beyond Japanese borders for merger & acquisition (M&A) opportunities. In both cases, however, we believe that views are slowly changing for the better. For instance, the MoF suggested to us that stock buybacks have been surging in the last six quarters, and we note that dividend increases are also becoming more commonplace. *Dividends are not guaranteed and are subject to change or elimination.*

In our Weekly Chart below we wanted to focus on the issue of labor market tightness. Using a ratio of available jobs-to-applicants, we demonstrate that the Japanese labor market is as tight as it has been since the late 1980s. This suggests that it's a job-seekers' market, and that further wage gains for quality applicants could be on the horizon — we believe that this is important for the continued recovery of Japanese consumer consumption.

THE WEEKLY CHART



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Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.

The Tokyo Stock Price Index (TOPIX) is a capitalization-weighted index of all companies list in the First Section of the Tokyo Stock Exchange. The index is supplemented by the subindices of the 33 industry sectors.

Individual investors cannot directly purchase an index.