Matthews Asia Perspective

Looking for an Entry Point into Japan's Equity Market

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Current index levels in Japan's equity markets have approached bubble-era highs recently, raising the question of whether now would be an appropriate time to enter the market. It is reasonable to have a "fear of heights" given where Japan's market is currently. For the past 20 years, Japanese stock prices have generally remained in a broad range and are now near the high end of that perceived range. Additionally, we believe some caution is warranted in the short term as we have seen more participation from "tourist investors"—that is, those who follow momentum but do not usually invest in Japan longer term. That said, we believe there is no reason to avoid investing in Japan altogether at this point.

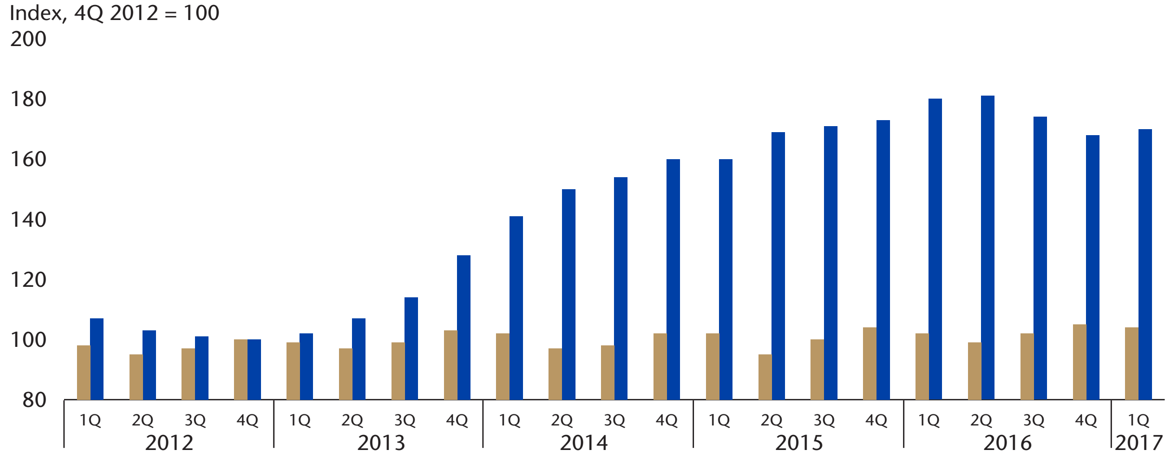
First, valuations have normalized and arguably are inexpensive relative to other developed markets. At the end of 1989, the Nikkei 225 was trading at a price-to-earnings ratio that in our view indicated a clear equity bubble. Unfortunately it took 20 years for multiples in Japan to normalize to global averages. With international investors experiencing an almost consistently underperforming Japanese equity market, there was little reason to be invested. Operating profits for Tokyo Stock Exchange-listed companies, meanwhile, have grown approximately 3.5x since 1998[1] and we expect profits to grow another 15% or so this fiscal year ending March 2018. This is not an apples-to-apples comparison as there are more listed companies today. It may surprise people, however, that Japanese companies have actually grown their profits significantly over the past 20 years. We continue to believe that the combination of normalized valuations and profit growth justifies having at least some exposure to Japan in a global equity portfolio.

Structural Improvements in Profit Margins

Second, from a bottom-up perspective, we are seeing encouraging improvements in profit margins, which we believe are structural in nature. A meaningful amount of supply-side reform is taking place in Japan and it does not get as much media attention as topics such as political elections and monetary policy. One example is in Japan's food and beverage industry, where we have seen many companies restructure their product portfolios, concentrate on core products and reduce wasteful marketing spending. We can point out more than a dozen companies in this sector that have seen profit margins double over the past five years. These companies have realized there is no point in competing over the shrinking domestic market and have turned their attention toward growing in overseas markets, particularly in Asia. As they seek to invest in growth overseas, they need their domestic business to be the "cash flow generator" to fund their investment overseas, prompting them to make more rational decisions about product development and pricing. In addition, from a regional perspective, China's role as a "price disruptor" is fading. For the past five to 10 years, China has been the price disruptor in the sense that Chinese companies overinvested in various sectors such as steel and petrochemicals. This overinvestment eroded the pricing power of companies trying to do business in China or across Asia. China is now conducting supply-side reform in sectors such as heavy industry in order to deal with environmental issues. This has restored pricing discipline in commodity products across Asia, which has also helped margins for Japanese companies that operate in that space.

Figure 1. Corporate Profit Growth Outpacing Real GDP

Index, 4Q 2012 = 100

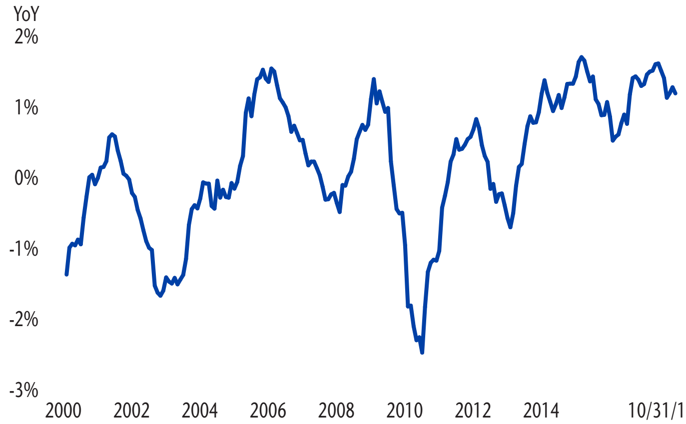


Source: Cabinet Office of Japan; FactSet Research Systems, Inc.

Wage Increases May Lead to Improved Pricing Power

Third, we are seeing stronger signs of future wage increases. The labor market in Japan is very tight and there is not going to be a lot of immigration that would otherwise solve this imbalance. Wages for part-time workers, who comprise approximately 40% of the workforce, are rising at over 2% this year[2]. A number of our portfolio companies are converting their part-time workers to full-time workers in response to this labor imbalance. We have invested in several business-services companies that benefit from the labor-tightening dynamic, including a provider of "outsourced" information technology (IT) engineers and a provider of temporary staff. We do not wish to overstate the argument that consumption will grow substantially because of these wage increases, but we do see tangible evidence of reflation as a result of these supply-side dynamics. Companies that have relied on easy access to low-cost labor (perhaps better phrased as "stagnant wages during Japan's lost decades") are struggling now and we expect to see some of these companies go out of business. Companies that are more productive and can afford to pay their workers more will enjoy a "survivor's benefit" as they consolidate market share. We believe that listed companies may see an improvement in their pricing power as they gain market share from smaller unlisted companies. We expect our portfolio companies to convert this opportunity into revenue growth and margin improvement.

Figure 2. Morgan Stanley Japan Hourly Wage Growth Indicator



Source: Japan Ministry of Health Labour and Welfare

All of the above has little to do with politics. Obviously having a stable regime has been quite positive for continuity of fiscal and monetary policies, but some of these dynamics should continue beyond the tenure of Prime Minister Shinzo Abe and Bank of Japan Governor Haruhiko Kuroda.

1 Source: Japan Exchange Group

2 Source: Japan Ministry of Health Labour and Welfare

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