Crossbow Partners
Experience & Discipline

Goldman Sachs Symposium in Tokyo

October 11 - 12, 2017

Executive Summary

Well organized and well attended conference with 65 hedge funds presenting and 150 investors attending

Shinzo Abe's re-election was very welcomed by the markets, as the Nikkei gained 16 days in a row – the longest streak ever – and reached a 26-year high

Since Abenomics started, most of the stock market advance has been driven by earnings growth while multiples have contracted

Japanese companies are adopting a more investor friendly western style approach with a strong focus on profitability and return on equity

There are very strong secular growth opportunities in Japan that can be found in the small and mid-cap space

The re-election of President Xi Jinping at the recently concluded 19th Party Congress bodes well for a continuation of reform in the Chinese economy

The Chinese government re-emphasized its commitment to focus on the quality of economic growth, reform the state-owned sector, continue to open up the economy, invest in innovation and combat pollution and climate change

Japanese economy and market outlook

The current economic expansion in Japan that started in 2013 with the emergence of Abenomics is now 58 months long and has surpassed the second longest economic expansion period since WW2 the so-called “Izanagi boom” (57 months from 1965 to 1970). Japan seems to be well on track to surpass the longest postwar expansion period, the “Izanami Boom”, which lasted 73 months from 2002 to 2008.

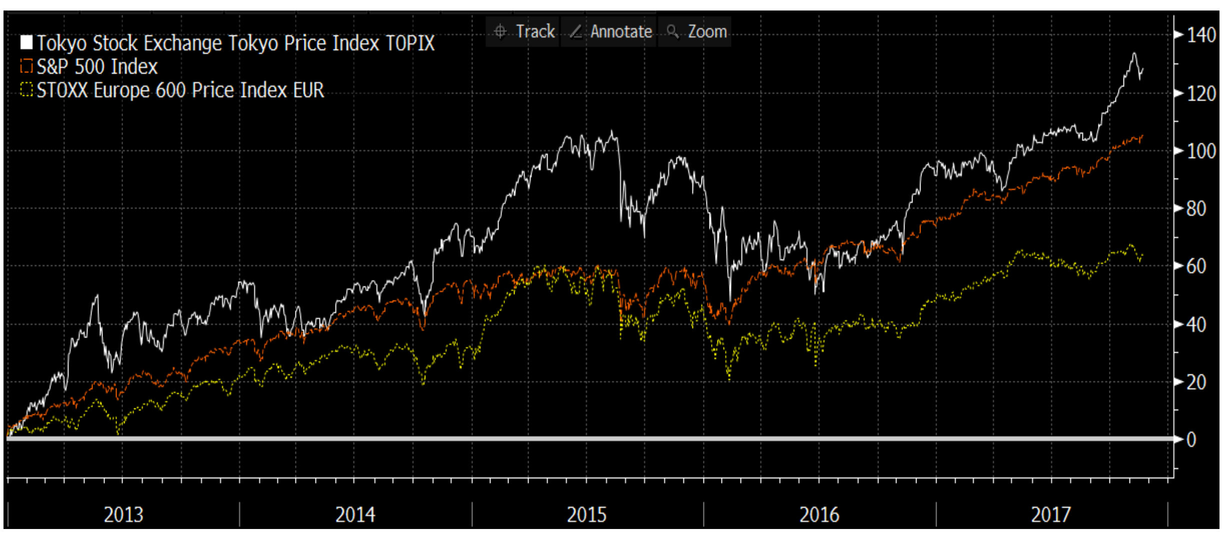
The impact of Abenomics

Consumer confidence has recently hit a 4-year high, business conditions are improving and unlike during the economic expansion before the global financial crisis, small businesses are reasonably upbeat. The unemployment rate has reached a 22-year low, corporate profits rose to record levels with Japan Inc. adopting a more investor friendly western style approach with a stronger focus on profitability and return on equity. Recently, the stock market reached a 26-year high.

	December 2012	October 2017	Change
USD/JPY rate	86.6	112.3	+29.7%
Unemployment rate	4.3	2.8	-1.5pp
Job offers to applicants - ratio	0.83	1.52	+0.69pp
Nikkei 225 Index	10'395	22'012	+112%
Topix Small Index	1'010	2'325	+130%

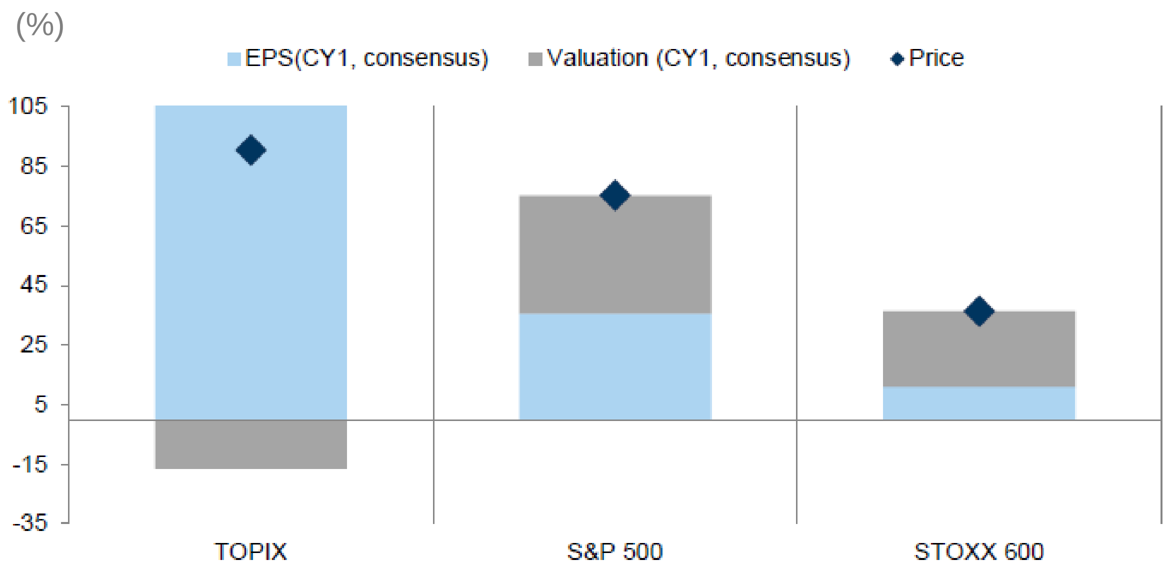
Source: Bloomberg, Japan Ministry of Wealth, Labour and Welfare, Ministry of Finance

Since the beginning of 2013, Japanese stocks have outperformed major developed equities in local currency terms:



Source: Bloomberg

Despite the strong outperformance, Japanese equities still trade cheaper than their US and European counterparts on a forward P/E basis. According to Factset, the forward P/E ratio for Japan stood at 14.2x, versus 17.9x for the US and 15.1x for Europe at the end of October. When comparing the different drivers of stock returns, one gets very interesting results. As can be seen on the following chart, the entire advance in Japanese stocks can be attributed to earnings growth, while valuations have contracted from 18x P/E to 16x P/E. This is different to the US or Europe, where multiple expansion has been more or less the main driver of returns.

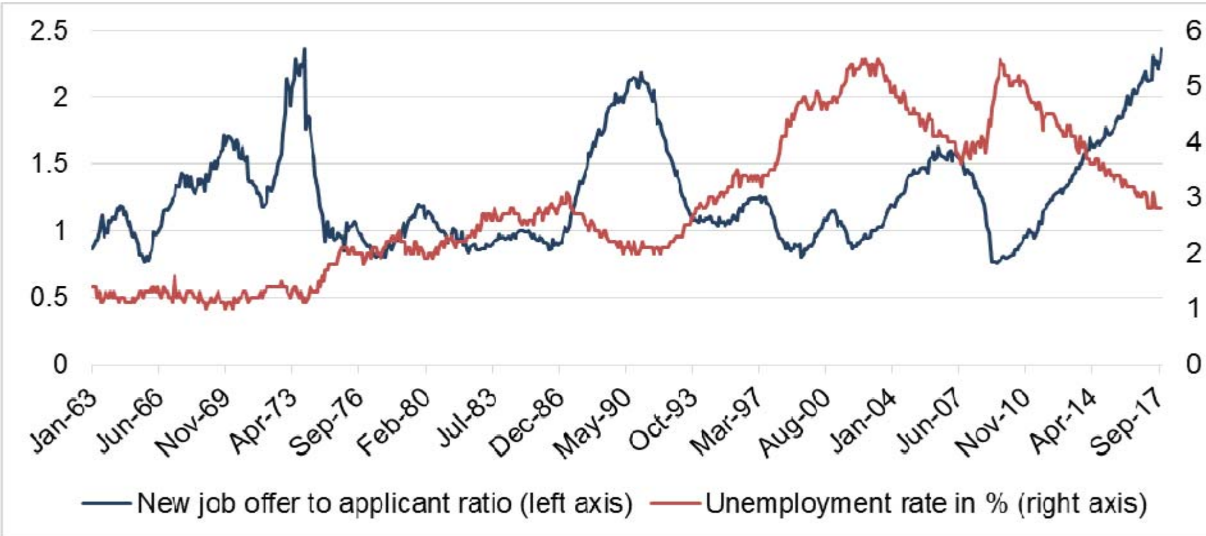


Source: Goldman Sachs

Given that Japan is perceived to be a large export nation, the expectations on the Nikkei's performance are closely linked to the expectations regarding the local currency, meaning that a weak JPY should lead to gains in the Nikkei and vice versa. Historically, this correlation has not always been true. From 2002-2006 for example, the JPY strengthened, while the stock market appreciated. When looking at Japan's GDP composition, exports account for only 16% while domestic consumption makes up 59% of GDP. From this perspective, investors should not be surprised to see a stronger JPY together with a stronger stock market as evidenced this year (+3% respectively +16%).

Job market

The Japanese job market is very tight, with an unemployment rate of 2.8% (lowest since 1993). The job offers to applicant-ratio of 1.5 just hit a 43-year high, meaning that there are 50% more job offerings than Japanese seeking jobs:



Source: Ministry of Health, Labour and Welfare

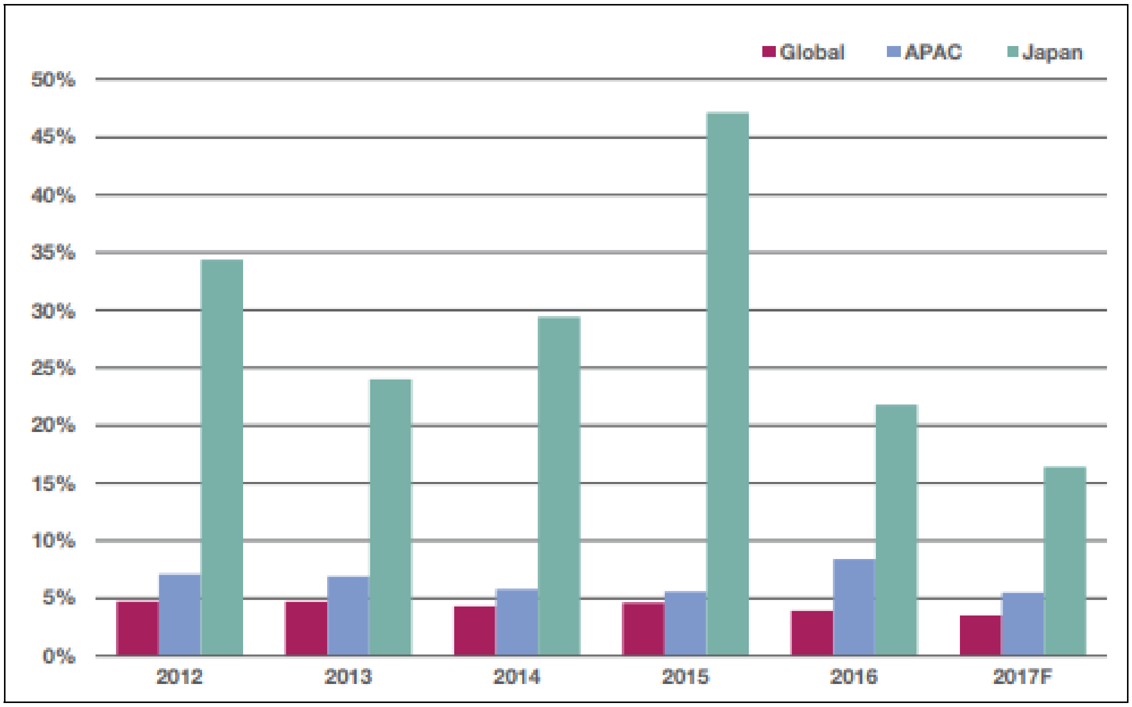
Looking at the labour participation, Japan is one of a few OECD nations at present which are reaching record high labour participation rates, as more women and elderly people are entering the workspace. On a proportional basis, there are today more women working in Japan than in the US. Current nominal wage growth is 2.7% and we are seeing evidence that wages and incomes are growing. Faced with the shortage of labour, Japanese companies are forced to invest in productivity enhancement. This comes at a time, when they are holding record amounts of cash. The total amount of cash held by Japanese non-financial corporations is about 40% of GDP which is four times higher than in the US (10%).

Small and mid-cap outperformance

Japanese small and mid-caps have enjoyed a nice outperformance in the last couple of years. When looking at Japan, most investors measure its performance versus other countries by citing the Nikkei 225 Index, which is a bit misleading. Given its price-weighted calculation methodology, just 10 companies make up 30% of an index which is comprised of over 200 companies. Those heavy weightings of giant conglomerates explain a large part of the underperformance of the index. Beneath the lumbering corporate giants that dominate Japan's main equity indices lies a tier of a small and mid-cap companies whose business models are typically more streamlined. There are many companies that experience high earnings growth due to some secular growth opportunities in Japan. Such opportunities can be found in nursing care, generic medicine, funeral services, work style reform (recruiting agencies), labour shortage (companies offering education, workforce re-training and automation solutions) etc.

Inbound tourism

An area of strong growth is inbound tourism. As part of its growth agenda, Prime Minister Abe set the goal to double the number of foreign tourists to 20 million by 2020. Having already met the target as early as 2016, the government has revised up its target to 40 million by 2020 and to 60 million by 2030. The number of tourists travelling to Japan has tripled since 2012 and visitation growth has outpaced the rates in the rest of the world by a wide margin:



Source: Savills World Research (2017 estimates)

The main inbound tourism growth driver have been Chinese tourists due to relaxation of their visa requirements. Last year they made up over 25% of total tourist flows to Japan. With the 2020 Tokyo Olympics in sight, tourism is one of the areas which will offer attractive investment opportunities in hotel chains, shopping malls, duty free stores, travel agencies, amusement parks, etc. There is still plenty of room to grow, given that the impact of tourism on Japan's GDP is still relatively low. Tourism income represents just 0.5% of GDP, significantly lower than in popular destinations in developed countries such as France (2.4%) and the US (1.3%).

Risks to the bullish story

It is important to acknowledge the growing geopolitical risk to the bullish Japan thesis, where North Korea is at the top of the list. There are growing concerns that the worsening rhetoric between Donald Trump and Kim Jong-un could lead an escalation of the situation with far reaching consequences for political stability and economic activity in the region.

On the monetary policy front, the BoJ is staying its course with keeping rates at zero and buying equity ETFs as they have not reached their 2% inflation target yet. On the other side, the US Fed has started reducing its balance sheet and is hiking interest rates (albeit at a slow pace) while the ECB will probably announce a further slowdown in the pace of its own quantitative easing program soon. Those measures will lead to a reduction of overall liquidity and will have a negative impact on the markets and the real economies of the world. However, current economic indicators show a very low probability of a recession within the next 12 months.

Domestically, the tail risk of an abrupt stop to Abenomics has faded with the outcome of the lower house elections in October 2017, where the ruling parties (LDP & Komeito) held on to their two-thirds majority. Prime Minister Shinzo Abe's win will bring continuity to monetary policy and signals further political stability to the markets, as he is likely going to be re-elected for a third term in the LDP presidential election in September 2018. This should give him further time to implement additional necessary reforms to further improve the economy and fight the headwinds of the aging population.