

Global Equity Observer

Signs of Life in Tokyo?

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Following the election of Emmanuel Macron in May this year and his success in the general election the following month, the market seems to have developed a crush on all things European. Expectations of recovering economic growth and a rejuvenation of the euro in a “two speed” Union has pulses racing. Twelve-month forward earnings expectations for the MSCI Europe ex UK Index have risen 17% since October 2016, with the index itself up over 20% in the same period. Meanwhile, on the other side of the world, Japan has been undergoing a major recovery of its own, largely without participation by foreign investors. Japanese earnings expectations rose 18% over the last 12 months and the MSCI Japan Index is up 25%.¹ However, despite the nominal similarity, there are significant differences between the two trends.

The year-on-year improvement of earnings expectations in Europe was driven by Financials, Consumer Discretionary, Industrials and Materials, which contributed more than half of the growth, while 90% of the earnings improvement in Japan came from Industrials, Consumer Discretionary and Technology.² The European earnings outlook, therefore, depends heavily on a cyclical recovery in commodity demand as well as hopes for rising interest rates. On the other hand, Japan has benefitted more broadly from a

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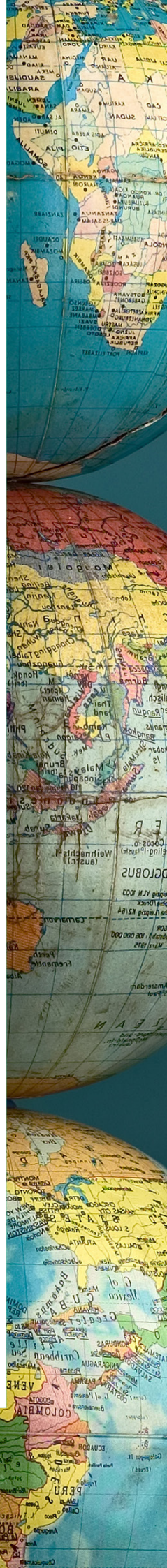
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“With the MSCI World Index trading at 16.8x 12M forward P/E, and the U.S. at 18.2x, the valuations for Europe ex UK stocks at 15.5x and Japan at 14.7x look positively attractive³ for global investors.”

¹ Source: FactSet, as of 31 October 2017.

² Source: FactSet/MSCI, as of 31 October 2017; Bloomberg.

³ Source: FactSet, as of 31 October 2017.



recovery in demand for its products as well as a significant improvement in margins – supported by helpful currency moves.

With the MSCI World Index trading at 16.8x 12M forward P/E, and the U.S. at 18.2x, the valuations for Europe ex UK stocks at 15.5x and Japan at 14.7x look positively attractive³ for global investors. One should note, however, that the delta between Europe and Japan widens further when the sector distribution is taken into account.⁴ With the exception of Consumer Staples and Health Care, which are much smaller sectors in Japan, the other sectors mostly trade at multiples below, and in the case of Industrials, well below, European valuations.

Following the recent re-election of Shinzo Abe, Japan has now become one of the few countries in the G7 with an elected government that relies on a majority traditional party. In the Eurozone, France is ruled by a president and party that have not been tested, while Germany struggles to create a new government and Italy faces elections in the new year. Meanwhile, the UK is struggling with Brexit and the U.S. is trying to find a modus operandi with its new president. That leaves Canada as the only other G7 member with a “traditional” political environment.

As a team, we have often been sceptical of Japan, mainly because the capital allocation decisions of Japanese management teams have frequently been hard to fathom. The return on capital of listed Japanese companies still stands at around half the level of the global market. Reasons for this vary but typically include expensive acquisitions, sometimes in areas where the acquirer has little expertise, large cross-shareholdings with little or no economic rationale, unnecessarily huge cash buffers, poor discipline on price, a high tolerance for inefficiencies and weak governance.

“Quality in Japan, when found, is the most expensive in the developed world... some 50% more expensive than our quality portfolios...”

As always, our approach as investors is bottom-up and fundamentally driven, but we do monitor Japanese government efforts to bring about change and we are beginning to see some improvement to returns across the market. For now, we have no Japanese companies in the portfolio. Frankly, we find quality is scarce in Japan, with only 12% of the market qualifying for the returns, margin and balance sheet profiles we look for. This is before any assessment of the quality of the franchise or management, which disqualifies the remaining names to very few indeed. Moreover, this scarcity comes at a price. Quality in Japan, when found, is the most expensive in the developed world, trading at a median FCF yield of 3.3%,⁵ some 50% more expensive than our quality portfolios which trade at just a 10% premium to the broader market for significantly higher quality. So for now, we wait in the wings for valuations to become more palatable, and for Japanese management to become more shareholder focused and returns-driven.

⁴ Source: FactSet, as of 31 October 2017.

⁵ Source: FactSet, as of 31 October 2017.

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The **MSCI Europe ex UK Index** captures large- and mid-cap representation across 14 developed market countries in Europe. With 336 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across European developed markets excluding the UK.

The **MSCI Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%.

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