The Intelligence Report

Our views on the latest investment events - FOR PROFESSIONAL INVESTORS - 10 October 2017

Overview

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Politics has been a recurring theme over the past several years, with more recent headlines provided by the escalation of tensions in the Korean peninsula, German election surprises, the latest twists in Brexit negotiations and dramatic developments in Catalonia. With so many new and complex stories to grab market players' attention, it is perhaps unsurprising that foreign investors have reacted somewhat nonchalantly to Japanese Prime Minister Abe's recent calling of snap elections – after all most investors are underweight Japanese assets and may feel that they therefore have little at stake.

However, the outcome of these elections, and their implications for future leadership, may have a significant impact on the outlook for monetary policy, asset prices and the yen in the months and years to come. In the first of our articles, Tony Glover takes advantage of this event to take stock of Japanese equities, analysing their prospects through focusing on such factors as earnings revisions, improvements in corporate governance, productivity and demographics.

In our second article we return to another recurring theme of recent years: the outlook for oil prices. Guillermo Felices argues that technological advances in shale production have changed the supply and demand landscape for oil, and analyses the outlook for oil prices in this context as firming demand meets a more elastic supply curve.

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Productivity gains: the hidden benefit of Japan's aging population

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Political uncertainty

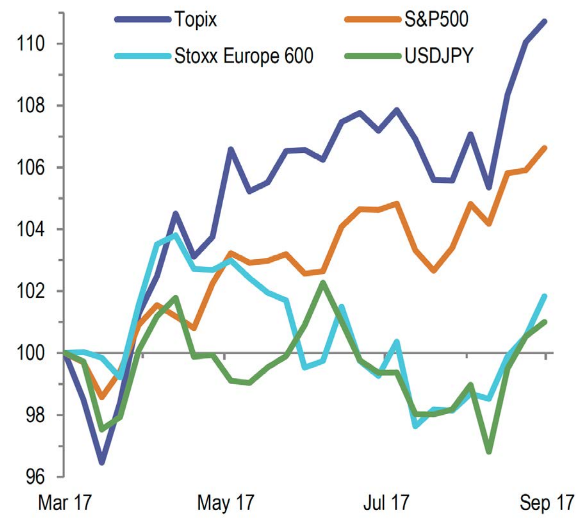
It's been a topsy-turvy year so far for Japanese Prime Minister Shinzo Abe and his cabinet. A number of political scandals led cabinet approval ratings to tumble in July to their lowest since Abe came back to power in 2012. But the summer recess of the Japanese Diet (parliament) meant less media focus on the alleged political shenanigans, and Abe stepped up to the plate as defender of Japan's national security in the face of rising tensions in North Korea. This was enough to bring about an improvement in the ratings to a point where Abe decided to call a national election in an attempt to strengthen his mandate. But with the emergence of Tokyo Governor Koike's Party of Hope and the changing political landscape in Japan, it is as yet far from certain whether Abe's gamble will pay off, or whether the outcome of his decision will mirror that of UK Prime Minister Theresa May's earlier this year.

It is nonetheless clear that we can no longer use the word 'stability' when discussing Japanese politics, and we certainly cannot use political stability as a reason for advocating holdings in Japanese equities. It would be worthwhile then to reflect on where we stand with this asset class, and look at some of the fundamental reasons for believing the country still deserves attention.

Performance

The Topix Index has outperformed other developed market indices since the start of the fiscal year, with the only slightly weakening over the period against the US dollar.

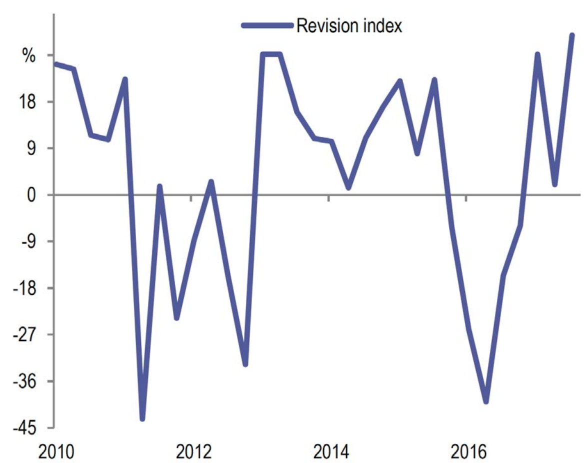
Figure 1. Recent market performance



Data as at 29 September 2017. 31 March 2017 = 100
Sources: Bloomberg, BNP Paribas Asset Management.

We see strong corporate earnings growth as the main reason for the index's performance. Current Nomura forecasts point to 13% YoY growth in recurring profits for the current fiscal year for companies in the Russell Nomura Large Cap Index, which would be just over a 10 percentage point increase on the previous fiscal year[1]. But perhaps even more startling is the large number of corporate earnings revisions in the past few months. The graph below shows that the revision index has reached levels not previously seen this decade[2].

Figure 2. Revision index, Russel Nomura Large Cap Index



Data as at 30 September 2017. 31 March 2017 = 100
Sources: Nomura, BNP Paribas Asset Management

The sectors and segments with the largest improvement include chemicals, automobiles, electronics, and trading companies. We expect some further upside if the yen stays at its current level - the most recent quarterly Bank of Japan Tankan survey[3] indicated that the USD/JPY exchange rate predicted by large manufacturing companies for the current fiscal year was 109.29. The yen is currently trading above this rate, i.e. it is cheaper. We would like to stress, however, that earnings growth has not all been about the yen's value. Volume growth, cost-cutting efforts and price increases were all cited as factors underpinning (manufacturing sector) earnings growth in the most recent quarter[4].

Valuations

While we believe that valuations are a further reason to have a bullish stance on Japanese equities, it is not as clear-cut as it has been in recent years. We have been saying to clients that Japan looks comparatively cheap, from both a historical and geographical perspective, but now we suspect that only the latter is true. We use 15x forward-looking price-to-earings ratio as a 'rule-of-thumb' for fair valuations. Currently, Topix is trading at only slightly below that level (14.9x)[5]. It looks as though stock prices have caught up with the pace of EPS growth, and we can no longer say that the market is cheap from a historical perspective. It does, however, still look cheap from a geographical perspective. The table below[6] shows that both large and small cap Japanese equities are trading at levels below those of other developed markets.

Figure 3. Global index valuations, this fiscal year

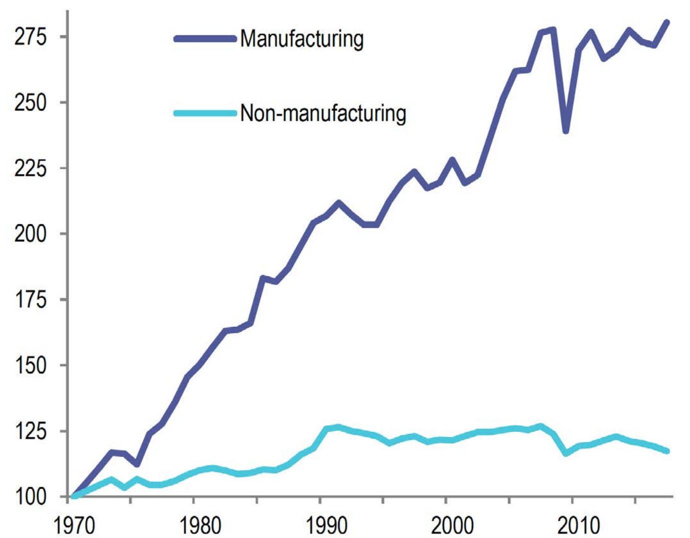
	PE	PBR
Topix	14.9	1.3
S&P 500	19.2	3.2
MSCI Europe	16.0	
Topix Small	16.6	1.2
Russell 2000	32.6	2.4
MSCI Europe Small	19.4	

Productivity improvements

We continue to believe that improvements in corporate governance in Japan can be an important driver for the stock market in the coming years. We are not just talking about increases in dividends and shareholder buybacks, which have been increasing. We believe that the change in the corporate mind-set that we have seen since the start of Abenomics can lead to a more efficient use of capital, for example investment in high growth-potential areas, or to increase productivity.

We think that the latter is particularly important. The most recent OECD Economic Survey of Japan[7] points out that Japan's labour productivity is around 25% lower than that of the top half of OECD countries, and points to some of the reasons: a widening productivity gap between manufacturing and non-manufacturing sectors, a lack of economic dynamism at small firms, and the low share of entrepreneurs in the workforce. We see the first of these, shown in the graph below, as the most important and is actually a reason for optimism.

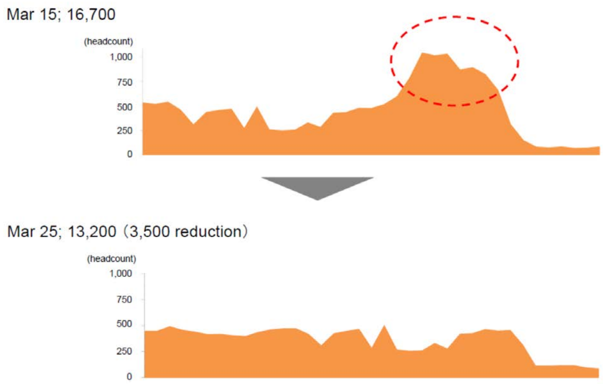
Figure 4. Japan productivity Index



Data as at 30 September 2017. 1970 = 100
Sources: OECD, Japan Productivity Center, BNP Paribas Asset Management

Our view is that the perceived demographics 'problem' in Japan can have a big role to play in improving non-manufacturing sector productivity. The following is a page from an investor conference presentation[8] from Mitsubishi UFJ Financial Group showing the planned reduction of their retail banking workforce (although not labelled, the X-axis is the age of their workers, from fresh graduates to retirees).

Figure 5. Anticipated workforce reductions



Sources: MUFG - Note: Simulation based on present data

The circled 'bump' on the graph shows a large number of workers in their fifties, hired in the 1980s. Such employees tend to be the most expensive due to seniority-based pay structures. The left axis of their 2025 projection shows the company's hiring plans for the next 10 years at around 400 a year: i.e. its idea of an efficient number of workers per age group. It follows that a large portion of current workers in their fifties (the 'bump') are considered as an 'excess' above this efficient level. We believe that many non-manufacturing companies in Japan have similar excess employees, which has led to a lack of incentive to invest (e.g. in IT technology) to change workflows and improve labour productivity. Put another way, they have excess human 'capital' that is difficult to let go. This might have even led to companies choosing to diversify into non-core activities to keep these excess workers in employment[9].

So Japan's demographics 'problem', which will see a large number of workers retire over the next 10 years or so, should help companies return to their normal employment levels, incentivize investment to increase labour productivity and permit a renewed focus on core businesses. We are hopeful that this will lead to higher real wages ('good' wage inflation), and are pleased to see that Abe has prioritised labour market reform policy. It just remains to be seen whether he is still in power at the end of the month to push such reforms through.

1. Source: Nomura Equity Research, September 2017
2. Revision index calculated by: (no. of estimate increases - no. of estimate reductions) / no. of companies x 100, source: Nomura Equity Research, September 2017
3. Source: Bank of Japan, September 2017 Survey, released on 2 October 2017
4. Source: Daiwa Securities, October 2017, breakdown of profit boosting factors
5. Source: Bloomberg, as at 4 October 2017
6. Source: Bloomberg, as at 4 October, current fiscal year, using Bloomberg 'BEST' estimates.
7. Source: 2017 OECD Economic Survey of Japan, April 2017. www.oecd.org/eco/surveys/economic-survey-japan.htm
8. Source: MUFG Homepage, from BoA Merrill Lynch Japan Conference, Sept 2016. Via Macquarie Securities
9. N.B. In our view, foreign competition combined with operating overseas has forced Japan's manufacturing sector into productivity improvements, which is not the case in non-manufacturing (and generally domestically focused) sectors.

Crude market outlook – the new oil era

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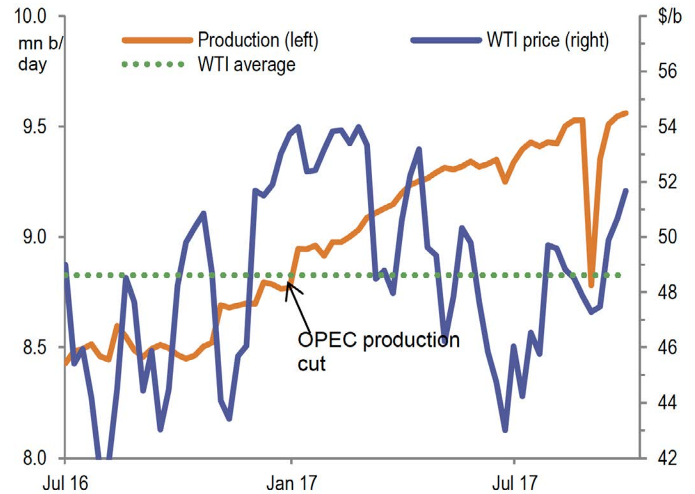
Crude oil prices have been volatile this year. For example, WTI prices fell by close to 21% between early January and late June, and since then they have bounced back by 18%. These moves have been within a USD 40-60/bbl trading range, which is quite narrow compared with previous intra-year swings. The main reason behind this tighter trading range is that we have entered a new era for crude oil supply, one that is characterised by the continued rapid expansion of US shale production. This production boost has overwhelmed OPEC's efforts to cut supply; it is only in the last few months that prices have marched higher again, helped by stronger demand growth. But we expect the upside to be limited as we foresee US shale supply growth capping price gains over the next six to 12 months.

Supply – US shale is key

Technological advances in the extraction of US shale oil are defining a new era for crude oil supply and prices. US shale production has increased rapidly since 2012 and has played a major role this year. After falling by 12% from mid-2015 to mid-2016, US crude production (of which 48% was extracted by shale producers in 2016, according to the IEA) has bounced to close to the mid-2015 highs.

WTI prices rose in November last year following OPEC's announcement of production cuts, the first such cut in eight years. However, the rally proved short-lived and WTI prices fell sharply in the first half of 2017, suggesting that the increase in US supply was more than offsetting the prospect of OPEC cuts (Figure 1). In the last few months prices have bounced back, but in our view, this reflects stronger demand growth and falling inventories, especially in the US where stocks are at multi-year highs.

Figure 1. US crude production up, WTI prices down year to date



Data as at 29 September 2017. Source: Bloomberg, BNP Paribas Asset Management

One of the key characteristics of US shale production is that efficiency gains have materially reduced the costs of producing crude. According to Barclays' research, for example, close to 80% of shale producers operated at a cost of below USD 60/bbl in late 2016. Furthermore, their research also suggests that such costs of production have fallen further recently. In other words, innovations in the extraction of crude oil from shale fields are still ongoing. This has two clear implications for prices. First, they are likely to stay below their levels prior to the shale boom. Second, it suggests that shale production can respond rapidly when demand picks up, i.e. US crude supply is much more elastic than in the past.

Demand – the unsung hero

Despite the downward pressure on prices exerted by US shale producers, demand has been the unsung hero of the crude oil market. Demand growth was robust in the years that followed the global financial crisis and has gradually picked up in 2017 in line with stronger global GDP growth.

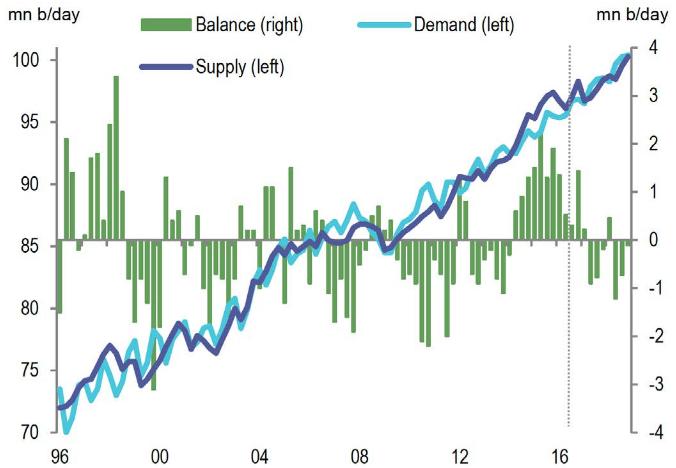
Demand from emerging market (EM) economies (non-OECD demand, in oil market jargon) has been the main source of the latest strong growth, and we expect this continue to be the case over the next few quarters. We assume an annual growth rate of around 1.7%, the average year-on-year growth rate since the global financial crisis.

Oil market balance – from surplus to slight deficit

Combining our assumptions for demand growth with our assumption of a very gradual increase in OPEC supply from 2018, and a 5% increase in OECD supply (the same pace as in the 2010-15 shale boom years), we forecast a slight deficit in the global crude market over the next year or so. This follows at least three years of surpluses that coincided with the sharp correction in WTI prices from c. USD 105/bbl in mid-2014 to below USD 30/bbl in early 2016 (Figure 2).

Another indicator that suggests a tightening crude oil market is the crude futures curve. The front-end of the Brent futures curve, for example, recently shifted from contango (an upward-sloping curve) to backwardation (a downward-sloping curve) after close to three years. This means that demand pressure on supply in the physical (spot) market is pushing prices higher at the front end of the Brent futures curve relative to contracts further out on the curve.

Figure 2. Demand to outpace supply in H2, leading to a deficit in 2017-18



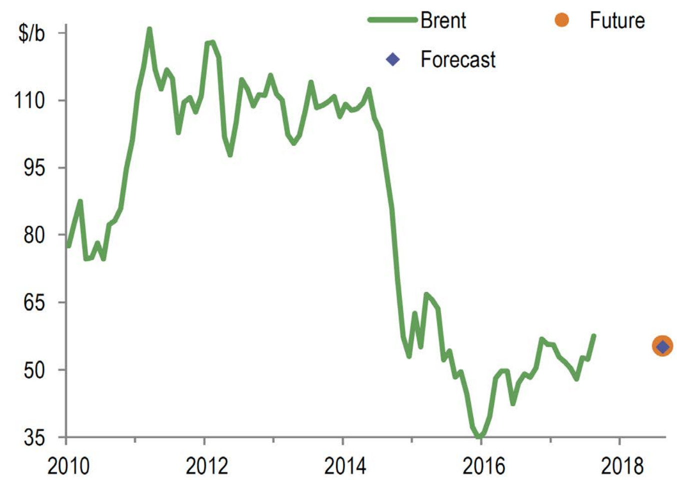
Data as at 29 September 2017. Sources: Bloomberg, BNP Paribas Asset Management

Price forecasts – limited upside

Looking ahead, we still see crude prices in a range between USD 40-60/bbl. This range is only a reference, of course. US shale production should cap the upside since supply responses are likely to be quick and large as prices approach the upper bound. At the same time, as prices approach the lower bound, OPEC is likely to threaten the market with sharper production cuts, which should help put a floor under prices.

Furthermore, because demand is picking up, we would expect prices to drift above the mid-range point of USD 50/bbl in our baseline scenario. We therefore forecast Brent at USD 55/bbl and WTI at USD 52/bbl in 12 months' time (Figures 3 and 4).

Figure 3. Brent spot, 12-month futures prices and 12-month forecasts



Data as at 29 September 2017. Sources: Bloomberg, BNP Paribas Asset Management

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