

BREXIT – JAPAN EQUITY UPDATE

In light of the significant volatility ensuing from the results of the EU Referendum in the UK, we share our initial thoughts on the evolving situation as well as provide an update on the strategy you are invested or have an interest in and the implications of the event on the broader investment landscape in Japan.

Effect of the UK Vote to Leave EU on the Japanese Market

On 23 June, the UK held a referendum asking voters to decide if the country should remain in the EU. The final results were announced on the morning of 24 June (in the afternoon on the same day in Tokyo) with the option to “Leave” the EU winning by a slight margin over the option to “Remain”. Right up until 23 June, financial markets around the world had risen as they priced in a victory for Remain. However, once it became clear that Leave would prevail, Japan’s Nikkei Stock Average (Nikkei 225) saw a sharp drop, falling over 1000 points or almost 8% on 24 June^B. In addition, on the foreign exchange market, the yen strengthened against the US dollar to below JPY 100 for the first time in two years and seven months. The euro also temporarily fell 7% against the yen, while the pound fell over 10% against the US dollar, dropping to its lowest point in about 30 years.

For the time being, demand is expected to grow in financial markets for the relative safety of the yen and the US dollar. As a result of the stronger dollar, companies with USD-denominated debt will see their repayment burdens increase. In addition, there are concerns that emerging countries will have no choice but to tap into their foreign exchange reserves in order to prevent a flight of capital. Should the stagnating political and economic situation in Europe lead to investors withdrawing from the market, the effect would likely be felt on stock markets globally.

With regard to the Japanese equity market, it is still too early to determine if the UK’s exit from the EU has been fully factored into stock prices so far. Over the short term, concerns remain that the yen will continue to strengthen against the US dollar and the euro, and that global stock prices may continue to decline. However, if financial markets were to see significant turmoil, we believe that there would be a high likelihood of central banks in the US, Japan and Europe swiftly issuing a joint emergency statement and taking steps to increase the supply of US dollars to the financial markets. As a result, we do not think that the current situation will result in a crisis of the same magnitude of the Global Financial Crisis.

As for the foreign exchange market, in terms of purchasing power parity, we believe the US dollar at about JPY 100 has become a point of reference for the market. With the dollar/yen at this level, the TOPIX has a forward EPS of about 90.

Since 2013, the average P/E ratio for Japanese stocks has been about 14x. However, to take a slightly more conservative view, we assume for our analysis an average forward P/E of 13x, which puts the TOPIX at about 1180 points and the Nikkei 225 at around 14,600 yen¹. Additionally, a P/B ratio of 1x for Nikkei 225 names would result in the index hovering around the 14,500 yen level, which should also provide downside support to stock prices.

In the medium term, if uncertainty toward the global economy increases due to the current turbulence in the financial and foreign exchange markets, this would weigh on investment sentiment of corporations and result in a slowing of capital spending, which would inevitably have an impact on corporate earnings.

¹ Based on the NT ratio of 12.4x. The NT ratio is the Nikkei 225’s level divided by that of the TOPIX

Appendix

Below is the Nikko AM in-house forecast for the TOPIX range assuming an exchange rate of JPY 100 to the US dollar and a forward EPS of 90.

Estimated TOPIX range based on EPS & P/E (FY16 consolidated forecast)

		P/E	12.0	12.5	13.0	13.4	14.0	14.5	15.0
		EPS				(3/31)			
↑ Increase from current level	+20%	108.0	1,296	1,350	1,404	1,445	1,512	1,566	1,620
	+15%	103.5	1,242	1,294	1,346	1,385	1,449	1,501	1,553
	+10%	99.0	1,188	1,238	1,287	1,325	1,386	1,436	1,485
	+5%	94.5	1,134	1,181	1,229	1,265	1,323	1,370	1,418
	-	90.0	1,080	1,125	1,170	1,204	1,260	1,305	1,350
↓ Decrease from current level	-5%	85.5	1,026	1,069	1,112	1,144	1,197	1,240	1,283
	-10%	81.0	972	1,013	1,053	1,084	1,134	1,175	1,215
	-15%	76.5	918	956	995	1,024	1,071	1,109	1,148

Note: The TOPIX is estimated using the forward EPS for FY17 (based on consolidated ordinary profits excluding loss-making companies); forward EPS is 90.0 with the yen calculated at 100 JPY to 1 USD

Source: Created by Nikko AM with data collected from Toyo Keizai etc.

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