Kimura Dreamvisor Newsletter Summary 10th July 2006

Companies' earnings improvement trend looks to be long term…

The surprising consequences of workers global arbitrage.

Looking at it worldwide, companies' profitability is enjoying a positive trend not witnessed in the past. In addition to a financial friendly environment with BOJ ZRP (zero rate policy) and FRB accommodate financial strategy, they benefited from developing countries investment boom and succeeded at the same time to expand earnings and lower prices thanks to shifting from developed countries expensive labor force to developing countries cheap labor.

Recent stock markets falls do not stem from investors questioning as to how long this will continue but rather the consequences of this. BRIC's stock prices have shown volatile movements. This is not due to a bull trend breaking away with main countries earnings level but more with a typical bubble correction (this was the case when Japan tested new lows three years ago).

As we are close to the end of financial easing central bankers do not plan a severe tightening that would dampen worldwide economy but rather are trying to initiate an environment where world growth rate could continue at a sustainable cruise speed (around 4 % maybe).

I want to stress global workers arbitrage consequences within the United States.

United States have made good use of the US$ strength in the 80's and IT revolution since the 90's by setting up production bases overseas and closing domestic unprofitable plants. Recently even Software development is slowly shifted to India or China

This may be tough for the domestically dumped workforce but companies have to choice to act before competitors in order to maintain or expand market share. It is q question of survival.

As a direct consequence US middle collars type workers population has been on the decrease .In addition the workforce contribution within added value has been on the decline, said in other words the workforce contribution percentage has been lowered resulting in widening gaps for wealth repartition. However this also brought solid profit expansion. US companies net earnings amounted to 150 billion US$ in 1986, 500 billion US$ in 2000, 1.2 trillion US$ in 2005 and even for current fiscal year this figure is going up by 10 % !

The process cannot be described in a simplistic way: i.e., just shifting high salary paid workforce to cheaper developing countries workforce. Companies have to always keep ahead in terms of new technology or know-how introduction in a globalized marketplace. In that sense global companies who succeeded can now enjoy a strong position.

Japanese companies experienced double whammy of bubble expansion and burst plus huge Yen appreciation nor to mention repeat financial crisis and were late in the cycle to recognize IT global workers arbitrage implied changes. Furthermore Japanese companies were late in riding the IT revolution. IT revolution and global workforce arbitrage were recognized altogether from 1998. This has hurt earnings of numerous companies in Japan but finally companies have taken the problem seriously and are now in the process of ripping the fruits of their efforts.

It looks highly probable that current Japanese workforce contribution percentage will remain stable and low.

As I wrote previously if companies' restruturation goes forward competition decreases and industries profitability goes up. This is especially true for industries that succeeded to go totally global up the point new competitors just cannot materialize (Microsoft, Merck). Global industries are quick to grasp the IT innovation and world workforce arbitrage.
Speaking about workforce worldwide arbitrage, comparative labor cost is not the sole focus. In Japan the interesting point lies with differences between regular employees and part time employees for service industries like supermarkets for example (the same goes for foreign workforce of Japanese car makers & affiliates). The social cost of a standard employee is 20 % higher than simple wages payout, nor to mention that such type of regular employees cannot be employed and dismissed in a flexible way,
In the Nikkei Business 10th of July edition there was an article nicknamed 'the century discrepancies'? The article was of course focusing on global industries workforce arbitrages victims but inside the article a worrying graphic was published. The part time employee percentage evolved from 20,1 % in 1994 to 32,5% in 2005 but workforce contribution percentage decreased from 54,3% to 51,5%. Even if earnings improved the arbitrage leading to low wage employees had a substantial impact on earnings.
As Japanese supply demand situation in the job market remain tight recently the fact that bonus are on the rise has sidelined the decrease of workforce contribution ratio to added value. However considering that baby boomers retirement ratio will raise by the end of current fiscal year the uptrend in part time employees is going to continue

unabated. Therefore the upward pressure on wages remain limited I believe. Numerous retired employees are seeking re-employment but with lower wage requirements.
As a consequence even if Japanese companies forecast only a +5,1% rise in sales considering they can restrain employees cost this way the fixed costs burden will remain relatively low thus leading to further current earnings rise.
Japanese companies' business model has changed. They now focus on profitable niche markets and aim at keeping strong positions in such niche markets. This strategy seems to have evolved in the new standard format. In addition the fact that Japanese companies are increasing Asian sales percentage within their global sales should be considered as a very positive development. As only Asian markets show strong expansion.
Now Coming back to the US, provided the finished products price and wage gap remain, outsourcing from high priced countries to low priced countries will continue to support earnings improvement.
Regarding Japan, as above mentioned, pressures on wages increase will continue and companies are in a position to maintain earnings growth.