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BOJ tankan allows upside potential

Companies’ earnings forecasts are conservative but should be revised upward.

BOJ tankan published on 15th December show that industrial DI has been moving above forecasts for more than 3 months in a row, next three months should be slightly down as earlier forecasted. This did not surprise market but investment and employment figures negate any immediate economic slowdown. This led to core stocks basket buying. Obviously buyers are cautious about Nikkei 225 reaching fast the 17,000 level however previous October’s high was broken on the upside allowing further upside. This said TOPIX rose to 1663 and did not overcome previous October’s high at 1672.

Tankan shows that there is further upside potential for companies’ earnings. Large companies and industrial production sales were revised + 1,0 % at + 4,7 %. Breaking down this figure gives first half +6,7 % and second half +3,0 %, which equals to 1% upward revision for the full year. Current full year earnings were revised +5,1 % at real +6,6 % which looks convincing but against first half revised + 13 % leading to + 14,8 % growth, second half was revised –1,6 % implying –0,6 % profit decrease. Foreign exchange basis has been revised from 111,31 to 113,40 recognizing Yen weakness, consequently second half downside revision looks dubious. Said in other words as full year earnings upward revision were all but postponed, second half figures were made low on purpose. I believe that we should have a one shot rush upside revision toward the end of current fiscal year

Large companies in the service sector are even more conservative. Sales were revised +0,8 % leading to real + 4 % YOY. Breaking down this figure gives first half +5,5 % increase and second half + 2,6 %, this is more or less the same pattern as industrial sector. Service sector current earnings pattern is also similar to industrial sector. Full year earnings were revised + 3,8 % leading to +5,2 % earnings increase but first half was revised +12,6 % translating into +14,4 % current earnings growth, meanwhile second half revised down 4,5 % implying current earnings down 2,8 %. The discrepancy in forecasts between first and second half is even clearer for non-manufacturing sector. If we pay attention to current profitability (current earnings/sales) first half was 4,54 %. Although earnings continue increasing second half profitability decreases to 3,44 %. Clearly I can’t trust this and we are bound for a substantial upward revision later.

For the full fiscal year mid caps industries show +4,4 % current earnings increase, small cap industries +2,0 % but in both cases again second half forecasts are archconservative. Industrial production DI for large and mid to small caps alike has kept its highest level since bubble burst. Excluding non-manufacturing mid small caps DI the overall figure is clearly trending in positive range. In fact industries are too conservative as they are concerned about future ‘overlap scale’ and if this is perceived at face value by the market then it cannot lead to a bull market.

Reasonable equipment investments increase is much welcomed.

Current economic expansion is mostly driven by foreign demand and export industries, domestic demand recovery is trailing and it looks difficult to become too optimistic. This said,

companies are planning their expansion in orderly manner without over recruiting or over investing (although they claim to invest a lot). We had rather weak figures for machinery and equipments investments recently but companies are just avoiding the excess investment risk.
Employment DI is slightly down YOY, Manpower shortage is severe. Few companies are aggressively recruiting as this could lead to uncontrolled labour cost expansion. Companies are trying to make the most efficient use of their equipments using a limited pool of employees. This is the most efficient method to increase profits when market new entrants flow leads to price war.

Despite the unusual length of current economic expansion phase, uneasiness about future prospects lead to growth healthy control. Excess investment, inventory adjustments and prices sharp fall fear cycle is perfectly kept at bay.
Excluding specific industries like pulp paper I believe most industries profitability will continue increasing.

As there is no profitability problem companies should continue registering increased earnings next fiscal year. According to company's handbook latest version for March 08 all industries are expected to see +4,2 % sales increase, +8,7 % current earnings increase and +9,7 % after tax profit increase. Overseas sales contribution level will be more important than domestic level on both profit margin and growth rate. As we can expect stock prices to rise side by side with earnings increase then I would say it is reasonable to expect stock prices to rise 10 % on average next fiscal year (even without a new specific bull surge). Putting aside unexpected factors I believe that this scenario will slowly filter down the market by January February 07.

Next week BOJ meeting is focusing market's attention, for now current hypothesis are Yen further weakness toward 118 (BOJ postpones rates tightening) or bond market sold in a row (rates tightening possibility) but whatever scenario I believe we should not care too much. I do not think current situation calls for rate to be tightened in a hurry; I believe BOJ will postpone tightening. In addition I personally believe US economy will show weakness in the New Year, unless US ISD shows a quick bounce I believe that BOJ tightening probability is low for current calendar year.

Japanese equities would be sensitive to a continuous weak US ISM much more than BOJ tightening itself.