Japan Macro Strategy

Investment strategy for rising wages

Economics

Japan

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Summary

Macro viewpoint on beneficiaries of rising wages

Our view is that rising nominal and real wages will drive consumption in H2 2015. On top of package tours, recreation services and restaurants, we think we can look for recovery in automobiles, clothing & footwear and household durables from the drop after the consumption tax hike. On the other hand, there is the risk of a rise in food and energy prices. Although The Indices of Tertiary Economic Activity show an inverse correlation between rising food and energy prices and areas such as recreation services and overseas travel, there is little correlation with clothes, food & beverages and domestic travel, and these can perhaps be seen as sectors relatively unaffected by rising prices.

Is an upturn to wage growth the starting point for retail stock bull market?

Our first thought that comes to mind in response to rising wages is the impact on retail sector earnings. Although it is hard to quantify the cause-and-effect relationship between these two, such a relationship appears to exist over time in that rising wages are followed by earnings recovery. What this observation suggests in particular is the importance of wage growth sustainability. Robust growth in retail sector OP in the past has occurred after recovery in real wages, but retail OP gains have been particularly strong after sustainable wage growth. Although we are still in the initial stages at present, this may be a good time for long-term investors to load allocations to the retail industry.

Key points for retail sector investment

Retail sales still lack any momentum, but we believe are solidly underpinned. From here on we will also need to keep an eye on trends in imported goods prices in light of the weakening yen and on the associated inflation trajectory, while also monitoring the impact of seasonal bonuses and improving sentiment. The capacity to handle the weaker yen and pass costs along into prices can easily open up a gap in earnings in the retail sector, and we highlight this in stock selection. Specifically, we believe confidence in earnings recovery scenarios could grow for retailers seeking differentiation through intrinsic product appeal (for example, Fast Retailing, Nitori, Seven-Eleven), as well as at firms such as United Arrows (7606) and Yamada Denki (9831) if demand picks up for clothing & footwear and durable goods, which were weak following the consumption tax hike.

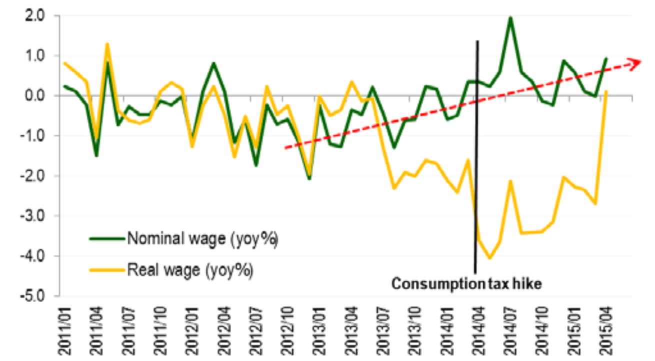
Macro viewpoint on beneficiaries of rising wages

Gradual acceleration in wage growth continues

Real wage growth turns positive, Consumer Confidence Index also improving

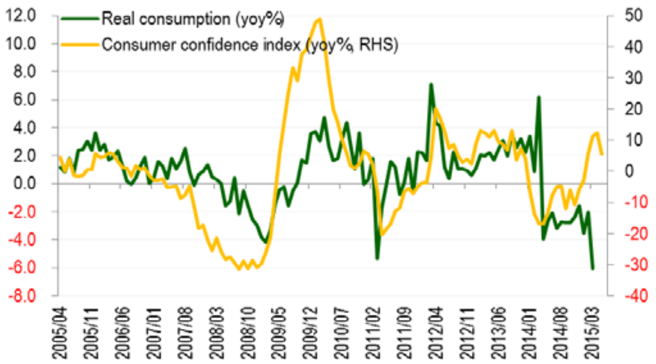
April nominal wage growth stood at +0.93% yoy, the highest level since July 2010 except during bonus periods, and real wage growth turned positive for the first time since April 2013 at +0.1% yoy. Our view is that wages will continue to rise from here on, given factors such as the tightening labour market and rising output prices in the manufacturing sector, as well (Figures 1, 2). The Consumer Confidence Index, which correlates closely with consumption, also continues to improve.

Figure 1: Real wage growth finally turns positive



Source: Ministry of Internal Affairs and Communications, UBS

Figure 2: Consumer sentiment in recovery



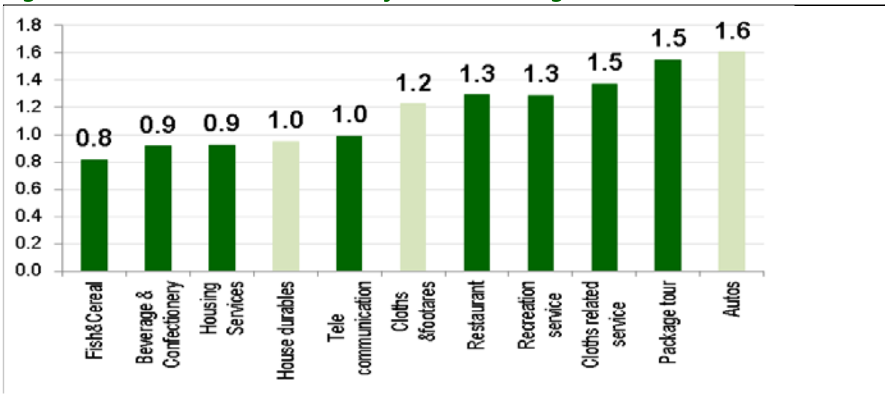
Source: Ministry of Finance, Cabinet Office, UBS

Consumer goods at the front line of buying when incomes rise

Consumer goods with nominal income elasticity of at least 1 tend to benefit

Looking at the elasticity of consumer goods to nominal income growth based on the Family Income and Expenditure Survey, elasticity is high for automobiles and clothing & footwear among durable goods, and areas such as package tours, clothing related services, recreation services, and restaurants among non-durable goods. We think we can also look for a rebound in household durables from reduced buying after the consumption tax hike.

Figure 3: Nominal income elasticity of consumer goods

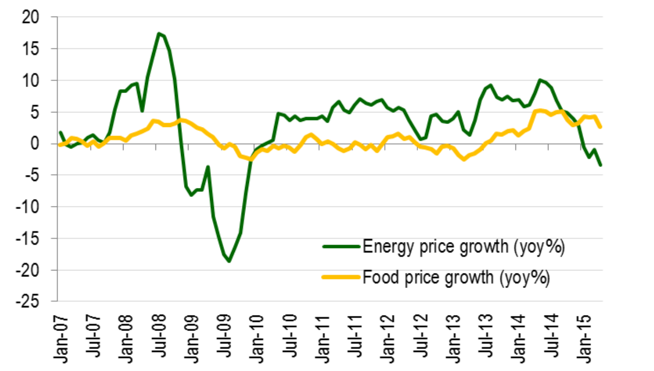


Source: Ministry of Internal Affairs & Communications, UBS Note: Pale bars denote durables/semi-durables

However, points of concern are rising food prices and the resumed climb in energy prices. Although the increase in food prices is slowing (Figure 4) the index has risen to an all-time high (106.5). Although energy prices are still down yoy at present, there is the risk of a return to growth into summer because of the rapid recent fall in the yen.

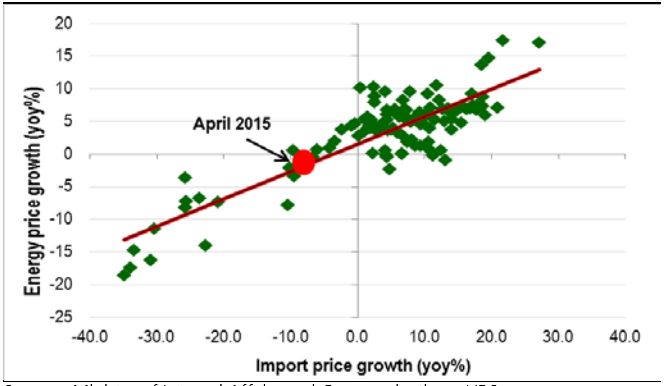
Risk of persistently high food prices, resumed rise in energy prices

Figure 4: Yoy growth in food and energy prices



Source: Ministry of Internal Affairs and Communications, UBS

Figure 5: Energy prices to stop falling due to weak yen

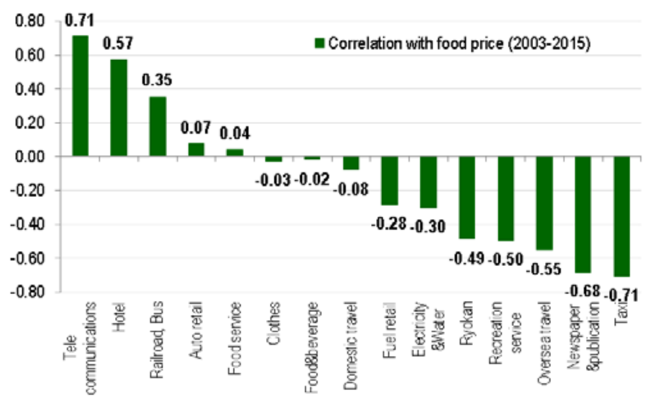


Source: Ministry of Internal Affairs and Communications, UBS

Consequently, we expect consumer goods that are resilient to rising food and energy prices to continue to perform well. We have plotted the correlation between industries in The Indices of Tertiary Economic Activity and the respective price indexes (Figures 6, 7). Rises in prices for both have an inverse correlation with areas such as recreation services and overseas travel, but there is little correlation with clothes, food & beverages and domestic travel, and these can perhaps be seen as sectors relatively unaffected by rising prices. Correlation is negative for taxis but positive for railways & buses, and negative for *ryokan* (traditional inns) but positive for hotels, and we think this shows an element of substitution.

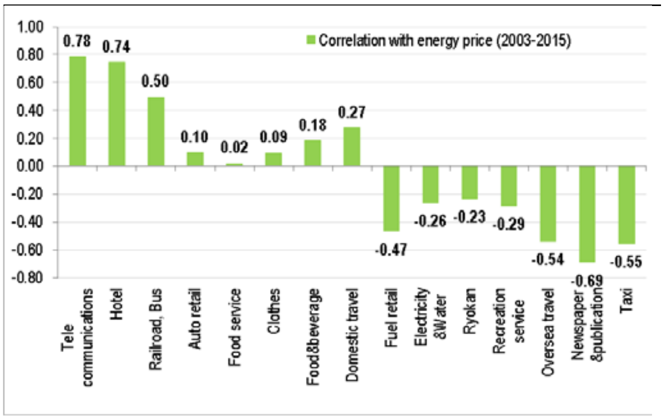
Industries relatively unaffected by rising food, energy prices

Figure 6: Correlation between food prices and industrial activity



Source: Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, UBS

Figure 7: Correlation between energy prices and industrial activity

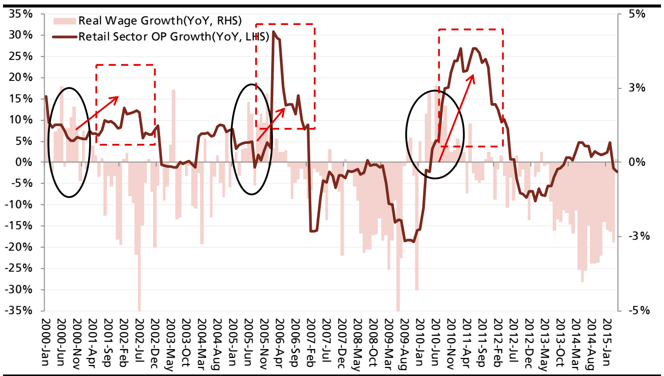


Source: Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, UBS

Is upturn to wage growth the starting point for retail stock bull market?

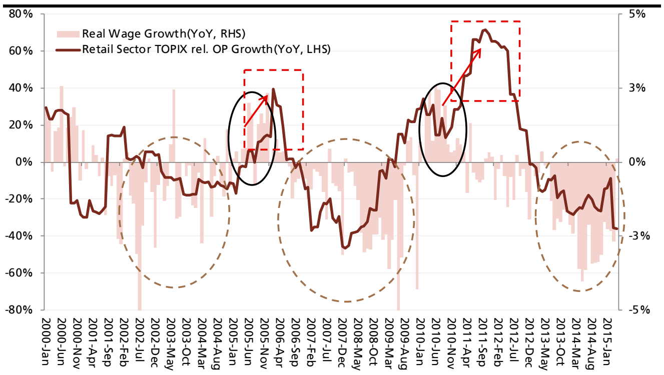
It is easy to imagine a connection between recovery in real wages and recovery in consumption, but there are wide swings in both wages and profits over time, while growth/contraction in consumption is affected by countless factors other than wages, and rising wages are unlikely to be reflected immediately in consumption growth, so it is hard to quantify the supply-demand relationship. That said, comparing trends in real wages and OP growth rates does appear to show some kind of causal relationship between the two, in line with the initial image.

Figure 8: Growth in real wages and in retail sector OP



Source: Bloomberg, UBS

Figure 9: Growth in real wages and in retail sector OP (relative to TOPIX)



Source: Bloomberg, UBS

Key is 'sustainability' of wage recovery

One thing we can say with a high degree of certainty is that once sustainable real wage growth is confirmed, earnings in consumption-related sectors climb a long way, after a certain time lag. During the past two periods of strong recovery in wages and earnings, earnings recovery and growth have generally peaked after wages have risen consistently for 8–10 months both in absolute terms and relative to TOPIX, and it is fair to conclude that consumers increase consumption to the extent this affects corporate earnings once they have confirmed that wages have picked up sufficiently. In particular, in growth rates relative to TOPIX, earnings also fall convincingly in periods of faltering real wage growth, and this trend is clearly evident. Although slightly off-topic, we think conspicuous recovery in retail sector profit growth relative to TOPIX after the Lehman Brothers collapse was solely because of the defensive nature of domestic demand plays as other cyclical sectors plummeted. Be that as it may, the key point in wage growth is 'sustainability'. Sustained growth gradually improves consumer sentiment, and the ensuing transfer into actual consumer behaviour could affect corporate earnings.

We recommend long-term investors increase retail sector weightings from now on

In other words, we would expect a step-up in consumption-related share prices in the event real wage recovery continues over the coming few months, and we think the retail and service sectors are relatively attractive investments, at least in cyclical terms. We believe it might not be too late to make major allocation changes once sustained recovery has been confirmed, but glimpses of this have already started to become evident at present, so we recommend long-term investors in particular to increase weightings in retail.

Key points for retail sector investment

Retail shares have risen in anticipation of upturn in real wages

The value of retail sales has swung widely, falling 9.7% in March but rising 5% in April. However, this was because of the demand rush ahead of last year's consumption tax hike and the subsequent retreat, and compared with two years ago retail sales value edged up 0.2% in March and 0.5% in April. Although lacking in any great momentum, we believe retail sales are solidly underpinned by the upturn to positive real wage growth and ongoing recovery in consumer sentiment. That said, retail shares have outperformed since the start of this year, and prices may already presuppose recovery in real wages as the impact of the consumption tax hike winds down. At the individual share level, share prices have even risen on some companies for which it is unclear when earnings will bottom, looking ahead to the future.

For stock selection from here on we flag differences in ability to cope with weakening yen, inflation

From here on we think will also need to keep an eye on trends in imported goods prices in light of the weakening yen and on the associated inflation trajectory, while also monitoring the impact of seasonal bonuses and improving sentiment. Pricing strategies affect both sales and margins in the retail sector, so the ability to deal with the weakening yen and to pass costs along into prices can easily lead to differing earnings, and we highlight these for stock selection. Specifically, we think retailers such as Fast Retailing, Nitori and Seven-Eleven that seek differentiation through intrinsic product appeal may continue to find support from customers even after the tax hike impact has wound down, and their relative superiority could open up still further. Among these we like furniture retailer Nitori (9843) for the growth potential and margins driven by its product strategy and store-opening drive, and we rate the company a Key Call Buy. We believe confidence in earnings recovery scenarios could also improve at firms such as United Arrows (7606) and Yamada Denki (9831) if demand picks up for clothing & footwear and durable goods that were weak following the consumption tax hike, in line with our economist Daiju Aoki's analysis.

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Neutral	FSR is between -6% and 6% of the MRA.	43%	33%
Sell	FSR is > 6% below the MRA.	12%	20%
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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 March 2015.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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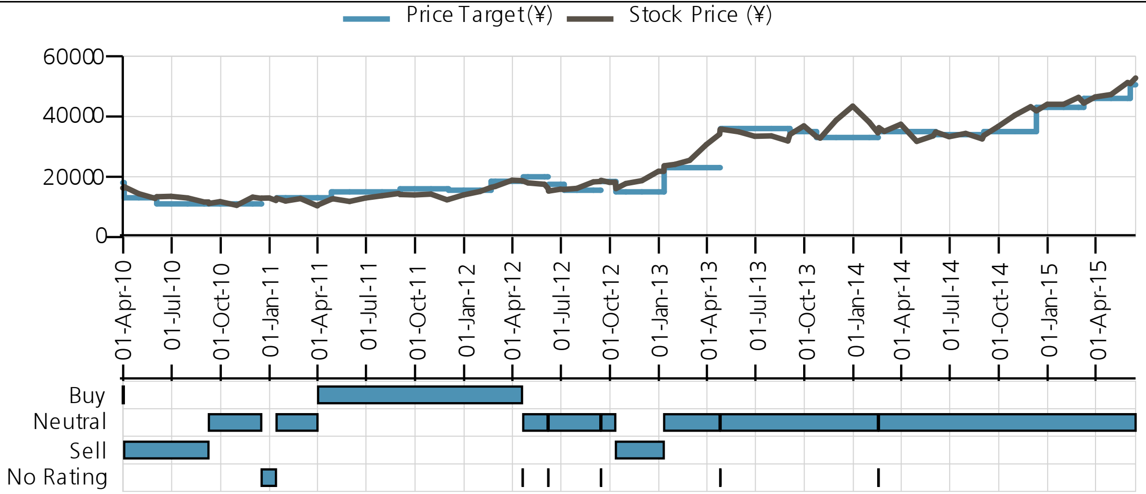
Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Fast Retailing	9983.T	Neutral	N/A	¥52,740	15 Jun 2015
Nitori Holdings	9843.T	Buy	N/A	¥9,170	15 Jun 2015
Seven & I Holdings	3382.T	Neutral	N/A	¥5,171	15 Jun 2015
United Arrows	7606.T	Buy	N/A	¥3,855	15 Jun 2015
Yamada Denki	9831.T	Buy	N/A	¥518	15 Jun 2015

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

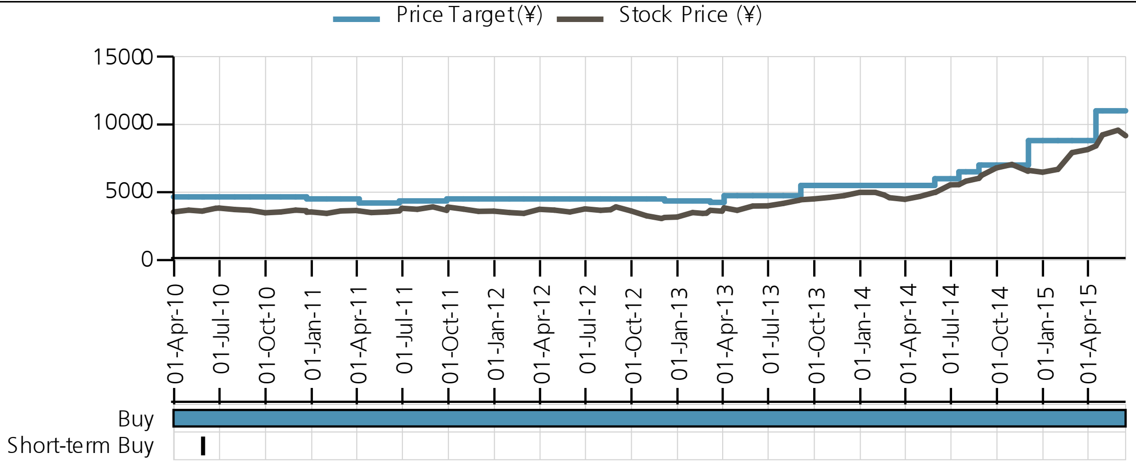
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Fast Retailing (¥)



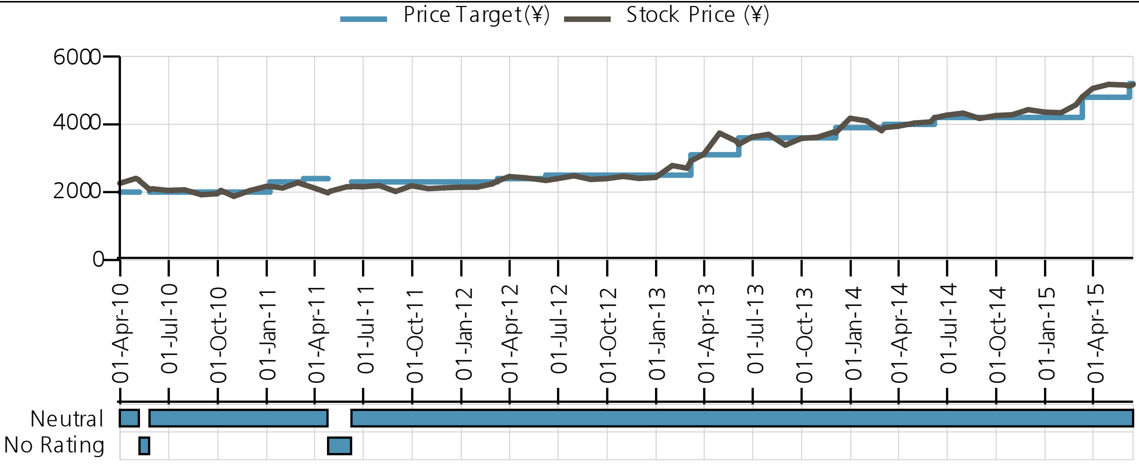
Source: UBS; as of 15 Jun 2015

Nitori Holdings (¥)



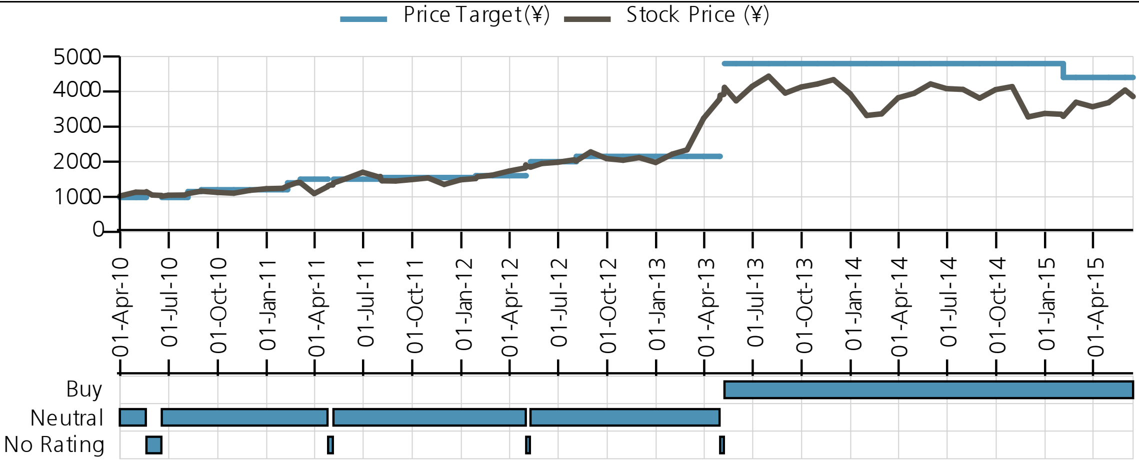
Source: UBS; as of 15 Jun 2015

Seven & I Holdings (¥)



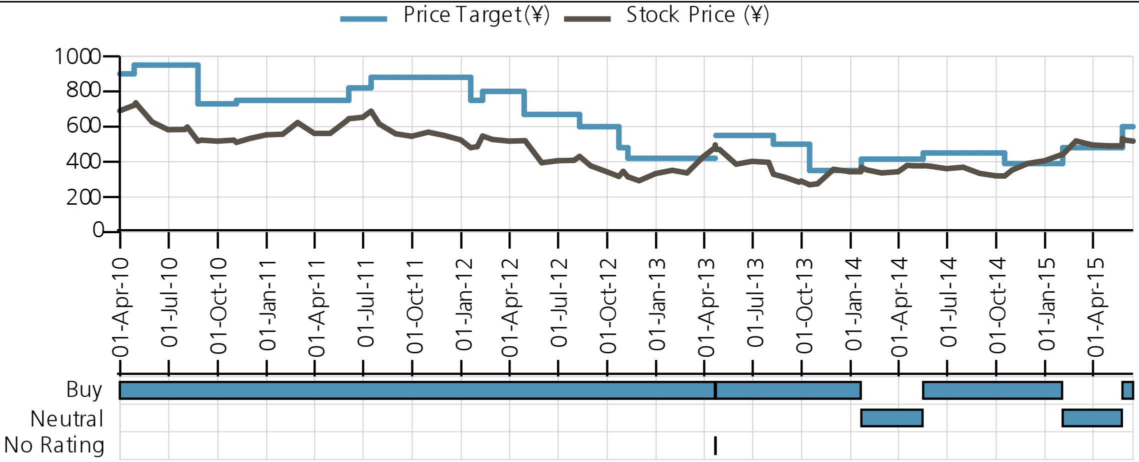
Source: UBS; as of 15 Jun 2015

United Arrows (¥)



Source: UBS; as of 15 Jun 2015

Yamada Denki (¥)



Source: UBS; as of 15 Jun 2015

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