

Focus on Japanese corporate earnings in view of normalising economic activity

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- ▶ During the January-March quarter of 2021, the level of recurring profits for the manufacturing sector in Japan (seasonally adjusted, annualized) exceeded that of the pre-COVID-19 pandemic in FY2019. While the profit level in the non-manufacturing sector has also recovered, it only recovered by around 80% in comparison with the same period.
- ▶ While the manufacturing sector has recovered faster, there are renewed concerns about the deterioration of Terms of Trade due to rising commodity prices. We think that two of the main areas investors will focus on with FY2021 corporate earnings (Apr 2021 – Mar 2022) are the impact of this deterioration on profits and recovery of sales momentum.
- ▶ We expect the normalisation of economic activity around the world to provide a tailwind for the recovery of corporate earnings in Japan. In the manufacturing sector, higher sales volumes associated with increased global demand will offset downward pressure on profits caused by worsening Terms of Trade, while in the non-manufacturing sector, the ongoing vaccination program is expected to boost domestic consumer demand.

Yuko Iizuka
Economist

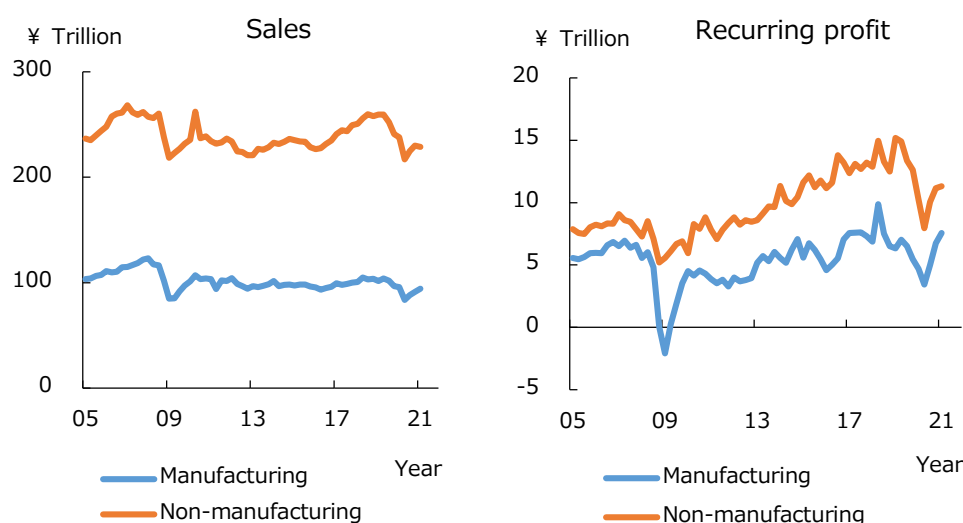
In 2021, as the economic recovery in the United States became clearer and Europe gradually picked up, a state of emergency (SoE) was declared twice in Japan due to the re-emergence of COVID-19. These SoE covered mainly large metropolitan areas and were applicable during the periods from early January to mid-March and from late April to mid-June. Domestic consumption was affected, especially face-to-face activities, although the impact was not as significant as during the first emergency declaration in 2020.

According to the Surveys for the Financial Statements Statistics of Corporations by Industry from the Ministry of Finance, top line growth for all industries (excl. finance and insurance) was -3%. On the other hand, recurring profits for the same segment were +26%, turning positive for the first time in eight quarters. One of the reasons for the year-on-year increase in recurring profits is that the figures for the January-March quarter in the previous year, which is used for comparison, already reflected a level of impact from the COVID-19 pandemic.

“Recovery in recurring profits in the January-March 2021 quarter driven by the manufacturing sector”

Comparing the level of the January-March quarter in 2021 (seasonally adjusted, annualised) with the level in 2019 before the COVID-19 pandemic (Figure 1), in the manufacturing sector, sales were only 95% of FY2019 level, but recurring profits have recovered to 30% above FY2019 levels, indicating that margins have improved. In the non-manufacturing sector, on the other hand, sales have recovered to 93% of the FY2019 level, while recurring profits represent only 85% of the FY2019 level. It is obvious that there is a divergence between the recovery of corporate performance in the manufacturing and non-manufacturing sectors.

Figure 1 : Sales and Recurring Profit (seasonally adjusted)



Period : From Jan.-Mar. 2005 to Jan.-Mar. 2021 (Quarterly)

Note : Seasonally adjusted, all market capitalization, all industry ex. finance and insurance, by Financial Statements Statistics of Corporations by Industry, Ministry of Finance Japan

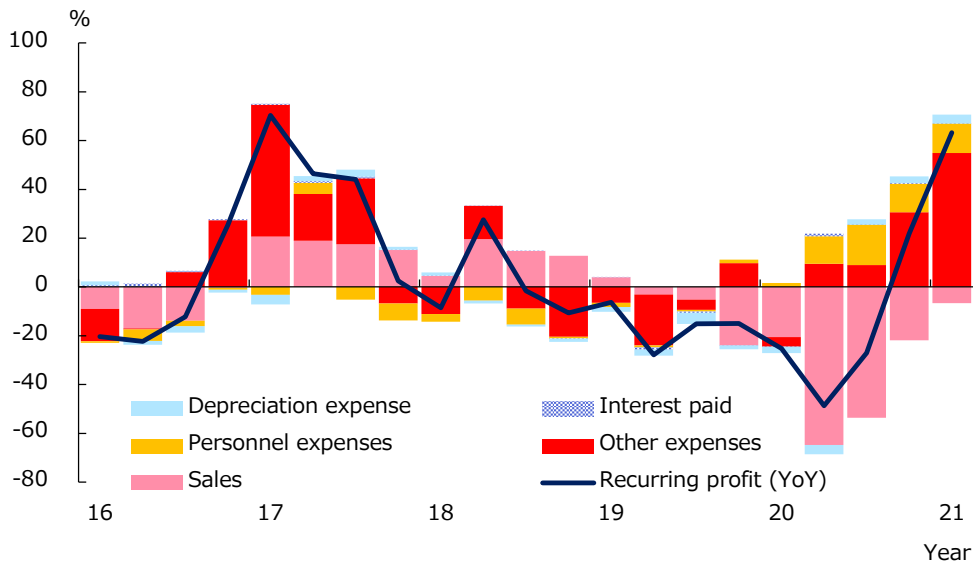
Source : NEEDS-FinancialQuest

To explore the background to the disparity between the manufacturing and non-manufacturing sectors, we break down the factors that have contributed to the year-on-year change in recurring profits since 2020. In the manufacturing sector, after the start of 2020, the rapid spread of COVID-19 led to lockdowns around the world, which in turn led to a sharp fall in exports. In addition, disruption to supply chains also adversely affected production activity.

In particular, sales fell sharply in the April-June 2020 quarter. On the other hand, variable costs, personnel costs, and other expenses decreased due to sluggish business activities. In the second half of 2020, the recovery in exports and production, along with the reopening of the global economy, resulted in a narrowing of the decline in sales and an increase in recurring profits (see Figure 2).

“Drivers of change in company performance from 2020”

Figure 2 : Attribution analysis of recurring profit (Manufacturing)



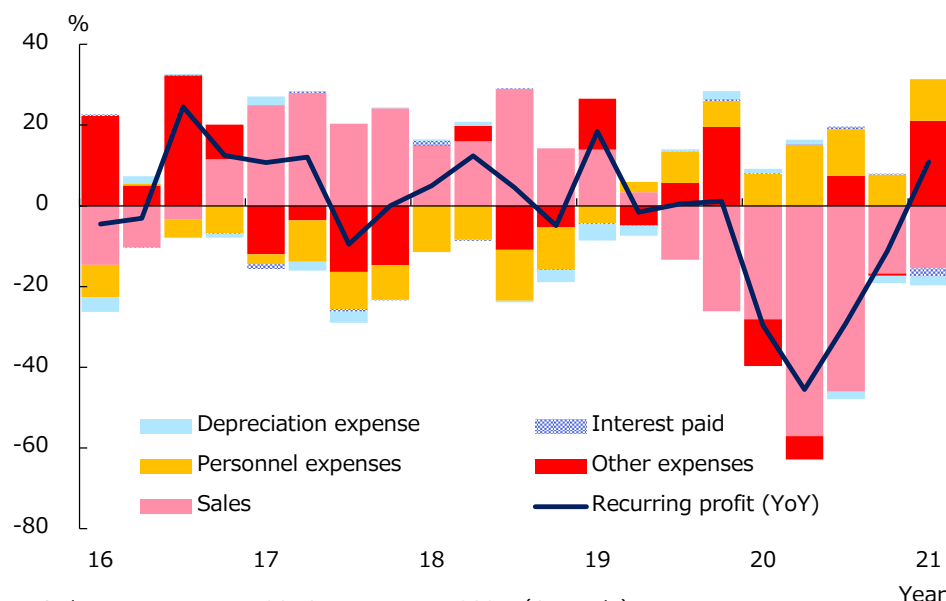
Period : From Jan.-Mar. 2016 to Jan.-Mar. 2021 (Quarterly)

Note : All market capitalization, all manufacturing, by Financial Statements Statistics of Corporations by Industry, Ministry of Finance Japan

Source : NEEDS-FinancialQUEST

In the non-manufacturing sector, the first state of emergency was declared in Japan in the April-June 2020 quarter, resulting in a significant drop in sales as retailers and restaurants were asked to close and people were requested to refrain from going out. Since then, measures to prevent the spread of the virus have remained in place and the decline in sales has continued. Although the decline in recurring profits has been halted by the reduction in labour and other costs, the slow recovery in sales has weighed on the sector (see Figure 3).

Figure 3 : Attribution analysis of recurring profit (Non-manufacturing)



Period : From Jan.-Mar. 2016 to Jan.-Mar. 2021 (Quarterly)

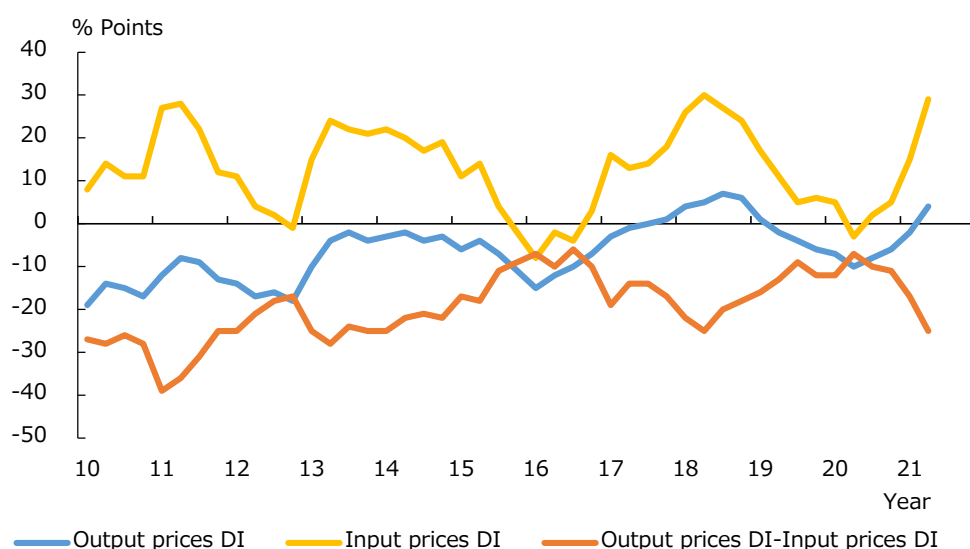
Note : All market capitalization, all non-manufacturing ex. finance and insurance, by Financial Statements Statistics of Corporations by Industry, Ministry of Finance Japan

Source : NEEDS-FinancialQUEST

While profits have recovered in the manufacturing sector, some have begun to express concern about the impact of deteriorating Terms of Trade. As economic activity begins to normalise, particularly in China, the US and Europe, there has been a notable rise in the price of commodities such as crude oil, steel, timber and non-ferrous metals. According to the Bank of Japan's Tankan survey in June, the Diffusion Index (DI) for input (purchase) prices rose sharply from the view of corporates, and Terms of Trade, as calculated by subtracting the DI for input prices from the DI for output (sales) prices, has worsened (Figure 4).

“Concerns over downward pressure on profits through deteriorating Terms of Trade”

Figure 4 : Price Diffusion Index (DI)

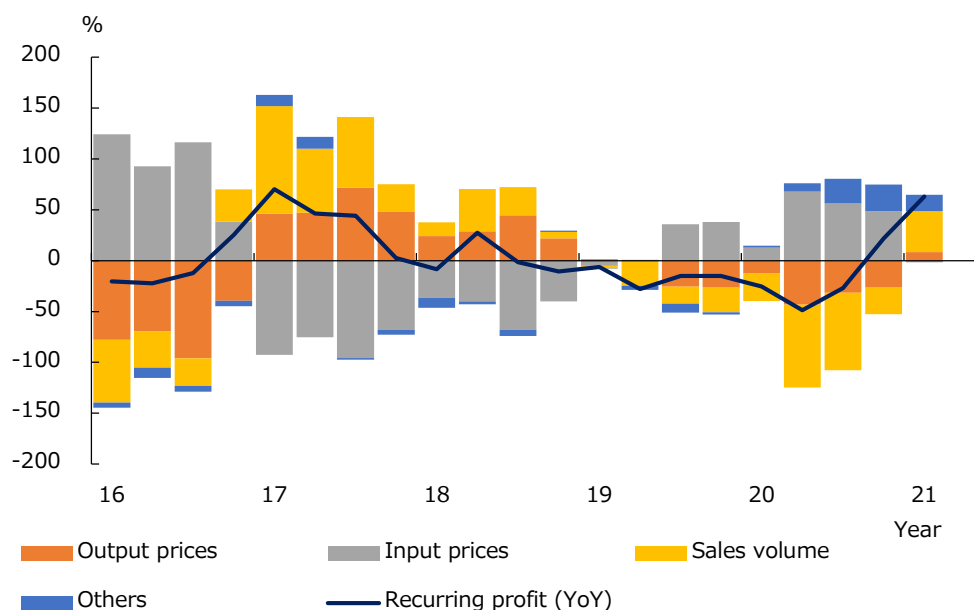


Period : From March 2010 to June 2021 (Quarterly)
 Note : TANKAN by Bank of Japan, Large Enterprises of Manufacturing, DI is calculated by 「Rise」 - 「Fall」
 Source : NEEDS-FinancialQuest

Decomposing profits by incorporating the factors of input and output prices shows that the fall in the input prices contributed to boosting profits in 2020 (Figure 5, Input price factors played a role to boost profits in 2020). Given that rising commodity prices will exert downward pressure on profits through worsening Terms of Trade, we should keep an eye on the trend in forecasting corporate results over the coming years.

For FY2021, the focus will be on the impact of worsening Terms of Trade due to higher commodity prices in the manufacturing sector and the recovery of demand in the non-manufacturing sector.

Figure 5 : Attribution analysis of recurring profit using input and output prices (Manufacturing)



Period : From Jan.-Mar. 2016 to Jan.-Mar. 2021 (Quarterly)

Note : All market capitalization, all manufacturing, by Financial Statements Statistics of Corporations by Industry, Ministry of Finance Japan

Source : NEEDS-FinancialQUEST

It is important to note that in the manufacturing sector, the impact of commodity price increases on profits varies by industry. According to the statistics of the input-output price index of the manufacturing sector, some of the materials industries, such as chemical products, iron and steel, and non-ferrous metals, have been able to pass on the rising input prices to customers by raising output prices. The processing industries, on the other hand, tend to find it difficult to pass on rising costs to their customers. However, the recovery in global demand that has caused rising commodity prices is expected to lead to an increase in sales volumes for these industries.

For example, in the automotive industry, the shortage of semiconductors for automotive applications in the first half of this year is expected to gradually dissipate in the second half of the year, and with global demand recovering, we anticipate the positive effect of increasing sales volumes will outweigh downward pressure on profits caused by worsening Terms of Trade. In addition, demand for Japanese industrial machinery, including semiconductor manufacturing equipment is increasing amid the global shortage of semiconductors, and exports of machinery-related products, such as industrial robots to China, are also on the rise.

“Normalization of economic activity around the world to provide tailwind for corporate earnings recovery”

In Japan, restrictions on businesses are still in place, particularly in the service sector in large cities in order to prevent the spread of the disease. However, Japan is making solid progress with its vaccine rollout. Prime Minister Suga's target of one million doses per day has been achieved, and we are now looking at the possibility of completely vaccinating those who wish to be vaccinated by October or November. For the service sector, the easing of restrictions on economic activity thanks to vaccination progress is the first step towards a recovery in revenues. In fact, the June 2021 Consumer Attitude Index, which measures consumer attitudes, is approaching the level it was at the beginning of 2020, before the pandemic began to take hold.

Going forward, we believe investors need to consider the possibility that the cost reduction and increased efficiency levels achieved during the pandemic through digitalising operations can be maintained and even enhanced as the economy continues to normalise.

There is still a possibility that it will take some time for economic activity to fully normalise due to the re-emergence of variant strains of the virus. Also, we need to pay attention to the risk of a prolonged rise in commodity prices. However, we believe that the normalisation of economic activity around the world will provide a tailwind for the recovery of corporate earnings in Japan. In the manufacturing sector, we expect that the negative impact of worsening Terms of Trade on earnings will be offset by higher sales volumes due to rising global demand, while in the non-manufacturing sector, the ongoing spread of vaccines in Japan is set to boost consumer demand.

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