Mizuho Economic Outlook & Analysis

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Impact of the global economic slowdown on corporate earnings

Even though the impact on ordinary profits should be limited, watch out for a dampening of business sentiment

< **Summary** >

◆ Amid wavering expectation toward global economic growth, a decline in overseas sales and sluggish exports from Japan are leading to concerns over corporate earnings. Its impact is already surfacing in the sales of overseas affiliates (USD basis) of Japanese companies.

◆ However, corporate earnings are currently solid due to the yen depreciation and fall of crude oil prices. Nonetheless, there are concerns that the global economic downturn may affect business sentiment, prompting firms to refrain from active capital investment.

◆ The possibility of a further global economic slowdown of the global economy or prolonged economic downturn requires ongoing attention. Signs of a downturn of business sentiment - which are not always visible in corporate financial reports - must be watched closely.

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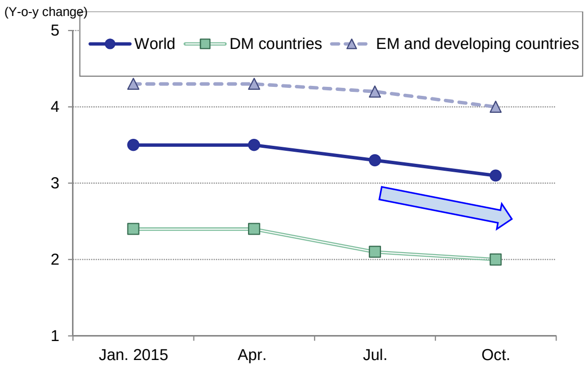
1. Rising concerns over global economic slowdown

Amid wavering expectations toward the economic growth of emerging market ("EM") countries, concerns regarding global economic slowdown are rising. Anxiety over the outlook on the Chinese economy is particularly strong. Given its position as the second largest economy in the world, attention is gathering over the spillover of China's economic slowdown to the rest of the world.

In the IMF's *World Economic Outlook* released in October, global economic growth was slashed by 0.2% point to 3.1% from July of the same year. This was the second consecutive downgrade of growth since the beginning of 2015, and should be noted that the downgrade involved not only the EM countries but also the developed market ("DM" countries (**Chart 1**).

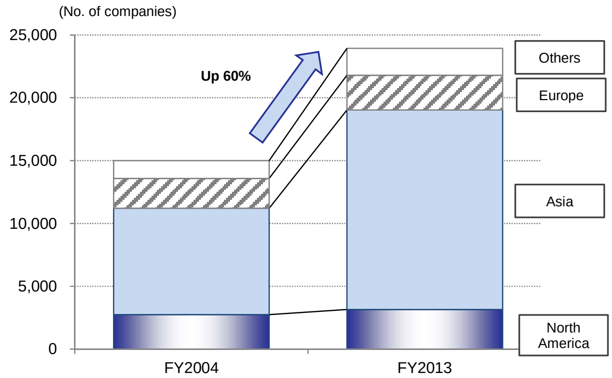
Under such circumstances, concerns are rising over the adverse impact on corporate earnings stemming from a decline in overseas sales and sluggish exports from Japan. This is because a fall in earnings may be translated into weakening of the job situation and capital investment. This report analyzes how the slowdown in the global economy may affect corporate earnings.

Chart 1: Change in the economic outlook for 2015 (IMF)



Note: The graph plots the outlooks on the global economy at the time of their announcement.
Source: Made by MHRI based on the IMF.

Chart 2: Change in the number of overseas affiliates



Source: Made by MHRI based on the Ministry of Economy, Trade and Industry, *Survey of Overseas Business Activities*.

2. Japanese companies depend more on overseas markets

First let us examine the extent to which Japanese firms depend on overseas markets.

Amid the wave of globalization, the overseas expansion of Japanese companies is accelerating. According to the *Survey of Overseas Business Activities* compiled by the Ministry of Economy, Trade and Industry, the number of overseas affiliates[1] stood at approximately 24,000 at the end of FY2013, up 60% compared with 2004. The increase was particularly notable in Asia, and around 80% of the increase since 2004 can be accounted for by the increase in companies in Asia (**Chart 2**).

With the expansion of international operations, Japanese firms' earnings depend more on overseas markets. Sales of overseas affiliates (JPY basis) amounted to about JPY243 trillion in FY2013, up 49% from 2004. Ordinary profits reached approximately 10 trillion, an increase of 61% from 2004 (**Chart 3**). If we look at the operating performance on a consolidated basis, adding the figures of overseas affiliates to those of companies located in Japan, sales and ordinary profits generated by the overseas affiliates accounted for about 15% of the total, respectively. This means that the earnings of overseas affiliates have now become an important source of profit for Japanese companies.

In this situation, the impact of the decelerating global economy has already surfaced in the sales of overseas affiliates of Japanese manufacturing firms. According to the *Quarterly Survey of Overseas Subsidiaries* by the Ministry of Economy, Trade and industry, sales (USD basis) of overseas affiliates of manufacturing companies[2] have continued to decline since the Oct-Dec quarter of 2014. Sales in the Apr-Jun quarter of 2015 were down 4.9% y-o-y, marking the biggest decline in six years since the financial crisis triggered by the collapse of Lehman Brothers (**Chart 4**). This result was primarily attributable to the greater drop in sales generated in Asia (-4.7% y-o-y in the Jan-Mar quarter of 2015 ⇒ -6.5% in the Apr-Jun quarter of 2015), which account for about half of overseas sales, and the lower growth rate in sales earned in North America (+4.4% y-o-y in the Jan-Mar quarter of 2015 ⇒ +2.7% in the Apr-Jun quarter of 2015), which account for about 30% of international sales.

It should be noted, however, that overseas affiliates' sales on a Japanese yen basis maintained growth momentum compared with the same period of previous year (+13.0% in the Apr-Jun quarter of 2015) based on a roughly 20% depreciation of the Japanese yen to the US dollar exchange rate in the same period that offset the decrease in sales of local currencies. If the yen continues to weaken, yen-based corporate earnings should remain

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1 Overseas subsidiaries and sub-subsidiaries are collectively referred to as "overseas affiliates." Overseas subsidiaries are foreign affiliates in which a Japanese company has invested capital of 10% or more, and overseas sub-subsidiaries are foreign affiliates in which a "subsidiary," funded more than 50% by a Japanese company, has invested capital of more than 50%.

2 The survey covers Japanese companies that meet all the following criteria: (1) all industries except finance, insurance and real estate, (2) companies with JPY100 million or more in capital, (3) companies with 50 or more employees, and (4) companies with overseas subsidiaries. The survey also targets overseas subsidiaries of the above Japanese parent companies that meet all of the following criteria: (1) manufacturing companies, (2) companies with 50 or more employees, and (3) companies with 50% or more of their capital, including both direct and indirect funds, coming from their parent companies.

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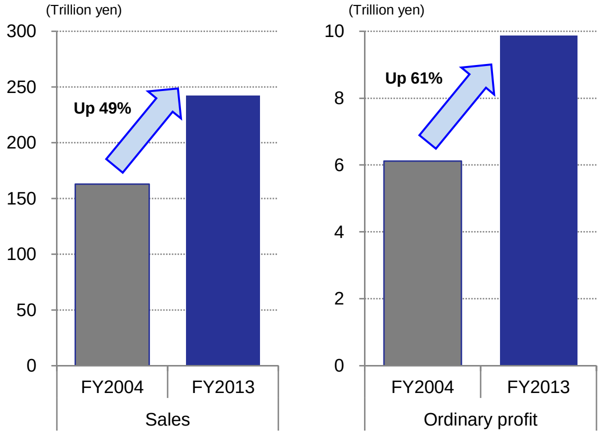
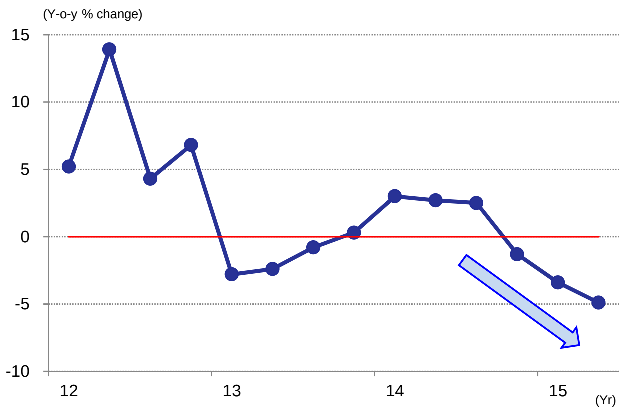
Chart 3: Changes in sales and ordinary profits of overseas affiliates (all industries)



Source: Made by MHRI based on the Ministry of Economy, Trade and Industry, *Survey of Overseas Business Activities*.

Chart 4: Changes in sales of overseas affiliates (manufacturing industry)



Note: The graph depicts sales on a USD basis. Because the y-o-y changes are calculated taking into account the substitution of survey target companies, they are not consistent with the figures calculated based on the actual operating results.

Source: Made by MHRI based on the Ministry of Economy, Trade and Industry, *Quarterly Survey of Overseas Subsidiaries*.

3. Decline in earnings will also be driven by a dip in exports

To fully grasp the impact on corporate earnings, we also need to look at how the drop in exports will affect profit gained within Japan itself, in addition to the sluggish sales generated by the overseas affiliates. The export volume index for the Jul-Sep quarter of 2015 (seasonally adjusted by MHRI) fell 1.9% from the previous quarter, representing two consecutive quarters of decline. Looking at the index by destination, while the drop in exports to the United States came to a halt, exports bound for Europe and Asia continued to decline (**Chart 5**). According to the Bank of Japan's *Short-Term Economic Survey of Enterprises in Japan* ("*Tankan Survey*"), exports represent approximately one-tenth of the total sales of companies in Japan (non-consolidated basis). Hence, if exports continue to weaken over an extended period, we need to watch how this will adversely affect corporate earnings (ordinary profits).

According to the estimates calculated using MHRI's macro model, a 10% drop in exports will trim ordinary profits by JPY10 trillion. If we assume a continuation of the declining trend seen in the first half of FY2015, the volume of exports in FY2015 is projected to fall by approximately 6% y-o-y, cutting down ordinary profits by around

JPY6 trillion. Given that ordinary profits in FY2014 amounted to about JPY66 trillion yen, it is reasonable to say that the potential impact on corporate earnings driven by weaker than expected exports will be significant.

4. Weakening of the Japanese yen and lower crude oil prices will offset the impact of the global economic slowdown

On the other hand, we believe that the yen depreciation and cheaper crude oil prices are mitigating the adverse impact on corporate earnings in domestic factors. The weaker Japanese yen and the decline in crude oil prices can lift corporate earnings through various routes. While the lower Japanese yen carries the negative feature of inflating prices of import goods, it also has the positive feature of creating more corporate earnings, thereby pushing up the volume of exports, improving export profitability and boosting primary income. Moreover, the fall of crude oil prices will likely have a positive impact on corporate earnings by lowering overall energy prices, such as electricity costs, resulting from decreased outlays for imported crude oil and LNG, among others. MHRI estimates the effect of the current yen depreciation and fall in crude oil prices (value of the Japanese yen lowered by 20% and the price of crude oil falling by about half) to exceed JPY10 trillion, even if we limit the estimate to corporate earnings (non-consolidated).[3] This figure is expected to more than offset the adverse impact on corporate earnings driven by the overseas economic slowdown.

Thus, thanks to this favorable development, we think that the actual impact on companies' ordinary profits has been limited so far.

Needless to say, we must also continue to be alert to the possibility that the sluggish overseas economy will exert downward pressure on business sentiment, leading to a cutback in capital investment activities that would place companies in a negative spiral. The capital investment plan (including land but excluding software, companies of all sizes and industries) of FY2015 in the *Tankan Survey* (as of September 2015) increased by 6.4% from the same period of the previous year, marking the highest growth in the September survey in nine years. The appetite for capital investment seems robust on a superficial level, but once the outlook becomes uncertain, firms may simply shelve their investment plans.

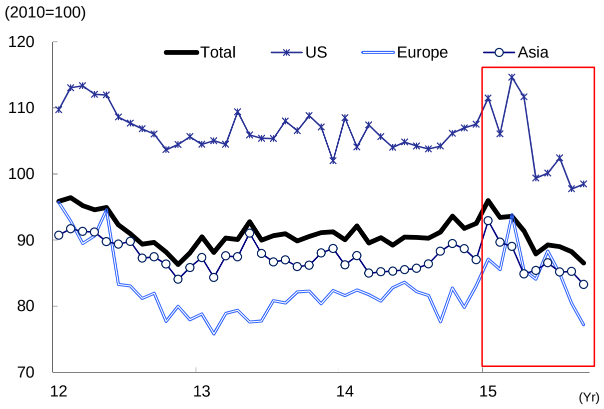
A questionnaire survey conducted by Nikkei Inc. on Japan's leading companies

[3] With regard to the effects of the yen depreciation and decline in crude oil prices, see "Summary of spillover effects of the yen depreciation and lower crude oil prices – trade deficit will halve and real GDP will rise in the 1% range if the current level prevails" by Hidenobu Tokuda, Kaori Yamato and Yayoi Sakanaka (*Mizuho Insight* (in Japanese only), January 29, 2015, Mizuho Research Institute).

revealed that top managers are showing a more cautious attitude about the economic outlook. Asked on Japan’s economic growth rate in FY2015, the answer with the greatest number in the June survey was “over 1.5% and below 2.0%,” but in the September survey it was “above 1.0% and below 1.5%.” Also on the question of Japan’s capital investment in the same year, while in the June survey more than 40% of the respondent companies answered that it would exceed the actual value of the preceding year, the number of respondents with the same answer in the September survey was down to about 15% (**Chart 6**).

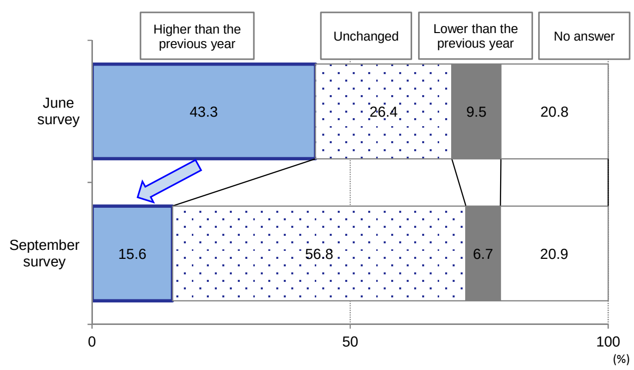
Given the positive effect of the yen depreciation and cheaper crude oil prices, we believe that there is no need to be overly pessimistic about the outlook on corporate earnings at the moment. However, in the event the global economic downturn persists over a longer-than-expected period, we should remain vigilant on its potential impact. It seems necessary to maintain a watchful eye for negative signs in business sentiment, which we cannot always discern through corporate financial reports.

Chart 5: Trends in the export volume index



Note: Data in the graph are seasonally adjusted by MHRI.
Source: Made by MHRI based on the Ministry of Finance, *Trade Statistics*.

Chart 6: Capital investment policy in FY2015 (questionnaire survey)



Notes: 1. We compared answers of the “questionnaire to 100 CEOs” conducted in June and September 2015. This is a questionnaire survey to top managers of Japan’s leading companies conducted every quarter by Nikkei Inc.
2. Ratio of answers to the question “what will be the trend of capital investment in FY2015 compared with FY2014?”
3. “Higher than the previous year” is the total of “higher than the previous year” and “slightly higher than the previous year, ” and “lower than the previous year” is the sum of “lower than the previous year” and “slightly lower than the previous year.”

Source: Made by MHRI based on Nikkei Sangyo Shimbun (June 22, 2015 and September 28, 2015).