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Japanese equities remain neglected by managers. But the return of inflation, improving fundamentals, attractive valuations and better corporate governance are a recipe for renewed investor appetite.

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Synopsis

There is currently a confluence of positive factors in Japan, including government policy, regulation, activists, flows from domestic and foreign investors, and attractive stock valuations. These are all ingredients that have the potential to lead to a significant market revaluation.

The Topix index at its highest level in 33 years

While the financial world is focused on US equities and the Nasdaq, a small earthquake has just occurred in the land of the rising sun: the Nikkei 225 index closed above 30,000 for the first time since September 2021 while the Topix index is at its highest level since 1990.

Over the past seven months, the MSCI Japan Index has generated a 20% return in dollar terms, compared to 10% for the MSCI USA. The Japanese equity market has already attracted more than $33 billion in foreign flows in 2023, the largest wave of foreign buying since 2013.

Despite the strong gains in recent months, the Topix index still needs to rise 26% before it reaches its historic 1989 level, the "peak of the Japanese bubble."

Topix 26% Away From 1989 Record High

Sources: Bloomberg

Before discussing Japan's upside potential, it is interesting to look at the reasons for such a long period of underperformance.

The lost decade(s)

Many global investors still associate investing in Japanese equities with "Japan's lost decade" and the image of a country with no growth whose stock market has chronically underperformed U.S. and even European equities.

Japan is an aging country plagued by deflation. Years of monetary policy aimed at weakening the yen have not been as successful as expected. Once a leader in the electronics industry, Japan missed the turn from analog to digital. The decline of the Japanese electronics industry was very visible, as the brands that have disappeared or weakened (e.g., Sony, Sharp, Hitachi, Panasonic, etc.) were once standard equipment in many middle-class homes around the world. Japan copied the world's leading manufacturers by making incremental improvements to existing technology. A strategy that turned into a disaster when the Koreans fully embraced the digital world to become forerunners.

Japan's problem has been referred to in part as the "Galapagos Syndrome." These islands, due to their isolation from the rest of the world, have fauna and flora that have developed endemic characteristics to adapt to the local environment. By extension, in the context of globalization, Japan, economically and culturally isolated, has experienced a particular development of certain products to meet local demand.

Japan had phones capable of surfing the Internet almost a decade before the iPhone, but was unable to export them. Sony invented an e-reader several years before Amazon's Kindle, but failed to market its invention. Sharp was the first company to integrate a camera into a cell phone. Steve Jobs had a close relationship with Japan, and he traded his knowledge of Japan for Apple's shareholders. Although the Japanese industry was a pioneer in many fields, it was unable to adapt its innovations to the demands of international markets because it remained fixated on its domestic one.

The "Abenomics" era, between early 2013 and late 2015, promised serious reform of the economy and financial markets under Prime Minister Shinzo Abe. But the years that followed have not brought the expected results.

However, many economists now agree that the tide is about to turn. There is even talk of a generational shift and the beginning of a new era.

Improved macroeconomic outlook

The Japanese equity market is the third largest in the world. Due to the high weight of export stocks, the Japanese stock market reacts to global economic conditions more sensitively than other developed markets. The fact that the US and Europe are on the verge of recession, while China is struggling to recover from years of containment, should not, at first glance, be seen as a positive for the Japanese economy.

However, the pandemic and the war in Ukraine have created the inflationary pressure that the Bank of Japan was looking for after 20 years of quantitative easing to counter falling prices.

In April, the inflation rate in Tokyo accelerated sharply to +3.8% year-on-year. The return of inflation is a game changer for businesses and consumers. After decades of deflation during which most economic agents systematically postponed spending, the fact that prices are rising again is about to change consumption patterns and boost nominal GDP.

Goldman Sachs forecasts real GDP growth of 1% for the years 2023 and 2024. This may seem low, but it is above potential growth of 0.7 percent, in contrast to the U.S. and Europe, where growth is expected to decelerate below potential rates. Nominal GDP growth is well above what Japan has experienced over the past two decades.

Wage growth is expected to be close to 2.8% and support consumption. Consumer sentiment is improving. With the country just emerging from confinement, tourism is picking up while businesses are planning strong capital spending.

BoJ's monetary policy remains accommodating

With inflation returning, many investors are speculating that the Bank of Japan (BoJ) will abandon its ultra-accommodative policy. However, it seems unlikely that the central bank will be able to make a 180 degree turn. Indeed, it holds more than 100% of Japanese GDP in JGBs (government bonds), which makes a normalization of monetary policy very complicated.

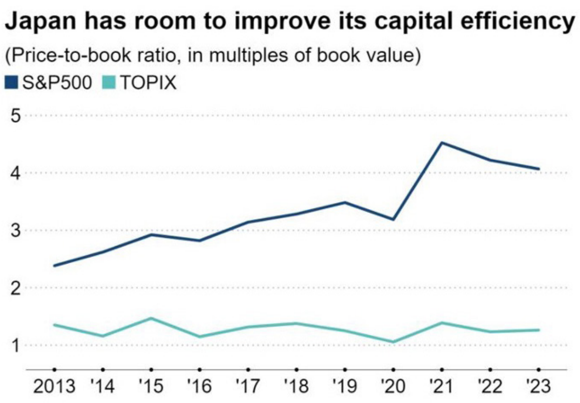
Despite the return of inflation, the BoJ's monetary policy under new Governor Ueda is likely to remain relatively accommodative even as other G7 central banks are in tightening mode.

Even in the case of a slightly less accommodative policy, the Japanese equity market could benefit as a stronger yen will facilitate capital repatriation to Japan.

A better corporate governance

Japanese (non-financial) stocks are flush with liquidity. But the propensity of companies to hoard, rather than deploy or return cash to shareholders, has long contributed to the undervaluation of Japanese stocks. This situation is changing.

In April 2022, the Tokyo Stock Exchange (TSE) overhauled the market structure, reducing the number of divisions from five to three and tightening listing criteria to discourage cross-shareholdings and increase free float. The approximately 10 to 20 per cent of listed companies that do not meet the new criteria have until March 2025 to improve their performance before facing delisting. The TSE has also asked Japanese companies to reduce their discounts (see chart below comparing price to book value ratio in Japan vs. the US).



Sources: Quick FactSet

About half of all listed companies are trading below their book value, and the TSE now requires these companies to submit detailed plans to improve their valuations.

With more than half of Japan's listed companies still having positive net cash, compared to less than 20% in the U.S. and Europe, Japanese companies still have plenty of room to redistribute more of their cash ($2.5 billion) to investors.

Many Japanese companies are now under domestic and international pressure to respond to shareholder activism and improve their performance. And today's corporate executives have become more receptive to this type of pressure because they are less attached to traditional Japanese-style management.

Institutional investors are playing a role. Since last year, Institutional Shareholder Services (ISS), Nomura and other managers have been recommending voting against a company's manager if the company allocates more than 20% of its net assets to cross-shareholdings.

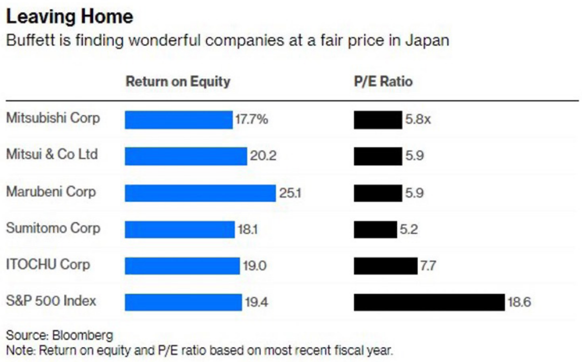
The government is also turning up the heat. On March 26, Prime Minister Kishida said that "the asset management industry needs a fundamental reorganization. Currently, most retail investments (90%) go into overseas stocks, which results in capital outflow from Japan. But individual investor interest in local stocks is expected to be boosted by impending rule changes to double the size of tax-exempt individual savings accounts (Nisas) over the next five years to 56 trillion yen ($430 billion).

The Warren Buffet effect

As early as 2020, Buffett began to focus on the big five Japanese trading houses. These huge conglomerates, known as sōgō shōsha, are deeply embedded in Japan's economy and history and supply a range of commodities (food, textiles, machinery, energy and metals).

After meeting with these companies last month, he revealed that he has increased his stake, making it his largest investment outside the United States and Europe. And he may acquire more.

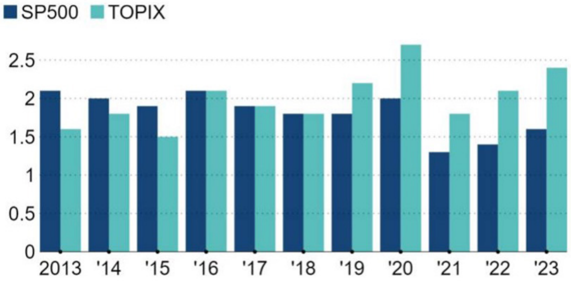
And there is some logic to this: these companies meet all of Warren Buffett's investment criteria: quality, profitability, high barriers to entry, good management, high dividends and valuation discounts. As the chart below shows, these companies are attractive compared to US stocks.



Warren Buffet's investment strategy in Japan also consists of borrowing in yen (at very low rates) and investing in high dividend stocks. This strategy is now widely copied by other global investors, encouraged by efforts to increase the dividend payout ratio to shareholders. It is worth noting that the Topix dividend yield is now higher than that of the S&P 500.

Japan dividend yields now outshine U.S.

(In percent)



Sources: Quick FactSet

Japan remains unloved and under-owned in international portfolios

According to Goldman Sachs, hedge funds bought Japanese stocks in April for the fourth consecutive month. But long-only funds remain underweight Japanese stocks overall. In its latest survey of fund managers by BofA, the allocation to Japanese stocks reached a net underweight of 10%.

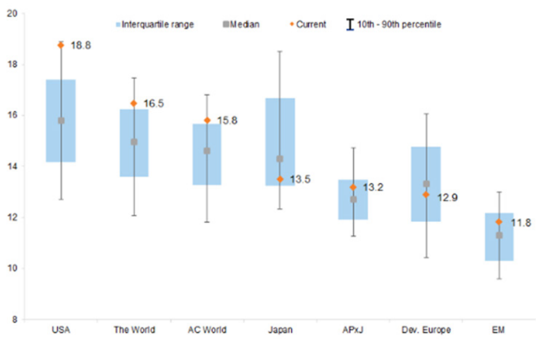
However, TSE data shows that foreigners are once again net buyers of Japanese stocks. We note that Ken Griffin's Citadel hedge fund plans to reopen its Tokyo office after an absence of nearly 15 years.

Attractive valuations

While most global equity markets remain expensive relative to their historical averages, this is not the case for Japan, which is still at the bottom of its range with a 12-month P/E of around 13x.

Exhibit 7: Equity markets, particularly in the US, remain expensive versus history

12-month forward P/E, valuation ranges (MSCI Regions) over a 20-year timeline



Sources: FactSet, Goldman Sachs Global Investment Research

The comparison of the equity market with government bonds is also very favorable (risk premium of 6.2%), especially relative to other developed markets.

Equity Risk Premia across countries

Country	Risk Premium	Currency	Region
S&P 500	2.5%	USD	US
Nasdaq	1.2%	USD	
Russell 200	2.1%	USD	
Canada	5.1%	CAD	America
Mexico	-0.3%	MXN	
Brazil	2.4%	BRL	
Chile	5.7%	CLP	
Germany	7.3%	EUR	EU
France	5.5%	EUR	
Spain	6.1%	EUR	
Italy	8.6%	EUR	
Netherlands	4.8%	EUR	
UK	5.9%	GBP	Europe Non-EUR
Switzerland	5.2%	CHF	
Sweden	4.9%	SEK	
Poland	7.2%	PLN	
Czech	6.6%	CZK	
Japan	6.2%	JPY	Asia & Pacific
China	9.1%	CNY	
Korea	7.3%	KRW	
India	-1.0%	INR	
Taiwan	6.5%	TWD	
Turkey	13.6%	TRY	
Australia	3.7%	AUD	
New Zealand	0.3%	NZD	

Source: TheMacroCompass.com, Bloomberg

Risks

There is of course downside risk to Japanese equities. The magnitude and pace of change in Japanese companies could disappoint. In addition, it is difficult to assess the impact of a change (still possible) in BoJ policy on its propensity to hold stocks (about 8% of market capitalization) and on the yen.

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