Wasabi 2.0

Why the end of negative interest rates is no obstacle to the continued bull market in Japanese equities?

Read more on page 2

Image source: DALL·E

Introduction

While other central banks are preparing to cut interest rates, the Bank of Japan (BoJ) has chosen a different path. Last week, the BoJ decided to raise interest rates for the first time in seventeen years, ending eight years of negative interest rates. How will this shift influence the trajectory of the economy? What impact will it have on the trajectory of Japanese equities?

Charles-Henry Monchau *Chief Investment Officer*

Assia Driss *Junior Investment Analyst*

PRIVATE BANKING

Wasabi 1.0: Our investment thesis on Japan in 2023

In May 2023, we published an article entitled "Wasabi" highlighting the promising prospects of Japanese equities. Our investment thesis was based on 5 pillars:

1) Attractive macroeconomic outlook: the pandemic and the war in Ukraine created the conditions for the return of inflation that the Bank of Japan was seeking after 20 years of quantitative easing to counter falling prices. At the time, we were expecting wage increases close to 2.8%, which would support consumption;

2) Monetary policy was expected to remain accommodative, while other developed countries continued their monetary tightening. The interest-rate differential was expected to contribute to the weakness of the yen, thereby preserving the competitiveness of Japanese exporters;

3) Improved 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 equities. This situation is changing under the impetus of the Tokyo Stock Exchange (TSE), which has 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;

4) The Warren Buffet effect: back in 2020, the sage of Omaha began to take an interest in the big five names of Japanese trading houses. These huge conglomerates, known as sōgō shōsha, supply a range of commodities (food, textiles, machinery, energy and metals). Warren Buffet's investment strategy in Japan also involved borrowing in yen (at very low rates) and investing in high-dividend stocks. A strategy now widely copied by other global investors, encouraged by efforts to increase the dividend payout ratio to shareholders;

5) Japan's under-representation in international portfolios and attractive valuations (the P/E was then 13x expected earnings).

In 2023, Japanese equities were the best-performing market among the major developed countries. The rally continued in 2024; the Nikkei 225 index surpassed 40,000 points to reach its all-time high.

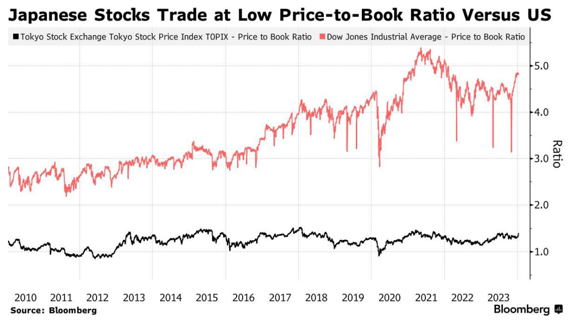
Source: Barchart

Despite this rally, Japanese equities are still valued at attractive multiples (see chart below).

Moreover, they remain underweighted by a considerable number of international asset managers. GMO's research reveals that a large majority of managers continue to substantially underweight Japanese equities.

In the Nasdaq eVestment database, which includes 225 active management strategies benchmarked to the MSCI EAFE index (a global equity index excluding the US and Canada), 84% maintain an underweight position on Japan.

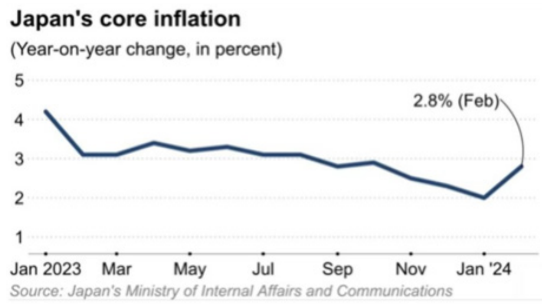
Price to book (P/B) of US equities (red) vs. P/B of Japanese equities (black)



Source: Bloomberg

One of the fears of international investors is that rising inflationary pressures will put an end to the Bank of Japan's accommodating monetary policy, leading to an appreciation of the yen with negative effects on corporate margins.

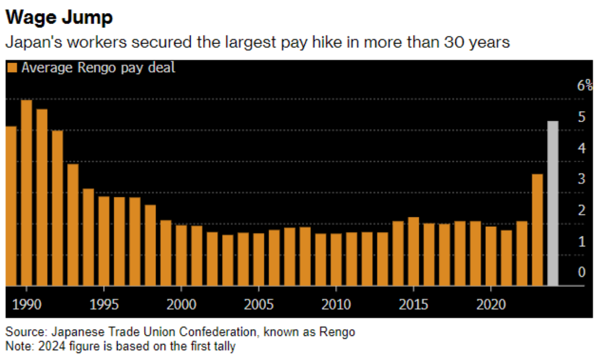
Indeed, Japan's consumer price index (CPI) rose by +2.8% in February, well above the Bank of Japan's annual target rate and reinforcing the need for a change in the central bank's monetary policy.



Source : Win Smart

Meanwhile, Japan's largest trade union, Rengo, declared two weeks ago that workers at the country's largest companies should receive the biggest pay rise (+5.28%) in over thirty years.

Bank of Japan Governor Kazuo Ueda had repeatedly mentioned that the outcome of this year's wage negotiations would influence the central bank's decision on when to exit the world's last negative interest rate policy.



Source: Bloomberg

Wasabi 2.0: The end of negative interest rates could have positive effects on equity markets

As expected, the Central Bank of Japan (BoJ) took a historic step on Tuesday March 19, 2024 by raising interest rates for the first time in seventeen years, marking a significant break with its negative interest rate policy initiated in 2016. By fixing the short-term rate in the [zero to 0.1%] range and ending the yield curve control on the 10-year Japanese government bond, the BoJ is fostering an environment conducive to economic recovery and growth.

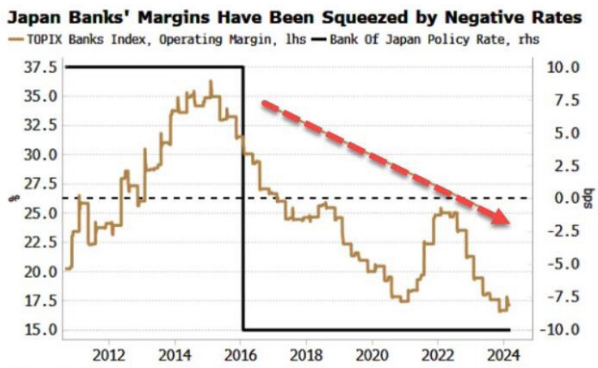
When a central bank raises its interest rates, the intuition is to anticipate more restrictive financial conditions, lower inflation, and weaker equity market. However, when it is to exit a negative interest rate environment, it is set to be stimulative, signaling a move towards normalisation in monetary policy. Explanation below.

Japanese banks set to boost earnings following BoJ policy change

According to Bloomberg, Japan's major banks collectively hold 107 trillion yen ($712 billion) in reserves with the BoJ. These reserves do not generate any income. In addition, these institutions hold 79.4 trillion yen in deposits, currently yielding 0.1%.

Given the BoJ's recent policy change, which introduces an interest rate of 0.1% on balances in excess of reserve requirements, these banks should benefit from an increase in annual interest income of around 100 billion yen. This adjustment, as calculated by Bloomberg, represents a significant improvement in revenues.

Japanese banks' operating margins (brown) vs. BoJ reference interest rate (black)



Source: ZeroHedge, Bloomberg

In the absence of negative interest rates, banks are likely to increase lending

Despite the steepening of the yield curve over the past two years, which should have encouraged banks to lend more, they have continued to reduce their lending (as a percentage of assets). Negative interest rates appear to be the main reason.

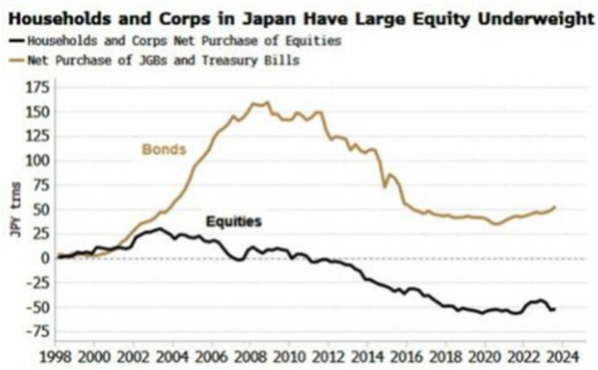
The departure from negative interest rate policies should stimulate lending, especially given the gradual and modest nature of the rate increases, as indicated by BoJ Governor Ueda's recent remarks that the 2% inflation target is still some way off.

Return of inflation should drive up equity investment

Instead of the negative effect it can have in other developed markets by penalising corporate margins and raising the cost of living, it is positive in an economy like Japan's, which has suffered from deflation for so many years. In particular, Japanese companies can finally raise their prices and potentially increase their margins after many years of forced cost discipline.

As the chart below shows, local investors have avoided equity markets for years. But with the return of inflation, investors should be more inclined to invest in risky assets. Indeed, years of deflation or low inflation have led households and companies to favour bonds over equities. However, as inflation erodes the real value of government bonds, equities offer more attractive prospects. What's more, if the yen strengthens, Japanese investors could be led to reduce their exposure to US equities in favour of domestic equities.

Individual and corporate purchases of equities (black line) vs. purchases of JGBs (brown line)



Source: ZeroHedge, Bloomberg

Impact on the yen

Last Tuesday's interest rate hike triggered a significant fall in the Japanese yen in a "sell the news" move by investors. On Wednesday, the yen reached its lowest level against the euro since 2008. The Japanese currency also weakened against the dollar, falling to a four-month low of around 151 yen. This drop exceeded the 150 yen threshold, which has historically led to intervention by the Japanese authorities.

Source: CNBC

The market assigns (for now) a very low probability to the USDJPY reaching 130 by the end of June.

However, Japan's status as the world's largest net creditor means that even a slight shift towards greater currency hedging by domestic investors could quickly have an impact on the yen.

The weakening yen has led investors, including large participants such as life insurers, to reduce their currency hedges, with hedge ratios recently falling below 50%. This reduction should soon exert upward pressure on the yen, leading to further hedge reductions and a rising yen. Such a virtuous circle was already observed in 2016, when the yen rapidly appreciated by 20% following hedge reduction movements.

Another catalyst that could lead to a strengthening yen is capital repatriation. This dynamic offers advantages for foreign investors in unhedged Japanese assets. In addition, a potential strengthening of the yen could increase the purchasing power of Japanese consumers.

These factors could lead to a revaluation of Japanese assets, making them more attractive to domestic and international investors.

Conclusion

Counter-intuitively, the BoJ's abandonment of negative interest rates could make Japanese equities even more attractive to investors. The favourable effects of the end of negative interest rates combined with corporate governance reforms, Japan's strategic geopolitical positioning and attractive valuation multiples make Japanese equities a particularly attractive market.

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

Assia Driss, Junior Investment Analyst
assia.driss@syzgroup.com