Six questions on Japan

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The Japan equity team explains why a global cyclical market like Japan warrants a differentiated and disciplined active valuation approach to stock picking to reap significant alpha over time.

1. THE RETURN OF VALUE INVESTING HAS RENEWED INTEREST IN JAPAN EQUITIES. IS THIS TREND SUSTAINABLE?

The swing towards older economy sectors and value stocks since late 2020 has benefitted Japan given the country's relatively higher concentration of cyclical stocks. The current inflationary and higher interest rate environment continues to favour value stocks as investors focus on companies with long-term earnings growth potential.

That said, regardless of the trend in play, we have always found plenty of opportunities; there are many companies with mispriced but good quality income streams that remain out of favour. The corporate changes are also underappreciated. The upside potential is large for patient investors.

Opportunities also exist where changes to the market's risk perceptions and expectations have caused a substantial disconnect between market price and the value of an asset. We focus on identifying and exploiting such price dislocation episodes – this is our investment edge. Investors should thus choose managers with a demonstrated long track record of discipline and doing things differently from the market.

2. NOT ALL VALUE STOCKS EQUATE TO GOOD INVESTMENTS. HOW DO YOU IDENTIFY THE WINNERS?

With an active approach, we aim to avoid both value traps and overpriced companies. Value traps are often companies which are not focussed on shareholder returns; their earnings power has deteriorated permanently and unlikely to return to prior levels of profitability and valuation. Materially overpriced companies are an equally dangerous proposition for long-term investors, regardless of their quality.

Investors are prone to biases and as such we start with a clear understanding of behavioural sources of mispricing and focus on outliers in relative valuations across the market. We analyse a company's long-term sustainable earnings trend. If there is a sufficiently big margin of safety, we will stay invested to lock in alpha.

Our active process has a disciplined approach to portfolio construction, and we regularly trim our winners and recycle the proceeds into new stock ideas with more upside. Japan is a very liquid equity market which makes this easy to implement. This is arguably a more sophisticated approach than rebalancing the weight of 2000 stocks which is typical of passive investments.

3. IS THE CURRENT MACROECONOMIC ENVIRONMENT FAVOURABLE FOR JAPAN'S EQUITY MARKET?

The 2023 forecast for real GDP growth in Japan is amongst the highest of other developed markets at +1.8%.[1] There should be a degree of resilience in the face of global slowdown pressures. Meanwhile inflation is showing signs of slowing after hitting a 41-year high of 4.2% year-on-year in January. Still, it is well above the Bank of Japan's 2% target.

The yen has fluctuated strongly over the last year or so, first weakening to 150Y/USD in October 2022, a level not seen for more than 30 years, and subsequently strengthening back to the current 130Y/USD levels. A weaker yen is on average positive for Japan's stock market's earnings, but this impact has declined over time, as Japan's corporates localised production overseas; it is positive for exporter's earnings, but negative for domestic companies and consumer.

The market was taken by surprise by the Bank of Japan in December when they announced an increase to the upper band for 10-year Japanese Government Bonds. This has led to a stronger yen and possibly sets the scene for further monetary policy tightening in 2023, especially if the current Bank of Japan Governor turns more hawkish.

Japan's corporates are still very competitive globally. We are not concerned about the yen strengthening towards its longer-term average level as our valuation models use the 110-120 range. A more stable yen backdrop will hopefully persuade international investors back to Japanese equities after having been absent for the last three years.

4. WHAT IS THE CORPORATE PROFITS' OUTLOOK AND WHERE ARE YOU FINDING OPPORTUNITIES?

In the near term, the boost from the domestic re-opening, resilient consumers, the normalisation of the Chinese economy, and the recent hikes in wages are tailwinds for Japanese corporates. The normalisation of supply chains, lower commodity and logistics costs, and the ability to pass-through higher cost to consumers should also be positive for profits. Margins are improving and the long-term upward trajectory for earnings remains intact.

Excess savings and pent-up demand will benefit the domestic mall operators while the continued removal of global supply constraints will help manufacturers, especially the auto companies. Companies in the inbound tourism space are expected to benefit alongside steel and chemical companies catering to the recovering Chinese demand.

Separately the recent sell off in Japanese financials is largely due to revised market expectations of a flatter Japanese yield curve, not a result of contagion fears. The team continues to favour banks that will benefit from restructuring and cost efficiencies, manage their interest risks well, and do not actively use hold-to-maturity securities.

5. WHY INVEST IN JAPAN NOW VERSUS OTHER DEVELOPED MARKETS?

Japan is the world's 3rd largest stock exchange by market capitalisation. It is also a very liquid, deep, and broad market with over 2000 listed companies. Japan has outperformed other developed markets in terms of earnings per share growth over the last 10 years. Yet it is one of the most neglected, under-appreciated and under-owned markets. The Japanese equity market was down -4% in 2022 in yen terms. This was a 'relatively' decent performance compared to other developed markets which were down nearer -20% in their respective local currencies. This resilience was due to a late Covid reopening, a weaker yen and the fact that Japan did not have the same magnitude of growth stock excesses that markets like the US experienced in the prior years.

Valuation is another strong reason; Japan remains cheap versus history and other markets. Despite strong earnings revisions and improved companies' fundamentals, the market did not re-rate and is trading at very attractive valuations versus global peers. A point to note is that lower starting valuations are supportive of likely future outperformance for the market.

Corporate governance reforms have also prompted cost cutting, balance sheet restructuring, more efficient capital allocation and resulted in rising dividends and share buybacks, all of which are underpinning shareholder value. In our recent conversations with company CEOs, it feels like

Source: [1]World Economic Outlook, 2023

we are perhaps entering a new phase for Japan, with higher prices and rates - time will tell how persistent these forces will be.

Over the longer term, Japanese companies are at the gateway of Asia ex-China, where they can both facilitate and partake in Asia's growth story via the finance, retail, and consumer goods growth, but also by means of supporting factory automation, infrastructure, and energy transition.

6. WHAT KEY RISKS ARE ON YOUR RADAR?

The biggest risk is a deceleration of corporate governance reforms, but we see good momentum and multiple drivers pushing this forward in a sustainable fashion. Such drivers are government support, unwinding of cross-shareholdings, increased shareholder activism, corporate restructuring that contributes significantly to a company's financial sustainability, employee motivation, and shareholder returns. Other shorter-term risks are obviously recessionary risks, with Japan being a cyclical market, but fundamentals seem more resilient now.

Investors are prone to biases and markets are subject to periods of irrationality where value will deviate from price (e.g., Covid lows in March 2020 or the extremes of technology valuations in 2021). Indiscriminate sell offs typically present opportunities where the excessive short-term pessimism results in one underpricing a company's long-term earnings.

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