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ON GLOBAL EQUITIES

The Japan Story Is Gathering Momentum

Macro risks have risen, but the outlook for Japan appears bright.

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KEY INSIGHTS

- Despite heightened macro uncertainty, the Japan story is gaining momentum, with much to be encouraged by moving forward.
- Signs of a sustainable return of inflation, particularly wage inflation, in Japan is encouraging and a huge boost for investor and business sentiment alike.
- Macro risks appear priced in, with Japan market valuations looking attractive compared to other major equity markets.

The uncertain global macro environment has understandably dominated investor thinking and press reporting over the past 12 months—from heightened geopolitical tensions to rising inflation and interest rates, to the stress in the U.S. banking system and fears of a potential U.S. recession. One market that has perhaps flown under the radar amid all the macro noise is Japan, with the broad TOPIX Index hitting a 33-year high in May.[1] The post-pandemic reopening of the Japanese economy, ongoing structural market reforms, and the fact that many of the global macro risks appear to be fully priced into Japan market valuations have all played a part in driving Japan's strong performance year-to-date. What's more, the Japan story is gathering momentum, and the outlook appears positive.

The Path to "Normalization"

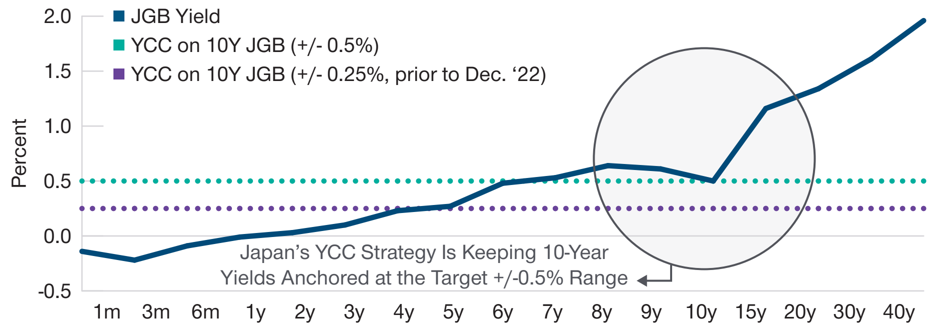
Relative to other major world economies, Japan remains a policy outlier. In a global environment of heightened inflation and rising interest rates, the Bank of Japan (BoJ) continues to hold short-term interest rates at -0.1% while reiterating its 0% target for 10-year Japanese government bond (JGB) yields. It continues to adhere to its large-scale bond-buying yield curve control (YCC) strategy, with 10-year JGB yields allowed to fluctuate in the range of around +/- 0.5% from the target 0% level.

The idea behind the strategy is to control the shape of the yield curve, specifically to suppress short- to medium-term rates, which affect corporate borrowers, without depressing super-long yields too much and reducing returns for pension funds and life insurers. YCC worked well when inflation was low;

[1] TOPIX Index, in local currency terms, as of May 15, 2023. Source: Refinitiv Eikon. © 2023 Refinitiv. All rights reserved.

Bank of Japan's Yield Curve Control Strategy in Action

(Fig. 1) 10-year government yields remain anchored at the bank's curve control range



As of May 15, 2023.

Japan government bond yield curve 1m—40y issuance. Yield curve control policy in action as the BoJ focuses on buying 10-year bonds to peg yields to a target range of +/-0.5% of 0%. Prior to December 2022, the target range was +/-0.25%.

Source: Eikon Refinitiv. © 2023 Refinitiv. All rights reserved.

however, as inflation has started to rise, investors have sold low-yielding bonds, forcing the BoJ to ramp up its buying to maintain its yield range target. Amid growing criticism of distorting market pricing, the strategy has caused the value of the yen to fall sharply and, in turn, inflated the cost of raw material imports.

On April 9, 2023, Kazuo Ueda was announced as the new governor of the BoJ in a surprise move that raised hopes of a potential shift toward policy normalization in Japan. Such a move would be significant for Japan, unwinding policies that have kept the yen depressed for years, while higher rates would also help to encourage the trillions of dollars of Japanese cash back onshore, having been lost to higher overseas rates. In the short time since his appointment, Ueda has acknowledged that the bank's current ultra-loose policy is not sustainable; however, he has also indicated that the BoJ is in no rush to push through changes.

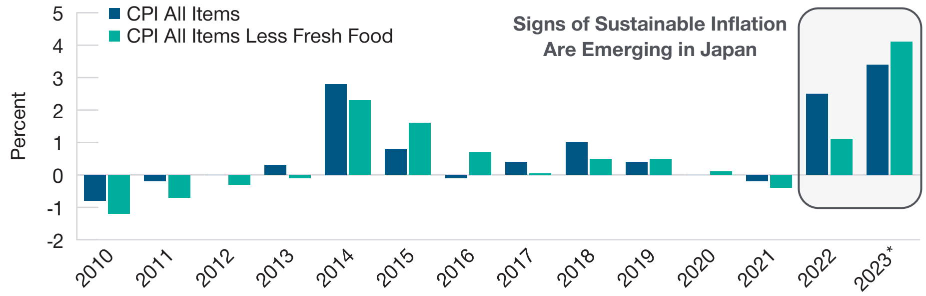
Sustainable Inflation Is Key

A prime consideration for any potential shift in policy is inflation. Core consumer price index (CPI) inflation rose at an annual rate of 3.4% in April, above the BoJ's target 2% rate but sharply down from the multi-decade-high 4.2% recorded in January. However, the preliminary outcome of the annual spring wage negotiations between company management and labor unions, known as shunto, offer encouragement that inflation may at last be sustainable. Initial data point to an overall year-over-year wage increase in the range of 3%, which would be the highest number since the early 1990s. Such a wage increase will put pressure on the newly appointed BoJ governor to move forward with the normalization of Japanese monetary policy—the likely first step being the removal of the current yield curve control policy (Figure 1).

At its policy meeting in December 2022, the BoJ shocked the market by announcing a tactical change to its yield curve control strategy, shifting the band from +/- 0.25% of its target 0% interest rate to +/- 0.5%. This was a hugely unexpected policy change. The BoJ remains adamant that this is not a precursor to a broader policy pivot (yet) and insists that it wants to see durable signs of inflation above 2% before it tightens policy.

Signs of Durable Inflation Are Emerging

(Fig. 2) Importantly, wage inflation is beginning to come through in Japan



As of April 30, 2023.
Annual change in Japan consumer price inflation, in percentage terms.
*2023 covers the period January 1, 2023, to April 30, 2023.
Source: Eikon Refinitiv. © 2023 Refinitiv. All rights reserved.

"Wage inflation appears to be coming through, and this is far stickier than food and energy inflation and so a more robust sign of Japan breaking its 20-year run of near zero inflation.

While Japan technically exited deflation under the Shinzo Abe/Haruhiko Kuroda regime, it has yet to confidently shake its deflationary mindset. We believe that the inflation we are seeing already, and expectations of higher inflation moving forward, could lead to positive—and sustainable—changes in consumption and investment behavior by Japanese individuals and corporations. The last time annual CPI inflation was above the Bank of Japan's 2% target was in 2014. This is why this year's shunto wage negotiations are so important. Wage inflation appears to be coming through, and this is far stickier than food and energy inflation and so a more robust sign of Japan breaking its 20-year run of near zero inflation (Figure 2).

Japan's Recovery Is Potentially Still in the Early Stages

While a degree of higher short-term market volatility can be expected (across all major markets), the outlook in Japan appears favorable. Importantly, Japan's borders only fully reopened, post-COVID, in October 2022, and, after three years of restrictions, tourists are returning in volumes and taking advantage of the cheap yen. At the same time, China's economy (and Japan's biggest trading partner) is also fully opening again, with the country posting an expectation-beating 4.5% growth in the first quarter of 2023. Finally, long-term secular trends like growth in factory automation, use of robotics, and vehicle electrification are highly supportive of many Japanese industries.

A Stronger Yen Is Positive for Japan

The multi-decade weakness of the yen has been a significant factor in the performance of Japanese markets over the past year, but as we saw in late 2022, this can quickly reverse and become a significant tailwind for the broad market.

With 10-year JGBs at 0% (+/-0.25%) for most of 2022 and the U.S. Fed hiking aggressively, pushing 10-year Treasuries to 3.5%, a huge yield differential opened up between the Japanese yen (JPY) and the U.S. dollar (USD). This prompted a precipitous fall in the JPY versus the USD (-31% between January and October 2022).

The weak yen was supportive of Japan's export-oriented businesses, with many auto companies and manufacturers (primarily large-caps) benefiting significantly from increased competitiveness. However, Japan is also a net energy importer and so started to import inflation as energy costs soared, putting pressure on the domestic consumer and undermining spending. As inflation has ticked higher in Japan,

> "Ultimately, a stronger currency is supportive of a broad range of Japanese industries, beyond just the large export names.

expectations have increased that the Bank of Japan will start to pivot from its ultra-loose monetary policy stance and start to tighten. The tangible impact of this thinking was evident in late 2022 and into early 2023, as it sparked a strong rally in the yen (+14%) from JPY 150/USD 1 on October 20 to a peak of JPY 128/USD 1 on January 16, 2023. Ultimately, a stronger currency is supportive of a broad range of Japanese industries, beyond just the large export names.

The Governance Story Cannot be Overstated

The Tokyo Stock Exchange (TSE) in January 2023 announced new proposals to put further pressure on listed companies to meet its higher standards of governance or otherwise face delisting. As part of its proposals, the TSE would "require that management and the board of directors properly identify the company's cost of capital and capital efficiency," especially for companies that have consistently traded below book value. This additional requirement to "comply or explain" will further pressure Japanese management teams to address issues of capital inefficiency. As these corporate governance reforms continue to make headway, we would expect to see higher returns on capital—and a lower cost of capital—as Japanese governance standards progressively improve.

Outlook

While short-term market focus will be centered on near-term economic and financial conditions, we continue to believe that the outlook over a medium- and longer-term horizon is growing more favorable for Japan. Signs of a sustainable return of inflation in Japan is extremely encouraging and a huge boost for investor and business sentiment alike. It is noteworthy that, despite the current uncertainty in the global economy, Japan's corporates continue to buy back stock and return capital to shareholders at record levels. This is very encouraging in terms of the health of Japanese companies and signals the ongoing improvement in governance at the company level in Japan.

Should the U.S. economy tip into recession in the second half of 2023, there is no denying that this will present a considerable headwind for Japanese equities, given the export-oriented nature of the economy. On the positive side, however, the risks appear priced in, and valuations are attractive relative to other major markets. The TOPIX Index is currently trading at a valuation of 13x forward earnings, compared with a long-term average of 14x forward earnings,[2] indicating that much of the potential bad news is already reflected in company valuations. This is creating opportunities for bottom-up, fundamental investors to find quality businesses at reasonable prices.

[2] As of May 15, 2023. Source: Refinitiv Eikon. © 2023 Refinitiv. All rights reserved.

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