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International Equity

A SEEMING RESURRECTION FOR LONG-STAGNANT JAPANESE STOCKS?

KEY POINTS

- By the end of 2017, the Japanese economy had recorded eight straight quarters of expansion, its longest growth streak since the 1980s, and in January of this year, the Nikkei 225 Index hit its highest level since 1991
- In this interview, Archibald Ciganer, manager of the Japan Equity Strategy, discusses what's driving the Japanese economy and equities: Abenomics and the U.S. recovery.
- He believes that the overall Japanese market is not expensive and that it's not too late to invest because the improvements are taking place slowly and will continue for a long time.

By the end of 2017, the Japanese economy had recorded eight straight quarters of expansion, its longest growth streak since the 1980s, and in January of this year, the Nikkei 225 Index hit its highest level since 1991. Archibald Ciganer joined T. Rowe Price in 2007 and has managed the Japan Equity Strategy since December 2013. In this interview, he discusses what's driving the Japanese economy and equities and his expectations going forward.

Q. What are the economic and political factors that have created this seeming resurrection in the Japanese stock market?

A. The first factor is Abenomics—the fiscal, monetary, and structural reform policies introduced by Prime Minister Shinzo Abe. And the second is the prolonged U.S. recovery after the global financial crisis—the U.S. consumer has always been important to demand for Japanese products.

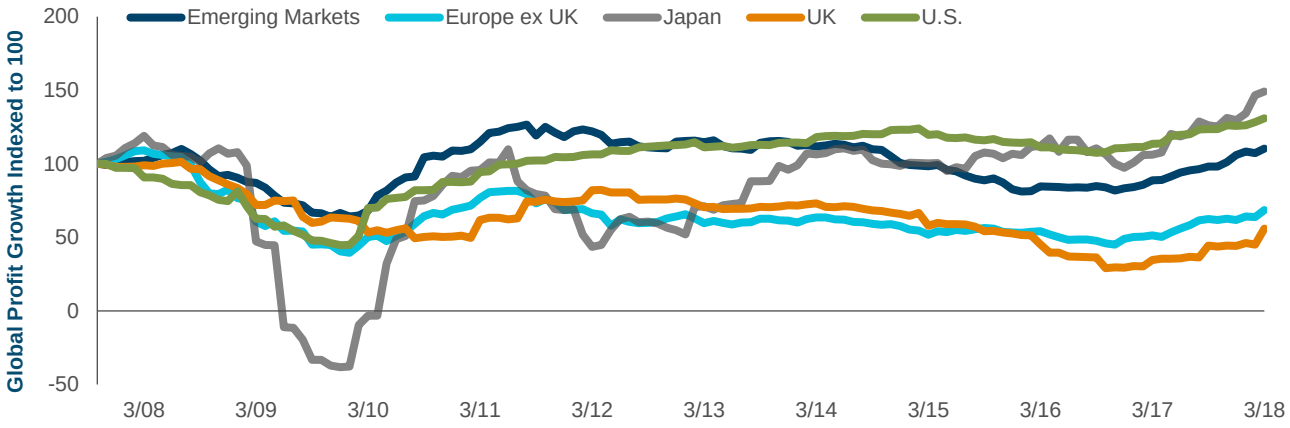
The Bank of Japan's monetary policies, massively expanding its balance sheet, helped weaken the yen significantly. It went from roughly ¥80 to the dollar after the crisis to, at one point, about ¥120. The cheaper yen has helped Japanese exports to the United

States and made Chinese imports to Japan more expensive, importing inflation after years of Japan being mired in deflation. That changed Japanese consumer and corporate expectations and behavior.

Even so, after 20 years of stagnation, it has taken a long time for positive views to evolve on Abenomics. Part of the success story here is political stability. After years of short-term prime ministers, Mr. Abe has been in office since 2012, so he's been able to stick with the reform path.

Figure 1: Global Corporate Profit Growth by Region*

Indexed to 100, October 2007–March 2018



*Corporate profit in U.S. dollars by region based on companies within the S&P 500 Index and the MSCI Emerging Markets, Europe ex UK, Japan, and United Kingdom indices.
Source: FactSet.
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Q. What about the corporate and equity market factors?

A. Japan is an advanced economy, but the quality of its companies has lagged that of the United States and Europe. They're catching up now, starting to deliver better returns and treat shareholders better. A big reason for that is the new Corporate Governance Code under Abenomics, which sets higher standards, more disclosure, and better treatment of minority shareholders.

Another new regulation, the Stewardship Code, requires investors—pension funds and asset management companies—to show how they're protecting investors and engaging with companies to align their interests. It used to be, for example, that large Japanese insurance companies were major shareholders but would not encourage corporate managements to run businesses better.

These are big changes that have improved Japanese stocks' return on equity, which used to lag that of European stocks. Last year, Japan's return on equity exceeded Europe's. And that has drawn in foreign investors, who now own more than 30% of the Japanese equity market—more than Japanese domestic financial institutions.

Q. After this big runup in Japanese stock values, are there still investment opportunities?

A. There are a lot. The market has many expensive stocks, but it is a very broad and deep market and is not expensive overall. Valuations are not rich. Among 1,200 stocks that I can buy here, we continue to regularly find good opportunities. It's not too late to invest. We believe the improvements will continue for a long time because the changes are still taking place slowly.

Q. What is your overall approach to managing the strategy?

A. My approach is to look for secular growers, companies benefiting from social or technological change. Because they are seeing increasing demand, growth comes more easily even if these companies don't invest aggressively. As an investor, you want to be on the right side of major trends, such as Japan's aging population, the rising purchasing power of emerging market consumers, and stricter environmental regulations. You want to be exposed to rising demand and have the competitive moat necessary to enjoy that tailwind.

An easy example is that the strategy holds several Japanese staffing companies. The economy is strong, there are structural labor shortages, and workers are starting to change jobs more. So if they execute well, it's very easy for staffing companies to grow fast.

Another attractive category is companies undergoing a transformation. These are companies that are restructuring or changing their strategy, product mix, or governance—anything that might lead to a market reevaluation. These tend to be value stocks that are genuinely changing where there's a catalyst.

Now may be the time to invest in Japan. We think it's a quality market that is improving, and the risk/reward balance is really attractive. Japan has the attributes of a developed market, but it also has the advantage of having a lot of room for improvement. It's potentially going to be a 20-year process, so I see a lot of runway for gains.

Q. Right now, which sectors of the market appear most promising?

A. First, services in a broad sense, particularly including staffing companies. Beyond these firms, anything that plays to the evolving Japanese consumer.

Second, automation-related companies. There's very strong demand for improved productivity all over the world. Demand for automation is still strongest in advanced economies, but it's growing very quickly in China, and the number of robots there could expand multiple times.

Q. Which sectors are you underweighting?

A. Banks are the largest underweight. We think Japan has far too many lending institutions, from banks to government-affiliated lenders, and you have a virtually unlimited supply of credit. As a result, net interest margins have been compressing forever, yield spreads are really thin, and, effectively, you still have negative interest rates. It's just too difficult to make money. On top of that, you have very strict bank regulations. Bank fundamentals are not likely to improve until the sector sees consolidation.

We also are underweighting old-style manufacturers, such as steelmakers, which are in direct competition with China and other low-cost producers. It's very difficult for these industries to retain pricing power, and many of them are being shipped to China.

Q. Over recent decades, there have been more than a few "false dawns" for Japanese equities. Could this be another one?

A. True, but we believe what is different this time is that there are so many factors pushing Japan along that there is no turning back. It used to be that when things got bad, Japanese companies would temporarily raise their game—and then return to their old ways when things were better. This time, you have new governance and stewardship legislation, increased foreign investment, and growing competition from China preventing Japan from going backward.

There are risks, of course. Not every company is getting better, and some are resisting change. The Japanese market is slowly becoming more diverse, less cyclical, and less dependent on exporters. But it remains very exposed to the global macroeconomic cycle. So if there's a global downturn, particularly if it starts in the United States, Japanese profits will be hit—there's no avoiding that.

Q. Last words?

A. Now may be the time to invest in Japan. We think it's a quality market that is improving, and the risk/reward balance is really attractive. Japan has the attributes of a developed market, but it also has the advantage of having a lot of room for improvement. It's potentially going to be a 20-year process, so I see a lot of runway for gains.

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