Having outperformed developed market peers in 2015, concerns about global economic growth, the outlook for China, and renewed yen strength, have caused some investors to re-evaluate the case for Japan in recent months.

Heightened volatility has been a notable change, prompting the flight of some ‘hot money’ that has been directed towards Japan.

However, any re-assessment of the case for Japanese equities should give focus to the high quality nature of market returns. The rally over the past three years has been driven by a real recovery in Japanese corporate profits – a feature we have seen little of elsewhere in the world.

Despite the strengthening trend of the yen, we continue to believe that the valuation case for Japan still holds and that Japanese corporate earnings growth is likely to exceed that of developed world peers.

In this Price Perspective, Archibald Ciganer, portfolio manager for T. Rowe Price’s Japanese Equity Strategy, explains why he remains positive on Japan, continuing to actively target durable businesses with long-term futures which are capable of weathering any economic turbulence that Japan encounters.

Buoyed by an outstanding profits recovery, the structural change thesis of Abenomics, and cheap valuations relative to peers, Japan continued to deliver superior performance versus other developed markets in 2015. However, headline returns mask a trend of rising volatility and a shift in sentiment during the early part of 2016. Concerns about global economic growth, the outlook for China, and renewed yen strength, have caused some investors to re-evaluate the case for Japan.

With the Topix First Section Index falling by almost 30% (in yen terms) by mid-February, from its August 2015 peak, before seeing a considerable rally in recent weeks, the question many are asking is, are we seeing a temporary shift in sentiment, or an evolution of the fundamental case for Japanese equities?

RE-ASSESSING THE CASE FOR JAPANESE EQUITIES

When assessing the current case for Japanese equities, it is important to understand how the thesis and standing of Japan has changed. Back in the summer of 2012, Japan was regarded as ‘the ultimate contrarian play’, characterised by very weak investor sentiment as expressed by valuations touching multi-decade lows. Two catalysts subsequently turned this contrarian thesis into reality; the advent of Abenomics and, equally important, data indicating global economic stability and latterly, recovery.
Following an Abenomics-led renaissance in terms of investors’ perception of Japan, the idea of positive secular and cyclical change has attracted meaningful support, with an acceleration of flows into the domestic equity market, especially via ETFs (Figure 1).

Time will tell how ‘sticky’ some of this capital proves to be but by the end of 2015, the Abenomics self-help thesis, inexpensive valuations, earnings recovery and weak currency, were all well-narrated stories feeding through to investment flows. When one considers the quality of the Japan equity rally, relative to that of the U.S., for example, (Figure 2) it is easy to see why investors have so dramatically changed their view on Japan over the past three years.

REAL PROFIT GROWTH UNDERPINS JAPAN’S ‘HIGH QUALITY’ RALLY

What exactly do we mean when we label Japanese equity market returns as ‘high quality’? Essentially that the rally has been backed by a real recovery in corporate profits, in contrast to being driven by the expansion of multiples (i.e. valuations rising). Such fundamental improvement has been a rare feature within global equity markets over the past three years. This trend has certainly helped investors feel that material change is happening and provided a solid investment case, particularly when viewed alongside Japan’s inexpensive valuation, relative to developed equity market peers.

Indeed, re-examining the valuation argument today, after the pull-back we have seen in 2016, Japan remains cheap relative to peers, both in absolute terms and versus the previous cycle high in 2007 (Figure 3). On this basis, we believe current levels offer an appealing entry point for investors who are capable of sifting through the volatility for attractive stocks unduly caught up in a period of worsening sentiment.
LET’S NOT FORGET, JAPAN IS A CYCLICAL ECONOMY

One point we have sought to reiterate over the past year is that Japan remains a cyclical economy. Indeed, corporate Japan has more earnings sensitivity to global economic conditions than almost all of its developed world counterparts. This has not changed as a result of Abenomics, especially with the limited progress made on Prime Minister Abe’s goals for domestic wage, consumption and inflation.

While this cyclical aspect used to be presumed wisdom, we observe that the Japan narrative in this cycle has not centred on this fact during the latter stages of the recent global and Japanese equity rally, either from a risk or return perspective. This may have created an environment ripe for a pull-back, just at a time when the global economic growth outlook has become less certain.

Two headline-grabbing, Chinese growth-related sell-offs have hit markets particularly hard in the past nine months, bringing Japan’s economic sensitivity front and centre in the minds of investors. Concerns about growth in China are especially relevant given Japan’s high dependency on intra-region trade. Some market volatility will therefore be related to capital repositioning by short-term investors worried about these factors.

YEN STRENGTH IS SIGNIFICANT

While helpful to returns in U.S. dollars in the near term, the year-to-date strength of the yen, up c.7.5% versus the dollar (to 21 March 2016), is also a significant change. The pattern of yen weakness over the past three years has stalled and recent strengthening goes against many predictions of further weakness. This matters because Japanese equity returns have become increasingly correlated with the weakening currency. Central to this is the fact that currency weakness has boosted corporate earnings growth and, in turn, resulted in the high quality equity market rally that has been so important to the case for Japan.

Having held a view since late 2012, that the Bank of Japan’s (BoJ) policy decisions would likely weaken the yen, our perspective today is of an increasingly unpredictable currency outlook. While the yen first began to rise as a safe-haven asset amid January’s market turmoil, unusually the currency strengthened even further when the BoJ intervened to cut interest rates. This is driving today’s volatility, alongside the fundamental factors that we can analyze. Recent strength may also suggest that the ammunition available to the BoJ to control the currency is close to being spent, a meaningful change if true. While we struggle to see any reason why the yen should meaningfully strengthen from here based on economic fundamentals, we have been examining our earnings expectations and will continue to do so in the event of the currency strengthening further.

Meanwhile, with the weak yen view becoming more uncertain, some of the ‘hot money’ has been shaken out of Japan, creating opportunities. This is especially true given our belief that the market is about to transition into a more stock-specific period, as the magnitude of market return (or beta) fades and greater stock dispersion (potential alpha) arises. If we are correct, this may represent an attractive point for investors to buy conviction ideas at cheaper levels and benefit from the very real regime change in Japan.

EXPECTATIONS OF SUPERIOR CORPORATE EARNINGS IN JAPAN REMAIN INTACT

It is important to make clear that we firmly believe that the valuation case for Japan still holds and that Japanese corporate earnings growth is likely to exceed global peers. This view underlies many of our preferred stock ideas today. There is one note of caution however, which is that further currency strength, if it transpires, will most likely begin to diminish expected growth in corporate earnings.

The condition of the global economy also remains a critical factor in terms of support for the Japanese equity market. On this point, our view is that we remain in an environment of low, mildly improving global growth, which should help the best of corporate Japan to perform reasonably well. This is particularly the case for the highest quality stocks that fell sharply in January and February, as capital flight accelerated.
On the subject of high quality stocks, Figure 4 highlights one measure of clear success, and potential evidence of structural change, among Japanese companies. While profitability, return-on-equity (ROE) and corporate governance standards are all improving in Japan, the improvement is not even and not a trend that is captured well by passive investing – particularly as Japanese equity indices are biased to ‘Old Japan’, where companies have been slow to adopt structural change. Looking at the top quintile of Japanese companies by pre-tax margins (i.e. the most profitable stocks within the Japan equity opportunity set), levels are close to a 30-year high. The best Japanese businesses have been working hard to improve profitability and their success in this regard is particularly noteworthy given the backdrop of muted global and domestic growth. This trend represents an opportunity for investors, and a tangible sign that structural change in Japan is occurring at a company level.

**IMPROVING CAPITAL RETURNS AND GOVERNANCE, BUT SELECTION REMAINS KEY**

The focus on capital return and improving corporate governance, a key element of Abe’s ‘three arrows’ strategy, also continues to evolve. Japan is forecast to reach a new all-time high for share buybacks in 2016, as well as total capital returns, when factoring in dividend payments. More dividends, more share buybacks and less idle cash (earning zero or negative returns on Japanese balance sheets) are all positives for overall returns and for valuations, as investors will pay higher multiples for those companies improving their capital allocation and shareholder returns policy. However, while often held up as a key pillar of the case for being overweight Japanese equities, this is not an index-based investment case in our view, but rather one that calls for active management.

In summary, we see signs of increasing dispersion and this should be an appealing environment for patient investors. That said, we may be set for a period of elevated volatility in the near term as the market digests subtle changes in the top-down investment case. However, we remain upbeat about the Japanese equity market over the medium term, especially those stocks central to Japan’s evolution. In particular, we believe that investing in durable and improving businesses capable of weathering economic turbulence remains an advantaged approach to Japanese equity investing.