Crisis-Level Equity Valuations Do Not Reflect Japan's Potential

Compelling equity valuations may offer exciting Japan entry point.

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KEY INSIGHTS

- The sell-off in global equity markets during the fourth quarter of 2018 saw Japanese equities end the year at their lowest valuation levels in a decade—effectively pricing in expectations of a crisis-like environment in 2019.
- This bleak scenario is unlikely, in our view. Consequently, with many quality, growth-oriented businesses down 20%–50% from their 2018 highs, we believe now is an attractive entry point for investors to access the longer-term potential of Japanese equities.
- The structural improvement taking place in Japan, such as shareholder-friendly corporate reform, and the increasing importance of Japan's domestic economy as a driver of growth are secular stories that continue to underpin Japan's positive, long-term outlook.

The rout that impacted Japanese equities in the final quarter of 2018 has markedly improved valuations. Indeed, with many good-quality companies trading at multiyear lows, combined with a supportive structural backdrop, we believe an attractive entry point currently exists for investors to access the longer-term opportunities of Japanese equities.

What Happened in Late 2018?

Global equity markets suffered their worst quarter of performance since the global financial crisis in the fourth quarter of 2018, amid fears of slowing global growth and trade wars. Japanese equities were particularly impacted by the market turmoil, posting sharp declines.

Softening global growth prospects, concerns about the trajectory of U.S. interest rates, and ongoing tension in U.S.-China trade relations all contributed to a dramatic weakening of investor sentiment at the end of 2018. The TOPIX TSE First Section fell -14.7% in U.S. dollar terms during the fourth quarter, more than erasing the gains accumulated earlier in the year to finish 2018 in negative territory.[1]

Given concerns about weakening global demand, selling pressure in Japan was not wholly unexpected.

[1]Source: Thomson Reuters as of January 31, 2019.

The TOPIX is currently trading at around 12x earnings—a level not seen since the depths of the global financial crisis in 2008/2009.

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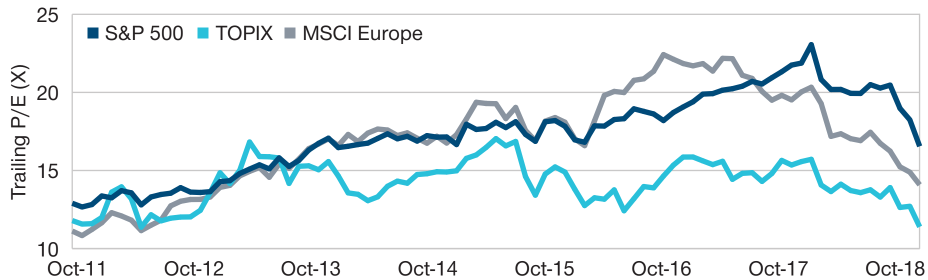
(Fig. 1) Japan Equity Valuations At Lowest Levels In A Decade

Market is pricing in expectations of a deep recession in 2019
As of December 31, 2018



Past performance is not a reliable indicator of future performance.
Source: Financial data and analytics provider FactSet. Copyright 2019 FactSet. All Rights Reserved.
Source: Tokyo Stock Exchange, Inc. via FactSet.

What was very surprising, however, was the severity of the sell-off, which saw Japanese equities end the year at their lowest valuation levels in a decade—effectively pricing in expectations of a deep global recession in 2019. This "doomsday" scenario is highly unlikely, in our view. Consequently, the current valuation case in Japan looks especially compelling.

Earnings Likely to Be More Resilient Than the Market Expects

The traditional view of Japan as a heavily export-dependent economy has seen consensus earnings growth expectations revised sharply lower for 2019. While we could see some negative impact on earnings from weaker global growth and trade in 2019, we believe embedded expectations for the coming year are unreasonable and are well below our expectations.

The TOPIX is currently trading at around 12x earnings—a level not seen since the depths of the global financial crisis in 2008/2009. Not even in 2011, when Japan was hit by the Tohoku earthquake and Fukushima nuclear disaster—twin crises that tipped Japan into recession—did equity valuations fall to current lows. The picture is equally perplexing when viewed in relative terms. The U.S. S&P 500 Index, for example, is currently trading at approximately 21x trailing earnings—a differential that seems excessive.[2]

The Structural Backdrop Remains Promising

While current valuations have created a timely opportunity, it is important to reinforce the broad structural backdrop that makes Japan so compelling over a longer-term view.

The structural reforms taking place in Japan, particularly at the corporate level with improvements in governance standards, have been tangible. These measures have been pushed through as a priority, with the aim of building a more robust and globally competitive business environment.

One of the most striking aspects of the Japanese equity market revival in recent

[2] Source: Financial data and analytics provider FactSet. Copyright 2019 FactSet. All Rights Reserved. Source: Tokyo Stock Exchange, Inc. via FactSet. As of January 31, 2019.

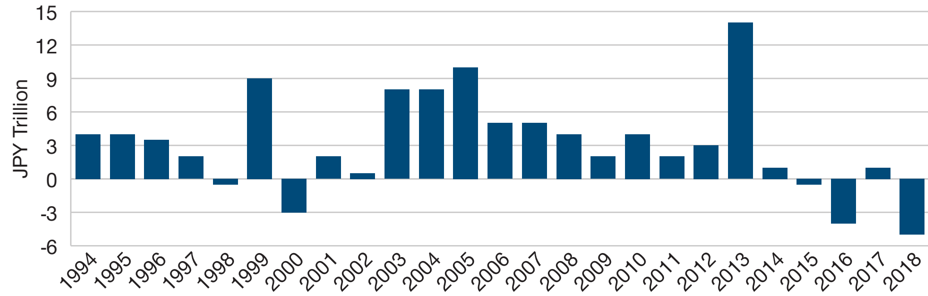
20%–50%

Price declines (in Q4 2018) of many quality, growth-oriented Japanese companies, from 2018 highs.

(Fig. 2) Foreign Net Buying Of Japanese Stocks

Japanese equity outflows in 2018, more severe than the depths of the global financial crisis

As of December 31, 2018



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years has been the strength of the corporate sector. Among the principle drivers have been:

Record Aggregate Profits—Japanese company profits have outpaced all other major markets.

Cash Flows—Management teams are using cash flows more efficiently than in the past.

Capital Expenditure—Is on the rise, reversing a long-term trend of underinvestment.

Investor Returns—Greater focus on shareholders, including increased dividends and share buybacks.

Over the past five years, the return on equity (RoE) from Japanese equities has almost doubled and overtook Europe last year. We believe that there is a real possibility that Japan's RoE could equal that of emerging markets at some point over the next five years.

The Global Environment in Context

Much of the sell-off at the end of 2018 was driven by concerns about the potential impact of lower global growth on Japan's export-oriented economy. Slowing growth in China and the country's ongoing trade war with the U.S. have both been key factors undermining confidence in Japanese equities. This ratcheting up of fear drove heavy outflows from active funds globally, including Japan, to a magnitude that exceeded even the depths of the global financial crisis.

However, the traditional image of Japan's economy being dependent upon export industries is less relevant today than in the past. The considerable size of Japan's domestic economy means that local demand, including private consumption, is an increasingly important driver of Japanese economic growth. Indeed, while stocks sensitive to external demand (as well as growth stocks with high price/earnings ratios) were particularly hard hit at the end of 2018, stocks more aligned to domestic demand held up relatively better.

These shifting dynamics mean that Japan is perhaps less vulnerable to the threat of a global trade war than many believe, and maybe even less so than some other markets. As more investors put these macro developments in perspective—and appreciate the many undervalued, quality companies available—there is real potential for an increase in capital inflows and an upward rerating of the market.

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> *Portfolio Manager, T. Rowe Price Japan Equity Strategy*

Add to this the Bank of Japan's accommodative monetary policy, which contrasts with a tightening path in the U.S. and we believe that Japanese equities currently offer an exciting risk versus reward opportunity.

Attractive Entry Point to Access Japan's Long-Term Potential

Of course, low valuations alone are not enough to indicate an attractive buying opportunity. However, the improvements taking place in Japan, such as the progress on shareholder-friendly corporate reform, is already a positive story. Japan is also home to many high-quality companies that are leading players in their respective field, businesses that are well placed to benefit from long-term structural changes or trends that are taking place in both the domestic and global economies—these are the kinds of qualities that we look for in an investment.

With many of these quality, growth-oriented businesses currently trading at some 20%–50% below their 2018 highs, we believe now is the time to invest in Japan to take advantage of the attractive long-term return potential on offer.

WHAT WE'RE WATCHING NEXT

We still believe the world will see economic growth this year, albeit more modest growth on both an economic and earnings basis. This does not imply the need to rotate into defensive stocks or to sell Japan stocks. What it does imply is the need to acid test our portfolio to gauge whether market expectations for 2019 are realistic, or too low, for the stocks we own, especially versus our own fundamental estimates of long-term earnings power.

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