In 2019, Japanese Equities Still Have Plenty to Offer

Japan's equity fundamentals remain supportive.

December 2018

KEY INSIGHTS

- Japanese equity fundamentals remain intact. Attractive relative valuations, solid earnings growth, and improved corporate governance are reasons to be positive.
- Japanese companies are using cash more efficiently. This could see equities positively re-rated in 2019, due to improved returns on equity.
- With corporate profitability outpacing all other major markets, Japan offers a rich opportunity set for quality-focused, active investors.

Archibald Ciganer
Portfolio Manager, T. Rowe Price Japan Fund

Global investors' risk appetite was tested by various factors in 2018, including rising U.S. interest rates, a slowing Chinese economy, and a breakdown in U.S./China trade relations. Amid this backdrop, Japanese equities, along with most other major markets, ended the year in negative territory. The pullback also reflected a narrower market leadership, with fewer stocks posting positive returns as the near-perfect conditions for equity markets in 2017 faded.

However, we believe that Japanese equities retain the characteristics that can continue to work well in 2019, supported by a stable economy and positive, although slowing, global growth. Japanese equity valuations are below their long-term average, companies are delivering positive earnings growth, and structural market reforms should also prove supportive of rising corporate returns.

Slower, Stable Growth Remains Supportive

While the broad outlook remains favorable, headwinds are rising, and we anticipate a slowdown in global growth momentum in 2019. Although Japan is more than a cyclical story, the global economy remains a key influence on the equity market. The main risk from the global economy stems from the ongoing U.S./China trade dispute. Japan's manufacturing and technology sectors stand to lose in the event of any significant disruption to Asian supply chains.

Locally, the decision to increase the consumption tax in 2019—while welcome in terms of long-term stability—has the potential to undermine near-term growth. We anticipate further stimulus measures over the coming year as the government attempts to mitigate the impact of the sales tax hike.

More broadly, the Bank of Japan (BoJ) continues to affirm its accommodative

2.2%

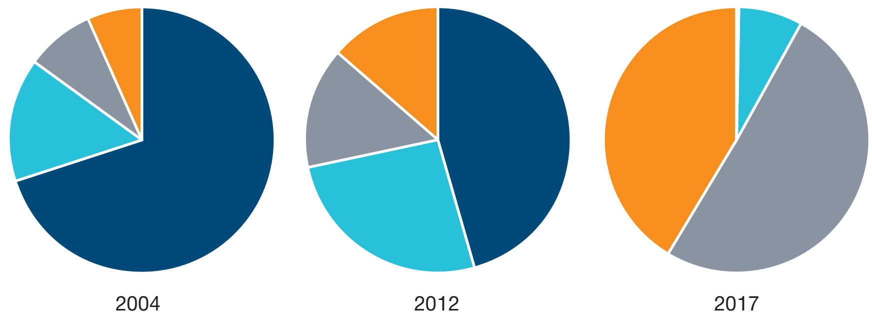
Unemployment is at a 25-year low, with a sharp rise in female participation in the workforce.[1]

(Fig. 1) Change Is Visible In Japanese Boardrooms

The number of independent, external directors is growing

As of December 2017

No. of external directors on company boards: None 1 2 3+



Sources: Corporate Reports, Japan Exchange Group, Empirical Research Partners Analysis.

policy stance. While inflation data have increased recently, current levels of inflation, and wage growth, remain shy of BoJ targets.

Favorable Equity Fundamentals

Despite the possibility of slower global growth in 2019, the fundamental equity story in Japan remains intact. Attractive relative valuations; solid earnings growth; and, perhaps most significantly, improvements in corporate governance give us reason to be positive about the outlook for Japanese equities in 2019.

Capital spending data also suggest that Japanese companies are using their cash more efficiently. This raises the prospect of Japanese equities being positively rerated in 2019 as a result of improved returns on equity. Share buyback activity and higher dividend payments are also expected to remain a feature of the market, providing near-term support for equity markets.

Abenomics and the Impact of Reforms

We are six years on from the launch of the "Abenomics" market and economic reform strategy, and the accomplishments have been considerable. Some of the key achievements, to date, include:

- Unemployment is at a 25-year low, with a sharp rise in female participation in the workforce[1]
- The fiscal deficit has been halved
- Deflationary risks have reduced
- Corporate cash generation is at an all-time high
- Corporate governance standards have been raised

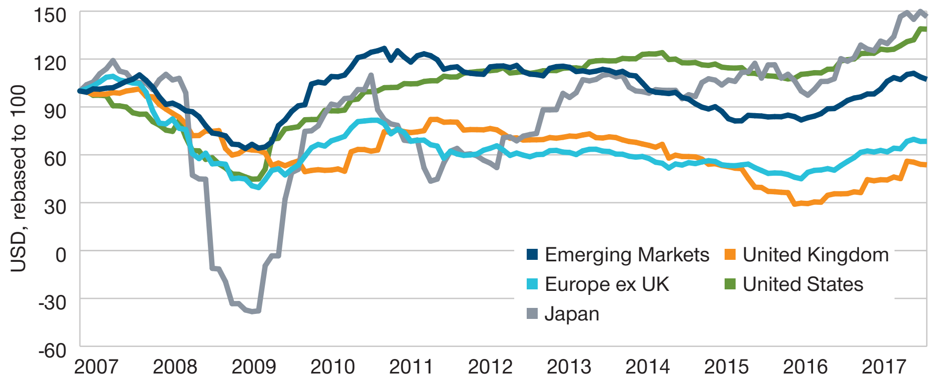
The improvement in governance standards is particularly noteworthy. Corporate governance and stewardship codes have been implemented with speed and determination, designed to encourage a more robust and globally competitive business environment.

Obligations such as improving returns for shareholders and increasing external director representation on company boards are driving renewed interest and confidence in the Japanese equity market. Companies are rising to the challenge. In 2004, for example, the

[1] Japan Ministry of Internal Affairs and Communications, as of May 1, 2018.

(Fig. 2) Japanese Company Profitability Is Striking

Japanese corporate profits have surpassed all major markets
As of June 30, 2018



Past performance is not a reliable indicator of future performance.
Source: FactSet Research Systems Inc. All rights reserved.

Share buyback activity and higher dividend payments are also expected to remain a feature of the Japanese market, providing near-term support for equity markets.

— **Archibald Ciganer**
Portfolio Manager, T. Rowe Price Japan Fund

majority of Japanese companies had no independent external directors on their boards. Today, nearly every Japanese company boardroom has at least one external director at the table—a trend that we see continuing into 2019 and beyond.

Japanese Companies Are Delivering

Perhaps the most striking aspect of the Japanese equity market revival in recent years has been the strength of the corporate sector. Companies delivered another record level of aggregate profits in 2018, far outpacing other major markets.

Crucially, Japanese companies are using these substantial cash flows more efficiently than in the past. Historically, companies tended to stockpile cash on their balance sheets, earning very little return. Reform initiatives, along with pressure from foreign investors, are encouraging Japanese companies to put their cash to better use, including paying higher returns to shareholders in the form of increased dividends and share buybacks. We see this efficiency momentum continuing during 2019, providing a positive stimulus that will benefit both the economy and equity investors.

Portfolio Positioning

In terms of our Fund as we head into 2019, we continue to focus on several key investment themes within the portfolio. We seek companies that are direct beneficiaries of the fundamental societal changes taking place in Japan, including the shift to electronic payments, changing consumer preferences, the aging population, and the ever-tightening labor market.

We remain overweight in the industrials sector, via our holdings in staffing companies supplying labor in an environment of labor shortages, as well as holdings in high-quality machinery stocks, with a tilt toward automation. We also like the valuation and capital return characteristics of specific telecommunications stocks, which also offer some downside resilience potential.

In contrast, we continue to avoid areas that are directly challenged by competition from low-cost countries. China, for example, is moving up the value chain and increasingly challenging Japan's traditional manufacturing base. Areas like steel and cement have been

> Japanese corporate earnings growth is likely to exceed global peers.
>
> — **Archibald Ciganer**
> *Portfolio Manager, T. Rowe Price Japan Fund*

under pressure for some time, and this trend looks set to continue. We also have no exposure to banks, given our negative view of the sector and our belief that monetary policy is unlikely to tighten in the near term.

In Summary

As we enter 2019, we believe that the valuation case for Japan still holds. Japanese corporate earnings growth is likely to exceed global peers, and reform measures will continue to provide a positive near-term impetus for Japanese equities.

The global economy remains a key factor affecting the performance of the Japanese equity market. While we anticipate a slowdown in global growth in 2019, an environment of lower, stable growth should continue to support the best of corporate Japan to perform reasonably well.

Our principal worry is any potential escalation of the simmering trade war between the world's largest trading partners. If this scenario were to eventuate, jeopardizing the supportive growth environment, our quality bias within the portfolio means we are relatively well placed to weather any uptick in market volatility.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of December 2018 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc., Distributor.

ID0001821 (12/2018)
201812-683646