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In-depth analysis and insights to inform your decision-making.

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Japan Equities

JAPAN: FALSE DAWN OR STOCK PICKER'S DREAM?

KEY POINTS

- For much of the past 20 years, economic stagnation, political instability, and elevated debt have kept Japanese equities off the radar of global investors. In recent years, however, economic and market reforms have improved the investment landscape.
- Central to this change has been a prolonged period of political stability. Under the government of Prime Minister Shinzo Abe, and with broad support from politicians, business leaders, and bureaucrats, much-needed structural change is being delivered.
- A central thesis for investing in Japan today is the improving structure of the market and the quality of corporate governance. Nevertheless, there are certain market aspects where Japan still lags Europe and the U.S. in terms of best practice. So while Japan offers a potentially rich opportunity set, we think an active stock-picking approach is essential.

For much of the past 20 years, global investors have generally steered clear of Japanese equities, finding little enticement in a landscape of economic stagnation, elevated debt, and political instability. Despite intermittent periods of renewed confidence and expectation, the much hoped-for recovery has failed to sustainably take hold.

Encouragingly, however, we are finally seeing a prolonged period of political stability. Under the government of Prime Minister Shinzo Abe, much-needed structural change is underway at both an economic and financial market level. This is driving renewed interest in Japan as an investment opportunity. For many, however, this recovery road has been traveled before, which begs the question: Is this yet another false dawn or a stock picker's dream?

MARKET REFORM: A CLEAR TURNING POINT

Talk of Japan's improvement since the global financial crisis focuses on Prime Minister Abe and the impact of his Abenomics market and economic reform strategy. However, rarely have we seen the kind of broad-based support for reform initiatives in Japan as has been the case in recent years. The political establishment, bureaucrats, as well as corporate leaders have united behind the Abenomics program, suggesting a clear commitment toward addressing the country's problems.

One indication that reform efforts are bearing fruit is the return of positive inflation. While inflation remains below the Bank Japan's (BOJ's) of 2% target, it is important to remember that, for much of the past 20 years, Japan has been

suppressed by the weight of deflation. In setting a 2% target, the BOJ aims to try and shift embedded deflationary behavior and expectations. And (with a little help from the global macro environment) it appears to be working, as Japan has now been free from deflation for four years.

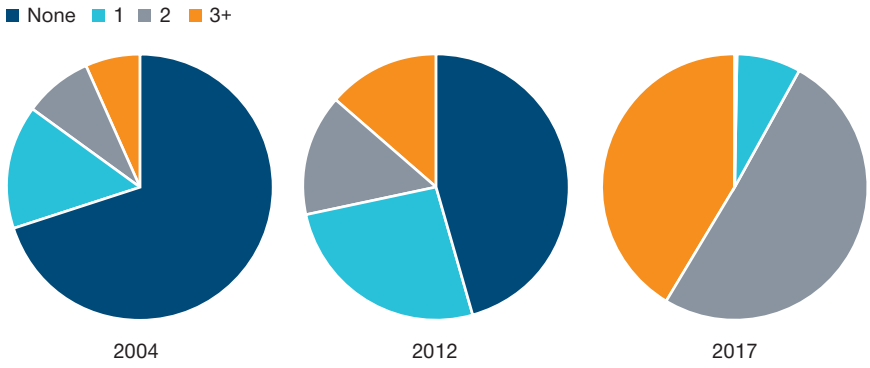
One of the most significant achievements of Abenomics is the improvement in Japanese corporate governance. Corporate governance and stewardship codes have been implemented with unexpected speed and determination, visibly changing the corporate atmosphere. Japan's regulatory reforms are pushing companies to raise return on equity and be more receptive to external directors. And this regulatory change is irreversible.

Another important factor here is the increasing influence of foreign shareholders. In recent years, foreign investors have become the largest shareholder class in Japan. This is significant because foreign investors expect a comparable level of shareholder focus and capital allocation discipline from Japanese investments as they do when investing in European or U.S. equivalents. With foreign ownership increasing, the influence of offshore shareholders is set to become more prominent. A striking example of this can be seen in the changing representation on Japanese company boards. In 2004, the majority of Japanese companies had no independent, outside directors. Today, almost all companies have at least one external director on their board. (Figure 1)

But while the quality of the market overall is improving, the gap between those companies leading the change and those resisting it is widening. This is one reason why Japan is a rich environment for active investment.

FIGURE 1: Companies Hiring External Directors Is An Increasing Trend

As of December 2017



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

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JAPANESE DEMOGRAPHICS—GLASS HALF EMPTY OR HALF FULL?

Population demographics are often cited as a potential barrier to long-term investment in Japan. The country's working age population is set to shrink by 20% over the next 25 years. With a rapidly aging population and a shrinking workforce, the fear is that this will have a negative impact on Japan's future growth potential.

It is worth noting that Japanese society is very pragmatic—there is a general understanding that the country faces very real labor shortages in the decades ahead and that action is needed. A common misconception among foreigners is that Japan is strictly averse to immigration. This may once have been true, but sentiment is slowly changing. With various polls suggesting that the Japanese people are open to it, immigration could help to mitigate the impact of the country's aging population profile.

Meanwhile, with such a globalized economy, many Japanese companies are more exposed to industry trends within the U.S. and Chinese economies than they are to the Japanese economy. As such, the market-wide implications of Japan's population dynamics are somewhat limited when looking on a stock-specific, profits-growth basis.

Of course, certain market areas and companies are acutely exposed to demographic dynamics, but, again, this is where an active manager can identify potential opportunities. In the T. Rowe Price Japan Fund, for example, we are invested in companies that help Japanese society cope with labor shortages and improve efficiency.

JAPANESE COMPANIES ARE DELIVERING

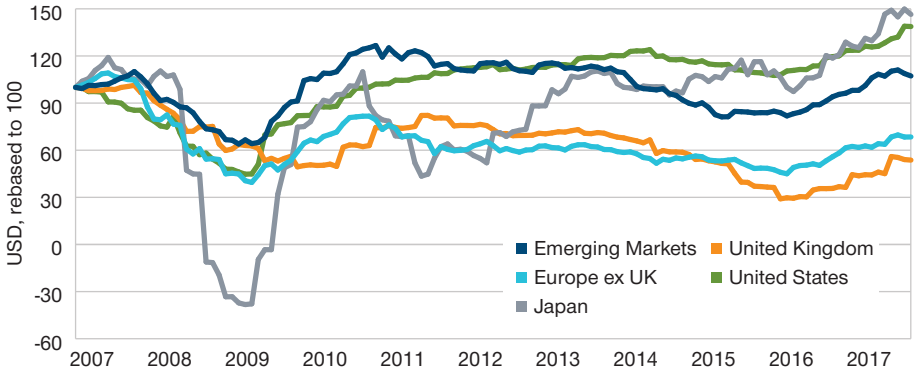
Perhaps the most understated element of the Japan equity market revival in recent years has been the level of corporate profitability, which has outpaced the U.S. (Figure 2)

With the global market cycle now in its latter stages, the question is: Can this high profitability continue? Japan is still a very cyclical market.

This is why Japan is such a rich environment for active investors, because even though the quality of the market overall is improving, the gap between those companies leading the change and those resisting it, is widening.

FIGURE 2: Japanese Corporate Profits Have Surpassed All Major Markets

Earnings per share since last cycle peak (October 2007)
As of June 30, 2018



Source: FactSet Research Systems Inc. All rights reserved.

As such, any downturn in the global macro environment will see Japanese company profits negatively impacted overall. This could be compounded by a strengthening yen, given the currency's safe-haven status.

It is, therefore, key to strike a reasonable balance between cyclical sectors and defensive sectors of the market. The stage of the cycle dictates the kind of opportunities that are available, but it will not determine overall performance.

OPPORTUNITIES LIE AHEAD—BUT ALSO POTENTIAL PITFALLS

A central thesis for investing in Japan is that the quality of the governance is catching up with Europe and the U.S. At the same time, however, there are many ways in which the market is well behind Europe and the U.S.

In terms of opportunities, the structure of the market is becoming less reliant on exporters and traditional manufacturers, while domestic sectors, like consumers and services, are becoming more influential. The positive trend is a clear reflection of the evolving Japanese economy, with new and influential areas of domestic demand emerging.

In contrast, the least attractive areas are those that are secularly challenged by competition from low-cost countries. China is moving up the value chain and is increasingly challenging Japan's traditional manufacturing base. Areas like steel and cement have been under pressure for some time, and this trend looks set to continue. The banking sector is also problematic, undermined by complex industry structure issues and in need of large-scale reorganization and consolidation.

The continuity of government in Japan, and the broad support for its market and economic reform program, are crucial factors that we believe will continue to underpin Japan's sustainable growth path. Meanwhile, structural reform of the market is encouraging renewed investment in Japan. This is no "false dawn," in our view, but rather a market that is undergoing positive change, creating a fertile environment for bottom-up, quality-oriented stock pickers.

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