A New Imperial Era in Japan Adds to the Positive Outlook

Japan's new Reiwa imperial era brings a sense of renewed positivity.

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Archibald Ciganer
T. Rowe Price Japan Fund

KEY INSIGHTS

- The new Reiwa imperial era in Japan has been warmly welcomed, representing a symbolic reset for the country following the beleaguered 30-year Heisei era.
- Structural market reform in Japan over the past decade is translating into higher company profitability and greater returns for investors.
- However, Japanese equity market valuations remain cheap. In our view, this presents an attractive entry point to access Japan's long-term potential.

On May 1, 2019, the new Reiwa imperial era commenced in Japan, as emperor Naruhito officially acceded to the throne. While the direct impact of this on the economy, markets, or politics will be minimal, the psychological significance—Reiwa translates to "beautiful harmony"—is important. It represents a symbolic clean slate for Japan, drawing a line under the beleaguered 30-year Heisei era. Given the positive economic and market changes already underway, Japan now has the potential to redefine itself and its role in the world.

Overcoming a History of Policy Inertia

While authorities have been slow to adopt pro-growth policies, the Shinzo Abe-led Liberal Democratic Party (LDP) has successfully broken the long-held tradition of policy inertia on this front. Key among these is attempting to deal with the economy's structural challenges, where a range of encouraging measures have been implemented, including:

- Lower corporate tax rates
- Enhanced corporate governance code
- Initiatives to encourage married women and foreign workers into the labor force

Improving Governance Supports Profit Growth

An increasing number of companies are defying skeptics by transforming business practices and governance standards. We believe this can help corporate profit growth and generate improving shareholder returns. The volume of shareholder buybacks is increasing while merger and acquisition activity also shows promise.

12.9X

Japanese equities (Topix) are currently trading at 12.9X price/earnings (P/E) (trailing), below the long-term average of 14X P/E.*

From an investment perspective, the equity market is now supported by strong growth in company profits. Indeed, aggregate corporate profits have been exceptional over the past decade, with Japan breaking away from its history of lower returns to converge with the profitability levels of global market peers.

The quality of Japanese companies, both in terms of governance standards, and returns for investors, has continued to rapidly improve, closing the gap with Europe and U.S. equity markets. Over the past five years, for example, the return on equity from Japanese companies has almost doubled. Companies are allocating capital more efficiently, paying higher dividends, and increasing share buybacks (Figure 1), and these improved returns are attracting greater foreign investment.

Global Growth Environment Remains Supportive

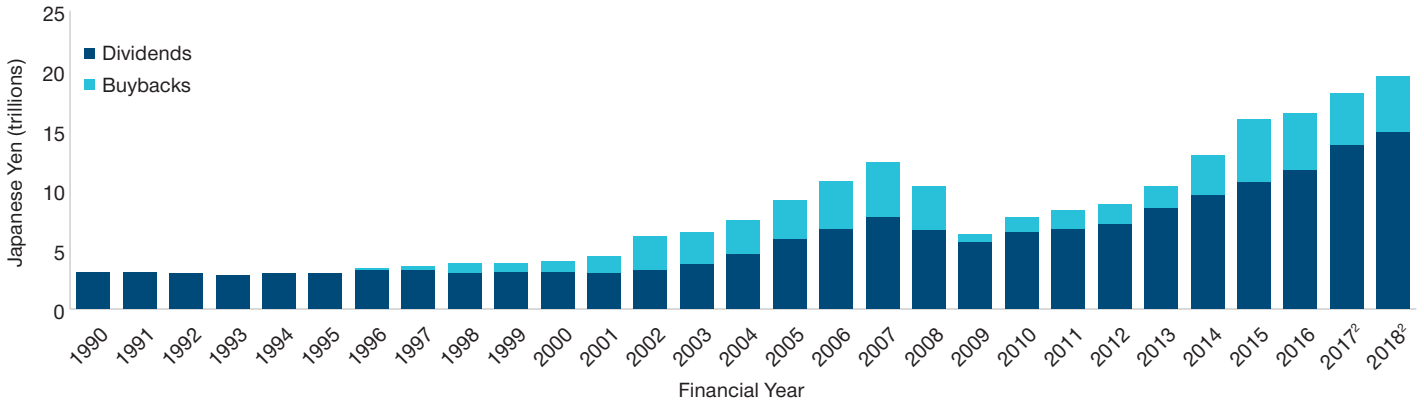
As well as market-specific drivers, the condition of the global economy remains a key factor supporting the Japanese equity market. An environment of modest global growth should continue to help corporate Japan perform well. We are, however, mindful of the trade-related tensions between the world's two largest trading partners, China and the U.S., and any escalation here is a key risk. While the ideal scenario is that trade war concerns subside and sanctions are lifted, we believe the quality bias within our portfolio holds it in good stead should the trade situation deteriorate.

Looking ahead, increasing dispersion between stocks is likely to be a feature and will need to be navigated accordingly as the market digests subtle changes to the macro environment and reacts to any specific surprises or disappointments. We continue to believe that investing in durable and improving businesses that are capable of weathering economic turbulence is an advantaged approach in Japan.

(Fig. 1) Changing Capital Allocation Should Continue To Drive Japanese Stock Prices

Total shareholder returns of all Japanese listed companies[1]

As of June 30, 2018



Past performance is not a reliable indicator of future performance.

[1] Data exclude financials and utilities. Share buybacks net of share issuance. Based on governance reports submitted by mid-July each year.

[2] Estimate.

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

*Source: FactSet (see Additional Disclosures). As of March 31, 2019.

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>
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> *T. Rowe Price Japan Fund*

Compelling Structural Changes Are Underway

The range of Japanese structural reforms over the past decade are crucial to the market's reinvigorated prospects. At the corporate level, improving governance standards and a greater focus on delivering higher investor returns are game-changing. The aim here is to build a more robust and globally competitive business environment. Indeed, foreign investment has increased to over 30% of the total compared with 5% in 1990. Some of the principal attractions for foreign investors include:

- **Record Aggregate Profits**—Japanese company profits have outpaced most other major markets.
- **Strong Cash Flows**—Management teams are using cash flows more efficiently.
- **Capital Expenditure**—Capital expenditure is rising, reversing a long-term trend of underinvestment.
- **Investor Returns**—There is greater focus on shareholders, including increased dividends and share buybacks.

The Global Environment In Context

Meanwhile, it is arguable that Japan's economy today is not as heavily dependent on exports as it has been in the past. In recent years, improving domestic demand, including private consumption, has become an increasingly important driver of economic growth. These shifting dynamics mean that Japan may not be as vulnerable to the threat of a global trade war than many believe and possibly even less so than some other markets. As more investors put these macro developments in perspective—and appreciate the many undervalued, quality companies available—we believe there is the potential for an increase in capital inflows and a positive rerating of the Japanese market.

Consumption Tax Hike Is Manageable

A planned increase in the consumption tax rate, from 8% to 10% on October 1, 2019, has raised concerns that this might negatively impact domestic spending and, in turn, undermine Japan's economic revival. Certainly, when consumption tax was raised in 2014, from 5% to 8%, the move saw consumer sentiment negatively impacted, ultimately pushing the country into a mild recession.

The tax hike is a necessary one, in our view, as Japan seeks to account for higher social welfare spending. However, despite concerns, there are reasons to believe that the impact on consumer confidence and spending will be less dramatic than was the case following the hike in 2014. For a start, the planned 2% increase in October is smaller than it was in 2014. The government has also approved a ¥2 trillion package of consumer and retail stimulus measures—including retail vouchers for low-income families and a reduced 8% tax rate for basic foodstuffs—aimed at softening the impact of the tax rise.

A Promising Entry Point to Access Japan's Potential

As we head into the second half of 2019, we believe that Japanese equities will be supported by a stable economy and positive global growth. At the market level, structural reforms—such as higher governance standards—combined with positive earnings growth should continue to support corporate returns. We continue to target quality companies that are direct beneficiaries of fundamental changes taking place in Japan, including the shift to electronic payments and a tightening labor market. Finally, from a valuation perspective, Japanese equities remain at a discount to regional peers.

WHAT WE'RE WATCHING NEXT

The growing trend among Japanese companies of paying higher returns to investors suggests that corporate Japan is learning the art of capital allocation and how it can be used for good. Skeptics, however, suggest that any slowdown in the domestic or global economy, combined with trade war uncertainty, would see companies quickly revert to the conservative, shareholder-unfriendly norms of the past. We continue to watch for any signs of this and have yet to see any.

Additional Information

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