Asset allocation: why we still like Japanese equities

Multi-asset | August 2023

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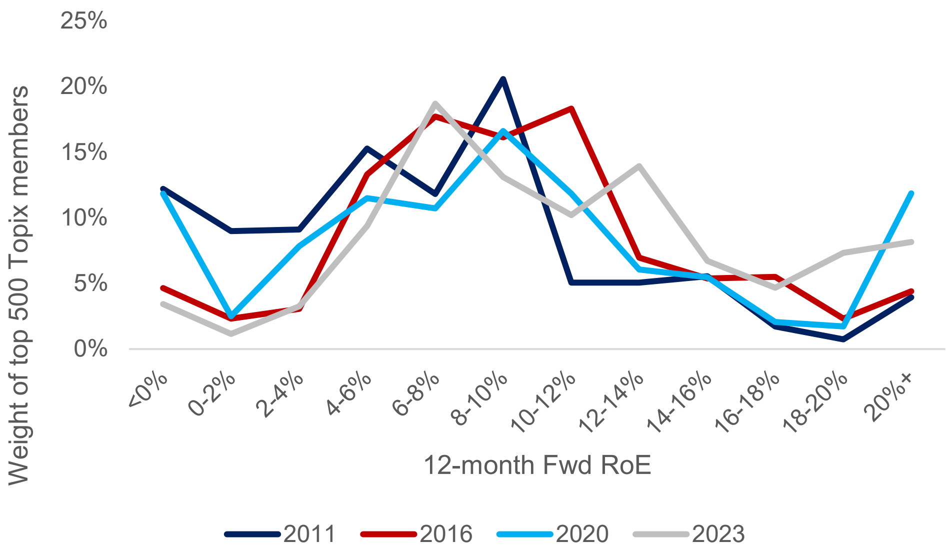
- **Japan has made another step forward on its long-term path to improved corporate capital efficiency**
- **For a long time we have favoured the region and believe this ongoing change has further to run**
- **In addition we see a constructive medium-term backdrop for the allocation**

Japan is an equity region we have long favoured. Central to this view has been the long-pursued improvement to corporate governance and increased shareholder focus of Japanese firms. In a globalised world where tying regional equity market performance to regional economic outcomes can be misleading, this is an idiosyncratic catalyst that should benefit Japan-listed companies specifically.

As we entered the 1990s Japan's equity and real estate bubbles burst. This established a cautionary corporate mindset among Japanese firms where excessive cash balances were maintained, which led to reduced levels of return on equity (RoE). From 2012, under the then-president Shinzo Abe's so-called Abenomics programme, numerous reform efforts have been made at improving Japanese corporate profitability and capital efficiency. The upwards trend in the RoE distribution of the top Topix 500 firms (Figure 1) shows that this appears to have been slowly working. Firms have made efforts to improve capital efficiency and increase the return generated on investors' equity.

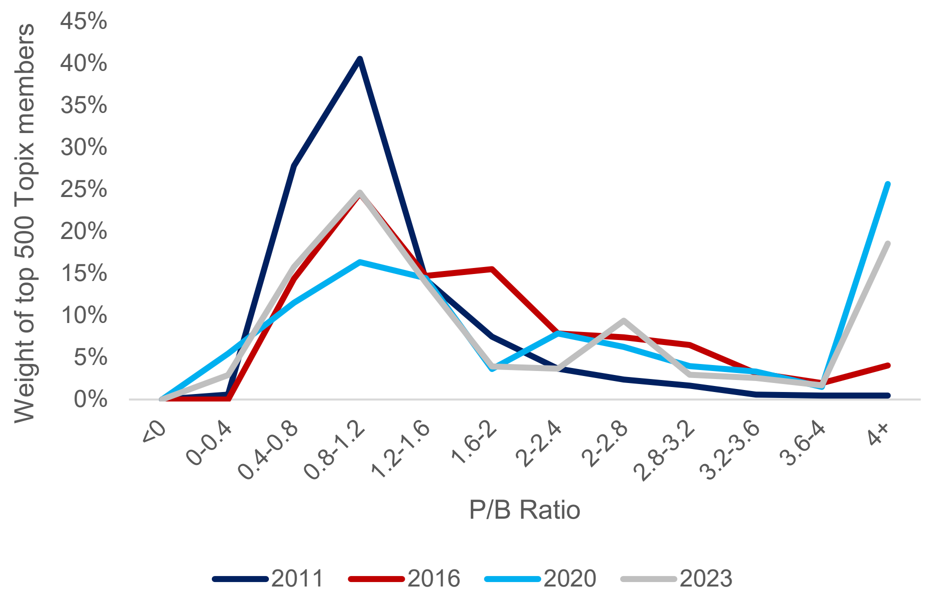
Figure 1: Distribution of Top 500 Topix members' weights by RoE



Source: Bloomberg, 31 March 2023

As the ability of firms to generate returns for investors increases, an observable measure of market appreciation of this is any increase in the price/book (P/B) ratio. And in line with this upwards trend in RoE, the distribution of P/B ratios of the same cohort of stocks has also shifted upwards from its pre-Abenomics profile (Figure 2). However, a significant concentration of firms remains with a P/B ratio around 1x.

Figure 2: Distribution of Top 500 Topix members' weights by P/B

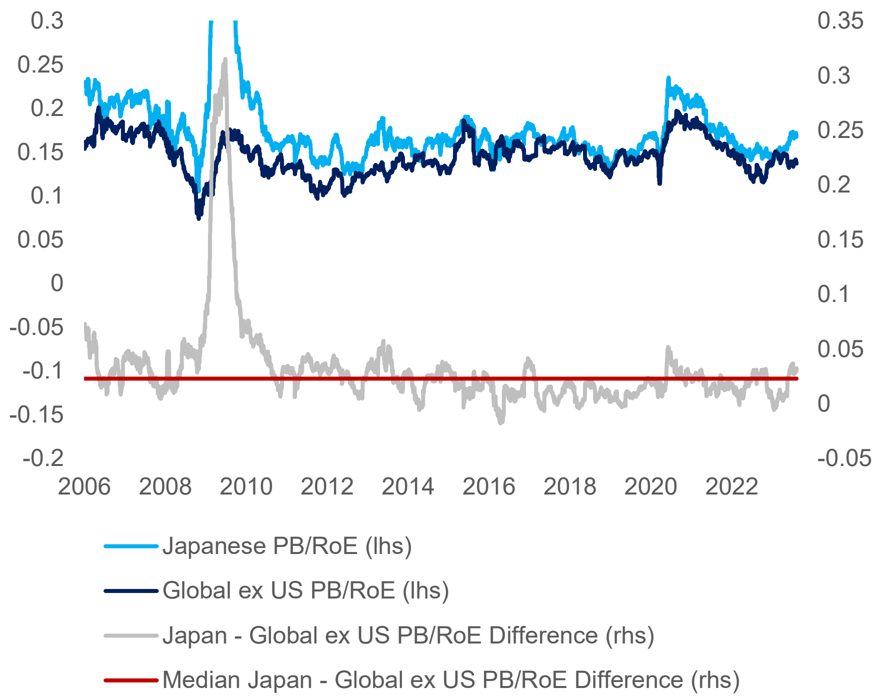


Source: Bloomberg, 31 March 2023

In April this year the latest policy move aimed at increasing Japanese profitability was launched. This saw the creation of the "Action Plan for Substantiation of Corporate Governance Reform"[1]. Key within this is the requirement by the Tokyo Stock Exchange for firms to disclose risk-taking plans and measures taken to achieve growth whilst keeping profitability in mind. In particular, firms with a P/B ratio below 1x will be flagged and requested to "properly identify" their cost and efficiency of capital.

As at the end of July, Japanese equities had rallied almost 16% since this announcement, outpacing global equities in local terms by 5%. Naturally, questions have emerged around whether the potential upside is now factored into prices. We note that the premium in terms of P/B per unit of RoE of Japanese stocks versus non-US global peers has increased (Figure 3). However, it has only moved to the extent that a 0.5% increase in RoE would shift this back to median levels (Figure 4).

Figure 3: Japanese P/B per RoE premium to global peers

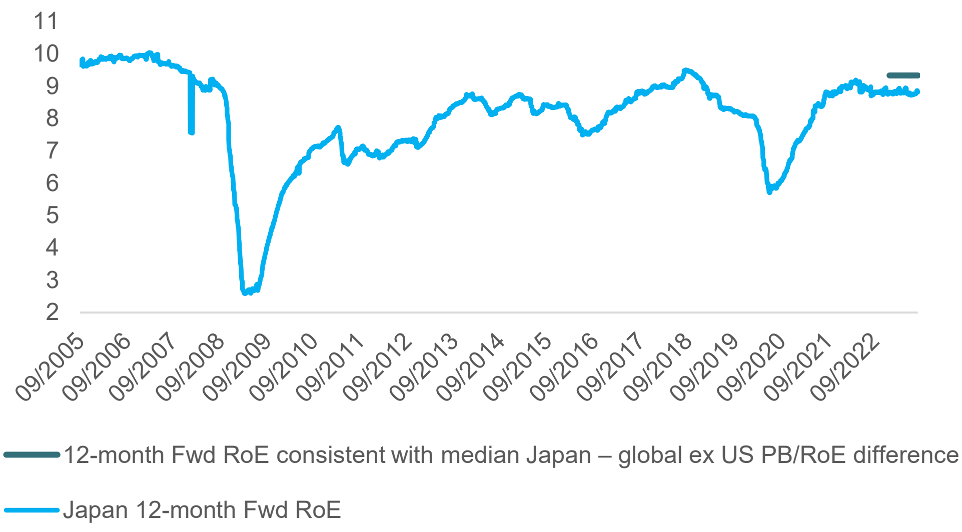


Source: Bloomberg, 9 August 2023

Our Global equity team have flagged that the magnitude of cash on some Japanese firms' balance sheets provides clear opportunities to increase RoE by around 5%. As such we do not currently view the Japanese rally as overextended.

[1] Japan Financial Services Agency, Action Program for Accelerating Corporate Governance Reform: From Form to Substance, 26 April 2023

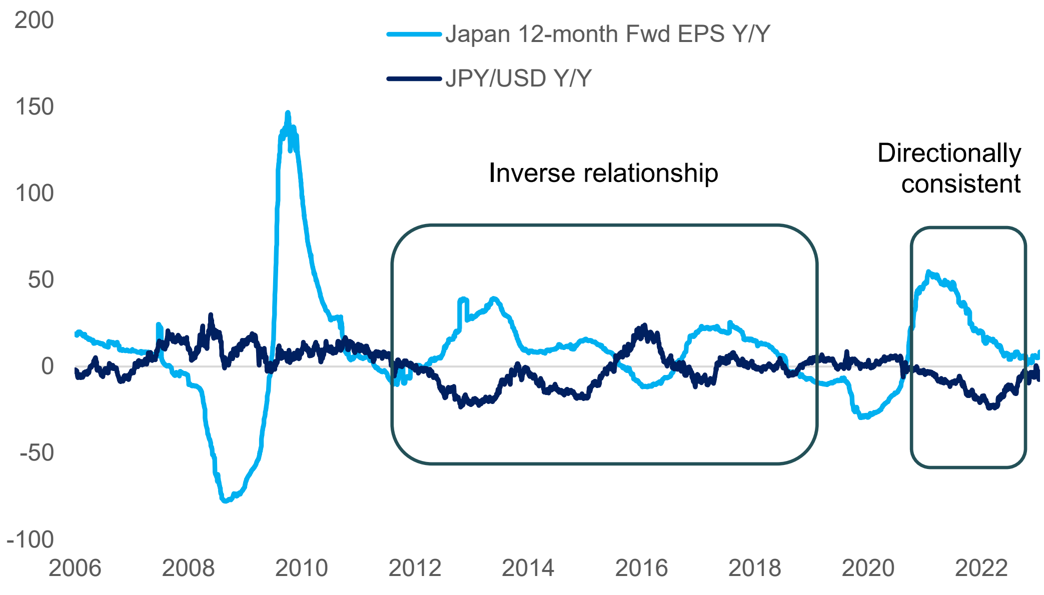
Figure 4: RoE required to revert to median premium



Source: Bloomberg, 9 August 2023

Aside from the long-term reform-driven upside for Japanese equities, we also see medium-term tailwinds from both the domestic and external environment. On the domestic front, lingering Covid restrictions into 2022 set a low starting point for activity, relative to other regions. Today, consumer confidence has recovered, household balance sheets are healthy and domestic consumption still has room to improve before it reaches pre-Covid levels. The scope for Japan's tourism industry to continue improving relative to 2019 levels is also notable.

Figure 5: JPY/USD year-on-year versus MSCI Japan forward earnings per share Y/Y



Source: Bloomberg, 9 August 2023

From an external perspective, the case can be made for an upcoming period characterised by a change to the typical inverse JPY and Japanese earnings relationship (Figure 5). Increased non-Bank of Japan key developed market central bank rates have reduced global growth expectations and associated cyclical Japanese earnings expectations, while depreciating the JPY through increased rate differentials. From here, with rate differentials expected to gradually reduce from both sides, alongside a potential bottoming of the global cycle, the case can be made for an appreciation in JPY alongside an increase in Japanese earnings. This provides an attractive set-up for non-JPY-based investors like us.

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