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COLUMBIA THREADNEEDLE INVESTMENTS

Viewpoint

Japan's economic revival – the first steps of a long-awaited transformation

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At a glance

- Japanese equities have enjoyed strong returns in recent years. Have investors missed the boat? We think not and remain constructive on the outlook from here.
- Japan's revival story remains underpinned by strong earnings, corporate governance reform, sustained inflation, rising wages and a pick up in merger and acquisition activity.
- Corporate Japan has transformed from the market-share-chasing, low margin, high capex model of the 1980s, to one with a focus on returns and capital efficiency.
- We believe Japanese companies are in much better shape than in previous decades and the market remains attractively valued relative to history and the global average.
- Japan's equity market presents investors with a broad and under-researched opportunity set. We believe our research driven approach that seeks opportunities across the market cap range positions us well for outperformance potential.

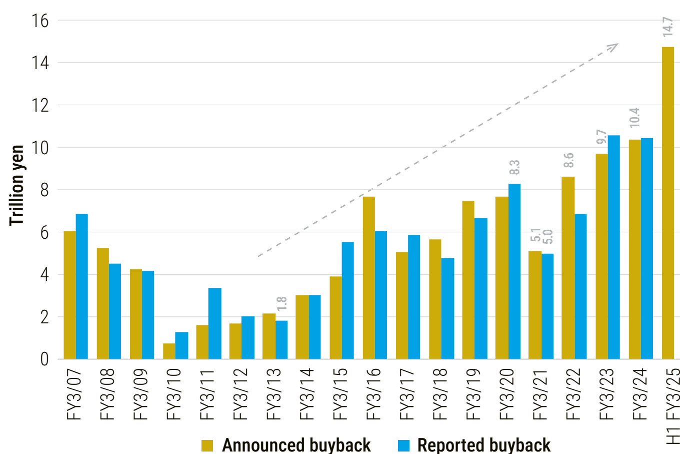
At the beginning of last year, we sat down and put pen to paper on a thought piece which argued this was Japan's decade of sustained economic momentum. The events of 2024 certainly strengthened our case. Japan's revival story continues to be underpinned by strong earnings for both international and domestic demand companies, corporate governance momentum, sustained inflation, rising wages, and improving merger and acquisition (M&A) activity. Following a period of strong performance over the past two years, some investors are questioning whether they have missed the boat; we don't believe so. Our constructive long-term view on Japan's equity market remains intact. We believe we are still at the start of Japan's long-awaited transformation.

Corporate governance reform bolsters shareholder returns

Similar to last year, we remain most excited about corporate governance reform as we move through 2025. The drive to improve profitability and valuations for Japanese corporates is far from over. We frequently tell our clients that the keys to Japan's bull case is better allocation of capital by companies and a greater focus on investor returns. Japanese companies are more profitable versus previous decades; they're converting operating profit into net profit more efficiently and returning more cash to shareholders than ever before! The share buyback bonanza continues; during the first half of the fiscal year (April – October 2024) a record ~¥15 trillion buybacks were announced versus just ~¥8 trillion at the same time the previous year. Using a conservative assumption of the same level of buybacks from the previous year over the remainder of the fiscal year (November 2024 – March 2025); full year buybacks would equate to ~¥17 trillion. That's a 70% surge year-on-year![1]

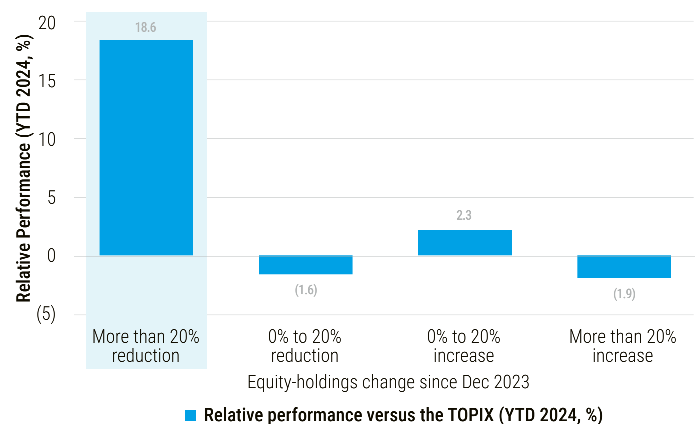
Alongside the spike in share buybacks, Japan's cross shareholdings unwind is accelerating, and those companies at the forefront of the unwind are generating strong returns. This archaic shareholding structure has been a chronic drag on capital efficiency in Japan for decades. However regulatory reforms are swiftly changing that trend by encouraging Japanese companies to divest value-destructive equity holdings. Insurance, banks and autos are at the forefront of the unwind, however, we are witnessing this theme in other pockets across the market. Companies with large equity holdings (as a percentage of their market cap) and who are already undergoing this process are more likely to continue this shareholder-friendly activity, and more importantly, outperform the index. In fact, companies that have reduced equity holdings by more than 20% have outperformed the Tokyo Stock Price Index, or TOPIX, by around19% year-to-date. We believe this theme is still in its infancy stage and we continue to exploit high quality beneficiaries in portfolios.

Figure 1: TOPIX share buyback bonanza continues[2]



Source: Jefferies, FactSet, November 2024.

Figure 2: The cross holding unwind has significantly boosted returns in 2024[3]



Source: Jefferies, FactSet, November 2024. For companies with market cap more than $2 billion.

"Savings to Investments" - structural shift in retail purchases of Japanese equities

Alongside excess cash being put to work in the corporate sector, we are simultaneously witnessing Japanese households move their cash savings into investment products. Historically, Japanese households have typically held significant amounts of cash (more than 50% of their assets versus 12% in the US[4]) given their conservative nature and the deflationary environment. However, against the backdrop of inflation eroding the value of individual savings, there has been a more recent shift into investment products. Government measures such as the launch of the new Nippon Individual Savings Account (NISA) in 2024 (tax-efficient investment savings account) have significantly contributed. This allocation shift reminds us of a similar government initiative in 2015 when Japan's Government Pension Fund (GPIF) boosted domestic equity exposure from 12% to 25% and reduced Japanese Government Bond (JGB) exposure from 60% to 35% - aiming for a higher risk-adjusted return. Furthermore, a change in mindset from the younger demographic to focus on securing wealth through growing personal assets is expected to further drive the purchase of domestic and international securities. Importantly, we witnessed this trend in the US over 40 years ago following the establishment of similar tax incentive programs such as the individual retirement account (IRA) and 401k. We believe the "saving to invest" trend is a powerful theme for Japan over the long term and expect the restructuring of household assets to catalyse Japan's long-term wealth accumulation and positively impact consumption.

Improving M&A activity - a positive catalyst for business restructuring

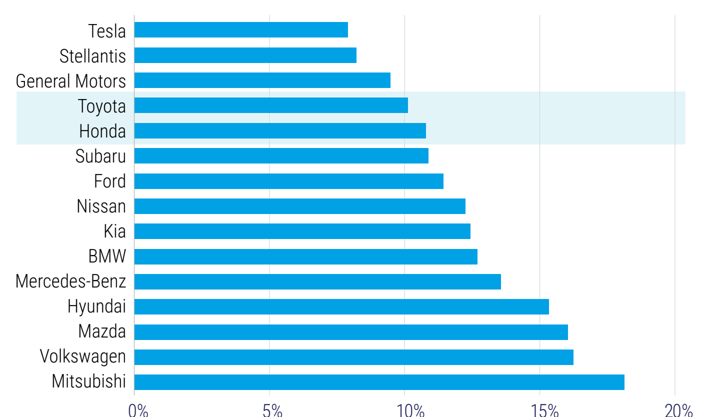
As Japan's decades-old governance standards continue their radical transformation with companies embracing reforms, we also expect an increase in M&A momentum given the strong and improving shareholder returns and the lucrative potential for business restructuring. Japan is set to witness a surge in deal momentum as investors look to exploit the highest sector fragmentation globally - 55% above the global average. In fact, the average Japanese company is exposed to 2.4 sectors versus just 1.5 for US/EU peers.[5] Companies with revenue exposure to only one core sector tend to have superior return-on-equity, margins, and board quality versus those companies with fragmented revenue exposure.[6] It's fair to say this fragmentation has hurt governance, margins, and profitability in Japan over the years. However, as corporate governance reform evolves from balance sheet optimization to business restructuring and an inorganic shake up of inbound and domestic takeovers catalyses the market (e.g. the ongoing Seven & I saga), we expect a sizeable positive impact on deal pipelines. Using a portfolio example, spark plug manufacturer Niterra is undergoing the acquisition of another auto component manufacturer's – Denso - spark plug business, which is a major catalyst for Niterra's value. Niterra has an agreement in principle to acquire part of Denso's business and if the regulators approve this acquisition, there will be a meaningful contribution to Niterra's earnings over time.

Politics

For the first time since 1905, every incumbent political party in a developed economy that faced re-election in 2024 lost vote share. In Japan, the ruling Liberal Democratic Party (LDP) lost its majority in the election, however, the ruling coalition remains the largest bloc in the lower house. We can expect some market volatility going forward due to uncertainty, however, we believe it is highly unlikely that the pro-market policy agenda will be derailed. For some background, the LDP brought stability to Japanese politics throughout the previous decade and has implemented a series of corporate governance and labour reforms – irreversible structural legislation – that will be transformational for corporate Japan in the next decade.

Across the Pacific, the US election took the political spotlight in the fourth quarter of 2024 as investors weighed up the ramifications of Trump's second term. Japan has historically been a geared play on global growth and the index would most likely perform well if the US economy reheated – a key focus for Trump. The US capital expenditures (capex) recovery, a pick-up in US production, and faster growth globally should benefit corporate Japan. However, the extent of the US re-heat will certainly depend on the magnitude of US tariffs, which the incoming administration will be using as a negotiation tool. Regardless, Japan should be among the least impacted by tariff threats of major economies due to extensive offshoring and geopolitical relations. For example, Japanese auto maker Honda built its first plant in the US in 1981 and predominantly supplies the US market from what is manufactured over there. Around the same time Toyota established assembly plants in the US and still make their highly popular hybrid models stateside.[7] When looking at the percentage price hikes required to cover Trump's automotive tariffs, both Japanese manufacturers Honda and Toyota would be less impacted by US tariffs than American auto maker Ford.[7] This assumes 25% tariffs on autos and components coming from Mexico and Canada, 60% for China and 20% for everywhere else.

Figure 3: Percentage price hikes needed to cover Trump automotive tariffs: Toyota and Honda would be less impacted by Ford[7]



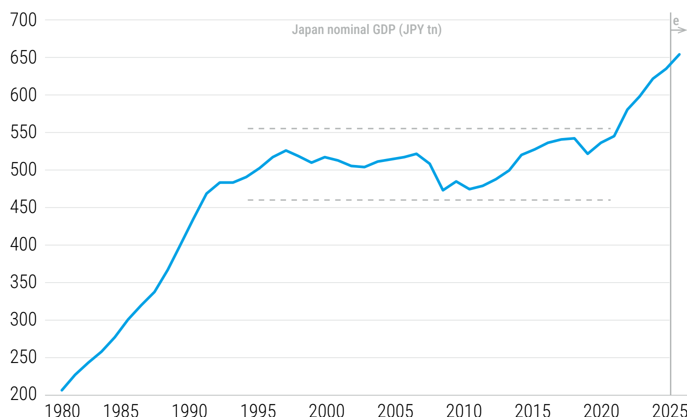
Source: Source: CLSA. January 2024. Percentage price hikes needed to cover Trump automotive tariffs – assuming 25% tariffs on autos and components coming from Mexico and Canada, 60% for China and 20% for everywhere else.

A virtuous cycle of wage growth and inflation

In our last piece, we mentioned our excitement around the Bank of Japan's (BoJ) commitment to achieving a positive cycle of wage growth and inflation which we believed would kick-start Japan's new era of economic growth. Many sceptics doubted this could be achieved. Over the past 12 months, we have witnessed a sustainable inflation rate above 2% and a wage increase rate slightly above 3%. We now have good reason to believe that Japan's inflation is not a temporary phenomenon, and instead evolving into a more sustainable format based on a virtuous cycle of wage and prices which indicate sustained nominal GDP growth. This should continue to support a positive economic cycle, as it will spur corporates to increase growth investment and improve capital efficiency. Some investors argue that a stronger yen in 2025 – a likely scenario - will undermine Japan's beneficial inflation trend. We believe this is unlikely. Japan's labour supply is limited - the retirement age has gone up, female labour participation rate has risen, and a significant change in immigration policy is highly unlikely – so labour supply should remain below labour demand. We expect this to support sustained wage growth and inflation even if the yen strengthens, which is unlikely to return Japan's underlying price trend to deflation. Japan's nominal GDP has escaped the deflation equilibrium and has begun a moderate growth trajectory with sustainable wage increase as a tailwind.

Strong underlying wage-price dynamics are expected to lead to further policy normalization by the BoJ, and we anticipate incremental hikes as we move through 2025. Against the backdrop of central banks easing globally, this should cause the yen to strengthen. While foreign exchange (FX) bets are not our skill set, we remain cognisant that the Japanese yen plays a role in corporate fundamentals, as a weaker yen benefits export orientated sectors and pressures domestic businesses, and a stronger yen has the reverse effect. Throughout the deflationary years, Japanese companies made a significant effort to bring down the breakeven sales ratio, so companies are still able to produce profits in a stable manner when external factors — like FX — fluctuate.

Figure 4: Japan's nominal GDP is taking off into a gradual growth trajectory[8]



Source: Morgan Stanley Research Estimates. Cabinet office, Morgan Stanley Research.

Japanese companies are in much better shape than in previous decades and the market remains attractively valued relative to history and the global average.

The bottom line

We believe Japan's economy is well positioned to reaccelerate in 2025 given the focus on reflation, rising wages, better corporate governance, and a pick-up in M&A activity. Unlike in the past, the earnings growth of domestic demand-driven companies is also likely to support Japan's market. From a macro perspective, we believe Japan will be among the least impacted by US tariff threats of major economies due to extensive offshoring and geopolitical relations. The long-term story also remains intact, corporate Japan has transformed from the market-share-chasing, low margin, high capex model of the 1980s, to one with a focus on returns and capital efficiency. We believe Japanese companies are in much better shape than in previous decades. Furthermore, the market remains attractively valued relative to history and the global average. In sum, this is a very exciting time. We are witnessing a market driven by solid fundamentals, where growth is expected to accelerate, which provides a deep, attractively valued opportunity set for active investors like us.

Sources:
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Get to know the authors

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Daisuke Nomoto is head of Japanese equities at Columbia Threadneedle Investments. Prior to his current role, he was a director and senior portfolio manager on the International Equity Team. Mr. Nomoto joined one of the Columbia Threadneedle Investments legacy firms in 2005. Previously, Daisuke worked as an equity analyst at Putnam Investments. Prior to that, he held a variety of positions for Nippon Life Insurance, including four years as a senior portfolio manager and equity analyst at Nissay Asset Management, Tokyo, and five years as an equity analyst with NLI International. Daisuke received a B.A. from Shiga University, Japan. He is a chartered member of the Security Analysts Association of Japan.

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