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VIEWPOINT

Japan's decade of sustained momentum: is it here to stay?

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- We believe several catalysts are creating a paradigm change in the country: the shift from deflation to inflation, corporate governance reform and increased domestic flows
- Higher inflation is changing the dynamics of the labour market, with businesses under pressure to improve profitability and employees increasingly able to seek higher wages by switching jobs
- Companies have introduced measures to shore up return on equity (ROE) in the near term, alongside rolling out long-term growth strategies by focusing on organic and inorganic investments for sustainable growth

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We are frequently asked by clients if this time will be different for Japan. Are we finally entering the long-awaited phase of sustained momentum, or will short-lived excitement once again precede a period of stagnant growth? We actually think the next decade is shaping up to be different, with several catalysts creating a paradigm change:

1 **Deflation to inflation**
This is expected to benefit consumers and corporates, simultaneously kick-starting a new era of economic growth.

2 **Corporate governance reform**
The Tokyo Stock Exchange (TSE) announcements throughout 2023[1] triggered a better allocation of capital by Japanese companies and a greater focus on shareholder returns.

3 **Increased domestic flows**
The updated tax exemption investment scheme or "NISA" is expected to create a structural shift in retail purchases of Japanese equities.

1 Deflation to inflation

Last year, we wrote a piece on the end of the deflationary mindset in Japan[2] and how important the consequences were for the economy, policy and market. The team were excited about this shift back then; six months later we remain optimistic that it will be a key driver for long-term economic growth.

Japan is synonymous with deflation; the "lost decades" from the late-1990s onwards characterised a prolonged period of deflation which hindered consumer spending and economic growth for nearly 30 years. Society was accustomed to falling or stable prices. People had no urgency to buy goods as the likelihood was that they would become cheaper. This mindset kept demand low, which in turn impacted business sales and subdued economic growth. Today, with prices slowly rising, the consumer may start buying more goods now rather than later (Figure 1). This marks a significant change from companies protecting consumers from rising costs and suffering lower margins themselves, demonstrating a shift in Japan's deflationary mindset.

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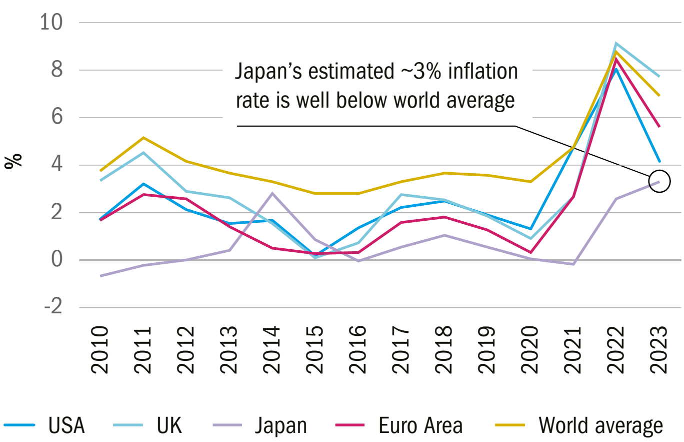
[1] Japan Exchange Group, Tokyo Stock Exchange, Enhancing Corporate Governance, June 2023
[2] Columbia Threadneedle Investments, Japanese Inflation: signs of meaningful change, 26 July 2023

Figure 1: Japanese inflation remains moderate despite the rise



Source: Citi, Inflation, Consumer Prices Y/Y % change, October 2023

The dynamics of Japan's labour market are also changing due to inflationary pressures. As inflation rises, businesses are under pressure to improve profitability, forcing wage hikes to secure human resources. In turn, employee behaviour is changing as workers are more able to seek higher wages by switching jobs.

More broadly, the labour market will become more mobile, with higher inflation breaking key structural bottlenecks that have hindered Japan's economy. Increasing labour mobility has been politically sensitive in Japan for decades given the social stigma around unstable employment. Workers predominantly prioritised ongoing employment versus wage increases, with previous legal efforts to reform the labour market seeing a decline in government approval ratings.

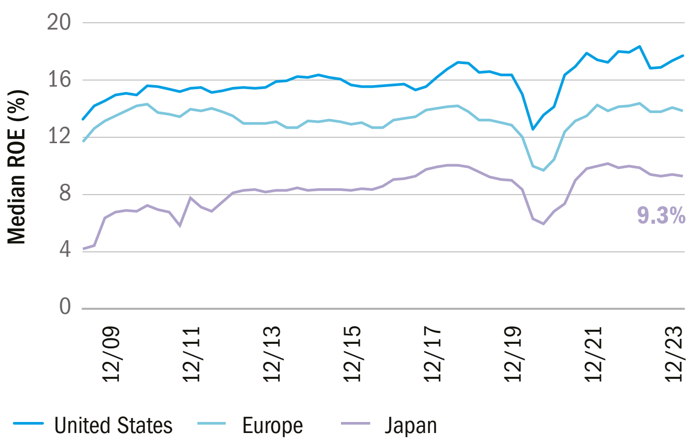
However, the recent uptick in inflation and the weak yen are prompting change from companies and employees, rather than legislation. Throughout 2023 investors were pondering whether the convergence of cost pressure, labour market tightening and government policy changes would alleviate Japan's deflation. This notional idea is swiftly materialising.

2 Corporate governance reform

Although the shift in government policy started over a decade ago with Abenomics, the more recent TSE reforms seem to have triggered an adequate response from Japanese companies. Since 2012 the government and regulatory bodies have implemented various corporate governance measures; despite moving in the right direction, progress has been limited in terms of corporate responses over the same period.

Fast forward to the start of 2023 when the TSE urged listed companies with low price-to-book ratios to improve their corporate value, we noticed more companies putting measures in place to create value on a sustained basis. We are seeing these measures take place in many forms: share buybacks have soared to an all-time high, dividends are rising year-on-year[3], and there's an increase in M&A spending.[4] Alongside the recent measures implemented to shore up return on equity (ROE) in the near term, companies are rolling out long-term growth strategies to address this by focusing on organic and inorganic investments for sustainable growth, for example investing in research and development (R&D) and human capital. (Figure 2)

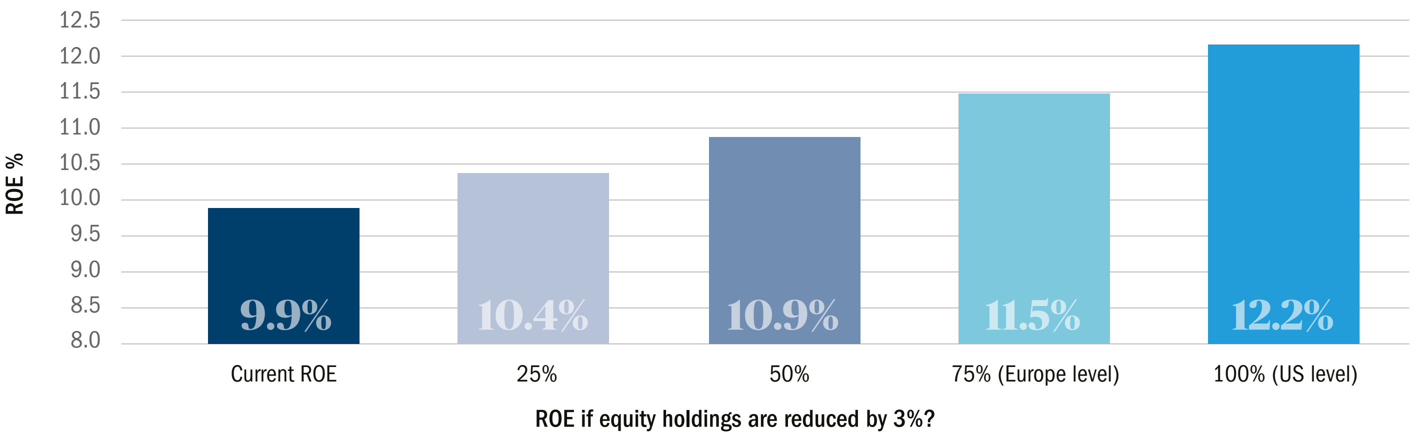
Figure 2: Japan's ROE is trending up towards US and European levels



Source: CLSA, Microstrategy, December 2023

[3] Bloomberg, as at December 2023
[4] Nikkei Asia, Japan domestic M&A spending at 18-year high as buyout deals surge, 21 December 2023

Figure 3: TOPIX ROE could rise to more than 12% if companies sell their equity holdings



Source: Jefferies Microstrategy, FactSet, December 2023

The unwinding of cross-shareholdings in Japan will be a further boost for ROE. Japan's archaic shareholding structure has been a chronic drag on capital efficiency. This should change as more companies are responding to regulator requests to improve disclosure, especially regarding cross-shareholding relationships and rationale. In a scenario where all companies in the Tokyo Price Index (TOPIX) sold their equity holdings and used the proceeds to fund buybacks, all else being equal the average ROE of the index could rise from 9.9% to 12.2% (Figure 3).[5] We are already seeing a trend of companies selling their holdings. The median number of equity holdings per company in the TOPIX has fallen by approximately 30% in 10 years.[6] If the proceeds from divesting shares continue to be allocated towards growth investments or returned to shareholders, it will be positive to shareholder value. This significant unwind is expected to accelerate this year.

3 Increased domestic flows

In a culmination of corporate governance reform and inflation, Japan's government is also updating its tax-exempt investment scheme, the NISA. Changes include expanded tax brackets which should boost low investment rates among Japan's population and help reactivate the economy. The mindset to keep cash in the bank should quickly change, particularly among the younger generation who are beginning to seek investment opportunities amid a backdrop of higher inflation. This is underpinning a structural shift from domestic household savings to investments.

Japanese equities could see an annual inflow of about $14 billion from the NISA. This assumes approximately 40% of new money flows into Japanese equities either directly or through investment trusts. In Q4 of 2023 alone, retail purchases of investment trusts with Japanese equity mandates outpaced foreign-focused vehicles by 38%.[7] Furthermore, if Japanese domestic institutional investors, such as life insurers and pension funds, follow suit and re-allocate out of yen fixed income into domestic equities, the positive impact on Japan's equity market would be accentuated.

Additionally, domestic flows are simultaneously converging with foreign flows. Japan is no longer viewed as a potential threat to the US and its allies, pursuing pacifist foreign policies and building strong economic and security ties with other regional powers. This underpins a stable socio-political environment, while favourable technology partnerships with Taiwan and investor diversification away from China continue to make Japan an attractive investment opportunity for foreign investors.

Japan is in a transformational decade and presents an increasingly compelling long-term investment opportunity for active investors. The world's third largest economy is characterised by a combination of technological prowess, well-established infrastructure and economic stability. Factors such as forward-thinking government policies, a positive cycle of wage growth and inflation, and rising asset flows to support growth and investment have catalysed economic momentum. This makes us even more excited about Japan's investment landscape for the decade ahead.

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[5] Columbia Threadneedle Investments' analysis, December 2023
[6] Jefferies Microstrategy, December 2023
[7] Bloomberg, Retail Traders May Boost Japan's Stock Market More Than Expected, 7 December 2023

Get to know the authors

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Daisuke Nomoto is head of Japanese equities at Columbia Threadneedle Investments. Prior to this he was a director and senior portfolio manager on the International Equity Team, having joined one of the Columbia Threadneedle Investments legacy firms in 2005. Previously, Mr. Nomoto 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.

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Simon Morton-Grant is a Client Portfolio Manager within the Japan and Asia Equity teams. He is responsible for providing detailed information on the company's capabilities and investment views to existing and prospective clients as well as to consultants and other intermediaries. He joined the company in 2017 as a graduate on the Investment 2020 programme before joining his current team in February 2018, having previously completed an internship at Morgan Stanley.

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