EQUITY STRATEGY INSIGHTS

Rediscovering Japan After Lost Decades

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EXECUTIVE SUMMARY

- Japan has not been a particularly enticing place for U.S. investors to look for attractive returns in recent "lost" decades.
- Japanese stocks started garnering more attention in recent months after some widely-followed indexes broke out to new multi-decade highs.
- Accommodative monetary policy, solid anticipated earnings growth, improving corporate governance, and attractive valuations are among several factors that LPL Research believes enhance the appeal of Japanese equities currently.

Japan has not been a particularly enticing place for U.S. investors to look for attractive returns in recent "lost" decades. In fact, despite breaking out to new 33-year highs earlier this year in yen terms, the Nikkei 225 Index in U.S. dollars remains more than 15% below its all-time record high set in December 1989 **(Figure 1)**. For comparison, the S&P 500 Index is up about 12 times since then, while the global all-cap world index (MSCI ACWI) in U.S. dollars is up more than 400%.

1 Japan's Nikkei is at 33-Year Highs

Source: LPL Research, FactSet data as of 07/25/23
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

The Japanese equity market has become more attractive recently for several reasons. Besides low valuations that come with decades of lackluster performance, global inflation is helping Japan fight deflation, a battle it's been losing for decades until recently.

Other factors increasing the appeal of Japanese equities:

- Monetary policy remains accommodative as much of the world's central banks tighten policy
- Slow global growth makes Japan look better on a relative basis

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- Additional stimulus from China increases Japan's appeal as a major China trading partner
- Corporate governance is improving, with greater focus on enhancing shareholder value
- Warren Buffett made headlines recently for increasing his equity stakes in Japan

Warren Buffett recently made headlines for increasing his investments in Japan

At the same time, Japan's problems including an aging population and high government debt levels have not gone away and increase the risk that deflationary pressures return at some point in the future. These concerns are contributing to the Bank of Japan's (BOJ) hesitation to tighten monetary policy further even as the economic outlook has improved.

The Bank of Japan Remains An Outlier

Investing in Japan has always been interesting, but probably even more so at the moment with the recent change in leadership at the Bank of Japan (BOJ). Kazuo Ueda, who replaced Haruhiko Kuroda in April, was a bit of a dark horse pick for governor (not the first choice).

Initial thinking was that whomever took over the BOJ would be tasked with normalizing policy more aggressively, a line of thinking further exacerbated by the raising of the yield cap on Japanese Government Bonds (JGBs) in December 2022 before Kuroda's term ended.

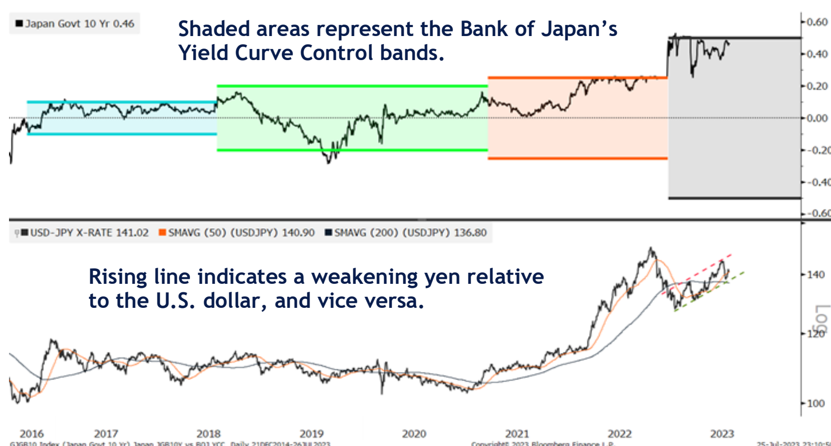
But coming into this week's BOJ policy meeting, few expected a change. Ueda then surprised markets by tweaking the BOJ's asset purchase program—so called yield curve control (YCC). Specifically, the BOJ increased flexibility of its yield cap, letting 10-year yields move above 0.5% by offering to buy 10-year government debt each day at 1%. Yields traded up to 0.55% in response and the yen rallied as markets digested the news. At the same time, the BOJ made it clear that its inflation flight is far from over and that this was not a step toward a prompt end to YCC. The central bank sets the stage for an eventual exit, but the BOJ stated the move was intended to improve YCC's sustainability and enhance bond market functioning.

The BOJ has been implicitly trying to stoke inflation for three decades now, so they want to be sure their deflationary episode is over before tightening.

Monetary policymakers in Japan have understandably been slow to normalize policy. Remember the BOJ has been implicitly trying to stoke inflation for three decades now, so they want to be sure their deflationary episode is over before tightening. So, going forward we expect a long drawn out progress with gradual adjustments. The BOJ remains an outlier with very low rates as the rate hiking campaign for the Federal Reserve (Fed) potentially continues and the European Central Bank (ECB) continues to hike rates to much higher rate levels than Japan's.

Bottom line, this policy dynamic will be an ongoing important driver of the yen **(Figure 2)** and Japanese equities in the short and intermediate term.

2 Japanese Yen Remains Weak Amid Bank of Japan's Yield Curve Control



Source: LPL Research, Bloomberg, as of 07/25/23
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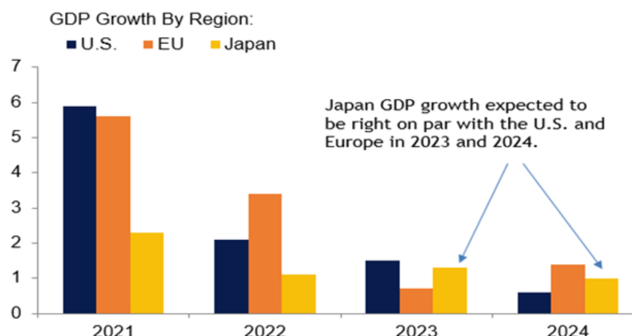
Economic Growth Picture Looks Good By Comparison

One of the reasons investors largely shunned Japanese equities for decades was because its economy struggled to grow for so many years, due to a combination of an aging population, little immigration, a heavy debt load, and an inefficient corporate sector. Those growth headwinds haven't completely gone away, although the corporate sector is becoming more efficient, as discussed below. Retail sales and industrial production have picked up some lately, but machine tool orders are down 21%. The economy is growing but it's not a straight line up.

Deflation has been the country's greatest challenge, so a wave of global inflation essentially provided just what the doctor ordered.

What has changed and makes us more interested in investing in Japan is how Japanese economic growth compares to other major global economies. As shown in **Figure 3**, Japan's forecasted GDP growth compares quite favorably to the U.S. and Europe this year and next. Deflation has been the country's greatest challenge, so a wave of global inflation essentially provided just what the doctor ordered as an incentive for consumers to spend and for companies to invest in future growth.

3 Japanese Economy No Longer A Relative Laggard



Source: LPL Research, Bloomberg 07/25/23
Estimates may not develop as predicted.

Japan also offers a backdoor China play, as a key seller into the Chinese market with about 20% of Japanese exports sold to the world's second largest economy. Japan may also be a beneficiary of global tensions as a global leader in industrial automation, semis, and other key industries that can help support supply chain diversification to de-risk from China.

On the fiscal policy side, it's noteworthy that Japan implemented the largest amount of fiscal stimulus as a percentage of GDP in response to the COVID-19 pandemic, providing an economic tailwind similar to what the U.S. has experienced.

Exit From Deflation to Benefit Earnings

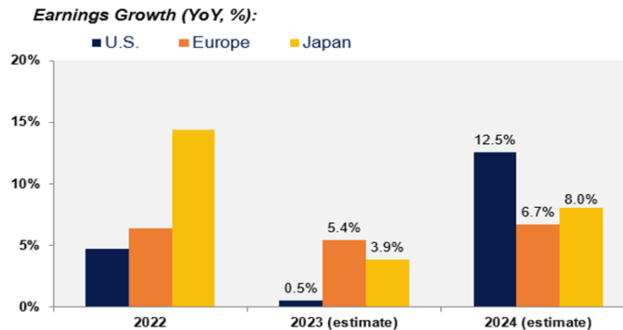
Not only does deflation hamper economic growth by encouraging consumers to save rather than spend, it also depresses revenue.

When an economy is fighting deflation for decades, not only does it hamper economic growth by encouraging consumers to save rather than spend, it also depresses revenue by preventing companies from generating any pricing power. Remember nominal GDP (which includes inflation, unlike the more oft-cited "real" version of GDP) correlates well to revenue—as we've seen in the U.S. with strong revenue growth during the inflationary post-pandemic period. Japanese companies are getting a lift from inflation via higher revenue. Per FactSet, revenue for the MSCI Japan Index is expected to increase more than 3% in 2023 and approach that pace in 2024, and those expectations have been rising steadily over the past six months.

That revenue growth has not translated into much earnings per share growth in U.S. dollar terms recently because margins have been under some pressure. Earnings may be around flat in the second quarter, based on current consensus estimates, though that will likely be better what U.S. and European companies are expected to produce.

For the full year the consensus estimate is calling for just under 4% earnings per share growth for the MSCI Japan Index in 2023, followed by 8% in 2024. Those numbers aren't particularly exciting on the surface, but when compared to the U.S. (flat in 2023, up 12.5% in 2024) and Europe (+5.4% in 2023 and +6.7% in 2024), they look pretty good (Figure 4).

4 Japan Expected to Produce Solid Earnings Growth



Source: LPL Research, FactSet 07/25/23
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Also consider a weaker U.S. dollar could lift non-U.S. earnings in the coming year, a wave of share repurchases in Japan may lift earnings per share (more on that below), and U.S. earnings estimates calling for double-digit gains in 2024 look too high to us. Finally, eventual normalized monetary policy in Japan should help lift Japanese bank sector profits.

Changing Corporate Culture

Earlier this year, the Tokyo Stock Exchange requested that companies trading below book value come up with a plan to improve capital allocation.

Evidence is building that corporate culture is changing in Japan in a meaningful way. This shift has been mandated in some ways because the Tokyo Stock Exchange (TSE) earlier this year requested that companies trading below book value come up with a plan to improve capital allocation. The move to improve corporate governance has sparked some sizable share repurchase announcements from companies such as automaker Honda (HMC) to help put cash to work and enhance shareholder returns. ETF provider WisdomTree recently cited an estimate that one-third of companies with price-to-book ratios below one in Japan have already taken action to conduct buybacks or increase dividends. Nikkei reported in March that share buybacks by Japanese companies this year were set to reach their highest level in 16 years.

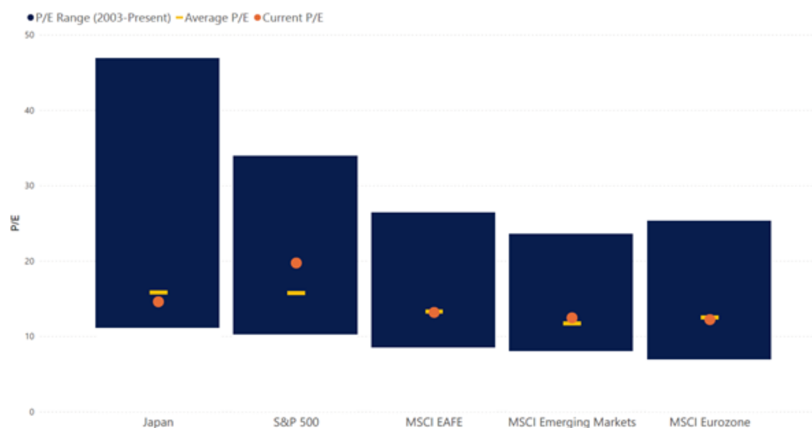
This program affects more than just a small handful of companies. We ran a screen of companies trading below book value on the TSE and found about 40% of the more than 4,200 Japanese companies listed on the exchange meet this criteria. Some of the companies are quite well known, including financial giant Mitsubishi UFJ (MUFG) and its US$94 billion market cap. Toyota Motors (TM) comes close at about 1.05 times book value.

Supportive, If Not Compelling, Valuations

The MSCI Japan Index trades at a next 12 months price-to-earnings ratio of 14.6 times, compared to its 20-year average of 15.6, and a 26% discount to the S&P 500.

Attractive valuations underpin LPL Research's slight preference for international equities in developed markets over U.S. equities—although our neutral stance on U.S. equities is hardly a bearish position. The MSCI EAFE Index is trading at a next 12 months price-to-earnings ratio (P/E) of 13.2, compared to its 20-year average of 13.5 and a 33% discount to the S&P 500. Europe is depressing international valuations more than Japan, but Japanese equities are trading at a bigger discount than they have historically. The MSCI Japan Index trades at a next 12 months P/E of 14.6 times, compared to its 20-year average of 15.6, and a 26% discount to the S&P 500. Figure 5 illustrates that Japanese stock valuations are low relative to their 20-year history and, like their Eurozone counterparts, are below their 20-year average.

5 Japanese Valuations Are Attractive Despite Strong Recent Performance



Source: LPL Research, FactSet 07/26/23
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When discussing valuation we always offer the disclaimer that they are not good timing tools. Markets can remain cheaply priced for a long period of time. Japan offers a lesson in just that as its stock market got cheaper and cheaper for many years.

Sentiment Also Looks Supportive

Sentiment is another way to assess valuations. Investors globally remain underweight Japanese equities according to the July Bank of America Global Fund Manager Survey. If global asset allocators shift out of the U.S., potentially due to valuations, China tensions, or even fear of an upcoming recession, Japan would be expected to be a major recipient of those foreign inflows—at least the proceeds that don't end up going into bonds.

Corporate Japan has among the lowest debt levels in the world, enhancing the quality of the investments there.

Interestingly, even though the Japanese equity market has a cyclical sector mix, with higher weights in consumer discretionary, industrials, and materials in the MSCI Japan Index than the U.S. counterpart, Japan's sensitivity to global equity market movements, or beta, is below that of the U.S., as shown on the horizontal axis in **Figure 6**. In addition, corporate Japan has among the lowest debt levels in the world, shown in the figure **Figure 6** on the vertical axis, enhancing the quality of the investments there and offering opportunities for shareholder value creation.

6 Japanese Stocks Offer Quality With Relatively Low Volatility

Source: LPL Research, FactSet 07/24/23
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Risks to Bullish View

The Japanese economy relies on exports, so a strong currency can hamper growth.

A surge in the yen if inflation goes above BOJ target of 2% and cannot be easily controlled may be the biggest risk in the Japanese equity market at this time. The Japanese economy relies on exports, so a strong currency can hamper growth. Given still-low interest rates in Japan due to the BOJ's aggressive policy stance, even after today's tweak, we would expect any strength in the yen to be contained. That said, currency-hedged positions in Japanese equities look a bit less attractive than unhedged at this time.

On a related note, it's reasonable to think a new BOJ Chief from academia (MIT PhD) may take some time to adjust to the role and that the risk of a policy mistake is elevated. Ueda is, however, credited by some for calling the bubble that led to the lost decades for the Japanese economy and markets, and we would consider him a pragmatist. Perhaps he is more wise owl than hawk or dove.

Demographics are another risk. The aging of the Japanese workforce with limited immigration will hamstring economic growth potential for the Japanese economy and is one of the reasons for the economy's lackluster performance in recent years.

Conclusion

Bottom line, we believe Japanese equities offer an attractive risk-reward trade-off currently. For those investors who are concentrated in the U.S., and particularly in large growth stocks that have done so well this year, this may be a good time to consider shifting a portion of your allocation over to Japan, the second largest country weighting in the MSCI World Index. Supportive monetary policy, progress in warding off deflation, improving corporate governance, and attractive valuations make Japan an interesting investment currently.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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For a list of descriptions of the indexes and economic terms referenced in this publication, please visit our website at lplresearch.com/definitions.

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