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A look at Japan

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The Japanese stock market is the second largest in the world but often gets little attention. Recently, the Nikkei stock market has been crushing records and topped the 40k mark for the first time at the time of writing.

The business community has been celebrating this historic moment and see it as a possible end to the nation's lost decades. The country's macroeconomic reality, however, remains fragile and it is a stretch to say that the profitability of Japanese companies' main business activities have significantly improved. The high stock market may be a unique phenomenon, leaving some investors to wonder why and question whether the rally will continue.

While some investors may be put off by Japan's sluggish economic growth in recent decades, it is important to note that many Japanese companies like Sony and Toyota have more than 70% of their sales internationally. This global exposure has helped to propel earnings growth even as domestic economic growth has been weak. The recent return to the 1989 bubble peak for Japan's stock market has been supported by much higher earnings per share than would be presumed by economic growth. Corporate profits for Japanese companies are now almost three times what they were the last time stocks were at these levels.

This growth came despite Japan's economy slipping into a technical recession in the third and fourth quarters of last year before revisions. For decades, international investors shunned Japan's stock market, whose meagre gains mirrored the country's protracted economic stagnation. However, significant structural changes are being implemented with government, policymakers and shareholders working together. The country is shifting to an inflationary economy after years of deflation, and corporate governance reforms are taking root. At the same time, market valuations are not overstretched, something capturing the interest of foreign value investors, underpinned by billionaire investor Warren Buffet's bullish outlook on Japanese equities since early last year.

Since January 2016, the Bank of Japan's (BoJ) policy of zero or negative interest rates has enabled the country to be an important source of investment funding, with negative interest rates allowing investors to borrow cheaply in yen and then purchase investments in other countries offering higher yields. The Bank finally exited negative interest rate territory this year at its March meeting, signalling its confidence that the country has emerged from the grip of deflation. Wages have already started to rise with one of their biggest increases since the early 1990s happening this year.

The Bank eliminated its yield curve control framework and announced that its short-term interest rate will be the primary policy tool. It also terminated its exchange-traded fund (ETF) and Japanese real estate investment trust (J-REIT) purchase program, although this did not come as a surprise because no meaningful purchases have been seen in a long time and there are no plans to sell current holdings. With the end of negative rates, the Bank is now widely expected to hike rates by this June. Any rate hikes this year have the potential to prompt Japanese investors to sell foreign assets and bring funds home, incentivized by higher interest rates and the best performing stock market in developed markets so far.

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Meanwhile, the Tokyo Stock Exchange (TSE) has requested listed companies to take "Action to Implement Management that is Conscious of Capital and Share Price". This has resulted in announcements of planned operational changes to boost corporate value and an increase in share buybacks by many companies. Over the past two years, Japanese companies have been increasing their stock buybacks and have made efforts to increase dividend payouts. With the push to increase Price to Book Ratios (PBR) by the government, further increases in share buybacks and dividends are more likely.

To ensure that listed companies can maintain returns exceeding the minimum investment return (cost of capital) for investors, management reforms have been focused on changing the structure of the boards and the mindsets of teams. Many listed companies have had PBR below one which meant that the values of these companies were lower than their dissolution value. This persistent sluggish stock price performance which is now going away had been pointed out as a long-standing problem for listed companies. Recently, there have been a number of multibillion-dollar all-cash acquisition transactions which have been financed by debt, indicating that Japanese firms are now thinking strategically about how to grow their businesses and are also more willing to take on risk.

Under Prime Minister Fumio Kishida's new capitalism drive, Japan has also sought to encourage a shift from saving towards investing, relaunching its Nippon Individual Savings Account (NISA) programme with higher annual investment limits and extended tax-exemption periods. This programme may bring more local buyers into the market as the new savings program aims to encourage Japanese investors to move money from cash into stocks. According to BoJ, only about 13% of Japan's liquid household assets are in stocks compared to over 40% in the US and more than 20% in Europe. This is also in-line with cash deposits making up over 50% of households' financial assets in Japan compared to less than 15% in the US and about 35% in the eurozone. The behaviour of households and corporations in Japan has been the direct result of a deflationary mindset. As this mindset changes, there is likely to be changes in consumption, investment, and savings patterns, which in turn, will have significant ramifications for the equity market and the broader economy over the longer term. January inflows into NISA has already approximately tripled compared with 2023 levels, based on a tabulation by five large internet brokers in Japan.

Another factor also contributing to Japan's higher stock prices has been the decline in investment appetite for China, not only by European and American investors but also by Chinese investors due to the slowdown in the world's second-largest economy and increasing geopolitical risks. As China's economy grapples with challenges ranging from crackdowns on private industry to a slow-moving real estate crisis, foreign investors have been pulling out of the Chinese stock market. Instead, many investors have diverted their money to the Japanese market. Global companies have also been diversifying their supply chains away from China, benefitting Japan, particularly in the very high-end technology sectors like semiconductors. A weaker yen, hovering at its lowest levels since the 1990s, has also boosted corporate profits. In fact, the forward price-to-earnings ratio for the Japanese stock market is close to 15, in line with the 20-year historical average. In comparison, the S&P 500 forward price-to-earnings ratio is now over 20, which is more than 30% above its 20-year historical average. Even though certain pockets of the market may appear to be ahead of fundamentals, aggregate valuations in Japan remain compelling.

Japanese equities remain attractive on a medium to long-term view providing these two key themes continue to play out: corporate governance improvement which is driving better capital efficiency and higher shareholder returns, and the shift from deflation to inflation. With the market reaching new highs lately, a market pullback due to a short-term momentum reversion is likely. However, considering the positive structural changes underway, this could be an opportunity for investors to re-evaluate their portfolio weightings to Japanese equities.

Sources: The Japan Times & Bloomberg Economics

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