Market Insight: Japanese Equities

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Seeing the positives in Japan: Five factors to support the market

Negative impact of yen strengthening and Asia slowdown on Japanese corporates as well as fading expectations for Abenomics weigh on market and obscure reasons for optimism.

After hitting the heady heights of 20,000 points at the end of last year, the Nikkei index plunged by more than 25% to just under 15,000 points in early February, before staging a recovery. However, while other developed markets have returned to or even exceeded their pre-January levels, the Japanese market is still down over 18% YTD.[1]

The negative impact of the strengthening currency and the slowdown in Asia on Japanese corporate earnings could be one reason for this. Another could be fading expectations for Abenomics, particularly its "third arrow" of structural reforms. Limited action by the BOJ this year is also making investors uneasy and undermining the central bank's commitment to reaching its own 2% inflation target.

As a consequence, we have seen net outflows from foreign investors in all but one month in the first six months of this year, according to data from the Tokyo Stock Exchange.[2] So, are investors right to leave? Is Japan a lost cause that will return to deflation? Or are there are signs of hope and reasons for optimism?

In our view, the Japanese stock market still has more to offer investors considering the five supportive factors highlighted in this report. These include:

1. Political stability
2. Policy supports still in place
3. Improving shareholder return
4. Yen weakness, not strength expected
5. Reasonable valuations

[1] Bloomberg, as at 5 August 2016.
[2] http://www.jpx.co.jp/markets/statistics-equities/monthly/nlsgeu000001s4q0-att/09_t-kabu1606.pdf

We believe these “positives” may have been overlooked so far this year.

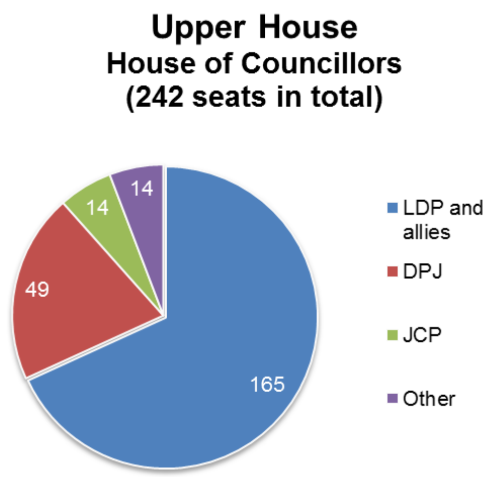
1. Political stability

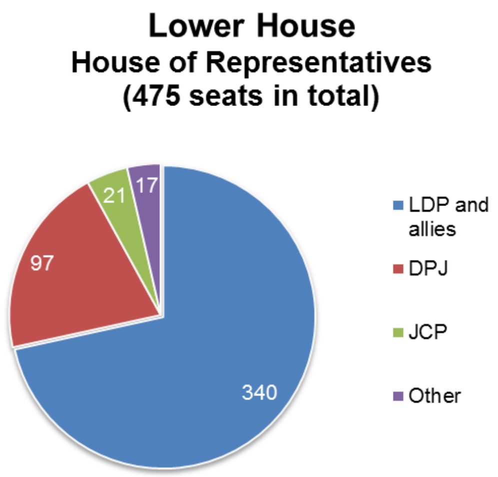
At the moment, we are seeing stability not in the West but in Japan and this could become an important factor in the medium term. Recent events in Europe (Brexit referendum) and the US (rise of Trump) demonstrate the level of dissatisfaction with the traditional political establishment; people are unhappy with social and economic conditions, creating political uncertainty.

On the other hand, we don’t believe Japan will follow a similar path. In fact, we saw social frustration due to decades-long deflation and economic hardship peak after the Lehman crisis. In 2009, there was a rare change of ruling party from the Liberal Democrats (LDP) to the Democratic Party of Japan (DPJ), who were elected on the back of promised reforms. However, once these reforms failed to materialise, Japan descended into political chaos. A new prime minister was appointed each year until eventually, in 2012, the LDP were voted back into power again under the leadership of Shinzo Abe.

Having felt little benefit from this political upheaval, we believe that Japanese people are reluctant to make changes. They now understand that governments alone have limited power in solving society’s biggest problems. This realisation, along with the lack of credible opposition in the country, is what we feel helped Abe and the LDP easily win the Upper House election at the start of July.

Following the result, Abe and his coalition allies now command a supermajority (over two-thirds of seats) in both houses of parliament (as shown below).





Source: Yomiuri Shimbun

This should enable him to continue to push through the policies he feels are necessary to revive the economy. With Abe's term set to last until 2018, we feel the benefits of this sustained period of stability in Japan relative to other developed countries may be underestimated by some investors.

2. Policy supports still in place

At the same time, we expect the government to maintain its fiscal loosening stance. Indeed, Japan has been one of the few industrialised nations to buck the recent austerity trend since Abe has been in power. Fresh from having convincingly won the Upper House contest, he signalled his intention to shift his focus back on the economy.

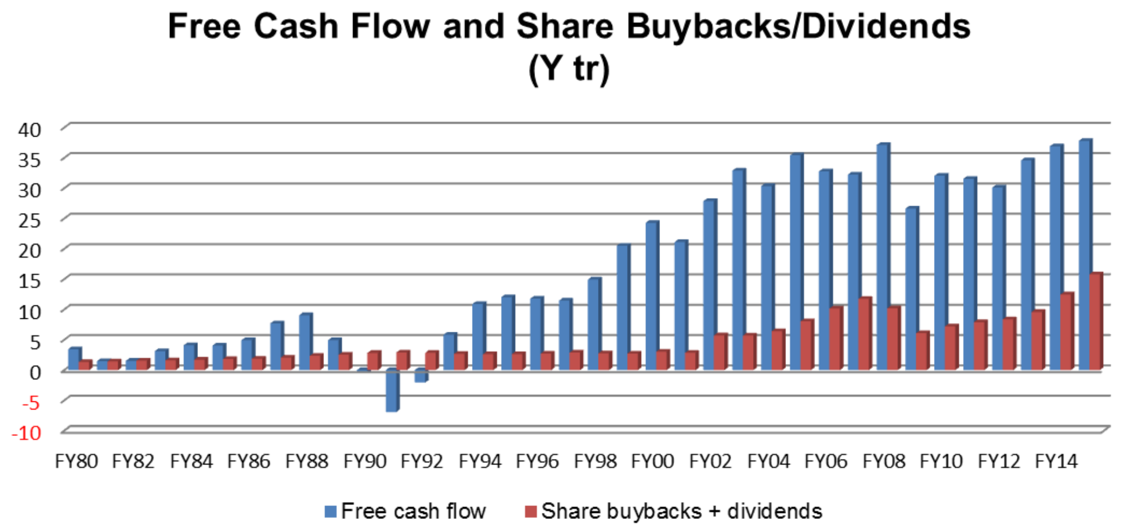
In a bid to inject demand, he unveiled a new fiscal stimulus package reported to exceed 28 trillion yen (approx. $270 billion), part of which would be spent on public works projects, pay-outs to households and cheap loans for infrastructure projects. This follows on from his decision in early June to delay the next scheduled consumption tax hike to 2019.

In addition, we believe the BOJ will continue its accommodative policy. It announced an acceleration of ETF purchases at the end of July, doubling its annual purchase of equity funds to 6 trillion yen a year. Further measures are expected to be announced in September after their next meeting if deemed necessary. These policy measures should continue to be supportive for Japanese stocks.

3. Improving shareholder return

One undoubted success of Abenomics so far has been its impact on shareholder return and corporate governance. We have seen some companies make significant improvements in their ROE following the introduction of the Japanese version of the Stewardship and Corporate Governance codes in 2014 and 2015, respectively.

These initiatives, along with Japan's first-ever negative interest rate policy introduced at the end of January, have encouraged corporates to utilise the vast sums of cash they accumulated under deflation. As a result, share buybacks and dividends have increased to record levels (as shown below).



Source: Toyo Keizai

We expect this cash deployment trend to continue as more corporates incorporate ROE targets into their mid- to long-term plans. In addition, we believe that corporates will be under greater pressure to make efficient use of its capital from the rising number of independent directors and greater shareholder engagement.

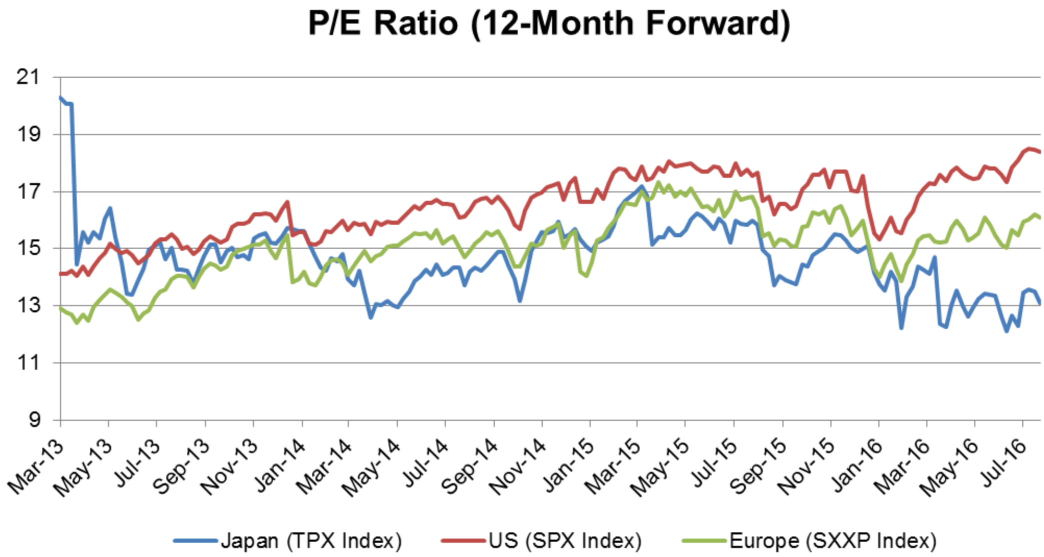
4. Yen weakness, not strength expected

Yen appreciation since the turn of the year has had a big impact on Japanese corporates, with earnings growth being revised down from 10-15 per cent to just 5 per cent. As expected, exporters such as auto and steel makers, have been hit the hardest. However, we do not expect this situation to continue.

While much will depend on the health of the US economy and whether the Fed resumes its rate hike cycle, we believe that yen strength will turn to weakness at some point. This could potentially lead to an upward revision of Japanese corporate earnings, thereby providing an unexpected boost to the market.

5. Reasonable valuations

Even at a conservative 90 yen to the dollar exchange rate, we estimate the EPS for Japanese corporates to be roughly 85-90 yen. Based on this level and the recent TOPIX low of 1,200 points, the P/E ratio is 13-14x, which is much lower than its historical average. It is also lower than multiples in Europe and the US, which have been rising in recent years (as shown below).



Source: Bloomberg, as at 5 August 2016

Coupled with the relatively stable political environment in Japan described earlier, we believe the risk-return aspect of the Japanese market is still appealing.

Outlook

We do not believe that Japan's recent revival is a short-term, cyclical one that relies solely on a weaker yen to increase corporate earnings. We are seeing structural shifts also play their part; for example, we are seeing a recovery in the labour market. Unemployment is just over 3 per cent, a 20-year low, owing to a tighter supply and as a result, the participation rate is going up. While wages may be sluggish, income per household is rising and this, in turn, should help support the economy.

Stock prices, while down this year, are still much higher than they were before Abenomics started. And, despite the recent pessimism, we are constructive on Japanese equities and believe that Japan continues to offer an attractive investment opportunity if you consider the five supportive factors mentioned above.

● Tokio Marine Asset Management is a Japan/Asia equity specialist with 30 years' market experience and approx. $57bn AUM. Our flagship Japanese Equity Focus strategy is a concentrated portfolio of 20-40 high conviction stocks using the best investment ideas of today.

● Please contact the Business Development team at Tokio Marine Asset Management (London) Limited (details below) if you have any queries regarding the above or wish to discuss Japanese equities with us.

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