Equity Insight
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Monthly Equity Market Topics

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In brief

- **Reflation and reform are reigniting the Japanese equity market.**
- **Europe is cheap, but so what?**

Reflation and reform are reigniting the Japanese equity market.

Behind the steady march of Japanese equities since Q1 2023, is a reflating economy and accelerating structural reforms. Monetary and fiscal policies continue to support economic growth, which is reflating the Japanese economy, and structural reforms introduced by the Tokyo Stock Exchange (TSE) are driving a focus on profitability and shareholder value.

The reflation phase of the business cycle is supportive of equities.
As growth picks up, the Japanese economy is reflating. The Bank of Japan ended its eight-year experiment with negative interest rates and its promise to keep the yield curve flat after hiking the policy rate to a zero to 10 basis point range (from -10 bps). At these levels, rates are set to stay well below nominal economic growth and be supportive of economic growth. Japan has not escaped post-Covid inflationary pressures. Recent union wage settlements resulted in a 5.3% wage increases for employees, something we haven't seen since the early 1990s.[1] Real wage growth should support Japanese consumption.

Reform efforts are driving shareholder returns.
Corporate Japan is turning increasingly shareholder friendly. The TSE is driving corporate governance reform and balance sheet efficiency by penalizing price-to-book discounts and forcing listed companies to focus on improving profitability. Additional governance progress is being made with the elimination of cross holdings and the restructuring of corporate boards to increase independent and female directors. Boards are increasingly engaging in constructive dialogs with investors and improving disclosure.

Japanese book values are depressed. Return on equity trails western equivalents and Japanese companies hold significantly higher cash balances (on average of twice those of US corporates).[2] The TSE's efforts have also led to increasing dividend payouts, buybacks and disclosure of improvement plans for low price-to-book ratios and lifting ROE.

However, not all companies are embracing change or reforming at the same pace, but the weaker yen has supported pockets of profitability. While the long-term structural dynamics remain supportive, some valuations have surged, so selectivity is important in this market.

Europe is cheap, but so what?

European equities are cheap, and especially so relative to US equities, but that may not be enough. However, at these levels, the probabilities are skewed to the US valuation premium closing or, at least, remaining stable rather than continuing to expand, especially if the European economy continues to recover following some positive data.

European equities are trading near all-time high discounts to the United States, but is relative cheapness enough? Adjusting for sector differences, Europe remains cheap. Is this justified and what would cause it to change? Or is the risk lopsided towards the US premium remaining constant or even narrowing?

At the end of April, the S&P 500 one-year forward multiple trades at a 53% premium to the MSCI Europe. That's more than double its 20-year average of 21%. Allowing for the flaw of averages (remember the six-foot tall person who drowned crossing a river that, on average, was five feet deep?) and breaking this down by sector, across all Europe stock sectors trade at discounts to their US brethren. Furthermore, removing the influence of the Mag 7 reduces this premium to approximately 30%, still higher than the 20-year average. As the saying goes, history is there to be rewritten, and relying on mean reversion is somewhat naïve, so what are the markets telling us?

The long-term premium tells us that, yes, US companies have structural advantages. The US has had higher growth and higher growth prospects, so yes — for these and other structural reasons — a premium is deserved, but what level? We would suggest 53% is quite extreme.[3] Investing is about taking risk where you will be rewarded, and there seems to be limited further upside expansion for the US premium, but it doesn't need to contract. It just needs to stay where it is and we should see similar performance out of both regions.

Due to the composition of the benchmark, Europe skews toward value, and investing in Europe is, of course, a play on global GDP. A pan-European portfolio is not about European domestic risks. Far from it. LVMH handbags are a global treat. Novo Nordisk obesity drugs solve a global problem. ASML is critical to the global growth of semiconductors. And then there is Diageo with brands like Guinness, Johnnie Walker, Casamigos, Tanqueray, Bulleit and Seedlip, among many more.

As natural gas prices have settled down at tolerable levels and real wages across Europe have turned positive, we are starting to see signs of economic recovery in Europe. A narrowing of the relative growth gap could be a catalyst for closing some of the US premium and a boost for European equities. You certainly don't hear of European equity valuations being stretched or in a bubble. In addition, German business conditions and expectations are improving while breadth remains intact.

The question investors should be asking is, is it worth paying a 50% premium for a dollar's worth of earnings from US companies? Markets and stocks go up on stories and, in most cases, there is a lot of truth to these, but focus on the fundamentals that are on the way down. We would suggest on balance, the probability that the premium staying steady or closing over the coming years is more likely than the probability for it continuing to expand. In our view, you do not outperform by reflecting what the market is already telling you (and valuing) today, you do it by being different. This can be uncomfortable, and you need a long-term mindset, especially if valuation is driving your decisions.

At a personal level, it seems like *déjà vu* all over again. Over a roughly 13-year stretch from the late 1990s to early 2010s, the Australian equity market outperformed global markets (in AUD terms) and it was very difficult to get investors to reduce their significant home country bias. That all changed, and since the early 2010s, Australian investors have been far better off with global equity portfolios, but it took many years of domestic equity underperformance to change that mindset.

Endnotes

[1] Reuters, Japan union group announces biggest wage hikes in 33 years, presaging shift at central bank. March 15, 2024.

[2] FactSet Portfolio Analysis.

[3] Factset.

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