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Japan's Revitalisation In The Reiwa Era

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In Brief

- **Yen weakness is set to remain a feature for Japanese investors.**
- **This has proven a boon for exporters.**
- **Structural changes continue to broaden and benefit shareholders.**

The Japanese equity market continues to go from strength to strength. In our 2023 paper, we laid out some of the macro factors and structural changes that were supporting our positive view on Japanese equities. In this paper, we expand on why we continue to have a positive view.[1]

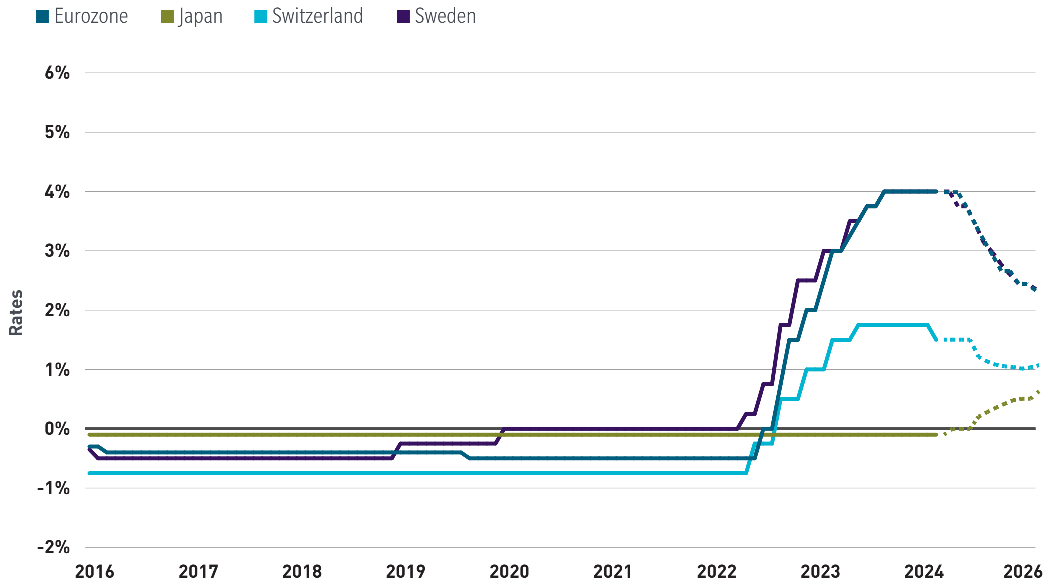
We will show how shifting monetary policy reflects growing confidence in the economy and how yen appreciation may face structural hurdles. While the weak yen has been a huge benefit for exporters, corporate Japan continues to embrace reforms to improve governance and unlock value from balance sheets, all of which may benefit shareholders.

The shift in policy reflects growing confidence in the economy

The Bank of Japan (BoJ) seems set for a gradual and measured normalization of monetary policy. Substantive first steps were taken at the March 2024 meeting in its revised balance sheet and interest rate policies, marking a *"normal phase of monetary easing"* that is expected to remain highly supportive of growth.[2]

- Balance sheet policies: Testament to this restrained optimism was the simultaneous ending of several quantitative easing policies extending support to the government and business sector. Top of mind was the termination of yield curve control over the 10-year Japanese government bond, with other asset purchases either subject to immediate cessation (equity exchange-traded funds) or a 1-year phase-out (corporate bonds). Looking ahead, we feel the BoJ will likely carefully calibrate quantitative tightening measures that reduce its balance sheet given its financial stability mandate and large asset holdings.
- Interest rate policies: Alongside this, the effective policy rate was raised by 0.1% to slightly above 0%, making it the last central bank to exit the unconventional negative interest rate policy, which seems unlikely to be repeated. Our baseline view of further increases to 0.5% over the next year would leave the policy rate stance still highly accommodative for the economy and likely tolerable for financial markets, which are pricing a similar terminal policy rate. Indeed, the market-expected policy rate path would still leave the yen as the lowest yielding currency for some time yet.

Exhibit 1: Recent history of negative policy rates & future expectations



Source: Bloomberg. Quarterly data from 31 January 2016 through 18 June 2024. Expected terminal rates are quarterly data from September 2024 through June 2026 and are dashed lines on the chart.

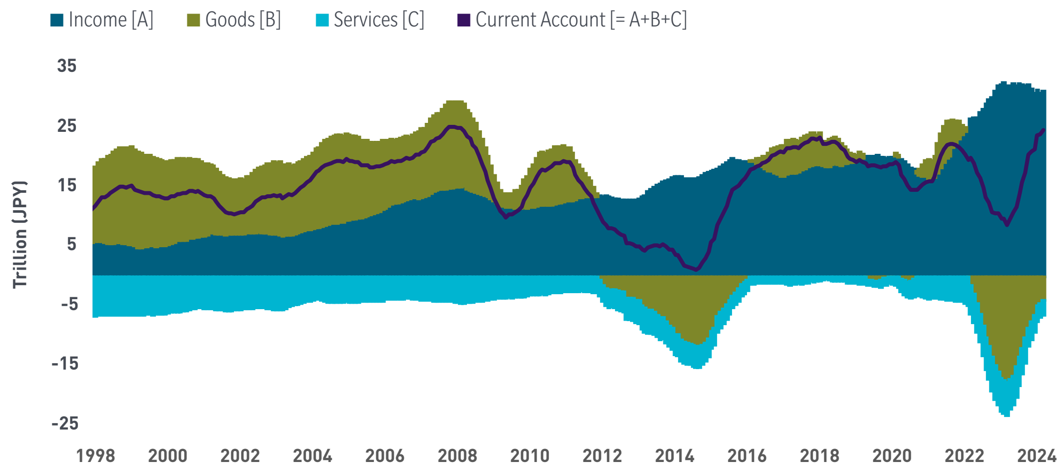
Nevertheless, sustained yen appreciation faces structural hurdles

Consistent with it being a largely free-floating exchange rate, performance of the yen has empirically been closely linked to global interest rate differentials. One market aspect to this is the carry trade which involves selling low yielding currencies like the yen to buy other higher yielding currencies. However, a more fundamental explanation for the yen's sustained weakness and global yield sensitivity can be found in Japan's transforming current account surplus.

Persistent surpluses in the income component are now behind the overall surplus in the current account, rather than in the trade balance as observed in the pre-Abenomics years. As a mature creditor nation, Japan has accumulated large investments overseas, both direct investments like factories and portfolio investments like equities and fixed income, resulting in growing income surpluses generated by interest, dividends and reinvested earnings. This income surplus more than makes up for the increasingly frequent deficits in goods (*e.g.*, commodity import shocks from geopolitical and natural disaster events) and services (*e.g.*, digital service imports by consumers and businesses).

The tendency for re-investment overseas is usually higher for income surpluses, with the investment returns outlook also a key consideration. The increasing dominance of the income surplus in the overall current account surplus acts as a structural suppressant of appreciation pressures in the yen, and particularly so when the overseas rates of interest and return are high by comparison. This is also a reasonable expectation for the coming years given the increasing recognition for post-pandemic industrial economies that real interest rates, expected inflation and nominal interest rates may be materially higher in equilibrium.

Exhibit 2: Current account breakdown



Source: Ministry of Finance. Monthly data from 31 January 1998 through 31 March 2024. 1-yr running totals in JPY trillions.

Will the outperformance of Japanese stocks continue?

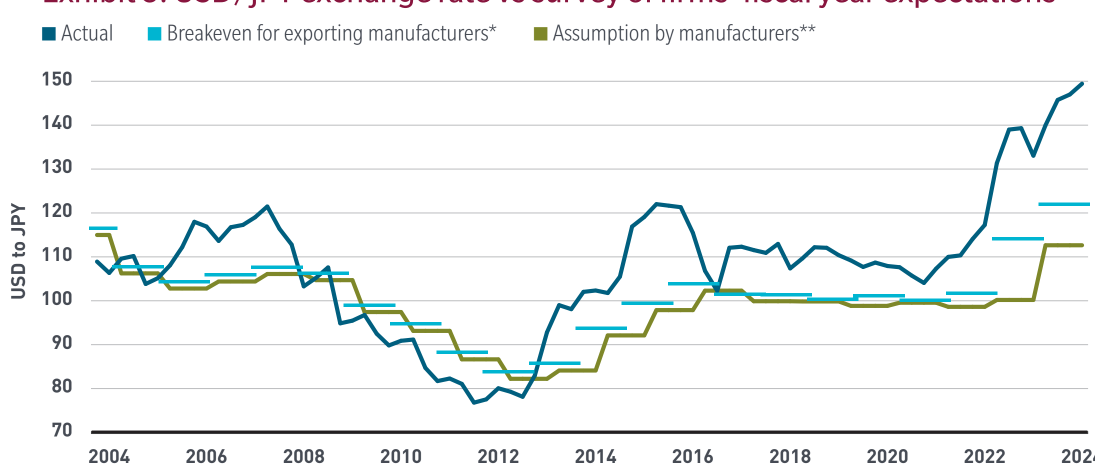
Japanese equities have languished. They have only recently reached the same levels the Nikkei 225 hit in December 1989. All the while, equity markets in Europe and the United States have continued to forge ahead.

What is driving this renaissance in Japanese equity performance, and can it continue? We believe it can, propelled by several factors such as improving fundamentals driving earnings momentum, funds flows and ongoing corporate reform. We examine each factor below.

Earnings momentum on an upward trajectory

Improving company fundamentals across multiple fronts are supporting Japanese earnings. First, and the most obvious, is the yen. As outlined above, we believe the long-term prospects are one of persistent yen weakness, a particularly supportive environment for those large- to medium-sized exporters with the capacity for cost pass-through to prices. Their increasing international competitiveness is reflected in exchange rate surveys of Japanese enterprises as highlighted in exhibit 3, where , by way of example, the estimated breakeven USD/JPY rate is significantly below both what manufacturers are forecasting and the realized rate.

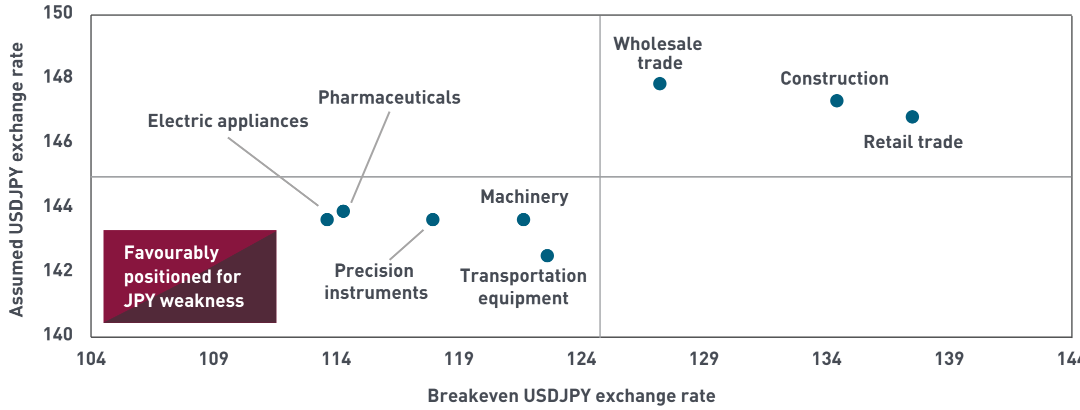
Exhibit 3: USD/JPY exchange rate vs survey of firms' fiscal year expectations



Source: Bloomberg, *Cabinet Office, **Bank of Japan. Quarterly data from 31 December 2003 through 31 March 2024.

Some firms and industries are better positioned than others for prolonged yen weakness, and one indicator is those with relatively low assumed and breakeven USD/JPY levels (exhibit 4). At the industry level, more export-driven electric appliances, pharmaceuticals, precision instruments, machinery and transportation equipment stand out for being well positioned. At the other end of the spectrum are the more import-dependent industries like retail trade, wholesale trade and information and communications.

Exhibit 4: USD/JPY exchange rates (breakeven and assumed) for select industries



Source: Bank of Japan, Cabinet Office, MFS estimates.

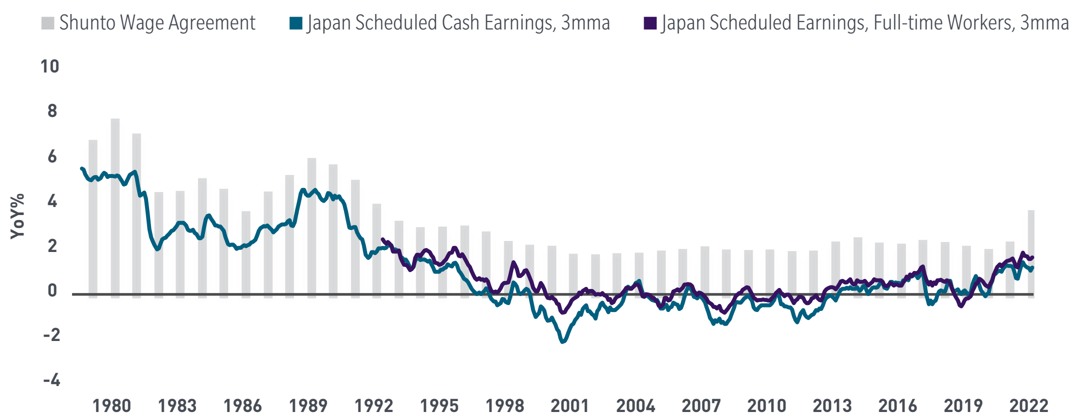
For many years, the impact of higher input costs driven by a weakening yen hurt the profitability of domestic industries who, due to years of sticky deflation, do not have pricing power. However, the post-COVID inflationary climate exacerbated the impact dramatically, increasing input costs and increasing consumer prices for wide range of goods and services. There are growing signs that rising prices are being accepted, contributing to one of the most macro supportive operating environments for firms in the past 3 decades. Since last year, we have witnessed domestic consumption-driven businesses increasingly able to pass through costs onto consumers and protecting profitability. A rapid rise in real wages is supporting higher consumer prices and shifting their deflationary mindset. In the spring Shunto wage negotiation this year, wages rose on average 5.2%, which is the highest in 25 years. These gains are starting to trickle down to mid- to small-sized enterprises. Additionally, the BoJ Tankan July survey highlighted a significant increase in planned capital expenditure by both large and small companies.

Exhibit 5: Domestic demand-related sectors are expected to grow earnings further in this year

MSCI Japan Sector	Forward Earnings %
MSCI Japan / Energy - SEC	**-2.4**
MSCI Japan / Materials - SEC	15.1
MSCI Japan / Industrials - SEC	0.2
MSCI Japan / Consumer Discretionary - SEC	15.8
MSCI Japan / Consumer Staples - SEC	15.9
MSCI Japan / Health Care - SEC	7.6
MSCI Japan / Financials - SEC	17.6
MSCI Japan / Information Technology - SEC	11.7
MSCI Japan / Communication Services - SEC	28.1
MSCI Japan / Utilities - SEC	1.2
MSCI Japan / Real Estate - SEC	3.9

Source: MSCI, FactSet, MFS as at 14 June 2024.

Exhibit 6: Shunto wage negotiations driving real wages



Source: Absolute Strategy Research. Monthly data from 30 June 1980 through 31 December 2023.

Rising foreign funds flow

The positive outlook for Japanese equities has driven flows into the equity market, much of this directed by foreigners. While we are not able to confirm, local media have reported some of this may be driven by investors reallocating their Asian exposure away from China. In addition, investors have been taking an increasingly positive view on Japan after 30 years in the doldrums. According to J.P. Morgan's global mutual fund allocation analysis, Japan has been an underweight relative to its global index allocation. As you can see in the chart below, the allocation remains lower than the index weight. This gap narrows if global investors become increasingly confident of the structural changes and potential upside of Japanese stocks.

Exhibit 7: Global active funds weighting on Japan equity vs. MSCI World Index

Source: EPFR, J.P. Morgan QDS.

Corporate reforms continue

Japanese corporate reform has continued to gather pace. Ten years ago, the Japanese government introduced stewardship and corporate governance codes. These were non-compulsory, comply-or-explain rules which we explored in greater depth in our previous paper. Initially, companies worked on those that were easy to apply, such as increasing independent board members and introduction of female board members. However, the other important aspects of governance, capital allocation and balance sheet management, were slow to change, disappointing global investors during the early years of Abenomics.

Over the last couple of years, we have witnessed steady and increasing focus driving improvements in both corporate governance and capital allocation. For example:

- The Toyota Group announced its review of cross-shareholding policy, resulting in Toyota Motor and two affiliates divesting 8% of their stake in tier 1 supplier Denso. The divestment was absorbed by Denso buying back its shares. The event reinforced expectations by global investors that Japanese companies are going to unwind their cross shareholdings to free up capital to either return to shareholders or invest.
- Activist funds have played an important role as we have witnessed several companies discussing changes to their capital allocation policy after activist funds invested. This has impacted share prices positively. For example, Keisei Electric Railway (Keisei) has a 22% of stake in Oriental Land Corporation (OLC), the owner of Tokyo Disneyland (TDL). This has been a longstanding investment and Keisei provided funding for the construction of TDL. Today that investment in OLC is valued at more than the entire market cap of Keisei. Activist investors pushed for this be unwound and capital returned to investors. Keisei initially announced it would sell 1% of its OLC stake, which disappointed the market. The value of the OLC stake has different meanings for different shareholders of Keisei; however, if it continues this path, they can unlock capital to fund growth in capex or return funds to shareholders. We also saw similar discussions at Mitsui Fudosan, a major real estate developer who owns 6% of OLC. Mitsui was challenged by an activist fund who agitated for them to sell their OLC stake and return the funds to shareholders. They did not sell but set a new capital allocation plan which was appreciated by the market, driving the share price higher.

In summary, we see numerous structural changes in the Japanese stock market, and the changes have just started in certain areas. We believe these to be long-lasting and will continue to unlock value for investors. Economic policy remains supportive. The yen, in our opinion, will remain structurally weak, sustaining exporters. Yen-driven dispersion across industries, and the different pace and opportunities for reform and balance sheet restructuring, highlights the various opportunities that can arise from bottom-up stock picking. Investors in Japanese stock markets have seen strong returns in recent years and, given the conditions outlined in this paper, we believe the foundation looks robust for the years ahead.

Endnotes

[1] The Reiwa Era is 232nd and current era of the official calendar of Japan. It began on 1 May 2019, the day on which Emperor Akihito's eldest son, Naruhito, ascended the throne as the 126th Emperor of Japan.

[2] Summary of Opinions at the Monetary Policy Meeting on March 18 and 19, 2024. Released on 28 March 2024 by the Bank of Japan.

Keep in mind that all investments carry a certain amount of risk, including the possible loss of the principal amount invested.

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