Invesco Investment Insights
Demystifying Japanese equities in the "Abenomics" era

April, 2018

Daiji Ozawa
Managing Director & Chief Investment Officer, Japan

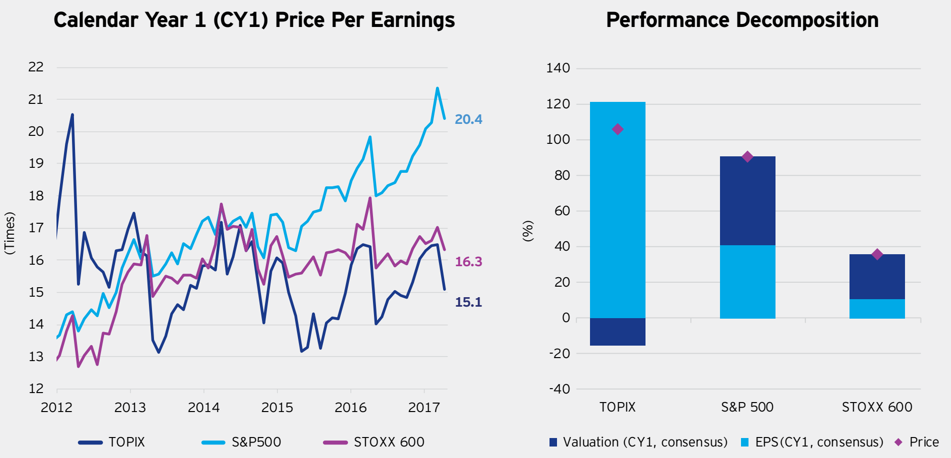
Key takeaways

- Japanese equities trade at a discount versus developed markets
- Valuation gap reveals investors not yet convinced about turnaround in Japanese companies and economy
- Concerns about structural challenges do not account for recent positive developments

Japanese equities are among the best performers globally in local currency terms since December 2012, when Prime Minister Shinzo Abe took office and put in motion a series of expansionary polices referred to as "Abenomics." However, the current valuation gap with other global markets demonstrates that investors have yet to be convinced the corporate and economic revival is sustainable. Invesco's Daiji Ozawa examines the common concerns linked to Japan and explains why they may be overstated.

The TOPIX Price Index exceeded its 26-year high in early 2018. On the economic front, nominal GDP, which had stagnated during the deflationary years, has finally resumed growth and surpassed its historical peak in 1997. Despite these milestones, the Japanese stock market is currently trading at a discount compared to the pre-Abenomics level and major developed markets. Japan has not benefitted from the same buoyant sentiment as other developed markets, which charted higher returns largely on the back of multiple expansions (Figure 1).

Figure 1: Japan's equity market is undervalued versus global peers



Source: FactSet, IBES, Goldman Sachs. Price per earnings: Data is as of 28 February 2018. Performance decomposition: Data is from 30 December 2012 to 28 February 2018. EPS growth based on consensus. The TOPIX, S&P 500 and STOXX Europe 600 benchmarks are used for comparison.

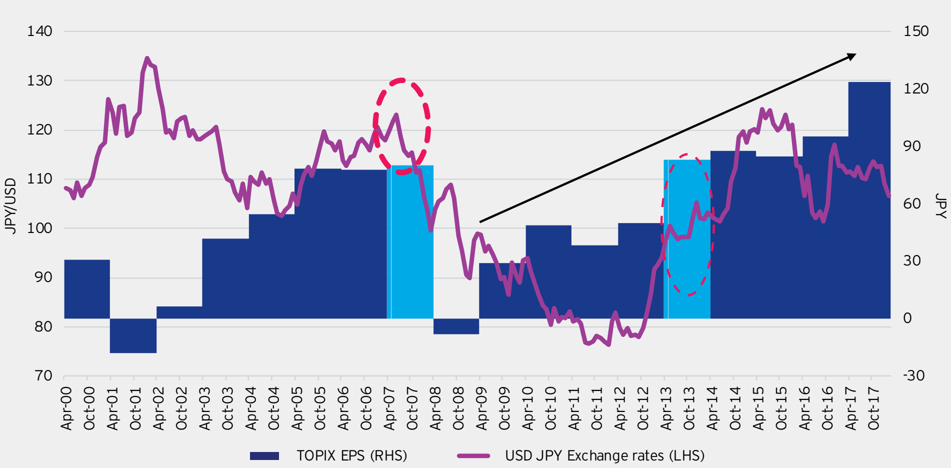
This white paper aims to address common concerns over Japan's structural issues: (1) Japanese yen appreciation (2) ageing demographics (3) high government debts and (4) capital inefficiency coupled with shareholder-unfriendly corporate governance.

Japanese corporations have built resilience to currency appreciation

Japanese corporate earnings suffered during the Global Financial Crisis (GFC) under the combined pressures of the severe contraction in global demand and the sharp appreciation in the yen as a safe-haven currency. Although the GFC originated and intensified outside of Japan, Japanese stock markets still suffered the most among the major markets.

After 2009, corporate earnings started to pick up, even with the yen continuing to strengthen (Figure 2). Eventually, Japanese corporate earnings exceeded the pre-crisis 2007 peak in 2013 despite the yen (approximately JPY100 per USD) trading more than 10 percentage points higher than in 2007 (approximately JPY113 per USD).

Figure 2: Japanese corporate earnings increasing despite currency fluctuation



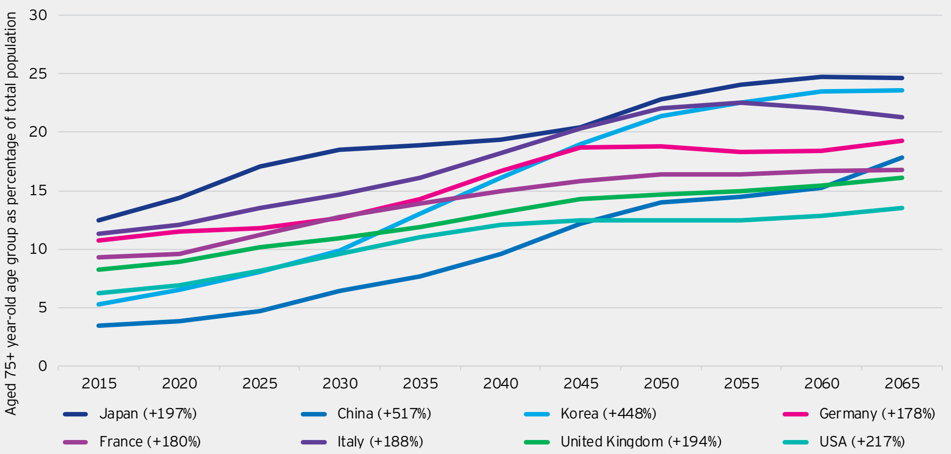
Source: Bloomberg, Nomura Securities. Fiscal year 2017 EPS is forecasted by Nomura Securities. As at 28 February 2018.

The steady growth trend in earnings broadly remains uninterrupted, supported in the midst of a global synchronised recovery, and more importantly, thanks to Japanese companies' deliberate strategic improvement efforts. They are leaner than before, having cut costs and restructured their business portfolios to survive and thrive. In addition, there are several companies that have proactively adapted to structural industry/macro changes like automation, electronic vehicles and an ageing society. Given the attractive combination of the healthy Japanese corporate fundamentals and valuation supports, the yen appreciation would not derail the stock market recovery unless it spikes to the crisis level and breaks through JPY100 per USD for a prolonged period.

Ageing demographics is a common global challenge that all key economies must face, not just Japan

Japan is home to the oldest population in the world. The elderly aged 75 or older have already exceeded 10% of total population and is expected to increase in percentage as a segment. Although Japan will be a front-runner for the next decades, there are a few runners-up, especially in North Asia, such as China and Korea, which will experience a higher rate of increase in the elderly population segment than Japan. In addition, even among countries with relatively high fertility rates, including France, UK and US, a rapid increase in the elderly population is an inevitable long-term trend (Figure 3). Ageing demographics is not a Japan-specific issue but rather a common challenge that key global economies must all face.

Figure 3: Aging population is a global issue



Source: "World Population Prospects: The 2017 Revision." UN Department of Economic and Social Affairs, retrieved 15 March 2018.

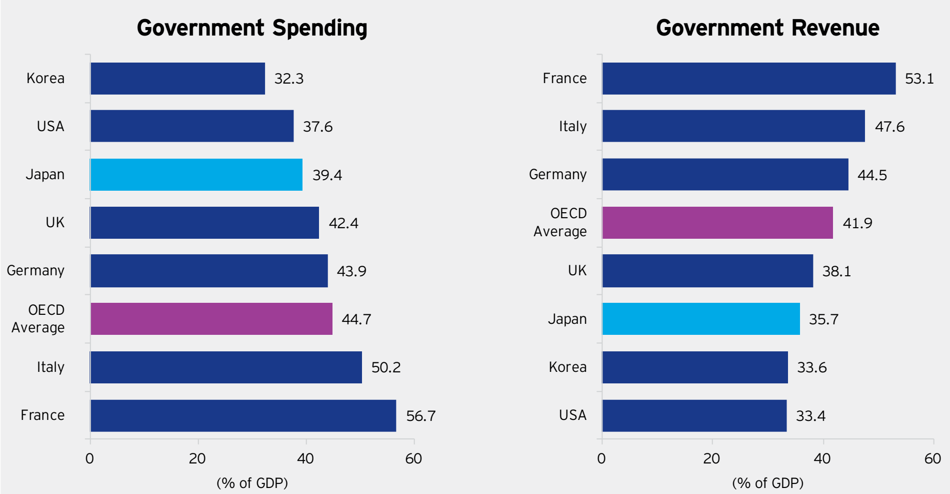
Interestingly, while the working-age population is already declining in Japan, the labour force and employed populations have been increasing. The recent recovery in corporate activity and economic growth has led to a return of female workers to job markets and a prolonging of retirement among seniors. These trends will mitigate the negative impacts of ageing on the economy for the next few years.

From an equity investment perspective, Japan's focus on this issue also stands to stimulate innovation and facilitate new growth opportunities for companies. For example, a group of Japanese companies (Yamaha Motor, Hitachi and Toyota Tsusho) runs the "Last Mile Mobility" project through a government partnership to develop a driverless short-distance transportation service. This innovation reduces operating costs, eases driver shortages and supports elderly mobility especially in rural areas on a sustainable basis. The system employs a self-learning road image-recognition technology integrated with a cloud-based server. A series of field experiments are planned in multiple cities in 2018 aiming to make automated mobility a reality on a commercial basis by 2020.

Excess savings in private sector eases concern over Japan's government debt level

Japan's general government debt to GDP ratio was nearly 240% in 2015, the highest among major countries, followed by Greece and Italy. Investors often worry about a lack of fiscal discipline or increasing social security costs in the ageing society. Interestingly though, Japan's government spending is among the lowest within the OECD, even though its population is the oldest. The root cause of Japan's debt issues stems from depressed government revenues under the persistent deflationary environment, where two significant tax sources-corporate earnings and personal incomes-were squeezed (Figure 4).

Figure 4: Japan's government debt not driven by spending

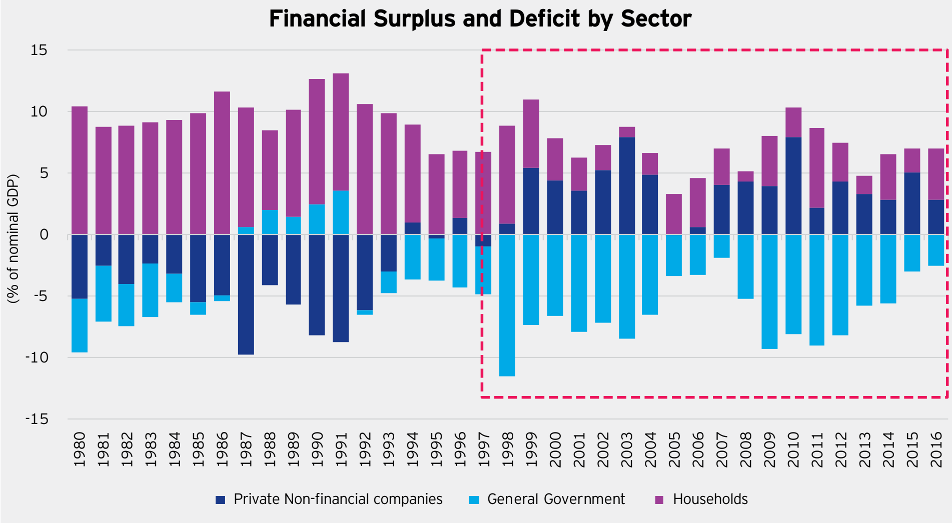


Source: OECD (2018), General government spending (indicator). doi: 10.1787/a31cbf4d-en, General government revenue (indicator). doi: 10.1787/b68b04ae-en (Accessed on 27 March 2018) Note: Data for 2015.

As such, the recent visible signs of the end of price and wage deflation and an upturn in the nominal GDP growth signal a positive turnaround.

Moreover, in contrast to the heavily indebted government, Japan as a whole is in excellent financial shape and remains as the largest creditor in the world thanks to excess-savings in the private sector (households and corporate) (Figure 5).

Figure 5: Japan's private sector generates significant surplus



Source: The Bank of Japan (Flow of Funds), Cabinet Office Government of Japan (National Account of Japan), Okasan Securities. Data up to March 2016.

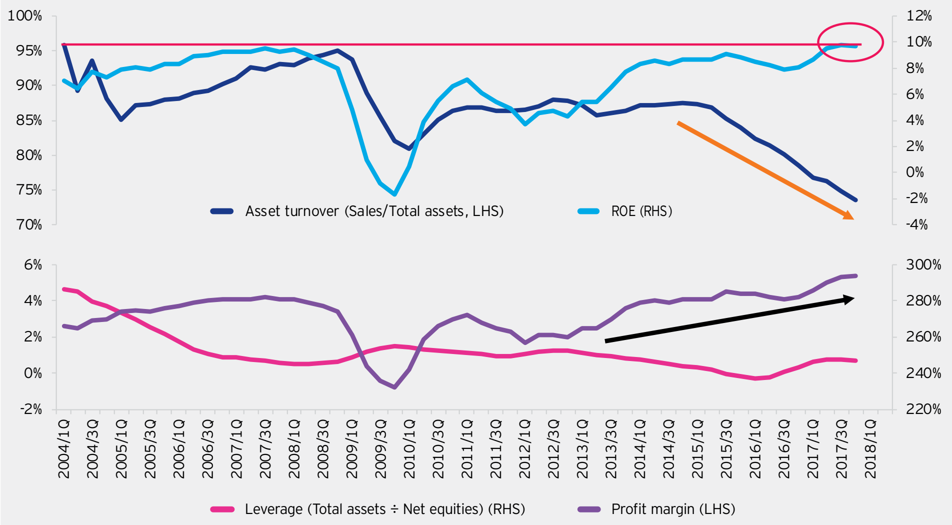
The question is whether, when and how Japanese corporates and households start to use their savings. The end of deflation means that cash is no longer king, possibly inducing increased spending levels. On the corporate front, we think that corporate governance reforms also play an essential role. The wise use of cash hoardings to improve capital efficiency and increase the labour share of income from its current lowest level since the early 1970's is a critical step. This will create a virtuous reflationary cycle resolving the asset imbalance in Japan and eventually reducing the government debt.

Positive strides made in enhancing corporate governance standards

Corporate governance reform is one of the most successful Abenomics policy agendas. Since 2013, the Stewardship Code and the Corporate Governance Code have been introduced and updated. Japan's Stewardship Code sets institutional investors' responsibility, focusing on facilitating constructive dialogues with management for the purpose of achieving sustainable corporate value growth. The Corporate Governance Code lays out fundamental principles for listed companies to achieve sustainable growth and increase corporate value over the mid to long-term.

The new government initiatives have led to gradual but steady progress in capital efficiency. For instance, asset managers and owners have been setting stricter rules for proxy voting such as return on equity (ROE) hurdle rates. Engagement with management is also becoming a common practice. On the corporate front, now 88% of companies listed on the Tokyo Stock Exchange 1st Section have two or more independent external board members, which is a big leap from 13% in 2010. Perhaps the most notable achievement is the rise in Japanese companies' ROE, which has at last caught up with a standard level among European peers, around 10% (Figure 6).

Figure 6: Historical ROE and ROE breakdown of TOPIX Index constituents



Source: Nikkei Astra, Daiwa Securities. As at October-December Quarter 2017

Japan is still in the process of enhancing corporate governance standards. According to DuPont Analysis, the improvement in ROE for the last five years mostly resulted from margin expansion while leverage is broadly shrinking with asset turnovers declining. To achieve a secular ROE increase, further collective efforts are crucial from both investors and corporate management to make headway in corporate governance reform.

In the past two decades of challenging investment environments, many investors walked away from Japan. Behind the scenes, however, the country has been steadily addressing its unique structural challenges, namely the two-decade-long deflation, shareholder-unfriendly corporate governance and capital inefficiency.

Meanwhile, Japan is facing problems not unfamiliar to other countries. Being a front-runner in common challenges, such as the ageing population, is stimulating innovation and incentivizing Japanese companies to become leaders in the field. Given the current discounts on the Japanese equities, the positive strides taken to address structural challenges and adapt to cyclical headwinds, including yen strengthening, offers a unique entry opportunity that appears to be underestimated by many investors.

Important information