Japanese equities

Can structural changes lead to sustained growth for Japan?

Daiji Ozawa
Chief Investment Officer and Chief Portfolio Manager - Japanese Value Equity
Tokyo

Key takeaways

- After years of Abenomics, the Japanese economy and equity market have begun to respond.
- Earnings growth is solid, and both nominal GDP and the Nikkei 225 Index have reached 20-year highs.
- Key structural changes currently underway should assure that growth is sustained in 2018.

The Japanese economy and equity market regained steam in 2017. Nominal GDP, which had stagnated during the deflationary years, has finally picked up in response to Abenomics and has reached a historical high, surpassing the previous peak in 1997. The Nikkei 225 Index coincidentally rose to its highest level since 1996 against the backdrop of solid earnings growth. This performance was boosted not only by macro factors (notably the yen stabilization effort) but also by restructuring efforts over the two "lost decades" and the unique competitive advantages of Japanese companies. Looking forward to 2018, we would like to highlight three key structural changes we believe will lead to sustained growth in Japan.

> Nominal GDP, which had stagnated during the deflationary years, finally picked up in response to Abenomics and has reached a historical high, surpassing the previous peak in 1997.

1. The end of deflation should boost capital spending by cash-rich Japan Inc.

To cope with weakened domestic demand, Japanese companies cut wages and capital spending, reduced excess capacity and accumulated cash on their balance sheets. This created a vicious deflationary cycle over the last two decades. However, cash is no longer king – the extremely tight labour market (partially due to the aging society), coupled with healthy economic growth is building up reflationary pressures on prices and wages. In addition, the lack of investment has created capacity shortages. We believe that we have reached the tipping point – corporate Japan now needs to stop saving and spend cash on innovations in order to sort out capacity and labour constraints and grow its earnings. A good example is IT investment, especially among small to mid-sized companies. Their underinvested IT systems are currently obsolete and should be upgraded to improve efficiencies and to cope with labour shortages and the resultant rise in wages.

2. The current labour shortage is stimulating innovation and labour productivity

Japan is indeed facing a severe labour shortage. The job-to-applicant ratio has reached 1.52, matching the level at the height of Japan's economic boom in the 1970s.[1] The unemployment rate has come down below 3%, the lowest over two decades.[2] This situation has been highly motivating to corporate Japan, resulting in the development of innovations in automation across industries. Japanese companies have seen breakthroughs in robotics and automation systems that are now used in a multitude of scenes, from factories to logistic centres to airports. The government also needs to foster innovation to improve productivity and raise future gross domestic product (GDP) growth. In fact, Abenomics has been taking necessary steps to alleviate labour shortages. For example, we have seen gradual progress on immigration, including an introduction of permanent visas for skilled workers and extension of trainee visa terms from three years to five years. The next important move is labour market reform, including the adoption of "equal pay for equal work" (narrowing the large pay gap between regular full-time workers and part-time contractors) and a loosening of layoff restrictions. We are now hopeful about this critical reform, as the landslide election victory last October has given Prime Minister Shinzo Abe's administration time and a mandate to push it forward.

3. Corporate governance reform is progressing

Corporate governance is another transformation under Abenomics. Since 2013, a series of reform measures, including the introduction of the Stewardship Code and the Corporate Governance Code, have been producing a virtuous circle of improving governance structures and increasing shareholder returns. Under pressure from the government, asset owners and asset managers have set stricter rules for proxy voting such as establishing return on equity hurdle rates, and have more proactively engaged in dialogue with company management. Under pressure from investors and even peers, company management has been prompted to improve its profitability and capital efficiency. This is another gradual but steady development in Japan.

1 Source: Ministry of Health, Labour and Welfare, Japan. Data as of Sept. 30, 2017.
2 Source: Ministry of Internal Affairs and Communications. Data as of Sept. 30, 2017

Structural changes may bring sustained growth to Japan

Structural changes that can lead to sustained growth are gradually but steadily taking place in Japan. We are finally putting an end to deflation, the green shoots of corporate and household spending are appearing and corporate governance continues to shape up. However, these structural changes both pose risks and open up opportunities for Japanese companies. From a Japanese equity investment perspective, these changes bring a considerable advantage to active managers who have insight into how these transformations evolve, how they affect companies and, most importantly, which company management teams are capable of taking advantage of these profound changes.

> In Japan, structural changes leading to sustained growth have gradually but steadily been taking place.

Important information

All data as of October 31, 2017 unless stated otherwise.

All investing involves risk. Past performance is not a guarantee of future returns. An investment cannot be made in an index. Diversification does not guarantee a profit or eliminate the risk of loss. Invesco does not provide tax advice.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.