Japan equities

The Japanese economy is on track for strong long-term economic growth

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Key takeaways

- The private sector's capital spending will sustain economic growth, and economic stimulus is expected to mitigate the impact of an anticipated jump in the consumption tax.
- A recently revised Corporate Governance Code has helped Prime Minister Abe live up to his promise of corporate governance reform.
- Japan's total factor productivity growth between 2012 and 2016 was the highest among the G7 countries.

Although global political and macro headlines weighed on its stock markets in 2018, Japan's economic and market fundamentals remain on the right track toward normalization: Nominal gross domestic product (GDP) growth was broadly sustained; core consumer product inflation (which excludes fresh food) remained around 1% as of the end of October[1]; and – most importantly for equity investors – corporate governance reform has made steady progress. Looking forward to 2019, although we are aware of the increased macro and market uncertainties externally, Japan's sustained recovery may not be derailed given several ongoing structural changes.

Abenomics has sustained economic growth

Last September, Prime Minister Shinzo Abe won the Liberal Democratic Party (LDP) presidential election as widely expected. Now he is set to become Japan's longest-serving prime minister in history, ensuring that his economic policy mandates continue to progress. Domestically, the biggest macro risk in 2019 may be a scheduled October increase in the consumption tax to 10% from 8%, which is designed to restore the nation's financial credibility. Although the previous tax hike to 8% from 5% in 2014 undermined household consumption and private capex, the 2019 rise isn't expected to derail Japan's economic growth this time around because the Abe administration plans to launch stimulus packages to cushion the impact. The Bank of Japan also continues to demonstrate its commitment to current easing policies, taking into account uncertainties such as the effects of the coming consumption tax hike. Although some investors worry about deceleration of asset purchases by the central bank, we think it allows the bank to extend the life of monetary easing measures. Such political stability and promises of a stimulus support healthy structural growth in Japan's economy and corporate earnings, bolstering a much-needed recovery in capital expenditures. Cash-rich Japanese companies plan to step up capital spending to upgrade facilities that have been underinvested over the last two decades and to accelerate automation in order to cope with labor shortages. The labor shortage also has spurred a rise in wages, which often lifts consumer sentiment. Capital expenditures and household spending have been the drivers of the recent GDP growth, finally forming a long-awaited virtuous circle in Japan.

Corporate governance reform progressing slowly but surely

Corporate governance is regarded as the most successful Abenomics policy agenda. In 2018, the Tokyo Stock Exchange and Japanese Financial Services Agency revised the Corporate Governance Code, targeting core issues such as high cross-shareholdings among non-financials (around 20%) and low capital efficiency. The revised code has established stricter principles for listed companies to disclose cross-shareholding policies and to issue an annual assessment examining whether the benefits and risk of each holding satisfy their cost of capital. Listed companies now also need to set and communicate business strategies with profitability/capital efficiency targets based on reasonable cost-of-capital estimates. Japanese companies' return on equity has been picking up but still has room to catch up with the global standard. These tighter guidelines are expected to provoke business portfolio restructuring through divestment and acquisition, further narrowing that gap.

Breakthroughs in improved productivity

Reforms to cut Japan's infamous long work hours, endorse flexible working styles and close the gap between regular workers and temp staffs is one of Abe's policy highlights that has appealed to voters. In addition to private capital spending, rising productivity has ensured a sustained recovery in Japan's recent GDP growth. In fact, Japan's total factor productivity (TFP) growth from 2012 to 2016 was the highest among the G7 countries, according to the Organisation for Economic Co-Operation and Development (OECD). Work Style Reform likely will reinforce the upward trend further.

> Japan's sustained recovery may not be derailed given several ongoing structural changes.

1 Ministry of Internal Affairs and Communications as of October 2018
http://www.stat.go.jp/english/data/cpi/1581-z.html

In addition, although the immigrant worker population in the production workforce remains low on a percentage basis (around 2%), the total number of immigrants is among the highest for the last couple of years, thanks to policy support, namely the introduction of the technical intern training program. To address that particular labor issue, the government has promised that by April 2019, it will accept foreign human resources in the regions that have suffered the most severe labor shortages, such as construction, agriculture and nursing care.

> In the long-term, the Japanese economy remains on an upward trajectory.

Increased global political and macroeconomic uncertainty has disrupted global markets – and Japan is no exception. Patchy global economic growth has softened its near-term economic recovery. Yet in the long-term, the Japanese economy remains on an upward trajectory. Such positive trends, a recovery in capex and consumption, progress in corporate governance reform and improved productivity all have yet to be priced in stock valuations, but we believe it may create opportunities to rebuild strategic allocations in Japan.

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