

5<sup>th</sup> May 2023

## Japanese equities look quietly compelling

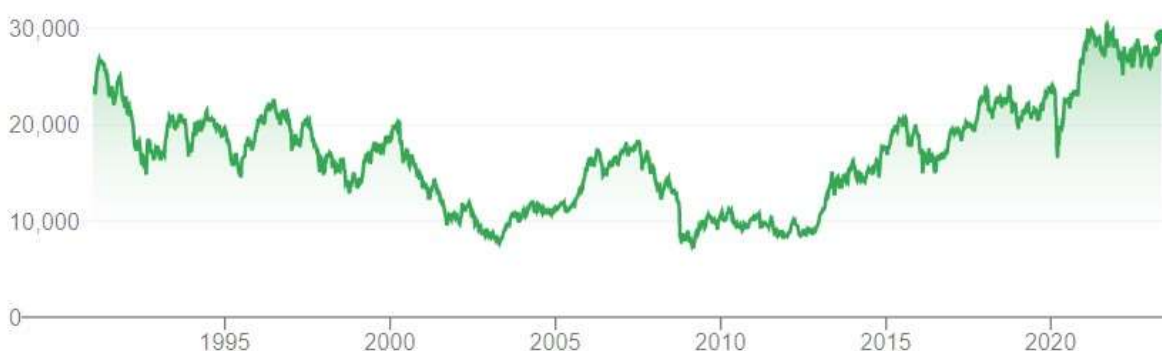
- Japanese equities entered the doldrums post-1989
- Recovery has been slow but, since the financial crisis, sustained
- Currency appreciation could provide additional support

### Japan's lost decades

There was a time in the 1980s when Japanese equities accounted for around half of global indices, such as the boom in the far corner of east Asia. But reaching a peak in 1989, boom turned to bust and the country entered what came to be termed the 'lost decade', albeit that the stagnation of both markets and GDP in fact lasted well into the 21<sup>st</sup> century. Periodic rallies failed to sustain momentum, companies' competitiveness suffered from protectionist holding structures and government debt ballooned.

The graph below shows the performance of the Nikkei 225, Japan's main equity index, from the inflection point at the end of the 1980s through just over three decades to the present.

*Fig.1. Nikkei 225 performance*



Source: Nikkei

### A Japanese pathway out

Conventional wisdom suggested that the way out of this morass was to overhaul outdated social, political and economic structures and 'westernise' in the process. But in fact to a great extent, Japan has ploughed its own furrow, restricting immigration, minimising crime and operating a

near-perfect, privately-run public transport system. Importantly, for a long time it also maintained a culture of zero inflation.

Fig.2. The transformation of Japan's economy under prime minister Shinzo Abe



Source: Bloomberg

### The effect of Abenomics

The arrival of Shinzo Abe as prime minister in 2012 heralded the start of what came to be described as 'Abenomics': a three-pronged approach to try and stimulate sustained growth. There was no pivot to the West as such, but monetary policy became expansionary, fiscally there was more flexibility and he initiated a series of structural reforms aimed at boosting productivity. The chart above illustrates the traction achieved by the economy during Abe's time in office.

The Nikkei has risen by 275% in the past 12 years and continues to look like an attractive investment today. It trades on approximately 12 times earnings – more expensive than the UK (with its structural and political problems) but considerably cheaper than the US. The yen is cheap, so currency appreciation is likely to add to returns. Inflation – for so long non-existent – now stands at about 3.2%, down from a high of over 4% at the start of the year. Inflation has largely been fed by higher energy costs but the planned reopening of Japan's nuclear reactors (closed since the Fukushima incident in 2011) should serve to ease this.

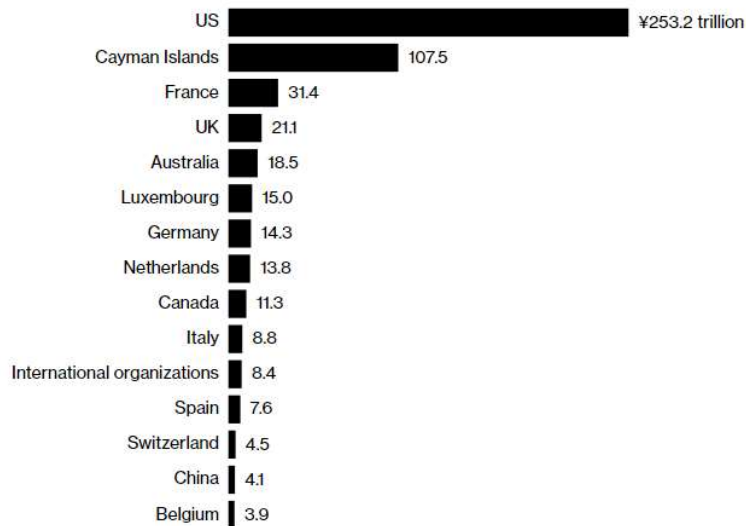
### The currency dimension

An additional key factor this time is the currency dimension. In December 2022, the Bank of Japan surprised markets by widening the bands around its "Yield Curve Control" policy – the mechanism whereby the central bank intervenes to impose caps on government bond yields<sup>1</sup>,

<sup>1</sup> <https://www.bloomberg.com/news/articles/2022-12-20/yen-jumps-dollar-sinks-after-boj-surprises-with-policy-tweak>

which impacts the relative attractiveness of the Yen. Historically, low domestic interest rates have prompted Japanese investors to seek out higher-yielding assets overseas, weakening the yen. Higher domestic bond yields could potentially attract capital back to the Yen, thereby driving currency appreciation.

Fig.3. Japan portfolio investments in 2021



Sources: Bloomberg, BOJ

Appreciation in the Yen has potential room to run, with some analysts estimating that it is 30% undervalued relative to its fair value, estimated at JPY100 per USD whilst Fed policy is tight, and potentially JPY85 per USD if the Fed were to pivot into loosening mode<sup>2</sup>.

<sup>2</sup> <https://www.bloomberg.com/news/articles/2023-03-06/yen-has-scope-to-jump-around-60-if-boj-normalizes-and-fed-eases>

## The Yen Is Still Well Below Historical Levels

The bounceback in the Japanese currency could have further to run



The tailwind for the Yen created by a widening – or potential abandonment – of the yield curve control bands means that the Yen has acted as a safe haven during bouts of market volatility this year<sup>3</sup>.

## Yen Shows Bouts of Strength in Market Turmoil



<sup>3</sup> <https://www.bloomberg.com/news/articles/2023-04-27/yen-to-regain-status-as-world-s-preeminent-haven-barclays-says>

## Summary

Culturally, change tends to happen slowly in Japan but in its own way this is a boon for business as it simplifies planning for the future. Property prices are generally low, rent is affordable and as visitor numbers have risen, so the country has become more international, enabled by technology. At a time when global markets are characterized by volatility and undermined by a lack of growth, Japanese equities look to have a lot to offer. The potential Yen appreciation relating to the widening or ending of yield curve control could provide additional positive support for Japanese equities over and above their fundamentals.

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