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Three misconceptions about Japanese equities

Long-term investors in Japanese equities have seen their hopes dashed many times. Like the famed cherry blossoms in spring, a stock market rally might flourish once in a while, only to wither and fade. In 2023, investors once again flocked to a booming stock market, certain that this time would be different. We don't disagree, but we believe that investors have three misconceptions about the drivers of the current stock market rally – and that only once reality matches perception will the Japanese stock market fully benefit from the profound changes underway. These misconceptions concern corporate governance reform, central bank policy, and public perception of inflation.

The letter and the spirit of corporate governance reform

The first misconception concerns the expectations and reality of corporate governance reform. In recognition of the deleterious effects poor governance and financial disclosure standards were having on Japanese stock prices (encapsulated in particularly by low Price-to-Book Ratios), in March 2023 the Tokyo Stock Exchange (TSE) embarked on a range of initiatives aimed at improving these. The "Price-to-Book (PBR) guideline" singled out capital mismanagement as a core issue for the low valuation of many Japanese companies.

And as such, it sought to specifically address corporate Japan's Achilles' heel of low profitability, partly brought about by very high levels of cash on corporate balance sheets in the deflationary and low interest rate environment. A further concern was the recognition, and disclosure, of relevant figures related to cost of capital and return on equity (ROE), given a history of unprofitable capex expenditures by corporations.

Koji Nakatsuka, CFA
CIO Equity Japan

Performance of TOPIX Index since 2000 and Reform packages

Source: Bloomberg, as of 16 April 2024.

TSE Reforms

- Biggest structural overhaul to Japan equity market structure since founding in 1847. Equity market consolidated into 'Prime', 'Standard', 'Growth'
- To qualify for 'Prime' need to meet new listing rules on liquidity, business performance, corporate governance
- March 2023 'Price-to-book guideline'. Encouraging companies to generate returns above cost of capital
- TSE publicly discloses companies that have responded and those that have not
- Addresses low ROEs and high net cash on corporate balance sheets in deflationary environment

The interim results of this initiative were certainly positive: by February 2024, 59% of Prime Market listed corporates (and 22% of Standard Market listed companies) were disclosing the required information. In addition, share buybacks and dividends reached historical high levels as Japanese companies started to more actively deploy their under-leveraged balance sheets. These positive developments have, however, obscured some important details: instead of recognizing the cost of capital, some companies have instead focused on the allocation of annual flow-based profits.

A case in point is a well-known clothing company with approximately 2000 stores: in response to the new rules, it increased its dividend payout ratio, but left its overall inefficient capital structure mostly untouched. In contrast, a more positive example is a trading company that reacted to the new rules by increasing the level of transparency (thus facilitating an analysis of the drivers of its ROE), as well as developing a more comprehensive strategy for disciplined balance sheet management. Active investors will look for the second type of company: those that apply the spirit of the new regulations, and not just the letter, and develop a clear strategy to optimize their balance sheets.

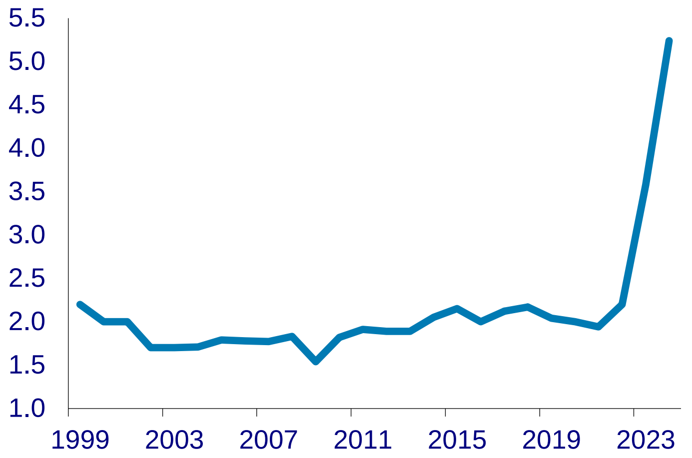
While we therefore caution against taking effusive corporate statements at face value, we do believe that a change in management approach is taking hold in Japan, which can – with continuous pressure from the TSE, as well as dialogue and engagement from investors – ultimately lead to a substantial and long-term improvement in the profitability of Japanese corporates.

The elusive dynamics of Japanese inflation

The other two misconceptions concern inflation. First, foreign investors tend to associate a falling inflation rate with central bank interest rate cuts, which can ultimately lead to a rise in stock prices. In Japan, however, the policy espoused by the government and the Bank of Japan (BoJ) aims at increasing and entrenching inflation, and to lift the country out of its deflationary spell and zero-interest-rate environment. This policy fuels the bullish sentiment of market analysts.

While investors may consider such views contradictory, a look behind the headline figures provides a clearer picture: inflation indeed rose over the course of 2023, yet its increase was mainly due to food and durable goods. From the BoJ's perspective, the specter of a return to a deflationary scenario has therefore not yet been fully checked, and it will look for a sustained increase in demand-pull inflation, such as inflation in the services sector, as a sign that the deflationary page has been turned.

Yearly wage increase rate (%) in Shunto (Spring wage negotiations)



Source: Ministry of Health, Labour and Welfare, Rengo, AllianzGI, as of 4 April 2024.

Japan CPI ex fresh food (YoY, %)

Source: Bloomberg, AllianzGI, as of 31 March 2024.

Until then, while interest rates may be kept in positive territory, we expect that the BoJ will maintain a negative real rate policy to foster an increase in wages and trigger such demand-pull inflation. A better communication strategy by the BoJ could help clear the misconception investors have about its policy.

Finally, the third misconception concerns the mindset of the *Watanabes*, the stereotypical Japanese household. Investors may be excused thinking that the recent surge in inflation would lead to a change in household expectations. However, this is not yet the case. After decades of falling prices, households are seemingly still in thrall of a deflationary mindset: a recent Grassroots survey indicates that 52% of respondents don't expect a wage hike this year, and 65% plan to keep their savings in cash or bank deposits.

Change could be in the air, however. The latest 'Shunto' spring wage negotiations indicate wage hikes not seen since the early 1990s (above 3% in 2023, and 5% in 2024); furthermore, a survey conducted by Rengo (an umbrella trade union group) shows that wage hikes are no longer reserved for large corporations, but are trickling down to small and mid-size companies. Nevertheless, in 2023, the pace of price increases was higher still, resulting in negative real wage growth. Given the long history of deflation, it is therefore unlikely that mindsets or asset allocations will change quickly, even if wage growth exceeds 5% this year and real wage growth turns positive.

We anticipate that wage increases will continue into next year and beyond, albeit at a possibly slower rate than this year, and we expect a transition to demand-pull inflation. The long-term deflationary environment has kept wages stagnant, and with the yen's depreciation, the wage gap between Japanese companies and those in other developed economies, when viewed in dollar terms, has widened. Japan's prolonged labour shortage (exacerbated by its demographic situation) also suggests that retaining talented employees will be challenging without ongoing wage increases. Companies may find it more rational to raise the salary levels of existing employees rather than engage in fierce recruitment competition for new hires.

Turning perception to reality

After 30 years of disappointment, investors in Japanese equities can be forgiven for the euphoria with which they have welcomed corporate governance reforms and a surge in inflation. While we believe that reality does not yet match the euphoric perception of investors, and that three misconceptions may still cloud some views, there are signs that change is afoot. Addressing these misconceptions, by fostering dialogue between institutional investors and companies, and by increasing accuracy and transparency around inflation and central bank policy, would fundamentally transform Japan, and re-establish its stock markets as worthwhile investment destinations.

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