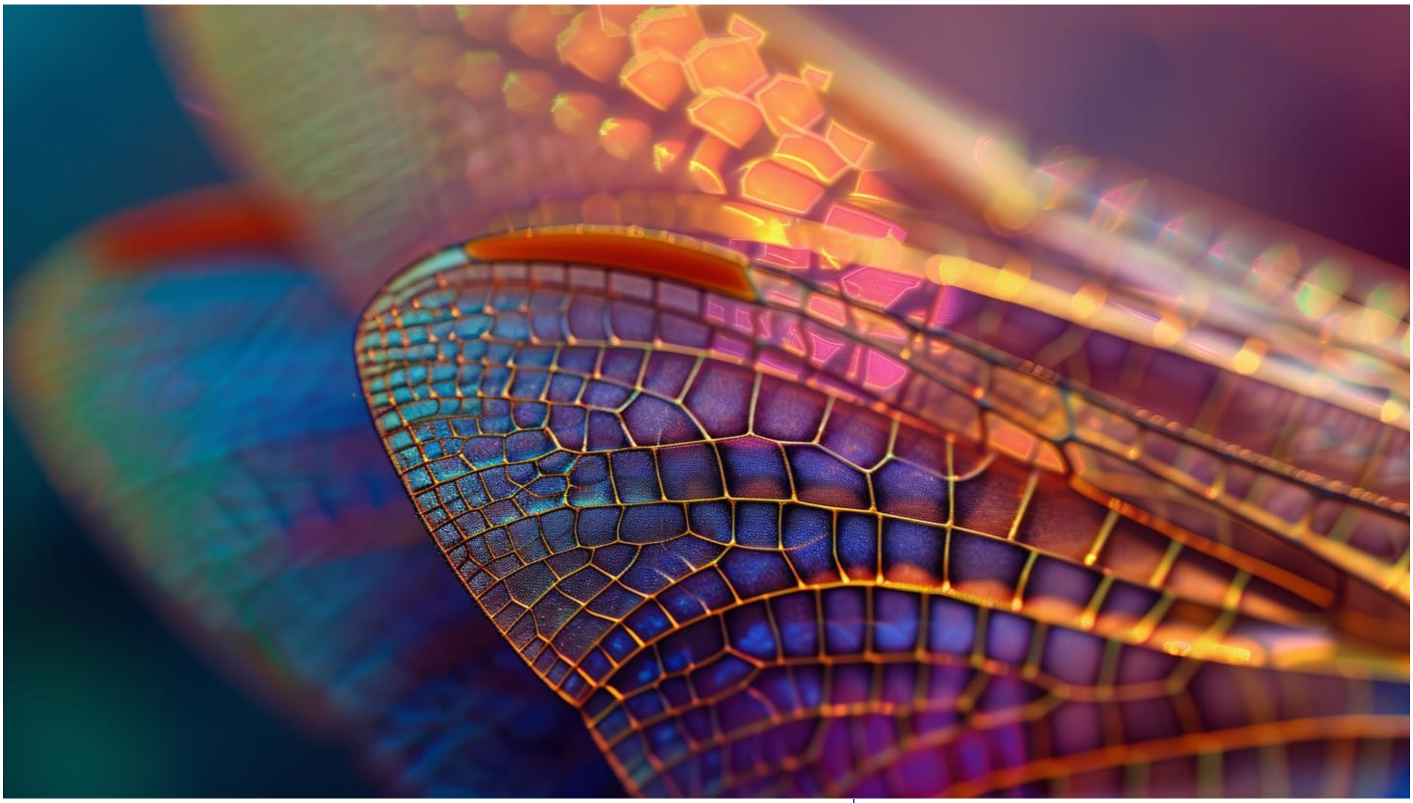

Global Investment Research | Equities

What has led to Japan's come-back?

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Key takeaways:

Japanese equities have staged a strong come-back since 2023, leading many to query the reasons for the rally and wonder whether it can last. In this paper we highlight some of the key recent changes to the Japanese economy and financial markets, which may provide the answers.

1) By end-April 2024, Japanese equities had outperformed the FTSE All-World index over 12 months and in the year to date. They had also only slightly lagged the top-performing US equity market so far in 2024. Japan's economy has recovered moderately, with the Bank of Japan's (BoJ's) goal of sustainable inflation finally in sight. The Abenomics "three arrows fly" economic policies (covering monetary policy, fiscal policy, corporate governance and structural reforms), rolled out in late 2012, seem finally to be paying off.

2) Japan has undertaken significant structural corporate reforms in recent years. These include enhanced listing criteria by the Tokyo Stock Exchange (asking listed companies to increase their price-to-book (P/B) ratios, to boost capital efficiency and profitability). The call for improved capital efficiency has led to a focus on boosting shareholder returns, and record share buybacks in 2023. Returns on equity (ROE) and P/B ratios have increased following these reforms.

3) Active share buybacks by listed Japanese firms have attracted foreign investors back to the Japanese equity market. Foreigners' net buying of Japanese equities has surged, spurred by Warren Buffett's increasing stakes in Japanese companies.

4) Retail investors in Japan are too big to ignore. They are likely to buy more Japanese equities through the new tax-saving NISA (Nippon Individual Savings Account) program.

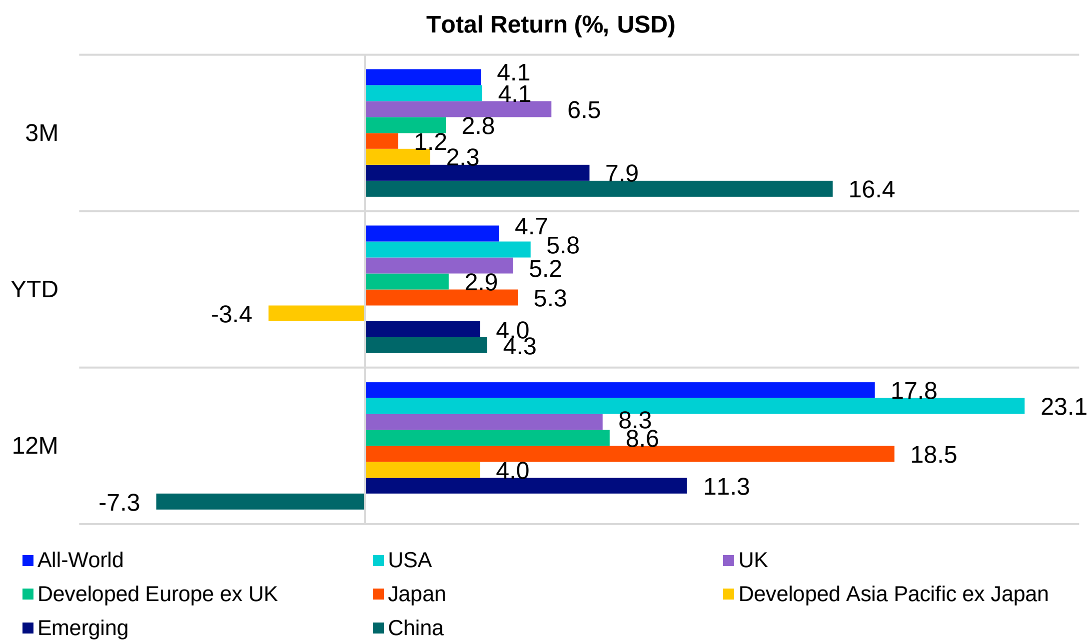
5) Japan's price/earnings (PE) ratio is slightly higher than its decade average, meaning that equity valuations could provide further tailwinds for the rally. The BoJ is expected to retain its accommodative stance, while Japanese Government Bond (JGB) yields have been more stable than G7 yields and have avoided a yield curve inversion, leading to a supportive rate environment.

Contents

Japanese equities have rallied strongly in the last 12 months, outperforming global equities and only lagging the US

Japanese equities have outperformed most of their global peers since April 2023 (see Chart 1). Their 12-month returns of 18.5% (in US dollar terms) only lagged the US equity market's returns of 23.1%. This was despite a weaker yen reducing returns for dollar investors by 13.5% over the period. 2024 year-to-date returns show a similar trend, with the Japanese equity market closely tracking the top-performing US market.

Chart 1: Equity total returns Japan vs major peers



Source: FTSE Russell. April 30th, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Multiple factors are likely to have driven the rally, including Japan's resilient economic growth after the post-Covid reopening, the return of inflation after decades of fighting chronic deflation, and more recently the significantly increased "Shunto" wage growth since 2023. Importantly, structural reforms to Japan's corporate governance (as a part of Shinzo Abe's "three-arrow" policies) and the resulting improvement in corporate earnings have increased investors' confidence in Japanese firms, driving foreign investors to increase their holdings in Japanese equities. Below, we look at these factors in more detail.

Macroeconomic backdrop in Japan – resilient growth and inflation since 2022…reversing the stagnation from the Lost Decades?

Following the economic stagnation since the early 1990s (known as the "Lost Decades") and the disruptions of the great financial crisis (GFC) and Covid, the Japanese economy has showed resilience after its reopening. Real gross domestic product (GDP) grew by 1.9% y/y in 2023, helped by auto exports, corporate profits and rebounding tourism. Despite a retreat in Q3 GDP (it fell at a -3.2% annualised rate quarter-on-quarter), Japan managed to dodge a technical recession with Q4's real annualised growth of 0.4%, helped by a capital expenditure rise of 16.4% from a year earlier. While some data show Japan on the brink of losing its position as the world's third largest economy to Germany in 2024, it's important to note that a weak yen may have distorted the output figures, which are denominated in US dollars.

Japanese inflation started to decline in early 1990s after the bursting of the asset bubble and falling prices had been a major challenge in Japan until recently. However, inflation climbed to 2.1% year-on-year in April 2022. By March 2024, inflation had stayed above the BoJ's 2% target for two years.

Meanwhile, a fiscal year 2024 wage increase of 5.28% year-on-year among large companies, as agreed in the 2024 Shunto collective wage round, follows a wage hike of 4% in fiscal 2023. This is expected to help achieve the virtuous cycle between wages and prices in Japan, and therefore to help its economy grow with healthy income and spending.

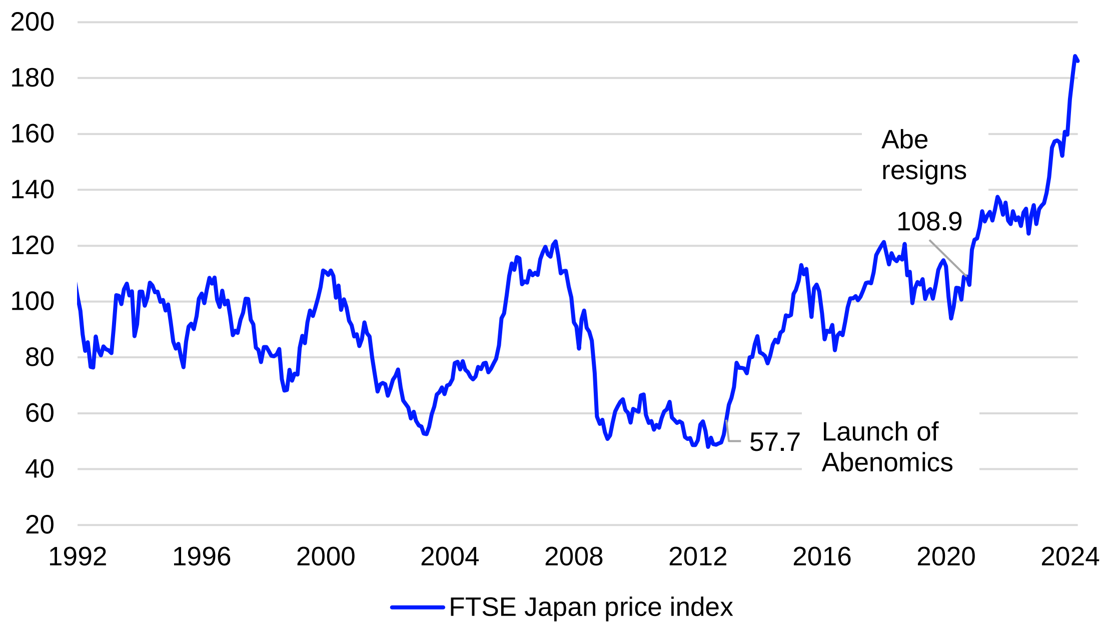
Abenomics effects are promoting sustainable growth

To pull Japan out of two decades of economic stagnation, raise the country's real potential growth rate and address concerns about deflation, Shinzo Abe rolled out three arrows of "Abenomics" in December 2012, at the beginning of his second term as Prime Minister:

1) Monetary easing, with increased money supply, government bond purchases and negative interest rates, together with yield curve control
2) Fiscal stimulus, such as expanded government spending on critical infrastructure
3) Corporate governance enhancement measures, such as structural supply side reforms, corporate tax cuts, getting more women into the workforce and maintaining the yen's value at a relatively weak level (to promote exports).

Abenomics helped boost economic confidence in Japan. Chart 2 shows that the FTSE Japan price index of 108.9 in August 2020 (when he resigned) was nearly twice the level of 57.7 in December 2012 (when he launched the Abenomics policies).

Chart 2: FTSE Japan price index doubled during 2013-2020, in response to Abenomics policies



Source: FTSE Russell. Monthly data from April 30, 1992 to April 30, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

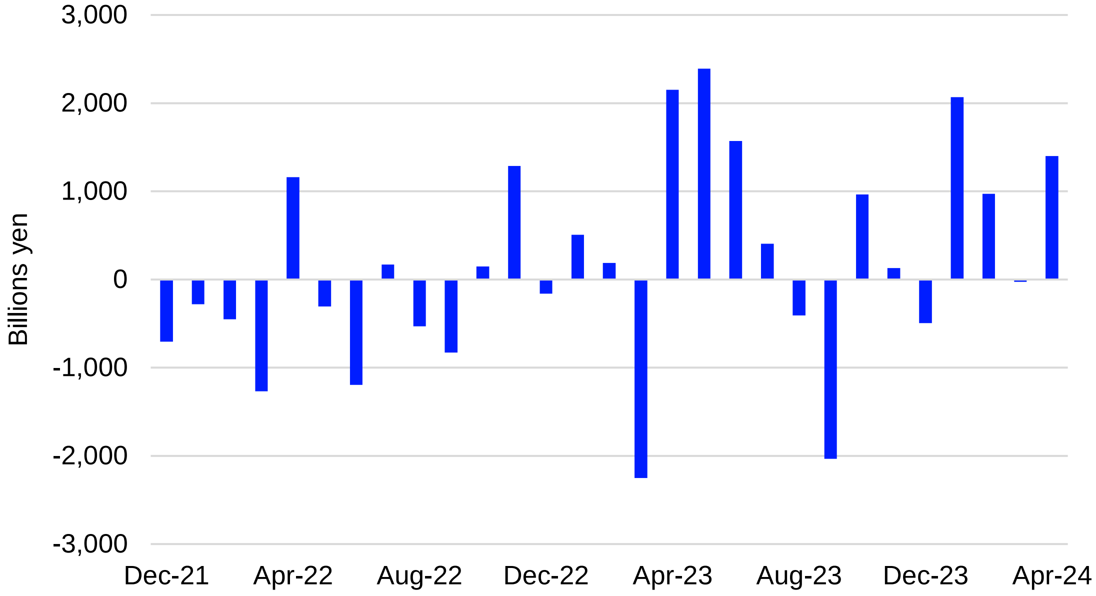
With monetary and fiscal policy support maybe starting to finally pay off, recent structural reforms to corporate governance might be one of the most important factors in fueling further optimism about Japan.

This is evidenced by the stock rally following the Tokyo Stock Exchange's 2023 announcement requiring an improvement in the price-to-book (P/B) ratio of listed companies (particularly for those with a P/B ratio below 1) and increased capital efficiency. As a result of the exchange's mandate, Japanese listed companies have conducted share buybacks totalling about 9.6 trillion yen ($65 billion) in 2023, increasing both returns to shareholders and P/B ratios. Peer pressure has also helped to keep the share buyback momentum continuing.

An upward spiral effect can be seen in the Japanese equity market's rally, reflecting both stock price appreciation and foreign investors' participation. Optimism in Japan's corporate governance reforms is attracting increased foreign investor inflows into the Japanese equity market, as Chart 3 shows.

Net foreign purchases of Japanese equities reached a record high in May 2023, at almost 2.4 trillion yen, following Warren Buffett's disclosure of increased stakes in several Japanese companies. These inflows have had a significant effect on the Japanese equity market as well (according to the Japan Exchange Group, foreign investors own about 30% of Japan's stocks and are the largest group of investors in the market). From the perspective of foreign exchange risk, the recent weakening of the yen against the US dollar (due to widened interest rate differentials) didn't prevent the foreign buying of yen assets, since the widespread use of currency hedging through forwards and options would have helped compensate for any losses in the yen's value.

Chart 3: Monthly net purchase of Japanese stocks by foreign investors since 2022



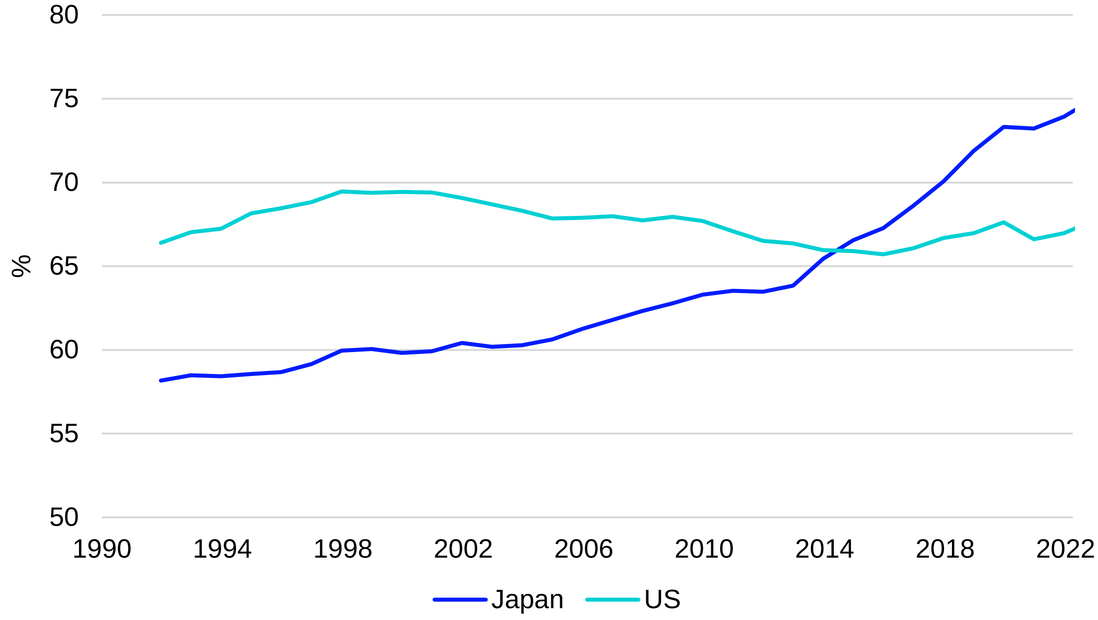
Source LSEG. Tokyo Stock Exchange. Monthly data from December 31, 2021 to April 30, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Japan faces problems with ageing population and labour supply shortage…labour market reforms could mitigate these risks

One important concern about Japan's economic growth lies in its ageing population, alongside the low fertility rate. By the end of 2022, Japan's share of population aged 65 and above had reached 30%, higher than global peers, and the country's pace of ageing is also faster.

Both the ageing population and the low fertility rate have created a serious labour crisis in Japan, while demographic trends suggest this may continue and even worsen. A mitigating factor could be the recent rise in Japan's female labour force participation rate, which increased to 75% in 2022, from only 58% in 1991, as Chart 4 shows. There are now also more females in the workforce in Japan than in the US (where the latest participation rate is 68%). The rise in female employment reflects Abenomics' focus on getting more women into the workforce, with the rate at only 64% in 2012. Rapidly growing immigration and the Japanese government's initiatives to train less-skilled foreign workers (both part of broader labour market reforms) have also served to alleviate labour market shortages.

Chart 4: Labour force participation rate, female (% of females ages 15-64)



Source: LSEG. Annual data from December 31, 1991 to December 31, 2022. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

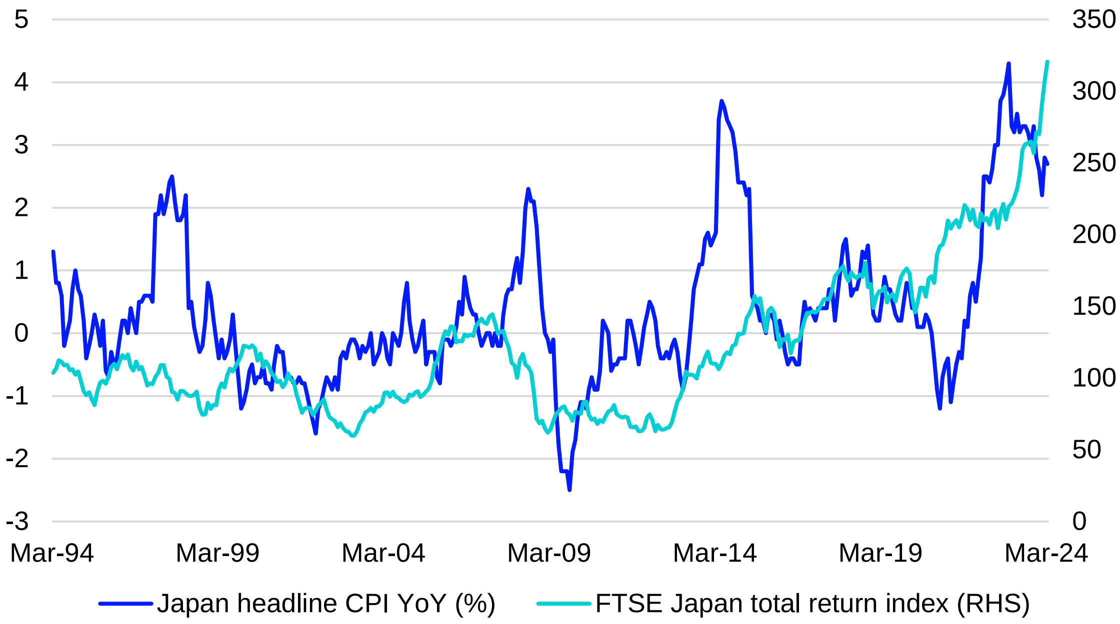
In addition to recent efforts to increase the labour supply, increasing productivity may also drive future growth in economic output. This is likely to reflect the adoption of artificial intelligence (AI) and productivity increases by female workers, in particular. According to recent IMF research[1], the latter could be achieved by more women pursuing careers in STEM (science, technology, engineering and maths) fields, as many fewer Japanese female university students currently major in STEM subjects than male students. And fewer Japanese women pursue STEM careers than women in comparable countries.

Retailed investor participation could further support the rally in Japanese equities

Data for the last three decades show a positive correlation of 0.52 between Japanese equity total returns and inflation, (see Chart 5). If the BoJ's price stability target of 2% continues to be met in 2024, which is likely the case, the Japanese equity market may continue to draw support. Further traction from retail investors is possible if they believe inflation is now here to stay, since households may then seek to protect their purchasing power by investing in the equity market. A revamped Nippon Individual Savings Account (NISA) programme, made effective in January 2024 by Prime Minister Kishida as a pillar of "new capitalism", aims to incentivise Japanese households to invest their cash into riskier assets such as equities.

[1] https://www.imf.org/en/News/Articles/2023/11/13/cf-japans-economy-would-gain-with-more-women-in-science-and-technology

Chart 5: Japanese inflation vs equity market performance since 1994

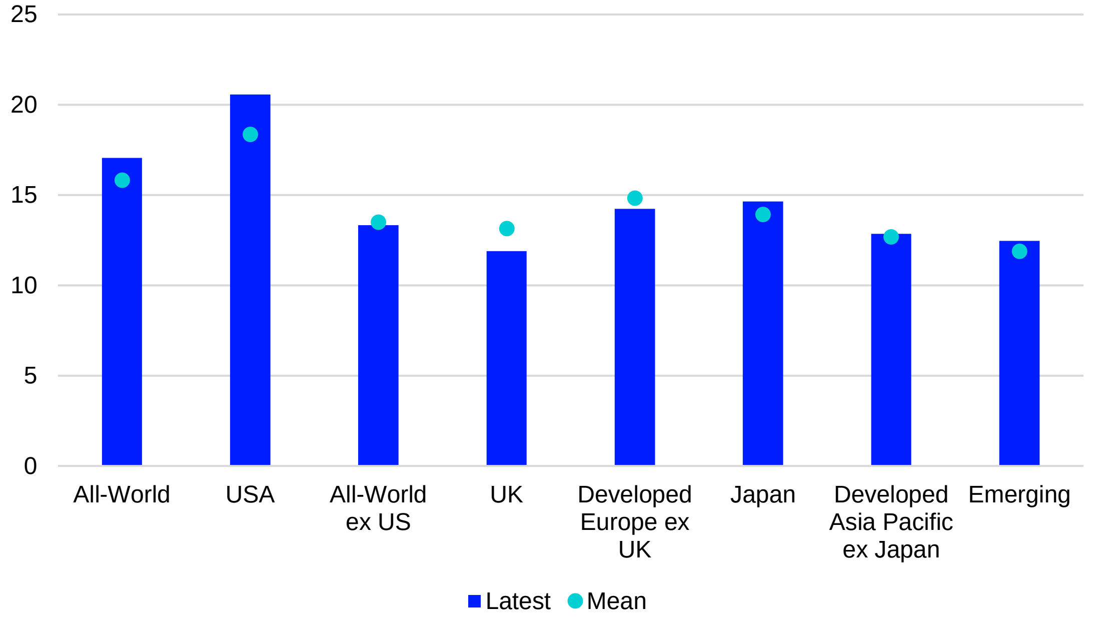


Source: FTSE Russell. Monthly data from March 31, 1994 to March 31, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

The euphoria in Japanese stock market following the launch of Abenomics in late 2012 was short-lived and stalled after 2013, as Chart 5 shows. The 2023 and early-2024 rally may have more staying potential if this round of corporate governance reforms leads to consistent improvement in corporate fundamentals and therefore boosts investors' confidence in the longer-term prospects for equities.

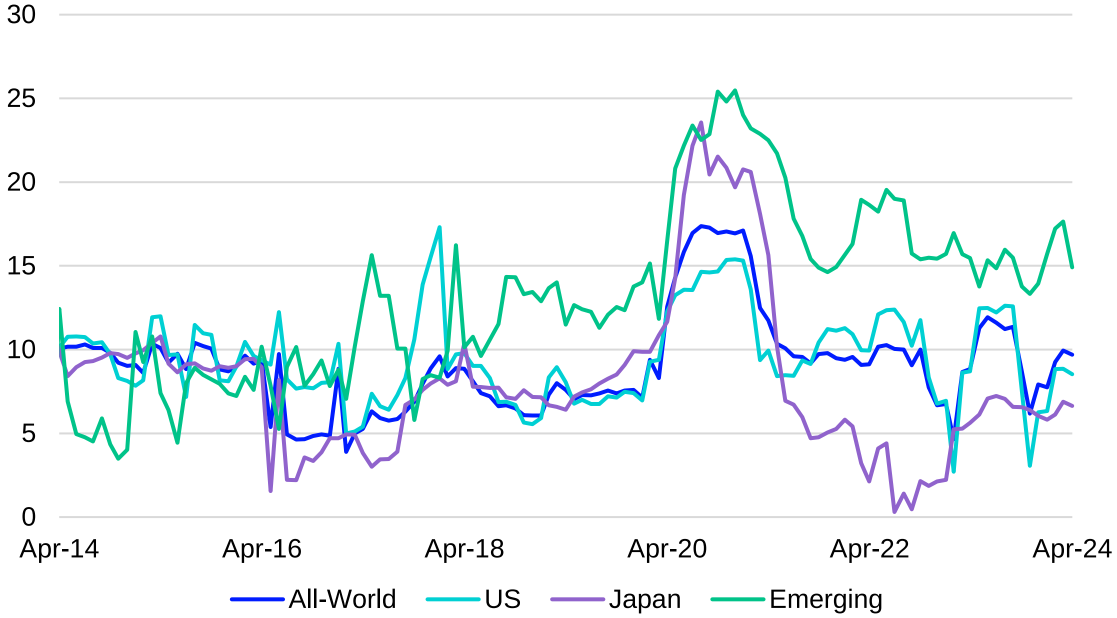
Even after the recent rally, Japan's latest forward P/E ratio (15x) is only slightly above its 10-year average (14x), as shown in Chart 6, and is not much higher than the 13x ratio of one year ago. Also, Japan's forward P/E ratio remains comparable to global peers, and remarkably lower than that of the US equity market (21x). A stable-to-increasing trend in Japan's forward earnings (see Chart 7), helped by Japanese firms' profitability enhancement, is another likely booster for the Japanese equity market.

Chart 6: Regional equity index forward PE ratios – latest vs 10-year average



Source: FTSE Russell. April 30th, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chart 7: Earnings growth 2-year forecasts for Japan vs other countries



Source: FTSE Russell. Monthly data from April 30, 2014 to April 30, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

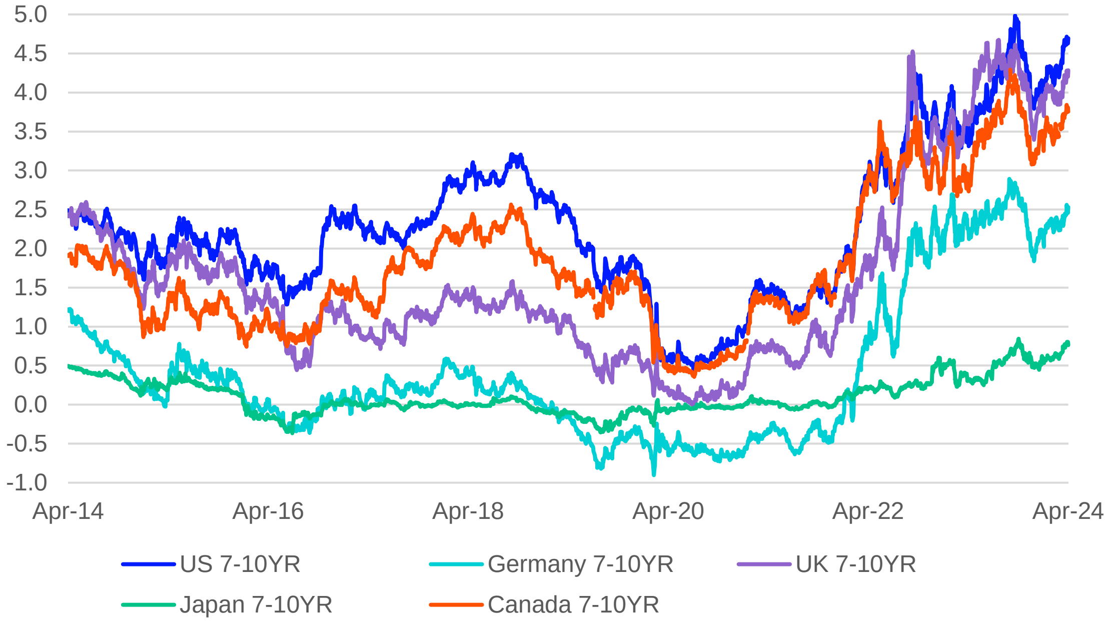
Accommodative monetary policies are being maintained, despite the ending of negative interest rates and yield curve control…this could continue to provide tailwinds to Japanese equities

Japanese government bond yields remained stable throughout the Covid shock and are still relatively low, despite the rapid interest rate hikes in other G7 countries since 2022. This reflects the BoJ's steady and ultra-loose monetary policy, known as the Quantitative and Qualitative Monetary Easing (QQE) with yield curve control (YCC). As Chart 8 shows, Japanese 7-10-year government bond yields have been far less volatile than bond yields in other G7 markets since the policy of YCC was introduced in September 2016.

The Japanese bond market has also avoided the yield curve inversion observed in other G7 markets due to rapid monetary tightening and rising concerns over a future recession. Although the BoJ has raised its policy interest rate target from negative territory (-0.1%) to a current range of zero to 1% and the central bank exited its yield curve control (YCC) policy at its March 2024 meeting, the BoJ promises to maintain an accommodative monetary policy to support the economy and to promote rising prices, which could in turn continue to support equities.

From the exchange rate point of view, the prospect of further interest rate hikes from the BoJ bodes well for the yen, as narrower interest rate differentials could lead to the yen's appreciation against US dollar, making yen assets (equities and bonds) more attractive to investors. In the longer term, the yen could also be supported by expectations of rate cuts by the US Fed and other G7 central banks, alongside its safe-haven demand (given rising geopolitical tensions).

Chart 8: Japanese 7-10yr government bond yields vs other G7 markets



Source: FTSE Russell. Monthly data from April 30, 2014 to April 30, 2024. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Conclusion

In summary, Japan's resilient growth, its 2% -plus inflation target, its Abenomics policies and its structural corporate reforms have all driven the country's recent equity market rally. The increased net purchases of Japanese stocks by foreign investors have underpinned the rally as well, given that foreigners are the largest group of investors in the Japanese equity market. Labour market reforms and an improved female labour force participation rate have helped mitigate labour supply shortages. Looking forward, the outlook of sustainable inflation, an accommodative monetary policy, moderate valuations, promising earnings growth, higher investments by retail investors and the expectation of a stronger yen are all likely to provide tailwinds for Japanese equities.

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