Liquid Insight

Japan's outward FDI behind yen's sticky weakness

22 May 2023

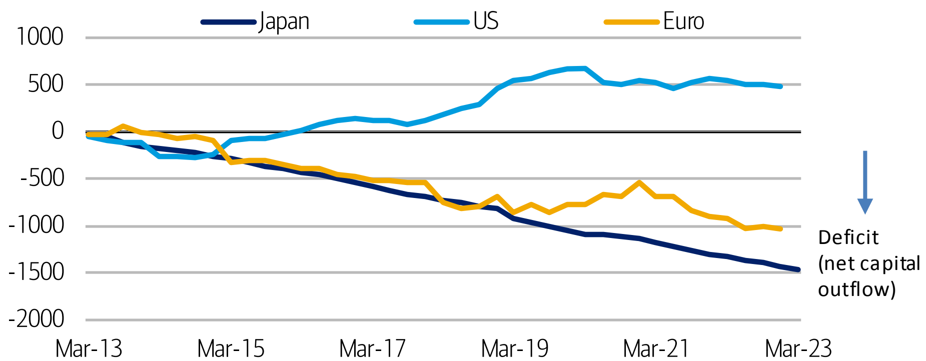
Rates and Currencies Research
Global

Key takeaways

- Japan's FDI deficit weighs over JPY as it prevents Japan's basic BoP from recovering to surplus despite cheap JPY.
- Demographic constraints, cheap funding cost, JPX reform promoting outward FDI
- Japan trade for 23 = buy Japan stocks, sell JPY (yen carry trade). Potential Japan trade for 24 = buy Japan (JPY + stock)

By Shusuke Yamada and Tony Lin

Chart of the day: Cumulative FDI account flow for Japan, US, and Euro Area ($bn, + = net inflow to the region, - = net outflow from the region)
Japan's FDI deficit has been persistent across economic cycles



Source: BofA Global Research, Haver, Bloomberg
Latest = 1Q23 for Japan, 4Q22 for US and Euro Area

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Outward FDI weighs on JY

We remain bearish on JPY in 2023 despite its cheapness for two reasons – a persistent FDI (foreign direct investment) deficit and a potential rise of yen-carry trade (see: Patient BoJ = greenlight for yen-carry trade 01 May 2023). We discuss the former in this report. In particular, we explore the following: (1) why Japan's outward FDI remains strong; (2) what could change this trend in the future; (3) implications for JPY.

In our view, the Japan trade for 2023 is to buy Japan equities, funded by JPY ("yen carry trade"). Long Japan equities and JPY ("Buy Japan") is premature in our view but could be a potential 2024 trade conditional on confirmation of a virtuous inflation cycle in Japan and the government's policy to promote domestic capex and inward FDI. We expect USD/JPY to rise to 143 by 3Q23.

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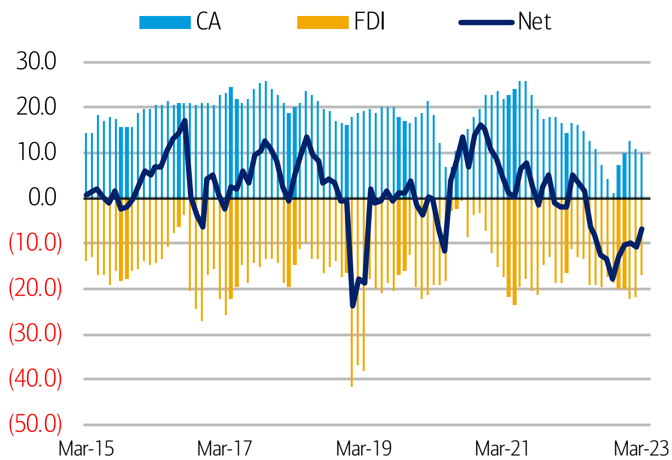
FDI deficit to keep Japan's basic BoP in a deficit

One positive catalyst for JPY in 2023 is a recovery in Japan's current account surplus due to the lower oil price and a return of inbound tourists. However, we do not think this is enough to correct the yen's undervaluation as Japan's FDI deficit remains wide (Exhibit 1) and the BoJ (Bank of Japan) does not seem willing to raise interest rate in the near term. In 1Q23, Japan's current account recovered to a ¥2.5tn surplus (¥10.2tn annualized) while its FDI account generated a 4.2tn deficit (¥16.7tn annualized).

While the current account is expected to recover further in 2Q23, it is unlikely to be enough to bring the net balance to a notable surplus (see: Japan BoP: FX carry vs US recession risk 11 May 2023). Japan's FDI deficit is likely to persist in coming months, judging from active outward M&A announcement by Japanese firms (Exhibit 2), which tends to lead the FDI account by 3-4 months as cross border deals would be recorded in the BoP statistics when completed – we think FX transactions are often executed closer to completion of deals. This goes against the global trend of slowing cross border M&A deals and also the cheaper level of the yen compared to recent years (Exhibit 2).

Exhibit 1: Japan's basic balance of payments (annualized rolling 3m, ¥tn)

FDI deficit offset current account surplus



Source: BofA Global Research, Haver

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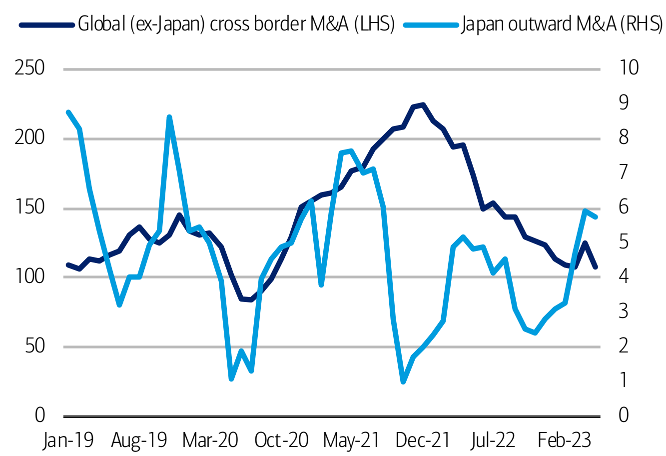
Exhibit 2: Global cross border M&A volume and Japan's outward M&A volume* (6mma, $bn, announcement-base)

Japan's outward M&A has been recovering while global M&A has slowed down



Source: BofA Global Research, Bloomberg

*Excludes Softbank-related deals

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What is behind Japan's FDI deficit?

In fact, Japan's FDI deficit in recent years stands out among major economies (Chart of the day). The US's FDI account has been balanced during the pandemic after having generated a surplus in the second half of 2010s as its resilient economic growth and technological advantage may have attracted inward FDI. The Euro Area used to run the same level of an FDI deficit as Japan in the USD term (less in the % of GDP term), but since 2019, the account has fluctuated and the deficit trend appears to have eased.

We find three structural factors encouraging Japanese firms' outward FDI:

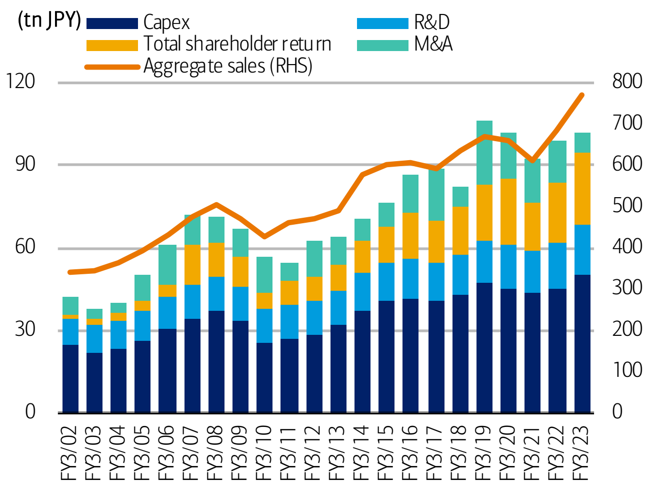
- **A structural divergence in growth**: Japan's demographic constraints keep expectations for its economic growth rate lower than for the rest of the world and encourage Japanese companies to expand abroad.
- **Low funding cost**: The BoJ's distinctively accommodative policy stance allows companies to lever up and expand balance sheet.

- **Pressure to use cash to increase ROE (return on equity) and PBR (price to book ratio)**: Companies are pressured to utilize unused cash to improve ROE and PBR in response to corporate governance reform and more recently, the JPX reform (see: Appendix: JPX's market).

Exhibit 3 shows Japanese companies' cash usage. One interesting observation is that the overall spending increase was more modest than the strong aggregate sales growth in FY22, which likely reflects corporates' conservatism but could imply pent-up demand in FY23.

While companies could also spend cash on shareholder return and domestic capex, the BoJ's patient stance means domestic investment would first lower real interest rate until the BoJ's patience matures to confidence, which we think will take time and evidence. While our economists remain bullish on Japan's inflation, they expect the BoJ will keep the YCC framework and NIRP until 2Q24 (see: BoJ review: Continuity and difference 28 April 2023).

Exhibit 3: Major cash spending of Japan Inc.
The overall spending increase was modest vs. the aggregate sales growth in FY22, suggesting pent-up corporate demand in FY23



Source: BofA Global Research, Astra Manager, Bloomberg, BoJ
Note: Fiscal year base. Based on TOPIX constituents for M&A and total shareholder returns, capex and R&D; based on TOPIX companies with fiscal year ending Mar for aggregate sales. Using the forecast growth of all enterprises' Fixed Investment including Land Purchasing Expenses and R&D Investment, respectively, to calculate Mar-23 capex and R&D, based on March 2023 BoJ Tankan. For M&A deals, we aggregate the completed deals that TOPIX members served as acquirers

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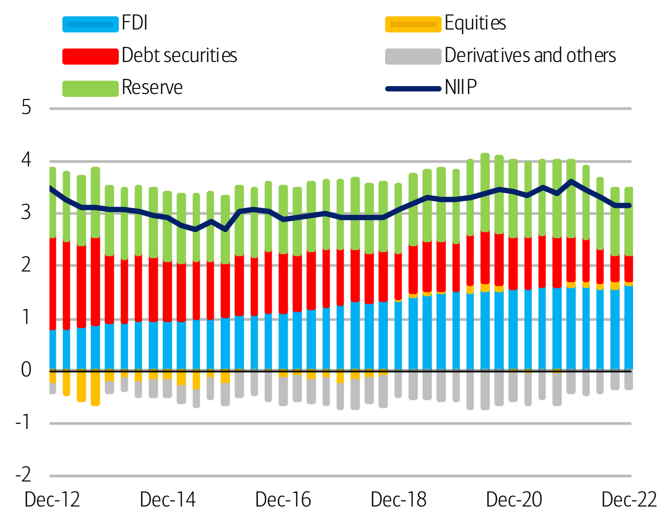
Exhibit 4: Japan net international investment position ($tn)
Japan's NIIP composition has shifted away from foreign bonds into FDI



Source: BofA Global Research, Haver

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What can change the trend of FDI deficit?

Structural changes would be needed to change this trend. First, the outlook for Japan's domestic growth should improve. Second, the government's policy should promote domestic capex and inward FDI.

On the first point, the strong result of the spring wage negotiation this year is encouraging as a strong wage increase could possibly lead to strong domestic consumption (see: High inflation + firm domestic demand = strong nominal growth 17 May 2023). The wage pressure could also encourage domestic capex to increase productivity to compensate for increased labor cost. Sustainable inflation also allows the BoJ to normalize policy, supporting JPY.

On the policy front, Prime Minister Fumio Kishida instructed the Finance Minister in April to come up with policy proposals to increase inward FDI balance to ¥100tn by 2030 (up from the previous target of ¥80tn) from ¥46.6tn as of 2022, and also to promote domestic capex.

While these can attract net FDI inflow to Japan and be positive for JPY, we do not expect the underlying trend of FDI deficit is impacted in the near term. We need to see wage inflation as sustainable and the government's policies to be effective. We will closely monitor the wage trend into the next year's spring wage negotiation, and possible tax reform to promote inward FDI at the annual tax reform plan for FY24 due year-end.

Market implications

- **Sticky JPY weakness in 2023**: The persistent FDI deficit can keep JPY undervalued longer and the JPY weakness sticky while the BoJ's patient stance promotes yen-carry trade.
- **JPY's diminished status as a safe investment option**: Structural outward FDI has also undermined JPY's status as a safe investment option. Net FDI assets have become the biggest component in Japan's net international investment position after years of net FDI outflow and the recent reduction in foreign bond holdings by banks and lifers (Exhibit 4). In 2012, foreign bonds accounted for half of Japan's NIIP and FDI 24%. Today, foreign bonds are just 15% of Japan's NIIP and FDI has risen to half. This change reduces repatriation flow during risk-off as FDI is much more illiquid and long-term oriented than foreign bond investments.
- **Japan trade for 2023 = buy Japan equities and sell JPY (yen-carry trade)**: Japan's delayed cyclical recovery and the BoJ's distinctively patient stance are positive for Japan equities and negative for JPY. Buying Japanese stocks still reasonably valued, funded by JPY, can be an attractive carry trade. If this trade accelerates, negative correlation between JPY and Japan equities may arise as foreign investors need to adjust currency hedge on stock market fluctuations.
- **Potential Japan trade for 2024 = buy Japan equities and JPY (buy Japan)**: If Japan's wage inflation proves sustainable and the government implements effective measures to promote inward FDI and domestic capex, both Japan equities and JPY can rise and "buy Japan" can be the right trade. However, we think this is a potential story for 2024, not 2023.

Appendix: JPX's market reform

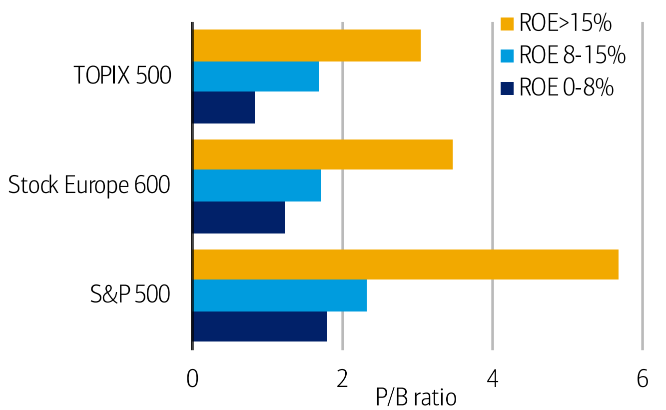
When capitalism meets with populism…

- We believe the scheduled NISA expansion in 2024 may have prompted the JPX to accelerate the market reforms following the segment recategorization in 2022, which may be able to narrow the valuation gap between Japan vs. peers (Exhibit 5, Exhibit 6).

- For the analysis of current situation (Exhibit 7), key focus indicators include 1) cost of capital (WACC, CoE); 2) balance sheet profitability (ROIC, ROE) and 3) market valuation (PBR/PER). Active corporate responses could mean management upgrades, especially in terms of capital efficiency and information disclosure.

- Investors' engagement would be key, as the TSE allows a full explanation of the reasons for non-compliance (the "comply-or-explain" approach). June AGM season is likely to provide more catalysts for in-depth investor-corporate discussions.

Exhibit 5: International comparison of median P/B by ROE level
Valuation upside for TOPIX500 vs. peers, assuming future convergence amid monetary policy divergence



Source: BofA Global Research, Bloomberg

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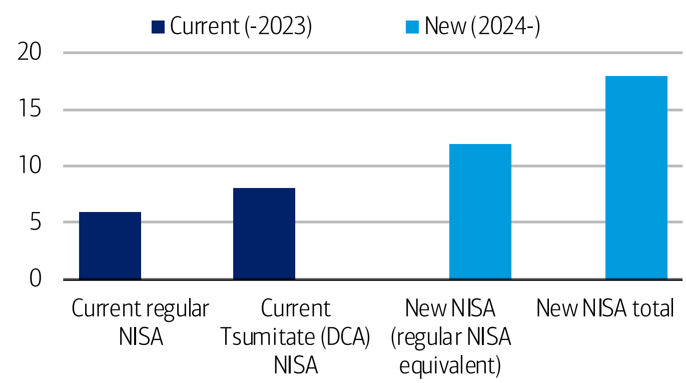
Exhibit 6: Cap on total balance in tax-exempt NISA accounts under current and potential new system (¥mn)
Cap on NISA accounts likely to rise substantially



Source: BofA Global Research
[FX Watch: Japan's push for retail investments – risk or opportunity for JPY? 16 December 2022]

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Exhibit 7: Requirements to promote business management that take into account the cost of capital and share prices
When a stock's P/B is below 1x, the company is to be clearly asked to take adequate remedial steps, except when the low P/B is a result of a deterioration in business conditions or other one-time factors

Current situation	• Accurate grasp of company's cost of capital, such as ROE and ROIC • Analysis and assessment of the details and valuation (stock price, market cap, P/B, and P/E, for example) by Board of Directors	(Examples of analysis and assessment) • Whether ROE and ROIC exceed the cost of capital, and if not, why • If ROE and ROIC exceed the cost of capital, the reasons for the stock's inadequate valuation, including a P/B of less than 1x
Drafting and disclosure of plans	• Review and drawing up of measures, target timeframe, and specific initiatives for improving ROE, ROIC, and valuation • Easy-to-understand disclosures to investors of the details, along with an assessment	• Setting of target indicators based on company's situation • If adequate levels have already been achieved and improvement is deemed unnecessary, disclosure of such • Permissible disclosure using a format newly provided by the TSE or as part of a disclosure of business strategies and business plans, based on Principal 5-2 of Japan's Corporate Governance Code (in either case, such disclosure is to be stated in the corporate governance report)
Execution of initiatives	• Promotion of business management that takes into account the cost of capital and share prices based on plans	Active communication with investors based on the disclosures

Source: BofA Global Research, JPX
Note: Analysis and updated disclosures of progress at least once a year.

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- A different May narrative, **Global FX Weekly**, 19 May 2023
- The Godot recession**, Global Rates Weekly**, 19 May 2023
- Behind the latest USD rally, **Liquid Cross Border Flows**, 15 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: A different May narrative 19 May 2023

Global Rates Weekly: The Godot recession 19 May 2023

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