Japan Equity Strategy

North American trip: Room for further allocation to Japan equities

Investment Strategy

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Japan

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Ample interests from North American investors

On 11-15 March, we visited investors in the US and Canada (many in Canada are pension funds and other large-scale long-only investors). Many Asian investors, who have been shifting funds from China to Japan since last year, are already overweight on Japanese stocks. In contrast, only a small minority of US and Canadian investors are overweight, while the vast majority are either in the process of raising those weightings or are seriously considering doing so. Many of these investors seem to be experiencing FOMO (Fear of Missing Out) with Japanese stocks, with one investor notably expressing jealousy over the performance of Japanese stocks. We also heard several say that they were seriously looking at Japanese stocks for the first time in 10 years (i.e., since Abenomics began). The catalysts for the sharp climb in Japanese stocks since last year were a shift of funds from China combined with inflation and corporate reforms, and there is still upside in the Japanese stock weightings of European and North American investors, who are yet to climb aboard.

Five topics in focus

What is it that North American investors were most interested in? Although discussions were wide-ranging, investors asked the most questions about five topics: (1) BOJ monetary policy; (2) forex impacts on Japanese stocks; (3) why corporate reforms have started progressing so quickly; (4) whether a rotation in preference is coming up; and (5) the Chinese economy's impact on Japanese stocks.

With a BOJ policy meeting scheduled for the following week, nearly every investor wanted to hear an explanation of our outlook for BOJ monetary policy. Although not many had an accurate understanding of the big picture, more than a few grasped the seriousness of the risks. We explained that the BOJ is likely to raise rates gradually, and that the market is pricing in a rate hike up to 0.5% over the next two years (we expect the policy rate to be raised to 0.5% over the next year), and assuming a core CPI at 2%, the real policy rate would remain at -1.5% for the next two years. Some of the investors pointed out that if Japan has entered its first inflationary period in 30 years, the policy rate may peak at a higher level.

(Continued on the following page)

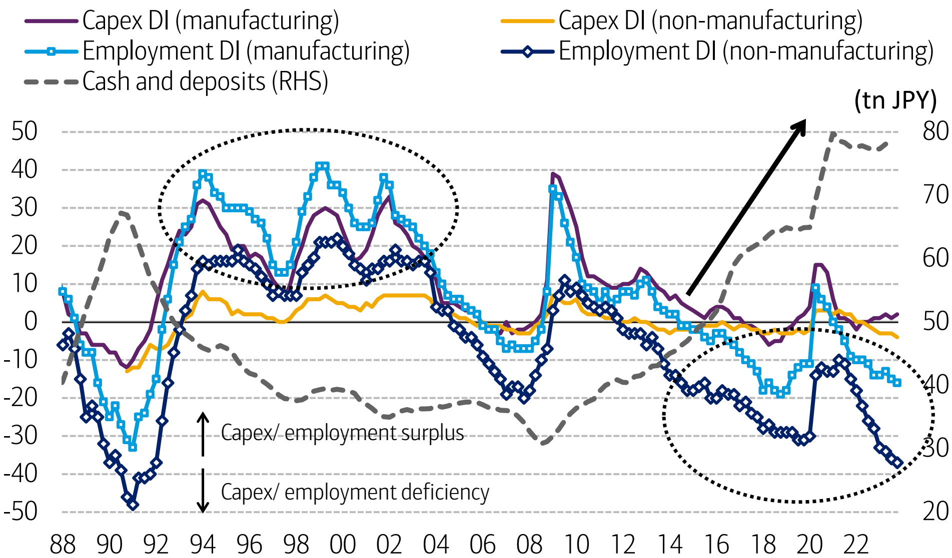
Another frequent question was about why corporate reform has suddenly taken off

There were still many investors noting that, with the BOJ poised to raise rates and the Fed poised to lower, there were risks from yen appreciation caused by differences in monetary policy direction. Our response was that the pace of yen appreciation should be moderate (we forecast a USD/JPY of 142 at end-2024). In addition to expecting both BOJ rate hikes and Fed rate cuts to be gradual, outward direct investment's share of forex supply-demand has increased significantly, and these factors mean that rapid yen appreciation is structurally less likely than before. We also noted that forex impacts must be understood holistically, given that (1) the forex sensitivity of earnings has declined recently through a combination of low forex volatility and lower earning sensitivity and (2) dollar depreciation stimulates the global economy while gradual yen appreciation helps to alleviate cost-push inflation. There was no significant push-back against our explanation.

Another frequent question was about why there has been such a sudden increase in corporate reforms. Last year we frequently heard doubts about whether the TSE rule changes would be effective, given that they did not include penalties, but progress with corporate reforms was largely taken as a given this time around.

We noted that since the corporate governance code was introduced in 2015, Japanese companies have steadily become more familiar with the concept of cost of capital. In 2015, however, the yen had stopped depreciating and deflationary pressures were building globally, conditions that made it premature to pursue corporate reforms. We explained that the change to an inflationary environment has made it irrational to hold onto unnecessary cash and surplus capital. This paved the way for corporate reforms that were further boosted by the TSE rule changes. Inflation is rooted in the structural labor shortage, while also pushing companies to optimize their pricing strategies to enable sustained wage increases, concentrate their business resources into sectors of strength, and make capital investments to replace labor (whereas under deflation, the focus is on cutting costs to keep both prices and wages low). Japanese companies built up large reserves of cash during deflation and now have considerable leeway to fund improvements in capital efficiency and productivity.

Exhibit 1: BoJ Tankan: capex, employment and cash
The three excesses of the 1990s (employment, facilities, debt) have become the three shortages; time to deploy the cash accumulated during deflation to eliminate those shortages



Sources: BofA Global Research, BoJ, MoF
Note: Based on large corporations.

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Could there be a rotation in preferences?

As with domestic investors, one area of interest for North American investors is whether there will be a rotation in stock preferences. Investors who have been overweight on Japanese stocks since last year have been heavily weighted in banks, trading companies, autos, and SPE (Semiconductor Production Equipment), and are now looking for where to go next.

We noted that during Japan's first year of inflation, the global economy was recovering and the yen weakening, resulting in cost-push inflation and a preference for external demand-driven stocks. We also noted that with inflation entering its second year, cost-push inflation is changing to wage inflation, thereby broadening stock preference to include domestic demand-driven stocks, including the retail and services sector, which benefits from wage inflation; IT services, which gain business opportunities from the labor shortage brought by the domestic economic recovery; and, assuming the increased utilization of surplus capital under inflation, the real estate sector, companies that own real estate, and the P&C insurers. We pointed out as well that the major brokerage firms, which get business opportunities from the unwinding of cross-shareholdings and the increase in M&A and MBO (Management Buyout) deals, can also be positioned as corporate reform stocks, and that, if the recovery of the manufacturing cycle continues, we expect the preference for external demand-driven stocks to broaden beyond semiconductor stocks, which benefit early in the demand recovery cycle, to include electronic components and factory automation-related stocks.

Lastly, there were many questions regarding the Chinese economy, including what to do with the Chinese stock weightings that North American investors already have. We noted that although the future direction of private consumption in China is uncertain, some recovery of the manufacturing cycle can be expected based on where the inventory cycle is, and that Japanese companies are primarily exposed to the latter. Additionally, with trade between China and the US to be disrupted more likely than before, it could lead to a loss in consumer markets for US companies, whereas Japanese companies, which supply China with components and materials, may see more business opportunities as China and the US rebuild their supply chains.

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