Lazard Insights

Is the Third Time a Charm for Japanese Equities?

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Summary

- Global investors have largely ignored Japanese equities for years as a series of macroeconomic reforms and a valuation multiple contraction have led historically to unfavourable results.
- On a valuation basis, we believe Japanese equities stand out as an opportunity relative to other developed markets and to their own history.
- Strong earnings growth for Japanese companies combined with an improvement in corporate governance will likely mean better returns for shareholders.
- We view the Japanese market as under-researched and underappreciated, which creates a prime opportunity for fundamentally focused investors.

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Many investors outside of Japan do not have long ties or a deep understanding of Japanese companies, and as a result they often rely on a macro or political "hook" to justify an investment. The two most notable recent examples of these are the "Koizumi Reforms" and "Abenomics."

When the hook doesn't quickly materialize into better returns, investors often get frustrated and leave. Japanese equities' historical underperformance, particularly relative to US equities, has only reinforced this pattern.

Yet, we believe investors are missing a tremendous opportunity by looking at Japan only through a macro or political lens. In our view, the key to opportunities in Japanese equities going forward will lie in evaluating company fundamentals and valuations. With valuations near historical lows and earnings growth powering ahead, we believe there is a need to reconsider Japanese equities.

Historical Context

Japanese equities have long been an easy underweight for global investors. Going back to the asset bubble of the late 1980s, valuation differences between Japanese and global equities were so extreme that when the bubble deflated, global investors slashed their holdings, and many all but ignored the country for years.

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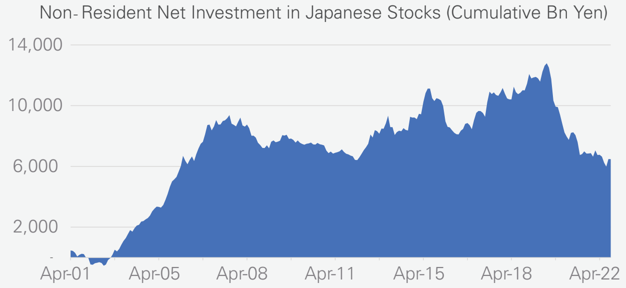
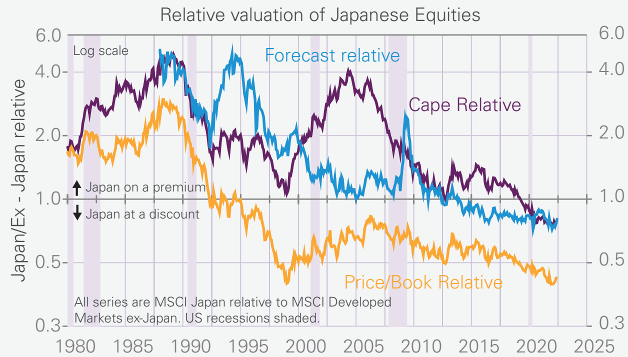
Exhibit 1
Peaks and Troughs in Japanese Equity Flows



As of 31 May 2022
Source: Lazard, Bloomberg

Exhibit 2
Valuation Distortions in Japanese Equities



As of 31 March 2022
Source: Minack Advisors

This changed in 2003 when Prime Minister Junichiro Koizumi spearheaded the privatization of the Japanese Post Office. Global investors embraced Koizumi's reforms and dipped their toes back into the water (see Exhibit 1).

At this time, Japanese valuations appeared reasonable as the forward multiple had narrowed to the level of other global markets (see Exhibit 2). However, this hid the fact that Japan was close to a peak in its earnings cycle and was almost as expensive as it was in 1989 at the height of the bubble on a cyclically adjusted price-to-earnings (PE) basis.

Eventually the equity market stalled, and investors sought an exit when the global financial crisis arrived in 2008. With Japan marred by low growth, poor governance, and the very strong Japanese yen, global investors once again largely deserted Japan.

Investors' hopes returned with the election of Prime Minster Shinzo Abe in 2012 and the start of his "Three Arrow" policies: aggressive monetary easing, fiscal stimulus, and structural reform. Yet history repeated itself, following investors' disappointment in Abe's third arrow. The famous "Abenomics" trade has finally fully unwound in the past year. While investors now look to Prime Minister Fumio Kishida's "New Capitalism" as a potential catalyst for Japan, this narrative also misses the mark, in our view.

Fundamentals Matter

We believe a more fundamental story can explain both the disappointment of recent cycles and more importantly, the potential of Japanese equities over the medium term.

Earnings or the Multiple?

The fact is Japanese companies have been able to deliver double-digit earnings-per-share (EPS) growth over the last twenty years (Exhibit 3), but total return over this longer period has faced the headwind of a valuation multiple contraction. At an aggregate level, the Japanese equity market has moved from trading on 30 times P/E to just 12 times P/E, and this level of multiple contraction has overwhelmed the positive impact of any earnings growth on total returns. Meanwhile, in stark contrast, the US market has benefited from both earnings growth and multiple expansion over the same period.

We believe this disappointing relative performance has reinforced the fallacy that Japan is an unattractive equity market that global investors can continue to ignore.

Exhibit 3
MSCI EPS Growth (%)

	MSCI EPS Growth (%)			
	Japan	Europe	US	Asia ex-Japan
5-Year CAGR	12.08	15.86	14.89	6.00
10-Year CAGR	13.50	5.31	8.02	2.14
20-Year CAGR	11.28	8.27	12.66	7.96

As of 27 June 2022
Source: Bloomberg, MSCI

Exhibit 4
Valuations Are Now Attractive

	10 Year CAPE	Price to Earnings	Price to Book	Return on Equity	EV/EBITDA	Dividend Yield	Payout Ratio
MSCI Japan	20.93	12.49	1.29	9.42%	8.09	2.47%	34.1%
MSCI USA	31.20	17.32	3.91	19.88%	13.49	1.63%	37.1%
MSCI Europe	21.96	11.70	1.77	13.50%	9.26	3.56%	45.4%
MSCI Asia ex - Japan	17.33	12.71	1.35	10.37%	9.32	2.55%	34.4%

As of 11 July 2022
Source: Bloomberg, MSCI

Although Japan has some of the most globally competitive companies capable of delivering robust medium-term earnings growth, investors have continued to focus on negative macro trends, such as demographics and deflation, an approach supported by uninspiring total returns. This has acted as a negative feedback loop, dissuading global investors from re-entering Japan.

The Opportunity: Four Reasons Why

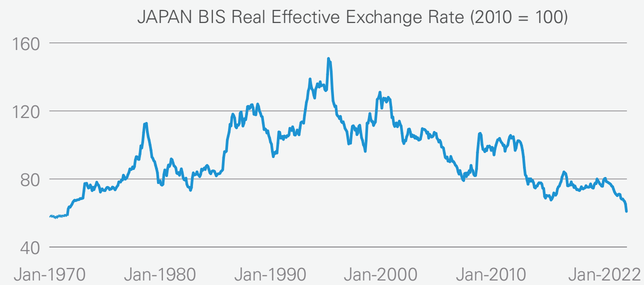
Japanese Equities are currently the most attractive it has been in decades for several reasons:

1. The valuation headwind that has plagued Japan for three decades is no longer an issue: Japanese valuation multiples are now some of the cheapest in the developed world (Exhibit 4). In addition, they are the cheapest on a relative CAPE basis since 1980 (Exhibit 2).

2. Japanese corporations have had to fight the headwind of a strong yen for decades. However, thanks to aggressive monetary easing, even as other developed countries have tightened, Japan's real effective exchange rate is the cheapest it has been in fifty years. Only a decade ago, Japanese companies were tooling themselves to compete as the yen strengthened to 75 against the US dollar; it is currently above 135 (Exhibit 5). Accordingly, Japanese global competitiveness is now the strongest it has been in decades, and the currency headwind is becoming a tailwind.

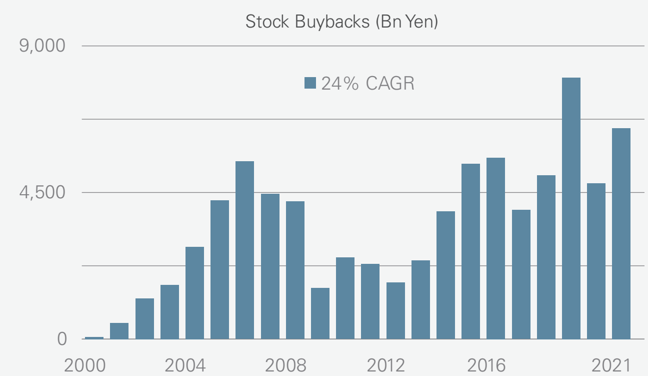
3. The third arrow of Abenomics might have been a short-term market disappointment, but the framework for stronger corporate governance has been established, and the momentum for it is increasing. Japanese corporates are more focused on shareholder return than ever before, as illustrated by share buybacks (Exhibit 6), while the potential for return of excess capital is enormous (Exhibits 7 and 8).

Exhibit 5
The Yen – From a Headwind to a Tail Wind



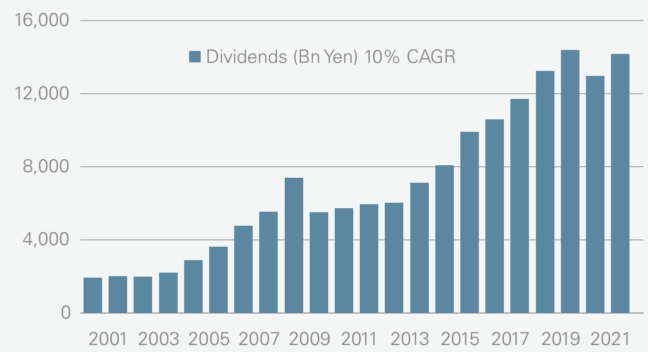
As of 30 April 2022
Source: Bloomberg

Exhibit 6
Buybacks on the Rise



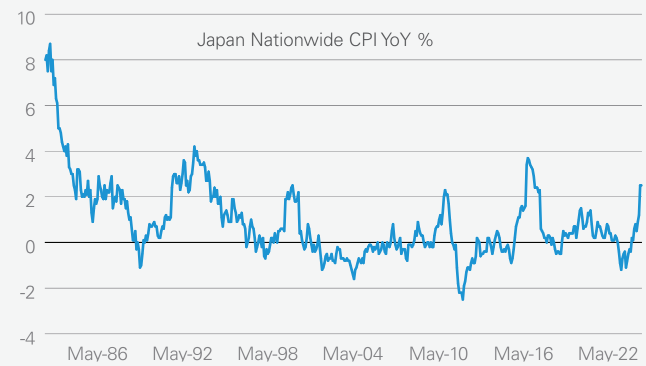
As of 27 June 2022
Source: Bloomberg

Exhibit 7
Dividends on the Rise



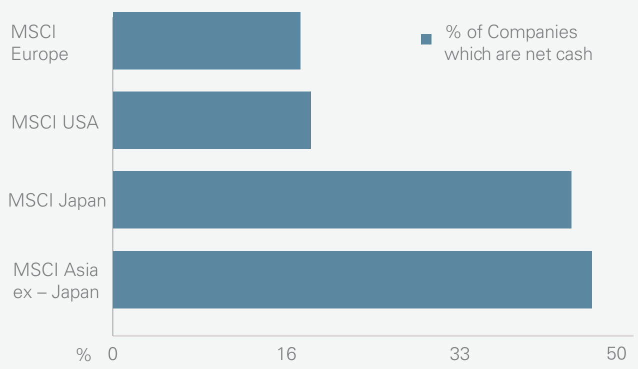
As of 27 June 2022
Source: Bloomberg

Exhibit 9
Inflation on the Rise: Japan's Consumer Price Index



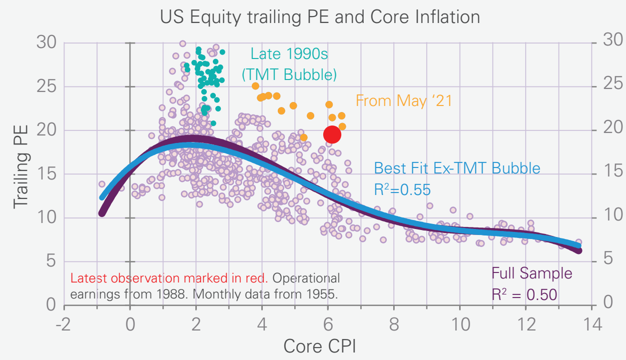
As of 24 May 2022
Source: Bloomberg, Ministry of Internal Affairs and Communications

Exhibit 8
High Potential for Increase in Buybacks



As of 27 June 2022
Source: Bloomberg

Exhibit 10
Correlation of PE and Inflation in the US



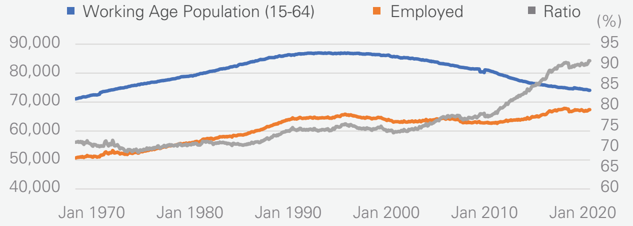
As of 31 March 2022
Source: Minack Advisors

4. While deflation has dogged Japan for decades, the country is beginning to see inflationary pressure (see Exhibit 9), much as other developed countries did last year. For decades, deflation has dictated the mindset of not only the global investor looking at Japan but also the Japanese consumer. As observed in the United States (Exhibit 10), moving from deflation to modest inflation has resulted in a higher valuation multiple. In addition, rising inflationary expectations could have a meaningful impact on attitudes toward domestic consumption and investment. While some would argue that the current trend is transitory due to higher energy prices and a weaker yen, we would argue that the shrinking labor pool in Japan will eventually lead to higher wage growth, sustaining an inflationary backdrop (see Exhibit 11).

Finally, we believe the opportunity in Japan is not yet fully appreciated, which makes it even more compelling. Global investors' continual underweighting of Japan has had an important effect; over the past few decades, we have seen more and more investors reduce their resources directed at the Japanese market. Not surprisingly, then, the Japanese stock market is relatively under-researched and underappreciated (Exhibit 12), especially compared with the US market.

Exhibit 11
Japan's Demographics Likely to Sustain Wage Pressure

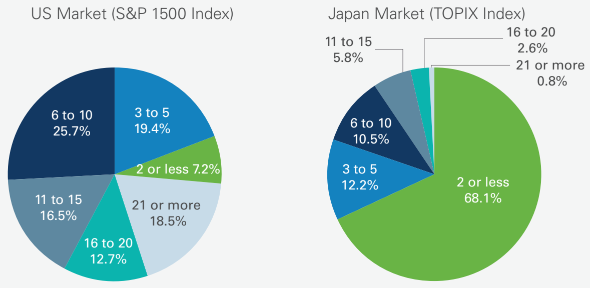
Number Employed versus Working Age Population (Thousands)



As of 31 May 2022
Source: Bloomberg, OECD, MIAC

Exhibit 12
Japanese Equities: Under-Researched and Underappreciated

Total number of sell-side analysts covering each stock in the index



As of 27 June 2022
Source: Bloomberg

A Simple Equation

Looking at Japan mainly through a macro and political lens, global investors may not be seeing the strong fundamental drivers that should support Japanese equity returns over the medium term—drivers that we believe are self-sustaining and not dependent on government action. Rather than focusing on the next political theme, we suggest that investors think about this simple equation: Change in PE x Change in EPS = Change in Price. Already, we are seeing positive change in the EPS side of this equation, and we think a change in the multiple will follow.

Since the late 1980s, two major equity rallies in Japan ended before global investors could realize the longer-term gains they had hoped for. Today, some might say we are guilty of crying wolf, but with fundamentals on our side, we strongly believe that the third time is the charm.

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