Lazard
Perspectives

Japanese Equities:
Is Now the Time?

High returns in Japanese equities have gained investors' attention recently, and we think the attention is well deserved.

Japan is in the midst of positive long-term structural change, stemming from corporate reforms that began more than a decade ago. At the same time, macroeconomic trends, including the shift to modest inflation after years of deflation, also bode well for Japanese companies.

Longer-term valuations do not yet reflect the potential in Japanese equities, in our view, making Japan one of the most attractive markets for investors.

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Returns for Japanese equities over the past year were, at first blush, largely influenced by the generally favorable environment for global equities. World markets, measured by the MSCI All Country World Index (MSCI ACWI), posted a gain of 17.15% in USD and the MSCI Japan USD Index similarly rallied 18.4% (12-months to 30 June 2023).

At the same time, however, the Tokyo Price Index, or TOPIX, gained more than 25% in Japanese Yen (JPY). This was in part the result of a weakening Japanese currency, but we think it also signaled something more.

In our view, Japanese equities have been one of the most attractive opportunities for some time (Is the Third Time a Charm for Japanese Equities?) and the arguments for a positive medium- and long-term view on Japanese equities have become even stronger to us over the past year.

Here are four reasons why we see Japanese equities as more attractive than they have been in decades.

1. Inexpensive Valuations

Valuations in Japan are attractive compared with those in other developed markets (Exhibit 1). This remains the case even though valuations have generally risen with equity prices over the past 12 months.

Valuations are also the most inexpensive on a cyclically adjusted price-to-earnings (CAPE) basis since at least 1980, as Exhibit 2 shows. Valuations in Japan had previously traded at premiums to other markets for many years.

2. The Tailwind of a Weaker Currency

Thanks to aggressive monetary easing by the Bank of Japan (BoJ) as many other developed markets central banks tightened over the past year, the yen has fallen from 136 against the US dollar in June 2022 to 145 as of mid-August. As measured by Japan's real effective exchange rate (REER), the currency is the cheapest it has been in fifty years (Exhibit 3).

Accordingly, Japanese global competitiveness is the strongest it has been in decades: The currency headwind, which plagued Japan's companies is becoming a tailwind. For perspective, only 11 years ago, Japanese companies were tooling themselves to compete as the yen strengthened to 75 to the US dollar.

3. Improving Corporate Governance

Structural reforms introduced under Prime Minister Shinzo Abe in 2012, while initially disappointing to the markets, established the framework for stronger corporate governance, and the focus has become intense over the past 12 months.

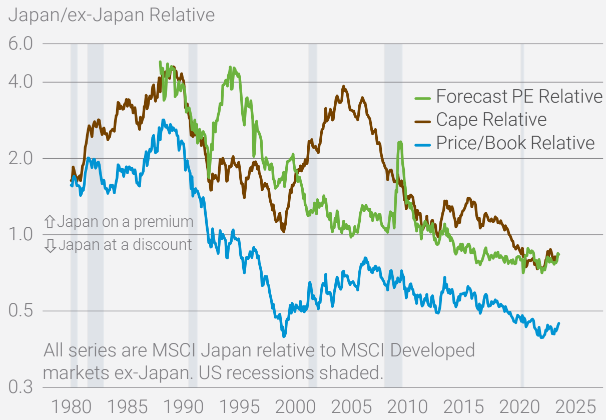
In January, the Tokyo Stock Exchange (TSE) began a campaign designed to make Japanese companies more appealing to investors. Among its new requirements, companies that consistently trade below book value must submit an improvement plan to "comply or explain." This is significant because nearly half of the 1,832 listed companies trading on

Exhibit 1
Relative Valuations: Japan Is Inexpensive

	10 Year CAPE	Price to Earnings	Price to Book	Return on Equity (%)	EV/ EBITDA	Dividend Yield (%)	Payout Ratio (%)
MSCI Japan	22.39	15.12	1.47	8.98	5.77	2.30	36.4
MSCI USA	33.61	21.03	4.37	17.07	14.93	1.51	39.1
MSCI Europe	22.56	13.04	1.71	12.11	9.40	3.47	47.9
MSCI Asia ex Japan	17.27	14.40	1.47	9.75	9.80	2.59	42.2

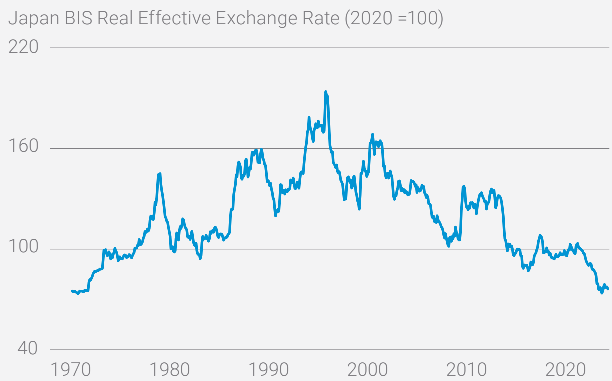
As of 30 June 2023
Source: Bloomberg and MSCI

Exhibit 2
Japan CAPE Valuations Near Record Lows
Relative Valuation of Japanese Equities



As of 30 June 2023
Source: Minack Advisors

Exhibit 3
The Yen at Its Weakest Level in 50 Years



As of 31 May 2023
Source: Bank of Japan and Bloomberg

the Prime Market (the market division with the highest listing standards) have a return on equity below 8%, a price-to-book ratio under 1.0 as of 31 March 2023, or both.

The TSE also urged listed companies to take action to enhance their long-term corporate value, such as promoting "cost-of-capital-conscious management." In the past, many Japanese management teams have shown limited awareness of how the cost of capital affects share prices; building their understanding could potentially bolster both their capital efficiency and credibility.

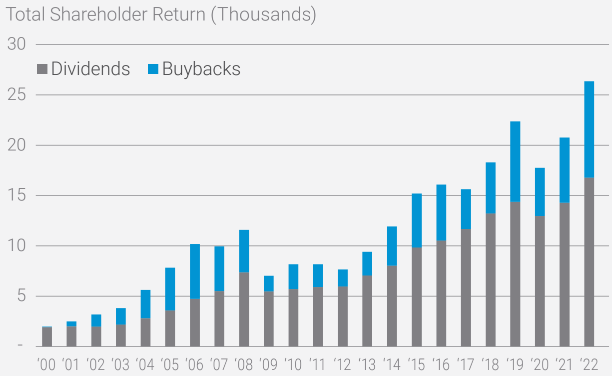
So, are companies responding? Based on our recent discussions with Japanese business leaders, management behavior is changing for the better, and we believe the TSE could be on the way to achieving its goal of increasing investor engagement.

The flurry of share buyback and cross shareholding announcements during fiscal 2022 earnings season suggests that Japanese companies are more focused on shareholder return than ever before (Exhibit 4). Increasing dividends and buybacks are trends that we believe are now well entrenched.

Inflationary pressures are likely to have other far-reaching effects. This past spring, the annual labor negotiation known as Shunto resulted in a base wage increase of 2.1% for the new fiscal year, nearly double expectations and the highest year-over-year increase since 1992. This is important because BoJ officials have said that they are paying particular attention to wage growth as they consider normalizing monetary policy. In fact, the BoJ made a move toward relaxing its yield curve control in late July by raising the high end of its target range for the 10-year Japanese government bond yield.

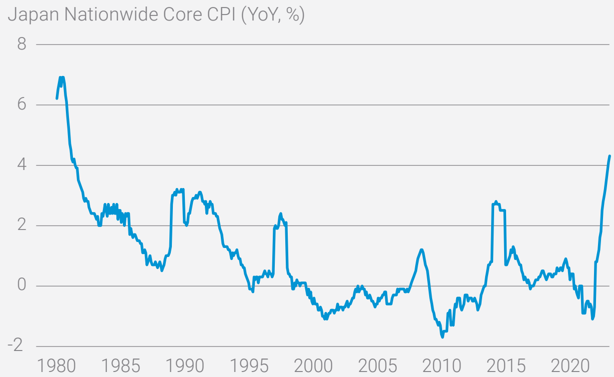
Finally, earlier this year, the government finalized changes designed to bolster its Nippon Individual Savings Account (NISA) system, a program launched under Abenomics in 2014 that uses tax incentives to encourage savers to invest in risk assets. By tripling the allowed investment amounts and making the tax exemption period unlimited, the latest changes could ultimately affect how Japanese households manage their balance sheets as the country moves from a deflationary regime to a modestly positive inflationary one.

Exhibit 4
Long-Term Trend of Buybacks and Increasing Dividends



As of 30 June 2023
Source: Bloomberg

Exhibit 5
Inflation Gains Its Footing in Japan



As of May 2023
Source: Bloomberg and Japan's Ministry of Internal Affairs and Communications

4. Higher Inflation

Following decades of deflation, inflation has finally taken hold in Japan—a very positive development for several reasons (Exhibit 5).

For one, we expect valuation multiples to improve, as they did in the United States, when inflation levels moderated in the 1990s, attracting more investors along the way. In addition, as inflation expectations rise, Japanese consumers, who have held on tightly to their savings over the deflation years, are likely to feel comfortable spending more, potentially fueling economic growth. The price-setting behavior of Japanese companies should also change; based on our meetings with corporate managements, we believe that their willingness to pass through higher prices should not be seen as temporary but rather, long-term.

Fundamentally Focused

The Japanese equity market is undergoing tremendous long-term change. Its magnitude is still not well understood by most global investors, nor is it reflected in longer-term valuations, in our view.

Japanese companies have massive potential to increase their corporate value through better capital efficiency, business portfolio reorganization, and improved shareholder returns, which could represent an unusually interesting investment opportunity. We saw a version of this play out in the United States in the 1990s and Europe in the 2000s. In Japan, we believe investors driven by fundamentals may be best placed to understand the situation, effect change company-by-company, and benefit financially from the structural shift now underway.

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Important Information

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