GW&K INVESTMENT MANAGEMENT

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BY WILLIAM P. STERLING, PH.D.

Global Strategist

THE UNTAPPED POTENTIAL OF JAPAN'S EQUITY MARKET

HIGHLIGHTS

- Japan's equity market offers significant untapped potential, characterized by impressive earnings growth, attractive valuations, and improving corporate governance.
- Despite these favorable factors, both domestic and foreign investors have largely overlooked Japanese equities, making them an unloved and under-owned segment of the global developed equity market.
- The notable improvement in corporate governance and shareholder returns, coupled with its undervalued status, make the Japanese equity market an attractive opportunity.

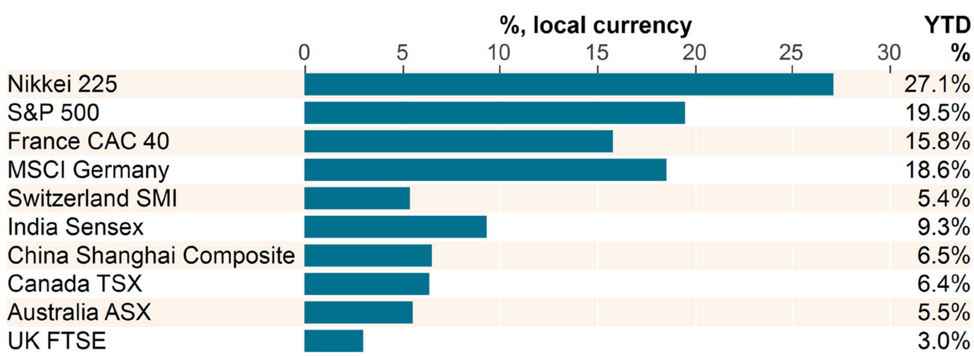
AN OVERLOOKED AND UNDERVALUED ASSET CLASS

Japan's equity market has long been overlooked and undervalued, but beneath the surface lie attractive opportunities for global investors. Despite impressive earnings growth and compelling valuations, Japanese equities remain unloved and under-owned by both domestic and foreign investors. In this piece, we delve into the untapped potential of Japan's equity market, highlighting key factors that make it a compelling investment opportunity.[1]

As background, Japan has been the best-performing major market in the first seven months of this year, with a gain of 27.1% in local currency terms for the widely tracked Nikkei 225 Index **(Figure 1)**. That said, the Nikkei posted a less impressive return of only 17.9% in US dollar terms, with the Japanese yen having weakened by about 10% over the same period. It is also worth noting that the Nikkei at mid-year was still trading 15% below its peak level reached in December 1989, at the zenith of Japan's "bubble economy" more than 33 years ago **(Figure 2)**.

FIGURE 1

Performance Of Select Stock Indices: December 31, 2022 To July 31, 2023



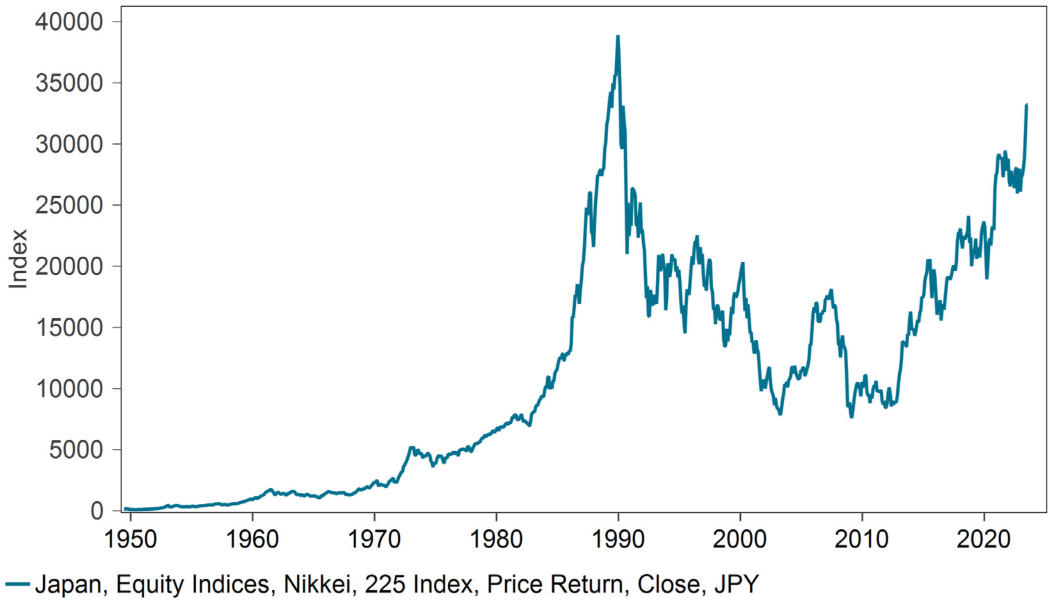
Sources:GW&K Investment Management and Macrobond

Japan's Nikkei 225 Index has posted the best performance in local currency terms for the first half of 2023 among stock indexes of the major nations.

[1] For further analysis of the case for Japanese equities, please see comments from Reid Galas, GW&K's Portfolio Manager for Global Equity Strategies, in the Global Equities section of GW&K's 2Q23 Quarterly Investment Review.

FIGURE 2

Japan's Nikkei 225 Index Still Trades Below Its December 1989 Peak



Sources: GW&K Investment Management and Macrobond

Despite recent strong performance, Japan's Nikkei Index still stood 15% below its all-time high recorded more than 33 years ago at the zenith of the so-called "bubble economy."

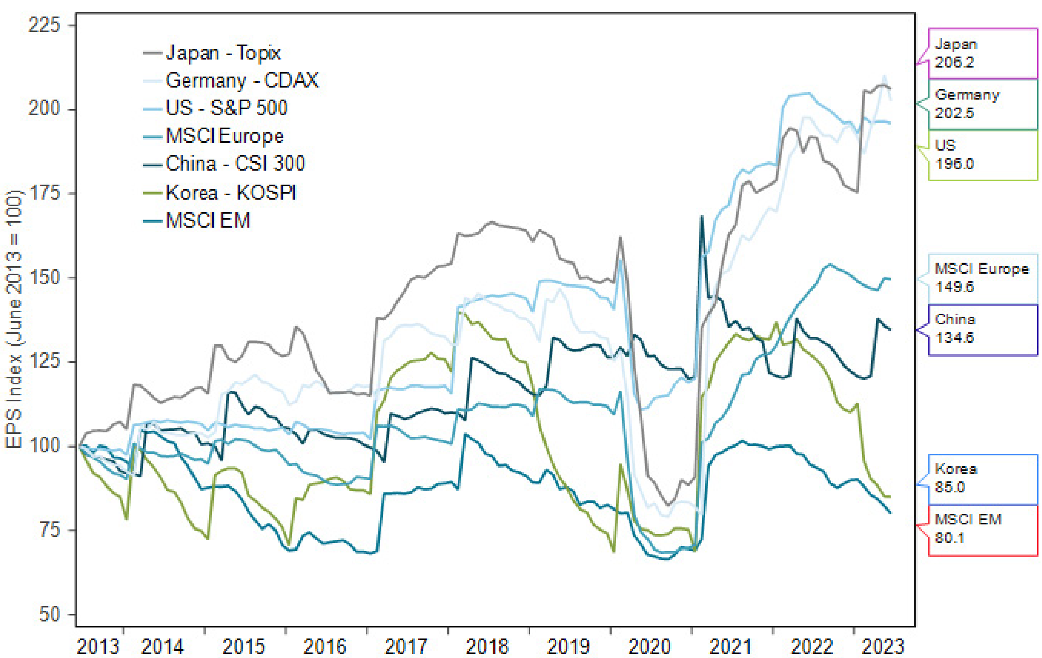
This was a bubble that took roughly 20 years to fully unwind, with a peak-to-trough decline in the Nikkei of nearly 80%, with the low point in the market finally being hit in mid-2009. Since then, the Nikkei has delivered respectable annual returns of 12.5%. However, the bitter memories the Japanese market created for both domestic and foreign investors for several decades certainly help explain its unloved status.

JAPAN'S EARNINGS GROWTH AND COMPETITIVE ADVANTAGE

Notwithstanding this sorry history, Japan surprisingly has posted the fastest growth in earnings per share (EPS) among major global equity markets over the past decade, at least in local currency terms **(Figure 3)**. Japan's annual EPS growth of 7.5% over that period becomes more astonishing when we consider that it was achieved despite anemic nominal GDP growth of only 1.1% per year. In comparison, the S&P 500 achieved EPS growth of 7.0% against average US nominal GDP growth of 4.8% per year.

FIGURE 3

Japan In The Lead Over The Last 10 Years: 12-Month Forward EPS (June 2013 = 100)



Sources: GW&K Investment Management, Bloomberg, and Macrobond

In local currency terms, Japan's growth in Earnings Per Share (EPS) has led that of the world's major nations over the past decade, an impressive achievement against the backdrop of tepid economic growth.

Adjusted for inflation, Japan's trend compound annual growth rate of EPS stands at an impressive 3.8% over the past decade, outperforming the S&P 500's rate of 3.0% **(Figure 4)**. It's as if Japanese companies have not only survived but thrived in a high-altitude training camp marked by low inflation, unfavorable demographics, and intense international competition.

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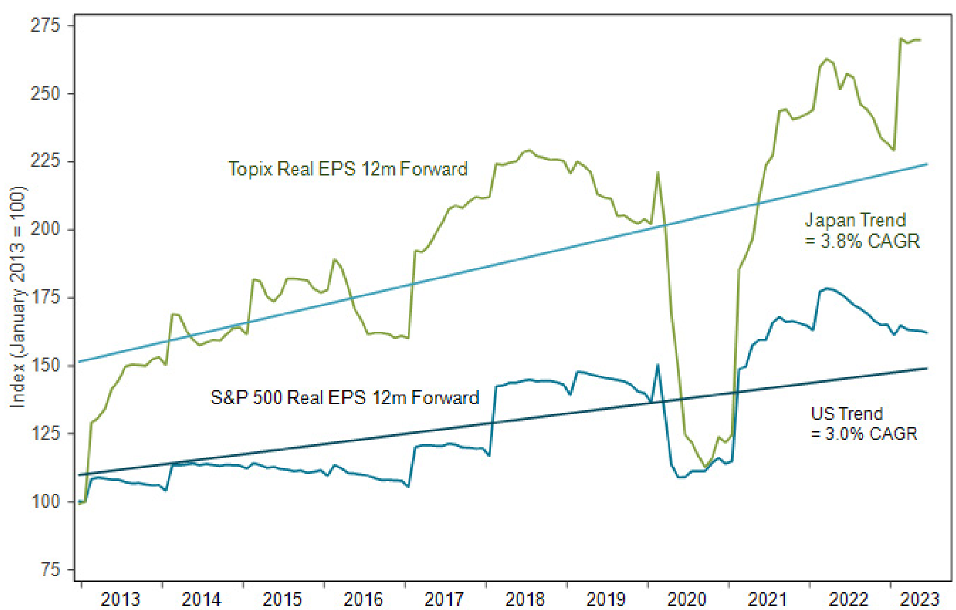
FIGURE 4

Adjusted For Inflation, Japan's EPS Growth Has Outpaced US EPS Growth In The Last Decade



Sources: GW&K Investment Management, Bloomberg, and Macrobond

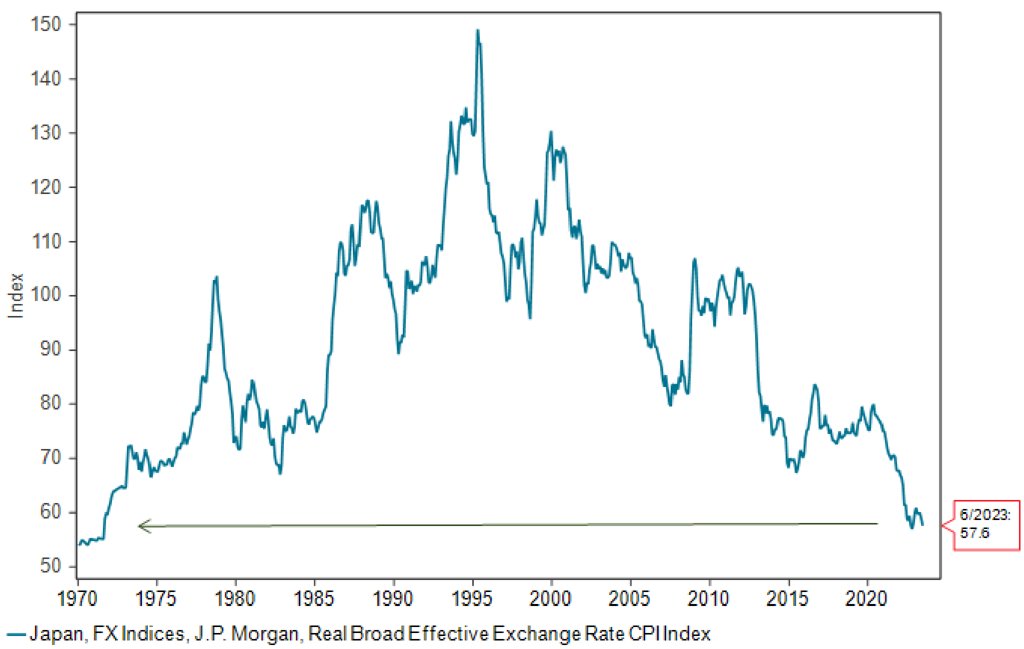
Adjusted for inflation, Japan has posted a trend compound annual growth rate in EPS of 3.8% over the past decade, compared to only 3.0% for the S&P 500.

FOREIGN INVESTOR SENTIMENT, THE WEAK YEN, AND VALUATIONS

Another factor behind the underappreciation of Japan's equity market has been the persistent downtrend in the value of the yen, which is at its weakest level in real terms since the early 1970s **(Figure 5)**. Japan's weak currency policy has made its production costs highly competitive, just as global supply chains are diversifying away from China.

FIGURE 5

Fire Sale On Japanese Assets: In Real Terms The Yen Has Not Been This Cheap Since The Early 1970s



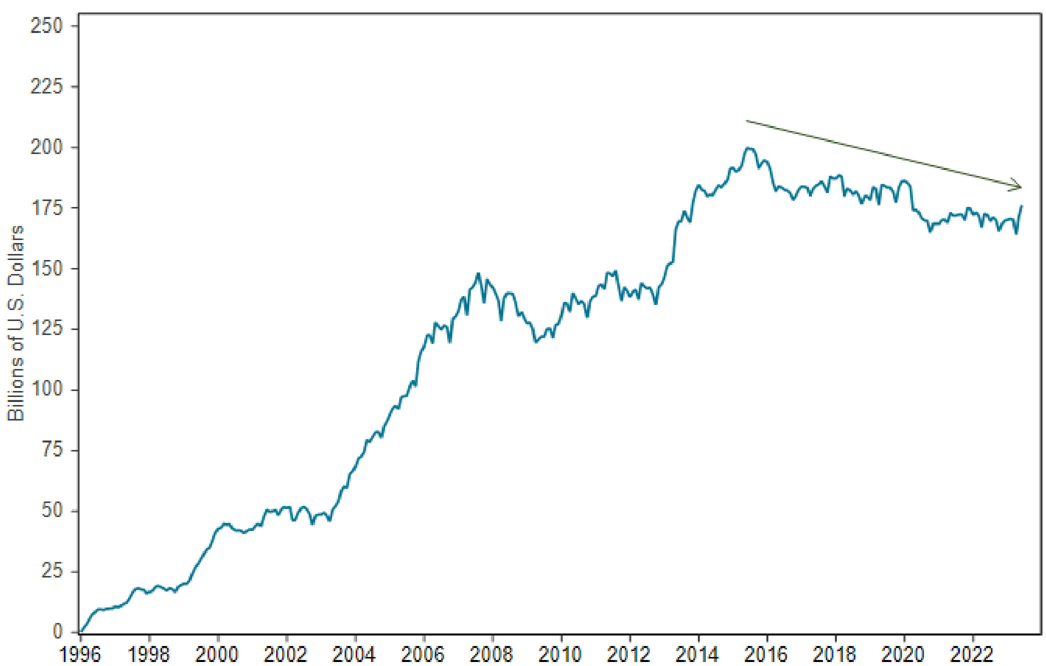
Sources: GW&K Investment Management, J.P. Morgan, and Macrobond

The real value of the Japanese yen against a basket of foreign currencies is down by more than 60% since its peak in 1995, bringing it to among its cheapest value since the early 1970s.

However, yen weakness has also deterred foreign investors, who have been net sellers of Japanese equities since mid-2015, unloading some $25 billion in holdings even as the market capitalization of the MSCI World Index gained $24 trillion over the same period **(Figure 6)**.

FIGURE 6

Foreign Exodus Since 2015:
Cumulative Foreign Buying Of Japanese Stocks



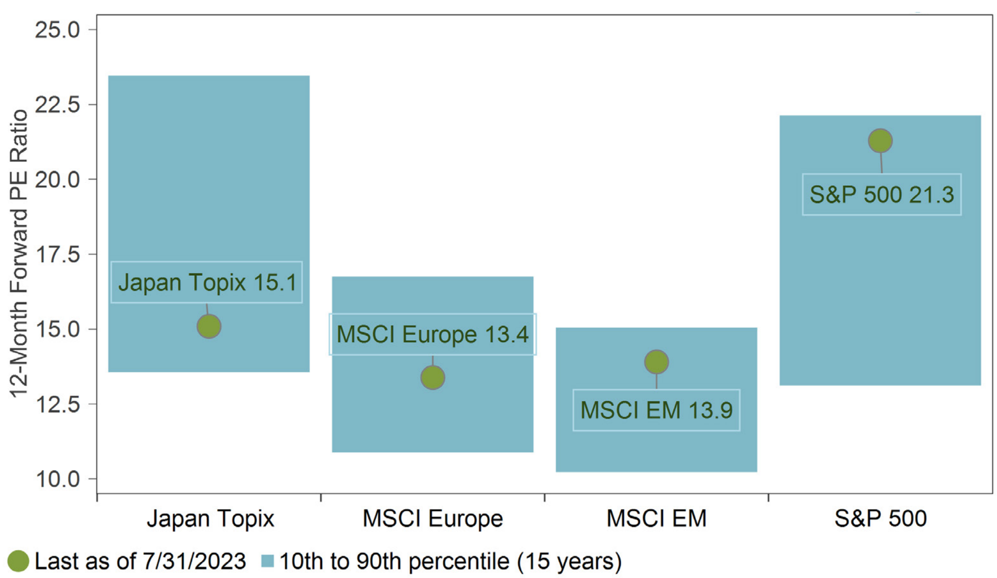
Sources: GW&K Investment Management, Japan Ministry of Finance, and Macrobond

Foreign investors appear to have given up on buying Japanese stocks as of 2015 and have sold a net $25 billion since then — and during a period when the MSCI World Index gained nearly $24 trillion in value.

Lack of investor interest has made Japanese equities a bargain, with the TOPIX Index trading at a 12-month forward price-earnings multiple of 15 times at the low end of its 15-year range **(Figure 7)**. Compared to the S&P 500, Japan's valuation represents a 29% discount, with Japanese equities offering an attractive forward earning yield of 6.7% (= 1/15).

FIGURE 7

Japan Topix, MSCI Europe, MSCI EM, And S&P 500: Forward PE Ratios vs 15-Year Historical Ranges



Sources: GW&K Investment Management, Bloomberg, and Macrobond

Japanese equities currently trade at a 12-month forward price-earnings ratio of 15.1 times, which is toward the low end of the range of the last 15 years despite impressive earnings growth.

To be sure, the trend toward yen weakness has represented a significant headwind to returns for foreign investors in Japan. But to the extent it is trading at a generationally low level, it may also represent an opportunity for foreign investors to acquire Japanese equities at a "fire-sale" price from a currency perspective.

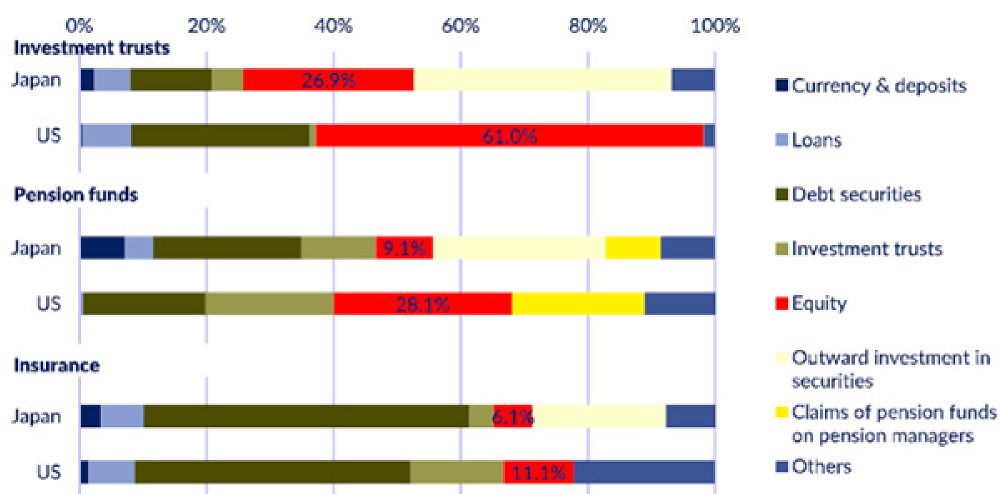
At a very minimum, those who have ever been inclined to visit Japan as tourists may want to consider visiting sooner rather than later to take advantage of the weak yen. Indeed, the same logic applies to "investment tourists," who have recently seen bargains in Japan — including one rather famous investor from Omaha.[2]

DOMESTIC INVESTOR ALLOCATION AND POTENTIAL SHIFT

Despite the recently improving fundamentals, even domestic investors in Japan have been hesitant to embrace equities. Japanese pension funds allocate a mere 9% to equities, while their US counterparts allocate triple that amount at 28%. Similarly, Japanese investment trusts allocate only 27% to equities, contrasting with the 61% allocation by comparable US institutions **(Figure 8)**.

FIGURE 8

Breakdown Of The Financial Assets Of Institutional Investors



Sources: CLSA, BoJ, and FRB

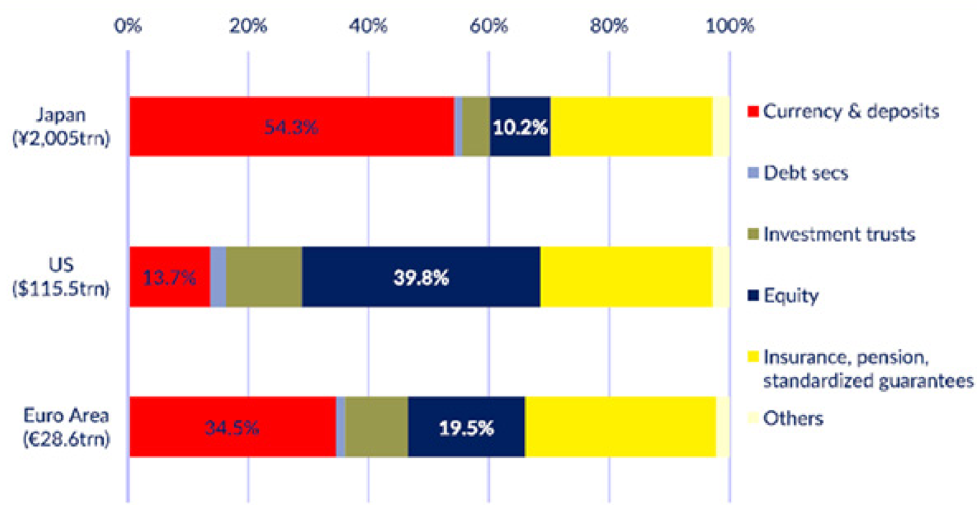
Japanese institutional investors are heavily underweight equities and notably so relative to peer institutions in the US.

[2] Elliot Smith, "Warren Buffet doubles down on Japan, increasing stakes in five trading firms," *CNBC*, June 19, 2023.

Japanese households exhibit a similar tendency, with only 10% of their financial assets allocated to equities compared to approximately 40% for US households. Astonishingly, Japanese households keep a staggering 54% of their financial assets in cash equivalents, while their US counterparts allocate only 14% **(Figure 9)**.

FIGURE 9

The Breakdown Of Household Financial Assets



Sources: CLSA, BoJ, FRB, and ECB

Japanese households have also shunned equities, with only 10% exposure compared to roughly 20% and 40% respectively in the euro area and the US. Remarkably, they have more than 50% allocated to cash.

The underinvestment in equities is especially puzzling since yields on Japanese government debt are still negative for short maturities (-0.09% for 1-year tenors) and stand at a paltry 0.60% for 10-year maturities. With all measures of core inflation now running above 2%, these starting yields virtually guarantee negative real returns on Japanese investors' cash and fixed income holdings. This situation sets the stage for a significant shift of asset allocations toward equities for their higher return potential.

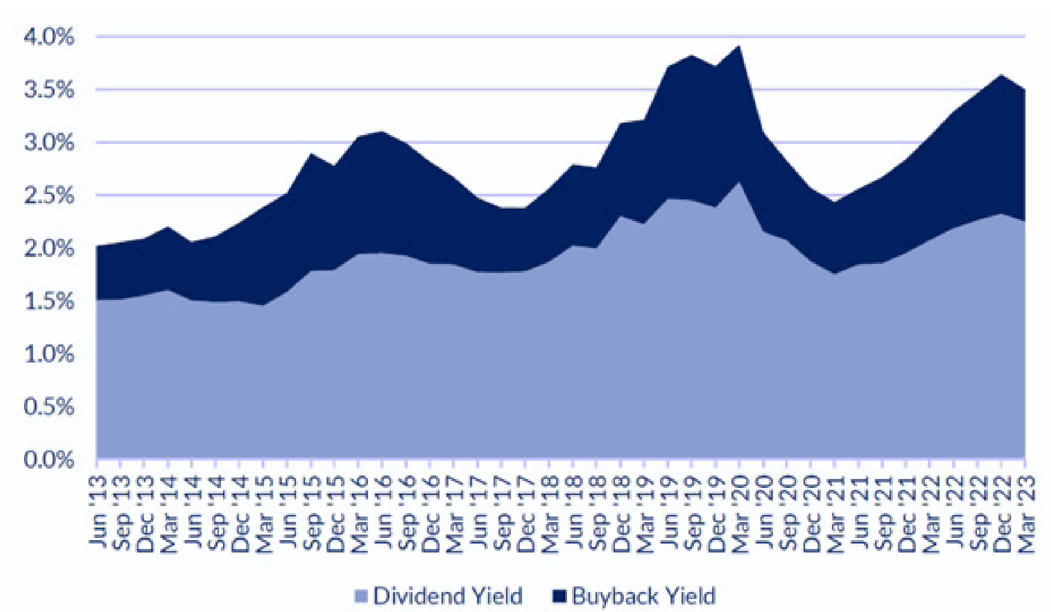
IMPROVED CORPORATE GOVERNANCE AND SHAREHOLDER RETURNS

In recent years, Japan has witnessed a sea change in corporate governance, with a growing focus on shareholder returns. The government and the Tokyo Stock Exchange have actively pushed companies to improve returns, leading to a surge in buybacks and dividends. Reflecting the efficacy of the "name and shame" approach to pushing for higher returns, share buybacks grew by 29% in the last fiscal year through March 2023.[3]

As a result, the shareholder yield — which combines buybacks and dividends — reached an impressive 3.5% at the end of March **(Figure 10)**. Importantly, these shareholder returns are not being financed through increased leverage, but rather, from retained earnings. This key distinction reflects the robust corporate fundamentals and balance sheets in Japan. While governance is still a work in progress, the rapid improvement in shareholder returns adds another layer of attractiveness to Japan's equity market.

FIGURE 10

The TOPIX Buyback And Dividend Yield (%)



Sources: CLSA and Bloomberg

In a country with near-zero interest rates, Japan's TOPIX Index offers a combined yield of 3.5% from share buybacks and dividends.

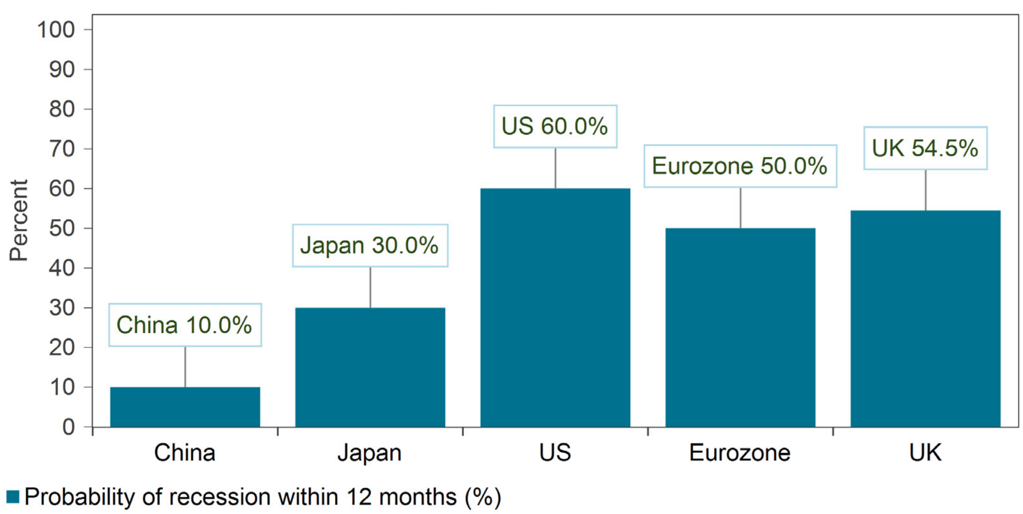
[3] For additional perspective on improved corporate governance in Japan, see Nicholas Smith, "Japan's on a roll," CLSA Market Strategy, May 26, 2023.

RISKS AND OPPORTUNITIES

No equity market is without risks, and Japan's market is no exception. It remains correlated with the global growth environment and susceptible to homemade recessions and geopolitical shocks. However, Bloomberg's survey of economists indicates lower recession risks in Japan (30%) over the next 12 months compared to the US, eurozone, or the UK **(Figure 11)**. Additionally, the OECD's index of leading economic indicators for Japan remains in positive territory **(Figure 12)**, which cannot be said for the US, eurozone, or the UK.

FIGURE 11

Based On Bloomberg's Survey Of Economists, Japan Has Relatively Low Risk Of Recession Among Major Economies

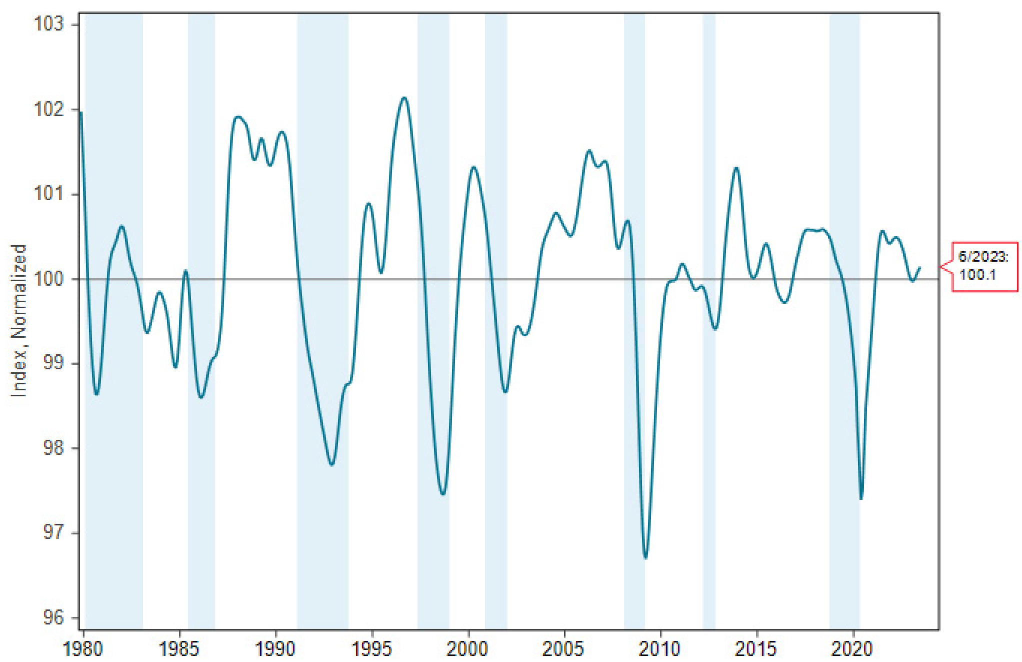


Note: Bloomberg survey data as of August 1, 2023
Sources: GW&K Investment Management, Bloomberg, and Macrobond

Thanks to accommodative monetary policy and lower inflation pressures, economists currently see lower recession risks for Japan over the next 12 months than for the eurozone, the UK, or the US.

FIGURE 12

Japan: OECD Leading Economic Indicator



Note: Shaded areas denote ESRI recession periods
Sources: GW&K Investment Management, ESRI, OECD, and Macrobond

The OECD's index of leading economic indicators for Japan is still in positive territory (above 100), suggesting a positive outlook for growth. The same cannot be said for the eurozone, the UK, or the US.

Furthermore, while the Bank of Japan is expected to tighten monetary policy, it is widely anticipated to remain more accommodative relative to other central banks. Even a modest tightening, accompanied by an eventual end to the Bank of Japan's "yield curve control" of suppressing bond yields, could initially saddle Japanese investors with capital losses on their bond portfolios that further add to poor returns for Japan's fixed income investors.

CONCLUSION

Japan's equity market, unloved and under-owned, now presents an intriguing opportunity for global investors seeking diversification. With impressive earnings growth, attractive valuations, and a shift in corporate governance, Japanese equities offer a chance to invest in well-managed businesses with strong fundamentals. As bond returns continue to disappoint, the flow into Japanese equities could act as a significant tailwind for equity prices. While risks persist, the untapped potential of Japan's equity market makes it a compelling addition to a diversified global portfolio.

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William P. Sterling

William P. Sterling, Ph.D.
Global Strategist

DISCLOSURES:

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GW&K INVESTMENT MANAGEMENT

www.gwkinvest.com

Boston Headquarters
222 Berkeley Street
Boston, Massachusetts 02116
617.236.8900

Other Locations
New York, New York
Winter Park, Florida