Investment Strategy

Equity Strategy | September 20 2022

ADCB ASSET MANAGEMENT LIMITED

Why we are overweight Japanese equities

- **Stable albeit slower growth, subdued inflation, and delayed 'reopening' put Japan at a different phase of the cycle compared to other developed markets.**
- **Weakening JPY is a double-edged sword for investors – provides tailwinds for corporate earnings but headwinds for currency returns.**
- **We reiterate our overweight on Japanese equities along with other Asian markets – a position we held since September 2021.**

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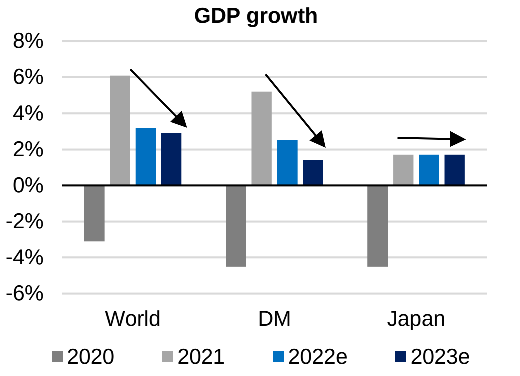
Japan has been cautious in removing its COVID-19 restrictions, at least in comparison to elsewhere in the developed world. This means that the gains from increased operational leverage are yet to play out fully in Japan. International Monetary Fund (IMF) in its July update of the World Economic Outlook, estimated the GDP growth of Japan to remain steady at 1.7% this year and the next. While this may not sound very much in absolute terms, this stability in growth needs to be appreciated considering the rapid slowdown in growth of advanced economies which IMF estimates to slow from 5.2% in 2021 to 2.5% this year and further to 1.4% in 2023 (exhibit 1). Furthermore, unlike in Western developed economies, Japan does not have a major inflation problem. For the context, Japanese consumer price inflation for August was 3% which is a rarity these days (exhibit 2). Better growth-inflation dynamic does put the Japanese economy at a different place than other developed economies where the reopening-linked operational leverage gains have been realized already, growth is slowing incrementally, and inflation is a major headwind. This divergence in economic path allows the Japanese fiscal and monetary policies to be different too. Especially the monetary policy in Japan is unlikely to tighten anytime soon while the other developed world central banks are in a race to raise rates to fight multi-decade high inflation (exhibit 3).

Broader political scenario appears stable. Unlike in the US and Europe, Japan does not face any immediate political risk events. Approval rating for Prime Minister Fumio Kishida's cabinet has remained at elevated levels despite criticism that it has not implemented meaningful policies. However, PM Kishida's New Capitalism action plan proposes to invest in people and support for technology and start-ups. Improving social stability including falling youth unemployment helps. On the currency side, traditionally the Japanese Yen (JPY) enjoyed the safe-haven status, and this has helped it strengthen during periods of global economic weakness. However, because of policy and real rate divergence, as well as the negative terms of trade shock from higher commodity prices, the JPY has recently fallen to fresh record lows on a real effective exchange rate basis (exhibit 4). One of the largest transmission channels of a weaker JPY into supporting domestic services and employment is through tourism activity which should pick up as COVID-19 related restrictions on foreign travellers are eased. From an investor point of view, on the one hand, weaker JPY has been providing tailwinds for the earnings of the export-oriented corporate sector. On the other hand, for international investors, especially for those who deal with USD and pegged currencies, weaker JPY has been a source of negative drag on overall returns.

Corporate sector related improvements have been a source of resilience for Japanese equities. Profit margins for the corporate sector remain elevated compared to their history and are being helped by industry consolidation (exhibit 5). Improvement in capital discipline is helping shield the profitability further. Lower leverage for the corporate sector is a big positive at the time when global interest rates are rising sharply. Also, the corporate governance related reforms are helping remove the long-standing overhang on Japanese equities. Furthermore, share buybacks have strongly risen this year and are tracking at a record pace of JPY10trn on an annualized basis. This is happening at a time when retail investor participation is on rise. For instance, the Financial Services Information survey on households over the recent years showed a remarkable increase in the share of households who indicated that future price growth is a key criterion while choosing financial products. This trend is supportive of demand for equities. Japanese equity market valuations are cheap. The current 12-month forward price-earnings (PE) ratio for MSCI Japan is 12.6x – trading at the lower end of range observed over the past 10 years during which the metric averaged 14.0x and the past 18 years during which the average valuation was 15.1x (exhibit 6). This compares with the developed world aggregate where the current 12M forward PE multiple is in line with the 10Y average of 15.3x.

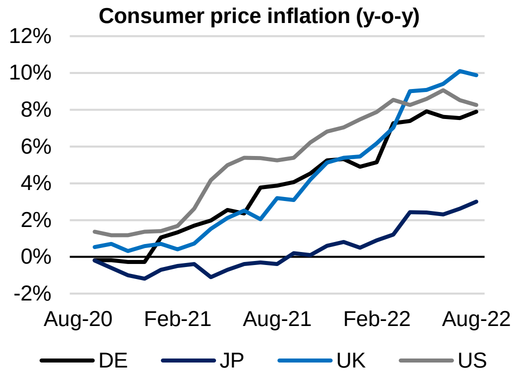
Taking all these together, we remain overweight Japan in our global equity allocation. Just as a reminder we are neutral equities in our asset allocation. We believe that Japan and other parts of Asia offer diversification opportunities given where they are in the post-COVID economic cycle. Unlike in the west, the recession probabilities are low in the east. However, though not our base-case, in case a global recession does materialize, most equity segments are likely to post losses. Even then, given the depressed valuations Japanese equities could still outperform in relative sense. Especially they could extend their year-to-date outperformance in local currency terms. Further, when the JPY bottoms out, investors in international currency terms are likely register stronger outperformance.

Exhibit 1: Japanese macro presents stable, albeit low growth…



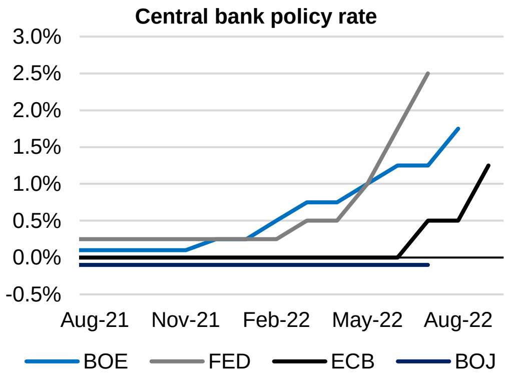
Source: International Monetary Fund (IMF) World Economic Outlook Update (July 2022), and ADCB Asset Management

Exhibit 2: …and subdued inflation…



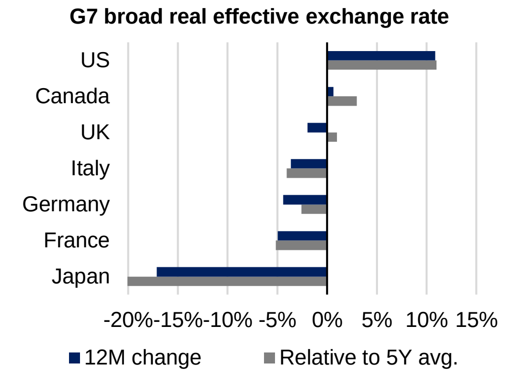
Source: National Statistical Offices, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 3: …allowing Bank of Japan (BOJ) to pursue easier monetary policy…



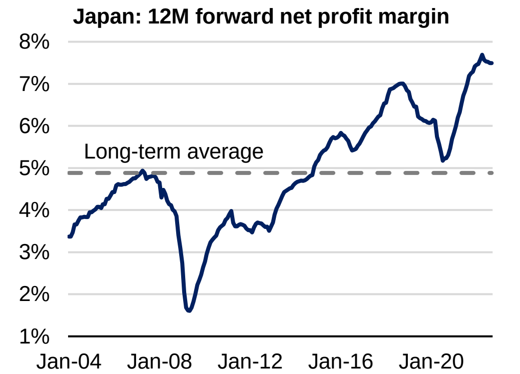
Source: Central Banks, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 4: …but at the cost of weakening JPY



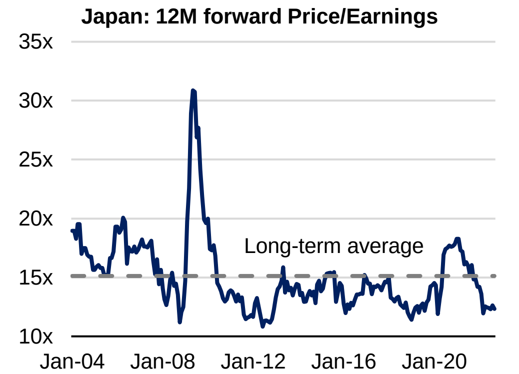
Source: Bank for International Settlements (BIS), Datastream, Refinitiv, and ADCB Asset Management

Exhibit 5: Japanese corporate profit margins are elevated…



Source: MSCI, I/B/E/S Global Aggregates, Datastream, Refinitiv, and ADCB Asset Management

Exhibit 6: …while market valuations look cheap



Source: MSCI, I/B/E/S Global Aggregates, Datastream, Refinitiv, and ADCB Asset Management

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