A brighter outlook for the Land of the Rising Sun

Last month, investors in London and on Wall Street cheered all-time highs for the UK and US stock markets. Anyone who celebrated the same feat in Tokyo is probably long retired. Japan’s benchmark TOPIX index peaked at 2,885 in December 1989 and is currently standing at roughly half that level (1,470), though it has been much lower in the intervening years. Unlike investors in the US and UK, holders of Japanese equities have painful memories.

There are, however, striking differences between Japan’s stock market 30 years ago and today. The most important of these, in our view, is valuation. In 1989, the TOPIX index was trading at a price-to-earnings ratio of c60x, more than three times the multiple on which it now trades. Unsustainably high valuations are part of the explanation as to why the market has done so poorly since 1989. Current valuations suggest that its experience might be better looking forward. Below, we explore this prospect and present our case for increased allocations to Japan.

Japan is changing...

Shinzo Abe’s second spell as Japan’s Prime Minister which began in December 2012 followed a period of 20 years with 14 different Prime Ministers, including seven in the previous seven years. He has now cemented his position at the head of a stable government, which in partnership with the Bank of Japan has embarked on an aggressive policy agenda to revitalise Japan’s stagnant economy. Abe’s ‘three arrows’ approach, generally referred to as ‘Abenomics’, encompasses monetary stimulus, fiscal flexibility and structural reform. Aided by this programme, the economy is now expanding and two decades of deflation look to be over. While growth is only modest (with GDP expanding at an annualised pace of 1.2% in the fourth quarter of 2016) and inflation is rising only gently (by 0.3% year-on-year in February), we believe that the policy prescriptions are working and that structural reform is prompting positive change in the corporate sector.

...and companies are at the heart of this

Japanese companies have a reputation of being inwardly focused: growing organically, holding excess cash and placing the interests of stakeholders (employees, banks and trade partners) above those of shareholders. However, with the introduction of the Japanese Stewardship Code in February 2014 and the Corporate Governance Code in June 2015, as well as other government-sponsored corporate reform measures, the mindset of management teams is now changing. More than three-quarters of companies listed on the Tokyo Stock Exchange (TSE) now have more than one outside board director, up from roughly one-quarter in 2014 (Fig. 1). Additionally, the total amount of dividends and share buybacks by First Section companies (excluding financials) has almost doubled over the same period (Fig. 2) as companies have become more focused on profitability, with management teams explicitly setting return on equity targets and increasingly using this as a key performance indicator.
Lastly, there is growing evidence of, and a less hostile attitude towards, mergers and acquisitions. The announcement in January that US private equity firm KKR will buy Hitachi’s power tools unit, Hitachi Koki, is one such example. Toshiba’s willingness to sell its prized memory chip business as part of a wider divestment drive is another. We anticipate that the increased emphasis on corporate governance and shareholder returns will be a long term trend from which investors will benefit.

In addition to the longer term improvements to governance and management focus, in the shorter term, we are encouraged by the outlook for corporate earnings. Aggregate profits for constituents of the TOPIX index have doubled since the beginning of Abenomics four years ago, and are projected to grow at a double-digit rate over the next 12 months according to Thomson Reuters IBES estimates. Japan’s large export sector is well placed to benefit from an improved global economic backdrop, while the yen’s depreciation against the US dollar since the middle of 2016 is also helpful. This brings us back to valuations.

Japanese equities are attractively valued. The TOPIX index trades on a 12 month forward-looking earnings multiple of 13.5x, compared to its 10-year average of 14.8x (Fig. 3). Only 14% of the time in the last 30 years has the stock market been cheaper. Notably, when Japanese equities have traded at this valuation level in the past¹, real returns over the next 10 years have been around 10% p.a., or better. Japanese equities also look attractive relative to other developed stock markets, trading on a lower earnings multiple than the UK, Europe and the US. Only emerging markets and Asia Pacific ex Japan are cheaper on this metric, though on a price-to-book basis Japan looks more attractive than these (Fig. 4).

¹ Based on price-to-earnings valuations dating back to 1973 (the earliest available date) for the Thomson Reuters Datastream Japan stock market composite.
With a supportive policy backdrop, improving corporate fundamentals and attractive valuations, we believe that now is a good time to increase weightings to Japan. We are recommending that allocations are invested in unhedged share classes of Japanese equity funds. This is in line with our currency positioning for all of our recommended overseas equity allocations. This is because, at present, we do not believe there is a strong valuation argument to support hedging the yen exposure. We are also mindful that, should global risk appetite deteriorate sharply, the yen’s ‘safe haven’ status should serve to protect value for sterling investors. We are reviewing client portfolios and will be in contact shortly with specific recommendations as appropriate.

If you have any questions on the above do please contact me or your usual adviser.

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