NPB | Neue Privat Bank

Investment **News**

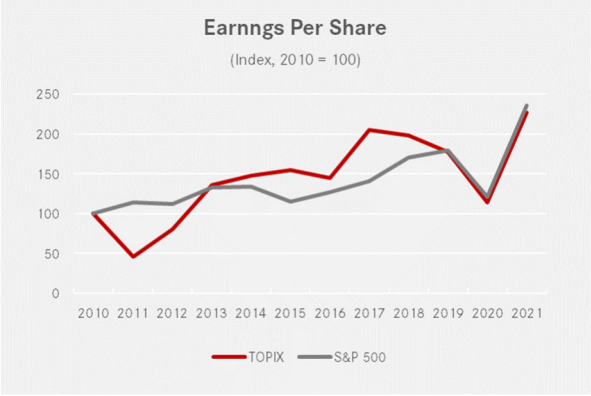
Stop looking at the big picture!

Japan: value or a value trap?

Country update: Japan

Investors have grappled with whether Japan is an opportunity or not. From a macro economic perspective it can hardly be considered compelling. The 2022 GDP growth expectation of 2.9% falls significantly short of the 4.4% forecast for the world. What is more, structural headwinds surrounding labour shortages continue to weigh on the economy, which partly explain why there has been a three-decade long economic stagnation. Yet, could an improving corporate backdrop be the catalyst for investors to start paying attention to a country that has been relatively cheap for over a decade?

Efforts have been made to address the demographic challenges of an ageing population. For example, offshoring manufacturing hubs to China to benefit from cheap labour. This, however, has come under pressure as China faces its own labour shortages, eroding any competitive advantages. Moreover, growth remains stubbornly subdued despite extraordinary use of both monetary and fiscal tools. Instead, what has resulted is a 'lost decade' (or three), accompanied by a staggering national debt of 250% of GDP, the highest such ratio in the developed world.



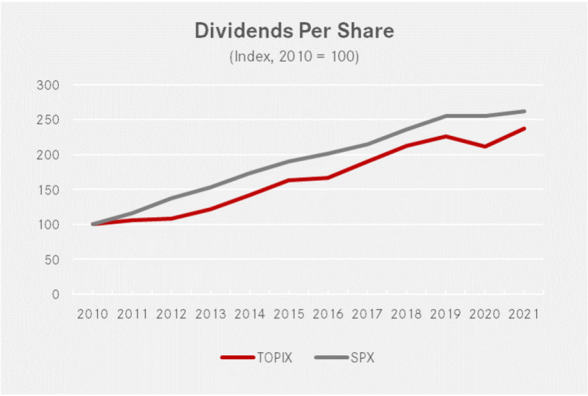
While the macro challenges remain, the interesting story that has not got much attention is what is happening at a micro economic and company level. There seems to be a sea change in Japan's corporate governance story.

Historically, Japanese management teams spent little time focusing on shareholder value. However, with "Abenomics" and the "third arrow" policy, the importance of corporate governance has risen substantially. This can be evidenced by an increasing management focus on shareholder topics such as return on equity, capital allocation efficiency and a renewed emphasis on shareholder returns.

The question is, is this now the shift in mind-set that might be the catalyst for investors to consider Japan in a different and more favourable light?

A further development that has gone under the radar is the strong fundamentals of corporate Japan. In 2021 Japan's earnings per share (EPS) growth was comparable to the US. Thus focusing solely on earnings would suggest that the market returns of these two countries should be comparable. Yet the reality is that the S&P 500 has outperformed the Topix by nearly 30% in 2021.

Now, sceptics would point to the currency as a major reason for the divergent performance, which would be fair. However, even if we take out the currency implications the difference at 18% is still dramatic. Again, it would be too simplistic to concentrate solely on earnings growth, especially, given the macro-overhang previously discussed.



For six months of 2021 Japan was in a State of Emergency given its low vaccination rate in dealing with the Covid pandemic. However, since May 2021 the vaccination rate has accelerated from a low of 2-3% of the population, to closer to 80% in December.

An improved vaccination rate, however, cannot be the sole ointment in healing the performance divergence, but it does pacify one of last year's major overhangs on the region and point to the potential catch up that could be in play.

Earnings are only part of the story. It is also important to consider valuations. Japanese equities have been undervalued for over a decade versus other developed markets. For example, there has been a very strong relative undervaluation versus the United States (US). Currently the SP&P 500 is trading at a P/E multiple of 23.7x, whereas the Topix trades at 14.3x.

	Long-Term EPS Growth	Dividend Yield	P/E ratio
S&P 500	10.45%	1.40%	23.70
Topix	12.50%	2.20%	14.30

What is different today is that Japanese companies are far more shareholder friendly, and earnings growth is more comparable to the world's largest economy. Despite this, valuations have not adjusted. This begs the question whether Japanese companies are undervalued, or US companies are overvalued and need to fall back in line with their Eastern counterparts.

To conclude, Japan continues to baffle investors whether it is of value or simply a value trap. The macro dynamics remain weak and despite a recent record stimulus plan of 56 trillion Yen, and a new political leadership providing hope for the future, it is not enough for investors to think that this time is different. Instead, it is the changing corporate story that challenges the old view and brings some light to the idea that Japan could once again not just be a forgotten region in investors' portfolios. Whether this materialises or not is still to be seen. At a time when investors are scrambling around to find the next idea, it at least warrants a closer look.

Nathan Dodson, CFA
Global Head of Advisory

Source information: Unless otherwise stated, the data used in this publication are from NPB and Bloomberg, as at publication date.