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Shinzo Abe; a tragic death but a promising legacy

by Robert White, CFA

Japan has been in the headlines for the sad and shocking death of Shinzo Abe, one of the few truly visionary democratic leaders in modern times. The former Prime Minister was instrumental in transforming Japan's economic and military ambitions, and while both remain a work in progress, he became a revered figure on the international stage. As investors, we are optimistic about the opportunity in Japanese equities; not only are they cheap, but nascent structural reforms and robust corporate profitability should provide a healthy tailwind over the coming years. As a result, our Japanese equity allocation is one of our largest overweights today.

The valuation case for Japan is nothing new; Japan has been consistently cheap over the past two decades, both in relative and absolute terms. Despite being a value trap for much of this time, the extent of the valuation gap relative to the S&P 500 is now historically large, despite a small retracement this year.

Aside from the equity market, the yen also looks cheap on purchasing power parity terms, undervalued by over 30% relative to the dollar according to Organisation for Economic Co-operation and Development calculations. This comes as we enter what has historically been a strong month for the currency, and growing recession fears combined with lower US yields over the last month should provide some support for the yen, which has struggled so far this year.

Part of the currency's weakness has been due to continuing easy monetary policy, now sharply diverging from Western central banks which have been aggressively tightening. The Bank of Japan (BoJ) maintained its negative 0.1% short term interest rate target in July, as well as its yield curve control policy and quantitative easing program. These extraordinary measures are consequences of Abe's bold economic reforms dubbed "Abenomics", which focussed on three arrows of change through higher government spending, loose monetary policy, and structural reforms.

While current Prime Minister Kishida has somewhat distanced himself from Abe's economic program, putting more emphasis on narrowing the wealth divide, Japan's monetary policy has remained accommodative as a reaction to a chronic lack of inflation. Kuroda's goal as Bank of Japan (BoJ) governor has been to reverse two decades of deflation that has curtailed long term growth. As global inflationary pressures have risen, consumer price inflation in Japan has risen to 2.4%, above the targeted 2%, however it remains well below the US at 9.1%.

Intriguingly, there have been numerous reports of Japanese firms increasing prices for the first time in decades[1], something that was recognised in the latest BoJ meeting summary, published last week[2]. It seems that the BoJ is keen to increase the likelihood of sustained and stable wage price increases to break the deflationary rut that has embedded itself in the Japanese economy. This stands at odds with concerns about wage price inflation and the impact on corporate profitability in the US, and this is because Japan (and Asia in general) is on a very different cyclical path to western economies, given proximity to the economic slowdown in China.

It is important to also recognise that Japan does have long term structural issues that have held back growth in recent decades. Notoriously, the country has the world's oldest population with a median age of 48.4 years[3]. It is also shrinking due to the low birth rate, and because immigration is low due to cultural, as well as language barriers. Without population growth, economic growth has been difficult to achieve. Despite this, corporate profits have been encouraging, and we think a big reason for this has been the structural reforms which have been undertaken in recent years.

The main thrust of these reforms has improved corporate governance of Japanese companies, with the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015. These changes have helped to increase institutional and foreign ownership, while also reducing crossholdings, increasing director independence, and increasing mergers and acquisitions activity. Shareholders return on equity has been increasing as a result, and we think that the recent upward trend here can continue.

Here at Momentum, we are accessing this opportunity through active, mid cap Japanese equity specialists with a focus on domestic companies. Specialist managers are important in Japan, where it pays to understand the language and culture when meeting companies, and there are plenty of undiscovered gems in the 1,800 stocks listed on the local exchanges. In a global market which has become overly concentrated in a few giant US technology stocks, Japanese equities should form an important part of any truly global portfolio today.

Sources
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