Marketing material

New dawn for Japanese equities

Japanese equities are on the cusp of a new era, with two key developments forcing companies to rethink how they do business – for the better.

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Firstly, years of corporate governance reforms are starting to pay off, nudging companies towards a more strategic and focused approach. Secondly, inflation has finally returned after two decades of stagnant prices and wages.

That means it no longer makes sense to keep large piles of cash on corporate balance sheets – a common tendency among Japanese companies, who have amassed some JPY258 trillion of cash on their books to the chagrin of investors.[1]

Over the coming months, we expect companies to start spending those cash piles. The quick and easy way to do so would be through share buybacks and dividend payments. The more strategic, long-term options include merger and acquisition activity and capital expenditure. Both paths should be good news for investors.

Spending spree

We are already seeing signs of companies loosening their purse strings. According to the Tankan survey, they are intending to invest faster than they have at any point in the last 40 years (see chart). That momentum will only strengthen as domestic activity picks up. (Our economists estimate Japan's gross domestic product to grow by around 1.5 per cent in 2024 – above potential and faster than both the US and the euro zone.)

Given the size of the cash pile at Corporate Japan's disposal, we expect this investment to be material and to lead to not only increased capex, but also increased M&A activity, increased share buybacks and increased dividends. As balance sheets normalise, we will also see an increase in leverage from current lows. (Adjusting for different sector weights and excluding financial stocks, the median leverage of Japan's TOPIX 500 stands at around 2.19 times compared to 2.79 for the US S&P 500.[2])

The increase in leverage will then lift the Return on Equity (RoE) for Japan. While many people rightly point out that Japan's RoE is considerably less than that of, say, the US, it is less widely understood that, once adjusted for the different sector weights, the median Return on Assets of the TOPIX 500 index is very close to that of the S&P 500. The difference in RoE is in small part due to the different rates of corporate taxation and in large part due to leverage: Japan has cash, the US has debt. That is about to change.

The positive shift in Japan's balance sheets and business practices comes at a time when the structural dynamics are also looking very positive thanks to the corporate governance reforms. Today, 97 per cent of listed companies now provide English investor materials (up from 80 per cent just three years ago), while 99 per cent have at least two independent directors (from 22 per cent in 2014). Cross-shareholdings have fallen to new lows, as Japanese companies focus on core competencies.

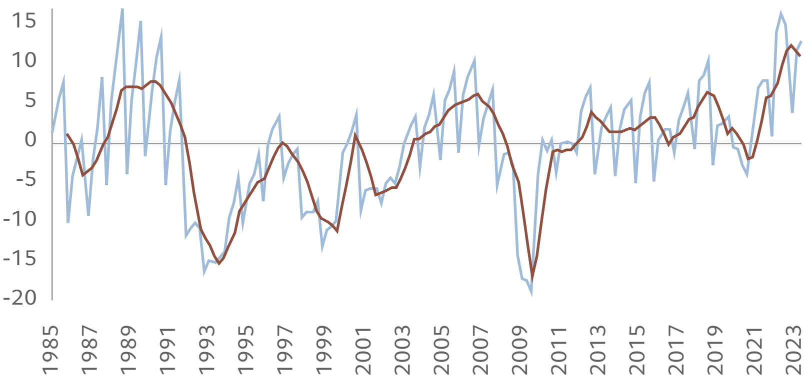
Authorities have also opened up tax free investments in Japanese stocks for domestic investors, potentially opening up a significant new source of demand which could support the market.

Stock pickers' advantage

But not all companies will cope equally well in this new normal. Some, for example, are better equipped to make the most of potential capex or M&A to grow their business and increase competitive advantage. So while investing in Japan Inc in general should reap rewards, a bottom-up, stock picking approach could help maximise returns by drilling down into the idiosyncrasies of each company.

Take the tech industry, for example. Tech in Japan looks very different to tech in the US. The latter is focused on

Fixed Investment Intention
(Tankan survey, all companies, 4Q moving average)



Source: Bank of Japan, Pictet Asset Management.

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communications services and service system providers and dominated by a handful of giants like Alphabet and Microsoft. Japan's tech sector is much more diverse, featuring precision engineering, electronic components, and high-tech functional materials.

A company at the cutting edge of its industry and with strong governance should be well-placed to effectively spend its cash, in a way that benefits both its business and its investors. That's where the stock picking comes in. In the Pictet Japanese Equities team, we do not start our bottom-up process with a fixed style of company in mind. We are agnostic about whether we find valuation upside from the market's misperception of the balance sheet and the probability of realising its value (classical value investing) or from its misperception of the company's likely future growth (classical growth investing). That frees us to pick the best stocks regardless of style. Valuations are key though. So, for example, while the pharmaceutical sector in Japan offers innovation and growth potential, much like tech, we see few opportunities there as much of that potential is already largely priced in.

With a strengthening economy, improved governance and stronger incentives to spend balance sheet cash, the investment case for Japan Inc looks very compelling. Particularly for those investors who can identify the companies which are best placed to capitalise on the changes and grow their business.

For more insights on the investment case for Japanese equity, please scan the QR code or visit **assetmanagement.pictet**

FOOTNOTES:
1 As of 01.06.2023.
2 Based on the median leverage ratio for each GICS sector, and then taking the median of all of those to give an index average. Using FY 2022 data.

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