Outlook on

Japan

JAN 2024

Summary

- Two themes became more prominent in Japan over 2023 and, in our view, will be driving factors for equities going forward: corporate governance improvement and the shift to inflation from deflation.
- Governance progress has accelerated with the Tokyo Stock Exchange's policy initiative over the past year, and we have already seen market-friendly changes in management behavior.
- In our view, the Bank of Japan is likely to begin normalizing policy in April 2024 if spring wage negotiations show that Japanese inflation is firmly rooted, as we expect.
- Our medium- and long-term outlooks for Japanese equities remain very bright, and we would view a near-term market pullback in Japan as an opportunity.

As we reflect on the past year, two underlying themes in Japan have become more prominent, and looking ahead to 2024, we expect both to remain driving factors for investors. First, the corporate governance conversation that began more than 10 years ago under Abenomics has been revitalized with the Tokyo Stock Exchange's (TSE) new policy initiative in 2023 aimed at improving corporate value. Additionally, inflation has finally taken hold in a major shift from decades of deflation. We cannot overemphasize the significance of this shift for the long-term potential of the Japanese equity market.

Governance: Change Is Underway

Governance progress has continued to accelerate with the TSE's highly positive policy initiative that encourages companies to focus on cost-of-capital management and capital efficiency in order to improve their value. After launching the initiative in early 2023, the TSE followed up in October with an announcement that it would publish a list of companies disclosing their capital improvement plans in January 2024 and provide monthly updates. While its focus had initially been on companies trading with a price-to-book ratio of less than one, the TSE is now urging even higher valuation companies to pay closer attention to their cost of capital and improve their valuations. This is immensely helpful for our engagement efforts in this area. In December, the TSE also brought attention to the peculiar issue of Japanese company relationships with their listed subsidiaries, which have raised concerns about subsidiary independence and potential conflicts of interest.

Combined with renewed efforts from the Japanese Ministry of Economy, Trade and Industry and the Financial Services Agency, these policy moves may have contributed to several recent market-friendly changes in management behavior.

First, the value of management buyouts announced in Japan has reached an historical high, as some management teams seek to go private to avoid facing higher standards. Recent examples include over-the-counter drug maker Taisho Pharmaceutical, education and publishing company Benesse, and temporary staffing company Outsourcing. We see this as positive because the healthy premiums of more than 50% in many cases highlight the market's mispricing of numerous companies. Second, the taboo on unsolicited takeover bids is gradually lifting. Life insurance leader Dai-ichi Life, a respected member of the Japanese business establishment, surprised the market

in December by making an unsolicited bid for the listed human resource benefits provider Benefit One, which had already agreed to sell a majority stake to medical information platform provider M3. This follows similar unsolicited bids by motor maker Nidec and furniture retailer Nitori. Such moves represent a further positive step in the opening of Japan's market for corporate control.

Perhaps the most telling sign of the sea change we are observing in corporate Japan is the reduction of cross-shareholdings by the stalwart Toyota group of companies. Just in the last quarter, we witnessed Toyota selling down its prized asset, its key tier-one OEM supplier Denso, and the announcement that it would abandon its 5% stake in Harmonic Drive Systems; at the same time, Toyota-affiliated bearing manufacturer JTEKT announced its plan to cut its cross-shareholdings to zero. The Toyota group represents the pinnacle of Japanese manufacturing, but it has also been an unfortunate example of the corporate governance problems that Japan faces. We are heartened by the steps that the entire Toyota group is taking and further encouraged by the fact that as a leader in Japan, Toyota is taking action that may well accelerate cross-shareholding unwinding throughout corporate Japan.

Inflation and "Normalization"

The Bank of Japan (BoJ) kept current monetary policy in place—including negative interest rate policy—at its December meeting. However, we believe a change is likely in April 2024. The BoJ's position is that current higher-than-target inflation is the result of exogenous shocks and will moderate over time. The central bank believes it can only begin policy normalization after seeing a firm foundation for endogenous inflation driven by wage growth in Japan, and confirmation of this trend is expected to come with the spring wage negotiation (Shunto) season. The media has already reported that labor unions will seek an even higher base wage increase this Shunto than the 2.1% they won in 2023.

We are focused on this shift from deflation to inflation because we believe many of the behaviors exhibited by households and corporations over the last three decades since the bubble burst—an unwillingness to consume and invest, along with overall risk aversion—were the direct result of a deflationary mindset.

With a change in this mindset, we expect changes in consumption, investment, and savings patterns that will have significant ramifications for the equity market and the broader economy over the long term.

Bright Outlook

As we look forward to 2024, our medium- and longer-term outlooks for Japanese equities remain very positive, driven by the two key themes of corporate governance improvement and the shift to inflation from deflation. Nevertheless, we also recognize that near-term financial conditions are uncertain. Global markets have already started to price in a peak in US interest rates and significant rate cuts in 2024, which could lead to a "Goldilocks" soft landing for the US economy. While we are optimistic about this narrative, we understand that from an historical perspective the likelihood is low.

As a result, we still think it is reasonable to see choppiness or even an outright correction in Japanese stocks over the next quarter or two. However, in our view, this would be an excellent opportunity for investors to re-evaluate their portfolio weightings to Japanese equities, considering the extremely positive longer-term structural changes underway.

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