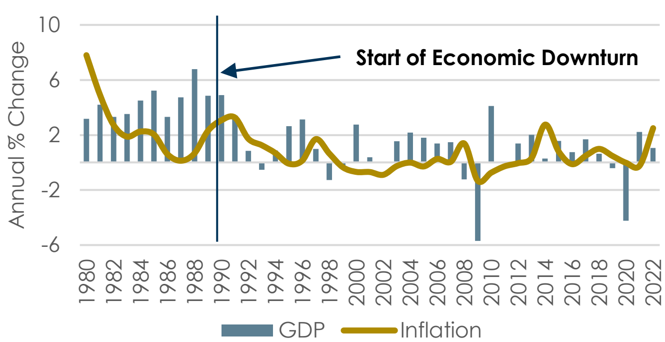
Japan - Can the Recent Equity Rally Continue? January 2024

- **Japan has been a tough market for investors – with uneven historic GDP growth, deflation and low corporate productivity**
- **Prior government policies (Abenomics) and recent initiatives by the exchanges are starting to show tangible progress**
- **Given the strong performance in 2023, how should investors think about Japanese stocks?**

Background
From 1980 to 1990, GDP in Japan grew at an average rate of just over 4% and inflation averaged about 2.6%, contributing to strong equity performance. In fact, in 1990 eight of the ten largest public companies in the world were Japanese. This high-growth/low-inflation environment drove asset prices to such levels that in 1990 the Bank of Japan (BOJ) aggressively increased short-term interest rates in an attempt to slow the growth. The central bank's credit tightening essentially popped the asset bubble and began an economic unraveling that lasted approximately two decades, characterized by inconsistent economic growth, deflationary trends and overly conservative balance sheet management by corporations.

Japanese GDP Growth and Inflation Rates



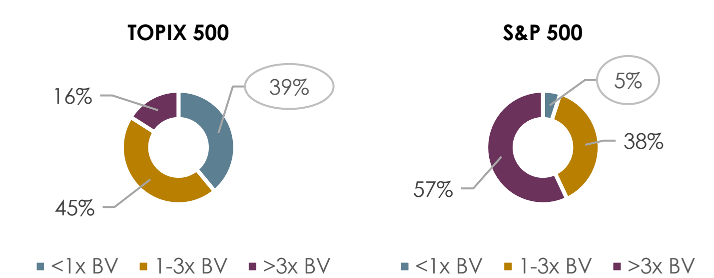
Source: IMF, WEO Database, ACG Research

Abenomics
In late 2012, understanding the country's trajectory was unsustainable, Prime Minister Shinzo Abe presented his economic vision for the country ("Abenomics"), a comprehensive policy package with "three arrows;" aggressive quantitative easing, government spending programs, and initiatives to improve corporate culture and governance. Abe's third arrow, arguably the most complex of the three, tackled the deeply rooted corporate culture and weak governance practices. Japan has made progress in this area as evidenced by recent efforts to increase independent board member representation.

Efforts by the Bank of Japan (BOJ)
As part of Abe's quantitative easing arrow, the Bank of Japan implemented a Yield Curve Control (YCC) program in 2016 after the central bank aggressively cut short-term interest rates to combat an unwelcome strengthening of the Yen. At the time, the goal of YCC was to artificially suppress long-term interest rates and keep pressure on the Yen to ease financial conditions and stimulate economic demand for companies in Japan. The interest rate cut collapsed yields across the entire yield curve, reducing the attractiveness of longer term holdings, which in turn further drove investors to hold cash or seek yield outside Japan. Today's improving-growth/moderate-inflation environment has significantly reduced the need for stimulus, potentially clearing the way for interest rate normalization.

Initiatives by the Exchanges
In early 2023, Japanese exchanges announced their own set of initiatives to address low equity valuations, identifying publicly traded companies that were inefficiently managing their balance sheets, as evidenced by stocks with price-to-book (P/B) ratios below 1X. These low valuations are partly due to high levels of cash on balance sheets, which results in low yields and inefficient returns on capital. Approximately 39% of Japan's TOPIX 500 stocks recently traded at a P/B ratio <1X, compared to the S&P 500 where the comparable figure is 5%. The Japanese stock exchanges now require companies in this valuation category to either improve their price/book ratio or show progress toward improvement, otherwise they are subject to potential de-listing from the exchanges.

Price to Book Ratio Comparison



Source: Capital Group, ACG Research

Are the Initiatives Working?
In 2023, Japanese companies put excess cash to work by either increasing stock buybacks, increasing dividends, or investing in capital projects. Since 2017, announced share buybacks on the TOPIX have been generally increasing each year. From an improving governance perspective, the number of companies whose board of directors was represented by at least 1/3 of independent directors rose from 6% to 92% from 2014 through 2022. Efforts to reduce cross-share ownership between companies are now underway, a move that could help unlock equity value. These developments have provided a tailwind for equities as Japan's TOPIX posted a 2023 return of 28.2% in local currency terms (19.3% in USD terms), ahead of the S&P 500, which gained 26.3%.

Concluding Thoughts
Starting with Abenomics more than a decade ago and the more recent initiatives by Japanese stock exchanges, the tangible changes in Japan are attracting investors once again. The degree to which corporate managers in Japan will embrace corporate reforms could differ, resulting in dispersed equity performance going forward. Investment opportunities will likely vary by company, by sector, by equity style and by market capitalization. The relevance of Japan lies in its 22.8% weight within the MSCI EAFE index (developed non-US equities). Accordingly, ACG believes implementing Japanese equity exposure through active non-US managers is the most prudent approach and provides the best opportunity to capitalize on the changing investment landscape in Japan.

Disclosures and Legal Notice

The views expressed herein are those of Asset Consulting Group (ACG). They are subject to change at any time. These views do not necessarily reflect the opinions of any other firm.

This report was prepared by ACG for you at your request. Although the information presented herein has been obtained from and is based upon sources ACG believes to be reliable, no representation or warranty, express or implied, is made as to the accuracy or completeness of that information. Accordingly, ACG does not itself endorse or guarantee, and does not itself assume liability whatsoever for, the accuracy or reliability of any third party data or the financial information contained herein.

Certain information herein constitutes forward-looking statements, which can be identified by the use of terms such as “may”, “will”, “expect”, “anticipate”, “project”, “estimate”, or any variations thereof. As a result of various uncertainties and actual events, including those discussed herein, actual results or performance of a particular investment strategy may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making investment decisions. ACG has no duty to update or amend such forward-looking statements.

The information presented herein is for informational purposes only and is not intended as an offer to sell or the solicitation of an offer to purchase a security.

Please be aware that there are inherent limitations to all financial models, including Monte Carlo Simulations. Monte Carlo Simulations are a tool used to analyze a range of possible outcomes and assist in making educated asset allocation decisions. Monte Carlo Simulations cannot predict the future or eliminate investment risk. The output of the Monte Carlo Simulation is based on ACG’s capital market assumptions that are derived from proprietary models based upon well-recognized financial principles and reasonable estimates about relevant future market conditions. Capital market assumptions based on other models or different estimates may yield different results. ACG expressly disclaims any responsibility for (i) the accuracy of the simulated probability distributions or the assumptions used in deriving the probability distributions, (ii) any errors or omissions in computing or disseminating the probability distributions and (iii) and any reliance on or uses to which the probability distributions are put.

The projections or other information generated by ACG regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Judgments and approximations are a necessary and integral part of constructing projected returns. Any estimate of what could have been an investment strategy’s performance is likely to differ from what the strategy would actually have yielded had it been in existence during the relevant period. The source and use of data and the arithmetic operations used for calculating projected returns may be incorrect, inappropriate, flawed or otherwise deficient.

Past performance is not indicative of future results. Given the inherent volatility of the securities markets, you should not assume that your investments will experience returns comparable to those shown in the analysis contained in this report. For example, market and economic conditions may change in the future producing materially different results than those shown included in the analysis contained in this report. Any comparison to an index is for comparative purposes only. An investment cannot be made directly into an index. Indices are unmanaged and do not reflect the deduction of advisory fees.

This report is distributed with the understanding that it is not rendering accounting, legal or tax advice. Please consult your legal or tax advisor concerning such matters. No assurance can be given that the investment objectives described herein will be achieved and investment results may vary substantially on a quarterly, annual or other periodic basis. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.

231 South Bemiston Avenue ♦ 14th Floor ♦ Saint Louis, Missouri 63105 ♦ 314-862-4848 (ph) ♦ www.acgnet.com