

# Japan's Renaissance

Moving from “why” to “how” to capture Japanese equity exposure



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## Setting the scene

Selling Japan's equities to global investors was a breeze some thirty years ago, until it wasn't. The fall of the Berlin Wall in November 1989 heralded a golden era for globalization. Economic prosperity enabled many nations to lift billions of people out of poverty. Japan's fate was different. Its successful industrialization post World War II had started to test limits. Corporate debt and stock valuations had risen to unsustainable levels,<sup>1</sup> just as fear that Japan would take over the world spread like wildfire.

Protectionism contributed to gradually erode growth prospects for many Japanese companies and the country entered a prolonged deflationary spiral. Japan's equities went from a well-regarded asset class to an unloved one, evidenced by global investors' perennial underweights.<sup>2</sup>

We believe a pivot is underway and see opportunity for these investors to build more diversified, more resilient portfolios, not predicated on Japanese equities having enough gas in the tank to extend the strong rally of the past year and a half, but on structural forces that are providing profound and likely lasting effects.

The deflationary equilibrium of the past 30 years is giving way to a reflationary equilibrium (see chart). Corporate reforms reveal a more shareholder-friendly mindset, and recent trends underpin a rewiring of globalization. We believe Japan is well positioned for the emerging era in global investing and that challenges in demographics or exchange rate jitters won't derail what could well be a Japanese renaissance.

To navigate the next leg of stock-market opportunities we believe an active, flexible strategy will be more effective than anything else.

1. Japan Cabinet Office, historical data, as of 30 Jun. 2024.

2. Tokyo Stock Exchange, as of 30 Jun. 2024.

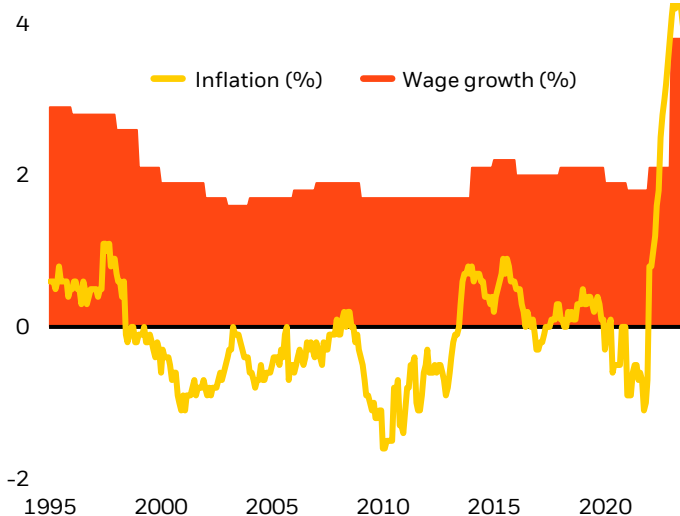
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## Highlights

- **Japan's big change at the economic and corporate level invites global investors to revisit their long-held underweights, and possibly reduce them.**
- **The shift from deflation to reflation is the biggest test Japan's economy has seen in decades and we see a good chance for success.**
- **We believe the easy stock market gains are behind, and that an active, flexible approach will be better to capture potential alpha opportunities.**
- **We see a future of greater dispersion of returns based on idiosyncratic factors, and believe opportunities abound by industry and theme.**

## Long awaited

Wage and inflation trends, 1995 - 2023



Source: Refinitiv Datastream, Reuters, BlackRock, Japan Ministry of Internal Affairs and Communications, as of 31 Dec. 2023. The chart shows annual change in consumer price index (CPI) excluding food and energy, excluding the impact of the consumption tax rise, and results of annual shunto wage settlements.

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**What the data show**

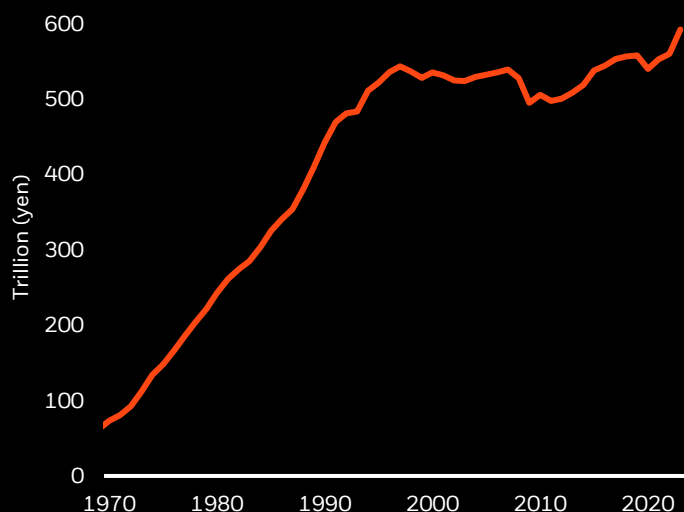
- **Growth** – Japan’s gross domestic product is picking up after a prolonged economic stagnation. See chart.
- **Inflation** – Inflation is also back, with concerted efforts by policymakers and industry leaders to make it stick.
- **The yen** – The yen is very far from all-time lows, in 1971 it took 348 yen to buy one U.S. dollar.
- **Valuations** – The price earnings ratio for the MSCI Japan Index was 16 as of June 2024 vs. 79 in December 1999.

**What the data don’t tell**

In the 1980s-90s Japan’s equity valuations were sky high, driven by soaring land, real estate and other asset prices. They are now down to earth, related to prospects for real corporate earnings growth, we believe. The world has also changed a lot over time, and Japan has been part of it. We capture this in the table below.

**Picking up**

Japan nominal GDP, 1970 - 2023



Source: Wind, as of 31 Dec. 2023. GDP stands for gross domestic product.

**Japan’s scorecard – A historical view**

Economic and stock market indicators, average annual for periods shown, 1970 – 2023

Indicator/period		1970 - 1980	1980 - 1990	1990 - 2022	2022 - 2023
Economy	GDP growth nominal (%)	13.6	6.4	1.0	5.8
	Inflation CPI y/y (%)	9.1	2.1	0.4	3.2
	BoJ policy rate (%)	6.1	4.5	0.7	-0.05
	USD/JPY	272	191	110	141
	Wage growth (%)	13.5	4.2	0.8	1.8*
	Defining characteristics	Energy efficiency and affordable option amid rising U.S. inflation, export boom, quality and efficient products.	Manufacturing prowess, fear of Japan dominating the global economy, world’s most expensive real estate.	Deflation, economic stagnation, aging population, domestic stability, losing ground on the global stage.	Post Covid recovery, reshoring, national security, inflation return, corporate reform, optimism.
Equity market MSCI Japan	Total return (% , USD)	23.8	31.1	2.9	20.8
	Total market cap (billion, USD)	86.7	927.8	2,359.7	3,633.2
	PE	17	34	22	15
	Investor sentiments	Global investors in a wait-and-see attitude. Potential opportunity, unclear access.	Diversification opportunity, animal spirits, valuations secondary.	Great country, unloved asset class, lack of catalysts, underweight in global portfolios.	It feels different this time, FOMO, worth re-examining portfolio allocations.

Sources: Japan Cabinet Office, Haver, MSCI, and BlackRock calculations, as of 31 May 2024. In the periods from 1970 -2022, the data shown represent the average for the period based on annual data; 2022-2023 data show one-year change to 31 Dec. 2023. \* Wage growth based on monthly data from 31 Dec. 2022 through 31 Mar. 2024, annualized. CPI stands for consumer price index; BoJ stands for Bank of Japan; JPY stands for Japanese yen; PE stands for price-to-earnings ratio.

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# Q

## Japanese equities have rallied strongly. Is it too late to buy?

**We don't think it is too late. Japan's story is structural, and we believe it is here to stay.**

### On demographics

No matter how conversations about Japan begin, they always lead to the aging of the population as a risk for investment and economic growth. We offer a different take on the matter.

#### 1. It is in the stock price.

The issue is real; it is well known and has been for decades. The government can't fix it magically but has taken steps to lessen the impact. In the process, the world has noticed this is a global matter and because Japan has been dealing with it for a long time, many countries are turning to it for insights. Stock prices reflect the issue, and the risk of surprises may be tilted to the upside, we believe.

#### 2. Opportunity knocks.

Japan's long quest for creative solutions to address an aging society has brought advances in robotics, automation and the digital transformation. Japan is no outlier but a frontrunner on the issue, and many countries, especially developed economies, have increased demand for products and services related to aging. In Japan, these products and services are available today and will likely get better as the country seeks to cement its lead in this space. The other side of a challenge is opportunity.

# A

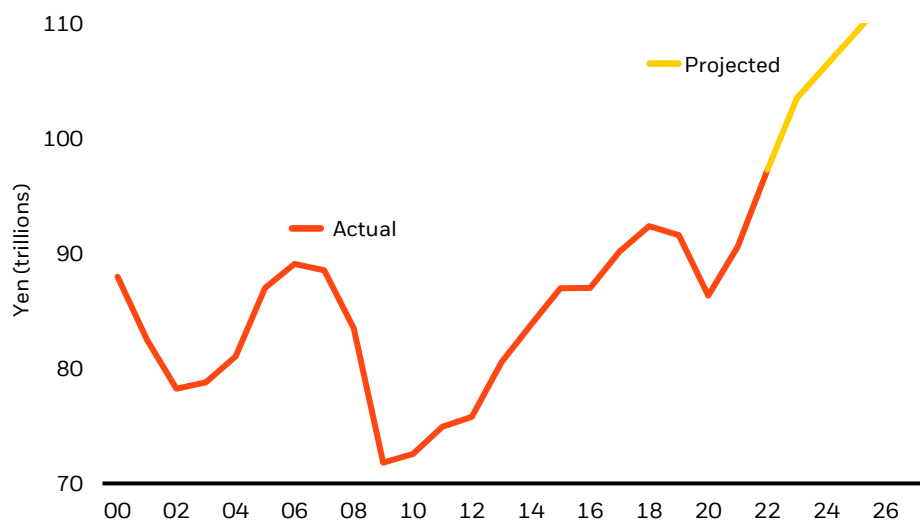
We don't believe it is too late. Japan's story is structural. Its main macro driver is the shift from deflation to inflation. For 30 years, households and companies dealt with the pain of falling prices. Savings grew but not spending and investing, causing wages, corporate profits and economic growth to stagnate. Not anymore. Japan's CPI rose 3.2% in 2023, it has continued to climb this year, and we see a high probability for inflation to hover around the BoJ's 2% annual target.

In contrast to false dawns of the past, there is now a concerted effort from the private-public sectors and regulators to make it work this time. A can-do attitude is revitalizing corporate expenditure, now at all-time highs and expected to grow in coming years. See chart. Wages have risen two years in a row,<sup>1</sup> supporting the possibility of a virtuous cycle of more consumption and investing turning into higher corporate earnings, higher wages and so on. We see tax break extensions and subsidies remaining government priorities as is BoJ's careful managing of interest rates to ensure inflation sticks.

Some market observers argue the BoJ needs to hike interest rates to stop the yen's depreciation. We believe that is secondary to their commitment to maintain accommodative monetary conditions that ensure a sustained transition from deflation to inflation. The newsflow suggests the yen is at all-time lows, but in 1971 it took 348 yet to buy one U.S. dollar. We would like to see the yen stronger than 155 per dollar, and do not rule out more government intervention in the FX market. But the yen's slide since January 2024 is hardly the emerging-market-style falls we've seen in the past. The exchange level creates a lot of noise in the market, but for monetary authorities and the real economy it isn't the top priority. Corporate earnings are less exposed to currency risk thanks to offshoring of Japanese production. And a weaker yen has boosted exports of goods and services, recently soaring to almost double the share of GDP from the mid 1980's.

### Spending boom

Corporate capital expenditures, 2000 – 2026 (projected)



Source: Bloomberg, as of 29 Sep. 2023. Forecasts are based on estimates and assumptions. There is no guarantee that they will be achieved.

1. Japan Ministry of Health, Labor and Welfare, Mar. 2024 data.

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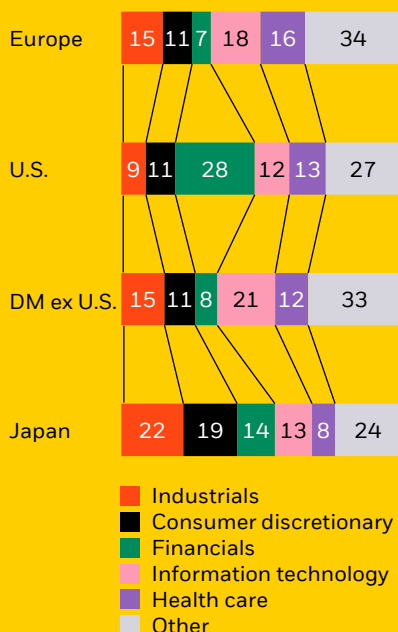
# Q

## What are you hearing from clients? Has the conversation evolved?

**Investors want to hear how to approach Japan's equities now, and we believe an active approach presents the best prospects.**

### Sector composition

Various MSCI benchmarks, 2023



Source: BlackRock. 31 Oct. 2023. Chart shows GICS sector composition in MSCI US (US), MSCI EU(Europe), MSCI World ex US(DM ex US), MSCI Japan(Japan). Sectors shown should not be deemed as a recommendations to buy or sell in those specific sectors. Numbers may not add up to 100% due to rounding.

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Yes, about a year and a half ago conversations about Japan focused on major macro and corporate shifts underpinning equity market opportunities. Index and exchange traded funds were easy, cost-effective ways to gain exposure, and indeed passive flows squeezed much return over the ensuing months. The conversation has evolved into what's next and how to invest in Japanese equities going forward.

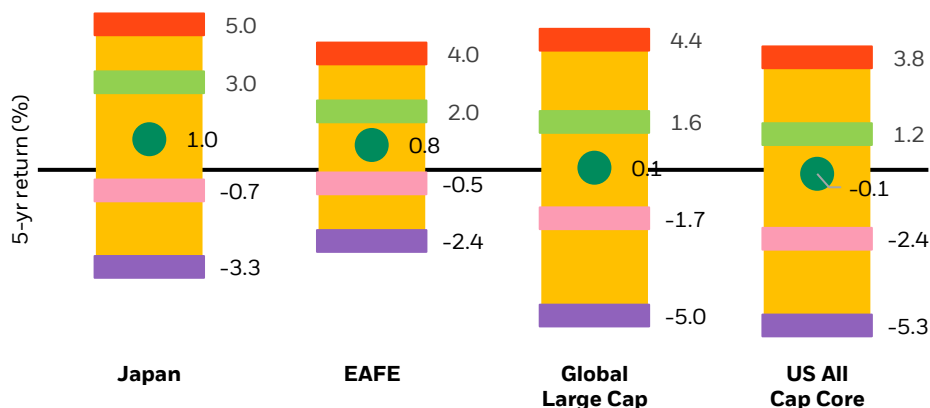
The next leg won't be as easy and will be more nuanced, in our view. We see greater return dispersion from idiosyncratic factors, and investment opportunities more attuned with an active approach, especially if you have boots on the ground. Japan's equity market inefficiencies offer potential for alpha generation, more so in the small-to-mid capitalization arena. About half the companies in the investment universe report in Japanese only. Also, many CEOs are passing on the baton, seeding uncertainty about their companies' future. We can't overstate the value of face-to-face meetings in formulating an investment case beyond financial analysis.

Investing tactically in Japan has resulted in excess returns above those associated with broader mandates representing indices such as EAFE, Global Large Cap and U.S. All Cap Core. The 25<sup>th</sup> percentile in Japan produced 3% annualized alpha over the past five years, through December 2023. See the chart below. Japan's higher alpha scores are unusual for a single country exposure given the ample allocation levers afforded to broader universes. This is worth looking into because the same story applies for returns over the 10-year period. A word of caution about Japan's equities: the opportunities for alpha generation have for years bounced around based on style factors, such as value or growth. A flexible active approach can increase the odds of consistent top-ranked performance, in our view.

The chart on the left shows the relatively more balanced sector composition of a Japan equity benchmark relative to other regions. We believe this underscores the breadth of opportunity for active managers to generate alpha in Japan's equity market and may contribute to diversify industry exposure in global portfolios.

### It pays to be active in Japan

Range of excess returns versus benchmark, 2019 - 2023



— Top 5%tile — Top 25%tile ● Median funds — Bottom 25%tile — Bottom 5%tile

Source: eVestment, BlackRock, as of 31 Dec. 2023. The chart's range focuses on the excess returns of funds, ranging from the top 5% tile to the bottom 5% tile in each category. The black line represents the respective benchmarks (0% excess return). The median represents the result at the 50% tile.

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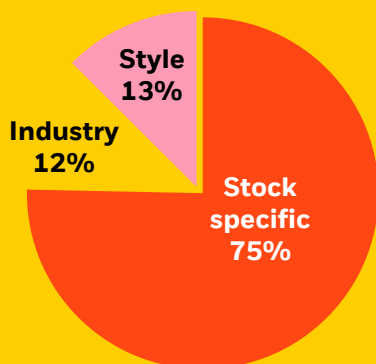
## Q

### How does your team seek to generate alpha in Japanese equities?

We apply an active flexible approach and run high conviction portfolios that we calibrate based on a range of dimensions to complement our bottom-up selection, which represents most of the risk budget in the portfolios.

#### Stock pickers

Active risk contributions



Source: BlackRock as of 29 Mar. 2024. For illustrative purposes only. Active risk of a representative Japan large cap equity mandate.

## A

Our portfolios change dynamically based on our highest conviction ideas seeking to generate investment returns and maintain high information ratios. Bottom-up selection is the cornerstone of our process and by far the main alpha source. The portfolio mix and relative position size matter. We may sell or reduce holdings of a well-managed company that we like to increase something else, based on multidimensional analyses of the portfolio and market conditions.

Flexibility and breadth are core to our approach. Style factors frustrated many investors with a value or growth bias as leadership changes occurred frequently in the past several quarters. If adding alpha is the goal, style flexibility has paid off and the characteristic is built into our investment process. But style leadership is just one dimension of our flexible approach. We regularly stress test<sup>1</sup> our bottom-up assumptions across multiple dimensions and dynamically adjust portfolios accordingly. What could alter the mix?

#### Relative style positions

Bottom-up stock picking may lead to unintended overweight/underweight positions in style factors. Adjusting certain positions to balance portfolios and avoid unintended risks has helped us generate alpha more consistently.

#### Relative valuations

We seek to spot price mismatches between the market and our estimation of a stock price potential. When the gap fades and the stock reaches our target price, we seek to substitute for a better valued alternative, unless we reassess a new target price.

#### Style factors

Changes in style factor leadership happen frequently in Japan's stock market, but they're always unannounced. Value stocks outperformed during most of the rally in 2023. Marginal portfolio shifts on perceived pivots help us manage upside/downside risks.

#### Macro catalysts

Banks and other rate-sensitive sectors could raise their appeal for equity investors upon a rate hike that impacts their margins. Changes in rate differentials alters the yen exchange equation, impacting exporters vs. domestic-focused companies differently.

#### Relative earnings trends

We seek return opportunities based on earnings of domestic and overseas sources, accounting for FX effects, as well as local or global trends that may create or alter the relative earnings prospects across sectors.

#### Macro policy decisions

Having a view on potential policy decisions, such as rate policy by the Bank of Japan in relation to how stock prices are reflecting or not the magnitude and direction of such views. Our firm's expertise in local and global fixed income can provide an edge.

1. Stress test results illustrate impact of a fund's baseline allocation (against the secondary benchmark) during different market conditions. There is no guarantee that stress testing will eliminate the risk of investing in a fund or strategy.

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## Q

### As active investors, how do you see the current and future opportunity set in Japan?

We see strong revenue and earnings growth prospects for many Japanese companies and are re-evaluating our investment cases in the pursuit of potential alpha opportunities.

#### Possible macro headwinds

Our mostly benign outlook sees Japan at a pivotal point, predicated on fundamental/structural drivers, including corporate reforms, and on inflation supporting a virtuous cycle of wage growth consumption and investment and positive earnings growth.

Two perceived headwinds in the near-term may be a potential policy mistake by the BoJ as it aims toward policy normalization, and continued U.S. dollar strength versus the yen. Both issues stem primarily from rate differentials, which we believe shift the uncertainties to when rather than if the gap will narrow.

Alongside Japan's structural story, we see geopolitics as possibly the most persistent future headwind. But this is a global, not a Japan-specific issue. We believe Japan is well positioned to benefit from investment opportunities that partly arise from the situation, such as we discuss on the right.

## A

Japan's macro and micro backdrop is as strong as it has been in years. Decades of deflation removed incentives for business investment and companies built huge cash piles while economic growth stagnated. That is no longer the case. The economy is expanding, and capex is now at all time highs.<sup>1</sup> Key triggers include the fear of profit margin erosion under the inflationary equilibrium and the will to boost competitiveness that has brewed for some time. We see Japan's corporate reforms moving from aspirational and nice-to-have to crucial for survival.

This year, the Tokyo Stock Exchange tightened rules on listed companies, urging monthly disclosure on value-creation plans, such as increased dividend payouts, share buybacks, merger and acquisitions and capital spending plans. Today's capital efficiency mindset seems more pervasive than ever before. And because the culture is prone to peer pressure, firms happy with the status quo may find themselves in the minority. Traditional cross-shareholdings are unwinding fast, and past critics of Japan's corporate governance are more open to reassessing.

We regard the impressive beta returns of the past year and half as largely behind and expect greater dispersion in the future due to idiosyncratic fundamentals. We don't see a possible further depreciation of the yen as a great call to buy Japan's stock market, but believe in a structural, broad-based reform story that resonate with global themes that may persist for years and possibly decades, including:

**Semiconductor industry revival** – Chip makers and the broader ecosystem required to deliver on the AI revolution and supply chain revival.

**Electric vehicles** – Battery makers and growing demand for hybrid vehicles in which Japanese companies possess strong competitive advantages.

**Decarbonization** – Japan produces efficient and reliable equipment that can help reduce the footprint of harmful gas emissions.

**Factory automation** – Japan is frontrunning the global demographic challenge, and its advances in robotics and automation are in high-demand globally.

**Digital transformation** – Digital monitoring/controls touch on modernization across industries, and Japan's health care industry applications standout.

We believe Japan's new inflationary equilibrium underscores the need for alpha-seeking strategies to exercise greater flexibility at the portfolio level, and in-depth reevaluation at the stock level.

1. Japan Cabinet Office, as of Q1 2024 Quarterly Survey of Corporations.

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