Japan Macro and Investment Perspectives: Part II

The Thinking Man's Approach

April 2024 | Series #100

Rene Negron | *Analyst*

- In spite of the appreciation in Japanese equities over the last couple of years , relative valuations remain attractive
- Relative weighting of Japan and US equity markets relative to global market cap is at historical extremes
- Momentum from reputable investor base deploying capital into Japan continues
- Corporate governance reforms continue to gain traction and are essential for creating a more shareholder friendly market
- Lack of sector and market concentration of the Japanese equity market is more attractive than in the US
- End of YCC / NIRP is a net positive as healthy inflation is accretive to corporate earnings (i.e. margin expansion) and wage inflation is constructive for domestic consumption

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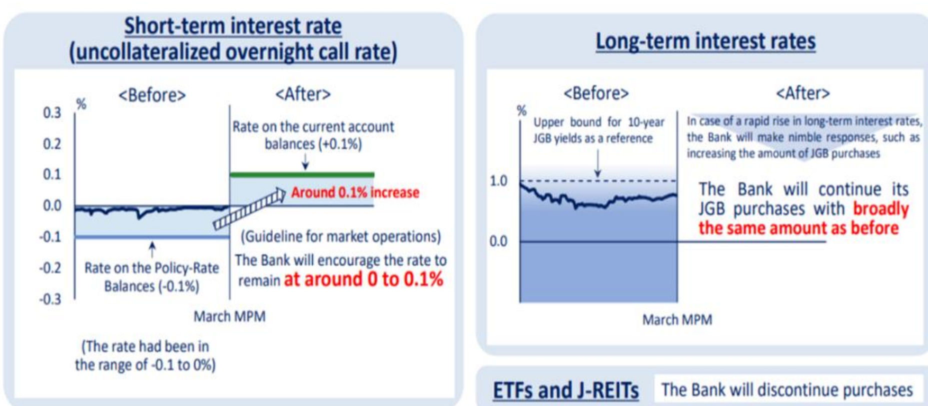
This edition of our Thinking Man series is a follow-up to our publication in October 2023 which made the case for long-term investment into Japanese equities. Since publishing our bull case, a lot has happened on the macro front:

1. Japan slipped in and out of a technical recession after the initially negative Q4 2024 GDP print was revised from negative to positive growth;

2. At the Shunto spring wage negotiations, Japanese unions were successful in negotiating near all-time high levels of wage increases;

3. The Bank of Japan (BoJ) formally exited its NIRP, or Negative Interest Rate Policy, representing the first rate hike in 17 years, and the end of an era where the BoJ sought to combat chronic deflation with ultra-easy monetary policy;

4. The Bank of Japan formally ended its policy of YCC, or Yield Curve Control, whereby it kept long yields below 1% by purchasing government bonds. Though the BoJ will continue to buy government bonds at a similar pace, it is no longer formally committed to keeping long yields below 1%.



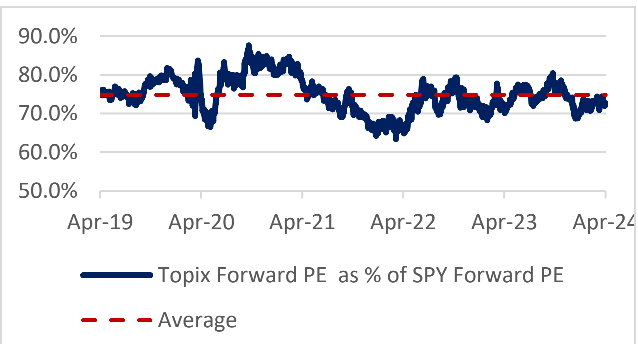
Source: Goldman Sachs GIR

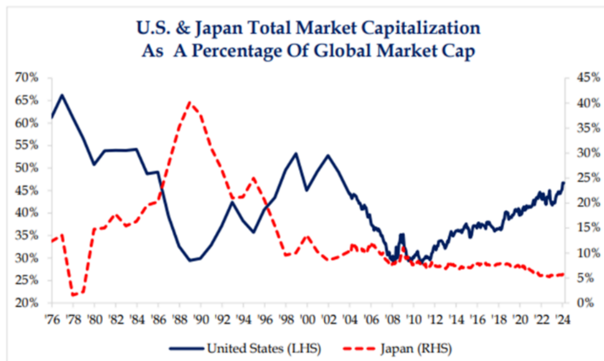
As we enter this new era where all major developed economies in the world have positive policy rates, we think it worthwhile to revisit the key themes that are central to our continued long thesis in Japan. We will also discuss how we would anticipate the end of NIRP / YCC affecting U.S. fixed income (given that Japanese buyers are among the largest owners/buyers of US Treasuries and corporate bonds.)

US / Japan Relative Performance & Fundamentals

Since our last publication, **the TOPIX has returned 23% in local currency terms, and 21% in U.S. dollars** (as of the writing of this note). Over the last three years, the TOPIX has returned 76% in local currency terms, and 40% in U.S. dollars (given that the divergence in Japanese and U.S. monetary policy caused the Yen to weaken by ~50% against USD.) Additionally, over the last year, the MSCI Japan Value Index has outperformed the MSCI Japan Growth Index, in contrast to the U.S. where growth has dramatically outperformed value.

The U.S. total market capitalization now represents more than half of global market capitalization, while Japan, in spite of its recent run-up, still only represents a mere 5%. This is in stark contrast to the late 80's where the US and Japan's market cap represented 30% and 40% of global market cap, respectively. Additionally, while the U.S.'s market cap weighting (+50%) is about twice its GDP weighting (+25%), Japan's market cap weighting is roughly equal to its GDP weighting (both ~5%). All of this to say that, in spite of Japan's recent run, relative fundamentals are still supportive. Forward PE ratios still trade at meaningful spreads — 21x in the US vs. 15x in Japan, or a difference of ~30%, which is roughly in line with the average discount over the last five years. We continue to believe that now is as good a time as ever for that delta to narrow.





Source: FactSet, Strategas

Return of "healthy" inflation

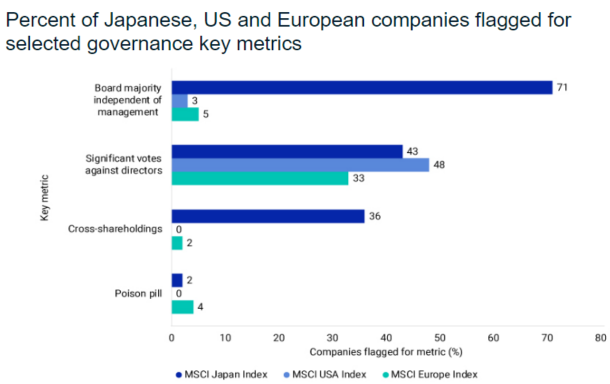
Higher prices are pointing towards higher corporate operating margins. Higher wages are translating to more consumer buying power (in spite of yen weakening leading to lower purchasing power parity on imported goods) and higher prices as companies maintain margins. A historically weak yen is resulting in more profits for Japanese multinationals with overseas revenues (which in the case of Japan's export dominant economy are significant). The end result is an opportunity for a virtuous cycle of sustained earnings growth. For reference, consensus estimates expect high single digit/low double digit earnings growth for 2024 /2025.

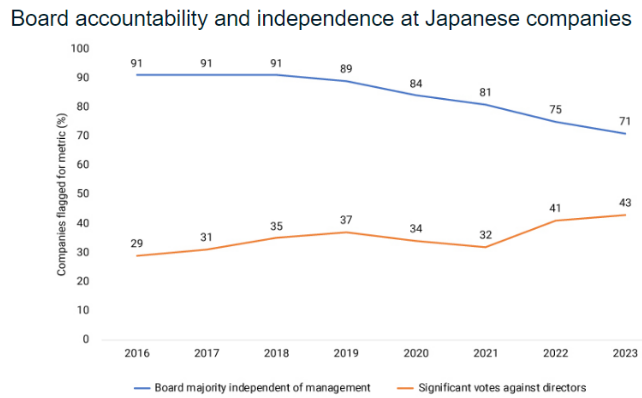
However, given that JPY/USD is trading near all-time highs (i.e. a weak yen), currency at this point likely represents a headwind, at least from the perspective of Japanese companies repatriating overseas profits at favorable exchange rates. On the other hand, as Japanese and US monetary policy begins to converge (i.e. BoJ hiking while Fed cutting) equity investments that are unhedged (i.e. long yen) should outperform. All other factors remain tailwinds: Shunto wage negotiations were just completed in March meaning that demand-pull inflation still has room to run, and margin expansion is only now beginning to materialize.

Continued implementation of capital markets & governance reforms

Companies are continuing to spend their large cash hoards on capex, R&D, buybacks, dividends, and/or higher wages in order to avoid being delisted. More efficient capital allocation reduces cash drag on corporate valuations and over time should close market value discounts to book value.

An increased focus on ROE (return on equity), leverage, and operating margins, is still in the early innings. Additionally, governance changes which are driving improved board member independence, decreases in cross-shareholdings, and increases in shareholder engagement are all finally gaining significant momentum, which all point to a more shareholder friendly backdrop for investors.



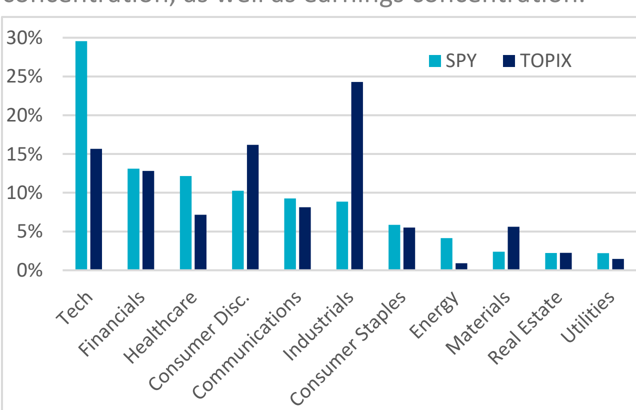


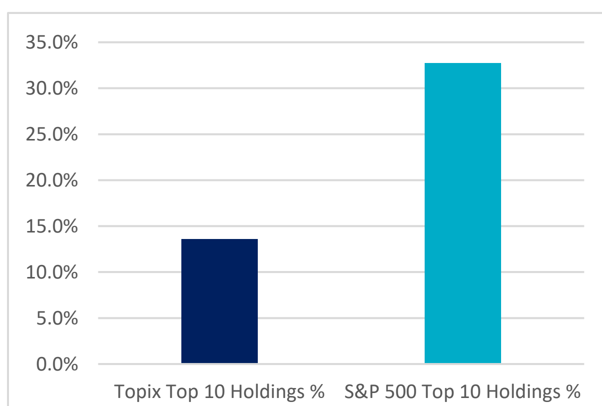
Source: MSCI

Favorable investor momentum & market composition / concentration

Reputed investment firms (i.e. Berkshire Hathaway, KKR, and others) continue to take large strategic positions in both private and public Japanese markets. This has created broader investor interest, driven particularly by the gap in Japanese valuations vs. other potentially overextended developed markets.

Additionally, with US and European markets at all-time high levels of sector concentration (i.e. tech) and company concentration (i.e. Mag7) Japan offers more diversified exposure to a number of high quality companies in more value-oriented sectors. This applies both at the level of market capitalization concentration, as well as earnings concentration.



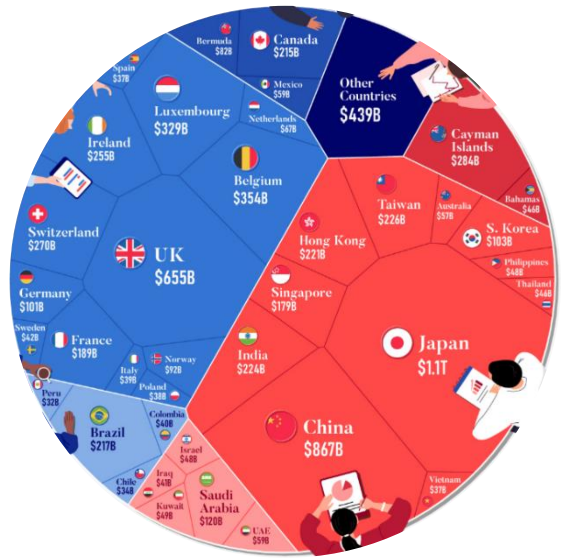


Source: Factset

Effect of rising Japanese interest rates on U.S. interest rates

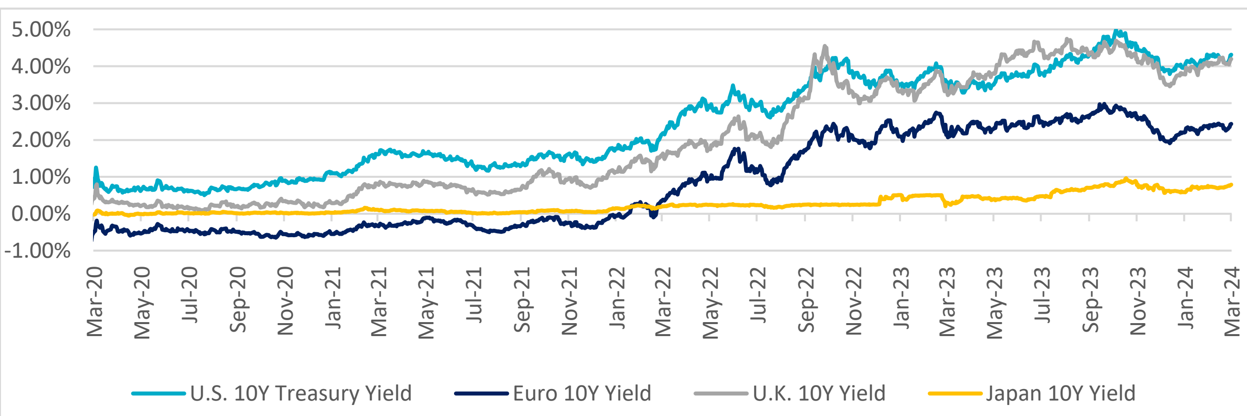
One topic which has been widely discussed in the financial news media is how higher interest rates in Japan will affect interest rates in other developed economies, particularly in the US. The thinking goes that Japanese buyers of US Treasuries were a significant source of US Treasury demand over Japans 30+ year deflationary cycle. With that cycle now coming to a close, and with higher home country yields, Japanese investors may pull that demand for US Treasuries, resulting in upwards pressure on US yields.

Foreign Holdings of US Treasuries



Source: Visual Capitalist

As of now, we are of the view that that the effect of modestly higher yields in Japan on US fixed income will be relatively muted. This is because 1) though Japan is the largest foreign owner of US Treasuries, at $1.1 trillion this still only represents 3.2% of total US debt, which currently stands at $34.6 trillion. And 2) even though Japanese yields are set to rise, the interest rate differential between Japanese government bonds and US Treasuries, remains very wide. Consequently, Japanese buyers will only be marginally inclined to put money to work in Japan vs. in the U.S. Additionally, since we continue to believe that the Fed will have to hold rates higher for longer than what the market currently anticipates, we see this spread remaining wide for the foreseeable future. As the Fed begins to cut rates, and long-term Japanese yields begin to creep upwards (i.e. as these two sovereign yields converge) we will surely have to revisit this view, but as of now we continue to believe long US yields will remain between 4-5% for at least the next year.



Source: Factset

In conclusion, we would take the opportunity to increase Japanese equity exposure on any weakness, particularly in unhedged exposure which would benefit from an eventual strengthening in the yen.

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BigSur Wealth Management, LLC
1441 Brickell Avenue, Suite 1410
Miami, FL 33131
Office (Main): 305-740-6777
Fax: 305-350-9998
http://www.bigsurpartners.com