

Strategist View

LDP leadership election: Implications for Japan equities and overseas investor interest

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The Liberal Democratic Party (LDP) held its election to appoint a new leader on 29 September, choosing Mr. Fumio Kishida, former Foreign Minister and LDP Policy Chief, as the new party president. Expectations for the incoming cabinet have underpinned the Japanese stock market's strength since early September up until the very day when the Japanese market followed the global stock markets into a sharp sell-off amid fears of an accelerated rise in the interest rates and concerns about the US government debt ceiling. This report examines trends in Japanese stocks and global investor interest in the wake of this leadership election.

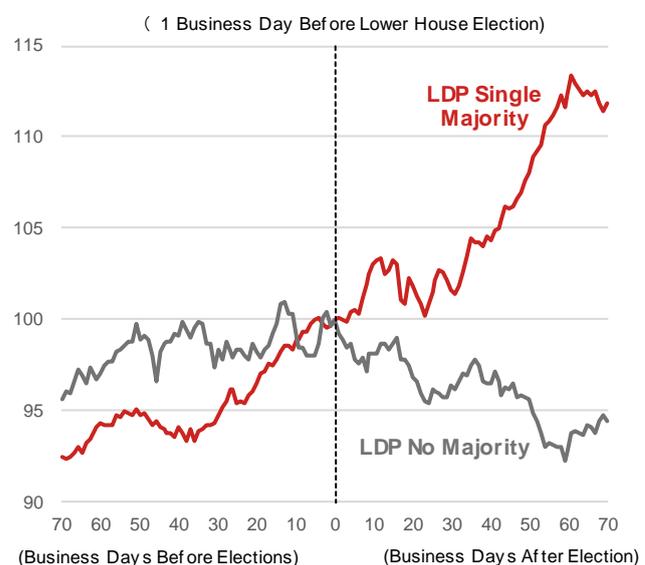
Near-term focus will be the House of Representatives election

With the LDP presidential poll decided, the market's attention is likely to shift to the ensuing cabinet reshuffle and the upcoming House of Representatives (Lower House) parliamentary election. The number of seats secured by the ruling Liberal Democratic Party will be a key factor in the House of Representatives election, as it could influence the ability of the new Cabinet to pass and implement its policies.

Since 2007, there have been seven changes of prime minister, and in each case, initial approval ratings for the incoming cabinet increased from that of the outgoing cabinet, rising by an average of about 37% points (see

"Japanese Equity Market Outlook: Suga Makes Way for a New Prime Minister" released on 7 September, 2021). From this perspective, the new cabinet is likely to enter the lower house election later this year with a high approval rating. Moreover, given the rising popular support for the LDP in recent opinion polls, the likelihood of a single-party majority in the House of Representatives election is increasing. Looking at developments in the Tokyo Stock Price Index (TOPIX) before and after the previous 10 House of Representatives elections, when the Liberal Democratic Party won a majority, stock prices remained on an upward trend after the House of Representatives elections (Fig. 1). Japanese stocks have been on an upward trend lately reflecting such expectations; but in fact, if the government secures an unqualified majority, then this reappraisal of Japanese stocks could continue based on positive expectations for the new cabinet's ability to implement policies.

Figure 1. TOPIX movement before and after the House of Representatives election



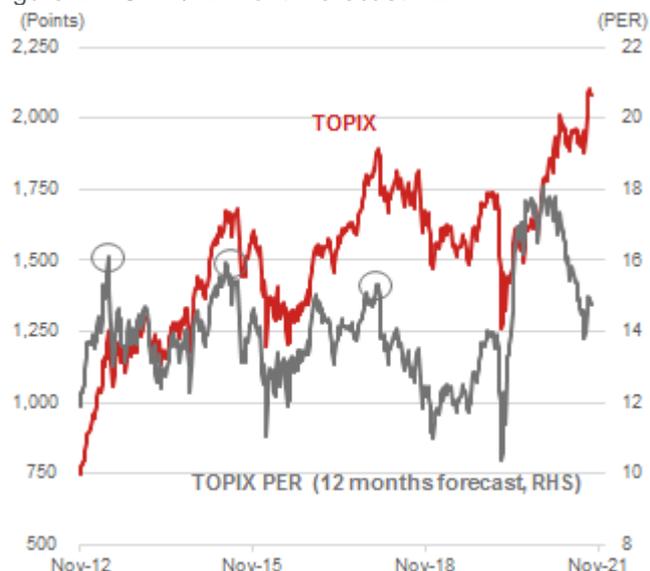
Period: 70 business days before and after the House of Representatives election
 A total of 10 House of Representatives elections have been held since the bursting of the bubble economy in 1990. The movements of TOPIX for the five times when there was a single majority and the five times when there was no majority were indexed and averaged setting the business day before the election as 100.

Source: Nomura Asset Management, Bloomberg

Room for possible reevaluation in terms of business performance

These welcome political developments could also help to keep a positive spotlight on the Japanese equity market. The 12-month forward P/E ratio does not appear to be overheated compared with previous highs in the TOPIX index, and this suggests there may be more room for upside in Japanese equities from a business earnings perspective. Prior to the Covid-19 pandemic, when the TOPIX P/E ratio rose from around 15 to around the 16 level, the stock price temporarily peaked before a period of price weakness. Recently, the market has remained close to the 14.8 level (Figure 2). In the short term, there is a possibility that the trend towards assessing Japanese stocks from the perspective of corporate performance will continue.

Figure 2. TOPIX/12 month forecast PER



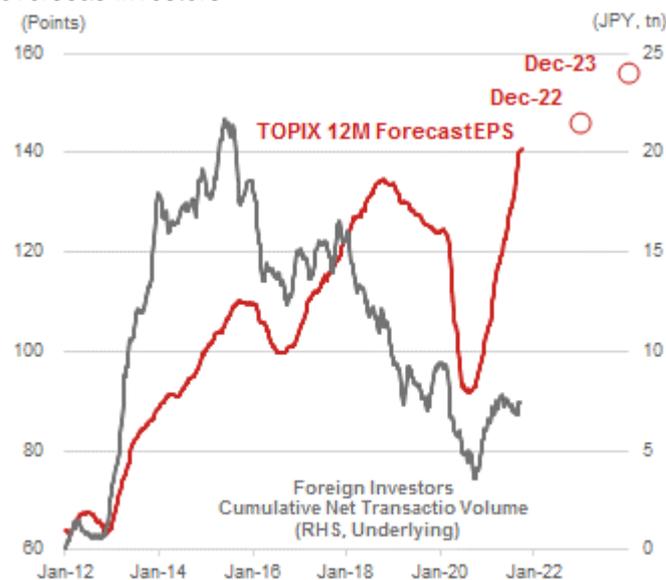
Period: November 16, 2012 (start of Abenomics market) - September 28, 2021.

What are the long-term issues for Japanese stocks?

However, the Japanese stock market's upside could be limited if it depends solely on expectations of the new cabinet. From a longer-term perspective, the prospects for overseas investors matter, since they are now among the largest holders of Japanese stocks by value. Since the launch of the Abenomics policy program in November 2012, foreign investors remained net buyers against the backdrop of expectations that Japan could overcome deflation and show progress in corporate governance reforms. However, since 2015, foreign investors have been reducing their holdings, and in recent years, new investments in Japanese stocks have been limited despite the improving earnings performance of Japan's corporate sector (Figure 3).

One reason for this has been the fact that return on equity (ROE) of Japanese stocks remains low relative to other developed markets. During the period from 2012 to 2015, when the ROE gap between Japanese stocks and stocks in other developed countries narrowed, buying interest among foreign investors who appreciated the improvement in profitability gained momentum. This has not been sustained in recent years as the ROE gap has widened again. Therefore, from a longer-term perspective, the crucial issue for Japanese stocks is how to boost corporate profitability.

Figure 3. TOPIX 12-month forecast EPS and net sales by overseas investors



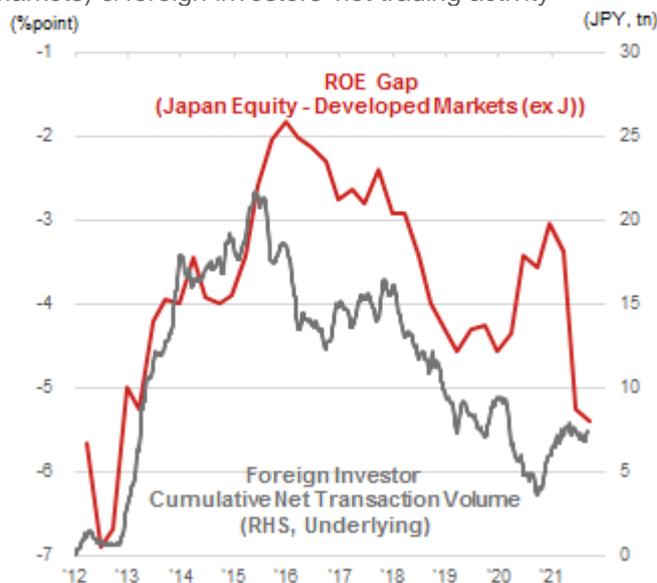
Period: (Forecast EPS) January 6, 2012 to September 28, 2021, weekly (Cumulative Net Transaction Volume) 1st week 1 of January 2012 to 3rd week of September 2021, weekly (EPS circled marks for Dec-22 and Dec-23) Bloomberg estimates
Source: Nomura Asset Management, Bloomberg

Fortunately, one of the causes of the lagging ROE could also become one of the sources of renewed interest in the Japanese equity market. Japanese companies collectively hold huge amounts of cash and deposits (316 trillion yen* or approximately 2.87 trillion US dollars) on their balance sheets.

A new government with a more proactive economic agenda could introduce policies that encourage companies to make capital investments, increase research and development spending, or return retained earnings to shareholders. Such policies could encourage the more productive and effective use of surplus funds and improve the profitability of Japanese companies. In recent years, overseas investors have not held high expectations of Japanese companies, but their return to this market could be encouraged by corporate reform and new policy opportunities.

*Note: Bank of Japan, "Flow of Funds Statistics (as of June 30, 2021)" (including private non-financial corporations and unlisted companies)

Figure 4. ROE difference (Japan vs other developed markets) & foreign investors' net trading activity



Period: (ROE Gap) Q1 2012 – Q3 2021 (most recent is September 28), quarterly, (Cumulative Net Transaction Volume) 1st week of January 2012 to 3rd week of September 2021, weekly
 Japan equity: TOPIX, Developed markets: MSCI World Index
 Source: Nomura Asset Management, Bloomberg

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