Rediscovering Japan
with Nomura Asset Management

Andrew McCagg
Senior Client Portfolio Manager

Published July 2023

Japanese equities have been one of the top performers over the first half of 2023, gaining 22.69% in local currency terms through the end of June (TOPIX). As such, many investors have started to question whether they have missed their chance to participate in the market rally. However, there are several reasons to believe Japan still has significant upside, especially relative to other developed markets.

Robust Domestic Economy

While a large piece of Japan's upside is tied to the continued improvements in corporate governance and shareholder returns over the long term, there are also reasons to believe that Japan will have positive relative returns in the shorter term as well. Speculation over whether central banks need to induce a recession to tame inflation may be gaining speed, but the OECD Composite Leading Indicators by region in Chart 1 clearly show Japan is in a relatively stable position. Our GDP forecast in Chart 2 also calls for Japan to benefit from the continued domestic post-pandemic recovery to see quarter-on-quarter (q/q) growth throughout 2023, compared to expectations for US and Eurozone GDPs to contract q/q in the second half of the year. Looking ahead to 2024, we believe Japan's q/q GDP growth will remain higher than Europe and comparable to the US.

Chart 1: Regional Composite Leading Indicator

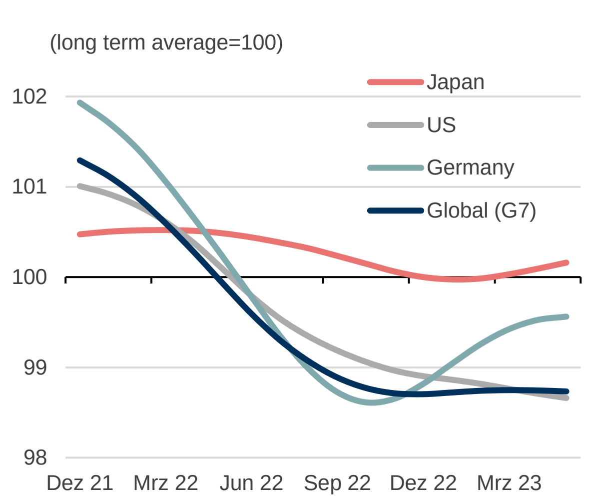
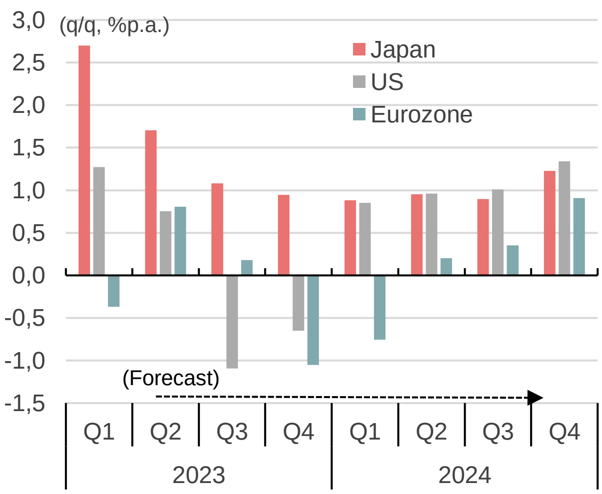


Chart 2: In-House GDP Forecast

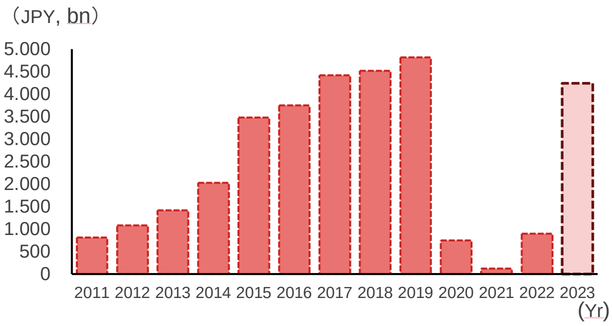


Source: Chart 1: OECD Composite Leading Indicator by region, September 2021 to May 2023, monthly. Chart 2t: Nomura Asset Management, Forecast for Q2 2023 and thereafter.

Tourism Boost

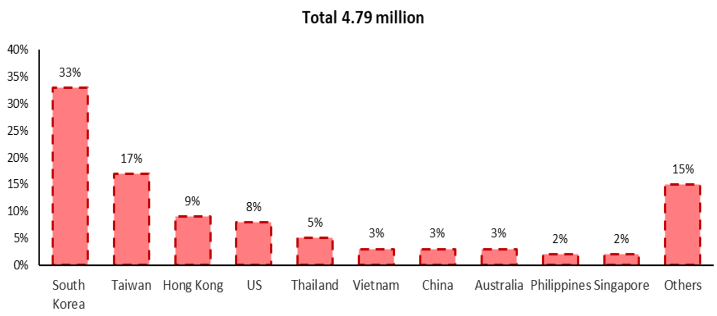
A full recovery in in-bound tourism is expected to drive Japan's continued domestic recovery going forward. Based on the January to March data provided by the Japan Tourism Agency and the Ministry of Economy, Trade and Industry, we forecast consumption by international visitors to have an economic impact of over 4.4 trillion JPY in 2023, which would amount to 0.8% of nominal GDP, as seen in Chart 3.

Chart 3: Inbound Spending & Economic Impact



	2019	2023*
Tourism consumption (JPY, bn)	4,814	4,241
↓		
Primary spillover effect	4,023	3,544
Secondary spillover effect	1,003	884
Total	5,026	4,428
% of nominal GDP	0.9	0.8

Chart 4: Visitors to Japan (Jan-Mar 2023)



*Source: Chart 3 Top: Nomura Asset Management based on Japan Tourism Agency. As of March 2023. Bottom: Nomura Asset Management based on the Ministry of Economy, Trade and Industry's analysis data. *Estimate using data as of March 2023. Chart 4: Japan National Tourism Organization*

Additionally, there is good reason to believe these estimates may be low, as the January-March data had minimal contribution from China. At the peak of inbound spending in 2019, Chinese visitors made up approximately one-third of the total visitors, and accounted for over 50% of the total consumption by inbound tourists. As Chart 4 shows, however, Chinese visitors comprised only 3% of the total visitors in Q1 due to country-specific border restrictions implemented by Japan in reaction to the abrupt end to China's zero-COVID policy. These restrictions have since been lifted as of the end of March, and a recovery in Chinese tourists to Japan could significantly raise the forecasts given above. Of course, even if the Chinese impact disappoints, the continued domestic recovery is still expected to help offset global recessionary concerns and keep Japan in a relatively favorable position over the next 12 months.

Improved Corporate Governance

Chart 5: Return to Shareholders

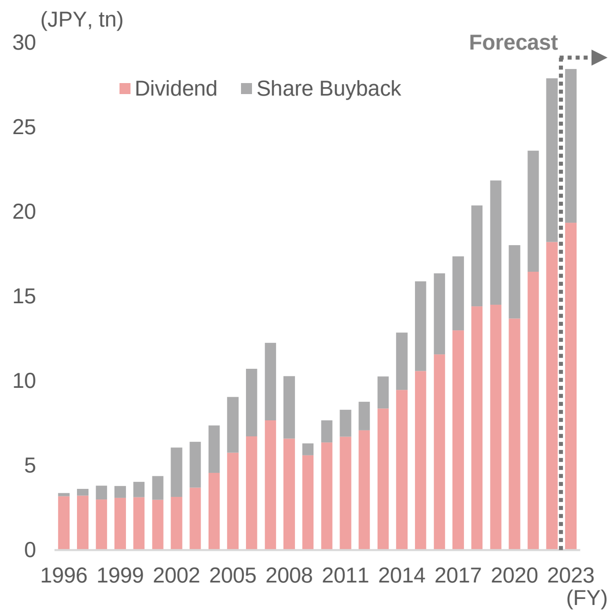
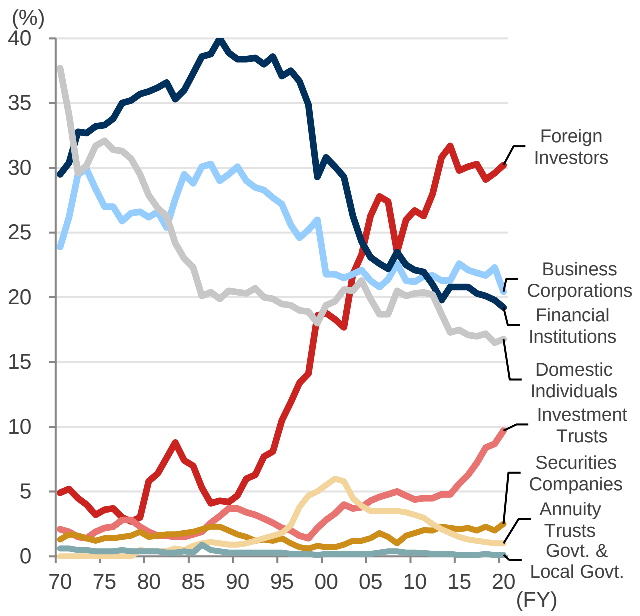


Chart 6: Investors' Shareholding at Market Value



Source: Chart 5 Nomura Asset Management based on Nomura Securities data. Nomura Asset Management based on Nomura Securities data. FY1996 - FY2023. For all listed companies' actual ordinary shares excluding preferred shares buybacks as well as shares purchased from the Resolution and Collection Corporation. Share buybacks and dividends for FY2023 are Nomura's forecast as of the end of June 2023. Chart 6: Note: FY1970 - FY2021. Financial institutions indicate financial stocks acknowledged by the TSE excluding investment trusts and pension funds. Source: NAM based on TSE "Share ownership Survey" data.

That being said, it's the longer term potential that truly makes the Japanese market so attractive, even after the year to date rally. Investors who have followed Japan closely over the years are likely tired of hearing about the changes in corporate governance and increased shareholder returns, but it's a story worth repeating here once again. As Chart 5 shows, shareholder returns have more than doubled in the last decade, increasing from approximately 10 trillion JPY in 2013 to approximately 25 trillion in 2022, but payout ratios in Japan remain in the 30% range compared to over 90% for companies listed on the S&P 500. Pessimists may see the fact that payout ratios remain low as a lack of real change because the increased shareholder return is more a reflection of improved earnings. However, the remaining high levels of cash and retained earnings are a strong basis for this trend of improved shareholder returns to continue.

Firstly, Japan's payout ratios may be low, but they have improved from the 20-25% range up to the 30-35% range over the last decade. Secondly, and perhaps more importantly, there is reason to believe this improving trend may accelerate going forward due to the trends in ownership of the market. Vocal investors who are looking to actively engage with companies, represented in Chart 6 by foreign investors and investment trusts, have increased their market share to approximately 40%, while silent, cross-shareholders represented by business corporations and financial institutions (banks) have fallen significantly to also reach approximately 40% in total. We believe we are at a tipping point where the effectiveness of engagement by investors may increase and help accelerate the improvements in payout ratios and drive the continued rise in shareholder returns.

TSE Pressure

In addition to increased pressure from shareholders, the Tokyo Stock Exchange (TSE) recently announced aims to change the thought process of management with regard to cost of capital considerations, requiring companies trading below book to disclose business plans for how they might achieve a return on invested capital that exceeds their cost of capital in the future. The ultimate goals of the TSE are:

1. For Japanese management to improve their awareness of the cost of capital, and
2. For listed companies to function as publicly traded companies, by providing a risk premium.

While one-off responses to raise ROEs and by extension PBRs aren't the TSE's main objective, we are also encouraged by the number of companies that responded immediately in the form of dividend hikes or share buybacks, which has gotten shareholder returns off to a strong start in FY2023.

Again, this story of improving governance and shareholder returns has been repeated many times over the last decade, to a point where investors likely became bored. However, these changes are fundamental and game changing over the long term, and Warren Buffett's recent comments make it seem that these improvements only required a new spot light to increase awareness, shift the sentiment and allow investors to rediscover Japan.

One of Buffett's tenants has been to avoid investing in ABCs; or companies that are arrogant, bureaucratic, and complacent. Whether Japanese companies are arrogant may be in the eye of the beholder, but Japan has historically been very bureaucratic and complacent. And yet, despite being a market full of ABC companies in the past, if Buffett can see Japanese companies are changing enough to invest in, perhaps this time really is different.

Disclosure

This document is for information purposes only. The evaluations presented in this document are based on information from various sources which are considered to be trustworthy by Nomura Asset Management Europe KVG mbH (collectively with other group companies "Nomura"). No guarantee is given in relation to the accuracy, completeness or currentness of the information, calculations and forecasts. Nomura does not accept liability for any loss, damage, cost or expense resulting from the use of or reliance on the document or other written or verbal notices and information by the recipient, including his/her executive bodies, employees, advisors or representatives or other entities. All forecasts and calculations (or statistical evaluations) are for explanatory purposes only. They are dependent upon evaluations, models and historical data, as well as interpretation by Nomura. The forecasts and calculations are based on subjective estimates and assumptions and do not constitute a prediction of future developments, and should not be construed to mean that the occurrence of one possible future result is more likely than the occurrence of another possible future result.

The content of this document is considered as minor non-monetary benefit in the meaning of MiFID II and not to be construed as legal, business or tax advice or as a recommendation of any kind.

Performance in the past is no guarantee of future success.

The opinions of and statements from Nomura contained in this document represent the current assessment at the time of publication and may change at any time without advance notice.

July 2023
Nomura Asset Management Europe KVG mbH