What's Hot: Corporate governance reforms are working for Japan

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Japan1 is trading at a 33-year high, despite a challenging global macro backdrop. At 15x forward Price to Earnings (P/E) ratio, Japan has been trading at a valuation discount versus global peers, for a considerable period of time. We are finally starting to see a number of catalysts help narrow the wide valuation gap versus global peers – an improvement in corporate governance, rebound in domestic consumption post the pandemic, strong earnings results in FY3/23 and a weaker yen. This has led to a notable influx of overseas investor capital into Japanese stocks for 8 weeks in a row.

This rally was initially stoked by Warren Buffet publicly investing in Japan's five leading trading companies. Berkshire Hathaway, Warren Buffets industrial and insurance conglomerate also said it intended to hold onto the investments for the long haul and could increase the size of its holdings to as much as 9.9%.

The Japanese equity rally has also been fuelled further by a combination of strong macro-economic data and solid earnings results which saw ¥5Trn in buyback announcements. On the macro front, the re-opening driven rebound in domestic demand is supporting the economy.

Recovery in Travel demand boosts business confidence

According to data on travel and tourism from the Japan Tourism Agency (JTA), spending on domestic travel reached ¥4.2Trn in Jan- March 2023, surpassing pre-pandemic levels slightly. The rapid recovery in inbound consumption is also a tailwind with the number of visitors to Japan in April back up to 73% of the 2019 average. Strong travel demand is supportive for business confidence. In tandem, the May services Purchasing Managers Index (PMI) reached its highest level since the survey began in 2007. This is consistent with trends in consumer sentiment evident from the May consumer confidence survey which showed an improvement in the consumer confidence index for the third month in a row2.

Rebound in domestic demand aids growth

According to preliminary estimates, GDP in Jan-Mar Calendar Year (CY)23 grew by 0.4% following two quarters of negative growth3. The main driver was private second demand, with consumption rising 0.6% and capex up 0.9% quarter on quarter (QoQ)3. Even public investment, which has been weak for a while, rose 2.4% QoQ contributing 0.1% to GDP growth. On the flipside external demand, highlighted in the export trade data, contracted 4.2%, dragging down headline GDP growth by 0.9%. While inbound spending, classified as services exports in the GDP statistics, increased 5.6% QoQ, goods exports contracted 6.5%3.

Fast forward through years of deflation, inflation is beginning to trend higher. Inflation triggered by structural labour shortages is forcing companies to raise wages meaningfully and re-think their pricing strategy. So, while the rest of the world is battling inflation fires, Japan is trying to ignite one. However, the most recent inflation print in May showed a surprising slowdown in Tokyo core price gains. Slower inflation is good news for households, which are spending more as the economy re-opens. It also gives further ammunition for the Bank of Japan (BOJ) to maintain its stance on ultra loose monetary policy.

Source: Bloomberg, Ministry of Internal Affairs and Communications, WisdomTree as of 31 May 2023.

Historical performance is not an indication of future performance and any investments may go down in value.

BOJ governor Kazuo Ueda acknowledges that Japan's economy continues to require significant stimulus to maintain a goal of stable demand-driven 2% inflation. Owing to which, we have seen the Japanese Yen decline 5.51%4 versus the US dollar. This in turn has made Japanese exports cheaper aiding Japanese export companies.

Source: Bloomberg, WisdomTree as of 2 June 2023.

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The myth that Japanese companies do not reward shareholders has been dispelled now

Japan's Fiscal Year 31 March 2023 earnings season witnessed results that were resilient overall. What stood out was the large increase in the number of share buyback announcements ¥5Trn. This was not a consequence of profit growth alone but more likely a result of the changes of the Tokyo Stock Exchange's (TSE) Price/Book (P/B) criteria as discussed here. Share buybacks have attracted foreign investors and is providing an important tailwind for Japanese equities.

Source: Factset, WisdomTree as of 31 May 2023.

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Corporate governance reform has been a thematic in Japan for seven years. However, this time we are seeing reform make breakthroughs. We got early indications from the mini-March annual shareholder meeting that showed Japanese investors voting more actively at AGMs. The next major catalyst will be the June AGM season. In regard to the potential impact to the new TSE guidelines on Japanese companies, feedback initially was mixed. However, we have seen 15%+ moves on the day of reform announcements by Japanese companies which confirms the market is clearly rewarding companies that are being proactive.

Solid earnings results provide a tailwind for Japanese equities

Japan's Fiscal Year 31 March 2023 earnings results were resilient highlighting sales growth 16.4% YoY and 2% in net profits YoY5. The sectors that guided for the highest earnings growth in Fiscal Year 31 March

2024 are the ones that benefit from lower materials prices, namely electric power & gas, pulp & paper, and glass & ceramics. The domestic demand-led sectors are posed to benefit from reopening and inbound tourism, including land transportation, retail, and financial. They also issued the next strongest earnings guidance.

1 Tracked by the Nikkei 225 Index as of 31 May 2023

2 Bloomberg as of 31 May 2023

3 Japan Cabinet Office as of 17 May 2023

4 Bloomberg from 31 December 2022 to 2 June 2023

5 Source: Factset, WisdomTree as of 31 May 2023

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