Firepower abounds for Japanese equities

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Aneeka Gupta
Director, Macroeconomic Research

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Japanese equities ended 2023 on a high note. Japan's post pandemic re-opening, accommodative monetary stance, high equity risk premiums and improving corporate governance reforms were important tailwinds for Japanese equities in 2023.

Over the last 12 months Japan has benefited from global investor inflows who are diversifying their investments in Asia, with geopolitical tensions and sluggish growth causing a rotation from China to Japan. There are several catalysts in place to fuel Japan's equity market rally:

1) Increasing capex & higher wage growth
2) Revamping the Nippon Individual Savings Account (NISA)
3) Corporate Japan's ongoing reform initiatives

Capex outlook bolstered by manufacturers

The end of deflation is a catalyst unique to Japan. The Bank of Japan's (BOJ) December Tankan survey indicates manufacturers will continue to boost capex in fiscal 2024 to prepare for the next growth cycle. Manufacturers plan to increase capex in fiscal 2024 by 14.6%[2]. Higher cash holdings for Japanese corporates and labour shortages are important incentives to invest in automation over the long run. Japan is at a demographic crossroads. The employment conditions diffusion index (DI) highlights Japan's labour shortage to be the worst in 30 years[3]. To compensate, companies will need to invest in improving productivity.

Demographics driving wage inflation

At the same time, waning labour supply owing to an aging population is likely to bring back wage growth. The spring wage growth negotiations in 2023 drove wages up by 3.6%[4] (the highest level in 30 years) and 2024 could see a further rise. Demand continues to increase in healthcare and social welfare owing to increasing domestic demand. Strong wage growth remains the key to the sustainability of inflation and inflation is likely to influence investors choice of asset allocations. As long as Japanese equities continue to benefit from inflation, we believe it would be natural for funds to increasingly flow into Japanese equities.

Japan's savings to investment drive

Japan is transforming into an asset management led nation under the leadership of Prime Minister Kishida. In an effort to unlock nearly US$14Trn of household financial assets tied up in cash deposits, Japanese leaders are embarking upon reforms, like the introduction of 401(k)s in the US back in the 1970s. This is

being done with the introduction of a revised Nippon Individual Savings Account “NISA” program offering tax benefits and portability. Starting in 2024 maximum investment amounts allowed under NISA have been increased and investors can enjoy the system’s tax benefits permanently.

Source: Japan Financial Services Agency (FSA), WisdomTree as of 31 December 2023. The Tsumitate NISA is a tax-efficient investment account designed for monthly investments into Japanese-domiciled mutual funds

Japan’s wave of reform

Corporate Japan’s ongoing reform initiatives, which include the Tokyo Stock Exchange’s (TSE) March 2023 announcement dubbed the “Price to Book (PBR) Guideline”, discussed here had a strong impact on companies. This was evident from the immediate rise in payout ratios following the announcements. By the end of January, the TSE plans to provide a list of companies that have either disclosed capital efficiency measures or have such measures under consideration. There is a strong likelihood that companies ‘under consideration’ could surprise on the upside with capital return announcements in the upcoming results season.

Source: Factset, WisdomTree as of 31 December 2023. Historical performance is not an indication of future performance and any investments may go down in value.

Japan continues to deliver strong earnings results

Japan’s economy has continued to recover, and we expect the economy to withstand the modest slowdown in global growth. Japanese equities are testing 34-year highs in 2024, bolstered by 2Q FY3/24 earnings results. Net income for Japanese equities came in 6.2% ahead of consensus, with beats concentrated in domestic-oriented sectors including utilities & food/household products[5]. Corporate reforms had a significant impact on chemicals and auto parts sectors. Japan’s earnings revision breadth remains in positive territory in contrast to earnings trends in China and Europe. Positive earnings revisions alongside a structural trend to rising return on equity (ROE) is supporting Japan’s equity outperformance versus the rest of the world.

Source: Factset, WisdomTree as of 31 December 2023. Historical performance is not an indication of future performance and any investments may go down in value.

Monetary policy likely to stay on hold until Q2

An important concern in 2024 remains the path of monetary policy by the BOJ, its impact on the yen and the repercussions for Japanese equities. Governor Ueda told Prime Minister Kishida that the Bank will monitor the strength of domestic demand, taking into consideration whether higher wages push services prices higher and the 2024 wage outlook. Recent inflation data continues to slow, as the prior high import costs work through the system amidst soft domestic demand. We expect the BOJ to exit negative interest rates in Q2, taking into consideration the spring wage negotiations. The yen may appreciate in H2 2024, on narrowing US-Japan interest rate spreads. A stronger yen could renew concerns over a possible negative effect on Japanese corporate earnings. However, a strong yen may not be too much of a hindrance to

Japanese equities, with the market set on the theme of further vitality in the economy with rising wages and improving capex.

[1] Factset, WisdomTree as of 31 December 2023

[3] Bloomberg as of 31 December 2023

[4] Japanese Trade Union Confederation (Rengo)

[5] IBES, Factset, MSCI Japan

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