State Street Global Advisors (SSGA) investment teams meet regularly to discuss macroeconomics, financial markets and implications for investors. This time we focus on opportunities in Japan, where the extraordinary policies designed to spark reflations and sustain the recovery may finally be paying off.

Key Points

• After years of attempts at policy stimulus and structural reform, Japan's economy is on track to perform better than we expected this year — albeit far from an upside breakout given the onerous demographics.

• New incentives for better governance have encouraged companies to focus on shareholder returns, and the tone of our conversations with managements has improved dramatically over the past couple of years.

• In our view, Japan has strong earnings fundamentals and attractive valuations relative to other major developed markets, along with compelling investment themes and favorable currency trends.

• SSGA's fundamental growth and value and asset allocation teams view Japan as a particularly interesting opportunity, with overweights across a number of strategies as a way to play the global growth recovery.

Little Moves in the Right Direction

After Shinzo Abe was elected prime minister in 2013, Japan embarked on a bold policy experiment characterized by the three arrows of fiscal stimulus, monetary accommodation and structural reform. Based on measures of the Japanese economy, however, we could argue that the impact of “Abenomics” has been limited: Real GDP growth has hovered around 1% for the past two years, and we have only modestly raised our expectation for 2017 to 1.25% on some upside economic surprises in the short term.¹ Core consumer price inflation excluding volatile food and energy has stayed stubbornly below the 2% targeted by the Bank of Japan (BOJ). And wage inflation has been largely absent, although unemployment stands at 2.8% — that is, roughly 1.5 jobs available for every applicant.²

Even so, the BOJ and the Ministry of Finance (MOF) are committed to reflating the economy. As ever increasing asset purchases have become infeasible, the central bank has pledged not to hike rates while establishing a policy of yield curve control (YCC) to limit the damage that a negative slope can do to bank earnings. We believe Japan is one of the most politically stable countries in the world now. With a solid political base, Abe is likely to call an election in the lower house of the National Diet by early 2018, which raises the likelihood of more fiscal stimulus that could be good for the investment environment.

New Culture for Corporate Governance and Stewardship

Less has been done on the third arrow of structural reform. In a country where the fastest growing age cohort is over 80 years — an ominous demographic headwind, indeed — tight immigration policies and social norms that have relegated women to dead-end jobs leave a lot to be desired. Yet we have perceived major inroads as the government has put incentives in place to promote a culture of better corporate governance and stewardship.

We used to find capital inefficiencies across Japanese business sectors, with shareholders having little input on allocation decisions. Now we can meet with management teams who are open to discussing topics like excessive cash balances or crossholdings that would have stopped the conversation in the past. Capital allocation policies have changed, with firms increasing dividends, repurchasing shares and seeking to
Japan Stages a Comeback on Governance Reforms

Figure 1: Japan’s TOPIX Benchmark Moves with ROE

![Graph showing the relationship between ROE and TOPIX benchmark from 1994 to 2018.]


Improve balance sheets and returns on equity (ROE). Japan’s Financial Services Agency (FSA) has focused on transforming corporate behavior, revising the stewardship code so that companies report how their investors voted. In what has traditionally been a shame culture, this is a way to bring to light those firms that are not doing right. And we have seen some success among activist shareholders, which had been unthinkable before.

Perhaps most encouraging, a new tax-efficient way of issuing restricted shares to employees will allow more Japanese companies to offer stock incentives — not only boosting domestic demand, but also serving to align company interests with those of stakeholders. In our view, the economic environment has an impact, of course, but the TOPIX equity benchmark tends to move with ROE (see Figure 1). So the real cornerstone of the investment case for Japan is whether managements will continue to make the right decisions.

Based on our observations of an expanding market ROE, that evolution has proceeded favorably.

Earnings Growth Higher, Valuation Multiples Lower

Following several years of robust gains, Japanese company earnings were up another 28% in the first quarter, with more surprises than in any other developed market (see Figure 2). Using a conservative forecast of the yen (JPY), we believe the earnings can expand at a pace of 9%–10%, with the potential for faster growth next year given the positive signposts in the marketplace. Our bottom-up stock pickers are finding many opportunities that screen positively on qualitative and quantitative factors, including sustainable growth rates and improving estimate revision cycles.

In the past, the Japanese equity market could be considered attractive only compared to its own history, never other markets. After peaking at a remarkable six or seven times book value in the mid-1980s, Japan is no longer a special case, and price to book (P/B) and price to earnings (P/E) are now on a par with developed country peers. Japan’s dividend yield has increased impressively, almost equal to the US, and could go even higher as more companies raise payouts. So SSGA’s fundamental growth and value teams view Japan as particularly interesting at the moment, with overweight allocations across a number of strategies.

Investment Themes Big in Japan

In our search for thematic catalysts, we have discerned several avenues for Japanese companies to excel globally:

**Tourism.** The government has worked to increase tourism through changes to the visa process and the value added tax (VAT). Real estate, hospitality and consumer goods companies can take advantage of strong demand from roughly 20 million visitors a year, and even more are expected to come for the Tokyo Olympics in 2020.

**Automation technology.** Japan is a leader in developing a range of productivity-enhancing technologies from robots that operate autonomously, to “cobots” that interact with humans, to sensors and measurement equipment; these companies can benefit as the internet of things moves into factories, offices and homes.

**Vehicle safety.** The country has a core competency in electronic components and materials, and with the push for lighter, faster and safer automobiles through advanced driver-assisted systems (ADAS) and even driverless cars, we have a portfolio focus on this rapidly evolving area.
Japan Stages a Comeback on Governance Reforms

**Energy efficiency.** Japan relies on external sources of energy. Out of this necessity comes opportunity: not only has the country become one of the most efficient in the world, but firms have also started to export technologies for heating, ventilation and air conditioning (HVAC) as well as fuel and energy efficient autos and household goods.

**Exporters.** Of Japan’s primary export-related sectors responsible for the recent gains in industrial production, transportation equipment has shown the greatest strength. With most of these exports shipping to China, resilience there has bolstered Japanese companies with capabilities and competencies like those listed above. Given the country’s unfavorable demographics, we tend to avoid pure domestic companies (aside from a few beneficiaries of reflation), preferring to invest in firms growing outside Japan.

Given this focus on exports, currency values ought to play an outsized role in the outlook for Japanese equities, with a stronger JPY making it harder. However, we have observed companies in Japan becoming increasingly resilient to JPY appreciation, which is critical for a currency that often serves as a “defensive” investment amid economic and geopolitical turmoil elsewhere. Our models put fair value for US dollar (USD) to JPY exchange rate at 90 for the longer term, although that could go from 110 to as high as 120 this year — especially now that the European Central Bank (ECB) has dropped its guidance for further rate cuts, and the BOJ is one of the last standing with an accommodative posture.

In addition to the improving governance structure, trend increases in ROE and earnings potential, relatively attractive valuations and catalytic investment themes, Japan scores well on our asset allocation models. Overall, we find a compelling argument for building our position in Japanese equities by increasing our existing tactical overweight to the region as a play on the global growth recovery, with the currency probably working in our favor — particularly against the USD — and without the crowding starting to be seen in flows to Europe.

**Glossary**

*Abenomics* The nickname for the multi-pronged economic program of Japanese Prime Minister Shinzō Abe that seeks to remedy two decades of stagnation by increasing the nation’s money supply, boosting government spending and enacting reforms to make the economy more competitive.

*Dividend Yield* A dividend expressed as a percentage of a current share price.

*Price to Book (P/B)* A ratio used to compare a stock’s market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share.

*Price to Earnings (P/E)* A ratio used to measure a company’s current share price relative to its earnings per share. P/E ratio is sometimes called the price multiple or the earnings multiple.

*Reflation* A fiscal or monetary policy that is designed to expand a country’s output and curb the effects of deflation. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates. The term “reflation” is also used to describe the first phase of economic recovery after a period of contraction.

*Return on equity (ROE)* The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested.

*Tokyo Price Index (TOPIX)* A capitalization-weighted index for firms on the Tokyo Stock Exchange (TSE). TOPIX lists all firms that have been determined to be part of the “first section” of the TSE, a section that organizes all large firms on the exchange into one group. The second section pools all of the smaller remaining companies.

*Yield Curve Control (YCC)* An effort by the Bank of Japan (BOJ) to boost the Japanese economy. The policy entails keeping the 10-year government bond yield at zero. Generally, it’s thought that central banks can control only short-term interest rates, but the BOJ is trying to use quantitative easing to control 10-year rates and steepen the yield curve — that is, increase the difference between the yields of short-term bonds, which are negative in Japan, and long-term bonds.

Japan Stages a Comeback on Governance Reforms

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