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Edison Explains

Japanese equities

Has Japan seen the last of deflation and have strong economic growth figures bolstered the equity market?

How has the Japanese economy fared historically?

As it developed into a high-income economy after recovery from the Second World War, Japan experienced three cycles of expansive growth. The post-war 'economic miracle' period began with the Iwato Boom in the late 1950s and ended with the Heisei Boom, whose crash effectively halted Japanese economic growth for a decade.

During the 1980s Heisei bubble, aggressive speculation on domestic stocks and real estate pushed Tokyo's Nikkei 225 Index to an all-time closing high of 38,916 points in 1989. By March 2008, the Nikkei had reached lows of 7,055.

When the Japanese Ministry of Finance finally began to tighten its monetary policy in the early 1990s , the bubble burst, leading to a 'lost decade', a period defined by deflation, anaemic GDP growth and weak wage growth, the effects of which continue to put pressure on the Japanese economy today.

Has the Japanese economy recovered from the 1980s?

The policies of Abenomics, named after Prime Minister Shinzo Abe, have been broadly beneficial to the Japanese economy since 2013. GDP growth reached an annualised 3.0% in the second quarter of 2018 and unemployment was at 2.4% in June, the lowest rate of unemployment since 1994. At the same time, the IMF put inflation at around 1.1% in April, a strong result for a nation that has become used to deflation.

That does not mean that Abenomics has been a complete success, nor that the country has fully recovered from the Heisei bubble bursting. Deflation may have disappeared, but inflation remains well below the government's 2% target, and 10-year government bonds still yield close to zero.

Japanese government debt also remains a problem, although it stabilised at 240% of the country's GDP in April. By comparison, the IMF estimated Italian debt at 131% of GDP in 2017.

Edison's insight:

"Japan's demographic challenges – an ageing population, falling birth rate and rising old-age dependency ratio – are feeding investment opportunities in areas like factory automation and recruitment agencies, while brand strength and a reputation for quality are helping Japanese companies to expand into new markets in Asia and globally." Sarah Godfrey, investment companies analyst

Even so, Bloomberg reports that the Japanese economy grew at its fastest pace for more than two years during the second quarter of 2018.

Have Japanese stocks benefited from strong economic growth?

The value of the Nikkei 225 Index, one of two commonly quoted indexes of the Tokyo Stock Exchange, has trebled since 2009. During the same period, the UK's blue-chip FTSE 100 index has doubled in value.

More recently, the Nikkei rose to 27-year highs in early October, although it remained 40% below the height of the Heisei bubble. Bloomberg points out that the surge in the Nikkei is weighted, to a certain extent, towards its top two stocks, Fast Retailing Co and SoftBank. The two companies account for 14% of the index and grew 38% last year.

The Tokyo Stock Exchange Tokyo Price Index (TOPIX) has not performed as well as the Nikkei, but still beat its 2017 numbers. In 2018 Bloomberg reported that the TOPIX traded at 14x estimated 12-month earnings versus the Nikkei's 17x.

How much foreign investment does Japan receive?

The level of foreign direct investment (FDI) in Japan hit record levels in 2016. Japan's External Trade Organization reports that FDI reached $34.3bn in that year.

Even with this improvement, however, Japan's FDI inflows remain small compared to other developed countries, accounting for 0.4% of Japan's GDP according to The World Bank. By comparison, FDI in the UK and France was around 1.8% and 2% of GDP in 2017, respectively.

Returning to the stock market, Japanese equities have performed well in sterling terms since 2013. The TOPIX has produced total returns of 81.1% over five years to 30

September 2018, and mid- and small-caps have performed even better, returning 95.1%, compared with 43.5% for the FTSE All-Share index.

Even so, UK investors remain under-exposed to Japan, with figures from both the Association of Investment Companies (AIC), which covers closed-ended funds, and the Investment Association, which covers open-ended funds, suggesting Japanese equities make up only c 2% of UK investors' fund portfolios.

This is from the second largest stock market in the world, which makes up 7.6% of the MSCI AC World Index, a global equity index spanning 47 developed and emerging market countries and $46.8tn in assets.

Why are UK investors wary of Japanese stocks?

The memory of the Heisei bubble bursting and the long years of declines that followed may continue to make some investors wary. However, others feel that the Japanese recovery has yet to fully mature, and with the 12-month forward P/E ratio for Japanese companies 7pp below its five-year average in September, at 13.3x compared with 14.7x for global equities, this suggests Japanese stocks are not overvalued.

With foreign investment having largely fled the Japanese equity market after the 1980s boom and bust, many UK investors may also be unfamiliar with the current generation of Japanese companies, which offer a much broader opportunity set than the familiar names in automobiles and home entertainment.

Over the long term, there are fears that unfavourable demographic trends in the Japanese economy may cause growth to stagnate. The ageing population is a major factor behind high jobs-to-applicants ratios, especially in factory work and social care. Japan has long hoped to mitigate the risk of a shortage of factory workers by pioneering automation in industry.

Which funds are involved in Japanese equities?

In sterling terms, funds in the AIC Japan sector saw an average net asset value total return (NAV TR) of 12.7% over the 12 months to 5 October 2018. NAV total returns are a common measure of how well a fund's portfolio is performing.

A number of funds outperformed the sector average, with JPMorgan Japanese at 19.3%, Baillie Gifford Japan at 17.0% and CC Japan Income & Growth at 16.5%.

Fidelity Japan Trust also outperformed the sector average, ranking second, with a one-year NAV TR of 18.2%. Fidelity Japan Trust recently moved into the AIC Japan sector from the AIC Japan Smaller Companies sector.

In the Japan Smaller Companies sector, Baillie Gifford Shin Nippon performed well, with a one-year NAV TR of 32.1% against a sector average of 20.4%, and the Atlantis Japan Growth Fund returned 17.2%.

Over three years, the sector average NAV total returns for the AIC Japan and Japan Smaller Companies sectors were 67.4% and 96.2% respectively, rising to 103.0% and 144.1% over five years.