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Investment Publications Highlights

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"It Ain't Over 'Till It's Over"

Chen Zhao, BCA Research, January 18, 2013

A large portion of the recent outperformance of Japanese equities can be attributed to yen weakness. Although many argue that the yen's recent move has fully discounted expected policy changes, there is still room for the yen to devalue further. This could have positive implications for the stagnant Japanese economy and bodes well for equity investors.

One of the more notable marketplace stories in early 2013 is the resurgence of Japanese equities. This perennial underperformer has surged in recent months thanks in large part to Prime Minister Shinzō Abe's call for inflation targeting and the subsequent devaluation of the yen. Many believe the yen's recent move has fully discounted expected policy changes from the new Japanese leaders, and that there is little room for further devaluation. However, there is still downside potential for the currency, which could have implications for investors.

The yen has often moved in big cycles, and its recent fluctuations are by no means unprecedented. Perhaps what is more surprising is the recent strength in the yen relative to the U.S. dollar when one considers the severe stagnation in the Japanese economy and the fiscal deterioration over the past two decades. This disconnect can mainly be attributed to the poor economic policies and political incompetence of Japanese leaders, though the aggressive policies pursued by the Federal Reserve and the subsequent weakness in the dollar also played a role.

It is not clear why Japanese authorities have tolerated a strong yen, though some cite a fear of inflation and the political power of retirees living off a fixed income. However, Abe's landslide election victory awarded him a clear mandate to stimulate economic growth and end deflation. Public frustration over the length of the current recession, the rise of the Chinese economy, and increasing tensions between the two nations has altered the mentality of policymakers. A weaker yen is now viewed as necessary to make Japanese exports more attractive, to boost corporate profits, and to restore a trade surplus to the island nation. In response, Abe has already unveiled a ¥10.3 trillion stimulus program (amounting to 2% of the nation's GDP) and has publicly shared his plans to target a 2% rate of inflation. The Bank of Japan (BOJ) has announced additional easing efforts that will bring its total planned balance sheet expansion to ¥120 trillion.

Those who are against monetary and fiscal reflation in Japan make several arguments. One is that deflation is a structural problem, as the BOJ has been trying to reflate for more than a decade to little effect. This argument seems to fall short; if a central bank is serious about creating inflation, it can always do so by selling the local currency to drive down the foreign exchange rate. Skeptics of Abe's policies might also argue that Japan's economic stagnation is rooted in structural problems around competitiveness and that devaluing the yen will not fix anything. This is a valid argument, but decades of declining prices are themselves a structural problem and this can be addressed. Finally, some argue that Japan's public finances are in shambles, and additional reflation could lead to a loss of investor confidence, in turn precipitating a sovereign debt crisis. It is true Japan's fiscal condition is horrible, as public sector net debt–to-GDP is 140%. However, all of Japan's outstanding government debt is denominated in yen. This means that the BOJ, the source of yen supply, can effectively guarantee the solvency of Japanese liabilities. While the BOJ's aggressive policies could lead to hyperinflation and a weakening yen, they cannot increase sovereign default risk.

The key question for investors is how much further downside potential is there for the yen. This depends in part on how serious the BOJ is about inflation targeting. If Abe were to achieve his headlined figure of a 2% rate of inflation, this could entail an additional 20% decline in the yen, though this may take months or years. While the recent fall in the currency has been abrupt, it has not brought about a meaningful increase in inflation expectations. From a valuation perspective, the yen does not appear cheap, as depreciation has offset nominal appreciation. However, the recent contraction in Japanese exports and the rapid deterioration in the country's trade account suggest the yen is still cheap. Periods of yen weakness historically have been long, and even the shortest down cycle was 28 months. If the recent fall is indeed the beginning of a major downswing in the yen, this could inject necessary stimulus into the Japanese economy, which bodes well for corporate profits and further equity performance.

"Is Japan the Ultimate Contrarian Play?"

Campbell Gunn, T. Rowe Price, November 2012

Decades of underperformance for Japanese equities may finally be coming to an end, as valuations already factor in company fundamentals and the government debt challenges that lie ahead. Investors would be well served to remember that low absolute valuations often lead to the best subsequent returns; relative to other developed equity markets, Japanese equities may finally be poised to end their streak of relative underperformance.

The absolute and relative underperformance of Japanese equities over the last two *decades* has left many investors permanently scarred. However, to ignore the world's second-largest stock market and some of the world's leading global companies would be a mistake. In spite of many of the well-known challenges the Japanese economy and government face, Japanese equities appear to be set up for success as a classic contrarian investment opportunity. Equities are cheap, skepticism is high, and investors are struggling to find a meaningful catalyst to propel equities higher. If history is any guide, some of the greatest investments of all time have been made at exactly these moments.

As many developed equity markets produced negative absolute returns over the 2000–10 period, it has become more and more common to question the merits of long-term investments in equities. Japanese equities are the perennial underperformer, crashing during the depths of the credit crisis in 2008, yet failing to participate in the ensuing recovery for global equity markets. In fact, the Topix Index hit a 28-year low in the summer of 2012. The reasons why Japanese equities have recently underperformed are well known, and include a strong currency, the burden of increased energy imports, and a stagnant global economy that reduced demand for exports. There are also secular challenges, which include large fiscal deficits, demographics, excess manufacturing capacity/weak profitability, and poor corporate governance.

The key for investors in Japanese equities going forward is that much of this is already baked in to Japanese equities prices, suggesting attractive long-term returns. At their depths in the summer of 2012, Japanese equities were trading at a cyclically-adjusted price-earnings ratio of 7.1, about one-third the level of U.S. equities. Japanese companies trade well below book value, and on a relative basis have only been this undervalued relative to global peers during two months of the last 25 years. Further, relative to other global equity markets, Japan has less risk of earnings disappointment, as there is additional pessimism baked in to stagnant earnings forecasts.

Despite these valuations, many investors find it difficult to increase their exposure because they fail to see a clear "catalyst" or set of reasons why Japanese equities will move higher. It does not help that for years Japanese equities have appeared cheap, only to get cheaper as time went on with investors receiving nothing but relative underperformance in return—a classic example of a "value trap."

Still, at current levels, valuations are the best argument to buy Japanese equities. In addition, there are catalysts that may push equities higher. First, signs of a global economic recovery could trigger a relief rally from today's extreme valuations. Second, the yen could depreciate, perhaps because Japanese companies that are flush with over ¥200 trillion in reserves accelerate their recent international buying spree. Finally, Japanese pension funds have been reducing their exposure to Japanese equities for decades and are significantly underweight. A rotation into equities—driven by low valuations and the need for higher returns to support an ever-aging population—could be a step in the right direction. Global investors have been underweight Japanese equities for years; a renewed focus on fundamentals and valuations could also help trigger a rally.

Japanese equities have been a classic "value trap" for years, repeatedly disappointing investors. With most of the well-known issues facing the Japanese economy and government at large already priced in to Japanese equities, investors would be well served to keep in mind that periods of low absolute valuations often lead to the best subsequent returns. Relative to other developed equity markets, Japanese equities may finally be poised to end their streak of relative underperformance. ■