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Key Takeaways

- Contrary to nearly all forecasts, the world economy is now re-accelerating and market participation is broadening out from a narrow set of US technology leaders.
- Japan's stock market, with its heavy weight in cyclically-gearred companies serving the global marketplace, has been — and will continue to be — a beneficiary of this macro backdrop.
- Beyond the cyclical horizon, things become more challenging for Japan. Better secular opportunities exist in emerging market countries with longer-running structural support drivers.

Ask Forstrong: Is Japan in a new bull market?

“Don’t look them in the eyes or they become hostile”, warned the attendant. My teenage son anxiously glanced at me as if he wanted to jump on my back. We were hiking in Iwatayama Park in Kyoto’s Arashiyama district last week to see Japanese macaques — semi-wild monkeys that live across the main islands of the nation (his idea, not mine). Once you reach the mountain peak, you can mingle with the monkeys, but are sternly reminded that they are rather territorial and can quickly become belligerent. Things we do for our kids, right?

As it was, the young lad was there for the monkeys. But dad was there for the macroeconomics. Japan has long fascinated macro nerds like us. We first visited more than three decades ago. Back then, the world closely watched the country’s every move. The nation’s stock market was booming, everyone was learning the language and Ivy League business schools were teaching Japanese “kaizen” management philosophy. We all stood in awe.

Everything changed following the bust of the country’s spectacular late-1980s dual bubbles in housing and stocks. Asset values evaporated but liabilities stayed constant, and the country slid into stagnation, decades of deflation and an agonizing “balance sheet recession” (side note: [very different than China’s current cyclical slump](#)).

But this is 2024 and global investors are again giddy for Japan. Local stock markets have been on a tear, with the Nikkei 225 recently leaping past its record set in December 1989. Warren Buffet even visited Tokyo last year and promptly built up big holdings in five trading houses that offer exposure to a cross-section of corporate Japan. Then, last month, Larry Fink, CEO of the world's largest asset manager, joined the pilgrimage to Japan's capital, affirming the optimism: "we are overweight in Japan, and our investors like the overweight."

But wait — is history repeating itself here? The miracle of 1980s Japan ushered in a long period

of false dawns. It took years for investors to give up on the country, with several echo rallies engineering hope that the boom was back. This pattern can be seen after all the biggest manias. The behavioural explanation is that people don't give up their investment paradigms easily. Many refuse to abandon the assets and the stories that made them money in the past. True to form over the last few decades, investors regularly warmed to a new Japanese prime minister, with signs of change and claims to see the sun peeping over the horizon. Foreign investors flooded back. And then disappointment followed. Eventually, the lower highs and lower lows in the stock market killed the faith.

Japan's External Drivers

Could this latest promised dawn be any different? We think it is, with a few caveats. A combination of external shocks and internal shifts has reshaped the landscape of the Japanese economy. The most palpable shock relates to prices. The pandemic was a moment of inflationary breakthrough after the 2010s period of worldwide disinflation. For Japan, global supply constraints and a depreciating exchange rate finally achieved what years of aggressive monetary easing could never do — pushing the headline inflation rate beyond the Bank of Japan's 2% target (inflation has been above the bank's target for 22 months).

Granted, this was not the healthier type of demand-driven inflation. However, supply-

driven price increases altered the perspectives of firms, workers, and consumers toward prices, and most importantly, wages. The widely-watched shunto wage negotiations resulted in a 5.3% increase in incomes for trade union workers this year. That's the highest level in 33 years and it is a trend that will almost certainly percolate into small and medium businesses (which employ more than two-thirds of the workforce). Add it all up and a path has now emerged towards a virtuous cycle of higher wage and consumption growth — and a lasting escape from deflation.

Our visit could not have been timed better as we were in Tokyo during a historic announcement: the Bank of Japan (BoJ) announced its move to finally raise interest rates above zero and scrap a

suite of measures designed to pull the economy out of its deflationary doldrums. In terms of central bank policy, this marked the end of the world's greatest monetary experiment. For a generation, the BoJ has led the world into exotic innovations such as negative interest rates (1999), quantitative easing (2001), and fully embraced the wild side of monetary policy with the arrival of Kuroda Haruhiko as governor in 2013.

The second shock is geopolitical. The conflict in Ukraine and escalating tensions between America and China have prompted a fresh wave of investment in crucial industries and a restructuring of global supply chains. With Japan increasingly being viewed as a safe-haven, the country stands to enormously benefit. Unlike Europe which is plagued by the Russia-Ukraine war, the Japanese economy has been operating in a relatively tranquil environment. America, for its part, needs Japan not just as a military

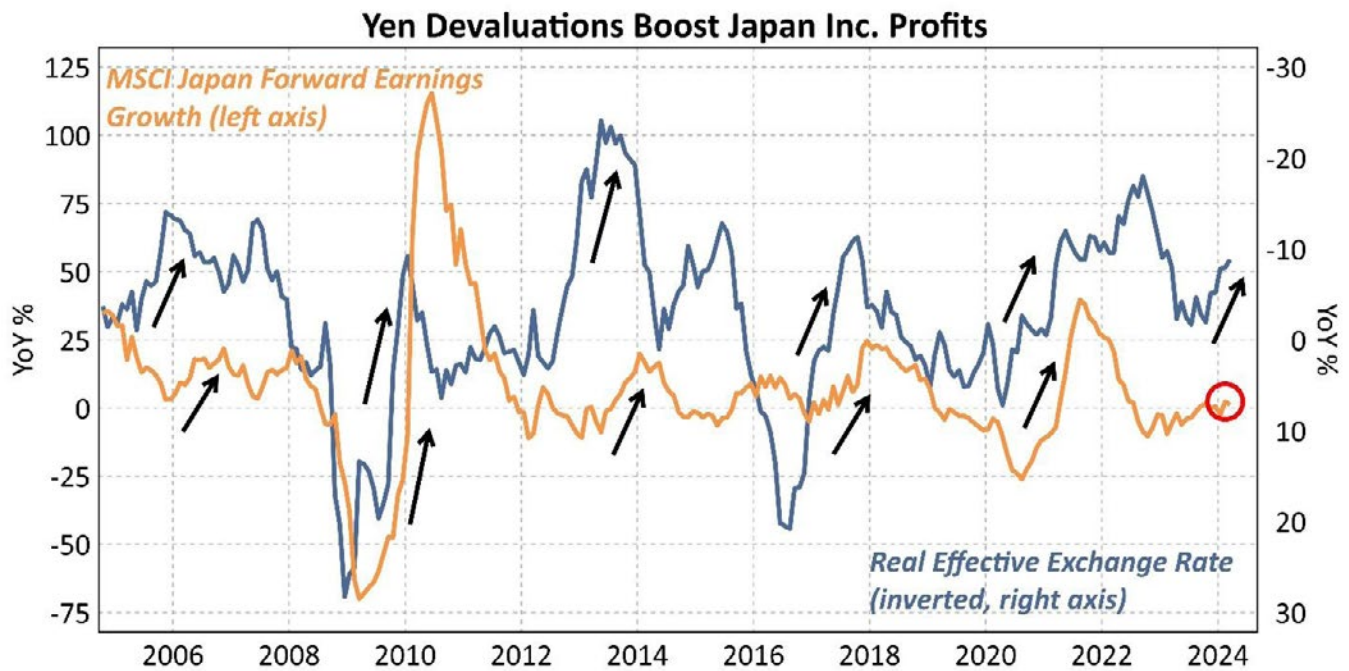
partner in Asia but also relies on the country as an economic counterweight to China.

Japan's government has seized the opportunity to leverage Washington's concerns. Nowhere is this more evident than getting back into a game it once dominated: the semiconductor industry. Over the past two decades leading up to 2019 with a strong yen and limited capital investment, the country's chip sector hemorrhaged a staggering 30% of its jobs, as its share of the global chipmaking market fell from over 50% to less than 10% (losing ground mainly to Taiwanese and South Korean rivals). Now, with prime minister Fumio Kishida's bold ¥4 trillion (USD \$27 billion) spending spree to revive the nation's semiconductor industry, there are more incentives for other nations to align with Japan. Progress is swiftly underway, with reports emerging from the northern island of Hokkaido and from Kumamoto in the south that new chip projects are starting to stimulate local economies.

Inside Japan's Economy

The internal shifts are subtler, but no less significant. First, Japan is extremely cheap. The yen's nominal effective exchange rate is at a 33-year low, and its real effective exchange rate is at a 53-year low. American tourists are everywhere. We even splurged on a few Michelin-starred restaurants (that didn't break the bank of dad). For a Canadian perspective, Tokyo is far

better value than Toronto. Cheap currencies have always been the cheat code for national economies. A weak currency not only fattens corporate profits for Japanese multinationals, but also boosts export competitiveness. Unsurprisingly, low currency valuations are also often wonderful starting points for massive stock market outperformance.



Sources: Macrobond, JP Morgan, MSCI, Forstrong Global Asset Management Inc.

The other internal shift relates to corporate reform. A long-running regulatory campaign aimed at boosting shareholder returns, that began under previous prime minister Shinzo Abe, is starting to deliver tangible results. The Tokyo Stock Exchange (TSE) is directly calling on Japanese companies to reduce their valuation discounts. Around 40% of all listed companies trade below book value, and the TSE now requires these companies to detail plans to improve returns. Japan's non-financial stocks have regularly attracted attention for their mountainous cash piles — worth around half the sector's market capitalization. This propensity

to hoard, rather than deploy or return cash to shareholders, has long kept value locked up. Japan Inc. finally appears to have taken the message seriously with rising dividends and share buybacks, and corporate earnings well into a solid uptrend (MSCI Japan earnings are currently clocking in at over 15% year-on-year.) Meanwhile, domestic investor interest in equities is likely to be sharpened by impending rule changes intended to double the size of tax-free Nippon individual savings accounts or NISAs (similar to Canada's TFSA) over the next five years to ¥56trn (USD \$430bn). Between a regulatory push to boost shareholder value and

an imminent spurt in demand from domestic investors, the pillars of support for Japanese

equity prices are broadening.

Secular Headwinds

Naturally there are risks to this bullish story. Beyond the cyclical horizon, things become more challenging for Japan. More important than an economy's cyclical attributes such as inflation, currency levels and stock market growth are its structural features. All of Japan's longer-running challenges — ageing, population decline, sluggish consumption and high public debt — remain the same. At over 250% of gross domestic product, Japan's national debt is the highest across the world's major economies. The country could not withstand a monetary tightening cycle like the one just served up in America.

What is also directly evident about Japan is a simple observation: it remains a highly developed economy, with none of the dynamism you would witness in, say, Dubai or [Shanghai](#). The main attraction of many emerging markets — young demographics and the enormous rise of their middle classes — are the opposite features of Japan's longer-term outlook. And while other developed countries have opened their borders to immigration and boosted growth rates, Japan remains wary of large-scale immigration. Only

about 2.5% of Japan's population are foreigners. Japan is also about to confront the so-called "2025 problem", the moment when that last of the post-war baby boomers turn 75, and when mortality and healthcare needs really start to accelerate. The demographic numbers are sobering: Japan's working-age population peaked at 87 million in 1995 and is projected to fall to 55 million by 2050. With this backdrop, there is limited prospect of real growth in Japan's economy as a large part of the population's desire to save remains high and the desire to invest is low.

Now it is true that generational change is happening. We spoke with several local professionals who agreed that an entire cohort of senior executives, many of whom may be attached to ways of doing business that worked during the heady days of the 1980s, are exiting the scene. A new generation of entrepreneurs is building a new Japan. But these developments take time.

Investment Implications

With persistent low growth and low inflation in the 2010s, most investors believed that the global economy was turning Japanese. That abruptly changed in 2020 with the pandemic's large fiscal response, ushering in a global economic reset, and a new period of higher inflation and higher growth. This remains our investment team's central macro roadmap. Even now, contrary to nearly every forecast, the world economy is re-accelerating and market participation is broadening out from a narrow set of US technology leaders. Japanese stocks have benefited here. But the

longer-running question still lingers: if the world is indeed no longer turning Japanese, how much will Japan come to resemble the rest of the world?

In the meantime, Japan's stock market, with its heavy weight in cyclically-gearred companies serving the global marketplace, will continue to be a beneficiary of a continuing global economic expansion. That means, at least for this cycle, investors should stay long the Japanese bull market. And go hang out with the monkeys. Just don't look them in the eyes.

Tyler Mordy, March 2024



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