Why you should not ignore Japan Inc.

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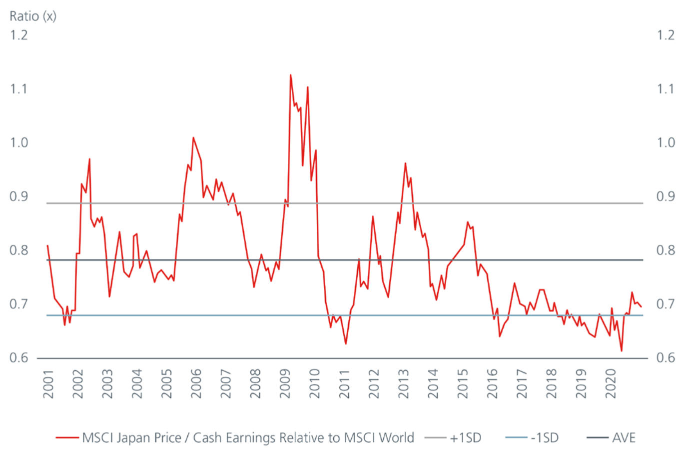
The rotation into unloved, undervalued, and more cyclical stocks has pushed Japanese equity markets to 30-year highs in the first quarter of 2021. But despite the rally, the market continues to trade at a relative discount to global peers. There continues to be pockets of opportunity within the Japanese market for patient, fundamentally driven stock pickers.

Since late 2020, we have observed a rapid shift in market risk preferences which has coincided with improving global macroeconomic news flow, vaccine optimism and better-than-expected corporate earnings, and this has been supportive of a range of market laggards such as cyclical assets. The shift is also indicative of a softening of entrenched market beliefs around the perceived safety of growth assets which justified paying any price for growth.

Japan has benefitted from this tide given that the country's stock indices have a relatively higher concentration of cyclical stocks. Foreign investors, who have been net sellers since 2015, are returning to this market.

But will this recovery sustain? Should sentiment turn, will investors abandon Japan again? Perhaps, but timing the market in periods of extreme market behaviour is very difficult which is why we rely on a disciplined approach to look through short-term market volatility. Investors willing to look beyond the headlines on Japan will discover a market that remains attractively valued compared to global equities and one that offers opportunities on a bottom-up basis. See Fig 1.

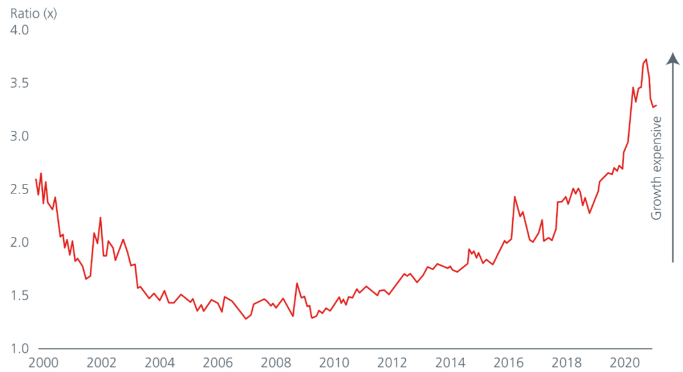
Fig 1: Japan equities are attractively valued compared to global equities



Source: Eastspring Investments, Refinitiv Datastream, as at 30 April 2021. MSCI World = MSCI AC World Index.

While there has been some near-term rotation in the market, valuation dispersion remains very stretched and implies a continuation of the same extrapolation of thematic preferences that have been evident for an extended period. See Fig 2.

Fig 2: Growth stocks are expensive relative to Value stocks



Source: Eastspring Investments, Refinitiv Datastream as at 30 April 2021. *MSCI Japan Growth Index Price-to-Book / MSCI Japan Value Index Price-to-Book.

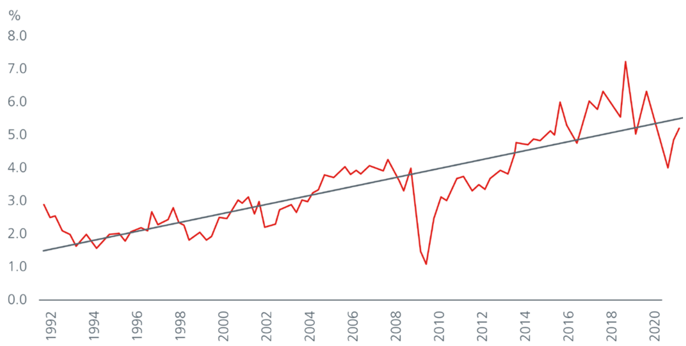
TREND IMPROVEMENT IN CORPORATE JAPAN'S FINANCIAL HEALTH REMAINS INTACT

Japanese corporates have also been surprisingly resilient despite the pandemic. Gradual but steady restructuring over the last decade has been supportive of higher operational efficiency and improved trend profitability and consequently put Japan on a stronger footing to weather the major exogenous shock.

A key factor that benefitted many Japanese companies last year was their strong balance sheet health compared with global peers. Long-term restructuring efforts have included deleveraging of balance sheets, which has led to high levels of cash and offered many companies a level of flexibility in funding their ongoing operations. Crisis response from Japanese corporates amid the challenging environment has also been unprecedented – with many taking the opportunity to further accelerate their restructuring initiatives.

While the pandemic has certainly dealt a cyclical hit to margins, the impact does not appear to be permanent as trend improvement has remained intact. See Fig 3. This is likely a testament to the progress made from the consistent and ongoing corporate reforms.

Fig 3: Profit margins as a % of sales are on a rising trend



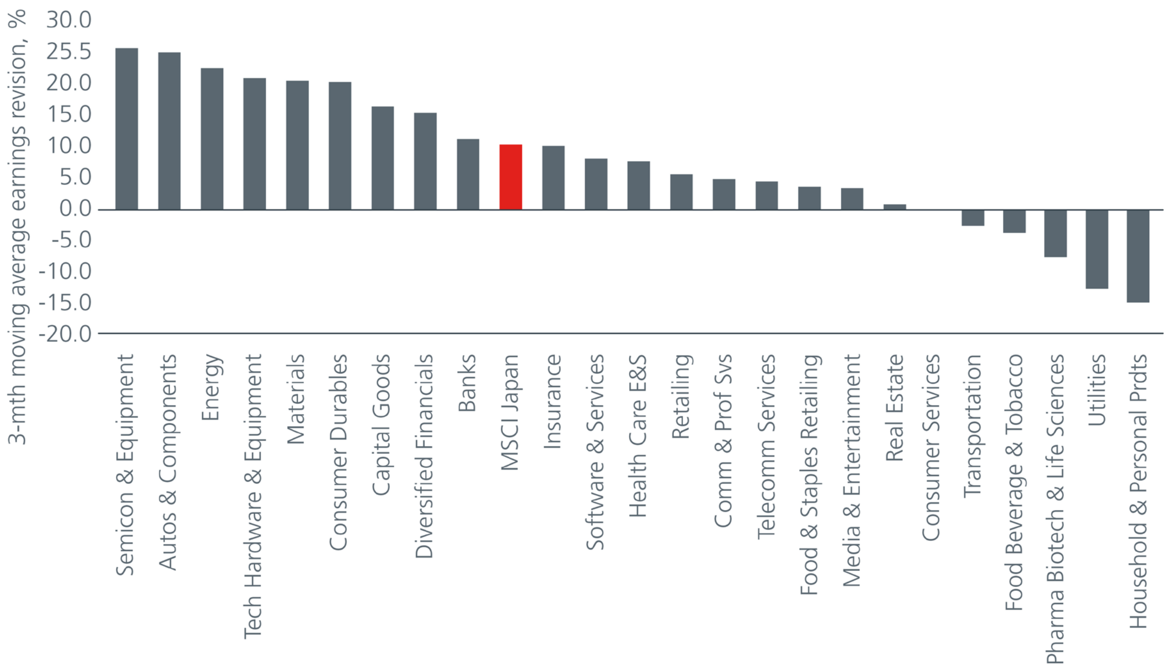
Source: Refinitiv Datastream, MOF as at 30 April 2021. Grey line represents trend.

Overall, the business environment for corporates appears to be recovering quicker than expected. As long-term investors, we remain focused on testing longer-term earnings assumptions that underpin our valuations. That said, we have observed shorter-term earnings revisions and management guidance that have surprised to the upside. See Fig 4. Notably, upward earnings revisions have been among the highest for the more unloved cyclical stocks, with majority of them reporting more recent earnings performance that has clearly been better than the excessively negative market expectations.

Whilst the current conditions i.e. accommodative policies, ample liquidity and a reflationary environment, have been more supportive to cyclical and value counterparts than recent history, the disruptions caused by the pandemic necessitate a scrutiny of businesses; some value stocks are cheap for a good reason. To avoid value traps, employing

Source: [1]Goldman Sachs.

Fig 4: Upward earnings revisions highest for cyclical stocks



Source: MSCI, IBES, Datastream, Factset, RIMES, Morgan Stanley Research, data as of 31 March 2021.

a disciplined approach to screening companies and evaluating them on material factors such as their competitiveness, capital policies and ability to adapt to new challenges are key to determining their ability to deliver long-term sustainable earnings.

Improving profitability and return on equity, and attractive valuations are not the only reasons to invest in Japanese corporates. The increased emphasis on corporate governance reforms over the past few years is also bearing fruit.

CORPORATE GOVERNANCE REFORMS SHOWING SIGNS OF STRUCTURAL IMPROVEMENT

Structural changes in corporate governance have been underway for many years in Japan. There has been a real economic imperative for this as the need to remain globally competitive and demands from asset owners, such as Japanese pension funds, for better returns have put pressure on Japanese corporate management to change their behaviour.

Cash-rich Japanese companies have begun to demonstrate more alignment with shareholder interests. Not only are dividend payouts on the rise, 2019 was a record year for stock buybacks; Topix buybacks rose 109% year-on-year. While activity was impacted in 2020, buybacks still exceeded 2018 levels. Cheap valuations amidst a loose fiscal and monetary policy environment also offer many cash-rich companies with robust balance sheet health the ability to fund their future investment requirements. See Fig 5.

The first-quarter Bank of Japan Tankan survey indicated that capital spending plans are at its highest compared to previous first-quarter readings. The March quarter represents the beginning of the fiscal year for Japan corporates, and corporate guidance for the period tends to be more conservative versus the later part of the year. The more recent buoyant sentiment appears to reflect that companies have not only been more resilient despite the uncertain environment but are also increasingly more positive on the economic outlook in terms of their desire to invest. These factors could contribute to higher capital efficiency.

What has lacked, up until late, has been a market for corporate control in Japan. Increasingly, however, we have observed a growing occurrence of hostile and, in some cases, contested takeover bids since 2019; historically, there were few unfriendly takeover bids. Although it is still early days, this adds further evidence that the change in governance observed has been meaningful and offers further potential for value realisation.

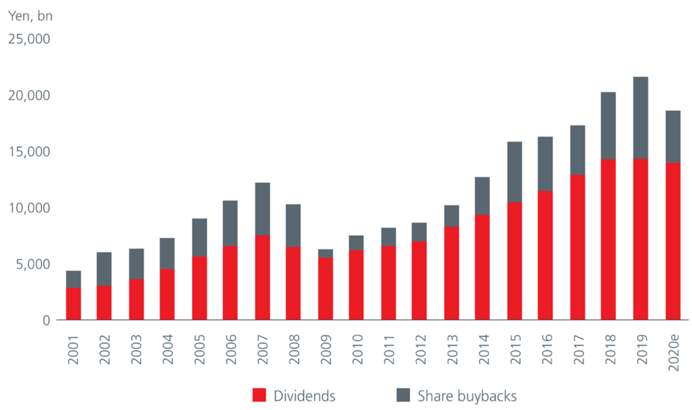
Ultimately, the corporate restructuring happening in Japan, fuelled out of necessity as well as by the government's push for reforms, could serve as material contributing factors to the longer-term re-rating for Japan.

DON'T LET MACRO SKEPTICISM MASK VALUE

So, will this near-term recovery be the turning point for Japan? We don't claim to have the ability to predict market direction, but the facts above appear supportive of the likelihood that the deeply entrenched beliefs of the market could become increasingly challenged. Investor skepticism, however, remains deeply ingrained.

The general perception of the market is that Japan is characterized by its aging demographics as well as a low growth, low inflation and low interest rate environment. But a key point to note is that Japanese corporates have remained resilient despite the pandemic; there are many companies with mispriced but good quality income streams that remain out of favour with the market.

Fig 5: Dividends and buybacks firm despite Covid shock



Source: Nomura, as at 28 February 2021.

We believe the "catalyst" for outsized returns is not based on a forecast or macro theme. Instead, we systematically look for mispriced assets, focusing on extremes and identify maximum impact opportunities. We are finding plenty of such opportunities given that the dispersion of valuations between value and growth stocks is at generational extremes.

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