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A Prudential plc company

Japan's good value creates alpha opportunities

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Japan's companies are among some of the most cash rich, globally. Equally, some of the most attractive developed market valuations are to be found in Japan. Investors willing to look beyond the economic headlines will discover a market of stocks that is attractive on many fronts.

Japan is typically perceived as a low growth economy with a rapidly ageing population, both of which keep the lid on domestic consumer spending. The country's ability to attract investors thus has been low since its stock market hit an all-time high in 1989. Yet Japan has always been a corporate, not an economic, revival story. There is a very compelling corporate reform revival story that is ongoing.

Another key point to note is that Japanese corporates have remained resilient despite the pandemic. Gradual but steady corporate restructuring over the last decade has resulted in higher operational efficiency and improved trend profitability. This is fairly well known but is yet to be fully recognised by international investors. We expect the benign impact of the reforms to continue, justifying a strategic allocation to Japan equities in portfolios.

JAPAN'S CORPORATES DEMONSTRATE EARNINGS RESILIENCE

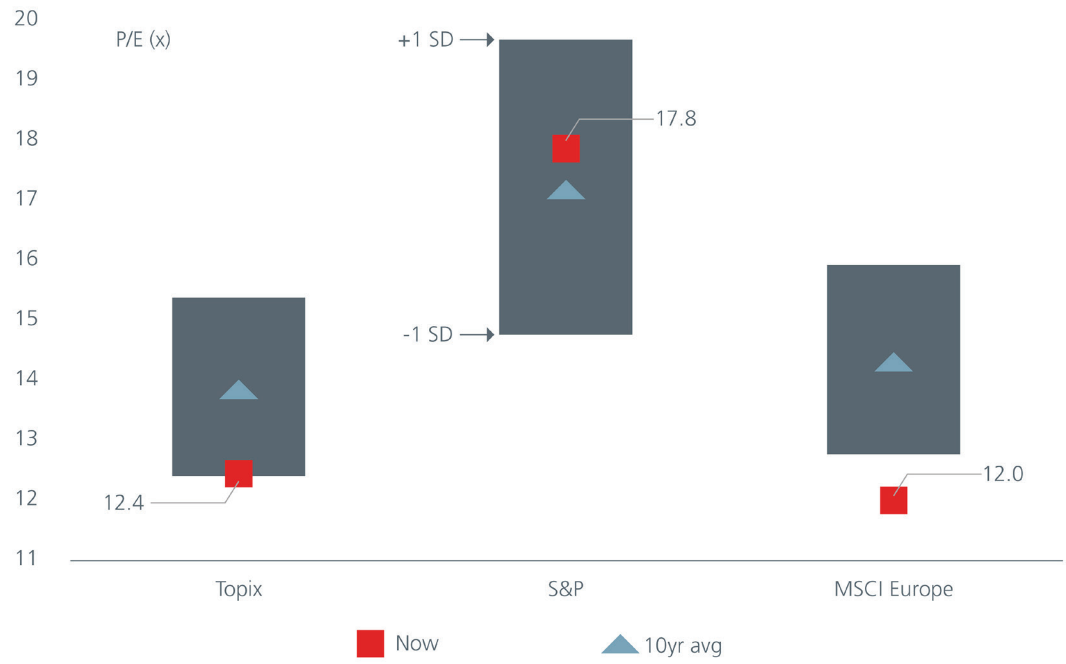
We think that Japanese corporates have shown significant earnings resilience in recent years – with Topix EPS outperforming S&P and MSCI Europe EPS over 10 years. This is no small feat given the scale of financial engineering going on in US corporates! Examples of proactive policy that have boosted earnings include restructurings, where excess capacity has been taken out in steel and autos companies, and a focus on pricing, for example in beer and beverages.

Many companies exceeded the earnings expectations in 1Q22 (e.g., Nippon Steel, MMC, Mazda, Honda, Credit Saison) and delivered growth even in difficult conditions i.e., China lockdowns and raw material price hikes. Production is yet to normalise in the auto value chain given the negative impact in 1Q22. Furthermore, Japan's Covid-related economic reopening is still unfolding versus the rest of the world in areas such as rail transport and domestic consumption. All this points to Japanese companies being much more immune to a global slowdown than investors are currently pricing in.

At 12x price-to-earnings ratio, Japanese equities are cheap both versus its own history and other developed markets; Europe is on a similar valuation multiple to Japan but has neither the earnings resilience of Japan nor the longer-term structural tailwinds. See Fig 1. With significant corporate governance reforms and a gradual shift in mindset towards profitability, margins have been expanding and return on equities (ROEs) have been improving. Abenomics kick-started the market reform process, but we believe that current Prime Minister, Fumio Kishida, will continue to back corporate reforms and these structural changes have another five to ten years to play out.

After an initial frenzy in 2013-15, international investors have largely shied away, and Japanese equities remain chronically under-owned in foreign portfolios. This is different from what

Fig 1: Japan is cheap compared to global peers



Source: CLSA, Bloomberg. Valuations based on price to earnings ratio.

one might expect when you consider the earnings per share trajectory over the last decade. See Fig 2. Furthermore, Japan is the only major market in positive territory year-to-date (in local currency terms) and we expect to see international investors return to the fray as they reallocate away from their US equities' overweights.

WHY INVEST IN JAPAN VALUE

Growth stocks in Japan never quite traded at the extreme levels that we saw in the US, but we still observed relative valuations of growth versus value reach multi-decade highs. There has been a pullback year-to-date in the multiple that investors are willing to pay for growth and a positive re-rating for value companies, especially in certain sectors.

The price-to-book valuation multiple differential between growth and value stocks has thus closed slightly but remains at high levels. See Fig 3. However, after years of cheap companies being neglected, we think this trend has persistence as investors refocus on areas of the market where mispricing is prevalent.

Our recent analysis on how much historical earnings growth has been delivered by companies in the MSCI Japan Value index versus the MSCI Growth Index too revealed an interesting result. Over the last five years, value companies have seen their earnings grow faster than growth companies. This suggests that the very reason to invest in the growth segment of the market turns out to be a bit of a fallacy.

Our sweet spot has always been to invest in companies where trend earnings are not properly reflected in prevailing share prices, and we believe this will continue to deliver strong outperformance through a market cycle. It is also worth noting that based on analysis done by BofA, value has outperformed the market in six out of eight recessions since the 1980s.

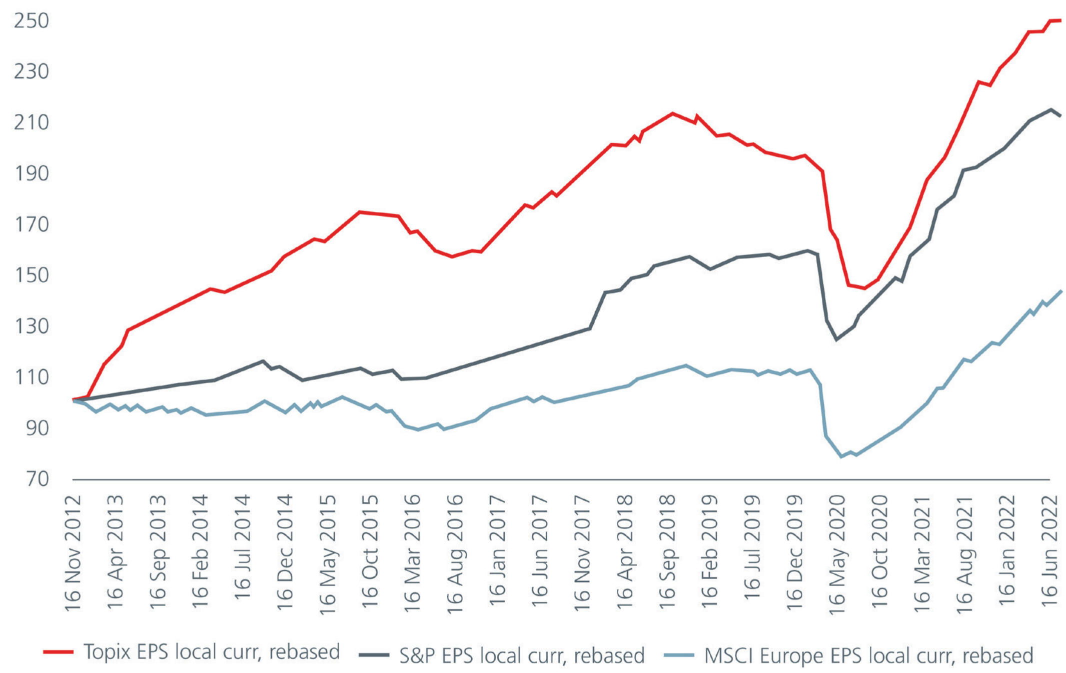
OPPORTUNITY TO REAP DOUBLE DIGIT RETURNS

Japan remains a very cheap equity market versus global peers, and we expect the gap to narrow. In addition to continued earnings per share growth, dividend growth, and ultimately higher return on equity, any multiple re-rating would be a cherry on top for investors.

Ultimately there's lots of opportunity for double digit returns for investors in Japan over the coming years. This is predominantly from 1) more efficient balance sheets/capital allocation, 2) improved margins from high pricing, costs efficiencies and culling underperforming products, 3) corporate governance reform being more friendly to shareholders, and 4) potentially a stickier inflationary environment.

Investors who remain skeptical on Japan risk missing out on long-term gains.

Fig 2: Japan's earnings per share is on the rise



Source: CLSA, Bloomberg, as at 4 Aug 2022, EPS: Earnings per share.

Fig 3: Growth stocks continue to be valued higher than value

Source: Eastspring Investments, Bloomberg, as at 22 August 2022. *MSCI Japan Growth Index Price to Book / MSCI Japan Value Index Price to Book. Please note that there are limitations to the use of such indices as proxies for the past performance in the respective asset classes/sector.

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