



## JAPAN. SUBARASHII DESU

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### Reasons to be cheerful

With mounting overseas investor interest and a stock market that is trading, in yen terms, at 30-year highs, we review our optimistic December 22 Japan thesis, Sugoi Desu Ne ([enclosed](#)). The conclusion remains the same. A once in a generation transfer of wealth from corporates to shareholders remains a multi-year investment thesis with attractive valuations. Critically, this is supported by the recent intervention from the Tokyo Stock Exchange (TSE) over corporate governance directive as the final piece of the strong investment story.

### Higher wages, reshoring, tight labour market and consolidation

Back in December 22, we highlighted, based on extensive corporate research, widening evidence of the first wage hikes in 30-years across many industries and that these would prove to be multi-year in nature. Given our discussions with companies and policy maker observations, we believe it would be unwise to see the recent pay hikes as a purely one-off response to inflationary pressures. There is minimal risk that these ongoing wage hikes will materially affect profit margins as the ratio of labour to total sales has declined markedly, especially in the last 10 years. The recent trend of reshoring of production across manufacturing and tech sectors has accelerated and will materially support capital investment over the next few years, further tightening an already tight labour market. Investors often under-appreciate the impact of new factory capex as this requires not just a plant but an upgrade and expansion of the supply chain network. There are already signs that the tight labour market is accelerating industry consolidation in certain areas.

### Tourism and consumption are back

The reopening of the economy is now fully underway and the return of tourism, from late October, has gathered pace with March figures implying a 25m annual count. This is without the significant return so far of Chinese tourists, but certain retailers have already returned to pre pandemic revenue levels, implying a strong domestic consumption pattern. We anticipate that the wage hikes, in excess of more persistent inflation, will contribute to more durable domestic spending patterns and reduce the historic reliance on older more affluent consumers.

### Solid corporate results

The recent annual corporate results season has further illustrated the robust improvement in corporate profitability and free cashflow, which remains the critical component of our investment approach. Forecasts in many cases imply moderate profit declines for the next 12 months, largely on expectations of a stronger currency but all the latest mid-term plan releases expect further profitability improvement over the next few years. The current DX initiative, technology related capex, to raise historically low white collar labour productivity, remains a key contributor to these improved margin expectations.

**BOJ attitude**

We therefore retain our Dec 22 thesis that multi-year wage hikes will lead to sustained inflation and that this, in turn, forces the more pragmatic new BOJ governor, Ueda, to expand the YCC from 50bps to 100bps. Further, we see the BOJ ultimately removing any control and then marginally hiking short term interest rates, leading to yen appreciation, a process that will start in H2 2023. The gradual introduction of these changes will not lead to any material negative impact on either the stock market or the domestic economy as we expect yen appreciation to be mild in the initial stages, especially if US interest rates stay higher for longer.

**Japan's reforms helping push the change in corporate and investor behaviour**

Our positive stock market outlook has been reinforced by a major development, the recent engagement of the Tokyo Stock Exchange with corporates that have low valuations. This is hugely significant for many reasons. First, although the directives are non-binding, the TSE has the ultimate sanction of removing persistent corporate offenders to the junior indices as part of the planned shake-up and introduction of new indices. We can see a similar parallel to the changes today to the way in which banks pressured various Japanese conglomerates post-GFC, when they made them restructure to retain bank funding, which provided a catalyst for the introduction of corporate restructuring in Japan. Such actions quickly rippled through the entire corporate landscape, so we expect that these new directives will be a warning shot to the entire corporate sector. The most significant aspect of this intervention is that finally domestic authorities are imposing change on domestic companies. Investors are wary of the impact of activism, especially from foreigners, but this TSE intervention is very different and likely to harden domestic institutional attitudes towards those persistent corporate under achievers. There is already evidence recently of cases where domestic institutional investors have sided with foreign activists against certain corporates, a trend only likely to accelerate and prove accretive to share prices.

This matters as our optimism for Japan in recent years has been anchored around the transfer of wealth from corporates to shareholders, driven by underleveraged cash rich balance sheets and surging free cashflow. Since December, this has been reinforced by the scale and sheer number of share buybacks, ranging up to nearly 20% in some holdings in our portfolio alone. Consequently, the Tokyo stock market free float is therefore declining every single day the market is open. This alone implies cheaper valuations, from an already low starting point relative to other developed markets and is driving sustained shareholder return improvements. Japan offers the only stock market where the dividend yield, leaving aside the total return including share buybacks, exceeds the inflation and interest rate.

**We remain positive**

Congratulations to the domestic retail investors who returned in droves to the market over the last 2 years, sensing the opportunity. As for the sceptical foreigners, ask yourselves where else you can enjoy such sustainable returns? If you can find alternatives, please send us a postcard. Otherwise get engaged with this once in a generation opportunity.

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