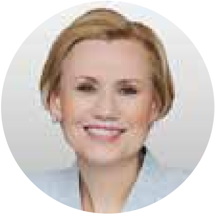
The Japanese stock rally may have more room to run



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Laying the groundwork

“Abenomics,” an ambitious economic plan created by late prime minister Shinzo Abe, laid the groundwork for today’s Japanese stock rally.

Reforms taking hold

Today, I think it’s fair to say that Japan is realizing much of Abe’s vision, as structural reforms appear to be taking hold.

Further growth ahead?

Attractive valuations, cash on the sidelines, and monetary policy could drive Japanese equities higher going forward.

It feels like the late 1980s again. Not because I’m wearing Reebok high top sneakers, Guess jeans and Esprit jackets or listening to Men at Work and Yes, but because there’s a lot of excitement around Japan’s economy — and Japanese equities have experienced a strong rally over the past year.[1]

Is this a fleeting trend, or a “Japanaissance” in the making?

Japan’s economy and stock market have certainly benefited from the strong fiscal and monetary stimulus it received during the pandemic. However, from my perspective, the groundwork was laid years ago with “Abenomics,” an ambitious economic plan introduced more than a decade ago by late prime minister Shinzo Abe.

The “three arrows” of Abenomics

Abenomics was designed to pull the Japanese economy out of its decades-long stagnation. This plan involved three key initiatives, known as the three arrows:

- Fiscal stimulus
- Very accommodative monetary policy
- Structural reforms to improve economic competitiveness and growth.

This would be a powerful combination that could enable the Japanese economy to escape deflation through monetary and fiscal stimulus, with structural reforms intended to improve confidence and make economic growth sustainable for the longer term.

- **The first arrow,** fiscal stimulus, was simply government spending that began in 2013. This included a large infrastructure spending plan soon followed by an additional fiscal stimulus package.
- **The second arrow,** very accommodative monetary policy, has included not just ultra-low rates but also large-scale asset purchases. In Japan, large-scale asset purchases do not just involve quantitative easing, with the Bank of Japan buying Japanese government bonds, but also involve qualitative easing, with the Bank of Japan buying risk assets such as Japanese equity exchange-traded funds. One objective of this arrow was to encourage Japan’s older population to invest rather than keep assets in bank deposits. Another objective of this arrow was to weaken the yen and support export growth.
- **The third arrow,** structural economic reform, was comprised of a piecemeal set of policies that were intended to increase the size of the workforce, reduce business regulations, and generally make the Japanese economy more competitive. This included corporate governance reform initiated in 2014 intended to improve capital efficiency among companies. This also included policies to encourage more women to return to the workforce and to encourage companies to increase the wages of their employees.

How Abe's vision is influencing Japan today

Fast forward to today. I think it's fair to say that Japan is realizing much of Abe's vision, as structural reforms appear to be taking hold. Japan's Shunto wage negotiations yielded results that were better than expected. Japan's largest union group, Rengo, and corporations agreed on a 5.28% wage hike — which is much higher than last year's increase of 3.8% and is even better than expectations of a 4.1% hike by economists surveyed in a recent Bloomberg poll.[2]

Capital efficiency has improved for Tokyo Stock Exchange-listed companies because of the corporate governance reform initiated a decade ago, and the TSE is pushing for greater progress. What's more, Japan is continuing to support two of Abe's three arrows: We've seen additional substantial fiscal stimulus under current Prime Minister Fumio Kishida, and he continues to support structural reform. Kishida recently eased regulations and streamlined business practices — enabling foreign investors to complete government applications in English — in order to encourage both domestic and overseas investment.

Three reasons we could see further growth in Japanese stocks

Some would argue that the strong Japanese stock market rally over the past year has priced in all the improvements in the Japanese economy. However, I would argue that there are additional reasons that could drive Japanese equities higher going forward.

- **Attractive valuations.** First, despite a strong rally over the past year, Japanese equities still look attractive. The valuation of the MSCI Japan Index is still low at a trailing price-to-earnings (P/E) ratio of 16.35 relative to other major indices such as the S&P 500 Index at 22.93.[3] In addition, the dividend yield on the MSCI Japan Index is 1.99%, well above that of other major indices such as the S&P 500 Index at 1.4%.[3]
- **Cash on the sidelines.** Second, there is quite a bit of cash on the sidelines in Japan. Cash deposits comprise a whopping 52.5% of households' financial assets in Japan, but only 12.5% in the US and 35.5% in the eurozone; not surprisingly, households in the US and eurozone have higher allocations to stocks.[4] The catalyst to move cash into equities could be the new NISA (Nippon Individual Savings Account), a tax-exempt investment savings plan launched in January that is intended to encourage Japanese households to move money from bank deposits to equities.
- **Normalizing monetary policy.** Finally, the Bank of Japan's decision to gradually normalize monetary policy could also be positive when it occurs. Such normalization could be a boost to confidence — the first rate hike in 17 years would send a strong message that the Japanese economy no longer needs such a high level of support because it is in better condition and is expected to continue to improve. In addition, monetary policy normalization is likely to cause a strengthening of the Japanese yen which could also be positive for Japanese equities. This could encourage foreign investors who have been deterred by yen depreciation, which has negated much of Japanese stocks' returns for foreign investors in the past year.

Back in December, my colleague Daiji Ozawa, Chief Investment Officer and Head of Japan Equities, accurately predicted the Nikkei 225 Index would rise above its previous peak back in 1989. He posited that if sustained nominal gross domestic product growth backed by the Bank of Japan's careful monetary policy normalization and government reforms to enhance the entire investment chain takes place, the Japanese equity market would likely continue to perform well. I couldn't agree more with this assessment and look forward to more positive developments for the Japanese economy and stock market.

Dates to watch

All eyes will be on central banks this week – especially the Bank of Japan, the Bank of England and the US Federal Reserve. They're all close to altering their respective monetary policy, although the Bank of Japan is expected to move first and begin to normalize monetary policy either this week or in April, with the Shunto negotiations likely to improve the Bank of Japan's confidence about normalizing sooner rather than later.

We're also likely to get some valuable guidance this week on when the Federal Reserve and Bank of England will begin cutting rates after some recent and surprising data points. I will be particularly keen to see the Fed's dot plot, given whispers that it could show only two expected rate cuts this year. Don't fret if it does; as I've said before, the dot plots can be wildly inaccurate – just look at the December 2021 dot plot if you want to calm your nerves.

Date	Event	What it tells us
Mar 18	Eurozone Consumer Price Index	Tracks the path of inflation.
	US NAHB Housing Market Index	Indicates the health of the housing market.
	Bank of Japan decision	Reveals the latest decision on the path of interest rates.
	Reserve Bank of Australia decision	Reveals the latest decision on the path of interest rates.
Mar 19	Germany ZEW Economic Sentiment	Measures opinions on the direction of the economy for the next six months.
	Eurozone ZEW Economic Sentiment	Measures opinions on the direction of the economy for the next six months.
	US building permits and housing starts	Indicates the health of the housing market.
	Canada Consumer Price Index	Tracks the path of inflation.
Mar 20	UK Consumer Price Index	Tracks the path of inflation.
	Germany Producer Price Index	Measures the change in prices paid to producers of goods and services.
	US Federal Open Market Committee Meeting	Reveals the latest decision on the path of interest rates.
Mar 21	Swiss National Bank decision	Reveals the latest decision on the path of interest rates.
	Bank of England decision	Reveals the latest decision on the path of interest rates.
	UK Purchasing Managers' Index	Indicates the economic health of the manufacturing and services sectors.
	Eurozone Purchasing Managers' Index	Indicates the economic health of the manufacturing and services sectors.
	US Purchasing Managers' Index (S&P Global)	Indicates the economic health of the manufacturing and services sectors.
	Japan Consumer Price Index	Tracks the path of inflation.
	UK retail sales	Measures consumer demand.
	Canada retail sales	Measures consumer demand.

With contributions from Daiji Ozawa and Tomo Kinoshita

Notes

[1]Source: MSCI as of Dec. 31, 2023. The MSCI Japan Index returned 20.77% for calendar year 2023.
[2]Source: Bloomberg Poll, March 12, 2024.
[3]Source: MSCI, as of Feb. 29, 2024, and Bloomberg, as of March 15, 2024.
[4]Source: Nikkei Asia, "Japan households' investments drive 80% of asset growth," Dec. 26, 2023.

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The MSCI Japan Index measures the performance of the large- and mid-cap segments of the Japanese market.

The Nikkei 225 Index is a price-weighted average of 225 top-rated Japanese companies listed in the first section of the Tokyo Stock Exchange.

The price-to-earnings (P/E) ratio measures a stock's valuation by dividing its share price by its earnings per share.

Shunto refers to the annual wage negotiations between unions and employers in Japan.

Quantitative easing is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

Qualitative easing is a policy designed to shift the composition of the assets on a central bank's balance sheet toward less liquid and riskier assets while keeping the size of the balance sheet steady.

Dividend yield is the amount of dividends paid over the past year divided by a company's share price.

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time. Nominal GDP is not adjusted for inflation.

The Federal Reserve's "dot plot" is a chart that the central bank uses to illustrate its outlook for the path of interest rates.

The opinions referenced above are those of the author as of **March 18, 2024.** These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.