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Rising Sun: 5 reasons to go big on Japan

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After 15 years of deflation, the tide of sentiment is turning, driven by a resurgent domestic economy. In the following investment insight, Joel Le Saux, fund manager of the OYSTER Japan Opportunities fund at SYZ Asset Management gives five reasons why investors and asset allocators should not ignore Japanese equities.



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> *"After almost 15 years of uninterrupted deflation, it is time to forget about "the lost decade"."*

Japan is back. Abenomics may not have fully delivered on its much vaunted promises, but the Japanese economic growth engine is steadily springing to life. Strong deflation pressures appear to have been consigned to the past, while the dual tailwinds of increased business confidence and consumer sentiment are boosting domestic Japanese business growth.

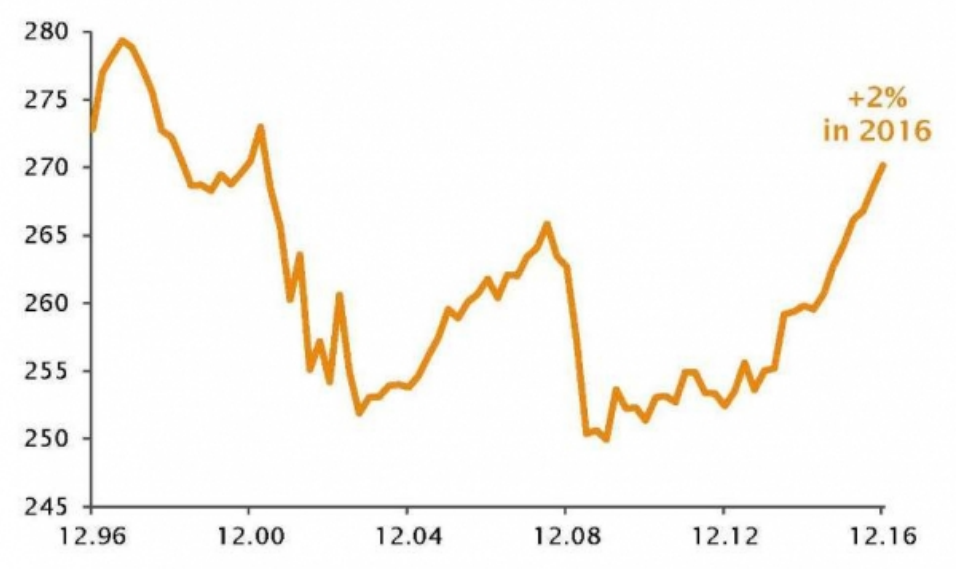
As the economic environment improves, asset allocators and investors are beginning to shift their focus again to Japan where valuations look increasingly attractive. Against this improving backdrop, on both a macro and fundamental level, I see five key reasons why investors should reassess portfolio exposure to the country.

Japan has emerged from its 'lost decade'

After a mostly uninterrupted 15 years of deflation, it is time to forget about "the lost decade". Since the end of 2014, inflation has returned. While it is far away from satisfying Bank of Japan (BoJ) aspirations, the key point is not the level but the momentum: the direction of the travel appears clear.

Moreover, due to a very tight job market – the jobs-to-applicants ratio is at a 43-year high – we can expect wage inflation, as well as price inflation, to continue to grow. This has been a positive trend since 2009, accelerating from 2014. A consequence of this tight jobs market has been a material increase in wages that is a major positive for private consumption and thus, for the economy overall.

Compensation of employees



Source
SYZ Asset Management, Bloomberg. Data from December 1996 to December 2016 (Quarterly figures)

Domestic recovery is under the radar

While the actions of the BoJ and Abenomics tend to steal the headlines, the real story has been a domestic recovery quietly gathering steam. This has been largely ignored by international investors, despite mounting economic data. For example, real GDP growth has annualised at 1.2% over the last five years. This is significant in a low-growth world, when you consider that Eurozone grew at a 0.8% per annum over the same period. UK and US GDP grew by 2.1% each.

Japan is also stepping out from the aftermath of a housing bubble, which devastated banking balance sheets and severely damped consumer confidence. Following a cut in capacity and a closure of factories, we are seeing leaner Japanese companies grow profitability levels. In a sign of their much-improved financial health, many of these companies have been re-investing capital both domestically and abroad.

Profitability trending positively

This relentless focus on profitability has reaped rewards across sectors. Manufacturing & non-manufacturing companies have seen profits increase – a positive trend since 2008. We have also seen secular growth in the service sector, which has brought about consolidation led by market winners. This profitability has been assisted by the evolving employment dynamic. Many baby boomers are retiring which is hollowing out many of the inefficiencies and bureaucracies historically associated with "Japan Inc."

Stocks are cheap on a relative basis

In a world where investors are chasing a diminishing set of opportunities, it is becoming ever more difficult to capture alpha from a regional allocation and stock selection perspective. From a relative valuation standpoint, Japanese companies are among the cheapest in the developed world. This is relative to its peers and also to Japan's historical average.

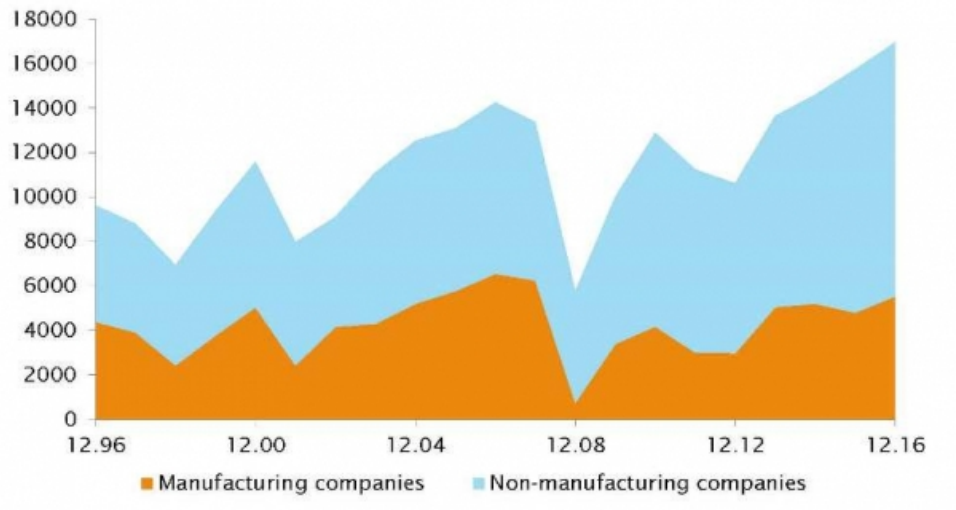
For example, Japanese stocks currently trade at 14x 12 month forward P/E ratio, a significant discount vs S&P 500's 18x and STOXX Europe 600's 15x.

A potent multi-asset diversifier

While it may seem the case for investing in Japan is back, but the truth is it never really went away from an allocation point of view. Time has proven the country to be a strong diversifier. To illustrate the impact of a Japanese equity allocation, we ran a simulation of two multi-asset portfolios – one with exposure to Japan and the other without over the period starting December 2006 until the beginning
of May 2017.

The data shows that having exposure to Japan in JPY improved performance, albeit modestly, while the reduction in overall portfolio volatility was far more pronounced. Over the period noted above, the ex-Japan portfolio had an annualised return of 5.9%, while the one with exposure to Japan in JPY outperformed, posting an annualised return of 6.2%. The ex-Japan portfolio also delivered a significantly choppier ride: it generated an annualised volatility of 8.8%, while the one with Japanese exposure delivered a smoother volatility level of 7.7%. The Japanese market, and indirectly the Japanese yen, has been shown to be a true diversifier in a global portfolio.

Manufacturing & non-manufacturing companies profit increase



Source
Bloomberg, SYZ Asset Management. Data from December 1996 to December 2016

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