Japan Equity
Reflections on 2019 and Market Outlook

Key Takeaways

- In the near-term global issues are likely to remain the main factors influencing the direction of Japanese equities with US-China trade relations a key focus.
- Global growth will slow but monetary and fiscal stimulus should keep it in positive Territory. Neither Japanese economics nor policy are likely to surprise.
- Corporate earnings in Japan declined in 2019, but we believe that 2020 should see at least a modest recovery, with growth probably in the high single digits.
- Ongoing improvement in corporate returns remains a potent longer-term theme in Japan and is a story largely independent from global market issues.
- Japanese equity valuations remain attractive but our positive return forecast for 2020 is based on earnings progression alone.
- We forecast returns in 2020 in the high single digit range.

2019 Market Review

At the end of 2019, the TOPIX index in Japan registered a local currency gain for the calendar year of 18.1% on a total return basis, an outcome that was slightly better than our December 2018 forecasts. For most of 2019 the Japanese equity market has been driven by global, ‘big picture’ issues, most notably:

- The twists and turns in the long-running US-China trade dispute
- The outlook for growth around the world
- The overall direction of monetary policy.

Despite the fact that the first two factors might have been expected to have dragged on equities, monetary policy has proved a key support. The pause in interest rate increases by the US Federal Reserve in the first quarter of the year followed by a reversal in direction over the summer were factors behind equity market strength. However, all was not plain sailing and markets around the world including Japan have seen volatility levels rise as the backdrop has become more fraught.

As far as Japan is concerned, in addition to these ‘big picture’ issues, equity investors had to contend with specific concerns about slowing growth in China, Japan’s largest trading partner, and the possible implications of trade disputes. On the domestic front the economic indicators have remained sluggish but at least the scheduled increase in the consumption tax from 8% to 10% in October does not appear to have caused as big a stumble as was once feared, possibly due to the partial offset of tax giveaways.

Whilst there was some fiscal stimulus over the year, the Bank of Japan left monetary policy essentially unchanged. In contrast to parts of Europe, on the political front stability was the main feature, with Mr Abe becoming Japan’s longest serving post-war prime minister and winning an upper house election along the way in July.
With so much going on globally, Japanese corporate earnings results seemed to fade into the background with stock prices proving resistant to earnings disappointments. This was possibly because investors were quick to discount declines given the softening demand globally and at home. There were few currency-induced shocks, the yen having remained relatively stable over the period. The fiscal half year for the six months to September saw recurring profits of the Russell/Nomura Large Cap stocks (ex. Financials) decline by 12.3% (yoy). Flattening sales growth and increased labour and material costs were a major drag on numbers. However, the market seemed unmoved as it focussed on the possibility of an imminent bottoming of profits and a subsequent modest recovery in the period leading up to the fiscal year ending March. This expected recovery could well have been the biggest factor behind the more bullish stance by foreign investors who, having been net sellers for most of 2019, turned net buyers of Japanese stocks from September.

Earnings Outlook
For the moment, equity markets remain transfixed by developments in US-China trade relations, with stock prices moving up or down on each twist and turn in the story. Unfortunately, trade friction looks likely to continue in one form or another with the attendant market volatility.

On a more positive note, the risk of a significant deterioration in global economic conditions looks limited in view of the accommodative monetary stances of the major central banks together with economic stimulus measures, most notably in China. Whilst recent Japanese earnings reports have been soft, excluding the impact from Softbank Group, which recorded a large loss from its investment business, earnings for the second quarter of this fiscal year were up slightly on the previous quarter’s results. We have made no major changes to the longer-term earnings outlook, which is projected to improve from next fiscal year with earnings rising by more than 8% (Source: Nomura Securities).

The Japanese equity market continues to represent good value for investors. Although stock market valuations have increased along with the index, they remain at attractive levels compared with other developed markets. At the end of November, the Japanese market was trading on a price to book ratio (PBR) of around 1.3 times with an earnings yield of 6.1% and an expected dividend yield of 2.3%; well above the current negative yield on 10-year government bonds (Source: Nomura Research Institute, based on the TSE 1st Section).

Moreover, investors should not forget that the case for Japanese stocks is most compelling over the longer-term as ongoing corporate change and the continuing focus on improving shareholder returns points to higher stock valuations. It is certainly worth noting that share buy-backs in the first ten months of 2019 were up over 100% (yoy) and companies are awash with cash to fuel further buy-backs and dividend increases. Financial leverage has continued to fall and over 50% of TOPIX non-financial listed companies now have net cash, compared to under 15% for the US and Europe.

This outlook compares favourably to the picture in most developed markets.

Return Expectations
Taking everything into account, we remain positive on the prospects for Japanese equities. Although short and even medium-term market return forecasts are fraught with difficulty, assuming EPS growth follows the latest projection of 8% with no significant rerating of valuations, the TOPIX could follow this year’s solid performance with returns in the high single digits over the coming year.

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