

## **Goldman Sachs Exchanges**

### **Why 'everything aligns' for Japanese stocks**

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**Allison Nathan:** Japan's stock market is booming. But does this rally have staying power?

**Bruce Kirk:** We've seen this before in the past in that every decade or so we will have a period in Japan where everything aligns the right way and suddenly it becomes a lot easier to make money on the long side.

**Allison Nathan:** I'm Allison Nathan and this is Goldman Sachs Exchanges.

[MUSIC INTRO]

**Allison Nathan:** Joining me to discuss the drivers behind the rally in Japan's equity markets and the state of the country's economy is my colleague in Goldman Sachs

Research, Bruce Kirk, our chief Japan equity strategist.

Bruce, I think it's the first time that we've had you on this program. So, welcome to the program.

**Bruce Kirk:** Thank you very much for having me.

**Allison Nathan:** So, it's been a long time since we focused on Japan on this podcast. But one of the surprise performances of the year has been Japanese stocks. The Tokyo Price Index, otherwise known as TOPIX, has recently hit its highest point since August 1990. So, what's been driving that performance? Tell us a bit about what you're seeing?

**Bruce Kirk:** One of the main drivers of performance that we have seen is the fact that after a period of seven years when foreigners have been net sellers of Japan to the tune of about 27 trillion yen, they're finally starting to come back and readdress the underweight position that they've had on Japan.

What's making them come back? I think one of the main factors has been the corporate governance reforms that

have been pushed by the Tokyo Stock Exchange since January this year. The Tokyo Stock Exchange came out with a presentation in January where it laid out the fact that it wanted companies that traded below book value in Japanese, so at prices to book upon times or less, to boost their corporate value. It's significant because half of the market in Japan trades below book value.

We're suddenly starting to see the value unlock in Japan that people have been waiting for decades to experience and have been disappointed with on a number of occasions. But it does feel like the top down focus, not just from the Tokyo Stock Exchange but the regulator and the government as well is very focused on trying to create a market that has better returns, that has more of a focus on corporate governance, and is a market that looks and feels a lot more like the S&P.

**Allison Nathan:** And why has it been such a long and somewhat painful process in achieving the corporate governance that investors want to see?

**Bruce Kirk:** The big change this time around is that for the first time in 30 years we have meaningful inflation in

Japan. Now, we've had basically 30 years of a deflationary environment. And once you start to get inflation, things like wage growth, which we haven't had in Japan for 20 - 30 years, or earning income from financial assets hasn't been as important for Japanese households because in a deflationary environment, your savings keep pace with the price of goods. And even if your wages don't go up, you're not feeling price erosion.

Now that we have inflation in Japan, I think the government understands that if without wage growth, without financial asset income growing, then sooner or later it'll become a social problem. So, that's why the government is so focused on doing something about it. And that's part of the drive towards trying to make companies in Japan raise their dividends, buy back more stock, make themselves more attractive to retail investors so that retail participates more in the market.

Because at the moment, only 10 percent of Japanese household assets are in the stock market. Compared with the US where that figure is closer to 40 percent. So, that's the challenge and that's the opportunity, I think.

**Allison Nathan:** And so, we think about the recent rally, what investors have participated in that? Has it been retail investors?

**Bruce Kirk:** It's actually been driven by foreigners. Foreigners have been net buyers of Japan for the last 12 weeks. And that's consecutive. And that's quite an unusual length of consecutive buying to have.

And we've seen this before in the past in that every decade or so, we will have a period in Japan where everything aligns the right way. And suddenly, it becomes a lot easier to make money on the long side. And the last time we had that was 2012/2013 with Abenomics. Previously, if you go back another ten years before that, it was when Koizumi was in power as prime minister, and he was focused on structural reform within Japan.

There's always a policy element to this. The policy changes, foreign investors come back into the market. And that's what starts to drive the market higher. And that's what we've seen so far this year. It really fits into that cyclical pattern.

**Allison Nathan:** And do you expect the continuation of the pattern in that sense? Can this rally continue?

**Bruce Kirk:** That's a very good question. And I think if you go back and look at previous rallies like what caused the up cycle, if you ask what caused the down cycle, in both cases, it was when we started to run out of positive momentum around the thematic. So, with Koizumi, he was in power until 2006. And then he resigned very suddenly. And that took a lot of steam out of the rally. And then with Abenomics in 2012 up to about 2014/2015, the first two arrows of Abenomics, so fiscal and monetary, had a big impact on the stock market. The third arrow, which was structural reform, was just a little bit more difficult to quantify. And there wasn't the sort of top-down government focus that we're having currently on TSE, on corporate governance and structural reform back in 2015/2016.

To answer your question, what has to happen for us to avoid this sort of petering out? I think it will come down to the level of commitment and level of momentum from the TSE in terms of actually doing something structurally to change the valuation distribution of the market.

**Allison Nathan:** And let's talk a little bit about the valuation because you've obviously seen these big gains. And so, our Japanese stocks just getting too expensive at this point?

**Bruce Kirk:** A lot of what we've seen so far has been driven by multiple expansion. There is some earnings growth there. But it's single digit. But it is positive.

So, from an earnings-based point of view, we're probably 14 times at the moment. Average is closer to 15 times. So, we're not unusually expensive at the moment. But I think the area to focus on is not the PER, but the PBR of the market.

So, PBR means price to book value. Price to book ratio. So, it looks at the market cap of a company versus its net assets. And even now after the rally we've had still something, 47 - 48 percent of TOPIX is still trading below book value. And that's the group of companies that the TSE is focusing its efforts on.

I think until we see sub book PBR profile similar to either the US or Europe where companies that trade below book

are maybe about 20 - 15 percent of the market, I think it's difficult to argue that we're over valued at this stage of the cycle.

And again, if you want to focus on flows and think about previous rallies, if you look at the foreign buying of Japan from the start of Abenomics to the peak of Abenomics and then you look at the buying that we've had so far this year by foreigners, we're less than a quarter of the way there. And I'm not saying that everything will go up in a straight line. It never does. And it does feel like we may have some sort of correction or pullback over the summer just given how extended the technicals are at the moment. But it's very difficult to articulate an argument that says that Japan is overbought or overvalued at this stage.

**Allison Nathan:** And are you expecting upside? How much upside might we see over the course of the next six or 12 months?

**Bruce Kirk:** So, our near-term three-month target price is 2,200. So, downside from here. And that's based on the fact that technically I think we've had a very good run in Japan so far. And you've got to leave some room for profit



taking. Seasonality. TOPIX is usually quite weak over the summer. And then in terms of catalysts, it does feel like after the annual general shareholders meeting season, which finishes this week, we're not going to have any major corporate governance related catalysts until the early autumn. So, that's why we're looking for a bit of downside in the near-term.

But then going into the end of the year, we're looking at that to rise again to 2,400, which would be, I guess, 5 - 6 percent upside from where we are at the moment. And then our 12-month target is 2,500. So, slightly weak over the summer. But then recovering into the end of the year.

**Allison Nathan:** But even amid all of this investor enthusiasm, the gains you are expecting are not particularly high. But maybe high relative to the recent history in Japan.

**Bruce Kirk:** Yeah, if you look at the rally so far, it's really been driven by the large cap, the large constituents of TOPIX and Nikkei. And some of these names have gone up over 100 percent. The SPE sector has gone up 60 percent. Trading companies have gone up close to 50 percent. There

are still a lot of laggards left in the market. So even though we're not looking for a huge amount of upside, I think it's possible to see some sector rotation take place as we go through the summer and as we go into the end of the year.

**Allison Nathan:** So what sectors or types of companies are best positioned here?

**Bruce Kirk:** Yeah. Look, we are focused on the barbell strategy going into the end of the year. So, the sectors that we think will move from, say, September into December, on one end of the barbell we're looking at, let's call them foreign favorites. The type of stocks that large, institutional foreign shareholders like to buy in Japan. Your fast retailings. Your world leaders. They've been some of the biggest movers so far this year. And I think if you're a foreign investor coming back into Japan, it's easy to buy what you already know and what you already own. And I think that's one end of the barbell.

The other end, I think, will be liquid names that are trading at a discount to book value that fit within the TSE guidelines or the TSE focus and that have a level of, say, quality or brand recognition. These are reasonably high-

quality names that are trading below book value but have the type of liquidity profile that would attract foreign institutional investors.

So, that's what we see into the end of the year. And in terms of how that would play out in a sector basis, it would be machinery, particularly the factory automation side of machinery, electronic components and precision autos and banks. Those are our preferred sector choices.

**Allison Nathan:** So let's pivot for a moment because, of course, the stock market is not the economy. And the economy has its own set of fundamentals. Talk to us a bit about the state of the economy and how it's faring.

**Bruce Kirk:** It is very buoyant at the moment. I think if you were to go to Japan, you really would feel the difference compared with even like 12 months ago. From October we've had Japan opened up to tourism again. In terms of in-bound spending, we're pretty much back to the levels that we had pre pandemic. Even though the number of tourists that are coming to Japan is about 50 percent from those peak levels.

So, what's happening is we seem to be having higher value tourists coming back into the market and spending more per capita. Hotel rates are up. It's very difficult to get hotels in Japan at the moment. Restaurants are full. It does feel like the economy is going through a very strong demand period. And part of that is inbound tourism. But also, we have wage growth with the highest levels we've had for 30 years. Prices are going up. But there's still a decent amount of accumulated savings left over from the pandemic as well.

It really does feel very constructive at the moment. That is playing out in the sales numbers that we see from domestic demand-related companies as well.

The ideal for Japan is that you would have this virtuous cycle of rising prices and rising wages that would keep demand strong. And so far, at least, that seems to be what we have.

**Allison Nathan:** So, we began this conversation talking about inflation and it's come up several times. We have the Bank of Japan continuing to keep its interest rates ultra low. So, do you expect that to change given this inflation

trend?

**Bruce Kirk:** If you went back to October last year, the expectation when Mr. Kuroda was still the BOJ governor was that something would happen between the last six months of his tenure as BOJ governor. I think there was high expectations that something would happen with yield curve control and also with the normalization of monetary policy. And that's what really drove the increase in bank share prices over that period.

When that didn't materialize at his last meeting in March, and that was combined with the sell off that we saw in the US triggered by Silicon Valley Bank and Signature Bank, a lot of money came out of the banking sector very quickly. So, at the moment it feels like positioning is quite light. Valuations are still pretty low. The banks are about .6 times PBR which fits in that TSE thematic quite nicely. They have dividend yields between 4 - 5 percent, which is quite high by Japanese standards. And they are improving their ROE. So, there's a lot going for the banks even if you don't focus on what's happening with the BOJ.

I think our expectation as a firm is that you might see a

tweak to YCC at the next meeting at the end of July. But it seems clear that the new BOJ governor Mr. Ueda is going to take his time and look at what's happening with the sustainability of inflation and look what's happening globally with the US and recession risks there. And he's going to be very data driven in terms of the last piece of the puzzle, which would be to normalize rates.

So, I think the bank trade, if you like, which was viewed as quite a short duration earlier this year is the direction of travel and the end destination are still exactly the same, but it's probably going to take a little bit longer, I think, is the best way to think about it.

**Allison Nathan:** And you just mentioned recession risk. We're also seeing a slowdown in China at the moment and somewhat of an unexpected slowdown. And Japan is still an export-driven economy. So, is that the primary risk? Is it external or internal?

**Bruce Kirk:** There are both external and internal risks to be concerned about. Externally, I think you've hit the nail on the head with China risk and US risk. TOPIX as a market is equally exposed to the US and to China in terms

of revenues. So, if there's a big slow down in China or a big slow down in the US, that will have a negative impact on the Japanese market.

From a domestic point of view, the risk of policy missteps, either raising income tax or consumption tax by the Kishida government, I think that could also have a negative impact on the Japanese markets. So, you've got to keep your eye on what's going on globally, but also locally as well.

**Allison Nathan:** Thanks so much for joining us today, Bruce.

**Bruce Kirk:** You're very welcome. Thank you for having me on.

**Allison Nathan:** And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called The Markets. Each week in just ten minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for The Markets and follow wherever you get your podcasts.

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