

# JAPAN EQUITY OUTLOOK 2019

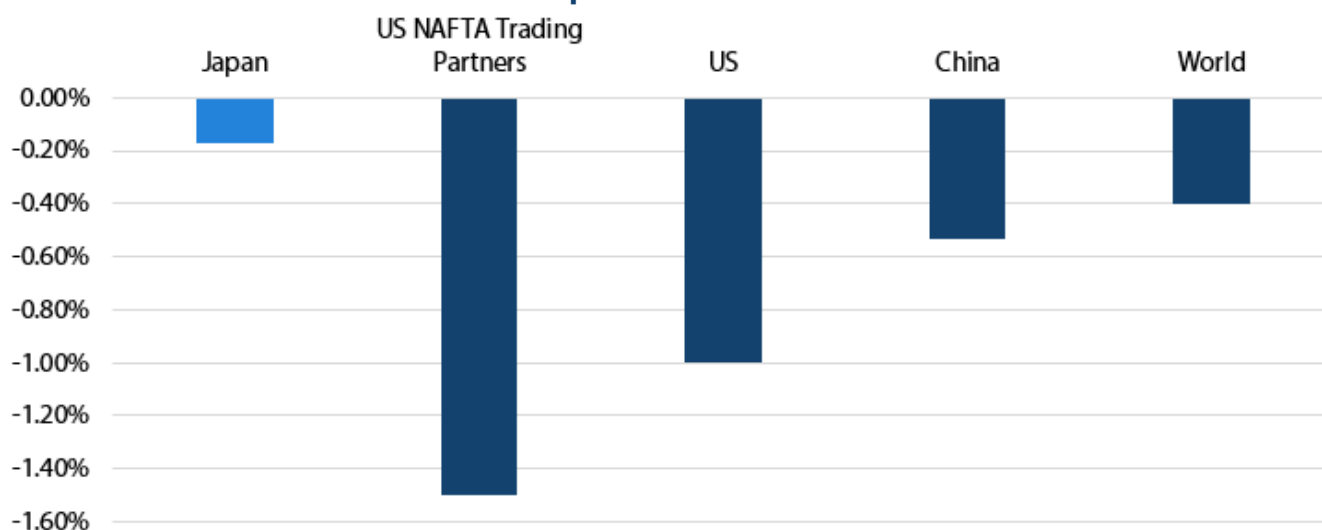
As we reflect on 2018, we would all agree that Trump and his trade policies dominated the conversations and dictated some of the major moves in the financial markets around the world. While the US midterm elections are behind us, we think it is likely that the world will continue to face protectionist moves by the largest economy, given the sheer size of its trade deficit and the continued Republican control of the Senate.

Japan isn't immune from global trends. However, we believe the country offers a unique opportunity set for global investors looking to enhance investment returns while benefiting from diversification.

## Trade tension and Japan

In October, the IMF ran several scenarios for how the trade tensions will play out in the global economy in its latest World Economic Outlook. In the worst case, the long-term negative economic impact for Japan could be "just under 0.2%," with "almost 1%" for the US, and China "just over 0.5%." US NAFTA trading partners could see a 1.5% decline, and the world, "roughly 0.4%" (See Exhibit 1). While there will certainly be sector winners and losers from the tensions, we believe Japan, as a market, is better positioned than others to stand firm against any moves to slow down global trade.

### Exhibit 1: IMF estimates of trade tension impact on Real GDP



Source: Nikko AM based on IMF World Economic Outlook (October 2018)

One of the interesting developments unfolding behind the headlines on US-China trade tensions is that Japan is taking steps to accelerate its free trade policy. In July 2018, Japan signed an EPA (Economic Partnership Agreement) with the European Union, which is expected to take effect in February 2019. The two markets together account for as much as 1/3 of world GDP and 40% of global trade.

Furthermore, the 11-member TPP (Trans-Pacific Partnership), which the US withdrew from in the early days of Trump's presidency, is now scheduled to take effect on Dec. 30, 2018. The group will initially be made up of Japan, Canada, Mexico, Singapore, Australia and New Zealand, followed by Vietnam, Malaysia, Chile, Peru and Brunei. Thailand and the UK have also shown interest in joining. One of the key drivers that led to these developments to promote free trade at a time when protectionism is on the rise, is the strong political leadership in Japan.

## Political safe haven

Japan is currently facing few obstacles to push through agendas and implement policies, as Prime Minister Abe and his ruling party control a majority in both houses of parliament. We believe this substantial political capital can be leveraged to withstand any headwinds, whether it be trade tension or other event risks to the economy.

One such event risk we foresee in 2019 is the VAT hike (from 8% to 10%) scheduled for October 2019. Having learned from its previous experience with a VAT hike in 2014, the government is said to be considering ways to smooth out any impact this time. Specific measures such as tax cuts and subsidies to ease the burden on households and to boost consumer spending on durable goods are said to be considered, in addition to keeping the tax rate on food, beverages and other consumer staple products at 8%. Burdens will also be lessened as approximately 1/3 of additional tax revenue (JPY1.7tn out of JPY5.6tn) is to be used for childcare and other subsidies for households. Moreover, a large-scale fiscal stimulus package, which includes spending on public works to strengthen infrastructure and support the economy, is also expected to be announced ahead of the VAT hike. We believe it is good timing to implement the VAT hike as consistent policy support can ensure a smooth transition.

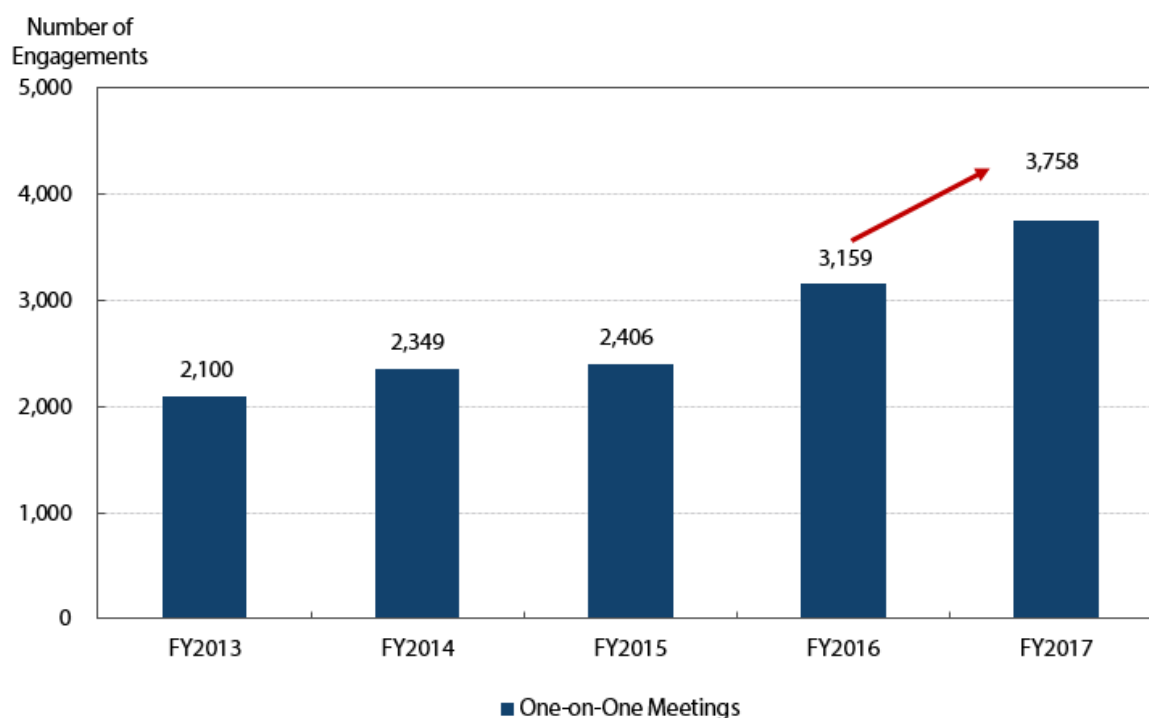
On the monetary side, BOJ governor Kuroda was re-appointed in April 2018 for another five-year term. In the latest monetary policy meeting statement (released Oct. 31), the BOJ stated explicitly that it is committed to continue its accommodative monetary policy for an “extended period of time,” to cope with any uncertainties (including the upcoming VAT hike). The policy accord between the government and the BOJ (from 2013) on their inflation policy is still in effect and thus, we can expect to see consistent policy coordination.

## Inflection point in Corporate Governance reform

Another area in Japan where we see uncorrelated alpha opportunities with the rest of the world is the ongoing corporate governance reform.

Under Abe’s leadership, Japan’s Stewardship Code was introduced in 2014, followed by its Corporate Governance Code in 2015, together calling for companies and institutional investors to engage in constructive dialogue to enhance shareholder value. In May 2017, the Stewardship Code was revised, urging the disclosure of detailed proxy results. Institutional investors and asset owners are required to assume a higher level of fiduciary responsibility, with the aim of enhancing their investee companies’ return on equity (ROE). (See Exhibits 2 and 3 for Nikko AM’s recent stewardship activities).

### Exhibit 2: Nikko AM - Engagements with Firms



Source: Nikko AM

**Exhibit 3: Nikko AM – Proxy Voting Results (July 2017 – June 2018)****Company-Generated Proposals**

	<b>Proposal</b>	<b>Yea</b>	<b>Nay</b>	<b>Subtotal</b>	<b>Nay ratio</b>
Proposals on company functions	Election/Dismissal of directors	14,183	2,934	17,117	17.1%
	Reference: In terms of no. of firms	1,252	832	2,084	39.9%
	Election/Dismissal of corporate auditors	1,568	162	1,730	9.4%
	Reference: In terms of no. of firms	893	135	1,028	13.1%
	Appointment/dismissal of accounting auditors	40	0	40	0.0%
Proposals on executive remuneration	Executive remuneration amount	699	73	772	9.5%
	Retirement benefit payments	162	26	188	13.8%
Proposals on capital policy (excluding proposals on articles of incorporation)	Appropriation of surpluses	1,374	135	1,509	8.9%
	Restructuring	43	11	54	20.4%
	Introduction/renewal/abolishment of anti-takeover measures	0	62	62	100.0%
	Other capital policy proposals	110	8	118	6.8%
Revision to articles of incorporation		510	41	551	7.4%
Other		0	1	1	100.0%
<b>Total</b>		<b>18,689</b>	<b>3,453</b>	<b>22,142</b>	<b>15.6%</b>

**Shareholder Proposals**

	<b>Proposal</b>	<b>Yea</b>	<b>Nay</b>	<b>Subtotal</b>	<b>Yea ratio</b>
<b>Total</b>		<b>25</b>	<b>139</b>	<b>164</b>	<b>15.2%</b>

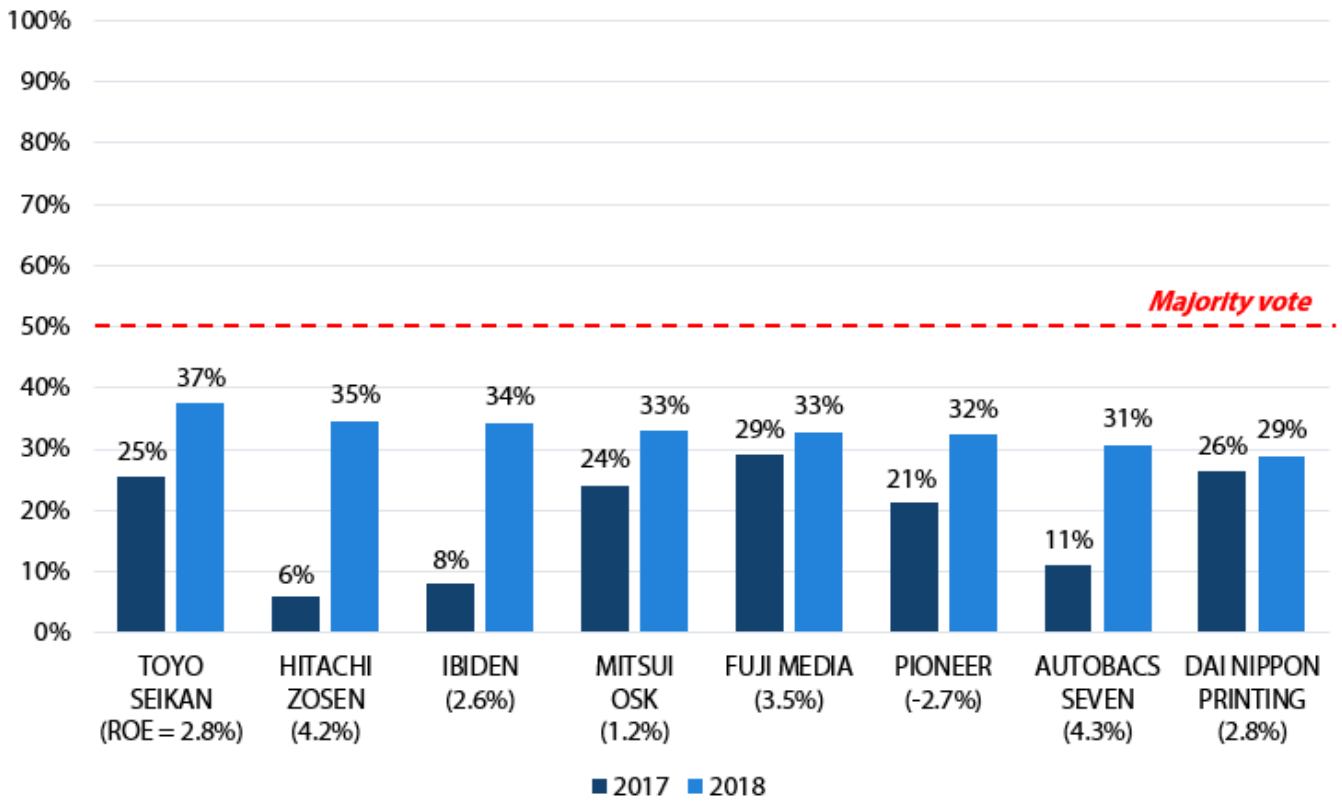
Source: Nikko AM

Note: The ratio of votes against company proposals increased significantly after we signed the Stewardship Code.

Three years after the Corporate Governance Code was introduced, the revised version was announced by the Tokyo Stock Exchange and took effect on June 1, 2018. The core of the revision is an unwinding of cross-shareholdings, enhanced board committees and mobilizing Japan's corporate pension funds toward greater engagement. Companies are now under strict scrutiny by investors and must justify their stock holdings and therefore, boards will annually assess whether or not to hold each individual cross-shareholding. They're examining whether the purpose of each holding is appropriate and whether the benefits and risks cover the company's cost of capital. Japanese companies' ROE is around 9%, lagging that of the US, which is consistently in the mid-teens, so there is still work to be done.

We believe that corporate governance reform can't be done overnight as it is a continuous effort by management teams to change their practices. But we also believe that the aforementioned codes have started to have a meaningful impact on companies. For example, many companies that have low ROEs are increasingly facing "No" votes against the re-election of their top executives (CEO/Chairman) at their annual general shareholder meetings (**See Exhibit 4**). We think an inflection point is just around the corner, and believe it is only a matter of time before we see top executives being ousted by unhappy shareholders due to weak operating results. Corporate governance reform is creating this pressure and investors are well positioned to reap the benefits from proactive actions taken by the companies to enhance shareholder value.

**Exhibit 4: %Votes against re-election of top executive at AGMs vs. ROE**

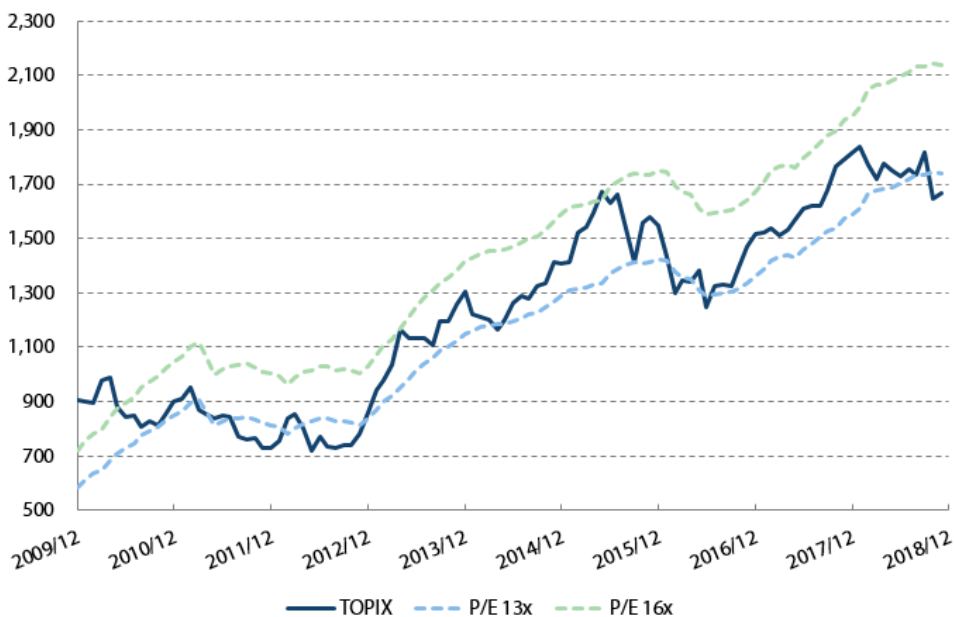


Source: IR Japan and Bloomberg. ROE is 5-yr average adjusted ROE.

### Excessive pessimism

We believe the market is at an attractive level if you are a fundamental investor. The TOPIX index P/E (12-month forward) is hovering at around 12.8x (at the time of this writing on Dec. 13, 2018), falling outside of the trading range of 13x -16x since the start of Abenomics (**See Exhibit 5**). We believe excessive pessimism and fear about the trade war are to be blamed for the recent drawdown, which was then exacerbated by non-fundamental investors such as quants or risk-parity funds.

**Exhibit 5: Valuation outside of the Post-Abenomics trading range**



Source: FactSet. As of end-November 2018.

## The new era

Japan will step into a new era in 2019. The Heisei period (1989 – present) is scheduled to come to an end on April 30, 2019, after Emperor Akihito abdicates the Chrysanthemum Throne. There will be various festivities throughout the year including an abdication ceremony in April and the enthronement ceremony in October to celebrate the ascension of Crown Prince Naruhito. There will also be a one-time, 10-day public holiday at the end of April through the beginning of May, and the country will be in a mood of celebration throughout the year, likely boosting consumption. Inbound tourism (up from 6.2mn in 2011 to 28.7mn in 2017) is also expected to continue to soar with the help of major sporting events such as the World Cup Rugby in September and the 2020 Summer Olympics. The city of Osaka was also elected in November 2018 as the host city of the World Expo 2025.

In sum, Japan today has several aspects that offer attractive uncorrelated investment opportunities to global investors looking to enhance performance with diversification benefits. It has a unique position in the global trade scene, political stability, corporate governance reform, and attractive valuations. We expect 2019 to mark the start of a new era with more investors (and tourists) showing ever more interest in Japan.

## About the Japan Equity Team

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