Outlook on **Japan**

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Summary

- Prime Minister Yoshihide Suga looks set to carry on reformer Shinzo Abe's policies.
- Unlike many developed markets, employment in Japan has remained stable, which has helped manufacturers restart relatively quickly.
- We believe low valuations, political stability, and the potential for a strong recovery make Japanese equities attractive.

There are a lot of moving parts to assess in the coming quarter, both politically and economically. For starters, the sudden resignation of Japan's Prime Minister Shinzo Abe due to a chronic illness opened the way for the election of a new leader, Yoshihide Suga. Abe was the country's longest-serving prime minister and deserves credit for unifying Japan's Liberal Democratic Party (LDP) despite the existence of factional biases under the party's umbrella. Suga's election has solidified Abe's legacy, as the next round of parliamentary voting is not due until October 2021. Suga looks set to carry on Abe's policies, with the sole exception of those around telecoms. Suga has made it clear that he believes the high fees Japanese telecoms charge compared to carriers around the globe put Japan at a competitive disadvantage to other markets, and he wants to change embedded attitudes about setting fees. Rakuten, a Japanese tech company that is rolling out a 5G network, is one of the companies that is likely to benefit from Suga's policies.

Despite the loss of a leader who has been in power since 2012, Japan's politics remain peaceful and civil, while unrest, dissatisfaction, and chaos are the order of the day elsewhere in the world. The United States, for example, is in the midst of a contentious presidential election, with a monumental divide between the two political parties. The battle to replace a Supreme Court justice has carved American political fault lines even deeper in recent weeks. Yet, equity investors seem to have paid little attention to relative political stability in the third quarter, with US stock indices reaching new highs. The FAANG+ stocks have been particularly noteworthy outperformers, as well they should. An increase in digital spending and working from home during the pandemic has helped the likes of Amazon, Alphabet, and Facebook easily beat companies and sectors with brick-and-mortar businesses. Many have claimed this is a new tech bubble which is ripe for a fall, but as long as actual earnings exceed consensus expectations, we believe these tech juggernauts still have upside potential.

In other news, Japan stands out for having one of the lowest COVID-19 infection rates among major economies, which we believe will help manufacturers restart idle facilities and get production back to pre-pandemic levels. Unlike many developed markets, Japan's unemployment rate did not spike when infections peaked, so getting workers back into their previous roles should be fairly straightforward.

In addition, Japanese stocks remain extraordinarily inexpensive on many investment measures, including earnings, dividend yield, and price-to-book. We believe such extreme valuations should drive investors other than Warren Buffett, who recently invested $6 billion in a few Japanese value stocks, to reassess their existing allocations.

The Japanese equity market contains a number of interesting storylines. For starters, SoftBank has been in the headlines with plans to divest itself of ARM, a British semiconductor and software design company, and pursue further buybacks. Some reports have indicated that CEO Masayoshi Son wants to take Softbank private. If that happens, the implications for other cash-rich companies would be profound. We have been pushing for some companies with similar characteristics to SoftBank, like Jafco, a firm that invests in life sciences companies in the US and Japan, to go private. We believe such companies could achieve a positive outcome with a management buyout.

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Nintendo also remains an investor favorite, and it's easy to see why. The company is a major beneficiary of the higher rates of digital consumption the pandemic helped usher in and seems intent on monetizing its recent success in converting customers from buying physical games to downloading them. The company recently raised its manufacturing forecast for the Switch console to 30 million units this fiscal year. Nintendo appears confident in their ability to extend the Switch product cycle. Given that such a huge portion of sales comes from software developed in house, extending the Switch product cycle bodes well for consistent profit improvements.

In aggregate, we believe Japan remains cheap and offers a direct play on global economic progress. The country's political stability, increasingly rare in the world, is an additional plus. There are few equity markets that can claim to have a global pandemic well in hand, boast low valuations, compelling dividend yields, and a leveraged link to manufacturing production.

Important Information

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