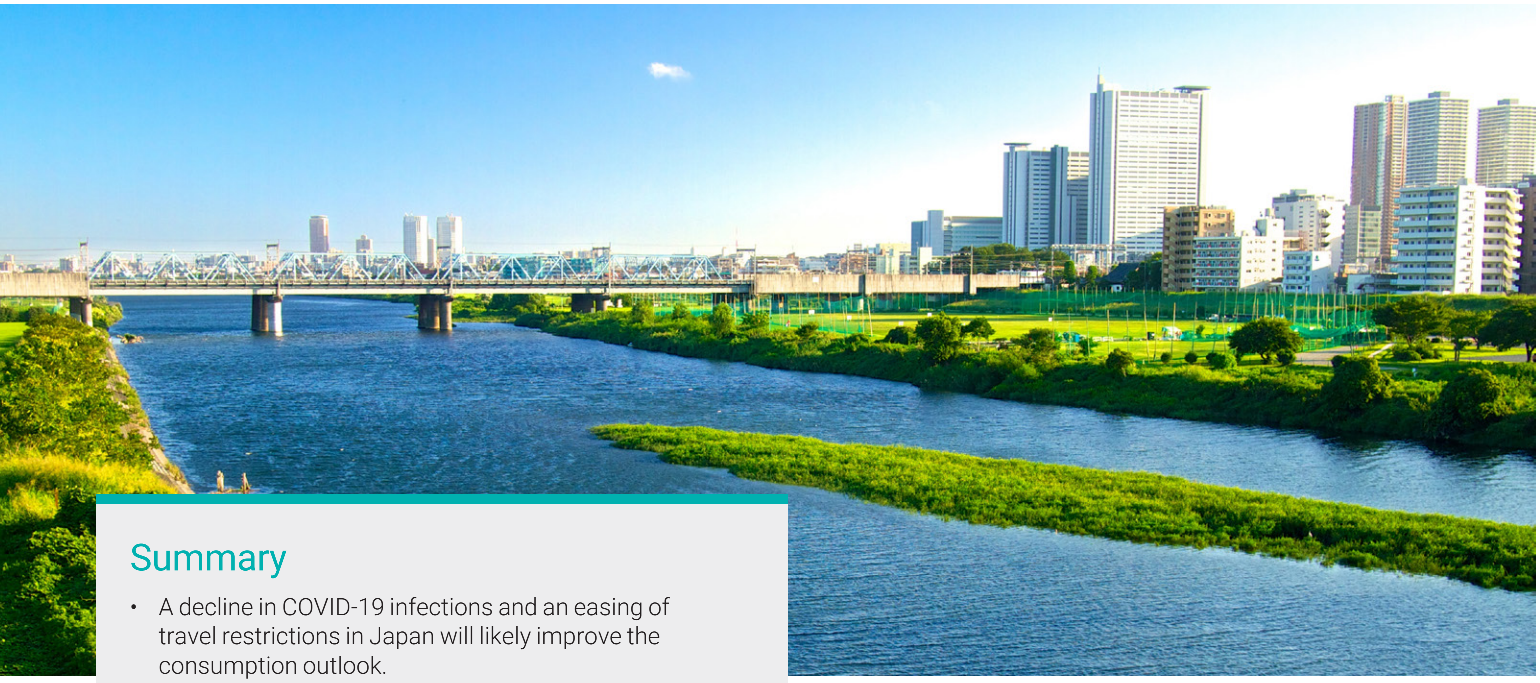
Outlook on

Japan

JUL 2022



Summary

- A decline in COVID-19 infections and an easing of travel restrictions in Japan will likely improve the consumption outlook.
- Weak currency and rising inflationary expectations could positively impact the economy and equity market.
- Most Japanese companies delivered better-than-expected fiscal year results and expressed a positive outlook despite challenging conditions.

Japan continues to move toward a reopening of its economy, following an easing of COVID-19 restrictions. Thanks to a continued decline in the number of infections, Prime Minister Fumio Kishida has proposed a gradual reopening of Japan to overseas visitors. For the first time in two years, the country has opened its borders to foreign tourists on group tours; as of 10 June, the number of entrants allowed in per day rose to 20,000, double the previous number. Not surprisingly, investors have already started to focus on stocks that might benefit from this return of inbound tourism—but more importantly, we are heartened that this could improve the overall consumption outlook.

With oil and other commodity prices rising and the yen weakening, inflationary expectations have increased. This presents a challenge for the Bank of Japan (BOJ), which has largely maintained the status quo, as the US Federal Reserve and many other central banks around the world have hiked rates. The gap between negative Japanese interest rates and rising rates in the United States and Europe has resulted in the Japanese yen weakening to levels not seen in the last 20 years.

We believe that the combination of a weak currency and rising inflationary expectations will have positive implications for the Japanese economy and equity market. First, it makes Japan the most cost-competitive it has been since the early 1970s, in terms of the real effective exchange rate. We would also note that a weak yen is a positive for aggregate Japanese corporate earnings. Second, we believe that rising inflationary expectations could have a meaningful impact on attitudes toward domestic investment and consumption, which still suffer from a deflationary mindset.

Economy and Market

Japan's GDP contracted 0.5% on an annualized basis during the first quarter of 2022 due to a slowdown in private consumption and a pickup in imports. However, this contraction was less severe than expected. Our reading of corporate earnings suggests that momentum remains positive. In general, most companies delivered better-than-expected fiscal year results, and maintained a positive outlook despite challenging macro conditions, such as the ongoing war in Ukraine and continued supply chain disruptions.

Corporate Japan remains awash with cash. Despite shareholder returns increasing to record highs, net cash continues to accumulate on corporate balance sheets. This remains a key focus of our continuous engagement with Japanese management teams. We sense that

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companies are becoming increasingly uncomfortable about holding excessive net cash positions as Japan's market for corporate control continues to open. Domestic growth is also expected to improve because of a large fiscal package and a reopening tailwind. In addition, Prime Minister Kishida's commitment to nuclear power should help alleviate the energy crunch.

We reiterate that Japanese equities present an attractive opportunity for investors. In our view, improving shareholder returns and corporate governance standards, attractive valuations historically and relative to other countries, and a strong fundamental outlook are setting the foundations for strong absolute and relative returns over the long term.

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