Outlook on Japan

The tide appears to be turning for value investors. The valuation spread between the least expensive Japanese stocks, or value stocks, and passive, exchange-traded funds (ETFs) hit an all-time gap of 2.5 standard deviations in August.1 The subsequent reversal in September was remarkable as Japanese value measures, such as price-to-earnings and price-to-book, strongly outperformed their growth counterparts during the month.2 Will investors who have given up on active value investing in favor of passive, lower fee options eventually pay the price? We believe the answer is yes. There appears to be a looming ETF liquidity crisis—these funds have grown too big, too quickly, which is particularly concerning if and when ETFs start to experience outflows.

In Japan, there are indications that a revival of value investing is now under way. A modest recovery in oversold cyclical and technology stocks appears to have broadened into an attempt by investors to reposition their portfolios in reaction to an unexpected shift in this trend. This development is being driven by a modest shift in the US yield curve that suggests that the US economy is slowing. The fact that this recalibration is occurring most noticeably in financials sector stocks is not a surprise to us. However, we believe that it has caught a large number of active managers ill-prepared to deal effectively with significant, unpredictable sector movements. As we have discussed in the past, it is difficult to predict when the market rotation from fixed income to financials stocks would occur. Because of this, we continue to maintain that it is critical to have the optionality in a portfolio for when such an event does happen.

Japanese bank stocks have experienced a bubble once before. During the 1980s, prices for bank shares rose so significantly at one point that they comprised 60% of the Topix Index. Most investors will agree today that this extreme level of overvaluation, which at the time was driven primarily by a spurious notion of hidden assets held in company balance sheets, is not something that can be easily monetized. Japan’s banks have done an admirable job of selling non-core assets (mostly cross shareholdings) and look well positioned to produce modestly growing profits through downsizing and staff cuts.

The ongoing expense reductions at major Japanese banks are legitimate. If smaller banks move to impose deposit fees, it will likely serve as a catalyst for small investors to look to larger, better-capitalized banks as a solution. While the deposit flows into larger banks will exacerbate loan/deposit ratios, the problem appears to be nominal given the sheer size of these institutions. After more than 10 years of coping with deflation, Japanese banks are finally in a position to take aggressive steps to adjust business structures to accommodate shrinking net interest margins. Given the severely depressed valuations in this sector, a rebound to a more normal level of inflation should not come as a big surprise, especially as lenders show evidence of improving profitability. Contrary to the skeptics, we believe this value-led rally has further to go and will most likely more than offset the discrepancy between overvalued, low volatility sectors of the market.

Summary

- Japanese value stocks showed signs of life in September following a prolonged period of underperformance.
- We believe this value-led rally has further to go and will most likely more than offset the discrepancy between overvalued, low volatility sectors of the Japanese market.
- After more than 10 years of coping with deflation, Japanese banks are finally in a position to take aggressive steps to adjust business structures to accommodate shrinking net interest margins.
This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes
1 Source: CLSA
2 Source: MSCI

Important Information
Published on 4 October 2019.

Mention of these securities should not be considered a recommendation or solicitation to purchase or sell the securities. It should not be assumed that any investment in these securities was, or will prove to be, profitable, or that the investment decisions we make in the future will be profitable or equal to the investment performance of securities referenced herein. There is no assurance that any securities referenced herein are currently held in a portfolio or that securities sold have not been repurchased. The securities mentioned may not represent an entire portfolio.

This document reflects the views of Lazard Asset Management LLC or its affiliates (“Lazard”) based upon information believed to be reliable as of the publication date. There is no guarantee that any forecast or opinion will be realized. This document is provided by Lazard Asset Management LLC or its affiliates (“Lazard”) for informational purposes only. Nothing herein constitutes investment advice or a recommendation relating to any security, commodity, derivative, investment management service or investment product. Investments in securities, derivatives and commodities involve risk, will fluctuate in price, and may result in losses. Certain assets held in Lazard’s investment portfolios, in particular alternative investment portfolios, can involve high degrees of risk and volatility when compared to other assets. Similarly, certain assets held in Lazard’s investment portfolios may trade in less liquid or efficient markets, which can affect investment performance. Past performance does not guarantee future results. The views expressed herein are subject to change, and may differ from the views of other Lazard investment professionals.

This document is intended only for persons residing in jurisdictions where its distribution or availability is consistent with local laws and Lazard’s local regulatory authorizations. Please visit www.lazardassetmanagement.com/globaldisclosure for the specific Lazard entities that have issued this document and the scope of their authorized activities.

This report is being provided for informational purposes only. It is not intended to be, and does not constitute, an offer to enter into any contract or investment agreement with respect to any product offered by Lazard Asset Management, and shall not be considered as an offer or solicitation with respect to any product, security, or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.

Equity securities will fluctuate in price; the value of your investment will thus fluctuate, and this may result in a loss. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy. Investments in Japan are subject to certain risks, such as the risks associated with the economy of Japan generally. A portfolio of securities concentrated in one country or geographic region may be subject to greater volatility than a more diversified portfolio.