

The Wonders of Japan's Economy

Disruptive Forces in Investing

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Anu Rajakumar: Japan continues to play a key role in the global economic landscape. With significant corporate reforms, foreign inflows, and its position as a potentially more stable alternate to China, Japanese markets have been of great interest to global investors, but there are a number of headwinds to consider. Slow consumer spending, wage growth, and demographics, to name a few. But what learnings can we glean from Japan as we consider this rich investment opportunity, and what fragilities should investors be aware of? My name is Anu Rajakumar, and to hear more about this topic, we brought back one of our favorite Japanese portfolio managers, Kei Okamura, to give us a recap on how the economic backdrop has shifted and what other factors investors should consider when it comes to Japan. Kei, thanks for coming back to the show.

Kei Okamura: Thanks, Anu.

Anu: All right, Kei. So, it's been about a year since the time that we had you on last, and in that episode, we did a deep dive into the impact on monetary policy reform, in addition to discussing company engagement, which I know is a focus for your team. Now, since that time, there's been a lot of activity and interest in Japanese markets. So, let's start by just hearing a quick overview on what are some of the notable events that have transpired in the Japanese economy over the last 12 months or so?

Kei: Thank you very much, Anu. Just to give you a bit of a recap, with some figures. So, in the last year ending April, we saw Japanese equities led by Nikkei 225 and TOPIX gaining more than 30% and of course, we have seen the Japanese yen depreciate significantly against major currencies, say, for instance, the US dollar, down from 138 to 158, a ¥20 move over the year. And then at the same time, the Bank of Japan has raised interest rates for the first time in 17 years in March.

Now, this we think is on the back of really, three key pillars, that are supporting Japan's, economic and equities market. The first one being, of course, the economic fundamentals. In that in the past year, we've certainly seen, wage growth, continuing to pick up and this has become increasingly, in our view, more sustainable and this is not just across, large caps, but also smaller companies and then at the same time, we've also seen consumer prices, you know, stabilize as well. On the reform front, we have seen many companies announce very bold moves to shore up capital efficiency.

And we have seen, the government continuing to commit to, revamping and reforming, Japanese companies. And last but not least, geopolitics. I think clearly, we have seen Japan become a favored destination for investments by both businesses and investors.

Anu: All right, terrific. So, let's just recap those three key pillars that you talked about, economic fundamentals, reforms, and geopolitical dynamics. So, maybe for my follow-up question, let's start from the last one there, geopolitical dynamics. Tell us a little bit more about how those issues have really impacted Japan.

Kei: Certainly. The businesses and investors that we speak to look at Japan as sort of a geopolitically neutral market, given its very strong relationship with the US and Europe, and at the same time, it's, very geographically well-situated market, given its close proximity to Asia. And I think, you know, we can't hide from the fact that in the past several years we have witnessed, you know, US and China relations continue to become more challenged. And as a result, many global businesses, and investors, have become a little bit concerned about where they should be investing next.

And they don't, obviously, want to lose sleep over this every night. So, when you look across Asia and you try to figure out, you know, which are the markets that will continue to remain an okay destination, irrespective of, say, the geopolitical tensions. And then, of course, you know, a market that has, you know, deep liquidity, good infrastructure. I think if you put that through a screening process, the list becomes shorter and shorter, and you reach Japan. And this is why in the past, 12 to 24 months, we've seen global semiconductor companies set up manufacturing operations, in Japan we have seen Mag Seven companies announce big data center investments in the multi-billion-dollar range, in Japan. And then, of course, you know, we've had very strong foreign fund inflows, coming from, global investors, seeing that, you know, this is a market, that will continue to

do well, irrespective of many of the risks that we're seeing on the geopolitical front. So, I think in that sense, the current geopolitical landscape, has been a tailwind, for this market.

Anu: Yeah, no, that's great to hear, and very excited to see the keen interest from so many around the world in Japan. You know, just sticking on the topic of geopolitics, obviously it's a big election year across the globe in 2024, how is the election cycle going to impact Japanese economic policy?

Kei: Absolutely. So, I think there's really two important aspects to cover in the story. The first one is domestic politics in Japan and then there's obviously the global politics and the elections that are happening around the world, the key one being of course the November US elections, so I'll touch on the first part. In terms of Japanese domestic politics, we have seen Prime Minister Fumio Kishida announce a number of very innovative and progressive market reforms, which have been well received by global investors and we believe this is one of the three pillars that has really driven Japanese equity markets', strong performance in the last 12 to 24 months.

However, his public approval rating has not been very strong. In fact, it's been one of the lowest among prime ministers historically, and we believe one of the key reasons has to do with the fact that wage growth, even though it has been increasing, hasn't caught up with inflation. And so, if you, go across Japan outside of the key metropolitan areas, you do see weakness in consumption sentiment does seem a little bit weaker, but that said, once we see this year's very positive wage negotiations filter through to actual month-on-month pay increases, we think this will recover but one concern is that obviously whether Prime Minister Kishida's, popularity will rise with that in tandem. And then on the second part with respect to global elections, our view is that Japan will continue to remain a favorable market destination for investments irrespective of what the election outcome might be in the November US elections. However, you know, I think it's in the best interest for Japan to maintain a stable political environment domestically and continue to have good friends globally.

Anu: Yeah, absolutely. Now, you did mention a few of the macroeconomic variables up top, as you mentioned, we've seen the BOJ hike rates for the first time in many years, the currency has weakened more recently. How are these issues impacting things like, you know, consumer dynamics, you mentioned wage growth, and ultimately equity markets in Japan?

Kei: Thanks for that question because it is quite important. What we have seen, as I mentioned at the very top, is that the Japanese yen has weakened considerably against major currencies, notably the US dollar. One of the key driving forces of this is the uncertainties about the outlook for US Fed decision-making going forward and this has been, part of the reason why despite the Bank of Japan, raising interest rates for the first time in 17 years in March, we had continued to see, weakness of the currency. And this was partly, accelerated by the governor's, dovish comments at the recent, press conference, post the monetary policy meeting.

However, as I alluded to earlier with the, broadening out of the wage effects across the economy, we should, begin to see a pickup in consumption, more sustainable increases in wages. And then that in turn will also, we believe, move on to a more sustainable increase in consumer prices. And this, I think, will become increasingly clearer in the second half of this year towards autumn. And what is important is that, the Bank of Japan wants to see, evidence that, there's more sustainable growth in wages and prices, but once it does, they will be, more keen to raise interest rates, normalize monetary policy and I think that is when we will begin to see the ball shift from, US dynamics to Japan dynamics for, the yen's direction going forward. The investment companies that we're speaking to say that they're anticipating around 100 to 145 for the next fiscal year. We think that sounds about right, and in that kind of environment, most Japanese businesses think they'll continue to do, quite well, albeit it is a little bit higher than the current yen levels that we're seeing today.

Anu: Okay, great. Thank you very much. Now given a lot of these in some ways, monumental changes both in the macro as well as some of the corporate reforms happening, tell us a little about how you as an investor on the ground are really reacting. What is changing about the way that you're approaching the Japanese market again, as a portfolio manager?

Kei: You know, Anu, one of the things that we do here in Tokyo is that we continue to look for high-quality companies with strong moats characterized by pricing power that have good growth potential and are not priced, egregiously expensive and that investment approach, hasn't changed. It's the same as it was 12 months ago. It's the same as it was 10 years ago, but, you know, one of the things that we continue to look for is the opportunity to find the next company that could potentially be the key winners.

And I think the one thing that has changed compared to, say, one or two years ago, is that this market dynamic of, real wage growth potential for inflation going forward, and then of course Japan possibly coming out of the lost decades, this has become

increasingly clear. And I think in that kind of environment, we will continue to see winners outperforming at the expense of losers. And on this backdrop, we also have continuous very strong corporate governance and capital management reforms taking place in this market, but increasingly, the market will look for companies that are moving a step further to address the capital mismanagement in this market.

So, you know, a year ago when we spoke, we had seen this sort of wave after wave of share buybacks and dividends, which was a great first step, but that alone will probably not result in a fundamental re-rating of the market. Since then, we've seen a number of companies announce management buyouts, takeover bids, letting go of unprofitable businesses, things that 10 years ago would've seemed unimaginable in this market because of the antiquated views of many corporate management in Japan are now being changed.

So, if we want to look for the winners that will continue to win at the expense of losers, if we want to look for companies that are going a step further in reforms, this is companies run by progressive management, you need an active investment approach and hopefully one, like ours, that will continue to seek out those companies that will win, and at the same time, pursue good reforms that will create amazing shareholder value over the mid to long term.

Anu: Now, Kei, you have been quite articulate in expressing what seems to be quite a positive outlook for Japan. What are the biggest risk factors to your viewpoints that you've shared today?

Kei: Absolutely. I think, one of the issues that Japan has always had, is that, you know, whether it comes to this sort of, good momentum that we're seeing, the potential for inflation to root itself and to become sustainable, and then whether it's the reforms led by the government, to take off the beginning sort of, first base is going well.

The issue is getting to second base, third base, and then back to the home base and during the Abenomics era, what we saw was very similar to what we're seeing today. We got to the first base, that was great, but the follow-through to the second and third was weak. And this led to the exodus of foreign equity foreign investor influence into this market.

Our view though, today, is that many Japanese companies that we're speaking to, many Japanese regulators that we're speaking to, they think that this is the last chance to get it right for this market. We literally had one regulator tell us this is the last chance that Japan has to keep Japanese to keep global investors in this market. So clearly the sense of awareness, the sense of urgency is there.

And then on top of that, we're speaking day to day with many corporate management, and 10 years ago, some of them might have played lip service, some of them probably wouldn't have invited us to speak at the first place, but now today, you know, they've rolled out the red carpet, they're willing to listen to us, they're willing to take the pain in the short-term, to reap the rewards of the mid to long-term. This is a clear difference in management mindset, but that said this needs to be self-sustaining. The government can't continue to push companies. Shareholders will obviously continue to encourage and push companies to do better, but at the end of the day, it does come down to the companies themselves to continue to be better and to outperform over the mid to long-term. So, I think in our view, this is beginning to take place. I'm more optimistic than I was 10 years ago, that this will become self-sustaining, we need to be patient, but I think we'll get there, and I think the pace at which these, wins and results will come through will accelerate over the mid to long-term.

Anu: Terrific. Thank you so much for that. Now, Kei, as we wrap up here, want to ask you for any final closing thoughts from your seat in terms of your general outlook and what we've discussed today.

Kei: Certainly. In the past sort of 12 to 24 months, I sort of mentioned this at the very beginning, we have seen strong investor inflows into this market. This has been good. However, part of that was driven by short-term momentum type fund flows from CTA's and our view is that for this rally in, Japan to continue, we need those long-term institutional sticky money to come into Japan. And our conversations with clients interested clients globally, is that they are keenly looking at Japan, they're sending their teams to do due diligence. We think that as more evidence emerges that, the end of the lost decades has come, that Japan's economy is on a self-sustaining track to see a real wage growth inflation, those investors will finally come to Japan and invest in some of the great companies in this market.

The second point, I think, which is also of interest, is that domestic retail participation has been somewhat weak. At the beginning of this year, the Japanese government put in place incentives, that are in the form of tax breaks for retail investors to invest in this market but unfortunately, many investors at the beginning of the year invested in overseas assets.

However, in the recent, you know, last one or two months, we've actually witnessed domestic retail investors be more interested in Japan. Recent surveys found that 54% of respondents, about 3,000 people participated, said that they would want to top up on domestic Japanese equities followed by US mutual funds, which was at 33%. So, 54% of respondents said, you know, they'll invest in Japanese equities versus US equities at 33%, which until, you know, about six months ago was probably number one.

So, now we are about to see domestic retail participation take place. There is ¥200 trillion, \$13 trillion worth of, household assets, half of which is in cash sitting in banks. This, if it gets unlocked, will be a very, very important, wave of capital that will be going into Japanese equities. That along with you know, long-term global institutional capital, we think will make for a multiyear rise in Japanese equities and we're very hopeful that that will happen in the near term.

Anu: Terrific. That's a great place to end on. I appreciate your thoughts and your time Kei. before I let you go, I have to ask you a quick bonus question. We talked today about the weaker yen, which, is great for those of us who are interested in traveling to Japan, but maybe for those of you who are in Japan, it probably makes travel outside of your country, perhaps not an urgent priority, given the currency there. So, if you were to tell us about travel within Japan, what would be a hidden gem that you found amid your travels that you'd love to share with our listeners?

Kei: Certainly, you know, during the pandemic most of us could not travel abroad. So, it was interesting, during those two to three years my family and we actually spent a lot of time on the road traveling, across all parts of Japan that we had never been to. I think one part that I had sort of overlooked, which I found to be absolutely, just mesmerizing was Shikoku, which is one of the key islands in Japan. It's in the South. They are known for their udon noodles, which I don't know if you've had, but they're very delicious, but they're surrounded by water, that has both cold currents and hot currents, so the fish that you catch there are fatty, but they're also lean at the same time. They also have some great vegetables, fruits. The natural environment is absolutely beautiful. And, sitting in Tokyo, it's great to be surrounded by the Japanese culture, but we're also always constantly surrounded by this concrete jungle, and just to get away from that and to be in this area overlooking the ocean, with the mountains in the backdrop, great food on the table, it really made me appreciate, how important it is to have this sort of beautiful, natural environment. And it also made me realize that there's so many parts of this country that I haven't yet visited. So, you know, Anu if you please come to Japan, I'd love to take you around. There are even parts of this city in Tokyo that I haven't visited yet, so hopefully we'll be able to do a little bit of a discovering in this great country.

Anu: Absolutely. I'm a fan of udon noodles, fish, and getting outside of the concrete jungle, which I also live in in New York. So, I will put Shikoku on my list of places to visit next time that I come to Japan.

Kei: Please do.

Anu: Kei, thank you for sharing your views today on the Japanese market. Clearly, there are a number of tailwinds that make it a highly attractive market, both for investors, as well as, as you mentioned, major multinational companies who, you know, as you explained, are also setting up shop, in Japan. I think you've given our listeners plenty to digest today, and we always appreciate you coming on to share your thoughts. So thank you again for being here.

Kei: Thank you, Anu.

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