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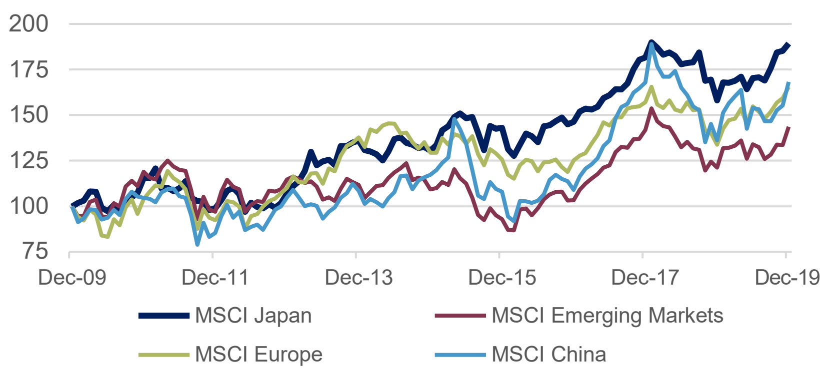
CYCLICAL AND STRUCTURAL TAILWINDS DRIVE JAPAN

For many years, Japan has been an easy investment to ignore. Long entrenched in a low growth, low inflation, low yielding environment, it has taken a while for the rest of the world to catch up. Lost somewhere in the shuffle between China and Emerging Markets within multi-asset portfolios, Japan, a global leader in technological innovation, quietly outperformed them both, as well as Europe, over the last ten years.

Exhibit 1: Ten-year cumulative returns



Source: MSCI; Columbia Threadneedle Investments; from January 1, 2010 through December 31, 2019

Japan's returns look even better on a risk-adjusted basis. For the 10-year period ended 9/30/2019, the MSCI Japan Index delivered a Sharpe ratio well above its Asian and European peers.

Exhibit 2: Risk-adjusted returns

Index	10-YR Sharpe Ratio through 12/2019
MSCI Japan-GD	**0.47**
MSCI AC Asia ex-Japan-GD	0.37
MSCI AC Europe All Cap-GD	0.34
MSCI China-GD	0.26
MSCI EAFE-GD	0.38
MSCI EM-GD	0.21

Source: eVestment. FTSE 3-Month T-bill = risk-free rate; through Dec. 31, 2019

We believe that the past decade’s results were shaped by domestic corporate reforms and cultural changes, as well as the growing demand for technology and robots—areas in which Japan excels. Further, we believe that this dynamic is repeatable well into the future.

Beyond that, there are several reasons that Japan equities are an attractive choice for long-term investors.

Positive factors

The aggregate country valuation, using either price-to-book (PB) or price-to-earnings (PE) ratios, is among the cheapest within developed equity markets, trading at a significant discount to other developed markets.

Exhibit 3: Country/region valuations

	Price/Book Ratio	Price/Earnings Ratio
MSCI Japan	**1.29**	14.62
MSCI United States	3.26	22.20
MSCI Europe	1.80	17.26

Source: MSCI; Columbia Threadneedle Investments; as of December 31, 2019

Japan's economy saw modest growth in 2019, amid a slowing global growth environment. A global rebound would likely benefit the cyclically geared Japanese equity market. When global growth picked up in 2016–2018, the MSCI Japan Index surged roughly 50% in just 19 months.

Domestically, Japan is committed to growing its workforce to boost GDP. The government has provided some support for women to return to work (the female labor participation rate in Japan has already exceeded that of the U.S.) And Japan is now actively accepting highly skilled foreign workers—the number of foreign workers has been almost doubled in a decade.

Labor productivity growth (per hour worked) in Japan is now the highest among all developed economies, providing a boost to economic growth. Japanese companies are looking to invest in areas to further drive their productivity, such as in IT and employee education. We see sectors such as business services, outsourcing, IT and software benefiting. Also, 5G wireless technology is starting to be rolled out across China, the U.S. and Japan as a next generation infrastructure to support new technology frontiers such as the Internet of Things and autonomous driving.

On the consumer side, the recent hike in the consumption tax on goods sold, which went from 8% to 10% in October, has had less of an impact on the economy than many expected. The increased tax is intended to keep funding increasing welfare costs in Japan’s aging economy. There were many exemptions and subsidies provided by the government, and we saw less evidence of preemptive purchases by consumers ahead of the hike than with past increases. Even if the Japanese economy were to slump because of this additional tax, it is highly likely that the Japanese government would announce some type of fiscal stimulus package to support the economy.

Olympics, casinos and tourism

The 2020 Summer Olympics will be taking place in Tokyo. Historically this has been a stage for the host city and country to be on global display, and we expect it to be no different this time around. In 1964, Japan used the Olympics to introduce its pioneering high-speed train, the Shinkansen; this time it will showcase its many technological innovations, from robotics to autonomous driving, attracting the attention of global investors and consumers alike. The Tokyo Metropolitan Government estimates the economic effect will amount to ¥32.3 trillion ($300 billion) and 1.94 million additional employees from 2013 through 2030. We are not expecting a significant post-Olympic economic hangover, as seen in some other host countries, as the government has been careful not to over-invest.

Unrelated to the Olympics, Japan's Integrated Resort Bill could make the nation the next great gambling destination, and casino operators are competing heavily to win concessions. For however much as building a casino will cost, the resulting payoff for being one of three concessionaires will be substantial. Fitch estimates that gambling revenue could be $10 billion annually, topping the $6.6 billion the entire Las Vegas Strip generates per year.

Underlying this is a larger plan to increase tourism. The government has ambitions to significantly ramp up overseas visitors, from current levels of approximately 30 million, to 60 million a year by 2030. This would provide a significant consumption boost and follows an already steep rise in tourism. In comparison, there were just over 6 million visitors to Japan in 2011 (source: Japan National Tourism Organization).

Corporate governance reform

Despite everything discussed above, we believe corporate governance reform may be the most critical positive long-term development for both corporate management and investors. Overhauling corporate governance rules and harnessing the power of private enterprise to benefit stakeholders is a key aspect of Japan's growth strategy.

Allowing corporate management to focus on return on equity (ROE), increasing external board membership and encouraging constructive communication with investors have been extremely beneficial. Corporate governance reform has materially changed the mindset of Japanese corporate management teams—they are now focusing more on profitability, capital efficiency and shareholders' interests. As a result, the average ROE has risen to about 10% over the past five years, in line with European averages—and the tremendous amount of cash Japanese companies have on hand represents low hanging fruit for further increases (source: Columbia Threadneedle Investments).

According to Goldman Sachs research, approximately 50% of the Topix 500 Index non-Financials are in a net cash position. Looking at it another way, cash as a percentage of the MSCI Japan Index's market capitalization is about 20%, which is twice as high as the MSCI Emerging Market Index and four times the MSCI USA Index. Despite ten consecutive yearly increases of dividend payments, and a roughly 50% year-on-year rise of share buyback activities, corporate Japan's financial leverage has fallen consistently throughout most of the decade. All these data suggest that Japanese companies are highly likely to continue putting excess cash to work in the decade to come, through dividend payments, share buyback, internal investment and mergers and acquisitions. The average ROE of Japanese companies has already doubled since Abenomics was initiated, but we believe there is further to go, which can only be positive for share prices. This will be particularly true over the longer term, as the compounding effect of these reforms takes hold.

Conclusion

Signs of bottoming process of the global economic growth, as well as relatively attractive valuations, bode well for Japanese equity markets. Adding to this, the continuing positive impact of corporate governance reforms should play a critical role for share price appreciation in the coming years. As investors look to China and emerging markets to identify long-term growth opportunities and inefficiencies to exploit, they should consider the unlocked potential in Japan. It is a large and robust developed economy with investment opportunities across sectors and market capitalizations. The changes we are observing—revival of the economic growth, the end of deflation, and structural reforms ranging from corporate governance reform to immigration reform—have significant implications for the country's future. Given the diversity of opportunity, we believe that investors would be well-served to revisit this dynamic economy and the innovative companies located there.

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