



Macro Strategy

JAPAN: THE SLEEPING GIANT AWAKENS?

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- We upgraded Japanese equities to +1 in last month's Asset Allocation
- While strong rallies in Japanese stocks are not unusual, they are often short-lived
- We see signs of structural improvement, though near-term challenges remain

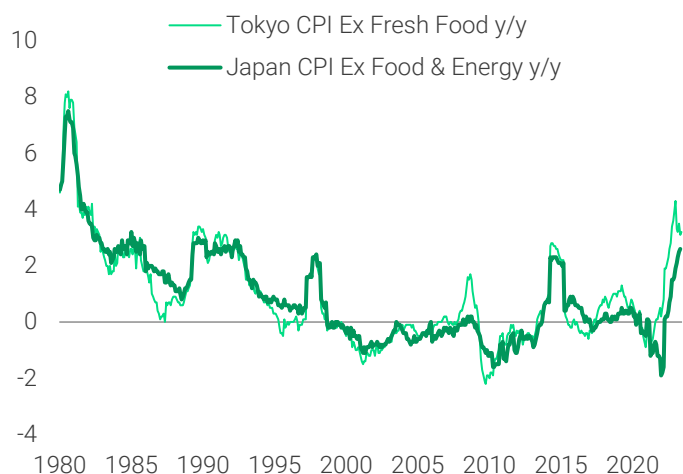
Japan equities upgraded to +1 on inflation developments. In our [June Asset Allocation](#), we upgraded Japanese equities to +1 and increased our portfolio allocation to a larger overweight. We have been overweight Japan stocks since April, based on the market having responded well to a surge in Tokyo ex-fresh food inflation, which reached levels not seen since the 1980s. Inflation has been a problem throughout most of the rest of world, so could these developments be a sign that the deflationary era in Japan is coming to an end?

Inflation is only one of the reasons why [Japanese equities have been performing well this year](#). Below we examine the many factors behind Japan's strong showing year to date – including macro forces, corporate fundamentals, valuations and technicals – and take a look at what could go wrong and derail the rally.

Macro forces: Early signs of structural change

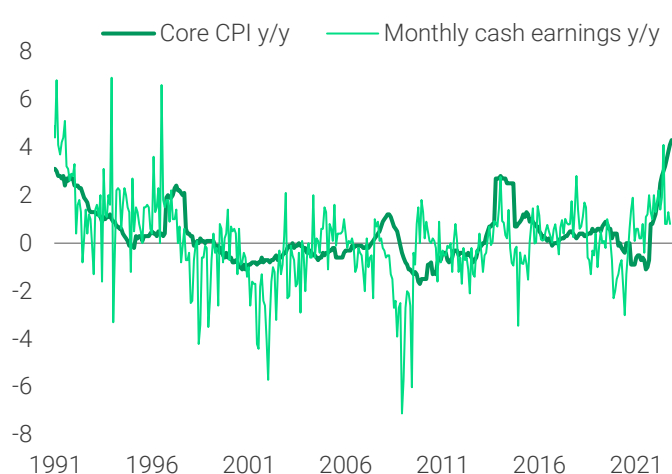
A wage-inflation feedback loop in the making? Above we mentioned inflation and how the recent surge in prices could, in fact, be good for Japan. Since 2000 Japan core CPI has been mostly in negative territory, except for short periods when external shocks (e.g., VAT hikes) bumped the y/y number up. While the current wave of inflation is largely global in nature, the hope is that it could spark a positive feedback loop with domestic wages (chart below right).

Japan and Tokyo core CPI highest since 1980s



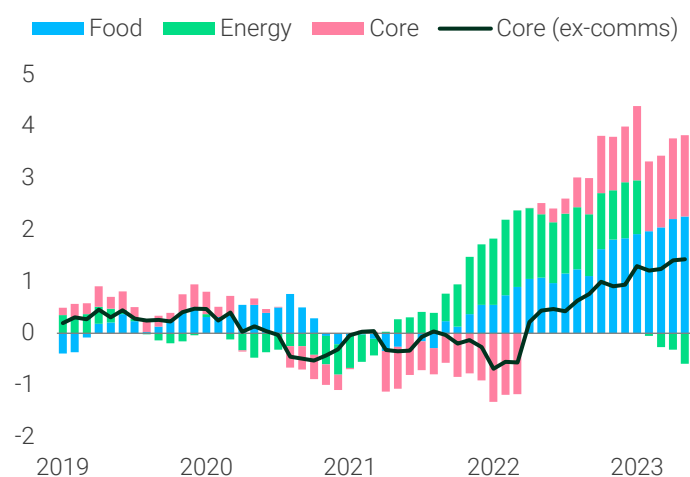
Source: Bloomberg.

CPI and wages tend to move together



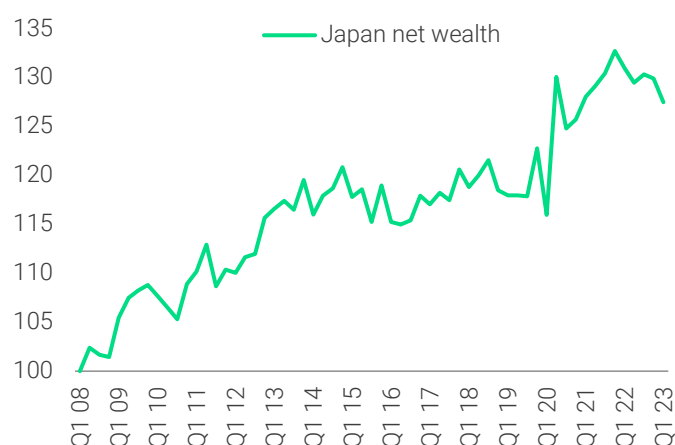
Source: Bloomberg.

Food price rises adding to core inflation



Sources: DataStream, TS Lombard.

Still-high surplus wealth should be inflationary



Sources: DataStream, TS Lombard.

Wage rises filtering through to the SME sector is crucial. This year's Shunto wage negotiations saw significant pay increases. Employers and unions agreed on a 3.8% pay rise, the highest since 1993 (+2.3% ex seniority pay). Toyota, too, awarded its highest pay increases in 20 years. But real wage growth remains negative. So, perhaps the more fundamental question is whether this time will be different and these large salary increases will finally filter into the SME & part-time segments of the economy, which account for more than 70% of overall employment. If this happens, then we may see higher trend growth at last and, more important, domestic demand momentum that is sustainable and endogenously driven. This could underpin a genuine bull market and Japanese equities could become a true diversifier from the rest of the world's macro and business cycles.

To be sure, some structural barriers to inflation are waning:

- Chinese labour is no longer grossly undervalued, with ULC now in growing line with the US;
- Japanese baby boomers are starting to retire, which means their propensity to save should turn in a propensity to spend; and
- Corporate over-indebtedness has ended.

And, cyclically, the ongoing surplus of financial wealth in the household sector due to pandemic stimulus will continue to serve as fuel for real economy inflation (chart above right).

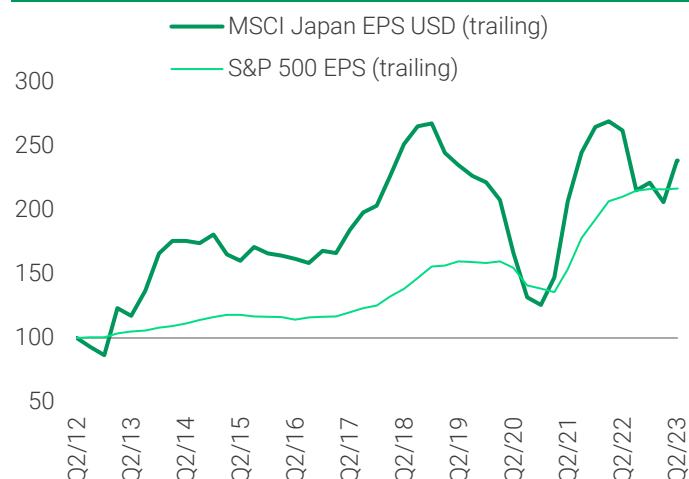
Nonetheless, significant challenges remain. Abenomics failed to deliver its stated objectives. And monetary policy, which remains looser than in most other economies, is causing continued yen depreciation. Demographics are still a major structural headwind, as is an overly rigid labour market. However, we note that women's participation in the job market is a welcome development, as is the fact that the seniority-based pay system is starting to dissipate at the margin, with some big companies moving towards performance-based remuneration.

Main near-term macro risk is US recession. On balance, both cyclical and structural forces are positively aligned for Japan at the moment. The main risk in the near term is the likely recession in the US later this year or next year, to which the Japanese economy would not be immune.

Corporate fundamentals: Positive for now, but more is needed

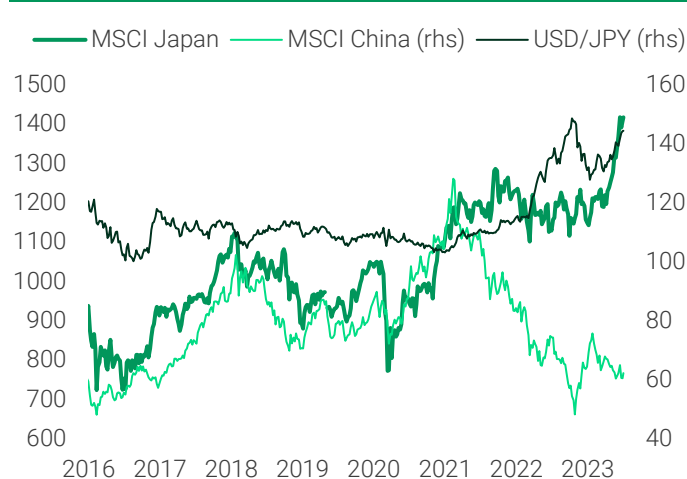
Japan is a cyclical market. As the top-left chart on the next page shows, EPS growth in USD has been on par with that in the S&P 500. However, it has also been a lot more volatile. Japan EPS correlates strongly with the country's exports and is therefore often at the mercy of global trade.

Japanese earnings are very cyclical



Sources: Bloomberg, TS Lombard.

JPY weakness is helping Japan outperform



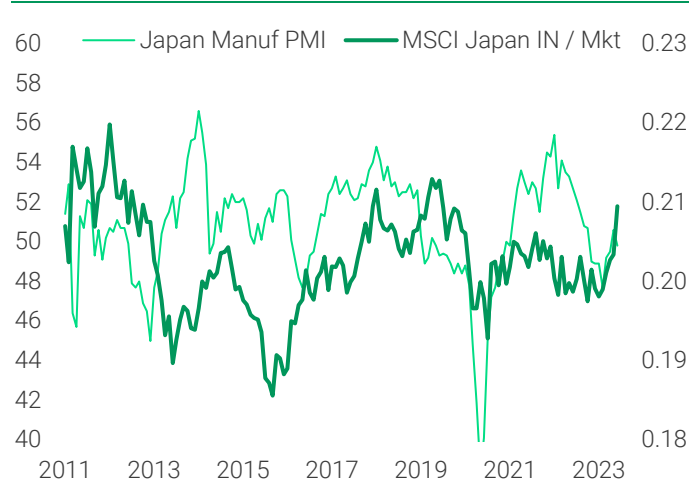
Source: Bloomberg.

JPY remains an important factor. Because of the export-oriented nature of Japanese stocks, movements in the yen have a large bearing on equity performance. As the chart above-right shows, the climb in USD/JPY since 2021 (when the Fed started hiking rates but the BoJ did not) has helped MSCI Japan outperform (even in dollar terms).

Double whammy for EPS on the horizon? Japan's easy monetary-policy stance is set to remain a tailwind, as it is unlikely to change anytime soon. However, the risk is that a US recession pushes other global central banks back into easing mode. A global slowdown and a stronger yen would be a double whammy for Japanese earnings.

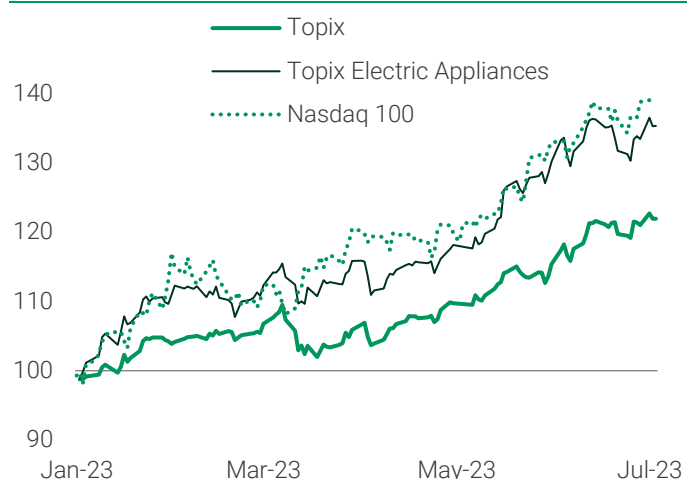
A long-standing issue with Japan is the historically low return on equity. Over the past seven-and-a-half years, Japanese RoE has averaged 8.5%. Over the same period, the corresponding figure for the US was 16.1%, the EA 10.2% and the UK, Canada and Australia around 12%. Until the low RoE issue is resolved, through-the-cycle returns for Japanese equities are likely to remain sub-par. The good news is that there does finally seem to be an effort under way to improve this state of affairs. In May, Hiromi Yamaji, the new Tokyo Stock Exchange CEO, issued a "name and shame" statement about TSE-listed companies with p/b ratios below 1.0. The aim is to remedy this undervaluation. In order for that to happen, capital efficiency needs to be improved (asset turnover, ROCE, etc.), all of which would also boost RoE.

Industrials performance follows industrial activity



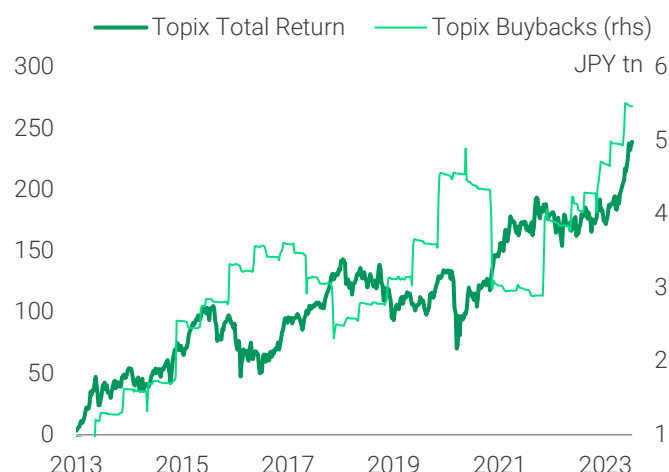
Sources: Bloomberg, TS Lombard.

'Old fashioned' Japanese Tech in line with Nasdaq



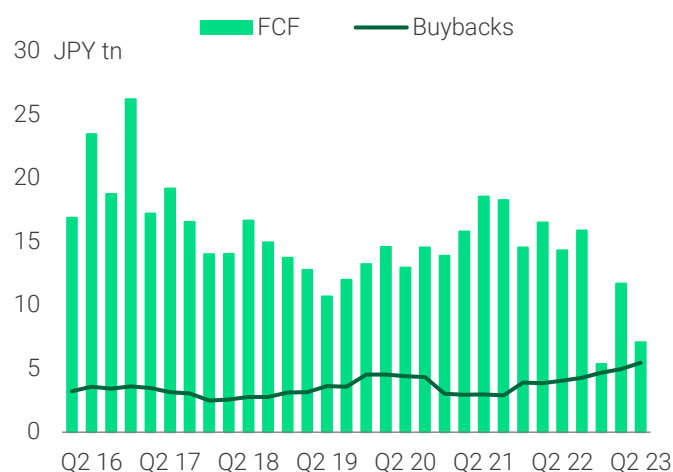
Sources: Bloomberg, TS Lombard.

All-time record buybacks boosting equities



Sources: Bloomberg, TS Lombard.

Recent buybacks barely covered by free cashflows



Sources: Bloomberg, TS Lombard.

Industrials at the mercy of the global cycle. Sector-wise, the strongest performance year to date in Japan has come from Tech, Consumer Discretionary, Industrials and Materials. This paints a somewhat mixed picture going forward. As the charts at the bottom of the previous page show, both Industrials and Tech have outperformed the market. Industrials tend to do so when manufacturing PMI rises; with a US recession on the horizon and China investment disappointing, the strong performance in H1 2023 may be difficult to replicate in H2.

Japan's Tech unlikely to be recession proof. As for Tech, the Topix Electric Appliances index has performed in line with the Nasdaq this year. Tech is considered to be more recession-proof than cyclical Industrials; however, Japan's Tech is more "old fashioned" than that of the US and much more exposed to the vagaries for the global economic cycle. So are Materials and Discretionary, making the rally in Japan stocks vulnerable to a possible downturn.

Valuations: No longer cheap

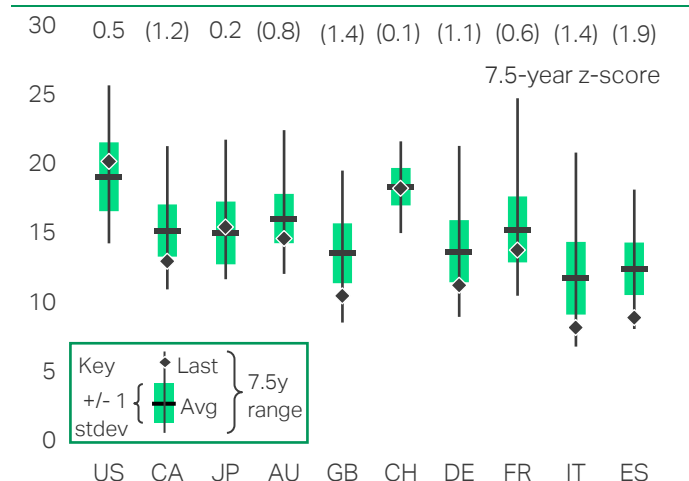
Cheap valuations have often been touted as a reason to buy Japanese equities. For the most part, the market proved a value trap – unable to deliver the hoped-for re-rating that would have resulted in better returns. Following the recent rally, this is no longer the case. Among major DMs, only the US and Switzerland are trading at higher forward p/e multiples than Japan. Even relative to its own cycle, the market is no longer cheap: today, the p/e is above its own seven-and-a-half-year average.

Japan's p/b of 1.3 is too high given its 8.8% RoE. We discussed too-low p/b and RoE in the section on corporate fundamentals above. While it is true that Japan's forward p/b of 1.3 remains low compared with other countries, it does not seem that low overall when the market's RoE is taken into account. The empirical relationship (backed by a theoretical one) between the two metrics shows that even a low p/b of 1.3 is too high for the index's RoE of 8.8%.

Technical: Buybacks are a positive tailwind; short-term overbought

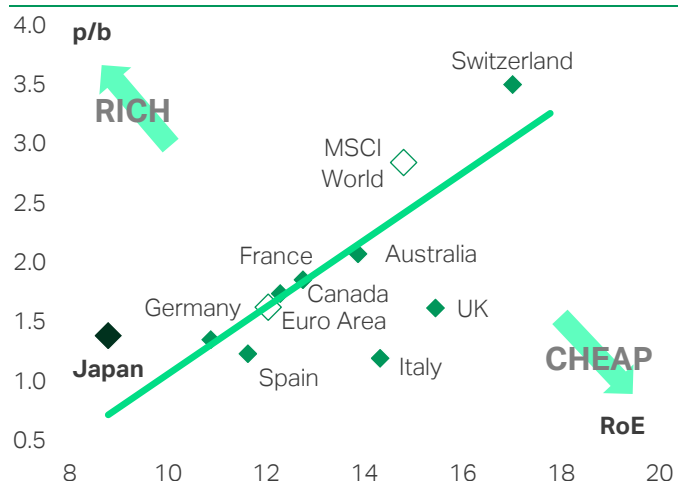
Buybacks and total shareholder payouts are at record highs. The recent rally in Japanese equities has been boosted by higher inflation trends, but a big factor behind the rally was a surge in share buybacks. As the chart above left shows, Topix buybacks has made new all-time highs this year. Including dividend payments, the total shareholder payout yield reached an all-time high of 3.8% in Q1 2023, while 42% of Topix companies have a total payout yield of more than 3%.

Japan no longer cheap either on a p/e basis...



Sources: Bloomberg, TS Lombard.

...or on a p/b vs RoE basis



Source: Bloomberg.

Total payout yields matter for domestic-focused Japanese investors. Buybacks are important for global investors, but perhaps less so than they were only a few years ago when global bond yields were much lower. For Japanese investors with a domestic focus, however, JGBs remain unattractive: the higher payout by equities should continue to boost demand for the asset class.

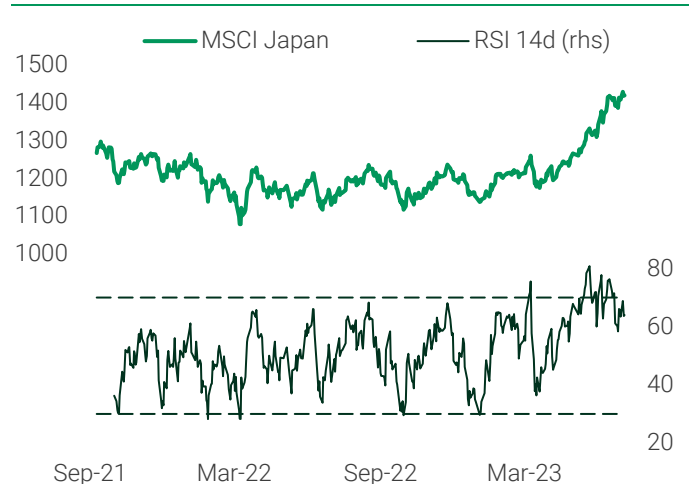
In the near term, Japanese equities look overextended, though perhaps not as much a few weeks ago. The good news is that the rally was very broad, with nearly 80% of the Topix constituents trading above their respective 200-day moving average.

Conclusion: Structurally promising, but cyclically challenged

Hopes of structural improvement. The rally in Japanese equities this year has been remarkable. Cyclical rallies are not unusual, but for the first time in what has been several decades it looks like the structural stars are lining up favourably for Japan. For now, many of the hopes underpinning the rally (the end of deflation, corporate governance reform, improvement in profitability) remain just that – hopes. But equity markets are built on hope.

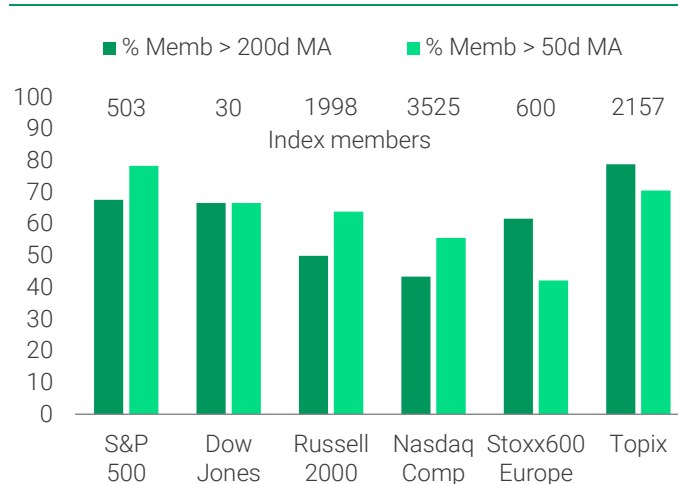
The main near-term challenge for Japan is cyclical. With a likely US recession just around the corner, Japan's exposure to global trade is likely to be a hinderance, and even the market's sizeable Technology sector will not be immune to a global slowdown. Overbought technical conditions and valuations that are no longer cheap are other near-term headwinds.

Japanese equities look overbought in the near term



Source: Bloomberg.

Most Topix stocks above the 200d moving average



Source: Bloomberg.

Current trade recommendations

Macro Strategy	Opened	Entry	Last	P&L	Target	Stop	Original rationale / comment
Risk rotation							
Long USD IG vs HY	24-Aug-22	-67bp	-100bp	33bp	-100bp	-80bp	Sell 5x protection CDX IG, buy CDX HY. IG risk pricing more generous than HY*
Long Healthcare & Staples vs Energy & Real Estate	17-May-23			-2.1%			Defensive markets outperform as the cycle matures
Long MSCI US Quality vs MSCI US	03-May-23			0.7%			Quality outperforms as the cycle matures
2023 Fed cuts							
Long TIPX US Equity	17-May-23			-2.3%			end-23 US recession and Fed cuts are bullish treasuries
Long 2s10s USD steepener	28-Jun-23	-100.2	-102.64	-2.44			Cuts & recession => bull steepening
Short DXY	18-Jan-23	102.4	102.9	-0.5%			Slowing US vs RoW growth & Fed cuts
Inflation volatility							
Long TIP US Equity vs IEF US Equity	17-May-23			1.2%			Markets misprice inflation volatility & persistence
Policy divergence							
Long Gilts vs Bunds	07-Jun-23			-0.7%			STIR overestimates BoE vs ECB hawkishness
Long 1-5y Gilts**	08-Feb-23			-3.5%		-3.5%	The BoE has limited tightening ahead before cuts in 2H23
Long Canadian Govvies	01-Feb-23			-3.1%		-3.5%	The BoC tightening cycle is over
Short French 2y BTAN	26-Apr-23	2.96	3.5	52.7		30	ECB hawkishness + french fiscal problems
Long carry							
Long NZD, GBP & CAD vs SEK, CHF & JPY	14-Jun-23			7.6%		5.0%	
Growth divergence							
Long NOK/SEK	22-Feb-23	1.00	1.02	1.8%		1.0%	Norway's economy to outperform; risk of Riksbank policy mistake

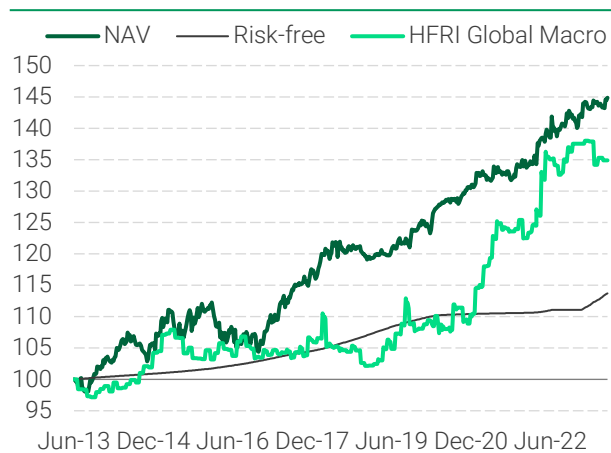
Bold indicates new trades or changes made this week. (**) Closing today.

EM Trade Recommendations

Asset	Asset class	Long	Date	Units	Open	Current	Total
		Short	Opened		Level	Level	Return (\$)
BR + MX + ID	Local debt	Long	<u>9-May-23</u>		100.0	105.5	+5.5%
USD/CNY		Long	<u>22-May-23</u>		7.032	7.244	+3.2%
Brazil		Long	<u>12-Jun-23</u>		1,623	1,651	+1.8%
India vs China	Equity	Long	<u>26-Jun-23</u>		3,321	3,307	-0.4%

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Model portfolio historical performance



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since inception return	44.87%	34.92%
Annual return		
2020	4.51%	5.38%
2021	2.12%	7.72%
2022	6.26%	11.36%
YTD	1.96%	-1.91%
Volatility (ann.)	3.83%	4.60%
12m Sharpe	0.83	0.08
12m Sortino	1.52	0.21
Max drawdown (12m)	-2.23%	-2.78%

* Calculated using excess returns & monthly volatility

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