Japanese Financials: The Long and Short of It

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The Japanese financial sector has not been immune to the recent negative sentiment surrounding the financial industry globally. However, we do believe the reaction is over-done and that there are still opportunities in life insurers in the short term and banks in the long term.

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Introduction

In December 2022, as Governor Haruhiko Kuroda unexpectedly widened the target band for the 10-year JGB yield, the Topix Bank Index had its best month of performance relative to the wider market since January 1987. Seen as the beginning of monetary policy normalisation in Japan, the index continued to outperform in the first few weeks of 2023 as global investors piled into Japanese financials, culminating in a high for the Topix Bank Index on 9 March.[1]

Then came the news of a capital crisis and bank run facing Silicon Valley Bank ('SVB') in the US.

In Japan, this news – as well as the ensuing turmoil at Credit Suisse – resulted in a violent market rotation from Value to Growth; and a flight to defensives and tech. Between 7 March (when news of SVB broke) and 11 April, Japanese banks and insurers were the two worst-performing sectors in the Topix.

In this article, we discuss the short- and long-term opportunities that remain in the Japanese financial sector.

The Short-Term Opportunity

Japan's banking sector had, for many years, been an ugly duckling; a reputation that intensified when the Bank of Japan introduced its negative interest-rate policy in 2016. Then, in December 2022, the BoJ announced it would relax its yield curve control ('YCC') policy, allowing the Japanese 10-year bond yield to reach 0.5% (versus a previous cap of 0.25%). This was widely regarded as a long-awaited pivot by the BoJ to move away from an ultra-loose monetary regime, with the banking sector being the biggest beneficiary.

Of course, there are potentially significant positive effects on bank profitability from rising rates. However, thanks to the issues faced by the US regional banks, the market is also now acutely aware of the potential balance-sheet risks. There is no suggestion that Japanese banks are as vulnerable to the same liquidity risks as US or European banks as deposits are very sticky. However, with March's stark reminder of the interest-rate risks that bank stocks can face when bond yields rise, the market's enthusiasm for the monetary policy normalisation trade has tempered. So, the short-term trade in Japanese banks is perhaps now less compelling, in our view.

> "The recent underperformance of life insurers presents an investment opportunity."

Instead, we believe the more interesting investment within Japanese financials in the short term is life insurers. The recent underperformance of life insurers has been in line with the banks as the sector is not immune from the recent negative sentiment surrounding the financial industry globally. However, we believe this presents an investment opportunity.

First, life insurers in Japan currently trade at attractive valuations, in our view, particularly from a price-to-embedded value perspective. Second, their profitability should also benefit from the normalisation of domestic monetary policy. Third, they look more attractive than the banks from a balance sheet perspective. While bank depositors can always ask for their money back, this is not the case for an insurance contract. As such, Japanese insurers are unlikely to face the same liquidity risks as banks. Life insurers' long-term liabilities also fall as rates rise, offsetting the declines from bond prices.

The Long-Term Opportunity

While the recent underperformance of the Japanese life insurers may have opened up an interesting investment opportunity in the short term, they also present a compelling investment case in the long term as they are managed by quality management teams who are focused on improving corporate value.

1. Source: Bloomberg.

Are the Japanese banks still an interesting investment opportunity in the long term?

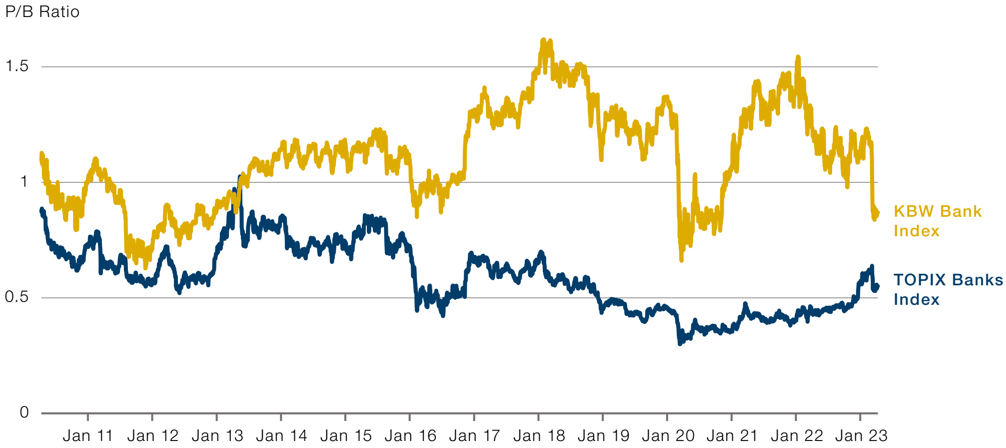
In one word: yes.

Well, what about the banks? Are the Japanese banks still an interesting investment opportunity in the long term?

In one word: yes.

First, from a long-term investment perspective, the valuations of Japanese banks are attractive when compared with their US peers, and they remain depressed relative to history (Figure 1). The Japanese bank sector as a whole trades on a price-to-book ('PB') ratio of 0.55x, a steep discount to the US banks, which even after their recent drop, still trade on nearly 0.9x.

Figure 1. Valuations of Japanese Banks Are Attractive



Source: Bloomberg; as of 11 April 2023.

Second, Japan's core CPI rose at an annual rate of 3.1% in February, the fastest pace in 41 years.[2] We believe this will raise pressure on the BoJ to end its monetary easing and raise interest rates. The effect on Japanese bank profits from rising rates is substantial, in our view, as the sector has more than $3 trillion sitting on excess reserves at the BoJ, earning basically zero at present. Indeed, any further policy normalisation will improve the underlying profitability of the Japanese banks, particularly the regional ones.

Third, as is the case with all Japanese companies consistently trading below a **PB ratio of less than 1.0x**, the country's banks are under pressure to improve their return on equity and shareholder value.

Conclusion

The Japanese financial sector has not been immune to the recent negative sentiment surrounding the financial industry globally. However, we do believe that the reaction is over-done and that there are still opportunities in banks and life insurers.

In the short term, the recent underperformance of the life insurers has, in our view, opened up a potential opportunity to gain exposure to quality management at attractive valuations, as well as exposure to improving sentiment towards financials and any further tweaks by the BoJ.

For Japanese banks, we believe the long-term investment case lies in the valuation, the profitability upside as the BoJ raises rates and the fact that they are under pressure to improve their return on equity and shareholder value.

2. Source: Bloomberg.

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