Views From the Floor

Japan in the sun again after years in the shade

Please note that the opinions discussed below are those of the individual authors and do not reflect a Man Group house view.

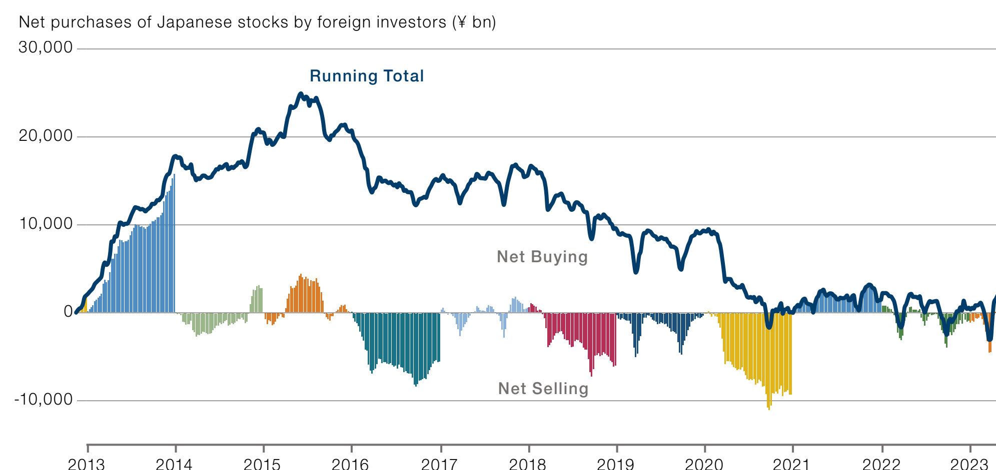
21 June – 27 June, 2023

Time to read: 6 minutes

Foreign investors rediscover Japanese equities

The Nikkei index in Japan is now trading at a 33-year high, driven by foreign inflows into Japanese equities. The key driver of these market highs is the pace of inflows from foreign investors: in the past 11 weeks there have been $69 billion of net inflows from foreign investors. To illustrate the pace of these inflows in a historical context, from the end of 2012 to mid 2015, in response to Abenomics, around $250 billion flowed into Japan from foreign investors, so the current pace is notable, as illustrated in Figure 1.

Figure 1. Foreign investors driving Japanese equities



Bloomberg, data shown on a weekly basis; 02 Nov 12* to date. (2023 YTD: 31 May 23).
*Shinzo Abe won the election on 16 Dec 2012: the stock market anticipated this victory by a month, starting to rise on 14 Nov 2012.

Why are foreign investors so involved in the Japanese market? They own 33% of the market but trade as much as 70% of daily volumes[1] so they have a significant impact on market direction.

What is attracting foreign investors? There are three key drivers:

Firstly, valuations: the Topix is trading around average levels in term of price-to-book (P/B), implying that investors have not yet bid up stock prices despite earnings increasing rapidly. In fact, it was Warren Buffett's investment in Japan that helped to open investors' eyes to the attractive valuation levels on offer in the Japanese market.

1. Source: Japan Exchange Group.

Secondly, the corporate governance movement, where the Tokyo Stock Exchange issued an improvement order earlier this year to any company trading below a P/B of 1 to improve their capital efficiency. Some 50% of the Tokyo Stock Exchange prime index is trading below 1x book[2], so this is a widespread improvement request affecting a broad section of the market.

Finally, the yen: with the Bank of Japan's continued easy monetary policy, the currency has fallen to a seventh-month low against the US dollar, so it is an interesting time for foreign investors to be looking at Japan.

Investors will surely be asking whether this rally can continue. In terms of the outlook, Japan is the only place in the world attempting to create inflation whereas every other region has been trying to contain it. The Bank of Japan (BoJ) last week made comments suggesting there is room to run. BoJ Governor Kazuo Ueda said the economy faces huge uncertainty, which may not be the case in reality, but this assertion allows him to maintain policy status quo. He also believes it is riskier to tighten policy too soon than too late. Lastly, he maintains that rising asset prices are good for the economy. Overall the message is clear: the BoJ is not likely to raise rates soon, and may attempt to keep real rates negative for the foreseeable future.

With an economy that is already strong, a weak currency, and rates staying put, the drivers are in place to allow for more asset price increases. Japan is having its first few days in the sun after many years in the shade, and the recent rally may not be the end of it.

China's policy conundrum

Despite investor enthusiasm that China would in 2023 finally leave behind the problems of the pandemic, with hopes that the country would have the same sort of recovery as the West and that its growth rates would resume, the data is starting to disappoint.

Our view however was that despite these hopes, there would not be a strong consumption recovery; rather, any recovery in the Chinese economy would be shallow and narrow, requiring investors to be highly specific in their exposure, such as sectors benefiting from the mobility-led recovery rather than areas that would benefit from households drawing down excess savings or investment. This recovery has indeed proven to be shallower and narrower; in fact, China's recovery appears to have already peaked and the economy is already slowing down once again. Rhetoric from companies is that there is another wave of Covid that is temporarily hampering mobility and consumption patterns but there appears to be a far larger structural issue at play, with three components:

- Local government debt problems are coming to a head;
- The country's unemployment issue is not being solved; and
- Deleveraging effects are taking hold in households.

These three components add up to an overall deflationary force that is rapidly emerging in China, and is accelerating now that the economy has weakened further. The government is deliberately trying to dampen speculation in the local property market and that has been the lifeblood of the local economy but has not been replaced as a source of revenue.

Local government debt in China has steadily increased at a time when there has been a fall in revenues. The government was hoping for land sales to be flat this year but in fact they are down approximately 20%[3]. The solution to this conundrum seems to be to absorb that debt at the national level into the state-owned banking system, extending the term and lowering the interest cost. While this may be a solution to tackle the debt, it leaves no room for economic stimulus. China appears to be approaching the very end of the useful life of the economic model that has driven its growth ever since the Global Financial Crisis.

2. Source: Bloomberg. **3.** Source: Bloomberg.

Unemployment reduction has stalled because of the drop in manufacturing and property-related construction-type activity. There has been a rebound in the service sector, which has helped unemployment to remain at 5.2% in May[4].

The household sector has been the one remaining hope of the government to boost internal consumption, but the problem is that there is a lack of consumer confidence. There is very little opportunity for households to invest and make money via property like they have done in recent years, and the local government debt problem is not helping returns from the wealth management products, often backed by local debt. This leaves few avenues for wealth creation, and so people are deleveraging. This trend is concerning.

This deleveraging may well be a good development for China in the much longer term but is a negative for its growth prospects in the foreseeable future. The bigger and more immediate concern for China is the deflation impulse, which appears to be emerging quite quickly. The authorities may make some attempts at stimulus but what China really needs is hard structural reform to improve productivity. There is, however, little sign of this happening in the near term. It looks like China's economy is not going to be saving the world this time.

With contributions from: Emily Badger, CFA (Portfolio Manager, Man GLG) and Andrew Swan (Head of Asia ex Japan Equity, Man GLG).

4. Source: Chinese government website, https://english.www.gov.cn/archive/statistics/202306/15/content_WS648a7e44c6d0868f4e8dcdfc.html.

Important Information

This information is communicated and/or distributed by the relevant Man entity identified below (collectively the 'Company') subject to the following conditions and restriction in their respective jurisdictions.

Opinions expressed are those of the author and may not be shared by all personnel of Man Group plc ('Man'). These opinions are subject to change without notice, are for information purposes only and do not constitute an offer or invitation to make an investment in any financial instrument or in any product to which the Company and/or its affiliates provides investment advisory or any other financial services. Any organisations, financial instrument or products described in this material are mentioned for reference purposes only which should not be considered a recommendation for their purchase or sale. Neither the Company nor the authors shall be liable to any person for any action taken on the basis of the information provided. Some statements contained in this material concerning goals, strategies, outlook or other non-historical matters may be forward-looking statements and are based on current indicators and expectations. These forward-looking statements speak only as of the date on which they are made, and the Company undertakes no obligation to update or revise any forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements. The Company and/or its affiliates may or may not have a position in any financial instrument mentioned and may or may not be actively trading in any such securities. Past performance is not indicative of future results.

Unless stated otherwise this information is communicated by the relevant entity listed below.

Australia: To the extent this material is distributed in Australia it is communicated by Man Investments Australia Limited ABN 47 002 747 480 AFSL 240581, which is regulated by the Australian Securities & Investments Commission (ASIC). This information has been prepared without taking into account anyone's objectives, financial situation or needs.

Austria/Germany/Liechtenstein: To the extent this material is distributed in Austria, Germany and/or Liechtenstein it is communicated by Man (Europe) AG, which is authorised and regulated by the Liechtenstein Financial Market Authority (FMA). Man (Europe) AG is registered in the Principality of Liechtenstein no. FL-0002.420.371-2. Man (Europe) AG is an associated participant in the investor compensation scheme, which is operated by the Deposit Guarantee and Investor Compensation Foundation PCC (FL-0002.039.614-1) and corresponds with EU law. Further information is available on the Foundation's website under www.eas-liechtenstein.li. This material is of a promotional nature.

European Economic Area: Unless indicated otherwise this material is communicated in the European Economic Area by Man Asset Management (Ireland) Limited ('MAMIL') which is registered in Ireland under company number 250493 and has its registered office at 70 Sir John Rogerson's Quay, Grand Canal Dock, Dublin 2, Ireland. MAMIL is authorised and regulated by the Central Bank of Ireland under number C22513.

Hong Kong SAR: To the extent this material is distributed in Hong Kong SAR, this material is communicated by Man Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission in Hong Kong. This material can only be communicated to intermediaries, and professional clients who are within one of the professional investors exemptions contained in the Securities and Futures Ordinance and must not be relied upon by any other person(s).

Japan: To the extent this material is distributed in Japan it is communicated by Man Group Japan Limited, Financial Instruments Business Operator, Director of Kanto Local Finance Bureau (Financial instruments firms) No. 624 for the purpose of providing information on investment strategies, investment services, etc. provided by Man Group, and is not a disclosure document based on laws and regulations. This material can only be communicated only to professional investors (i.e. specific investors or institutional investors as defined under Financial Instruments Exchange Law) who may have sufficient knowledge and experience of related risks.

Switzerland: To the extent the material is distributed in Switzerland the communicating entity is: To the extent the material is made available in Switzerland the communicating entity is:

- For Clients (as such term is defined in the Swiss Financial Services Act): Man Investments (CH) AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland. Man Investment (CH) AG is regulated by the Swiss Financial Market Supervisory Authority ('FINMA'); and
- For Financial Service Providers (as defined in Art. 3 d. of FINSA, which are not Clients): Man Investments AG, Huobstrasse 3, 8808 Pfäffikon SZ, Switzerland, which is regulated by FINMA.

United Kingdom: Unless indicated otherwise this material is communicated in the United Kingdom by Man Solutions Limited ('MSL') which is a private limited company registered in England and Wales under number 3385362. MSL is authorised and regulated by the UK Financial Conduct Authority (the 'FCA') under number 185637 and has its registered office at Riverbank House, 2 Swan Lane, London, EC4R 3AD, United Kingdom.

United States: To the extent this material is distributed in the United States, it is communicated and distributed by Man Investments, Inc. ('Man Investments'). Man Investments is registered as a broker-dealer with the SEC and is a member of the Financial Industry Regulatory Authority ('FINRA'). Man Investments is also a member of the Securities Investor Protection Corporation ('SIPC'). Man Investments is a wholly owned subsidiary of Man Group plc. The registration and memberships described above in no way imply a certain level of skill or expertise or that the SEC, FINRA or the SIPC have endorsed Man Investments. Man Investments, 1345 Avenue of the Americas, 21st floor, New York, NY 10105.

This material is proprietary information and may not be reproduced or otherwise disseminated in whole or in part without prior written consent. Any data services and information available from public sources used in the creation of this material are believed to be reliable. However accuracy is not warranted or guaranteed. ©Man 2023.

MKT008396/NS/GL/W