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CAN PRIME MINISTER KISHIDA REVIVE ABENOMCIS?

JAPANESE EQUITIES A DIVERSIFIER INSIDE GLOBAL EQUITIES

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SUMMARY

- Japan proved an exception to the negative returns registered by developed-market equities in September and even reached all-time high on a total return basis in the middle of the month.
- The catalyst for Japanese outperformance was the resignation of prime minster Yoshihide Suga. The new prime minister, Fumio Kishida, is not expected to be a be a policy innovator himself but he will provide stability.
- The state of emergency imposed following a covid-19 outbreak during the summer Olympics was fully lifted on 1 October. This should pave the way for recovery of the domestic economy that so far has proved sluggish.
- A stimulus package to be discussed later this year could further boost the Japanese recovery and so, potentially, could see returns on equity for Japanese stocks catch up further.
- The Bank of Japan's equity ETF buying programme stopped in Q2 2021. But the central bank may provide further direct help to equities if market jitters increase.
- Even though Japanese earnings have outperformed European earnings over the past couple of years, Japanese equities still show a slight valuation discount.
- At a time when the classic diversification benefits of bonds are being challenged, it makes sense for equity investors to look for diversification within equities themselves.
- Japanese equities could be just such a diversifier, thanks in part to the yen, which historically has tended to appreciate during global equity sell-offs. Japanese equities also stand out for their idiosyncratic behaviour as highlighted in September.

September revival

This year started well for Japanese equity indexes, which include plenty of cyclical stocks that benefited from the post-pandemic reopening trade. But after reaching an all-time high in mid-February on a total return basis, the following six months were uninspiring for Japanese equities. The positive image that could have been expected from hosting the 2020 summer Olympics was tarnished by a covid-19 outbreak that was far more virulent than the one Japan had to face in 2020. Then, in early September, prime minister Suga's resignation proved a catalyst for another revival in the performance of Japanese equities just as the coronavirus was being brought under control and vaccination rates reached European levels. After outperforming other markets in September (with the TOPIX total return index surpassing the previous February peak in the middle of the month), we could see Japanese equities benefit from portfolio rotation as surveys show that portfolio managers remain underweight Japan. Despite weaker performance over the past week, September's outperformance enabled Japanese equities to bridge most of the gap that had built up with other markets year to date *(chart 1)*.

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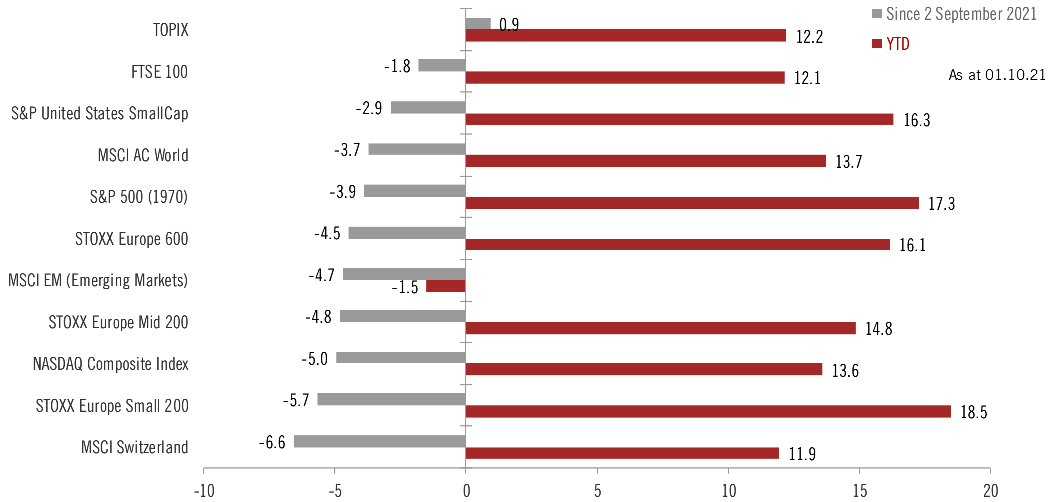
CHART 1: MAJOR EQUITY MARKET RETURNS IN SEPTEMBER AND YTD



Source: PWM - AA&MR Factset, 1 October 2021

Recovery ahead

Fumio Kishida was appointed as head of the governing Liberal Democratic Party and then prime minister on 4 October. Unlike the previous prime minister, Yoshihide Suga, Kishida will not face a covid-19 crisis, with the latest state of emergency, introduced during the summer, fully lifted on 1 October. While Kishida is not considered to have the same charisma or vision as Shinzo Abe, Japan's prime minister in 2016-2020, he is at least expected to provide continuity and stability with a view to ensuring the LDP wins the snap elections to the lower house of parliament called for end-October.

From March and up until the September turnaround, Japanese equities reflected the sluggish recovery in the domestic economy. Japanese stocks failed to match the massive and synchronised rise seen in the US and Europe that saw returns on equity (ROE) rise above their pre-pandemic levels. But as the economy in Japan re-opens, equities there could catch up (chart 2), perhaps helped by a fresh economic stimulus package. The discussed package could reach up to JPY 30 trn, i.e. 6% of Japanese GDP.

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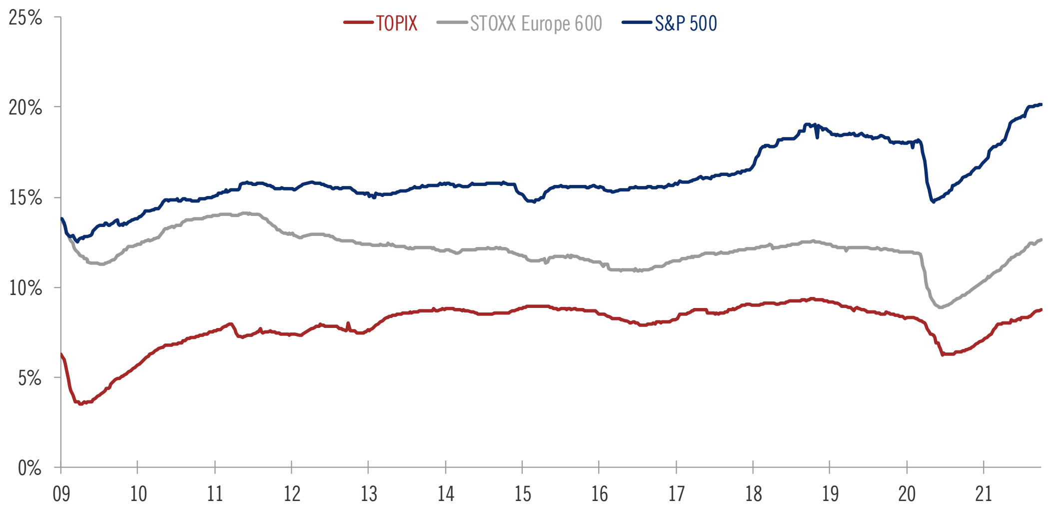
CHART 2: 12-MONTH FORWARD RETURN ON EQUITY IN THE US, EUROPE AND JAPAN

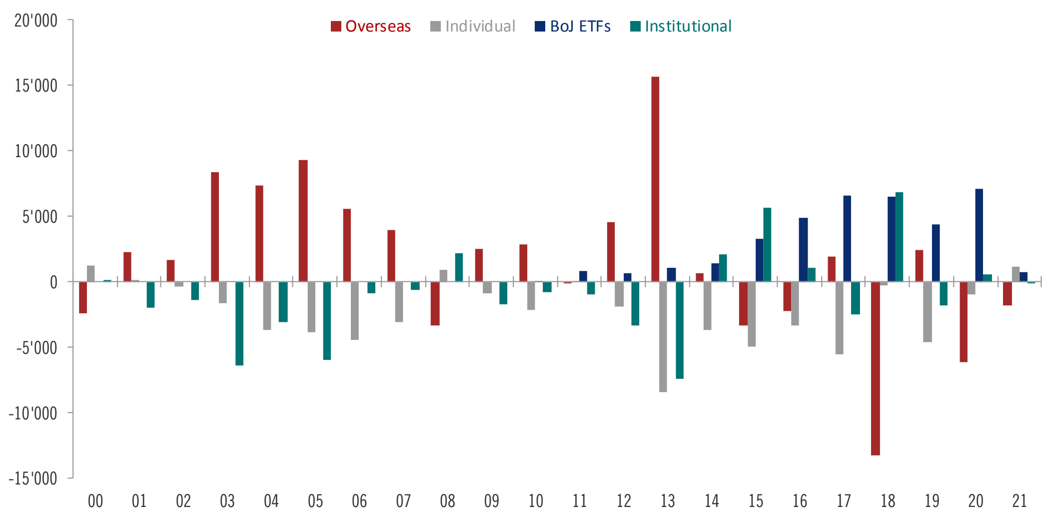


Source: PWM - AA&MR Factset, 30 September 2021

Bank of Japan on hold

A major factor in the disappointing performance of Japanese equities for much of 2021 has been the Bank of Japan (BoJ). The BoJ became a trailblazer among central banks in 2016, when it introduced explicit yield-curve control to keep long-term interest rates near zero and began buying equity ETF (even doubling the volume of its potential acquisitions in March 2020). However, since May, the BoJ has virtually halted its purchases, going far beyond more flexibility in asset purchases. This has restored foreigners as the marginal buyers of Japanese equities *(chart 3)*. However, the BoJ could well revive its ETF purchases should markets become unsettled once more.

CHART 3: JAPANESE EQUITY FLOWS (JPY BN)



Source: PWM - AA&MR , Nomura

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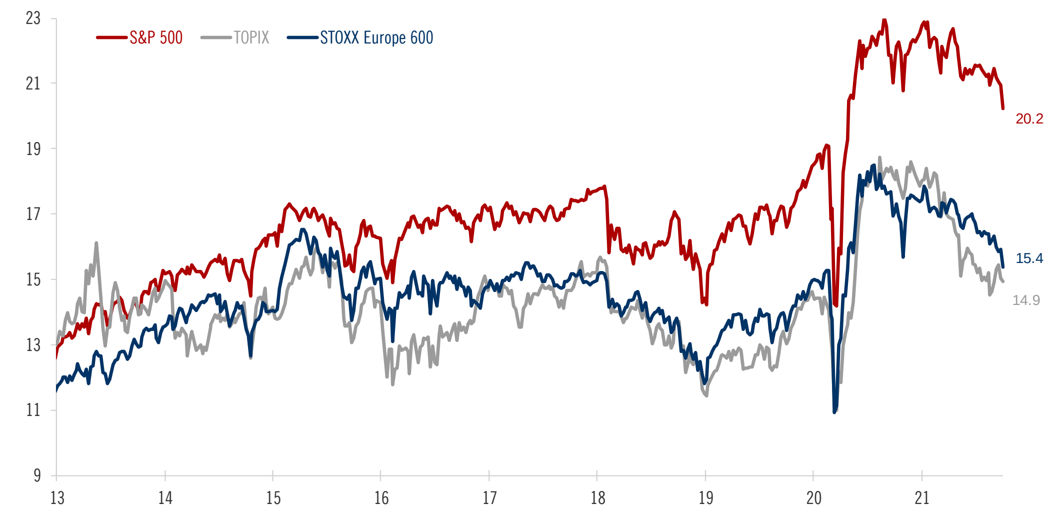
Japanese fundamentals are sound

Usually, Japanese and European equities trade at fairly similar price-to-earnings (P/E) multiples. But average PE premium of European equities relative to Japanese equities widened this year and was at 1.6 point at end of august, close to the highest premium since 2012. This gap fell to 0.5 in September *(chart 4)*. P/E ratios for Japanese and European equities have been generally close in the past because earnings growth has been similar. Japanese earnings tend to be a bit more volatile because of the higher proportion of cyclical stocks, but if we smooth out such variations, we see that earnings growth trends do not differ much between Europe and Japan: looking for data for the period 2018-2021 and 2019-2021, we can see that earnings in Japan have grown even slightly faster than in Europe.

CHART 4: 12-MONTH FORWARD PRICE-TO-EARNINGS



Source: PWM - AA&MR Factset, 30 September 2021

Japanese equities a diversifier

Since May 2020, there have been eight corrections on the S&P 500, with drawdowns ranging from 1.5% to 9.5%. Interestingly, 10-year US Treasuries failed to make a positive return during any of these sell-offs. This is in contrast with classic patterns that show Treasuries notching up positive returns during two-thirds of S&P 500 sell-offs over the past two centuries. The reason for the recent break in the pattern is persistent inflationary pressure together with a less accommodative Fed, both factors that are weighing on fixed-income returns.

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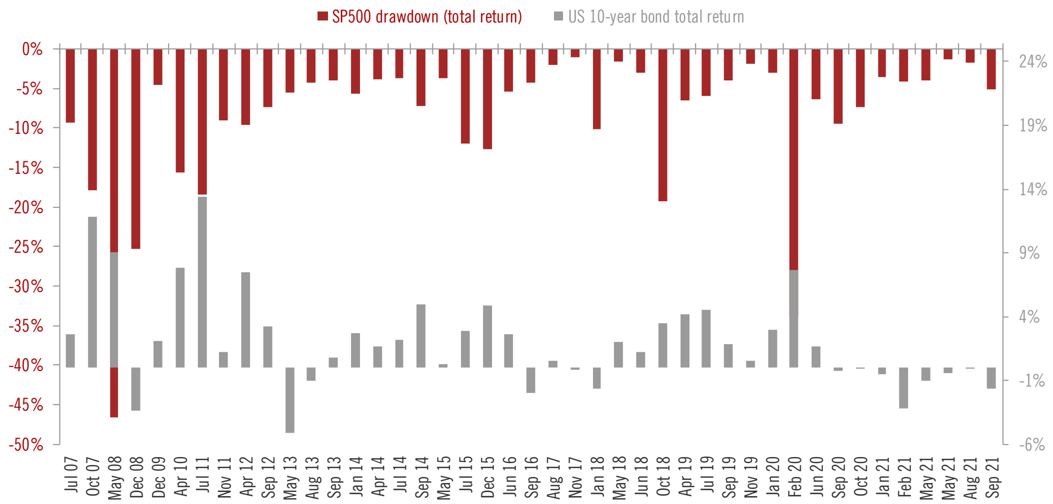
CHART 5: RETURNS FOR 10-YEAR US TREASURIES DURING S&P 500 DRAWDOWNS SINCE 2007



Source: PWM - AA&MR Enter Source information

This means that diversification inside equities is key more than ever. And Japanese equities could play a part in this diversification. First, Japanese equities embed idiosyncratic factors, as their performance in September 2021 highlighted. Second, Japanese equities are a way to access the yen, a defensive currency that since 2007 has appreciated by an average 1.8% against the USD during S&P 500 sell-offs (with some recent exceptions such as last month).

Conclusion

After Japanese equities' outperformance in September, we are leaving unchanged our year-end target of 2,050 for the TOPIX (which stood at 1,947 on 5 October) as we wait to assess potential policy initiatives following the change in prime minister and the calling of early elections. Overall, we feel the diversification benefits they offer justify our positive stance on Japanese equities at a time when fixed income is being challenged by on-going inflation pressures.