

WHY THE  
JAPANESE MARKET  
IS PERFORMING  
WELL AGAIN

White Paper

Marketing document

May 2021



UNION BANCAIRE PRIVÉE

## Key points

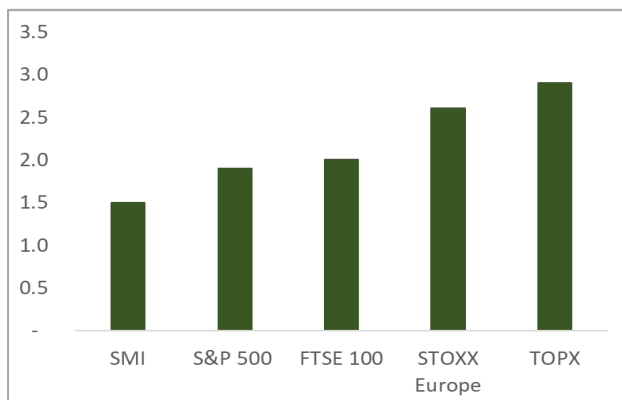
- ◆ *Japan's equity markets have outpaced other major developed market equities in both 2020 and year-to-date in 2021 as the world seeks to transition to a post-pandemic recovery.*
- ◆ *Historically, Japanese equities have generated high beta for global economic recoveries in major developed market regions.*
- ◆ *Japan presents an excellent opportunity for stock-selection-driven alpha and, at a minimum, favours active solutions over index-oriented solutions.*
- ◆ *Since the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015, there has been a slow but steady improvement in governance standards.*
- ◆ *The new listing criteria will tighten governance standards for large-cap stocks listed on the new "prime" section of the exchange.*
- ◆ *The short-term revival for Japan and its long-term target to reform governance should together provide solid grounds to reconsider allocating to Japan.*

In this white paper, we will take a closer look at the underlying reasons behind Japan's comeback in investors' minds and its relatively good performance. The first reason is the embedded cyclicality of Japanese equities in most investors' minds; the second, which we think calls for a structural change in the way we consider Japan, is the ambitious progress that has been made and the goals that have been set in terms of corporate governance improvements.

## Japan: positioned for a global cyclical recovery

Though under the radar since the onset of the global pandemic, Japan's equity markets have outpaced major developed market equities both in 2020 and year-to-date in 2021 as the world seeks to transition to a post-pandemic recovery.

### Beta of equity returns to world trade growth (1-year lead)



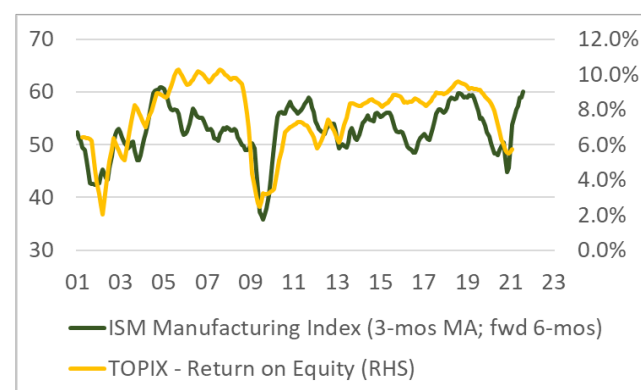
Sources: UBP, Goldman Sachs, March 2021. Past performance is not a guide to current or future results.

Indeed, Japanese equities have historically generated high beta for global economic recoveries in major developed market regions. Perhaps just as importantly, earnings of

Japanese corporates deliver the highest beta to changes in local nominal GDP growth of any of the major developed market regions, suggesting the potential for significant earnings surprises as the economic recovery continues to take hold over the coming quarters.

Along with a deeply cyclical earnings stream, the high valuations offered by Japanese equities are somewhat misleading. Looking back to the turn of the century, Japanese corporate returns on equity have been consistently cyclical, led by global and, in particular, US economic trends. Indeed, with the sharp rebound in US leading indicators, 2021 should see Japanese corporates experience a cyclical rebound in returns on equity from the sub-6% that is common during economic downturns to the near 9–10% that is typical during such economic recoveries.

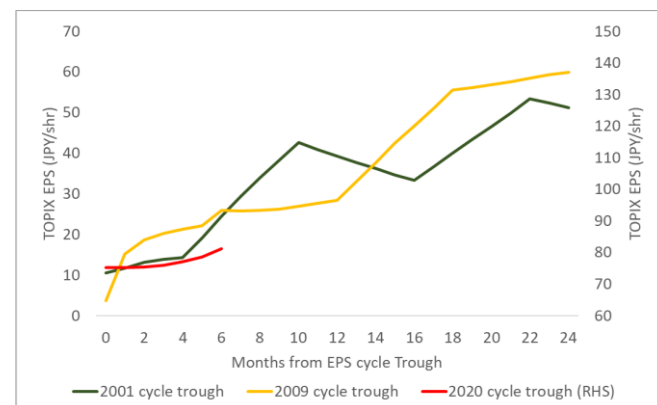
### ISM Manufacturing and TOPIX index ROE (RHS)



Sources: UBP, Bloomberg Finance L.P., March 2021. Past performance is not a guide to current or future results.

Thus, although Japanese corporates have not become as significantly loss-making as in the 2001 and 2009 global recessions, the scale of the economic stimulus and emerging economic rebound suggests meaningful cyclical earnings upside in the quarters ahead. Assuming that 9–10% peak-of-cycle returns on equity reappear, Japanese equities could still see a substantial earnings surprise above the current consensus expectations, which forecasts 42% EPS growth for FY2021.

### Number of months from EPS cycle trough

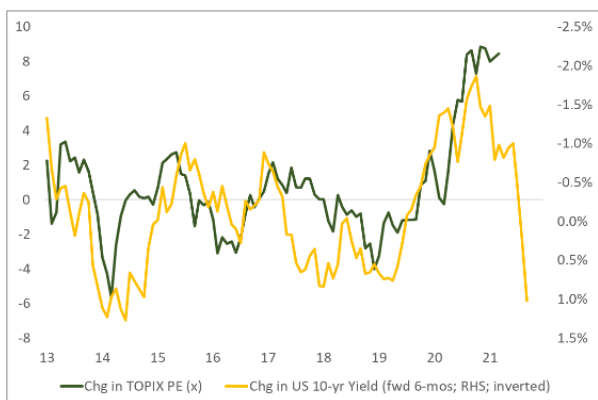


Sources: UBP, Bloomberg Finance L.P., March 2021. Past performance is not a guide to current or future results.

Admittedly, these earnings expectations are impressive, with the rally from the March 2020 lows leaving Japan's TOPIX index at its highest level since the peak of the 1989 bubble and, on a forward-earnings basis, apparently highly valued at close to 21x earnings. However, assuming peak-of-cycle returns on equity, this leaves Japanese equities at 13–15x earnings, close to cyclical trough multiples.

To put it another way, with rising US 10-year yields having historically served as a driver to compress multiples in Japanese equities, the pace of earnings growth that Japanese corporates can potentially deliver amid a cyclical recovery should be more than enough to offset even the sharp rise in Treasury yields seen to date, as well as provide modest positive returns for index investors in the future.

### TOPIX P/E and change in US 10-year yield

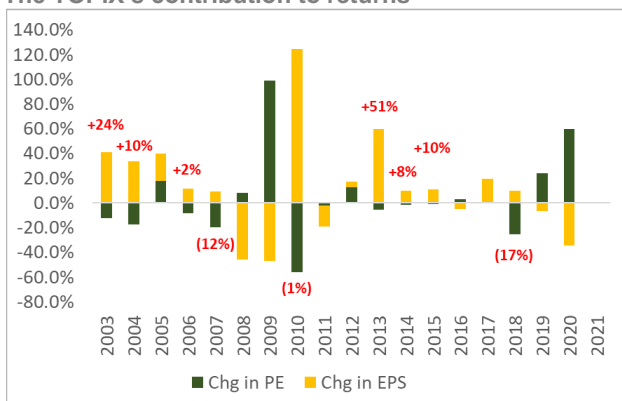


Sources: UBP, Bloomberg Finance L.P., March 2021. Past performance is not a guide to current or future results.

Indeed, looking back to the turn of the century, years of multiple compression combined with earnings growth have occurred on nine separate occasions, with six years seeing positive returns for investors and the rest seeing negative returns. Strong earnings growth has typically characterised years of positive returns amid compressing margins.

The key exception to this is 2010 following the global financial crisis, when robust earnings growth was more than offset by a significant P/E ratio compression. Should US Treasury yields continue to climb and replicate the 160-point rise seen going into 2010, which pushed nominal yields beyond 2%, there is a risk that Japan could repeat the 2010 experience.

### The TOPIX's contribution to returns



Sources: UBP, Bloomberg Finance L.P., March 2021. Past performance is not a guide to current or future results.

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On balance, Japanese corporates are well positioned to benefit from a global cyclical recovery both in absolute terms, as well as relative to comparable developed market alternatives. With multiple expansions having driven total returns, a strong corporate earnings recovery should be sufficient to offset a likely compression in P/E multiples in 2021, as long as further rises in US 10-year yields are more measured than they have been in recent weeks.

Given this interplay between P/E compression and earnings growth, Japan presents an excellent opportunity for stock-selection-driven alpha and, at a minimum, favours active solutions over index-oriented solutions at this stage of the economic recovery.

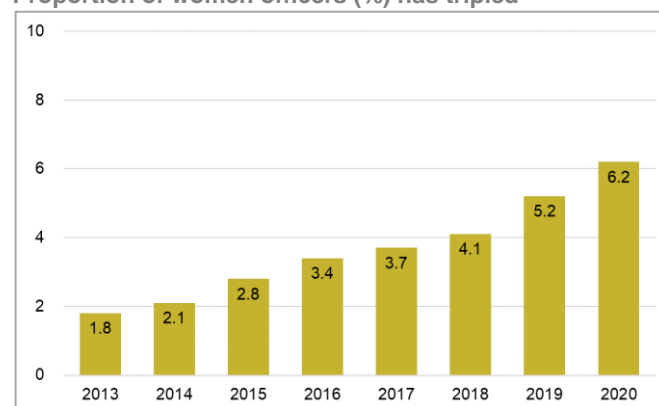
### Can the good performance of Japanese equities be sustained thanks to steady improvements in governance?

Since the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015, there has been a slow but steady improvement in governance standards, with a continuous stream of catalysts driving the improvements. First and foremost are revisions that have tightened up the Stewardship and Corporate Governance Codes every three years, i.e. 2014/2017/2020 and 2015/2018/2021, respectively.

After the Corporate Governance Code revision that will come out in May 2021, the next catalyst will be a revision of the Tokyo Stock Exchange's market structure and listing requirements in the summer of 2022. In particular, the new listing criteria will tighten governance standards for large-cap stocks listed on the new "prime" section of the exchange.

The 2018 revision to the Corporate Governance Code included a greater emphasis on diversity on boards, particularly women directors.

### Proportion of women officers (%) has tripled



Source: JFSA, based on Cabinet Office and Toyo Keizai data, 2021. Past performance is not a guide to current or future results.

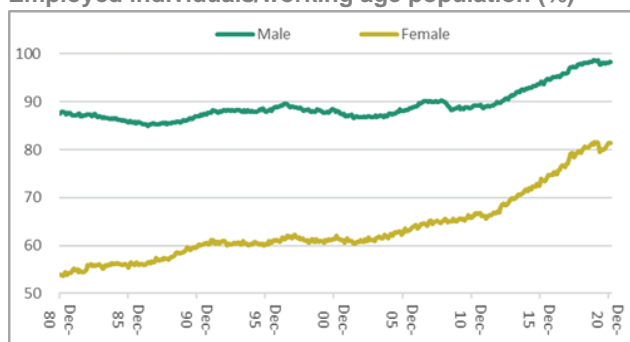
This revision acted as a catalyst for greater dialogue on diversity, inclusion and empowerment throughout Japanese society. While the proportion of women directors remains low by global standards, there has been a steady improvement, with the proportion of women officers (board directors, statutory auditors and executive officers) tripling since the Corporate Governance Code was adopted. Besides the quantitative increase in the proportion of women directors, we have also seen a qualitative improvement, rather than just tokenism: recently appointed women officers are increasingly

likely to be business executives in their 40s and 50s, rather than academics and retired bureaucrats in their late 60s and 70s; this change was particularly noticeable in 2020.

This inclusion of women due to governance reforms has been complemented and strengthened by the strong labour market which has significantly increased opportunities for women. Coinciding with the period of reform, female participation in the labour force has seen a sharp rise. This has also seen increased job opportunities for men over 65 years of age, as well as for women of all ages. The fight for talent has opened many professional career opportunities for women that were not previously available.

The empowerment of women can be seen in the successful campaign, particularly by younger women, to remove the former prime minister, Yoshihiro Mori, from the Olympic Committee chairmanship for his controversial comments.

#### Employed individuals/working age population (%)



Sources: UBP, Bloomberg Finance L.P., March 2021 Ministry of Internal Affairs, OECD  
 Note: The working age population ranges from 15–64 years old, whereas the employed population also includes individuals above age 65.

## Conclusion

Most market movements in March were dictated by US long-term rates. The increase in US rates is a result of the US economy’s recovery and is a phenomenon that has been seen during previous recoveries. The increase in long-term rates will lead to corrections to valuation multiples, especially for high-growth names. While adjustments to valuations should be in line with the new interest rate regime, we believe investors will continue to be sensitive to EPS growth and corporate governance improvements.

We are convinced that further corporate governance improvements will be made, and corporate earnings forecasts should continue to be revised upwards because of a better-than-expected recovery in the real economy, in particular in China and potentially in the US, too. As the Japanese equity market has already undergone a rapid recovery in 2021, it is hard to envision any further increase in prices. However, we believe we will go on seeing stable growth as the market factors in an end to the pandemic by FY22 and we should continue to reap the rewards of improved governance.

**Norman Villamin**  
 Head of Asset Allocation  
 & CIO Wealth Management

**Zuhair Khan**  
 Senior Fund Manager

**Cedric Le Berre**  
 Fund Analyst  
 & Investment Specialist

Union Bancaire Privée, UBP SA  
 Rue du Rhône 96-98 | P.O. Box | CH-1211 Geneva 1  
 T +41 58 819 2720 | cedric.leberre@ubp.ch



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