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JAPAN – OPPORTUNITIES AMIDST UNCERTAINTY

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While Japan might be set to break free from its deflationary shackles, our positive view on a variety of leading Japanese companies derives more from our bottom-up fundamental analysis than from hopes about the country's economic transformation.

Recent events speak of a marked change in Japan's macroeconomic dynamics. Two percent inflation has been a long-sought-after goal for the Bank of Japan (BoJ), and now it has got it...and then some. Aside from Covid-19 supply

chain issues and rising oil prices, the widening gulf between higher interest rates elsewhere and the BoJ's monetary abandon, has exacerbated the weak yen trend that has largely been evident since the advent of Abenomics.



CHARLIE MACQUAKER
Executive Director – Investment

Historically a positive for the reported earnings of Japan's exporting companies, the sharp depreciation of the yen for most of 2022 was nonetheless a factor in the 4% gain in the consumer price index in December which was the highest level in 41 years. However, the BoJ view is that inflation will abate as energy prices come down, so it is not planning any drastic monetary shift, although a new bank governor will be at the helm in April.

But inflationary perceptions are showing signs of changing in Japan. The coming annual Shunto, or spring wage offensive, will see unions argue for a 3% rise, which in the context of stagnating real wage growth over the last couple of decades, represents an improvement. The Japan Business Federation, Keidanren, is pressing its members to pay more. However, there are hurdles.

“Japanese companies are masters at driving efficiency and productivity improvements”

Rising costs, as elsewhere, have provided a challenge for Japanese businesses, but some larger companies are now exercising pricing power *and* increasing wages. The global economic outlook remains murky, but there remains pent-up, post-pandemic consumer demand in Japan. China, a good customer of Japan's manufacturers is looking to reinvigorate its economy, while Japan remains a favoured destination of Chinese tourists. With the economy showing at least some resilience and wages picking up, the chances of an end to chronic, economy-throttling deflation have probably increased.

And Japan Inc is rethinking how it operates, re-evaluating lifetime

employment, looking to a shift towards remuneration based on merit rather than length of service. This is fuelled, not only by government prodding, current cost pressures and a potentially higher cost of capital, but also by a shrinking labour force.

While there are some incrementally positive economic developments occurring in Japan, our particular interest lies in how these changing dynamics are creating opportunities for leading companies. Japanese companies are masters at driving efficiency and productivity improvements. That remains paramount as input costs rise, and this continues to provide a positive backdrop for automation trends, and the digitisation of manual processes.

Businesses such as Keyence, the world's leading supplier of sensors and measuring instruments, and SMC, a maker of factory automation-related pneumatic products, are benefitting from the secular adoption of automation across multiple industries at home and abroad. Both are highly cash-generative companies with strong balance sheets and an attractive return structure, with impressive growth track records, and excellent prospects. They navigated the challenges of Covid-19 and China's lockdowns well, displaying resilience and growth. However, this did not insulate them from the valuation compression that afflicted growth stocks globally last year, with the falls in their share prices in US dollar terms compounded by a weak yen.

“Over the decades we've been investing in Japan, our perspective on investment opportunities has not been defined by the nature of the economic backdrop”

The valuation vice squeezed many Japanese growth companies in 2022, including Sysmex, a world-leading player in in-vitro diagnostic testing. Granted, China lockdowns induced a temporary growth wobble for the company for part of the year, but the most recent quarterly results saw Chinese revenues rebound 89% sequentially. This financially strong, innovative company, which recently announced an assay kit for the diagnosis of Alzheimer's disease, is in prime position to benefit from long-term growth in the in-vitro testing market, given the increasing focus on early detection and preventative healthcare.

Over the decades we've been investing in Japan, our perspective on investment opportunities has not been defined by the nature of the economic backdrop. We invest in companies, not stock markets, and the country remains home to many leading companies that compete and thrive on a world stage. Enterprise and innovation can be found in businesses irrespective of the economic challenges in their country of domicile, and these qualities are evident in many of Japan's leading companies.



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