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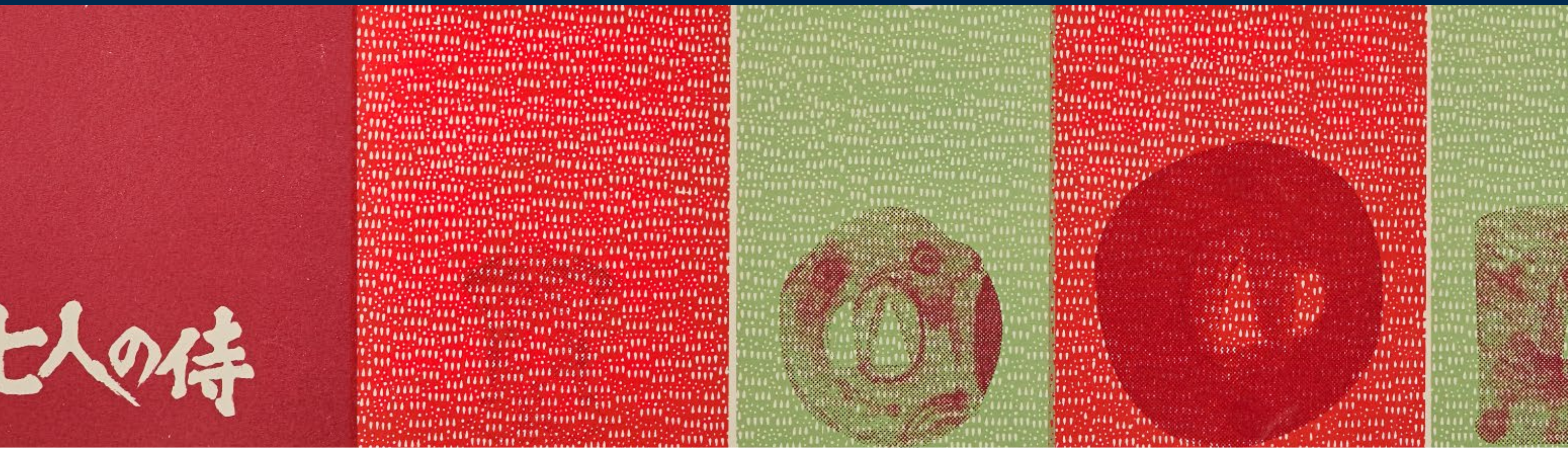

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NIPPON OLÉ!

ON THE ROAD IN JAPAN

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Economic renaissance or another false dawn? Executive Director Charlie Macquaker and Investment Analyst Connor Graham recently spent two weeks in Japan, gauging the tempo of the country, and also meeting with leading companies in what remains a fertile hunting ground for the long-term investor, despite some of the nation's challenges.

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Executive Director – Investment

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Our visit to Japan came at the tail end of what was a banner year for Japanese equities following a Covid-blighted 2022. This resurgence of enthusiasm stems from the confluence of a number of factors. The prospect of a breakout from the economy's longstanding deflationary straitjacket, improvements in the country's competitiveness thanks to yen weakness, moves to promote better corporate governance, and the relative cheapness of Japanese companies (many of which are replete with cash), have largely been behind the market's revival.

News headlines over the last few months have tended to focus on the prospect of the Bank of Japan shifting to monetary policy normalisation in view of above-target inflation. 'Ca canny' is a Scottish expression that would likely be lost on the governors of the BoJ, but in our meeting with the central bank it was evident that it is 'acting cautiously' with regards to any significant shift from its negative interest rate policy. Behind this reticence lies a lack of conviction that inflation is here to stay. Inflation has been falling, and price pressures are expected to moderate further as the impact of higher import and energy costs, which has been exacerbated by the weak yen, eventually dissipates.

"Growing confidence was evident in our meetings with a variety of companies"

Japan's post-Covid recovery hit a speedbump in the third quarter of 2023, as overseas uncertainty affected business investment, while inflation weighed on the consumer. The queues we saw outside luxury shops such as Hermès in the glitzier parts of Tokyo should perhaps not be taken as a representative sample! Despite current pressures on the economy, the December *Tankan*, the BoJ's quarterly sentiment survey, showed growing confidence amongst manufacturers and non-manufacturers alike, and this was evident in our meetings with a variety of companies. Yen weakness, easing supply constraints, inbound tourism, and expectations of an improved domestic consumer environment, despite the third-quarter hiccup, have helped drive this optimism.

Rising real wages in Japan would improve the consumption outlook and help distance the economy from deflation, but nominal wage growth hasn't kept up with rising prices. However, wages are set to rise further, amidst structural changes in the labour market arising from the country's demographics and greater worker mobility. We got the sense that the BoJ is not worried about a wage spiral inflationary blowout, (as we in the UK fondly remember in the 1970's!), but there are noteworthy pay rises happening here and there, and it was apparent companies are having to be competitive on the wage front. Encouragingly, more companies spoke of employee stock ownership programmes to reward workers, which is positive from an investor and market angle. With incomes rising, and 'Japan Inc' more willing to pass on cost increases, perhaps the stars are aligning for a break from a stifling deflationary mindset.

"We have always found Japan a home to many innovative, leading companies"

These various economic developments represent an improvement on a broad investment narrative often blighted by stagnation and Japan's well-catalogued structural impediments such as poor demographics. We have always had a more nuanced view. Over the forty years we have been visiting and investing in Japan, we have often seen promise give way to false dawns. As bottom-up investors, our view on companies has never been based on a 'macro' wish list or market mood swings. Through the lens of fundamental analysis, we have always found Japan a home to many innovative, leading companies with enviable market positions, sound financial profiles and excellent management, that can compete and thrive on a domestic or global stage, and deliver strong returns to investors. Over the course of our four-city, 23-company visit we met with a number of such businesses.

Shin-Etsu Chemical sits firmly in the leadership bracket, in our view, and we enjoyed an upbeat meeting with company president Yasuhiko Saitoh at the company's headquarters in Tokyo. After a period of exceptional profit expansion, parts of the business are undergoing a normalisation of growth. Shin-Etsu is the world's leading PVC producer, and the company has been benefiting from extraordinary profit spreads between input costs and end prices. However, higher mortgage rates have hit the residential market in the US with concomitant effects on PVC profitability. Saitoh-san's view is that recovery will be forthcoming as US interest rates are cut, and continued growth in the use of PVC in housing should lend long-term support. The company also sounded upbeat on infrastructure-related demand, with the US Inflation Reduction Act working in its favour. Shin-Etsu also makes key products involved in semiconductor production. Although this business has witnessed a recent growth hiatus, the long-term story is still sound with the overall semiconductor market expected to rise from US$500bn in 2020 to US$1tn by 2030 driven by growth in data, AI and auto-related demand.

Japan has been seen as a beneficiary of the 'China+1' diversification shift, and indicative of this, Saitoh-san discussed developments with regard to rare earths. This is an area where industries such as EV manufacturers are over-reliant on China, and Shin-Etsu is very close to commercialising a new product which would be a technological breakthrough in significantly reducing rare earth metal requirements. It was pleasing that President Saitoh recalled a 2015 meeting with Walter Scott managing director Jane Henderson and members of the research team at which we pressed the company on a range of issues including supressed levels of capital investment and returns to shareholders. The company has made excellent progress on these issues since that time.

“We’ve always been impressed by Fanuc’s commitment to innovation”

While ‘China+1’ represents an opportunity, a variety of companies we met with spoke about stodgy demand conditions in China, with only a few signs of imminent respite. In the thirty-plus years we’ve been visiting Fanuc, we’ve always been impressed by the company’s commitment to innovation. The ongoing remodelling of the Yamanashi headquarters production facility, situated in the foothills of Mount Fuji, speaks to investment in the business despite some of the current headwinds. After an always-impressive factory tour, the CEO and CFO highlighted the challenges. The company is seeing inventory corrections across much of the business, and China orders are noticeably weak. However, in the long run, tight labour markets amidst demographic challenges, the effect of high inflation, and corporate pursuit of efficiency, points to an onward march of the factory automation trend.

For a country so vested in the production of information technology hardware, the forces of digitalisation have yet to permeate through many enterprises, as a visit to many a paper-strewn Japanese office will quickly confirm. In a standout meeting, enterprise software company Obic explained how it is outperforming its Japanese peers and some international majors by offering more-tailored, better-value solutions. The shift to the ‘cloud’ has helped growth and profitability as well as scalability, and as it penetrates the larger company segment there is still lots of room for growth.

“Our optimism derives from the individual company opportunities we see in Japan”

“Nippon Olé!” is a favoured chant of supporters of the Japanese national football (soccer) team. As per the Spanish meaning, it represents approval and encouragement. Perhaps it can be aptly applied to the current situation in Japan, given the renewed vigour of the stock market, improving governance and hopes of an economic reset that may see the country finally shake off deflation. But our optimism derives more from the individual company opportunities we see in Japan. Trips such as these are key elements of our investment approach, giving us deeper insights into both existing holdings and potential investment candidates. The visit affirmed our view that there are plenty of world-class companies in Japan that are taking advantage of long-term growth trends, irrespective of the country’s economic and structural challenges.

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