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Source : Wealth Professional Date : 14 mai 2024

Industry news

Can Japan deliver double-digit growth?

After decades of stagnation, Japanese equities have hit historic highs. Economist explains why and how that new growth might be maintained



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May 14, 2024

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Since its bubble burst in the 1990s, Japanese equities have stagnated. In line with an economic period of deflation and stagnation, the country has not been viewed as offering much of a return to speak of for foreign investors. All that has changed in the past year.

The Nikkei 225, taken as the primary index for Japanese equities, has climbed rapidly following the pandemic and broke its pre-bubble 1989 historic high last month. It's a sudden change in performance that has many investors asking why and how Japan has made itself into a growth market again.

Anne Vandenebeele is an Economist with Capital Group with a view into what's caused this change in Japanese equities. She explained that regulatory changes and incentives laid down over the past decade are beginning to bear fruit, just as Japan's demographic crisis works counter-intuitively to modernize its labour market. Many other forces currently plaguing developed economies in Europe and North America — such as inflation — have also been greeted as positive developments for Japan.

"There was a big push that began under the late Prime Minister Shinzo Abe to push towards improved corporate governance, efficiency, and digitization in the service sector," Vandenebeele says. "Then on the fundamental side you have inflation in Japan right now, as well as labour shortages. We're at a point in time when all these things are converging and the Bank of Japan (BoJ) can stop easing policy quite as much and nudge rates a little bit higher."

Improvements in corporate governance and a trend towards more shareholder friendly policies have pushed Japanese companies to engage in share buybacks and increases in dividend payouts, which have encouraged investment. Investors have been given greater license to engage with management, too, creating more accountability in the system. Rules for M&A have simplified and companies have been given greater license to use the huge amounts of cash they hold which had been a characteristic of 'inefficient' Japanese balance sheets. The Tokyo Stock Exchange is pinpointing companies with price to book ratios below one and asking them to share plans to improve that and has published those plans in Japanese and English on their website. All of these changes have brought in a huge wave of foreign investment into Japanese stocks.

Vandenebeele notes that the majority of the rally we've seen in Japanese equities has been from foreign investors. Domestic money remains somewhat on the sidelines as equity markets move from a stagnation period into what Vandenebeele calls a 'reflection period' where valuations are normalizing. Many domestic investors are waiting to see where those valuations end up normalizing to. She adds that some of the drive behind foreign investment has to do with underperformance in Chinese equity markets, driving that foreign capital to seek returns elsewhere.

While equity returns may look great for those foreign investors, it's notable that the Yen has moved down somewhat against both USD and CAD over the same period that the Nikkei has enjoyed its growth. That currency move has detracted from foreign investor returns and reflects the fact that the US and Canada have tightened their monetary policy but Japan has remained relatively dovish. Even if the BoJ takes Japan out of negative rates, the country's interest rates remain incredibly low.

It's not just shareholder-friendly decisions making investors more interested in Japan. Through digitization Japanese companies have powered remarkable productivity growth, especially in the service sector. Where Japanese manufacturers and exporters have always been highly productive, services have lagged. Digitization has improved that outlook significantly.

There is also a major change in the labour market due to the aging of Japan's population. With fewer workers, there is greater competition between firms to hire the best talent and the next generation of workers have rejected the ethos of the 'company man' that had typified Japanese working life. Many Japanese workers will now change jobs to maximize their own salaries or leave companies that they see stagnating. Vandenebeele says that for the first time Japan has a labour market that is "actually a market."

This is not to say Japan is now a market without risks. Vandenaabeele notes that if domestic demand weakens enough it could erode some of the equity gains made. While wages are growing given tighter labour market conditions, they are not growing faster than inflation. That inflation is also introducing political risk, with the current Prime Minister Fumio Kishida falling in popularity. There are questions around succession and what any future economic policy might look like. Nevertheless, compared to where Japan had been since the 1990s, Vandenaabeele sees a broadly positive outlook for Japanese equities going forward.

“All of these forces are potential long-term improvements and as they fall into place they paint the picture of improving long-term equity returns,” Vandenaabeele says. “There will be fluctuations year after year, but on a trend basis I think the conditions are in place for improved earnings growth and more normalized valuations. We might be looking at some very solid equity returns, potentially double-digit equity returns longer-term in Japan.”