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Marketing material

Japan – still on track

Japan's financial markets suffered more than most in the early August global market correction. While this shows the perils of leveraged carry trades based on a weak yen, the investment case for the country remains positive.

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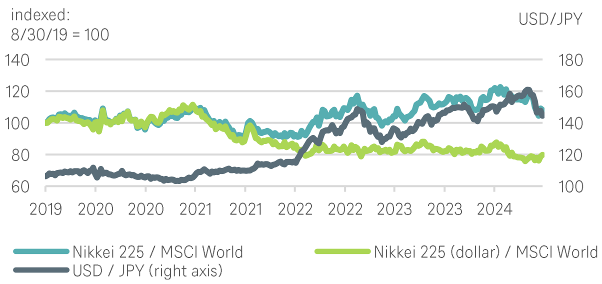
IN A NUTSHELL

- The global market meltdown early in August put Japan's assets in the spotlight.
- Though the road ahead is unlikely to be straight, we believe the economic backdrop for Japan's equities – above all because of the country's reflation story – is still positive.
- In addition, corporate reforms are continuing to deliver visible results, earnings momentum is still positive and relative valuations look attractive.

Japan became the focus of investors' attention in the global market turbulence at the beginning of August. Mainly because it was seen by many as one of the main ingredients in the fatal mix that led global markets to retreat. In what was a surprise move for most market participants, the Bank of Japan (BoJ) raised overnight rates from 0.1% to 0.25% on July 31st. In the next three trading days the yen appreciated while Japan's stock market fell by 20%. We believe the unwinding of Japanese yen (JPY) carry trades has partly been responsible for this massive move. While domestic investors in the search for higher yields abroad can also move markets, it was probably foreign investors that had been taking advantage of Japan's low interest rate and borrowing yen cheaply to invest the funds in higher yielding assets in other countries. This might have caused the bigger turmoil as they often invest on a leveraged basis. Since the market low on August 5th, the Nikkei 225 has not recovered all its losses in local currency terms, but it has done so in dollar terms, thanks to the yen's big rise in August: Japanese assets should be looked at in conjunction with the yen. The chart shows how different the Nikkei 225's relative performance versus the MSCI World Index looks when adjusted for currency.

The gyrations in the market give us an opportunity to update our readers and reiterate our overall positive view on Japan's economy and stock market, as we set out in our earlier note,[1] even if, as we explain, there are also some grounds for caution.

The yen's strong depreciation should be considered when looking at Nikkei's relative performance



Sources; Bloomberg Finance L.P., DWS Investment GmbH as of 08/26/24

[1] See https://www.dws.com/insights/cio-view/macro/cio-special-01102024/ ; DWS; CIO Special_Reflation in Japan; as of 10/01/2024)

1 / Inflation and reforms fuel the economy

1.1 Inflation after decades of deflation

We just need to look at a very recent data point to get a feeling of what is currently going on in Japan: inflation in August was up 2.6% year on year (y/y), up from 2.2% in July[2]. And Nikkei reports that minimum wages have been increased by the highest since 2002[3].

Economic growth is picking up

Japan's economy is going through a period of transformation and recovery. After a challenging start to 2024, with Q1 growth held back by declining private consumption, the economic outlook has shown signs of improvement. In the second quarter, the growth domestic product (GDP) growth rose to a robust 3.1%, more than the 2% that had been expected. This resurgence was primarily fueled by strong domestic demand, reflecting rising real incomes and household consumption. While consensus growth expectations for 2024 have been cut from 0.8% to 0.05% in the course of the year given that globally manufacturing is recovering slowly, Japan’s growth is still expected to hit 1.2% in 2025.

All about the yen

The yen hit its weakest level against the dollar since 1986 in early July of this year. After having weakened already considerably from 2012 to 2015, another strong wave of depreciation started in 2022, when the U.S. Federals Reserve (Fed) began hiking rates while the BOJ stuck to an ultra-loose monetary policy involving negative central bank interest rates. The weakening yen has helped Japan’s exports. But it has also motivated probably the biggest global carry trade – investors have been borrowing low yielding yen assets in order to invest in higher yielding foreign assets. Carry trades have their dangers which became apparent this summer when the Bank of Japan put interest rates up and the yen gained 12% against the dollar in less than a month. This ultimately provoked the Japanese stock market collapse in early August.

Despite its rally, the yen as of now is still considerably below its average level in 2023, which is good for Japan’s export competitiveness and encourages tourism to Japan. But whether this is sustainable is uncertain. A long-term observation: In the past 50 years, the yen has never deviated so much from its value as calculated by Purchasing Power Parities (PPPs). The Organization for Economic Co-operation and Development (OECD) calculates that the Yen is currently 40% cheaper than PPPs would suggest. This contrasts with the period from 1985 to 2013 when the Yen was more expensive than PPPs suggested.

We forecast the yen to appreciate mildly

We forecast that the yen will be range bound with a slight tendency to appreciate over the coming 12 months. It may be volatile, however, and vulnerable to any changes in a few key factors: above all, the U.S. Fed rate cut cycle and the commitment of the BoJ to its rate hike plans even if economic (or inflation) dynamics weaken somewhat. For the time being, we believe that the carry trade remains very much on, especially among Japanese investors looking for higher yields.

Real wage growth and price inflation are finally back

The recent volatility in financial markets masks improving economic fundamentals. The spring wage negotiations between unions and business are pushing up wages further, bolstering domestic demand. In June, real wages have risen for the first time since mid-2021. Our GDP growth forecasts remain cautiously optimistic, with growth likely to pick up to 1.2% in 2025 after a flat 2024 provided consumer spending remains firm and economic reforms continue.

Inflation dynamics in Japan are also evolving. After inflation was initially boosted by strongly rising import costs (as everywhere in the world), the process of hiking prices now is on a more self-sustaining footing as the initial price hikes have fostered long-awaited wage hikes which in turn led to another round of price increases. We expect inflation to moderate but remain above the 1% threshold. For 2024 headline inflation is projected at 2.5%, eventually easing to 2.0% in 2025. This persistent inflation, although quite modest, represents a recovery from Japan’s deflationary past and provides a favorable backdrop for the BoJ to continue with its cautious policy normalization. For a more in-depth analysis of Japan growth story, please see our special “Reflation in Japan” (https://www.dws.com/insights/cio-view/macro/cio-special-01102024/).

[2] Tokyo CPI; Bloomberg Finance L.P; as of 8/30/24.

[3] https://asia.nikkei.com; 8/30/24

Central bank wary of stifling inflation – we expect moderate rises in bond yields

The Bank of Japan plays a pivotal role in Japan's economy. In only its second rate hike since 2007 the BoJ increased its policy rate to 0.25% on July 31 this year. Though this decision triggered a significant market reaction, with a sharp selloff in equities and a flight to Japanese government bonds (JGBs), it underscores the central bank's cautious approach to monetary normalization. But an intervention seemed inevitable in light of the dynamic yen depreciation. BoJ Governor Kazuo Ueda emphasized that further rate hikes would be data-dependent, allowing for flexibility in policy adjustments so as not to jeopardize the slowly re-emerging inflationary mindset that the central bank and the government have aimed to foster. Sticking to the ultra-expensive monetary policy was no option, as the costs for the financial system and consumers' and corporates' behavior were too high. We expect a further rate hike in January and another in mid-2025, based on the BoJ's view that the underlying domestic inflation dynamics are strong enough, which in turn requires another round of supporting (2025) spring wage negotiations. The rate hikes will, we believe, lead to slightly higher bond yields along the curve on a 12-month horizon: we expect 2-year JGB yields to hit 0.7% and 10year yields 1.4% in September 2025.

Japan's world-beating debt leaves little room for error

Japan's huge public debt pile is one reason to be cautious about the country's prospects. It has the highest debt to GDP ratio (both gross and net) of all developed countries. With an average duration of 8 years, Japan needs to refinance a large amount of JGBs each year: around 30% of GDP, much higher than roughly 20% in the U.S. and Italy. To stabilize or even reduce debt ratios, it is crucial that Japan manages to grow strongly in nominal terms in coming years. In addition, fiscal policy needs to become more frugal.

2 / Capital markets - Japanese equities still a favorite

2.1 Earnings momentum, favorable yen and corporate drive for shareholder value

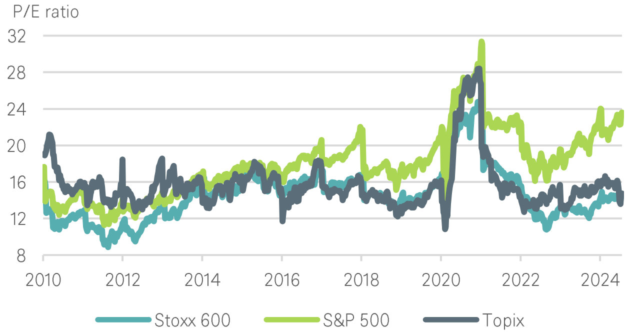
Reforms to increase shareholder returns

The Japanese equity market has performed well over the past year in yen. The weak yen is supporting earnings, Japanese equities look like a good alternative if one wants to play a potential improvement in China's economy without having to invest in Chinese equities; foreigners have been reducing their heavy underweight in the country. What is driving the market above all is corporate reforms and improvements in shareholder returns. In March 2023 the Tokyo Stock Exchange called on the listed companies to take "action to implement management that is conscious of the cost of capital and stock price" and disclose information about board discussions and the companies' initiatives for improvement. As of end-June 2024, 81% of the larger listed companies had disclosed the necessary information. But it was not all words and letters – there was action too. The unwinding of cross-shareholdings between Japanese companies (that often prevent corporate restructurings and efficient use of capital) is well under way and share buybacks are increasing. In the first quarter of 2024 buybacks amounted to roughly two and a half times the value of Q1 in the year before.

Earnings upgrades outpace the U.S. and Europe

Furthermore, in contrast to their peers in many developed markets, Japanese listed companies have made positive earnings revisions. Year-to-date estimates for 2025 earnings have been increased by 6%; in other regions they have been mostly flat. We believe that another wave of earnings upgrades could materialize once reporting for the first half of the fiscal year (which ends on September 30) starts, as companies again guided very conservatively at the end of FY 2023/24 in March. As the chart shows, the positive earnings momentum is not yet reflected in relative valuations; the gap between Japan's average price-to-earnings (P/E) ratio and that of the U.S. is still widening. We would use short-term weakness in selected names to build positions for the long term, aiming for a balanced portfolio of export-oriented and domestic names.

Japan equities traded at record price/earnings ratio discount to the U.S.



Sources; Bloomberg Finance L.P., DWS Investment GmbH as of 08/26/24

Sectors we like in Japan

Amongst exporters we like global champions. This sounds trivial – who wouldn't want them? But we believe that even at relatively high prices they offer good value, especially for investors with a long-term horizon. In addition, their risk profile has been better than average, as their outstanding product range makes them highly competitive and may help shield them from currency movements. We find companies of this kind in the Japanese automotive sector and among suppliers for industrial automation and semiconductor equipment. Furthermore, we also find champions within the video gaming industry, be it suppliers for content, hardware or software.

We also like sectors with a domestic focus, such as IT services companies, as Small and medium-sized enterprises (SMEs) are still playing catch up when it comes to digitalization and need their support. We also favor selected companies from the retail and consumer space as Japanese consumers are benefiting from rising real wages and tourism is making a comeback. And we are, even if only for hedging reasons, looking at companies that would actually benefit from a strengthening yen.

Glossary

The Bank of Japan (BoJ) is the central bank of Japan.

Carry is a strategy in which an investor sells a certain currency with a relatively low interest rate and then buys another, higher-yielding currency.

Consensus growth expectations expresses the average of a range of forecasts from different analysts or brokers on a given data point.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

The Japanese yen (JPY) is the official currency of Japan.

Leverage attempts to boost gains when investing through the use of borrowing to purchase assets.

The MSCI World Index tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

The Nikkei 225 is a price-weighted index of Japan's 225 most important listed companies.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

Purchasing power parity (PPP) is a technique used to determine the relative value of currencies, whereas the purchasing power in both currencies is the same.

Real income is the income of individuals or nations after adjusting for inflation. It is calculated by dividing nominal income by the price level.

The Organization for Economic Co-operation and Development (OECD) started in 1948 as the Organization for European Economic Co-operation (OEEC) and changed its name in 1960, now representing 34 countries with democratic governments and market economies.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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