



Why Japan in 2023?

Today Japan remains unloved, under owned and cheap and is presenting an excellent opportunity for medium term investors. This opportunity is being driven by a combination of an improving macro-outlook over the next few years, and more importantly by high quality individual companies from a bottom-up perspective, which are beneficiaries of structural changes taking place in Japan.

Whilst we are cognizant of the longer-term issues that surround the Japanese economy, we are also seeing some very encouraging signs from a more tactical perspective over the next few years. There have been a number of headwinds over the last couple of years that are gradually starting to ease, and in some cases could provide tailwinds. These include:

The COVID rebound - The economic cycle in Japan is different from the US/Europe. Japan only lifted strict border controls in October 2022. Many activities, such as consumption and travel, remain well below pre-COVID levels but are finally starting to normalize. Whilst we have seen the post COVID recovery in western economies, growth in Japan has been slow, but set to outperform in 2023. This should provide some cushion in the event of a global slowdown or recession.

Inflation – compared to the rest of the developed world, inflation has not been a major issue in Japan (**Exhibit 1**), and it is mainly imported inflation: weaker Yen and commodity and energy price rises have been the main culprits behind this. In other developed markets, wage inflation has been fueling inflation; in contrast, the magnitude of wage inflation seen in Japan so far is still very low. Average monthly scheduled cash earnings of full-time salaried employees rose by 1.3% YoY in October 2022, following a 1.6% YoY rise in both August and September. This might not sound much, but for Japan, 1.6% YoY was the largest YoY monthly wage growth seen since October 1997. Japanese nominal wage data should be watched closely for any evidence that inflationary pressures are not just imported, which had been the Kuroda (Governor of Bank of Japan) argument all last year for not adjusting policy.

Exhibit 1: Headline Inflation (% change yoy)

	Dec '20	Mar '21	Jun '21	Sep '21	Dec '21	Mar '22	Jun '22	Sep '22	Oct '22
Euro Area	-0.3	1.3	1.9	3.4	5.0	7.4	8.6	9.9	10.6
UK	0.6	0.7	2.5	3.1	5.4	7.0	9.4	10.1	11.1
U.S.	1.4	2.6	5.4	5.4	7.0	8.5	9.1	8.2	7.7
Japan	-1.2	-0.4	-0.5	0.2	0.8	1.2	2.4	3.0	3.7
China	0.2	0.4	1.1	0.7	1.5	1.5	2.5	2.8	2.1

Source: ECB, Japan Ministry of Internal Affairs & Communication, National Bureau of Statistics China, US Federal Reserve, J.P. Morgan Asset Management. Heatmap colours are based on the absolute level of inflation. Blue is below 2%, white is at 2% and red is above 2%. Data as of 31 October 2022.

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Wage inflation, if trade continues to develop, could be broadly positive in Japan. Wages have been stagnant in Japan for thirty years. The tight labour market is likely to become even tighter as the economy re-opens while, longer term, many workers will retire. Our meetings with companies on the ground paint as positive a picture of wage growth as we have seen in a long time?¹ Companies such as NTT (Telecoms) have raised the starting salary by 14% and JGC (designs, maintains and constructs industrial facilities) are raising the base salary for all employees by 10% from April 2023.² That makes us optimistic about wage growth, but it also means there will be opportunities in companies that help boost efficiencies, such as software services and automation.

Yen is very cheap right now!

Whilst USD is expensive against virtually all major currencies, JPY is one of the cheapest developed market currencies based on a real effective exchange rate (REER) calculation³. For example, a typical lunch in New York costs around 5x more than its equivalent in Tokyo and you can get Michelin star quality food for as little as \$7.50. This may not be sustainable over the long term but has provided an opportunity for corporates and investors in Japan, helped support earnings and will make Japan a great place to visit in 2023.

Reopening – The return of the Tourist!

(Exhibit 2) As mentioned above, Japan was slow in reopening, along with much of Asia. But now Japan has fully reopened for foreign travelers, and the ending of the zero covid policy in China is likely to drive up tourist numbers in the next few years. Given Japan's proximity to the rest of Asia with its emerging middle class anxious to travel and experience the Michelin star restaurants, the skiing, beaches, shopping, culture and temples, Japan will be the destination of choice. To put this into perspective, the spending by inbound tourists contributed ~1% to GDP prior to COVID.

Exhibit 2: Tourist Arrivals in Japan



Source: Japan National Tourist Organization, As of 30 November 2022.

¹ Source: Recruit Jobs. As of 31 October 2022.

² Source: NTT, J.P. Morgan Asset Management, As of 31 October 2022.

³ Source: FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management, As of 30 September 2022.

The biggest opportunity in Japan remains at the stock level

Whilst signs from the economic market are encouraging and should provide support to some companies, investing in Japanese companies is very different from investing in the economy. Despite the country's low growth, TOPIX EPS has grown as strongly as S&P500 Earnings Per Shares (EPS) over the last decade.

There are a number of structural changes taking place in Japan, which are providing investment opportunities. COVID-19 has accelerated changes, such as automation, internet and digitization which were already taking place before the pandemic. We believe that all of these trends will happen regardless of the economic backdrop, especially digitization, which is at a very early stage in Japan compared to the rest of the world. Japan's strong intellectual property and brands, aging population and a push towards higher use of renewable energy, also provide attractive investment opportunities. For example, Japanese intellectual property is world leading in areas such as manga and anime, and within the gaming industry Super Mario and Pokémon.

Corporate governance is improving from a low level, and the trend increasingly looks structural in nature. Japanese companies have been making progress in terms of corporate governance and shareholder returns, and the market has rewarded them for it. Real

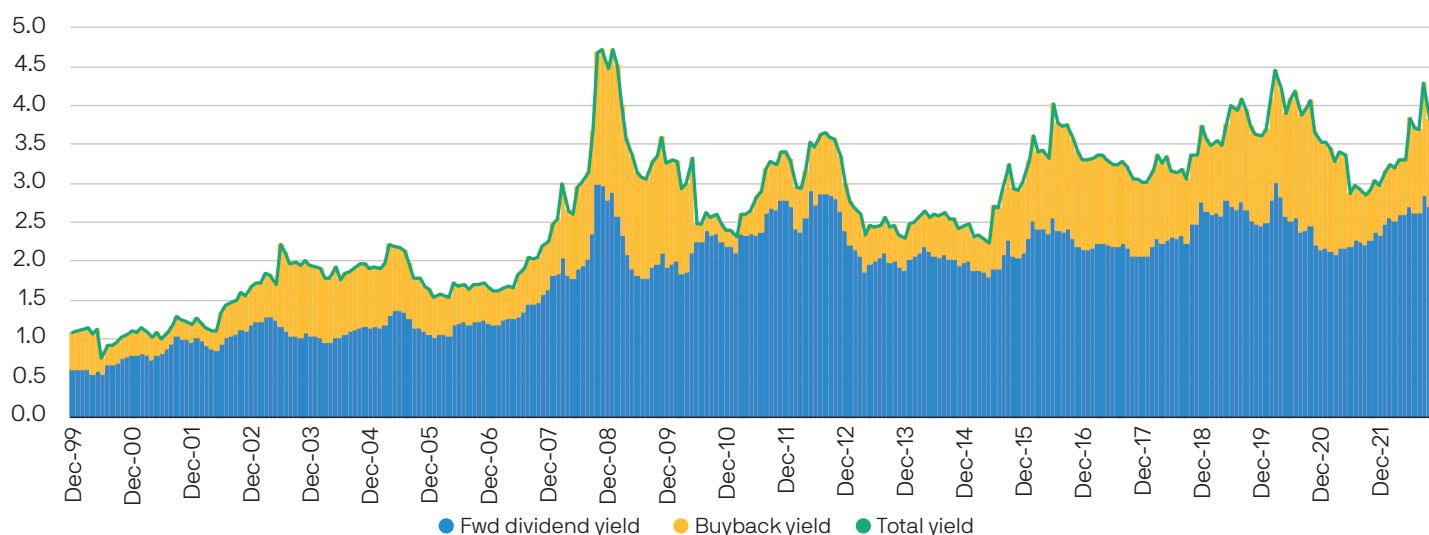
returns to shareholders have been rising and could rise even further; the trend did not slow down despite the pandemic. While many companies globally cut or suspended dividends, Japanese companies returned cash to shareholders (**Exhibit 3**). We believe that the potential for improvement in Japanese corporate governance is the single biggest reason for the persistent discount in Japanese equities.

It is a trend that can play out over many years and presents a particular opportunity in Japan. Share buybacks are up 54% from last year's record level.⁴ We have seen large buybacks across many sectors and at some ultra conservative companies. With over 50% of non-financial companies' net cash, much higher than the US or Europe,⁵ there is so much more to go for. Strong balance sheets also mean Japanese corporates are resilient to economic recession.

The corporate governance code started a process whereby companies and shareholders have become more aligned and the tone of our company meetings has changed to the extent that some companies are asking for our thoughts and advice. Japan has an attractive bond yield for investors: 3.7% total yield, dividends and buybacks combined compared to 0.5% yield on 10-year government bonds.

Exhibit 3: MSCI Japan – Total yield trend (dividend & buyback)

Dividend + buyback yields (%)



Source: FactSet, Data compiled by Goldman Sachs Global Investment Research. As at 30 November 2022.

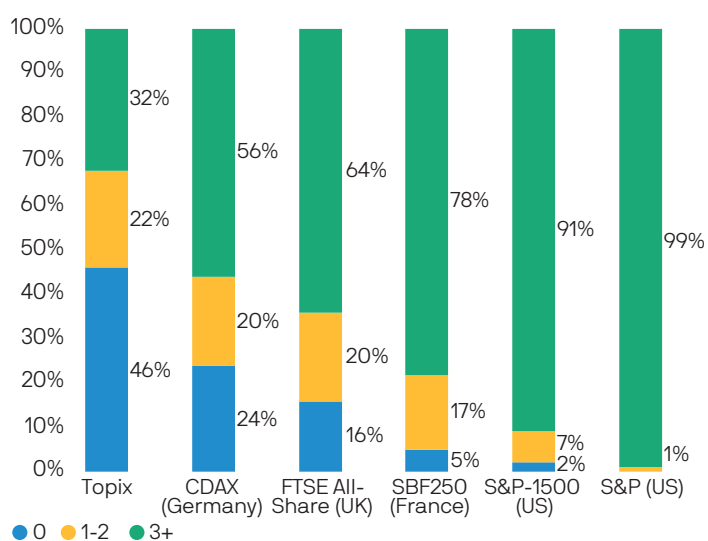
⁴ Source: FactSet, Data compiled by Goldman Sachs Global Investment Research. As of 30 October 2022.

⁵ Source: FactSet, Data compiled by Goldman Sachs Global Investment Research. As of 30 September 2022.

Why Japan in 2023?

Given the apathy around Japanese equities, over the last 20 years we have seen swathes of buy and sell-side research capability leave the market. Today almost 50% of the listed companies have no sell-side coverage at all. If you compare this to the US where 50% of companies have 20 or more sell-side analysts covering them (**Exhibit 4**). This creates an opportunity for well-resourced teams based locally, who can identify opportunities and insights that other managers are just not focused on. In addition to this, most sell-side analysts are short-term (for example only 2 sell-side analysts publish 5-year EPS forecast of Toyota), missing out on the great long-term opportunities.

Exhibit 4: Japan vs US & EU: analyst coverage



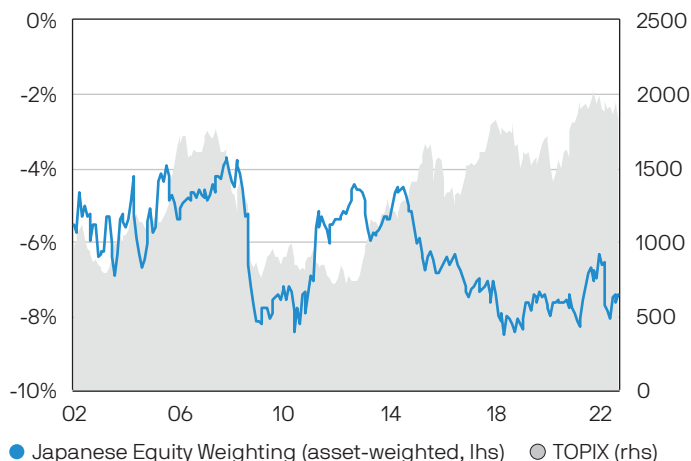
Sources: J.P. Morgan Asset Management, Jefferies, Factset, data as of 31 October 2022.

If an improving economy and great companies is not enough for investors... the Japanese equity market is unloved, underowned and cheap!

Japan remains a market that polarizes opinion despite being the world's third largest economy and third largest market. After being one of the world's most dynamic markets for many decades, structural issues led to a period of low growth, deflation and a fall in asset prices. Japan lagged global markets in the late 1990's and 2000's in the lost decade(s) and since then investors have grappled with Japan's relevance in their asset allocation, as more and more investors cut direct exposure or just group it into broader Asia Pacific or Global equity portfolios. Today Japan is broadly underowned by global investors (**Exhibit 5 & 6**).

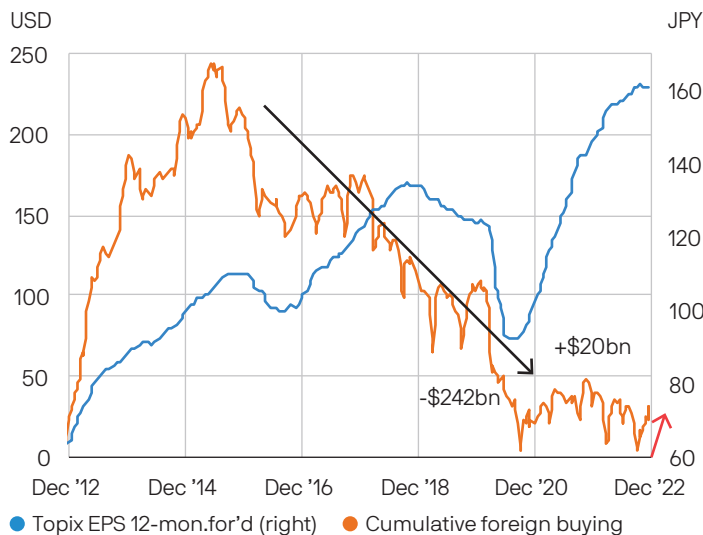
However, the combination of an improving macro and micro-opportunity set aligned with the market current valuation levels has created a big opportunity. Today Japan is trading on 12x earnings and 1.1x book value. Historically, this is close to the trough and in the past Japan valuations didn't stay this cheap for long.

Exhibit 5: Japanese equity weight by global active fund manager



Source: CLSA, Bloomberg. Japanese equity weighting and TOPIX are as of Sep-2022. MSCI EAFE Index used as benchmark.

Exhibit 6: Cumulative purchases of Japanese equities by foreign buyers

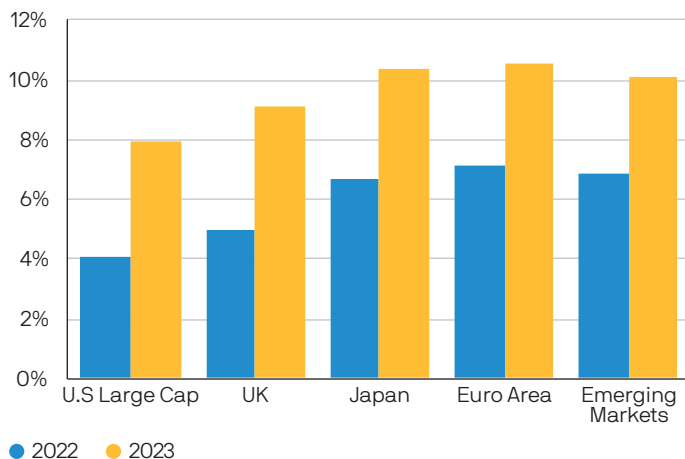


Source: CLSA, Bloomberg. As of December 2022.

Why Japan in 2023?

In J.P. Morgan's recently released Long Term Capital Market Assumptions forecasts 2023 (**Exhibit 7**), the Multi Asset Solutions group highlighted the opportunity for Japan.

Exhibit 7: Long-Term Capital Market Assumptions forecasts, 2023 vs 2022, USD terms



Source: J.P Morgan Asset Management: data as of September 30, 2022.

Investment implications and ETF solutions

The JPM Japan Research Enhanced Index Equity (ESG) UCITS ETF (JREJ)* offers a cost-efficient, active way to benefit from the long-term opportunities of the Japanese market.

JREJ* seeks to deliver index-like characteristics while exploiting stock-specific insight. Built on the expert stock research of our Emerging Markets and Asia-Pacific equity group, JREJ targets consistent positive excess returns at low tracking error. JREJ is categorized as SFDR Article 8 and follows an active ESG approach including exclusions, the consideration of ESG factors within the investment process and security selection as well as engagement with companies.

Reasons to invest in Japan

The macro outlook for Japan is improving

- Japan is in a different cycle from the West, with stronger projected growth in 2023 which provides a degree of downside protection in a global recession. Japan's reopening will provide a boost to the domestic economy
- Yen is cheap
- Inflation could be a positive for Japan

Many investors confuse corporate fundamentals with the Japanese economy – the opportunity is primarily a bottom up story

- Poor coverage by buy and sell side creates opportunities for well informed investors and active managers.
- Japan is a global leader in many areas, such as Factory Automation and Gaming, and the home to global leading companies.
- Japan is undergoing a corporate governance revolution!

Under owned, unloved & cheap!

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