Japan: on the rise

For professional investors only | Marketing communication

Asian Equity team

RBC BlueBay
Asset Management

Published October 2023

> "While the equity market has moved somewhat autonomously against these challenges, we feel that the asset class has been overlooked as a result of these headwinds."

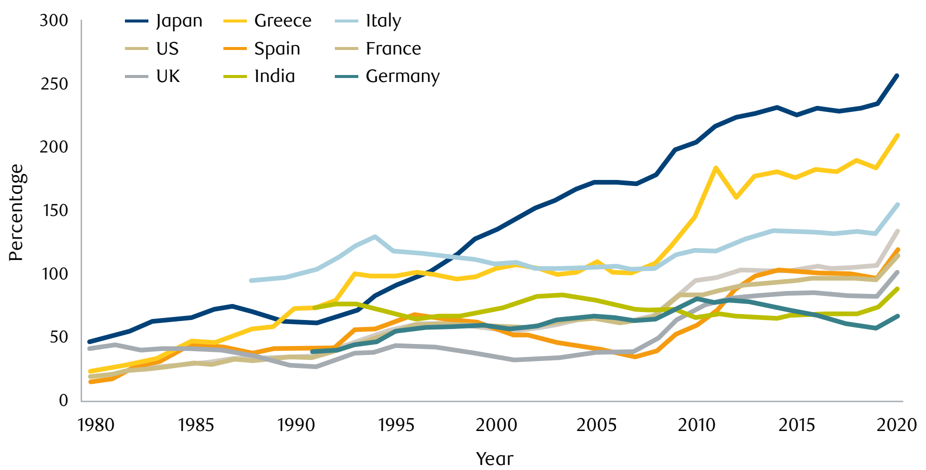
Why Japan now?

Over the past few decades, Japan's backdrop has made the economy less appealing to investors than its developed market counterparts.

Japan's economy has experienced decades of challenges including unfavourable demographics, a heavily indebted economy, the real estate bubble of the late 1980s and other issues including the keiretsu system (a network of interlocking businesses that has contributed to dominant Japanese companies taking on bad debt). While the equity market has moved somewhat autonomously against these challenges, we feel that the asset class has been overlooked as a result of these headwinds.

However, as the macro environment for the country improves, we are seeing renewed interest in Japanese equities and potential strong tailwinds for investors in the asset class.

Exhibit 1: Japan public debt as % of GDP versus other developed markets

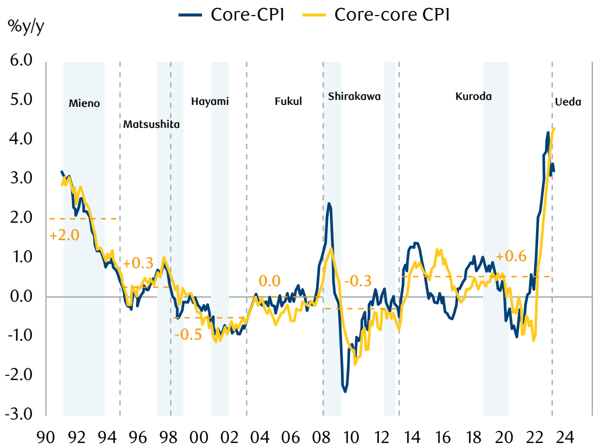


Source: MUMSS Research, IMF World Economic Outlook. Data as at January 2023.

Inflation

Rising global inflation and associated rate hikes have created an exogenous shock for Japan, entering unchartered territories in terms of its Consumer Price Index ("CPI") and the Japanese yen. While inflation is currently above target, the rise in Japan's CPI has been treated positively as the country has faced a relatively constant state of deflation since the 1990s.

Exhibit 2: Average core CPI inflation during each governor's term



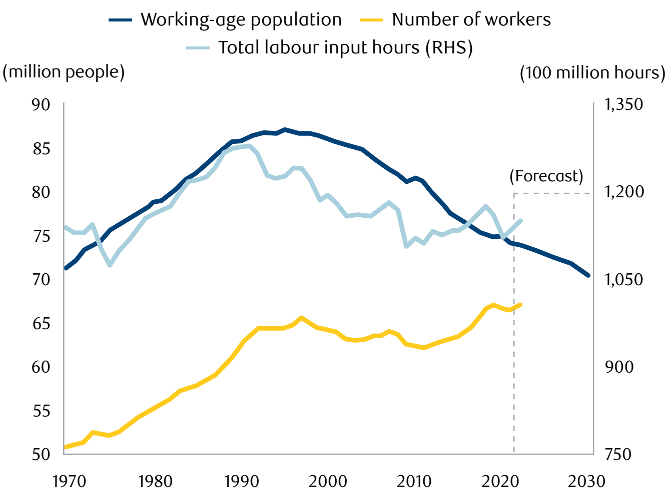
Source: UBS Research, MIC (Ministry of Internal Affairs and Communications). Note: VAT hike impact in 1997 and 2014 are excluded. Shaded area shows recession; red figures show average core CPI inflation during each governor's term. Data as at April 2023.

Labour market

Despite demographic challenges and a declining younger population, Japan has historically resisted increasing its foreign labour force. While that may continue to be the case, the domestic labour shortage is making wage hikes and labour market structure changes seem inevitable, and we are seeing evidence of companies placing stronger emphasis on employees and corporate governance reform.

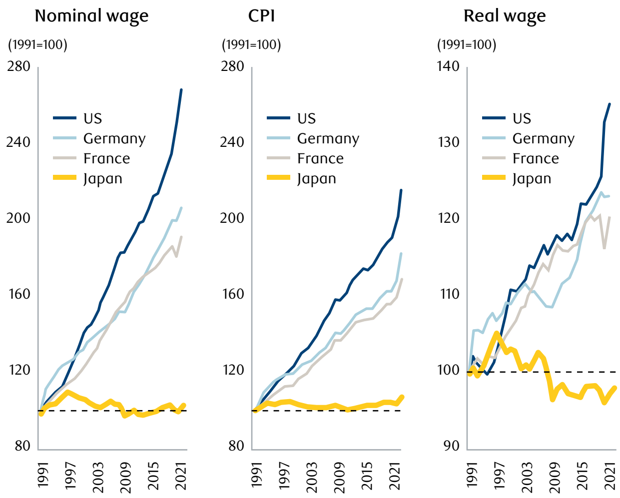
Wage hikes are particularly important to a country like Japan where real wages have been in decline since the 1990s. This weak wage growth explains a significant portion of Japan's CPI trends versus other developed markets. While recent spring annual wage hikes (Shunto) have been led by large corporations, if these trends spill over into SMEs, long-held inflation expectations can materially shift into positive territories.

Exhibit 3: Labour demographics



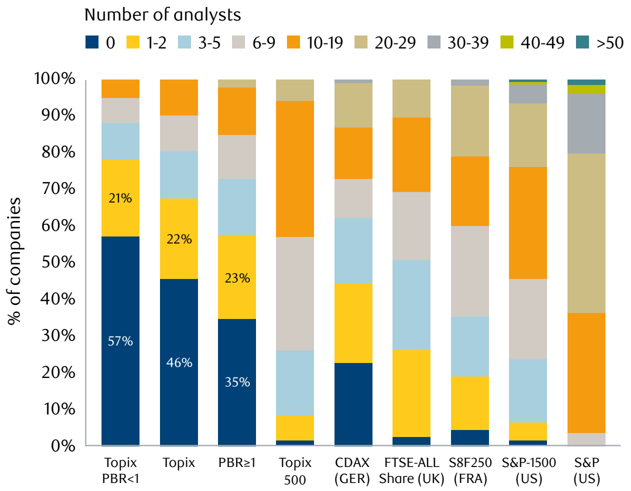
Source: Mizuho Securities Equity Research, based on MHLW. Data as at December 2022.

Exhibit 4: Wage inflation



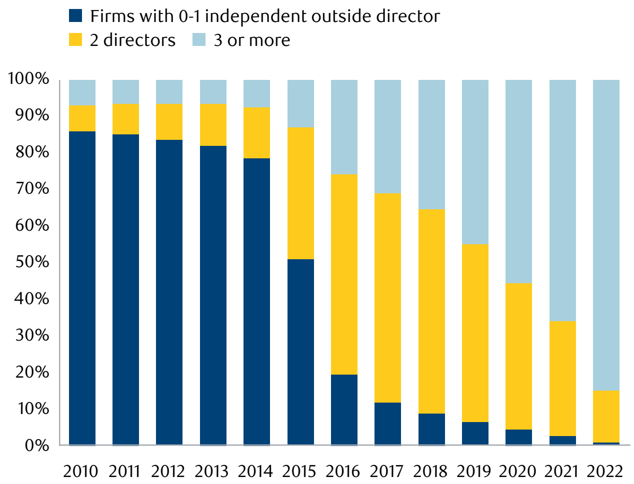
Source: Mizuho Securities Equity Research, based on MHLW. Data as at December 2022.

Exhibit 5: Sell-side coverage



Source: CLSA Research. Data as at June 2023.

Exhibit 6: More independent outside directors



Source: TSE, Corporate Governance Report. Data as at December 2022.

Why active?

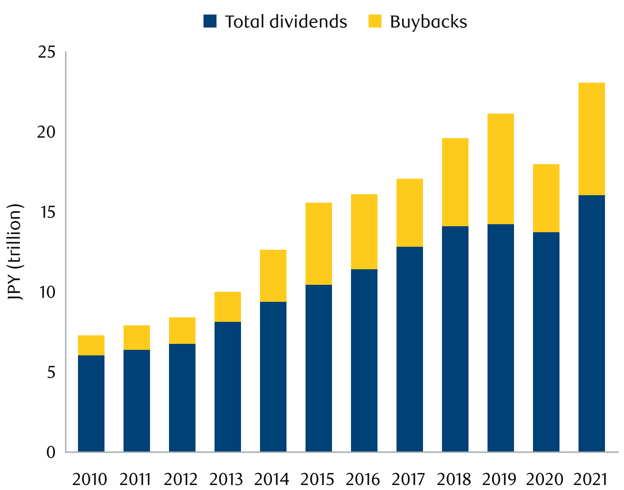
Japanese equities today provide an attractive opportunity for active investors. The asset class is under-researched compared to other developed markets, providing ample opportunities for active investors in stock picking and idiosyncratic alpha. Additionally, active managers are well positioned to capture opportunities arising from disruption, as well as those associated with ESG; elements that are not captured by backward-looking passive strategies.

Unlike passive strategies, active investors are also able to provide selective exposure to the asset class in structurally winning industries and companies. Through fundamental, in-depth research, active investors are able to identify distinct opportunities in companies with high quality management and strong corporate governance.

As previously mentioned, we have seen progress when it comes to corporate governance and best practice in Japan, including improvements in board structure and reporting, increasing the opportunity set for stock pickers and leading to growth in total shareholder returns.

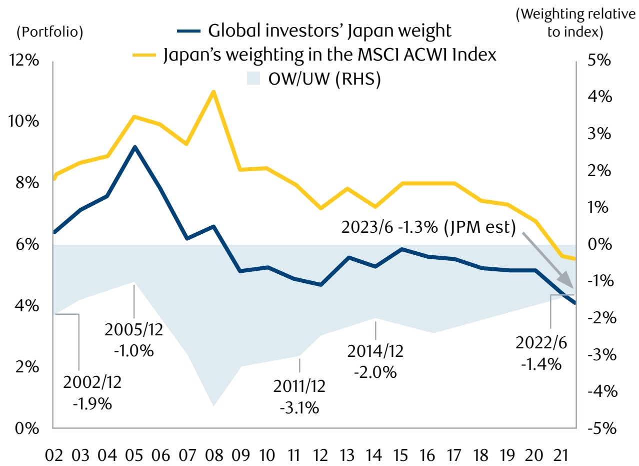
Finally, despite Japan being the third largest economy globally, the market is under-owned by global allocators. Given relatively muted performance, in particular versus U.S. equities in the last decade, allocators have underweighted Japan significantly in recent years. This presents another compelling argument for active investors, as both corporate fundamentals and fund flows could provide strong tailwinds to the market.

Exhibit 7: Growth in total shareholder returns



Source: TSE, Corporate Governance Report. Data as at December 2022.

Exhibit 8: Global investors' Japan weighting and Japan's weighting in the MSCI ACWI Index



Source: IMF, MSCI, Bloomberg Finance L.P., J.P. Morgan. Note: date for 2022 as of end June; OW (overweight and UW (underweight) relative to MSCI ACWI Index. Data as at May 2023. Note: IMF publishes data every six months. June 2022 is the latest published data as of June 2023.

Why RBC Japan Equity?

As a team, we are long-term and risk aware in our approach, with a near 10-year track record of investing in the region. The RBC Japan Equity Strategy employs an all-cap core exposure to Japanese equities, driven by regional perspectives and industry specialists. Our bottom-up approach allows us to focus on companies with strong balance sheets, consistent cash flow generations, and high and/or improving return on capital. We take a disciplined yet unconstrained view of the benchmark to build differentiated excess returns over time, through a high conviction portfolio.

Combining our industry expertise alongside the growing tailwinds in the market, RBC Japan Equity may provide differentiated exposure and performance to an otherwise underweighted portfolio to the Japanese market.

Published October 2023

GUKM/23/226/SEP24/A

RBC BlueBay
Asset Management