

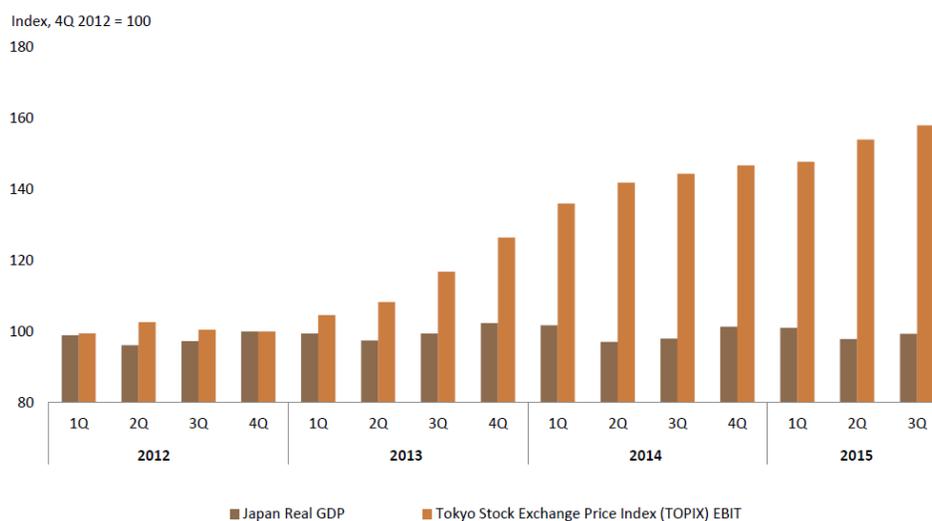


Why is there still a compelling case for investing in Japan? Kenichi Amaki, Lead Manager of the Matthews Japan Strategy, discusses the Japanese investment climate, including the impact of negative interest rates, “Abenomics,” and Japanese corporate governance improvements.

Q: Is Abenomics working in Japan or not? What does it mean for investors?

A: If you were to use just one measure, GDP growth since Shinzo Abe, the Prime Minister of Japan, took office in 2012, you would conclude his policies are clearly not working. GDP itself is flat to slightly negative since he took office. On the other hand, if you look at the Tokyo Stock Exchange Price Index as a reflection of corporate profits, it has grown more than 60% since he took office. Perhaps around a third of that comes from currency weakness, but even without that factor, corporate profit growth in Japan has been quite robust since Abe came to power. As equity investors, we’re investing in a share of corporate profits, not in the Government or in units of GDP.

Figure 1: Corporate Profit Growth Outpacing Real GDP
Equities buy a share of corporate profits



It is not possible to invest directly in an index.
Sources: Cabinet Office of Japan, FactSet Research Systems

One initiative that Abe has been pushing very strongly is improving corporate governance. Returning cash to shareholders by paying dividends and conducting share buybacks is one key component of improving governance, and that has been going well. Although it is on the back of strong profit growth, dividend payouts in Japan are at a historical high and we have seen share buybacks increase quite a bit as well. Of course, improving corporate governance in Japan is not simply about dividends or share buybacks. In the long run, it’s about improving capital returns and capital allocation. We see signs of that happening and that is one area we believe worth watching in Japan over a three- to five-years.

Q: What’s happening on the ground? What does Abenomics look like in action?

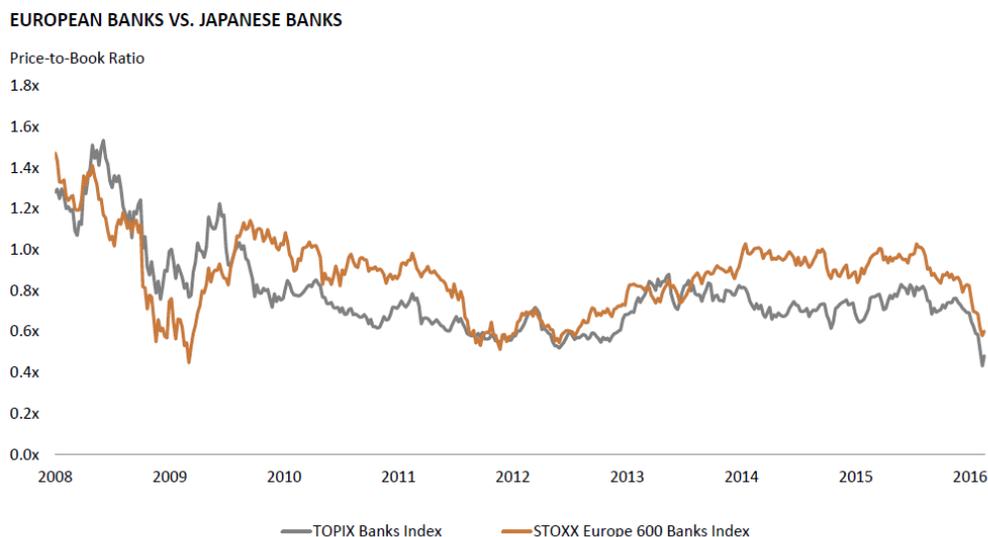
A: The question about Abenomics is always very difficult to answer, because it covers so many areas, but one thing we are seeing is the large numbers of Chinese tourists in Tokyo. It used to be fairly easy to book a good hotel room. Now it’s a scramble, the rates are much higher and we actually have to book two months in advance. That’s an effect of Abenomics. When Abe came in, he set a goal of 20 million inbound tourists per year. Last year, it was a little over 18 million, and about five million of those were visitors from China. Japan relaxed visa requirements for China and other Asian countries. They opened more landing slots for low-cost airline carriers, lowered the threshold for tax-free purchases, and expanded the categories that are available for tax-free purchase as well. They have done all this to increase inbound tourism under Abenomics, and it appears they have done a phenomenal job.

Q: The Bank of Japan (BOJ) recently implemented negative interest rates on bank deposits in the hope of stimulating bank lending and corporate investment. What is the likely effect?

A: While the BOJ’s negative interest rate policy (paying negative interest rates and charging depositors to keep their money in an account), applies only to a portion of excess reserves in the banking system, the response thus far has generally been negative. Will it work? Probably only to a certain extent. The reality is that bank loans have been growing. Loans outstanding are nowhere near where they were in the mid-90s, but with the current lending attitude of banks, it’s easier for any size company to get a loan than it’s been in the past 20 years. So using negative interest rates to drive down the cost of loans is not in itself going to create a lot of new demand.

What the policy has done, though, is hit bank stocks hard, probably a little too hard. The price-to-book ratios of Japanese banks are now lower than they were during the global financial crisis of 2008, yet the Japanese banks are nowhere near crisis mode. Yes, their earnings will likely decline because of negative interest rates and their net interest margins may shrink, but there is not a lot of risk that they’re going to have to write off loans or take excessive losses. The markets seem to have jumped to conclusions based on what’s happened to European banks since the European Central Bank implemented negative interest rates. European banks in general are in worse shape than the Japanese banks in terms of loan exposures and net interest margins. Japan has been in a very low interest rate environment for a long time, so the banks have already adjusted to that kind of situation.

Figure 2: NIRP Has Penalized Bank Shares
Is this the bottom or just the new normal?



It is not possible to invest directly in an index.
Source: Bloomberg; data as of 2/18/2016

One possible concern is that corporate savings rates have been rising. Japan's economy is a bit strange in that regard. Usually households are the savers and the corporations and government borrow from their savings. In Japan, though, the corporations are savers, too. Typically, when the corporate savings rate is rising, there is deflationary pressure on the economy. Meanwhile, the government has been removing itself from the economy as well. Its fiscal deficit is shrinking. Some might call that a good thing, but to the overall economy it is really not so great. So, the negative interest rate is an attempt to incentivize companies to spend more, invest more in their future and make acquisitions. But to really create demand for bank loans, there needs to be fiscal expansion in Japan.

Q: The Japanese economy has been flat for many years. How can we expect Japanese corporate earnings to continue to rise in this flat GDP environment?

A: One reason for optimism is that companies are much more nimble than countries. They can grow their business outside of their own country. Japanese companies have historically been less aggressive moving overseas than, for example, South Korean companies in Asia, simply because their home market has been larger than South Korea's. Today, the Japanese companies we talk to are well aware that their mother market is not going to grow and they're putting their incremental investment into growing their overseas business. These are not just large companies, but also medium-size and smaller companies.

There's definitely a focus on overseas growth, and it's different today than it was in the 90s or early 2000s. Back then it was about moving factories to China or Thailand because it was cheaper to produce goods there, but the end market for those goods was still Japan and the U.S. or Europe. Today, it's about targeting growth within China, or targeting the consumer in Thailand. That is the model of growth that we expect to see going forward, because households in those markets are much richer than they were 10 years ago. They are spending on things that they didn't buy 10 years ago, and there are a lot of opportunities that Japanese companies can capitalize on.

That is one way for Japanese companies to grow their earnings, even though the domestic economy is flat. The second factor that's often overlooked is that listed companies in Japan are still just a subset of the overall economy. Not all companies are listed on the stock market, but those that are tend to be the larger businesses in Japan. They have better pricing power. They're more productive. Over time, if listed Japanese companies can consolidate market share, their profits can grow, even though the entire profit pool for the country may not be growing.

Q: Do small-cap companies represent an attractive opportunity now compared to large caps, many of whom are exporters with more currency exposure?

A: The question of currency exposure has more to do with the type of business than whether it's large or small. That said, the smaller companies we look at tend to be service companies, which generally do not have much exposure to currency volatility.

Many investors are focused on the top 400 companies, the household names where there is liquidity, familiarity and a lot of sell-side analyst coverage. Looking at our Japan Strategy and how it has outperformed over the past five years, we have been able to add value through our stock picks in small- to mid-cap names. These are companies that are growing in Asia or in niche pockets in Japan. We look for companies that we think have good pricing power, a great brand, great technology and differentiated service. Small- and mid-cap companies like that don't get a lot of investor attention, especially outside of Tokyo, in places like Osaka and Nagoya. That's where we've been able to find companies and add value over time.

Q: What other opportunities do you see in Japan in the next year or two?

A: Long term, we're watching the trend towards improved corporate governance and how that impacts return on capital allocation decisions in Japan. Can Japanese companies become better stewards of capital? We're not 100% convinced yet, but we are seeing signs of improvement. If you have a three- to five-year time horizon, that would be a reason to consider investing in Japan today.

Aside from that, we think Japan is looking at a huge opportunity in the rest of Asia. It has been a challenging couple of years, especially with growth slowing in China and in Southeast Asian economies, but household incomes are still rising. That is important to remember. As Asian households get richer, they are not just consuming more but they are trading up in quality. We believe Japanese companies are well positioned to capitalize on the growth of the middle class in Asia and its newfound spending habits.

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