Global Investor

Spring brings fresh hope for Japan

How many times have you heard it over the last 15 years: a recovery in Japan is just around the corner. The whispers are starting again. Caroline Allen finds asset managers remain divided about the right moment to return

It used to be said about Brazil in the 1970s and 1980s: it's the market of tomorrow...and always will be. But while the sun has risen over Latin America's biggest market -- one of the fast-growing BRIC economies and now the darling of global investors – Japan is still waiting for a new dawn.

Any seasoned investor will testify how the world's second largest market is also one of the hardest to make any money in, or to develop a scaleable local business. Time after time, investors have been disappointed. But perhaps precisely because of that history, Japan now offers real possibilities and the potential is now the subject of debate, and even public discussion.

"There are some important questions to be asked about the future direction of Japan's capital markets and also whether this is an opportune time for global investors to alter their positions in Japanese assets generally," says Andrew Milligan, head of global strategy at Standard Life Investments.

Charles Beazley, the London-based president of Nikko Asset Management, says he has seen more interest in the last year as contrarian investors and those seeking shelter from more choppy markets turn to Japan.

"We have seen strong demand for Japanese equities in the past six months from Institutional investors in the Middle East and from deep value investors elsewhere in Europe and recently the US too. We share their enthusiasm for entering the market at this point, with a view over the long term."

He comments that with GDP growth of 0.9% in the fourth quarter 2007 (or 3.7% at an annualized rate), the economy appears to have surprised international observers, who now have to contemplate the fact that Japan is in somewhat better shape than many had predicted.

"With the sharp sell off in global equities and significantly improving market PE's, Japan looks to be back in relative contention again," notes Beazley. "If you add to this the striking increases over recent years in corporate dividends, share buybacks and overall levels of corporate earnings, Japan has moved significantly up the rankings of investor interest.

"It's certainly worth looking at," says Peter Jenkins, investment strategist at Nomura Asset Management in London. "Japan has lost all its premium over other global markets; 50% of the (Topix Tier 1) market is trading below book value, and the dividend yield is now higher than government bond yield by 20-30 basis points, which has previously been a signal for the market to move up."

But he concedes that investors remain cautious. "There is plenty to go for at one level, especially given the headwinds in other markets. Value driven players are paying more attention, but I would say there is interest, rather than a wall of money heading that way. It is more of a stock picking opportunity than buying the whole market, and unlocking value is often difficult given local corporate structures."

Douglas Hodge, head of Pimco's Asia Pacific region, said that Japan has tapped into Asian economic growth and had developed strong trade links in the region but that sentiment both within Japan and towards the market had softened in recent months. "Sentiment can turn negative relatively quickly," he noted. "There has been a retrenchment in risk appetite."

However, Standard life's Milligan believes a recession in Japan is not inevitable. "Although domestic demand has been weak, part of that has related to short term headwinds affecting housing construction, while the pressures on the corporate sector do not look sufficient to bring about another collapse in consumption. External trade and investment remain the primary drivers."

In London in February, some 600 guests attended a briefing hosted by the Japanese Securities Dealers Association (JSDA) to outline upcoming policy measures intended to strengthen the competitiveness of Japan's financial and capital markets and make them more attractive to foreign investors.

Since Japan's Big Bang in the 1990s, market reforms have been gradually introduced and implemented in the financial and capital markets, although often not fast enough for foreign players.

Diversification

At the meeting, measures contained in the Japanese Financial Services Agency's plan for strengthening competitiveness were presented. Discussion then focused on diversification of exchange tradeable products and the revamping of firewall regulations among banking, securities, and insurance businesses.

Most market participants agree that the Financial Instruments and Exchange Law (FIEL), in force from the end of September last year, has established a more comprehensive regulatory framework to ensure investor protection and offer a degree of flexibility which will improve market efficiency.

At the forum, JSDA Chairman Toshio Ando alluded to intensifying competition globally and the "misconception" that many foreign investors have about Japan, which still has the largest pool of household financial assets in the world. "It is a pressing issue to meet the demands of domestic and foreign users and thereby raise its attractiveness as a market as well as boosting its international competitiveness," he said.

A report from Boston-based investment consultants Cerulli Associates, issued in November last year, said the introduction of the FIEL is likely to have negative near term effects, but backed the JSDA's assertion of a deep and growing pool of local assets. "The introduction of the FIEL is likely to put the brakes on investment sales, but only in the short term...Banks are expected to feel the brunt of the slowdown, thereby allowing brokerages to gain further market share in the months to come."

The law marks a pause in what was a promising start to 2007. At end March 2007 Japanese mutual fund assets reached a new high of JPY115 trillion, a 19.3% growth over the previous year. That growth was largely fuelled by sales of retail multimanager products, notably funds of funds. In fact, the report said Japan was the world's fastest growing multimanager marketplace in 2006.

Shiv Taneja, Cerulli's managing director, expects this pace of growth to continue. "Japanese investors are demonstrating a keen desire for diversification and a growing awareness of their retirement needs. Funds-of-funds have enjoyed considerable popularity as a result."

The recent activity has benefitted brokerages, which are recovering some of the share of mutual find distribution channels they lost to banks in previous years. Through 2007, brokerages leveraged the rally in global markets and their more risk-tolerant client base to boost mutual fund sales.

In 2006-7, Japan's pension market also expanded, by 13% in the 2006 fiscal year, led by the increased outsourcing of public pension funds, including a portion of Japan's Government Pension Investment Fund (GPIF), the largest pension fund in the world.

However, that promise once again failed to materialise. According to Standard & Poors Fund services, Japan was the worst performing of any developed market in 2007, notably the poor performance of Japanese equity funds. The median fund in the S&P Japan mainstream sector returned minus 10.4% over the 11 months to the end-November, while its small- and mid-cap counterpart returned minus 16.1%.

Yet sentiment towards parts of the market appears to be improving. "Given the extent of the underperformance and continued growth in corporate profits, the Japanese market is seen as attractive on fundamentals," said S&P Fund Services lead analyst Alison Cratchley.

She cites Richard Aston, manager of the S&P A rated JPMorgan Japan Equity fund, as one of many who see the Japanese equity market now trading on valuations that are attractive relative to both its own history and global markets. "The view is that Japan offers a compelling proposition on valuation metrics that give consideration to the balance sheet such as EV/EBITDA or PBR (price to book ratio)," said Cratchley.

Several other managers, including highly rated Japan expert Scott McGlashan of the S&P AA rated JOHCM Japan fund, pointed out that the dividend yield on the equity market is now higher than the yield on the 10-year Japanese Government Bond. This has only happened four times since 1960, and each time it led to a significant rally in the stock market as Japanese investors increased their exposure to domestic equities.

"There is the equity/bond yield premium," commented Pimco's Hodge. "But we have been there before. It does bring in money, but there is the wider global market to consider. The measure of value in a bond market is the steepness of the yield curve, and there is an opportunity for price appreciation in Japan. It is also a high quality market, but I would say it is more of a safe haven given the dislocation of credit markets elsewhere."

Glitches

However, other factors have led investors to pause. The Tokyo Stock Exchange has recently experienced a number of glitches that have led to trading being suspended or disrupted. Earlier events occurred in 2003 and then 2006.

"Especially in the present climate, following the Societe Generale disclosure, trading platform performance is a growing issue of concern," comments Graham Smith, head of client engagement at technology firm AppLabs, in London. "You can maybe get away with one, but repeated failures do immense damage to the exchange brand and to the investment companies involved. All stock exchanges should be reviewing performance testing programmes and surveillance systems, to be able to offer the stability of service investors need."

Japan's fate is tied, at one point or another, to that of the US economy, and asset managers still differ as to the effect of a US economic slowdown on Japan. Some, like JPMorgan's Aston, believe any slowdown will be offset by growing demand from emerging markets. So export related sectors will benefit at the expense of domestic sectors.

Ed Merner, president of Atlantis Investment Research Group, and previously a long time Japan fund manager at Schroders, said the situation is uncertain, but not serious. "Many Japanese companies are very competitive and will remain so. They are world class, well run, financially strong companies, trading very cheaply. A concerned reaction is justified, but there is no need to go to extremes."

Hideo Shiozumi of the Legg Mason Japan Equity fund, suggests that if the US economy softens further and the US dollar continues to weaken against the yen, Japanese exporters will suffer earnings downgrades, encouraging investors to focus on domestic-oriented companies.

Other attractions, such as the yen 'carry trade', which has allowed investors to borrow cheaply in yen and invest elsewhere, is unwinding as the yen soars. It has strengthened between 10% and 15% in the last six months alone. That doesn't help Japanese exporters but it may boost inward investment.

Jenkins at Nomura feels that what is needed for Japan is a catalyst of some sort – which may come from the markets, or from the political sphere. A domestic political stalemate has frozen the corporate reform agenda, leading to a hiatus for any policy initiatives.

"There is general agreement that the Bank of Japan is in a bind! " notes Milligan at Standard Life. "It had hoped to see a classic business cycle create domestic inflation, but the internal dynamics of the ever evolving Japanese economy prevented this occurring. Could deflation become entrenched again? In my view, it looks much less likely because of the current strength of the corporate and banking sectors compared with years past. All in all, the Bank will need to wait for the next uptrend in the global business cycle before normalising can return to the agenda."

The triggers to "pull back or invest" he adds, will be domestic and micro, such as changes in dividend or M&A policy, but at a macro level - aggressive monetary tightening by a Chinese central bank worried about inflation would have important implications for Japanese assets.

Commentators note that Japan has more in common with Western developed markets than with its high growth Asian neighbours. Although trade flows within Asia are strong, Japan battles deflation and an ageing workforce while the rest of Asia, benefiting from the growing wealth of its youthful populations, wrestles with inflation.

Uncertainty

Those bullish about the Japanese market are making much of how it has managed so far to avoid the worst consequences of the US sub prime lending crisis and the subsequent securitisation and leverage of that debt, which has got so many financial institutions in the US and Europe into difficulties.

However, according to Pimco, it is going to be difficult to untangle Japan's involvement from what is clearly a global problem. The subprime loan problem is not just a matter of bad debt due to a correction in housing prices.

"Investors are nervous, there is so much uncertainty," says Hodge. "SIVs, CDOs...investors don't know what to think of them. I would say we have by no means seen the bottom of the cycle; in fact we may only be six months into it. The huge numbers of the (subprime) write-downs are shocking."

Some maintain that even if the estimated $5 billion of sub prime related losses at Japanese banks should double, they are covered by annual earnings flow. Others insist that Japanese institutions, like those elsewhere, are not going to be able to hide their losses forever, and strict new accounting laws require full disclosure by end March 2008. Mitsubishi, the largest of the three banks that have even admitted any effect from the sub prime crisis, has just hiked the sum it estimates might be involved.

But like all tipping points, there are those poised to swoop when previously identified targets are sufficiently weakened. "I would say we are in defensive, but opportunistic mode," commented one fund manager. "We are not buying group or bulk anything. It's all selective. We are prepared to be patient but by the end of this year we expect to be active in the Japanese market."