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More room to grow. Surging Japan remains attractive investment target for institutional investors.

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In U.S. dollar terms, Japan's Nikkei 225 index was up about 7.6% year-to-date through April 15, following a 21.3% jump in calendar 2023.

Japanese equities have blossomed in recent years due to a number of favorable factors, but some asset managers think stocks in the world's third-largest economy remain attractive, especially for institutional investors seeking more diversification in their portfolios.

In late March, the Bank of Japan raised its benchmark interest rate for the first time in 17 years, pulling the plug on a long-term policy of maintaining negative rates as a means of spurring the economy. The change was slight — rates edged up to a range of between 0% to 0.1% from -0.1% — but it marked a significant shift away from an ultra-easy monetary regime.

The move followed almost two years of superb performance by Japan's stock markets. In U.S. dollar terms, the Nikkei 225 index was up about 7.6% year-to-date through April 15, following a 21.3% jump in calendar 2023 (after an 18.9% decline in 2022), making the Nikkei one of the world's top-performing indexes over the past two years.

In the U.S., the S&P 500 returned 7.9% year-to-date through April 12, after returning 26.3% in 2023 and dropping 18.1% in 2022.

Even so, while the Japanese markets are flourishing, a number of challenges remain, including the country's aging population, lack of a heavy presence of retail investors in local markets and a still weak yen.

James Wesley, CEO and country head of Nikko Asset Management-Americas, attributed the recent stock surge to two primary factors. "The cyclical drivers include a positive environment for equities, triggered by improving fundamentals," he said. "The ongoing 'carry' trade has kept the yen weak, giving overseas revenues of listed Japanese firms a boost."

The second factor relates to structural shifts among large, listed firms.

“There have been positive developments with cross-shareholding divestments, increased dividends and buybacks, and deploying capital into productivity-enhancing investments,” Wesley said. “There has also been widespread embracement of governance reforms, which has been appealing to foreign investors.”

For example, in early 2023, the Tokyo Stock Exchange imposed a rule requiring listed companies that are trading below a price-to-book ratio of 1 to present plans for improvement or otherwise face delisting by 2026.

Parent company Nikko Asset Management has $228.6 billion in AUM.

James Thorne, chief market strategist at Wellington-Altus Private Wealth, is also bullish on Japanese equities.

Japanese companies have reported better-than-expected earnings, driven by cost-cutting measures, restructuring efforts and a recovery in global demand, Thorne noted. “This has increased investor confidence and led to higher stock valuations, and Japan's economy has shown signs of recovery, with GDP growth picking up in 2023,” he said. “This is supported by a rebound in consumer spending, government stimulus measures, and a recovery in the global economy.”

Thorne also pointed to Japanese companies' progress in improving corporate governance practices, such as appointing more independent directors and focusing on sustainable growth. These measures have attracted more foreign investment into the Japanese stock market, he said.

Toronto-based Wellington-Altus has C$25 billion ($18.4 billion) in assets under administration.

Japan has witnessed a broad recovery of the economy and an exit from a multidecade deflationary environment, added Jon Withaar, Singapore-based senior portfolio manager at Pictet Asset Management. “Inflation is now running at or above the Bank of Japan’s 2% target and is the highest in over 30 years, as are wages,” he said. “Many economists predict that nominal year-over-year GDP growth in Japan will eclipse that of China for the first time in decades.”

Japan has also been a big beneficiary of diversification away from China, both from a foreign direct investment and equity investment perspective, Withaar said. “Investors, wary of continuing regulatory and geopolitical risk in China, as well as the unresolved property market issues, have reallocated funds to Japan where earnings are strong and risk of negative geopolitical headlines are less,” he said.

Room to grow?

Despite the recent run-up in prices, Wesley thinks there are still good bargains in Japanese equities.

“Overseas investors are currently the prevalent buyers of Japanese stocks, due in part to corporate Japan's changes in practices such as improving profit margins and return on equity,” he noted. “However, many firms have yet to maximize profitability so there are still opportunities to find great value stocks.”

Shuntaro Takeuchi, portfolio manager of the Matthews Japan Fund at Matthews Asia, noted that despite this strong performance, global investors remain underweight in Japanese stocks, suggesting more room for price expansion.

The most attractive sectors in Japan are technology, industrial and healthcare, Takeuchi said. “Japan corporate profits, compared to other regions, are relatively geared toward industrial production,” Takeuchi said. “The value-add resides in contributing to labor productivity enhancement. Also, its aging society leads to constant upward pressure in healthcare costs, so healthcare solutions that cater to capping healthcare inflation is an opportunity.”

Matthews Asia has $8.4 billion in AUM.

Wesley said that half of the companies on the Tokyo Stock Price index still have a price-to-book ratio below 1. “While risks including geopolitics, overseas elections, wars in Europe and the Middle East remain, there are compelling reasons to expect further value in Japanese stocks,” he said. “It’s worth noting that in contrast to the concentrated nature of global stock returns and challenging tech sector valuations, Japan is enjoying a broad-based rally with valuations remaining compelling.”

In addition, Japan is being reevaluted (or re-rated) by overseas institutions as an attractive destination for their funds, Wesley noted, adding that “this process of re-rating will likely continue for some time, as institutional allocations are often slow-moving.”

CPP Investments, which manages the assets of the C$590.8 billion ($431.6 billion) Canada Pension Plan, Toronto, has a significant stake in Japan and has been invested there for a while, making it first direct investments back in 2011.

Agus Tandiono, senior managing director, head of Asia-Pacific and active equities Asia at CPP, said that as of Dec. 31, CPP’s investments in Japan accounted for 22% (or about C$30 billion) of the fund’s total assets in Asia-Pacific, making Japan its second-largest market in the region, after China.

“Our investments in Japan span public and private markets as well as real estate,” he noted. “Japan’s share of our overall Asia-Pacific assets has also grown, from less than 19% at the end of March 2023.”

CPP is focused on investments in management services, technology, education, healthcare, data centers and consumer sectors, he said. “We are invested across different asset classes in Japan and continue to see opportunities across asset classes and sectors,” he added.

Some notable investments include a data center development venture with Mitsui & Co.; a logistics facility development venture with logistics firm GLP; as well as stakes in Hitachi Metals, medical service provider Sogo Medical and messaging and media firm Kakao Japan.

“Japan is an economically diverse and dynamic country,” Tandiono added. “The economic revival in Japan, assisted by the government’s policy objectives of ‘new capitalism’ and economic security, has led to significant opportunities and growth in various sectors."

While favorable market conditions have contributed to equity flows, there also remains more cash that could flow into Japanese equities from Japanese retail investors, Wesley noted.

Withaar said Japanese retail investors themselves are very underweight their own market. In Japan, he said, only 10% of household financial assets are held in equities, with a massive 55% being held in cash and deposits. This compares to 40% invested in equities by households in the U.S., and 20% in Europe.

Withaar explained that the Japanese government is aware of this disparity and this year put into place reforms to the government's Nippon Individual Savings Account program, principally by increasing both the tax-free threshold and tax-free period.

"This program is designed to incentivize Japanese households to move money out of inflation-exposed cash and deposit accounts and into alternative forms of investment to better prepare for the inflationary environment to come," he said.

"The Japanese retail investor has responded and NISA account openings in January-February were three times the number they were for the previous year's corresponding period."

“I do not see any reason to underweight the region,” Takeuchi said.

However, Peter Perkins, partner, global strategy and regional equities at research firm MRB Partners, cautioned that Japanese stocks are overbought and therefore vulnerable to a consolidation or correction phase.

“That said, the economy should improve in the year ahead, aided by an upturn in the global trade cycle, which should add further support for earnings,” he added. “Given that the Japanese market is very pro-cyclical in its sector composition, the implication is that there is more underlying upside — despite the potential for a near-term consolidation or correction.”

Wesley of Nikko also pointed out that Japan’s equity market is relatively inefficient with comparatively low sell-side coverage of stocks outside of the largest 100, leaving more than 1,400 stocks with limited to no coverage, and even fewer with coverage in English.

"The mid/small stocks are particularly interesting from an alpha opportunity,” he noted. “The culture focusing on shareholder value is still developing, so direct company and management engagement is critical to understanding earnings and growth expectations.”

Land of the rising yen

The recent decision by the Bank of Japan to hike rates will likely raise hopes of the yen bouncing back against the dollar after years of depreciation.

Takeuchi of Matthews Asia said the primary driver of the weakening yen has been the widening spread between U.S. and Japan bond yields, especially in two-year bond yields.

Pictet's Withaar thinks it is likely that the yen will begin to strengthen in the midterm as Japan continues down its path to rate normalization — but a lot will depend on the trajectory of Japan’s economic recovery and the inflation outlook in the U.S.

“Assuming both trajectories remain on track, this would most certainly be positive for the yen,” he said. “The U.S. inflation outlook remains key to the yen picture. I don’t think we necessarily need a strengthening yen to entice U.S. (institutional) investors to go overweight Japanese equities, but stability would certainly be a help.”

In early trading on April 11, the U.S. dollar surged to a new 34-year high against the yen.

Wellington-Altus' Thorne posited that the divergence in monetary policy between the BOJ and the U.S. Fed could indeed lead to a stronger yen against the dollar. “If the BOJ continues to normalize its monetary policy and the Fed begins to cut rates, the interest rate differential between the two countries would narrow, making the yen more attractive to investors,” he said. “A stronger yen could prompt U.S. institutional investors to increase their allocation to Japanese equities, as a stronger currency would enhance the returns on their investments when converted back to U.S. dollars.”

Demographic challenges

Still, like Western Europe, Japan is an aging society facing demographic challenges. According to the World Economic Forum, as of September 2023, 10% of the population is at least 80 years old, and nearly one-third of its population is over 65.

According to an April 2023 report from Harvard International Review, “many younger Japanese investors and companies are turning their focus abroad as their country's aging population and stagnant growth lead them to believe that foreign companies throughout Asia might be better investment destinations.”

“The working age population is declining and finding workers to sustain growth will continue to be a challenge,” Withaar said. “The government is aware of this though and is attempting to address the issue.”

For example, he noted, starting on April 1, the government doubled its foreign specialized worker quota to over 800,000. As of last year, only 200,000 workers were working under this framework.