
OUTLOOK ON
JAPAN
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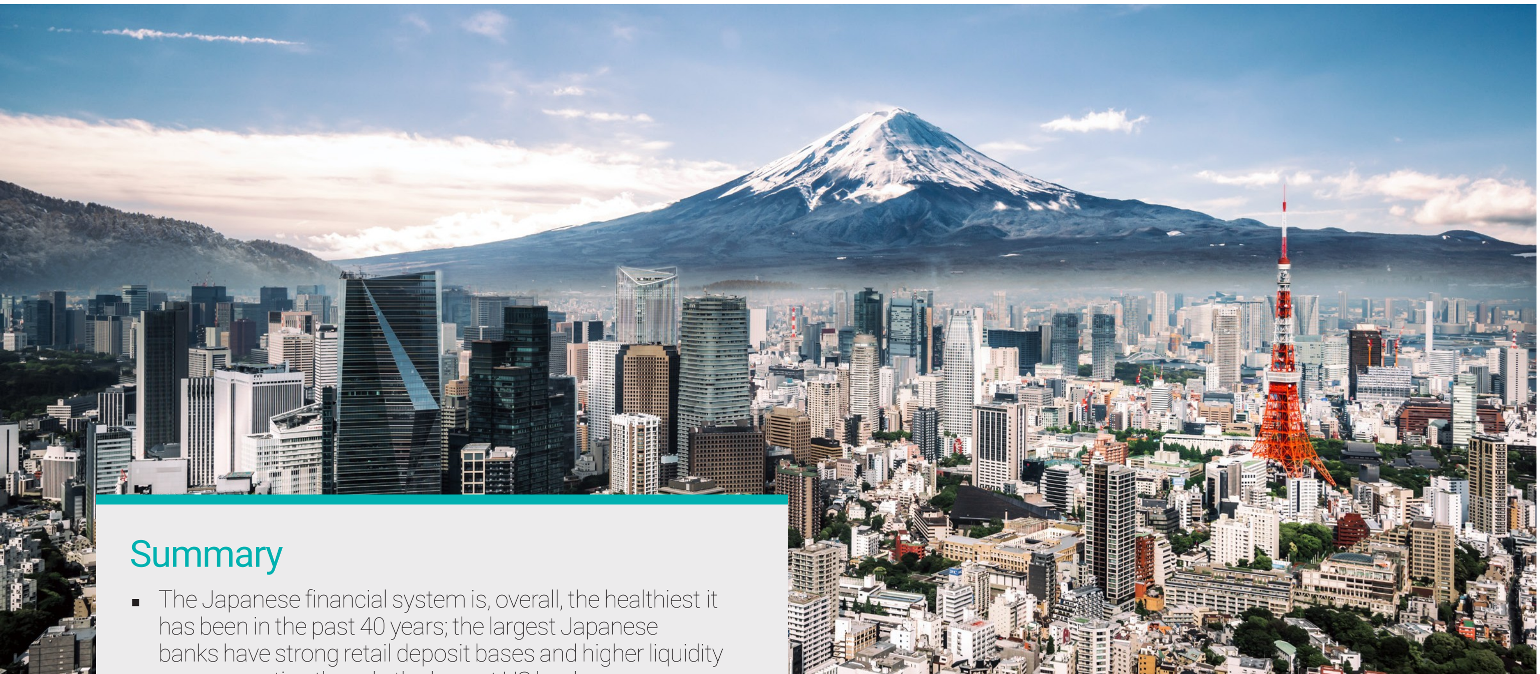
Outlook on
Japan

MAY 2023



Summary

- The Japanese financial system is, overall, the healthiest it has been in the past 40 years; the largest Japanese banks have strong retail deposit bases and higher liquidity coverage ratios than do the largest US banks.
- In the near term, we believe the Japanese financial sector will likely be subject to concerns about financial contagion following the run on US banks, but we think the more pertinent issue is inflation.
- Japan's Shunto, the annual spring wage negotiations, is pointing to the highest wage hikes since the early 1990s, which we believe will press the Bank of Japan to further normalize monetary policy.
- In January, the Tokyo Stock Exchange announced plans to put further pressure on listed companies to meet its higher standards or face de-listing, continuing to advance corporate governance reforms and address inefficiencies.

The year 2023 started off on a positive note as expectations of an economic soft landing for the United States increased along with heightened prospects of a recovery in Chinese economic activity following the government's zero-COVID policy U-turn. However, this reprieve following the weakness of equity markets in 2022 was short-lived as March's deposit run on Silicon Valley Bank set off financial contagion concerns leading to the FINMA (Swiss financial regulator)-orchestrated takeover of troubled Credit Suisse by its competitor, UBS. We hold the view that the current turmoil represents idiosyncratic liquidity problems rather than systemic solvency risk as seen during the global financial crisis (GFC). In hindsight, it seems clear that the deposit structure at Silicon Valley Bank would put the bank at risk of a run. Not surprisingly, Signature Bank and First Republic both shared high levels of concentrated deposits not covered under FDIC insurance. We are heartened by how quickly the US government stepped in to mitigate systemic consequences. We were also encouraged by how quickly FINMA and the Swiss National Bank moved to save Credit Suisse. Nevertheless, we expect that market concerns will likely remain elevated as memories of GFC contagion remain top of mind.

Unsurprisingly, we have seen what we consider to be a knee-jerk sell-off in Japanese bank stocks. We would first note that the overall Japanese financial system is in better shape than it has been over the last forty years as Japan has, slowly but surely, dealt with the excesses of its financial bubble of the 1980s. Also, the nonfinancial sector has completely unwound its excess leverage. At the height of Japan's banking crisis in 1997, nonfinancial sector net debt to equity stood at 110% as compared to the rest of the world, which was at 65%. Most recently, Japan's nonfinancial sector net debt to equity stood around 35% as compared to the rest of world, which was around 50%. Second, we would note that the structure of Japanese deposits is more robust relative to the credit structure at Silicon Valley Bank and other banks as it is driven more by sticky retail deposits. We highlight that under Basel III, the international regulatory framework for banks, the largest Japanese banks have higher liquidity coverage ratios than do the largest US banks. We continue to view the largest Japanese banks as overcapitalized and believe they will continue to pursue a strategy of higher shareholder returns over the medium term to improve returns on shareholder equity.

In the near term, we believe the Japanese financial sector will likely be subject to the whims of contagion concerns, but we also believe that the more pertinent issue over the medium term for the financial sector and the Japanese market will be inflation. We recently saw the preliminary outcome of the annual spring wage negotiations between company managements and labor unions, which is known as "Shunto." Initial data points to an overall 3.8% year-over-year wage increase which includes a base increase of 2.3%. Japan's Shunto is the highest number since the early 1990s. Consensus expectations for this most important base increase was about 1.5%. We believe this higher-than-expected wage increase will put further pressure on newly appointed Bank of Japan (BoJ) Governor Kazuo Ueda to continue further normalization of Japanese monetary policy. We expect a significant change in Yield Curve Control policy, or even its outright abolishment. Subsequently, an end to the BoJ's negative interest rate policy is a likely next step. While Japan technically exited deflation under the Abe/Kuroda regime, it has yet to shake its deflationary mindset. We believe that rising inflationary expectations could lead to positive changes in consumption and investment behavior by Japanese individuals and corporations.

On a positive note, the Tokyo Stock Exchange (TSE) in January announced new proposals to put further pressure on listed companies to meet its higher standards of listing under its new three segment structure (Prime, Standard, and Growth) or otherwise face de-listing. As part of its proposals, the TSE would, "require that management and the board of directors properly identify the company's cost of capital and capital efficiency," especially for companies that have consistently traded below book value. We believe this type of "comply or explain" directive will further pressure Japanese management teams to address issues of capital inefficiency. As these corporate governance reforms continue to make headway, we would expect to see higher returns on capital and a lower cost of capital as Japanese governance standards move toward Western levels.

While short-term market focus will be centered around near-term economic and financial conditions, we continue to believe that the medium- and longer-term outlooks are becoming more favorable for Japan. As discussed in our previous Outlook, we believe that the changes in global economic structures such as reshoring as well as longer-term secular trends such as factory automation and vehicle electrification, are supportive of many Japanese industries. The significant weakening of the yen over the last decade has put Japan in its most cost-competitive position since the 1970s. Valuations remain attractive relative to historic levels and relative to other markets, while underlying core profitability continues to improve. Lastly, corporate governance reforms continue to make headway in Japan and have seen a further boost by the TSE's most recent actions.

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