State of Play

Return of the rising sun

29 June 2023

In 1989, the Japanese Stock Market hit an all-time high following an asset price boom triggered by loose monetary policy. Faced with an overheating economy, policymakers began to raise interest rates, bursting the bubble, and the aftermath lasted far longer than anybody could have imagined. However, this year, share prices in Japan have made a remarkable recovery, prompting many investors to question whether this is the return of the rising sun or just investor speculation? Simon Durling from Santander Asset Management shares his thoughts in this week's State of Play.

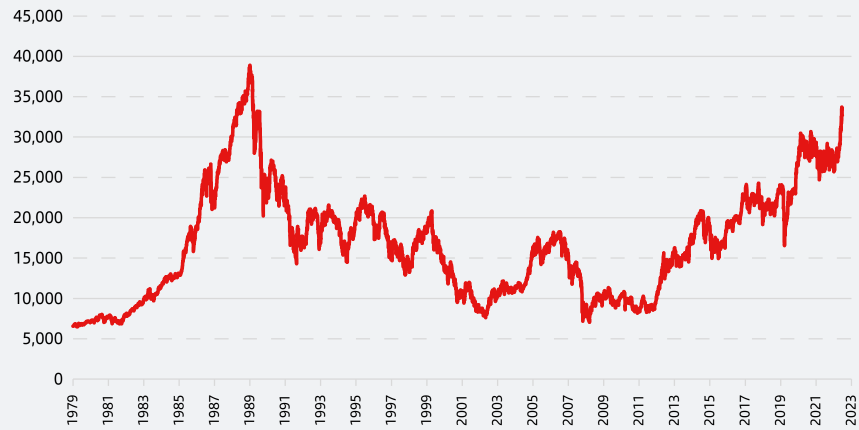
Key highlights from this week's State of Play

- Asset bubble bursting
- Lost decade
- Return of the rising sun
- The barriers of age

Asset bubble bursting

Towards the end of 2010, China overtook Japan as the world's second-largest economy, behind the US.[1] Despite this demotion in the world's economic league table, Japan is an extraordinary story of an economy built from the ruins of the Second World War into a manufacturing powerhouse once described as the 'economic miracle'. Towards the end of this golden period, the Bank of Japan cut interest rates significantly to spur domestic growth, which prompted banks to open lending to businesses on a vast scale, who used this money to invest heavily in factories, equipment, and office construction. In addition, it triggered a residential real estate boom, with property prices soaring. Businesses that bought land benefited from higher capital values, sending their share prices much higher, prompting more borrowing and more investment. At one point land prices became so extreme that the land on which the Imperial Palace in Tokyo stood would have been worth more than the whole of California.[2] Finally, in late 1989, in fear of an overheating economy, policymakers reacted by raising interest rates, bursting the asset bubble—land prices, share prices, and private company investments all fell sharply. On 29 December 1989 the Nikkei 225 Index hit an all-time high of 38,916. Since then, the Japanese Stock Market has never recovered those highs in 33 years.

Nikkei 225 - Price Index



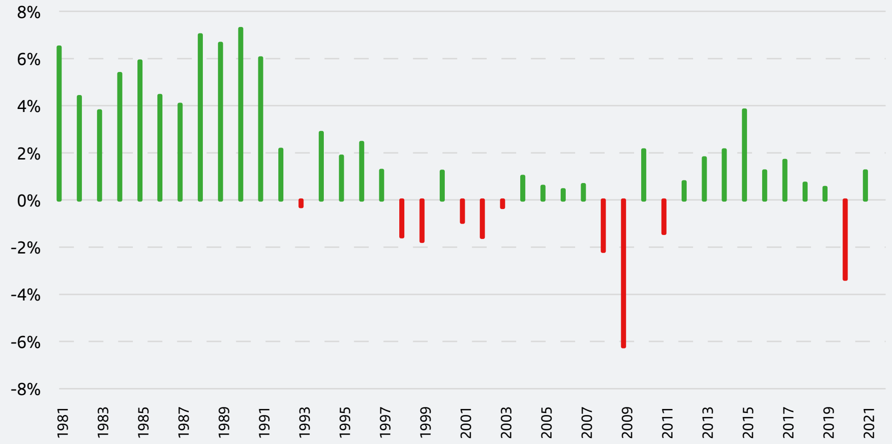
Source: Datastream
Data: Nikkei 225 stock average - Price Index (as of 26/06/2023); In local currency
Data as at June 2023

Lost decade

The 1990s proved a very difficult period for the Japanese economy, experiencing a recession of depth and duration virtually unprecedented for a major industrial country since the Second World War, only beaten by the Global Financial Crisis in 2008. From 1991 to 1999, output growth averaged only a little over 1%, compared with around 4% achieved in the 1980s. This experience led policymakers to question many of the most basic tenets about Japan's economy, including the potential growth rate, the effectiveness of fiscal and monetary policies, and the strength of the Japanese system of corporate governance.[3] In truth, Japan had been investing too much for a rich country, and still investing as if it were catching up the developed countries.

Eventually, this had to come to an end, with all of the financial consequences with it.[4] Japan's web of company cross-shareholdings was a key contributor to a big rise in zombie companies that should have been allowed to go bust or restructure rather than being kept on a life-support machine. Such restructuring would have allowed the economy to be rejuvenated, despite the initial pain this would have caused.

Annual Change (%) in Gross Domestic Product - Japan



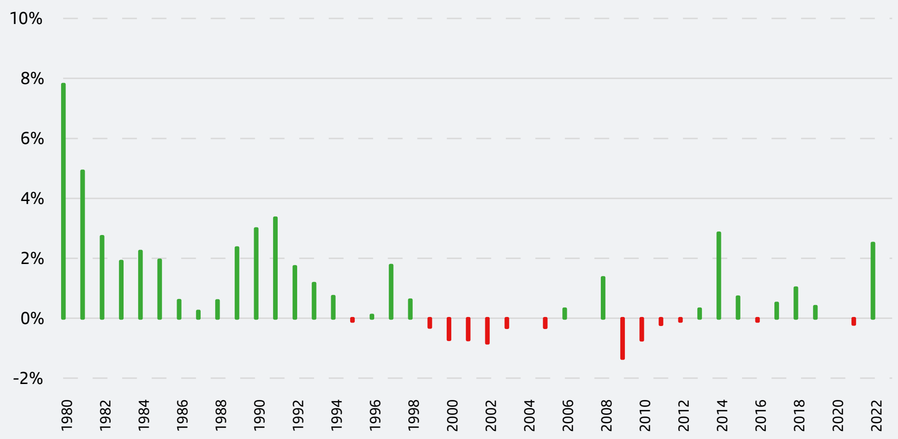
Source: The World Bank
Data: Nominal GDP per capita (as of the end of 2021); In local currency (current)
Data as at June 2023

Economic growth slowed markedly from 1991 as a tightening in monetary policy prompted the collapse of equity and land prices. The continued appreciation of the yen through early 1995 was an additional factor depressing activity, contributing to a period of stagnation that lasted through most of the early 1990s and left the economy lagging its international peers. Policymakers responded by combining fiscal stimulus with monetary easing (lower interest rates and printing more money) and some deregulation, prompting a recovery that led to the economy growing by 5%, ahead of the other G7 nations. Initially, in 1997, consumers were incentivised ahead of a rise in consumption tax, triggering individuals to bring purchases forward. However, the lull in activity after the tax rise extended much further than anybody had anticipated, leading to a sharp recession in 1997 and 1998 in which the economy shrank by more than 5%, the worst since the Second World War (excluding 2008).[3]

Damaging deflation

The other aspect of the lost decade is the drop in consumption, prompting the price of goods to start falling – known as deflation. State of Play in previous editions has explored inflation, deflation, and stagflation. Deflation is when prices start to fall, which on the surface sounds great for everyone. Let's face it, all of us would prefer that prices fell, making us richer. Assuming our income remained constant or growing and prices fell, we would be able to buy more with less. However, most economists would acknowledge that deflation can be very damaging – especially for a country's economic growth prospects. Let me explain why. Firstly, a period of deflation is likely to become embedded given that the most significant effect of falling prices is, perhaps, that it encourages consumers to defer their current consumption in the hope that goods will get even cheaper in the long run. Falling prices are regarded as a significant macroeconomic problem as it is associated with other problems, including unemployment and falling national income. Finally, deflation is also associated with an increase in the value of government and corporate debt. As more people become unemployed, the benefit payment burden increases for a government and their tax revenues decrease along with falling consumption and recession. As you can see from the chart, Japan suffered from prolonged bouts of deflation (The bars in the chart in red) which proved very difficult to escape from. During this key period, Japan embarked on quantitative easing (QE) in 2001, (which is where interest rates are cut to near zero and additional money is printed by the central bank to buy bonds from the banks and the financial market) almost a decade before central bankers in the west adopted the same policy in response to the financial crisis. As we have seen, once begun, QE is difficult to give up.

Annual Change (%) in Consumer Price Index - Japan



Source: Datastream
Data: Japan Monthly Consumer Price Index, 2020 = 100 (as of 15/05/2023)
Data as at June 2023

Return of the rising sun

In 2023, the Japanese stock market has made a remarkable recovery, providing investors with a total return, including dividends of 27% in the first 6 months.[5] So, what are some of the reasons for this, and more importantly, is this a longer-term momentum shift? In recent times, Japan has undergone changes in corporate governance where companies have been under pressure to return cash to shareholders. For decades, investors biggest complaint about companies in Japan has been their obsession with building up huge cash piles and inward investment, with too little of the growth and profits being returned to shareholders. Last year saw the largest buy-back numbers in their history, in which some of the cash was used to buy back shares.[6]

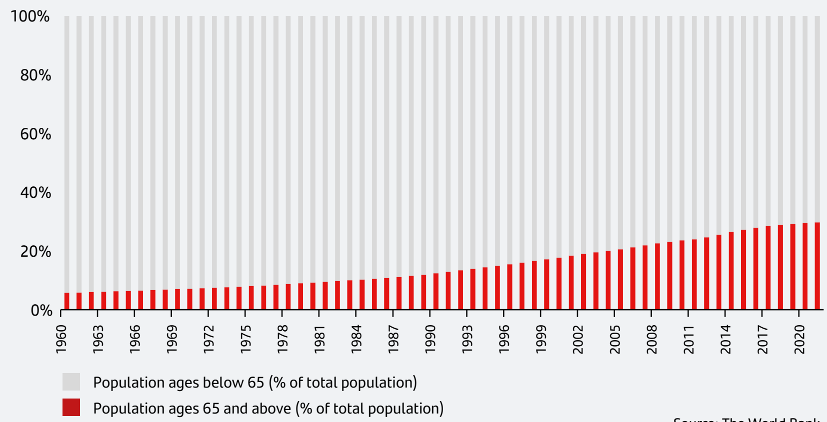
This is important because if there are less shares available to buy after the company buys shares back, but the same number of buyers usually triggers a rise in a share price. In addition, Japan's economic cycle appears de-synchronised from other countries where the US growth is slowing and Europe is flirting with recession again but Japan's economy is by some measures heating up. Up until recently global investors have been underweight Japan (when compared to their share of the global stock market), so the recent outperformance this year appears to be inviting inflows of foreign investors tapping into this new momentum. Japan also represents an opportunity for some investors to get exposure indirectly to China by way of Japanese companies active there but without the political risks Chinese companies carry.

Finally, after nearly three decades of deflation holding back economic growth, inflation has finally returned. Company profits are improving, and Japan's economy, the world's third largest, is basking in a post-pandemic glow where consumers are spending and foreign tourists have returned. Japan was among the last countries to lift restrictions, and while the number of tourists is still much lower than what it was before 2020, overseas visitors are streaming in.[7] Even the famous value investor from Berkshire Hathaway, Warren Buffett, has decided Japan represents an investment opportunity not lost on other investors. The rest of the world's economies are still hiking interest rates, the Bank of Japan is sticking to its ultra-loose policy to push growth. Not to forget the impact this has on the Japanese Yen, which has weakened against the US dollar, helping Japanese companies that heavily rely on exports probably leading to growth, in their earnings.

The barriers of age

Despite what appears to be an improving picture for Japan as described in the previous paragraph, it is important to understand a more rounded picture, including the ongoing challenges and headwinds that potentially lie ahead. Firstly, given the strong link between Japan's exports and the health of the world's economy, slowing global economic growth has the potential to hit both future exports and company earnings. In addition, given the Bank of Japan's policy of maintaining low interest rates and loose monetary policy in comparison to the rest of the world, the Yen has devalued against the dollar and other international currencies, reducing the potential investment returns.

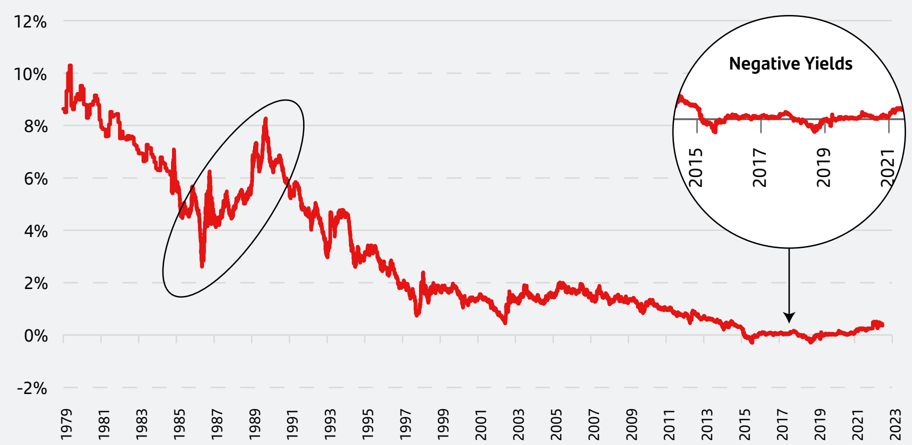
Japan Population Ages 65 and Above (% of Total Population)



Source: The World Bank
Data: Japan Population ages 65 and above (% of total population) (as of the end of 2021)
Data as at June 2023

One of the biggest challenges for Japan is the ageing population, which is shown in the chart on the previous page. Japan has the largest portion of people over the age of 65 and this is growing rapidly. Why is this an important factor for the future? As individuals age, they change the way in which they spend their time and importantly their money. When people are younger, they work, spend and pay taxes, contributing fully to the wider economy. When we retire, we typically earn less, pay less taxes and more importantly, the older we get, the less money we spend changing and reducing our consumption. Those just retired, aged 60-70 will likely travel and buy themselves things off their bucket list. As we get older in our 80s and 90s (assuming we live that long), we are less likely to travel and less likely to want new things, whether this be clothes, gadgets or eat out. This older portion of the population does, however, need more health and social care as we get older, draining resources from the taxes collected from those who are still working. When the working population gets smaller and the retired population continues to grow, this represents significant headwinds for any country, not just Japan. While Japan is probably at the forefront of both robotics and artificial intelligence (AI) in making processes and manufacturing more efficient, the demographic hurdles are very difficult to overcome regardless of your economic policies.

Japan 10Y government bond yields



Source: Eikon
Data: Japan 10Y Government Bond Yields (as of 26/06/2023); In local currency
Data as at June 2023

One aspect of the economic policies pursued by Japan in the last 30 years has been keeping interest rates very low and controlling the yield on government bonds (otherwise called controlling the yield curve). As you can see on the chart, the initial large spike in yields burst the asset price bubble in late 1989. More recently, low interest rates affecting bond yields where from 2015 until very recently, was negative, meaning banks and investors were paying the central bank to hold their money.

A recent change of Governor at the Bank of Japan to Kazuo Ueda signals a change in policy as he starts to remove the strict controls on government bond yields, encouraging companies to award large pay rises to spark higher consumption and in doing so, normalisation of inflation should be the result. Wages in Japan have remained stagnant for most of the past 30 years despite an ever-tightening labour market through the demographic challenges I have just described. The government continues to lobby businesses to raise wages in the wake of rising inflation triggered by the war in Ukraine and the global energy crisis. Finally, after such a long-time, big companies have offered the biggest salary increases seen in thirty years this spring.[8]

Investors are keeping a close eye on developments as the new governor tries to bring about sweeping changes in the hope he is able to wake the economic powerhouse out of its long running doldrums. Clearly, while Japan does indeed provide investment opportunities, there are pros and cons for investing in Japan. As always, typically, the best approach for most people is to diversify their portfolio across different asset classes and different regions to smooth the investment journey, align to their risk comfort, financial goals and time horizons.

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Note: Data as at 29 June 2023.

[1] BBC, 14 February 2011
[2] SCMP.com, 1 July 2020
[3] International Monetary Fund, 1 January 2000
[4] The World Bank, 31 December 2021
[5] Eikon, 28 June 2023
[6] Finshots.in, 2 June 2023
[7] New York Times, 13 February 2023
[8] Financial Times, 25 May 2023

Asset Management

A Week in the Markets

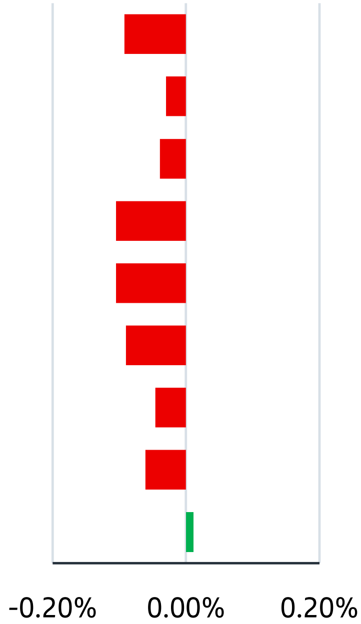
Performance

Index	Value	Change	%	12 Month High	12 Month Low
FTSE 100	7,462	-180.85	-2.37%	8,014	6,826
FTSE 250	18,062	-968.56	-5.09%	20,615	16,611
Dow Jones Industry	33,727	-571.69	-1.67%	34,590	28,726
S&P 500	4,348	-61.26	-1.39%	4,426	3,577
NASDAQ	14,891	-192.44	-1.28%	15,185	10,679
Hang Seng	18,890	-1,150.40	-5.74%	22,689	14,687
Nikkei 225	32,782	-924.54	-2.74%	33,706	25,717
CAC 40	7,163	-225.23	-3.05%	7,577	5,677
DAX	15,830	-527.69	-3.23%	16,358	11,976
FTSE Eurofirst 300 Eurozone	2,379	-63.06	-2.58%	2,547	1,950
S&P TSX Composite Index	19,418	-557.14	-2.79%	20,767	18,206
Commodity markets*					
Gold	$1,924.05	-35.30	-1.80%	$2,047.01	$1,628.00
Crude Oil	$74.10	-2.24	-2.93%	$122.27	$70.96

Source: Eikon, prices displayed in the local currency.
*Gold Bullion London Bullion Market $ Per Metric Tonne Ounce Delay & Brent Forties and Oseberg Dated Free on Board Northsea Crude used for commodity performance.
Source Data from the 19 June 2023 to 23 June 2023.

10-year bond yields

Country		Variation	12 Month High	12-Month Low
UK	4.32%		4.50%	1.81%
US	3.74%		4.23%	2.61%
Japan	0.37%		0.51%	0.17%
Euro	2.36%		2.75%	0.76%
Germany	2.36%		2.75%	0.76%
France	2.88%		3.24%	1.35%
Italy	3.99%		4.82%	2.95%
Spain	3.32%		3.79%	1.86%
China	2.71%		2.99%	2.62%



Currencies

Currency	Conversion	Price	Change	12 Month High	12 Month Low
Dollar	GBP > USD	$1.27	-0.01%	$1.28	$1.07
Euro	GBP > EUR	€ 1.17	-0.01%	€ 1.20	€ 1.11
Yen	GBP > YEN	¥182.67	0.82%	¥182.67	¥154.73

Source: Eikon.
Source Data from the 19 June 2023 to 23 June 2023.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

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