The Dawn of Japan: Historical Turning Point for the World

March 2024

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On February 22, 2024, Japan's Nikkei average closed at 39,098 yen, surpassing the 38,915 yen reached at the end of 1989 and setting a new all-time high for the first time in 34 years. This symbolic achievement should not come as a surprise if you are aware of how much the fundamentals of Japan's economy and its companies have improved over that same period.

It is common sense for stock prices to eventually reflect the reality that we have observed in Japan over the past 30 years.

But more importantly, I believe that this is just the start of a new long-term bullish trend for Japan and its stock market.

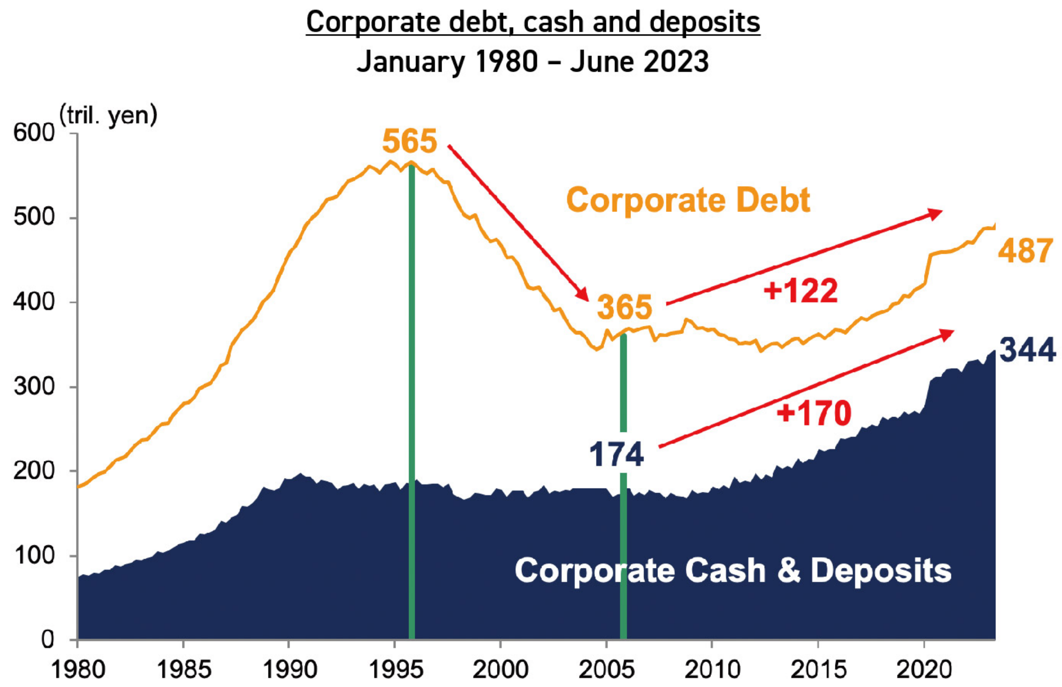
Japan's Deflation Has Been Finally Eradicated

After the bubble burst in 1989, Japanese companies prioritized debt repayments and were unable to make new investments. Even if this re-capitalization strategy was the right one at the company-level, in aggregate, the overall reduction of spending and investment had a devasting effect on Japan's economy. The so-called fallacy of composition triggered and sustained the nation's decades-long deflationary spiral.

Today, corporate debt has been repaid and there is no excess debt left in the system. The roots of deflation that had caused Japan's economy to stagnant for 30 years have been eradicated. In fact, companies are accumulating cash (Exhibit 1).

The key question facing Japan's companies is how to allocate the record-level of cash to increase their profitability.

Exhibit 1: Cash accumulating after paying down debt



Note: Data is based on all industries in Japan except finance and insurance.
Sources: BOJ, SPARX

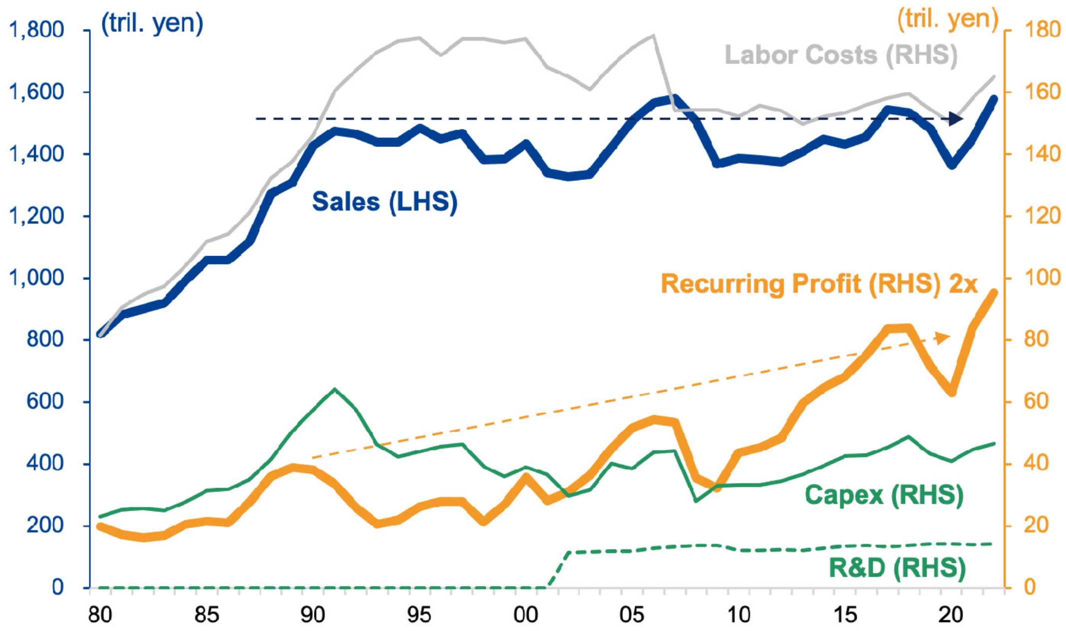
Japan's New Era: Inflation Tailwind To Boost Sales And Profit Growth

Suffering from real deflation where prices declined over 30 years, Japanese companies performed quite well with limited and in most cases shrinking resources. They were able to still generate profits while sales remained flat – in fact, aggregate recurring profits doubled (Exhibit 2).

Exhibit 2: Root cause of deflation; Sales were not growing

Changes in sales, recurring profit and cost

1980 – 2022FY



Note: Data is based on all industries in Japan except finance and insurance.
R&D data is based on 13,868 companies.
Sources：MIC, MOF, SPARX

At the same time, Japanese companies became very conservative and unwilling to invest for the future in this severe deflationary environment. As a result, wages, capex, and R&D spending did not grow at all and Japan's economy greatly suffered (Exhibit 2).

Today, particularly in Japan, changes in the post-COVID environment, where there is a shift from severe deflation to normal inflation among other trends, are providing tailwinds. Finally, Japanese companies can enjoy an environment of growing sales and higher profits.

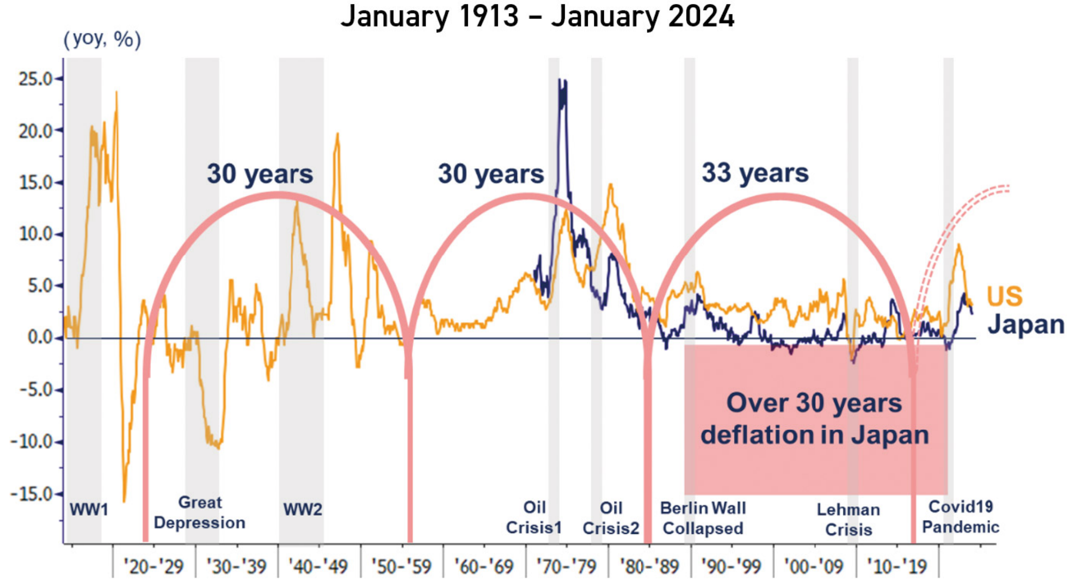
Although the United States is experiencing disinflation, it has not experienced true deflation like Japan, with its prices moderately increasing 3-4% a year over the past 30 years.

In contrast, Japan suffered from true deflation and prices were in negative territory, excluding consumption tax hikes (Exhibit 3).

Exhibit 3: Inflation is the most favorable for Japan

Inflation in US and Japan

January 1913 – January 2024



Note: Shadow lines show as following events; WW1 (1914-1918), Great Depression (1929-1932), WW2 (1939-1945),
Oil Crisis1 (1973), Oil Crisis2 (1978), Berlin Wall Collapsed (1989), Lehman Crisis (2008), Covid19 Pandemic (2020).
Both CPI are all goods and services base.
Sources：FactSet, SPARX

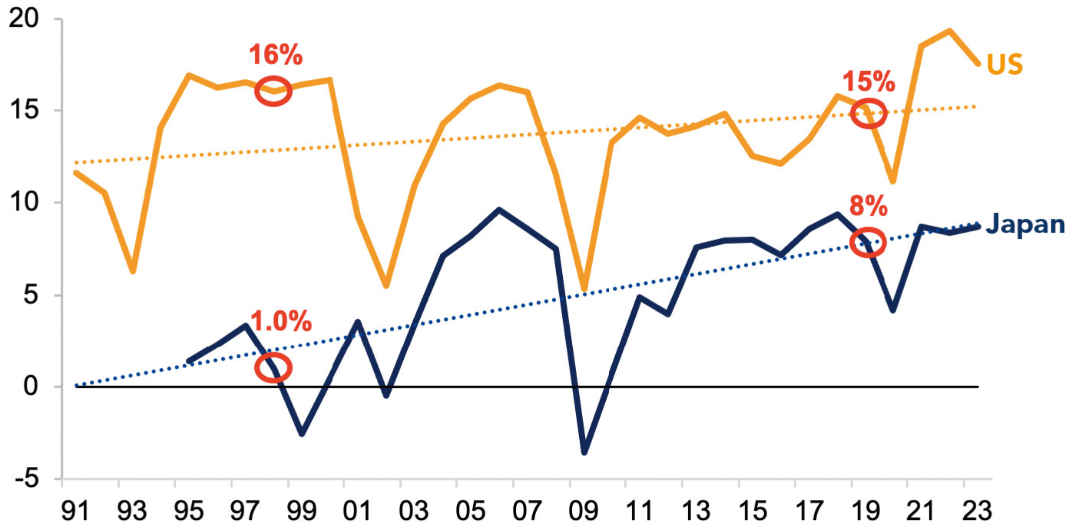
Along with this shift, we are observing a change in management's mindset to focus on growth and profitability. A key indicator, return on equity or ROE, has been steadily increasing over the past 10 years (Exhibit 4).

The implementation of corporate governance reforms by the government and the market are also reinforcing management's focus on increasing shareholders' value. Most recently, as an example, we have observed an uptick in "take private" transactions and spin-offs of majority-owned, listed subsidiaries.

Over the past 30 years, market analysts argued that it was our culture that caused Japanese companies to act cautiously and less growth oriented. I have always stated that it was not our culture, but it was the deflationary environment. Today, I believe that the market is starting to recognize that we are entering an era like Japan's post-1970s oil crisis, post-war recovery (1950s), and Meiji Period (1870s) when entrepreneurialism and the economy flourished. Historically, in the face of a social crisis, Japan's recovery has been sparked by its entrepreneurs. This time would not be an exception and I believe a new entrepreneurial spirit and energy will re-emerge in Japanese society.

Exhibit 4: Japanese companies are urged to improve ROE

Average ROE
1990 – 2023CY*



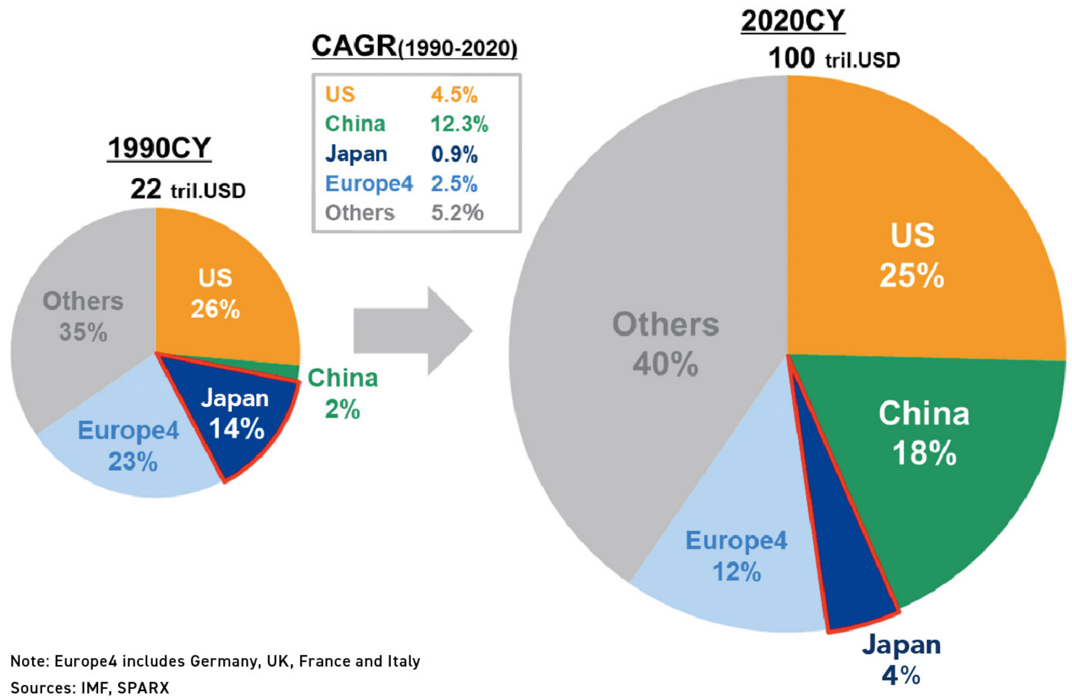
Note: Calculated using TOPIX for Japan and the S&P 500 for the US. Dot lines show the trend.
Data on Japan is plotted after 1995. Each data is as of the end of December of the calendar year. Japan's data for 2000 and 2010 are interpolated values.
Sources: FactSet, SPARX

Spotlight Is Once Again Shining On Japan

Over the past 30 years, Japan's average GDP annual growth rate has been +0.9%, an abnormally low rate rarely witnessed in history, and its global share as a percentage of the world's GDP has shrunk significantly from 14% to 4%. During this period, China grew at an annual rate of +12.3%, growing from a mere 2% global share to a superpower with an 18% global share（Exhibit 5）.

Exhibit 5: GDP Japan shrinks, China grows, US maintains lead

Comparison of GDP shares in the world
1990 vs 2020



Note: Europe4 includes Germany, UK, France and Italy
Sources: IMF, SPARX

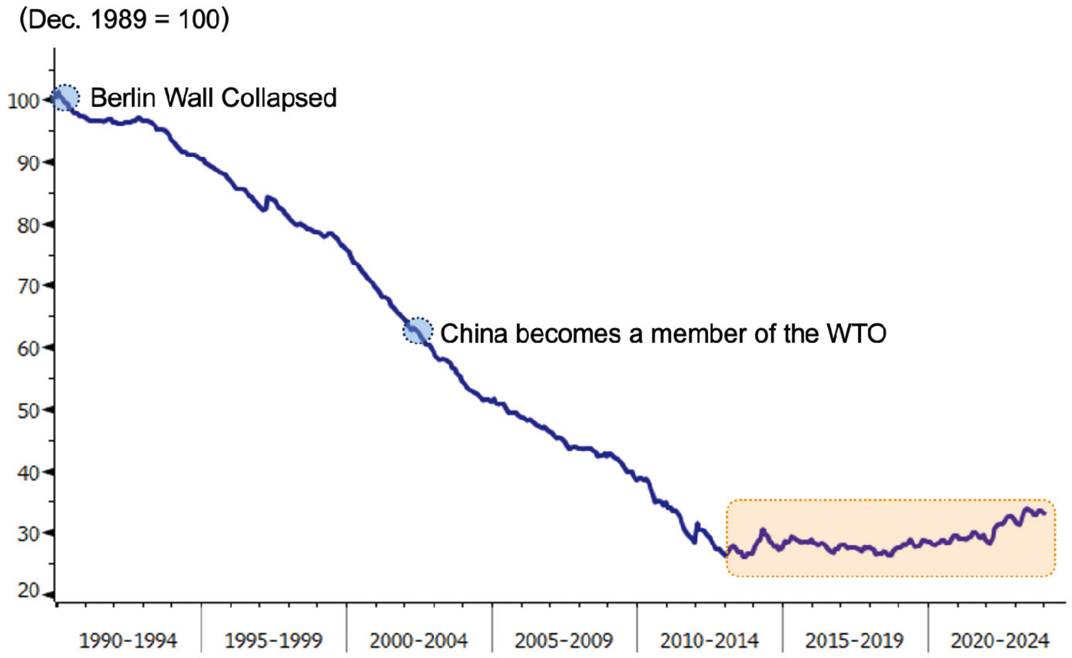
In other words, the growth and productivity that Japan had lost over the past 30 years was transferred to China, and China established itself as the world's factory. Today, China is slowing down, but even if we assume China's economic growth drops from 12% to 3-4%, the world's average, it will still account for 18% of the world's GDP.

From the outset, the roots of Japan's deflation began sprouting as the world's markets began to merge into one. China's 1970s economic reforms that opened its economy to the outside world was the first shoot to emerge, which was then followed by the fall of the Berlin Wall in 1989. Not only did this event trigger the unification of West and East Germany and the birth of the EU market, but also led to the creation of one global market, with the West connecting to the East.

While global demand increased, supply exploded with the world's labor market welcoming hundreds of millions of low-cost, lower-skilled laborers from the East. As a result, Japan surrendered its position as the world's factory and greatly suffered in the transition where it became an importer of structural deflation（Exhibit 6）.

Exhibit 6: Durable goods deflation ended

Household durable goods price
December 1989 – January 2024



Sources: MIC, SPARX

Today, I believe China will shift from being the "The Factory of the World" to a consumption-driven economy. China's deceleration should translate into higher growth opportunities for other nations as the world's consumption will not abate.

I believe that Japan is well-positioned to benefit from this shift in tide. Japan still has the skills and resources to provide high-quality, high-value-added products that not only China desires but the world too.

Global Capital Is Investing In Japan's Production Platform

On February 24, 2024, the TSMC Kumamoto semiconductor production plant, which is sponsored by Sony and Toyota, opened. TSMC's expansion into Japan has been a catalyst, with construction of other foundries beginning to spread from the south of Japan in Kyushu up to Hokkaido in the north.

The fruits from this chip revitalization are yet to be seen, but as a semiconductor analyst in the early 1980s, I experienced the rise and fall of Japan's semiconductor industry. I saw major Japanese companies like Toshiba move their production platforms to China in the late 1980s in pursuit of lower production costs.

It is a very important sign that overseas production platforms are now moving back to Japan.

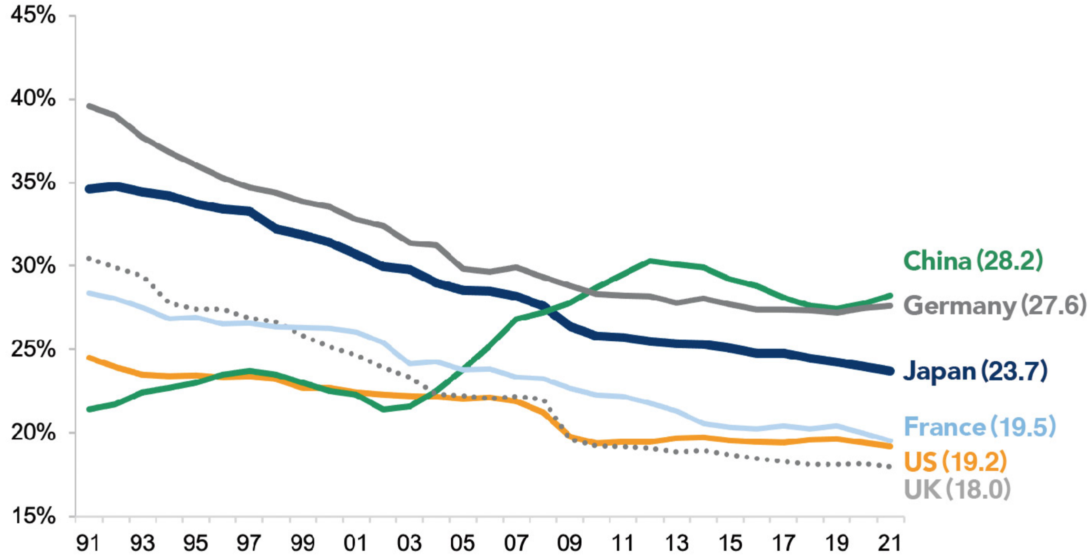
Of course, there are geopolitical and strategic factors driving these decisions to establish secure, local supply chains but I want to emphasize that Japan is also simply too cheap. The cost of its skilled labor is low, and all the advanced factory equipment and infrastructure remain cheap too.

Unlike Europe and the United States, which have mostly abandoned unprofitable or low-profit businesses (i.e. their manufacturing platforms), Japan's corporate leaders protected and nurtured their manufacturing capabilities over the past three decades (Exhibit 7).

TSMC and increasingly other multinationals have come to appreciate the strengths of Japan's manufacturing infrastructure and skilled, affordable labor pool.

Exhibit 7: Japan maintains manufacturing platform

Changes in the ratio of manufacturing industry workers*
1991 – 2021CY



Note: *Non-agriculture and service sector.
Sources: ILOSTAT, SPARX

Japan's newly expanded semiconductor industry is expected to become a major base that handles everything from mature products that control industrial products to cutting-edge products for generative AI.

Japan's semiconductor industry, which once held a 50% global market share in 1988, and whose market share has now declined to around 10%, would be at the center of the world once again.

The recent rise in stock prices probably reflects the fact that investors around the world have begun to factor in the construction of new semiconductor factories in Japan as a leading trend, which could eventually spread to other industries.

With more production coming onshore, I believe that a virtuous cycle is being created from the demand side in which wages are rising due to tighter labor conditions.

Higher wages are stimulating consumption and finally fueling signs of inflation for the first time in decades. Although this speed is still slow considering the size of Japan's economy, it is a positive trend that contrasts with past ones.

We don't think investors have fully realized that Japan's economy is finally becoming a "normal" one.

Long-Term Investment In Areas Of Future Massive Growth Never Stopped

In addition to the semiconductor industry, I believe that Japan's environmental-related technologies used in its manufacturing industries such as steel, energy, and transportation equipment will be prime beneficiaries.

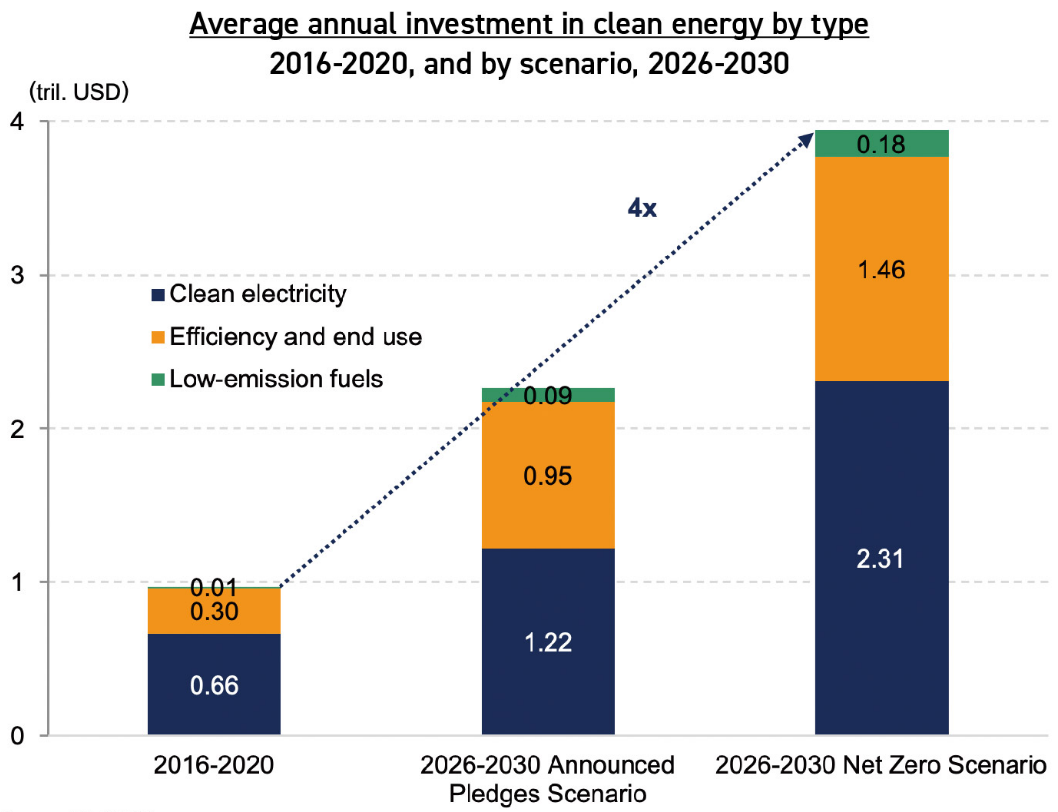
Since the oil crisis in 1973, Japan continued to develop world-leading energy efficiency and carbon reduction solutions. Meanwhile, in Western countries, manufacturing facilities and the workforce in environmental-related industries were drastically reduced under the call for focus and profit optimization as the oil price surge began to subside.

After thirty years of hardship, Japan's leading environmental technology companies – such as Mitsubishi Heavy Industries and Hitachi – who continued to allocate resources to nurture their talents and technologies despite being criticized for their low profitability are well-positioned to greatly benefit.

While the semiconductor industry is expected to grow by 75% to $1 trillion by 2030, investments in plants and power generating systems needed to achieve a carbon-neutral society are projected to reach $4 trillion annually by 2030 (Exhibit 8).

Unbeknownst to many, Japanese companies already have a dominant market share in this enormous market.

Exhibit 8: CN needs 4 tril. USD investment annually by 2030



Sources: IEA, SPARX

Japan Is Cheap, Especially Compared To The Rest Of The World

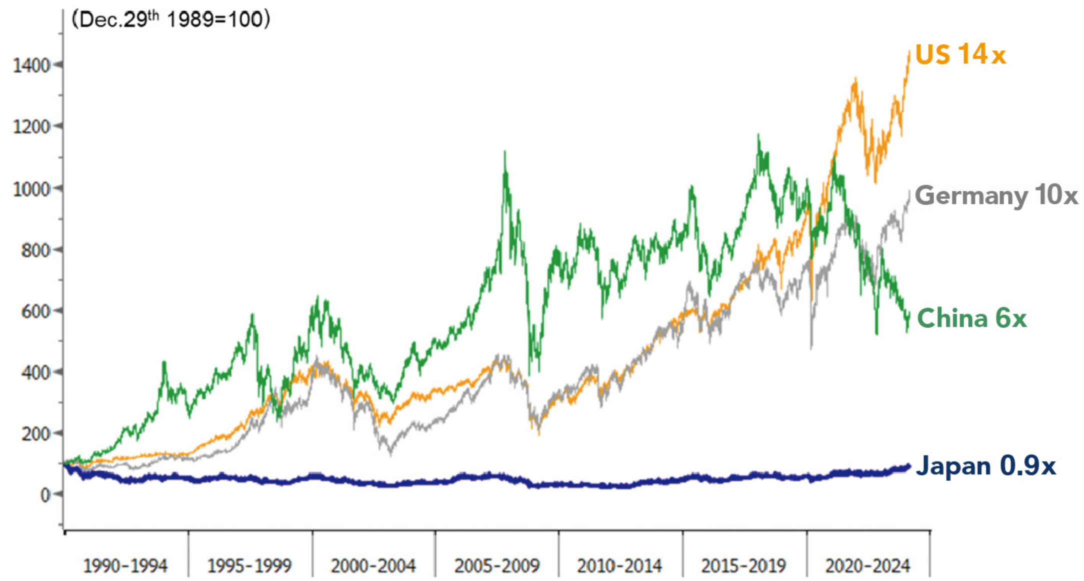
Once again, the Nikkei average reached its highest level since the end of 1989. However, it has only finally returned to the level of 34 years ago.

During the same period, global stock markets rose 14 times in the United States, 10 times in Germany, and 6 times in China (Exhibit 9).

In the early 1980s, after the "Death of Stocks" in the US, some of the smart investors on Wall Street started investing aggressively. At that time, about half of the stocks in the S&P 500 index were trading below their book value (or, at a PBR of less than 1x). With most afraid to invest into a value trap, those investors emboldened by the knowledge that these assets were undervalued acted and were rewarded. This is a truth that would not change over time.

Exhibit 9: Stock markets after Japan's bubble burst

<u>Changes in major stock indices</u>
January 1990 – February 2024



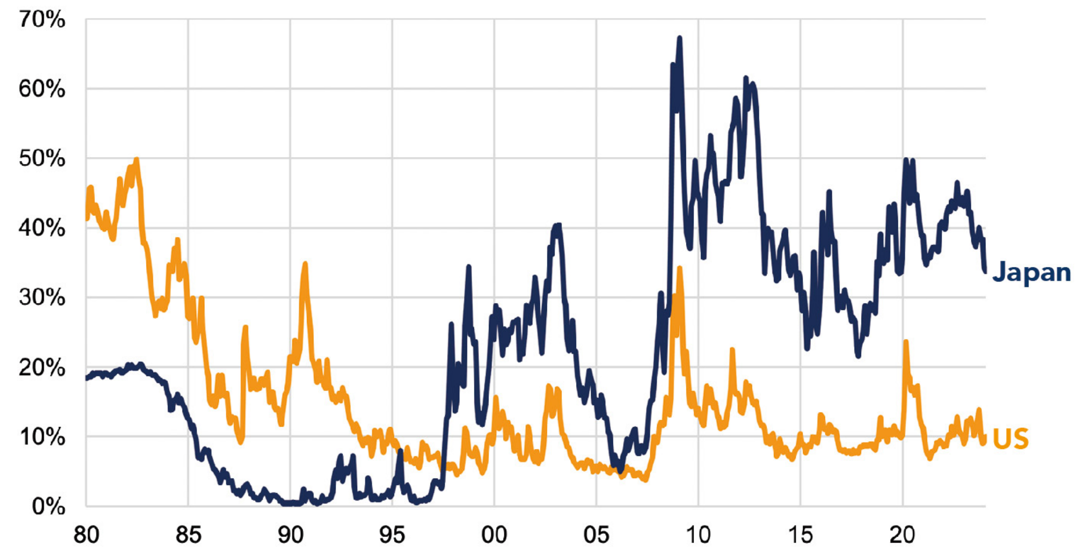
Note: Data is as of February 29, 2024. US: S&P500, Germany: DAX, China: HSI, Japan: TOPIX
Sources : FactSet, SPARX

When comparing the percentage of stocks trading at a PBR < 1x in Japan and the US since 1980 (Exhibit 10), we see a major divergence between Japan and the US. In fact, Japan is more like the 1980's US where more than 30% of its companies are trading below their book value.

Despite its recent trajectory, Japan remains the cheapest of the world's major markets. I strongly believe that Japan's recent momentum might just be the start of a new long-term trend of value creation. If you agree, I would be happy to provide more details and propose a range of solutions.

Exhibit 10: Low valuation correction will begin

<u>Percentage of Companies with PBR less than 1x</u>
January 1980 – February 2024



Note: Japan: TOPIX500, US: S&P500, Data is as of February 29, 2024
Sources : FactSet, SPARX

Important Notice

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