Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

By Patrick Fearon-Hernandez, CFA

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Is Japan's Sun Rising Again?

Ever since Japan's "bubble economy" imploded at the end of the 1980s and its population began to fall in the 2000s, investors have tended to dismiss the country's financial markets as well as its geopolitical and economic standing. Japan's pacifist constitution and its diplomatic deference to the United States constrained its international influence, while its slow economic growth, rising debt, and ultra-low inflation made its business environment seem sclerotic and stagnant. Likewise, through much of the past few decades, Japanese stocks and bonds have not offered investors much to get excited about. In U.S. dollar terms, the MSCI Japan stock index including gross dividends only returned 5.5% per year in the two decades prior to 2022, versus an average total return of 9.8% for U.S. stocks.

Japan had plenty of false dawns in recent decades, which raised hopes for a rejuvenated society and economy. In this report, we explore whether the country could finally see reinvigorated economic growth and investment returns, not so much because of economic reforms like it has tried so often in recent years, but because of its unique role in the evolving geopolitical environment. Diving deeply into Japan's geopolitical position, economic situation, and financial market valuations, we will explore whether the country might find the catalyst needed to boost its power and growth again. We also lay out the specific investment implications for a range of asset classes.

Geopolitical Position

With its big population packed onto a set of rocky, mountainous islands with few natural resources, Japan has always faced military and economic vulnerabilities. Since the end of World War II, it has nevertheless felt a sense of security because of its mutual defense treaty with the U.S. This enabled Japan to avoid big military budgets and focus on its economic development. Our thesis is that Japan's security situation has now changed dramatically because of China's phenomenal economic growth, expanding military power, and recent aggressiveness in diplomatic and territorial disputes. The following considerations are especially important for understanding Japan's geopolitical position:

Key Member of U.S. Bloc. As the world breaks up into rival geopolitical and economic blocs, our analysis indicates that Japan will be solidly in the evolving U.S.-led camp, based on its security treaty with the U.S., its economic linkages with the U.S., and its status as a highly advanced liberal democracy. Indeed, as the U.S.-led bloc slowly decouples from the China-led bloc, Japan's relative importance to the U.S. is only increasing. Japan's gross domestic product (GDP) in 2021 equaled 8.2% of the U.S. bloc's total GDP, but only 5.1% of global GDP. Japan's relative importance as a trading partner for the U.S. and its bloc has similarly increased. Of course, Japan's military and diplomatic importance has also risen because of its strategic location in the Western Pacific, close to Chinese shores.

Since Japan is the U.S.'s key ally in the Western Pacific, China will naturally see it as an adversary as the U.S.-China geopolitical competition worsens.

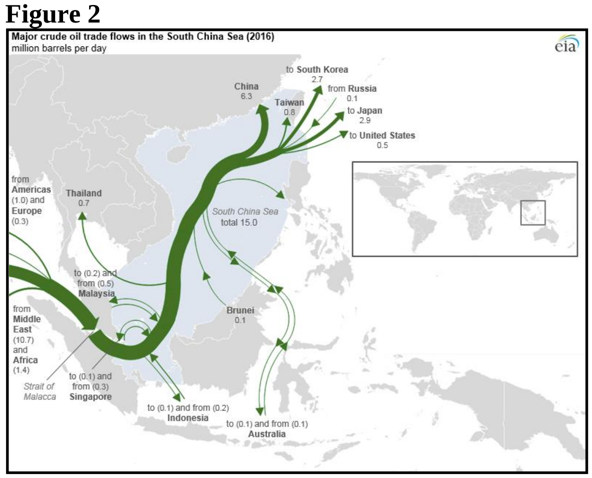
Host of Major U.S. Bases. Ever since World War II, the U.S. Army, Navy, Marines, and Air Force have maintained major bases across Japan, helping the U.S. to project power throughout the Western Pacific (see Figure 1). Japan currently hosts some 54,000 U.S. military personnel, along with a similar number of dependents and civilian Defense Department employees. Japan also hosts the U.S. Navy's Seventh Fleet. It is the home port of the aircraft carrier USS *Ronald Reagan*, its battle group, and more than 100 other Navy ships. Even more importantly, the majority of U.S. forces in Japan are stationed on the island of Okinawa, far south of the Japanese mainland. The U.S. forces there, including a Marine expeditionary force, a Marine air station, and a major Air Force base, are particularly close to China and Taiwan. In the event of a U.S.-China conflict, China would probably launch a preemptive strike against them and other U.S. bases in the region, which would almost certainly draw Japan into the conflict.

Dependent on Sea Lanes. Even if China were to take control of Taiwan without a kinetic conflict, Japan would be at risk. Given the centuries of antagonisms between the Chinese and Japanese, plus China's desire to weaken Japan, China would likely use its control of Taiwan to cut off Japan's key sea lanes, especially the oil tanker routes that pass between Taiwan and the Philippines. Those tanker routes typically account for more than 90% of Japan's oil imports (see Figure 2). Since Japan is resource-poor and dependent on imports from abroad, the country must prepare to stop such an eventuality from happening.

Figure 1

U.S. Military Bases in Japan
(Source: George Washington University)

Figure 2



Major crude oil flows in the South China Sea
(Source: EIA)

Territorial Disputes with China. Japan and China have also long been locked in a territorial dispute over a set of uninhabited islands in the East China Sea. The islands, known as the Senkaku Islands in Japan and the Diaoyu Islands in China, lie just northeast of Taiwan between Okinawa and mainland China. Both sides claim to own the islands and have staged provocative sailings around them or landings on them in the past. Because of China's increasingly aggressive behavior in its territorial disputes, especially in the South China Sea, officials in Tokyo are increasingly keen to shore up their ability to defend the islands.

Threats From North Korea. Finally, Japan is vulnerable to attacks from a belligerent North Korea. The North Korean government has long been at odds with Japan, and it has even fired missiles over Japan and into Japanese waters. As North Korea continues to improve its missile technology and expand its arsenal, Japanese officials have become increasingly focused on the need to boost the country's defensive capabilities.

Economic Situation

In addition to Japan's growing geopolitical concerns, the country's domestic economy also faces strong headwinds. Japan's top economic issues include the following:

Population Decline and Aging. Japan saw its birth rate fall below its "replacement" rate long before most other developed countries did, thus it has offered an early example of how an industrialized nation can face slowing population growth and population aging. Indeed, Japan's population has been falling for about 15 years. Former Prime Minister Shinzo Abe's policies encouraging more people – especially women – to start working did boost Japan's workforce over the last decade, but the rebound has hit a plateau, and the number of workers and potential workers looks set to begin declining again (see Figure 3). Moreover, the influx of new, less experienced workers has coincided with a decrease in Japan's productivity, defined as the average value of output per hour worked (see Figure 4). Since GDP growth is determined by the change in the number of workers plus their productivity growth, these trends suggest Japan's overall domestic economic output will be stunted or even fall in the coming years, with negative implications for corporate profitability, government tax revenues, and stock prices.

Figure 3

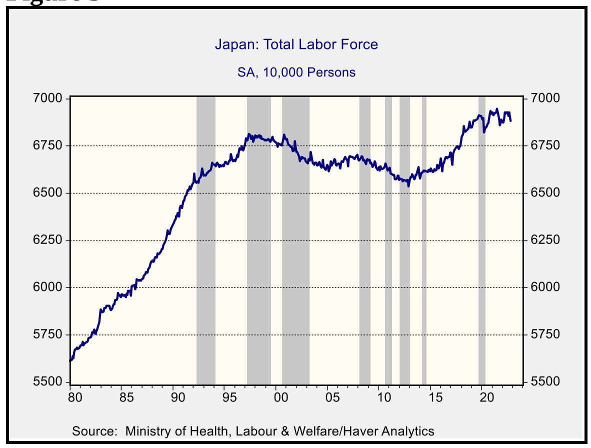
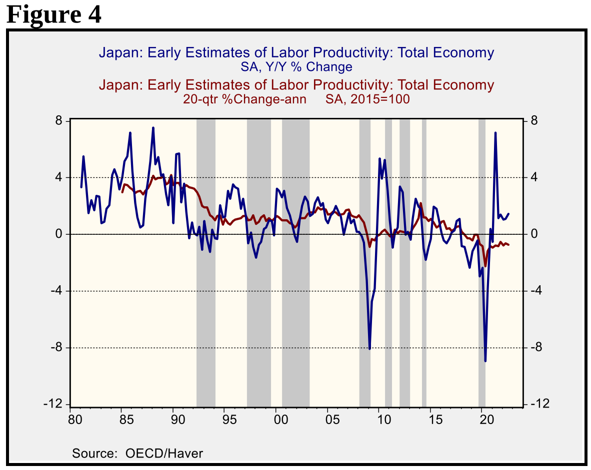


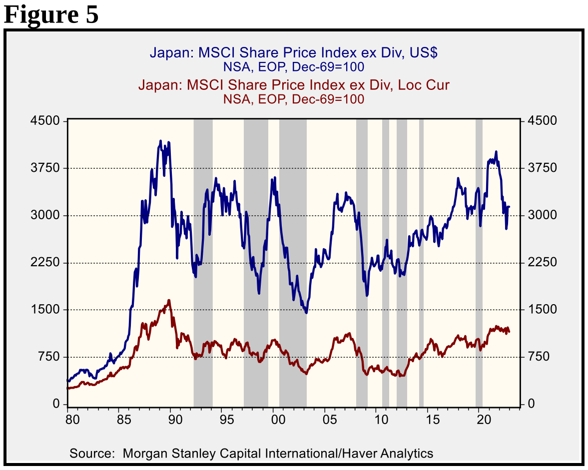
Figure 4



Enormous Debt Burden. Japan also faces continued economic scarring from the implosion of its bubble economy. As often happens when a country manages to produce fast growth through export-promotion policies, as Japan did for decades beginning in the 1960s, the inevitable end of that growth left Japan saddled with excess capacity and debt. The country dealt with those problems by simply muddling through and accepting slow economic growth, ultra-low inflation, and low interest rates for the past four decades. Stunted corporate profits, low tax revenues, and occasional government efforts to reignite growth through loose fiscal policies have left Japan with the developed world's biggest ratio of debt to GDP. As population aging boosts spending on social security, the debt burden continues to grow and [is now constraining how high the Bank of Japan can allow interest rates to rise].

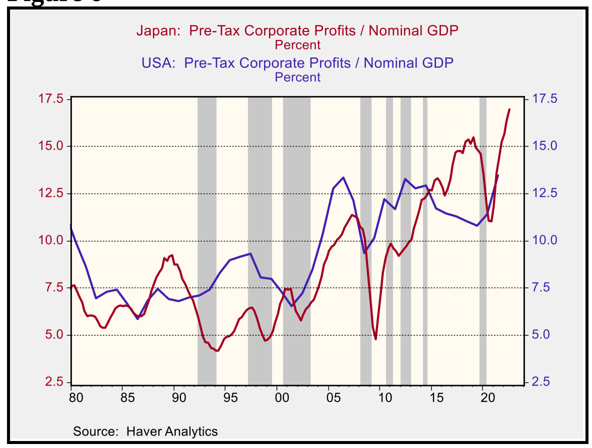
Financial Market Performance
Since a country's domestic economic dynamism affects its corporate profitability and investment prospects, an investor might be forgiven for thinking that the geopolitical and economic challenges described above would undermine corporate Japan. Domestically oriented firms certainly have faced challenges growing, but overall stock valuations have been low as well.

Figure 5



Low Stock Valuations. As shown in Figure 5, stock values in Japan still haven't returned to the levels last seen at the end of the bubble economy, whether they are measured in U.S. dollars or in yen. (Total returns, counting gross dividends, turned positive only in 2017 when measured in dollars and in 2020 when measured in yen.) Japanese stock prices have certainly been in a sustained uptrend over the last decade, mostly reflecting Abe's stimulative economic policies, but one shouldn't overstate the improvement. In the decade ending in 2022, U.S. stock prices as measured by the S&P 500 rose at an average annual rate of 10.4%, while Japanese stock prices rose at a rate of just 3.6%.

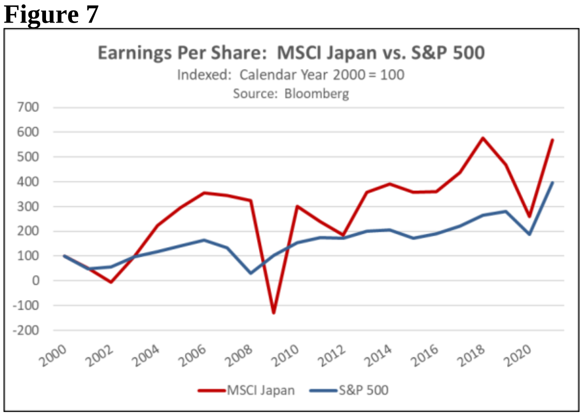
Figure 6



Rising Profits. Of course, a key question is whether Japan's stock market lethargy stems from weak profit growth. The answer is no. At the macroeconomic level, the share of Japanese GDP going to pre-tax corporate profits has risen just as strongly as in the U.S., from about 7.0% in 2000 to about 13% in 2021 (see Figure 6). Japanese GDP grew slowly during the period and inflation was quite low, so the volume of Japan's domestic corporate profits only rose at an average annual rate of 3.5%. All the same, Japan's larger, publicly traded companies were able to boost their profits more than twice that fast, probably because of their ability to shift operations to lower-cost locations abroad or otherwise build more efficient supply chains. Earnings per share on the MSCI Japan index rose at an annual rate of 8.6% from 2000 to 2021. In the same period, EPS on the S&P 500 rose at a rate of just 6.8% (see Figure 7 on next page).

Attractive Valuations. With Japanese stock values stagnant even as earnings have risen smartly, Japan has become well known for its low stock valuations. The average price/earnings ratio for the stocks in the MSCI Japan index currently stands at approximately 12.5, versus about 22.1 for the S&P 500. In broader terms, Japan's low valuations reflect how deeply investors have internalized the country's domestic demographic and economic headwinds. Not only have those factors convinced investors that Japanese EPS can't grow fast in the future, but a simple earnings discount model using recent P/E, EPS, and other parameters would suggest that investors as a group are expecting outright declines in Japanese EPS in the coming years.

Figure 7



Is There a Catalyst?
Here at Confluence, we preach that low valuation alone is never a sufficient signal that it's time to invest in an asset. Too often, the valuation is low for a reason, such as the country or company is facing poor prospects, has become too risky, etc. When valuation is low, we look for a catalyst that might spur investors to reassess the asset's prospects, upgrade their expectations, and thus boost their buying of the asset. At this point, we see no obvious or certain catalyst that would specifically change investors' currently low assessment of Japanese stock prospects. Even the modest economic improvements seen after Former Prime Minister Abe's reforms caused little lasting impact on Japanese valuations. On a more positive note, however, we do think the new, tougher geopolitical environment facing Japan could be a potential catalyst for stronger Japanese stock valuations in the future.

Importantly, Abe's multi-year effort to end Japanese pacificism and rebuild its defense capabilities have finally borne fruit under the administration of current Prime Minister Fumio Kishida. Since coming to power in late 2021, the former foreign minister has pushed several policies including higher military spending, expansion of the country's defense industrial base, further investments in Japan's own defense technologies, and a boost to Japan's defense cooperation with the U.S. and other allies. Not only has Kishida pushed through a planned doubling of Japan's military budget to as much as 2% of GDP, but he has also called for Japan to develop its own missiles that could preemptively strike Chinese bases in the event of war. Last month, the Japanese Ministry of Defense issued an ambitious plan to develop a range of cutting-edge defense technologies at home, including hypersonic cruise missiles, advanced drones, and improved anti-submarine helicopters.

As we noted at the beginning of this report, Japan is facing mounting geopolitical risks. The defense rejuvenation efforts undertaken by the Kishida administration, if continued and expanded to a level commensurate with the threat, could spur domestic economic growth through increased public spending and greater support for innovation. Of course, worsening geopolitical tensions and the fracturing of the world into relatively separate geopolitical blocs could weigh on some Japanese firms' profitability. For example, the U.S. has recently convinced Tokyo to restrict Japanese companies from selling some advanced semiconductor manufacturing equipment to China. All the same, the dramatic change in Japan's geopolitical environment may be its best hope for rejuvenating its economy and spurring stronger stock valuations.

Investment Implications

The lack of a clear and certain catalyst to specifically boost Japan's stock valuations doesn't mean that there are no opportunities in the Japanese stock market right now. We currently believe international stocks, in general, including Japanese stocks, are likely to outperform U.S. stocks in the coming years due to a probable extended retreat in the value of the U.S. dollar. Because of excessively loose monetary and fiscal policies and as some foreign countries try to reduce their holdings of dollar reserves, we expect the greenback to weaken against most major foreign currencies, including the JPY. Historically, broad dollar weakness has boosted foreign stocks, including Japanese equities.

Nevertheless, the lack of a clear catalyst for better valuations means it's difficult to make the case that Japanese stocks might outperform the international universe. Boosting exposure to the overall universe of non-U.S. stocks to take advantage of the weakening dollar makes sense but overweighting exposure to Japanese equities probably doesn't. At the same time, we continue to believe that geopolitical and economic fracturing will boost future global inflation and interest rates, pushing bonds into an extended bear market. In contrast, those same forces are likely to bolster commodity returns in the years ahead.

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