

## The outlook for Japanese equities remains positive as fundamentals strengthen

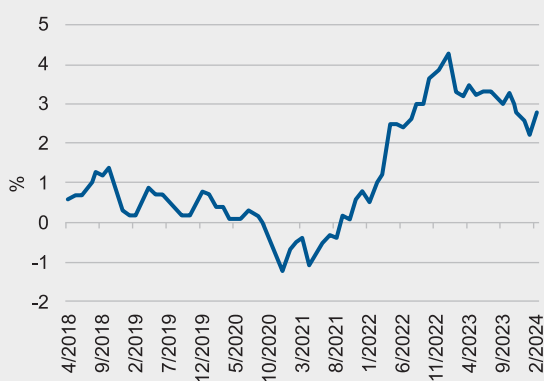
Japanese equities have come under the spotlight of global investors due to the post-pandemic economic recovery and Warren Buffett's investments in five Japanese trading companies. The Nikkei 225 gained 14.59% year-to-date but pulled back slightly in April as the Fed delayed rate cuts.<sup>1</sup>

The end of the negative interest rate policy (NIRP) and quantitative easing (QE) is a turning point in Japan's economy from long-term recession to recovery. Investors are positive towards Japanese equities and believe that there may be buy-on-dip opportunities, considering the structural changes in economy and corporate governance.

### Ending negative interest rates: a prelude to interest rate normalization

In March, the Bank of Japan (BoJ) announced the end of NIRP, yield curve control, and other unconventional policy tools, and raised the policy rate to 0-0.1% from -0.1%.<sup>2</sup> Investors maintain the expectation for the BoJ to hike rates again in June or July, which is sooner than consensus expectations, because economic and wage growth have been better than expected. In fact, Japan's core inflation has stayed above 2% since April 2022.<sup>3</sup> Investors also witnessed the biggest pay rise in three decades as the annual wage negotiation this year indicates an overall pay raise of 5.3% YoY, the highest increase since 1991.<sup>4</sup>

Japan's core inflation



Source: Bloomberg, as of April 8, 2024

That said, it's believed the BoJ is likely to maintain a cautious approach to tightening monetary policy, especially since household consumption remains fragile. For example, the BoJ's March JCB consumption was weaker than expected. Consumption is at the crux of the Japanese growth story in the coming year and is likely to motivate how quickly the BoJ normalizes monetary policy.

### BoJ shrinks balance sheet as growth stabilizes

It is well known that the Fed has said it has just one blunt policy tool – rates. This hasn't been the case for the BoJ because rates hit rock bottom in Japan in the mid-90s, when the BoJ was forced to think of other policy tools – and thus gave birth to QE.

In short, QE is a tool where central banks purchase a set amount of government bonds or other financial assets in order to add liquidity to the market and invigorate commercial activity.

The BoJ was the first to introduce QE in 2001, starting with foreign exchange, then Japanese government bonds (JGBs), and then equity ETFs. Both the Fed and Bank of England (BoE) performed QE during the global financial crisis, and the European Central Bank (ECB) reluctantly followed during the eurozone debt crisis in 2010. All these major central banks resumed QE during COVID.

Because the significant monetary and fiscal stimulus during the pandemic era caused inflation to take off, the Fed, BoE, and ECB began cutting balance sheets back down to size in 2022. Finally, the time for monetary policy change has come for Japan. After a long period of ultra-loose monetary policy, the BoJ announced the end of NIRP and QE in March. In fact, the central bank is shrinking its balance sheet as recent data shows that the BoJ reduced bond purchases by 36% in fiscal 2023 when compared to a year ago.<sup>5</sup>

In investors' view, the end of NIRP and QE is a meaningful sign of Japan's economic recovery from the long-term recession. The Japanese economy has been stuck in a vicious cycle of deflation for many years. The end of negative interest rates and QE is an endorsement by the BoJ to substantiate the economic recovery. This is a structural positive for the stock market, reflecting the sustainability of the current uptrend.

### Weak yen drives up stock market

The Japanese Yen (JPY) has been the worst performing major developed market currency this year, weakening by close to 8% against the greenback. It's expected JPY will stay weak due to the higher-for-longer interest rates. While the market expects a cut by the US Fed in June, the prospects of one have diminished given the most recent US labor and inflation data, both of which have been robust. Historically, a more resilient US growth environment generally portends a stronger US dollar and a weaker JPY. A weaker JPY boosts exports and helps the earnings of multinational companies and export-dependent enterprises, as local goods would be more competitive in the global market. This is a positive factor for the stock market.

# 市場觀望

## EYE ON THE MARKET

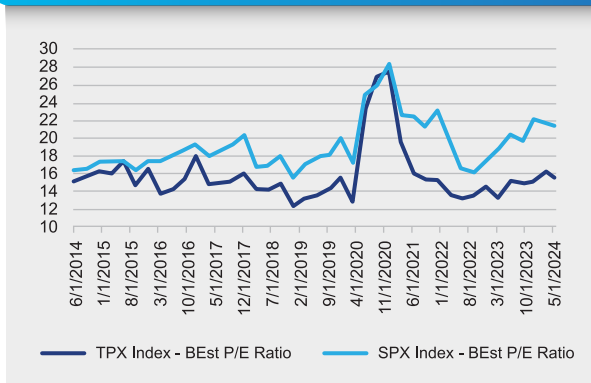
### USD/JPY spot rate



Source: Bloomberg, as of April 23, 2024. For illustrative purposes only. Past performance is not indicative of future performance.

### Reasonable valuation with strong momentum in corporate earnings

### Forward 12-month P/E ratio



Source: Bloomberg, as of May 9, 2024

Japan has been the top performing major equity market year-to-date. Current valuations look reasonable despite the strong rally in Japanese equities over the past few months. The consensus forward 12-month P/E ratio for TOPIX currently stands at 14x, right around historical averages and lower than other developed markets. By comparison, the same figure for the S&P 500 is currently at 20x, though US equities generally tend to trade at higher multiples.

Given the corporate governance developments and economic structural changes envisaged by investors, Japanese equity valuations could rise moderately over time. But even without a change in valuation, Japanese equities could rise further as analysts expect robust corporate earnings growth in 2024 and 2025 that could exceed market expectations.

EPS growth for the TOPIX has been robust and expected to be in double digit for the full year 2024. The recent rally can be attributed to corporate earnings outperformance, driven by both a stronger economy but also a fundamental shift of mindset by corporates towards maximizing shareholder profit. Listed Japanese corporates have been strongly encouraged by the Tokyo Stock Exchange to embrace more shareholder-friendly measures which in turn have led to raised dividends and share buybacks, all of which have helped boost share prices.

It's believed that Japanese equities could potentially go up further and that the recent rally still has legs. Japan's corporate governance and stewardship landscape is changing quickly. Balance sheet restructuring has revived dynamism in the corporate sector. Japanese equities' return on equity (ROE) levels are rising as a result and are up 2.5x since 2012 to near 10%.<sup>6</sup>

### Massive foreign inflows pushing up the Japanese market

Investor appetite for Japanese equity funds has been high and continues to rise. Foreign investors have shown strong interest in Japan, and data for Foreign Portfolio Investment (FPI) flows show that USD29 billion of inflows went into Japanese equities in full year 2023. YTD through 2024, inflows have already reached USD20 billion – indicating an acceleration.<sup>7</sup>

Passive flows have been directed into Japan because of its increasing allocation in benchmark indices. At the beginning of 2021, Japan's weight in the MSCI All Country Asia Pacific Index was 32%, and that has now risen to 35%. In long-only global equity allocation funds, Japan's allocations are also rising after decades of underweight, now close to a neutral position relative to benchmark. All in all, fund flows and asset allocations appear to be favoring Japan.

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Global equity funds' positions in Japan vs benchmark (below 0 = underweight)



Source: EPFR Global, Country Allocation Database, Morgan Stanley Research. Fund weights as of January 2024. Global long-only funds sample benchmarked to MSCI World, MSCI ACWI ex-USA and MSCI EAFE

### Risk factors to watch out for

Investors should pay attention to multiple factors when investing in Japan, in particular the impact of interest rates on JPY and the potential risk of a global recession.

Source:

1. Bloomberg, as of May 9, 2024
2. Bank of Japan, as of March 19, 2024
3. Bloomberg, as of April 3, 2024
4. Reuters, as of March 16, 2024
5. Nikkei Asia, as of April 2, 2024
6. Bloomberg, as of April 30, 2024. Past performance is not indicative of future performance.
7. Bloomberg, as of March 22, 2024

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## Opportunities in Emerging Markets

Emerging market equities posted a small positive return in April, outperforming developed market peers by some margin, as a rebound from China drove relative gains. In the developed world, a higher-than-expected US inflation print reinforced expectations that interest rates may remain “higher-for-longer.”<sup>1</sup>

Turkey was the top-performing index market in April amid strong foreign inflows into the equity market and president Erdogan’s post-election indication that economic policy will remain orthodox. China was the second-best performer, helped by a strong Q1 24 GDP result of 5.3% year-on-year and evidence that policy support is starting to bear fruit as manufacturing and infrastructure investment rose year-on-year in March. Hungary outperformed, followed by Peru, South Africa, and the Czech Republic. India, where voting for national elections began, continued to perform strongly.<sup>1</sup>

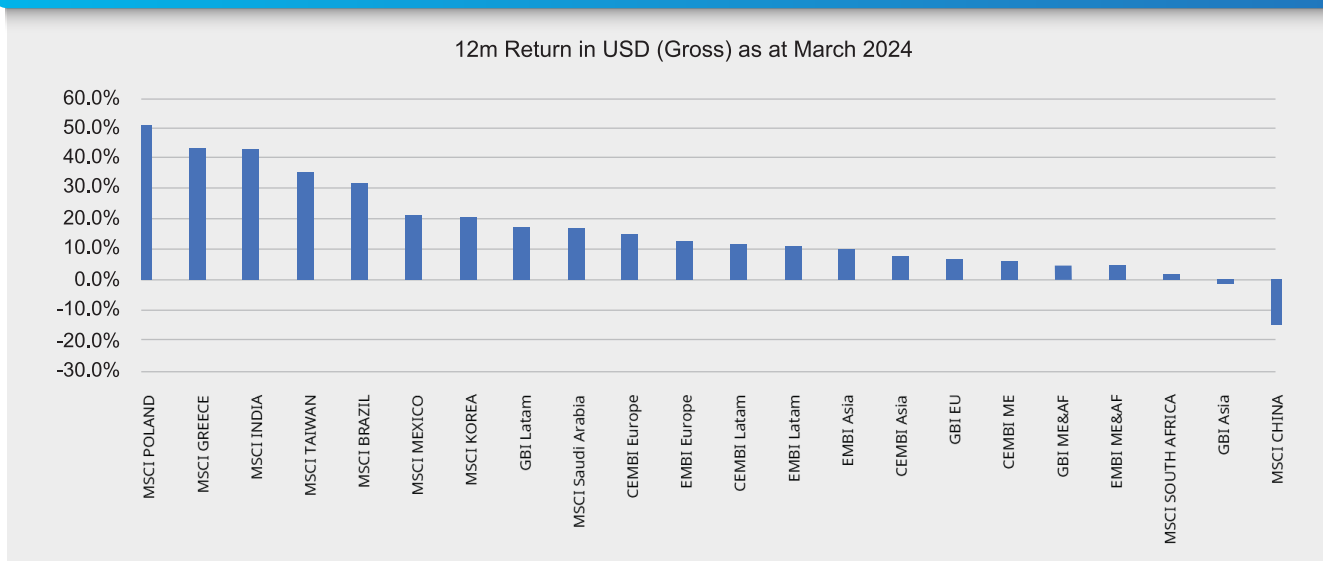
Chile posted a negative return, as did Thailand where economic indicators point to a slowing of activity. Taiwan lagged the broader index amid foreign selling of equities while the Middle Eastern markets, Saudi Arabia, Qatar, UAE, and Kuwait, posted losses on an escalation in regional geopolitical tension. The Latin American markets of Mexico, Brazil, and Colombia also delivered negative returns as all three currencies depreciated against the dollar. Brazil was negatively affected by the delay in expectations about the timing of US interest rate cuts, as was Korea where weakness in the tech sector weighed on returns. Egypt was once again the worst performing market.<sup>1</sup>

### Emerging markets benefiting from 3D Reset<sup>2</sup>

The 3D Reset of deglobalization, decarbonization, and demographics is expected to have significant long-term implications for the global economy, and emerging markets (EM) in particular. The reorganization of global value chains, including reshoring, near-shoring, and friend-shoring, is providing a significant boost to EM economies across regions.

The process of decarbonisation is leading initially to an increase in commodity prices, which in turn benefits traditional commodity-exporting EM countries. The declining working-age population in the world’s largest economies has prompted increased investment in technology, specifically in areas such as automation, robotics, and artificial intelligence (AI). This strategic focus on technology will also benefit key EM economies.

Fig 1. Diversification across regions and asset classes provides a wealth of opportunities



Source: Bloomberg, Schroders, 31 March 2024. MSCI denotes equity markets, GBI local currency bond markets, EMBI hard currency bond markets, CEMBI corporate bond markets.

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**Fig 2. Mexico overtakes China as the largest US trading partner**

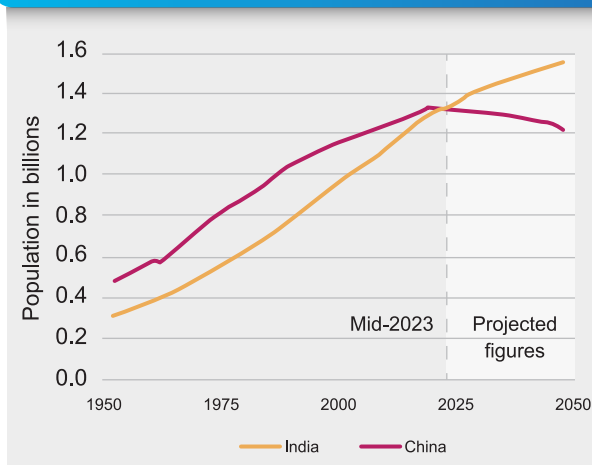


Source: LSEG DataStream, Schroders, 31 January 2024

**Fig 3. Brazil returns as exporting powerhouse**



**Fig 4. India overtakes China as the most populated country**



Source: UN World Population Prospects, Datastream, Schroders, 31 December 2023

**Fig 5. India government capital expenditure continues to boost growth**

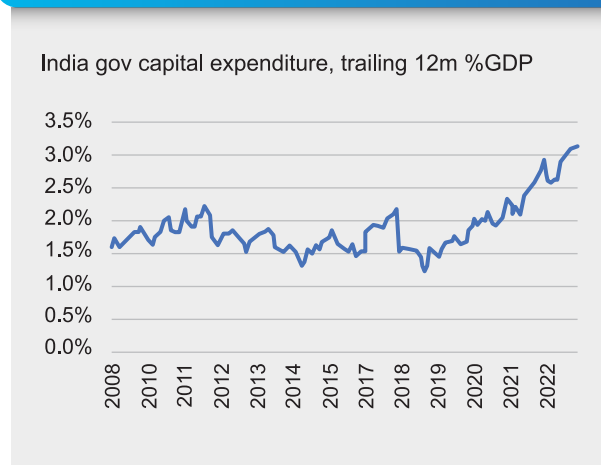
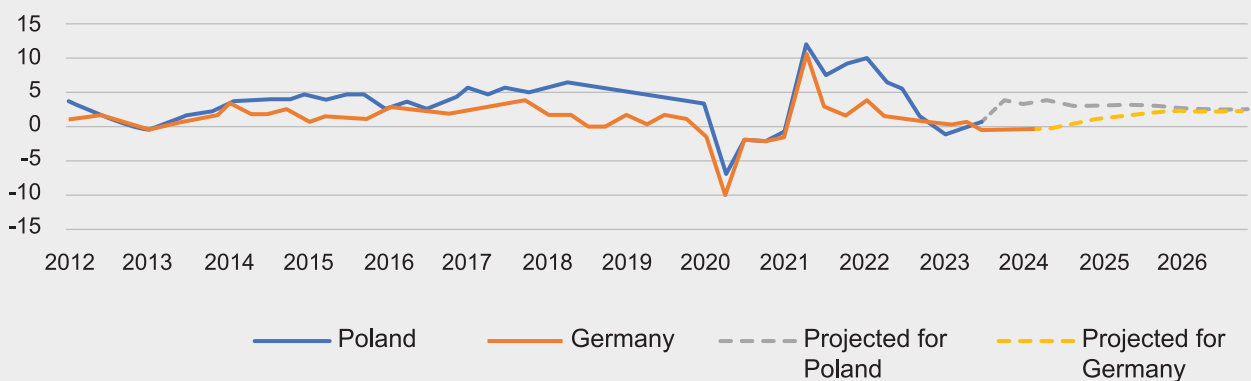


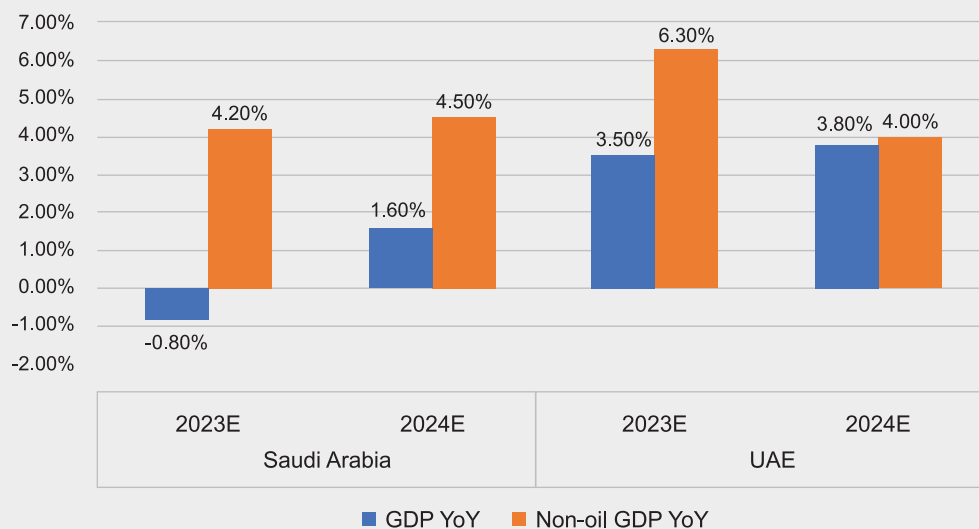
Fig 6. EM Europe recovery on track

Annual real GDP growth (%)

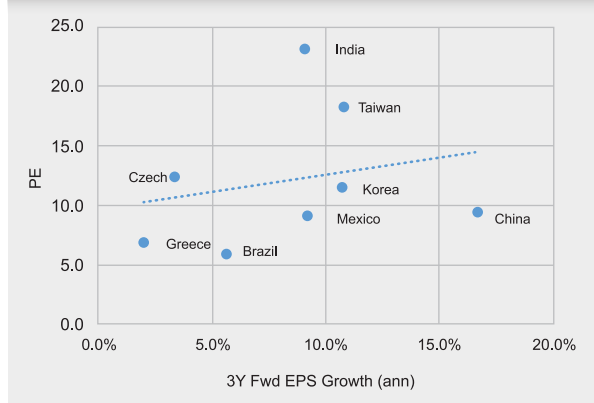


Source: Bloomberg, Schroders, 31 December 2023

Fig 7. Middle East Non-oil GDP growth resilient



**Fig 8. China moving to structurally low growth regime, but equities appear too cheap compared to projected earnings growth**



Source: Bloomberg, Schroders, 31 March 2023

## Emerging Market Stars<sup>3</sup>

Emerging markets enjoyed a turbo-charged period of growth during the 2000s, led by China. It was a decade of globalization, urbanization, the commodity “super cycle,” and a rising middle class. Manufacturing, commodities, and consumption all benefited strongly.

However, the following decade has been a disappointment. Persistent US dollar appreciation has dragged on EM financial conditions and nominal growth. Globalization levelled off as the loss of manufacturing jobs in developed markets added to populist pressure. Chinese property, infrastructure, and debt became increasingly developed and more recently geopolitical tensions have intensified, with both economic and market implications.

So where now for EM? How are the 3Ds of decarbonization, deglobalization, and demographics causing risks and opportunities? Let’s start with China, which currently accounts for 30% of the MSCI Emerging Market benchmark.

## China: Don’t write it off<sup>3</sup>

China faces slower growth in the coming decade. Its economy needs to transition away from an investment-led growth model. Investment share of GDP is high: infrastructure is considerably built out, while a years-long real estate boom has led to oversupply in many parts of the country. Debt levels are high and demographic trends are an increasing drag, with China facing a shrinking working age population, a marked fall in its birth rate and a rapid increase in its dependency ratio as the population ages.

What’s more, China is facing the “middle-income trap.” As wage costs have risen, China needs to continue to move up the value chain. Geopolitical tension with the US is adding to the economic headwinds. This contributes to supply chain diversification, and impedes access to advanced technology and knowledge transfer.

However, China is a US\$18 trillion economy with a very large domestic market and the scale to support its own industrial policy. If any country can move through the middle-income trap, China can.

China is highly integrated into the global economy and remains highly competitive, so supply chain diversification will take years to play out. The country is innovative and is a major potential beneficiary of decarbonization: it manufactures 80% of the world’s solar panels, sold two-thirds of the world’s electric vehicles in 2022, controls 75% of the world’s battery cell production capacity, and dominates large parts of the renewables supply chain. It has a high savings rate, so is not reliant on external capital for growth. Together with its control of the financial system, this gives China significant policy flexibility. Finally, in such a broad and deep market, there will always be opportunities at the company level.

## India: Demographics among the drivers of India’s inexorable rise<sup>3</sup>

India is the counterpart to China. Having been outstripped by China over the past 40 years, maybe it is now India’s turn in the sun.

Urbanization in India is low and represents a significant medium-term productivity opportunity. Returns from infrastructure investment are high. Demographics are supportive, and labor is abundant and cheap. Government policies to improve fiscal efficiency, increase infrastructure investment, reduce friction for trade between Indian states, and to drive import substitution have improved the prospects for growth. Meanwhile, digitalization and smartphone penetration creates the opportunity to improve economic formalization and improve financial intermediation and education.

However, caveats are required: issues of infrastructure, bureaucracy, protectionism, labor skills, and the labor code persist and despite its scale India is not necessarily the first choice for export manufacturing FDI. But India’s prospects for the next decade look promising.

## South Korea & Taiwan: Decarbonization and deglobalization beneficiaries<sup>3</sup>

South Korea and Taiwan are markets exposed to trade and in particular technology. Investors have a positive structural view on technology as the world becomes increasingly digitized. Some 70% of the benchmark in Taiwan is technology, while in South Korea it accounts for 50%, as at October 2023. Meanwhile, South Korea also has strong battery companies with excellent long-term growth prospects from decarbonization.



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Other countries in EM are beneficiaries of supply chain diversification. A mix of infrastructure, skilled labor, and geographic proximity supports the prospects for Mexico, Central Europe, and ASEAN. Manufacturing in developed markets can be very expensive both to build and operate, for example reshoring chip and battery production to the US requires enormous fiscal support. Hence deglobalization is likely to be more about near-shoring and friend-shoring than it is about reshoring. It is also more about de-risking supply chains.

The impact of commodities in EM has diminished markedly. But the investment requirements of the energy transition will strongly support certain commodities to the benefit of some markets, primarily in Latin America.

Finally, even though the Middle East will face challenges from the energy transition due its economic dependence on oil production, interesting opportunities now derive from a strong government focus on economic diversification, with significant fiscal support and reform in Saudi Arabia and the UAE.

Source:

<sup>1</sup> Schroders: Monthly markets review - April 2024 (as of 2024-5-7)

<sup>2</sup> Schroders: Schroder ISF Emerging Markets Multi Asset - New stars rising in Emerging Markets (as of 2024-3)

<sup>3</sup> Schroders: Outlook 2024: Equities in the age of the 3D Reset (as of 2023-12-4)

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