INVESTMENT BRIEF

Q1 2024

Strategic Investment Group®

Japan's Long Recovery

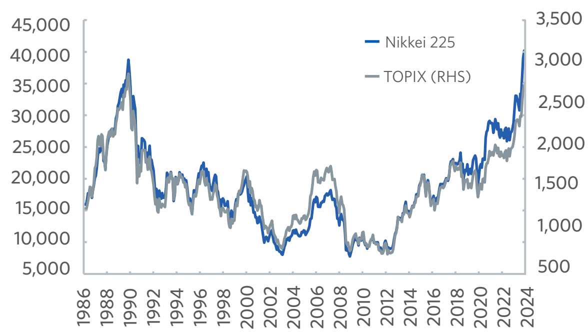
The Japanese economy and financial markets experienced three major milestones in the first quarter. After more than three decades, the Japanese equity market finally recouped the peak level it attained in 1989, when a massive equity and real estate bubble burst. Second, the Bank of Japan (BoJ) signaled victory in its decades-long fight against deflation with an increase in its policy rate and other steps to tighten liquidity conditions. Finally, the yen reached a 34-year low against the U.S. dollar, notwithstanding the BoJ's policy shift. In this Special Topic, we discuss these milestones and assess the prospects for Japanese equities.

Japanese Equities Reattain Bubble Peaks

Japan's equity and real estate bubble reached epic proportions in the 1980s. When it finally burst, the bubble left a legacy of stock and property market losses, and deeply entrenched deflationary pressures. Between 1980 and 1989 when the equity and property market bubbles burst, Japanese equities rose by a factor of 5.7 times and property prices reached outlandish levels. At the bubble's peak, the 1.3 square miles occupied by the Imperial Palace was valued to be worth more than all of the real estate in California. When the bubble finally burst, there followed a prolonged period of economic stagnation and deflation, made worse by a series of monetary policy missteps. In a milestone that symbolizes Japan's long-overdue emergence from the bubble's shadow, Japan's equity market at long last reattained in February the peak prevailing in 1989 just prior to the bubble's bursting (Exhibit 1).

EXHIBIT 1: JAPANESE EQUITIES FINALLY RECOUP BUBBLE LOSSES

Source: Bloomberg. Nikkei 225 and TOPIX Indexes.



Japan Exits Post-Bubble Liquidity Trap

For many years following the bursting of the bubble, Japan's economy stagnated, and deflationary pressures persisted despite low policy interest rates, a massive increase in the BoJ's balance sheet, and large fiscal deficits. The Japanese economy faced a liquidity trap in which monetary policy was largely ineffective. In a further sign that the lingering deflationary aftershock of Japan's equity and property market bubble was finally dissipating, the BoJ announced in its March meeting that it would raise its policy rate to 0.1% from -0.1%, abandon its control of the yield curve, and curtail its asset purchases. This shift ended nine years of negative policy rates, lifted the target ceiling of 1% on 10-year Japanese Government Bonds (JGBs), and suspended purchases of equity and real estate ETFs, while continuing purchases of JGBs.

Yen Depreciates to Three Decade Lows

Over the past two years, the BoJ has been an outlier among central banks – maintaining low policy rates and extraordinary measures of monetary ease, even as the Fed and other major central banks aggressively raised their policy rates. Since March 2022, when the Fed started raising rates, the yen has fallen by about 24% versus the U.S. dollar. It reached a 34-year low versus the U.S. dollar in March (Exhibit 2). Expectations that the gap between the BoJ's policy rate and those of other major central banks will remain wide despite the BoJ's shift in policy is contributing to the weakness of the yen.

EXHIBIT 2: JAPANESE YEN DEPRECIATES TO 34-YEAR LOW VERSUS DOLLAR

Source: Bloomberg. Yen per USD. Higer number = yen depreciation.

Japanese Equity Market Tailwinds

Japanese equities have enjoyed strong returns, gaining 10.5% in the first quarter and 26.8% in the year through March in U.S. dollar terms, notwithstanding the depreciation of the yen. Despite these gains, Japanese equities remain favorably valued. About half of Japanese equities trade at less than book value. Moreover, the market is likely to continue to benefit from favorable tail winds. Corporate governance reforms initiated in 2015 hold the promise of unlocking the significant value of Japanese equities that remains to be fully reflected in their share price. These reforms and more demanding reporting requirements have triggered a cultural shift in corporate management attitudes, resulting in renewed emphasis on increasing shareholder value. Moreover, with the yen at 34-year lows and the BoJ ending a long period of extraordinary monetary ease, a rebound in the yen has the potential to compound the local currency stock market gains to foreign investors. With these promising valuations and tailwinds, we see continued favorable prospects for Japanese equities.

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