2025 Investment Outlook – Japan Equities

January 2025

Author

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Key takeaways

- We are constructive on the Japanese equity market amid country-specific structural factors, the macroeconomic backdrop and corporate governance reforms.
- Against the backdrop of healthy corporate cash generation combined with labour shortages, a long-awaited wage-price cycle, which could revive domestic demand, is becoming a reality.
- We have seen the positive impact of the Tokyo Stock Exchange's corporate governance reform efforts in 2023 and 2024 and expect reforms to progress further in 2025.

The Japanese equity and currency markets have been fluctuating due to uncertainties in monetary policy pivots as well as political situations in both the US and Japan. Specifically, US President-elect Donald Trump's "America First" policy has shaken up markets globally. While we are mindful of the US policy risks, we maintain a constructive view on the Japanese equity market against the backdrop of Japan-specific structural factors, the comeback in real GDP growth, and corporate governance reforms to improve capital efficiency and shareholder returns.

Macroeconomic transitions towards growth

The recent positive developments underpinning our view include the comeback of Japan's real GDP growth over the last two quarters, bolstered by domestic consumption recovery. Since the influential "Shunto" spring wage negotiation yielded a higher-than-expected wage rise last year, wage hike expectations seem to have been building up among consumers. This year, the Japanese Trade Union Confederation (Rengo) aims for a similar increase. Given Japan's very tight labour market and Japanese companies' strong fundamentals, we think that is possible.

Real wage growth stagnated even during "Abenomics," which was the combination of bold monetary policy, flexible fiscal policy, and a growth strategy from 2012 to 2020. Even though the population already shrunk in Japan during this period, the labour force pool was broadly maintained thanks to a significant rise in participation rates among both the working-age and elderly populations. However, such labour force bonuses from female and elderly workers are disappearing, with the working-age labour participation rate exceeding 80% and the elderly rate hitting a peak.

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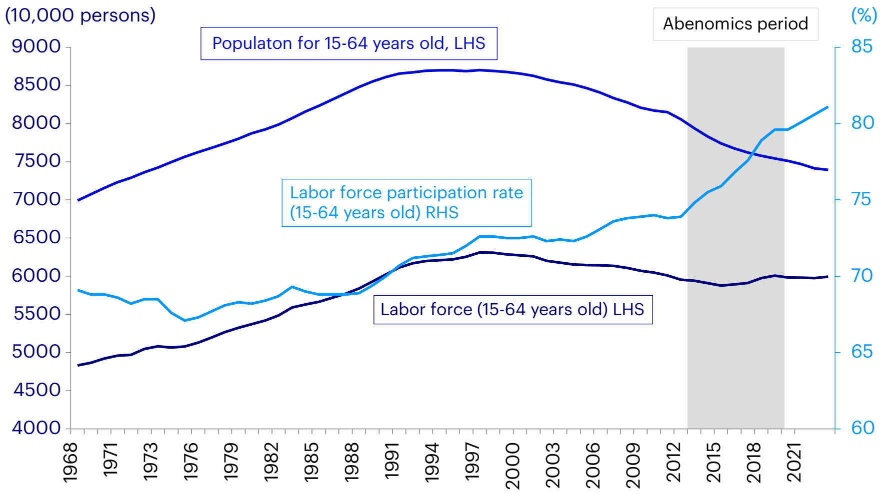
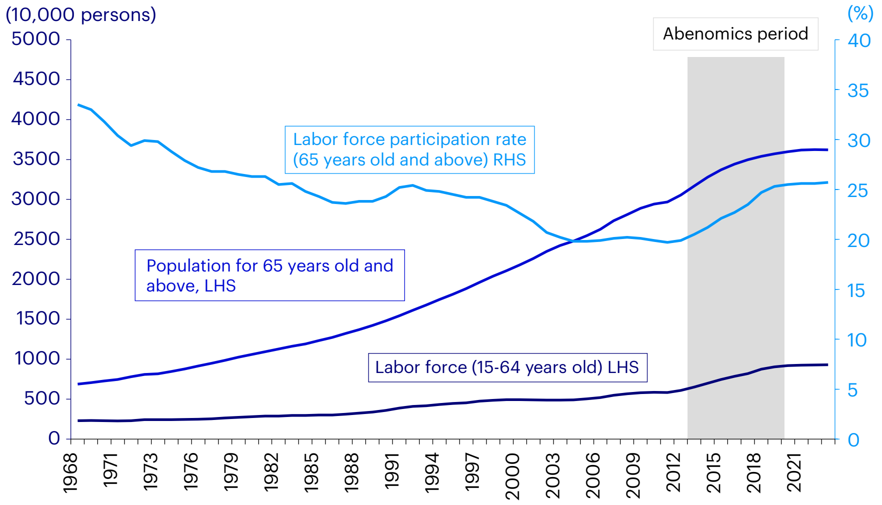
Chart 1: Japan's labour force, labour force participation rate and population (15 – 64 years old)



Source: Japan Ministry of Health, Labour and Welfare.

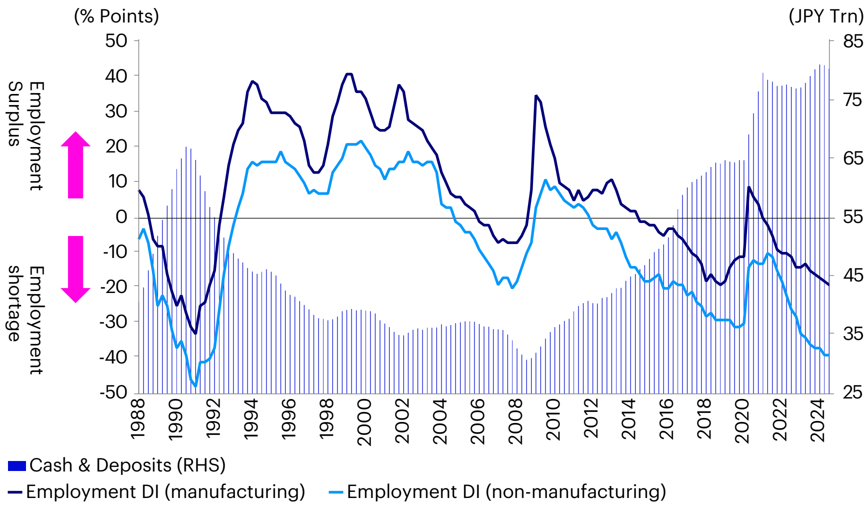
Chart 2: Japan's labour force, labour force participation rate and population (65 years old and above)



Source: Japan Ministry of Health, Labour and Welfare.

At the same time, the Bank of Japan's (BoJ) Tankan Survey points to overcoming the deflationary norm among Japanese corporations as output price diffusion indexes have stayed in positive territory for the last three years. Such cost pass-through has boosted corporate earnings and margins. Japanese companies have accumulated a high level of cash after experiencing sustained earnings growth combined with deleveraging efforts over the last three decades after Japan's asset bubble. This means these companies can now afford to pay higher levels of compensation and correct the current low distribution of income to labour amid the substantially tightening labour market.

Chart 3: Japanese companies' employment conditions and cash holdings



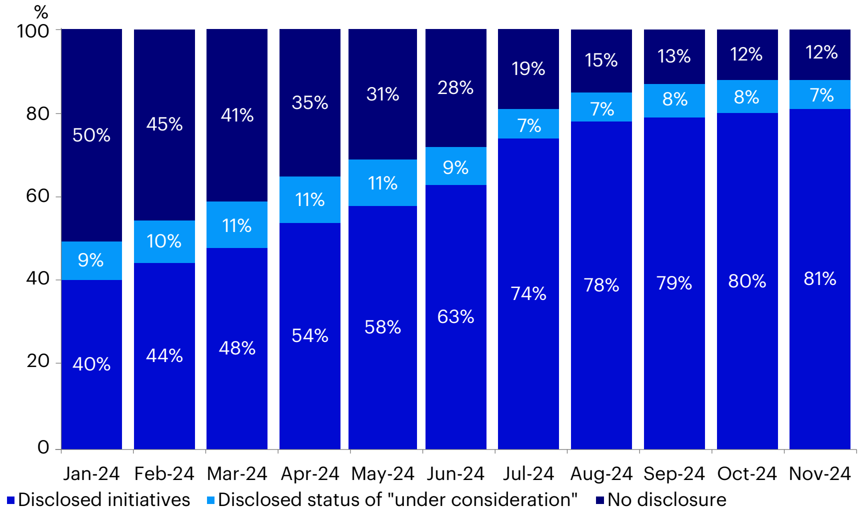
Source: BofA Global Research, Bank of Japan, Japan Ministry of Finance.

In addition, we expect that Japanese companies will need greater capital expenditure to cope with labour shortages. Against the backdrop of healthy corporate cash generation combined with labour shortages, a long-awaited wage-price cycle, which could revive domestic demand, is becoming a reality. Positive interest rates, price increases, and domestic economic growth are expected to take root in Japan. Against conventional wisdom, Japan's ageing demography can work positively for the country to exit from deflation to reflation.

Such macroeconomic transitions will enable the BoJ to pursue monetary policy normalisation. While there is no consensus on Japan's neutral interest rate, the BoJ has room to increase rates from the current very low level of 0.25% compared to the latest core Consumer Price Index (CPI) excluding fresh food and energy of 2.4%, creating a very accommodative negative real interest rate environment. Accordingly, while near-term volatility amid US policy uncertainty is inevitable, we think the significant downward pressure on the Japanese yen against the US dollar amid the expanding interest rate gap will ease from the significant downtrend over the last couple of years.

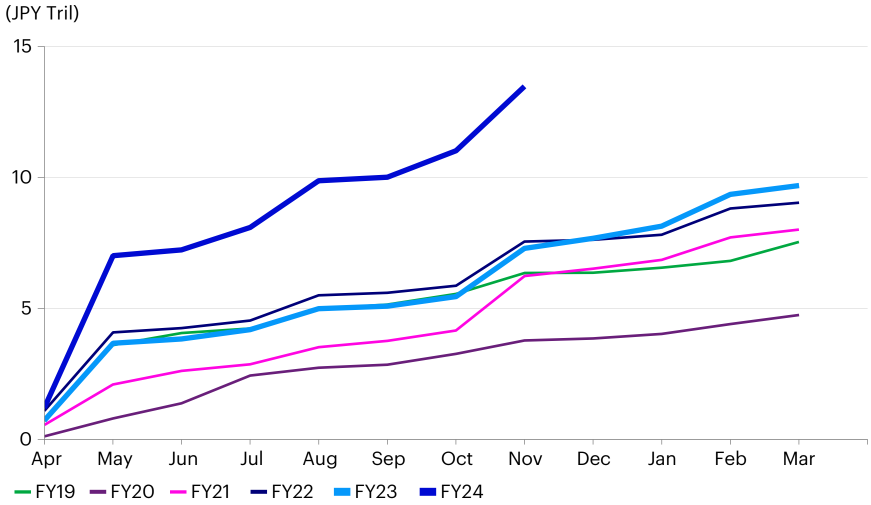
Corporate governance reforms among Japanese companies
The Tokyo Stock Exchange's (TSE) geared up reform efforts since 2023 had a real impact on Japan's corporate governance in 2024. By the end of the year, 90% of companies listed on the TSE Prime Market took action against the TSE's request to consider the cost of capital and stock price in management. 2024 also saw a significant rise in share buyback programme announcements, nearly doubling from the previous year.

Chart 4: Prime market-listed companies meeting/aiming to meet TSE requests



Source: BofA Global Research, Japan Exchange Group

Chart 5: Share-repurchase agreements



Source: QUICK, SMBC Nikko Securities. The universe is the TOPIX constituents.

These corporate governance reform moves coincide with the government's decision to enhance its tax exemption saving account scheme, or NISA (Nippon Investment Savings Account), from January 2024 to shift household financial assets to investments. Households have gradually been shifting their investment priorities away from safety toward profitability, as cash is no longer king amid inflation.

Against this backdrop, we expect corporate governance reforms to progress further in 2025. In addition to the TSE's initiatives to promote and encourage corporate value enhancement, the Japanese Financial Services Agency (FSA), with which the TSE has been working closely, is currently revising Japan's Stewardship Code to improve engagement effectiveness.

While the TSE's reforms spotlit value stocks at the beginning, its goal is not to achieve a one-off rise in shareholder return among stocks trading at below book value but to ensure sustained corporate value growth among all listed companies. Consequently, we are now in the phase where this initiative has spread to all listed companies. Taking advantage of the rising awareness of corporate governance among Japanese companies, asset managers like us can enter into deeper discussions with these firms on the effective use of capital and cash. We have been undertaking engagement activities in harmony with the TSE's reforms to achieve a common goal – enterprise value enhancement, which can ultimately lead to increases in returns for our clients.

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