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Japan Enters a New Era

Asian markets are undergoing major changes associated with shifting economic fortunes, reforms, supply chains and geopolitical tensions. In the first of a series of *Insights* on this evolving picture, we interview Kei Okamura, Portfolio Manager for Japanese Equities, regarding the fundamentals in Japan, its return to market strength after the deflationary “lost decades,” the pace of corporate reforms, and where opportunities in the market may emerge next.

Kei, thank you for joining us. Japan’s recent market returns have startled many investors. How would you characterize what’s happened so far?

In early March, the Nikkei 225 reached its first record high in 34 years, while other Japanese indexes also advanced. The Nikkei 225 has strong exposure to exporters, and some semiconductor stocks, and so has benefited from news around key AI-related companies, as well as the weak yen. However, this is really just the latest stage of a significant rally in Japanese equities.

Beyond that, Japan is on the cusp of a very fundamental change in its economy. For the first time in more than 30 years, there could be a virtuous cycle of wage and price growth, with one feeding into the other. If this change actually does materialize and become sustainable, it would effectively mean an end to the “lost decades” of deflation, with Japan entering a new economic paradigm.

Then, of course, there are the capital management reforms that have been accelerating since last year. It’s worth pointing out that they are a culmination of the decades-long corporate governance reforms that came before that.

And finally, geopolitics are a factor. This is a big election year, global relationships are changing, and we are seeing continued tense rhetoric between the U.S. and China. In this environment, businesses have to think about the mid- to long term: Where can they invest without having to spend sleepless nights about another conflict flaring up? Through a process of elimination, Japan becomes an attractive destination for a number of reasons. Geographically, it’s part of Asia, and from a strategic standpoint it’s closely allied with the U.S. and Europe, while still maintaining good relations with its neighbors, including China to some degree. This position is part of the reason a number of major global companies have been setting up new facilities here.

Can the gains continue?

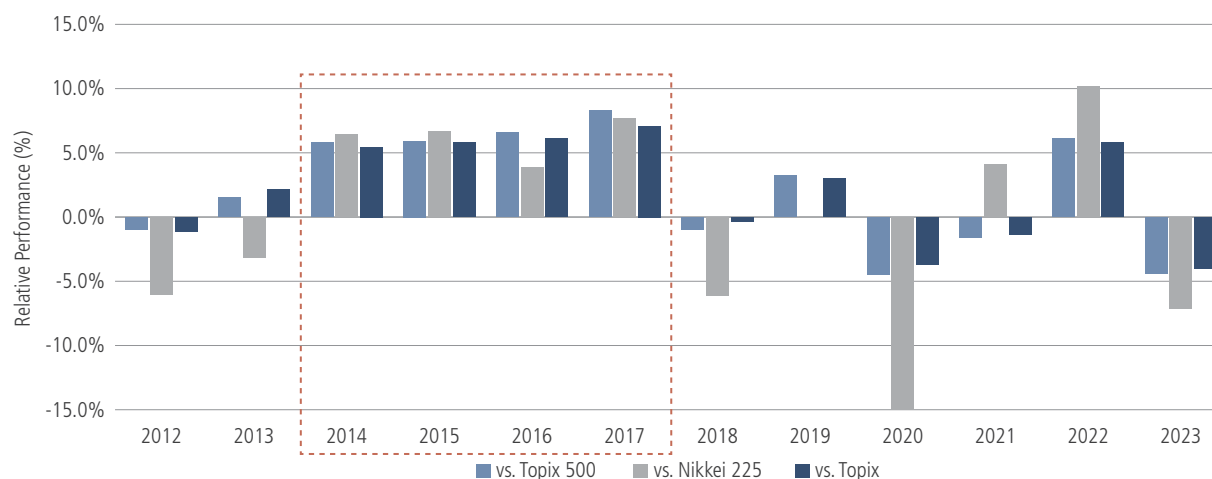
Yes, we believe they can, but a key question is whether that wage/inflation relationship can sustain itself. We think that wage growth will continue, given its structural nature. We have a labor shortage in Japan, including a shortage of skilled workers, which has forced companies to increase pay in order to attract talent. That, in turn, should feed into the rest of the economy, which will allow companies, especially those with pricing power, to flow through costs to end customers—which will be accepted because those customers will have the ability to spend because of higher wages. Here, we are starting to see that loop connect, which bodes well for the macro economy.

Where could we see the next leg up?

Given the extent of gains in the large-cap market, we think the rally could broaden to small and midcap stocks (SMIDs), which have underperformed. Historically, we've seen instances like this before, when large caps outperformed in the very early phases of the rally, but then the small and midcaps experienced an extended period of leadership. This happened a decade ago and could happen again given current fundamental tailwinds (see display).

A NEW SMID LEADERSHIP CYCLE?

Relative Performance of MSCI Japan Small Cap vs. Larger-Cap Indices



Source: Bloomberg, Neuberger Berman. Data as of January 2024.

In some ways, the fact patterns are similar. Back then, the late Prime Minister Shinzo Abe announced his program of “three arrows” to reinvigorate the economy, including monetary easing, fiscal stimulus and structural reform. With the implementation of the first two arrows, we saw an influx of foreign investors, who typically used cheap vehicles like ETFs for exposure to the broad market, which, along with a depreciated yen, helped large-cap stocks with overseas exposure. But with a narrowing of upside in large names, more global investors migrated to SMIDs, which in Japan are actually a deep and liquid segment. (The entire Japan equity universe includes around 3,800 stocks.) Now the third arrow is well on its way to reality, in terms of market and governance reforms, which has helped drive the current rally, in which SMIDs are showing new signs of life. In this case, we think their advantage could last longer than four years, given the potential impact of structural changes.

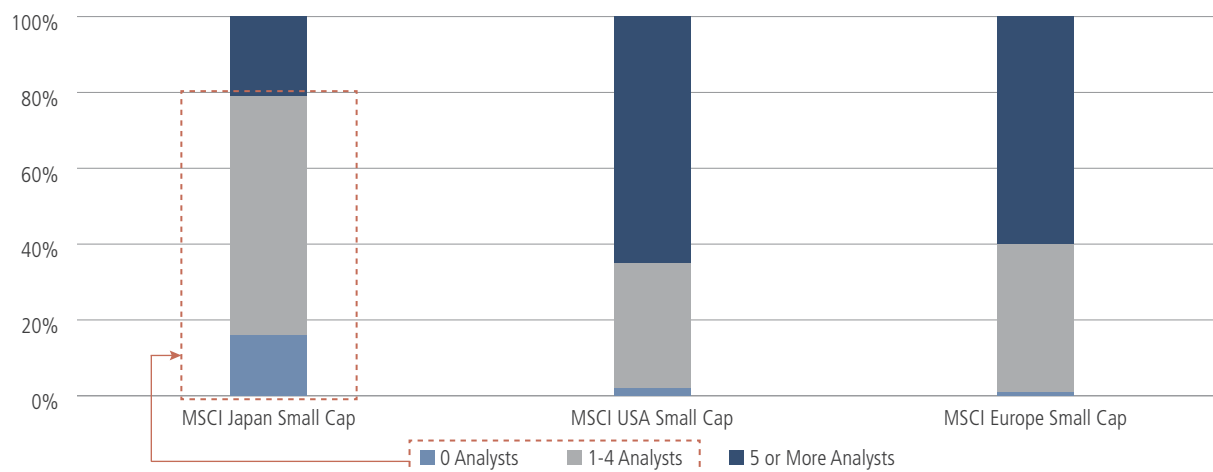
Does this place a premium on active management?

Entering this new paradigm of wages and inflation, we believe there are going to be definite winners and losers, so it will be important to distinguish between them. This has been evident in other markets as well, for example, with a broadening of the U.S. equities rally. However, with much lower valuations in Japan, we believe there are many under-discovered high-quality names. That's reflected in

sell-side coverage, where roughly 80% of small-cap companies are followed by fewer than five analysts, and 15% have no coverage at all (see display).

LAND OF POTENTIAL HIDDEN GEMS

Percentage of Companies With Sell-Side Coverage



Source: MSCI, Bloomberg. Data as of December 2023.

Overall, we think there's significant potential for a valuation re-rating in the SMID space, especially when you consider good companies. Looking at price/earnings, the Nikkei 225 was recently trading at 21 times earnings, while the MSCI Japan Small Cap Index was at just 14 times. Granted, there are fundamental differences in terms of capital efficiency and profitability between the segments, but by taking a selective approach, we believe you can find smaller companies with strong competitive positions, balance sheets and cash flows that may also have the potential to improve operationally—all at a much lower multiple than large caps or comparable names elsewhere in the developed world.

The Bank of Japan recently moved away from its negative interest rate policy for the first time in years. What's next?

The Bank of Japan believes if there's ever going to be a time in history to normalize Japan's extraordinary monetary policy, it's now. Governor Kazuo Ueda is taking a very measured, careful approach to this. Keep in mind that he was the only BOJ committee member who dissented back in the 2000s when it decided in similar circumstances to raise interest rates. As it turned out, the economy was not strong enough to withstand that change and Japan fell into recession. So, that experience will likely inform his stance moving forward as we move past the recent move to a neutral rate. Unlike what happened in the U.S. or Europe, aggressive rate increases are not in the cards—and aren't even necessary given that inflation is still at a "green shoots" level. What's more important for him is the development of a self-sustaining cycle of higher wages and price growth. He wants to get this engine back up and running.

What about the impact on the yen?

In our view, if the Bank of Japan normalizes monetary policy in this environment and the Federal Reserve and European Central Bank lower interest rates, the likely dynamic is that the Japanese yen should appreciate. This will happen because of that narrowing differential as well as the capital that will be repatriated because of higher Japanese rates. That said, I think there's going to be a lot of ups and downs in currency, just because of the uncertainties surrounding the U.S. Fed's next move and that every macroeconomic datapoint will be scrutinized by investors.

Can Japanese companies handle the change?

At most of the companies we're speaking to, management is saying that if there's moderate appreciation in the yen, which is what we anticipate, then they can handle it. It will be baked into their forecasts and manufacturing plans. It's important to remember that many companies have adapted to the currency volatility by relocating their production to their end-markets, which helps to mitigate the FX risks. At the end of the day, many of these companies made money when the yen was at 70 – 80 against the U.S. dollar, so we're not too concerned. It's the volatility, however, that tends to be a risk factor.

You referenced geopolitics. Let's talk more about the impact on investors and companies.

It's important for both, but in different ways. For global investors, we are already seeing changes in terms of allocation to Japan. Based on our conversations with investors in the U.S. and in the APAC region, many are reducing their exposure to China due to geopolitics and its lagging recovery from the pandemic. However, they still want exposure to Asia. Through a process of elimination, few markets in this region have the depth and liquidity to take in large inflows from institutions in the U.S. and Europe, but Japan does, and is generating enormous interest.

On the business side, companies are increasingly seeking to diversify their manufacturing operations to reduce risk. Japan's strong manufacturing know-how, given its decades-long growth in industrials, consumer discretionary and other sectors, obviously helps. Moreover, the government is very friendly to foreign businesses, often providing tax cuts and subsidies that add to reasons for investing here.

The governing party is set to choose a leader in September. Could that be disruptive?

This is something that investors tend to ask about: "Things seem to be going so well in Japan. Why is Prime Minister Fumio Kishida's popularity so low?" And it is unusually low—a historical low for a sitting prime minister.

This has been a recurring theme for him for the last year. And I think it has to do with the fact that consumption has been weak because of higher inflationary trends. People don't feel like they're benefiting from the rally that we're seeing in the equity markets—they believe they are being left behind, and rightfully so given that 50% of household financial assets in Japan sits in cash—in contrast to much of the world, where ordinary investors benefit from stock appreciation. Moreover, while wage hikes have been taking place, they are coming from a low base and haven't caught up with the inflation, although our view is that they will eventually.

However, global investors love Kishida. He started off on a rocky footing, but over his tenure, the ministries and regulators have done a lot to shore up Japan through aggressive reforms to kickstart Japanese companies and improve their return on equity. Of course, many of the reforms he has announced were actually started by his predecessors. That said, we think a change in prime minister would be unfortunate—but probably would not undermine what has already been put in motion. The reforms are built into ministerial guidelines, and most companies have announced their mid-term business plans to raise capital efficiency and have introduced governance reforms such as on board composition.

Regarding reforms, let's talk about corporate engagement and the difference it can make from an investment standpoint.

Engagement is core to our approach. Moreover, we believe the role that engagement can play to enhance value is often greater in Japan than elsewhere. There is often a lack of management know-how in Japan to address many of the underlying issues that are afflicting valuations, whether capital management, corporate governance or sustainability.

Unlike the rest of the world, Japanese corporate boards largely consist of internal executives and directors; this means an overrepresentation of day-to-day operational skills and an underrepresentation of corporate management, finance, human capital and legal skills.

"How can we increase productivity? How can we better allocate capital to our businesses? How can we improve the capital efficiency of our balance sheet?" Such questions require "hard" CFO experience, from those who have run companies in tough times, know

how to cut costs and can allocate capital to maximize shareholder value—and that experience is often lacking. Similarly, on the nonfinancial side, corporate governance and sustainability tend to fall behind global best practices.

Large-cap companies are often more sophisticated and internationalized, having benefited from the reforms of the 2010s. It's the midsection of the market that seriously lacks many of these resources—but is also most open to outside input.

How do you approach specific engagements?

When we come in, we take a friendly approach; we're not hostile like some activist shareholders, and we aim to collaborate with management. Often, we arrive with a 60- or 70-page presentation deck that goes line by line into the key issues affecting the company's balance sheet, governance and sustainability, and then we walk them through how to address these issues. Many firms roll out the red carpet for us because they appreciate that we don't have to take this approach—we are not consultants—and they know that our interests are aligned with theirs in seeking corporate value. It also helps that we've been long-term investors in Japan.

Governance reforms over the last decade-plus have helped this process by changing the corporate mindset. Ten or 15 years ago, it would have been hard to even get in the door, let alone get board members to listen to your advice. Now, they really attend to what we are saying; and they often widely distribute and use our materials as a guide to discuss how to run the business over the mid- to long term. In this way, we've had a tangible impact on the way these companies run their business and capital management.

Although larger companies are more developed in their practices, do you find that engaging with them can be rewarding?

On the large-cap front, many companies continue to have very specific, but important issues to address. At that level, however, it can be hard to gain access to the decision-makers. One thing we do to amplify our voice is to collaborate on engagements with our industry peers—something that the Japanese government actually encourages and has included in its stewardship code and recent amendments to regulation.

Along these lines, I serve as chair of the Japan Working Group for the Asian Corporate Governance Association, a group of roughly 30 asset managers and asset owners who manage around \$20 trillion, and work together to engage with leading Japanese companies. Through this forum, we interact with C-suite executives and external directors to address a range of issues, whether improving returns on equity, enhancing disclosures or strengthening materiality analysis, among others. Such interactions tend to be issue-specific—for example, creating a schedule to reduce cross-shareholdings, raising board effectiveness or pinpointing carbon emissions goals. It's a group effort, but we think it's also vitally important that Neuberger Berman take a leadership role to help drive the agenda, which not only can improve the company directly, but serve as a model for its customers and suppliers, some of which we may own as well.

How do you view the current risk/opportunity balance in Japan?

At the end of the day, the risks in Japanese stocks are well advertised, whether potential excessive tightening by the Bank of Japan or a political leadership change. However, if you balance out the opportunities and risks, we believe the opportunities are much greater—especially for companies with the potential to improve their businesses.

In terms of reform, we believe the train has already left the station and that pressure is mounting on companies to “stay on board” and follow through on changes that many did not even contemplate years ago. Helping this process is the generational change of management, as a new guard emerges that is thinking more progressively about corporate practices. This comes with improving macroeconomic fundamentals, including the potential for a virtuous cycle of wage and inflation growth, which has helped drive recent gains. So much is happening all at once, and it's bound to be an interesting time for Japanese markets.

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