



Investment Market In Focus: Japan's Bonds, Nikkei225, MOTHERS & Daiwa Non-Financial Indices

US Alternative

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Game of Thrones author George R.R. Martin said of winning, "the storms come and go, the waves crash overhead, the big fish eat the little fish and I keep on paddling."

One of the biggest fishes of 2020 who ate the little short open-interest fish was Japan's Government Pension Investment Fund (GPIF), whom alongside the Bank of Japan (BoJ) accumulated ninety percent of the country's total ETF & J-REITs onshore market share, which not unsurprisingly, saw the bellwether Nikkei225 hit its highest level since 1991 in November and helped the gauge break out of its rangebound 20,000 to 24,000 for the first time since 2017.

Breaking Out Nikkei 225 shifts away from its usual trading range



Not only do unique opportunities remain for Australian global investors following our 2017, 2018 and 2019 high conviction investment call on Japanese exposures, these investors continue to receive a stable and dependable alternative to the dynamic shift Bidenomics will have on the maturing US bull run.

Cite:- [Keeping It Simple: Japan](#), 25 April 2020

Cite:- [Ignore Japan At Your Peril If You're An Investor](#), 4 October 2017

Funded with big rises in monetary aggregates (euphemism for printing new money), Japan has evolved to be the apex canary in the mine for unconventional monetary experiments, broadly dubbed, Quantitative and Qualitative Easing, or QQE.

QQE with Yield Curve Control pioneered by the Japanese in 2013, has today been mimicked by Australia's Reserve Bank (RBA) in March 2020 and partially pantomimed by the US Federal Reserve's Open Market Committee (FOMC) throughout late 2020.

Cite:- [Central Banks Are Now Market Makers: Reshaping The Global Economy From A Torus Revolution Towards A Torus Knot](#), 22 July 2020

Cite:- [Australia Begins Quantitative Easing](#), 17 March 2020

Cite:- [Positive thinkers stick with Abe](#), 12 April 2014

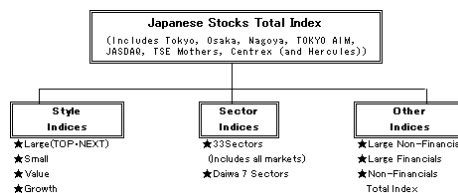
With a Debt-to-GDP ratio of nearly two hundred and fifty percent, sustainability has not been an issue; the Japanese have proven that QQE works to finance national

debts, atleast in the medium term.

For equities, high debt loads should continue supporting high shareholder payouts – although at reduced levels vis-à-vis recent years, driven by depressed earnings in the wake of the recent crisis – while dragging on net margins.

Japanese listed non-financial companies, for the first time in thirty years, since 2016, have enjoyed positive cashflows, with plenty of cash on their books and which are quoted in a cheap currency.

The Japanese non-financial sector – best represented by the Daiwa Non-Financial Index – is arguably the most inviolable investment an investor can make right now.



With the Yen undervalued, Japanese non-financial shares undervalued, Japanese corporate debt, cashflows and cash positions healthy, Japanese shares under-owned and their primary competitor, Germany, continuing to face ongoing structural problems.

Cite:- [A German Rough Patch 2019](#), 10 April 2019

Cite:- [Germany After Merkel](#), 21 November 2018

Of course, having the Japanese Government "Crowd Out" ninety percent of the Exchange Traded Funds (ETF)s market, purchasing physically backed instruments, has inflated single and aggregate stock scrip across TOPIX, 225-issue Nikkei subsectors and MOTHERS technology listed companies.

Cite:- [Pokémon Go Places Japan Tech On Investment Map](#), 30 July 2016

The big winners in terms of revenue generated off the BOJ purchases have been the asset management arms of the country's top brokerages, Nomura Holdings Inc. [8604:JP] and Daiwa Securities Group Inc. [8601:JP], whom neither have incentive to reduce fees as they are not being rewarded by the BOJ policy – this leads to stifled competition and a perverse scenario of larger assets under management allowing for higher fees levied to investors.

Big Fund, Big Fees Larger Topix ETFs have higher expense ratios

Fund	Fee (%)	Size (billion yen)
Nomura Asset Management Topix ETF	0.11	10,547.7
Daiwa Asset Management Daiwa ETF-Topix	0.11	5,007.2
Nikko Asset Management Listed Index Fund Topix	0.09	4,839.3
Mitsubishi UFJ Kokusai Asset Management Maxis Topix ETF	0.08	1,388.5
BlackRock Japan iShares Core Topix ETF	0.06	297.7
Asset Management One One ETF Topix	0.08	178.7

Source: Asset managers, Japan Exchange Group Note: Data as of end April

Followingly, BOJ Governor Kuroda has repeatedly said that the ETF purchases

are needed as part of monetary stimulus to reach the BOJ's inflation target and to boot, the Japanese Government under new Prime Minister Yoshihide Suga – who took office in September 2020 – is continuing to pursue Abenomics policy, but notably with a strong commitment to further structural reforms.

Reflecting the Suga administration's proactive engagement, additional economic stimulus measures approved by the Cabinet on 8 December 2020, include funds for digital transformation, green investments and policies aimed at boosting productivity through structural transformation of Japan's economy and promoting innovation.

Spurred on by Abenomic-driven QQE and now Sugaomics, most investors, when they look at Japan, naturally look at the performance of the overall market index, the TOPIX.

Cite:- [Stick with Japan](#), 7 March 2015
Watch:- [The Australian: Andrew Main & Stirling Larkin Discuss China & Japan in 2015](#), 29 May 2015

Shown by the white line in the chart, this has been in a broad trading range since around 1993 and the TOPIX alone does not tell investors anything useful: the true story is that from 1983 to December 1989, Japan's banks experienced a much bigger bubble than the rest of the market and over that period, the broad index quintupled, however, financial shares went up more than tenfold.

The Japanese market has bifurcated into financials and non-financials



As a result, by the end of 1989 the capitalisation of the broad TOPIX represented more than fifty percent of the entire world's market capitalisation and Japanese banks' shares by themselves made up half the TOPIX by capitalisation.

Therefore, at their height, Japanese bank shares made up a staggering quarter of the world's market capitalisation.

Then, in 1990 the bear market hit and everything fell but financial shares fell a lot more and from 1990 to 2003 the non-financial index fell seventy five percent and the financial index fell by a seismic ninety one percent.

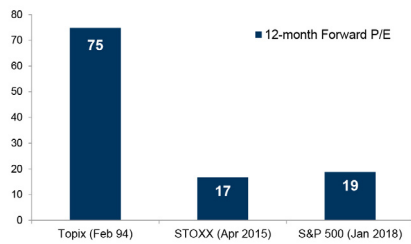
After that, from 2004 to 2009 everything went up or down more or less together

continue over



but from 2009 to today and especially since 2016, a pronounced divergence between financials and non-financials has appeared.

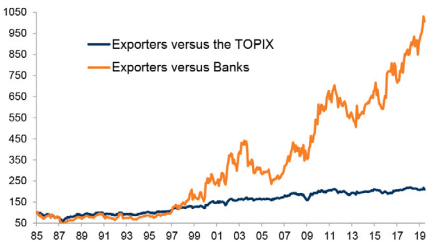
Peak equity valuations were far more stretched in Japan than in the US, Europe
Max. P/E post 1990 for Japan, Post 2009 for Europe / US



Source: Datastream

Since the crisis nadir of March 2009, non-financial shares have almost tripled, while bank shares have risen by a mere six percent.

Exporters in Japan performed especially well versus Banks and this has been persistent
Indexed to 100 in 1985



Source: Datastream

The distinctly uninspiring performance of the broad TOPIX masks the reality of what is really going on in Japan, which is that a new bull market began sometime between 2012 and 2016 and that it probably has a lot further to run.

Reassuringly, Japanese financials are seeing signs of recovering and remembering Japan has a particularly parochial and fragmented banking sector, the recent government push for regional banks to restructure is Nikkei-225 positive.

The Financial Services Agency (FSA) has been consistently sending a message for some time that regional bank realignment, centred on mergers and business integration, is essential given the current state of and future outlook for regional banks' business models.

Against this backdrop, Prime Minister Suga has expressed a proactive stance on this issue, which has increased the momentum for regional bank realignment and championed specific policy measures that have been determined or for which debate has progressed to some extent including Antitrust law exemptions that enable mergers within the same prefecture, a subsidy programme to

assist cover system integration costs accompanying mergers, the BOJ's Special Deposit Facility, which provides incentives for mergers and business integration as well as for streamlining cost structures and lastly, easing of restrictions on capital contributions to corporations by banks across their operations.

These domestic reforms were in kind with those Australia herself undertook following the Banana Republic epoch of Hawke and Keating, when State banks amalgamated with what we today refer as the 'Big Four', protected under the heinous Four Pillar Policy.

Cite:- Wealth Investors Sidestep A Potential Banana Republic, 15 November 2014

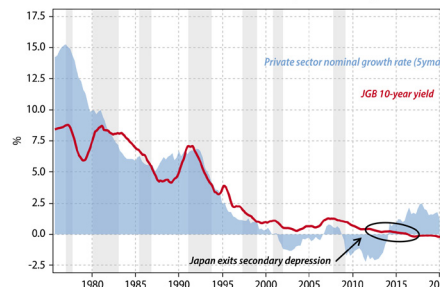
Cite:- Banks Role In House Price Surge, 27 June 2015

But to truly understand why Japanese financial conglomerates drag behind the rest of the listed economy, it is imperative to appreciate that when long term interest rates are higher than the growth rate of private sector GDP, then the growth rate of corporate earnings – which in the long run equals private sector GDP growth – must be lower than the cost of money.

In such an environment, the best investment any corporation can make is to minimise capital spending in order to generate a positive cashflow and pay down debt.

The result is that the economy moves ex-growth and towards a depression: Between 1994 and 2014, this is what happened in Japan.

From the mid-1990s to the mid-2010s, Japan went ex-growth



This dynamic explains why Japanese financials have not recovered along with the rest of TOPIX, when nominal interest rates are negative, the long-term savings industry goes bust, as the euro-bloc is currently discovering.

Japan struggled through its primary depression in the 1990's, its secondary depression from 2000 to the early-2010's and from the mid-2010s has started to emerge from its two-decade-long depressionary environment.

As a result, Japan's non-financial index is back in a structural bull market, but financials continue to go nowhere, because financial companies cannot make money when interest rates are negative.

Some time around 2016 corporate profits broke above their previous highs as a percentage of private sector GDP, appearing to confirm that Japan's depressionary period was over.

Cite:- Japan Hit Hardest In Brexit Shock But Remains An Opportunity, 2 July 2016

Cite:- Nikkei225 Exodus, 12 September 2018

From 1989 to 2010, non-financial profits fell in nominal terms and as Japan sank into its primary depression, Japanese companies tried to spend their way out of the slump but it didn't work and when the secondary depression hit, with banks unable to make new loans, companies had no choice but to cut capital spending and to work on boosting their margins.

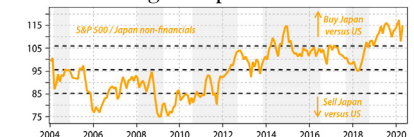
As a result, since 2010, Japanese industrial profits have tripled and with capital spending by industrial companies amounting to only sixty five percent of their profits, these companies have swung significantly into positive free cashflows.

Debts have been repaid and cash balances have gone up.

As of September 2019, Japanese non-financial companies had some ¥500 trillion of cash or cash equivalents on their books and to put that sum into perspective, the market capitalisation of the entire TOPIX index is now ¥330 trillion.

Since 2012, Japanese policymakers have made a political choice to protect corporate profitability through an undervalued exchange rate with the Yen currently undervalued by circa twenty percent.

Since 2005 or so, market participants have well understood the inverse relationship between the profits of Japanese companies and the Yen's exchange rate against the US Dollar – when the Yen is up year-on-year against the Dollar – the stock market index either goes sideways or down and the S&P500 remains more attractive for Australian global investors seeking Greenback hedged exposures.



The Yen is where it was in 2005 – from 2005 to 2018, the performance of the Japanese non-financial index and the S&P500 were similar in US Dollar terms, however, since 2018, a significant divergence has occurred and since 2005, in local currency terms, the growth of corporate profits has favoured Japan over the US.

The key to successful equity market investing, which is exactly inverse to that of bond investing is to decide whether you are chasing the winners, the laggards or free cashflows themselves. Found in Japan, you enjoy all three. ■

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