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Japan – Inflation Targeting
A long lasting relative outperformance for Japanese shares ahead?

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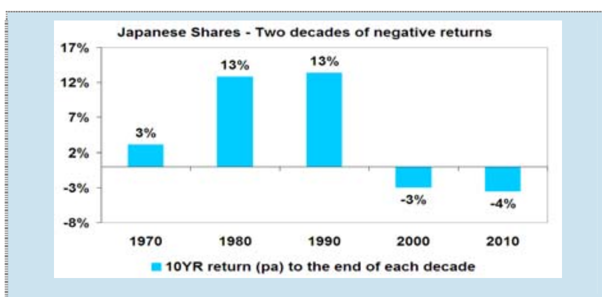
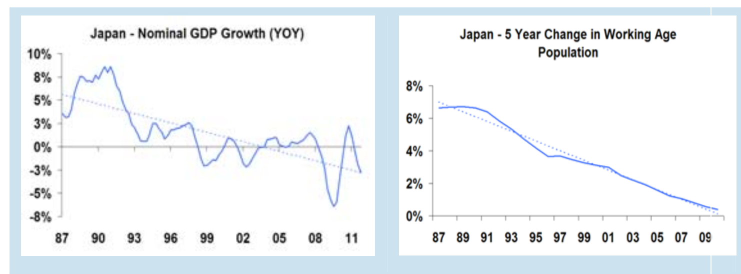
Overview

Several failed recoveries, numerous policy mishaps and two decades of poor performance have seen Japanese shares lose appeal as an investment. Conventional wisdom suggests Japanese shares will continue to be a poor investment over the years to come given weak demographics, terrible growth trajectory and the potential for further policy errors. This sounds logical. Japan is unlikely to be a fast growing economy and should continue to see its share of global output decline. Japanese policymakers made many policy mistakes over the past two decades and there are no guarantees that will not continue. However this ignores the fact that many of these negatives have to a large degree been priced in. What has not been priced in is Japanese policy makers finally taking aggressive steps to tackle deflation, the epicentre of Japan's economic and market woes. Perhaps the recent move by Japan's central bank to modify its stance on inflation by vowing to hit a target of 1% year-on-year change in the consumer price index is a start.



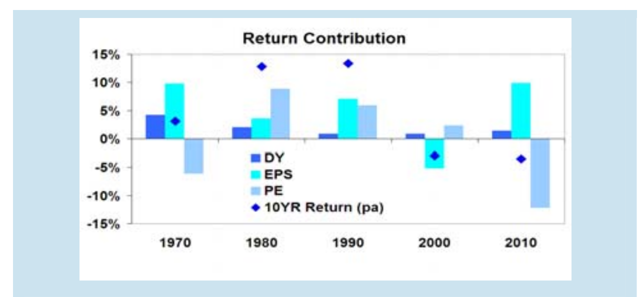
Understanding the drivers of relative underperformance

Japan saw an end to a robust economic expansion after property and equity bubbles burst in the early 1990s, pushing the financial system and the economy in a downward spiral as authorities struggled to deal with their repercussions. Japan's lost decade was a result. Despite several rebound attempts, Japan's share market has continued to drift lower ever since. At first glance it is easy to attribute this poor performance to a weak profit backdrop for Japanese companies. Dismal demographics, shrinking working age population and a mediocre growth profile add to the conviction that Japanese companies have been and will be suffering from a lack of growth pulse.



Zooming into drivers of Japanese share market performance over the two decades, however, reveals a different story. While earnings growth did in fact pose a significant drag to the performance of the Japanese share market in the 1990s, the contrary is true over the most recent decade.

This is shown in the graph below which breaks down total return from Japanese shares into contributions from dividends (DY), earnings growth (EPS) and changes in valuation (PE) (i.e. market rating). The contribution from earnings growth has been nothing less than spectacular over the past decade.

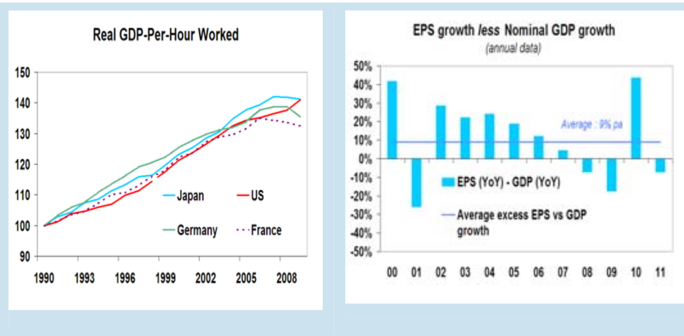


Contrary to popular opinion, Japan's weak growth backdrop has not impaired the ability of listed companies to generate strong earnings growth. To a large extent this is attributable to healthy productivity growth in Japan over the past decade. It also reflects the fact many Japanese firms are becoming less reliant on sluggish domestic demand with

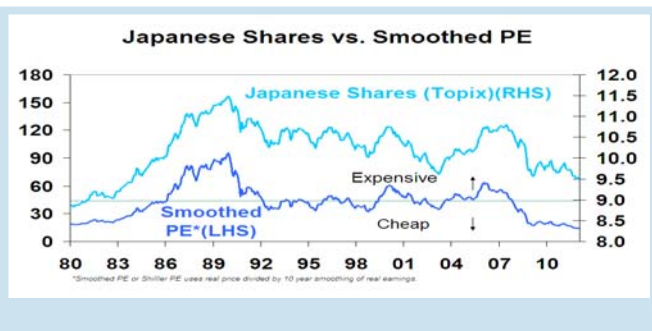
sales increasingly sourced from abroad and in particular from the fast growing emerging markets.

While Japan lost its way in the 1990s as real estate and equity bubbles burst, productivity growth has staged a strong comeback since 2000. Japan's productivity suffered in the 1990s as a result of failure to deal decisively with the bad loans clogging its banks, which propped up inefficient "zombie" companies rather than forcing them into liquidation. That meant less capital was available to lend to upstart firms.

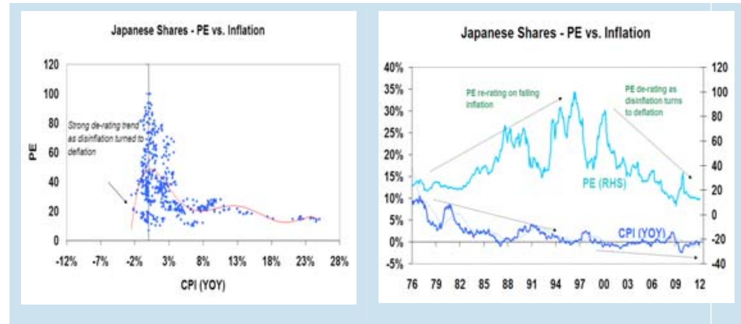
Workers' productivity depends on their skills, the amount of capital invested in helping them to do their jobs and the pace of "innovation" — the process of generating ideas that lead to new products and more efficient business practices. Over the years Japan has made various efforts at regulatory reform, from freeing up the energy market and mobile telephony in the mid-1990s to liberalising the financial sector in the late 1990s. These have produced some results. Japan's total factor productivity growth began to improve after 2000. This has filtered to earnings. Over the past decade the growth in earnings-per-share (EPS) of Japanese listed companies has outpaced nominal GDP growth by an average of 9% per annum.



It appears lacklustre domestic growth and domestic demand conditions have not been the driving force behind Japanese shares' flagging performance. More to the point, Japanese shares have suffered from a decade of de-rating. This has seen long-term price-to-earnings (PE) multiples for the Japanese share market fall to their lowest levels in 30 years. In other words, Japanese listed companies are trading at their cheapest levels in 30 years.



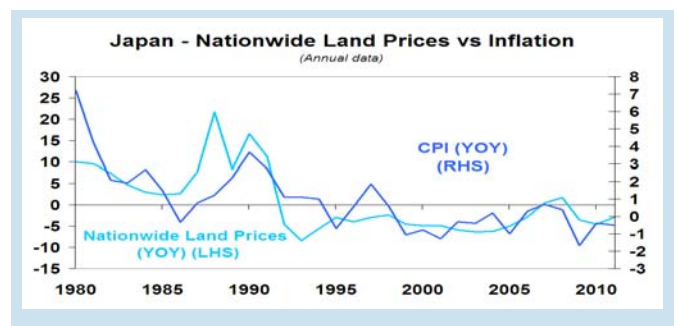
Indeed even with attractive valuations, Japanese shares will continue to lag unless the de-rating process gives way to a durable re-rating phase. A likely trigger for a re-rating of Japanese shares lies in inflation dynamics. Typically, price-to-earnings (PE multiple) moves in reverse to inflationionary trends. Falling inflation from high levels often leads to rising PE and a re-rating. Similarly, rising inflation often leads to falling PE and a de-rating. The relationship changes when falling inflation (disinflation) gives way to deflation where falling inflation leads to falling PE and a de-rating. This has been the case in Japan. As the deflationary forces became entrenched from the late 1990s, Japanese shares experienced a significant de-rating.



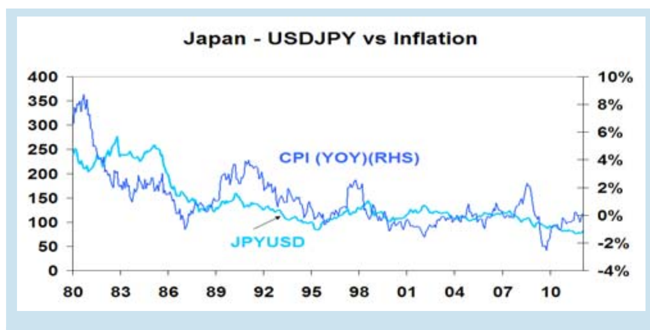
For Japanese shares to be perceived as a durable investment option as opposed to a quick trade, the PE de-rating process will need to abate. In turn, the past decade's de-rating of the Japanese share market can give way to a sustained re-rating **if deflation gives way to disinflation and rising inflationary expectations.**

Ending deflation in Japan?

It goes without saying the aftermath of the bursting of two enormous bubbles in real estate and equity markets has led to a devastating deflationary shock to the Japanese economy. Having said that, the deflationary backdrop has become too long in the tooth. Land and property prices have fallen in value for two decades with commercial land prices, adjusted for inflation, down by over 70% from their 1990 peak. Similarly, the inflation adjusted residential land prices are down by 60% from their early 1990s peak. At a minimum, the pace of decline should moderate given the duration and the magnitude of price erosion experienced so far.



Similarly, an important contributor to Japan's stagnation and deflation saga has been the ever rising exchange rate claiming Japan as "The Land of the Rising Yen". The ongoing appreciation of the Japanese Yen has been a strong contributor to Japan's deflationary pressures.

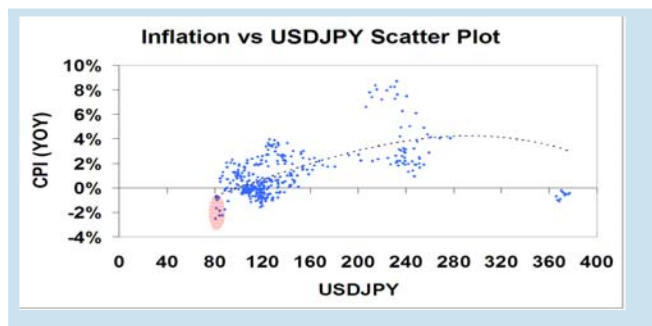


Worse still, the problem has become self-reinforcing. That is, the appreciating Yen is adding to deflationary pressures and with nominal interest rates already at zero, leading to higher real rates and improved currency valuation. This is where a serious commitment by the Japanese authorities is required to break the circuit of the rising Yen and more broadly the so called "liquidity trap"

Inflation targeting

The Bank of Japan (BoJ) made a significant step to break the liquidity trap on February 14 2012 by announcing an annual inflation target of 1%. The Bank of Japan has been reluctant to adopt a specific inflation target and the latest decision represents a step forward from BoJ's traditional stance. This should serve as a powerful message to the households and business enterprises and put a floor under inflation expectations. Although the general aim of monetary policy is clearly articulated in the Bank of Japan Law as the pursuance of price stability, this has been made more specific by a commitment to inflation targeting. This should help to anchor inflation expectations around a positive rate of inflation thereby providing a possible way out of deflation. Apart from anchoring inflation expectations, the introduction of inflation targeting has several other benefits such as **enhancing accountability** and **instrument independence**. Under the current framework for monetary policy, the BoJ has legal independence, granted in April 1998, but there is an issue about accountability. A specific inflation target as opposed to a vague objective of price stability should enhance accountability. The potential effect of inflation targeting on inflation expectations is perhaps one of the most important advantages of a new framework in Japan's case. The announcement of an inflation target should have a positive impact on financial markets and the economy as a whole provided, of course, the target is believed to be achievable. A positive inflation target of 1% should help curb deflationary pressures if the BoJ were successful in convincing financial markets and the general public that it not only has the measures to achieve this but it is also accountable for achieving that target. This would, in turn, help to stimulate the real economy making inflationary expectations self-fulfilling. Furthermore, with an improved accountability and instrument independence, the BoJ can act more aggressively in depreciating the Yen. Instead of the traditional large scale intervention practice typically carried out by the purchase of US Treasury Bills, currency depreciation can arise from changes in economic fundamentals, such as monetary expansion. This is more politically defensible than one brought about by unlimited foreign currency intervention.

Our analysis suggests that a sustained move in the Japanese Yen against the US dollar (USDJPY) to above 95 should bring about a positive impact on inflation. With the Yen weakening from as low as 76 in early February, prior to the BoJ announcement of inflation targeting, to above 80 currently, the long awaited process of a sustained weakness in the Yen may be in the making.



Conclusion

Japan's strong economic growth of the 1980s came to a sudden halt at the start of 1990s following the high profile burst of real estate and equity bubbles. The aftershock, together with a combination of policy errors and bad luck has thrown Japan into a deflationary spiral for the past two decades. Over this time, the Japanese share market has teased investors with several recoveries, none of which have ended up being more than just a quick trade. Investors, once bitten twice shy, have lost complete faith in Japanese shares as a viable investment option. Indeed, with dismal demographics, shrinking working age population and mediocre growth profile it is hard to get excited about long-term prospects for Japanese shares. This, however, ignores some crucial considerations. Firstly, many of these negatives have to a large degree been priced in. Secondly, weak economic growth and an aging population have not stopped Japanese companies from generating strong earnings growth. Over the past decade the growth in earnings-per-share (EPS) of Japanese listed companies has outpaced nominal GDP growth by an average of 9% per annum. In fact, the poor performance of the Japanese share market over the past decade can almost entirely be attributed to a de-rating of Japanese shares by investors (i.e. falling price-to-earnings). The de-rating process gained significant momentum from the late 1990s as the deflationary forces became entrenched. Our analysis suggests that for Japanese shares to embark on a durable re-rating and recovery process deflation must give way to disinflation and rising inflationary expectations. We believe that the BoJ made a significant step to break the deflationary spiral by announcing an annual inflation target of 1% in its last meeting. A positive inflation target of 1% should help curb deflationary pressures if the BoJ were successful in convincing financial markets and the general public that it not only has the measures to achieve this but **it is also accountable for achieving that target.**

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