Global Insights

Opportunities in Japanese Small Caps

Japanese Prime Minister Yoshihide Suga’s abrupt resignation caught investors by surprise. His short time atop the Liberal Democratic Party was fraught with difficulties, and his handling of the country’s vaccination rollout likely hastened his downfall. As Prime Minister Suga steps down after only a year on the job, his departure sets the stage for a replacement that will likely be laser-focused on deploying fresh fiscal stimulus and handling the country’s COVID-19 health care crisis.

After the US, Japan has the second largest weight in the MSCI All Country World Index. However, its stock market is often overlooked in the context of developed markets, given its well documented demographic challenges. As a result, you would be forgiven for not noticing the surge in Japanese shares following the prime minister’s resignation. Although Japanese companies have historically traded at deep discounts to their US peers, we see potential for a compelling catch-up trade given the wide valuation gap between the two markets.

- Amid growing criticism of his handling of the coronavirus pandemic, Prime Minister Suga will step down as the Liberal Democratic Party leader. Suga’s successor will face impatient voters who expect fresh fiscal stimulus and demand more accountability from officials regarding COVID-19.
- Among developed markets, Japan had a slow start to its immunization campaign. However, the number of fully vaccinated people is on track to surpass the US. Small-capitalization stocks in particular could see a boost as the government rolls back emergency restrictions.
- Japanese small-cap stocks could outperform large-cap stocks if supply chain challenges persist.
Decades of anemic economic growth and strong deflationary pressures have stunted interest in Japan. Although the country faces headwinds owing to well-documented demographic challenges, we see opportunities in Japan’s broad equity indexes, especially small-cap names. After moving sideways for much of the year, Japan’s equity market has rallied to record highs. In fact, the Nikkei Index notched a three-decade high earlier this month as investors bet on the global recovery supporting a positive risk-reward stance.

If our assessment proves correct, the country’s companies could see meaningful multiple expansion as investors price better growth prospects. In fact, before Delta variant threats and supply chain challenges sapped investor enthusiasm, Japan was delivering multiple expansion at a faster pace than the US. We would not be surprised if this trend reasserts itself (see Exhibit 1).

Exhibit 1: Japanese Equities Trading at Compelling Valuations Versus US

<table>
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<tr>
<th>25</th>
<th>12-Month Forward Price/Earnings Ratio</th>
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<tr>
<td>US</td>
<td>Japan</td>
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Although Japan has generally traded at a discount to the US, the widening gap between the two could narrow as investors price a stronger reflationary impulse. We are not ready to throw in the towel on Japan and are encouraged by the prospects of an extension of pandemic-era policies.

Extending pandemic-era policies. Japan is set to get a new leader following Prime Minister Yoshihide Suga’s surprise decision to step down as president of the ruling Liberal Democratic Party. Regardless of the outcome, the successor’s agenda will likely focus on accommodative monetary policy, aggressive fiscal spending and the government’s response to COVID-19. Although the new prime minister will take the reins during a difficult period for Japan’s economy, there are a few reasons why we think that strong recent performance is unlikely to abate.

First, the high degree of political consensus around hawkish fiscal policy is positive for risk assets. MS & Co. Research’s strategists anticipate that additional fiscal stimulus will be conducted on top of the 73 trillion yen approved late last year. Second, the candidates are broadly committed to driving reflationary policies. Therefore, we do not think that the Bank of Japan (BOJ) will tighten monetary policy. In fact, given that Japan’s -0.4% year-over-year headline inflation remains distant from the BOJ’s 2% target, we are confident the central bank will remain highly accommodative. Taken together, these create a positive backdrop for Japanese equities, especially small caps.

In the years following the global financial crisis, the TOPIX Small Index, which tracks small-cap companies on the Tokyo Stock Exchange, outperformed the large-cap TOPIX Index. Although we are in the early innings of a new business cycle, we are surprised to find that small-cap companies in Japan have lagged their large-cap peers (see Exhibit 2). As small-cap names are more sensitive to an improving economic cycle, we would not be surprised to see a change in leadership given that Japan is positioned for stronger growth.

Exhibit 2: Domestic Recovery Should Ultimately Benefit Small-Cap Stocks

Bringing up the rear in vaccination progress. Japan has struggled to contain the coronavirus pandemic, and a growing body of evidence suggests that voters, who are disappointed with the government’s handling of the crisis, played a key role in Prime Minister Suga’s decision to step down as leader of the Liberal Democratic Party. In fact, his surprise Sept. 3 announcement came within a week of Japan’s new COVID-19 case peak on Aug. 26 (see Exhibit 3) and within a few days of his sub-30% approval rating, the lowest of his tenure as Prime Minister.
Japan’s vaccine rollouts started a few months after those of other developed market countries, which likely contributed to the severity of its fourth coronavirus wave. As a growing number of businesses express frustration around emergency measures imposed by politicians to contain the more infectious Delta variant, we are encouraged by the uptick in the country’s vaccination rates. Currently, over 50% of the country has been fully vaccinated, and Japan is now on track to surpass the US.

This compares to a vaccination rate below 10% three months ago, just before the Summer Olympics. As economic activity normalizes, domestic consumption, which has taken a big hit due to COVID-19, will likely improve. This should benefit small-cap stocks, which generally do well in the early stages of a business cycle and are further removed from many of the supply chain challenges.

**Mending broken chains.** On an absolute basis, strong global demand has supported Japanese corporate earnings. This makes sense because Japan is a more export-oriented economy. However, as it stands today, Japan’s export-driven economy is on shaky ground.

The Shanghai Shipping Exchange Containerized Freight Index, which represents costs on major shipping routes, is up more than 200% from the same time last year (see Exhibit 4). Additionally, semiconductors, which are vital to Japan’s automobile industry, are still in short supply. While we see these near-term headwinds easing in 2022, which should benefit Japan’s economy, we see the more domestically oriented small-cap companies outperforming in the near term while multinational companies work out the kinks in global supply chains.

**Investment Implications**

Japanese equities lagged global peers for much of the year, but the country’s stocks have seen a sharp rebound and will likely benefit when global trade starts to improve. The continuation of pandemic-era policies and a supportive COVID-19 backdrop could boost Japan’s performance relative to international equities. This may be especially true if Japanese valuations trade in line with longer-term averages. We see higher immunization supporting small-cap Japanese companies that have underperformed their larger-cap peers. Easy monetary policy and aggressive fiscal stimulus should help these smaller-cap names reflate over the intermediate-term, especially as investors focus on names that are best positioned to wait out supply chain challenges.
Charts You Can't Miss

Exhibit 5: Merchandise Trade Elevated Despite Supply Chain Challenges

Exhibit 6: Increase of Orders Reflects Recovery Trends in Europe and the US

Exhibit 7: Japanese Stocks Break Above Longer-Term Resistance

Exhibit 8: Japanese Small-Cap Stocks Led Recovery Out of Global Financial Crisis

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 31, 2021

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 10, 2021

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 31, 2021

Ongoing Development Spotlight

The Bank of Japan (BOJ), which kept short-term interest rates unchanged at its September meeting, has struggled to achieve its 2% inflation target. Ultra-accommodative policies following the global financial crisis led to some improvement on that front, but inflation data flipped negative again in the second half of 2020. Bewildered Japanese policymakers have watched from afar as higher commodity prices, robust global demand and input costs have driven inflation among their developed market peers. Furthermore, if supply chain problems hamper trade momentum, Federal Reserve tapering could spell bad news for the BOJ just as it is wrestling with a potentially weaker-than-expected economic recovery.

Exhibit 9: Bank of Japan Monetary Policy Should Prove Reflationary

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 31, 2021
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Disclosure Section

Index Definitions

SHANGHAI SHIPPING EXCHANGE CONTAINERIZED FREIGHT INDEX: This index reflects the spot rates of the Shanghai export container transport market. It includes both freight rates (indexes) of 15 individual shipping routes and a composite index.

TOPIX SMALL INDEX: This index is a capitalization-weighted index designed to measure the performance of the stocks listed on the First Section of the Tokyo Stock Exchange, excluding the TOPIX500 stocks and non-eligible stocks.

For other index, indicator and survey definitions referenced in this report, please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

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