THE BIG PICTURE

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Japan: 28 years and counting

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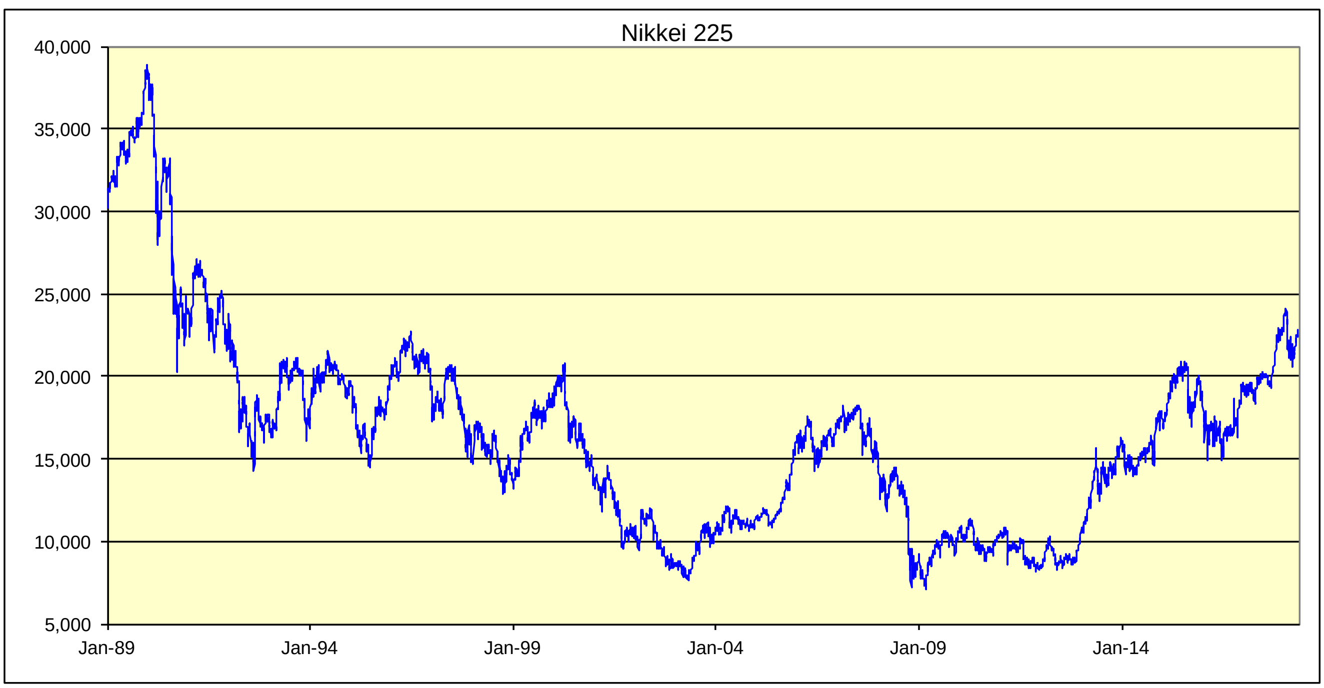
The first quarter of 2018 was characterized by considerable global uncertainty over political developments in North and South Korea, the future of energy prices, the escalating rhetoric surrounding international trade balances and a seemingly endless barrage of U.S. political news. Not surprisingly, this confluence was accompanied by a commensurate increase in market volatility. While many of the world's equity indexes were near new highs at the beginning of the year, the increase in volatility led to widespread market corrections. In fact, a number of major international markets corrected from all-time highs. Interestingly, the Canadian market (S&P/TSX Composite Index) was one that dipped from its all-time high but did not actually correct, falling "only" 8.4%. An equity market correction is generally thought to have occurred when a main index experiences a 10% decline. The other major anomaly was Japan where the market (Nikkei 225) did correct, dropping 12.8%, but it fell from a 26-year high, not an all-time high. Headwinds remain in Japan, as they do in all equity markets, but so do opportunities. Recent developments suggest continued equity market support going forward, even as Japan deals with the long-term concerns of trade and demographics. Taking advantage of professional advice and ensuring that a well-diversified portfolio is in place helps to improve risk-adjusted returns over the long haul.

Equity market

Figure 1

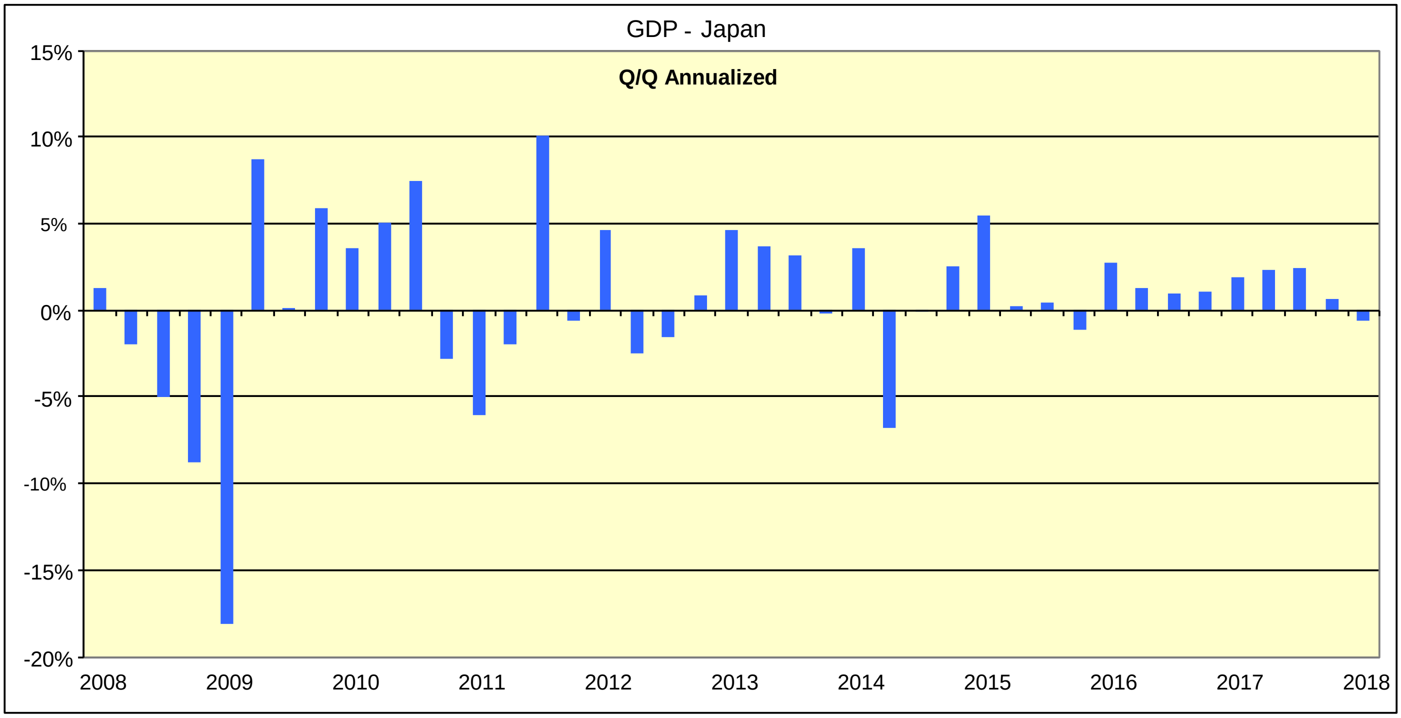


Source: Bloomberg

Many investors have been unaware of the improvements in Japan's equity markets since the financial crisis as there have been many other things to focus on. Shifting political winds, particularly in the U.S., and the proliferation of ETFs and cryptocurrencies have all proven to be sufficiently distracting. Even though most of the world's main equity markets have reached new all-time highs within recent months, a number of others have gone extended periods without one. Both Shanghai's SSE Composite Index and Australia's All Ordinaries Index have not reached all-time highs since before the financial crisis in 2008-09 (October 16 and October 31, 2007, respectively). Paris' CAC 40 has gone even longer without reaching a new high; the most recent high occurred during the dot-com era, on September 4, 2000. However, even this near 18-year gap pales in comparison to Tokyo's Nikkei 225. As can be seen in Figure 1, the main Japanese index had last posted a high on December 29, 1989, more than 28 years ago. Still, after bottoming out on March 10, 2009, the index advanced a cumulative 242% to reach a 26-year high on January 23, 2018. A good run for sure, but there is still plenty of runway given that the economy is 60% larger than it was at the end of 1989. So, why have markets continued to discount Japanese equities?

Economic growth

Figure 2



Source: Japan Cabinet Office

The huge economic and market success of the 1980s was followed by an extended period of malaise in Japan. Real estate prices increased dramatically and many of the country's financial sector entities (including mortgage lenders) were heavily invested in each other. The reversal of these situations took considerable time, particularly among the financial institutions as they propped one another up in a stop-gap effort to keep them from failing. Stubbornly slow economic growth, relatively high unemployment and the government's inability to alter either persisted for an even longer period. Nevertheless, despite a minor contraction in the first quarter of 2018, the nation now appears to have turned a corner. Economic activity contracted by 0.2% (0.6% annualized) in the first quarter of 2018. However, this was the first outright decline in real gross domestic product since the final quarter of 2015. The streak of eight consecutive quarters of growth had been the longest stretch of uninterrupted growth since the late 1980s. Analysts anticipate a return to growth in the second quarter. Still, a healthy skepticism is warranted as Japan has seen a number of near-recoveries that were short-lived. Even though international trade remains a critical issue, globally, economists expect support from trade to provide the basis for a return to economic growth.

Labour market

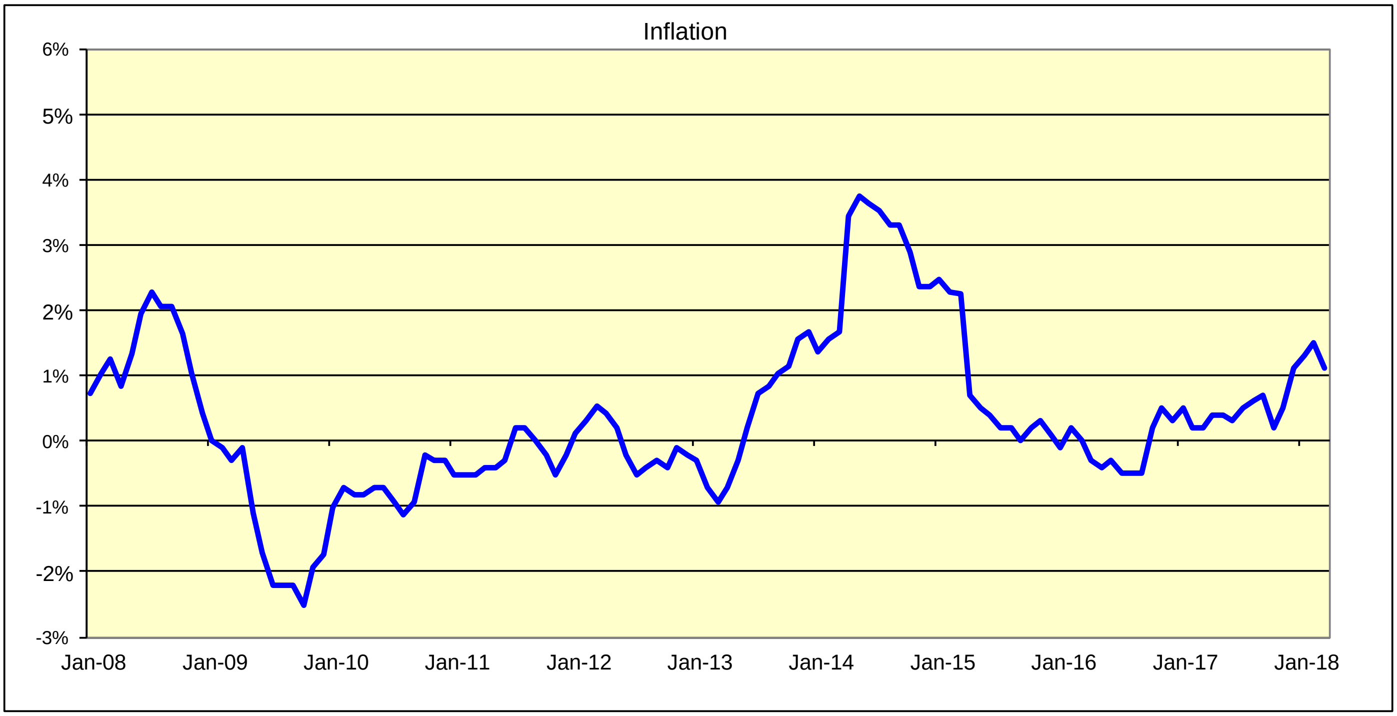
Demographics is another reason why international investors have been less interested in pushing the Japanese market back to its old highs. The country's fertility rate is low. Its population has declined for eight consecutive years and is expected to keep falling. As a result, the ratio of its working-age population to its dependent population (mainly retirees) is now 1.0, compared with approximately 1.5 globally. This means a Japanese worker must support both himself or herself and one other non-working person. Fortunately, a strong labour market has been moving to at least partially offset this. As can be seen in Figure 3, unemployment has been in a secular decline since hitting its modern-era high of 5.5% in July 2009. By January 2018, it had fallen to 2.4%, the lowest unemployment rate since April 1993 and the lowest among the G7 countries. This is a source of continued encouragement.

Figure 3

Source: Statistics Japan

Inflation and interest rates

Figure 4

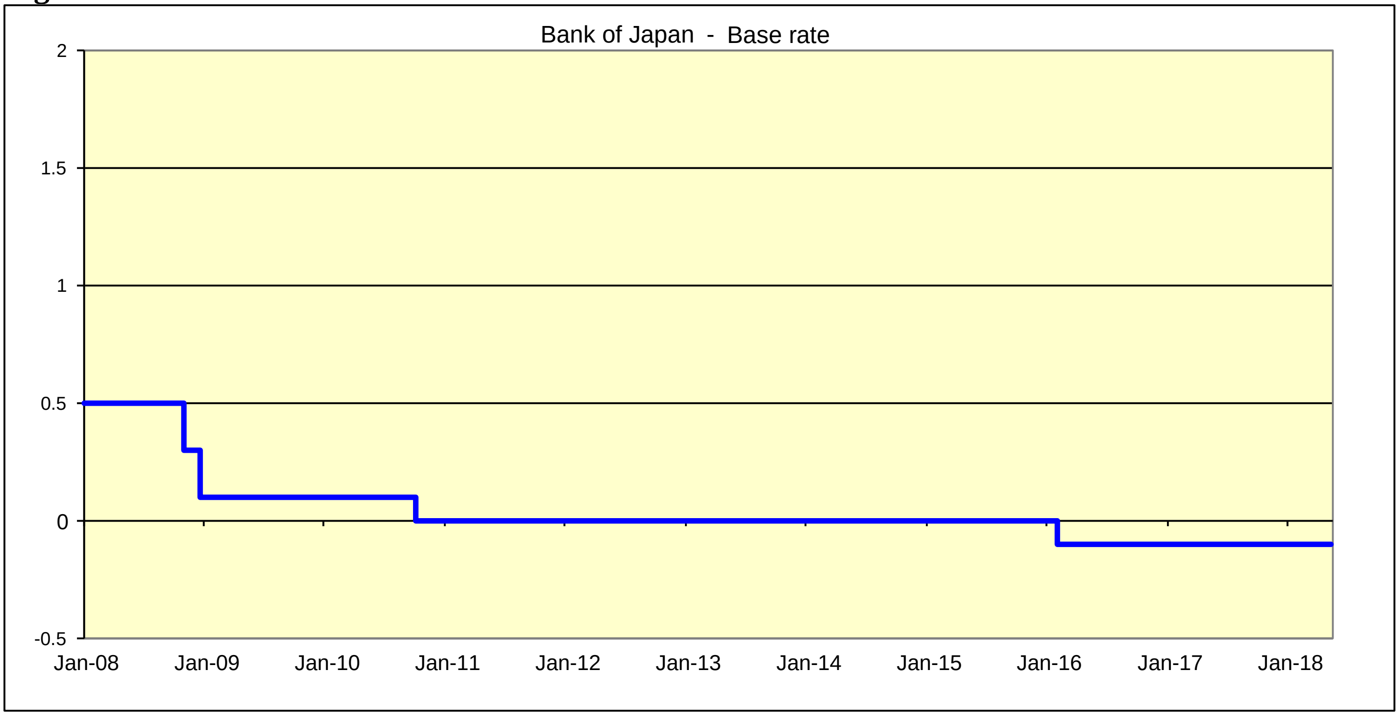


Source: Statistics Japan

As has been the case since the financial crisis, most major economies have been attempting to foster at least a baseline level of inflation. Many nations experienced brief periods of deflation over the past 10 years. The primary concern with persistent deflation is that it alters consumer behavior. Consumers become accustomed to prices going down. As a result, there is considerable incentive to defer the purchase of anything other than basic necessities as other items, particularly big-ticket items, will be less expensive in the future. As consumer spending is critical to the economic health of most industrialized nations, growth can be significantly dampened. Deflation has been most acute in Japan. As can be seen in Figure 4, deflation has been seen in Japan a number of times over the past decade and in some periods, it has been pronounced. However, inflation returned in October 2016 and has trended higher since.

In line with the prevailing deflationary environment, the Bank of Japan has maintained an extremely “easy” monetary policy. However, low interest rates had been a backdrop to the Japanese economy well before they were adopted by other nations in response to the 2008-09 financial crisis. The Bank of Japan had adopted a “zero” interest rate policy for its benchmark base rate as far back as February 1999. The intent was to stimulate the economy but the policy achieved limited success. Interest rates were increased incrementally to 0.50% in February 2007. As illustrated in Figure 5, rates were subsequently lowered to 0.0% again in October 2010. In February 2016, the Bank of Japan cut rates to -0.1%. Since then, there has been considerable speculation as to when the bank would be willing to reduce this stimulus. A stated 2.0% inflation target has been set. However, the timeframe for achieving this target is unclear as it was mentioned and subsequently pulled from the Bank’s announcements. In either case, compared to many other developed economies, considerable monetary stimulus remains in Japan.

Figure 5



Source: Bank of Japan

Currency

In addition to the economic fundamentals, Japan's political environment is also supportive. The re-election of Shinzo Abe as Prime Minister in October 2017 coupled with his party's retention of a "super majority" in the Japanese parliament's lower house point to an enhanced ability to pass legislation aimed at improving the nation's productivity. The Prime Minister's relationship with U.S. President Donald Trump has also helped insulate it against some of the more unpleasant rhetoric aimed at the United States' other trading partners. Even as an outright trade war may be averted, the yen has remained considerably weaker than the levels recorded at the end of the financial crisis. As well, the Canadian dollar has rebounded from the lows (against the yen) seen in mid-2016 when one Canadian dollar would buy less than 77 yen. The appreciation since then to recent levels above 85 yen per Canadian dollar gives Canadian investors more bang for their buck.

Figure 6

Source: U.S. Federal Reserve

Conclusions

- The Japanese equity market represents something of an anomaly having last established an all-time high almost three decades ago. There is no guarantee that it will establish a new high any time soon, but it is indicative of how out of favour the market has been.
- Recent volatility, corrections and general noise in the market can represent a material distraction and may discourage investors.
- Making use of professional advice will ensure a well-diversified portfolio and can help remove some of the emotion surrounding investment decisions.