Foreign Equities: Japan

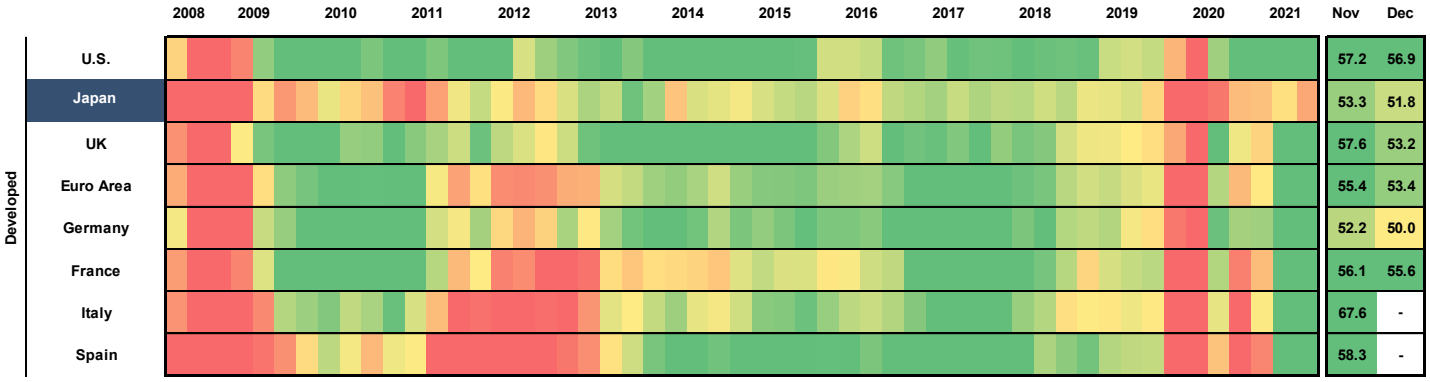
Quicktake: Japan is likely to see a re-acceleration in domestic activity this year, but we find the outlook for Japanese equities to be too reliant on assumptions of a reversal in consumer activity and sustainable strength in foreign demand to get too excited about early 2022 prospects. Second half prospects may improve as stimulus measures make their way through the economy. Fiscal and monetary policies remain highly accommodative and should help boost consumer activity and earnings projections. Additionally, any supply chain improvements will help support export growth. The risk of additional restrictions related to new covid variants, the propensity of the population to increase savings rather than spend, and weaker than expected export demand could thwart optimistic recovery efforts. We recommend an underweight and wait and see position for Japanese equities.

The covid driven decline in consumer activity has taken a significant toll on the Japanese economy. Compliance with strict activity restrictions has left Japan's recovery lagging behind other developed economies. GDP growth has failed to surpass pre-covid levels, but recent developments in fiscal policy and earnings projections support a more optimistic outlook for the second half of this year.

The fiscal outlook improved dramatically following the October 2021 general elections. Prime Minister Fumio Kishida's ruling party gained key representative seats which alleviated fears of a split government and revolving door of leadership. The outcome also paved the way for a seventy-nine trillion Yen spending package that includes support for business and sending checks directly to families.

Similar to the last global recession and recovery, Japan has struggled to keep up with DM growth rates

Global Composite (manufacturing & services combined) Purchasing Managers' Index, quarterly



Source: Markit, JP Morgan Asset Management

On the monetary policy front, the Bank of Japan (BoJ) has continued to promote easy money polices and has avoided the rate hike or QE tapering conversation. This year, the bank will be required to maintain bond purchases as the government seeks funding for fiscal spending measures. The BoJ has been the largest purchaser of government bonds since the QE program began, and is unlikely to relinquish this position any time soon. These highly accommodative fiscal and monetary supports are encouraging to the outlook for Japanese markets, but they will take time to work their way through the economy.

A sustainable recovery in consumer spending would support a bull case for Japanese equities. Japan has been in a long-term deflationary cycle which has led to a history of high savings rates. If inflation picks up and cash handouts encourage consumer confidence, we could see savings habits shift to

spending habits, but the timing and magnitude of such a shift is uncertain. Additionally, manufacturing and export activity make up a sizable portion of the economy. Global demand appears to be improving, but supply chain issues may have caused a short-term overshoot in recent orders. The potential for plateauing demand later in the year as inventories are replenished is a headwind to Japanese outperformance. The foundation for a rebound has been laid, but potential only goes so far. We would like to see how the first few floors of the building are coming along before entering in.

2700 Via Fortuna STE 100 Austin, TX 78746 • (512) 777-5900
5555 Glenridge Connector, STE 200, Atlanta, GA 30342 • (470) 552-5901
www.WaterlooCap.com