Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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Is Japan Back?

In the early 1960s, futurologist Herman Kahn boldly predicted Japan's economic dominance. He envisioned the nation surpassing the United States in per-capita economic output by 1990 and matching its total economic output a decade later. Kahn's vision seemed imminent, fueled by Japan's rise as a major exporter of autos and semiconductors. Japan's advantages stemmed from its relatively cheap labor force, weak currency, and lower borrowing costs, which gave Japanese companies a significant edge over their American counterparts.

Just as Japan appeared poised to realize Kahn's vision at the end of the 1980s, a series of setbacks plunged the nation into a prolonged economic slump spanning multiple decades. The yen surged, doubling in value against the dollar from 1985 to 1988, while decreased borrowing costs in the US eroded the competitiveness of Japanese exports. Concurrently, Japan's aging population exacerbated the existing challenges. Additionally, the country grappled with an insurmountable commercial real estate debt crisis, triggering a protracted period of asset deflation.

Decades later, Kahn's unfulfilled prophecies seem like a distant memory. Nevertheless, signs point to a genuine turnaround, with the Nikkei 225 recently reaching a new record high for the first time in 34 years — just the tip of the iceberg. The return of inflation, rising wages, and a modernizing corporate culture all suggest a more sustainable recovery. Japan's apparent reemergence is perfectly timed as investors seek alternatives to an increasingly insulated China and growing desires from the West to strengthen allies in the Indo-Pacific.

To assess the longevity of Japan's recent stock market swell, this report delves into its historical performance, including past periods of economic stagnation. We then examine recent changes within the country, particularly the initiatives designed to bolster corporate profitability and stock valuations. The report explores how the intensifying rivalry between the US and China has contributed to Japan's increased attractiveness to investors. Finally, we conclude by analyzing the potential market ramifications of this resurgence.

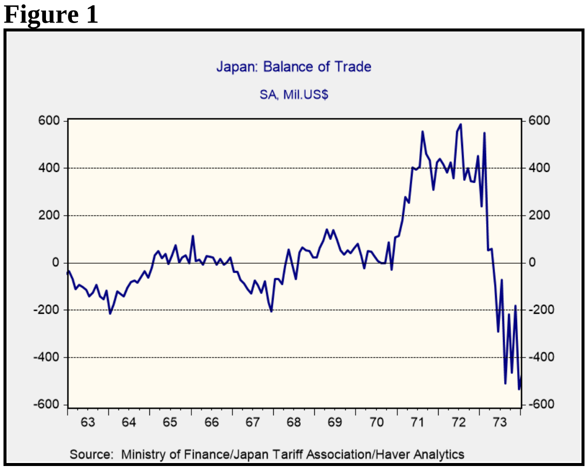
Transistors and Cars

Ravaged by World War II, Japan faced the daunting task of rebuilding its economy from scratch in the aftermath of the conflict. Recognizing the urgency of revitalizing its manufacturing sector, Japan embarked on a concerted effort with crucial support from the US. Together, they fostered the growth of pivotal industries such as semiconductors and automobiles, setting the stage for Japan's emergence as an economic powerhouse. However, as both nations surged forward, the dynamics of their partnership evolved into a competitive animosity.

After World War II, the US played a key role in shaping Japan's transformation into a stable democracy. Driven by the desire for a peaceful and prosperous ally, this initiative also aimed to revitalize the Japanese economy. The US supported Japanese industry and technological advancement by facilitating measures to open American markets to Japanese goods such as cars and semiconductors.

US policymakers underestimated Japan's industrial potential after World War II. They believed the US could focus on high-end goods while Japan filled the lower-end market. This miscalculation allowed Japanese firms to gain significant market share. For example, Japanese auto exports soared from 10,000 in 1961 to over 1 million by the early 1970s. Similarly, Japan was able to surpass the US in discrete transistor production by 1964.

Figure 1



The meteoric rise of Japanese firms caught US business leaders flat-footed. The country's exports started to surge, and by the 1970s, Japan was running large surpluses with the rest of the world. Facing intense competition, American automakers began to voice concerns about the uneven playing field. They pointed to alleged state support for Japanese firms, access to cheaper credit, and intellectual property theft as factors tipping the scales in their competitors' favor.

Strained relations between the US and Japan emerged as Japan's chip manufacturing prowess advanced. By the 1980s, tensions had escalated, culminating in a trade agreement that imposed quotas on Japanese chip and auto exports. To address the trade imbalance further, the Plaza Accord, signed in 1985, aimed to strengthen the yen against the dollar. Not only did this make Japanese goods costlier and less competitive in the US, but it also made US goods cheaper and more competitive within Japan.

The Bubble Bursts!

By 1989, Japan's economic and technological prowess had become undeniable, leading some to perceive that the US was declining in relative power. This sentiment was reflected in a collection of essays, categorized as business and economics, titled "The Japan That Can Say No" by Sony co-founder Akio Morita and Japanese right-wing politician Shintaro Ishihara. The book highlighted Japan's growing frustration with its subordinate role to the US and advocated for Japan to become more assertive.

During that era, a fervent belief gripped Japan: The nation stood poised to eclipse the US as the world's economic leader. Optimistic projections predicted that Japan's gross national product (GNP) would surpass that of the US by the early 21st century. This economic success fueled confidence among Japanese elites. They saw America's struggles — two decades marked by double recessions, high inflation, and foreign policy blunders — as the twilight of American dominance, which would pave the way for Japan's ascendancy.

Japan's overconfidence and its desire for greater independence from the US contributed to a series of strategic missteps. To comply with the Plaza Accord, Japan implemented measures to allow its currency, the yen, to appreciate against the US dollar.

The Bank of Japan intervened in the foreign exchange market by selling dollars and buying yen, effectively increasing the value of the yen relative to the dollar. This action was aimed at making Japanese exports more expensive and less competitive in international markets, thereby reducing Japan's trade surplus with the United States.

However, to offset the potential loss of exports caused by the strengthening yen, the government kept interest rates very low. This, coupled with the purchases of yen, led to a significant increase in the money supply and readily available cheap credit. This easy money environment fueled a rapid rise in asset prices, ultimately culminating in a burgeoning asset bubble in the stock market and commercial real estate. As a result, the Nikkei 225 Index rose nearly 200% over a four-year period from 1985 to 1989.

Figure 2

Deflation to the Pandemic

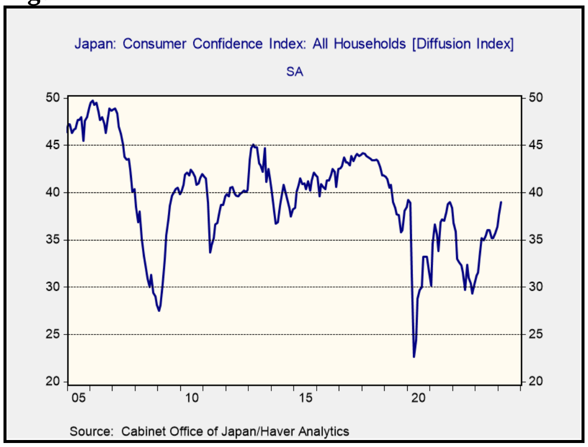
After Japanese stock prices reached their peak in 1989, it took a daunting 34 years to set a new record high. This prolonged period, often referred to as "Japan's Lost Decades," began when the Bank of Japan raised interest rates, triggering a sharp pullback in speculation. This, in turn, led to declines in land prices, the stock market, and corporate investment. The resulting economic stagnation, coupled with deflation, stemmed from a balance sheet recession where debt-burdened banks became hesitant to lend, which further hindered growth.

During Japan's Lost Decades, the government prioritized job security, leading companies to retain workers even as demand weakened. As a result, companies were forced to slash the prices of goods and services, while also restraining wage increases to stay competitive in a shrinking market. This fueled a decline in consumer sentiment as households adjusted to this shift by holding back spending, further exacerbating the deflationary cycle.

The belief that economic growth alone would solve Japan's financial system issues along with frequent leadership changes (prime ministers averaged two-year terms between 1990 and 2012) hampered economic recovery and created uncertainty for businesses and investors. This lack of direction made tackling the issue of non-performing loans on bank balance sheets a challenge. Public distrust of lawmakers, fueled by ongoing scandals, further hindered efforts to remedy the crisis.

To address the issue of bad loans, the government mandated bank audits, forcing them to identify and categorize non-performing loans. The transparency exposed the true state of the financial system. While some major banks were nationalized with public funds, essentially wiping out shareholder value, regulators allowed smaller, insolvent banks to fail. This selective approach aimed to preserve financial stability without a complete government takeover. Additionally, the Bank of Japan's return to a low interest rate policy, along with the rise in exports, helped stimulate the economy and pull Japan out of the crisis. However, the prolonged financial turmoil left a lasting impact on consumer confidence and spending habits.

Figure 3



Despite efforts by the central bank and government to revitalize consumer confidence, including the stimulative "Abenomics" policies of former Prime Minister Shinzo Abe, a significant shift only came about with the onset of the COVID-19 pandemic. The pandemic's unique economic forces triggered glimpses of optimism, suggesting a potential turning point for Japan. However, the long-term ramifications of these developments are yet to be fully understood.

The New Japan

In the aftermath of the debilitating banking crisis, Japanese policymakers turned their focus toward encouraging investment and restoring consumer confidence. A shared aspiration emerged to harness the passage of time since the financial upheaval and reemerge as a formidable global economic force. However, the realization of this optimistic vision proved to be a far lengthier process than Japan initially anticipated.

To revive the Japanese economy, the reforms targeted the country's powerful "keiretsu." These dominant companies, wielding significant economic influence, prioritized internal collaboration over shareholder value. This focus, while fostering loyalty and long-term planning, impeded broader economic goals in the short term. Dismantling these ingrained priorities has proven difficult as cultural change takes time. As a result, keiretsu companies often trade at lower valuations relative to their peers in the West.

At the same time, the government implemented expansionary fiscal and monetary policies. The Bank of Japan pursued an ultra-accommodative monetary stance, lowering borrowing costs for businesses and consumers and stimulated spending and investment. Concurrently, the government allocated increased funds toward infrastructure projects and provided tax incentives to businesses. Moreover, efforts were made to expand the workforce by integrating more women and immigrant workers into the labor market.

While these stimulus efforts helped mitigate the pandemic's economic blow, a substantial recovery only took hold in the years that followed. Among the positive signs now evident, headline consumer price inflation has finally surpassed the Bank of Japan's 2% target for two straight years, and the stock market recently hit a 34-year high. However, concerns linger about the sustainability of these trends.

Going Forward

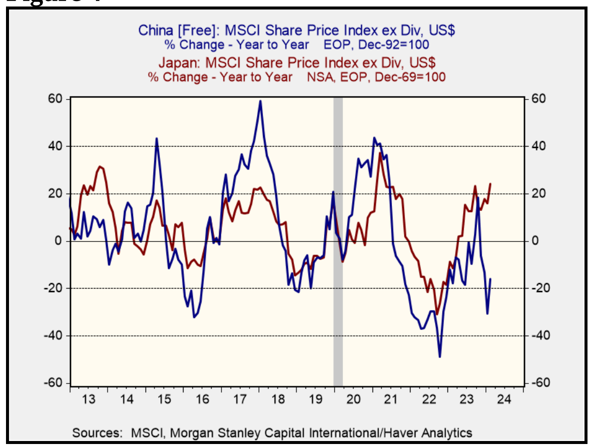
Buoyed by its economic resurgence, Japan finds itself in a prime position to breathe new life into sectors that have previously struggled with competitiveness. Against the backdrop of the intensifying rivalry between the US and China, coupled with Japan's burgeoning semiconductor industry, the nation has become an increasingly attractive destination for investors seeking to capitalize on the dynamics of Great Power competition.

In recent decades, Japan's grip on the global semiconductor industry has loosened dramatically. Its market share in semiconductors tumbled from a dominant 40% in the late 1980s to a meager 9% by 2022. This decline mirrored the rise of regional giants like South Korea and Taiwan, which now lead alongside the US. Policy shifts and stifling bureaucracy are widely blamed for hindering innovation and eroding Japan's competitiveness in this industry. Despite government efforts at revival, Japanese companies have slipped from the top ranks and the country no longer boasts chipmakers among its revenue leaders.

Now, however, due to intensifying US-China competition in artificial intelligence, Japan's semiconductor industry is experiencing a significant recovery (although it is still in the early stages). China, in particular, has become heavily reliant on Japanese chip-making equipment to fuel its domestic chip ambitions. Meanwhile, the US has sought to forge a supply chain alliance with Japan, South Korea, and Taiwan as it aims to fortify its strategic partnerships in semiconductor manufacturing.

In addition, China's economic slowdown has soured some investors' outlook on that country, making the Japanese stock market a more attractive destination. As the world's third-largest economy, with a broad and deep financial market, Japan offers a compelling alternative for investors seeking stability. This has resulted in a significant redirection of Chinese investment capital toward Japanese equities.

Figure 4



Market Ramifications

Japan's economic rebound shows signs of progress, but its long-term path is clouded by uncertainty. Despite a multi-decade high in wage growth, Japan's economic outlook faces a triple threat. Inflation exceeding the 2% target erodes purchasing power, while a resurgent China could lure investors away. Additionally, recent signs of moderating price hikes introduce further complexity, making it difficult to predict the long-term trajectory.

If Japan can maintain its current momentum, then it could become a magnet for value investors. The Tokyo Stock Price Index (TOPIX) currently trades at a price-to-earnings (P/E) ratio of just 15x compared to the S&P 500's P/E ratio of 25x. This lower valuation suggests Japanese stocks have more room for growth. Additionally, the BOJ's decision to end negative interest rates and yield curve control should benefit dollar-based investors in the long-run as tighter monetary policy will likely strengthen the Japanese yen against the dollar, further boosting returns.

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