

Is the sun rising for Japanese equities?



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COVID-19 and the consequent market volatility have had a huge impact on the Japanese economy. How will the situation affect the Japanese equity markets in the years ahead?

Equity portfolio manager Dickon Corrado shares his views on why Japan is well-positioned for the future.

Key takeaways

- Japanese firms are highly innovative and are global leaders in automation technology.
- Automation, the Internet of Things and cloud technologies are transforming manufacturing. Japan's shrinking and aging population may turn into a positive factor.
- Japan is a relatively resource-scarce island nation with companies that lead in energy efficiency and environmentally friendly technologies.
- Japan was slow to shift towards a digital economy, and there are opportunities in the catch-up phase.

Has Japan been successful at controlling the COVID-19 outbreak? Do we expect the coronavirus situation to worsen going forward?

What is so striking about the COVID-19 situation is the statistics in East Asia. The number of coronavirus cases has been relatively low in places like South Korea, Taiwan, Japan, Vietnam and other parts of China, outside the city of Wuhan.

In Japan, the total number of coronavirus cases is about half the level of the peak amount the US had in single days. One of the reasons the situation has been kept under control is that the Japanese are naturally good at social distancing. Japanese people normally greet each other by bowing instead of shaking hands, and hugging isn't part of its culture. Moreover, the Japanese wear masks regularly, especially when they are unwell. Hence as a society, Japan has been able to manage the outbreak without an extreme lockdown. I think the coronavirus situation in Japan will likely be short-lived.

What is your outlook for the Japanese economy?

The Japanese people can be highly innovative but may lack in creativity as they see the world generally in literal terms. Taking the Shinkansen (Japanese bullet train) as an example - it sticks to a schedule and always leave on time, to the minute. Rail companies' internal schedules take this to an even higher level, where processes are down to the second. This demonstrates a literal application of precision timekeeping.

And because of this literal way of thinking, the Japanese may not be as adept in abstract thinking, including in finance. At times, the Japanese government would pursue financial and economic policies that may not be effective. One example of literal thinking is when the government attempted to fund its social security costs by increasing the consumption tax. But this direct way of problem-solving may instead stifle demand, which is needed to beat deflation.

The upside to such mindset is that the Japanese culture is good at innovation, taking something that exists and then making it better (versus creativity, which involves the use of imagination to create something new). They do that through long periods of intense focus, which is an area that sets Japan apart from most other countries. This is why some of the most innovative companies in the world are found in Japan.

The most interesting transition I witnessed in Japanese manufacturing was when vision sensors were added onto robots over 10 years ago. The movements of the vision-enabled robots were very slow when they first started. Over the years, they became faster and more accurate. Factories that use these technologies can operate 24 hours a day without stopping. This is because the robots do not get sick or take coffee breaks; they do not need to go home or require pensions. Such efficiency cannot be achieved with a human worker.

In recent years, some Japanese companies have been using cloud technology to develop their own fog-based systems¹ where, through leveraging big data and machine learning, robots can teach other robots within the same factory the best movements to perform a particular task. The next step, I think, will be for robots to teach each other across different factories around the world. After my visit to a Toyota plant in Nagoya, it became clear to me that all the steps in automobile production can be automated. In the future, cars can be manufactured with just the push of a button without human interactions during the production process.

Based on United Nations' projections², the world population will increase from today's 7.8 billion to around 9 billion in 2037 and close to 10 billion in 2050. The rate of growth may be slowing, but the total global population is still increasing. Traditionally, agriculture and manufacturing could absorb many people and provide employment, but production in both of these industries is becoming automated at an accelerating pace. Many emerging markets have attractive population pyramids and possibly a big demographic dividend in their future, but the reality may be different. It could turn into a demographic tax as there may be just too many people with not enough jobs to provide for them.

Japan, paradoxically, is fairly well prepared for this world. The last 20 years have been difficult as its working age population peaked in 1997, and GDP growth has been almost negligible since. Going forward, however, having neither a large population nor a growing working age population may work to Japan's advantage with the help of automation and manufacturing technologies.

1. The fog extends the cloud to be closer to the devices that produce the data. Analysing the Internet of Things data close to where it is collected (e.g. on a factory floor) minimises latency (the time lag it takes two machines to communicate with one another) and offloads gigabytes of network traffic from the core network. Fog computing is a term coined by Cisco. Source: Cisco Systems, Inc.
2. World Population Prospects 2019. Source: United Nations, Department of Economic and Social Affairs, Population Division

Factories may move back to Japan as it could be less advantageous to look for lower labour costs overseas - the Japanese economy may then be supported to a degree. The potential robot tax in Japan, which may appear to be a heavy demographic tax for the country, could also turn out to be a blessing in disguise.³ Those are the things I keep in mind when I think about the outlook for the Japanese economy over the next 10 to 15 years.

For many years, Japan's equity market has struggled to keep up with those in other developed markets. What could make an allocation to Japanese equities meaningful today?

Japan is relatively well positioned for the world⁴ we are going into given its preparedness and technological advancement discussed earlier. The big transition from analogue to digital has been happening for a long time, but now technology is accelerating.

On top of the change that we may see in robotics, sensors and the impact of the cloud, Japanese workers are uniquely skilled at precision manufacturing as a result of their craftsmanship tradition and the attention to detail. Their ability to focus on one area for years or even decades is something that is difficult to find in other workforces. This positions them very well for helping to create the infrastructure that are needed moving towards a more digital world.

Another factor is that Japan has had to be very efficient as it inhabits on a relatively resource-scarce island. As a result, many companies in Japan grow to become leaders in energy-saving and environmentally friendly technologies - both of which are increasingly important for the rest of the world as the environmental problem we face today could become a bigger challenge as we move towards a 10-billion population world.

Looking ahead, will the information technology sector in Japan outpace other sectors such as health care, retail and machinery?

It is interesting when you are looking at, for example, payment companies in Japan. Japan has always been a 'high cash' society - the country advocates against the use of credit cards, with messages that say credit cards and credit card debts are dangerous. Hence credit card penetration is very low in Japan, and it makes the transition from cash to digital payment easier.

In countries like the US and South Korea where credit card penetration is high, people are much slower at switching to digital payments - the habits and preferences that have been established over a long period of time make it hard to switch. China, another cash society like Japan, has already moved to digital payments. In Japan, the shift in digital payments is only just beginning and has the potential to turn into a megatrend.

Another area of potential is in information technology services - Japan is currently many years behind in terms of investments in this space, which makes it attractive as it catches up with the rest of the world.

3. As companies gradually replace the labour force with machines, some have called for a robot tax to offset the loss of income tax revenues from displaced workers. The tax revenues from robots can then be used to reskill the unemployed, provide a universal basic income or fund society's needs in areas like health care and education.

4. OECD estimated that 14% of jobs in the world could be automated, while 32% are likely to change significantly. OECD Employment Outlook 2019: The Future of Work. Source: Organisation for Economic Co-operation and Development (OECD)

Japan, despite its economic difficulties, is essentially a stock picker's market. It is a place where deep, fundamental research and long-term thinking can help identify the eventual winners.

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