CAPITAL GROUP℠

Q&A

With portfolio managers
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Japanese equities: What the future holds after the pandemic

Japan faces many headwinds as it battles COVID-19 alongside other challenges unique to itself. Bright spots can still be found, however, amid the economic storm.

In this Q&A, the co-principal investment officers of the Capital Group Japan Equity strategy put into perspective the road ahead for investing in Japanese equities.

Given the heavy impact the coronavirus has on Japan's economy, what is your outlook for the Japanese equity market?

Seung Kwak: Japan experienced a very sharp downturn in recent months (April and May) due to lockdown restrictions that were introduced to contain the spread of COVID-19. But the COVID-19 situation is beginning to normalise in Japan with fewer new cases per day (below 100 confirmed cases per day since the middle of May[1]). Given that the pandemic appears to have peaked in Japan, economic activity is expected to gradually recover and many investors have pre-empted this recovery.

In addition, strong liquidity injections (funding operations by the Bank of Japan) and fiscal stimulus measures (¥234 trillion of stimulus spending this year[2]) have

1. Data as at 2 June 2020. Source: World Health Organization.
2. Data as at 11 June 2020. Source: Bloomberg

also helped to ease economic concerns and drive investor sentiment. The combination of these different push factors has prompted the market to recover ahead of earnings, which are still being revised downwards. However, I do expect earnings to bottom-out in the coming months alongside the resumption in economic activity.

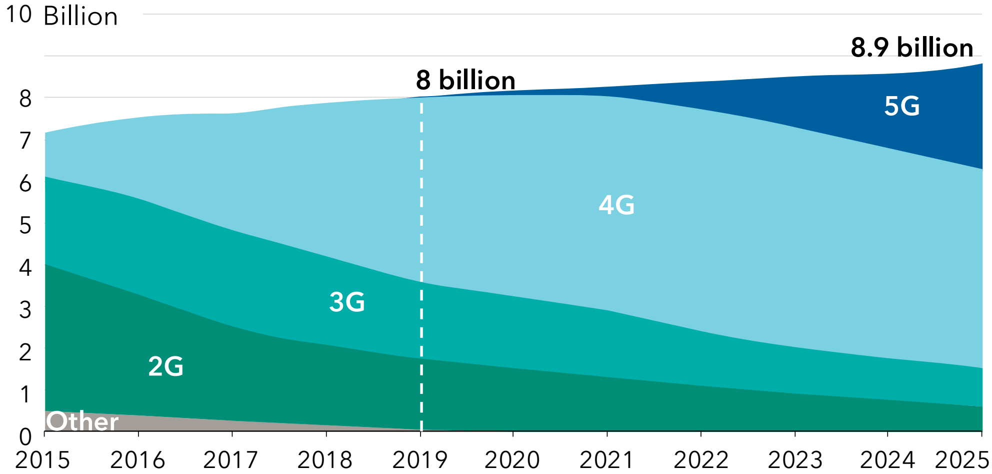
The TOPIX has gone up by more than 11% in April and May[3]. But even if you look at the situation over a longer timeframe, Japanese equities have proven to be one of the more resilient markets globally amid the COVID-19 downturn. Year-to-date (end of May), the TOPIX was down less than 8%[3]. In terms of valuations, Japanese equities are currently trading close to their historical low with an average price-to-book ratio of 1.2×[4], which can present very good risk-return opportunities for investors.

Akira Horiguchi: I think that conditions leading to deflation could persist in the current environment[5], as domestic demand is particularly challenged at the moment in the face of the coronavirus crisis. But domestic demand has less of an impact on the Japanese equity market than global demand.

Some things remain unchanged despite the market conditions. These include the technology war between the US and China on 5G, and the competition within the semiconductor space to meet the demands of an ever-connected world. These are the areas where Japanese companies could play an important role as what I call "key technology-enablers". These companies make up a sizable portion of the Japanese equity market and they are crucial for the global economy in that their products and services contribute to the digital transformation we see in the world. Looking from this perspective, one should be able to see the bright side of the Japanese equity market.

5G adoption could account for nearly 30% of total mobile subscriptions in five years' time

Mobile subscriptions by technology



For illustrative purposes only.

As at November 2019. Other includes: TD-SCDMA (3G) and CMA-only (2G/3G). Internet of Things connections not included. Sources: Ericsson and GSA

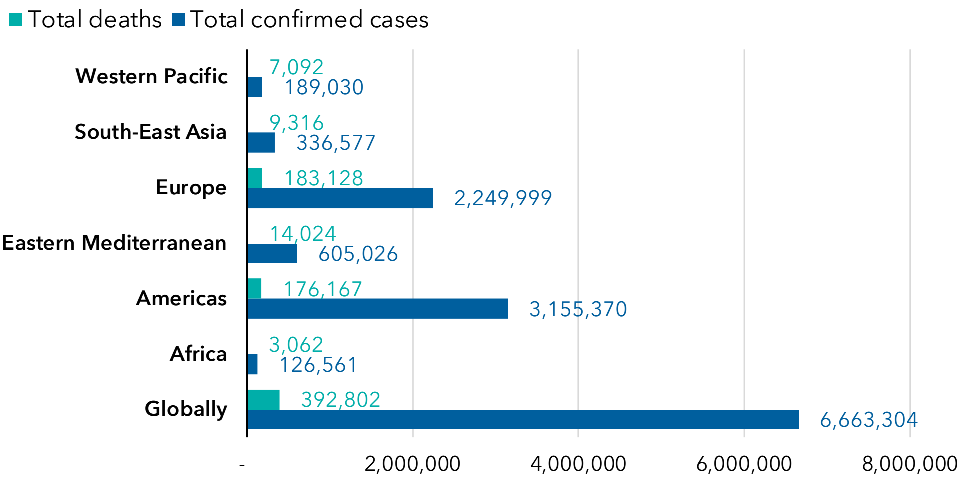
3. Source: Tokyo Stock Price Index, RIMES
4. Valuation is based on TOPIX data as at 29 May 2020. Source: Bloomberg.
5. Japan's core consumer prices fell 0.2% in April 2020 compared to a year ago, its first negative reading in more than three years. Source: Statistic Bureau of Japan

Investor sentiment seems to have picked up recently alongside the gradual resumption in economic activity. However, are there any potential risks that you believe shouldn't be overlooked?

Seung Kwak: I think there are still several downside risks that we should be on the lookout for. First is the possibility of a second wave of new COVID-19 cases especially as we enter the autumn and winter seasons. This is going to be critical because a large part of the recent recovery is based on the assumption that economic activity will improve, which, in turn, hinges on how well COVID-19 is being contained. It is fair to say all bets would be off if Japan experiences a second wave of COVID-19 cases and lockdown restrictions are put in place again. The silver lining here would be if the world is able to achieve a breakthrough in the large-scale commercialisation of COVID-19 vaccines.

The world braces for the possibility of a second wave of coronavirus infections as lockdown measures ease

COVID-19 situation in numbers (by WHO region)



Coronavirus disease (COVID-19) Situation Report – 138. Data as received by WHO from national authorities by 10:00 CEST, 06 June 2020. Source: World Health Organization (WHO)

Another risk is the growing tension between the US and China. The US has launched an aggressive campaign against China in recent months, denouncing and blaming them for the spread of COVID-19 globally. This brewing political tension is something investors should be aware of especially since there are related episodes (restrictions on US companies doing business with Huawei) occurring concurrently. I believe political tensions between the two countries are likely to be strained in the run up to the US presidential election this autumn. It would not surprise me if there were further rhetoric or policy moves by the US against China in the next few months. It also would not surprise me if China decides to retaliate, which could add to market volatility.

Akira Horiguchi: There are a few considerations needed to invest in the current market environment. In this new world, there are companies that will be able to benefit and thrive, as well as those that have been hurt or will be damaged once the pandemic is over. Given that an index is a collection of those different aspects, one will be exposed to both the good and bad by investing in the index through passive strategies. Differentiating between the potential winners and losers requires in-depth fundamental research.

Another point to consider is that headline valuations of countries should not be compared without taking into account their respective industry mix. For example, investors looking at a Japanese equity index may find that its headline valuation is cheap compared to a US equity index. But that should come as no surprise because the heavyweights in the S&P 500 Index, for instance, comprise some of the largest companies in the world, such as Microsoft, Apple, Amazon, Facebook and Alphabet. The stock market index in Japan, however, has 'old economy' businesses among its top holdings, including banks and automotive manufacturers. Despite this, the strong balance sheet nature of Japanese companies could add to the attractiveness of Japanese stocks in terms of valuation. Uncovering investment opportunities in these companies, again, requires bottom-up research.

Lastly, it is important to understand the connection between the Japanese equity market and the global equity market. Because of the dependency and link to the global market, the Japanese economy, which lacks domestic demand drivers, is particularly vulnerable to external factors like the troubling trade relations between the US and China.

How have recent developments affected business and consumer behaviour?

Seung Kwak: Many companies have implemented 'work from home' policies in order to keep their business running during lockdown. Some of these practices are likely to continue even after the pandemic eases – such as partial work from home arrangements, more teleconferencing, fewer business trips, higher hygiene awareness and greater emphasis on social distancing. The shift towards a more flexible working culture and structure is a long-term trend that predates COVID-19. The outbreak has accelerated this development and moved forward the expansion of the digital economy. In all probability this will have a massive impact on everyday life because once a person gets used to shopping online, for example, the convenience factor is likely to entice them to return even after COVID-19 is over. Such behavioural changes are likely to have a significant impact on businesses and therefore investments.

When it comes to growing US–China tensions, one particular event I'm closely following would be the possibility of further US sanctions. Currently, the business restrictions are still mostly confined to technology giant Huawei. But as tensions increase, it is certainly possible that sanctions could be extended to other Chinese firms within the tech space, such as semiconductor manufacturers, or even across a number of other industries. The world's two largest economies are currently in the midst of a political, economic and technological rivalry, and any fallout could potentially have a huge impact on global supply chains.

Depending on which side of the fence a Japanese company is sitting on, this could be either a positive or a negative development. On the positive side, if the US does indeed introduce broader restrictions on its companies to do business with Chinese firms, many Japanese companies could potentially serve as a substitute and provide China with the relevant products, components, services or technologies.

Because many Japanese companies are positioned across different parts of the global supply chain, any business or trade restrictions from either country will have an impact on the businesses of these companies.

Akira Horiguchi: In Japan, one cannot rely too much on the public pension[6], which may not be sufficient for retirement. That said, Japanese people have a saving habit that started long before the pandemic and is deeply ingrained into the Japanese culture. Savings in Japan are largely skewed towards the older generation, as opposed to the younger generation.

I think the savings trend in Japan could be reinforced even more due to the coronavirus experience, especially for households and small- and medium-sized companies, which have been experiencing very tough times. In contrast, the already cash-rich major companies may not see the need to save more.

This contrasts with the saving mentality of individuals and corporates outside of Japan. In the US and Europe, corporates are accustomed to the use of financial leverage and also at times they engage in share buybacks that can be excessive. Some of their balance sheets may not be as strong as those of Japanese firms. Similarly, consumers in the US, for example, tend to rely on credit.

I think after this experience with the pandemic, households and corporates everywhere may consider saving more for the future. A shift from borrowing to saving will not have a positive impact on the global growth rate, which can in turn impact the Japanese economy.

Should investors be worried about dividend cuts?

Seung Kwak: Relative to their global peers, Japanese companies have come into the COVID-19 crisis with strong cashflows and balance sheets. Japan-listed companies paid out US$85.7 billion of dividends in 2019, which is significantly lower than other key markets[7]. As a result, Japanese companies have a lot of internal reserves that could protect their ability to pay dividends. That is why many Japanese companies have continued paying dividends during this recession and we have not seen the same high-profile dividend cuts occurring as elsewhere in the world.

To put Japan's dividend growth prospects into perspective, it is one of the few markets in the world that recorded dividend growth in the first quarter of 2020 alongside north America (see table below). Within our portfolio, we focus strongly on cashflows and cash reserve positions to identify companies that can protect and grow their dividends even during troubled times.

6. Japanese from age 20 to 59 participate in the public pension system called the National Pension, which provides basic pension benefits for old age, disability, or death. Source: Japan Pension Service
7. Based on total amount of dividends paid out by companies listed in their respective markets in 2019. Source: Janus Henderson Global Dividend Index report, edition 26, May 2020

Annual dividend growth rate in Q1 2020

Adjustments from underlying to headline dividend growth, by region

Region	Underlying growth	Special dividends	Currency effects	Index changes	Timing effects	Headline dividend growth
Emerging Markets	12.6%	-2.8%	-2.1%	-5.9%	-8.4%	-6.6%
Europe ex UK	0.8%	-8.5%	-0.3%	0.1%	-2.2%	-10.3%
Japan	4.0%	1.0%	1.1%	-1.3%	0.0%	4.8%
North America	5.6%	8.0%	-0.1%	0.3%	-0.2%	13.7%
Asia Pacific ex Japan	-0.8%	-8.3%	-5.3%	1.1%	0.0%	-13.4%
UK	0.8%	-12.7%	-1.1%	2.6%	0.0%	-10.4%
Global	4.3%	1.1%	-0.8%	0.1%	-1.1%	3.6%

Past results are not a guarantee of future results.

Headline dividend growth: Refers to change in total gross dividends. Special dividends: Refers to one-off payouts made by companies to shareholders that are declared to be separate from their regular dividend cycle. Underlying growth: Refers to headline dividend growth adjusted for special dividends, change in currency, timing effects and index changes. Source: Janus Henderson Global Dividend Index report, edition 26, May 2020

Looking further forward, dividend policies are part of the Japanese government's efforts to enhance corporate governance. While we have seen decent progress since the enactment of the corporate governance code several years ago, the current economic downturn has prompted some companies to revisit their payout policies. A key topic of discussion right now is whether companies should be fully following the Anglo-Saxon model – which is to pay out most of their earnings. As we are seeing now, the downside of the Anglo-Saxon model is that it leaves companies vulnerable during a crisis. For example, defaults and corporate bankruptcies have increased sharply in the US because of liquidity issues. However, what has not changed is the need for Japanese companies to improve their asset profitability, better manage cashflow convergence cycles and generate a higher return on equity. Japanese companies are not likely to deviate from this course.

Akira Horiguchi: The dividend situation we see in the US and Europe is different than in Japan. For instance, in France some companies have received grants and subsidies from the government to support the labour force. And that is one of the reasons those companies are under pressure to withdraw or withhold dividend payouts, because otherwise they will be paying dividends to benefit global shareholders, using aid they received from the government that was intended to help employment.

In Japan, however, there is no such pressure. Instead, the Japanese government has been encouraging companies to pay dividends even in the current environment. Dividend yields in Japan should be sustainable in general, given the huge cash reserves held in Japanese companies.[8] In the regular

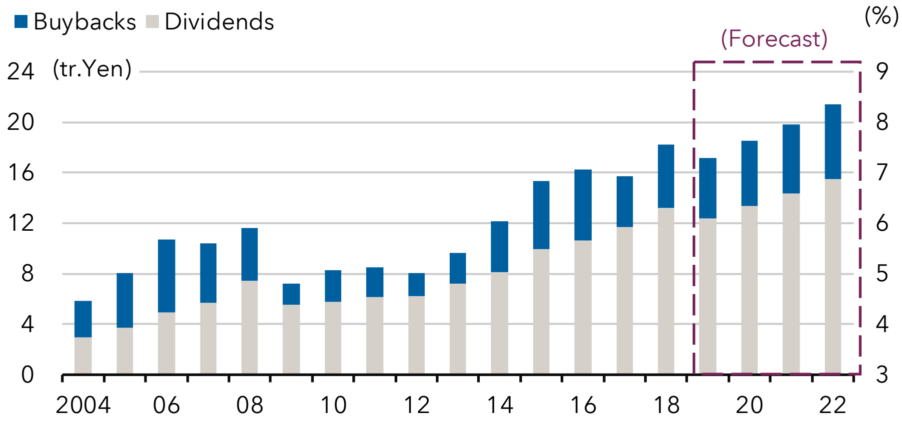
8. Listed companies in Japan held a total of ¥506.4 trillion in cash based on filings compiled by Bloomberg as of 3 September 2019. Source: Bloomberg

conversations we have with companies' management, we regularly discuss appropriate levels of dividends.

Dividends may be important but having a strong balance sheet and a healthy cash position are also key, particularly in this challenging period when earnings could fall. I pay attention to unique intangible assets such as brand and company culture. These are important values that are not visible on the balance sheet.

Japan making headway with governance and shareholder returns

Share buybacks and dividends of Japanese companies



Forecasts shown are for illustrative purposes only.

As at 15 January 2020. Data for 2019–2022 based on earnings-per-share growth forecasts from Bloomberg. For illustrative purposes only. Sources: Capital Group, Bloomberg

How are you investing in the current investment climate, and what are some of the investment opportunities you're seeing?

Seung Kwak: My investment style is to try and look at a company's future value typically within a three- to five-year horizon. In this current market environment, I'm seeing pricing inefficiencies in economy-sensitive and cyclical industries, such as industrials and automotive. I have been adding to several stocks in these areas since March. Many investors are worried about the possibilities of a second wave of COVID-19 cases and further downward earnings revisions, but from a valuation perspective, many of these companies are trading close to historical lows, yet their earnings prospects on a three-year basis are much brighter than their current valuations suggest.

The COVID-19 rebound in April and May was led by China and then subsequently Taiwan and Korea. Japan is now following suit with a limited number of new cases. Consequently, I have been looking closely at several Japanese companies with not only strong brand presence in Japan, but also China and the broader East Asia region, that stand to gain as the region slowly reopens from lockdown restrictions.

The third area I am looking at are companies that could benefit from the increased demand for work-from-home solutions as well as IT infrastructure. This includes firms such as NetOne Systems and OBIC – all of which are highly intertwined with the surge in domestic IT infrastructure and software spending, which is likely to see continued growth in the coming years.

Akira Horiguchi: In the current time, I prefer simple businesses and would avoid conglomerates, especially those with complicated structures. A conglomerate with hundreds of subsidiaries may be hard to manage in the current complex world given the exposure to many different markets. All it takes is for issues like corporate governance and weak demand to surface in just a handful of subsidiaries, and the valuation of the entire organisation will be dragged down. A situation like this is not hard to imagine for a Japanese conglomerate during the current market environment.

Apart from having an easy-to-understand business, I find it important for management to operate in an agile and flexible manner and be able to use technology to navigate the economic storm. Based on my experience, these traits are typically prevalent among founder-owned companies in Japan.

Companies that could enjoy several tailwinds despite the challenging environment include Shin-Etsu Chemical, which is the world's largest producer of semiconductor silicon and polyvinyl chloride (PVC). Volatility also leads to opportunities, for example one Japanese electronics and semiconductor company traded for a time at an attractive share price discount. In contrast the outlook for rail companies has become less attractive as people limit their travels in the current time.

There are many megatrends shaping today's world. The one that I have been paying increasing attention to is the global trend of connectivity. I hold companies that are expected to benefit from expansion in physical and/or virtual connectivity, and I think this megatrend will continue to grow in the long term regardless of the coronavirus situation. Ideally, they should have strong pricing power, supported by a dominant position in the industry, a strong brand, or an ability to produce their products at the lowest cost.

Seung K. Kwak *is an equity portfolio manager at Capital Group. He has 35 years of investment experience and has been with Capital Group for 17 years. Before joining Capital, he served as the Chief Investment Officer-Japan and the lead portfolio manager for Japan portfolios for Zurich Scudder Investments. He holds a master's degree in international relations from Yale University and a bachelor's degree in philosophy from Middlebury College. He also holds the Chartered Financial Analyst® designation. Seung is based in Tokyo.*

Akira Horiguchi *is an equity portfolio manager at Capital Group. Akira has 26 years of investment experience and has been with Capital Group for 19 years. Earlier in his career at Capital, Akira was an equity investment analyst and covered Japan as a small- and mid-cap generalist. Prior to this, Akira was an investment manager of Japanese equities with Gartmore Investment Management Japan Ltd. Before that, he worked with MeesPierson Capital Management Japan Ltd. He holds a bachelor's degree in economics from Tokyo University. He is also a chartered member of the Security Analysts Association of Japan. Akira is based in Geneva.*

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