NOMURA

Japan Equity Outlook 2021

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Summary

- The rolling out of an effective Covid-19 vaccination programme promises a gradual return to normal for the economy and the corporate sector.
- Even so, equity markets could see heightened levels of volatility in 2021, particularly after the strong gains of recent months.
- A new administration in Washington DC could pave the way for better relations with China, which would boost the prospects for many Japanese companies, most notably exporters.
- Japanese equities are attractively valued relative to historical prices and those currently on offer in other major global markets.
- Over the long-term, we believe continuing improvements in the governance structures of companies will remain a key driver of share prices in Japan.

Reflections on 2020

2020 proved to be a roller-coaster ride for Japanese equities, just as it was for markets all around the world. Having begun the year on a positive note, share prices fell dramatically in March, reacting to the rapid, global spread of the coronavirus pandemic.

Yet Japanese equities began to bounce back later in that month and, along with many others, gained momentum through the spring. Sentiment was boosted by the strong response to the virus by governments around the world, which consisted of major injections of liquidity by monetary authorities, as well as massive fiscal stimulus packages.

While this rally ran into resistance in June, as global investors suffered bouts of nervousness, the mood had brightened by August as they took heart from better-than-expected corporate earnings. Reported numbers by Japanese companies showed that a widely expected slump in revenues during the quarter had been mitigated by cost containment efforts.

Even the sudden resignation of Prime Minister Abe on health grounds at the end of August met with a muted market reaction, as his successor, former Chief Cabinet Secretary Yoshihide Suga, was seen as the continuity candidate, who would maintain the policy direction. He took office on 16 September.

The rally in Japanese equities finally stalled in October, but the bulls returned as soon as concerns over the US Presidential election eased. Additional boosts included rising hopes for an imminent Covid-19 vaccine and expectations that the accommodative monetary stance of the world’s central banks would continue.

The latest quarterly results from Japanese companies also pointed to a bottoming out of their earnings decline.

All this combined to see international investors returning to Japan, having been big sellers for most of the year.

Outlook for 2021

The news of highly effective results in the final-stage trials of two major vaccines helped push global stock markets to new highs at the end of 2020. While both vaccines present distribution and logistical challenges, the breakthrough represents a significant step towards overcoming Covid-19 – and returning to normal.

However, before we get back to "normal", we believe there are some obstacles that may lead markets to revisit at least some of the volatility we saw in 2020.

In the US, President-Elect Biden may struggle to implement a major stimulus package, thanks to a divided Congress. But if he takes a more co-operative and conventional approach to trade and international diplomacy, which is widely expected, there are many advantages for the global economy in the longer term. Specifically, we believe the easing of tensions between the US and China could indirectly benefit Japanese exporters.

Focusing on the Japanese economy, numbers have been improving since the summer. The latest releases have also pointed to a continuation of this trend, signalling the potential for an early normalisation of business conditions. It is worth noting that Japan's real GDP growth rate of +21.4 % (qoq, annualised) in the third quarter was well ahead of expectations.

Japanese corporate earnings are also finding their feet. Despite falling 14.8% on the previous year in the second quarter of 2020, the 59.1% rebound in recurring profits of listed companies over the next three months was impressive.

Whilst the earnings in some domestically-oriented industries continue to lag, manufacturing sectors, such as automotive and machinery, have rapidly improved, helped by a swift recovery in China. On balance, the worst impact of the pandemic on earnings seems to have passed, and we believe the Japanese corporate sector could rapidly regain its former profitability as the global Covid-19 inoculation programme gathers pace.

The Japanese equity market is currently trading on a price-to-book ratio of 1.34[1] with an earnings yield of 3.53% and an expected dividend yield of 2.0%. This is well above the 0.03% yield on the country's ten-year government bonds, and, after factoring in the expected recovery in corporate earnings, we believe this valuation is justified.

This time last year, the 12-month TOPIX index earnings-per-share forecast was around JPY130. Looking forward, if earnings recover to those levels, the TOPIX index could comfortably trade at 9% higher than its current level and still be on a reasonable price-to-earnings ratio of 15x.

As we enter 2021, it is important to note that we are basing our positive long-term outlook for Japanese equities on more than current valuations. Pressure from shareholders to raise returns is likely to improve overall corporate governance and be a key driver of Japan-listed company performance over the long term.

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[1] Source: Nomura Research Institute, based on the TSE First Section) – valid for all figures in this section.

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