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SUMMARY

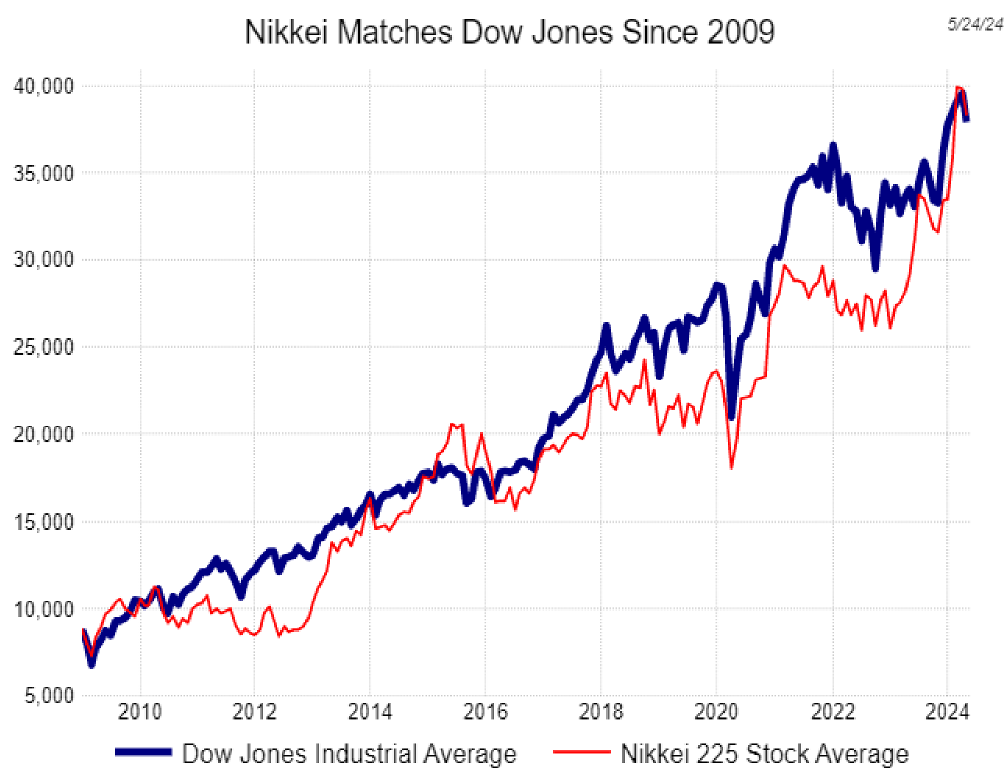
- Japanese equities have finally surpassed the previous high set in 1989.
- 1980's rally driven by excessive optimism; current rally driven by profit growth and a weak yen.
- We believe the case for Japan now compelling, given cheap valuation, strong earnings.

DATE 05.29.2024

Japan: A Stealth Bull Obscured by a Weak Economy and Currency

Today's Japan Story Not a 1980s' Rerun

The Nikkei 225, Japan's oldest stock index, recently surpassed the 40,000 level. This is quite a milestone as it has taken 34 years to break above 39,000, its previous high made in December 1989. This makes it one of the longest bear markets for any major stock index in post-WWII history. While a 34-year bear sounds terrible, it might surprise many to realize that, excluding dividends and ignoring currency effects, the Nikkei has managed to keep up with the Dow Jones Industrial Average index since 2009. What's more surprising is that this period encapsulates one of the best 16-year periods for US stocks, as shown in Chart 1, below. However, as we will show, this comparison is somewhat misleading.



Source: LSEG Datastream, RiverFront. Data daily as of May 24, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. Not indicative of RiverFront portfolio performance.

Looking closer at the rise in the Nikkei's price, we believe that it has been driven by two major factors: Japan's export-oriented companies being boosted by a weaker yen, as well as by an increased focus on corporate efficiency. The first factor is a double-edged sword for US investors, as the yen depreciated by over 40% over the same period. However, the improvement in profitability, coupled with the opportunity to buy Japan at cheap stock and currency prices, is now much more compelling than it has been, in our view, both relative to its own history and comparing Japan to other similar markets.

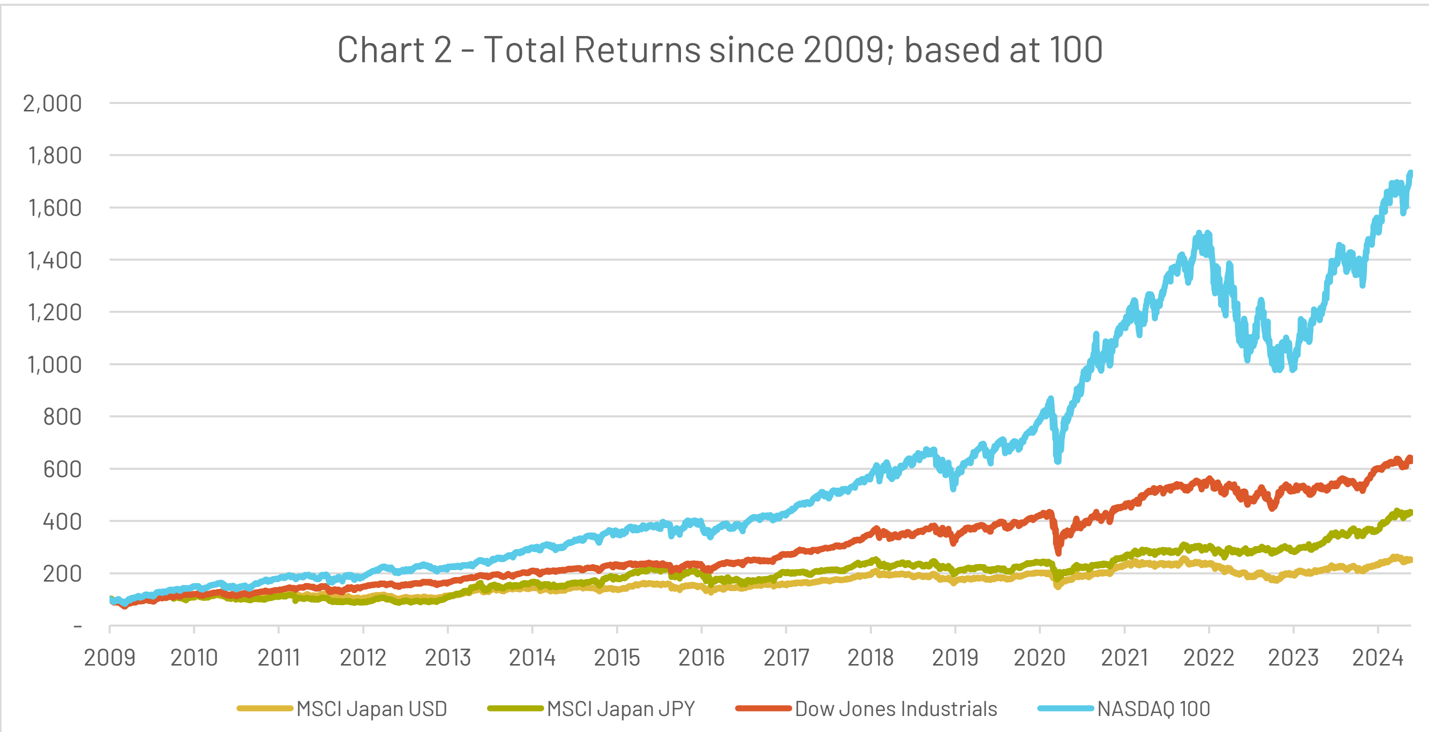
1980's Japan Was a 'Hare'...

In the 80's, the Japanese stock market experienced fast acceleration off the starting line, much like the proverbial hare. It took just 5 years for the Nikkei to increase from 9000 at the beginning of 1984 to 39,000 by the end of 1989. From an economic perspective, Japan was a dominant and growing supplier of automobiles, consumer electronics, semiconductors, and industrial machinery. In contrast to the last 15 years, US investors saw especially strong returns, as the yen also rose 75% relative to the US dollar over the same period.

However, the rise in stock prices far exceeded any fundamental improvements, in our view. Declining interest rates added fuel to the fire, providing liquidity to a speculative boom in both real estate prices and stocks. Eventually, Japan's economic competitive advantage proved unsustainable, as other Asian economies quickly created clones of Japanese businesses. These declining fundamentals ultimately caused Japanese equities and the economy to collapse, leaving a country already saddled with poor demographics with massive amounts of debt as well. As a result, Japan was relegated to two decades of listless performance. Just like the story, the hare's pace was unsustainable.

...But Since 2009, Japan More Like the 'Tortoise'

Since 2009, returns to US investors from Japanese stocks - taking Yen weakness into account - have been more reminiscent of the proverbial 'tortoise', growing only 6.2% per annum. Thus, the rise in Japanese equities since 2009, while impressive in Yen terms, has been more of a slow burn with much less fanfare in US dollars. There are several reasons for this, illustrated in Chart 2, below:

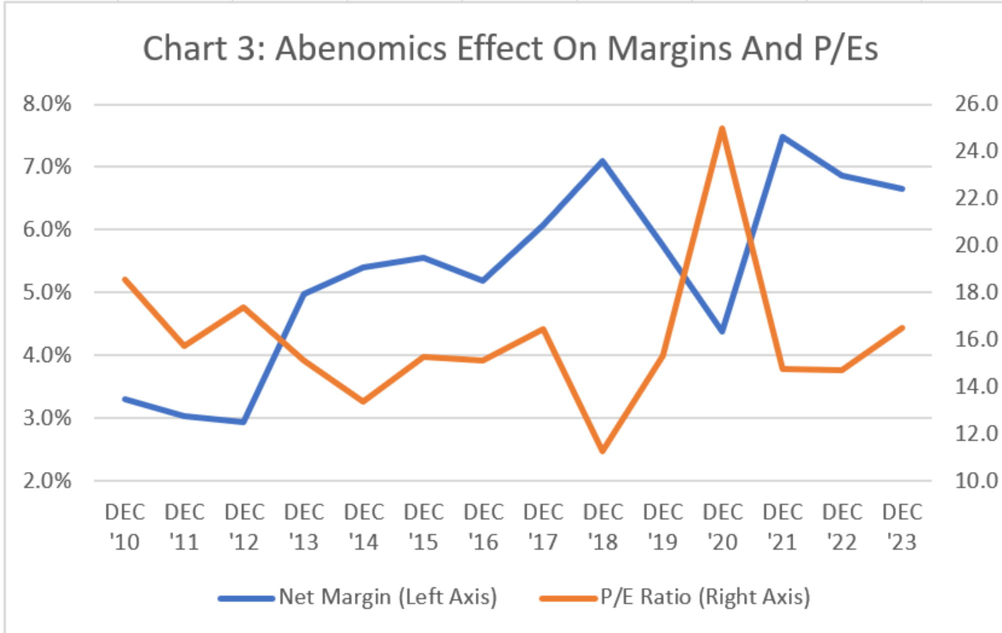


Source: FactSet, RiverFront. Data daily as of May 23, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. Not indicative of RiverFront portfolio performance.

1. Japanese equities tend to have much lower dividend yields – this is one of the reasons why there is a significant total return performance gap between the MSCI Japan and the Dow.

2. While Japanese stocks were up 333% in local terms on May 23, 2024 (see Green Line in Chart 2, above), US investors ended up with a much paltrier 151% (see Yellow Line in Chart 2) due to Yen weakness.

3. Japan and every other major index in the world were overshadowed by the growth in earnings that came from US Technology leaders that dominate the Nasdaq 100, as well as the higher multiples awarded to those earnings. The more common Index we use for US Large Cap equities, the S&P 500, has a much larger weight in these high growth themes than MSCI Japan or the Dow.



Source: FactSet, RiverFront. Data annually as of December 31, 2023. Chart shown for illustrative purposes only. Past performance is no indication of future results.

As to the macro reasons for underperformance, we see a mixed picture. One thing that has continued to hang over Japan is persistent deflation, which has contributed to Japan having an exceptionally high debt to GDP ratio – it currently sits at over 200%. This combination has necessitated 0% interest rates for a long time.

On the other hand, since 2012, Japan has embraced an enhanced corporate profitability model (coined 'Abenomics' in honor of its' primary champion, the late prime minister Shinzo Abe). The impact of these competing narratives has been a doubling in the profit margins of Japanese companies from 3% to 7%, as seen by blue line in Chart 3 (right), but a stagnation of price-to-earnings (PE) multiples, as shown by the orange line. This represents another contrast to US markets, which have seen valuation multiples expand over this time period. While Japan's multiple stagnation has hurt relative returns over the past decade, looking forward it may provide an interesting investment opportunity in our view, when paired with improving fundamentals.

One of the hurdles that Japan has now successfully cleared is navigating the liftoff from zero interest rates. Initially, we were skeptical of how the market would fare, but seeing positive returns compels us to take a deeper look. With what we discussed today, we can better contextualize the earnings analysis we performed in last week's *Weekly View*.

Conclusion: We are Optimistic About Japan in International Markets

As we think about our level of investment in Japan in our balanced portfolios, the discussion above provides a convincing case for Japan as a preferred investment for our developed markets. Our Price Matters® framework for long term valuation has been suggesting attractive valuations in international markets for a long time – this is further strengthened in Japan's case by a cheap yen. While we still see higher economic and earnings growth rates in the US on a forward-looking basis, we believe Japanese equities are proving to be an unsung hero that has stealthily developed a track record of profitability and earnings growth, all while maintaining low multiples due to macro challenges. While Japan continues to face demographic and debt challenges, the strength and steady growth of Japanese earnings makes the country attractive to us within the international sleeves of our balanced portfolios.

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Chartered Financial Analyst is a professional designation given by the CFA Institute (formerly AIMR) that measures the competence and integrity of financial analysts. Candidates are required to pass three levels of exams covering areas such as accounting, economics, ethics, money management and security analysis. Four years of investment/financial career experience are required before one can become a CFA charterholder. Enrollees in the program must hold a bachelor's degree.

All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Nikkei 225 Stock Average (The Nikkei), is the leading and most-respected index of Japanese stocks. It is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average (DJIA) Index in the United States.

The Dow Jones Industrial Average (DJIA) is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange (NYSE) and Nasdaq. The Dow Jones is named after Charles Dow, who created the index in 1896 along with his business partner, Edward Jones. Also referred to as the Dow 30, the index is considered to be a gauge of the broader U.S. economy.

The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market. With 217 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The Nasdaq 100 Index is a collection of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange. The index includes companies from diverse industries like manufacturing, technology, healthcare, and others. The index excludes those in the financial sector, like commercial and investment banks.

Definitions:

JPY is the abbreviation for the Japanese yen, the currency of Japan. The Japanese yen is the third-most traded currency in the foreign exchange market after the U.S. dollar (USD) and the euro.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Stagnation is a prolonged period of little or no growth in an economy often highlighted by periods of high unemployment. A rate of growth of less than 2-3% annually as measured by gross domestic product (GDP) is considered stagnation.

Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of a given country's economic health.

Abenomics is the nickname for the economic policies set out for Japan in 2012 when prime minister Shinzo Abe came into power for a second time. Abenomics involved increasing the nation's money supply, boosting government spending, and enacting reforms to make the Japanese economy more competitive.

The price-to-earnings (P/E) ratio measures a company's share price relative to its earnings per share (EPS). Often called the price or earnings multiple, the P/E ratio helps assess the relative value of a company's stock. It's handy for comparing a company's valuation against its historical performance, against other firms within its industry, or the overall market.