NAPLES GLOBAL ADVISORS

MARKET INSIGHTS

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LAND OF THE SETTING SUN?

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There is an adage in the finance industry: "when the Fed sneezes, the whole world catches a cold." In less than a years' time, the Fed (the US Federal Reserve) increased interest rates from 0.25% to 4.25%—the fastest pace of interest rate increases ever.[1] So after a year of the Fed sneezing heavily, we approached the end of 2022 on the lookout for who was feeling under the weather. One country which certainly caught a cold: Japan. After about five years of relative stability, the Japanese Yen fell precipitously against the US Dollar during 2022, at one point reaching a 24% decline for the year. That significant currency discount hinted to us, as USD-based value investors, that opportunities could be waiting. Our interest was piqued, so we packed our bags and set off to check the patient's temperature.

Often the most valuable information obtainable on a culture, economy, or business is simply not available on Bloomberg screens, financial disclosures, or conference call transcripts. So, we venture around the planet on a somewhat regular basis to uncover what is meant between the lines of what is being said. We headed to Japan with typical preconceived notions: efficient companies, widespread ingenuity, hardworking people, and a stable capitalistic society. While largely true, many of those notions come with nasty caveats, large implications, and minimal lip service.

If asked to describe Japan, Tokyo in particular, a single word comes to mind: "shocking." Shockingly clean, shockingly polite, and shockingly expansive. The Tokyo metropolitan area is the largest in the world and is home to **37 million** of Japan's **124 million** people **(30%!)**; it seemingly sprawls endlessly. The population density in the city is astronomical, and during a workday that population swells as an additional 2.5 million people commute from surrounding areas. Walking through a subway station at rush hour is truly overwhelming, with the act of navigating through a sea of people reminiscent of a movie scene. Almost as if to prove a point, during one of our rush hour sprints to a subway platform we passed a man slowly making his way up the stairs with a cordless vacuum cleaner, vacuuming away and paying no mind to the chaos surrounding him. How incredible!

"The nail that sticks out gets hammered," and so began our education of Japanese culture. A common term used to describe the Japanese office worker is "salaryman," and everything about the term's meaning screams loyalty, hard work, dedication, and **conformity**. During a breakfast meeting, a director of financial services research described Japanese culture as "*Mean Girls* on steroids," implying that the pressure to conform is extreme, at every age. Changing jobs is nearly unheard of and pay scales or pay raises are tied to little more than years of service with a company. A positive aspect is that the "loyalty" works both ways, and it's nearly impossible to get fired. However, as outsiders and efficiency-loving capitalists, we began to wonder how motivated Japanese individuals are to work hard, if working hard doesn't get them ahead. The extreme conformist undertones were also given as a reason why fewer and fewer people choose to have children, which adds credence to the concerns surrounding Japan's declining population. Official figures expect a decline to under 95 million[2] people in Japan by 2060, with some expectations as low as 80 million. Extreme pressure to conform takes another grim toll with Japan having the highest suicide rate of any developed nation in the world, especially among young men.

The past several decades of economic history have also had significant impact on the current landscape in Japan. Beginning in the mid-1980s, Japan experienced a truly astounding equity market bubble. At one point Japan was said to be taking over the world, with a global shopping spree including Rockefeller Center and even the Pebble Beach Golf Resort. The Nikkei 225, the key equity benchmark for Japanese companies, rose from a level of about 8,000 in 1983 to nearly 39,000 in 1989, a stunning 387% increase. Over the next 13 years, the Nikkei 225 proceeded to decline by 80% in one of the most brutal long-term bear markets in modern history. To this day, the highs set in 1989 have not been surpassed. Combine that with another 50% market crash in 2008, sprinkle in a few currency crises (plural…), and it becomes understandable why the investment temperament of both Japanese individuals and businesses is "risk-averse." Japan has the oldest population by median age in the world[3], and with that comes long memories of difficult investment experiences for the last three decades. No wonder only 15% of individuals in the country dare to own stocks, or even bonds. Of the 2.7 quadrillion Yen[4] (about 15 trillion USD) of total household wealth in Japan, **over 40% is held in either bank deposits or physical cash!**[5]

How is that even possible? What does that mean in a broader sense? From an individual perspective, these cash holdings are possible because for the past 30 years or so, Japan has been experiencing rather consistent deflation of 3% to 5% per year. In a practical sense, that means every year Japanese citizens hold onto cash, it is "worth" more than when they received it. From a business perspective, most large companies are so low-debt and so extremely diversified (both geographically and by business segment) that when asked their thoughts on the recent 25% currency plunge, their response was essentially "we don't really care…" The notion we began to crystallize was that the Japanese, both individually and in business, have come to expect currency volatility (on a global basis) and deflation (on a local basis). The problem with that notion is the Japanese central bank, the Bank of Japan, has been fighting for years with all its might to ***CREATE INFLATION!***

Similar to the stimulative financial gerrymandering of the US Federal Reserve in 2008 and 2020, the Bank of Japan (BOJ) has been aggressively buying Japanese government bonds in order to keep interest rates low, in the hope that low rates will stoke some wage growth and inflation. Even in 2022 when the central banks of the world reversed course and began aggressively raising interest rates, BOJ was still fighting to keep their rates pinned to 0%. We visited a large Japanese stock exchange operator, and one of their prime growth catalysts is the potential flood of trading activity if inflation takes hold and all that cash on the sidelines is forced to invest in stocks and bonds to achieve a positive real rate of return. Whether that premise plays out is yet to be seen. Our excitement in the idea was somewhat dampened during a meeting just a few hours later with a local Japanese fund manager who snickered at the suggestion and retorted "they (the BOJ) have been hoping that for years; the problem is they now own the entire bond market, and there's still no inflation." He was right, and most recently the BOJ has started hinting that they are running out of government bonds to buy.

Our research trip came and went with a flurry of additional meetings and interviews. The types of companies we visited covered a broad spectrum of the global business environment: a commercial real estate manager, a commodity mining and production conglomerate, a manufacturer of train parts and construction equipment, and everything in between. While our initial currency-related investment premise evaporated rather quickly, a new idea began to shine through—like the warm light of a rising sun. The biggest sources of risk in Japan seem to be the aging population and the financial engineering being conducted by the central bank. We need to pay close attention to investment opportunities where those risks are minimized. Japanese ingenuity is alive and well, with hardworking and disciplined individuals laboring tirelessly in the background to create products the world needs. Our objective is to find those businesses which leverage that ingenuity, talent, and commitment without getting wrapped up in the societal dramas or financialization games.

Sources:

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4 - Published by Statista Research Department. "Japan: National Wealth by Sector." Statista, Statista Research Department, 16 Jan. 2023, https://www.statista.com/statistics/1266691/japan-net-worth-by-sector/#:~:text=As%20of%20the%20end%20of,with%20the%20highest%20net%20assets.

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