

The Japanese market's upside potential: Vaccination inflection point and what rising interest rates may portend

31 May 2021

By Junichi Takayama, Investment Director

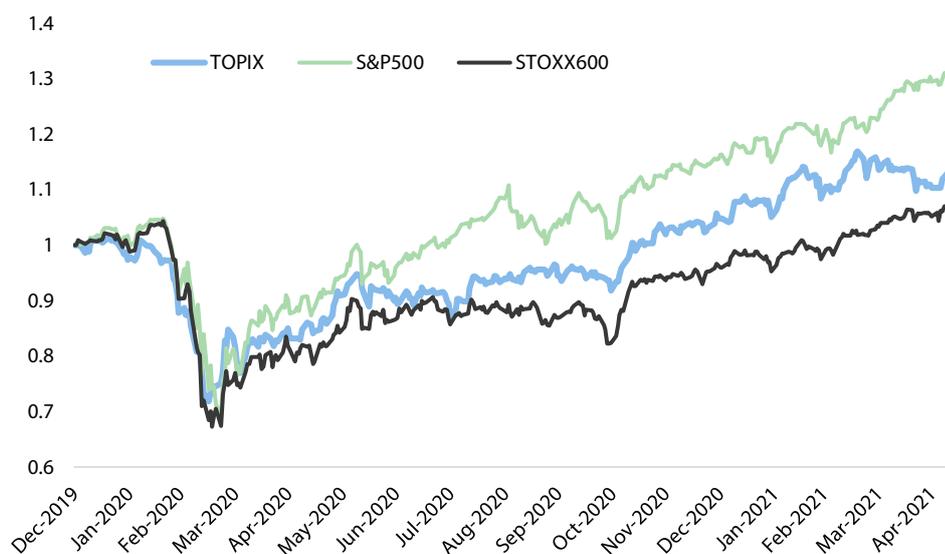
Introduction

While the Japanese equity market managed to strongly rebound in 2020 after a sharp fall at the start of the pandemic, it has lagged its peers in 2021 amid the country's struggle to contain COVID-19 and its slow rollout of vaccinations. However, the rollout of vaccines is gathering pace after a slow start. Japan's dividend yields are also showing potential appeal amid a rising interest rate environment.

Despite initial post-COVID-19 recovery, 4th infection wave looms over Japan stocks

The Japanese equity was hit hard by the outbreak of the COVID-19 pandemic at the start of 2020 and dropped sharply in tandem with its global peers. Japanese equities kept abreast with a subsequent rebound by global markets enabled by aggressive monetary and fiscal policies in large economies, notably the US. By 4Q 2020, the Japanese equity market had recovered to its pre-pandemic level, thanks in part to its relatively low level of coronavirus cases, which did not require strict lockdown measures that were taken in other parts of the world. A recovery in external demand from the US and China, Japan's two largest trading partners, also boosted the recovery and the domestic equity market performed strongly in 2020.

Chart 1: Returns from major developed markets since 2020



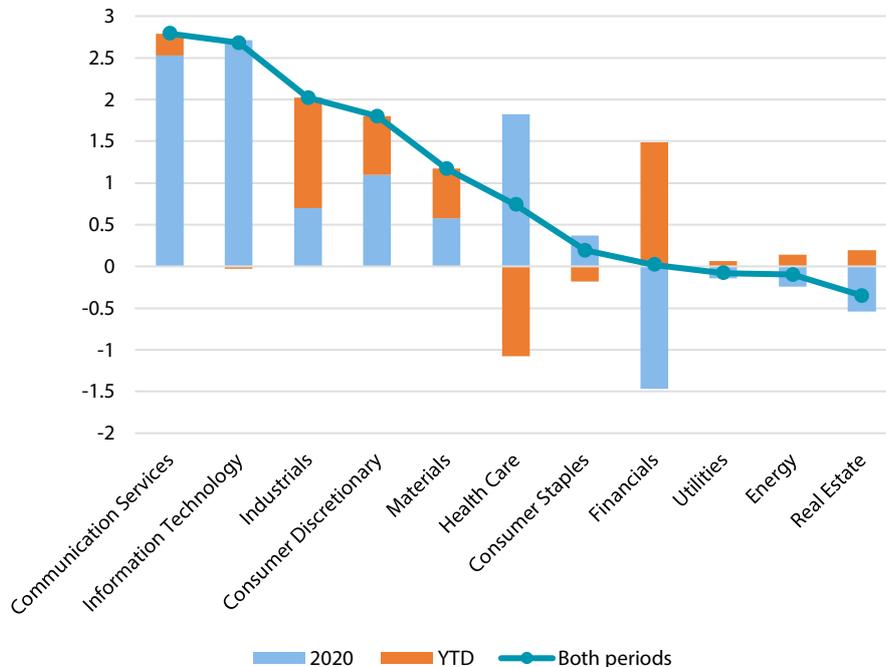
Source: Bloomberg, as at 13 May 2021

For sophisticated investors only • en.nikkoam.com

nikko am
Nikko Asset Management

The specific factors that contributed to the rebound by Japan's TOPIX index are summarised in Chart 2. We have split the time horizon into two parts. The blue bars indicate the sector return contribution in 2020 and the orange bars indicate the same contributions made so far year-to-date. The green line indicates the contributions for the entire period.

Chart 2: Sector contributions for TOPIX since 2020



Source: Bloomberg, as at 13 May 2021

We highlight three key observations from Chart 2.

1. The Japanese equity market's strong performance in 2020 was driven by IT and Communication Services (which includes software & other IT service companies), while Financials were a drag due to expectations that interest rates would remain low.
2. Sectors such as Financials, Real Estate, Utilities and Energy followed identical patterns. These sectors were hit hard by the pandemic in 2020 but have been rebounding since the beginning of 2021. This is due to a shift in the market which led to sector rotation, with investors picking up some stocks that had been oversold.
3. Technology names have been quiet so far in 2021. Despite a strong start to 1Q, recent weakness in the market has wiped out all the gains.

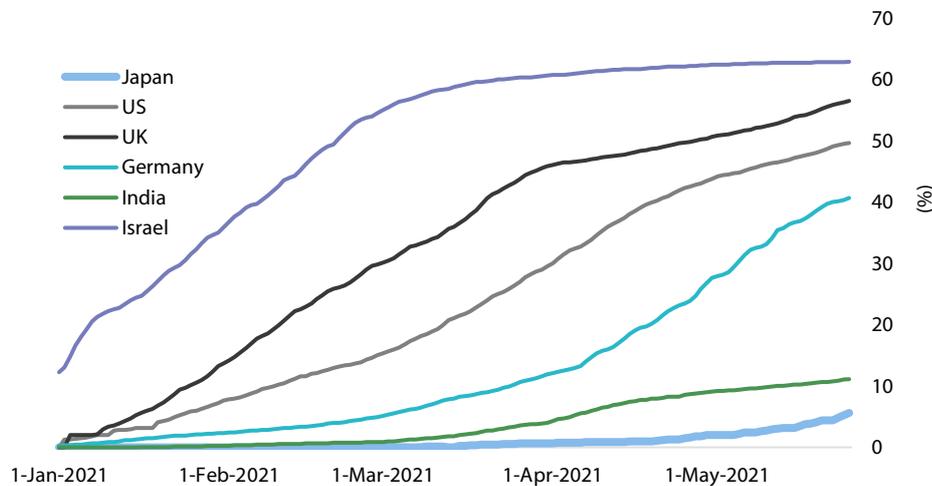
We think that the Japanese market's recent underperformance relative to its global peers is due to a fresh wave of COVID-19 infections in the country and Japan's slow vaccine rollout.

Japan's vaccination effort has been slow but it has started to step on the gas

Many of Japan's major population centres are under a state of emergency with the government trying to contain a fourth wave of coronavirus outbreak. The state of emergency is effective through 31 May, but has recently been extended into June as new coronavirus variants have become more dominant. The weakness of the Japanese market has coincided with the latest wave of COVID-19 infections, but we believe that vaccinations will play a key role in revitalising the market.

Chart 3 shows that other countries have had a head start in vaccinating their populations.

Chart 3: Percentage of population that has received at least one dose of COVID-19 vaccine



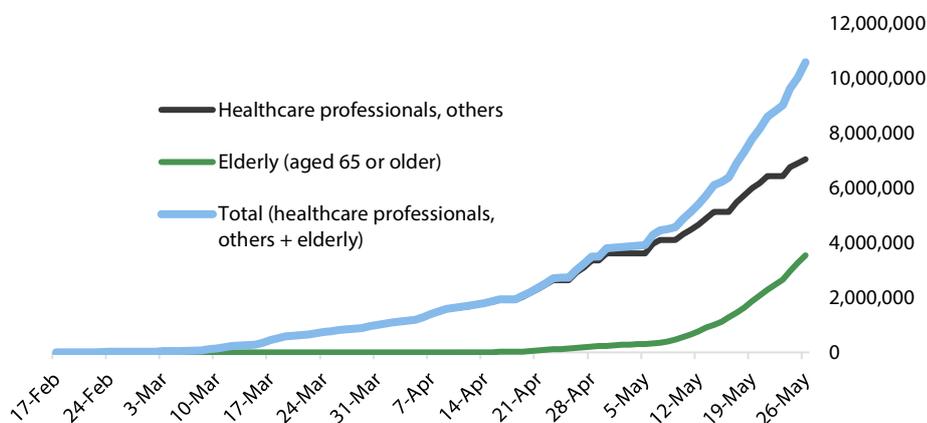
Source: Our World in Data, as at 27 May 2021

We can identify two main reasons for Japan's slow rollout. First, it has so far been unable to develop its own vaccine and is therefore reliant on imports; in other words, it essentially needs to wait until vaccine-producing countries are first done inoculating their own populations. Japan is home to some pharmaceutical companies with the potential ability to develop COVID-19 vaccines. However, the government, unlike its peers in countries such as the US, failed to swiftly provide Japanese pharmaceutical companies with the incentives for speedy vaccine development.

Second, Japan has a particularly onerous approval process for pharmaceuticals—developed because of numerous drug disasters in the past—which considerably slows the development and import of vaccines.

Japan, however, is starting to step on the gas. Following a sluggish start, vaccination in Japan is finally gaining momentum (Chart 4). State-run mass vaccination centres were opened in Tokyo and Osaka, Japan's two largest cities, on 24 May, with the government recruiting the country's military to operate the venues. Local governments in other areas are also planning to set up their own mass vaccination sites, with baseball stadiums considered as potential venues. Stringent regulations are also being softened so Japan can deal with a shortage of eligible medical staff allowed to administer shots. Furthermore, Japan, where only the Pfizer coronavirus vaccine had been approved, gave the green light to the Moderna and AstraZeneca vaccines on 21 May.

Chart 4: Total number of vaccine doses administered in Japan



Source: Office of the Prime Minister and the Cabinet, as at 27 May 2021

We believe that the Japanese equity market will be in a good position to benefit once a significant amount of vaccines are rolled out, permitting the re-opening of the economy.

Conservative guidance by companies

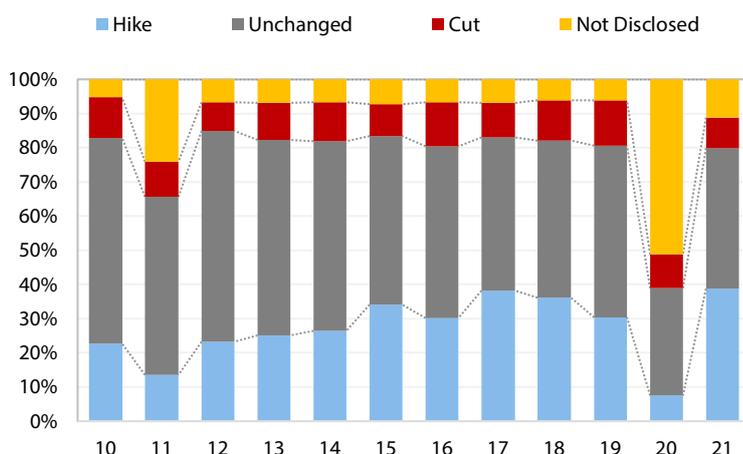
May was the peak of Japan's latest full year earnings season, and a striking feature was the divergence in the earnings of manufacturers and non-manufacturers. Manufacturers, including autos and machinery, were negatively impacted by the pandemic due to operational disruptions and deflated demand early in 2020. However, the sector recovered strongly in the second half of the fiscal year (which ran through March 2021). Driven by growing demand in the US and China, manufacturers posted a 35% increase in earnings for the fiscal year through March 2021. It is also worth noting that semiconductor-related names have announced strong results thanks to accelerated use of technology and an increase in end demand.

Non-manufacturers, on the other hand, struggled in the wake of the states of emergency declared in 2020 and 2021. As people were urged to stay home, the obvious losers included the transportation sector, such as railways and airlines, and restaurant chains.

Companies are collectively forecasting net income growth of 28% for the current fiscal year which started in April. But we think there is potentially more upside to this number because corporations are likely being conservative with their guidance.

Chart 5 shows the dividend forecasts of TOPIX-listed companies at the beginning of each fiscal year since 2010. The far-right column shows the composition of the most recent dividend forecasts in relation to the previous year. We can see that, at around 40%, the share of the companies planning to hike dividends would make it the largest such increase in the last 10 years.

Chart 5: Dividend forecasts of TOPIX companies



Source: Okasan Securities, QUICK Workstation, as at 11 May 2021

Another interesting feature is the yellow bar indicating that a relatively high number of companies have not yet disclosed their dividend forecast (although not as many as last year). This is understandable given the uncertainties surrounding the economy, but these companies have the potential to come out with dividend hikes as well.

The conservative forecasts should not come as surprise when the state of emergency, the current economic situation, and the slow vaccine rollout are taken into account. Once vaccinations progress and the economy re-opens, we think the conservative earnings guidance and the dividend forecasts could be revised up towards the end of the year, and that will be positive for market sentiment.

The relevance of dividends amid prospect of higher interest rates

Japan's current dividend yield level and the potential upside in dividends warrant attention. Chart 6 shows the dividend yields of Japan (TOPIX) and US (S&P 500). Both US and Japanese yields have been gradually declining over the past 12 months amid a rally by the markets. But as many Japanese companies are expected to hike dividends

this fiscal year, Japan's yield is higher. Chart 7 shows the relative ratio between the two markets (Japan dividend yield divided by US dividend yield); we can see that from this perspective Japan is currently more attractive.

Chart 6: Japan, US dividend yield

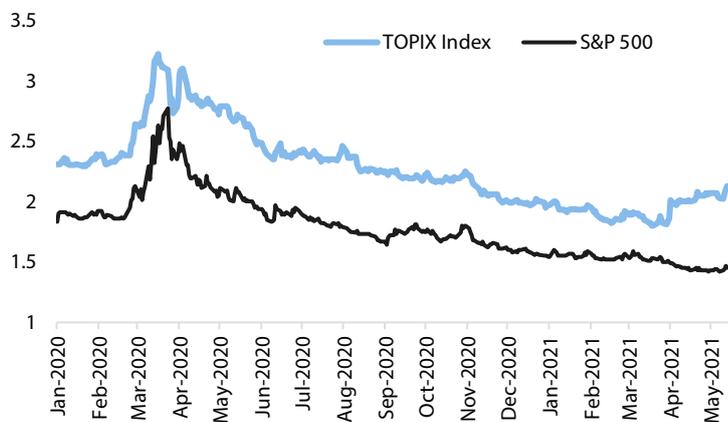
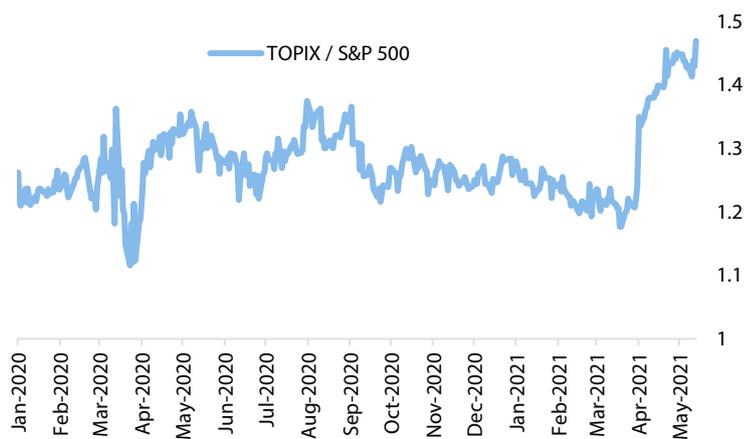


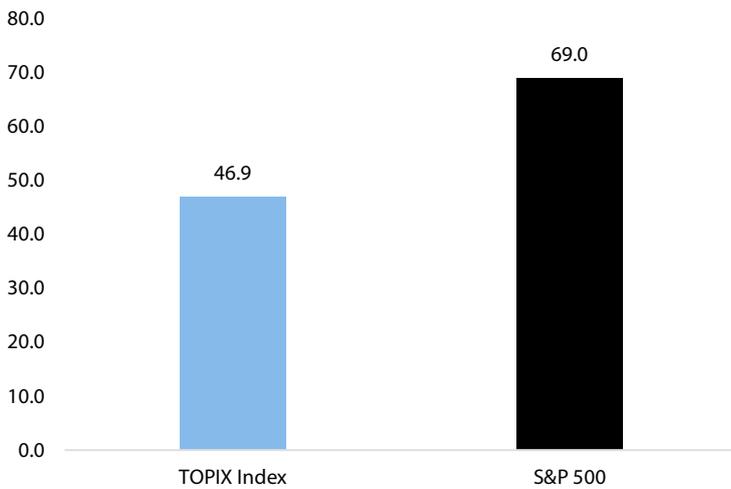
Chart 7: Japan, US dividend yield relative ratio



Source: Bloomberg, as at 13 May 2021

Chart 8 shows the two markets' equity duration—that is, the number of years it takes theoretically for invested capital to be recouped (i.e., inverse of dividend yield). Japan's is 47 years while that of the US is 69 years. A shorter duration can be construed as less sensitivity to interest rates as the proportion of cash flows that make up a stock's value will likely be received sooner. The Japanese equity market could therefore fare better when interest rates rise.

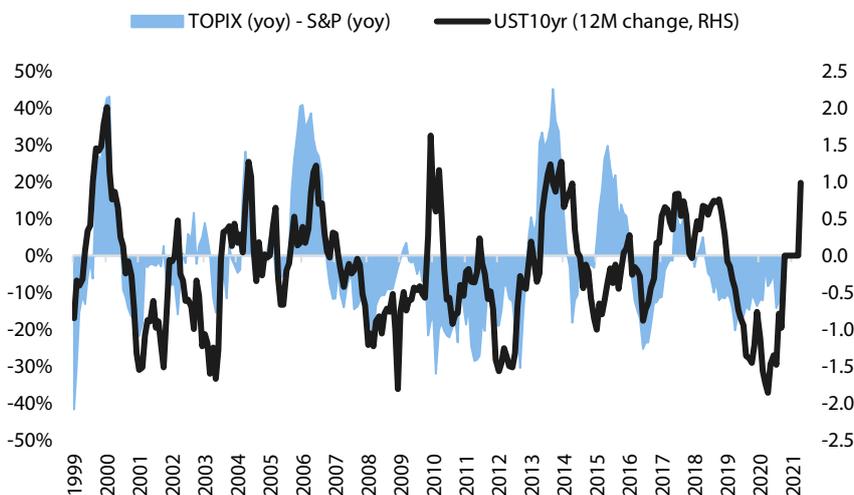
Chart 8: Equity duration (number of years required to recoup invested capital)



Source: Bloomberg, as at 13 May 2021

Furthermore, from a broader perspective the Japanese equity market has shown a tendency to perform better than its US counterpart when US yields are rising (Chart 9). This characteristic offers investors the option to diversify away from the US market, with its heavy exposure to the tech sector, when interest rates rise.

Chart 9: TOPIX tends to better than S&P 500 when US yields rise



Source: Bloomberg, as at 30 April 2021

Summary

While the Japanese equity market is lagging its peers due to virus-related economic restrictions and a slow start to vaccinations, the market will have significant upside potential once the rollout of vaccinations gathers speed. And while recent corporate earnings expectations have been understandably conservative, a re-opening of the economy could trigger upward revisions in earnings and dividends, with the latter to become more attractive in a rising interest rate environment. Such an environment will also be conducive to a shift from growth to value, which could also benefit from secular, structural changes unfolding in Japan.

Important information: This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment. This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice. In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell. Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements. All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME. This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients. Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request. The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.