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Matthews Asia Perspective

Navigating Japan's Changing Investment Landscape

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At first glance, Japan appears to be in a sweet spot. A combination of structural reforms, a stable political environment and consistently easy monetary policy has revitalized the country's economy since 2012. Thanks to changes in Japan's corporate governance requirements, the country has become a more attractive investment destination.

Now, however, Japanese companies face new challenges: a labor shortage, rising costs and low productivity. With Prime Minister Shinzo Abe's approval ratings falling, the stable political environment could soon be disrupted. How should Japan investors adapt to this new environment?

Today, when we visit companies in Japan, management teams discuss shareholder returns, balance sheet management and capital efficiency. That's a significant change from several years ago. As a bottom-up, quality growth investor who meets regularly with company managers, I see first-hand that corporate governance standards vary widely. Even progressive companies in Japan have yet to catch up with their counterparts in Europe and the U.S. But they are heading in the right direction.

Political Continuity and Economic Growth

The sharp decline of Prime Minister Abe 's approval ratings is a concern for political continuity as he is seeking re-election as the leader of the ruling Liberal Democratic Party in September. Japan's economic growth, meanwhile, is showing sluggishness. Annualized real GDP growth during the last quarter of 2017 was 1.6%, but those figures were supported by inventory build-up, which could cause issues over the coming quarters. Business investments and private consumption remain solid but we believe a contraction in net government expenditures will lead to slower growth this year.

A weakening economy, however, does not mean an absence of investment opportunities. Japan is home to many companies that benefit from growth at home and further afield and can adapt to the next stage of Japan's economy. Demand continues to grow internationally for Japan's world-leading technologies, services and products. We also have observed a deepening integration of the Japanese economy with the rest of Asia—and most notably with China.

This is due to a number of factors: First, as incomes in the region grow, local consumers increasingly can afford Japanese brands that are associated with affordable quality, thereby creating a market for Japanese brands that previously did not exist. Second, while rising incomes are good for consumers, they place greater pressure on companies that have to pay higher wages. As a result, businesses have been forced to adopt more technology into their processes to drive productivity and protect profit margins.

Robotics and other modes of automation are increasingly being utilized to counter the impact of more expensive and scarce labor. Indeed, the adoption of automation and robotics is set to soar in China and other Asian countries to both boost efficiency and improve quality. In addition, China is investing heavily in upgrading its manufacturing sector as it seeks to drive technology innovation. We firmly believe that sustained growth in Asia will lead to tremendous growth opportunities for select Japanese companies and we will continue to focus our research efforts on identifying these opportunities.

Challenges Lie Ahead

With opportunities, however, come challenges. Japan's labor market is very tight and immigration alone cannot solve this imbalance. A number of companies are converting their part-time workers to full-time workers in response to this labor imbalance. "Labor-heavy" operators in the retail and restaurant industries face a challenging environment from a cost perspective. As a result, companies increasingly are willing to pass higher costs on to consumers, who might be experiencing inflation for the first time in their lives. How will Japanese consumers react? We do not wish to overstate the argument that consumption will grow substantially because of these wage increases, but we do see tangible evidence of reflation as a result of these supply-side dynamics.

Companies that relied on stagnant wages during Japan's long period of economic stagnation are struggling now and we expect to see some of them exit the market. Companies that are more productive and can afford to pay their workers more will enjoy a "survivor's benefit" as they consolidate market share. We believe that listed companies may see an improvement in their pricing power as they gain market share from smaller unlisted companies. We expect select companies to convert this opportunity into revenue growth and improved margins.

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