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Pessimism about Japan is overdone.

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- **At first glance, Japan's outlook might seem gloomy but investors should not overlook the big changes under way.**
- **Policymakers appear determined to overcome deflation and stimulate growth, though efforts to reflate the economy have some way to go.**
- **Japan has become more welcoming to foreigners, and female employment has risen.**
- **Corporate mindsets are changing, with more firms focused on creating greater shareholder value.**

Widespread gloom about Japan's economy, alongside global uncertainties, have sapped investor confidence in Japanese stocks. The volatile yen has not helped. Disillusioned with Prime Minister Shinzō Abe's growth strategy, critics are predicting the end of his government's suite of economic measures, known as Abenomics. Japan, they say, is back in the deflation trap.

Their downbeat verdict looks premature. Having had a ringside seat since 1982 when we established a local presence, it is clear to us that Japan has embraced far-reaching structural changes – some that once seemed unthinkable. Many of those efforts would, however, take time to yield results.

Even so, the initial signs are encouraging. Thanks to monetary and fiscal stimulus, Japan, which has lived with deflation for much of the past two decades, is seeing an uptick in consumer prices. The core-core inflation index, which strips out energy and food, has stayed positive since October 2013. It was up 0.7% in the year to March, and should rise as oil prices stabilise. Point-of-sales data from supermarkets have been trending higher since February last year too.

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Reflating Japan

"There is no doubt that the Bank of Japan and the government are deeply committed to overcoming deflation and reviving economic growth."

To be sure, Japan still has some way to go. But there is no doubt that the Bank of Japan (BOJ) and the government are deeply committed to overcoming deflation and reviving economic growth. Further fiscal stimulus is a likely policy option, while the odds of delaying next year's planned consumption tax hike have risen in view of the recent earthquakes in southern Japan.

The BOJ, meanwhile, adopted negative interest rates in January this year, which in our view reflects its determination to push hoarded cash (a big source of Japan's deflationary spiral) out of corporate and household accounts into investment and consumption. The policy raised concerns over the negative impact on banks, but our assessment suggests that it should be limited.

For one, the negative rate applies only to a small portion of reserves that banks keep with the central bank. Moreover, Japanese lenders, having experienced prolonged deflation, have gradually shifted their business model from being loan-driven to transaction and fee-oriented; the profit share of the loan business at some mega banks has fallen to as low as 20%.

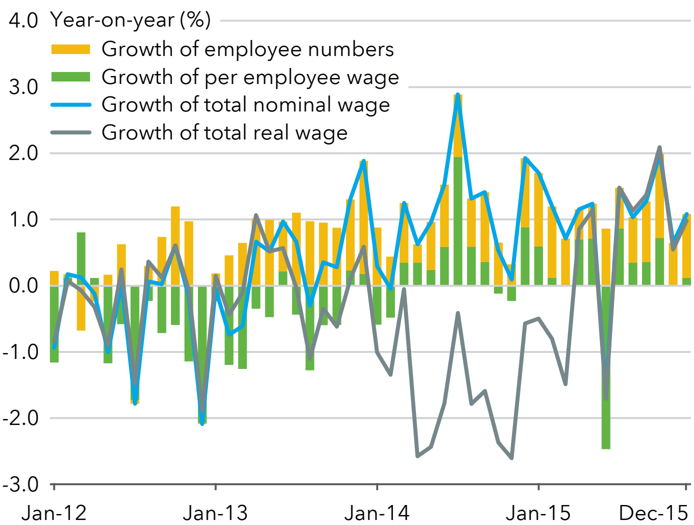
In our meetings with bank managements, while they acknowledged some pressure on profits owing to negative interest rates, they also expressed confidence that dividends and shareholder payouts will be maintained through cost cuts and the sale of cross-shareholdings. The latter is in line with government reforms to improve corporate governance and boost shareholder returns.

Most recently, in April, the BOJ dashed market hopes for further monetary easing. Rather, BOJ governor Haruhiko Kuroda prudently opted to wait until the impact of the negative rate policy is clearer. He stressed, however, that the central bank stands ready to take additional measures if necessary.

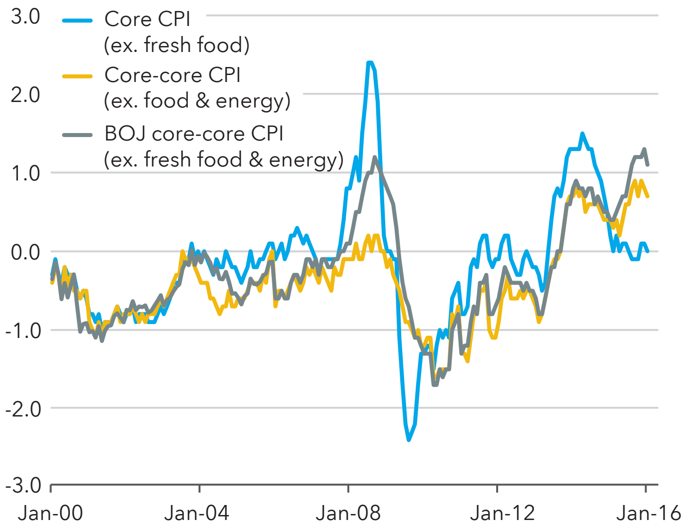
Another reason for optimism is Japan's tight labour market, which should support reflationary pressure – the ratio of job openings to applicants rose to a 25-year high of 1.3 times in March. Despite that, wage growth has appeared stagnant. Why? We believe this could be attributable to the changing composition of the workforce.

The growth in the number of part-timers has outstripped that of full-time workers. Their wages are also rising faster than

A tight labour market should translate into wage pressure and push up consumer prices



Data as at 31 December 2015
Sources: Cabinet Office, Ministry of Health, Labour and Welfare



Data as at 31 January 2016
Sources: Ministry of Internal Affairs and Communications, BOJ

the base wages of full-time employees, but they often earn much less. Therefore, salary per worker of the overall workforce appears flat, given the larger number of lower paid, part-time staff. In reality, however, total real wage growth is rising, and is in line with the increasing number of workers. The annual spring wage negotiations between unions and employers should further push up the average wage per employee.

Equally important, the Abe administration has made drawing more women into the workforce a priority. Policies aimed at increasing the female labour participation rate, such as expanding childcare facilities, have yielded some worthy results. The number of working women in Japan has risen progressively since 2012 and is now at a record high.

Opening up to the world

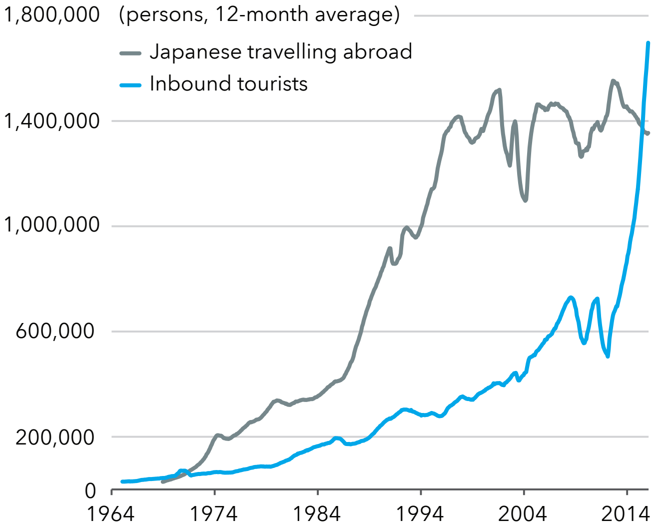
"Last year, foreign tourists surged to a record 19.7 million, marking the first time in over four decades that the number of inbound tourists has exceeded the outbound figure."

Furthermore, Japan has become much more welcoming to foreigners. Inbound tourism, arguably one of the country's most successful growth strategies, is a case in point. Just four years ago, visa requirements were very stringent owing to concerns over illegal overstayers. In 2013, the government relaxed its visitor visa rules, particularly for Asian tourists. That year Japan saw around 8.4 million overseas travellers. Visa requirements were further eased in the subsequent years, most notably in 2015 for Chinese citizens.

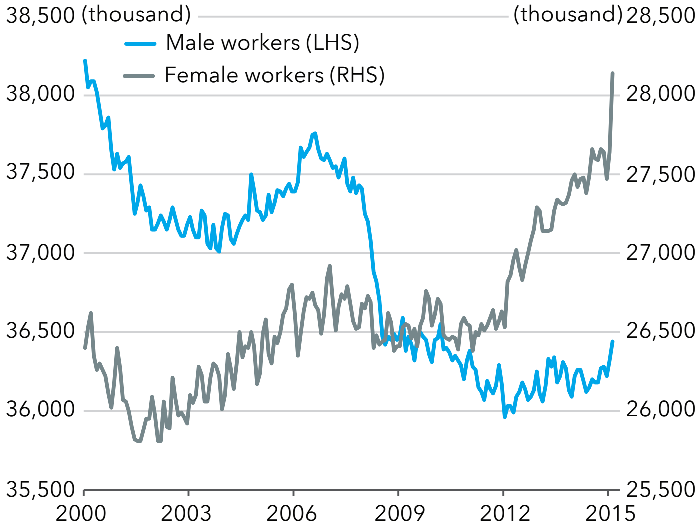
The upshot? Visitor arrivals have more than doubled. Last year, foreign tourists surged to a record 19.7 million, marking the first time in over four decades that the number of inbound tourists has exceeded the outbound figure. The official annual tourist target of 20 million by 2020 has been lifted to 30 million, though Mr Abe has said that he wants to raise that to 40 million. The government is also aiming to increase spending by foreign visitors to ¥8 trillion, equivalent to about 1.6% of GDP. This compares with tourist arrivals of between 60 and 80 million in countries such as the US and France. In short, there is significant runway for growth.

There is also talk of Japan relaxing policies on foreign workers, albeit only in targeted industries such as construction and nursing care, where shortages are acute. Nonetheless, that would be quite

The government has taken some bold decisions to fuel a tourism boom and reform the labour market



Data as at 31 January 2016
Sources: Mitsubishi UFJ (United Financial of Japan), Morgan Stanley Securities, Japan National Tourism Organisation (JNTO)



Data as at 15 January 2016
Source: Ministry of Internal Affairs and Communication

a momentous change for a country with little history of immigration. That matters because a dwindling population – and workforce – have long been a challenge for greying Japan.

None of this is to underplay the challenges facing Japan. We are mindful of the yen's recent strength and the corresponding impact on exporters in the short term. Other concerns include external pressures such as China's structural slowdown, with spillover effects on Japanese exports. While the Chinese government has every incentive to avoid a hard landing and restore stable growth, the process is unlikely to be smooth.

But these concerns should not detract from the fact that reforms are taking place in Japan. Attitudes are changing, and not just among policymakers. Japanese corporations, as we have pointed out before, are also paying greater attention to delivering shareholder value. The Abe administration's corporate sector initiatives provided the impetus for change. Payouts have risen thanks to the new corporate governance and stewardship code, as well as the JPX-Nikkei Index 400, which showcases better-run, shareholder-friendly companies, while measures to improve profitability and raise firms' return on equity are gathering pace.

Yet, Japanese equities remain inexpensive compared with their developed peers. The current valuation of the Japanese stock market – price-to-earnings ratio of around 15 times, price-to-book ratio of 1.1 times, and a 2% dividend yield with payout ratio of about 30% – creates an attractive environment for long-term investors such as ourselves. That said, the need to be discerning is as strong as ever.

We will continue to gauge whether Japan's structural changes are creating the dynamics that will boost the economy's growth over the longer run. At the corporate level, we will be assessing if companies are producing more value for shareholders. So far, on both counts, Japan appears to be making headway.