

## Shaking up corporate Japan

Frédérique Carrier – London

The Nikkei 225 just passed its record high reached 34 years ago, despite the Japanese economy being in recession. We explore the factors behind investors' enthusiasm and explain why the underwhelming macroeconomic backdrop is not viewed as a deterrent. We also suggest how investors should position their portfolios.

### Keen interest

Japanese stock indexes have risen dramatically for the past 18 months. The Nikkei 225, a traditional index which ranks 225 stocks in the Tokyo Stock Exchange by price, recently breached its 34-year high. The TOPIX, a more modern index based on market capitalization, had already broken out of its long-held trading range in June 2023.

Several factors conspired to attract investors' attention to Japanese equities.

- **The return of inflation:** Having endured bouts of deflation in the past two decades, inflation made a welcome return after the COVID-19 pandemic. This heralded a sea change in corporate behaviour, enabling companies to increase prices and suggesting profitability could improve.
- **Corporate governance reforms:** The Tokyo Stock Exchange introduced important corporate reforms last year, a follow-up to reforms introduced under former Prime Minister Shinzo Abe in 2012. The government shamed the corporate sector for its notoriously low returns and demanded change. As a result, many companies adopted more shareholder-friendly measures, improving disclosures, growing dividends, and announcing share buyback programmes. Many companies are dismantling old cross shareholdings

### Nikkei 225 Index breaches 34-year high



Source - RBC Wealth Management, Bloomberg; quarterly data through 2/22/24

structures (when companies own shares of other companies), freeing up capital that can be used to improve returns: Toyota Motor reduced its stake in telecom company KDDI, Fujitsu sold its chip packaging subsidiary Shinko Electric, while Nippon Steel and Hitachi have announced similar restructuring plans. Much more appears to be in the offing.

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

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Priced (in USD) as of 2/21/24 market close (unless otherwise stated). Produced: 2/21/24 2:18 pm ET; Disseminated: 2/22/24 2:29 pm ET

According to a Tokyo Stock Exchange list issued last month, only about one-third of the companies trading on the exchange have announced plans to improve shareholder returns. By divulging company names and using peer pressure, we expect the Tokyo Stock Exchange will encourage more companies to announce plans improve shareholder returns.

The results of the reform are already apparent, in our view. According to Bloomberg, 60 percent of companies trading on the TOPIX now trade above book value, up from 50 percent a year ago.

- **Savings reforms:** The Japanese government recently revamped the Nippon Individual Savings Account (NISA), a tax-free stock investment program for individuals, by expanding annual investment limits and granting indefinite tax-exemption periods. Given that as of September 2023, 52.5 percent of Japanese households' financial assets were held in cash, or almost twice the size of the Japan GDP, the new NISA could drive domestic retail demand for stocks.
- **Chinese stocks proxy:** In a world of increased geopolitical tensions, Japan may be seen as a proxy for investing in China.

## Stabilization ahead

The Tokyo Stock Exchange reforms are an attempt to shake up a corporate sector suffering from a disappointing domestic economy, in our opinion. After a promising H1 2023, Japan's economy finished 2023 on a subdued note. Q4 2023 GDP numbers pointed to a 0.1 percent quarter-over-quarter contraction, on the heels of Q3's more severe 0.8 percent contraction. We believe the main culprit was weak domestic demand, as inflation kept shoppers at bay.

Yet, we think there are reasons to believe the outlook will stabilize. Monthly trade data and economic indicators such as the Tankan Business conditions, both manufacturing and non-manufacturing, suggest that business conditions across all industries were the strongest in five years.

Meanwhile, Japan also benefits from the friendshoring and reshoring trends. Companies aiming to extract themselves from Chinese supply chains and build capability in strategic industries on its allies' terrain see Japan as a stable environment. The trend is particularly apparent in the semiconductor industry with both a joint venture between Taiwan's TSMC and Japan's Sony, and government support of its own local semiconductor industry.

Positive real wage growth should also help consumption recover. Already at 3.6 percent last year, wage growth will likely accelerate as labour shortages and high corporate profits entice companies to increase wages and secure the necessary labour force. A Nikkei survey of CEOs suggests that 80 percent of them expect wage growth between four and nine percent. This spring's Shuntō annual wage negotiations, during which thousands of

unions will simultaneously negotiate wage agreements with employers, are key to watch, in our opinion.

## Treading a fine line

The Bank of Japan (BoJ) has been hesitant to tame above-target inflation by ending its long-held negative interest rate policy for fear of knocking its already subdued economy further off course. Yet, maintaining a loose monetary policy is markedly weakening the yen, contributing to inflation.

Inflation above the two percent target for close to two years, as is the case in Japan, would have spurred most western central banks into a tightening cycle. But the BoJ is moving very carefully. Memories of tenacious deflation are still fresh, and consumption is brittle, given Japan's mature population (average 49 years old vs. 39 in the U.S.). Hiking rates too quickly could risk crashing the economy.

But loose monetary policy, with 10-year yields on JGBs, Japan sovereign bonds, below one percent compared to 4.2 percent in the U.S., has markedly weakened the yen, close to 40 percent against the U.S. dollar, since 2021.

A weak yen has been a boon for exporters but a headache for importers, and it is fueling inflation.

The BoJ is mulling over its first rate hike in 16 years. Markets are priced for a 0.10 percent rate hike by June and a full 0.25 percent by year end. Such careful moves are unlikely to throw the economy off course. And with other central banks cutting rates this year, the interest rate differential with Japan will diminish, in our opinion, alleviating the pressure on the yen. RBC Capital Markets' forecast is that the yen, as weak as 150 to the U.S. dollar recently, could reach 145 to the U.S. dollar at year end 2024.

Overall, the Bloomberg consensus expectation is for Japan's GDP growth to reach 0.8 percent this year, suggesting Japan will emerge from its technical recession.

## More to go for

We continue to suggest an Overweight position in Japanese equities. A period of consolidation is possible given the recent strong rally, but TOPIX earnings growth could increase by a strong 10 percent in 2024, according to Bloomberg consensus, largely thanks to the corporate governance reforms and the return of inflation as consensus expects. Moreover, valuations remain in line with the 20-year median, at 15.9x this year's earnings. This is in contrast to several other equity markets such as the U.S. and emerging markets which trade much above their long-term median valuations.

We prefer consumer sectors as higher real wages should encourage consumption, selective stocks in the financial sector as slightly higher interest rates should help profitability, and high dividend stocks that could benefit by retail fund flows under the new tax-efficient investment scheme.

*With contributions from Jasmine Duan*

## UNITED STATES

Alan Robinson – Seattle

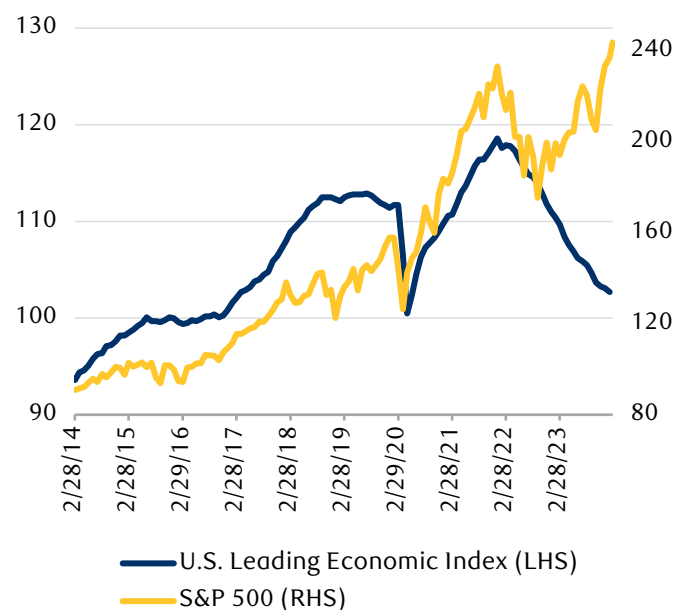
■ **U.S. stock indexes broke out to new highs during the week** fueled by a resurgence in artificial intelligence (AI)-themed optimism. Chipmaker NVIDIA's (NVDA) closely watched earnings release encouraged the bulls, as the company reported Q4 2023 revenue and EPS that beat the FactSet consensus forecast by more than 8% and 12%, respectively. Management suggested that accelerated computing and generative AI have hit the “tipping point” with demand surging globally across companies, industries, and nations. The stock rallied 15% on this news, resulting in a market capitalization gain of over \$200 billion, the largest one-day gain ever.

■ **Other industry sectors fared less well**, with pure-play electric vehicle (EV) manufacturers admitting that demand for their vehicles appears to have hit a wall. Rivian (RIVN) and Lucid (LCID) both reported underwhelming results and issued guidance for no growth in vehicle production in 2024. We believe competition from better-capitalized legacy automakers may limit adoption of these higher-end EVs.

■ **But, overall, earnings season appears to have progressed well.** With 85% of S&P 500 companies having reported by midweek, Q4 2023 revenues and earnings were up 4% and 8%, respectively, beating the initial FactSet consensus forecasts of 3% and 1%, respectively, with demand and input costs in the quarter both better than feared.

■ **The overall solid performance of the economy and guardedly optimistic forecasts are in contrast to the monthly release of the Conference Board's Leading**

## Stocks no longer follow the leader



Source - RBC Wealth Management, Conference Board, FactSet. Monthly data normalized with 12/31/15 = 100; data through 2/21/24.

**Economic Index (LEI) during the week.** The LEI was down 0.4% m/m, marking the 23rd consecutive month of declines. This indicator usually correlates well with stock market performance (see chart), but the relationship has diverged since Q3 2022. So, what has caused this breakdown? Specific aspects of the recent economic cycle are clearly different to what we've seen in the past, including an inflation spike caused by COVID-19 and deglobalization, and unprecedented advances in AI. While we don't believe this indicator is past its prime, we do believe it needs to include more service-sector inputs given the evolving nature of the economy.

## CANADA

Estefani Ayazo, CFA &amp; Richard Tan, CFA – Toronto

■ **Canada's inflation decelerated more than the Bloomberg consensus anticipated in January.** The headline Consumer Price Index (CPI) rose 2.9% y/y last month, following December's gain of 3.4% y/y, marking the **lowest level since June 2023 and falling within the Bank of Canada's (BoC) target range** of 1.0%–3.0%. Meanwhile, the BoC's preferred core measures, core-Trim and core-Median, came in at 3.4% and 3.3% y/y, respectively, below the consensus expectation of 3.6% y/y for both metrics. Falling energy and food prices helped alleviate price pressures last month, while shelter inflation, up 6.2% y/y in January compared to 6.0% in the previous month, remained a main driver of price gains. Though overall inflation continues to move in the right direction, BoC officials have opined that they want to see more evidence of inflation falling sustainably towards its 2.0% target before pivoting to interest rate cuts.

■ **The S&P/TSX Composite Index returned over 8% on a trailing one-year basis, underperforming the S&P 500 Index by more than 1,800 basis points (i.e., 18%).** While the variance is significant, we'd highlight that the composition and valuations across the two markets are materially different. With respect to the former, banks, telecommunications, real estate, and energy infrastructure companies account for approximately 36% of the S&P/TSX Composite. All else equal, fundamentals in these industries have been negatively impacted by a higher rate environment to a greater extent compared to other sectors. The good news, in our view, is that **the bond market is pricing in about 75 basis points of rate cuts in Canada through 2024, with the first cut expected to occur as early as July.** If this scenario unfolds, we believe this would be a tailwind for investors as earnings could rebound and could be a catalyst for share price appreciation. At present, the S&P/TSX Composite is trading at approximately 14x forward consensus earnings estimates, a discount to its long-term average of roughly 15x. Overall, we believe a falling interest rate environment could improve the appeal of Canadian equities.

## EUROPE

Frédérique Carrier &amp; Thomas McGarrity, CFA – London

■ **Average pay settlements in the UK for the three months to the end of January 2024 fell to 5.1% y/y**, according to XpertHR. While this is an improvement from the 6% figure in the prior three-month period, it remains too high for the Bank of England—which focuses its attention on this measure—to decide when to start to cut interest rates. **A tight labour market could mean that wage growth may well be sticky.** This and a likely small tax cut at the upcoming March Budget suggest market expectations of a first rate cut in August are well founded, in our view, particularly as economic indicators, such as the S&P Global UK Composite Purchasing Managers' Index (PMI), point to the economy recovering.

■ **In the EU, negotiated wage data covering 75% of employees in the bloc's five largest economies showed an increase of 4.5% y/y in Q4**, pleasant progress from the prior period's 4.7%. With inflation in the EU receding to 2.9%, this suggests to us that real wages are growing and should, in time, help prop up consumption. **Recent indicators point to a stabilisation of the economy**, with the HCOB Eurozone Services PMI reaching 50 to exit contraction territory for the first time since summer 2023. Markets expect the first rate cut from the European Central Bank in June.

■ **Nestlé's share price slipped over 4% following the announcement of 2023 results and 2024 guidance that is below consensus expectations.** In 2023, the company delivered organic sales growth of 7.2% y/y, purely driven by price increases of 7.5%, while real internal growth (RIG; the impact on sales of volume increases or decreases, weighted by the relative value per unit sold) declined 0.3%. Accordingly, Nestlé's CEO stated that the company is "prioritizing volume- and mix-led growth" in 2024. In the final quarter of 2023, Nestlé's volumes did turn positive, with RIG of 0.4%, although this was below the consensus expectation of 1.7% growth.

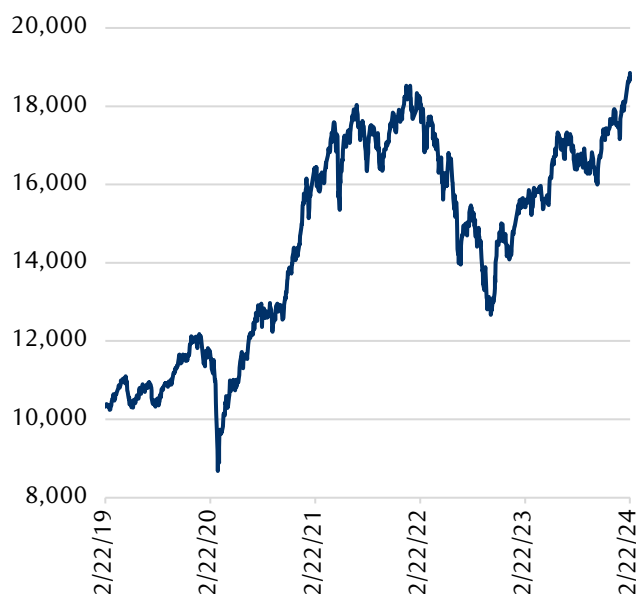
## ASIA PACIFIC

Emily Li – Hong Kong

■ **Taiwan's stock market index reached a new all-time high on Feb. 15 and has traded higher in recent sessions as investor optimism surged due to anticipated high demand for artificial intelligence (AI) technology.** The Taixi surpassed its previous peak, in January 2022, as trading resumed following the Chinese New Year holiday. **The majority of the market's gains came from a significant rise in TSMC (2330 TT) shares**, Taiwan's largest stock and a crucial provider of foundry services for NVIDIA (NVDA US). The new record level was achieved

## Taixi Index reaches all-time high

Majority of gains came from a significant rise in TSMC shares



Source - RBC Wealth Management, Bloomberg; data through 2/22/24

as investors worldwide continued to invest heavily in AI-related companies. Following the rally, TSMC is close to reclaiming a spot among the world's 10 most valuable companies.

■ **A resurgence in travel over the New Year holiday in China offers some signs of a pickup in consumer spending.** More than 61 million rail trips were made in the first six days of the holiday period. The average daily sales of the services sector rose 52.3% y/y with rapid growth in tourism, cultural and sporting activities, catering, and lodging. The daily average spending per tourist was no longer a drag on a year-over-year basis. Box office ticket sales reached a record high for the holiday period, with a jump in audience numbers a key driver. China's island province of Hainan reported daily sales of duty-free goods were up 40% y/y, thanks to strong growth in the number of shoppers.

■ **China implemented its largest reduction to a crucial mortgage reference rate, intensifying support for the struggling property sector.** The People's Bank of China announced a 25 basis points cut to the five-year loan prime rate, lowering it to 3.95%. This adjustment, announced on Tuesday, marked the first decrease since June and was the most substantial reduction since the rate was introduced in 2019. However, the response from investors was relatively subdued, leading to market expectations that more assertive measures will be necessary to bolster the economy in the coming months.



## MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,981.80	2.8%	4.4%	24.6%	14.6%
Dow Industrials (DJIA)	38,612.24	1.2%	2.4%	16.5%	13.3%
Nasdaq	15,580.87	2.7%	3.8%	35.6%	15.0%
Russell 2000	1,994.74	2.4%	-1.6%	5.6%	-0.7%
S&P/TSX Comp	21,172.38	0.7%	1.0%	4.5%	0.8%
FTSE All-Share	4,180.19	0.2%	-1.2%	-3.9%	0.2%
STOXX Europe 600	491.05	1.1%	2.5%	5.9%	8.0%
EURO STOXX 50	4,775.31	2.7%	5.6%	12.3%	19.8%
Hang Seng	16,503.10	6.6%	-3.2%	-19.6%	-31.7%
Shanghai Comp	2,950.96	5.8%	-0.8%	-10.8%	-15.5%
Nikkei 225	38,262.16	5.4%	14.3%	39.3%	42.2%
India Sensex	72,623.09	1.2%	0.5%	19.7%	25.9%
Singapore Straits Times	3,217.11	2.0%	-0.7%	-2.7%	-6.4%
Brazil Ibovespa	130,031.58	1.8%	-3.1%	19.1%	16.4%
Mexican Bolsa IPC	57,004.82	-0.6%	-0.7%	7.1%	9.6%
Gov't bonds (bps change)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Treasury	4.317%	40.4	43.8	36.4	238.8
Canada 10-Yr	3.547%	22.5	43.7	11.3	167.0
UK 10-Yr	4.103%	30.9	56.6	48.9	269.5
Germany 10-Yr	2.450%	28.4	42.6	-7.9	224.4
Fixed income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	4.90%	-1.6%	-1.9%	3.4%	-6.5%
U.S. Investment-Grade Corp	5.37%	-1.5%	-1.7%	6.2%	-4.7%
U.S. High-Yield Corp	7.86%	-0.1%	-0.1%	11.9%	5.2%
Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot \$/oz)	2,024.43	-0.7%	-1.9%	10.3%	6.2%
Silver (spot \$/oz)	22.88	-0.4%	-3.9%	4.8%	-4.3%
Copper (\$/metric ton)	8,423.99	-0.9%	-0.5%	-8.3%	-15.3%
Oil (WTI spot/bbl)	78.18	3.1%	9.1%	2.7%	-14.2%
Oil (Brent spot/bbl)	83.11	1.7%	7.9%	0.1%	-12.9%
Natural Gas (\$/mmBtu)	1.77	-15.6%	-29.5%	-14.5%	-60.0%
Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	104.0360	0.7%	2.7%	-0.1%	8.3%
CAD/USD	0.7403	-0.6%	-2.0%	0.2%	-5.6%
USD/CAD	1.3508	0.5%	2.0%	-0.2%	5.9%
EUR/USD	1.0819	0.0%	-2.0%	1.6%	-4.3%
GBP/USD	1.2636	-0.4%	-0.7%	4.3%	-7.1%
AUD/USD	0.6553	-0.2%	-3.8%	-4.4%	-8.9%
USD/JPY	150.2800	2.3%	6.6%	11.3%	31.0%
EUR/JPY	162.6000	2.3%	4.4%	13.1%	25.3%
EUR/GBP	0.8562	0.4%	-1.2%	-2.6%	3.0%
EUR/CHF	0.9515	2.1%	2.4%	-3.7%	-8.2%
USD/SGD	1.3440	0.2%	1.8%	0.3%	-0.2%
USD/CNY	7.1912	0.3%	1.3%	4.5%	13.5%
USD/MXN	17.0493	-1.0%	0.5%	-7.7%	-16.1%
USD/BRL	4.9382	-0.3%	1.7%	-4.3%	-3.3%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

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Source - Bloomberg; data as of 2/21/24

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			Count	Percent
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