

## Principal Equities

# Japan: A timely investment in deglobalization

Japanese companies are well-positioned to benefit from a reshoring of the global supply chain. This presents a timely—and yet largely overlooked—opportunity to generate potential alpha.

Concerns over dependability of global production in China have caused Western companies to reduce reliance on Chinese suppliers in certain sectors, resulting in a generational change in global trade flows. While global manufacturers diversify production, Western governments are supporting this push through a combination of policies intended to catalyze reshoring of global supply chains.

Japanese companies are poised to help drive a manufacturing renaissance—ultimately creating potentially appealing opportunities for investors.

## Generational change in globalization

More than 77 years have passed since the end of World War II, and in some ways, the global economic and trade landscape is strikingly similar.

After the World Trade Organization (WTO) accepted China in 2001, the country's integration into global supply chains was built upon 1) access to abundant, cost-competitive labor, 2) protection of intellectual property, and 3) consistency of supply and access to distribution channels. China's own domestic economic reform initiatives, tied to WTO accession, created the conditions for manufacturing clustering and positive network effects. This 20-year period of "high globalization" was undermined by the collective impacts of the pandemic, the 2017 U.S. trade war between the U.S. and China, and the geopolitical uncertainties touched off by Russia's invasion of Ukraine and China's relationship with Moscow.

The world is experiencing an acceleration of deglobalization where companies are re-assessing and pivoting to other locations to secure supplies for agriculture, healthcare, energy, defense, technology, and other industries by reshoring away from China.



*Author:*

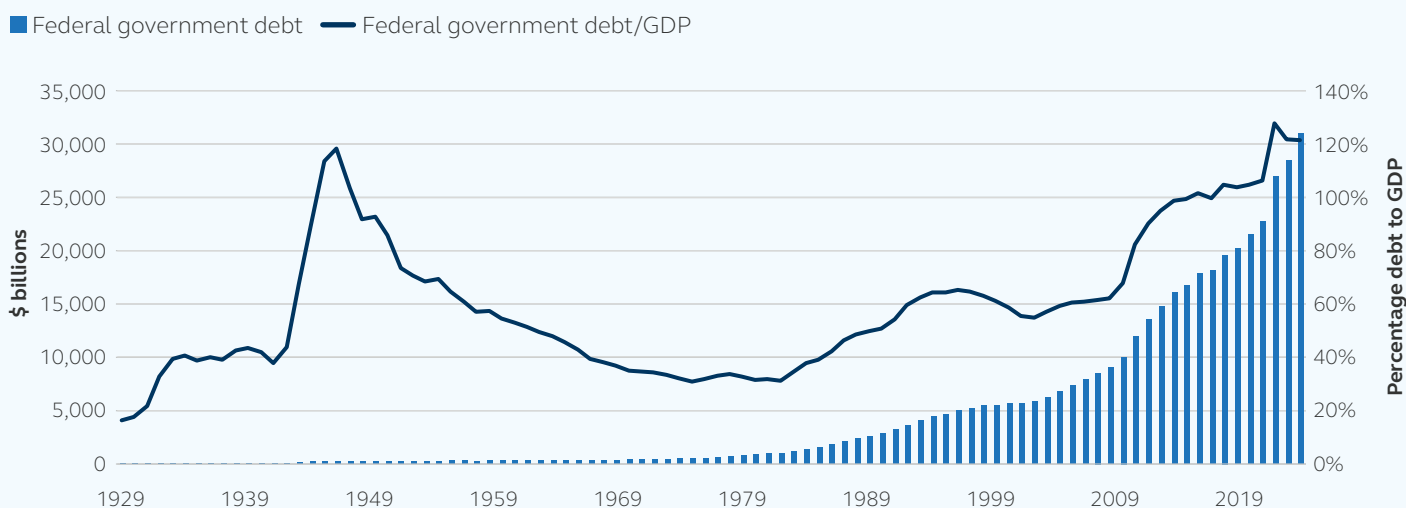
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## Supportive government policy

Today, the U.S. government's debt/GDP (gross domestic product) has reached a staggering 121%—a level last seen post-World War II. And while war spending was responsible for the deficits in the 1940s, the budget deficits of the last two decades are more broad-based. During both periods, the buildup of debt was aided by the U.S. government working closely with the Federal Reserve (Fed) in a way that enabled higher debt levels to remain affordable. From 1941 to 1951, the U.S. kept short-term and long-term interest rates low relative to inflation and debt levels. More recently, and since the Global Financial Crisis (GFC), quantitative easing (QE) has done the same. Looking ahead, both fiscal and monetary policy will likely create conditions for a capital expenditure boom needed for supply chain security.

### U.S. federal government debt to GDP, \$ billions, %



Source: U.S. Department of the Treasury's Bureau of the Fiscal Service, U.S. Bureau of Economic Analysis, Principal Asset Management. Data as of December 31, 2022.

## Japan may offer investors an edge

Too often, investors are focused on the short-term headlines and noise related to international investing, missing potential long-term opportunities with companies that may be part of the solution to today's global challenges.

At a time when the country's expertise and leadership in materials and manufacturing technologies will be in high demand, Japanese companies (and the Japanese yen) are attractively valued—and Japan continues to make significant strides in corporate governance and capital allocation. Characteristics of Japanese companies—stronger balance sheets, more focused, better managed—make them uniquely poised to benefit from the reshoring trend. The opportunity is ripe for sustainable long-term value creation.

## Strong positions in the right industries

Japanese industry has long benefited from historic strengths in materials and precision manufacturing technology and will likely continue to maintain a high global market share in those sectors because of continued investment in research and development. Additionally, many management teams have improved the allocation of capital to narrow the scope of their business, focus resources, and strengthen competitive positions in technologies poised to benefit from global trends.

Industries such as semiconductor production equipment and machine and electronic tools/components, where Japan maintains high market shares, make it a critically important player in creating more secure supply chains. Additionally, the country benefits from strong positions in industrial robotics and factory automation—imperative to bringing manufacturing back in an automated, efficient, cost-competitive way.

## Japan: A leader in manufacturing technologies

Sector	Market share estimated range
<b>Industrial machinery</b>	
Industrial robotics	33–40%
Machine tools	28–30%
Factory automation—pneumatic	30–35%
Factory automation—linear motion	40%
<b>Industrial electronic</b>	
Programmable Logic Controllers (PLC)	25–35%
Distributed Control Systems (DCS)	10–15%
Photoelectric sensors	25–40%

Source: Mizuho Group (Securities), Principal Asset Management. Data as of December 31, 2022.

## Significant progress in corporate leadership

Over the past decade, Japanese companies have made great strides in corporate governance and capital allocation. Former Prime Minister Shinzo Abe's push in 2012–13 to improve capital allocation in the corporate sector has had a lasting impact, driving more long-term, value-enhancing decisions by Japanese companies.

Continued progress on these fronts is primed to release shareholder value in the coming years. As companies focus on strengths and improve balance sheet efficiency, return on assets (ROA) will likely continue to improve given the tailwinds of reshoring and improving governance.

Japan's reputation among investors as a laggard in corporate governance is an increasingly inaccurate characterization. Many Japanese companies have taken significant steps to improve, such as:

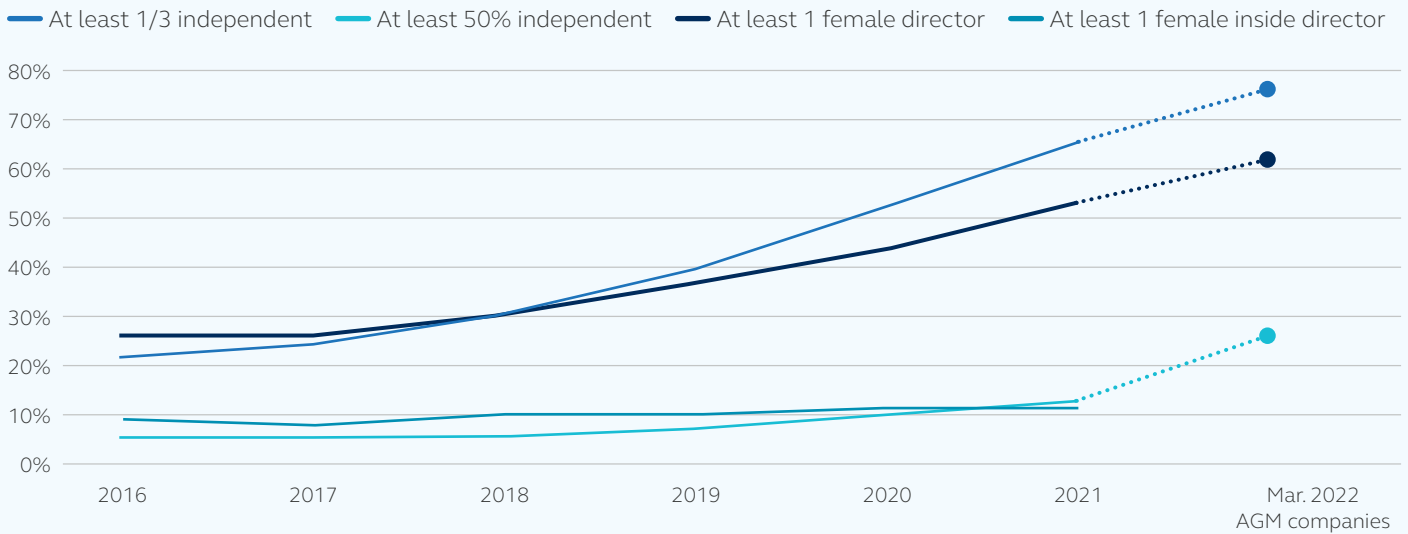
- Corporate action/consolidation to improve competitive positions and narrow the focus of overly diverse business models.
- Rising willingness to use more free cash flow to raise dividend payout ratios.
- Improving balance sheet efficiency by lowering large net cash positions through greater use of buybacks.
- Unwinding of cross-shareholding arrangements with other Japanese companies to improve balance sheet efficiency.
- Greater discipline in acquisitions, with more focus on value-accretive deals.

**HITACHI, LTD. IS A GOOD EXAMPLE.** This well-known manufacturer transformed itself from a sprawling, unfocused conglomerate with 22 separately listed subsidiaries to a focused industrial company with strengths in digital solutions, energy, and industrial electronics. The company now has only two listed subsidiaries.

## Improving board independence and diversity

Japan still lags U.S. and European companies in terms of board independence and ethnic and gender diversity. But trends are improving in both cases. As boards in Japan become more independent and global in perspective, they should reinforce existing favorable trends. The increasing presence of activist investors in Japan, many of whom strive to identify undervalued assets and ultimately improve long-term shareholder value, is also a positive.

### Japanese companies board composition trend (ISS coverage) independence based on TSE definition

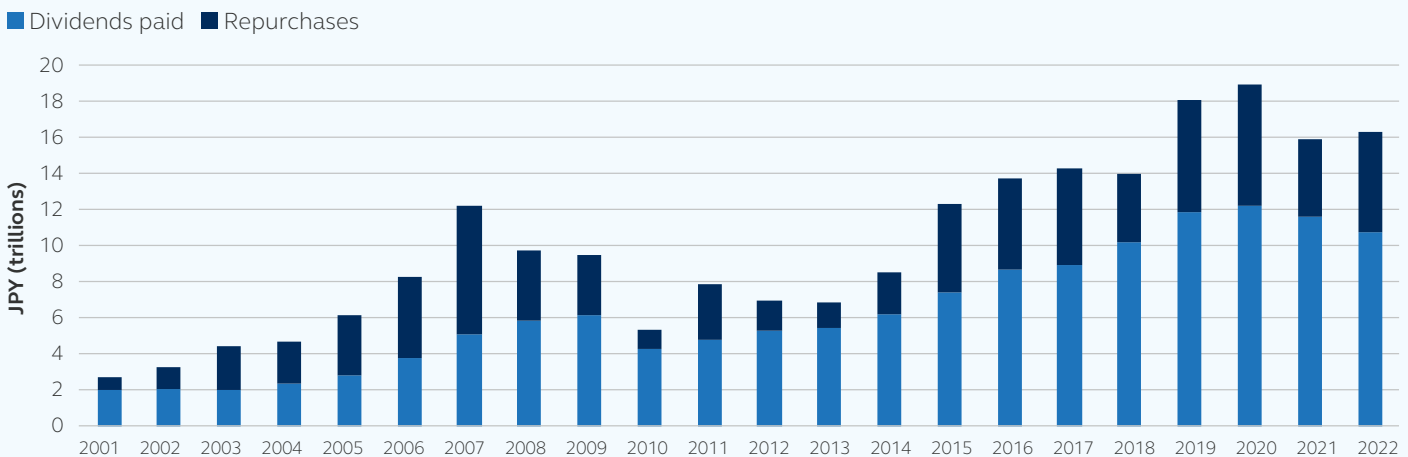


## Better capital allocation through buybacks

Recent conversations with Japanese companies indicate a greater willingness to use strong balance sheets for modest share buybacks. In fact, they seem more attuned to the greater value accretion of counter-cyclical share buybacks (buying when shares are depressed) than U.S. companies—which tend to use traditional rolling buyback programs that don’t emphasize buying for value.

Based on the TOPIX1000, 50% of Japanese companies have more cash than debt, standing out positively in comparison to the U.S. and Europe (at approximately 20% of companies). This provides plenty of firepower for management teams as they increasingly view buybacks as a viable option for capital allocation.

### Shareholder returns increasing in Japan (MSCI Japan)



## Structural tailwinds with cyclically depressed valuations and attractive yen

While the Japanese market has been attractively valued across numerous metrics for some time, valuations alone rarely represent an effective buy signal.

The emergence of sustainable and fundamental changes to structural drivers of long-term performance (supply chain security and improving governance) now aligns with attractive valuations and have created an enticing opportunity for investors.

The Japanese yen (JPY) is at its cheapest level versus the U.S. dollar (in inflation-adjusted terms) since the 1970s. As it stands, Japanese products are attractive in overseas markets, especially in dollarized sectors (in which many Japanese companies are active). Buying assets in JPY at these levels should provide a modest increment to medium-term returns as the JPY eventually returns to more fair-valued levels.

### Japan's real effective exchange rate at 50-year lows

Bank of Japan (BOJ) effective exchange rates



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2022.

### INVESTMENT IMPLICATIONS

While these structural changes are just beginning, both corporations and Western governments are highly supportive of efforts to build a more global supply chain. Japan is well-positioned to benefit given innovation in materials technology, precision manufacturing, automation, and other key areas that will be vital in helping the global economy achieve greater independence from Chinese manufacturing.

The market has yet to recognize this scenario's full potential and scope. Still, the intersection of well-positioned, well-managed Japanese companies, and a global economy in search of dependable suppliers, presents a timely—and yet overlooked—opportunity for investors.

## Risk considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility. International investing involves greater risks such as currency fluctuations, political/social instability, and differing accounting standards.

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