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# A Turn to Japan

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The dominant equity markets of the world's two largest economies, the US and China, have fueled returns and commanded headlines over the past year. This month, we turn our attention to Japan, a country on the cusp of an economic rebound and gathering new interest. Looking at Japan, we find earnings booming, valuations coming in at reasonable levels, and corporate catalysts boosting returns.

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## Beyond US and China

The equity market narratives of the US and China that have played out over the past year and more are by now very familiar. First, US exceptionalism and an AI-induced fervor have driven the US market on an unrelenting upward trajectory. This improvement has been centered in a few winner-take-all names, as we have written about in prior commentaries [on diversification](#), [fundamentals](#), and [concentration risk](#).

Second, the equity market in China, the world's second largest economy, has struggled as insipid growth, a property crisis, a global trend to re-shoring and overreaching government intervention have sapped investor enthusiasm. Support measures announced at March's National People's Congress may help to address some of these headwinds, but so far the market reception has been muted.

Since the end of September last year, which approximately marked the last market low, the US equity market has returned 46%, while China's equity market has dipped by -2%, both in local currency.<sup>1</sup> This trend is not a surprise given the fundamentals developing in both economies and the headwinds facing China. One other major market, Japan, however, deserves attention as it has outperformed the US, delivering 52% return over that same period.

The outperformance of Japan compared to the rest of the world has been backed by increasing earnings forecasts, as well as price-to-earnings (P/E) expansion. In the US, earnings forecasts have still been increasing. However, investors must pay a significant premium, in terms of valuation multiples for those earnings relative to markets such as Japan and Europe.

Figure 1  
**Returns and Changes  
in Earnings Forecasts  
and Valuations**

	Index Total Return (%)	Change in Earnings Forecasts (%)	12M Forward P/E Ratio
Japan	52	13	15.5
USA	46	6	20.8
World Index	42	6	18.2
Europe	32	10	13.4
Emerging Markets	19	2	12.0
Pacific ex-Japan	18	-1	14.8
China	-2	3	9.1

Source: State Street Global Advisors, MSCI, FactSet. Returns are in local currency for MSCI Indices from September 30, 2023 to February 29, 2024; changes in next 12 months consensus earnings forecasts from September 30, 2023 to February 29, 2024; forward P/E ratios as of February 29, 2024. Past performance is not a reliable indicator of future performance.

Growth in the Japanese market has also been less concentrated than the US, with the top 10 names only delivering 34% of the total growth within the MSCI Japan Index. In the US in contrast, the top 10 securities delivered 83% of the total, with a sizable proportion of that lift coming from a very large, well known, semiconductor manufacturer riding the artificial intelligence highs. The increased breadth in markets outside the US creates opportunities for stock pickers to generate returns; in the US the key decision has really been about the 'Magnificent 7' versus the rest of the equity market.

## The Changing Face of Japan

Our view of the relative attractiveness of the Japanese market at present is not just predicated on a few simple ratios. Rather, our enthusiasm stems from the positive story supporting these ratios — namely a broader narrative of structural change, as set out in a [recent piece on Japan](#) by colleagues at State Street Global Advisors. Some of these structural changes have been the result of many years of work — in particular the corporate reforms that have driven positive changes in Japanese boardrooms and the evolution of more shareholder-friendly policies. The Tokyo Stock Exchange's recent directions and intervention to improve corporate governance and capital efficiency continue to support these developments, effecting a shift in approach with corporates reinvesting their large cash reserves to fund growth.

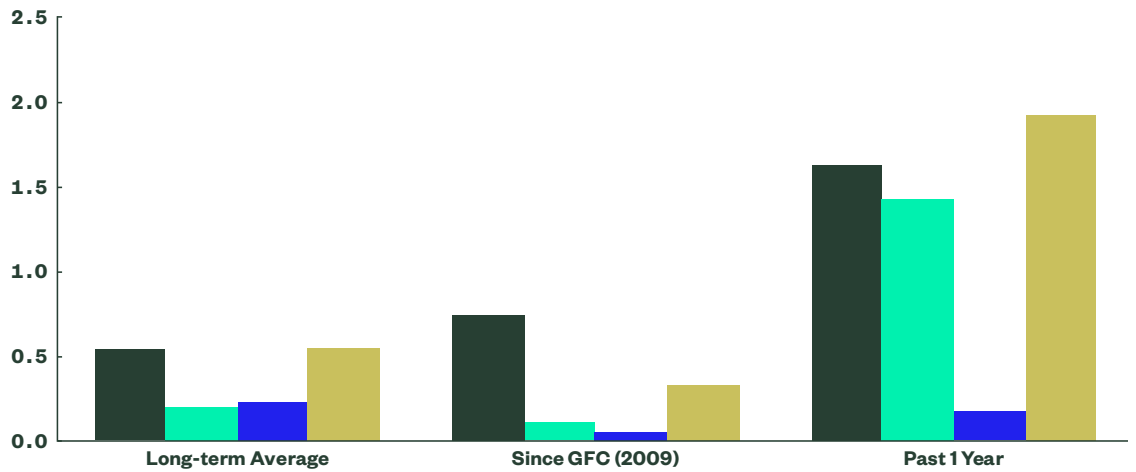
There are tentative signs that the recent reforms are having an effect, not just on the overall market direction, but on the relative drivers of returns within the Japanese equity market. Over the 'lost decades,' Japan has largely been viewed through the factor lens as a Value-driven market. With corporates hoarding large cash balances and not reinvesting, there was minimal top-line growth and earnings growth typically came from buybacks rather than increasing sales. Sentiment and Momentum factors struggled to perform with little fundamental improvements for them to grasp.

Over the long term in Japan the Momentum factor has delivered a positive return; however, that has been dwarfed by Value. In the time since the Global Financial Crisis, Momentum returns have been negligible. This contrasts strongly with the US market, which has been driven by strong top-line growth and winners that keep on winning. The result has been that Momentum has led as the more robust factor, with Value underperforming.

Since the Tokyo Stock Exchange's most recent intervention in March 2023, however, we have seen something of a turnaround for the Momentum factor in Japan. Over the past year Momentum has performed significantly stronger in Japan than its long-term average while Value has continued to perform very strongly.

Figure 2  
**Average Factor Performance of Value and Momentum in Japan and the US**

■ US Momentum  
 ■ Japan Momentum  
 ■ US Value  
 ■ Japan Value



Source: State Street Global Advisors, MSCI, Axioma, FactSet. Quintile spread returns in local currency for MSCI Indices from February 28, 2023 to February 29, 2024. Past performance is not a reliable indicator of future performance.

The Systematic Equity — Active team relies on Sentiment and Value signals as two of the four core themes within our return forecasting model. Our signals are more diversified and nuanced than the aforementioned more straightforward Momentum and Value factors, and over the long term have significantly outperformed them, despite exhibiting similar characteristics. The strong recent returns from our Sentiment signals in Japan, supported by still solid Value returns, have meant that our benchmark-aware strategies have benefitted positively from the alpha that we have been able to generate in Japan. Over the past twelve months the active return contribution from Japan has been the strongest individual country contributor within our Global Enhanced strategies.

## The Bottom Line

Structural and corporate reforms within Japan’s market have effected renewed investor interest in Japanese equities. Improving company earnings, and relatively cheap valuations have led to strong recent equity outperformance relative even to the US.

We have noted that recently long-term norms of factor performance have also started to change in Japan, in parallel with these structural shifts. While the Value factor has over the long term been a much stronger contributor than Momentum in Japan, over the past year we have seen a sturdy resurgence in Sentiment and Momentum measures. Time will tell if this is a transitory turn or a new paradigm as a result of the structural shifts evidenced in the Japanese market and Japanese corporates.

For now, as active investors we see many opportunities in turning to Japanese equities to generate not only significant alpha, but also compelling beta returns for our clients.

## Endnote

1 Total return for MSCI Country Index in local currency from September 30, 2023 to February 29, 2024.

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- Build from breadth
- Invest as stewards
- Invent the future

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\* Pensions & Investments Research Center, as of December 31, 2022.

<sup>†</sup> This figure is presented as of December 31, 2023 and includes approximately \$64.44 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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