Letter From Tokyo

Shigeru Oshita,
Chief Portfolio Manager, SuMi TRUST

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Standard Life Investments

View From Above

A recovery underway

Japan is recovering, although challenges remain. Global demand has picked up, notably in Europe and in China, while the US has reached a stronger point in its economic cycle. This backdrop boosted Japan's important export sector, the main driver of growth in late 2016. With real GDP growth up 1% quarter-on-quarter in Q4, I do see grounds for optimism for 2017. On the political front, most investors, including me, were relieved that the recent meeting between President Trump and Prime Minister Abe was more amicable than some had feared. Over the long term, I think Japan could benefit from the new US regime, via direct investment by Japanese companies (which Prime Minister Abe highlighted during his visit) and, potentially, from President Trump's priorities, such as US infrastructure renewal.

More broadly, beyond the US, there has been increased protectionist debate and evidence of populist movements gathering momentum. I am referring to European elections due this year – particularly in France and Germany – and the UK's Brexit process. Each of these events will have ramifications for Japan and its trade. Crucially, I am looking for Japan's own growth engines to fire more consistently, to really talk of a broad-based recovery. The latest monthly consumer confidence data was below forecast. However, unemployment, at 3%, is at its lowest rate for some 20 years. Recent wage data was slightly higher too. Let's look at developments in the labour market, and consider what contribution Japanese consumers might make to growth in 2017.

"Japan is recovering, although challenges remain"

Market Overview

Working it out

The arrival of President Trump certainly had a positive impact on Japan's equity markets, though we will have to see how he manages to deliver on such a busy agenda if this boost is to endure. We have seen improved earnings capability from a number of Japanese companies and sectors which I don't think have been fully reflected in share prices yet. Corporate earnings and business investment have all benefited already from relaxed monetary policy and recovering global demand. A further positive driver for Japanese stocks is that significant corporate governance reform is underway, even though there remains considerable work to be done here. There is now increased recognition of shareholders by Japanese companies, as is reflected by share buybacks, increasing dividends and more focus on margins and profitability.

How people actually work may be set to change too, with Prime Minister Abe's 'work style' 2016 reforms due to come into force shortly. His policy seeks to address a number of issues including equal pay for non-regular workers, increased wages across the board too and a change to the working culture. Japan has historically had a culture of extremely long working hours that has prevented those raising children or caring for older relatives from entering the workforce. This, in turn, was negative for the rate of productivity. New measures could help increase labour force participation overall – the participation rate of women and seniors has already increased slightly in the last five years. Changes in working culture could also be a trigger to improve productivity overall. A tight labour market is likely to continue to promote these changes.

As well as addressing public concerns that long working hours are damaging workers' health, Abe's reforms might ultimately boost consumer spending. In theory, workers with more time on their hands should spend more on leisure activities, dinner with family and friends and other forms of recreation. However, I think that any meaningful boost to discretionary consumption is still several years away, at best. Even so, I can already see some interesting areas that are benefiting from labour market changes.

"Changes in working culture could improve productivity overall"

Investment Insights

Automating the work environment

I think that Japanese companies will become increasingly polarised into two groups from a workforce standpoint. Quality companies should still be able to attract and retain talented people by introducing a better working environment. They can do this in a number of ways including shorter hours, better conditions and benefits. These companies can also seek to increase efficiency by investing in IT upgrades and robotics to streamline business processes. Meanwhile, companies perceived as less attractive employers could struggle to attract talented people. And, as existing workers leave, these companies could struggle to replace them and might suffer an increase in labour costs.

"IT upgrades and robotics could streamline processes"

An example of a company seeking to retain workers is Ajinomoto, a manufacturer of seasoning for food products. It decided to shorten its workers' hours by 20 minutes for all employees and it also increased their wages. Additionally, the firm is aiming to provide different types of working environment for different workers including mothers and elderly people. It is looking at working-from-home solutions too. Innovative companies such as this should be able to retain quality workers.

Logically, this process should provide a shot of adrenalin to an already fast-moving industry – automation and robotics. Japan may be regarded as one of the world leaders in these industries. However, there is still much further to go. Over the longer term, the strongest companies will sell off their non-core businesses to other companies to avoid labour cost increases. I see this as the continuation of the process of streamlining business activities in corporate Japan.

Other industries will benefit too from the labour market changes. For example, recruitment agencies are already profiting from a tighter labour market as companies engage their services to try to find the people they need. This may also involve technological advances. For example, Recruit Holdings uses artificial intelligence to match potential employees with the companies seeking to fill positions. Recruit Holdings is now expanding outside of Japan through the acquisition of overseas companies in countries including the US and the UK.

Automation and robotics covers a vast array of technologies. Examples would include Nidec, the world's largest motor manufacturer. The firm is seeing increased demand from companies that require a large number of workers for their warehousing operations. Nidec's motorised carts can alleviate this problem. Elsewhere, Mitsubishi Electric offers a vast range of automation and processing technologies that all aim to bring higher productivity to the factory floor.

Another example is Shima Seiki Manufacturing, which produces knitting machinery used primarily in the production of clothing. The company is now seeing increasing demand for its equipment in other countries where wages are rising. One application of its machines is in the production of the fabric on the top of sneakers. Automation can help manufacturers control and manage their costs and certain Japanese corporates are extending their local expertise to companies outside Japan.

Demographics should also boost the development of automation given that many developed countries have ageing populations. On a cultural basis, most Japanese people consider living with – and ultimately being assisted by – automated devices and robots as acceptable and useful.

As ever, we build our portfolio on a stock-specific basis, with the aim of creating a fund that has the potential to perform in various market conditions and which seeks to weather various financial and political headwinds.

Shigeru Oshita
Chief Portfolio Manager,
Japanese Equities

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Standard Life Investments' Japanese Equities funds are managed by strategic alliance partner SuMi TRUST

"Innovative companies should be able to retain quality workers"

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