



SUGA RUSH

October 2021

Despite a negative month for most equity markets, the Japanese Nikkei 225 managed to increase 4.85% in September. Whilst the US S&P 500 index posted its worst monthly return since March 2020, Japanese equities romped on to their best month since August of last year. This strong performance was largely observed in the first half of the month and was precipitated by the surprise announcement that the Prime Minister of Japan at the time, Yoshihide Suga, was not going to run in the upcoming leadership contest in late September.

Although the positive market reaction would have done nothing for Suga's self-confidence, it has sparked investor interest in Japan. This month, we consider how the leadership race played out, the effect Covid has had on the country and the impact of hosting the Olympics in a lockdown, as well as the makeup of the market and how it is placed within the backdrop of a wider global recovery.

LEADERSHIP RACE



The Liberal Democratic Party (LDP) have been in power since 2012 in Japan and in order to frame recent leadership events it pays to look back just over a year. In August 2020, the then serving Prime Minister, Shinzo Abe, announced that, due to ill health, he would be stepping down from his post after nearly eight consecutive years at the helm – the longest serving Prime Minister in Japan's history. At the time, Yoshihide Suga, Japan's longest serving Chief Cabinet Secretary (under Abe), was favourite to step into the role and, as expected, on 14th September 2020 Suga won the LDP leadership contest with 70% of the vote.

So why is it that, after just a year in office, Suga has decided to step back?

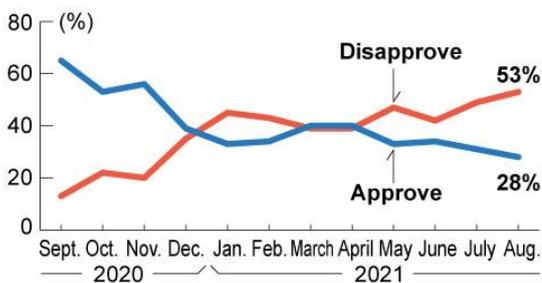
It's no secret that Suga had big shoes to fill. When Shinzo Abe won the Japanese general election with the LDP back in 2012, he vowed to fix Japan's economic woes by targeting deflationary problems through government spending and monetary easing. Abe's policies, or Abenomics as they became known, worked quickly. As monetary policy weakened the Japanese yen, inflation and exports rose and the economy grew making Abe a popular Prime Minister.



SOURCE: TRADINGECONOMICS.COM | MINISTRY OF INTERNAL AFFAIRS & COMMUNICATIONS

Abenomics reverses deflationary trend in Japan

Source: tradingeconomics.com



Note: "Others," no answers are omitted

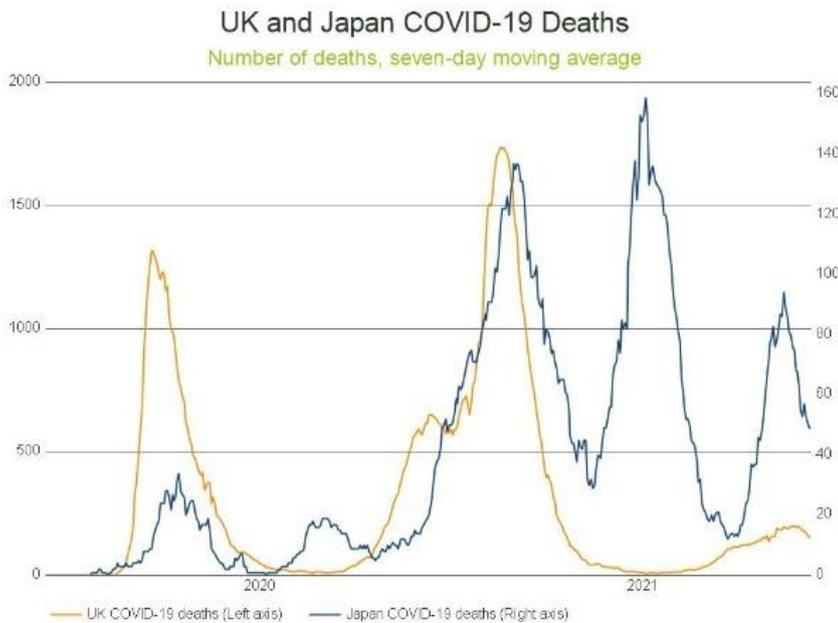
When Suga took over in September 2020, besides living up to his predecessor's legacy, he had a global pandemic to contend with and a much-anticipated, Covid-delayed Olympic Games to deliver in 2021. A difficult task by anyone's standards. Unfortunately for Suga, despite starting the job with relatively broad support, the last year has taken its toll on his popularity. The approval ratings for his cabinet have continued to fall throughout the year as

many feel he has not dealt with either the Olympics or the Covid crisis particularly well.

Suga Cabinet approval ratings

Source: asahi.com

Although Japan's overall cases of Covid (1.71m vs 8.01m) and resultant deaths (c.18,000 vs c.137,000) are significantly lower than the UK both on an absolute and relative basis (Japan has a far bigger population), Japan's waves have hit later in the pandemic, and these have predominantly been under Suga's watch. This has reflected badly on him and his government when compared to the earlier days of the pandemic, under Abe's premiership, when numbers were much lower:

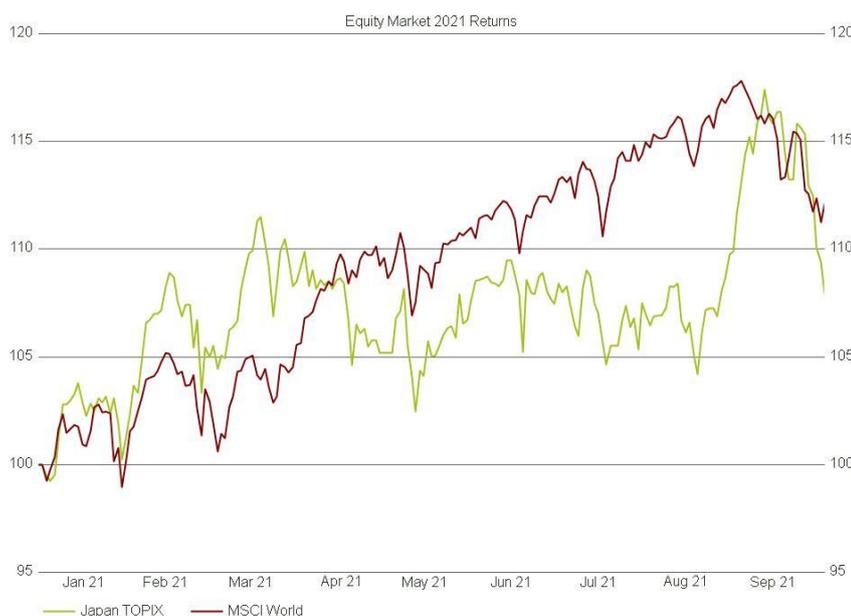


In addition to Covid criticism, Suga's administration came under fire for the decision to press ahead with the Olympics despite public opinion being opposed to the idea. Although Suga insisted the games would be held in a "safe and secure" environment, many questioned the resources available to prevent the Games exacerbating the Covid situation in Japan. Though it seems the safety bubble for the participants was largely successful, preventing the spread of the virus among volunteers and workers associated with the Games was less so. Vaccinations were only made available in late June to these parties, leaving no time for a second dose. With spectators banned from attending the Olympics, Japan took all the risks of hosting the games amid a global pandemic but received little upside – a problem levelled directly at Suga.

Japanese COVID Deaths have risen as US and UK numbers fall

Source: Refinitiv

Given the negativity surrounding Suga's tenure, it is perhaps no surprise that markets reacted positively when he stepped down. Before his resignation, the Japanese TOPIX equity index had underperformed when compared to global equities in 2021.



Japan catches up after underperforming all year

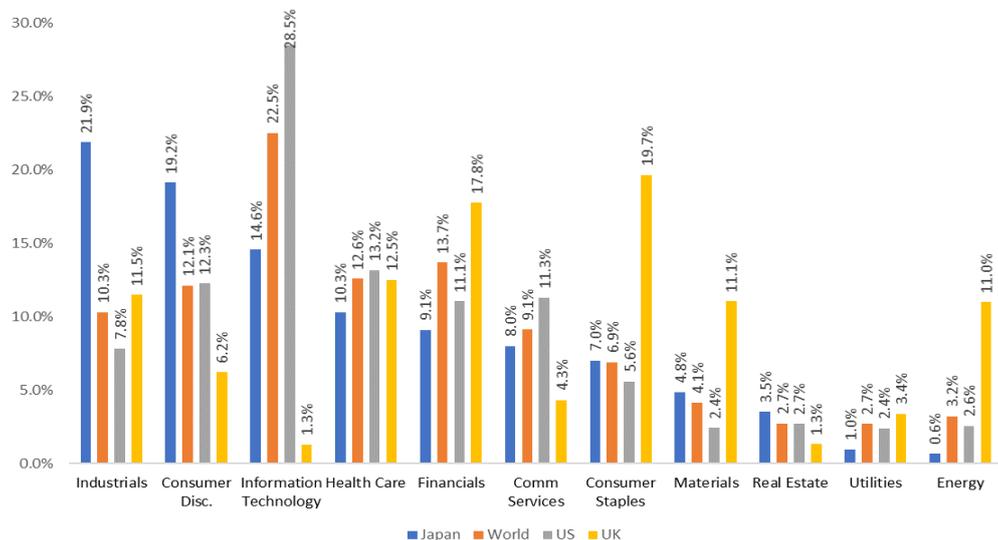
Source: Refinitiv

The sudden turnaround in fortunes for Japanese equities was reflective of the hopes pegged on the incoming PM to increase spending and support the economic recovery in Japan. The new leader of the LDP, and the man who will have to face a general election in Japan later this month, is Fumio Kishida. Whilst he has promised a massive stimulus package for Japan, in some reports up to ¥30 trillion (around US\$270 billion), Kishida's suggestion that capital gains tax may also need to be increased has concerned investors. This unpopular announcement, coupled with global concerns (inflation, Evergrande default and energy prices woes), meant much of the gains made by Japanese equities in early September were given back. Despite this, the gap to global peers has been significantly reduced.

JAPAN IN RECOVERY

Given that the Japanese equity market has lagged its peers, where is it placed within the global recovery?

The composition by sector of Japan's stock market sits somewhere between the growth-oriented Tech-heavy US equity market, which is dominated by names such as the "FAANGs" (Facebook, Apple, Amazon, Netflix and Google), and the value-focused, Financials and Energy-rich UK market, heavily laden with big banks and oil producers. Industrial and Consumer Discretionary stocks make up a large portion of the Japanese stock market, therefore offering investors more cyclical exposure and a diversifier within portfolios to the UK and US equity markets.



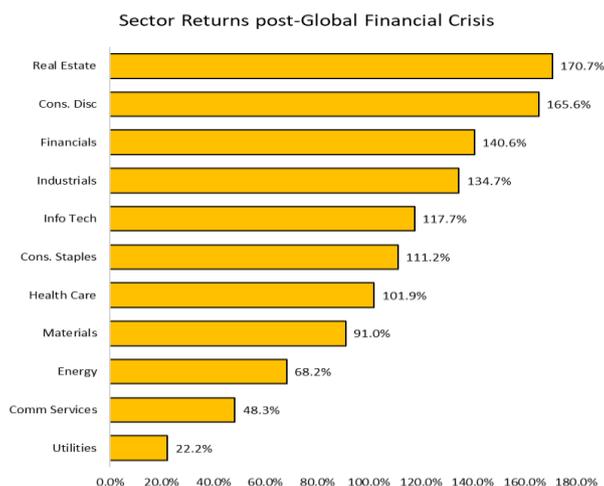
As we have seen this year already, it is likely that bouts of volatility will continue to test investor sentiment as the global recovery unfolds in a post-Covid world. Much will depend upon the winter and how infection rates progress, as well as the ongoing push for vaccinations and booster shots. Economic indicators will of course play a big part in the action taken by central banks, which will in turn affect decision making among investors.

The Japanese market offers broad diversification across sectors

Source: msci.com

With the above risks noted, we have already embarked upon the recovery stage and with this comes the opportunity to allocate accordingly. Japan offers an interesting proposition to investors who may wish to avoid overly inflated valuations whilst taking advantage of recovery-friendly opportunities.

The below chart shows the performance of the various sectors in the four years following the Global Financial Crisis. Within that period Consumer Discretionary, Financial and Industrial stocks provided stellar returns, three sectors that make up c.50% of the Japanese equity market.



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With the likes of US growth markets feeling the pinch as inflationary pressures rebound, a vaccinated Japan, backed by Kishida's stimulus promises, may start to play a bigger role in global portfolios. As for the Olympics, hopefully the people of Japan take solace and pride in their largest ever haul of gold medals at a Games, pipping team GB to third place!

Source: Morningstar

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