

Japan: the market the rally forgot

By Tom Stevenson, 14 July 2010

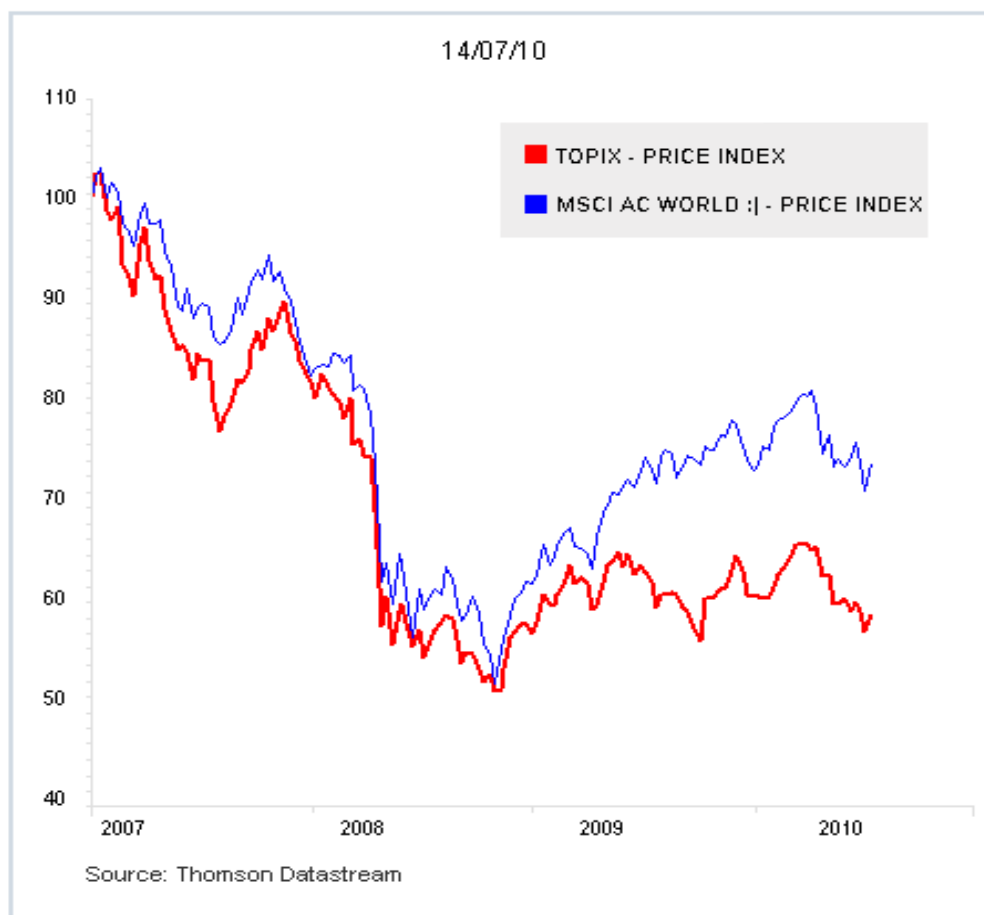
Investors have learned the hard way that Japan marches to a different beat. How long can the underperformance go on?

The Japanese stock market has been a frustrating place for as long as most investors can remember. Having peaked as long ago as 1989, Japanese shares have been trapped in a seemingly relentless decline ever since. Periodic rallies during the past two decades have always run into the buffers, with the market losing around two thirds of its value over that 20-year bear market.



The chart below shows that the disappointment goes on. Although Japan's benchmark Topix index moved in lock-step with world markets as they declined from the October 2007 peak, it has failed miserably to take part in the rally that began in March 2009.

"It is not immediately apparent why Japanese equities should have diverged from the global trend to such a striking degree." Tom Stevenson



It is not immediately apparent why Japanese equities should have diverged from the global trend to such a striking degree. Japan's economy is still highly dependent on exports and so sensitive to swings in global trade. That might have suggested that Japanese shares should have risen sharply when it became clear that massive government stimulus had averted a second Great Depression at the beginning of last year.

In the event, other factors such as the strength of the yen and a glut of share issues exerted a greater influence on the Japanese stock market. More recently political upheavals, a curiously permanent feature of an otherwise stable democracy, have also soured market sentiment. Despite signs that unemployment is retreating from its post-crisis peak and economic growth bouncing to an attractive annualised rate of around 5% in the first quarter of 2010, the market has failed to respond as frustrated Japan bulls might have hoped.

The underperformance in Japan has been such that valuations of Japanese stocks are now lower than at any point in the past 35 years or so. They are also throwing off more cash on average compared to their share prices than American stocks. On the basis that the most important determinant of long-term investment returns is the valuation at which an investment is made, the odds are more firmly stacked in Japan's favour than they have been for a generation and more.

There are other reasons why investors might want to give Japan a second look. One of the world's great export engines, Japan has always been reliant on the world's consumer of last resort, the US. But in recent years, China has emerged as Japan's biggest trading partner, taking around a fifth of its exports.

This should not be surprising. Japan specialises in the high quality machine tools that a rapidly industrialising country needs to fuel its own exports. It is a beneficiary of the trend towards greater automation in China as labour shortages and wage inflation begin to bite. And it makes many of the consumer electronics that an increasingly consumerist society craves. Japan is in pole position to benefit from the economic growth of its giant near neighbour. In the meantime, it should benefit from the US's economic recovery too.

There is no doubt that Japan has some deep-seated problems, most notably an ageing population. Cultural prejudices against immigration ensure that this is unlikely to improve much in future. There is, however, a price for everything and arguably, after a 20-year bear market, Japanese stocks are close to that price.

Attractive valuations, a wealth of intellectual property and a reversal of some of the currency and equity issuance headwinds that have affected the market in the short term mean Japan is once again worth a look.

While the world's investment attention has been focused on the remarkable growth potential of the emerging markets, the value opportunity in Asia's most developed economy has gone largely unnoticed. Japan has tested the resolve of contrarian investors over the years but maybe its time has come.

Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.