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Was Abenomics a Failure?

- Reflection on the past decade from a value investor's perspective

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After more than a decade since its introduction, the revitalization policy enacted by former Prime Minister Shinzo Abe, or Abenomics, has often been criticized for its apparent lack of significant positive impact on corporate Japan and the domestic economy. Chief Portfolio Manager Miyazaki Yoshihiro and Senior Portfolio Manager Mitsunari Kawano of the Japan Strategic Value Equity Team offer their insight into the actual impact of Abenomics. We also forecast the potential constructive outcomes of the policy if it is maintained by the Kishida Administration, assuming corporate Japan continues to improve governance and earnings.

Main points:

- Abenomics was not a failure and, in fact, is closer to success after a decade.
- Abenomics improved the business environment for Japanese companies, leading to an increase in their earnings (or earnings per share, EPS).
- However, while Japanese companies' balance sheets have improved, and return on equity (ROE) has reached 10%, it is not at a notable level compared to other countries. When focusing on this point, Abenomics may be viewed as a "failure", and investors' overall evaluation of Japanese equities has not been sufficiently high.
- Japanese companies are expected to make further efforts to improve their balance sheets, and ROE will likely improve through measures to increase in total shareholder returns, including dividend payout ratio.

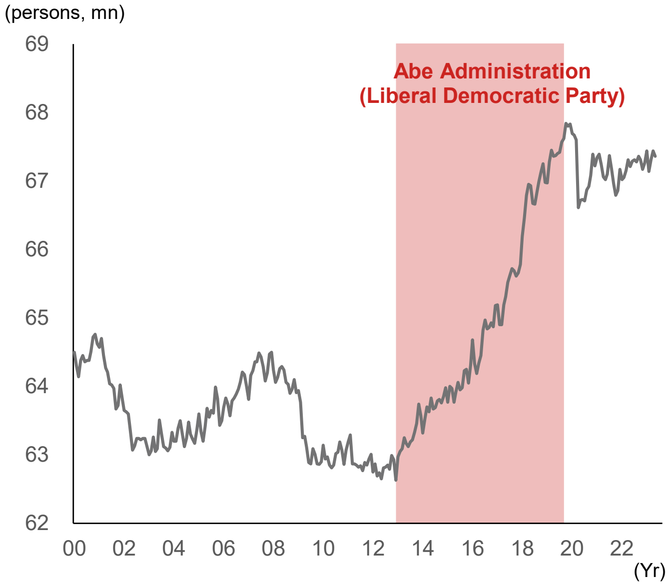
Abenomics – Looking back its implementation since late 2012

Shortly after former Prime Minister Shinzo Abe left the cabinet office in September 2020, there was a litany of criticism that Abenomics was a failure. However, looking back at the preceding decade, these scathing critiques may not be entirely accurate.

The pillar of Abenomics' plan to achieve economic growth was the "Three Arrows" of monetary easing, fiscal stimulus, and growth strategy. Several numerical targets were specifically set, such as a consumer price growth rate of 2%, a real GDP growth rate of 2%, and a nominal GDP of 600 trillion yen. None of these targets had been achieved by the time Abe left office.

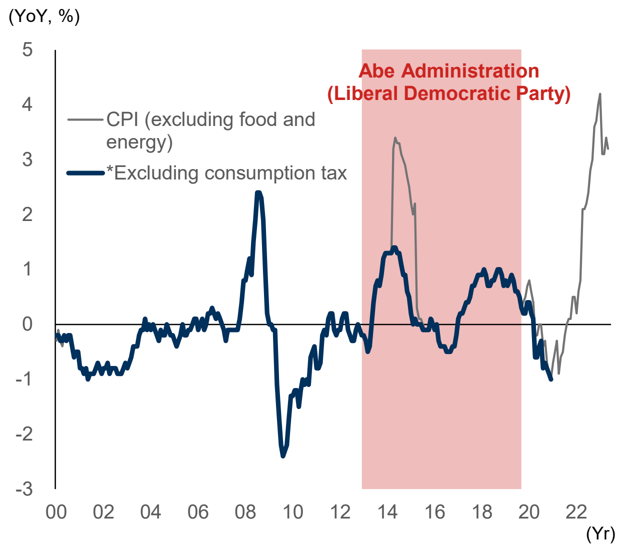
However, as shown on the right, the number of employed persons increased significantly and the consumer price index emerged from the so-called deflationary situation during Abe's Administration, undoubtedly changing the Japanese economy's course away from the stagnation that persisted prior to Abenomics. In addition, the consumer price inflation rate (excluding fresh food) has now exceeded 2% for more than one year, and nominal GDP was 590 trillion yen in the April-June period of 2023, just shy of the Abenomics target. Considering the intensification of U.S.-China friction and the outbreak of COVID-19, it can be said that the numerical targets of Abenomics are being achieved, though slower than initially expected, in the post-Abe era.

Figure 1. Employed Persons – Japan



Source: Nomura Asset Management based on Statistics Bureau of Ministry of Internal Affairs and Communications

Figure 2. Consumer Price Index – Japan



Source: Nomura Asset Management based on Statistics Bureau of Ministry of Internal Affairs and Communications

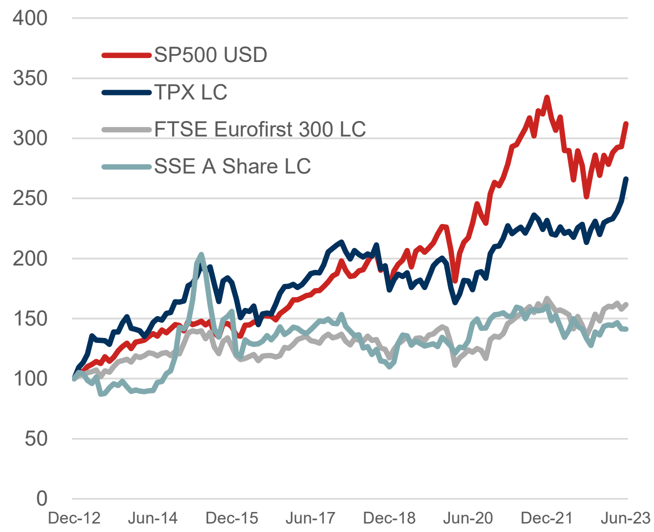
Looking back on the last 10 years from an investor's perspective

From an investor's perspective, let's see how stock prices have fared since Abenomics' inception in 2012. Figure 3 shows that the S&P500 had the highest return, while TOPIX was second highest. Until around 2018, TOPIX had the highest return compared to stock indexes in Europe and the US.

However, if we look at the return of the stock market of each country, as seen by international investors in US dollar terms, we can see that the TOPIX has the same return as the indexes of Europe and China, and does not stand out compared with them. This might be a significantly influential factor behind global investors viewing Abenomics as a failure.

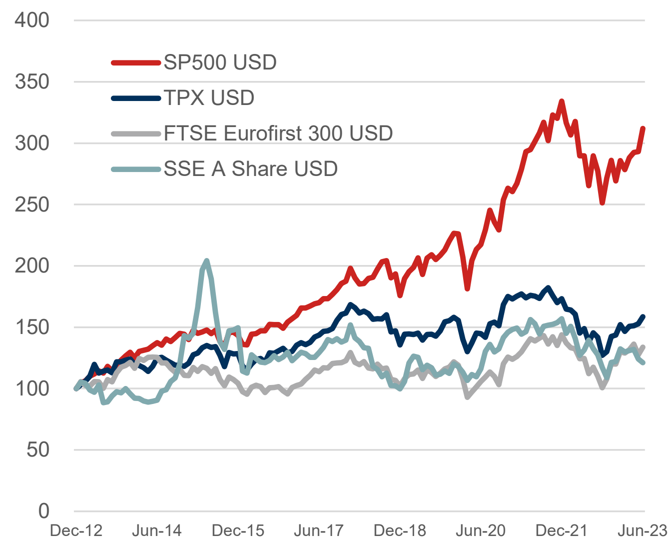
This is, of course, due to Yen weakness.

Figure 3. Stock market returns (local currency based)
(End of 2012 to June 2023)



Source: Nomura Asset Management based on FACTSET data

Figure 4. Stock market returns (US dollar based)
(End of 2012 to June 2023)



Source: Nomura Asset Management based on FACTSET data

Abenomics has improved the business environment

From a stock market perspective, the growth strategy that represents the third arrow in Abenomics seems to be underappreciated. However, to properly evaluate the third arrow, it is important to examine how the business environment surrounding Japanese companies has changed.

Before the start of Abenomics, it was said that the competitiveness of Japanese companies was being hindered by the "six-fold pain" of the super-strong yen, delays in economic partnership agreements, high corporate tax rates, strict labor regulations, strict environmental regulations, and power shortages/high electricity costs.

Figure 5. Present and future of the "six-fold pain" faced by Abenomics

		Six Struggles of Significant Weakness	Current	Hereafter
1	**Appreciation of the Yen**	75-80 yen in the latter half of 2011	The yen's appreciation will be resolved, and the cost of the yen's depreciation will be realized	?
2	**Delay in economic partnership agreement (EPA)**	Nearly 20% of exports and imports as of December 2011 (Economic Partnership Agreement with ASEAN, India and 3 other countries entered into force)	TPP11, Japan-EU EPA, Japan-US trade agreement, Japan-UK EPA, RCEP, etc., come into force, about 80% of exports and imports	Aiming to implement "DFFT" to promote free data circulation with international reliability
3	**High corporate tax rates**	37.00% in FY 2012	29.74%	4 - 4.5% increase at an appropriate time after 2024 (proposed tax increase due to drastic strengthening of defense capabilities)
4	**Strict labor regulations**	Inflows into and out of the unemployment pool 0.78% (2010)	Inflow and outflow of the unemployment pool 0.82% (2020), lower than in other countries	Trinity of Labour Market Reform (Support for capacity building through reskilling, introduction of job pay, and facilitation of labor mobility to growth areas)
5	**Strict environmental regulation**	Reduce greenhouse gas emissions by 15% from 2005 levels by 2020 (as of 2009)	Reduce greenhouse gas emissions by 46% from FY 2013 levels by FY 2030	As a new source of growth (¥150 trillion in public and private GX investment over 10 years)
6	**Power shortage and high electricity costs**	14.33 yen/kWh (For industry: FY 2010)	19.28 yen/kWh (FY 2021 for Industry)	Energy-saving promotion, mainstay power supply of renewable energy, utilization of nuclear power (concrete construction of next-generation innovative reactors)
	New challenges: Delayed digitization	The "Realization of the World's Highest IT Society" slogan in the Japan Revitalization Strategy 2013	IT delays more clearly under the pandemic	Accelerating DX and creating a Digital Garden City

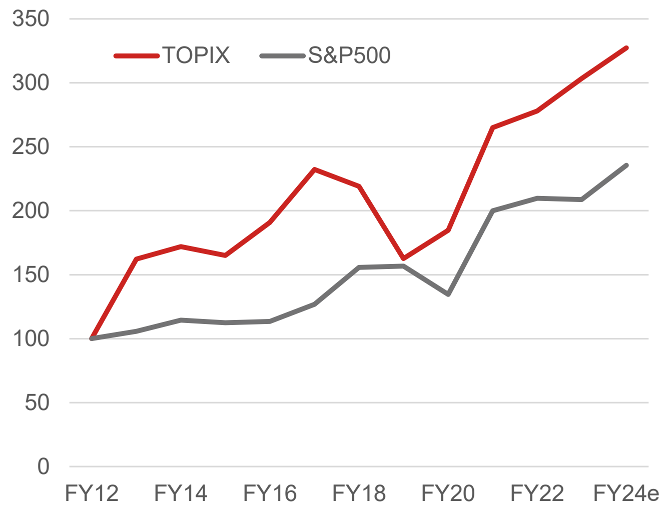
Nomura Asset Management based on Annual Report on the Japanese Economy and Public Finance 2021(White Paper), the Cabinet Office, and the Ministry of Health, Labor and Welfare data

Let us review what happened to these factors. First of all, the super-strong yen has reversed due to accommodative monetary easing, which was the first arrow of Abenomics. Second, many of the economic partnership agreements that experienced delays have been signed and come into force. For example, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership ("CPTPP" or "TPP11") was signed in March 2018, the Japan-EU Economic Partnership Agreement was signed in July 2018, and the Japan-US Trade Agreement came into force in October 2018. These agreements have had a cumulative effect of increasing the overall exports and imports coverage ratio to approximately 80%. Finally, the high corporate tax rate has been gradually reduced to 29.74%, the same level as in Germany.

While strict labor regulations, strict environmental regulations, and electricity shortages/high electricity costs continue to be points of pain, the other three show clear indications of improvements made during the Abenomics era.

In addition, the Corporate Governance Code and the Stewardship Code were introduced during the Abe Administration. As a result, since 2012, the earnings per share (EPS) of TOPIX has grown faster than that of the S&P500.

Figure 6. TOIPX and S&P500 EPS Comparison (FY12 = 100)

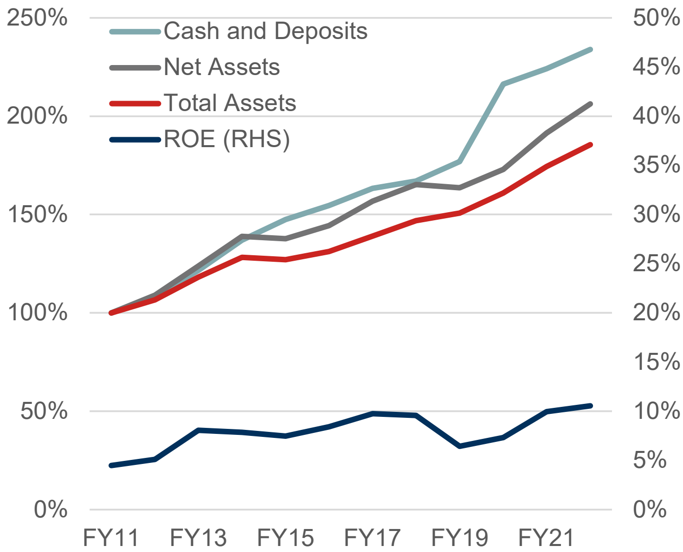


Source: Nomura Asset Management Based on FACTSET Data

A balance sheet perspective on investors' cautious view of Japanese stocks

As described above, Abenomics has improved half of the "six-fold pain" of Japanese companies, resulting in TOPIX EPS growth exceeding that of the S&P500 since 2012. However, TOPIX has failed to outperform the S&P500 in returns. In other words, the valuation of Japanese stocks did not increase.

Figure 7. Balance Sheet of TOIPX All Listed Companies (excluding Financials and Japan Post) (FY11 = 100)



Source: Nomura Asset Management Based on FACTSET Data

Our key findings of the data from 2011 onwards are as follows:

- Net profit growth was 421%.
- However, net assets also increased by about 2 times to 206%, so the ROE only improved by 2.0 times.
- Total assets have not quite doubled to 186%, while net assets have increased to more than 206% and cash and deposits to 234%.
- Interest-bearing debt increased less than total assets to 177%.
- As a result, the capital adequacy ratio improved from 38.6% in 2011 to 43.0% in 2022.

Overall, the net income of Japanese companies improved significantly, but at the same time, cash and deposits piled up and balance sheets improved, which shows that the improvement in ROE was held back. So there is clear evidence of progress, but further change is needed.

In March 2023, the Tokyo Stock Exchange put new pressure on its listed companies to not only increase profits but also to pay attention to their balance sheets, by requesting companies with a sub 1x price to book ratio (PBR) to disclose and implement improvement measures. After a number of discussions with corporate executives, we view that they are gaining a deeper understanding, supported in part by the Tokyo Stock Exchange's measures, that return on equity (ROE) will deteriorate if profits increase and capital simply accumulates. Moving forward, we believe that Japanese companies will be highly committed to improving their balance sheet management and improving their corporate value by improving their payout ratio.

As such, we believe that the outlook for Japan as a whole is extremely encouraging. There have been good flows from international clients into Japan this year, but the current market conditions coupled with the positive future that we have outlined above, means that there is a very attractive entry point into the Japan market right now.