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Japanese Equity Whitepaper

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Welcome to CAMRADATA's Japanese Equity Whitepaper

One of the world's largest economies, Japan is often overlooked by European institutional investors. A combination of poor growth and inflation, blended with a relatively inward looking culture and business community, has often pushed any portfolio allocation to the back of investors' minds.

However, with the slowing of the rest of the developed world's economies and the potential for tough times ahead, could Japan be back on the table for investors seeking new return opportunities?

It is not a straight-forward question as there are multiple factors to consider.

A weak currency is not unusual following a major international pandemic, but fiscal and monetary policy around the stubbornly fragile yen continues to give investors pause for thought.

On the one hand, it could entice more visitors to a famously expensive tourist destination, yet its impact on a corporate landscape, which has been devoid of any significant shake up for decades, could play out in a range of impactful ways.

Additionally, after decades of deflation, there are questions around how both the internal and export markets may react to higher prices for everyday goods, and how potentially higher revenues can be converted into better returns for shareholders.

Yet, against this uncertainty, Japan's tech and engineering sectors remain a constant for investors, especially in a world set on using both of them to reach sustainability and other business goals.

In this whitepaper we will look into the changing face of the Japanese equity proposition, and how investors can best place themselves to take advantage of any transformation of one of the world's most significant economies.

Japanese Equity Roundtable

At a recent CAMRADATA roundtable, participants discussed whether the Japanese equity proposition is changing, and why institutional investors should have an allocation to the region, however small.

A glance at Japan's economic and social history reveals much about international institutional investors' current perceptions of the country as a potential investment destination, but change could be on the horizon for the land of the rising sun nation – and its place in global portfolios.

Setting the scene, with some background on the third-largest economy in the world by nominal GDP, was Yoshihiko Ito, chief investment officer at Nippon Value Investors.

He explained that Japanese nominal GDP began the 1990s flat, after the collapse of the asset price bubble economy in the late 1980s.

Ito told the roundtable: "After the collapse of the bubble economy, Japanese inflation has been below 2% over the past three decades.

"Due to the low-growth, low-inflation environment, Japanese real wages declined."

Nippon Value's Ito also revealed that Japan's population peaked in 2008 at about 128 million, and that, since then, it has declined. By April 2022, it stood at around 125 million, a decrease of 3 million. However, Japan's workforce has grown in recent years.

"The working population grew to 68.6 million in 2021, from 66 million in 2011. The population has been declining but the labour workforce has increased, and that's largely due to the increase of female participation in the job market," he said.

"People may be concerned with Japan's population decline. We had a similar increase in permanent residents in Japan, which has increased from 2013 to a much higher level. Japan is opening to foreign skilled workers especially, by loosening restrictions and shortening the time required to apply for permanent residency – for some individuals it's as short as one year."

A change is going to come

When asked how this history has coloured the view of pension investors, insurance companies, and sovereign wealth funds, Tom Baird, senior vice president, equity manager research team at Redington, noted that when he has spoken to institutional clients about Japan, they talk about having "been burnt before".

"They experienced substandard returns from that market, versus other markets over the long term," he told the roundtable.

"The issue has been the story around Japan, which has often been quite positive about change, about improving governance, compelling valuations, and deleveraging. But that hasn't always translated into returns. Perhaps some of these changes have been slower than many people had professed they were going to be," he observed.

“ Institutional investors are looking for, not just a high return on equity (RoE), but a sustainable one. It’s about 8% at the moment. If we can see it sustainably at 8%, I think you’ll start seeing some traction.”

However, Baird said he recognised there are signs of change, particularly around governance which, in turn, is translating to shareholder returns.

“As you see returns on equity increase, you see much more corporate activity in the market, and companies are paying out much more cash to shareholders and special dividends,” he added.

Change was the watchword of the roundtable. Canaccord Genuity Wealth Management’s (CGWM’s) head of UK equity fund research Kamal Warraich agreed that “change is coming”.

“We think the effects of Abenomics is coming through now. You’re not just seeing it in dividends, you’re also seeing it in a reduction in cross shareholders, you’re seeing it in a reduction of listed subsidiaries. Japan is one of the few countries that has had those interesting quirks,” Warraich said.

“But those things are changing, shareholders are liking what they’re seeing, so I think it’s about promoting that.”

He also explained that institutional investors are looking for, not just a high return on equity (RoE), but a sustainable one. “It’s about 8% at the moment. If we can see it sustainably at 8%, I think you’ll start seeing some traction,” he noted.

William Bourne, principal of Linchpin Advisory, referred to recent data, which indicated investors’ current allocation to Japanese companies.

“In aggregate, investors are overweight, rather than underweight [Japanese equities]. If you held, for example, hedged Japanese equities over the past six or nine months you’ve done very well indeed, and your weighting in Japan has gone overweight by default. That’s one of the reasons why we’re seeing selling in Japan in recent weeks, rather than buying,” he explained.

Currency moves

Watts Itoh, chief strategist at Tokio Marine Asset Management, also talked about Japan’s “cycle of wage compression” and the impact this has had on investable companies.

He explained that, rather than making reductions in headcount which comes with a certain level of social stigma - not to mention government scrutiny – Japanese companies typically find ways to ‘adjust’ the salaries of employees throughout their careers.

“A lot of companies rely on this as a cost control measure with price pressures passed on to the workforce. It’s a bit of a survival tactic that doesn’t help productivity nor broaden labour allocation, as it leads to over-competition and hurts capital efficiency. These pressures start at the top of the supply chain, which in part is why bellwethers look attractive on the surface. What we should be looking for as signs of change are the companies that are thriving as game changers, or winners leading consolidation in a fragmented market,” Itoh said.

With the Japanese Yen currently at a record low against the US dollar, the roundtable considered what this might mean for equities.

Redington’s Baird said, in theory, low inflation and a struggling currency should put Japan at a competitive advantage, especially as tourist numbers increase post-pandemic which, in turn, “could be great for all-company investing”.

However, he noted: “The reality is we are not going to be making investments on the back of these currency fluctuations or economic moves. At Redington, we don’t see us having a particular skill in calling currency markets. We’re thinking in the longer term.”

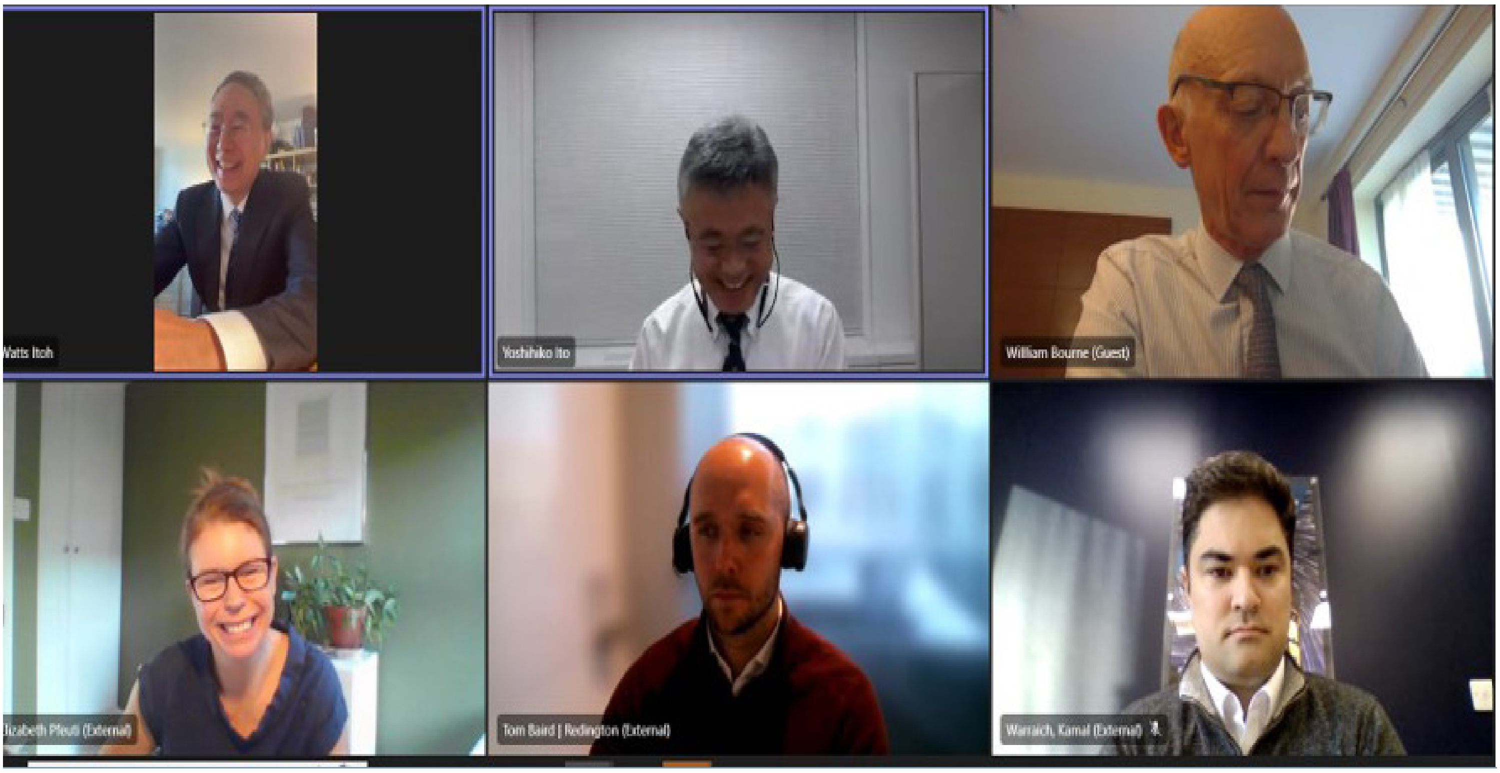
Baird explained a move in the currency could inspire a discussion about what it means for different styles of investing, in terms of growth versus value.

“Perhaps value has a longer way to run, given value has been a good play in Japan over the long term, but that would be a marginal decision in portfolio construction,” he commented.

Warraich explained that CGWM does not look at currencies when considering how to invest in Japan. Instead, its focus is on the medium to longer term and the propensity to generate growth from the equity market.

He added that CGWM has hedged the currency when investing in Japan.

“We would say we’re not taking a view on the currency, by hedging it out, and that we just want exposure to the underlying equities. Historically, there’s the old saying that ‘what you make on the market you lose on the currency in Japan’. This is a cultural aspect, given the investment culture here in the West and how we have historically viewed Japanese equities and the Yen. But, it bears fruit in that the Yen can be very volatile,” Warraich said.



He also observed that regarding investment style, value investors in Japan tend to be overweight the larger-cap companies "where the valuations tend to be lower than the small and medium-sized companies that are growing quickly and have higher valuations, resulting in a "distortion".

Bourne observed that Japan is cheap, at the moment, which prompted Tokio Marine's Itoh to consider the historic correlation between the yen and the dollar, and Japanese domestic equities.

"It used to be negative and then it became positive," said Itoh of the relationship between the yen and dollar. "It changed in the early 1990s because people bought yen to buy Japanese equities in bulk in the late 1980s to the early 1990s, but that has dispersed."

"If you look at the past three years, it's just become very noisy – noisy meaning, there's less correlation one way or other. The reason for this is there's been a tremendous shift over just less than a decade of institutional monies moving to foreign assets."

William Bourne of Linchpin Advisory remarked that some Japanese banks, including regional banks and mega banks, have benefited from the weaker yen by investing in US Treasuries, for instance, noting that a weaker yen is beneficial for Japan's Government Pension Investment Fund (GPIF).

Inflation: on the rise

Recently, inflation in Japan has exceeded the Bank of Japan's 2% target, with official data showing the National Consumer Price Index rose 3% year-on-year in September.

Nippon Value's Ito commented: "Until recently, Japan was stuck in a deflationary mindset, which could not be changed. Now we have excessive weakening of Japanese yen and rising inflation exceeding 3%, which hasn't happened in the past three decades at least. The dollar-yen may come back to a more manageable level in future." "But once the mindset gets switched to an inflationary mindset that the rest of the world has, Japan can have a better sense of awareness of the cost of capital. That's one more thing we can be positive, or hopeful about, that the Japanese equity market can experience from here."

For CGWM's Warraich, one aspect of investing in Japanese equities that is important, is to ensure investors take an active, rather than passive, approach, citing Japan's "inefficient market".

"When you look at the number of analysts covering stocks across the market cap scale, it has half the number of the US, so we do think that where inefficiencies exist you should go active," he explained.

Bourne agreed that "everybody should, in theory, be active in Japan". However, he noted that in practice it is much more difficult to do so, pointing to the language and cultural barriers that exist. He observed that language is a particular barrier when investing at the smaller end of the market cap scale.

Redington's Baird commented that there is value to be had from an "on-the-ground presence" of dedicated Japanese fund managers.

"Access, travel, meeting companies, cultural understanding, are all a huge benefit of having that dedicated, Japanese on-the-ground presence with people who understand the market," he said. "When we do our research, we like to go to Japan. We think that is very important, particularly accessing the all-cap opportunity set, which you don't get with the average global manager."

But he acknowledged that many of its clients would be getting exposure to Japanese stocks through a global fund, in which case, they are sacrificing some of the alpha "on the table".

Baird explained: "It comes down to governance – if clients haven't got the governance to construct regional portfolios, then we can't force them."

"If you haven't got some governance, you leave some alpha on the table but it's better doing that than destroying alpha, you haven't got the governance to monitor and end up making bad decisions."

ESG in Japan

With environmental, social and governance (ESG) issues top of mind for institutional investors, the roundtable considered where the Japanese corporate landscape sits on its approach to ESG, starting with environmental factors.

Nippon Value's Ito acknowledged Japan may not be an ESG "leader" but that, as a whole, the country has good environmental awareness.

"Japanese companies, in general, tend to have high environmental technologies to conserve energy and restrict CO2 emissions, although Japan is currently burning lots of oil after stopping all the nuclear power stations," he said. "Both the investment companies and the managers themselves are required to achieve net zero by 2050."

Itoh of Tokio Marine suggested that Japan is "slightly more conscious" environmentally at the consumer level, compared to the UK.

But he added: "It doesn't mean that the framework is stipulated in a Western context, so that's where we're currently struggling. If people are looking at SFDR [Sustainable Finance Disclosure Regulation] and our various ways of getting on board with that, we're probably going to need to take our time."

Baird agreed that Japan was neither "leading the charge", nor a "laggard" when it comes to ESG investing.

He commented: "Japanese investors do seem to care about this, led by GPIF – they've asked external managers to all incorporate ESG, they've made some significant ESG investments."

Baird also observed that a number of surveys suggest that domestic retail investors want to make more ESG-focused investments.

"Given the savings rates in Japan and how much of that is held in cash and could potentially go into the equity market over time, that might be quite a big driver," he added.

However, CGWM's Warraich argued that, while Japan has addressed the 'S' and the 'E' in ESG, the area of governance has not been so well covered. He put this down to certain metrics, such as the low level of female participation in the workforce – although he added that this is improving.

"Corporate governance issues, like the number of non-executive directors, that's increasing now and companies are acknowledging the need to have additional personnel on the board. Shareholder returns, that's an important part of governance."

"Historically, international shareholders view themselves as being scored by Japan because of the dividends and payout ratios that were so low relative to other countries. That's improving though, so Japan is heading in the right direction. But G is probably the weaker point," he concluded.

Nippon Value's Ito recalled that it was back in 2014 and in 2015 that Japan's Stewardship Code and Corporate Governance Code came into effect, respectively.

"We've been engaging with a lot of investee companies – this year we have made one shareholder proposal for the first time, to make them listen more carefully …. after having more than four years of discussion with the company about the same issue: [the] capital structure," he said.

"With that company, we have 5.9% ownership, but, including Nippon Value, a bit less than 22% of the shareholders, i.e., almost 16% of other shareholders, agreed with our proposal. I think we are making good progress over the past eight years, since Japan's first Stewardship Code was introduced, and it should accelerate from here."

Reasons to own Japan

When asked what role Japanese equities might play in an institutional investment portfolio, Baird said it comes down to diversification.

"Japan genuinely provides something that's differentiated. If you look at the correlations to other equity markets it tends to be much lower," he explained.

"There are different longer-term themes going on in Japan – they call it Japanisation. The demographic changes in Japan have prompted different market cycles. So, tapping into those holistic long-term trends gives you diversification that you can't get elsewhere. Diversification is a very compelling argument for Japan."

Bourne added: "It is astonishingly cheap, both in the currency and, also, the actual stocks, as well as being a great source of alpha for good stock pickers. Both those mean that, if we go into a 'bad world', there is greater protection than elsewhere because it shouldn't go down as much."

Tokio Marine's Itoh agreed that Japanese equities are a cheap option and that there's relatively little downside for owning Japan.

"If it does nothing, it will de-correlate your portfolio, so there's some benefit to diversification. It's lower volatility, and you get the global upside."

He suggested: "In the long run, there's potential for change – 30 years from now I do expect, despite the disappointing past 30, there will be some very interesting notable changes between Japan, China and the US."

Roundtable Participants

Mr. Yoshihiko Ito

Chief Investment Officer

Nippon Value Investors

Personal Profile

Yoshihiko Ito ("Yoshi") founded Nippon Value Investors in December 2005. Previously, Yoshi was a senior equity fund manager of Asahi Life Asset Management Company ("Alamco") and managed the Japanese equity value strategy (1999-2005).

Before joining Alamco, Yoshi was with Asahi Mutual Life Insurance Company ("Asahi") in Tokyo and in London, involved in Asahi's asset management business for 9 years (1990-1999).

From 1996 to 1997, Yoshi spent a year at Silchester International Investors Limited in London as a trainee investment manager and learned its value approach. Prior to joining Asahi, Yoshi worked with Zenkyoren where he was involved in its international investment program (1987-1990). Yoshi is a graduate of Tokyo University of Foreign Studies with an MSc in Finance from London Business School. He is a Certified Member Analyst of the Securities Analysts Association of Japan.

Company Profile

Nippon Value Investors KK ("NVI") is a Tokyo-based, employee-owned asset management company specializing in value oriented Japanese equity investments since 2006. Silchester Partners Limited in the UK is a passive minority shareholder.

As a long-term value investor, NVI adheres to a disciplined value philosophy. At the same time, NVI recognizes that, for a successful value investment, the quality of business matters. NVI's fundamental research to assess companies' quality is a key pillar that supports its value philosophy. NVI's experienced investment professionals are committed to value investments in Japanese stocks based on rigorous bottom-up company research and value disciplined portfolio management.

As of August 31, 2022, NVI's Japanese Equity Program had approximately USD 1.1 billion of assets under management from its clients worldwide.

Roundtable Participants

Watts Itoh

Chief Strategist

Personal Profile

Since joining TMAM in 2018, Watts has interacted with a broad range of clients on investment and allocation ideas predominantly relating to Japan.

He brings over 30 years of experience in the Japanese and international markets across fixed income, equity and derivatives, having held analyst, sales and portfolio management positions at Citigroup, Morgan Stanley, Credit Suisse, UBS and Oak Hill Platinum Partners.

Watts holds an MBA from MIT, MA from the New School, MM from NYU and a BA from Keio University.

Tokio Marine Asset Management

Company Profile

Tokio Marine Asset Management is one of the largest investment managers in Japan, overseeing approximately USD 60bn in assets (as at June 2022).

The firm has an established history of over 30 years in providing institutional fiduciary and award-winning fund management services to a broad audience comprising pension funds, financial institutions and sovereign wealth funds around the world.

Our extensive local resources and strong in-house research capabilities remain as the cornerstone of our investment strategy.

Roundtable Participants

Kamal Warraich

Head of Equity Fund Research

Kamal is the Head of Equity Fund Research at CGWM UK and is responsible for open and closed ended UK equity fund selection.

Kamal heads up the CGWM UK equity fund investment process and chairs the fund selection committee, which sets the firm's equity fund strategy, meets fund managers and makes adjustments to the buy list. In addition to fund analysis, he also contributes to macroeconomic research.

A member of the Chief Investment Office, Kamal sits on the ESG committee in addition to the fund selection and investment trust committees.

William Bourne

Principal of Linchpin Advisory Limited

William has worked in institutional asset management for 40 years, including three spells in Tokyo.

Since 2009 he has been advising public sector funds and currently acts as independent advisor to three LGPS funds. He also acts as independent chair of the Lancashire County and LPFA Pension Boards.

He has a Masters in Finance from the LBS, and is Director of Linchpin Advisory Limited, providing advisory services on investment and governance. William has three millennial and one Generation Z children and lives with his wife in Kent.

Outside work he plays bridge competitively and spends most of his spare time looking after and occasionally sailing a 55-year-old wooden boat on the River Medway.

Moderator

Tom Baird

Senior Vice President

Tom works as a Senior Vice President in the Manager Research Team and sits within the liquid markets segment. His primary focus is equity managers with both global and regional mandates. He has been heavily involved in the construction of preferred lists for global equity and sustainable equity managers.

Tom joined Redington in December 2017 having previously spent 4 years at Willis Towers Watson, where he researched both public and private equity managers, helping to lead the research on UK equities.

REDINGTON

Elizabeth Pfeuti

Chief Client Officer

Former Dow Jones staffer Elizabeth Pfeuti is Rhotic's Chief Client Officer and a member of the Rhotic Media executive leadership team. A highly-decorated journalist, Elizabeth has been in financial journalism for around 15 years. At Dow Jones, she covered the asset management, investment banking and investor services beats for Financial News, where she also wrote on a wide range of regulatory themes.

She was previously the European Editor for CIO Magazine and boasts an exceptional contact book of buy-side and in-house institutional CIOs and asset management executives. More recently she has worked on corporate briefs for pension consultants, investment banks and asset management groups.

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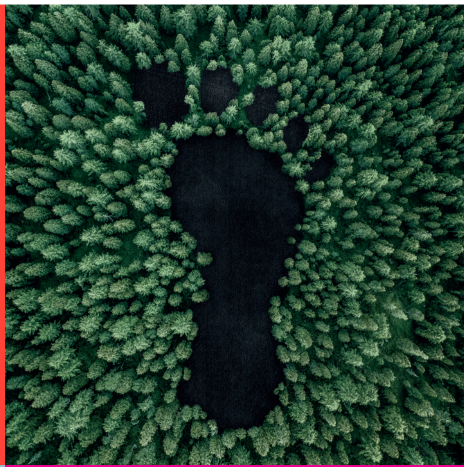

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Reversal of Deflationary Mindset

" In Japan, however, it seems that the persistent deflationary mindset of corporate executives, employees and consumers during the last three decades has at last started to change because of the current inflationary pressure. It is essential for the Japanese economy to shake off the deflationary mindset completely and drive wage growth to keep up with price increases. "

Author:
Yoshihiko Ito
Chief Investment Officer
Nippon Value Investors KK

In our quarterly newsletter in 2007, we commented as follows:

"For the first time in the past 17 years, Q.P.(Kewpie) Corporation, a Japanese mayonnaise manufacturer with a dominant domestic market share of 60%, raised its mayonnaise price by 10% in June 2007. This was due to a sharp rise in the price of soybean oil, which has been affected by increases in high profile bio-ethanol production in recent years. Initially, Q.P. was worried that its rivals may intentionally leave their prices constant to capture a larger market share. However, this concern has turned out to be groundless. Both Ajinomoto and Kenko Mayonnaise, each with a 20% market share in Japan, have followed suit by raising their prices by similar amounts. A feared backlash from retailers against such price increases also proved unfounded and there seems to be no reported reluctance to buy mayonnaise so far, despite weak personal consumption figures."

Unfortunately, the new trend of price increases initiated by Q.P. and other consumer related industry companies failed to continue in Japan since then. Some of the reasons include the global financial crisis in 2008, the Great East Japan Earthquake in 2011, a series of consumption tax rate hikes between 2014 and 2019 from 5% to the current 10%, and finally the Covid-19 pandemic that started in 2020. According to the Nikkei, a prominent Japanese financial newspaper, Japan is the only major country where nominal wages are lower than in the late 1990s. Until recently or, still in some cases, food and other consumer goods companies have absorbed all input price increases internally and have not passed them on to consumers. Instead, workers' wages have been sacrificed to offset higher input prices.

In the same newsletter in 2007, we also commented on the deflationary environment in Japan after the end of the bubble economy in early 1990s as follows:

"Retailers have been suffering from unit price decreases, which required them to sell more units at lower prices in order to maintain their overall sales. Hopefully, they will eventually be freed from climbing a descending escalator."

This time, however, Japanese companies are not absorbing input price increases internally. Since last year, companies in many industries have started to raise the prices of their products due to sharp increases in the cost of raw materials. As a result, the "descending escalator" has finally ended as Japan's consumer price index (CPI) has been consistently higher than one year earlier. The recent increases in raw material prices and transportation and other costs, which are due to supply shortages and supply chain disruptions on a global scale, are too large for Japanese companies to absorb while keeping their prices competitive. As a result, companies have been forced to negotiate with their customers for higher prices. This new trend is taking place throughout the value chain from upstream to downstream activities. We believe that price increases demonstrate that Japanese corporate management has clearly shifted their focus from growing sales at any cost in order to capture market share to placing more emphasis on profitability. On the other hand, the pace of wage growth in Japan is still lagging price increases.

We understand that high inflation is currently one of the most serious challenges in the global economy. In Japan, however, it seems that the persistent deflationary mindset of corporate executives, employees and consumers during the last three decades has at last started to change because of the current inflationary pressure. It is essential for the Japanese economy to shake off the deflationary mindset completely and drive wage growth to keep up with price increases. This will create the virtuous cycle of "price increases - wage increases – improvement of consumers' purchasing power" in the Japanese economy. We believe that the effect of the current reversal of the deflationary mindset in Japan is significant and cannot be ignored.

Currently, many Japanese stocks have very low valuations because of global economic uncertainty. However, the Japanese economy has been experiencing a unique transition from decades-long deflation to a moderate inflationary environment. In this transitional environment, at Nippon Value Investors, we continue to focus on attractively valued companies relative to the quality of underlying businesses. Most of all, we focus on companies that have a better ability to 1) pass on higher input costs to their customers in a sufficient and timely manner and 2) provide shareholders with a reasonable ROE by improving profitability and capital efficiency. As a long-term value investor, we believe that the current Japanese equity market environment with heightened global economic uncertainty has unique opportunities for us to identify undervalued Japanese companies that can generate sustainable cash flows by leveraging their strengths during this significant transitional phase.

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Flashpoint Taiwan: Where Japan Stands

Taiwan: Japan ready to help?

One question we have been receiving regularly from asset allocators and Japanese equity investors alike since the start of the war in Ukraine is on the tangentially related geopolitics surrounding the Pacific basin, particularly with regard to Taiwan, China, and Japan in conjunction with the foreign policy/security framework of the United States. The core question for a Japan/Asia watcher is what tangible risks are there for Japan to be dragged into a territorial/sovereignty dispute between China and Taiwan, and what might they do to alter/mitigate the outcome?

> ***"Japan has historically considered the territorial security of Taiwan as integral to its own, despite the lack of formal diplomatic ties"***

There is already increasing consensus that Japan won't have the luxury of watching from the sidelines in the unlikely event that China chooses to put its words into action and the US supports a counter-offensive on the ground. US Department of Defence publications point to Japan hosting by far the largest US military contingent in the Far East, easily surpassing the state of Hawaii in total military personnel particularly with deployment of naval assets. In the most benign of scenarios involving a direct offensive or forced landing on Taiwanese soil, Japan with its pacifist constitution would likely support the frontline through logistics, procurement, supplies and medical, and that would happen in its backyard, something that hasn't happened since the Korean War in 1950.

Just as background and based on regular surveys conducted by each nation's local missions, Taiwan and Japan embrace mutually strong economic and sociocultural ties with a strong majority of Taiwanese feeling close to Japan while a very large majority of Japanese find Taiwan trustworthy and friendly – a remarkable showing compared to similar surveys conducted for China and Korea. Aside from shared economic interests and common security concerns, the two countries have historical ties where pre- and post-war relations were relatively constructive even after Chiang Kai-shek retreated to the island having failed to counter the communist regime in the mainland. The symbiotic relationship still endures, largely in similar eco-political dynamics: adjacent borders, similar security issues and industry structure. Even without US involvement, Japan has historically considered the territorial security of Taiwan as integral to its own, despite the lack of formal diplomatic ties and somewhat vague acknowledgments directed to assuage the mainland.

But how likely is an imminent assault? While US commitment has been intentionally vague, a joint counter-offensive is already implied to be on the cards, and it would seem foolish for China to gamble. Considering the laundry list of other pressing global issues, all sides would probably prefer for diplomacy (and a little military shadowing) to take the front seat for the foreseeable future. As for Japan, if we assume with reasonable certainty that it will at least be logistically involved in a China-Taiwan confrontation in tandem with the United States, it has every incentive for a diplomatic solution. Consequently, we can probably shift our hypothesis to the slightly more realistic scenario of how Japan might chart its foreign policy to navigate the delicate waters involving its largest economic trading partner in a conflict with its closest and most powerful security partner, not to mention second largest trading partner, and close neighbour and ally (and coincidentally third largest trading partner in 2021, according to JETRO statistics). The answer certainly depends more than just a bit on the person at the helm of the cabinet/party administration, but the political backdrop in which this person will act is equally influential, noting the fact that Japan is a society of group consensus.

Author:

Watts Itoh

Chief Strategist

Japan's factional politics: Kishida brings a fresh approach

With a few notable periods of exception, Japan has had a long and reliably stable incumbent party – the Liberal Democratic Party (LDP) – controlling the government for over 60 years. However, often overlooked by pundits is the fact that this party is really a split-merger of opposing views on everything from economic policy to rewriting the (US drafted) constitution.

Factbox: Japan's neighbours & main trading partners

Trade ranking	Country	% total trade	Border dispute with Japan?
1	China	22.9%	Yes
2	US	14.1%	No
3	Taiwan	5.8%	Yes
4	Republic of Korea	5.5%	Yes
17	Russia	1.4%	Yes

Source: JETRO. Total trade and trade ranking based on combined imports and exports.

The former Liberal Party is generally deemed the mainstream of political conservatism within the LDP, embracing economic prosperity and open-border trade policies with less emphasis on nationalistic overtones, and perhaps comprising more members who are wary of a revision of the pacifist constitution. Contrary to Liberal Party ideals, the former Democratic Party from its very beginnings had advocated a new, self-drawn constitution and remilitarisation to assert the Japanese identity; former Prime Minister Shinzo Abe, as you may have guessed, falls into this group. Imagine the two sides locked in a constant power struggle, and you can see how power-broking in Japan is complex – policies can swing quite dramatically even between consecutive incumbent cabinets.

Current Prime Minister Fumio Kishida brought a refreshing, if not dramatic change in this context, coming from a group of politicians (the Kochikai faction) which traces its roots back to the dovish "mainstream conservatives" described above. And to some extent, this internal arrangement has kept a security uproar in check, despite the rude awakening of a possible military conflict with one, two, or all three neighbouring nuclear powers. (It was quite symbolic that Xi Jinping wrote a celebratory note in his own name to Kishida to mark the 50th anniversary of diplomatic ties this past September.) All the more ironic therefore that with the assassination of former PM Abe, the legacy of the rival Abe faction and its multi-generational ties to a religious cult have been brought to public scrutiny, marring the reputation of the entire incumbent party and taking a toll on Kishida's approval ratings. Not only will this take significant effort to dispel from the public mind, but what was initially favourably regarded as a balanced and measured approach to domestic and diplomatic issues is now being viewed as a lack of visible policy action in light of inflation (with ex-fresh food and energy CPI at 1.8% in September, it is really miles apart from what is roiling the U.S./Europe) and security issues that have come to the fore of voter attention.

In contrast to the US and other western nations where domestic issues are leading to a divided public, Kishida, unlike heavy-handed Abe, has found himself to be a social wrapper at a time when Japan is trying to find its place in a newly emerging Asian/global order. Despite his low ratings at the moment, his agenda will likely stay the course while he remains in office. With no simple solution in sight, a fragile balance with its neighbours may well be the next best thing to peace, and this could work quite well for all the Asian markets despite turbulent crosswinds from abroad. So long as unprovoked aggression is avoided, the status quo along treaty lines should help cushion multilateral tensions, providing fresh impetus for trade growth with a Yen middle-ground against majors, allow breathing room for corporate reforms, and most importantly, buy time for generational change on all sides. Memories of a war may become distant with 22 million tourist visits from East Asia (10 million from China alone) in pre-Covid 2019 according to Japan's official Tourism Agency, but blurring ideological borders will require more time.

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