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Lessons from Japan

What can we learn from decades of stagnation in a major global economy?

During the recent months, Charles Lannon, Cidel's Head of Equity Research, has presented our work across Canada on the lessons we can learn from the stagnation Japan has witnessed for decades. The following is a summary of the discussion and the key takeaways from our work on Japanification.

A Brief Background

During the summer of 2019, global bond yields collapsed as economic growth numbers continued to disappoint, especially in Europe. This prompted a wave of fear and a host of articles and research reports from the media and financial institutions on the threat of Japanification of the West. But what does that really mean? What are the risks? Will asset returns suffer? How should investors position their portfolios?

Japan's economic expansion post-World War II has largely been built on exports. Its success attracted imitators and helped build competing economies. Initially, China competed at the low end of the spectrum of consumer goods, while Korea and Taiwan competed in the mid-priced products and capital goods. The subsequent sharp appreciation of Japan's currency began to impact profitability. In turn, that led to problems in the banking sector. Japan's "lost decade" is now a "lost generation". Average economic growth in Japan has been abysmal - low growth coupled with low inflation has led to extremely low interest rates. Attempting to stimulate growth, the Japanese government took on more debt and ramped up infrastructure and social spending. Unfortunately, that resulted in little benefit to GDP growth. This created low confidence among businesses and consumers, which in turn led to prolonged low growth. A vicious circle.

So how does the West – post-global financial crisis – compare to Japan?

First let's look at the similarities. Growth in the West, especially in Europe, has clearly slowed. The average annual growth rate of nominal gross domestic product for the Eurozone during 2010-2018 was approximately 2.3% as compared to 4.2% during 2000-2008. Similarly, the U.S. economic growth rate averaged 3.9% during 2010-2018 as compared to 4.9% during 2000-2008.

Inflation has fallen in Europe to levels that are comparable to those in Japan and both the U.S. and European governments have borrowed heavily. However, while inflation remains largely unchanged in both of those economies, the debt level still remains about half of the levels seen in Japan.

Now let's look at the key differences.

Key difference 1: Population growth generally accounts for a significant portion of economic growth. Japan's population has been shrinking while the population has been generally growing in the major Western economies. Interestingly, Canada's population growth ranks amongst the highest and is not far off that of India. This is due to relatively high rates of immigration.

Key difference 2: The U.S. was quicker to clean up its banking system following the financial crisis whereas Japan took over a decade to clean up its non-performing loans.

Key difference 3: Government and central bank policy uncertainty, while higher in Europe, remains relatively benign in the US. In Japan, policies were less predictable.

Finally, what are the investment implications?

Japanification does not necessarily translate to poor stock market returns. Japanese equities in many sectors – particularly without the banks - have performed broadly in line with U.S. and Europe over the last two decades through a period of much weaker growth.

Also, stocks of globally competitive companies have still been able to thrive. Japanese exporters' stocks have delivered relatively strong returns because they sell quality products around the world; the benefits from overseas sales more than offset the weak domestic demand. By contrast, pure domestic companies have done poorly. It is important to remember that companies with global customers can perform well even if their local economy is not thriving.

While many global economies are currently witnessing very low or even negative interest rates, it is important to be aware that there is the potential for interest rates to stay low for a long period of time. Further, Japan specifically has a history of very low interest rates. This creates an investment opportunity in the fixed income universe, despite the low starting yield.

Lastly and most importantly, quality matters. In Europe and Japan over the last decade, the best performing stocks are mostly in healthcare, consumer staples, consumer discretionary, and information technology. These high performers have visible high earnings growth and earnings resilience (i.e., ability to keep or raise price and generate profits in slow growth environment). We expect a low growth environment for the next while. Stocks can be the most effective way to invest even in this type of environment. Further, an investment manager's capability of choosing quality stocks is key to success. At Cidel, we continue to focus on quality stocks, through our thoughtful research process and risk control, to build portfolios designed to outperform with lower volatility over a market cycle.