Reinvigorated Japanese banks

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"Japan's economy has suffered low growth and low inflation since the speculative excesses of the real estate and stock market asset price bubble burst in the late 1980s. A painful deleveraging process followed. Havoc wrought by high inflation is often well understood, but an environment of little to no inflation can be problematic as it reduces the desire to spend and invest."

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The gradual return of inflation in Japan could rekindle its economy's long suppressed 'animal spirits', potentially manifesting in increased private sector consumption and investment. Such investment activity should boost productivity and further spur economic growth. Japanese banks, two of which are explored herein, are at the forefront of benefiting from this potential turn of fortune.

Repressed by the Central Bank

Although it remains the world's fourth largest economy, Japan's economic growth in real and nominal terms has stagnated over the past three decades. As one of the first industrialised countries to grapple with population decline and enduring national debt levels well exceeding global norms, Japan has long been a laboratory for the adoption of unconventional economic policy.

It first adopted a zero-interest rate policy in the late 1990s as the country grappled with the continuing fallout from its earlier systemic financial crisis. Inflation remained absent despite the massive stimulus and the Bank of Japan (BoJ) introduced even more drastic measures. Yield curve control[1] was started by the BoJ in 2016 and first used by the US Federal Reserve Bank during the Second World War. The BoJ not only adopted negative short-term policy rates, but also managed 10-year government bond rates to be at 0%.

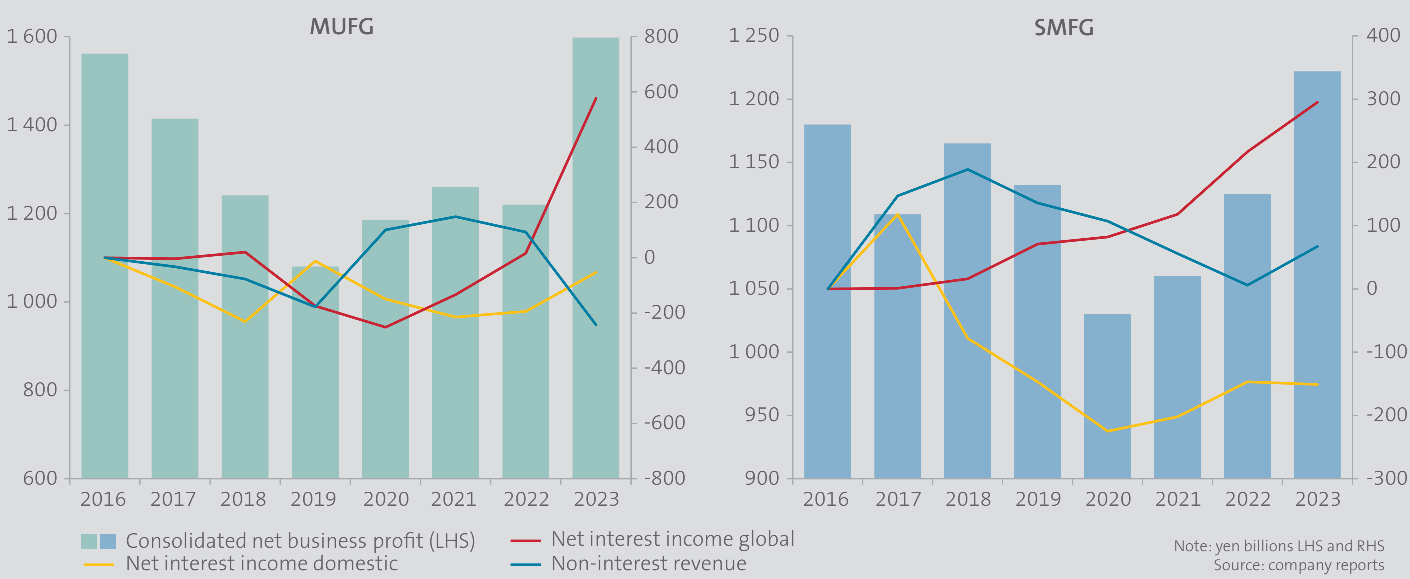
One way that banks generate profit is by borrowing (from customers) via lower cost, generally short-tenure liabilities such as deposits, and investing in higher-yielding assets like home loans, credit card debt and vehicle finance. They earn an interest rate spread between the loan and deposit rates (the net interest margin, or NIM) out of which they must absorb any credit losses. This is done while ensuring that no significant mismatches occur between the average duration of a bank's assets and liabilities. To the extent that the outstanding term of the assets do exceed that of the deposits, a term spread may also be earned.

The prevailing negative policy rates in Japan meant that Japanese banks were unable to make much interest rate spread, given that deposit rates cannot practically be lowered too far below zero and asset yields earned were little above zero. Additionally, they are effectively charged for the assets they are forced to retain with the Central Bank - earning below zero rates. Yield curve control of long rates also meant that term premiums were eroded.

Japanese banks earned very low profits during this time. The *charts below* show profitability metrics for two of the largest

[1] In an attempt to further stimulate an economy, the Central Bank purchases longer-term government bonds to reduce longer-term rates in the economy. Low long-term rates lower the cost of capital for longer-term investments.

Annual company profits and changes in specific income statement components (relative to 2016)



Note: yen billions LHS and RHS
Source: company reports

banks, Mitsubishi UFJ Financial Group (MUFG) and Sumitomo Mitsui Financial Group (SMFG). The bars demonstrate annual company profits, whereas the lines indicate the change in respective income statement line items per company, relative to 2016. Neither bank has managed to grow their domestic net interest income since the BoJ's policy changes in 2016. Business-related lending comprises roughly 70% of the domestic loan books of both banks. SMFG is more focused on retail customers and small to medium-sized businesses compared to MUFG.

A transitioning economy

The slight return of inflation over the past year has gradually seen the BoJ allow 10-year government bond rates to increase, while maintaining negative short-term rates. Early signs that this inflation may endure and perhaps increase towards BoJ targets have spurred expectations that a normalisation in monetary policy will see banks earn materially higher interest rate spreads. From a zero-rate starting point, assets will reprice higher far more than funding costs will rise. As interest rates gradually rise, the current significant gap that exists between the NIM generated by Japanese banks and foreign banks, should narrow. The *chart below* compares a selection of bank NIMs grouped by country.

In addition, higher economic activity should spur loan growth and generate higher bank non-interest revenues, due to more transactional activity on which fees are generated. These expected changes and very low starting bank share prices, have resulted in Japanese banks delivering strong capital gains over the past year.

Mind the turbulence

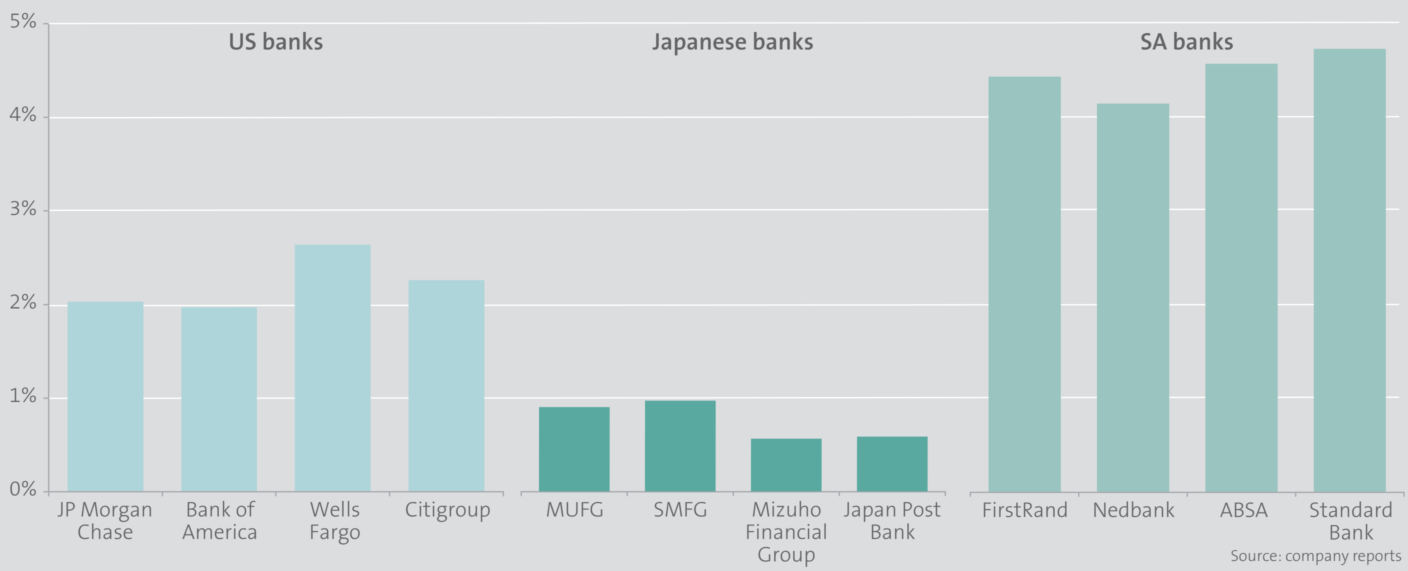
A faster growing Japan is positive, but higher Japanese interest rates will generate higher credit losses on bank loans as more borrowers come under financial pressure and default on repayments. We continue to closely monitor any evidence of emerging risk, which has not surfaced to date.

Improving returns and corporate governance

Corporate management teams in Japan are increasingly focused on generating returns that exceed their cost of capital and those of the banks are no exception. MUFG and SMFG are growing higher-return parts of their business, divesting from businesses that generate inadequate profits and returning excess levels of capital to shareholders via buybacks and increased dividend payout ratios. Cost efficiency also remains a focal point for both banks in pursuit of higher returns on capital.

Japanese banks have historically been very closely affiliated to related groups of companies. It was common for

A comparison of net interest margins for select US, Japanese and SA banks



Source: company reports

cross-shareholdings among companies to be maintained, led by a Japanese bank that provided financial services to the broader group. Depending on how these were structured, they were known as keiretsus or zaibatsus. For example, MUFG is considered one of the 'Three Great Houses' of the Mitsubishi Group, together with Mitsubishi Heavy Industries and Mitsubishi Corporation. These corporate relationships and the consequent friendly financing of related conglomerates often resulted in sub-optimal capital allocation decisions. With greater emphasis being placed on improving capital returns and free market behaviour, these investments are gradually being unwound, to the benefit of the bank shareholders.

Among the largest

Both SMFG and MUFG were formed through mergers of existing Japanese banks in the early 2000s. Their total assets place them within the world's fifteen largest banks. Their market share of Japanese domestic loans is approximately 10% each. Being large global megabanks, they offer the full range of traditional banking services, in addition to trust banking, brokerage, investment banking and asset and wealth management.

The proportion of SMFG's and MUFG's loan books in foreign countries has gradually increased over the past decade, now nearing 40% as they have tried to allocate capital to higher-yielding economies. Asia (excluding Japan) and the US are their largest foreign markets. Although its domestic asset base exceeds those they have in global markets, given the disparity in interest rates between Japan and the rest of the world, net interest income generated by MUFG outside of Japan in 2023 was 10 times higher than that generated in-country.

Both groups also own stakes in foreign financial services entities. These include MUFG owning 22% of Morgan Stanley and SMFG having a 5% stake in Jefferies.

A potential massive inflection in returns

A bank's performance is significantly impacted by monetary policy. As inflation returns to Japan and interest rates normalise somewhat, Japanese banks are well placed to generate substantially higher returns. The balance sheets of MUFG and SMFG are positioned to be able to positively navigate this significant change in economic environment and generate materially higher earnings in Japan in the years ahead. After substantial share price gains, these two banks continue to be modestly valued in relation to the cash flows they should generate in future years, and our clients remain invested. UP

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Footnote: [1]Annualised (ie the average annual return over the given time period); [2]TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 31 December 2023; #over 12 months to 31 December 2023. [3]Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Camissa Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 31 December 2023 # over 12 months to 31 December 2023. [4]Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5]Source: Camissa Asset Management; gross of management fees; [6]Median return of Alexander Forbes SA Manager Watch: BIV Survey; [7]Median return of Alexander Forbes Global Large Manager Watch.