Thematic Insight

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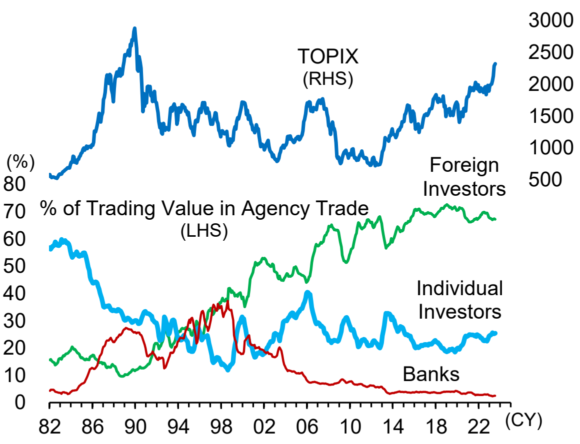
Will foreign investors continue buying Japanese stocks?

- **Foreign investors have become more diversified over the past decade. In the US, corporate and public pension funds are net sellers of stocks, while ETFs and households are net buyers, and emerging markets have an increasing presence in securities investment.**
- **In major countries, global equity funds have grown their assets under management (AUM) more than country- or region-specific funds, and for actively managed funds, earnings outlooks and business strategies of individual companies are becoming more important than macroeconomic issues. Moreover, as the market cap of Japanese stocks has dropped relative to other markets, foreign investors have increasingly assessed Japanese stocks relative to other markets.**
- **When the stock market of one's home country rallies, end-investors tend to move money into foreign equity funds. Foreign investors are likely to remain net buyers of Japanese stocks over the longer term, but in the short term, if US stocks drop, we think they are unlikely to continue buying Japanese stocks.**

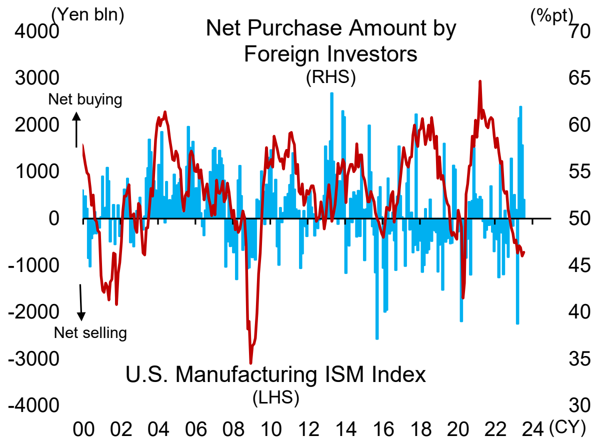
Trading by foreign investors has a major impact on the Japanese stock market. Foreign investors own 31.1% of listed stocks and account for 68.4% of total agency trading value in the cash market (FY22; Exhibit 1). While there are data limitations, it seems a bit stretched to treat such a large investor class as foreign investors as a single entity, in our view. From April to July this year, amid worsening business sentiment in the US and downward revisions to Japanese earnings forecasts, foreign investors were net buyers of Japanese equities by JPY6.5 trillion (Exhibit 2). This marks a departure from the past. In this report, we consider whether foreign investors' buying of Japanese stocks is sustainable by looking at changes in their investments over the past 10 years or so.

Exhibit 1: Foreign Investors Have Big Presence in Tokyo Market



Note: Figures are the percentage of agency trading value in the cash market, 6-month moving average; data as of July 2023.
Source: TSE, MUFG: Trust Bank

Exhibit 2: Foreign Investors were Net Buyers when Business Sentiment Good, but …



Note: Net purchase amount in cash market; data as of July 2023.
Source: TSE, US Institute for Supply Management, MUFG: Trust Bank

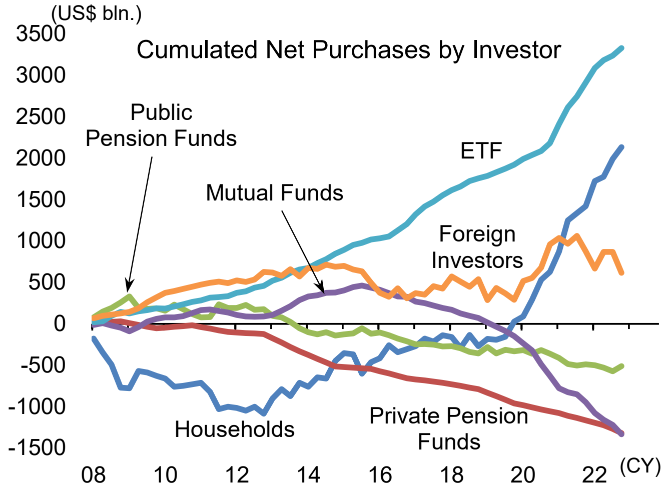
Diversification and growth in investments

First, the ranks of foreign investors have become more diversified, and investment capital has grown.

US flow of funds data show that corporate pension funds, public pension funds, and mutual funds have been net sellers of US equities. Cumulative net selling by these groups since 2008 have amounted to USD1.371 trillion, USD519 billion, and USD1.405 trillion, respectively (Exhibit 3). Net inflows into pension funds have declined as baby boomers have retired, making it harder for pension funds to take on risk. For mutual funds, holdings by life insurers and public pension funds are declining. To meet demand for higher yields, public pension funds have grown their positions in alternative investments such as private equity.

Meanwhile, the main buyers of US equities have been ETFs and households. We think money from retirees, high net-worth individuals, foundations, and others has moved into stocks. Family offices have been slightly increasing allocation weightings in listed equities in recent years (Exhibit 4). When interest rates were still low, investors were more focused on equities in developed markets than bonds. Additionally, "meme stocks" have been a hot topic. Brought into the spotlight on social media and elsewhere during the pandemic, speculative buying by individuals saw the prices of these stocks surge over short periods of time. The image of "foreign investors" is one of pension funds subject to strict accountability to an investment philosophy and process. However, capital is increasingly being deployed by individuals, family offices, and others that can flexibly change how they invest.

Exhibit 3: Pension Funds have been Net Sellers of U.S. Equities



Note: Figures are cumulative net purchases from 2008; data as of March 2023.
Source: FRB, MUFG: Trust Bank

Exhibit 4: Family Offices Slightly Increased Listed Equity Exposure Globally

(%)

	2018	2019	2020	2021	2022	2023
Fixed income (developed markets)	13	11	13	11	12	15
Fixed income (emerging markets)	3	6	5	4	3	4
Equities (developed markets)	22	23	24	24	25	24
Equities (emerging markets)	6	6	8	8	6	9
Private equity (direct investments)	14	9	10	13	9	6
Private equity (funds / funds of funds)	8	7	8	8	10	10
Hedge funds	6	5	6	4	7	6
Real estate	17	14	13	12	13	9
Cash	7	13	10	10	9	8

Note: The number of eligible family offices varies from year to year; 230 offices in the most recent survey; figures for 2023 show plans.
Source: UBS, MUFG: Trust Bank

Emerging economies are also a growing presence in securities investment. Globally, the net asset balance of investment trusts amounted to USD63.1 trillion as of March 2023, almost doubling from USD32.3 trillion at the end of 2012 (Exhibit 5). While US funds account for nearly half of this total (USD30.3 trillion), the balance of assets held by emerging Asian economies, particularly China, have grown. Assets in Chinese funds have increased from USD463.5 billion to USD3.35 trillion and comprise 5.3% of the global total (up from 1.4%).

In China, bond funds and mixed-asset type funds comprise a large share of publicly offered funds. While the asset balance for QDII funds, which are authorized to invest in foreign securities, remain small, it grew sharply during the late 2010s. (Exhibit 6). Japan equity funds attracted inflows of TWD20 billion (roughly JPY89 billion) from Taiwan in July this year. Comments from market participants also suggest there is interest from Middle Eastern investors with limited investment experience in Japanese stock investment.

Given increasing diversification in foreign investors and growth in their capital, we see considerable scope for buying of Japanese stocks over the long term.

Exhibit 5: Emerging Economies Accounting for Greater Percentage of Total Assets in Investment Trusts Globally

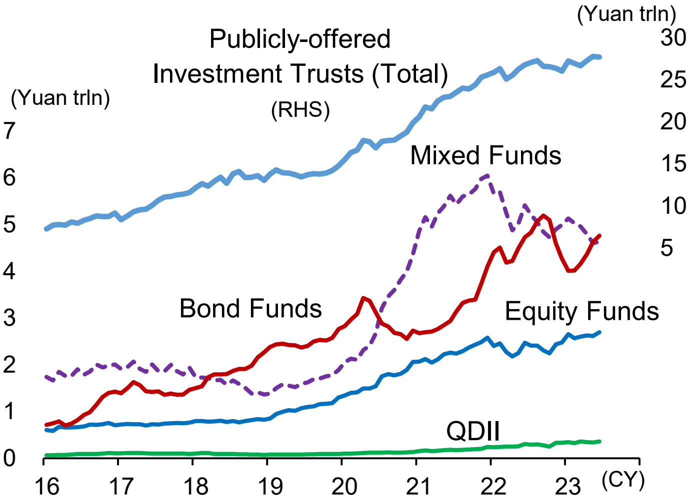
(%, US$ trln)

Country / Year	2012	2015	2018	2021	2022	2023
USA	44.5	46.4	45.2	48.1	47.5	48.0
Canada	2.8	2.5	2.5	2.7	2.6	2.6
France	6.2	4.8	4.5	3.6	3.7	3.7
Germany	5.2	4.7	4.7	4.2	4.1	4.1
Ireland	5.0	5.4	6.0	6.5	6.5	6.4
Luxembourg	9.7	10.0	10.0	9.4	8.9	8.9
UK	3.6	4.1	3.6	3.3	3.0	3.0
Australia	5.2	4.0	4.2	3.7	4.0	3.9
China	1.4	3.3	3.8	5.0	5.4	5.3
Japan	3.4	3.5	3.9	3.4	3.4	3.3
Korea	0.8	0.9	1.0	0.9	1.0	1.0
World (US$, trln)	32.3	38.2	46.6	70.9	60.1	63.1

Note: The ratio of the investment trust balance of each country to the world total; data as of March 2023.

Source: International Investment Funds Association, MUFG: Trust Bank

Exhibit 6: Investment Trust Assets Grew Significantly in China



Note: Public investment funds includes closed funds and money market funds; data as of June 2023.

Source: Asset Management Association of China, MUFG: Trust Bank

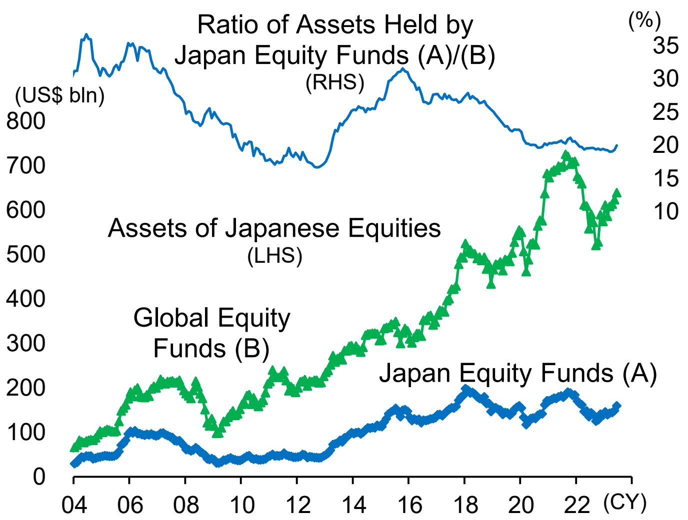
Growth of global equity funds

Second, in major economies, the AUM of global equity funds have grown more than country- and region-specific equity funds. When splitting the holdings of Japanese stocks by foreign equity funds into Japan-only funds and funds that invest in multiple regions such as global equity funds, we find that the former holds USD160 billion and the latter USD640 billion (Exhibit 7). While holdings by Japan-only funds have also grown, their share of the total has been trending down again after turning up over the period when the market was driven by Abenomics over 2013-15. It is now down to 20.0%.

A similar phenomenon is also evident in European and US stocks. Foreign European stock funds hold USD523 billion of European stocks, while global equity funds hold USD3.438 trillion. As for US stocks, the gap between is relatively smaller, with US-only funds holding USD1.203 trillion, versus USD1.444 trillion held by global equity funds.

Until the 2000s, the mainstream style of investing in Europe was to determine country and region allocations first, using top-down analysis, and then have experts on each country/region make individual stock selections. Since the global financial crisis, however, global equity funds that invest in stocks with high expected returns have become an increasing presence. Looking at European investor trends using UCITS, there has been pronounced growth in assets of global equity funds. From end-2015 to June 2023, assets increased from USD718 billion to USD755 billion for European equity funds, from USD207 billion to USD386 billion for US equity funds, and from USD49 billion to USD82 billion for Japanese equity funds. However, during this period, global equity funds considerably increased their assets from USD572 billion to USD1.467 trillion (Exhibit 8).

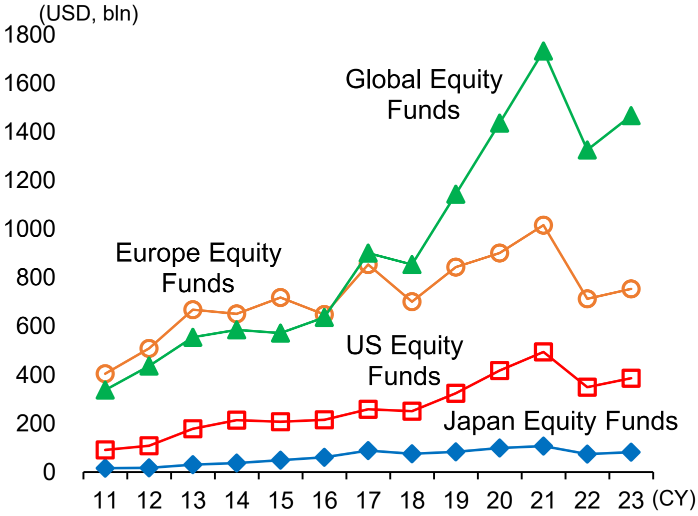
Exhibit 7: More Japanese Equities Held in Global Equity Funds



Note: Universe is foreign equities funds; global equity funds defined as those investing in multiple countries/regions; percentage of assets held by Japan equity funds calculated based on asset balance; data as of June 2023.

Source: EPFR, MUFG: Trust Bank

Exhibit 8: UCITS Global Equity Fund Assets Expanded Strongly in Europe



Note: Universe is equity UCITS in Europe with total assets above USD500 million; data as of June 2023.

Source: Morningstar, MUFG: Trust Bank

Actively managed global equity funds typically hold 50-200 individual stocks. Japanese stocks account for 5.5% of total market cap for the MSCI ACWI (All Country World Index), and funds own stocks of only a few Japanese companies. Since major global equity funds will hold several trillion yen in assets, the average holding of an individual name will be well in excess of JPY10 billion, and investments tend to be limited to large-cap companies.

These funds also select stocks based on bottom-up information, so earnings forecasts and company business strategies are important. Investment decisions are made based on macroeconomic trends less than they previously were. This may be one of the reasons Japanese stocks saw foreign investors' buying even in against a backdrop of bleak US business confidence, which did not happen in the past.

Share prices for industry sectors are highly correlated across major markets. Among 11 GICS industries, relative return correlations between Japanese and US stocks are lower than correlations between European and US stocks, while many industries have positive correlations. In the post-COVID era (since 2021), relative return correlations have exceeded +0.4 for the energy, materials, consumer staples, healthcare, financials, IT, and utilities sectors (Exhibit 9). We attribute this mainly to the fact that the earnings of companies within the same industry tend to track closely across regions due to economic globalization. While for stock supply and demand, asset expansion by global equity funds appears to be having an impact. In the Tokyo market, bank stocks rose sharply in December last year on the back of the widened trading band in the BoJ's yield curve control (YCC) program. Financial stocks have outperformed European and US markets since 2021 (Exhibit 10).

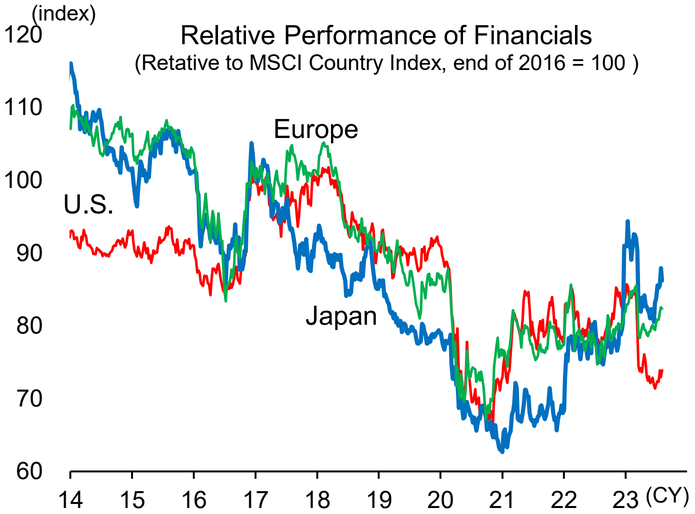
The TSE's Shareownership Survey shows that foreign investors' share of bank stock ownership has been on the decline since FY2013 but rose in FY2021-22 (Exhibit 11). We think that relative rises in stock prices in the European and US markets led to an increase in allocations to Japanese bank stocks as well. On the other hand, the electrical machinery and precision instruments sectors saw their foreign ownership ratios fall slightly in FY2022, which we attribute to a correction in information technology stocks in foreign investors' home markets. We think stock selection trends in the Japanese stock market will remain similar to those seen in the US and European markets.

Exhibit 9: Correlation of Relative Returns by Industry for U.S., European and Japanese Equities

Period \ Sector	Energy	Materials	Industrials	Consumer Disc.	Consumer Staple	Health Care	Financials	IT	Communi-cation	Utilities	Real Estate
US - Europe											
2011-15	0.74	0.77	0.65	0.42	0.79	0.57	0.58	0.21	0.33	0.40	
2016-20	0.53	0.59	0.50	0.29	0.73	0.72	0.68	0.65	0.35	0.70	0.61
2021-23	0.85	0.50	0.06	0.30	0.65	0.64	0.79	0.75	0.13	0.44	0.29
US - Japan											
2011-15	0.58	0.29	0.35	0.11	0.63	0.55	0.17	0.13	0.25	0.19	
2016-20	0.50	0.34	0.41	0.15	0.54	0.39	0.64	0.21	0.11	0.48	0.54
2021-23	0.81	0.46	0.07	0.00	0.54	0.45	0.62	0.65	-0.21	0.59	0.14
Europe - Japan											
2011-15	0.56	0.46	0.31	0.27	0.59	0.49	0.19	0.15	0.26	0.35	
2016-20	0.31	0.25	0.37	0.36	0.65	0.50	0.50	0.19	-0.04	0.31	0.45
2021-23	0.74	0.34	0.22	0.45	0.72	0.58	0.70	0.79	0.13	0.34	-0.10

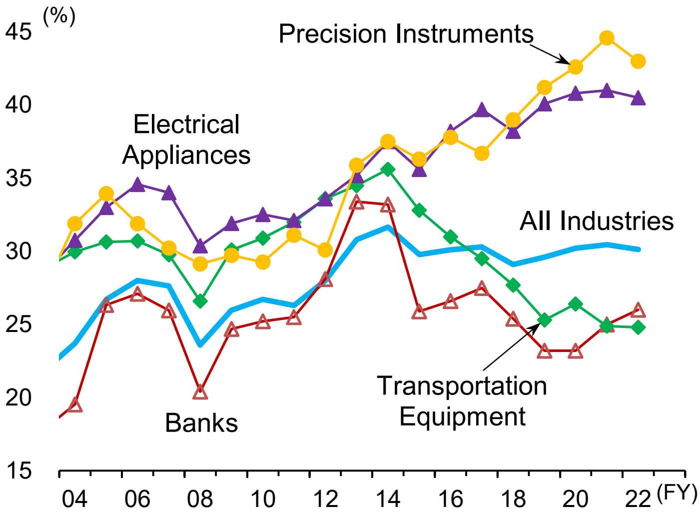
Note: The relative return by industry is the monthly return of the MSCI industry index for Japan, the US, and Europe against each country's index.; based on 11 GICS industry; data as of June 2023.
Source: Bloomberg, MUFG: Trust Bank

Exhibit 10: Financials Started to Outperform in U.S. and Europe from 2021



Note: The value of the MSCI Financial Index of Japan, the United States, and Europe against each country's index; re-indexed as the end of 2016=100; based on 11 GICS industries; data as of July 2023.
Source: Bloomberg, MUFG: Trust Bank

Exhibit 11: Foreign Investors Have Increased Exposure to Bank Stocks in Japan since FY2021



Note: Sectors based on 33 TSE sector classifications; data as of the end of FY2022.
Source: TSE, MUFG: Trust Bank

Investment decisions on Japanese stocks determined relative to other markets

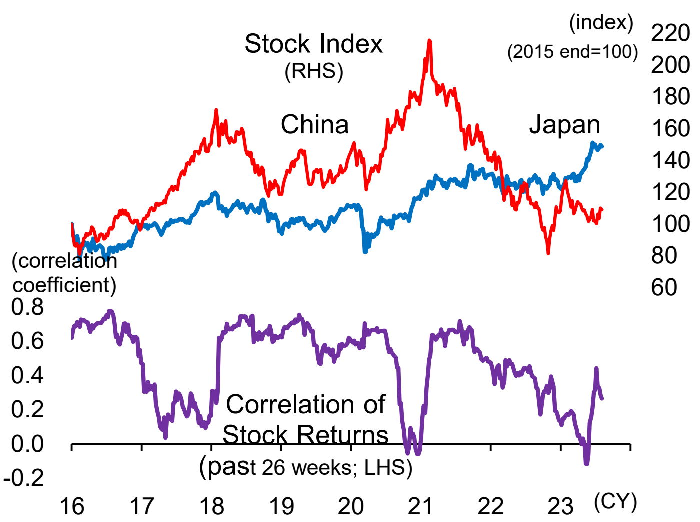
Third, foreign investors tend to make investment decisions on Japanese stocks relative to other markets. Some observers believe that recent buying of Japanese stocks reflects a shift of capital away from Chinese stocks. Weekly return correlations between Japanese stocks and Chinese stocks turned negative for a brief period (Exhibit 12). Japanese stocks have tended to rise when Chinese stocks fall.

Looking at Japanese, Chinese, and European stocks through the lens of capital flows from foreign equity funds, net outflows had continued from 2H 2018 as a result of Fed rate hikes and the spread of COVID-19. However, as policy support from both the monetary and fiscal side led to a global stock market rally, capital started flowing back from mid-2020. Thereafter, as aggressive Fed rate hikes caused stock and bond prices to fall, investors became risk averse and capital flowed out of foreign equity funds in 1H 2022 (Exhibit 13).

As stock and bond prices bottomed at the end of last year, outflows from overseas equity funds tapered off, and in Jan-Mar 2023, money flowed into Chinese stocks, with the end of the zero-COVID policy driving expectations for economic recovery. However, with China's recovery looking feeble, inflows into Chinese stocks slowed in Apr-Jun, while money moved into Japanese stocks. During this period, Europe's economy deteriorated as monetary policy was tightened to curtail inflation, and investors became cautious about the outlook for stock prices, resulting in slight outflow.

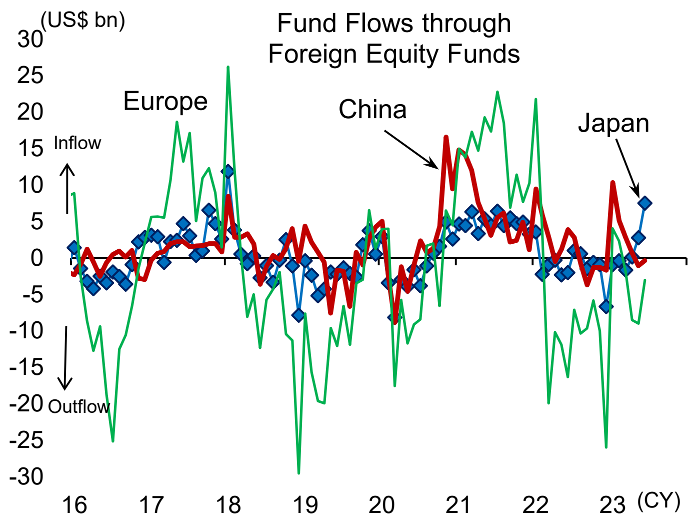
Foreign investors have been net buyers of Japanese stocks since April this year amid poor business confidence in the US. Japanese stocks had been viewed as economic sensitives among global stocks. Now, however, with the non-manufacturing sector accounting for a larger share of corporate profits, earnings have become less sensitive to the global economy than in the past. We also think this round of buying was partly spurred by investors upbeat on Japanese stocks relative to Chinese and European stocks. While a process of elimination, going forward it is possible that investment decisions will still be influenced by views on other markets rather than on factors specific to Japanese stocks.

Exhibit 12: Correlation between Japanese and Chinese Stock Returns was Temporarily Negative



Note: MSCI Japan and China Index; correlation is calculated from weekly returns over the last 26 weeks; data as of July 2023.
Source: Bloomberg, MUFG: Trust Bank

Exhibit 13: Funds Flows into Japanese Equities Increased Recently



Note: Fund flows are estimated from the inflow of the country/region-dedicated stock funds, and the inflow and the allocation ratio of the global stock funds; data as of June 2023.
Source: EPFR, MUFG: Trust Bank

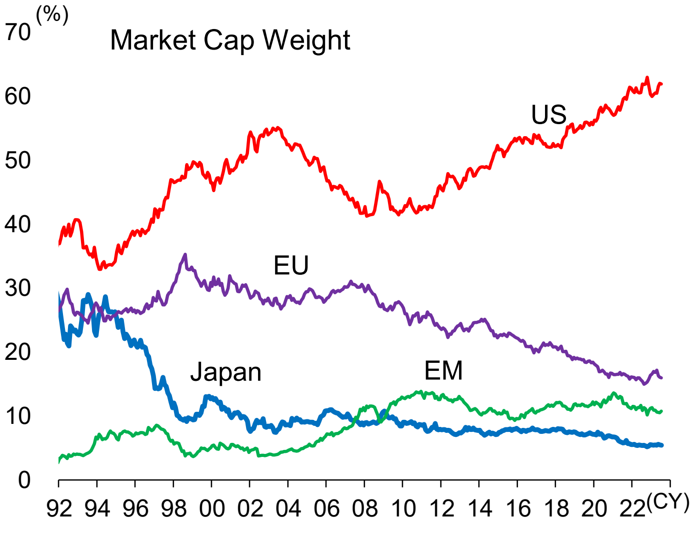
This comes against a backdrop of Japanese stocks with a smaller presence in global stock markets. Japanese stocks account 5.5% of the market cap (as of July 2023) in the MSCI ACWI (All Country World Index), far below the weightings of the 40% level at the end of the 1980s or the 20% level in the early 1990s (Exhibit 14). Until the 2000s, there was a fear of missing out if one did not own Japanese stocks, since portfolios that were underweight Japanese stocks would see relative returns worsen if Japanese stocks rallied sharply. Japanese stocks' share of global market cap is now low enough that investors are no longer too mindful of the fear of missing out.

The number of Japanese equity specialists has declined at the same time. In the UK, well-known Japan equity fund managers such as Man GLG's Stephen Harker, Schroders' Andrew Rose, and Baillie Gifford's Sarah Whitley have retired over the past few years.

One factor behind by foreign investors' buying since April this year is hopes for improved corporate governance, with the TSE urging companies trading below book value to improve capital efficiency. However, judging from their appointment of outside directors as well as dividends and share buybacks, major listed companies have been improving corporate governance since the mid-2010s, despite some lingering challenges (Exhibit 15). While the TSE's demand was arguably the catalyst for foreign investors to recognize corporate governance improvements, at the same time, the fact that they reacted so strongly seems to be an indication of decline in experts following Japanese companies and the economy due to the waning presence of the Japanese market.

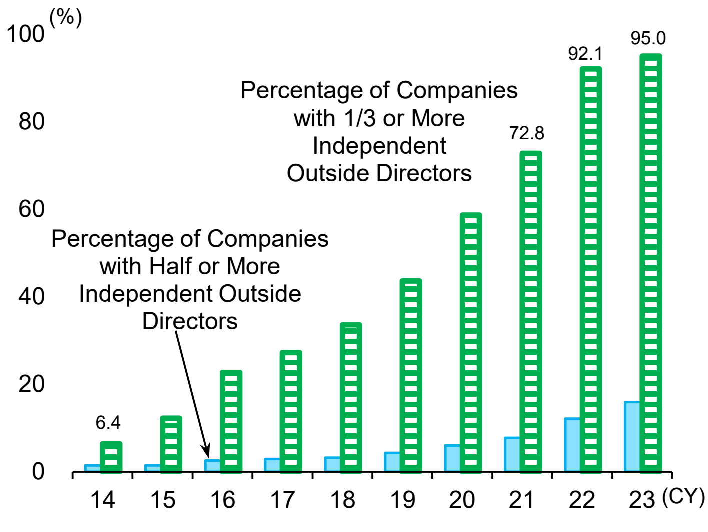
However, it is important to note that since 2016 capital flows into Japanese, Chinese, and European stocks from foreign equity funds have basically moved closely, rather than acting as alternatives. This is because when foreign investors' home stock markets rally, they also become aggressive buyers of equities abroad. When thinking about why Japanese stocks were bought starting April this year, the fact that US and European stocks had been trading strongly since the start of the year was arguably more important than China's economic recovery disappointing. Last year, stock and bond prices both fell, and many investors became risk averse. When stock markets at home began rallying in 2023, investors unwound bearish positions and some of this money appears to have been allocated to foreign equities.

Exhibit 14: Market Capitalization Weight of Japanese Equities Has Dropped Significantly



Note: Market cap weights are based on MSCI USA, Europe, Emerging Markets and Japan against MSCI All Country World; data as of July 2023.
Source: MSCI, MUFG: Trust Bank

Exhibit 15: Japanese Companies Increased Outside Directors Over Last Few Years



Note: Universe is TSE1 and Prime Market listed firms; data as of 2023.
Source: TSE, MUFG: Trust Bank

A pullback in the US stock market would make it hard for foreigners to continue buying Japanese stocks

How are foreign investors likely to trade going forward?

A breakdown by investor type of cash market trading on the TSE suggests that foreign investors may find it difficult to remain net buyers continuously. Until around 2015, there was a positive correlation between foreign investors' net buying in one month and their net purchases two months later (Exhibit 16). If foreign investors were net buyers of Japanese stocks one month, they also tended to be net buyers two months later. Over the 2003-04 timeframe, foreign investors remained net buyers for 13 months and during 2004-06, their net buying continued for 23 months.

Since 2015, however, the correlation between net buying by foreign investors in one month and net buying two months later has been negative. While impacted by the sharp rally in global stock markets after a steep drop in the wake of falling oil prices, Brexit, and the COVID-19 pandemic, the tendency has been for one month of net purchases to be followed by net sales two months later. The longest period of consecutive net buying by foreign investors was seven months, from October 2020 to April 2021. Conversely, the longest period of net selling lasted eight months, from August 2018 to March 2019.

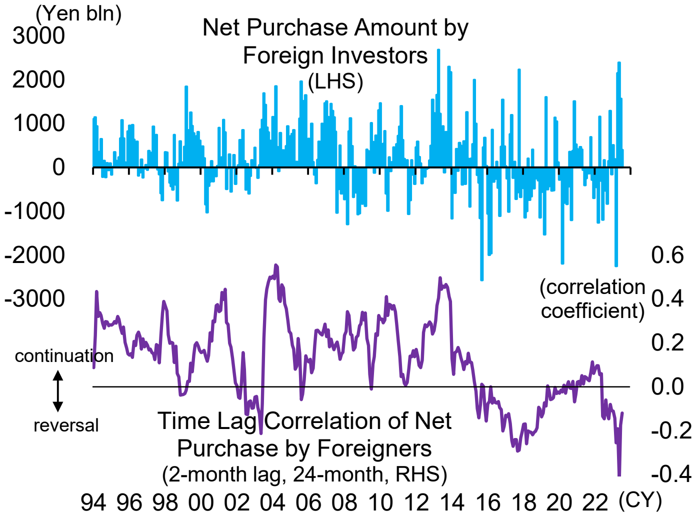
The growth in assets of global equity funds and a tendency to assess Japanese stocks relative to other markets have probably been underlying factors. Investment in Japanese stocks via actively managed global equity funds is based fundamentally on the evaluations of individual companies. For instance, even if the global economy recovers, foreign investors may not necessarily buy Japanese stocks aggressively if the earnings outlook and business strategies of Japanese companies are unimpressive, or if emerging-market manufacturers have major earnings upswings.

Moreover, if the home country’s stock market rallies, individuals and end-investors tend to divert capital into overseas equity funds, which would encourage foreign investors to buy Japanese stocks. On the other hand, end-investors will turn risk averse if the home market declines and foreign investors will tend to be net sellers of Japanese stocks.

Correlation between US and Japanese stock returns has increased in recent years. Monthly correlations (in USD terms) tend to rise when share prices fall and decline when share prices rally. However, the correlation since spring 2020 has stayed high at 0.78, even though Japanese and US share prices have remained elevated (Exhibit 17). In addition to economic globalization, we think investors' stance on risk assets has led to increasing correlation in terms of supply and demand for shares.

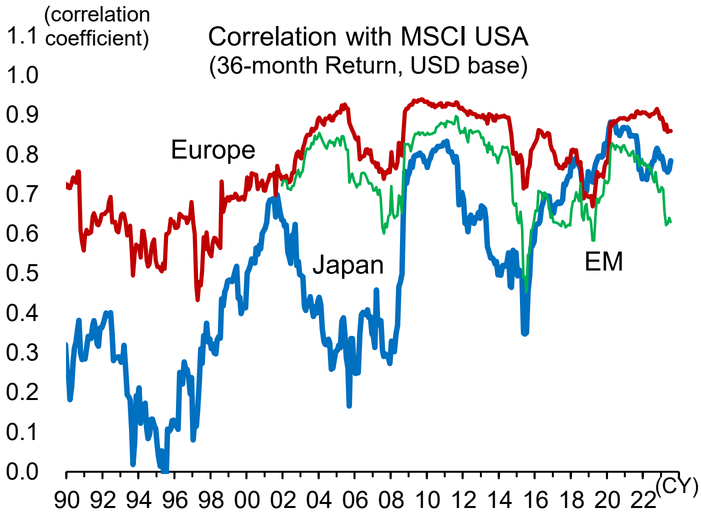
Foreign investors have undoubtedly started to focus on the possibility that deflation may be over in Japan and on improvements in corporate governance. If Japanese companies improve their profitability, foreign investors are likely to be net buyers of Japanese stocks over the long term. However, from a near-term investment perspective, if US stocks pull back, foreign investors are unlikely to continue buying Japanese stocks. Investors should probably eschew foreigner investors’ buying as their basis for turning bullish on the Japanese stocks.

Exhibit 16: Net Buying of Japanese Equities by Foreign Investors Volatile Recently



Note: Time lag correlation is calculated from the net purchase in cash market and the net purchase two months later; data as of July 2023.
Source: TSE, MUFG: Trust Bank

Exhibit 17: Correlation between U.S. and Japanese Stock Returns is Increasing



Note: MSCI USA, Europe, Emerging Markets and Japan Index; correlations are calculated from dollar-denominated returns over the past 36 months; data as of July 2023.
Source: Bloomberg, MUFG: Trust Bank

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