Stephen Harvey: Hey, everybody, and thanks for taking the time to watch this video. We thought at Grayhawk, it could be very interesting for our clients to get an inside perspective on some of the strategies or themes that we've been looking at in our portfolio. Today, we're very lucky to have Howard Smith, who's a partner and portfolio manager at Indus Capital, to talk to us about what's going on in in Japan, and particularly in their stock market.

Stephen Harvey: As you may know, we made an allocation to Indus Japan's fund through our Grayhawk Global Growth portfolio, our active equity portfolio, because we think there's some interesting dynamics inside of the equity market in Japan and also what's going on with the currency as well. We think the combination offers an asymmetric opportunity for our clients. So I won't spend too much time, but Howard has over 35 years experience working in and around Japan, including 25 years living in Japan, and for the last 22 years has worked at Indus Capital. So Howard thanks so much for making the time to join us today.

Howard Smith: Thank you, Stephen. It's a pleasure.

Stephen Harvey: Howard, let's start with, kind of, some of the macro things that have gone on in Japan. So we've got a yen that's at 35 year lows but we have a stock market at all-time highs. So first of all, what are the kind of macro-drivers of the yen? Why is it so weak?

Howard Smith: Yes, that's a great way to start a conversation, Stephen.

I think if you look at the yen prior to the pandemic, it was generally in a gentle, strengthening trend. It's only become profoundly weak since US inflation burst onto the scene in late 2021 or early 2022, which kicked off a cycle of rate increases from the Federal Reserve in America.

So a massive interest rate differential has opened up between the US and Japan and in our view that is the predominant driver of the Yen's weakness. We think the Yen is profoundly undervalued at the current level. It's at a record low in real effective terms. We know we haven't seen this level for the last 50 plus years.

Certainly, anyone who gets off the plane from a North American destination arriving in Japan will understand fairly quickly how cheap everything feels in Japan at these at these exchange rates. So I think it's only a matter of time before the Yen starts to strengthen again. And, in our view the key to that is going to be narrowing interest rate differentials between Japan and the US.

The recent data coming out of the US does suggest a slowdown in employment growth. It looks as though the labour market is starting to crack a little bit at the edges now and on the Japanese side, you know, inflation has been running above the 2% target for a couple of years already in Japan. The Bank of Japan has started to tighten monetary policy. We believe it will tighten monetary policy further. So, we think the interest rate differential will narrow from both sides, both from US rates falling and from Japanese rates increasing. And, we believe that will be consistent with some Yen strength in the months and quarters ahead.

Stephen Harvey: Thank you and Howard, maybe. Give us some examples, or talk about the implications for the stock market because of the weekend.

Howard Smith: Yes, if you look at corporate profits in Japan, at a macro level, based on Government data, roughly, half of profits are generated outside the country by, you know Japanese businesses, either exporting from Japan or having operations in overseas countries and the other half-generated in domestic Japan.

Generally speaking, a week Yen is positive for companies that do business outside Japan and negative for companies that do business inside Japan. Japan is a resource-poor nation that imports most of its food and energy or raw materials. So a week Yen is a reason for input cost-inflation in Japan, and that hurts the margins of companies doing business in the domestic Japanese economy.

But, it's a tailwind for those companies who are generating the majority of their profits outside Japan. If you look at Japan's equity market, particularly the large companies, the large big cap stocks in Japan tend to be multinational companies that generate most of their profits outside Japan. So I think it's fair to say that the weaker Yen has been a tailwind for the profits of listed companies in the Japanese equity market for the most part; and that has certainly been a driver, I think, of equity returns in local currencies in Yen terms. And why, one of the reasons, or maybe arguably the predominant reason, why we're at record high levels today. That's not the only reason to be interested in Japanese equities. And you know, there's lots going on, I think, in domestic Japan as well, that could be interesting, as the end starts to strengthen. But certainly the weak Yen has been a tailwind for the reported earnings of the multinational companies who dominate the indices in Japan. Yes.

Stephen Harvey: Howard, kind of, staying at a very high level and talking, kind of, much more macro and outside of the Yen, what have been some of the other drivers? We're at 2-and-a-half, you know, the last 2-and-a-half years of incredibly strong for Japanese equities in local terms; what have been some of the key drivers?

Howard Smith: Yes, I think there's two, really, Steven. One, is Japanese companies becoming much more efficient at running their businesses. And, I'm sure we'll touch on that a little bit later. Japanese companies have been very good over the last 5 or 10 years at divesting non-core businesses getting out of low margin operations. Generally allocating capital to areas with higher productivity and higher margins, becoming more focused, becoming leaner. So there's been a bottom-up self-help story that has driven operating margins of Japanese companies higher separately from whatever's going on in the world or from the exchange rate.

The second element of that has been uses of cash-flow, and it goes hand-in-hand with higher margins. So, as businesses become more profitable and less capital intensive, they tend to generate more free cash-flow and that free cash-flow has been finding its way, flowing back to shareholders in the form of higher dividends and share buybacks. So dividend payout ratios have been going up and share buybacks have been going up quite dramatically. Many Japanese companies have over-capitalized balance sheets, either sitting on excess cash. Half more than half the market actually has net a net cash position.

Japanese companies have been deleveraging their balance sheet for the last 20 years and so they're sitting on huge resources to buy back their own stock. And that's been another very important driver of returns, in our opinion, in in the equity market for the last 5 years.

Stephen Harvey: And maybe switching to a little bit more on the micro side. I mean, there's been quite the shift in, kind of, the board-room mentality in Japan over the last several years, but maybe talk about some of the policies that have been brought in that are not more shareholder friendly, and how that's kind of been playing out.

Howard Smith: Absolutely. So about 10 years ago, Japan promulgated a corporate governance code that applied to listed companies and a stewardship code that applied to the asset management industry and I think that's really changed the nature of the dialogue between owners and managers of companies.

And it goes hand-in-hand with the unwinding of cross shareholdings. That's something that you'll read a lot about in the international press. But Japanese companies historically had a web of cross shareholdings in each other.

Within their so-called Keiretsu groupings, so the banks and insurance companies, you know, tended to own shares in their clients. The automotive assemblers tended to own shares in their suppliers, and vice-versa. The unwinding of those cross shareholdings has accelerated dramatically in the last 5 or 6 years, and that's really driven a change in the shareholder registers of Japanese companies, and made the management of those companies much more responsive and willing to engage in dialogue with minority owners.

And that goes hand-in-hand with the corporate governance code and the stewardship code, and alongside some initiatives of entities like the Toko Stock Exchange. You know, the Toko Stock Exchange has made a big splash on the cost of capital and the return on equity of Japanese companies, and pointed out that far too many Japanese companies trade at less than one times book value. Even today, 40% of the Japanese equity market trades at less than one times book value, that reflects low historical ROEs.

So more and more Japanese companies are taking it upon themselves to reform and change the way that they think about capital allocation, and uses a free cash-flow to drive higher returns, and to lower the cost of equity. And, that multiple expansion is another important driver, I think, of what's been going on in the Japanese equity market for the last 5 or 6 years, and I think we're in the mid-innings of that process. You know, we're not at the end of that process by any means.

In the US, I think, only 5% of companies trade below book value in Europe. It's something like 20%. So there's a long way to go in terms of valuations for Japanese companies. We are not at a rich valuation, and bull markets I was always taught don't end on normal valuations. So you know, I think there's plenty of runway ahead of us for Japanese companies to become more efficient, and also to have rich evaluations.

Stephen Harvey: Howard as you mentioned at the top? You've been investing in Japan for a very long time. How kind of key a shift are you seeing kind of the interaction you're having with corporates? How are you engaging with them differently?

Howard Smith: It's really very different. 20 years ago I remember distinctly being thrown out of a company visit in Japan for daring to talk about the fact that the balance sheet, the net cash on the balance sheet of that company exceeded the market capitalization of that company. It had negative enterprise value, and the CEO didn't want to engage in that discussion, and asked me and the then portfolio manager to leave the room.

That's unthinkable in today's corporate Japan landscape. We're finding the door is more open than ever before. Our access to the CEO and CFO, the C-suite people at Japanese companies is better than ever before. The willingness of those companies to listen to the kind of letters or presentation materials that we're putting in front of them is greater than ever before.

And so, an asset management company like us as an agent of change, you know, without being what I'd describe as a hardcore activist, is really improving. We're having very constructive dialogue and really feel that we're able to make a difference. The managing partner of Indus Capital sits on the board of Fujitsu as an external director and that would have been unthinkable, I think, even maybe 5 years ago for a portfolio manager to be sitting on the board of a large Japanese corporation like that. So I think that's Testament to just how much the dialogue has improved, and how much we can affect change within the boardroom, and that, of course, in addition to all of the self-help initiatives that Japanese companies are undertaking. That's another driver, I think, of higher returns and better multiples for Japanese companies going forward.

Stephen Harvey: Great Howard, let's have some, kind of, quicker fire questions here and just talk about some different themes of things that are going on. Let's take the Yen, for example; What do you see as the catalyst for change.

Howard Smith: I think it's about the interest rate differentials. As I mentioned earlier, you know, the Bank of Japan has already exited from negative overnight interest rates. That happened in March. I think there's a very high likelihood that that Japan raises interest rates by 25 basis points. Actually, as soon as this month.

I think there'll be another rate increase before the end of the year, and probably another one in the 1st half of next year. There's more and more evidence that wage inflation in Japan is reaching higher levels and sustainable high levels.

The labour market in Japan is extraordinarily tight. There's a tremendous shortage of labour. Workers are becoming more mobile, much more willing to change employers and not sit at the same company for 40 years and the use of stock as a retention tool for highly skilled-labour is becoming a much more important element of HR management for Japanese companies.

So I think I think wage-inflation is very much here to stay. And I think that means Japan has a higher natural rate of interest than it has done historically, and that means the nominal rate of interest will go up in increments over the next one to 2 years, and if that coincides with the Federal Reserve cutting rates, I think naturally the interest rate differential between the US and Japan will narrow by 150, possibly 200 basis points, and I believe that will be consistent with a stronger Yen. We are profoundly dislocated, I think, on any measure, and I think it's a. It's a short term capital flow issue. It's not a long-term structural issue that tells us anything profound about the underlying growth, rate or productivity of the Japanese economy. I think it's an interest rate-differential issue that will resolve itself as the gap between rates narrows.

Stephen Harvey: Maybe Howard, highlight one sector inside, you know, Japan, that you're quite excited about.

Howard Smith: Yes, we're doing a lot more with financials now, Stephen. As you can imagine, Japanese financials for the last 30 years have not been a particularly interesting place to invest. The economy has had low nominal GDP growth.

You know, loan deposit ratios have fallen, deposits have grown much more quickly than loans have. So, many Japanese banks are sitting on loan deposit ratios of 60 or 70% and I've had to park their excess deposits in very low yielding instruments, or at the bank of Japan at 0, or negative rates.

So I think the ability of Japanese companies to grow their loans again in an economy that has higher nominal rates of growth, where there's some capital formation where companies are investing again and replacing their capital stock.

That's an important driver, I think, of asset expansion for Japanese financials. And then, of course, the net interest margin will expand. We think the Japanese curve will both move up and steepen. And, banks are in the business of, you know, typically funding at the short-end and lending at the longer end. So a steep ROE curve is highly accretive to the earnings of Japanese companies and that makes the ROE very sensitive. So we think we'll see a lot of Japanese banks go from 7 or 8% ROEs to possibly 11 or 12% ROEs, and that means they should go from trading at one times book value or less. Most Japanese banks are still trading at less than one times book value.

They can go back to one and a half, or possibly even more than one and a half times book value going forward. So we're doing a lot more with the banks. We're doing more with life insurance companies, which are highly sensitive to long term rates. And in the property and casualty insurance sector we're seeing massive unwinding of these cross shareholdings. The financial services agency in Japan has mandated that all of the property and casualty insurance companies should unwind their cross shareholdings.

And, most of them are doing that over the next 5 or 6 years and we think a large percentage of those proceeds will come back to shareholders in the form of buybacks and dividends. So we're finding all in yields of 7 or 8% on property and casualty insurance companies in Japan, which we think is, you know, highly attractive. So definitely doing a lot more in financials. We've also got a leasing company in the book and a non-bank financial lender in the book as well.

So that's a very exciting area, I think, for us that's consistent with rising rates in Japan, and a faster expansion of the economy going forward.

Stephen Harvey: Howard, on the, kind of, a Geo-political point of view, with kind of feels like we're moving away from, kind of, globalization towards de-globalization. More, kind of, on-shoring or production moves away from China. Is Japan or a winner or loser from that.

Howard Smith: I think it's a net beneficiary of that student, and I think the most obvious example of that is the semiconductor value chain. In the 1990s, Japan was a major producer of semiconductors, both in logic and in memory. It lost that business to countries like Korea, Taiwan, and mainland China, after 2000.

It always retained very high value-added in the upstream segments of the semiconductor value chain. So, the production equipment, the wafers, the intermediate materials like resists. These areas have always been dominated globally by Japanese companies, and will continue to be so, in our opinion, because the barriers to entry are very high. The moat is very wide. But Japan is a huge beneficiary of inbound investment, in the semiconductor manufacturing industry. TSMC is building 2 plants in Japan, and we'll probably build a 3rd plant.

The Japanese Government itself is underwriting a massive semiconductor project leading edge logic Fab, up in the northern island of Hokkaido. Many other multinational companies in the setting up the value chain are expanding CAPEX in Japan.

So we think that the geopolitical backdrop, particularly the backdrop between China and Taiwan is a tailwind for investment into Japan and Japan's a cheap place in which to invest at this exchange rate. You know, the return on assets in Japan at this exchange rate is very high. Labour is very cheap. TSMC is also investing in Arizona, in the US. But, the plants are getting put up more quickly in Japan, and the labour is cheaper and more available in Japan than it is in a state like Arizona in the US. So you know, we think Japan will continue to be a beneficiary of inbound FDI, and also by Japanese companies that that are finding it cheaper now to restock that capital base in the Japanese economy than in overseas markets. So that, that's definitely something that we look forward to in Japan over the next several years.

Stephen Harvey: Great Howard. It sounds like Japan's going to be a winner from, kind of, the AI boom through the CAPEX spending on the semis industry. So that's great to hear as well.

Howard Smith: Absolutely.

Stephen Harvey: This is our first in a series, Howard. We appreciate you being the first person to step up and do one of these. We really thank you for your time.

Howard Smith: Pleasure! Thank you.

Stephen Harvey: It was good listening.

Howard Smith: Yeah, really appreciate it, Stephen. Thank you very much.

Stephen Harvey: Thanks, Howard.

Howard Smith: Thanks. Bye.