Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Limited
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Market Outlook for Japan 2017

Following a turbulent 2016 for Japanese stocks, we look ahead at what's in store for the Japanese stock market in 2017 and the potential risks we see as a growth-biased manager.

Barring any unforeseen events, we expect that the Japanese market in general will be robust in 2017. Supporting factors for Japanese equities include:

- **Better prospects for global growth** following higher expectations of fiscal stimulus, rising US interest rates and a recovery in commodity markets should be a tailwind for Japanese corporates.

- **Sustained dollar strength relative to the yen** should help propel earnings upwards; earnings growth could be revised up to 15-20 per cent for the year.

- **Improving corporate governance and shareholder-friendliness** should see the cash deployment trend (dividends and share buybacks) continue and also apply upward pressure on ROE.

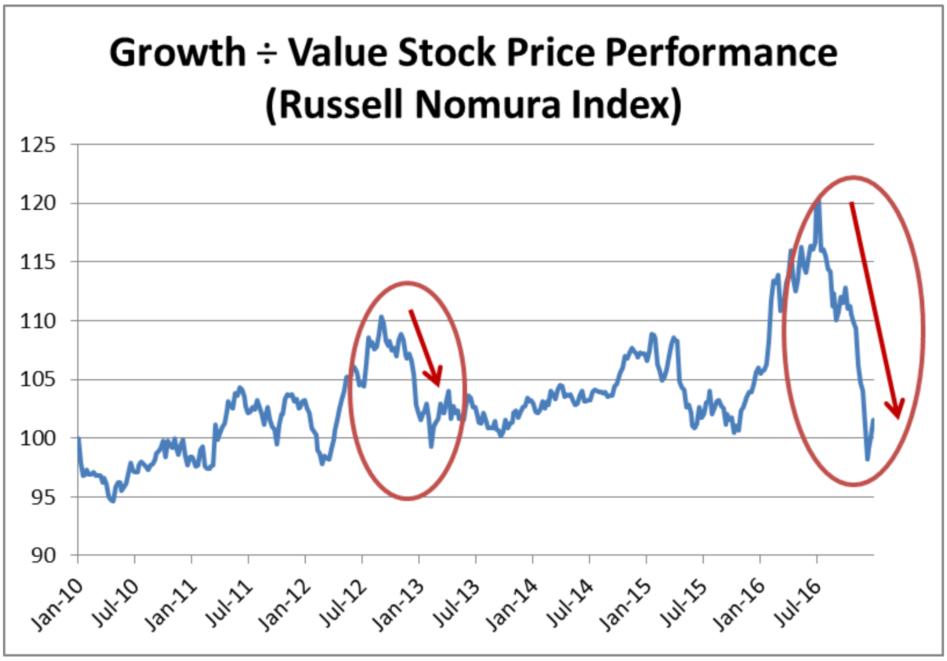
- **Renewed focus on fiscal policy and structural reforms**; a stable political backdrop should allow Abe to help boost the economy and follow up on promised reforms, such as for the labour market.

Transition Back to Fundamentals

At the same time, we believe the dynamics behind the recent upturn will shift. In our view, the first phase of the rally, which mostly comprised cyclical, high beta stocks (in the financial, exporter and commodity-related sectors), driven by macro factors since last summer and even more so after the US election is close to ending and will shift towards the next phase. As we have seen in the past, this type of environment (outperformance of value/highly cyclical stocks) usually coincides with the early stages of a market recovery and tends not to last for very long.

In fact, we saw a similar situation in the second half of 2009 (after the financial crisis) and again in the fourth quarter of 2012 (after the announcement of Abenomics). As highlighted in Chart 1, the value rally this time has been of a bigger magnitude (at least twice) than that of the one seen at the end of 2012, meaning the disparity in valuations between growth and value stocks as measured in the Russell-Nomura Index has already fallen to the level of five years ago.

Chart 1

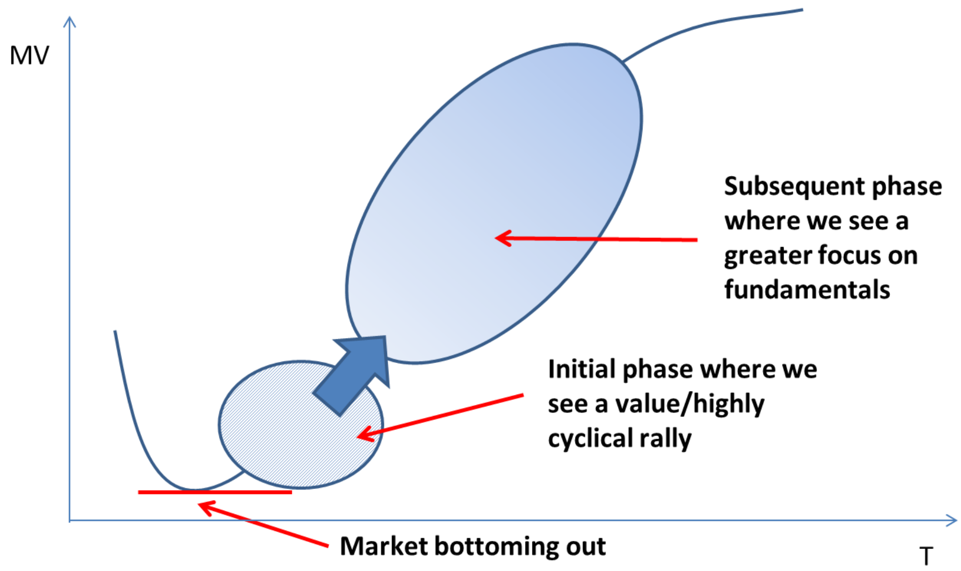


Source: Bloomberg

From here, as the impact of macro drivers has already been priced in, we believe the market will shift back to a fundamentals focus where the individual earnings prospects of companies matter more in determining stock price performance. This transition is our main scenario for this year (please see Chart 2). As such, we feel the importance of fundamental bottom-up stock selection will become greater from now on.

Chart 2

Return to a More Fundamentals-Focused Market

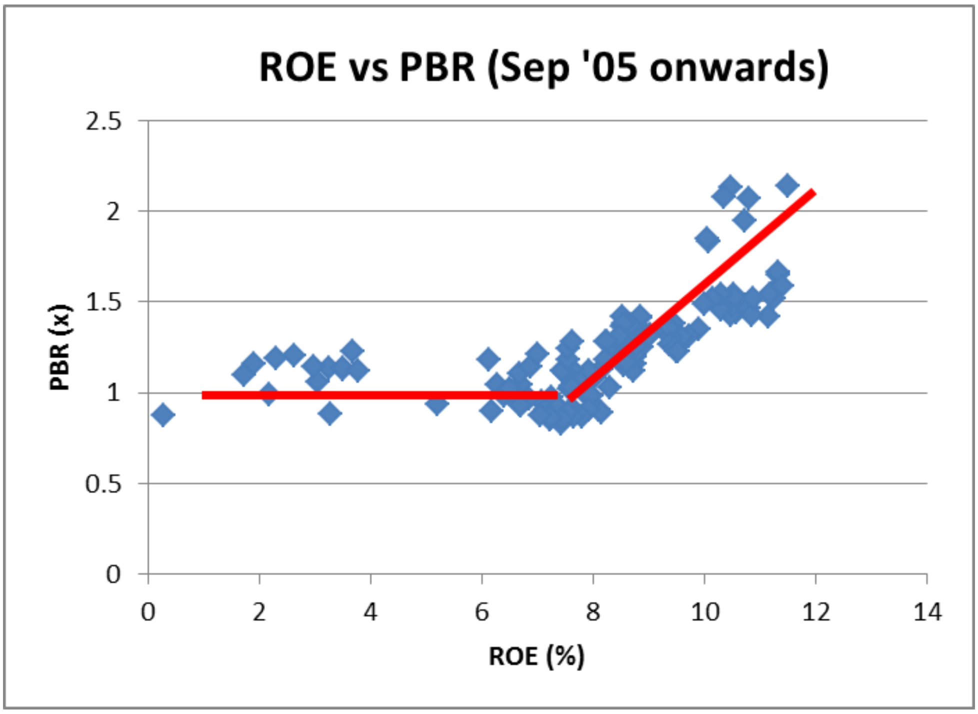


Potential Risks We See

Of course, there is the possibility that the Japanese market does not behave in this way. One potential reason for this could be an overshoot of global growth which leads to an extension of the macro-driven rally and the upward revision of sector valuations, whereby cheaper valued sectors are re-rated as higher valued ones. However, we feel that this scenario is unlikely as market optimism over Trump's expected policies seems to be overdone while global uncertainty could derail such a move.

Another reason could be if Japan falls back into deflation and a value-oriented market. However, we believe that there are structural reasons supporting Japan's return to a growth-oriented market. As shown in Chart 3, there appears to be a kinked relationship between ROE and PBR; the PBR of Topix starts to rise once the index ROE reaches above the 7-8 per cent threshold while it remains flat when ROE is beneath this level. With the upward momentum in ROE set to continue, we feel that this may be another supporting factor for the market's return to a fundamentals bias, where better performing companies are rewarded with higher multiples.

Chart 3



Source: Bloomberg

Conclusion

Given the current market environment, it may not be surprising to see growth-biased managers underperform the market. However, we firmly believe that once the market switches back from a macro-driven to a micro-driven one (which seems the most likely scenario in our view), the results of fundamental bottom-up stock selection will become more apparent. Of course, the same investment ideas that worked previously may not work again. As such, we still believe it is crucial to continuously monitor companies through frequent meetings and visits to refresh ideas and capture inflection points as they appear in Japan.

● Tokio Marine Asset Management is a Japan/Asia equity specialist with 30 years' market experience and approx. $55bn AUM (as at 31 December 2016). Our flagship Japanese Equity Focus strategy is a concentrated portfolio of 20-40 high conviction stocks using the best investment ideas of today.

● Please contact the Business Development team at Tokio Marine Asset Management (London) Limited (details below) if you have any queries regarding the above or wish to discuss Japanese equities with us.

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