Market Insight: Japanese Equities

Tokio Marine Asset Management (London) Limited
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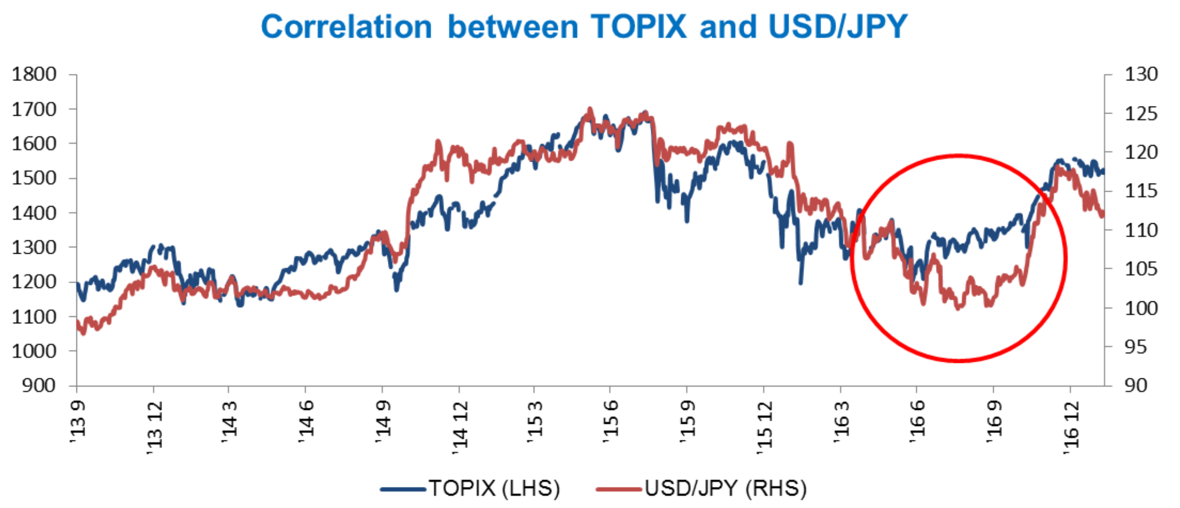
Why non-exporters are still worth considering in Japan

Weaker yen and global reflation trade have supported cyclicals but resilience of domestic-oriented sectors shouldn't be overlooked, particularly as Trump euphoria could fade and yen weakness gets priced in

Cyclicals in Japan, much like in other markets around the world, have enjoyed a surge since November following Trump's election win, with financials, materials and exporting sectors posting the largest gains. On the other hand, domestic-oriented sectors, such as foods, household goods and pharmaceuticals have performed considerably worse.

So, are investors right to believe that the performance of non-exporting sectors will continue to lag that of exporters in 2017 as well?

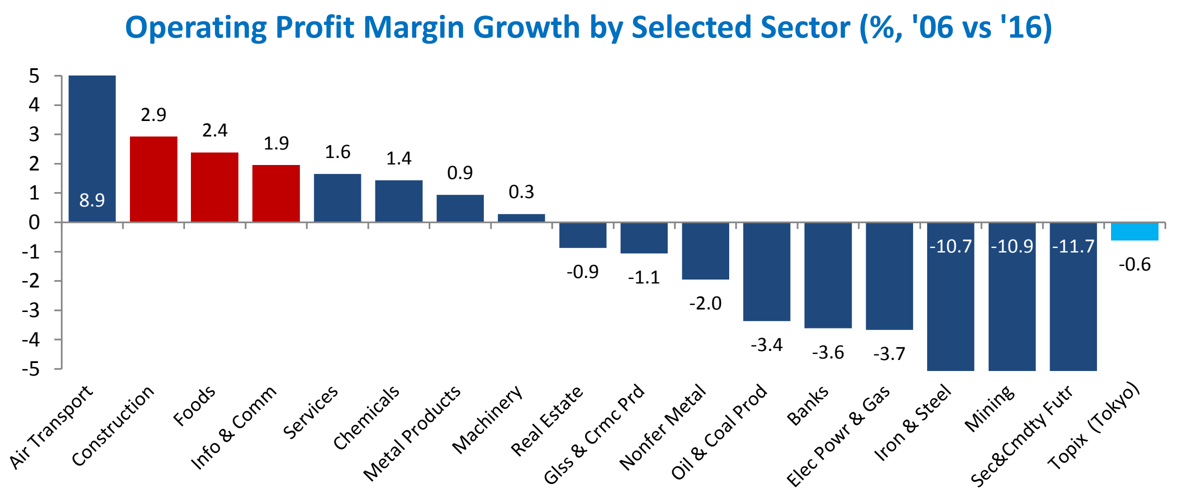
One chart we have been examining shows the relationship between the yen and TOPIX. As investors are no doubt aware, there has been a strong correlation between the relative strength of the currency and the domestic stock market historically. (A weaker yen boosts corporate earnings which in turn feed through to higher stock prices and vice-versa).



Source: Bloomberg

However, what we have observed in the past 12 months is a gradual decoupling of this relationship. As the chart above shows, the earnings of Japanese corporates remained surprisingly buoyant in spite of a sustained period of relative yen strength last year.

We believe one reason for this resilience in corporate earnings is in part due to the improving profit margins of companies in non-exporting sectors. While margins as a whole in Japan haven't changed significantly in the past 10 years, companies in sectors such as foods, information, technology and communications (ITC), and construction have been better performers in terms of margin improvement (through cost reduction and streamlining of business lines).



Source: Bloomberg

In our view, the main reason for this is that Japan has been shifting away from a deflationary regime to a new phase driven by changing demographics, a tighter labour market, and inflationary pressures. These changes have affected domestic-oriented companies the most and as a response to this, we are seeing many game-changing transformations in these sectors.

We feel it is this dynamism which has driven margin improvement in these sectors overall. We therefore do not view Japan as a short-term cyclical recovery story; rather, we believe this structural shift will continue to be a major determinant of Japanese corporate earnings developments in the coming years.

In addition to this structural view, we believe that these sectors will benefit from a further tailwind coming from a recovery in domestic consumption this year. While consumption has been sluggish in recent years following the consumption tax hike in 2014, expected wage hikes from this month's annual wage negotiations and continued policy supports from the Abe administration should provide a timely boost to household incomes.

As such, we believe it may be unwise to neglect non-exporters despite their recent underperformance. In fact, current market conditions may provide a good opportunity to re-enter higher quality, stable earnings growth companies in these sectors as their valuations have fallen to more reasonable levels.

The spotlight for now may be on exporters who have already priced in the potential benefits from currency depreciation and higher global growth. However, we feel that this situation could reverse once the market's focus switches back to individual company fundamentals and less-favoured non-exporting sectors could be viewed more favourably again.

● 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.

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