FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

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Time for a move into Japanese Equities?

Here at Fortem capital, we do not profess to be experts on Japanese equities as an asset allocation call, but what we do see across our clients and research sources is a growing positive sentiment towards Japanese equities. We therefore thought it useful, to draw together and summarise the thoughts of some of the more well regarded investors and analysts with respect to Japanese equities.

2017 Japan Outlook: Poised to Perform - WisdomTree's head of Japanese Research, Jesper Koll, January 17th 2017

"Japanese risk assets – equities and real estate – remain on track for a multi-year structural bull market". In 2017, they anticipate "strong performance, driven by an upturn in the business cycle in general," Taking the widely-held belief that the Topix has attractive valuations.

The TOPIX currently trades on a PE that is at a discount to both its own long-term average and to Wall Street multiples; many of our clients believe that Japanese equities could grow significantly **– Koll states** "as much as 20%" and **Citigroup's Japanese equity division** "see circa 10% growth this calendar year to above 1,650".

Positive earnings growth

Koll states that a positive inflection appears likely on both fronts in 2017 and, compounded by yen depreciation/dollar strength, this should result in a steady stream of upward revisions to corporate earnings. Moreover, the Japanese stock market has a much greater exposure to cyclical constituents (61% compared with a mere 26% in the UK for example). Japanese equities also have the best performance record during previous periods in which US Treasury yields rose.

Koll's facts and figures: *"Against a conservative consensus call for 10 per cent earnings growth in 2017, we forecast a rise of 25 per cent".*

"Our forecast is based on an average exchange rate of Y115/USD, while the consensus call appears to be based on Y103/USD at the time of this writing. Every 10-yen of sustained yen depreciation adds back approximately 8 per cent to listed companies' earnings." What about timings? Koll states that positive earnings revision momentum should be particularly strong in the run-up to the full fiscal year corporate results season end-April/early-May.

Portfolio re-balancing by domestic investors

Japan's public pension fund, GPIF, adjusted their asset allocation a couple of years ago, raising domestic equity holdings from 14 to 24%. Therefore, there is an expectancy that private institutional investors and retail investors will follow suit in 2017.

Koll states that in terms of timing, the major institutional investors typically set the asset allocation for the new financial year (mid-March).

Product	Participation
Citi 6yr Topix Daily-Hedged Callspread 100/140 60% EKIP	325%

Rates (bps)	Current	Week Chge
GBP 1yr	55.50	-0.20
GBP 3yr	71.30	-5.10
GBP 5yr	91.70	-6.10

Equity Indices (%)		
FTSE 100	7275.47	1.21%
S&P 500	2246.19	-2.23%
Nikkei 225	19301.44	2.03%
Eurostoxx 50	3306.21	1.01%

Currencies (%)		
GBPUSD	1.2177	-2.46%

5yr Credit Spreads (bps)		
Citigroup	73.63	4.79
Credit Suisse	118.92	8.14
Deutsche	162.42	7.90
GS	89.91	3.82
HSBC	69.88	5.65
JPM	64.53	6.78
MS	85.64	3.82

Commodities (%)		
Gold	1187.88	-2.66%
Oil	51.70	-3.96%

3m Implied (vol pts)		
FTSE 100	10.94%	-0.39%
S&P 500	11.34%	0.56%
Nikkei 225	18.61%	0.30%
Eurostoxx 50	15.41%	-0.24%

5yr Implied (vol pts)		
FTSE 100	18.85%	-0.28%
S&P 500	20.45%	-0.08%
Nikkei 225	19.74%	0.36%
Eurostoxx 50	19.51%	-0.28%

Source Bloomberg / Partner Banks
Data as at 10thFebruary, market close

Upcoming events	
14th Feb	UK CPI % y/y
14th Feb	Eurozone GDP (prelim) % q/q
15th Feb	US CPI % m/m
17th Feb	US Sovereign debt to be rated by Moody's

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Moreover, “In September 2016, the BoJ… changed its regime. Its ‘zero-rate bond yield anchor’ is now working to assure investors that equities are the primary domestic asset choice”, according to Koll.

Schroders, Head of Japanese Equities Shogo Maeda, 2017 Japanese Equity Outlook Research Note, January 2017

“The domestic environment remains rather more encouraging [as a result]. With coordinated fiscal and monetary policy providing strong support for equities we would expect the current period of political stability under Prime Minister Abe’s leadership to also provide an opportunity for longer-term structural reforms of taxation and the labour market.”

“Although we do not currently expect any significant new policy developments from the Bank of Japan (BoJ), its ongoing stance remains aggressively loose going into 2017. At present, we see no real pressure on the central bank resulting from the spike up in global bond yields, even though the BoJ has committed to maintaining 10-year yields around zero.”

Escaping deflation

Maeda is bullish for 2017, stating that “the current trends in currencies and oil prices, in particular, could now provide a tailwind for the BoJ’s efforts to pull the economy out of deflation.” At the same time, Schroders “see the outlook for corporate profits picking up and expect to see a positive cycle for profit revisions, especially among domestically-focused mid and small cap companies, while larger exporting companies could also see a strong benefit from the current weakness of the yen.”

Valuation and governance support

In addition, Maeda “expects 2017 to see further improvements in corporate governance in Japan, continuing the progress seen in the last three years since the introduction by the Abe administration of the Corporate Governance Code and the Stewardship Code.”

Koll ends his research with a strong nod to the effect of China’s elections and moving forward, the effects of Trump.

“In terms of timing, the immediate issue should be the run-up to China’s Communist Party Congress in the autumn of 2017” … [and then Trump]. The three pillars of Trump’s policies are: tax reform, deregulation and infrastructure spending. It is highly likely these measures will be implemented—in particular the tax reform—given that there will be an absence of political gridlock in Washington. These policies are expected to boost US GDP growth over the next few years, and, given Japan’s dependence on the US, which is the largest economic partner for Japan (20% of total exports, valued at JPY 15 trillion in 2015, and outbound direct investment into the US totalling USD 419 billion as of end 2015), it stands to benefit a great deal from the policies’ implementation.”

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