THE DRIVE YOU DEMAND

UBAM – SNAM JAPAN EQUITY VALUE

Why Value Investing is not Dead in Japan

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws

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Union Bancaire Privée, UBP SA | Asset Management

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Key points

- *Cyclicals and Financials stocks have been widely sold during the course last few years and so far in 2018.*
- *Based on the potential for upside in global long-term interest rates and relaxation in BOJ's yield curve control measures, Financials stocks seem likely to return back into action in the remaining part of 2018.*
- *After a long bearish cycle, the supply demand for crude oil is impacting prices, now reaching levels unseen since 2014 (WTI Crude).*
- *Information Technology and Robotics have been seen there valuations reflecting an important shift in investors tolerance for fast growing but also highly valued stocks.*
- *Most managers sticking to a "Value" style are now getting more exposed to the old economy sectors.*
- *Following the financial crisis, frustration deepens for Value investors as Growth style wins big.*

In this paper, we will take a closer look at what could be the drivers or catalysts for value stocks to come back into favour.

We see three broad themes that could result in a rerating scenario for Value names which have been disregarded by the market and left undervalued:

- End of "goldilocks" market
- Cool off in earnings momentum for tech-focused sectors
- Weak FY18 earnings guidance on FX assumptions likely to weigh on sentiment among export-centric companies.

As an auxiliary support factor for the value style, foreign investors are returning to Japanese stocks after having been net sellers by a wide margin of 8.7 trillion JPY. This net selling was particularly strong in the futures market and we interpret this to have temporarily widened due to the volatility spike and protectionism fears.

Cumulative Net Buying/Selling from Foreign Investors

Source: Compiled by Nomura using Tokyo Stock Exchange materials. Cumulative since December 2012.

"Goldilocks" market to come to end

The underlying theme throughout 2017 was short-term earnings momentum, as the year saw a quintessentially "Goldilocks" market, complete with a mix of strong growth, decent corporate earnings, low volatility, and a gradual drift higher in bond yields.

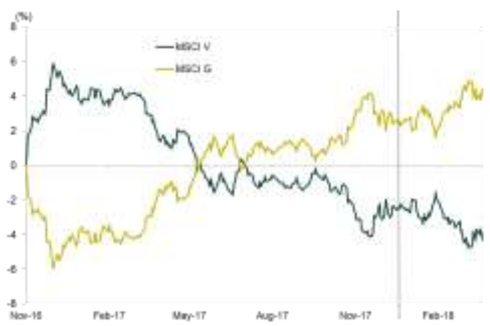
However, going forward it seems things are likely to play out differently. This is thanks to the emergence of a fusion of sudden rises in US interest rates, stronger than expected US CPI, and rising commodities and WTI prices, augmented with likelihood for a widening deficit due to expansionary fiscal policy in the form of tax cuts and infrastructure spending.

On the central banking front, in Japan, although we expect that the BOJ will maintain its negative interest rate policy for the short-term rate to avoid extreme yen appreciation, we think there is likelihood that the BOJ will tweak its yield curve control policy by raising its 10-year interest rate target sometime in the second half of 2018. Meanwhile, the ECB has also committed to winding back monthly asset purchases with a tapering program which began in January, with many believing the bank could cease QE by next year if we see a further pick-up in Eurozone area inflation. Value stocks have been significantly undershooting in view of an established correlation with long-term interest rates, and we believe that under such circumstances, value stocks stand a chance of outperforming in 2018.

Long-term Interest Rates and Value Stocks

Source: SNAM as of 20 April, 2018

Post US Election Value/Growth Index Performance



Source: SNAM as of 20 April, 2018. Outperformance versus MSCI Japan from 9 November 2016 to 30 March, 2018

Earnings momentum of hi-tech/machinery companies slowing in FY2018 likely to trigger sector rotation.

During 2017, the rapid jump in stock prices of FANG and other similar names on profit growth hopes in the US market also translated into buying of strong profit growth stocks in Japan. As a result of this, the valuation gap of companies in the economically sensitive electric appliances and transport equipment sectors also widened. In addition to structural tailwinds such as hardware upgrades (e.g. dual lens camera adoption within smartphones), cyclical tailwinds led to higher memory prices, therefore boosting earnings of semiconductor related firms. In Japan, stock prices in the appliances sector topped pre Lehman shock highs, with relative PBRs above IT bubble era levels.

Other than the technology sector, as the global economic recovery became more apparent, investments in automation and robotics related stocks expected to benefit from capex growth sent relative PBRs in the machinery sector to historically high levels, bringing them into overvalued territory. On the other hand, transport equipment saw primarily finished auto makers left undervalued over concerns of deteriorated margins given the expectation for accelerated EV adoption.

Sector relative Price to Book ratio

Source: Bloomberg Finance L.P., SNAM as of 20 April, 2018

Despite that we expect a continuing solid underlying global economy with further strengthening labor markets and a possible uptick in core inflation; it seems unlikely that the extremely strong earnings growth trend of the previous year will be sustainable throughout 2018. Based on the current consensus estimates, the earnings momentum in FY18, we expect that several leading companies within the technology and the machinery sector will likely see their earnings growth in FY18 to be noticeably lower compared to FY17. Consequently, we think a more difficult y-o-y comparison may lead to profit taking and therefore sector rotation especially considering the current valuation levels.

YoY Operating Profit Growth Comparison

Company name	Ticker	FY17 YoY OP growth	FY18 YoY OP growth	FY19 YoY OP growth
Facebook	FB US	62.6%	27.0%	22.3%
Netflix	NFLX US	231.1%	105.3%	61.2%
Samsung	005930 KS	83.5%	22.7%	0.5%
Tencent	700 HK	67.7%	48.6%	27.8%
Sony	6758 JP	145.9%	-0.1%	7.8%
Hitachi	6501 JP	32.5%	31.1%	5.7%
Fanuc	6954 JP	48.0%	-11.1%	17.2%
Keyence	6861 JP	28.8%	15.1%	13.5%

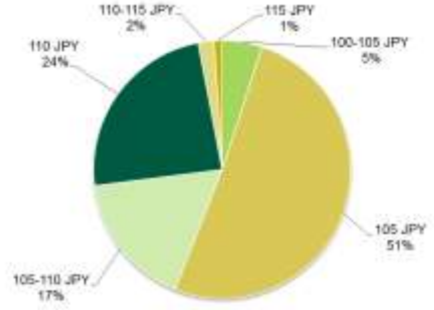
Source: Bloomberg Finance L.P., SNAM as of 20 April, 2018

Though somewhat priced in, a stronger Yen saw FY18 guidance fall short of consensus – this is likely to weigh on sentiment, especially among export-centric manufacturers.

As of May 15, with FY17 (2017 April – Mar) earnings out for the great majority of Japanese firms, FY17 operating profits were up 12.8% YoY, largely in line with consensus at +0.4%. However, the FY18 guidance indicated profit growth of just 2.2%, 6.9% lower than consensus due to many external demand-driven names using conservative 105 JPY per USD in FX assumptions.

Summary of YOY Operating Growth and FX assumptions by corporates

FY17 Actual		FY18 Guidance		
Actual	Difference from Consensus	Guidance	Difference from Consensus	Number of Companies
12.8%	0.4%	2.2%	-6.9%	1,265



Source: QUICK, 2018

This is true in particular of manufactures that have greater forex sensitivities.

FX sensitivity analysis: Recurring Profit Growth over various Scenarios

	FY18 (Apr18-Mar19) Recurring Profit Growth		
	200 major companies	Manufacturing	Non-manufacturing
1USD = 100 JPY; 1 EUR = 120 JPY	5.7%	5.1%	6.6%
1USD = 105 JPY; 1 EUR = 125 JPY	7.2%	7.2%	7.1%
1USD = 110 JPY; 1 EUR = 130 JPY	8.5%	9.2%	7.6%
1USD = 115 JPY; 1 EUR = 135 JPY	9.9%	11.1%	8.1%

Source: FY17-18 company earnings forecasts, analysis by Daiwa Securities

Key Takeaways

The pendulum has been swinging in favour of growth recently. In this piece we have attempted to provide a brief explanation of why that pendulum could start swinging back again sooner rather than later. On the back of a strong economic renaissance, Japan has an important role to play in most asset allocations and we have the conviction that not all segments of Japanese equities are created equal.

More dividends and share buy-backs, improved returns on equity, and the creation of indexes based on these criteria are all signs of a major change in shareholder–business relationships. In a country in which, in the past, conglomerates and a lack of transparency have caused a fall in value in comparison with global equities, this change of practice has seen Japan and Value investing back at the centre of major asset allocation discussions.

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