



UBAM – angel japan small cap Equity

Quarterly Comment | Q4 2018

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

Market Comment

- ◆ The Japanese market began the quarter down as investors became cautious about high growth stock valuations amid rising US long-term interest rates and major global equity sell-offs in light of a jump in the VIX index. November saw more negatives, such as falling WTI price and widespread selling of tech related names as fears of lower demand for Apple products hit the market. However, the month also gave way to a light rebound, as the US mid-terms went by with no surprises and anticipation for an amicable resolution to US-China trade frictions rose. Entering December the market was down by a wide margin, weighed upon by a strong yen on the back of risk-off sentiment given lack of visibility in Trump policy direction and heightened investor cautiousness over economic slowdown fueled by further Fed rate hikes. This saw TOPIX (TR) closing the Oct – Dec quarter down 17.60%.
- ◆ The JPY strengthened against the USD, seeing it move from the high 113's to the high 109's. The JPY also strengthened against the EUR moving from the low 131's to the high 125's.
- ◆ By style, value had the edge. By size, large-caps were ahead. By sector, all sectors were down. Falls were least severe in air trans, elec power & gas, land trans, rubber, and foods and most severe in oil & coal, mining, marine trans, glass & ceramic, and securities. By investor type, foreign investors sold around JPY 6.5tn of Japanese equities on a net basis, primarily in futures over Oct-Dec. Foreign investors were net sellers on a YTD basis in the region of 13tn JPY.
- ◆ In December, equity prices fell in the first half of the month as the arrest of the Huawei CFO and worse than expected US jobs data took their toll on the market in spite of positive sentiment surrounding the US opting to postpone enforcing additional tariffs on Chinese imports. These losses were extended in the latter part of the month as concerns over economic slowdown were stoked by Fed rate hikes and hawkish commentary, and the yen strengthened as murky Trump policy direction visibility caused a risk off mood to descend over the market.



Performance Review

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- ◆ The portfolio underperformed small cap indices (TR), with sector allocation having almost no impact on performance while stock picking was the main drag.
- ◆ The overweight in IT sector impacted the performance negatively as it posted a lower return than the one of the global benchmark. As well, being underweighted in Real Estate yielded negatively as the sector outperformed the overall benchmark. On the positive side, the cash position slightly helped in this bearish month for the Japan equity market.
- ◆ OPT Holdings, the internet advertising agency with broad knowledge and strong technology was one of the main detractors. The company focuses on advertising using the Internet movies, and has been developing using human resources for the past several years.
- ◆ Yume No Machi is another stock which significantly suffered during the fourt quarter due to market pessimism and relatively mild earning forecast.

Portfolio Activity

- ◆ We added Maeda Kosen, an independent manufacturer of building materials. The company is also a leader in its industry due to the edge it has in developing fiber based building materials.
- ◆ We also added Nextage, a very interesting and fast growing company operating a used automobile business. In addition to its second hand business, the company is also active in auto maintenance.
- ◆ We sold down to zero one stock over the quarter: Bronco Billy. It was somewhat a source of disappointment but sticking to our discipline we decided to reallocate the proceeds into a more promising investment case. The company is a very popular operator of restaurant chains, with leading position in hamburger and steak.



Outlook

- ◆ In December foreign investors stepped up their selling of Japanese equities as negative news broke on the fundamental and political fronts. This caused a stronger than expected level of decline in the market.
- ◆ Valuations in the Japanese market are down at around 11x, levels that greatly undershoot the average of around 14x since Abenomics began. Calculations suggest that this price in around a 20% downward earnings revision and this level of discount appears to imply a global recession. While we have seen signs of economic slowdown such as deteriorating PMI from major economies around the world, the US economy remains within an expansion trend and we think that the Chinese economic stimulus package is likely to keep the bottom from falling out of the economy. We think that this suggests the recent economic slowdown is largely cyclical in nature and unlikely to result in global economic recession. As Oct – Dec earnings season kicks in we expect to see some consensus downgrades, but nothing as overly pessimistic to the extent implied by current stock price levels.
- ◆ Along with upcoming earnings, going forward investors will want to keep a close eye on political movements such as US-China trade tensions and the Brexit negotiations. We think that in particular the former has been largely responsible for the unfavorable investor sentiment which has led to the current stock price valuations. Any developments in such stories are therefore likely to play an important role in dictating price action going forward. While we are not yet out of the woods, we think that it is realistic to assume that some kind of compromise will be found to avoid the kind of tit-for-tat escalation capable of doing real damage to the global economy.
- ◆ Going forward we are likely to see continued volatility in the markets due to earnings downside and political developments. Nevertheless we think a dearth in further negative newsflow will lead to firm stock prices over the Jan – Mar quarter. With PBR of the Japanese market hovering around 1.0 there appears to be limited downside risk on the valuation front and assuming a turn in sentiment, it is our belief that Japanese equities are a highly attractive prospect with strong potential upside in the midst of the current circumstances.

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