



UBAM - SNAM Japan Equity Value

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

- ◆ The portfolio underperformed the TOPIX (TR). Both sector allocation and stock selection contributed negatively to performance. Portfolio underweighting of energy and information technology, and overweighting of consumer discretionary was positive, while underweighting of consumer staples and utilities, and overweighting of financials was negative. For individual stock picks, Mitsubishi Heavy, NTT, and Sumitomo Mitsui Trust were positive contributors, while JFE, Credit Saison, and Dai-ichi Life were detractors.
- ◆ In December sector allocation, OW of consumer discretionary was positive, while OW of financials and UW of consumer staples was negative.
- ◆ In stock selection, KDDI, NTT, and Yamada Denki contributed positively, while Nomura Holdings, Nissan Motor, and NYK Line were detractors. In total, stock selection contributed positively in December.

Portfolio Activity

- ◆ The portfolio manager constructs the portfolio according to SNAM's expected alpha ranking (expected alpha = intrinsic value / market price), a reflection of the team's fundamental analysis, forecasting, and valuation methodology. Some of the stocks sold included Mizuho Financial, Dai-ichi Life, KDDI, Lawson, and Sawai Pharmaceutical, while the portfolio manager bought Mitsubishi UFJ Financial, Hitachi Chemical, Nitto Denko, Credit Saison, and Aisin Seiki. As a result of this bottom-up stock selection, as of the end of the quarter the sectors (GICS 11) that the portfolio was overweight in were financials, consumer discretionary, and materials. Conversely, it was underweight in healthcare, information technology, industrials, and consumer staples. We will continue to construct the portfolio based on our alpha rank measure of undervalue. Going forward, we intend to maintain our overweighting of undervalued financial and transport equipment stocks.



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 prices 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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