UBAM - SNAM Japan Equity Value

Quarterly Comment | Q2 2019

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

Market Comment

- Up until April, Japanese equities had been firm on anticipation that global economic sentiment had already bottomed out. However, as we entered May, aggravated tensions between the US and China, characterized by hiking of tariffs on 200bn USD Chinese imports from 10 to 25% and sanctions against Huawei saw the market rapidly revert to a more pessimistic outlook. This led to falling US long-term interest rates and a stronger yen. In June the spotlight was on dovish central bank rhetoric, resulting in a build-up of anticipation for rate cuts and thus buoying stocks. Despite these tailwinds, upside in the market was capped by a persistent strong yen undercurrent. This saw TOPIX (TR) closing the Apr – Jun quarter down 2.35%.
- The JPY strengthened against the USD, seeing it move from the high 110's to the high 107's. The JPY strengthened against the EUR moving from the low 124's to the high 122's.
- By style and size, large-cap growth had the edge, while small-cap growth lagged. On the factor side, high PER and low beta names underperformed, while quality factors like high ROE and low credit risk were preferred by investors. By sector, marine transportation, info & communication, appliances, and machinery outperformed, while underperformers were electric power & gas, foods, and retail. By investor type, foreign investors sold around JPY 1tn of Japanese equities on a net basis. Marking a third consecutive quarter of net selling.
- In the beginning of June Fed chair Jerome Powell's speech and weak jobs data fuelled investor expectations for rate cuts, pushing US equities up with the Japanese market following suit. After this, geopolitical risk weighed on stocks for a time, as major protests took place in Hong Kong and tensions sizzled in the Middle East. However, the market rebounded by the end of the month on the news of further US China talks and as ECB chief Draghi hinted at the possibility of further easing. Equities held onto their gains as the market was flat amid a pre G20 and US China summit wait-and-see atmosphere.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Performance Review

- The portfolio underperformed the TOPIX (TR). While sector allocation contributed positively, stock selection was negative to performance. Portfolio overweighting of consumer discretionary and underweighting of consumer staples and utilities was positive, while overweighting of financials was negative. For individual stock picks, KDDI, Takeda (underweight), and NYK Line were positive contributors, while JFE, Nissan, and Mazda were detractors.
- The strategy outperformed TOPIX (TR) in June. Both sector allocation and stock selection contributed to performance. In sector allocation, OW of materials, and UW of consumer staples was positive, while OW of financials was negative. In stock selection, Nomura Holdings, NOK, and Sumitomo Electric contributed positively, while Yamada Denki, Sumitomo Mitsui Trust, and KDDI were detractors. In total, stock selection contributed to performance.

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 Mitsubishi Heavy, Mitsubishi Estate, and Fanuc, while the portfolio manager bought KDDI, Murata Manufacturing, and JGC. 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 industrials, consumer staples, healthcare, and information technology. 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, with a focus on diversifying the alpha source to drive returns.

Outlook

- Several major developments from the June 29 US-China summit such as restarting of trade negotiations and postponing of tariffs on China have given rise to a risk-on resurgence for the time being. We maintain our view that it is highly unlikely the US will break off negotiations given a slowing pace of global economic growth and the upcoming US re-election campaign. Nevertheless, it is important to remain vigilant, and thus still consider this a potential risk factor until a final deal is signed.
- July sees the start of earnings season for the Apr-Jun quarter, and will likely reveal uncertainty from corporates towards the latter part of the year. However, given there have already been cuts to earnings forecasts, particularly in light of the recent bout of yen strength, we see strong likelihood that Apr-Jun announcements will mark a bottoming out in downward revisions.
- US interest rates fell sharply as the country’s relations with China deteriorated, and the market has already priced in Fed rate cuts. We expect that going forward easing US China tensions will lead to outflows from US bonds, triggering higher US rates and a giving way to a cheaper yen. These factors are likely to work to help push up lagging Japanese equities.
- Going forward we believe news flow stemming from political and monetary policy developments is likely to continue to be a key factor in dictating market behaviour. That said, the valuation gap between the Japanese market and global peers is at considerable proportions, and given they are in strongly oversold territory, we believe this represents a compelling opportunity set.

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