THE DRIVE YOU DEMAND

UBAM - SNAM Japan Equity Value

Quarterly Comment | Q1 2019

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

Market Comment

- January and February saw a rampant rally in Japanese equities as policy flexibility from the Fed and announcement of Chinese economic stimulus warded off slowdown fears, dissipating the extreme risk-off sentiment that had plagued at the end of 2018. This recovery was supported by anticipation for progress in US-China trade talks and a weakening yen (stronger dollar). As we entered March, the ECB cutting economic outlook and putting interest rates on hold until the end of the year, as well as the Fed showing a more accommodative stance than expected by slashing its rate hike schedule and surprise early termination of balance sheet reduction programme set for September this year led US long-term interest rates to plummet. Stock prices then also turned downward as an inverted yield curve conjured up images of economic recession and there was a break in the weak yen. This saw TOPIX (TR) closing this first quarter up 7.7%.
- The JPY weakened against the USD, seeing it move from the high 109's to the high 110's. The JPY strengthened against the EUR moving from the high 125's to the low 124's.
- By style, growth had the edge. By size, small caps underperformed by a narrow margin. By sector, cyclicals like appliances, machinery, and precision instruments, as well as some domestic-driven defensives, including real estate and services were the outperformers, while oil & coal, marine trans, financials, and transport equip underperformed. By investor type, foreign investors sold around JPY 358bn of Japanese equities on a net basis. This was down considerably from the 6.5tn net selling that occurred in the previous quarter.
- Early March, equities rose as US-China trade talks progressed and the yen cheapened. After this there were periods of uncertainty as the market followed the Shanghai index downward on negative sentiment over global economic slowdown and China's lacklustre exports. In spite of this, news of Chinese economic stimulus saw positivity return, leading to wide ranging rebounds. In the second half of the month a dovish Fed statement supported equities, although an inverted yield curve and lower US long-term interest rates, along with mixed US economic data led to a directionless situation in the markets.

Performance Review

- The portfolio underperformed the TOPIX (TR). While stock selection contributed positively, sector allocation was negative to performance. Portfolio underweighting of consumer staples was positive, while overweighting of consumer discretionary and financials was negative. For individual stock picks, Hitachi Chemical and Mitsubishi Heavy were positive contributors, while Nomura Holdings, Denso, and Dai-ichi Life were detractors.
- Particularly in March strategy's sector allocation, UW of utilities was positive, while OW of consumer discretionary and financials was negative.
- In stock selection, Hitachi Chemical, Yamada Denki, and Mitsubishi Heavy contributed positively, while NYK Line, Nomura Holdings, and KDDI were detractors. In total, stock selection contributed negatively till the end of March.

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, Hitachi Chemical, KDDI, Mitsui & Co, and GS Yuasa, while the portfolio manager bought Yamaha Motor, K's Holdings, Murata Manufacturing, Seiko-Epson, and NOK. 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 consumer discretionary, financials, 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.

Outlook

- Long-term interest rates fell sharply as the Fed demonstrated a more dovish stance than expected. We believe this happened in consideration of receding inflation risk and performance of the Chinese and global economies failing to keep pace. Some reports see the yield curve inversion as a negative, while on the contrary we commend the Fed, as we believe this kind of flexible action is important in helping to sustain global economic performance.
- After the panic selling at the end of last year and subsequent rebound, a sense of directionlessness has descended over markets as investors have been concerned about uncertainty surrounding the trajectory of where the global economy is going form here. Looking to the calendar, earnings announcements for the quarter ended March 2019 (the end of the fiscal year for many Japanese firms) will begin to come out from late April. While we expect guidance to be more conservative than usual, this is unlikely to impact equity prices as we believe it is largely priced in.
- PER levels of the Japanese market remain around historical lows at the 12x levels. We think this uncertainty over the direction of the global economy plus murky visibility with regard to the US-China trade situation is the primary discount factor at play. Our main scenario is that we expect policy driven support will mean that the Chinese economy, which is key to global economic performance, bottoms out and begins to recover and that the trade situation will be resolved reasonably. Given that we believe this to play out over the latter part of the year, we think that this will be the core rerating factor for the Japanese market.

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