



UBAM – angel japan small cap Equity

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.
- ◆ In spite of this uncertainty in the business environment, fiscal 2018 saw 55% of companies raise their dividend (conversely 11% lowered it) and 30% plan to raise in fiscal 2019 (conversely 13% plan to lower) . We believe this proactive shareholder friendly stance is strong evidence of robust improvements in corporate governance manifesting in the market.
- ◆ 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.



Performance Review

- ◆ 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.
- ◆ The portfolio outperformed small cap indices (TR), with sector allocation slightly negative and stock picking having a very strong and positive impact on performance. Stock selection was by far the main driver.
- ◆ Selection among Health Care names was very strong with Mani, Elan and Japan MDM being the key drivers of the relative contributors. Stock picking in the Industrials did also participate in the strong quarterly performance SMS and S-Pool RG are 2 names that stand out. This strong selection was further reinforced by Nittoku Engineer RG.

Portfolio Activity

- ◆ We added Rheon Automatic Machinery, the company has been developing, manufacturing and supplying a wide range of high quality food processing machines. The company is the world's first developer of fully automated bread production line. Then devices are exported to over 120 countries. Demand for improving production efficiency is a strong tailwind. Furthermore, Japanese style bread (similar to English style) has become more popular in China due to the expansion of convenience stores. As a consequence, the demand for their machines is also expanding.
- ◆ We also increased Oisix Ra Daichi Inc., Oisix delivers food products that are carefully selected for their safety, nutritional value, price, and taste for consumer's health mainly through internet. Increasing health awareness and number of double-income households have helped the company's growth power.
- ◆ We sold down to zero Trusco Nakayama Corp., a wholesaler of tools, consumables and equipment for industrial plants. The company accelerating growth is linked to the expansion of sales network for EC distributors. Though we do not change our long term view on the company's strength and growth potential, we sold out in June as current capital investment is too heavy and it may have negative impact over the mid-term.



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 behavior. 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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