

UBAM – ANGEL JAPAN SMALL CAP EQUITY

Quarterly Comment | Q1 2024

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

Market Comment

- TOPIX (TR) was up 18.14% during the January-March period. The rise in large-cap equities was particularly striking as capital flowed into Japanese stocks from foreign investors against a backdrop of US equity market record-highs following robust US corporate earnings and expectations for early rate cuts by the Fed. Expectations for Japanese corporate earnings also grew as JPY depreciated versus USD. The BoJ lifted negative interest rate policy and ended yield curve control (YCC) at its March monetary policy meeting following salary increases seen at the annual spring union salary negotiations. The Japanese equity market rose substantially on heightened expectations for deflation to end.
- In Q1, Japanese large-cap stocks led the market on foreign inflows driven by expectations for the end of deflation, while small- and mid-cap stocks underperformed. Overvalued names were avoided because of the slight rise in long-term rates in and out of the country. The Transportation Equipment sector was popular because the market was bullish on JPY depreciation versus USD. Names in the Financials and Real Estate sectors also outperformed on the BoJ's normalization of monetary policy and expectations for deflation to end. Domestic-focused sectors, for which the market was concerned because of prolonged high inflation, and sectors with high valuations, such as Services and Precision Instruments, underperformed.
- The Japanese market was weighted down at the beginning of March as expectations for the BoJ to put an end to negative interest rate policy at its March monetary policy meeting led to JPY appreciation versus USD. That said, sectors that rose were led by financials. The market then rallied as despite the BoJ putting an end to negative rates and abandoning yield curve control on prospects of the country having escaped deflation and seeing spring union wage negotiations lead to high raises, investors still believed monetary policy will remain accommodative for the time being. The market then gained support through the end of the month as JPY depreciated versus USD and on comments from Fed chair Jerome Powell after leaving monetary policy unchanged (much in line with market expectations) that there is a high chance the Fed will begin cutting rates before the end of 2024.

Sources: UBP, Bloomberg Finance L.P.

Past performance is not indicative of future performance



Performance Review

- The portfolio underperformed the MSCI Japan Small Cap index by -6.75% net of fees (Institutional share class in JPY, LU0306285197). Stock selection was the main driver of underperformance while sector allocation was also negative. Stock picking was very challenging in Materials and health Care. Stock selection and overweight allocation contributed to the strong contribution from Information Technology.
- Portfolio characteristic haven't change during the third quarter, average EPS growth remains higher than benchmark. We continue to monitor companies' earnings growth trajectory.
- One of the best performing stocks during Q1 and one of our largest position and conviction is **Fixstars**, an Information Technology name. The company is a developer of software that enables high-speed processing of semiconductors. The company has been seeking new business opportunities. For semiconductors used in self-driving system which started to contribute to the firm's earnings.
- Another good performing stock is **Rorze**, a global provider of highly reliable clean conveyor systems indispensable for semiconductor and FPD manufacturing processes. Orders for semiconductor-related equipment are expected to bottom out.

Portfolio Activity

- We added **Seria**. It is one of the major 100 yen shop companies. Seria's price advantage is increasing under inflation. Furthermore, the sales of existing stores are recovering thanks to their efforts to control cost and expenses, which had been a challenge in the recent past.
- We sold out **Matching Service Japan**. MS-Japan's main business is a recruitment service specializing in administrative departments and professionals such as accountants and lawyers. Although the company had grown by using its own website to attract job seekers, its growth rate is slowing down. In addition, they are expanding their business area into the financial sector and overseas through mergers and acquisitions.



Outlook

- We expect corporate profits could likely increase in FY24 given expectations for inventories at manufacturers to bottom out and domestic real wages to grow and capital efficiency improvement policies to be enacted on the back of pressure from the Tokyo Stock Exchange (TSE). However, it is also highly likely that profit growth momentum will slow given little room for further domestic economic normalization and JPY depreciation.
- Valuations are not at expensive levels despite haven risen at a fast pace since the beginning of the year on capital flows from foreign investors. While we believe that the market could readily respond to a new negative catalyst given that earnings improvements expectations are already baked into prices, it is difficult to envision a large correction to the Japanese market given expectations for capital efficiency improvements on TSE pressure and support for equity demand from the high level of large scale share buybacks seen recently.
- The probability of a 10 bp rate hike in October increased. We can't exclude the possibility of this taking place sooner in July, although the data remains inconclusive. Investors should examine BOJ's statement for cues on when that could be. A weaker yen and higher oil prices may also exert upside pressures on BOJ's inflation forecast. We are watching for signs that a virtuous wage-price cycle has started to take hold.

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