Heartwood Investment Management

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Investment Insight

# Weekly Insight

## Japanese equities: Embrace the structural challenges but watch the currency

Japan's equity market has suffered more than other developed equity markets in 2016. The overriding factor driving the downturn has been the significant appreciation of the Japanese yen this year, a consequence of its perceived 'safe-haven' status. The Japanese yen has followed a remarkably close path to the Nikkei 225, albeit inversely, appreciating by 9% this year against the Nikkei's 8% fall. This period of yen strength has been in spite of the Bank of Japan's efforts to depreciate the currency through adopting a negative interest rate policy.

### Japanese equities: volatile and cyclical

History shows that Japan's equity markets are notoriously volatile and cyclical, often characterised by episodes of hope and euphoria only to be replaced by periods of disillusionment and frustration. We have certainly witnessed this episodic rise and fall over the past eighteen months. The Nikkei 225 returned 18.7% between October 2014 and August 2015 in local currency terms, spurred on by aggressive Bank of Japan easing and hopes of overdue reform through so-called 'Abenomics', a programme designed to stimulate growth and reflate the economy.

However, when China's central bank allowed a depreciation of the renminbi in August 2015, global risk aversion took hold on concerns that the Chinese authorities were losing control of China's economic slowdown. Capital started to flow back into the yen in response to further steep falls in oil prices, on disappointing global economic data and uncertainty surrounding the future path of US interest rates.

It is easy for investors in Japan to become despondent. The macro environment is a source of perennial disappointment. Most recently, manufacturing output and exports have been constrained by slower global growth. Private consumption has not absorbed this slack, remaining subdued irrespective of tight labour market conditions and little price pressure. Furthermore, without the political capital to effect change, the longer-term structural challenges of ageing demographics and a shrinking working age population seem insurmountable.

### Micro changes tell a different story of a 'new' Japan

Nonetheless, despite all of these macro shortcomings, none of the above has precluded change from being effected at the micro level. There has been a strong focus on improving shareholder value within corporate Japan, particularly through strengthening corporate governance. Though the share price performance of large-cap export-orientated companies has been pressured in the last few months by yen strength, other sectors and stocks exposed to a 'new' Japan have told a very different story, particularly among smaller companies.

The Tokyo Stock Exchange Mothers' Index has returned 38.2% this year in local currency terms and 57.5% in sterling; all of this upside occurring since mid-February. What is telling is the sectoral make-up of this index: more than 50% is in health care, 30% in information technology and 8% in consumer discretionary (Source: Bloomberg, as of 21st April 2016). Investors are tapping those companies that are able to exploit and benefit from structural societal shifts occurring in Japan - an ageing population and changing consumer lifestyles – and which can potentially create long-term value. Examples of such industries include medical diagnostics, robotics and consumer digital.

The narrative of Japanese equity markets in the last few months is therefore rather more nuanced than the headlines suggest. When we took the decision to overweight Japanese equities across our portfolios in the fourth quarter of 2014, part of the rationale was to capture changes at the micro level; we still maintain this view.

### The currency implications of investing in Japanese equities

However, as sterling-based investors, we have also been cognisant of the currency implications. We initially invested partly on a hedged basis, taking the view that the yen would depreciate in response to Bank of Japan stimulus. We then successfully removed the hedge in July 2015 and this has proved to be the right decision, since which time the yen has strengthened against sterling by more than 15%.

Nevertheless we now believe that the yen could be approaching a turning point. The balance of views on the Bank of Japan's Board appears to be moving in favour of further stimulus, and perhaps not simply through more aggressive use of a negative interest rate policy, following Governor Kuroda's nomination of two new board members this year. Furthermore, with the Upper House election in the summer and negative rates being very unpopular with locals, arguably it is time for a more creative approach from the Government. Expectations are therefore building that the Bank of Japan will ease policy further to counter the deflationary impact of recent yen strength.

At such times, it is important for investors in Japanese equities to consider both equity and currency implications if they are to gain the most from their investment. On this basis, we now consider it prudent to partially re-hedge some of our Japanese equity exposure.

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