

# Schroders

## 2010: A year in Japan

Shogo Maeda, Head of Japanese Equities, looks ahead to 2010



**Although the Japanese stockmarket has participated in the broader equity market recovery this year it has underperformed, weighed down by recent doubts about domestic recovery and financial sector/political concerns. However, we remain relatively positive about the outlook. We see the recovery in industrial production and exports broadening out into the rest of the economy, although risks include the potential for further yen strength and weak corporate spending. We also believe there is scope for further earnings upgrades over the coming months.**

- Japanese market has benefited from the broad equity market rally this year although it has underperformed
- Recovery in industrial production and exports set to broaden out into rest of economy
- Potential for further earnings upgrades.

“Support for the Japanese market should come from further upward earnings revisions expected over the next few months.”

Following a torrid period for global equity markets in 2008, and in the early part of this year, we have seen a strong rally since mid-March as investor confidence in the prospects for global recovery has grown. Furthermore, there have been some positive domestic developments in Japan this year, including a strong bounce in economic growth and profits (from admittedly low levels). However, although the Japanese stockmarket has benefited from the rally, it has lagged the MSCI World index in the year-to-date by a considerable margin.

#### **Concerns over the recovery and financial sector have weighed on the market**

Why has Japan underperformed this year despite an apparently favourable backdrop? One reason has been recent concerns that the current production bounce is unsustainable. There is a view among some investors that as we have already seen an adjustment in inventories and the benefit of government stimulus, what will now drive growth going forward? Our view is that while it is true that production levels may fall back somewhat in coming quarters, estimates are for a fairly modest dip. Additionally, forecast production levels are being revised up and inventory ratios are still well below historical norms, suggesting that concern in this area may be overdone.

Poor sentiment towards the financial sector has also weighed on the Japanese market recently. Financial sector woes have included speculation about regulatory tightening of capital requirements (which would force further dilutive equity raising), renewed fears of bankruptcies in the consumer finance sector, and the suggestion of a debt moratorium by the new financial services minister. While we acknowledge that the troubles surrounding the sector are not over yet, in our view a worst case scenario has already been priced in after the sharp recent falls. Indeed, we believe that some good opportunities are opening up in this area of the market on a selective basis – valuations among the banks in particular look very cheap both relative to other sectors and to history.

#### **Political concerns have also been a negative**

Finally, political concerns have weighed on the market to some extent. The Democratic Party of Japan (DPJ) won a landslide victory in the general election that took place at the end of August, sweeping the Liberal Democratic Party from power for the first time in over 50 years (with the exception of a brief period in the early 1990s). The DPJ has won a huge mandate to effect change and has a goal of achieving sustainable growth by increasing



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### **Shogo Maeda, Head of Japanese Equities**

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He has previously worked at companies including Goldman Sachs Asset Management, where he was Head of Japanese Equities, before becoming Managing Director & Chief Investment Officer for Asia Pacific equity fund management.

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domestic demand as opposed to growth driven by exports. However, investors are sceptical about whether the new government has the right set of policies to achieve this goal. Poor communication from the administration about its new policy initiatives has led to a negative response from market participants, especially concerning the potential reversal of reforms put in place by the Koizumi administration. In our view, the market may have over-reacted to anti-business remarks by some members of the new government and we believe that these concerns may dissipate in the coming year as the administration becomes more settled and experienced.

### **Recovery in exports and production to benefit the rest of the economy**

Overall, despite the recent investor concerns that have weighed on the market we take a more positive view on the prospects for Japan. Economic data releases continue to support our view that the global economy is gradually bottoming out and beginning a mild recovery. Export demand has returned after unprecedented falls and has supported the production recovery of Japanese manufacturing companies. Although the speed of improvement may ease, and the potential for further yen strength is a risk, we expect the recovery in exports to continue. It is encouraging that demand from the US has remained reasonably firm, while purchasing managers' indices, which are leading indicators of exports, have exceeded the 50 level in both China and the US, suggesting that demand is increasing.

If industrial production and exports continue to gradually improve, this would be positive for the rest of the economy. We expect the recovery to broaden out into other areas, although risks remain such as weak corporate spending and unemployment, which impacts domestic demand. However, increased production should provide more employment, while improved consumer confidence is likely to help revive the domestic economy and retail sales.

### **Further earnings upgrades set to provide support**

Support for the Japanese market should also come from further upward earnings revisions expected over the next few months. A large part of the upturn so far has been driven by margin improvement through cost reductions (for example, in input costs or administrative expenses). However, sales revisions have also reached positive territory and, judging by production forecasts, sales should continue to be supported. Additionally, throughout the financial crisis, many companies revised down their forecasts sharply to reflect a 'Doomsday scenario', which leaves room for further upside now that we know the world is not going to end. Overall, ongoing positive earnings revisions would continue to improve valuations in price-to-earnings terms. On a price to book basis, meanwhile, Japan looks undervalued relative to history and to other markets.

In summary, although the Japanese market has underperformed in the year-to-date, we believe there are reasons for optimism looking into 2010. Although risks to the economic outlook remain, including the potential for further yen strength and weak corporate spending, we believe that the recovery we have seen in industrial production and exports will broaden out into the rest of the economy. We also believe there is potential for further earnings upgrades in the coming months.