Westhouse

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Japan equities: upside risk

Limited downside and the potential for historic upside

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Just as investors seem to have lost all interest in Japan, the recent yen weakness and pick-up in bank lending has prompted us to consider the likelihood of a trend developing and the major implications this may have on Japanese equities. We also highlight the investment trusts we believe are likely to benefit.

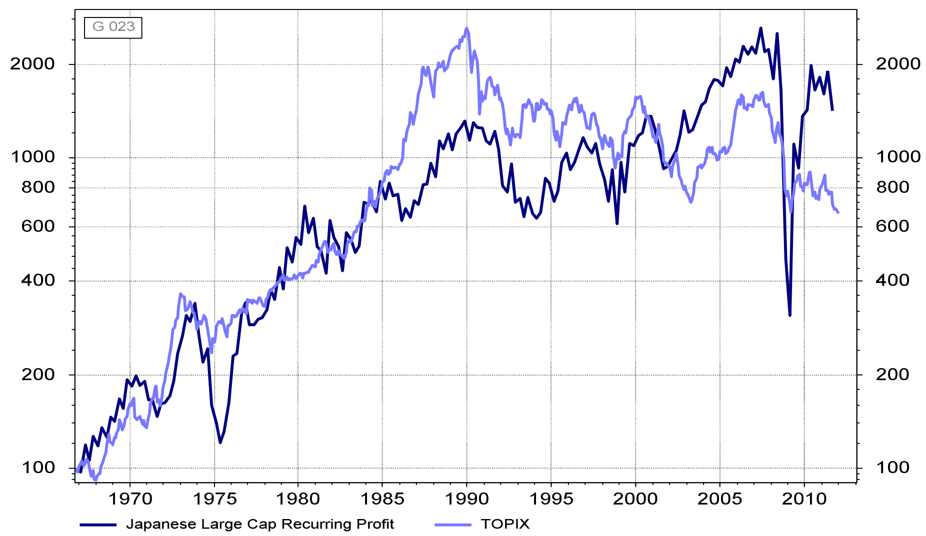
Risk strongly skewed to the upside

Cheap valuations, the prospect of a weaker yen and a pick-up in bank lending give Japanese equities an extremely asymmetric risk profile. While the downside looks very limited, there is a chance of an almost historic upside if macro trends continue in Japan's favour the way they have done recently.

Japanese equities look cheap

Compared to underlying earnings, the TOPIX is now as oversold as it was previously overbought at the top of the bubble at the start of 1990.

Figure 1: TOPIX index vs. Japanese large cap earnings



Source: Thomson Reuters DataStream, Westhouse Securities

Prospect of a weaker yen – exporters have the biggest gearing to the currency

There are a number of reasons to believe the recent yen weakness may be more than just trading volatility: the emergence of an almost unheard of trade deficit, the BoJ's recent sea change in its monetary policy and the prospect of a stronger dollar. A break from the relentless yen appreciation of the last 40 years would have a spectacular impact on Japanese exporters' profitability.

A well-functioning banking system could spark a recovery in domestic demand

Bank lending is picking up – if this were to gain traction, land prices could surge and domestic stocks should rally.

Quickest way to gain diversified exposure: Japanese equity funds

Investors have a choice of eight investments trusts investing in Japan, trading on discounts ranging from 6% to 15%.

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700 has proved to be a strong support line for the TOPIX

The three-year double-bottom is a powerful base formation pattern

On 25 November last year, the Tokyo First Section opened at 704, only a shade above its March 2009 closing low of 701. The last time the Japanese stock market had been so low prior to this was in December 1983. Since last November however, Japanese stocks haven't looked back, rising almost 19%, with the vast majority of that move occurring over the last five weeks. Chartists may not have noticed the three-year double-bottom – a powerful base formation pattern – because everyone gave up looking at the Japanese stock market some time ago.

Figure 2: Almost three years on, and 700 on TOPIX holds again

Source: Thomson Reuters DataStream, Westhouse Securities

The relentless rise of the yen has been squeezing profit margins

The yen has risen by c.30% each decade for the last 40 years

Sony has only managed an average operating profit margin of c1.5% since 2002

The country's world-class exporting manufacturers have had to contend with a currency that has risen by about 30% each decade for the last 40 years. Over the last decade alone, the yen has gained another 40% over the dollar. That's about 3.5% a year and is the main reason why a firm like Sony, for example, has only managed an average operating profit margin of around 1.5% since 2002.

1995-1998 respite: 25% decline in currency dramatically turned around margins

Sony's operating margin jumped from -4.2% to 7.7%

To get an idea of just how debilitating this currency water torture has been, you just need to look at those brief periods of respite. Between 1995 and 1998, the yen experienced a rare bout of weakness, falling from an average for the year of around 97 yen to the dollar to about 128. That roughly 25% decline in the currency sent Sony's operating margin from -4.2% to 7.7%; a turnaround of almost 12 percentage points.

A break from the grinding currency appreciation would have a dramatic impact on profits

The yen lost 8% against the dollar last month alone

In short, give Japanese exporters a break from the relentless and grinding currency appreciation, and the impact on profits would be spectacular. This is all very pertinent, since the yen has dropped 8% vs. the dollar over the last month alone.

The recent yen weakness: trading volatility or emergence of a trend?

There a number of reasons to believe the latter is a likely scenario:

An almost unheard of trade deficit has emerged

Japan's current account surplus is near a 15-year low

Since the Tsunami a year ago, which closed down a lot of Japan's nuclear facilities and forced oil imports up in their stead, Japan has been running an almost unheard of trade deficit. This means that the current account surplus (Japan still repatriates net foreign earnings when the capital account is included) has fallen from almost 5% of GDP in 2007, to a near 15-year low of 2.1%.

Movements in the current account lead the currency by several months

The last significant period of yen weakness coincided with a low current account surplus

In fact, the last significant period of yen weakness - 1995-98 - coincided with the current account surplus falling as low as 1.4% of GDP and averaging 2.1%. Given that movements in the current account lead the currency by several months, this suggests the outlook for the yen is pretty weak, which could be potentially explosive for exporters' earnings.

Sea change in monetary policy

The BoJ has set a 1% inflation target

Just last month, the Bank of Japan signalled a sea change in its monetary policy. After a mere two decades of fiddling through the extended slump, the central bank has finally decided to set an inflation target – of 1% "for the time being" – and to embark on Anglo Saxon-style QE as its means of getting there.

US dollar strength

US bank lending is finally on the rise again

It's not just yen weakness, but also US dollar strength that could drive the exchange rate in the exporters' favour. After five years of interest rate cuts followed by QE, US bank lending is finally on the rise again.

Once lending is expanding, no artificial QE boost is needed

This doesn't mean that Fed Chairman Bernanke won't do QE for a third time in the US as expected, but it does mean that technically there is no need to do any more. QE is how a central bank artificially boosts broad money supply to counteract the destruction of money inherent in bank lending contraction. Once lending is expanding again, money is no longer being destroyed and no artificial QE boost is needed. Without QE diluting the currency with excess supplies of dollars, the downward pressure on the dollar that has persisted for the last five years will cease.

About half of US's trade deficit is comprised of energy imports

There's another reason why the US dollar could strengthen markedly. About half of the US's trade deficit is comprised of energy imports.

The US is sitting on gas supplies equivalent to 40 years' worth of current gas consumption

Recent technological advances in horizontal drilling and hydraulic fracturing, generally known as 'fracking', is releasing so much shale oil, and shale gas in particular that, according to recent estimates, the US is sitting on shale gas supplies alone which are equivalent to 40 years of current gas consumption.

The US can expect to increasingly wean itself off imported oil

The US natural gas Henry Hub spot price has halved since June. Increasingly cheap and plentiful gas now looks assured and that means the US can expect to increasingly wean itself off imported oil. Gas is a substitute for other feedstock fuels like oil and coal, particularly in electricity generation but also in transport.

A smaller US current account deficit could boost the dollar significantly

Because the dollar is the main reserve currency, the rest of the world needs the US to run a decent-sized current account deficit or there won't be enough 'excess' dollars washing around to fund global trade. A shortage, brought about by a smaller US reliance on imported oil, will bid the price of remaining dollars up, potentially quite significantly.

The Japan equity investment trust sector

The quickest and easiest way to gain diversified exposure to Japanese stocks is via funds. There are currently eight funds in the Japan Equity investment trust sector. Two invest mostly in larger capitalisation companies, while six have a smaller cap remit.

Larger cap funds play on a weak yen

Table 1: Japan equities investment trust sector – larger caps

(%)		Fund manager	Focus	Mkt cap (£m)	Gearing	Disc (-)/ Prem (+)	GBP NAV total return YTD	1yr	3yr	5yr
	General									
JFJ	JPMorgan Japanese	Nicholas Weindling	Large caps	275	*1*	*-12.7*	*5.0*	*-6.0*	*40.0*	*-24.0*
SJG	Schroder Japan Growth	Andrew Rose	Large and mid caps	121	*4*	*-11.5*	*12.1*	*1.3*	*58.6*	*-5.2*
	TSE 1st Section (TOPIX index)						*8.0*	*-4.3*	*34.0*	*-4.6*

Source: Morningstar as of 9 March 2012

JPMorgan Japanese – most likely to benefit from a weak yen

Big name exporting manufacturers have the biggest gearing to the yen

The best way to play yen weakness is through big name exporting manufacturers, as these companies have the biggest gearing to the currency. As illustrated by the Sony example earlier, double-digit percentage changes in currency can lead to large, single-digit changes in operating margins, which can translate into multiple moves in actual reported profits.

The only listed fund that invests mostly in Japanese large caps, and therefore is generally most exposed to exporters, is JPMorgan Japanese (JFJ).

JFJ's underperformance should be put into context

JFJ has underperformed relative to the TOPIX index…

JFJ's performance has been rather disappointing when compared to the TOPIX index. Since the current manager, Nicholas Weindling, took over in November 2007, the fund has posted a NAV total return of -1.3%, compared to a gain in the TOPIX index of 11.9% over the same period.

…however, the TOPIX is not the most appropriate benchmark

However, the comparison to the TOPIX index is not fair when considering that the TOPIX index reflects the performance of nearly 1,700 companies and that the JPMorgan fund has a large cap focus. Seven out of JFJ's top ten holdings are members of the TOPIX Core 30 Index – the index made up of the TOPIX's 30 largest constituents by market cap. Their weightings in the fund are also significantly higher than in the broad TOPIX index (see Table 3 on next page).

JFJ has outperformed the mega caps

Relative to the TOPIX Core 30, which, in our view, is a more appropriate benchmark, the fund has outperformed by a good margin: -1.3% vs. -10.9%.

Table 2: Comparative returns under current JFJ manager (13/11/2007 – 9/03/2012)

GBP total return	(%)
JPMorgan Japanese NAV	*-1.3*
TOPIX Core 30 index	*-10.9*
TOPIX 100 index	*3.5*
TOPIX index	*11.9*

Source: Morningstar, Bloomberg

Table 3: JPMorgan Japanese top 10 holdings, 29 February 2012

	Holding	Sector	Fund %	Topix index %	Topix Core 30
1	Nippon Telegraph & Telephone	Information & Communication	*4.8*	*1.5*	Yes
2	Canon	Electric Appliances	*3.9*	*2.0*	Yes
3	Rakuten	Services	*3.8*	*0.0*	
4	Honda Motor	Transportation Equipment	*3.0*	*2.3*	Yes
5	Mitsubishi UFJ Financial	Banks	*2.9*	*2.7*	Yes
6	Konami	Information & Communication	*2.9*	*0.1*	
7	Nissan Motor	Transportation Equipment	*2.9*	*0.9*	Yes
8	Mitsubishi Electric	Wholesale Trade	*2.8*	*1.2*	Yes
9	Japan Tobacco	Foods	*2.7*	*1.0*	Yes
10	Orix	Other Financing Business	*2.7*	*0.4*	
	Total		***32.4***		

Source: JPMorgan Japanese

Table 4: TOPIX Core 30 index members, 12 March 2012

	Stock	(%)	JFJ top 10 holding
1	Toyota Motor Corp	*10.9*	
2	Mitsubishi UFJ Financial Group Inc	*7.7*	Yes
3	Honda Motor Co Ltd	*6.4*	Yes
4	Canon Inc	*5.7*	Yes
5	Sumitomo Mitsui Financial Group Inc	*5.1*	
6	Nippon Telegraph & Telephone Corp	*4.3*	Yes
7	Mizuho Financial Group Inc	*4.2*	
8	FANUC Corp	*3.7*	
9	Takeda Pharmaceutical Co Ltd	*3.6*	
10	Mitsubishi Corp	*3.5*	Yes
11	Mitsui & Co Ltd	*2.9*	
12	NTT DoCoMo Inc	*2.8*	
13	Komatsu Ltd	*2.8*	
14	Japan Tobacco Inc	*2.8*	Yes
15	Sony Corp	*2.6*	
16	Softbank Corp	*2.6*	
17	Nissan Motor Co Ltd	*2.6*	Yes
18	Mitsubishi Estate Co Ltd	*2.5*	
19	Seven & I Holdings Co Ltd	*2.4*	
20	East Japan Railway Co	*2.3*	
21	Shin-Etsu Chemical Co Ltd	*2.1*	
22	Panasonic Corp	*2.1*	
23	Tokio Marine Holdings Inc	*2.1*	
24	Nomura Holdings Inc	*2.0*	
25	KDDI Corp	*2.0*	
26	Astellas Pharma Inc	*2.0*	
27	Toshiba Corp	*1.8*	
28	Nintendo Co Ltd	*1.6*	
29	Nippon Steel Corp	*1.6*	
30	Kansai Electric Power Co Inc	*1.4*	

Source: Bloomberg

Smaller companies funds play on a recovery in domestic demand

A well-functioning banking system is key to a recovery in domestic demand

Whilst a weak yen would give the export sector an almost unprecedented earnings boom, the vast majority of the country is oppressed by another problem altogether; a bank system that just will not function. However, there are signs that this may change, opening up the prospect of a recovery in domestic demand.

Bank lending is picking up – if this gains traction, the upside could be substantial

Land prices have enormous upside

Excitingly, bank lending is once more picking up, because the BoJ has been boosting bank reserves again and this time (unlike the early 2000s when it didn't work), Japanese banks no longer need to concentrate on repairing their balance sheets. Bank lending is only 1.2% higher than it was back in June, but the vast majority of that move has occurred in the last two months alone. If this gains traction, we believe land prices have enormous upside. They could double for example and yet still only be back at their 1981 price, way before the bubble.

While European Banks are shrinking their balance sheets, Japanese banks need to significantly expand theirs

Mitsubishi UFJ has a loan book that is only 60% the size of its customer deposits

Whereas European banks are being force-fed ECB emergency funding in the LTRO programme because their loan books are too big to be fully funded by customer deposits, Japanese banks are in the exact opposite position. Mitsubishi UFJ, Japan's biggest bank, has a loan book that is only 60% the size of its customer deposits. That means that to return to a normal long-run position, where deposits and loans are roughly equal and where European banks would have to shrink loan assets by several trillions of euros, MUFJ needs to expand lending by two thirds. The economy-wide expansion of bank lending in 2005-08 totalled ¥33trn, which sent commercial land prices up by almost 50% and the stock market by an even larger amount. The gap between MUFJ's deposits and its loans is ¥54trn; and that's just one bank.

QE has a dramatic impact on asset prices, especially stocks

It is estimated that stock prices went up 20% as a direct response of the first £200bn QE in the UK

As we have seen since 2009, QE Western-style doesn't just boost CPI - it has a dramatic impact on asset prices, especially stocks. A Bank of England Working Paper estimates that stock prices probably went up 20% as a direct response to the first £200bn of QE in the UK, for example. Rising stock prices boost wealth, consumer confidence and the net asset values of companies' cross holdings of shares. Banking loan covenants also improve.

Table 5: Japan equities investment trust sector – smaller companies

(%)	Fund name	Fund manager	Focus	Mkt cap (£m)	Gearing	Disc (-)/ Prem (+)	GBP NAV total return			
							YTD	1yr	3yr	5yr
AJG	Atlantis Japan Growth	Ed Merner	Mid and smaller caps	72	*29*	*-6.6*	*5.3*	*0.6*	*46.7*	*-28.6*
BGFD	Baillie Gifford Japan	Sarah Whitley	Mid and smaller caps	129	*17*	*-6.6*	*5.6*	*-0.5*	*68.8*	*-6.0*
BGS	BG Shin Nippon	John MacDougall	Smaller companies	55	*13*	*0.3*	*2.7*	*0.3*	*83.0*	*-14.5*
FJV	Fidelity Japanese Values	Shinji Higaki	Smaller companies	53	*-5*	*-14.5*	*0.6*	*-5.4*	*50.3*	*-22.4*
JPS	JPMorgan Smaller Cos	David Mitchinson, Nicholas Weindling	Smaller companies	56	*-1*	*-15.1*	*-1.8*	*-8.7*	*24.7*	*-41.8*
PJF	Prospect Japan	Curtis Freeze	Smaller companies	52	*-6*	*-12.6*	*11.1*	*10.2*	*93.2*	*-51.2*
	TOPIX Small Cap index						*6.9*	*6.4*	*43.4*	*18.6*

Source: Morningstar as of 9 March 2012

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Funds to which Westhouse has supplied investment banking services	100.00%	0.0%	0.0%

Source: Westhouse

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