Quarterly Outlook – Japan Equity

ASSESSING ABENOMICS AGAINST A BACKDROP OF TRADE WAR RHETORIC

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KEY INSIGHTS

- Faced with stagnant economic growth, unfavourable population dynamics and a mountain of debt, Japanese Prime Minister Shinzo Abe has focused on loose monetary policy, fiscal stimulus and structural reform to counter these trends.
- An environment of modest global growth should continue to help corporate Japan perform well. However, we are concerned about the escalation of the trade war rhetoric that is coming from Japan's largest trading partners, China and the U.S.
- In the portfolio, we are finding opportunities in the broad information technology and services sector. Elsewhere, we continue to avoid the banking sector.

ASSESSING ABENOMICS

Shinzo Abe is on track to become Japan's longest-serving prime minister in November. Seven years ago, Abe assumed leadership of a country burdened by stagnant economic growth, unfavourable population dynamics and a mountain of debt. He adopted a "three arrows" approach (Abenomics) to countering these trends, centered around loose monetary policy, fiscal stimulus and structural reform.

> "The condition of the global economy remains a key factor supporting the Japanese equity market."

On the first arrow, Japan has certainly managed to leave behind a deeply entrenched deflationary cycle, although inflation is falling short of the Bank of Japan's (BoJ's) 2% target. This has been achieved in part by monetary expansion through massive bond and equity purchases—quantitative easing—and the BoJ has said that it will not hesitate to add further stimulus if needed.

A SECOND CONSUMPTION TAX HIKE

Regarding fiscal stimulus, Japan first hiked consumption taxes five years ago, from 5% to 8%, and followed this with a further increase to 10% in October of this year. In the first instance, the post-increase slump in spending dragged the Japanese economy into recession. However, there are few signs of consumers behaving the same way as they did when the tax previously went up, and the government has exempted items such as fresh food to smooth the impact, as well as introducing alleviation measures for automobiles and housing.

The third arrow of structural reform has contributed to an increase in female participation in the workforce and encouraged businesses to allocate capital more effectively. The productivity of capital has risen, albeit from a low base. Against this backdrop of change, an increasing number of Japanese companies are defying skeptics by transforming business practices and governance standards. We believe this can help corporate profit growth and generate improving shareholder returns. The volume of shareholder buybacks is increasing while merger and acquisition activity also shows promise.

> “In the portfolio, we seek for opportunities in the broad information technology and services sector.”

EXTERNAL FACTORS HAVING AN EFFECT

The condition of the global economy remains a key factor supporting the Japanese equity market. An environment of modest global growth should continue to help corporate Japan perform well. However, we are concerned about the escalation of the trade war rhetoric that is coming from Japan’s largest trading partners, China and the U.S. We continue to hope that sanctions and trade war concerns will subside but we think our quality bias within the portfolio should hold us in good stead if trade wars jeopardise the supportive growth environment.

POCKETS OF OPPORTUNITY

In the portfolio, we seek for opportunities in the broad information technology and services sector. We are bullish on the industry, specifically the scope for improving earnings, while valuations also look attractive. Elsewhere within the sector, we remained overweight staffing agencies. Signs of a tightening labour market are a key positive for the industry and one of the key themes to look for.

Elsewhere, we continued to avoid the banking sector. Intense competition in the sector means that there is an almost unlimited supply of loans at very low rates. Demand is improving for these loans, but they are being offered at the rate of Japanese government bonds in some instances. Net interest margin compression is easing but the benefits from this are being given up as banks try and gain market share. Furthermore, with the introduction of negative interest rates on excess holdings and with speculation that this could increase further, the outlook looks challenging for the foreseeable future.

RISKS

The following risks are materially relevant to the portfolio.

Currency risk- Changes in currency exchange rates could reduce investment gains or increase investment losses. **Small and mid-cap risk**- Stocks of small and mid-size companies can be more volatile than stocks of larger companies. **Style risk**- Different investment styles typically go in and out of favour depending on market conditions and investor sentiment.

General Portfolio Risks

Capital risk- The value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different. **Equity risk**- In general, equities involve higher risks than bonds or money market instruments. **Geographic concentration risk**- To the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area. **Hedging risk**- A portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended. **Investment portfolio risk**- Investing in portfolios involves certain risks an investor would not face if investing in markets directly. **Management risk**- The investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably). **Operational risk**- Operational failures could lead to disruptions of portfolio operations or financial losses.

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