



MARKET INSIGHTS

INVESTING IN JAPAN: JAPAN FUELS MARKETS WITH QUANTITATIVE EASING

NOVEMBER 2014



The Bank of Japan's (BOJ) recent surprise move to inject more money into the system resonated well with investors. Global markets rallied and Japanese shares in particular rose sharply; the Nikkei index ended October at its highest level since 2007.

The latest easing measures include expanding the monetary base through purchases of Japanese government bonds at an annual pace of 80 trillion yen, up from the earlier target of 60 to 70 trillion yen, and tripling investments in exchange-traded funds and real-estate investment trusts to 3 trillion yen and 90 billion yen respectively.

This is the first policy change since BOJ's Governor, Haruhiko Kuroda, began record asset purchases in April 2013, reasserting his determination to boost inflation towards 2%. Regardless of BOJ achieving its desired outcome, the market-oriented approach to policymaking will likely underpin market sentiment and stock prices in the near term.

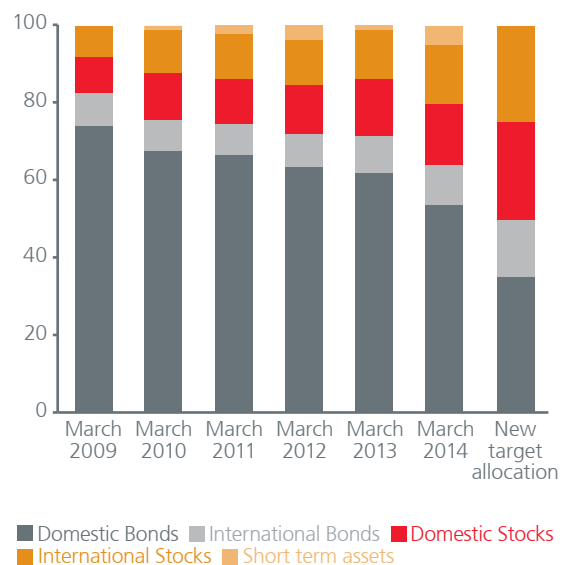
GPIF'S MOVE BODES WELL FOR EQUITIES

Separately, Japan's largest Government Pension Investment Fund ("GPIF") announced plans to double its holding of domestic stocks to 25% of its portfolio. GPIF will also raise the target for overseas stocks from 12% to 25%, investing in both developed and emerging economies for the first time. Given GPIF's USD1.3 trillion asset base¹, it is worth noting that a mere 1% increase in allocation to Japan equities will activate USD13 billion of inflows.

GPIF's move may be emulated by other pension funds, potentially adding even more liquidity to the equity market.

Individual investors too may be encouraged to invest more of their savings into risk assets. As Japanese households hold 53% of their assets in cash (compared to 15% in the US), a 1% shift from household financial assets into domestic equities over the next five years implies a USD150 billion of new funds into equities².

Fig. 1. GPIF asset allocation (%)



Source: GPIF, JP Morgan, Eastspring Investments, as at 31 October 2014.

Source: ¹GPIF as at 30 June 2014. ²Eastspring Investments, BOFA Merrill Lynch Global Research.



EXPLOITING INVESTMENT OPPORTUNITIES – WE LOOK THROUGH MARKET VOLATILITY

Whilst this latest news is supportive for equities, one cannot rule out bouts of market volatility. This year has been a case in point; market performance and volatility has coincided with short term focused participants responding to thematic macroeconomic news flow, irrespective of company fundamentals.

For example, following Japan's consumption tax hike in April, expectations for weaker consumption and economic growth posed a near term headwind for market sentiment. Retail stocks lagged the market and offered value investors like us an ideal opportunity to add to a number of high conviction names whose share prices had been affected by short term sentiment. A point to note is that whilst real gross domestic product shrank immediately after April's sales tax hike, there has since been three months of consecutive growth. Whilst the share price for a number of retail names continue to lag the market in the shorter term, we are willing to be patient and wait to be paid for holding these out of favour names with big valuation upside.

Our investment strategy is thus not based on analysing or extrapolating market themes but conceived on a thorough analysis of long-term company fundamentals.

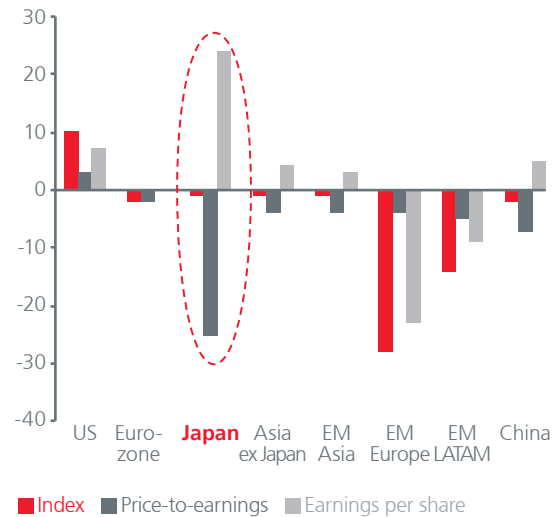
Big price dislocations are opportunities for us to buy shares in cheap companies we deeply understand from a fundamental perspective. We exploit extremes of market pricings.

WHY INVEST IN JAPAN TODAY?

We believe the investment case for Japan equities is based on an ability to identify attractively valued companies with sound fundamentals that have yet to be recognised by the market.

Japanese equities look undervalued relative to other developed markets and their own history. Moreover,

Fig.2. Decomposition of market performance (%)



Source: Eastspring Investments. Chart shows change in the relevant market MSCI Index and how much of that change was due to (a) a change in the historical price earnings multiple and (b) the declared earnings per share (as measured by IBES). Data between 29 October 2013 and 29 October 2014. All data in USD except China (in CNY). This chart is for guidance only.

over the past year, Japan delivered strong earnings growth which has not been reflected in share prices (refer to Fig.2). This provides an opportunity for investors like us to build meaningful positions in attractively valued companies with strong franchises. We find many companies in strong financial health. We observe that companies' restructuring efforts are continuing and in some cases have accelerated. The strength of earnings improvement remains under appreciated by the broader market. The signs have been encouraging thus far. To date, reported second quarter earnings have broadly exceeded expectations.

Abenomics has succeeded in bringing Japan's undervalued equity market into focus. The policy package has changed inflation expectations and served as a catalyst for global investors to reconsider their entrenched negative views about Japan. The recent moves will continue to fuel interest in Japan's equity market, we think. Ultimately, we believe real sustainable change in Japan will be delivered by further improvements in corporate efficiency and performance.



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