

INVESTMENT NOTE

September 2010

Japan – “Once More Unto the Breach Dear Friends”

With the Japanese Yen at 15 year highs is it time to revisit Japan?

You may recall our successful foray into Japanese equities in September last year which turned a profit for many Investors. We believe that a similar short term opportunity may be presenting itself now and are seeking to recommit investors, albeit for different reasons. Japanese equities have good defensive qualities in the current global environment but there are other factors which we believe are positive for Japan. We touch on three factors which form part of our case for investing now.



Politics

Japanese politics has been difficult to fathom at the best of times and, and one could argue, somewhat irrelevant for the stock market, preoccupied as it is, with foreign and domestic capital flows. With Ministry of Finance officials paying lip service to currency issues with often meaningless pronouncements on the value of the Yen commonplace. Inside a permanent coalition Government the result has been little real change despite talk of reform. Seasoned professionals have learned to take political headlines with a pinch of salt.

However, we believe that things may now be a little different. Japan has a new Government for the first time in 50 years and, on the face of it, a new agenda following a landslide election victory for the DPJ in August. This party broadly promotes the breakdown of historic bureaucratic and conservative regime established under the centre-right LDP. We can expect to see policies which support domestic incomes and consumption, as per their election manifesto. The picture is, as always, a complex one, and some of the initial euphoria has been dampened by the appointment of some of the old guard in key positions from the previous administration. But we believe this is an important development which may have a real and positive effect on the Japanese economy.

Currency

The new Government has undertaken intervention to weaken the Yen from its 15-year high against the US dollar. This resulted in an immediate 2.5% sell off in the Yen and a similar rise in the Japanese stock market as foreign investors piled into shares of exporters. It would seem to indicate that the Japanese authorities see ¥82 to the US Dollar as a line in the sand, beyond which it believes the economy is under threat. In past cycles, this currency strength would have caused investors in the Japanese stock market, which was dominated by exporters, a great deal of distress by inflating the cost of their goods abroad and eroding the value of profits repatriated back to Japan from the USA which has long been Japan's biggest market for manufactured goods. However, the continued rise of China as an economic power has changed the game significantly. China is now Japan's largest trading partner and a more balanced one in terms of imports and exports. Notwithstanding the change of emphasis towards stimulating the domestic economy, there is a palpable sense of Japan becoming more Asia facing in international trade with

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relatively less reliance on a weaker Yen/Dollar exchange rate. Indeed, Japan may yet assume a leadership role in the Asian economic region.

Yen strength may also be more the result of the weakness of the other two global currencies, the US dollar and the Euro having their well documented problems. The Yen is playing an unfamiliar role as a safe haven currency and better the devil you know. However, we believe that the US economy has the potential to surprise sooner rather than later and we believe that the result will be a stronger dollar as interest rates inevitably rise from unprecedented low levels. The resulting Yen weakness would no doubt attract buying of Japanese large cap exporters. At the margin this may actually help push up the Japanese equity market itself even if, in a relative sense, it goes against investing in Japan on the back of a domestic economic recovery under a new Government. **On balance, we are considering a Sterling hedged investment strategy in Japan.** Whilst we acknowledge the case for a stronger Yen, we believe the upside is limited. Conversely, we do not believe that Government efforts to weaken the Yen will succeed on their own. Such action is beyond the remit of the central bank and goes against the grain of the G7 countries which are committed to free floating currencies. Such intervention was undertaken in 2003/4 to limited effect and we do not believe it will succeed this time either.

Valuation

On a technical and valuation basis, we believe Japanese equities are cheap, and not just against the US and Europe, but against its Asian peers. The corporate earnings picture is at best “mixed”, making it difficult to justify on a pure price to earnings basis. However, on a price to book ratio, that is to say share price relative to the asset value of a company’s assets, Japan is historically cheap on around 1.2 times. Over the same 15 year timescale of the currency movement mentioned above, the TOPIX Index, the broadest equity index, has tended to trade in a range around 1.5x to 2.0x and as high as 2.5x. The current level of 1.2x would therefore appear to be cheap on an historical, relative and absolute basis.

Conclusion

Japan as an investment option is inexorably tied up with its boom years of the 1980’s, a period of excessive liquidity, overvaluation and rapid asset expansion. That is not the consideration here. At relatively cheap valuation levels and after another period of relative underperformance we see Japan in the next 3-6 months either following through higher with other global markets (ie “catching up”) or in the face of global setback providing some solid defensive characteristics. After our successful position taking some months ago, which turned a handsome return for most of our clients, we will for nearly all portfolios, where circumstances allow, from 4/10 (Cautious) on the risk scale upwards to 8/10 (Speculative) commit to a position in our favoured manager GLG Japan.

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