RWC

Japan Stewardship Strategy
2020 Outlook

December 2019

Anyone attempting to forecast the direction and nature of the Japanese equity market in the current environment must necessarily make assumptions about a range of real, fundamental and sentimental factors.

Uncertainties in the geopolitical backdrop present risks and, as always, potential opportunities and, in this context, our thinking inevitably turns to China. Whilst Sino-American trade war rhetoric dominates the headlines, and drives market sentiment in the short term, the underlying realities are likely to change at a steadier pace.

It is noteworthy that, whilst political posturing over other emotive/nationalistic issues can have dramatic short-term effects (think precipitate drops in the numbers of Korean tourists in Japan and Japanese beer sales to Korea) the pattern of commercial/industrial interdependency among the East Asian economies remains relatively robust and some companies involved in these trade flows hold sufficient market power that they will prosper in almost any event. At the political level, both the Chinese and Japanese governments will continue to try to balance appeasement of their more radical nationalist elements against trade-related pragmatism and, as long as the latter mind-set continues to dampen the gyrations in popular sentiment, the trade flows should continue to strengthen.

The Chinese have little empathy with Abe and there has been a steady slide in Sino-Japanese relations since the halcyon days of the Hatoyama administration. With the opposition hopelessly fragmented, it may be the style of the LDP leadership which will continue to determine the tenor of the Japanese side of the relationship, and it is far from clear who the successor to Abe will be.

We should therefore assume that we can expect more of the same on the Japanese side (although perhaps with a less obsessive stance on revision of Article 9 banning the maintenance of armed forces) and, as President Xi's position seems assured, on the Chinese side as well. So, we think China will continue to press to expand its influence in the region and beyond, whilst the US and Japan continue in their more or less coordinated efforts at containment.

On the positive side, President Trump's more hawkish assertions notwithstanding, domestic pressures on both sides are likely to grow for a rapprochement on trade, which would have immediate, mainly positive, implications for Japan. Things could get worse but, on balance, our assumption would be that they will improve and that, in the meantime, many Japanese companies, who are less directly affected by the bilateral sanctions, will see their business with China growing, come what may.

That said, "events" are likely to impact the shares of companies exposed to China in the short term, whatever the fundamentals may be.

Any hangover from the recent increase in the consumption tax is unlikely to be very long lasting and the combination of accommodating monetary policy and the one-off effects of the Olympics are likely to be at least slightly positive. While the extreme tightness of the labour market should drive wage settlements up in the spring, corporate Japan has proved to be remarkably stingy in recent years and has ignored calls, including those from the Prime Minister, to increase wages, and we cannot foresee a catalyst which will bring about a dramatic shift in this stance. Any upside in domestic consumption is likely to be constrained by continuing structural shifts, as the ageing population consumes less. So, overall, we expect the trend in domestic consumption to be broadly steady, although discount chains of one kind or another should continue to thrive.

The relative performance of our portfolio has been strongly influenced by month-to-month (sometimes almost day-to-day) sentimental swings between the quality/growth stocks which reflect a risk-off stance and the value/cyclicals which perform well when a rising economic tide is expected to lift all boats. If trade/recession anxieties recede, the value/cyclical cohorts are likely to outperform but it is our expectation that anxieties will persist, at least at a residual level, to rein in any over-exuberance in that regard and, in all, we remain comfortable with our carefully selected holdings.

Some analysts are predicting that companies displaying rapid growth, but no earnings and a constant appetite for funding, could fall from grace, as might some whose fortunes are heavily dependent on the value of their brands. We do not hold anything with those characteristics in our portfolio, preferring companies with proven earnings records and potential, and tangible competitive strengths.

For both the exporters and the domestic stocks in our portfolio, we expect earnings to continue to be the main driving force in share price performance, so stock selection and portfolio balance will be crucial, as will progress in our engagement agendas.

Parenthetically, we believe that the secular trend, which we have observed in the typical style of Japanese management, will continue to develop in a positive manner. While the well-worn template of the *sarariman shachou* (employee CEO) who joins a company on graduation from university and rises through the ranks to assume the CEO role at the age of 60 and then works in the same manner as his predecessor (who often stays on as chairman) remains the norm, we are now more often seeing CEOs who are capable of breaking the mould where they believe it to be necessary. This increased flexibility is welcome and gives more opportunities for the kind of positive shareholder engagement which we practice.

CONTACT US

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