بنك أبوظبي التجاري
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Japan equity upgrade, EM equity downgrade

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- **In mid-September we removed a 3-month long tactical overweight recommendation on emerging market (EM) equities, downgrading the region to neutral (see link). We now downgrade this further to underweight**
- **Simultaneously we upgrade Japanese equities to overweight from underweight**
- **EM equities are likely to be most negatively impacted by a Trump presidency, given his proposed policies are likely to see a strengthening of the US dollar and upward pressure on Treasury yields, a bad combination for EM assets**
- **Japanese yields, however, are capped at 0% by BoJ policy, helping to keep downward pressure on the yen, benefitting Japanese corporate earnings**

Japanese equities stand to benefit from a Trump presidency, but emerging markets are hurt by it

EM downgrade: The argument is quite straightforward, a Donald Trump presidency is bad for Emerging Markets. Leave aside the rhetoric from his election campaign about tariffs and currency manipulation most of which he is unlikely to implement. The biggest problem for EM comes from the US$ which is likely to strengthen as a result of higher government spending in the US and higher treasury yields. It will also allow the Federal Reserve to be more hawkish than what the markets currently expect. On top of this, as mentioned, although Mr Trump will not be as negative for global trade as he has suggested, he certainly won't be positive either. Protectionism had already been on the rise long before this presidential campaign started, we wrote about this in a note on 9 June 2016 (see link). However, we expect the protectionist trend to continue.

So, the downgrade of EM to UW is driven by weaker trade and a stronger US$. The second order effect of weaker EM currencies is higher inflation expectations, which will lead to tighter monetary policy in the EM world. This is bad for growth and negative equity markets.

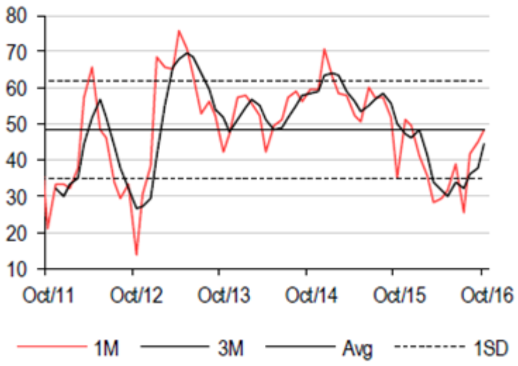
Japan upgrade (currency-hedged): We use the funds from our EM downgrade to upgrade Japanese equities to overweight. The rationale for this is a combination of domestic developments, as well as recent US developments. In terms of the domestic supports for the market, this comes overwhelmingly from monetary policy. At the September BoJ policy meeting, Governor Kuroda pledged to allow inflation to push above its target for an unspecified period of time. This has been met mostly by skepticism from investors given that the BoJ has been unsuccessful in raising inflation for a long time. However, what is different now is that this pledge came alongside an announcement to keep the 10-year government bond yield from rising above zero. This limits the extent to which a bond sell-off in other parts of the world can impact JGBs, in and by itself positive for equities. However, what is more important is what keeping bond yields artificially low means in terms of policy. The most plausible rationale for pegging 10-year yields is that this goes hand in hand with increased fiscal spending in Japan, which will ultimately (hopefully) lead to inflation. If this happens the BoJ will allow inflation to overshoot its 2% target, i.e. the economy will be allowed to overheat before policy is tightened in any way. The key then is to impact inflation expectations, given that if people believe prices will rise tomorrow, they will consume today. There are plenty of reasons for not believing inflation anywhere near 2% can be achieved, given the BoJ's track record on this front. However, with 20-year inflation swaps predicting inflation will average only around 0.3% over the next 20 years, it suggests that if there is to be a surprise, it is likely to be to the upside.

This is the main domestic argument for Japanese equities and a weaker ¥. Other supports are the fact that valuations for the market are not expensive, continuing to hover around the lows seen over the past 5 years and well below their 5-year average. Earnings revisions on the other hand have rebounded and will continue to become more positive if the currency weakens further. At the same time the market was at one point heavily over-owned, but is now much less of a crowded trade with global equity funds now broadly neutral Japanese equities.

Nikkei 225 trailing PE ratio (x)

Source: Thomson Reuters

Japan earnings revision ratio



Source: MSCI, IBES, Thomson Reuters, HSBC

The case for the market we believe is bolstered by the election of Mr Trump as president, as this will lead to a strong US$ under normal circumstances, i.e. unless there is a major risk off event. More government spending, especially to the extent this can boost growth will lead to higher than expected US interest rates and a stronger US$. The reaction of US treasury yields to Mr Trump's victory is also clear, should US yields now find a higher equilibrium (say around 2%) this will mean the differential between US Treasuries (which could rise further) and JGBs which are pegged to zero (10-year JGBs) will remain wide. The equity risk premium on Japanese stocks will therefore remain lower than in most other geographies.

The key driver, and therefore also the major risk to this call is the currency. If the Japanese ¥ strengthens against the US$, this will hurt Japanese corporate earnings and weigh on the market. The initial "shock" of Mr Trump winning the presidency saw a sharp appreciation of the yen from ¥105/$ to ¥101/$. Although, the currency soon weakened back beyond ¥105/$, the point is that global risk off events will see a strengthening of the currency. However, this will only be a problem to the extent that the risk-off event persists for an extended period of time so to negatively weigh on Japanese corporate earnings expectations.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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