Why we are underweight Japanese equities

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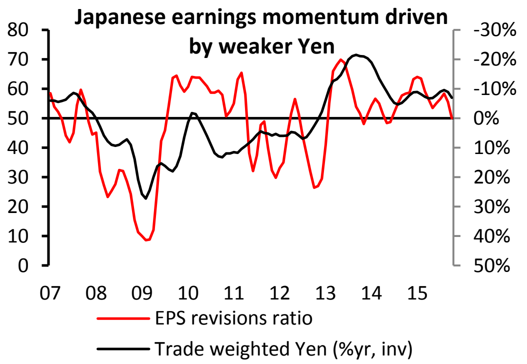
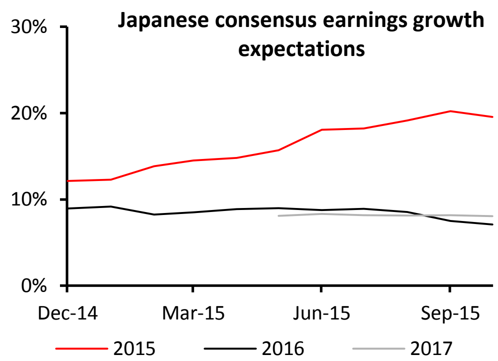
- **We are underweight equities in our global asset allocation**
- **Within equities our key calls are to be underweight US and Japanese equities and overweight Eurozone equities and selective on EM equities**
- **The key reason for our negative view on Japanese equities is the tangible probability of policy disappointment (as well as policy failure)**
- **Were this to materialise, it would likely feed through into earnings downgrades/disappointments in the absence of further Yen weakness**
- **Valuations and positioning do offer some downside protection, for this reason our underweight conviction on Japanese equities (at this stage) is lower than for example on US equities**

Limits of BoJ easing reached?

In spite of large scale monetary easing over the past two and a half years, including unconventional policies, the Japanese economy has failed to respond in the way policy makers had hoped. Growth has been disappointing, but even more worrying is the fact that inflation has refused to pick up as wages have stalled. As a result of these macro disappointments the consensus are pricing in a 64% likelihood that the BoJ will ease further (before the end of April 2016, see chart on next page). Our negative view on Japanese equities is in a certain sense independent of whether the BoJ will ultimately ease further or not. Indeed, whilst we have serious doubts about the BoJ easing further, we are even more concerned about the implications of further easing by the BoJ proving to be unsuccessful, thereby eroding the institution's credibility and shaking the confidence of Japanese financial markets.

The main way that either a lack of further easing or further unsuccessful easing will impact Japanese equities is through the exchange rate. The Japanese Yen has weakened significantly as a result of BoJ policy, this in turn has driven earnings and earnings expectations. The left-hand chart below show that there is a strong correlation between earnings revisions and Yen weakness. At the same time, the below chart on the right shows that consensus earnings expectations for Japan remain high, around 20% this year and around 8% over the next 2 years. We find it difficult to reconcile these strong earnings expectations without further sustained Yen depreciation and in the context of weak economic growth.

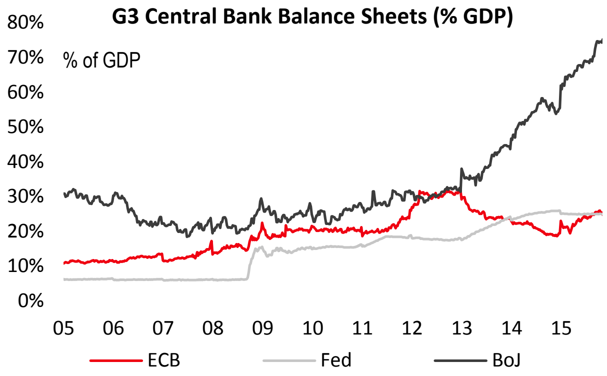




Source: MSCI, Thomson Reuters Datastream, IBES

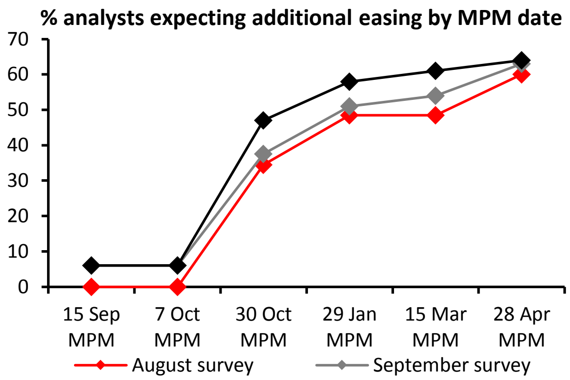
Japanese QE in context

Since April 2013, by purchasing Japanese government bonds, the BoJ's monetary base has expanded from JPY135trn to JPY332trn. As a percentage of GDP this amounts to around 75%, significantly more than what either the Fed or ECB have done.



Source: Central Banks, Bloomberg, IMF (2015 GDP estimates), Thomson Reuters Datastream, HSBC calculations

On top of this, the BoJ could start running into technical constraints which will lead to involuntary tapering of its asset purchase program. This is because there may come a point where there are not enough assets for the BoJ to purchase as the willingness of other large holders (banks, insurance companies, pension funds etc.) to sell government bonds is low. Reasons for this include asset allocation requirements and the need for institutions to hold sufficient collateral.



Source: Bloomberg

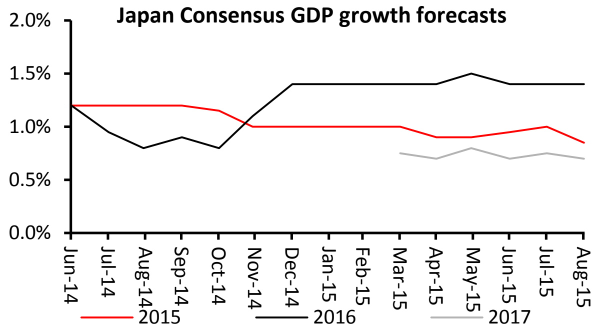
More Yen weakness not a given

In the space of several years the BoJ has succeeded weakening the Yen from around JPY80 vs. the US dollar to JPY120 (and even briefly JPY125). Indeed in real effective term, the Yen is now around levels not seen since the early 1980s. This we believe has been the key driver behind Japanese equities earnings momentum as shown in the chart on page 1.

However, in the absence of a major monetary easing "shock" like what the BoJ delivered in the past, we struggle to see what will cause further JPY weakness. In any case, it is not certain that Japanese policy makers want further currency weakness given that it would also push down real wages and harm purchasing power.

Domestic cycle not strong enough

If the Yen stays range-bound, as is our expectation, how else can earnings momentum be supported? It would need to come from an acceleration in the domestic cycle, which also appears unlikely to us. The country is already in a technical recession with Q2 and Q3 GDP growth both contracting. Other higher frequency data has also not been encouraging. In this context GDP growth forecasts for both 2016 (see chart below) seem ambitious.



Source: Bloomberg

Why then have Japanese equities held up of late?

Japanese equities have held up reasonably well in the backdrop of intensifying global growth concerns. However, it has been predominantly retail investors which have poured money into the market, presumably betting on a continuation of the "Kuroda put". Global institutional funds on the other hand have scaled back their exposure to Japan and are now broadly neutral, having been heavily overweight for a number of years.

From a valuations perspective, Japanese equities valuations don't look so bad, the Nikkei 225 is currently trading around 17x on a 12-month forward basis, considerably below its long-term average but in line with its own 5-year average. Relative to US equities, they look much more attractive.

Overall, we believe Japanese equities lack an obvious catalyst which would allow the market to outperform. In the absence of further Yen weakness it is unlikely that the export oriented side of the market can do well. While given the sluggish domestic cycle we are not much more optimistic on the domestic economy either.

In the near-term, mid-range valuations and neutral global institutional fund positioning in the market will likely limit downside for the market. Longer-term however, given that we believe the BoJ is running out of policy options, other developed markets, such as Eurozone equities represent a much greater opportunity.

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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