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Q&A: Japan, Covid-19 and coping with market volatility

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What is the team's view on the current environment?

The past few weeks have been volatile for both global and Japanese markets amid Covid-19 concerns, presenting a challenging time for investors globally.

In recent weeks, liquidity in the global economy has been a major area of concern. However, supportive measures from central banks and governments globally have been implemented to mitigate the challenges faced by households and corporates during the economic shutdown.

Relative to other countries, cases of Covid-19 in Japan have been modest. However, it is still witnessing a slowdown in domestic consumption growth, while its sensitivity to the global economy makes it susceptible to the recessionary environment in the near term. Once liquidity constraints return to normal, we believe the credit and corporate earnings environment should start to show signs of improvement.

The Bank of Japan has rolled numerous measures to cushion the impact of Covid-19, doubling its annual capacity to purchase ETFs and REITs, and increasing the purchase of commercial paper, alongside corporate and government bonds. Furthermore, we expect the government to approve a supplementary budget in late April, which, combined with ¥26 trillion in the previous stimulus package at the end of 2019 will be close to 20% of Japan's GDP – far larger than the country's stimulus measures during the global financial crisis.

For the remainder of 2020 we can expect a hit to both GDP and corporate earnings globally – with Japan being no different. While we don't expect the virus to derail long-term drivers, we believe there will be a transitory economic impact with a rebound in growth once the virus is contained. It's always tough to identify when markets bottom, however we wouldn't be surprised if we were close given the unprecedented size of the financial support. With that said, we still need to bear in mind that market volatility can be elevated occasionally until the dust settles.

Japanese companies have significant amounts of cash on their balance sheets, a total figure of approximately ¥200 trillion, which is equivalent to 40% of the economy's GDP. Given the challenging environment, we believe this cash hoard will be utilised effectively to cushion the blow.

Given Japan is currently one of the cheapest equity markets globally (where P/B is at 1x), we are starting to find a lot of opportunities to buy quality businesses with a huge discount to intrinsic value.

What has the team been doing in portfolios?

Despite the challenging economic environment, coupled with unprecedented levels of volatility in the markets, we continue to adhere to our disciplined investment process by focusing on the companies we want to own in the long term. We've been upgrading the quality of the portfolio by taking advantage of share price dislocation – increasing our exposure to those companies with solid balance sheets and which can generate sustainable free cash flow.

Given adjustments to cash levels over the past couple of months we have been deploying the dry powder in buying quality franchises at an attractive discount, while still maintaining a stable balance of secular growth and cyclical exposure in the portfolio.

We have managed to mitigate losses in this challenging environment, outperforming the benchmark (MSCI Japan) year to date, and demonstrating strong downside protection. In an economic downturn the team have been able to generate excess alpha both in cyclical sectors and stable sectors consistently. This highlights our strong ability of stock selection supported by multiple sources of proprietary research.

Have there been any changes to our outlook/long-term themes in portfolios?

In terms of our long-term outlook there has been no material change. Concerns surrounding Covid-19 have materially clouded the short-term outlook for Japan, given sensitivity to the global economy. However, stepping back from the near-term headwinds, there are still supportive structural trends, such as corporate governance and labour market reforms. Japanese companies are increasingly distributing their vast cash hoards to shareholders through dividends, buybacks and investments for organic/inorganic growth, benefitting long-term investors like ourselves.

Similarly, in portfolios we remain constructive on our long-term secular themes including automation, an ageing population, data traffic growth and shareholder-friendly activities. Given our differentiated investment process and strong investment capability, we remain well positioned to effectively exploit inefficiencies in the Japanese equity market. We believe our concentrated all-cap approach with a quality bias should continue to help preserve and enhance the value of our clients' assets – demonstrated by both our high upside participation and solid downside protection over the years.

Note: all data as at 8 April 2020, unless otherwise specified. Source: Bloomberg.

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