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A YEN FOR JAPAN?



COMMITTEE CHAIRMAN

Laura Suter

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Shinzo Abe's Liberal Democratic Party win in December 2012 marked the start of Abenomics and his three arrows to improve the country's economy. He kicked off the programme with the first two arrows: fiscal stimulus and monetary easing, which led to the country's stockmarket rising and his party's approval ratings soaring.

However, his third arrow of structural reforms has been harder to get right. After an initial attempt in 2013, which fell slightly flat, he tried again a year later hoping to have more impact.

Signs of this third arrow's effect have been seen already, with companies being more willing to take account of shareholder views, pay dividends and be more transparent. The increased shareholder involvement in companies has forced management to consider return on equity, examine cash on balance sheets and put it to better use.

Japan's economy is also receiving a boost from growing tourism numbers, particularly coming over from China, who spend more than domestic buyers. This is boosting consumer-focused businesses, and has been fuelled by the falling yen value.

However, wider macro issues could hamper these attempts at boosting growth. The fallout in China's stockmarket and the fall in commodity prices will have an impact on Japan's economy, both as a result of volatility and market nerves but also due to its reliance on China for exports. While the yen weakened considerably last year against the dollar and the yuan, it has slowed this year, which could present a further hit to Japanese exporters.

The weakness in China and slowing Japanese market could make Japanese equities less attractive, but proponents argue selective stock picking will still see outsized returns.



James Calder

HEAD OF
RESEARCH,
CITY ASSET
MANAGEMENT

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Abenomics and the three arrows are great for headlines but the two essential questions we debate are: Is there real substance to them? And will they make a positive difference? The short answer to both is yes, but they do not provide an overnight fix. The policy provides a route map for Japan's best chance to revive a moribund economy. While there will undoubtedly be blips along the way, a few examples of the many positives include a weak currency, a move to reward those companies with attractive returns on equity and a stockmarket that can actually post earnings upgrades. China's slowdown, albeit from a very high level, will have some impact on Japan, but we are of the view that the momentum of the reforms will carry the country through any short-term turbulence. Further stimulus is possible in the near future from an accommodative governor of the Bank of Japan, which would provide another fillip for markets.

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Peter Lowman

CHIEF
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While we have seen the yen weaken considerably against its peer group of leading currencies and the Japanese stockmarket rise by more than 80 per cent since the LDP took power, it's the structural reforms that are the most difficult of Abe's three arrows to implement. So far it is unclear whether Abenomics has been a total success. Outside forces such as the collapse in the crude oil price and concerns over the slowdown of the Chinese economy have taken their toll, suggesting that the Japanese economy could still fall back into its deflationary curse. While the Chinese situation is a worry, it's a worry for the world, not just Japan, and the weaker yen and oil price are a positive for many Japanese exporting companies. Clearly, the Japanese stockmarket has risen substantially over the past couple of years but with further QE, a successful third arrow and a weaker yen, the market could still continue its upward momentum.

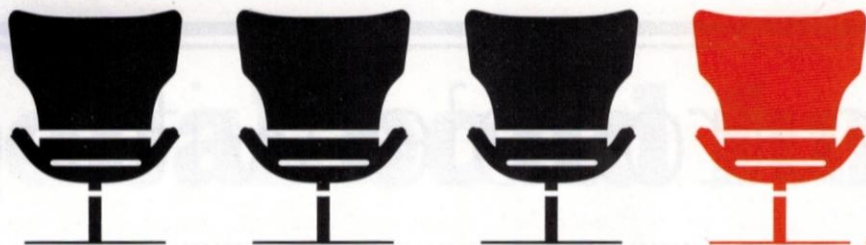
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Tim Cockerill

INVESTMENT
DIRECTOR,
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The falls in oil and commodity prices have numerous benefits, but they are also deflationary and with inflation at just 0.2 per cent this downward pressure is unwelcome. Interest rates are zero bound so stimulating demand is tough and this isn't helped by the fact the population is ageing and shrinking. Massive QE has weakened the yen by more than 30 per cent, which has made Japan's exporting industries competitive and is one of the reasons why we've seen the stockmarket perform strongly. The prospect of further easing also keeps the currency weak, but exporters need robust export markets and one of Japan's biggest trading partners, China, is rapidly slowing. A total of 18 per cent of Japan's exports go to China, so it is seeing a big hit from China's slowdown. Consequently Japan seems to be struggling to kickstart its economy. After the initial hope inspired by Abe's reform programme, the hard work of change has to start, but Japan is a culture which changes slowly – that 2 per cent inflation target is a long way off.



The committee gives its views on the future of the Japanese market and the effects of Abenomics

The first two arrows of Abe's plan involved fiscal stimulus and quantitative easing. These had an immediate effect on the stockmarket, which jumped significantly, although these effects are now waning. The third arrow of structural reforms is potentially the most interesting. In particular, Mr Abe wants to improve Japan's corporate culture. One way of doing this is the creation of a new index comprising only those companies that promise enhanced corporate values. This JPX Nikkei 400, or "shame index", plays on a very real Japanese concern: companies don't want the shame of not making it into the index or being kicked out. Other reforms centre on getting more women in work and pushing companies to increase employee pay as profits increase. While the slowdown in China will have a knock-on effect to Japan in the short term, longer term all this should be positive for investors. Although the downgrade of Japan's credit rating hits Abe's credibility, in reality it matters little since virtually nobody buys Japanese government debt other than the Bank of Japan.

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Japan's demographics are the worst in the developed world. The country's finances are the worst in the western world and will become progressively much worse. The country's solution is to debase its currency and print more than any other developed country to try to create inflation. This helps exporters – over the short term – but leaves small businesses and residents worse off in the long term. So, it has to rinse and repeat. This means that in the short term the stockmarket, which is an almost perfect inverse correlation to the yen, soars. With the current global stock bear market the yen is rising and Japanese shares are falling. Longer term, the debasing yen should bring super and possibly even hyperinflation into Japan and this would normally feed into the stockmarket. This all means Japanese shares have the chance to be the buy of the decade, out of the universe of indices, after this current correction. An ETF such as WisdomTree Japan Hedged Equity Fund allows access to the stockmarket while hedging against the debasing currency.



Jonathan Davis
MANAGING DIRECTOR,
JONATHAN DAVIS WEALTH MANAGEMENT

The recent fallout in markets, triggered by events in China are more a reflection of investor nervousness ahead of an impending US rate hike rather than a fundamental change in the path of global economic growth.

Japan has been one of the best-returning markets in 2015 both in local and sterling terms, supported by positive economic and political newsflow. There has been additional quantitative easing, delays to proposed tax increases and a confirmation of the support of the existing regime's reform with a snap election. However, the Nikkei has not been immune from the continuing shockwaves emanating from China. This alone does little to change the future of Japan, which is benefiting significantly from a lower for longer oil price and an improving corporate profitability outlook. Our Japanese fund managers continue to see value in the region and continuing much-needed improvements in corporate governance. One fund manager we recently met had profited in the fund from the continuing increase in Chinese tourists visiting Japan.

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Mike Deverell
PARTNER AND INVESTMENT MANAGER,
EQUILIBRIUM ASSET MGMT

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John Husselbee
HEAD OF MULTI-ASSET,
LIONTRUST ASSET MANAGEMENT

The excitement over Abenomics transforming Japan has long since faded and while reforms continue, the pace of change appears too slow to keep western investors satisfied. Nevertheless, progress has been made on the supply side, with continued falls in unemployment and the rise in female employment.

The S&P ratings downgrade we saw last week had no impact on sentiment although indicates a lack of satisfaction with the progress being made. The ongoing quantitative easing from the Bank of Japan has proved supportive for equity markets and corporate fundamentals have improved.

Japan faces several challenges, however, and while there remains little concern over the overall size of government debt, there is more concern over the ability of the Bank of Japan to meet its stated inflation target. Hence expectations are rising of an increase in the size and scope of QE. With the Federal Reserve failing to raise rates in September, central banks elsewhere may well feel the pressure to loosen their own monetary policy.

External risks are also increasing given fears over the slowdown in China, which is a significant export destination for Japanese goods. A conclusion of the Trans Pacific Partnership trade agreement between several Pacific Rim countries, including Japan and the US would also offer support and potentially offset a slowdown in demand from China.

Support should also come from the ongoing (but relatively weak) recovery in both the US and Europe. The valuation of Japanese equities remains reasonable and with the momentum in shareholder friendly activity in Japan we do think that the country offers better prospects than most in the Asia Pacific region.

THE INDEPENDENT VIEW

Anthony Willis

INVESTMENT MANAGER,
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