Market Thinking

By **Mark Tinker, Head of AXA Framlington Asia**

**Tuesday 31 March 2015**

·         Most equity markets were lower last week except China. The impact of the end of the quarter and the end of the Japanese financial year continue to be felt, with a shortened week for Easter exaggerating the impacts for the next two weeks.

·         With little momentum, noise traders take over and the importance of Fed actions becomes exaggerated and nerves are heightened  about signs of  bear steepening in the US.

·         As the S&P approaches earnings season, markets are nervous of high multiples – this is the classic ‘sell in May’ mind-set as we look into Q2. With poor liquidity almost everywhere, this suggests a pickup in volatility.

·         The Japanese market is looking increasingly interesting however, from both a top down and a bottom up perspective.

**After a necessary correction, the dollar looks to have stabilised**, while commodity markets remain very weak, which is good for consumers but bad for dollar debtors. In Europe, the Greek saga continues and  looks unlikely to settle anything before Easter, French local elections show large losses for the governing socialist party and the**UK moves into the final stages of probably the most uncertain General Election of a generation.**

**The one market that is looking particularly interesting at the moment in my view is Japan**, which is showing a number of very interesting developments, both  top down and bottom up. Interestingly this was a theme picked up at two different meetings last week that I attended, one by my old friend and colleague Andrew Garthwaite**at Credit Suisse**, who despite no longer being the co-sponsor of the Hong Kong Sevens rugby tournament continue to put on an excellent conference in ’sevens’ week,  and the other from the equally insightful (and newer friend) Louis Gave **at Gavekal**, who hosted a morning conference to take advantage of the number of clients visiting Hong Kong last week.

**The top down aspects are on the one hand obvious, but on the other tend to get forgotten about or overlooked** in all the excitement in Europe and currencies and general market noise. First, and most obvious is that **Japan is highly exposed to the global economy** and as investors start to move away from ‘depression obsession’ the attraction of cyclicals will be reassessed. In particular, as both Andrew and Louis pointed out, the **two big defining macro stories of the last nine months have been the sharply higher dollar and the dramatically lower price of oil**, more specifically the bursting of the commodity bubble. **Japan is a particular beneficiary of both of these trends**. However, what is ‘different this time’ is that this is likely to be more of a domestic story than an export one. This is less of a world of exporting capital equipment to China and more of a world in which you export services, particularly tourism.

While much of the attention has been on the negative side of lower oil prices, mainly the implications for investment spending and the mechanical impact on Consumer Price Index (CPI) numbers, **lower energy costs are good for economic growth in oil importing countries and global growth in general** with multiplier effects as**energy importing countries tend to have a higher propensity to consume,** while oil exporting countries have a higher propensity to save. Despite the shale revolution, the US is still an oil importer and for US consumers importing Japanese products they find they are now a lot cheaper in dollar  terms. Similarly, and arguably more importantly, they are even cheaper in RMB, something that we have highlighted in recent editions of Market Thinking with respect to **Chinese visitors shunning Hong Kong at Chinese New Year in favour of Tokyo.** This is not just the currency effect, part of the Abenomics reforms has been a drive to increase foreign tourism, with China a key component. Interestingly I spoke at a Reuters breakfast last week and one of the other presenters was the Treasurer at DFS (Duty Free Stores, the big Asian retailer) who discussed how they are adapting their offering as the higher spending Chinese tourists are branching out to Japan and Europe while a new wave, with less extravagant tastes fill the gap in Asia. As an aside, the luxury goods retailers are also having to adapt, with some of the high end watch makers such as Patek Phillippe cutting prices by 20% or more, not so much because demand is weak (although with the anti-corruption campaign this is certainly true) but to prevent the arbitrage with a sharply falling Euro.

Japan is definitely benefitting from dollar pegged Asian tourists at the retail end, while there are also finally signs of rising wages coming through and obviously the big hit to the stats from the hike in the sales tax last year is starting to fall out of the numbers.

**The bottom up considers technicals, market mechanics and equity fundamentals**.  As we come up to the end of the Japanese financial year, there is always a degree of ‘window dressing’ in the market (we will be kind and call it rebalancing), but this year, I wonder if Q2 might be the start of a new move in the Japanese markets. First, and from a purely **technical** point of view, the Nikkei is **close to a new 15 year high, not only in Yen but also in dollars, while the series of higher highs and higher lows is something that gets technicians quite excited.** The chart shows the Nikkei in Yen (black) and dollars (orange).

**Chart 1. Nikkei looking interesting to chartists**



Secondly, **market mechanics** are in favour of equities in Japan, as **almost uniquely in a world of financial repression, long term investors are being guided to buy equities, as opposed to being required to sell them**. The outline guidance for the giant GPIF state pension fund effectively sets the rates for most other pension funds to follow. They are being required to have higher weightings in the assets that the rest of the world are being told are ‘too risky’ mechanics. Moreover, the Bank of Japan itself is buying Japanese equities, and is now the second biggest holder after the Government Pension Investment Fund (GPIF), making for the type of buy on the dips bull market conditions that have benefitted fixed income markets for much of the last decade. **The next player to appear is likely to be the international institutional investor**. For much of the last twenty five years, the marginal buyer and seller of the Japanese stock market has been the overseas investor, as most domestic holdings have been largely passive – including cross shareholdings  as well as the large pension and insurance companies simply rebalancing once a quarter. For a while it was institutional, **but latterly it has been more of a hedge fund market**. Certainly the hedge funds were quick to gain exposure on the announcement of Abenomics – although more specifically it was the kuroda-nomics on monetary policy that acted as the real trigger, causing them to go aggressively long the Nikkei and short the Yen back in 2012/3. I suspect these are the same players currently playing the long Europe/short Euro trade, but it is the asset allocators that are of more interest this time.

**The ‘second leg’ of the Abenomics run took place in Q2 2013, as asset allocators,** having watched the run from 8600 to 12,400 on the Nikkei, **decided to ‘reduce risk’, by buying the market**. This might sound counter-intuitive, but is actually quite logical; most allocators had made good returns for their clients by maintaining a strategic long term underweight in the Japanese market, especially since 2008. There was a brief period of excitement in 2006/7, but, by 2012, the Japanese equity market was barely above the 2003 lows. The prospect of something, finally, changing in Japan therefore suggested a move to an in-line weighting. The hedge funds largely moved out at this point – and naturally started shouting bearish things from the side-lines, **but international retail moved in. They did this in a currency hedged fashion and it is interesting to see the rapid growth in the Wisdom Tree Japan Hedged Equity fund**, which came from nowhere to around $12bn in assets, mostly in 2013. Almost matching the  previously dominant Japan ETF, the Ishares MSCI Japan fund , at $14.5bn. Indeed, data from Deutsch Bank suggests that cash flows into Japan focussed funds from the US jumped from $350m in 2012 to $27.4billion in 2013, before falling right back to $1.6bn last year.

After a sharp Q2 2013 rally **In dollar terms the market then moved essentially sideways until a couple of weeks ago, which is why, breaking higher it is now once again on the radar for the international institutional investor.**  A catalyst may simply be that as the Japanese authorities continue buying  and the technicals trigger international participation, or it could be hung on a macro event such as one of the various trade deals circulating at the moment – note that Abe is in the US at the end of April and with the US still smarting from the fact that most of the rest of ‘the west’ has embraced China’s new Asian Infrastructure Investment Bank, pressure to announce a big US led deal will have intensified.

From a fundamental viewpoint, perhaps the most interesting development has been the launch of the **JPX Nikkei index 400 at the end of last year**, as part of a government initiative to try and align the interests of management with those of investor, particularly through the idea of return on equity. As such the index requires its constituents to have achieved targets for return on equity (RoE)and profitability. Interesting  to note that, so far at least, the return of these ‘RoE  stocks’ has been almost identical to the wider topix index. This may be because there has been a marked increase across the board  in the use of dividends and buybacks to return cash to shareholders.

**Finally, a brief comment on European companies**. An interesting email exchange with our Head of Research and Investment Strategy, Eric Chaney, highlighted what is emerging as an important issue for a number of European corporates – **the unintended consequence of QE on their pension funds**. This is causing a particular problem in Germany it seems, with a wide range of companies, from Lufthansa to Siemens to BASF having to top up pension funds as their discount rate drops precipitously. Consultants Mercer estimate that the discount rate  for a mid-sized pension fund has dropped from 6% to 2% between 2009 and the end of 2014, and as we discussed in the note last week, with German bond yields negative out for seven  years, the discount rate as calculated in this fashion is now all but meaningless.  The pension fund problem is not new, British Airways was historically referred to as a large pension fund problem with a mid-sized airline attached to it, and applies particularly to large legacy industrial or utility businesses, often post privatisation; Telecoms is an obvious area , BT also recently made a large provision.  However, **the extent of the problem is now getting serious**, particularly for shareholders who see themselves subordinated below pensioners due to government (unorthodox) monetary policy. The Financial Times also highlighted the fact that these rules have left Management Board members at large German Corporations with staggering pension pots – **Dieter Zetsche’s pension pot at Daimler is apparently worth in excess of Eur 30million.** Might make for some interesting corporate activist discussions!

There are a variety of options, changing the discount rate, perhaps to corporate bond yields, a debate that has run for a long time in the UK, but even here the financial repression runs amok – spreads are so compressed that some, such as Nestle already have bonds trading at zero to negative yields. Alternatively**, the trustees could do the unthinkable, and buy equities**, those terrible, risky things where the prices are set by free markets as opposed to frightfully clever central bankers and other great minds. After all, we have seen that **through share buy backs corporates are some of the biggest buyers of equities out there at the moment.** Who knows, perhaps, almost 60 years after George Ross Goobey of the Imperial Tobacco pension fund first made the case for pension funds to invest in common equity, the idea might come around again?