Alpha Japan Asset Advisors Ltd

April 2019

The Japanese stock market was positively oriented in April, as concerns about the global economy eased on the back of a robust US economy and improving picture in China and amid expectations of an imminent trade agreement between the world's two largest economies. Against this backdrop, overseas investors turned net buyers of Japanese equities for the first time in nine months. Nevertheless, the upside was somewhat capped as market participants later adopted a wait-and-see attitude at the start of the US-Japan trade negotiations and ahead of the prolonged 'golden week' holidays which cut the month short. With the Tokyo Stock Exchange unusually closed over ten consecutive calendar days to mark the abdication of Emperor Akihito and the start of the Reiwa era, investors squared off their positions to keep exposures in check. Overall, the Topix and Nikkei225 rose 1.65% and 4.97% over the month, accumulating gains of 9.52% and 11.21% respectively since the turn of the year.

Larger companies fared better than their smaller counterparts according to the respective performance of the Topix Core (+2.3%), Topix Large (+1.8%) and Topix Mid (+0.9%). The obvious laggard however was the TSE Mothers (where the shares of start-up companies are listed) following a loss of 1.2%.

About two-third of the 33 TSE-1 sectors indices registered gains over the month but there were noticeable disparities between economy-sensitive companies and so-called defensive ones. The biggest gainers were marine transportation (+17.5%), thanks to a rebound in shipping rates, and other products (+9.4%) in the wake of the Nintendo-Tencent Holding collaboration for sales of game consoles in China. They were closely followed by machinery (+8.0%), electrical appliances (+6.9%) and transportation equipment (+5.2%). At the other end of the spectrum stood electric power & gas (-9.2%), fishery, agriculture & forestry (-7.5%), real estate (-6.5%) and pharmaceuticals (-4.7%). The latter suffered a wave of broad selling after some candidates in the nascent 2020 US presidential race argued about the necessity of an overhaul of the US healthcare system. Pressure built up on US stocks in the sector, although at this very early stage, it is rather difficult to assess if any of these pre-electoral rhetoric will prove meaningful. The contagion seemed to have surprisingly spread overseas nonetheless and Japanese firms, some of which with no direct exposure to the US, became collateral victims.

In terms of investment style, factor analysis indicated improvements for value-related factors after negative returns across the board in March. In particular, undervalued stocks in the auto and materials segments outperformed. At the same time, risk-related factors such as 'fundamental beta' and volatility also delivered strong returns. All of these seemed to have pointed to a degree of market optimism toward the global economy and a repositioning into economy-sensitive themes.

At the start of May however, and in an abrupt departure from its previously optimistic rhetoric about US-China trade talks, the White House suddenly decided to raise tariffs from 10% to 25% on about USD 200bn worth of Chinese imports. It also threatened to tax an additional USD 325bn of imports at 25% “shortly”. China has subsequently announced retaliating measures. These rash actions reminded investors of the lingering threat that US protectionism poses to the global economy and paradoxically, it is the improving economic signs that partly emboldened both parties to take a tougher stand. At this point, both sides appear keen to continue negotiating and ultimately reach an agreement given what is at stake. But the impulsive decision from the Trump administration also highlights the lingering risks in the ratification of the United States-Mexico-Canada (USMCA) agreement and on-going trade negotiations with Japan and the EU.

Global financial markets are likely to remain jittery in the short-term and highly sensitive to any development on trade matters, but Japan may get some relative benefits from the US-China friction. It is a key US ally in Asia, with aligned interest on the subjects of China or North Korea among others, while Abe and Trump seem to have developed a strong personal relationship. As a matter of fact, the US president will be the first foreign head of state to have an audience with the new emperor on his next visit to Tokyo later in May. To some extent, the protracted negotiations with China could help facilitate a US-Japan deal by making it looks more straight forward in comparison. At the same time, the country is also well placed to benefit from production relocation out of China as a result of the higher tariffs, directly and through increased capex demand.