Views from the Japan Equities Small Cap Desk

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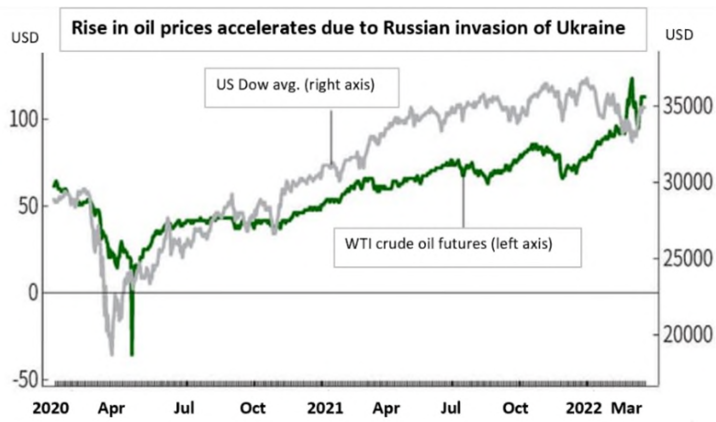
In an uncertain world, buy undervalued stocks at low prices

Since the start of the year, stock markets have been thrown into a state of increasing disorder. As a result of shortages and rising prices across various sectors, the US firstly brought monetary easing to an end, and this led to a global correction in stock prices. Furthermore, as Russia has increased pressure on Ukraine and has decided to use all-out military force, which most people thought it would never do, it seems as though the stock market has lost its steady foundations.

The only things we can say with certainty at this point about the future of the world are that Russia will lose the trust of the world for a long time and that energy prices will remain unstable for quite some time. Other than these two points, I think we are in such an uncertain situation that completely contradictory predictions can be made with regard to various key aspects of the economy.

Russian invasion will lead to higher energy prices

Currently, the largest repercussion of the Ukrainian crisis on the global economy is the steep increase in fuel prices. This is as a result of economic sanctions imposed by countries around the world placing a ban on energy imports from Russia, whose main exports are crude oil and natural gas. This has consequently put a strain on supply and demand in other fuel-exporting countries.



Source: Data from Quick and Factset

However, given Germany and other oil-importing countries' dependence on Russian oil, it is unlikely that they would be able to agree on a total embargo, so long as Russia does not commit further inhumane acts. At the time of writing, oil prices have settled. However, we are sure to see them fluctuate wildly in response to various news events.

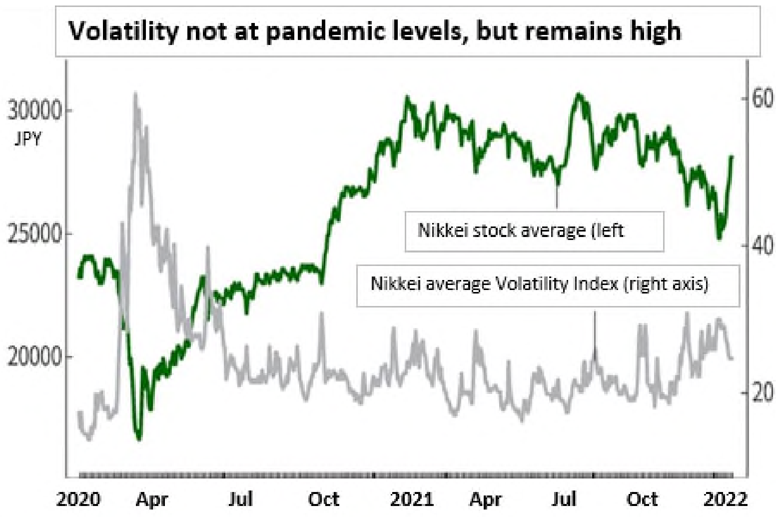
Long-term energy measures include strengthening nuclear power and renewable energy sources, such as solar and wind power, to reduce dependence on imported fuels. However, the short-term effects are limited and with any of these energy sources, there are associated political issues. Rising fossil fuel prices will increase the burden on consumers, making it difficult to raise energy prices any further in order to finance the measures required.

In Europe, where renewable energy adoption is higher, electricity prices have seen a sharp rise recently, triggered by the instability of wind power. As such, it will prove difficult to make renewable energy more widespread unless new methods to balance supply and demand are introduced.

As for other basic materials, we are similarly seeing a significant increase in prices in many cases. However, further price increases, including for fuel, could cool the global economy itself. With regard to economic trends, they also require more attention than in normal times, but here too we find a mass of uncertainties.

At present, there does not seem to be a global decline in consumer confidence amid the current climate of uncertainty. Now that restrictions on people’s activities in response to the coronavirus are easing outside East Asia, the situation is likely to remain stable for some time, at least for those who have the financial resources. As for those who lack financial resources and have nothing to benefit from inflation, life is expected to gradually become more of a struggle, thus it will be necessary to monitor the situation closely, including the relief measures provided by national governments.

For companies in the manufacturing sector, the demand side is looking favourable due to shortages and rising prices, at least for the most part. However, there are large disparities arising between countries, industries and individual companies in terms of their ability to fully pass on or absorb increases in raw material prices and logistics costs. In addition, as pointed out previously in this column, the trend of inventories accumulating as a result of supply issues or intentionally stockpiling as a response to strained logistics is growing further, and there is concern that this may have a terrible effect when the gears begin to turn in the opposite direction.



Source: Data from Quick and Factset

In terms of monetary policy, it is unclear whether there will be a rapid end to easing, as had been anticipated prior to the invasion of Ukraine. We believe that a hasty tightening of monetary policy is unlikely to bring orderly calm to the economy as a whole, and could be more destabilising by inflicting serious damage on just a few sectors.

However, if one expects the world to maintain a certain order without heading towards a catastrophic situation, then the current decline in stock prices can be seen as a buying opportunity. In the early stages of the coronavirus pandemic, when there were fears that the infection would spread from China to the rest of the world and global stock prices fell sharply, but after the pandemic actually spread, stock prices recovered despite the fact that we are still facing so many related problems.

All risks are inevitable

When it comes to stock selection in times of heightened uncertainty, one approach may be to avoid risk altogether and carefully select companies that are considered absolutely safe. However, I do not believe that all risks can be avoided in a situation where so many different and sometimes diametrically opposed risks can be anticipated. I believe that a selective strategy is dangerous because stocks that investors may consider as ‘safe havens’ are at risk of extremely large price declines when negative news comes out.

Rather, I am currently trying to focus on spreading my investments thin and wide in varied types of undervalued stocks. Such as companies that are minimally affected by inflation risk, companies that are expected to pass on higher costs, stocks that have been left undervalued for a long time or emerging stocks that have become undervalued considering their growth potential due to the sharp decline since the end of last year. Through this diversification, I am seeking to reduce risk while targeting the rebound.

The key to this strategy is not to chase the upside when the stocks you have been buying rebound sharply, but to move on to other stocks (and take profits if the rebound is substantial). With the current degree of uncertainty in the world, it is unlikely that a new, strong stock recovery story will emerge. My abiding belief is that the best way to reduce risk is to concentrate on selecting undervalued stocks at lower prices.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 29 March 2022.

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About Tatsuro NIGAURI, CMA

Mr Tatsuro Nigauri is a highly experienced Japanese small-cap equities manager based in Tokyo. He joined the firm in October 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017. He started his career as a research analyst at the Daiwa Institute of Research in 1991.

Mr Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017). He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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NOTES:
† Source: SMDAM, as at 31 March 2021.
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