Views from the Japan Equities Small Cap Desk

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Calmly seeking out fundamentally sound stocks

Since the beginning of this year, we have seen growing economic uncertainty driven by the plunge in share prices of companies in emerging markets, Russia's invasion of Ukraine, wild swings in commodity markets, the start of US interest rate hikes and the rapid weakening of the yen. Although it continues to be difficult to make definitive assertions, I aim to share my current thoughts in this article.

China risk – the worst has been averted

China's COVID-19 containment policy, which I mentioned as a new risk in my previous article, was successful in containing the latest outbreak of the coronavirus in a relatively short period of time. The worst-case scenario was that the number of infections would not decrease and the government would lose its grip on the situation, which would lead to further problematic steps, but this has been avoided for the time being.

It is surprising and even alarming that the highly infectious Omicron strain has been contained by social policy alone under circumstances where few people have natural immunity and the quality of the vaccine is said to be poor.

The impact on the earnings of Japanese companies will only become clear going forward. It appears that the automotive and apparel industries, among others, have received somewhat of a blow.

Full-fledged citywide lockdowns were only implemented in some areas of China, including Shanghai, and we heard some encouraging stories of companies taking market share from competitors in the city. Overall, however, this will have a clear negative impact on the first quarter performance of companies with a fiscal year ending in March (and second quarter if local subsidiaries are consolidated three months later).

Many companies that made their forecasts early in the year and announced them publicly have not factored in the impact at all, and we expect many quarter-end results to be disappointing. However, as coronavirus containment was successful in a relatively short period of time, it does seem possible to recover production, with the exception of seasonal products. As for export products, we expect zero impact when we look at the effect across the whole year.

In addition, the government's economic stimulus package appears to be quite robust, so there is no need to be overly concerned about the short-term impact of the lockdowns. Rather, the real issue is that containment may have gone too far. In order to maintain a completely Covid-free status, it would be necessary to restrict incoming and outgoing foreign travel to an extreme degree. Considering the negative impact of this on business activities in the medium term, and even more so the social and cultural impact, an adjustment to the current course would be desirable for China and for the world.

Excessive expectations are being pared back

Meanwhile, interest rate hikes in the US are taking place at a slightly faster pace than expected. In contrast, the overall economy is still overheated and inflationary pressures seem to be persistent at present. However, some industries are showing clear signs of weakness.

The most marked change has been in the US IT industry, which had continued to be a major driver of the US economy. Recently, many of the industry's leading giants have announced job cuts and hiring freezes. A number of start-ups are also thought to be struggling financially. The impact is thought to be significant in an industry that until recently has continued to generate high income jobs.

The semiconductor industry, which supports IT, has also recently seen an increase in negative news worldwide. We have known for some time that demand for smartphones and PCs is weakening, but it is now thought that demand for servers, for which a steady increase in demand had been assured, may not grow as much as expected.

Based on a long-term view, there will still be growth in terms of investment by corporate giants, as well as the development of industries by the Chinese government, which wants to break away from its dependence on the West. However, there is a risk of some adjustment in terms of overall production levels in the short term.

In both industries, it seems to me that part of the growth over the last few years has been due to excessive expectations, which have been spurred on by monetary easing. It will take some more time for inflationary pressures in the US economy as a whole to weaken and for interest rate hikes to run their course. Even if monetary policy is eased again after that, I think it will be difficult to return to the original growth trajectory.

However, the easing of semiconductor supply and demand is good news for Japan's key industry, the automotive industry. Since the beginning of 2021 automotive manufacturers have been unable to meet demand for production, mainly due to the semiconductor shortage, but that finally seems to be heading towards a resolution. Currently, production is still below capacity, partly due to the Chinese COVID-19 containment policy, but once recovery production gets started, the industry will be able to show its true potential for the first time in a long time.

Although I have written some slightly pessimistic things about some industries, my investment strategy is to diversify and trade against the trend in these industries as well. Whether it is semiconductor-related companies or raw materials companies that have benefited from global inflation, most of my investments have a conservative outlook, and in the last fiscal year when profits grew rapidly they increased the reserve of upcoming bonuses and other expenses, and most of their share prices are fully factored in for risk.

As for small Japanese IT companies, many of them are undervalued at the moment as a result of a significant fall in their share prices, despite their sound strategies and continuous growth. Rather than being too concerned about specific risks, I believe that by investing in fundamentally sound but undervalued companies we can improve investment performance.

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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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