

Alvine Capital May 2015

## Japan - go *East* young man

**Key issue:** a stabilised yen combined with solid fundamentals will underpin earnings growth.

**Key recommendation:** genuine 'alpha' generation can come from small and mid-cap Japanese stocks that remain under both under-valued and researched.

### After the volcano

In April 2014, we assessed how powerful the impact prolonged extreme monetary policy would be in the investment outlook. Here is a link to that newsletter.

<http://www.alvinecapital.com/docs/AlvineCapitalNewsletter-April2014.pdf>

Many of those themes remain in force demonstrating the power of governments to influence outcomes. However, we believe the next phase of this process is moving well beyond monetary policy and leading to a broad based advance.



‘The planning phase is over: we are at the implementation phase of Abenomics’  
Source: Sumi Trust March 2015.

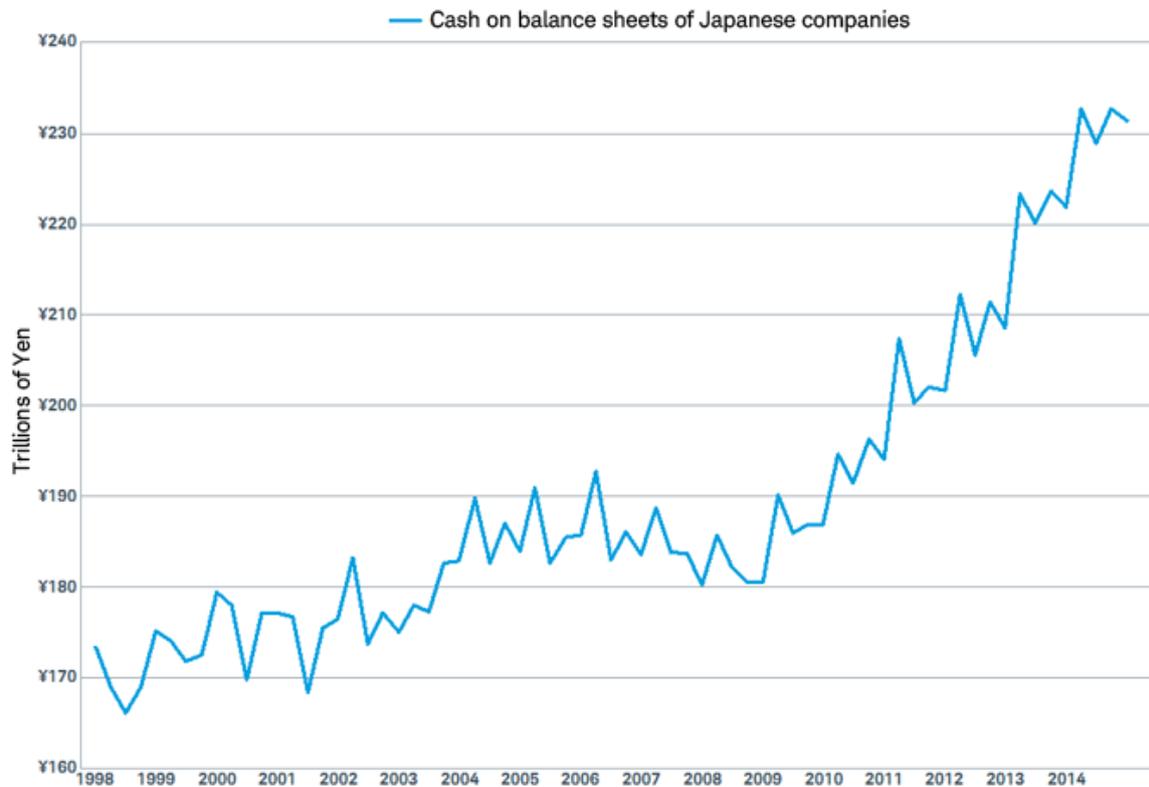
### Extra arrows - reform ahead

Calling and winning a second emphatic mandate set a clear objective of pulling off one of the three arrows - reform of the country’s sclerotic economy. With a four Year timetable, and the momentum with what has already been achieved progress is likely. While this will play out in a typically Japanese way - **consensual/measured/rounded** - solid outcomes are to be expected.

‘Abe’s [emphatic win in snap elections](#) in December 2014 may give him more time to take on entrenched interests and implement politically sensitive measures. In early February, for instance, the government reached a breakthrough agreement to [limit the power of the national agriculture cooperative](#), JA-Zenchu. The cooperative has long used its control over local farmers and its political heft to oppose the modernization of Japan’s moribund farming industry.’

James McBride 10/3/15 Council for foreign relations (source: CFR.org)

A new **corporate code** - covering corporate governance designed to draw in closer connections with shareholders, encourage dividends and takeover activity. Bearing in mind that many Japanese companies are sitting on huge cash reserves, the expectation is to free up much of the under-utilised capital.



**Plenty of ammo here** (source BOJ)

### Monetary policy - stability for the Yen

Japan is not immune to the recent deflationary forces sweeping globally. However having started the extreme phase of QE perhaps earlier than anyone else, and having got used to long term very low inflation the dangers of a Keynes ‘liquidity trap’ have perhaps been overestimated.

The **volcano is still spewing cash** while there is no apparent appetite to scale up even more bond purchases, or outright debt forgiveness. As others such as the ECB have belatedly joined QQE, the pressure on the Yen has abated. With US monetary policy still on hold yield compression from all major bond markets has injected further stability into the equation.

## Olympics - a symbol of determination



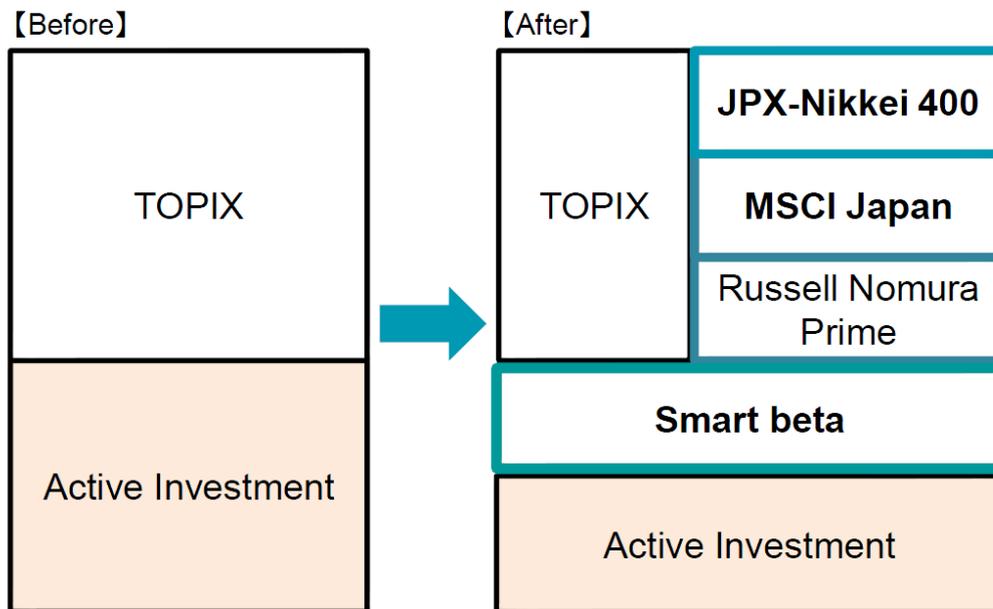
Winning the major global sporting event is no longer an economic paradigm, since the city of Montreal almost went bankrupted in 1976. However, for the still fragile psychology of Japan taking the place as a leading player in this jamboree has undoubtedly boosted confidence.

## Equity buyers emerge - The GPIF

Trying to engage a greater risk culture could start close to home. The government has indicated that effective in-house pension money be deployed beyond the overly safe JGB bond market, hence encouraging equity participation.

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## GPIF's Structural Change



### **Delivering on engagement in a risk culture**

#### **Tourism**

Japan was not exactly a cheap place to visit. From the notorious cost of getting from Narita airport into downtown Tokyo, to one of the most expensive places on the world, all discourages mass tourism.



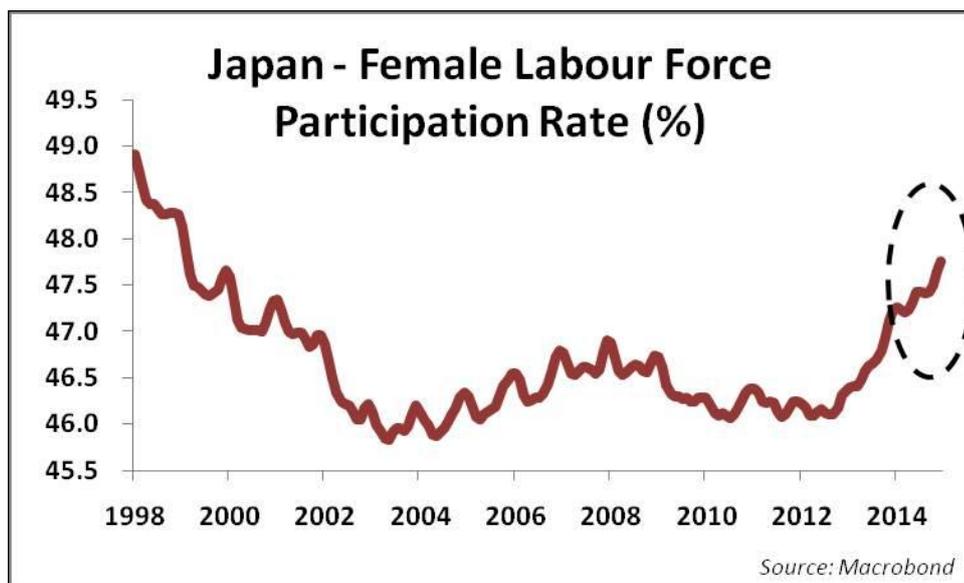
The near 50% fall in the Yen and a positive marketing campaign are delivering results. Well placed within the burgeoning populations of Asia, forecast of tripling numbers to 20 mio visitors by 2020 seem achievable.

### Small is beautiful

‘Many large-cap stocks are exporters, and can benefit from a weaker yen.’ Blackrock Jun 14

Having enjoyed all the benefits of a weak Yen big corporate like Toyota face a stiffer route forward. For the rest of the Japanese corporate world, many have yet to feel the full force of the new economic order. What small cap Japan needs is steady growth, low interest rates and a reforming administration allied to a stable currency.

**Corporate taxes are being reduced** from 35.6 to 29%, while steady progress on wage growth and female labour participation all help.



Blunting fears of poor demographics

### Who's looking - un-crowded space

Japan's asset management industry inevitably suffered in the long 25 year bear market. Accordingly, skills and resources have not been devoted to stock research and selection. While it is hoped that better times will allow some re-deployment, this will take time.

In the interim those companies and investment teams that stuck at it, and have retained knowledge and experience throughout, will benefit from this effect. **Many great companies remain undiscovered giving the opportunity for substantial alpha.**

**Conclusion - go East young man** (with apologies to Horace Greeley)

Where's the next big opportunity—the answer was often or not out west. First, perhaps as pioneers, and more recently with the San Francisco nexus of tech new ideas and incredible start up origination the west has had an enduring appeal.

However, with valuations now so fully priced - pace **Uber at a preposterous \$50bn market cap** - more humble long-term investors are forgiven to want to leave these momentum companies well alone.

Japan has emerged from a quarter of a century of torpor with a business minded government and a popular strategy. Investors can take comfort from a stabilised and competitive currency, and greater opportunities to stock pick.

The small cap sector is most likely to emphasis these traits.



Bonsai—small, beautiful and definitely Japanese



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