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Turning the corner?

Global Matters Weekly

10 January 2022

– **Stephen Nguyen, CFA**

Happy New Year to all our readers. As we enter the third year of the Covid-19 pandemic, uncertainty remains elevated in financial markets, largely centred on further Covid variants and the prospect of tighter monetary policy. Markets have largely brushed off these concerns of late and have come a long way since the lows of 2020. A quick reflection on the performance of different asset classes in 2021 highlights another strong year for risk assets, in contrast to bonds which were generally more challenged in the face of surging inflation. US equities again posted strong gains of close to 30% in local terms for the year whilst other equity regions lagged, particularly Japan. As equity markets continue to rise and reach new highs, valuations across many developed equity markets are looking stretched and it is becoming increasingly difficult for investors to find value. While many markets appear expensive, we believe there are opportunities to which investors should pay attention: one of those being Japan.

Historically, Japanese equities have been shunned by investors and they are generally only small holdings within global investors' portfolios with the region accounting for around 6.5% of the developed equity market. The 'lost decade', a period of economic stagnation with low economic growth and low inflation, has blighted the Japanese economy since the 1990s. Combining this with an ageing population, low profitability, and weak corporate governance has further deterred investors from allocating more to Japan.

We believe the corporate landscape in Japan has taken a turn for the better. The composition of the market is geared towards more cyclical sectors such as car manufacturers and exporters which are more likely to benefit from the post-pandemic global recovery. The country's progress on vaccinations (close to 80%, one of the highest in developed markets) is another key factor which could drive its recovery. The introduction of the Stewardship Code in 2014 and the Corporate Governance Code the following year has improved governance standards which will improve corporate performance. Accommodative monetary and expansionary fiscal policy are likely to remain in place for longer than elsewhere and could provide another tailwind. While inflation poses a challenge to other developed markets, it would be a welcome surprise for Japan.

As we enter the third year of the COVID-19 pandemic, uncertainty remains elevated in financial markets

The aforementioned points support the case for Japan, however the most important considerations for us, the one which we believe act as the best predictors of long-term returns, are fundamentals and valuations. As the saying goes; "price is what you pay, and value is what you get". All too often investors ignore the starting valuation, despite the critical importance of the price one pays for an investment.

Our analysis on this suggests that over the last 10 years (ending December 2021), we have witnessed significant fundamental improvements from Japanese companies, which are not yet being rewarded. For context, if we compare the performance of Japanese companies versus the US (far and away the best performing developed market), we find that the fundamentals (i.e., net margin, return on equity and real sales growth per share) of Japanese companies have either kept pace with or outperformed their US counterparts. Decomposing the returns of these two markets indicates that around 40% of the S&P 500 return has been driven by re-rating (multiple expansion, with PE ratios almost doubling) while approx. 60% came from growth in company fundamentals. We see a stark difference in Japan, which delivered stronger growth in fundamentals, but where valuations have instead detracted from returns (i.e. multiples have contracted). This clearly highlights investors' lack of appetite for Japanese equities over the last 10 years, with the region having delivered one of the strongest fundamental performances in the developed yet still trading at lower valuation multiples.

As a result, our equity modelling suggests that Japanese companies today appear more attractive than other developed regions (on valuation grounds). On this basis we are excited by the return prospects for Japan in the medium to longer term. A much lower starting valuation should provide a tailwind to returns whilst offering a healthy margin of safety versus other risk assets hovering near all-time highs.

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The **Marketplace**

- Global equities fell -1.7% last week
- Fed officials mulled earlier and faster rate hikes than expected due to rising inflation
- Brent crude rallied 5.1% over the week to $81.8 a barrel, the third consecutive weekly gain
- Gold declined -1.8% to $1796.6 per ounce

Market **Focus**

US

- US equities fell 1.8% last week, with Energy and Financials outperforming Homebuilders and Semiconductors. Tech came under further pressure due to concerns about rising rates.
- Fed officials mulled earlier and faster rate hikes than previously expected due to rising inflation, minutes from December's FOMC meeting showed. Some board members also called for reducing the central bank's balance sheet "relatively soon after beginning to raise the federal funds rate." Officials had concerns about the impact of rising infections on economic activity and the possibility "of more severe and persistent supply issues" as an additional downside risk. The Treasury (government bonds) Index had the steepest opening week decline since at least 1973.
- The US added far fewer jobs than expected last month, clouding the picture for the Fed. Nonfarm payrolls came in at 199,000, way below consensus for 450,000 and less than November's upwardly revised 249,000. The unemployment rate slipped to 3.9% and average earnings were ahead of their estimated average.
- The CDC panel recommended a booster shot of the Pfizer vaccine for 12- to 17-year-olds.

UK

- UK equities rallied 1.7% last week.
- Jacob Rees-Mogg last week called for the scrapping of a planned £12B rise in National Insurance contributions, but Rishi Sunak rejected the idea. The tax increase will be introduced in April to fund health and social care, which has stoked concerns about the looming cost of living crunch. It will cost middleearning households about £300 a year.
- UK Manufacturing PMI for December was 57.9 vs 57.6 estimate. Construction PMI of 54.3 was better than the 54 estimate.

Europe

- European equities fell -0.7% last week, with Banks and Auto & parts outperforming Technology and Healthcare.
- Inflation in the Euro region accelerated beyond already record levels, defying expectations for a slowdown and complicating the task for ECB officials who insist the current spike is temporary. Price growth picked up to 5% in December versus the previous month's 4.9% gain and more than the 4.8% consensus. The core print came in at 2.6%, matching November's reading.
- German unemployment for December was 23k lower than November, and the estimate was for only 15k less. Germany's PMI for December was 57.4 in line with previous but forecast was 57.9.
- Italy made vaccination compulsory for people over 50 and extended restrictions on the unvaccinated.

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned -1.7% last week.
- Japanese equities rose 0.2% over the week.
- Stocks in Asia fluctuated as investors braced for bondmarket volatility and stimulus withdrawal.
- Chinese equities fell 1.7% last week.
- China fell back after the PBOC withdrew net liquidity from the banking system.
- China brought in new restrictions for visitors from the US, Australia, and Thailand tightened curbs.
- The Russia and US administrations and their allies will discuss possible export controls on technology and electronics if Putin seizes more of Ukraine. Reuters reported that Russia said it won't make concessions under US pressure and warned the talks may end early. NATO secretary-general told the F.T. the US-led defence pact is prepared for "a new armed conflict in Europe" should negotiations fail.

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Asset Class/Region	Currency	Currency returns			
		Week ending 7 Jan. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-1.8%	-2.1%	-1.8%	24.2%
United Kingdom	GBP	1.7%	1.4%	1.7%	14.6%
Continental Europe	EUR	-0.7%	-0.9%	-0.7%	21.4%
Japan	JPY	0.2%	0.2%	0.2%	11.6%
Asia Pacific (ex Japan)	USD	-0.6%	0.0%	-0.6%	-6.0%
Australia	AUD	0.1%	-0.8%	0.1%	15.2%
Global	USD	-1.7%	-1.8%	-1.7%	17.8%
Emerging markets equities					
Emerging Europe	USD	0.2%	0.1%	0.2%	10.5%
Emerging Asia	USD	-0.7%	0.3%	-0.7%	-8.2%
Emerging Latin America	USD	-1.2%	-1.2%	-1.2%	-11.1%
BRICs	USD	-0.8%	0.6%	-0.8%	-13.3%
China	USD	-1.7%	0.2%	-1.7%	-24.2%
MENA countries	USD	1.1%	1.1%	1.1%	28.8%
South Africa	USD	2.1%	2.0%	2.1%	9.1%
India	USD	3.0%	3.8%	3.0%	26.1%
Global emerging markets	USD	-0.5%	0.3%	-0.5%	-5.3%
Bonds					
US Treasuries	USD	-1.5%	-1.4%	-1.5%	-2.9%
US Treasuries (inflation protected)	USD	-2.4%	-2.5%	-2.4%	3.8%
US Corporate (investment grade)	USD	-1.9%	-1.8%	-1.9%	-1.5%
US High Yield	USD	-0.9%	-0.9%	-0.9%	4.1%
UK Gilts	GBP	-2.2%	-2.0%	-2.2%	-5.8%
UK Corporate (investment grade)	GBP	-1.3%	-1.2%	-1.3%	-3.8%
Euro Government Bonds	EUR	-0.7%	-0.7%	-0.7%	-4.0%
Euro Corporate (investment grade)	EUR	-0.4%	-0.4%	-0.4%	-1.5%
Euro High Yield	EUR	0.1%	0.1%	0.1%	3.0%
Japanese Government	JPY	-0.3%	-0.3%	-0.3%	-0.5%
Australian Government	AUD	-0.9%	-1.1%	-0.9%	-3.7%
Global Government Bonds	USD	-1.3%	-1.1%	-1.3%	-6.9%
Global Bonds	USD	-1.2%	-1.0%	-1.2%	-6.0%
Global Convertible Bonds	USD	-1.4%	-1.4%	-1.4%	-6.0%
Emerging Market Bonds	USD	-2.5%	-2.4%	-2.5%	-5.7%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 7 Jan. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-3.3%	-3.1%	-3.3%	41.9%
Australian Property Securities	AUD	-2.3%	-3.8%	-2.3%	20.3%
Asia Property Securities	USD	0.6%	0.5%	0.6%	-2.2%
Global Property Securities	USD	-2.2%	-2.1%	-2.2%	22.4%
Currencies					
Euro	USD	-0.3%	0.4%	-0.3%	-7.4%
UK Pound Sterling	USD	0.3%	0.7%	0.3%	0.2%
Japanese Yen	USD	-0.5%	-0.4%	-0.5%	-10.1%
Australian Dollar	USD	-1.4%	-1.0%	-1.4%	-7.3%
South African Rand	USD	2.3%	2.4%	2.3%	-1.0%
Swiss Franc	USD	-0.8%	-0.5%	-0.8%	-3.7%
Chinese Yuan	USD	-0.3%	-0.1%	-0.3%	1.6%
Commodities & Alternatives					
Commodities	USD	2.1%	1.3%	2.1%	39.5%
Agricultural Commodities	USD	1.1%	0.6%	1.1%	34.2%
Oil	USD	5.1%	3.1%	5.1%	50.3%
Gold	USD	-1.8%	-0.9%	-1.8%	-6.0%
Hedge funds	USD	-0.4%	-0.4%	-0.4%	2.6%

Source: Bloomberg. Past performance is not indicative of future returns

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