CIO Perspectives

Second Quarter 2022

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Key points

- Japan equities sold off in line with the rest of the world on the outbreak of the Russia-Ukraine conflict
- While not directly impacted by the crisis, a spiralling oil bill will have a heavy impact on the economy
- As Japan is still struggling with Covid recovery, higher inflation would affect domestic sentiments further
- The outlook for Japan's electronics exports is intact, and the Russia-Ukraine conflict could extend the tightness in supply and drive pricing power
- We recommend staying in sectors where Japan has a global competitive edge, such as autos, automation, semiconductor sectors; and stick with quality big stocks that can manage costs better

EQUITY STRATEGY

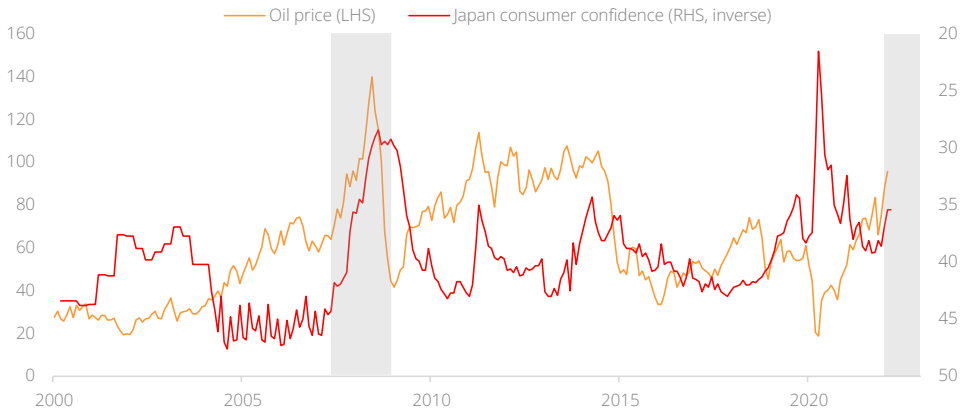
Japan Equities 2Q22: Uneven road ahead

Japan equities remained sensitive to external risk events as it corrected 14% at one point, before returning flat for the quarter. Heightened geopolitical tensions, Federal Reserve tightening, rising omicron cases in Asia, and higher inflation globally took a toll on the markets in a dearth of positive news domestically.

Japan's economy is likely to return to a negative territory in 1Q this year as omicron spreads, hindering the resumption of economic activities. This should, however, mark the nearing of the end of the pandemic when inferred from global trends. We have trimmed our GDP growth this year but pushed next year's higher, in view of the delay in consumption recovery. However, the development of the Russia-Ukraine crisis could hurt the nascent recovery.

Japan was sold off in line with the rest of the world as the Russia-Ukraine conflict deepened. Japan is not directly impacted by the crisis, but a spiralling oil price will have a heavy impact on its economy. As a heavy industrial user of oil and a net oil importer, a higher oil bill will worsen its trade balance. We estimate that a USD10 increase in oil price will reduce trade balance by 0.2% of GDP and raise inflation by 0.35 %pt. For an economy which is still struggling with Covid recovery, higher inflation would affect domestic sentiments further. Moreover, the Japanese yen will likely weaken as it loses its safe haven status under the threat of widening yield gap as a result of Fed tightening, thereby worsening the import bill.

Figure 1: High oil price, weak consumer confidence



Source: Bloomberg, DBS

Exports driver intact. Electronics exports have been Japan's key engine of economic growth. The outlook remains intact with the prospects of easing China policies. The crisis between Russia and Ukraine could extend the tightness in supply and drive pricing power for Japan's exports products such as vehicles, vehicle parts, and semiconductors. Meanwhile the yen's effective exchange rate has slumped to a historic low, driving Japan's competitiveness in the exports market.

Valuations are cheap but unexciting growth. The Topix Index trades at 13.3x, which is below its long-term average of 15x. While cheap, the lack of long-term growth drivers makes it an unexciting market. An ageing and declining population, inflexible labour market, and low productivity are some of the common reasons cited for the lack of growth.

Sector impact from rising oil and commodity prices. However, a weak yen supports global competitiveness but increases input costs, especially when global inflation is rising. We recommend staying in sectors where Japan has a global competitive edge, such as autos, automation, semiconductor sectors; and stick with quality big stocks that can manage costs better.

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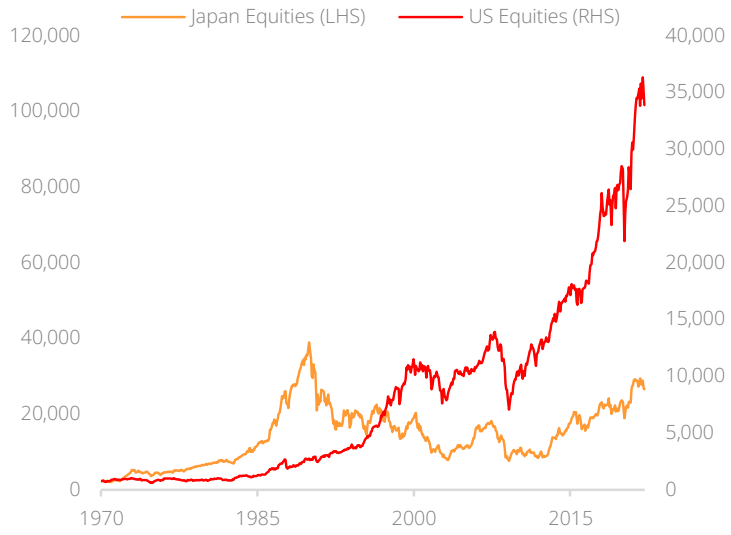
Figure 2: Cheapening yen

Source: Bloomberg, DBS

Figure 3: Structural differences between the US and Japan led to bifurcated performance



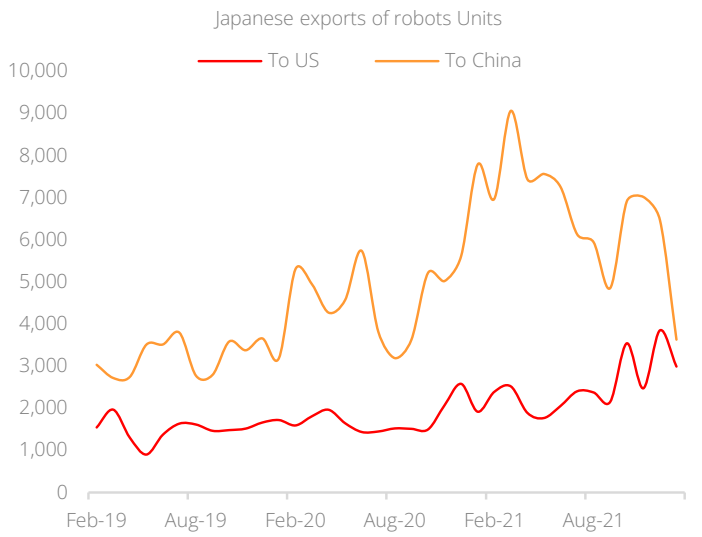
Source: Bloomberg, DBS

Autos. Moves to make up for lost car production because of supply disruption in the past two quarters will boost profits for automakers. Rising costs, however, will remain a concern as prices for raw materials such as steel, copper, and lithium are rising. A cheaper yen and having multiple models including EV or hybrid cars should boost Japanese automakers' brand competitiveness. We expect robust US and China sales in an economic recovery scenario.

Automation. Another sector which has been affected by a shortage of semiconductor chips is the robotics sector. We expect production to ramp up as supply chain disruption eases. Reflecting the post-pandemic recovery, the World's largest Robot Trade Show, iREX International Robot Exhibition, was just held in Tokyo in March this year after a three-year break. We expect demand for automation robots to extend to sectors beyond traditional industries such as in services to minimise human contact in the aftermath of the pandemic crisis.

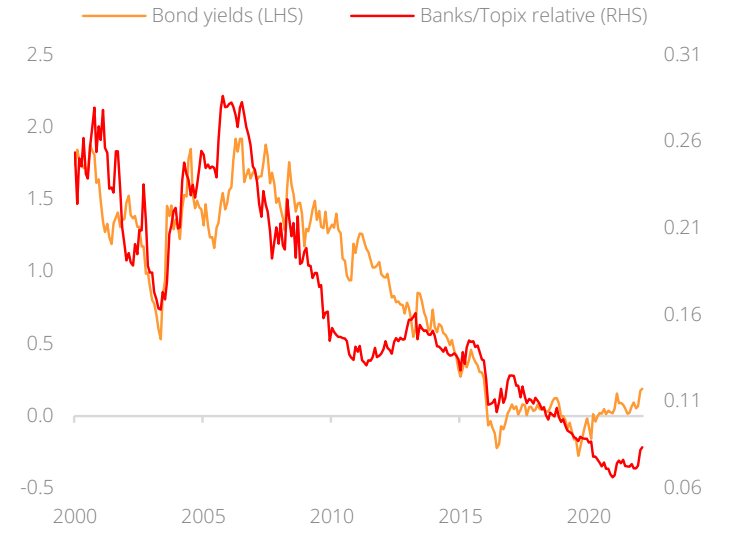
Upstream semiconductor. Notably the sector has overtaken Japanese vehicles as a key exports sector and global interest in the sector is high due to global supply shortage. However, Japan has yet to establish itself as a producer of high spec, globally competitive chips. A renewed R&D and capex drive will need to be undertaken in order for Japan to win in the semiconductor race. We are positive on the upstream semiconductor machinery sector.

Figure 4: The US and China are top two exports destination for Japan's robots



Source: Bloomberg, DBS

Figure 5: Limited margin expansion story for Japanese banks



Source: Bloomberg, DBS

Construction and mining equipment manufacturers. The demand for mining equipment could be lifted by high commodity prices driving bustling exploration activities. We think the property construction slowdown in China should be sufficiently priced in and stabilised as China is expected to stimulate the economy by increasing infrastructure investment, stabilising the housing market.

Trading companies should enjoy the windfall of high commodity prices amid strong demand. With supply shortages due to logistics disruption, Russia-Ukraine conflict, and natural disasters, we believe increasing trade margins for intermediaries can still be maintained.

Banks. Banks have outperformed the broad Topix index in line with rising yields since the beginning of the year. Focus is now on Fed rate hikes and quantitative tightening, and how these measures would change US and global long-term interest rate trends, especially when risk of stagflation is rising. The BOJ's view on how it sees "bad" inflation arising from oil to reach its 2% target also has bearing on Japanese yields going forward.

Given the limited scope of how Japanese bond yields can rise, we would be selective on banks and focus on those that can show improvement in capital efficiency and improve shareholder returns.

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