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Is it time to tap into Japan's small caps ?

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Abe's three arrows

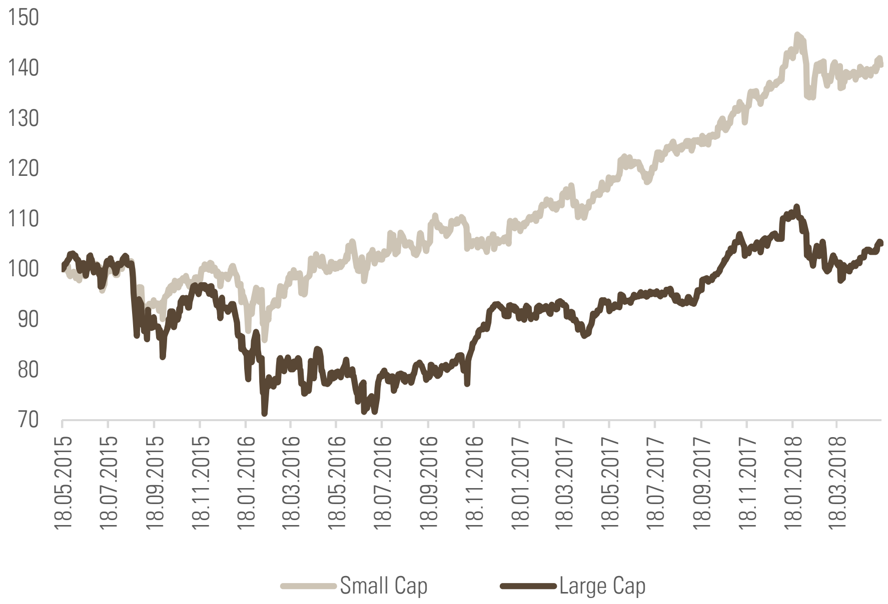
The three arrows of Abenomics, initiated five years ago by Prime Minister Shinzo Abe, aimed to improve the fundamentals of the Japanese economy in a three-step process. First, the weakening of the yen was designed to boost exporters' results. The second stage was the transmission of the benefits reaped by exporters to the rest of the economy (i.e. domestic focused companies). Finally, the third step was intended to enhance the structure of the economy by reforming the budget, labour laws, immigration laws and corporate governance.

A domestic story

The first step was completed quickly starting in 2013. The yen has weakened, exporters' profits have improved and wages have increased for international companies. The second step is currently work in progress, with wage negotiations in smaller companies underway, which could finally lead to the much-anticipated real wage growth.

This in turn would support domestic demand and fuel a virtuous circle. We are already seeing this as small cap stocks, with their domestic focus, have been strongly outperforming large cap over the past 18 months. With the Japanese economy on the right track with real wage gains driving domestic demand beginning to be reported, small cap, domestically focused stocks are best positioned to benefit. Small caps tend to be overlooked by the market and, thus, can provide more opportunity for finding hidden gems. It's interesting to note that 42% of the Topix Index has no coverage at all, in contrast to the S&P 1500 Composite with <6% of stocks covered by two or less analysts.

Chart 1: Japanese Small Cap Equities Outperforms Large Cap Equities



Source: Bloomberg, May 2018. Data normalised to 18/05/2018=100.

Highlights

1. Abe's second arrow is currently underway and should support domestic demand and thus help boost small caps.
2. However, as domestic-oriented sectors are less profitable than their international peers, we believe there is room for improvement for investors in Japanese domestic stocks.
3. We believe that an active approach to risk management will be essential for investors looking to capitalise on these attractive opportunities in Japanese small and mid-cap stocks.

Still room for improvement

Currently, domestic-oriented sectors are less profitable than their international peers, whereas exporters are already at par with their competitors. This implies that there is much more room for improvement for investors in domestic stocks. Abe's government is working intensively on this topic issue, which will likely be reinforced by the reopening of the negotiations on the Trans-Pacific Partnership (TPP) with the Trump administration.

Abe's government may seek a deal to push domestic sectors to reform through the forces of international competition, and by a phase of consolidation within those sectors through more M&A activity, which should also support the small and mid-cap segments. On the other side of the table, Trump has no doubt realised that it is not in the US' interests to leave a huge vacuum in the Asia Pacific region, a vacuum that China would be only too pleased to fill. Overall, this should help ensure that the negotiations are a success.

An active approach will be essential

Nonetheless, we believe an active approach to risk management will be essential for investors looking to capitalise on these attractive opportunities in Japanese small and mid-cap stocks. The Japanese economy is still hugely dependent on trade with China and any weakening in Chinese demand could be damaging for Japan.

Meanwhile, concerns about Abe's political situation in light of recent scandals could slow the progress of the government's policies, even though it is very likely the reforms will continue regardless of whether Abe is forced to step down. The last main threat is that the third arrow of structural reform is not implemented. Given today's uncertain markets and geo-political risks, albeit amid a favourable economic outlook, we believe a risk-managed strategy that provides growth exposure while managing risk is the optimal solution.