# TURNER INVESTMENTS COMMENTARY


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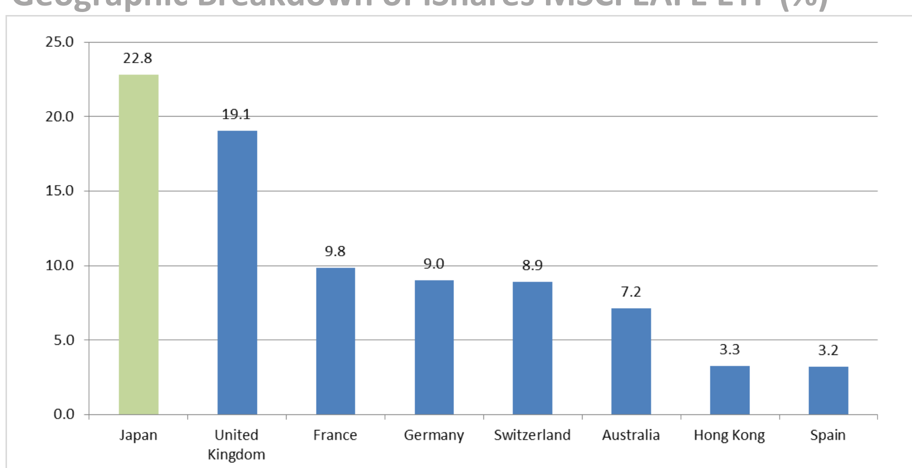
## DOMO ARIGATO

Japan's a nation plagued by almost continuous natural disasters, some so epic that Hollywood would have difficulty creating anything as spectacular. The massive 2011 earthquake and tsunami, for instance, made for some of the most compelling YouTube videos ever and caused the Nikkei 225 to plunge an incredible 19% in less than a week. Japan also suffers from antiquated immigration policies and (to put it mildly) unfavourable demographics. An astonishing 27% of the country, for example, is age 65 years or older compared to the rest of the world at only 9%. Japan's economy, not surprisingly, has stagnated and the nation has suffered through *four* recessions in roughly the past five years. It actually lost its position as the world's second largest economy when it was overtaken by China in 2010. And holding on to third spot is increasingly in doubt as Germany continues to nip at its heels. So what portfolio manager would want to give their clients exposure to this volatile and barely growing area of the world? Well, we would, and we'll explain why.

First, let's establish where the Japan exposure lies in your portfolio. The weighting comes primarily from the iShares MSCI EAFE ETF (most clients hold

**Geographic Breakdown of iShares MSCI EAFE ETF (%)**




Source: iShares

a US dollar and a Canadian dollar version). EAFE stands for Europe, Australia, Asia, and the Far East, but the single country with the largest weighting is, by far, Japan (see chart above). Some of the Japanese equities held in this ETF include the corporate giants Toyota Motor, Mitsubishi UFJ Financial, Japan Tobacco and Takeda Pharmaceutical. While the performance of the ETF over the past few years has been only modest, this hasn't been because of Japan. Impressively, the Nikkei 225 has returned more than 17% annually over the past four years. In other words, Japan has more than pulled its weight in this ETF.

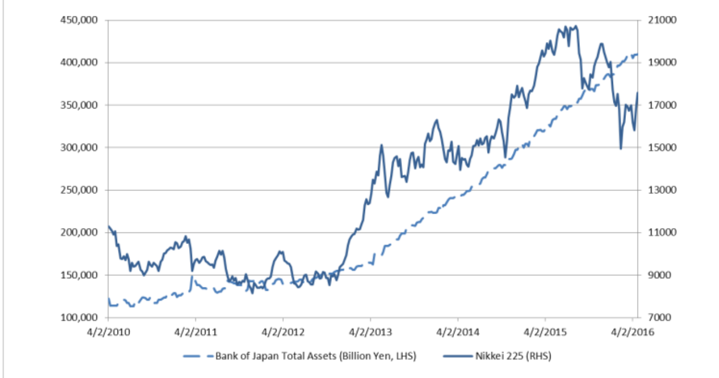
## THE SUN KEEPS RISING

So, how has a country with so many disadvantages been able to produce such strong market returns? In short, it's been because of Abenomics. Shinzo Abe is the current prime minister of Japan and has been in power since 2012 (Abe was also briefly prime minister in 2006–07). Since becoming prime minister, Abe has adopted aggressive economic policies, dubbed Abenomics, which are centred on fiscal stimulus and a devaluing of the Japanese yen. The impact of these policies has been dramatic. The Japanese yen, for instance, has fallen more than 30% against the US dollar since its 2011 highs and at one point was down almost 40%. The weak yen has been a boon for Japanese corporations as they have been able to realize more revenue from their exports because of the favourable currency exchange. Toyota Motor, as an example, sells 75% of its vehicles outside of Japan. Better corporate results have naturally led to better equity market returns.

The Bank of Japan has also been providing enormous amounts of monetary stimulus, mainly through bond purchases, which has also been beneficial to the Japanese equity market (see chart below). This strategy has not been that dissimilar to the quantitative easing programs of the US Federal Reserve, which were extremely effective in driving strong returns for the S&P 500 in the years following the credit crisis. One reason that we advise our clients maintain Japan exposure is that we expect further stimulus to be announced. While the Bank of Japan disappointed markets by not increasing its monetary stimulus at this month's meeting, we believe this is just delaying the inevitable. The country's still slack economy, which is bordering on deflation, not to mention the recent series of deadly earthquakes in southern Japan, lead many (including us) to believe that policy makers will further expand their stimulus programs. The Bank of Japan meets roughly monthly and we expect the Bank of Japan to increase its level of asset buying, which currently sits at 80 trillion yen per year (roughly US$725 billion), at its July meeting. Despite the negative reaction to the Bank's stand-pat announcement, we were encouraged by the Bank's comments afterwards where it vowed it will continue to do "whatever it takes" to boost the country's stalled economy. There could also be further positive spending announcements from the Abe government coinciding with the G7 summit on May 26–27, which Japan is hosting.

## Abenomics Has Weakened the Yen


## Monetary Stimulus Has Sent Equities Higher




Source: Bloomberg

Whether Abenomics and the actions of the Bank of Japan have actually been beneficial for the Japanese economy are hotly debated and certainly their decisions have been controversial. Wage growth, for instance, is still stagnant as is inflation, and the yen has recently begun to rally leading many to fear that Japan's economic policies are losing their effectiveness. But, as portfolio managers, we care most about the likelihood of continued liquidity measures as these tend to directly impact equity markets. At this point, we believe the odds of increased stimulus are favourable enough that, despite the recent disappointing news from the Bank of Japan, a modest Japan weighting in your portfolio is warranted.

## A HIGHLY EFFECTIVE OIL HEDGE

However, regardless of whether the uptrend in the Nikkei 225 continues, we want to maintain exposure to Japan as a hedge against further oil price deterioration. Japan is consistently one of the world's largest net importers of oil ranking alongside China and the US in this respect. Its dependence on oil was exacerbated after the 2011 earthquake and tsunami, which took most of its nuclear energy production offline. Accordingly, Japanese markets (and its economy) tend to benefit from weak oil prices. Not surprisingly, the Nikkei 225 has consistently had a high *negative* correlation to both the WTI oil price (the North American benchmark) and the Brent oil price (the international standard) over the past five years (see table below).

### Japan: Negatively Correlated to Oil Prices

| | Nikkei 225 | WTI Oil Price | Brent Oil Price |
|---|---|---|---|
| Nikkei 225 | 1.00 | | |
| WTI Oil Price | -0.67 | 1.00 | |
| Brent Oil Price | -0.77 | 0.98 | 1.00 |

Source: Bloomberg. Weekly correlations over five years. A negative correlation between -1.00 to -0.50 indicates a strong *inverse* relationship.

Therefore having exposure to Japan can smooth the negative impact of falling oil prices within your portfolio. We saw the usefulness of this hedge last year when the Canadian and Japanese markets moved in almost opposite directions with the S&P/TSX Composite declining 11% and the Nikkei 225 gaining 9%. As we don't know precisely what OPEC may do next to disrupt oil markets, we believe having this downside protection is important. While the recent rally in oil has been constructive, we are not prepared to conclude that an extended bull market is underway. The failure of OPEC to establish definitive production cutbacks at its recent Qatar meeting only highlights the ongoing risk facing the energy sector. Japan provides very effective portfolio insurance against OPEC uncertainty.

## BEAUTIFUL, EVEN IN DEATH

Japan is, quite literally, dying. And despite its demographic decrepitude, its government has done little to encourage immigration to offset its rapidly declining workforce. Naturally, this concerns us and we believe that the country faces massive long-term risks. However, there are enough short-term positives to warrant maintaining exposure to the region. Further monetary stimulus, we believe, is likely and should continue to support Japan's equity market and, equally important, this market serves as an excellent hedge against oil price weakness. No doubt another disaster looms on the horizon, but, for now, we believe that the Empire of the Sun still has the potential to shine brightly in your portfolio.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