

European, American and Chinese Investors Focus on Discounted Japanese Stocks in Wake of Earthquake

Japanese stocks plummeted immediately after the Great East Japan Earthquake on March 11, but soon recovered with investors buying the stocks back. Since then, however, the Nikkei Index continued to trade at the 9,000 yen level and was unable to reach the 10,000 yen mark again until July. How do overseas investors view the Japanese stock market after the earthquake? We asked the Head of Research at Merrill Lynch Japan Securities, the Japanese unit of Bank of America Merrill Lynch (BofAML), about these and other issues. Merrill Lynch Japan Securities was recently voted by Institutional Investor magazine readers as the top All-Asia Research Team and top All-Japan Research Team (2011).

Interview by Takahiro Kasahara of J-MONEY magazine on June 27, 2011



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Interest in Japanese Stocks Grows Along with Earthquake-related Discounts

Until early spring 2011, Japanese stocks continued on a path of recovery, but the shock from the nation's March 11 earthquake led the Nikkei Stock Average to suddenly plummet from 10,254 yen to as low as 8,605 yen on March 15. Soon after, it recovered to the 9,000 yen level as investors believed the stocks had been excessively sold off. Initially, there was even the view that the 10,000 yen level would be recovered quickly in anticipation of reconstruction-driven growth. Unfortunately, the sheer extent of the damage and of nuclear power risks has dampened volume through June with the slump continuing.

Furthermore, a strong U.S. economy is essential for Japanese stocks but the future for that market is starting to darken. Chinese economic growth is also starting to decelerate due to fears of inflation and a potential bubble. The scenarios in which Japan benefits from a steady global economy are weakening.

Indeed there is a mood of pessimism in the Japanese equity market. Having said this, overseas investors currently have interest in Japanese stocks and are closely watching their trends. Yohei Osade, Head of Japan Research and Deputy Director of Asia Pacific Equity Research at BofAML, explains, "Prior to the earthquake, some overseas investors went beyond simple

Japan stock 'bashing' to what we call in Japan stock 'passing' or avoiding the Japanese equity market. Others went so far as to reduce their position to zero. Ironically, the earthquake contributed to a perceived discount and foreign investors have developed an interest in Japanese stocks, although I wouldn't say they have gone so far as to be positive."

Osade met with dozens of European and American investors after the earthquake. He was asked what Western investors thought about Japanese stocks. Osade replied, "Immediately following the quake, some investors perceived a discount and bought. However, since then they have been holding back and watching how things develop based on three concerns: 1) politics, 2) performance and 3) nuclear power. There are two large issues in particular regarding performance. First, the summer power shortage problem, and second, the supply chain challenges. Investors saw both as problems that would increase in severity and potentially deteriorate the performance of Japanese companies notably. However, a growing number of foreign investors are reviewing their Japanese positions because the impact of power shortages does not look as dire as once expected. This is due to Japan's commitment to buckling down and conserving energy, and to a quicker-than-expected recovery of the supply chain."

Although any power shortage impact during the July through September period will not be clear until actual figures

Figure: Forecast for Stock Price Indices

		2011		2012			
		Jul – Sep	Oct – Dec	Jan – Mar	Apr – Jun	Jul – Sep	Oct – Dec
TOPIX End of period (rate)	Forecast	800	1,000	1,000	1,050	1,150	1,000
	range	850–900	900–1,100	900–1,100	900–1,100	1,000–1,200	900–1,150
Nikkei Stock Average End of period (rate)	Forecast	9,000	11,000	11,000	11,500	12,500	11,000
	range	8,500–10,000	10,000–12,000	10,000–12,000	10,000–12,000	11,000–13,000	10,000–12,500

Source: BofA Merrill Lynch Global Research

become available, the majority of overseas investors are looking to make a decision whether or not to buy back their position only after determining the results of said period.

With Few Places to Invest, Investors Re-examine Japanese Stocks

One other reason that overseas investors are keeping an eye on Japanese stocks is the lack of appealing investments elsewhere. Osade says, “There are fears that the U.S. economy is slowing and Europe is facing financial issues. Investors have also already invested in China and other emerging markets, and those markets are not ready for further investments. So by a process of elimination and the assumption that Japanese stocks won’t fall any further, Japan stands out in the eyes of investors.”

Osade added, “In particular, there are some Western investors who have either had Japanese stocks at underweight or at zero positions during the past few years. This is probably why it is easy for them to buy Japanese stocks today.”

Osade also indicates that the perspectives of European and U.S. investors differ slightly. He states, “European investors

face serious financial and monetary crises in their home countries and are anxious about the future of their economies. They are trying to incorporate Japanese stocks into their portfolios as Japan is among the better advanced country choices. Potentially they are interested in Japan as a means to geographically diversify their investments.”

Osade does feel that U.S. investors’ interest in Japanese stocks is not a matter of geography. He says, “As Americans globally analyze equity possibilities, they consider according to sector. For example, they examine whether or not Toyota is a good investment in comparison to GM or Hyundai. Apparently they are presently interested in individual Japanese stocks because of the discount and because of the country’s notable technological prowess.”

Osade states, “Japanese companies in particular are in a strong position to benefit from the growth of Asia due to geographic advantages. Many overseas investors are also interested in Japanese companies from the perspective of international competitiveness.”

It appears that this analysis may spread among investors. Osade says, “Ten years ago, stock price movements differed

among countries and there was a clear reason to geographically diversify, but today is a different era. There is more emphasis than ever on the intrinsic value of individual stocks when analyzing global targets by sector.”

Due to these developments, BofAML has reorganized its research team into a cross-regional team. Osade is not only Head of Japan Research, but is concurrently the Deputy Director of Asia Pacific Equity Research.

Despite the difference in perception, the reasons that Western investors switched from Japanese stock ‘passing’ to becoming interested are not limited to the discount but also include the mentality of Japanese people after the earthquake.

Osade states, “Westerners respected that after the disaster Japanese people did not act selfishly but instead tried to help each other. Another positive impression was of Japanese properly lining up for aid even in a time of crisis. It is irrefutable that the unified attitude and actions of Japanese to support the recovery has played a role in enhancing investors’ views of Japanese stocks overall.”

Unfortunately, however, the greatest perceived risk among Western investors

about investing in Japan is the lack of strategy and measures being taken by the government. Osade relates, “We are not talking about whether or not this government is good or bad – there are many investors who are convinced that present-day Japanese political leadership, regardless of the cabinet or the prime minister at hand, would be unable to spur the economy. Despite the fact that the technological skills and international competitiveness of Japanese companies are held in high regard and even despite any discount, the government is dragging investment opportunities down. This is very unfortunate.”

Chinese Investors Replacing Dollar Assets with Yen

Chinese investors are buying Japanese stocks for different reasons than the West. They also feel that the opportunity is right to buy Japanese companies today, but Osade adds, “The Chinese as a nation do not want to increase dollar assets any further and are more actively increasing their holdings of Japanese government bonds, stocks and other yen assets.”

Masatoshi Kikuchi, BofAML’s Japan equity strategist noted in a recent report that the amount of Japanese stocks held by Chinese funds increased from 2.1 trillion yen at the end of September 2010 to 2.8 trillion yen at the end of March 2011. The number of issues held increased during the same period from 145 to 237. China is showing a voracious appetite for yen assets, with the purchase of Japanese medium- and long-term government bonds outstripping sales in the month of April 2011 by 1.3 trillion yen.

Osade comments, “It is not just the Chinese – Asian investors continue to show a strong interest in buying Japanese stocks. The reasons probably include 1) Japanese companies easily reap the benefits of Asian growth, 2) the continued high reliability of the Japanese brand, and 3) wealth that has been created by economic growth particularly in China is looking to be invested. I expect the appetite for Japanese stocks to continue among Asians into the future.”

An increasing number of Japanese investors are diversifying investments to non-yen assets as a means of eliminating cross-holding of stocks, mitigating risk and correcting home country bias. Therefore, among the Japanese themselves it appears there is more pressure to sell than to buy

Japanese stocks. Nevertheless, it is evident from analysis that overseas investors are interested in Japan for their own reasons and due to their respective conditions.

Osade continues, “I don’t expect Japanese stocks to start climbing quickly in the summer, but overseas investors are presently reviewing them to determine when and in which companies they should invest. If Japan overcomes its power-shortage challenges during the July to September period, there is a strong possibility that overseas money will begin to flow back into the Japanese stock market.”

Osade concluded, “This is why Japanese companies need to emphasize their overseas IR activities.”

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Merrill Lynch Japan Securities to Hold Annual ‘Japan Conference’ One of Japan’s Largest Seminars for Institutional Investors

One of the best opportunities for Japanese companies to promote themselves to overseas investors is the Japan Conference hosted by Merrill Lynch Japan Securities. This year marks the eighth annual event, and it will run from September 12 to 16. The Japan Conference welcomes over 1,500 institutional investors, company representatives, and other leaders from Japan and abroad. More than 300 overseas investors are also expected.

Renowned leaders well-versed in the economy from both Japan and overseas will provide keynote addresses and participate in panel discussions. The content of the conference is rich and includes seminars by sector analysts as well as individual one-on-one meetings between investors and Japanese companies. The event offers an unsurpassed opportunity to review Japan as an investment destination.