


Eastspring Investments – Japan Dynamic Fund

eastspring
investments

A Prudential plc company 

Market review

In May, Japan's stock market rose despite concerns over sluggish economic growth and tepid consumer spending. The Nikkei 225 struggled to break above 40,000 points following its early 2024 rally, resulting in a mixed performance for the month. Interest rates continued to hover at near-zero levels in response to the country's fragile domestic consumption. Governor Kazuo Ueda emphasized the importance of resetting inflation expectations and the difficulty in determining Japan's neutral interest rate. Meanwhile, Deputy Governor Shinichi Uchida expressed optimism about overcoming deflation soon and projected wage growth. Core inflation, which excludes fresh food and energy prices, eased to 2.2%.

Key contributors

Month-to-date, Sumitomo Mitsui Financial Group, Furukawa Electric and Resona were key absolute contributors to Fund performance.

Sumitomo Mitsui Financial Group outperformed in May, with investors digesting the company's full year earnings release. The results came in ahead of expectations, with net income up 20% year-on-year. The company has managed its balance sheet well by shedding non-core assets and creating room for elevated returns to shareholders and investments abroad. On top of capital management, the company has also showed stringent cost management. SMFG has a diversified income stream with meaningful exposure and leading positioning in consumer finance and credit card businesses. It has also been focused on improving the profitability of its loan book through mix improvement. The company is moving to the offence by investing in its businesses in Asia.

Sentiment around Furukawa Electric was also positive as the company released its full year earnings. Although sales and income declined year-on-year, they surprised on the upside and were ahead of previous forecasts from management. The company has also recently been seen as an AI and associated infrastructure play which has boosted the shares. We are taking profits and reallocating to ideas with more expected upside.

Resona Holdings' share price continued to rise over the month. Higher domestic interest rates would be a big benefit to regional banks including Resona's portfolio across Japan, with their large domestic loan books, and the sector has been outperforming as expectations of the BOJ lifting rates rise. The company has started and could play a further role in consolidation of regional banks in Japan. Its consolidation of regional banks in Kansai region could give it a better pricing power, streamline costs and improve profitability. In addition, investors digested the company's full year earnings announcement over the month, with net profit coming in ahead of the previous target and up 7.9% year-on-year.

Key detractors

Month-to-date, Kubota Corporation, East Japan Railway and Tosoh were key absolute detractors from Fund performance.

Kubota is a leading global agriculture machinery company. The company has underperformed due to concerns surrounding the US housing market. In the shorter term, weather issues in Thailand had concerned the market, in addition to raw material inflation impacting profit margins. We feel that the industry in US is well concentrated and displays strong pricing power and expect this to offset raw material cost push over the medium term. Fundamentally, we take comfort in the company's leading position of its legacy diesel compact machinery and the significant valuation support, even after factoring in the rise in R&D and CapEx costs. Investors also digested the company's first quarter results and, whilst operating profit was near flat year-on-year, overseas revenue increased on a year-on-year basis.

East Japan Railway's share price underperformed during the month. This was despite the company publishing a set of full year results that showed net income up almost 100% year-on-year and an increase in profit margin. We have observed the company has remained focused on cost control in the rail business and increasing the value of its real estate assets. Our trend operating margin and capital expenditure assumptions for the rail business conservatively account for possible lower trend ridership level versus pre-pandemic level, as well as provisions for both large scale maintenance and CapEx programs. East Japan Railway plans to increase non-railway business profit share from 30% to 40% in five years' time. We have factored in higher capital expenditure as a result and our conservative return on asset assumptions are consistent with an asset-heavy business model for commercial property. East Japan Railway exhibits supportive trend valuation and the Fund built a moderate position amid share price underperformance.

Tosoh is mainly engaged in the provision of chemical products and is one of the largest chlor-alkali manufacturers in Asia. The company supplies the plastic resins and an array of the basic chemicals used in many aspects of modern life. Tosoh's petrochemical operations supply ethylene, polyethylene, and functional polymers, while its advanced materials business serves the global semiconductor, display, and solar industries. Tosoh has also pioneered sophisticated bioscience systems that are used for the monitoring of life-threatening diseases. The share price underperformed over the month, with investors digesting the company's full year results. Net sales decreased around 5.5% year-on-year, attributed to issues including the scheduled maintenance at the Nanyo Complex and plant troubles at the Yokkaichi Complex, whilst operating income increased around 7% year-on-year.

Fund activity

During the month, the Manager sold shares in companies where valuations look relatively less compelling and bought shares in companies where valuations look relatively attractive compared to other high conviction positions. A number of positions were trimmed, including Furukawa Electric, Honda and NEC, whilst the position in Koito Manufacturing was added to. The Manager also initiated new positions in Yamato Holdings and H.U. Group, and closed the position in Mitsubishi UFJ Financial Group.

Strategy and outlook

Although Japanese equities have had a phenomenally strong 2023, we believe that the long-term structural drivers of reflation, reforms and reallocation remain in place and corporate earnings can continue to improve over the coming years. Firstly, inflation appears to be becoming more entrenched and this is allowing companies to increase their pricing, benefiting margins. The labour market is also tighter than it has been in many years placing upward pressure on wages. This is key for a sustained move out of the deflationary era and we think this is the best chance Japan has had in a generation to do so. Secondly, the Tokyo Stock Exchange initiative and ongoing corporate governance reforms are positive for the value end of the Japanese equity market, where there is larger potential to improve Return-on-Equity and see a corresponding valuation re-rating. We expect the trend of share buybacks to continue in 2024 as more companies address the excess cash on their balance sheets and we are encouraged by corporate management teams' willingness to cut costs, restructure underperforming business units and unwind extensive cross shareholdings. Lastly, the capex environment appears to be improving, driven by the trends of re-shoring, friend-shoring and the green transition.

Sector attribution (one month)

Sector (%)	Average weights			Effects		
	Fund	Benchmark	Relative	Allocation	Selection	Total
AUTOS	9.3	11.2	-1.9	0.12	0.28	0.41
FINANCIALS	13.0	13.7	-0.8	-0.06	0.38	0.32
TECHNOLOGY	18.9	21.4	-2.5	-0.01	0.31	0.31
DOMESTIC	15.2	12.5	2.7	-0.06	0.27	0.21
TELECOMMUNICATIONS	-	4.2	-4.2	-0.03	-	-0.03
GLOBAL BASICS	16.8	12.9	4.0	-0.08	-0.33	-0.41
INDUSTRIALS	10.2	9.5	0.8	0.00	-0.68	-0.68
DEFENSIVE	14.5	14.7	-0.2	0.00	-0.70	-0.70
CASH AND EQUIVALENTS	2.1	-	2.1	-0.02	-0.03	-0.05
Total	100.0	100.0	-	-0.14	-0.49	-0.63

Top 10 absolute contributors (one month)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
SUMITOMO MITSUI FINANCIAL GROUP	4.9	2.0	0.68
FURUKAWA ELECTRIC CO LTD	1.8	-	0.41
RESONA HOLDINGS INC	3.8	0.4	0.31
BROTHER INDUSTRIES LTD	2.4	0.1	0.19
RICOH CO LTD	5.8	0.1	0.18
CREDIT SAISON CO LTD	1.2	-	0.18
DIC CORP	1.6	-	0.15
SOHGO SECURITY SERVICES CO	1.3	-	0.11
T&D HOLDINGS INC	1.0	0.2	0.10
TAISEI CORP	2.8	0.2	0.09
Total	26.7	3.0	2.41

Top 10 absolute detractors (one month)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
KUBOTA CORP	2.4	0.4	-0.33
EAST JAPAN RAILWAY CO	4.9	0.4	-0.27
TOSOH CORP	2.7	-	-0.24
KIRIN HOLDINGS CO LTD	3.8	0.3	-0.21
ASAHI KASEI CORP	2.5	0.2	-0.18
SUMITOMO CHEMICAL CO LTD	3.7	-	-0.17
AGC INC	2.1	0.2	-0.13
NISSAN MOTOR CO LTD	3.2	0.2	-0.11
SUMITOMO HEAVY INDUSTRIES	2.7	-	-0.10
SUNDRUG CO LTD	0.7	-	-0.10
Total	28.8	1.8	-1.84

Top 10 absolute contributors (year to date)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
SUMITOMO MITSUI FINANCIAL GROUP	4.6	1.9	2.13
RICOH CO LTD	5.8	0.1	1.72
FURUKAWA ELECTRIC CO LTD	2.2	-	1.58
RESONA HOLDINGS INC	3.2	0.3	1.46
NOMURA HOLDINGS INC	2.6	0.4	1.35
HONDA MOTOR CO LTD	3.7	1.4	0.89
BROTHER INDUSTRIES LTD	2.3	0.1	0.78
TAISEI CORP	2.6	0.2	0.66
SUMITOMO HEAVY INDUSTRIES	2.9	-	0.55
CREDIT SAISON CO LTD	1.6	-	0.54
Total	31.4	4.4	11.67

Top 10 absolute detractors (year to date)

Holdings (%)	Average weights		Contribution to fund performance
	Fund	Benchmark	
NABTESCO CORP	2.6	-	-0.28
SUMITOMO CHEMICAL CO LTD	3.5	0.0	-0.23
SUNDRUG CO LTD	0.8	-	-0.08
IZUMI CO LTD	1.0	-	-0.06
Total	7.9	0.0	-0.66

Statistics

Characteristics	Fund	Benchmark
Number of holdings	39	217
Price to earnings (number of times)	17.4	19.9
Price to book (number of times)	1.0	1.8
Forward 12-month dividend yield (%)	3.1	2.2
Active share (%)	90.7	N/A
Tracking error (%)	6.8	N/A

Additional notes

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Paying Agent: NPB-New Private Bank Ltd, Limmatquai 1/am Bellevue, 8024 Zurich

United Kingdom - Facility Agent

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