

## Market views



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This year few conversations about the Japanese equity market have ignored the strength of the Japanese Yen against other major currencies. Although this factor is perhaps better understood as weakness elsewhere (with the Euro battered by concerns about member solvency, and the US dollar falling ahead of further quantitative easing), either way the market has reacted negatively to the prospect of Japanese export champions losing their competitive edge in the global market.

It is worth noting at this stage that the Yen's strength is not unambiguously bad for the Japanese economy - it increases purchasing power for suffering consumers, and it raises the prospect of Japanese companies being able to make advantageous acquisitions. And several companies have prospered nonetheless. Honda, through a combination of excellent cost management and a high portion of local production in key markets, is almost as profitable at Y85/\$ as it was at Y115/\$. Fanuc, a robotics company, and Nidec, an electronics components maker, are two more large companies which have forged ahead under strong management.

And now, in the midst of all the angst about the currency, the Yen has begun to weaken again. This raises an interesting question. With so many shares having been hurt by the Yen strength, and with the Topix itself trading at close to an all-time low on price to book (barely 1x compared to a longer-term average of 1.6x), is there the potential for a significant upward move in the overall Japanese market? And if so, which stocks will lead the way? Will it be the likes of Honda, Fanuc, and Nidec, all of which are currency-sensitive stocks, or have they already run too far?

The Royal London fund seeks to invest primarily in shares which are out of favour with the market. The current situation seems to offer plenty of scope for this style. Instead of adding more capital to Honda, where the quality is near-universally acknowledged, why not Toyota? Certainly Japan's largest car company has had a tough year, with recall and quality problems, and latterly the currency problem has highlighted the downside of having so much production in Japan. But the stock is trading at only the book value of its assets (relative to a ten year average of 1.5x) and its management and employees have an excellent longer-term track record. Rather than adopt large sector positions based on a top-down view, this is the sort of stock-specific opportunity we will be studying closely in the coming weeks.

### Bull points

- Near all-time low valuations
- Potential for Yen weakness as a catalyst

### Bear points

- Burden of current Yen level on the export sector
- Uncertain economic outlook

Source: rlam as at 25th November 2010 unless otherwise stated.

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