THIS MONTH'S TOPIC

2021 investment case in equities and how Japan fits into it

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Although the global recovery began to be priced in last year, the current pro-cyclical rotation is likely to continue. Because of the dollar's weakness, we prefer emerging markets, but Japan has other things going for it that, at the very least, can help balance out the portfolio.

2021, a pro-cyclical year for global equities

In a year of economic recovery, the risk/reward ratio is generally favourable to equities. Although some countries, particularly in Europe, are still in lockdown, the month of January is starting well with the release of the vaccines, the Brexit deal, and a Democratic victory in the US Senate conducive to a major recovery plan.

▶ Equities will benefit from a strong recovery in profits

With global growth expected to amount to more than +5% in 2021, global profits should rebound by more than +25% (Chart 1). The economic cycle has only just begun, and the growth phase will be spread out over several years. Market indicators corroborate this constructive vision. The dollar is weakening, which is contributing to the rise in inflation expectations in the United States, expectations that are themselves correlated to the cyclical/defensive ratio and to industrial raw materials prices, the latter itself being a proxy for trends in global profits.

▶ Part of the recovery in profits will be absorbed by a decline in P/Es

Equity markets anticipated an economic recovery as early as 2020 following the strong support of central banks and governments and the November announcement of the arrival of the vaccines just after the US elections. As profits fell at the same time, P/Es rose to extreme levels, sometimes to levels not seen since 2000, with a notable difference between the two periods. The 2000 PERs referred to top-of-the-cycle profits, whereas current PERs are based on bottom-of-the-cycle profits. The recovery in profits will therefore be partly consumed by a fall in P/Es. However, liquidity provided by the central banks and the low interest rate context will allow PERs to remain at sufficiently high levels to allow equity prices to rise between +5% and +10% over the year.

▶ The climax of volatility was reached in 2020 and flows should now favour equities

Historically, volatility tends to decrease as profits recover. It is also a function delayed from 18 months to two years in the evolution of monetary policy (chart 2). The high point of Fed rates having been reached in 2019, It is therefore highly likely that volatility will fall structurally in the months and years to come.

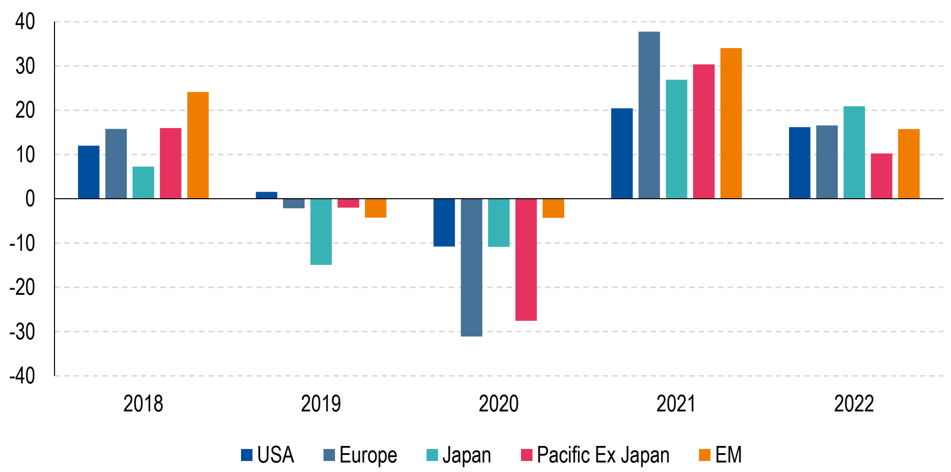
This should encourage a return of flows to equity markets, especially as high yield spreads have tightened, and alternatives for risky assets are therefore less generous.

▶ Risks are of course still present, but the risk/reward ratio is favourable

There are three kinds of risks. By far the most dangerous would be doubts cast on the vaccine's effectiveness and an uncontrolled resurgence of the virus. Beyond this black swan, a second type of risk would be a delay in the economic

Equity markets are likely to end the year higher than they began it

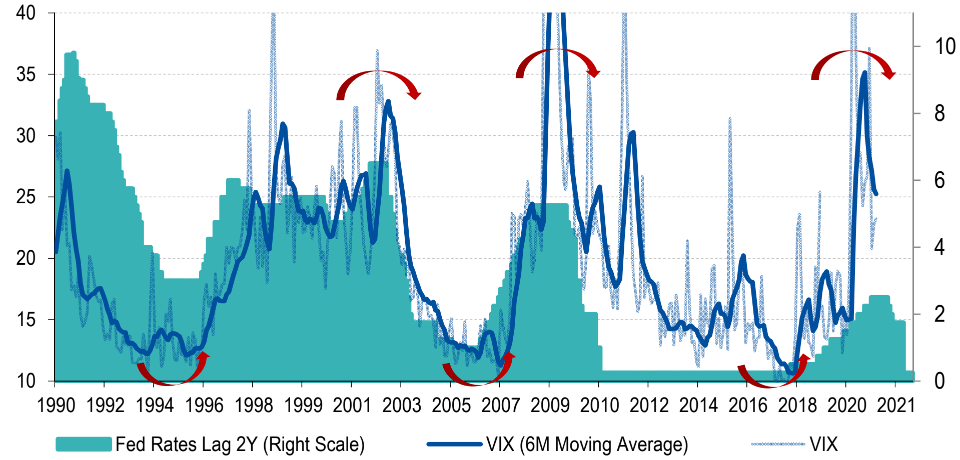
1/ **EPS Growth**



Source: Ibes, Datastream, Amundi Research - Data as of January 20, 2021

THIS MONTH'S TOPIC

2/ **VIX and Fed rates**



Source: Datastream, Amundi Research - Data as of January 20, 2021

recovery (caused by lockdowns, delayed vaccinations, etc.). This would rather create opportunities insofar as central banks and governments remain supportive.

Finally, the third type of risk consists, on the contrary, particularly in China and/ or the United States, in the possibility that the recovery would be sufficiently underway to envisage a withdrawal of support. However, while central banks may well end up being tested by the markets in this respect, it is likely that their initial response will be rather reassuring.

The pro-cyclical rotation is likely to continue

How to apply this pro-cyclical approach in an equity portfolio?

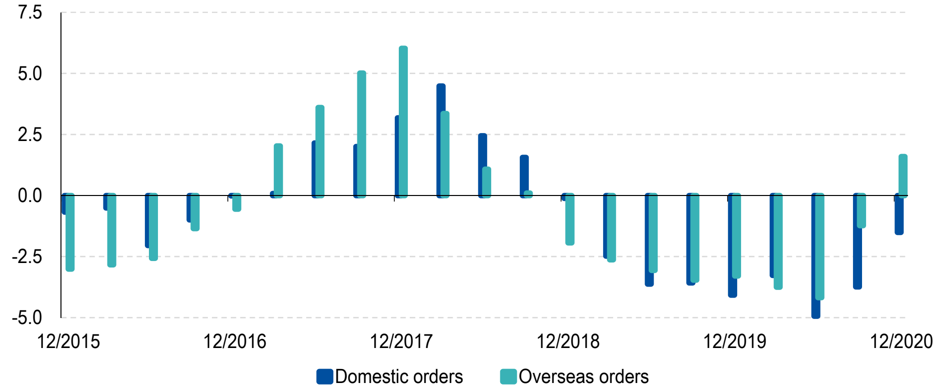
In terms of style, small caps are a great candidate. This asset class, which always outperforms at the start of the cycle, has already rebounded well, but its potential has not yet reached its limits. As for the Value style, which is lagging behind other cyclicals, it offers attractive potential for catching up. Finally, economic recoveries are usually not favourable for quality stocks, but given the low level of rates and the ongoing disruption, we believe that this style, as well as ESG equities, constitutes a valid complement to cyclical stocks to balance the risk of a portfolio, by accepting a longer-term investment horizon and as long as it is not overpaid. Geographically, this is reflected in a preference for emerging markets especially since currencies have broken out against the US dollar. However, Japan and the euro zone, also cyclical and value, should also do well at least initially.

Often atypical, the case of Japan seems interesting to us to highlight

A two-track economic recovery

Despite the winter pandemic outbreak in Japan, we note that external demand gained further momentum in Q4. Overseas machine tool orders grew by 15.9% YoY in Q4 after two years of contraction, while domestic demand stumbled (Chart 3). The Japanese market appears to be shrugging off the latest deterioration in mobility data, and focusing more on the economy's global demand exposure as well as the structural push by Suga administration towards digitalisation and carbon neutrality. So, unlike the European markets, the MSCI Japan more than erased the decline triggered by the pandemic in 2020 and ended the year with records (+7% in 2020, against -4% in Europe and +19% in the

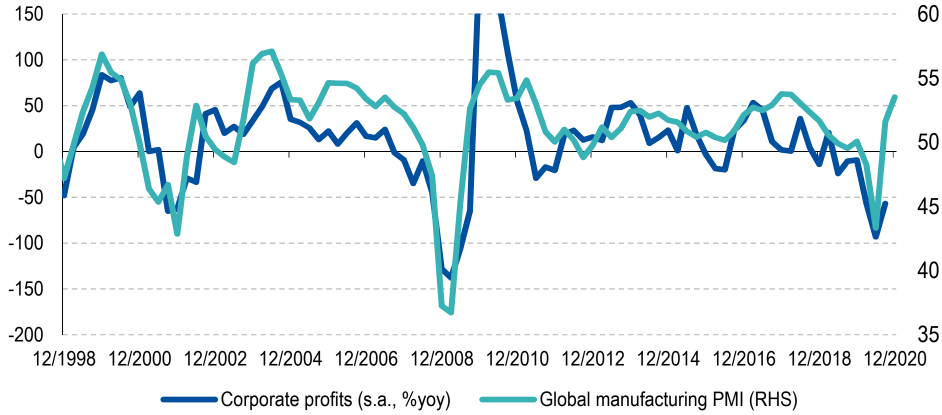
3/ **Japan's machine tool orders: domestic versus overseas**



Source: Economic and Social Research Institute, CEIC, Amundi Research as of January 14, 2021

THIS MONTH'S TOPIC

4/ **Japan's profit growth and global PMI**



Source: Ministry of Finance, CEIC, JPM, Amundi Research as of January 12, 2021

United States). The Nikkei index has even returned to its August 1990 level, which is still 30% off its all-time high of December 1989, but shows that structural changes underway in Japan are paying off.

An obvious candidate for a cyclical recovery

As a cyclical and inexpensive market, Japan has something to offer

In fact, Japan's corporate profits tend to move in tandem with the global cycle, making it an ideal candidate for the cyclical recovery trade. With global PMI firming up, Japan's corporate profit growth started to recover in Q3 and is expected to strengthen further (Chart 4). Rebased to 100 in 2019, MSCI Japan's profits should rebound, according to IBES, to 137 in 2022, i.e., a little less than emerging markets (148) but more than the United States (125) and Europe (112). The sector composition of the Japanese market also makes it better positioned to ride the global cyclical recovery. The top two sectors of the market are industrials and consumer discretionary, which account for, respectively, 21% and 18% of the MSCI index, or 39%, against 22% for the world average. In total, cyclical sectors, including technology, amount to 2.3 times the weight of defensive sectors. Certainly, a little less than for emerging markets (2.9x) but more than for the United States (1.9x) and Europe (1.1x).

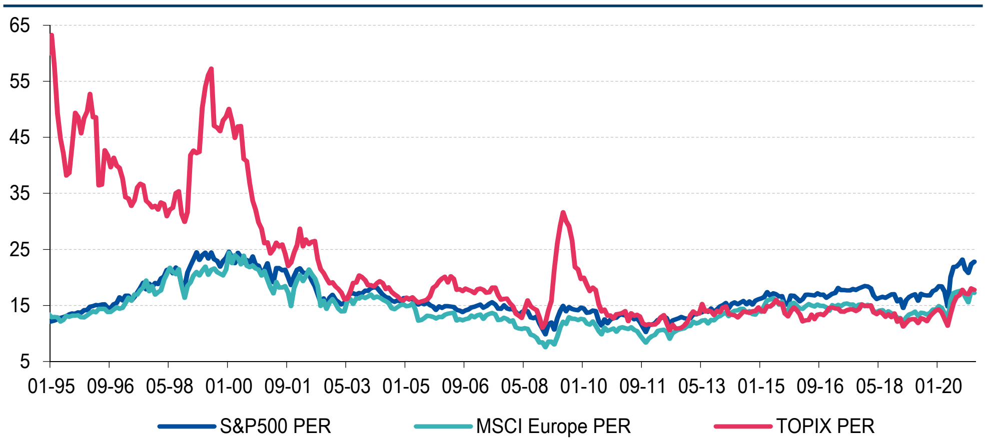
An attractive valuation

Since the 1980s bubble burst, the stratospheric PER of the Japanese market has gradually converged downwards towards the level of the PERs of other developed markets in the early 2000s (chart 5). Today, roughly equivalent to that of the euro zone (17.8x against 17.4x for the MSCI EMU), it posted a 23% discount, compared to the 12-month forward PER of the US market (23.1x). Adjusted for the cycle, the discount even reaches 35% (CAPE at 22.1x, against 33.8x for the United States). Supplemented by other valuation measures, such as Dividend Yield, Price Cash-Flow and Price to Book Value within a composite indicator, it also appears more attractive than its competitors'.

Debt under control at company level

Japanese companies started to deleverage after the bubble burst in the late 1980s. The Asian crisis of 1997, the bursting of the internet bubble, and the Great Financial Crisis have only encouraged this fundamental movement. The net debt

5/ **12 Months Forward PER**



Source: Ibes, Datastream, Amundi Research, data as of January 20, 2021

THIS MONTH'S TOPIC

of non-financial companies vs. balance sheet assets, for example, has halved over the past 20 years (from 30% to 15% according to Worldscope). This is despite the fact that distributions to shareholders have increased at the same time, notably due to buybacks, authorised since 2001 and encouraged by Prime Minister Abe, something that has also helped to improve the appeal of Japanese equities. The financial situation of Japanese companies has therefore improved considerably.

The risk? A correlation to the yen, which could act as a headwind

The link between the relative performance of the Japanese index and the MSCI World is resistant. The Japanese market underperforms when the yen appreciates against the dollar and vice versa. In a context of a downward trend in the greenback, this parameter, without being strongly negative, does not therefore work in favour of the Japanese market. In the end, however, it seems to us that the strengths of Japan in this phase of economic recovery are greater than this risk, especially since the regular purchases of ETFs by the BoJ, especially in downturns, help reduce the market volatility.

Conclusion

Although the global economic recovery was priced in as early as 2020, it should materialise in 2021. Part of the rebound in profits will be absorbed by the fall in PERs, but, provided that monetary and government policies remain accommodative, as we believe they will, equity markets are expected to end the year higher than they started. The ongoing pro-cyclical rotation should also continue. Regionally, while the weakness of the dollar makes us prefer emerging markets, Japan has other interesting arguments to surprise on the upside this year or at least to help balance a portfolio. It is indeed very cyclical, attractively valued, with a sound financial situation at the company level, and lower volatility than elsewhere.

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