Can the warming China-Japan relations bring opportunities to Japan market?

Against the backdrop of escalating trade disputes between China and the US in the second half of 2018, we have seen that Sino-Japanese relations are striding towards a new era, from competition to cooperation, from simple trade relations to all-round economic, cultural and scientific exchanges. China and Japan's "honeymoon" is coming soon.

This year marks the 40th anniversary of the signing of the China-Japan Treaty of Peace and Friendship. In May, Premier Li Keqiang visited Japan. In October, Prime Minister Abe of Japan paid the first visit to China in nearly seven years. The two countries decided to renew a bilateral currency swap arrangement worth 200 billion yuan. Chinese and Japanese companies also signed more than 50 memorandums on projects such as infrastructure development in countries along the "Belt and Road". President Xi Jinping is expected to make a state visit to Japan in the first half of 2019. All these initiatives show that Sino-Japanese relations are improving and reaching new heights.

After experiencing the "Lost 20 Years", Japan's economy began to recover, driven by the three arrows of Abenomics. Morgan Stanley in a recent in-depth report on Japan also said that, as one of the fastest-growing economies among the G7 nations, Japan's private capex is also rising for the first time since the end of the Bubble Economy era.

What does the improvement in Japan-China ties mean at this special historical moment? What are the growth drivers in the Japan market? **We invited Dr. Zhao Jian, Head of Atlantis Finance Research Institute, and Taeko Setaishi, Fund Adviser at Atlantis Investment Management to share their views with us:**

Question: As Japan's largest trading partner, what does the improvement of Sino-Japanese relations mean for Japan's economy and capital market?

Zhao Jian: The US-led trade protectionism is seriously affecting the global trade landscape. The broad-based WTO framework will gradually be replaced by the new and deepening intra-regional trade relations in the next few years. This just brings huge strategic opportunities to Sino-Japanese trade relations. After the US announced its withdrawal from the TPP, Japan has strengthened its trade and economic ties with China. Statistics also show that the trade relationship between the two countries has entered a "new era": In 2017, the bilateral trade volume between China and Japan reached US$297.3 billion, rising 10% year-on-year and a record high for many years; Japan's investment in China increased by 5%, ending five consecutive years of negative growth; Japan's trade balance with China also achieved a surplus after a lapse of six years. As of October this year, China-Japan trade volume has accumulated to US$271.6 billion, an increase of nearly 11% year-on-year, again hitting the highest level in recent years. China overtook the US to become Japan's largest trading partner in 2007, and Japan has become China's third largest trading partner. Since then, bilateral economic and trade dependence has been enhanced rapidly, and the industrial complementarity has continuously improved. China-Japan ties have increasingly become an important force affecting the global economy.

China and Japan can deepen its mutually beneficial cooperation in three aspects under the new trade pattern and framework: First, as two manufacturing powers, continue to cooperate on the industrial chain, especially to strengthen trade relations in high-end manufacturing, electronic and electrical products and other emerging industries, to achieve a win-win situation. At present, the two countries have both competition and complementarity in the manufacturing industry chain area. Building and perfecting benign competition and cooperation relations are very beneficial to the long-term development of the two economies. Second, as East Asian neighbors, the two counties can cooperate on "Belt and Road" projects on the national level. For Japan, China's "Belt and Road" strategy has provided enormous investment and trade opportunities, and China also needs Japan's deep participation. Third, as two countries that are about to enter/already entered the aging society, they can carry out in-depth cooperation in aging care. Japan has been transitioning into an aging society for many years, and has gained rich technology and experience in aging care area. Japan's market is still very broad. China is also entering an aging society with a larger market. The similar filial piety culture, physiological characteristics and eating habits of the two countries mean that their cooperation in elder care industry has advantages that other regions do not have.

Taeko: The year 2019 will be event-filled in Japan and, besides President Xi's visit, there will be the incumbent emperor's abdication (April), the installation of the new emperor, (May), G20 summit (June), upper house elections (July), and sales tax increase (October). Tourism might be a sector sensitive to country-to-country relations. Several years ago, Chinese tourism to Korea stopped when there was a semi-official boycott. Inbound tourist flows from China to Japan are still climbing, benefitting hotels, retailers, and cosmetics companies.

External demand accounts for about 15% of Japan's GDP, and China accounts for approximately 20% of Japan's exports (about equal to the U.S.'s share). China is a major buyer of Japanese automobiles and parts, machinery and machine tools, and electronic devices. This trade flow is dependent upon the state of China's economy with "relations" being a subordinate consideration.

Question: In recent years, Japan has actively implemented the "Nation-building upon Tourism Strategy". Are there any new trends in Japan's tourism industry?

Taeko: Tourism has become a growth industry in Japan due to the influx of Asian tourists. Four to five years ago, Japan was unwelcoming to Asian tourists but P.M. Abe targeted this for promotion by granting visas upon arrival. This coincided with LCCs (low cost carriers) which made travel to Japan from Asia affordable. Presently 70% of the in-bound flow comes from China, South Korea, Taiwan, and Hong Kong. In-bound tourists are expected to reach 31.7 million (+11%) in 2018 and grow to 33.7 million in 2019. Taking the ski destination Hokkaido as an example, in 2017, the total number of foreign visitors exceeded 2.79 million, an increase of 121% over 2016. Among them, the largest number of tourists were from China, reaching more than 660,000, rising by 122% year-on-year. Touring sites, eating, and shopping are the largest draws; however, spending trends have changed. During the initial surge of in-bound demand, travelers to Japan were mainly interested in buying electrical appliances (especially rice cookers), quality infant items (diapers, powdered milk), and cosmetics. Interest in the first two groups has diminished but cosmetics, medical devices, and OTC medicine purchases remain very brisk and benefit department stores and discounters (especially Don Quiote). Furthermore, visitors are becoming repeat-customers and consequently are venturing into different regions beyond visiting the main cities of Tokyo, Osaka, and Fukuoka. Hospitality companies (mid-priced hotels, Japanese style restaurants) have benefitted with hotel occupancy rates averaging in the 85%-90% range, and we have several in our portfolios.

Question: Against the backdrop of the US-China trade war, what kind of role will Japan play between China and the US?

Taeko: Japan seeks no role in the US-China trade dispute. Given the existing tense mutual relationships, neither of the antagonists see Japan as having a (presumably) mediating role. Japan, threatened with tariffs of 25% on its automobile exports to the US, prefers to stay on the sidelines, stay unnoticed, not antagonize either country, and let the two directly resolve the problem when they are ready to do so.

Question: Does the trade war affect investors' confidence in the Japanese market? What will be the driver of Japan's economic growth for the next few years?

Taeko: The principal drivers of Japanese economic growth over the medium term will be private sector capital expenditure and household consumption. If the trade dispute between China and the US is resolved, external demand could also make a positive contribution to growth. Japan's output gap, labour shortage, and cash flows are the impetus for higher capex while rising incomes are boosting consumption.

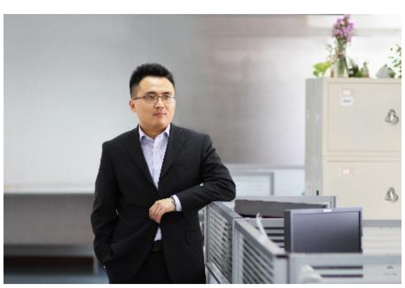
The trade war has not had any noticeable impact on investor attitudes regarding investment per se in Japanese equities. That said, if the US were to assess tariffs on Japanese automobile and auto parts imports, as it has threatened to do, Japan's economic growth would come to a halt and equity valuations would be severely discounted.

Question: Japan stock market has fallen sharply following the shares plunging in the US recently. Do you think Japan market is still a safe haven?

Taeko: While the Japanese yen has been assigned the status of a "safe haven currency", the Tokyo stock market (TSE) is unlikely to be regarded as an equity safe haven. Firstly, international investors, who account for 70%-75% of TSE turnover, consider Japan a warrant on global growth given the significance of trade in Japan's economy. This introduces a supplementary cyclical element to the TSE lacking in other developed market stock markets. In addition, the TSE is Asia's largest, open stock market with a full complement of accompanying structured products. Thus it has become the chosen vehicle for global hedge funds, utilizing futures, to establish short (or long) positions not just on Japan but also Asia without actually taking an equity position. By way of example, 48% of October's TSE turnover was short transactions. This is not the structure of a "safe haven".

Taeko SETAISHI
Fund Manager

Taeko is the manager of Atlantis Japan Opportunities Fund. With over 28 years experience in securities research and asset management in Japan. She joined AIRC in 1996, is a Japanese citizen and is based in Tokyo. After graduating, she joined Schroder Securities. In 1986, she worked with James Capel and in 1993 joined Schroder Investment Management as an Analyst and Fund Adviser. Taeko is a graduate of Pitmans College.



Zhao Jian
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About Atlantis

Atlantis Investment Management was founded in London in 1994 by three star ex-Schroders fund managers. Ms Yang Liu, now Atlantis' Chairman and Chief Investment Officer, joined Atlantis in 2002 as a Fund Manager. As Yang grew to become one of the most recognised names in China investing, she acquired the Atlantis group in 2009. Under Yang's direction, Atlantis' center of gravity has shifted to China. Our headquarters is now in Hong Kong, where we occupy the 35th floor of the Centrium skyscraper high above the Central district. Since inception, Atlantis has been dedicated exclusively to Asian equity strategies. Our two main investment focuses, China and Asia, are operated independently and led by our dedicated portfolio managers. While the non-investment functions (risk management, legal and compliance, trading, operations, marketing and investor relations) are provided from Hong Kong, our investment and research professionals are based regionally in Asia – Hong Kong, Shanghai and Singapore. This enables our investment professionals to focus on what they do best and provide us our key advantages: local, street-level intelligence. Atlantis currently offers a wide range of services for global institutional investors through the Atlantis funds and via segregated mandates.