FIM CAPITAL

Investment Management

BRIEFING

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Japan - Who wants in?

In the early 2000s, after a decade of economic and stock market stagnation, The Economist famously questioned whether Japan still mattered to global investors with the cover story "The Irrelevance of Japan". The headline attracted a great deal of attention because it was both unusual and controversial.

Many people found it hard to accept because Japan was still the world's second-largest economy behind the United States. Indeed, at $4.2 trillion, it was nearly three times China's GDP. Even back then, there was a school of thought that wonderful things were in store for Japan if only it could shift from its reliance on industrial manufacturing to an economy balanced by domestic demand and service industries.

But the Nikkei 225 Index had fallen 75% in ten years, and in the wake of the Asian Crisis in 1998, the headline seemed to perfectly capture the moment of maximum market pessimism with leading commentators saying Japan was finished, soon to be replaced by China as the prominent Asian growth story.

There was some justification for the gloomy outlook. The Japanese economy had stalled after the bursting of the property bubble in 1989, leading to years of weak growth and deflation.

To give some context to the absurdity of that bubble, at its peak, it was widely reported that the grounds of the Imperial Palace in Tokyo, an area of less than ½ square mile, was worth more than all the real estate in California.

The big Japanese banks, having been inextricably linked as they were to the property bust, were totally impaired, burdened by bad loans and unable to support any economic expansion. Every sector of the economy was affected, and all of this was reflected in the stock market. For years, foreign investors and institutional asset allocators viewed Japan as a value trap; the market looked cheap, and full of world-class companies, but never seemed to recover sustainably for any length of time.

Indeed, it gave rise to the slightly perverse situation where Yen weakness was often viewed as the only catalyst to buy the market because the currency effect boosted the foreign income, and therefore profits, for the large-cap exporters like Canon, Toyota and Sony who had export ratios in excess of 80%.

With the stock market often at the whim of the fluctuations in the Japanese Yen, investors commitment to the stock market was wafer-thin. Every now and then, when foreign investors appeared to re-engage with Japanese equities, encouraged by bullish headlines such as "The Sun Also Rises", they were actually just dancing near the door and were quick to take profits. The whole thing contributed to a chronic underweight of Japanese equities in global portfolios for years. Something had to change.

That change came in the form of the economic program launched by Japanese Prime Minister Shinzo Abe after he returned to power in December 2012. It involved money-printing on a massive scale, spending programs with stimulus packages and structural reform. The strategy was officially called "The Three Arrows" but became known as "Abenomics".

The intervention turned Japan from a market largely ignored by investors into one of the world's biggest reflation trades. Foreign investors poured money into Japanese equities, exporters benefited from the weaker currency, and corporate governance reforms gradually encouraged companies to focus more on shareholder returns.

It was a good start, but it didn't all go to plan. Raising taxes twice in the middle of it all was a policy error and the idea of structural reform felt distinctly unrealistic to a corporate culture clinging on to a tradition resistant to change. Economic growth remained modest by international standards. Improvements to productivity were limited and wage growth was weaker than hoped for.

These factors remained so embedded in the economy that, 10 years later, Japan sailed through the inflationary aftermath of the Covid pandemic that was so troublesome for the rest of the G7. Whereas the central banks of the US, UK and Europe all had to aggressively raise interest rates from 2022 onwards to battle rampant global inflation, the Bank of Japan kept interest rates, almost unbelievably, at minus 0.1%.

The interest rate differential with the rest of the world weakened the Yen, which inevitably led to Japan importing lots of global inflation. But in the spring of 2024, slightly fortuitously, it kick-started the largest annual pay demands for 30 years. In short, workers got higher pay, consumers spent more and companies felt able to raise prices. Convinced that Japan was finally escaping its long-running deflation trap, the Bank of Japan found the confidence to start the journey back to more normalised interest rates with a base rate hike to a largely symbolic 0.1%.

But the message was clear and, unlike the other main central banks who had to say their actions were in response to out-of-control inflation, the Bank of Japan could spin the line that all of the negative interest rates, money printing and other extraordinary measures had largely, and finally, fulfilled their purpose.

Since then, it is evident that inflation is being driven increasingly by domestic demand and services rather than imported energy and goods costs. For Japan's government, central bank and even corporations, the elusive dream of self-sustaining wage-price cycle has become a welcome reality.

If one is looking for evidence that this time really is different, a quick look at government bond yields among the G7 economies is revealing. Six months ago, as we entered the new year, the Japanese 10-year bond yield was 1.55% versus the German 10-year yield of 2.86%. Today, the Japanese yield has risen dramatically to 2.62% with the German yield virtually unchanged at 2.87%. Furthermore, and unlike previous cycles, this has happened without tripping up the Japanese stock market where the headline Nikkei index is up nearly 40% year to date.

Of course, the AI and semiconductor boom has had something to do with it. Japan is, and always has been, a leader in advanced electronics and those sectors have led the index upward, beating even a resurgent banking sector.

Stocks like Shin-Etsu Chemical and Kyocera may not be household names but their expertise and involvement in component manufacturing of silicon for semiconductor chips, ceramics and other critical parts, make them key to the infrastructure build out for AI data centres. They are just some of the names that we monitor closely in the funds in FIM client portfolios.

But away from the AI theme, there has been a fundamental change taking place in corporate Japan. Some corporate behaviour has been influenced by the Tokyo Stock Exchange itself which has forced companies trading on a price-to-book value of less than 1x, typically those sitting on large cash deposits or lazy balance sheets, to publish their plans for investment for improving returns. The name-and-shame nature of the disclosures appear to be working and may be evidenced by dividend payments, and share buybacks, that now account for double the total returns than they did 10 years ago; something unimaginable at the turn of the century.

It's been a long time coming. But those with a long enough memory will remember what it was like trying to invest in Japan back then and will see that, this time, it really is different.

Christian Holland

"Houston, we have a problem"

3 historic IPOs, data centres in space, the world's first trillionaire; what could possibly go wrong?

1 million seconds ago, I was sat at my desk, staring at a blank word document while furiously Googling "how to write an article"; 1 billion seconds ago, excited passengers were boarding the Eurostar for the very first public journey beneath the English Channel; 1 trillion seconds ago, in 29,800 B.C, the average caveman was more concerned with the ongoing Ice Age than whether data centres should one day orbit the Earth. The historic floating of SpaceX, which resulted in Elon Musk having a net worth almost triple the GDP of his home nation of South Africa, is the first of three highly anticipated 'Mega-IPOs', with Anthropic and OpenAI waiting in the wings, having the biggest of shoes to fill. With the introduction of what will likely be three new trillion-dollar companies, I can't help but think, how much AI is too much AI?

Over 40% of the S&P 500's total market capitalisation is made up by AI and AI-adjacent companies, with the titans in the Magnificent 7 typically steering the direction of trade on any given day. Sprinkle in another $3-4 trillion to the mix to account for the 3 newcomers and this figure will jump to over 50%. Further afield, half of the South Korean KOSPI index is accounted for by just two companies, Samsung Electronics, and SK Hynix, both chipmakers. In Taiwan, the situation is even more exaggerated, with Taiwan Semiconductor Manufacturing alone amounting to a staggering near 50% share of the index. If one of our discretionary portfolios were to be this concentrated, the client would be well within their rights to give us an ear-bending for jeopardising their hard-earned money!

Global markets are historically one dimensional. In February, the S&P 500's top 10 holdings surpassed its previous peak concentration, edging past the days of American Telephone & Telegraph and Standard Oil in 1932, and the 'Nifty Fifty' era of the early 1970's. During the height of the latter, valuations of the top companies went skyward, with an average price-to-earnings (P/E) ratio of 42x, more than the double that of the broader market. 2026 tells a similar tale, with the disparity between the P/E ratios of the top 10 stocks and the remaining 490 reaching levels akin to the dot-com bubble. It is in these extremes where interesting patterns are to be found, and potential opportunities arise. In scenarios like this, where the wider market has been rendered inexpensive, the bottom 490 stocks have typically outperformed by 2% on average over the next 5 years. Furthermore, as the adage goes, 'the bigger they are, the harder they fall', which is historically accurate in this context, as the heavyweight stocks tend to be susceptible to a more dramatic fall than the rest of the index, as the hype starts to fade and their accelerated growth starts to unwind, falling victim to their own success.

While many investors have benefitted from tech stocks going to the Moon, the concern is whether they can keep pulling rabbits out of their hat in order to propel themselves to Elon Musk's lofty ambition of Mars. The AI explosion has added trillions to global markets, fuelled by new models like Anthropic's Claude entering the fray, exponentially expanding capacity in data centres, and even the slightly far-fetched proposal of putting data centres in space (have these people never seen 2001: A Space Odyssey or Alien?!). Spending is outstripping earnings, however, with hyperscalers, the companies providing cloud computing services that act as the infrastructure for AI, pumping $1 trillion into capital expenditure across 2025-26, accruing billions of dollars of debt in the process. If this exorbitant spending isn't justified by eventual revenue and profit growth, it is difficult to see a world where this doesn't become a material issue with investors, which would surely cascade into wider markets.

The mention of a downturn is perhaps apt, as all of the periods mentioned thus far (1930s, Nifty Fifty, dot-com bubble) have preceded or coincided with a downturn that wiped in excess of 20% off indices worldwide. This is perhaps even more of a worry with the current lineup of mega-caps as previously, while there has been a high level of concentration, those at the top of the index have been quite diversified when it comes to industry (oil, tobacco, utilities etc), a far cry from the Magnificent 7 (tech, tech, tech etc). The lack of variation, both in weighting and industry, means that significantly fewer plates need to stop spinning before the markets start to worry, even more so in a time of bubble speculation, whipsawing oil prices and the most powerful man in the world starting wars on a whim.

When markets start to get turbulent, the "Say the line, Bart" scene from The Simpsons springs to mind, although instead of "I didn't do it", the word on investment professionals' lips is predominantly 'diversification'. The gauge of a portfolio's performance over the long term is generally defined not by gains in prosperous markets, but rather by how well the value is held when the going gets tough, highlighting the necessity for a well-balanced portfolio that isn't dependent on any one industry, market or currency. Over the 18 months or so that I've spent at FIM, I have learned a lot from the decades of experience within the Investment Team, allowing me to now witter away in this article, and the countless discussions regarding asset allocation and micro- and macroeconomics that used to leave my brain spinning (and still do occasionally!) reinforce the idea that a steady hand with a clear objective is the best way to navigate the maelstrom that is investment management.

Matthew Jones

Out of this World

It has already been quite a year, and one where we are only half-way through! After a difficult first quarter, markets advanced with intent in the three months to the end of June. Concerns over the overvaluation of technology shares, inflation, and war, outweighed a surge in demand for memory and data storage chips, shares in which underpinned the rally. So strong was this demand that Apple and Microsoft announced 20% increases in the price of their laptops and game consoles as the cost of two main types of computer memory chips leapt.

DRAM ('dynamic random-access memory') chips, like fast-twitch muscles, are needed for quick computer response times. The more ponderous, but capacity rich, NAND 'flash' chips are needed to store long-term data. The latest versions of each have been bought by so-called hyperscalers to occupy vast datacentres, either existing or under construction. In turn, these massive facilities are crucial for the anticipated growth of artificial intelligence. Hence the sudden shortage.

If all of that wasn't enough, then **Space X**, the Elon Musk-inspired venture into space infrastructure made its debut on the US market in June. This much hyped and ultimately successful public offering of shares, which valued Space X at around $2 trillion, will be followed by high profile share offerings from the AI software developers **Anthropic** and **OpenAI**. Each is expected to raise up to $1 trillion. Given that it is only a few years since **Apple** became the first company ever to breach the $1 trillion market capitalisation watermark, these numbers are truly staggering. With this sort of growth, it is little surprise that the US equity market now represents 71% of the developed world equity index.

Outside the rarified atmosphere of AI and space, stock markets were driven by the daily movement of a somewhat older commodity: oil. The price of this particular Grand Old Duke of York was duly marched to the top of the hill and back again as the conflict in Iran began, shifted back and forth, and then ended, at least on paper. Aside from the huge cost, both financial and humanitarian, we are now back where we started. The price of Brent crude oil has retreated to $70 having closed nearly 65% higher only a few weeks ago. But in between, market volatility was extreme and global trade spooked by the temporary closure and possible monetisation of a key trading marine thoroughfare.

Having started it all, President Trump subsequently declared an end to the conflict on no fewer than 38 recorded occasions. Not only did these announcements wrongfoot the markets, but they also confused the enemy, traditionally a key signatory in any peace accords. Maybe this was the intention. It was a boon (or bust) for day traders and the like who thrive on volatility and snappy, unpredictable news flow.

The movement in the price of oil dominated headlines outside of the AI space for much of the quarter. Second guessing which way the market would move on any given day was just that, a guess, and not at all helpful to the art of portfolio management. It was possible to lose, or gain, a lot of money very quickly on a single presidential comment. Our general investment brief, however, is to protect the downside as well as participating in the upside. When markets are shedding billions on a single 'Truth Social' release from a US president under pressure, then having confidence in the long-term quality and relevance of the assets in your portfolio is reassuring. Other than the occasional top-slice from certain tech shares, it was noteworthy that the FIM investment team saw little reason to alter their macro strategy much, if at all, during the quarter.

Closer to home, the UK is steeling itself for a 7th Prime Minster in a decade. This is a depressing statistic highlighting a political system which now seems more intent on party infighting than on running the country. That they do this so badly, ought to be a matter of shame. UK economic growth is scraping along the bottom, and the record tax collection is all too frequently squandered on insanely expensive infrastructure projects, a bloated health system or a lopsided welfare state. For investors, the result is that the UK equity market trades at a persistent discount to much of the world, most notably the US where more and more UK companies are choosing to (re)list their shares. The rising value of the US market means that firms there are taking advantage of the valuation gap and snapping up an increasing number of UK businesses. **Tate & Lyle**, **Spectris and Darktrace** have all fallen to US predators over the last 12 months. The airline **EasyJet** and property company **Segro** may be next. Other parts of the world are struggling too, but it is a poor consolation to measure performance against Europe's basket cases, when the UK has/had the necessary building blocks to do so much better.

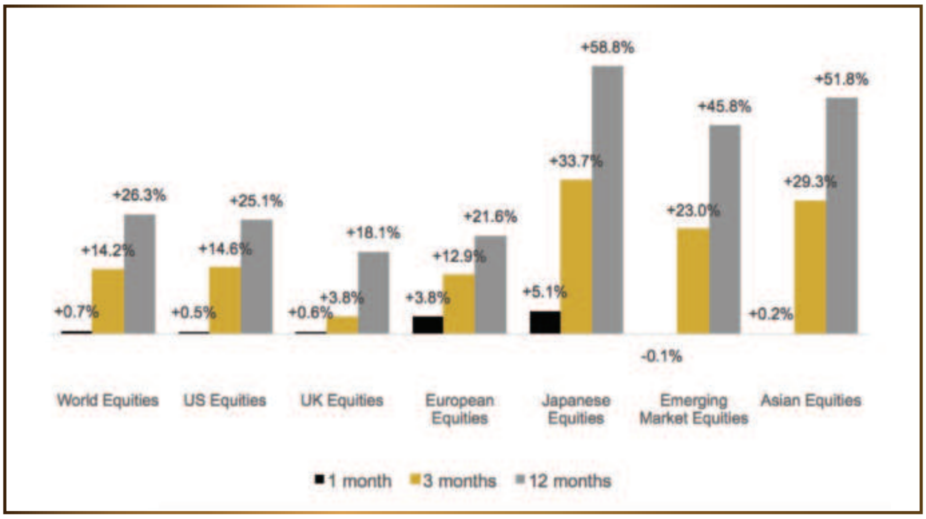
Whilst on this theme, an investment into UK government debt, or gilts, has lost investors over 4.4% annualised over the last 5 years, before inflation. US Dollar debt, whilst hardly inspiring, has lost just 0.2% in Dollar terms over the same period. Since COVID, government bonds have been a thoroughly depressing place to be. Thankfully, good quality corporate debt has performed better with yields on some of Europe's finest businesses like **L'Oreal** and **Axa**, dipping below those paid by the equivalent government bond – the ultimate price of shame for any western democracy.

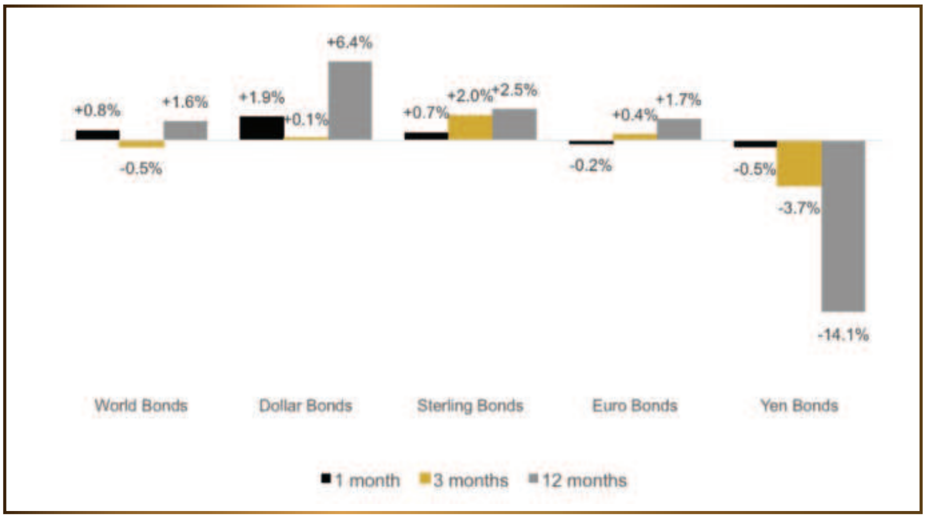
For all that, though, the world is breathing a little easier than it did a few weeks ago. Of course, problems exist. The better parts of the market look as fully valued as they always do, politics are increasingly vacuous and likely to become more so as we edge towards the US mid-term elections in November (which may see the Republicans lose control of one or even both US houses). And yet profitability from many companies is strong and technology is moving tremendously fast, potentially making businesses far more efficient. From a healthcare perspective there are some exciting developments in disease prevention in the pipeline made possible by advances in AI whilst investing into outer space is no longer the preserve of science fiction wonks. It is truly a remarkable time to be an investor.

Russell Collister

World Equity Returns (GBP)

Equity markets staged a rip-roaring rally from the March lows, with growth driven almost entirely by the AI theme which more than offset concerns over a potential prolonged conflict in the Middle East.



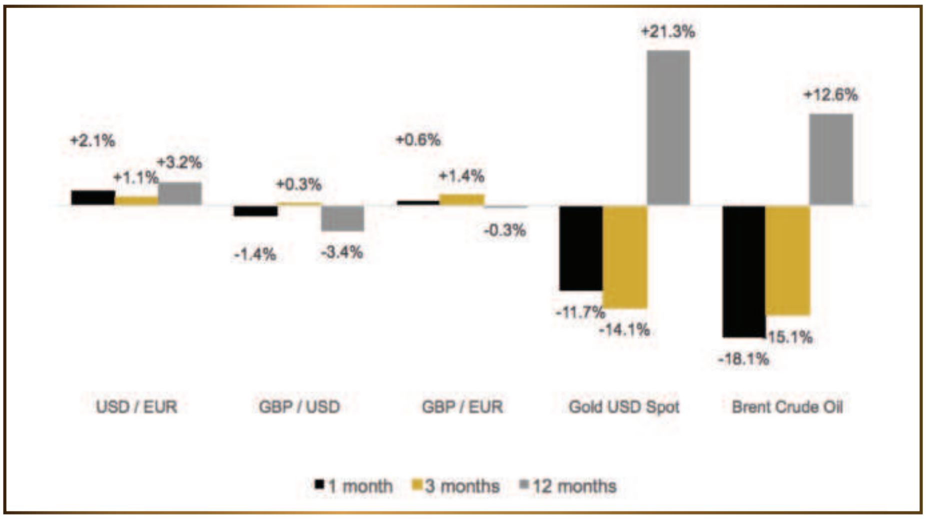


Bond Market Returns (GBP)

Bond markets generally ended the quarter where they began, with concerns over the potential for a rapid rate hiking cycle being tempered by an apparent resolution to the conflict.

Currency Movements

The price of gold and oil experienced big declines over the quarter, although each are trading a lot higher than they were in March 2025. The US Dollar also strengthened over the last 3 months, benefitting from a tailwind of safe-haven demand and resilient economic data.



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The investment team at FIM Capital Limited hopes that you have enjoyed reading our articles this quarter. If you are not currently receiving our Investment Briefing on a regular basis but would like to do so in future, or you wish to inform us of a change in your contact details, please contact us at enquiries@fim.co.im. Equally, please contact us if you no longer wish to receive our Briefing and we will remove you from our mailing list.

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