Lazard Japanese Strategic Equity Fund

Commentary

2Q
2024

Market Overview

Japanese equities rose modestly in the second quarter, as investors trod cautiously amid mounting concerns about whether the catalysts for Japan's stock market rally were sustainable.

The period was marked by uncertainty about the Bank of Japan's interest rate policy path. The Japanese central bank left interest rates unchanged in April and June but warned that it could raise them for a second time this year in July amid signs of growing inflationary pressure. The BOJ adopted the more hawkish tone as the yen continued to weaken, at one point falling to a 38-year low against the US dollar at the end of June. Investors grew increasingly worried about the adverse impact a weakened yen was having on the Japanese economy, including by boosting inflation. A weak yen raises the costs of imports and hurts consumer spending, which accounts for half of Japan's economic activity. Data released during the period suggested that Japan's economy shrank in the first quarter and that core inflation rose for the first time in three months in May due to higher electricity costs. In the second quarter, the yen depreciated 5.9% against the US dollar.

Investors were also closely monitoring developments in the US, where worse-than-expected inflation data for the first three months of 2024 stoked fears that the progress that the Federal Reserve had made in slowing price growth had stalled, potentially opening the door for no rate cuts in 2024 or perhaps even additional rate hikes. As expected, the US central bank held interest rates steady in May and June, leaving them at their highest level in nearly 23 years. With inflation data turning positive again for April and May, the world's most influential central bank stated that an interest-rate hike was unlikely, though it did acknowledge that progress in driving domestic inflation down towards its 2% target had slowed. In a further acknowledgment that domestic inflation has been stickier than anticipated, the world's most influential central bank predicted in June that it will likely lower borrowing costs just once in 2024—down from the three rate cuts it had projected late last year—and reiterated its warning that it would not move until it saw more data indicating that inflation was slowing sustainably. After retreating in April due largely to concerns about the US interest rate outlook, global equity markets rallied in the last two months of the period on revived hopes that the Fed will begin a monetary easing cycle this year. The yield on the benchmark 10-year US Treasury note ended the quarter at 4.40%, 19 basis points (bps) higher than three months earlier.

The conclusion of the first-quarter corporate earnings season painted a mixed picture of how company profits have held up as inflation pressure continued to exert itself. According to FactSet data, 57% of the companies in the TOPIX reported positive earnings surprises, which was below the 59% beat rate over the past four quarters. The first-quarter earnings growth rate increased 12.2% from a year earlier.

Against this backdrop, the TOPIX advanced 1.7% in the second quarter, raising its year-to-date gain to 20.2%. (Index performance is measured as a total return and in yen terms.)

Portfolio Review

In the second quarter, the Japanese Strategic Equity fund advanced in absolute terms and outperformed its benchmark, the TOPIX. (Excess return is measured net of fees and in yen terms.)

Stock selection in the Electric Appliances, banks, and Transportation Equipment sectors boosted relative performance. Overweight exposure to the Banks sector contributed. Underweight exposure to the Transportation Equipment sector was beneficial to relative performance.

Stock selection in the Retail Trade, Information & Communication, and machinery sectors undercut relative performance. Overweight exposure to the Retail Trade sector detracted.

Contributors

• Shares of TDK traded higher on positive sentiment about the electronic parts maker's upside potential after it announced a breakthrough in next-generation solid state battery technology. Shares received an additional boost from increased demand for its products, thanks to the growing focus in artificial intelligence (AI)-linked driving.

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• Shares of Sumitomo Mitsui Financial Group gained after the lending giant reported quarterly earnings that topped consensus estimates and issued a better-than-expected guidance. Shares received an additional boost when the company announced another share repurchase program.

• Shares of Hitachi traded higher after the industrial conglomerate reported quarterly earnings that exceeded consensus estimates and issued a better-than-expected guidance. Shares received an additional boost when the company announced a share repurchasing program.

• Property and casualty insurer Tokio Marine saw its stock price climb on expectations of cross shareholding reduction, which would result in excess capital being returned to shareholders.

• Shares of Kansai Electric Power appreciated after utility company reported better-than-expected quarterly earnings and increased its dividend forecast for the new fiscal year.

Conversely, the largest detractors to relative performance were:

• Furniture retailer Nitori, which imports most of its products, saw its stock price fall after reporting significantly weaker-than-expected quarterly earnings and disappointing guidance due to ongoing weakness in the Japanese yen. A weak yen raises the cost of imports, thus adversely impacting household consumption.

• Shares of Denso faltered after the auto parts manufacturer reported disappointing quarterly earnings.

• Traders sold off shares of THK on profit-taking after the linear motion provider reported quarterly results that were in line with expectations following a strong year-to-date stock price appreciation.

• Shares of Square Enix traded lower after the game software developer reported significantly weaker-than-expected quarterly earnings and issued a disappointing guidance as the company undertakes a restructuring of its business.

• Shares of Seven & I Holdings slid on negative sentiment about the convenience store chain operators plans to list its Ito-Yokado business. Shares came under addition al pressure from will be adversely impacted by Japan's dimming outlook for consumption.

Recent Activity and Trade Rationale

We initiated a position in broker Nomura Holdings based on our belief that company will be a large beneficiary of changing risk attitudes by Japanese investors. In addition, management appears more receptive to addressing overcapitalization which could result in increased shareholder returns.

We liquidated the fund's position in railway operator East Japan Railways after shares recovered from their pandemic-driven lows. While we expect continued earnings recovery, it is now a lower conviction idea.

Outlook

A balanced near-term outlook may result in more sideways movement in Japan's equity market, similar to what we have observed over the past few months. However, we remain upbeat over the medium and long term for Japanese equities because we see two key themes continuing to play out: corporate governance improvement driving better capital efficiency and higher shareholder return, and the shift from deflation to inflation gradually transforming consumer behavior.

We believe the market is still underestimating the potential of these two secular tailwinds. While price-to-earnings valuations have reverted to their 10-year average, the enterprise value (EV) to EBITDA ratio is still significantly lower than in other developed markets, and in our view, this is a better indication of the potential for improved capital efficiency. Market skepticism has grown recently as previously strong performance has moderated, but we view periods such as this as an opportunity for investors to revisit their strategic weighting to Japanese equities.

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