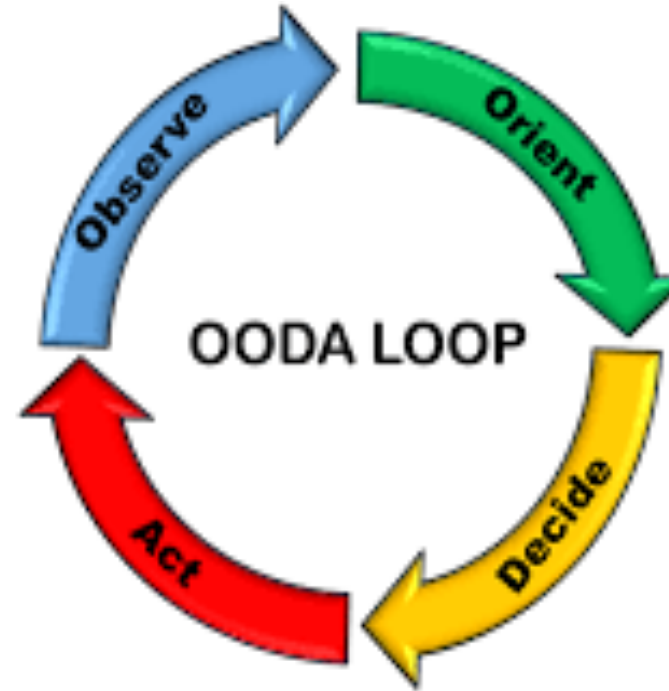


The Case for Japan (and against China?)

A Conversation with Andrew McDermott
of Mission Value Partners

14 December 2023



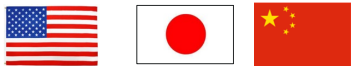





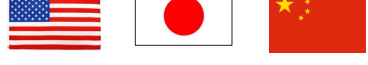


Capital Allocation @Hedgeye

David Salem

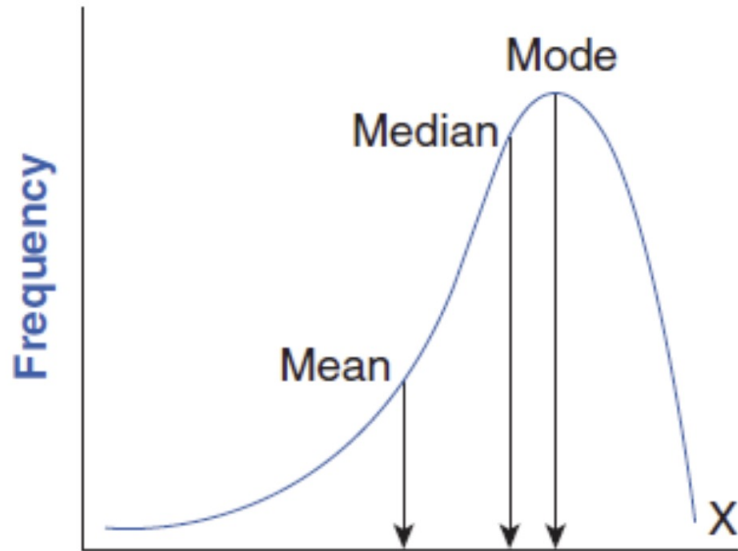
Potential Topics and Points of View for Today

Placement of flags is for aesthetic reasons alone with no rank ordering intended

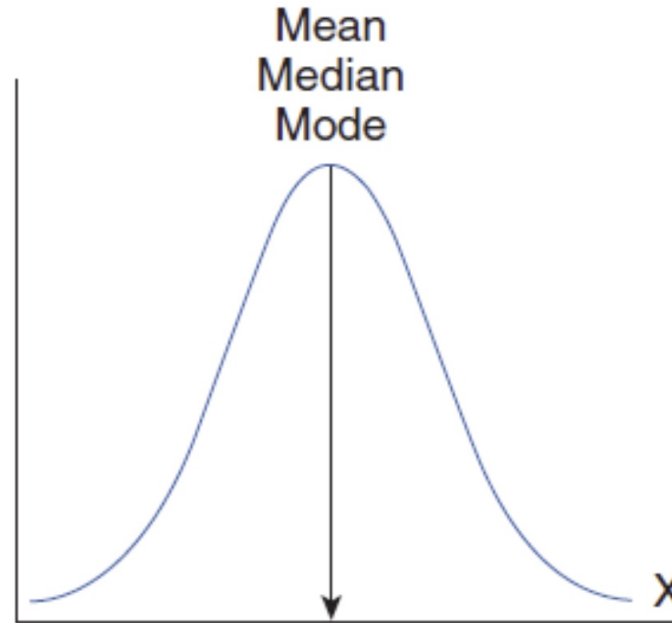
Preserve & Enhance ▼	Capital Allocators (OPM or Their Own)	U.S. Citizens (Current or Aspiring)	Patrons of U.S. Higher Ed (Current or Potential)
Investable Wealth <ul style="list-style-type: none"> - Rule of Law / Property Rights - Corporate Governance - Securities Analysis - ROIC - Innovation - Productivity inc. AI & Robotics - Energy inc. Nuclear Power - Demographics - Debt inc. Public at all levels 			
Personal Rights & Privileges <ul style="list-style-type: none"> - Fundamental Freedoms - Mobility of Human & Financial Capital 			
National Interests & Ambitions <ul style="list-style-type: none"> - Homeland Security - Territorial Expansion - Intangible Expansion (Soft Power) - Technology Transfer inc. Theft - Foreign Direct Investment (In or Out) - Trade & Capital Accounts 			

One Geek's View of Effective Investing

(a) Negatively skewed

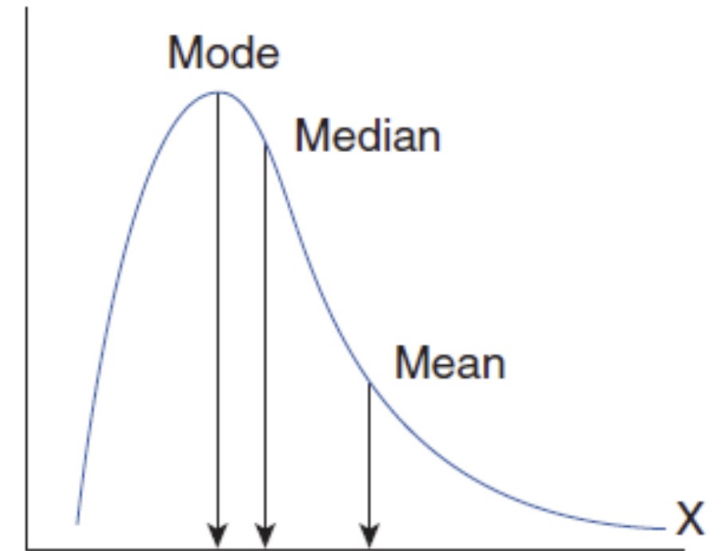


(b) Normal (no skew)

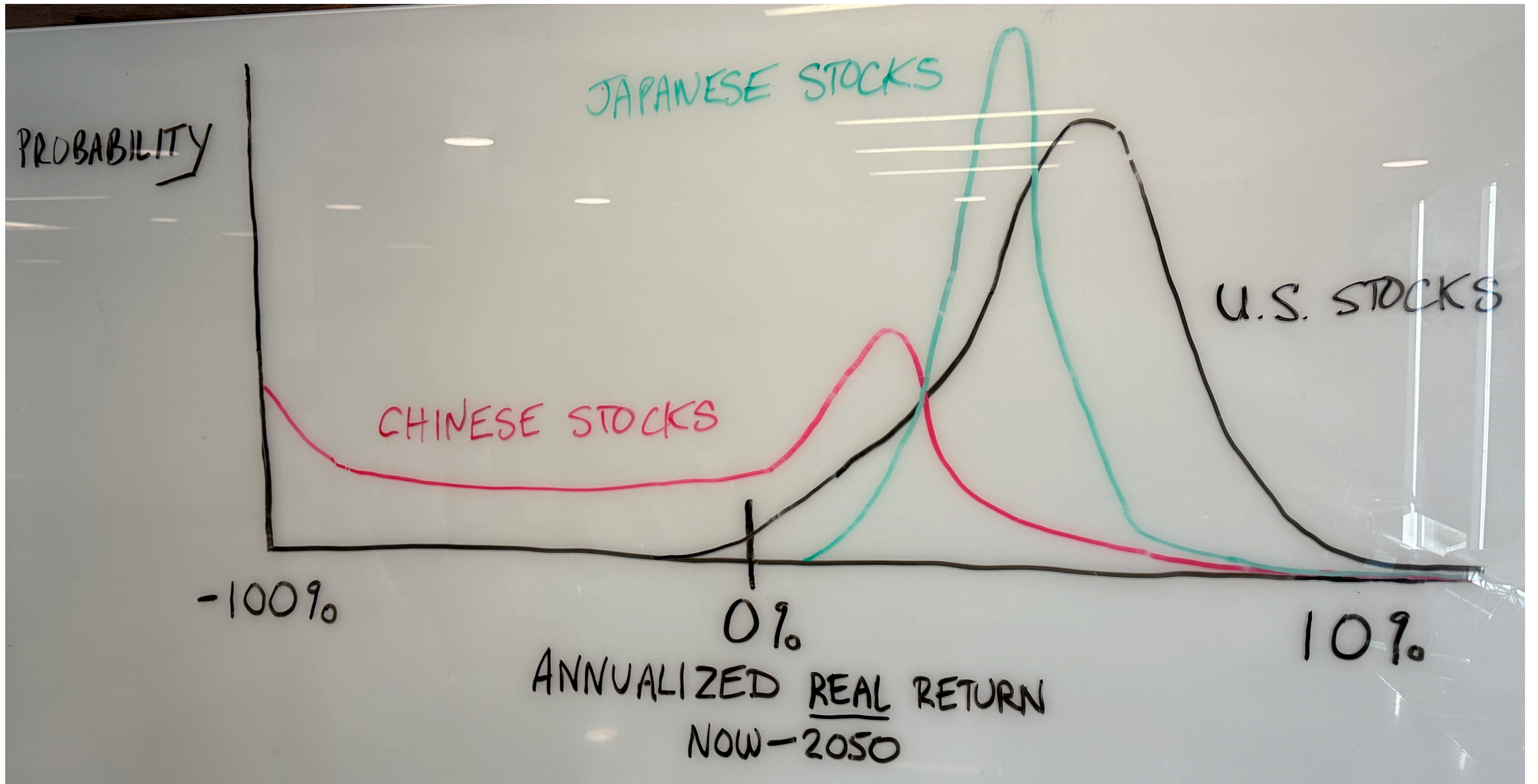


The normal curve represents a perfectly symmetrical distribution

(c) Positively skewed



Pictures Are Worth Many Words



Come again?

“After reflecting on what we know, what we learned, and our view of current markets, **we have decided to trim our Chinese equity exposure to about benchmark weight.** Until we see the Chinese government become more transparent about their longer-term goals and put the Chinese people and the country back in front of politicians, we think reducing position sizing makes sense. To be clear, we hope and expect to look back on this as a mistake, but a manageable mistake. The Chinese equity markets continue to be dominated by retail traders and represent a strong alpha-generation opportunity. However, the beta of Chinese markets remains in question, and maintaining a meaningful overweight in China could be very painful if things eventuated poorly. **As of now, we expect this positioning to stand for the long term.** We will continue to have some exposure in China, but will focus even more on other geographies where the potential for unexpected government policy surprises is lower and where we can maximize our ability to benefit from superior manager selection.”

-- Chief Investment Officer of Major U.S.-Based

Institution

Quarterly Commentary for Q3 2023

(emphasis added)

Old habits die hard

“I’m not so sure that that Belt and Road advantage is so critical especially since a lot of that Belt and Road is in hard infrastructure. And once you build it, everyone can use it.

You build a port, you build a railway. I mean, I’d rather Americans build it than the Chinese because it redounds more to American shareholders, sure. But you’d rather the port be built than no one build the port. Because that then leads to more economic growth.

And if the US is the largest economy in the world, **the U.S. benefits disproportionately from more economic growth around the world. That’s just kind of a reality. It’s what globalization is all about.” ***

*-- Prominent geopolitical analyst
TEDTalks -- 21 November 2023*

** Emphasis added*

“Iceberg, right ahead”

-- *Frederick Fleet, Lookout, RMS Titanic, 14 April 1912*

“My side bet with [redacted] is that the next group of Ivy leaders called before Congress will be endowment CIOs who will be asked to explain why they are long Chinese weapons manufacturers and short Japan in all its forms.”

-- *Andrew McDermott, Mission Value*

Partners

permission)

Recent email to journalist (shared with

OODA-Based Analysis of Japanese Stocks

Observe

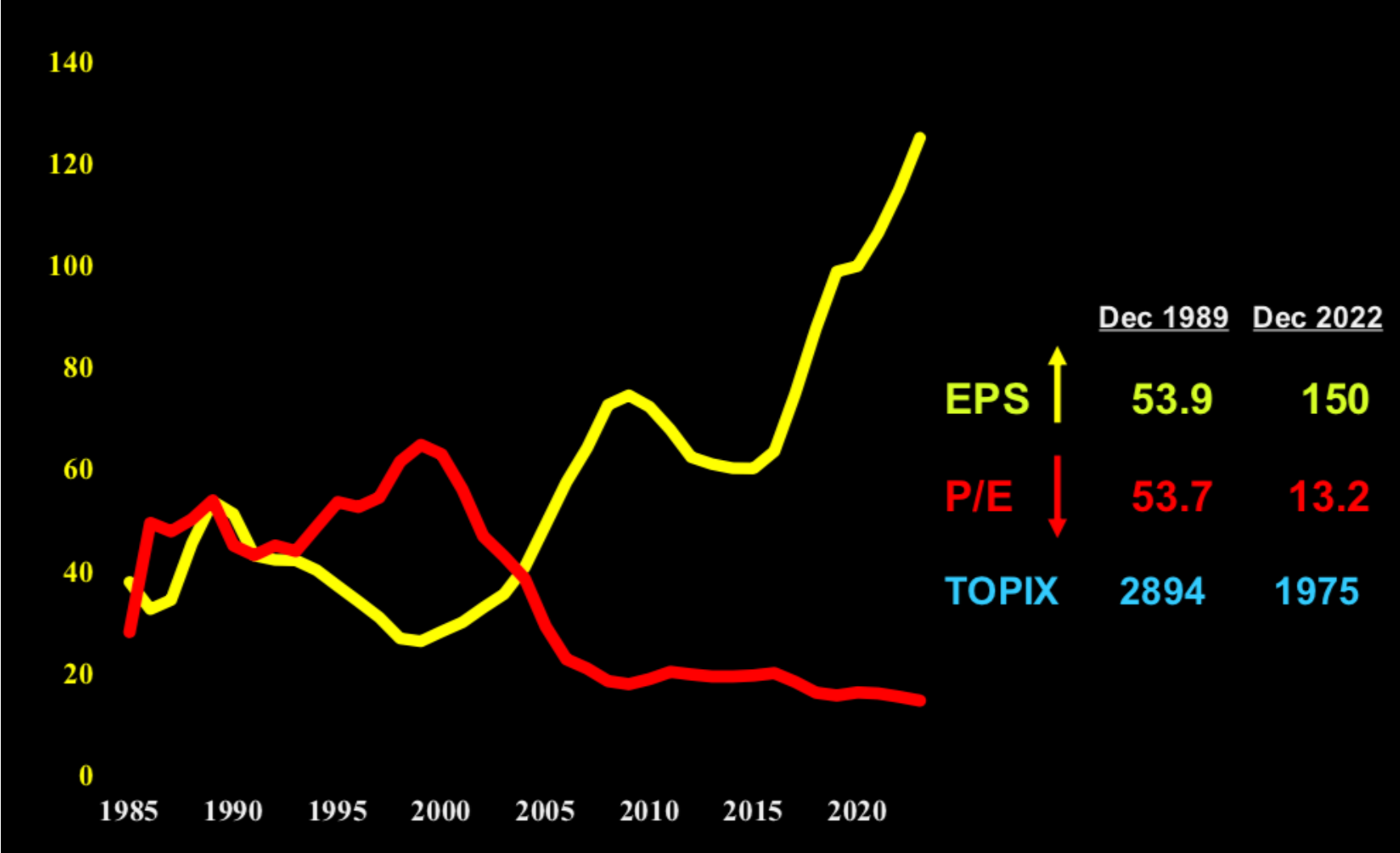
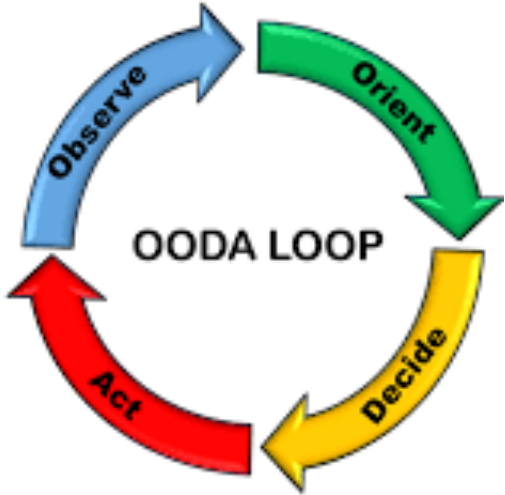


Diagram courtesy of Jesper Koll

OODA-Based Analysis of Japanese Stocks

Observe

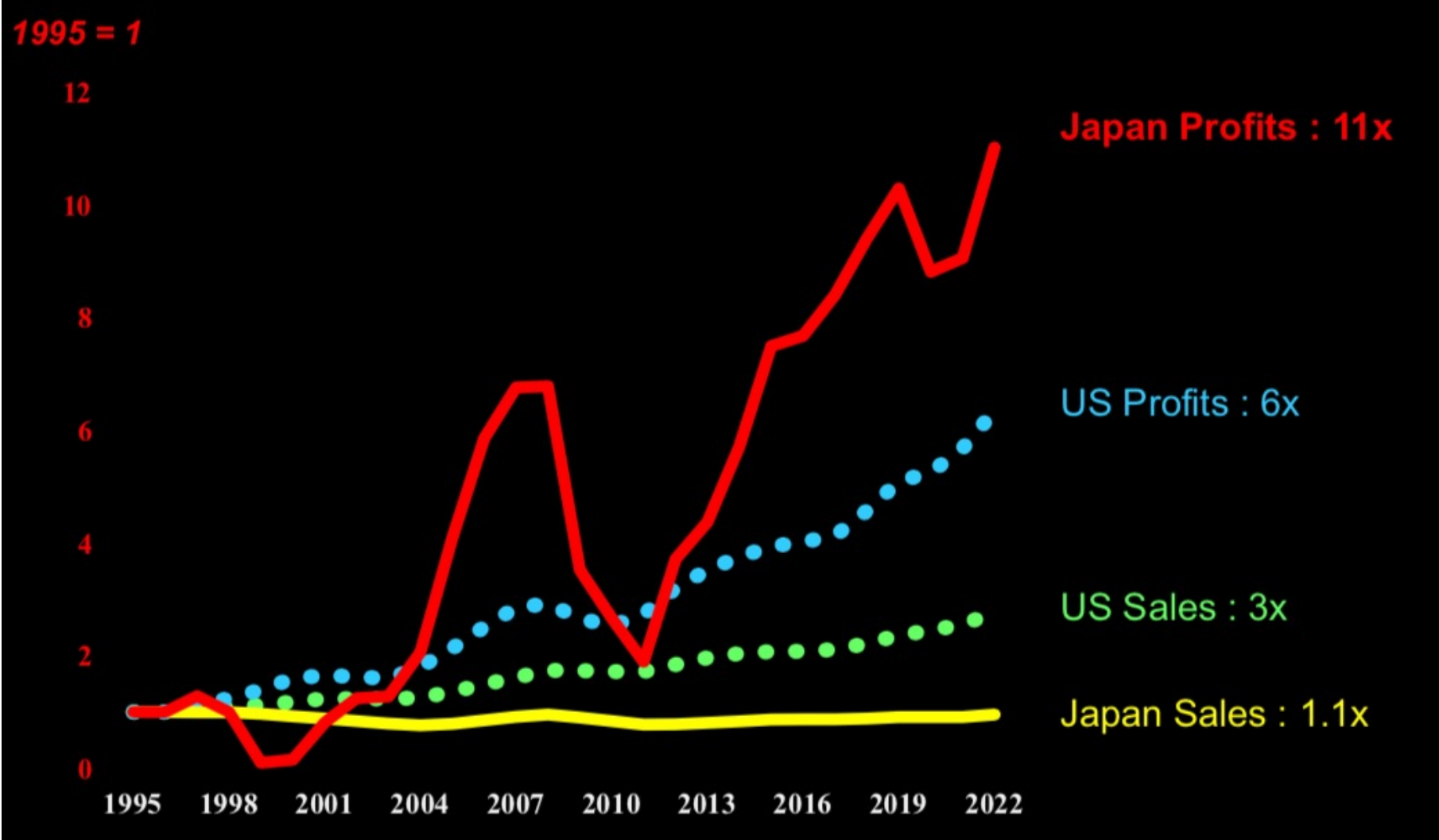
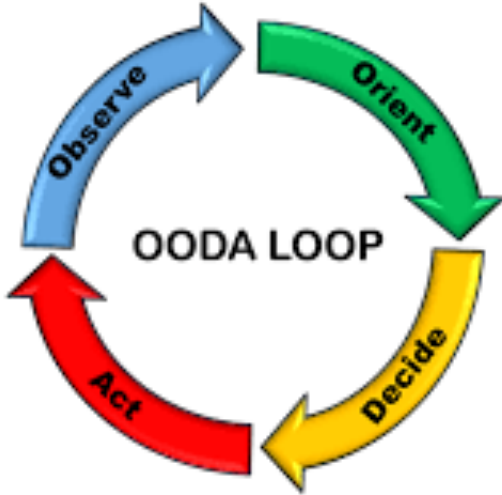


Diagram courtesy of Jesper Koll

OODA-Based Analysis of Japanese Stocks

Observe

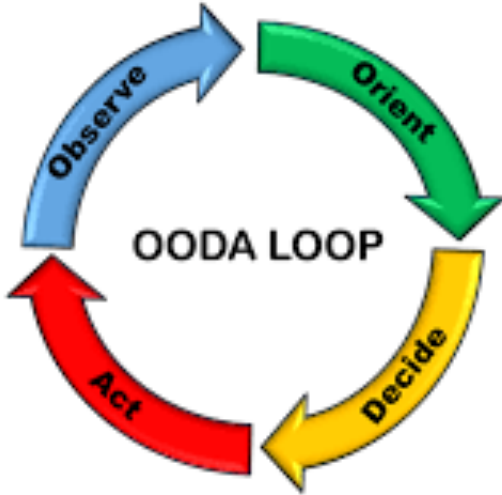
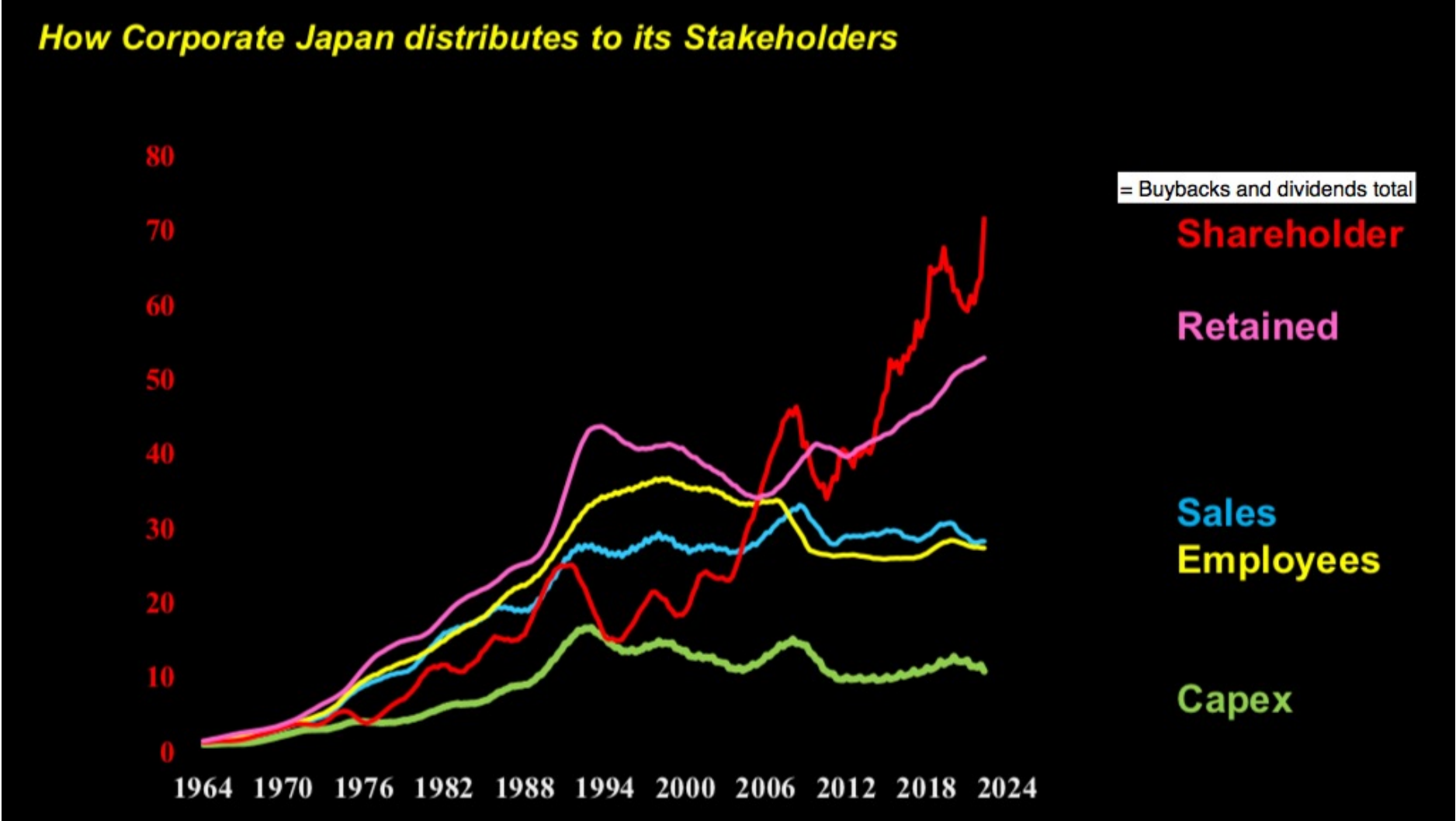
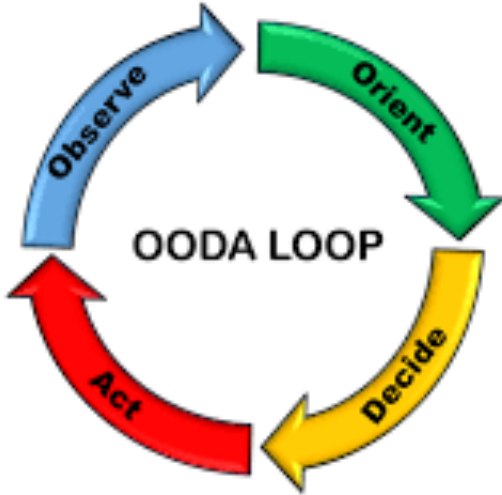


Diagram courtesy of Jesper Koll



OODA-Based Analysis of Japanese Stocks

Observe



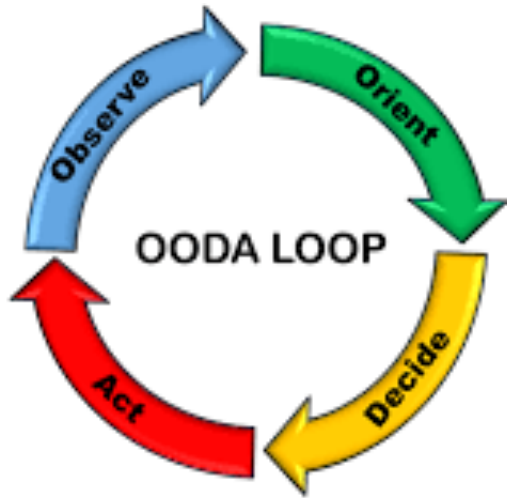
	<u>Dec 1989</u>	<u>Dec 2022</u>
Market Cap (<i>Y trn.</i>)	590	690
P/E	61x	12x
EPS	21	150
RoE	1.9%	8.1%
Cross Holdings	50%	5%

Diagram courtesy of Jesper Koll

OODA-Based Analysis of Japan's evolving economy

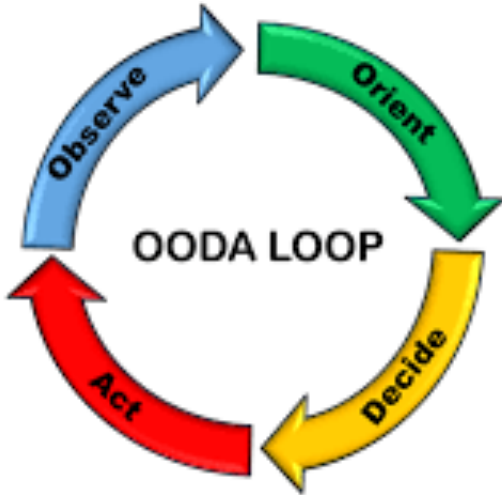
Observe

- Convergence of micro trends within Japan
 - Intergenerational management transfers
 - Unwinding of cross holdings
 - Rising returns on and of capital
 - Value-driven capital allocation
- Emergence of Japan's overlooked macro strengths
 - Political stability (notwithstanding three PMs within the last five years)
 - Unwavering commitment to liberal democratic principles
 - Strong social cohesion under stress
 - Preference for actual engineering over financial engineering
 - Regional leader on security and trade issues
 - Global leader in accumulation of net external assets (#1 for 32 straight years)



OODA-Based Analysis of Japan's evolving economy

Observe



Percentage of GDP in 2022	U.S.A.	Japan
Investment	20%	27%
Net Debt	95%	161%
External Debt	96%	101%
Net international investment position	-80%	+63%

Data sources: IMF, Nikkei Asia, Japan Today, CEIC.

OODA-Based Analysis of Japanese Companies

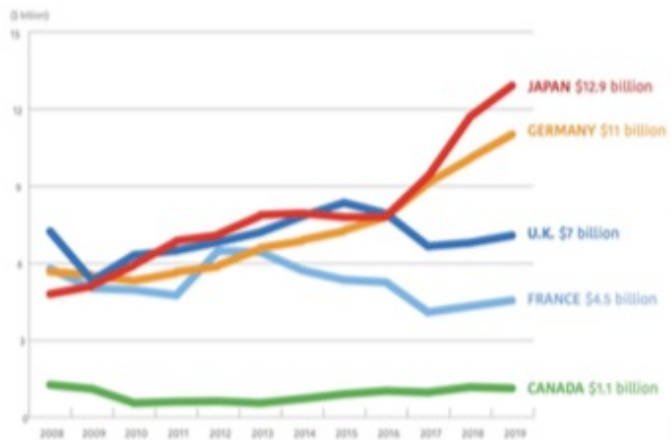
Observe

Comparison of Top U.S. Foreign Investors

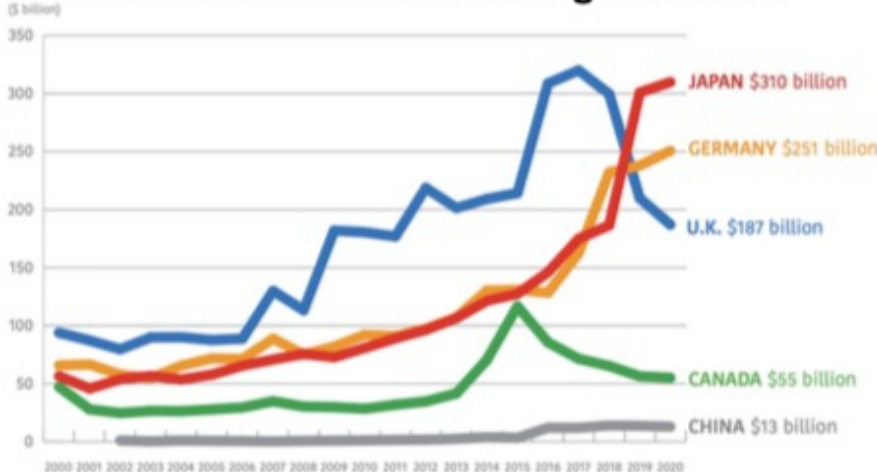
FDI Ranking	Japan #1	Canada #2	Germany #3	U.K. #4
FDI Total (2020)	\$679.0 billion	\$580 billion	\$521.9 billion	\$446 billion
Manufacturing Jobs	527,500	130,000	307,400	265,700
R&D investment	\$12.9 billion	\$1.1 billion	\$11.0 billion	\$7.1 billion
U.S. Exports	\$82.3 billion	\$16 billion	\$47.2 billion	\$52.3 billion
Top 6 Industry Sectors	1. Auto Components 2. Industrial Equipment 3. Plastics 4. Automotive OEM 5. Software & IT Services 6. Metals	1. Software & IT Services 2. Financial Services 3. Business Services 4. Real Estate 5. Industrial Equipment 6. Food & Beverages	1. Industrial Equipment 2. Software & IT Services 3. Auto Components 4. Transportation 5. Chemicals 6. Plastics	1. Business Services 2. Software & IT Services 3. Financial Services 4. Communications 5. Industrial Equipment 6. Transportation

Japan is:
 #1 in Total Foreign Direct Investment in the U.S.
 #1 in Creation of Manufacturing Jobs in the U.S.
 #1 in Total R&D Spending in the U.S.
 #1 in Total Value of Merchandise Exports from the U.S.

Japanese R&D spending



Investment in manufacturing in the US



Japanese FDI in the US at record highs

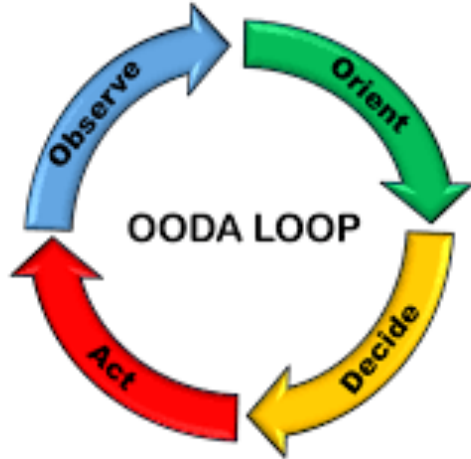
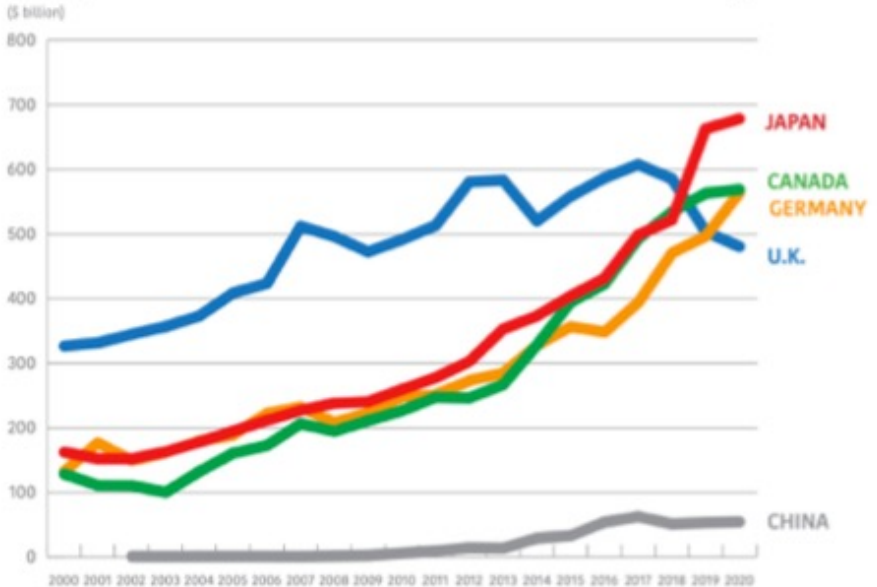


Diagram courtesy of Mission Value Partners

Source: Japan-U.S. Investment Report 2022, JETRO.

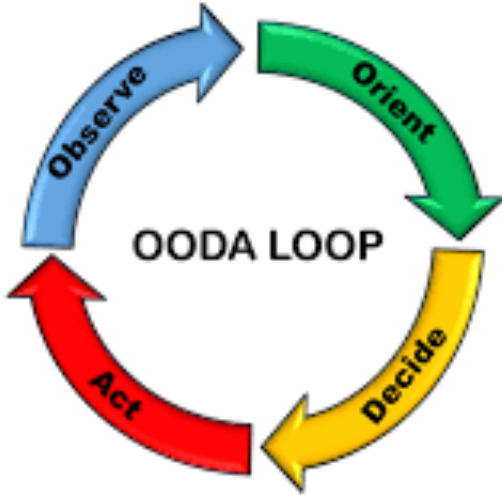
OODA-Based Analysis of Japan's economic footprint

Observe

FDI ranking

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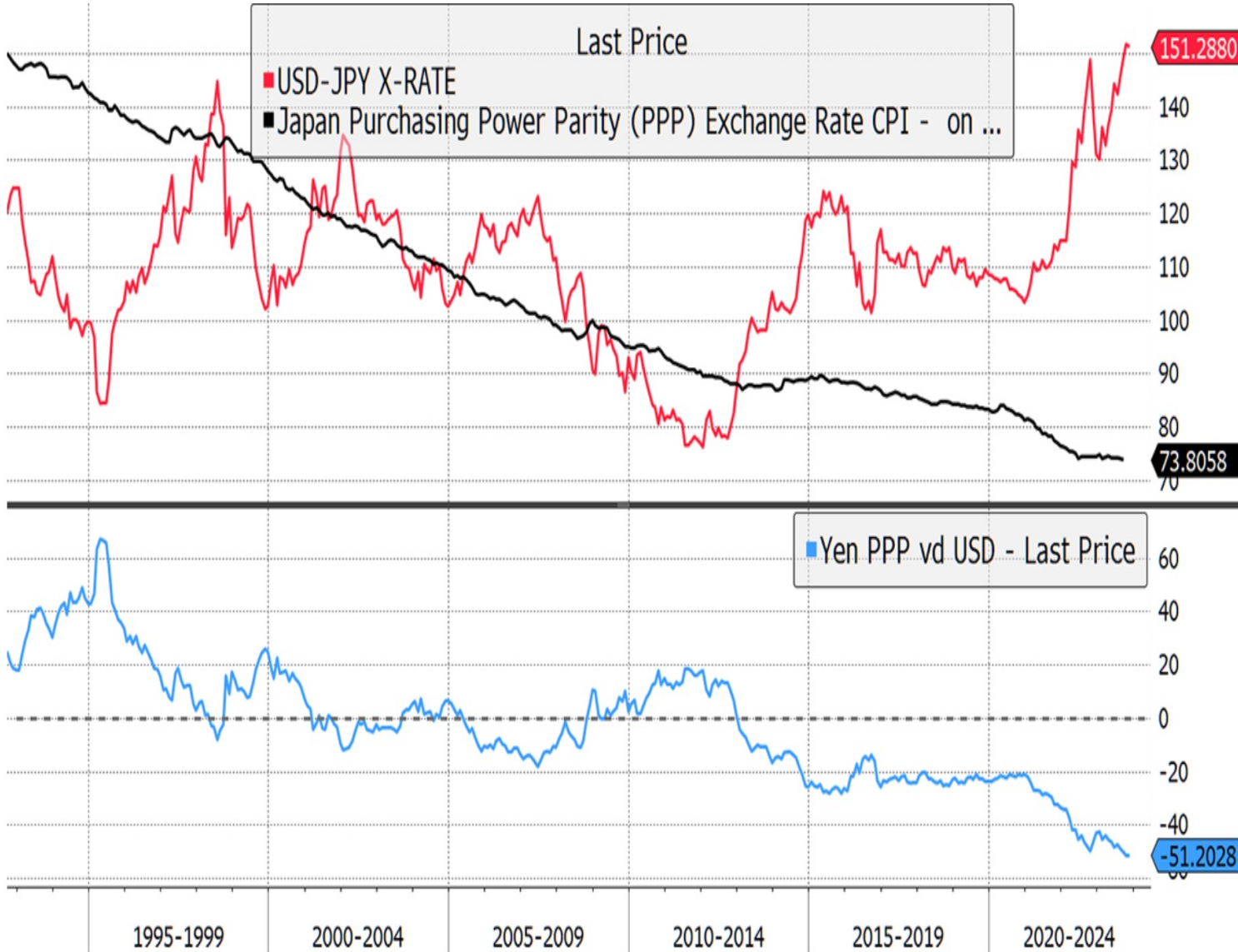


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Diagram courtesy of Mission Value Partners

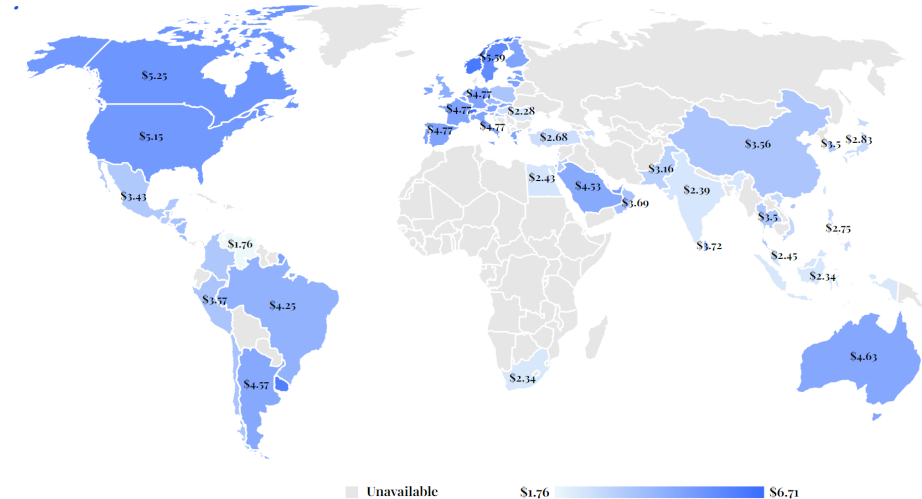


Big Mac anyone?



Key Takeaways

- One argument among several voiced by the many US-based investors maintaining minimal exposure to Japanese stocks is that they embody excessive currency risk. The yen has indeed generally shed value in USD terms in recent decades, as Big Mac lovers among others can attest: as against a recent average of \$5.15 for a Big Mac bought in the US, that tasty treat cost an average of just \$2.83 in USD terms if purchased in Japan. (Expand the map below for a closer look at the Big Mac Index.)
- Has the yen bottomed? With BoJ policies shifting on the margin toward tightness, we wouldn't bet against it. And with nearly half of the revenues of firms comprising the MSCI Japan Index generated by operations outside Japan, yen weakness is a mixed blessing **at worst** for stockholders in such firms with base currencies other than the yen.





How low can it go? JPY's real effective exchange rate

Yen at Five-Decade Low

As measured by real effective exchange rate



Key Takeaways

- Reasonable observers can reasonably differ respecting the significance and probable future trajectory of the data series plotted at left. What all such observers can agree is that its material if uneven descent from its memorable peak in the early 1990s has enhanced the price competitiveness of Japanese exports (and of goods and services sold to inbound tourists visiting Japan).
- Of course, goods produced in Japan for export markets wouldn't find homes in them if they weren't designed and manufactured soundly as well as being priced competitively. Is such soundness deep and broad enough to enable Japan to transform its recent annual trade deficits into trade surpluses if and as the line at left turns upward? We'd take the Over on that bet.

For more information, contact us at:

Support @hedgeye.com
(203) 562-6500