



Notes from the Road

October 2023

We believe in the importance of primary research and travel often, meeting with company managements and visiting sites. After every trip, we discuss our findings with our full team. Here, we share highlights with you. We welcome our Causeway clients to contact us for detailed discussions on any of these subjects.

Japan Rising?

[Jonathan Eng, Fundamental Portfolio Manager](#)

Coverage: Industrials, Energy, Materials

I recently returned from Japan where I met with about twenty companies across heavy industry, manufacturing, chemicals, leisure, and retail.

- **Valuation:** Many of these companies are expensive currently. Japan has been the best performing developed market this year in local currency terms—the MSCI Japan Index is up 26% through September 30. But we are diligently analyzing the opportunity set to unearth mispriced opportunities.
- **Price Increases:** As Japan enters an inflationary environment, some companies are increasing prices for the first time in decades. Examples from my meetings include an industrial gas business and a convenience store network. I met with management teams who appear focused on growing their margins. Others may just be paying lip service. Our research is focused on identifying profitability-focused corporate managements.
- **Shareholder Attention:** Some Japanese companies are paying more attention to shareholders. The Tokyo Stock Exchange is asking companies for a plan to improve capital efficiency if their price-to-book value falls below 1x. On this trip, many company managements asked me to fill out surveys to provide my perspective. These are shareholder-focused improvements, if slight.
- **Yen Weakness:** The historically weak Japanese yen has boosted profits for companies that generate revenues in foreign currencies and pay costs in yen. And yen weakness is reducing the expensiveness of Japanese assets for dollar-based investors.





Mitigating the Memory Cycles

[Naveen Bobba, Fundamental Senior Research Analyst](#)

Coverage: Technology, Communications

Technology investors must get more than the companies right—they must get the cycles right too. I spent thirteen days in Tokyo and Hong Kong meeting with over 45 Asia-based technology and communications companies, building a bottom-up view of these industry cycles. These are my key takeaways:



- **Demand Improving:** Slumping semiconductor and component sales may be reaching a trough. Several suppliers cited examples of improving component demand, and some hardware companies (cautiously) noted improving end-demand for devices such as PCs and smartphones.
 - **Inventory Levels Declining:** Except for certain automotive and long-lead-time parts, inventories across the semiconductor supply chain appear to be decreasing. Should end-demand decline, excess inventory levels are unlikely to exacerbate the weakness.
 - **Better Behavior in Memory Industry:** Looking ahead to the next upturn in the semiconductor memory industry, supply and demand balance will be more important to profitability than demand growth. The large manufacturers seem to be demonstrating supply and pricing discipline, driving the potential for a rebound in industry profits.
- **US-China Decoupling:** Decoupling may last a long time, and, in a positive development for Japan Inc., Japanese stocks may continue to benefit from redirected investment flows.
 - **Technology Services Spending:** Technology services spending is weakening, particularly in North America, with customers delaying or cutting new project spending. Japan, however, is seeing a healthy growth environment as businesses and the government attempt to accelerate modernization and digitization initiatives.

Pharmaceuticals: Understanding the Overhangs

[Gavin Scott – Fundamental Senior Research Analyst](#)

Coverage: Health Care

I traveled across Europe discussing the Inflation Reduction Act (“IRA”) and China anti-corruption measures with pharmaceutical company managements.

Inflation Reduction Act:

- Designed to reduce drug prices for Medicare patients, IRA legislation is pressuring pharmaceutical industry valuations by





creating substantial uncertainty for companies' business planning and top-line revenues.

- Granular analysis is required to assess the potential earnings impact to each drug and company; this is not a job for generalists. For certain pharma companies, the law may not be as damaging as feared.
- The IRA may change sector dynamics in unintended ways. For example, US drug launches might be delayed, and research & development dollars may redirect toward expensive, large molecule drugs.

China:

- My conversations with managements offered a different perspective on China than the generally negative investment community.
- According to some managements, anti-corruption measures and slowing economic growth have improved negotiations with Chinese government officials, who appear interested in preserving foreign investment.
- China's dependency on a narrowing set of foreign drug providers to the region is creating a favorable environment for makers of certain critical or unique drugs.

Unlocking Alpha Potential in China A

[Tong Lu, Quantitative Senior Research Analyst](#)

Coverage: Alpha factor research, China A-share market

I spent two weeks in China this spring studying its A-share market, its volatility and how we might use quantitative tools to try to extract alpha. Here is what I learned and how we are putting this knowledge to use at Causeway.

- **Market Evolution:** Local and international institutional investors are entering the retail-dominated China A market, which may increase its efficiency. Small and micro-cap stocks present attractive alpha opportunities.
- **Growth of Quantitative Strategies:** Quant investing in China A has become increasingly competitive, marked by rising computing power and model complexity. Natural Language Processing (NLP) research is on the rise. Data from connected holdings, institutional holdings, and financial flows can make alpha factors more effective.
- **Data Insights:** China-based data vendors typically offer richer local datasets than providers abroad. When crafting a China-A strategy, we believe a blend of local and foreign datasets can harmonize well.





- **Causeway Machine Learning Model:** Post-visit, my colleagues and I developed a machine learning model for the China-A market focused on interpreting technical market signals.

What Industrials Firms Told Me about the State of the Real Economy

[Michael Gianatasio, Fundamental Research Analyst](#)

Coverage: Industrials, Materials, Energy



Last month I met with nearly 30 industrials companies—in logistics, electronic instruments, agriculture and construction equipment, automotive technology, airlines, and aerospace & defense. From my discussions across this wide range of companies, some themes emerged about the state of the manufacturing sector and economy.

- **Infrastructure and Megatrends:** Companies linked to electrification, artificial intelligence, nearshoring, digitization, automation, and the energy transition are generally expected to dominate future growth. Companies in these areas cited strong backlogs, and their stocks are generally priced accordingly.
- **Weak Order Growth:** Outside of those longer-term drivers, order growth appears weak. Many companies reported “book-to-bill” ratios below 1x, meaning that new orders are totaling less than completed orders, partly attributable to lingering inventory buildup.
- **China’s Mixed Market:** Multinationals generally report softer end markets in property and retail. Yet, as my colleagues recently [observed in China](#), certain segments are robust. I heard from some companies including EV technology providers and precision instrument manufacturers for whom China remains an important and growing market.
- **Supply Chain Recovery:** Inventory corrections are still occurring throughout 2023 and should largely normalize in 2024. The worst of the destocking period should be behind us.
- **Operational Improvements:** From settling liabilities to spinning off underperforming businesses to taking market share from failing competitors, managements shared pathways to improved profitability independent of macro themes.

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The MSCI Japan Index is a free float-adjusted market capitalization index, designed to measure the performance of the large and mid cap segments of the Japanese market.

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