Could a change be as good as a rest?

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Prior to joining Fidelity, he spent two years with Barclays de Zoette Wedd in Tokyo as a Japanese equity analyst.

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Japan's economy was among the first to emerge from the global recession and forecasts now point to it being on a firmer economic footing once more, but the TOPIX has still underperformed other leading world markets since the lows of March. With a new government elected, ending more than half a century of rule by the Liberal Democratic Party, could that be enough to reignite interest in the Japanese equity market?

DO YOU BELIEVE THAT THE ECONOMIC RECOVERY IS SUSTAINABLE?

Japan's economy was among the first to recover after the shock of the collapse of Lehman Brothers and is now expected to grow faster than other developed nations, according to IMF forecasts. The IMF expects economic growth of 1.7% in 2010, versus 1.5% in the US and 0.3% in the eurozone.

However, the absolute level of economic activity remains low and any further pick-up is likely to be focused in exporting sectors, with little prospect of an immediate recovery in domestic demand. Although corporate Japan has become less pessimistic, capex plans and earnings forecasts remain sharply negative for 2009. Furthermore, employment and income conditions remain severe, and deflationary trends are becoming more entrenched.

For the time being, I have relatively low expectations for domestic newsflow and expect any positive catalysts to come from overseas.

DOES THIS MEAN THAT YOU HAVE POSITIONED THE FUND FOR AN EXPORT-LED RECOVERY?

Japan is facing a period of rebalancing as the recently-elected Democratic Party of Japan (DPJ) replaces various public works projects with its own fiscal stimulus, such as child allowance benefits and other income support measures. I believe that the anticipated economic benefits of the DPJ's policies are unlikely to materialise in the near term.

In the meantime, prevailing foreign exchange rates pose downside risks to exporters' earnings. Many Japanese companies have, however, become far more resilient to currency movements and the aggregate breakeven rate recently fell below ¥100 for the first time. Moreover, aggressive cost-cutting measures have created a leaner, more competitive corporate landscape that will translate into higher operational leverage once top-lines recover.

Given tentative signs of a more benign global macroeconomic backdrop and stabilisation in the global financial system, I have an overweight stance in cyclical manufacturers. I spread positions across a range of stocks in the electrical machinery, glass & ceramics and precision instruments areas, where I found high-quality firms with globally competitive products, solid balance sheets and sound management. Prime examples are Canon and Stanley Electric.

Meanwhile, I have taken some profits in a number of strong performers, including Toyota Motor, Honda Motor and Denso, and reinvested in undervalued financials. I have added to positions in Sumitomo Mitsui Financial Group, which traded on historically low valuations and offered attractive upside. I also increased positions in Sompo Japan Insurance and T&D Holdings, which traded at a discount to NAV. They should do better once interest rates rise.

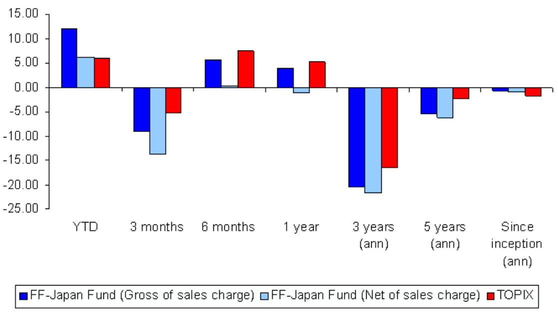
WHAT STOCK POSITIONS HAVE INFLUENCED THE FUND'S RECENT PERFORMANCE?

A number of holdings in blue-chip exporters which were heavily sold down in 2008 showed a clear trend reversal. Stocks in the automobiles and technology industries ranked among the top contributors. Meanwhile, an underweight stance in utilities paid off, as defensive sectors fell out of favour due to a rally driven by expectations for an economic recovery.

While operating conditions remained tough, leading exporters Stanley Electric, Denso, Canon and Nikon rebounded from their March lows. Progress in inventory adjustments and signs of stability in some economic indicators lifted confidence in the outlook for these global players. Furthermore, investors welcomed their far-reaching restructuring and cost-cutting plans.

FUND RETURNS (%)

as at 31.10.09



Source: Fidelity. Performance figures are in JPY terms NAV to NAV with dividends reinvested. Past Performance is not indicative of future performance

Since inception:01.10.99

Benchmark: Tokyo Stock Exchange TOPIX Total Return Index

FundPerspective:

TOP TEN HOLDINGS (%)

as at 30.09.09	Fund	Benchmark
NTT DoCoMo	**5.1**	1.2
Canon	**4.6**	1.8
Toyota Motor	**3.8**	3.9
Mitsubishi UFJ Financial Group	**3.4**	2.4
Sumitomo Mitsui Financial Group	**3.3**	1.4
Mizuho Financial Group	**2.8**	1.1
Orix	**2.5**	0.3
Sompo Japan Insurance	**2.4**	0.2
T&D Holdings	**2.1**	0.3
Honda Motor	**2.0**	2.0

Source: Fidelity

Benchmark: Tokyo Stock Exchange TOPIX Total Return Index

References to specific securities are for illustrative purposes and are subject to change without notice. They should not be construed as a recommendation or an advice to transact in them.

WHAT IS YOUR VIEW OF MARKET VALUATIONS AFTER SUCH A STRONG BOUNCE?

Following a five-month recovery rally, many stocks have lost their deep valuation discounts and further material upside will be harder to come by over the near term. Since equity markets moved off their lows in early March, the upturn has come hard and fast. In many ways, the recovery has been almost as indiscriminate as last year's sell-off and we now need to see positive earnings trends in order to justify the readjustment in share price valuations. However, the resurgence in the yen to ¥89 against the US dollar has negative implications for second-half earnings and the prospect of further large-scale capital raising is likely to hang over the market.

DO YOU THINK THE ELECTION OF THE NEW GOVERNMENT WILL HAVE ANY EFFECT ON THE DIRECTION OF THE STOCK MARKET?

At the end of August, a landslide victory in Lower House elections by the Democratic Party of Japan (DPJ) brought an end to more than half a century of dominance by the Liberal Democratic Party (LDP).

While the DPJ's win was undoubtedly a milestone event, it was widely anticipated and had little immediate impact on the market. Once in office, however, remarks from newly-installed DPJ ministers fuelled concerns about the direction of the administration's economic policies, particularly in the areas of financial regulation and foreign exchange. Financial stocks and exporters were most susceptible to statements from Financial Services Minister Kamei, who touted plans for a debt moratorium for SMEs, and Finance Minister Fujii, who appeared to endorse a strong yen. In contrast, shares in domestic demand-related companies that were seen as potential beneficiaries of the DPJ's child care and consumption-based measures held up well.

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