



Japanese Stock Market Outlook

SMAM monthly comments & views
- October 2016 -



Sumitomo Mitsui Asset Management

Executive summary

➤ Japanese Economy

Recent statistics are showing mild recovery in the Japanese economy. Fiscal spending plan of yen 28 billion is going to be approved at the currently held National Diet session and should underpin sentiment of both consumers and businesses. BOJ made a shift in the set of monetary policy on 21st of September making it more enduring and probably more credible. The focus will be on how successful “yield curve controlling” can be made and whether it is really effective in achieving inflation target.

- Global major economies are shifting from very restrictive fiscal policies to more stimulative ones. Monetary policies are facing difficulties in effectively stimulating economies globally, and fiscal policy is expected to increase its presence.
- The third arrow of Abenomics, “growth enhancing policies” such as deregulation has been lagging behind. The government is going to make a new push for “changing working practice” such as cutting unnecessary overtime working and enjoying life more.

➤ Japanese Stock Markets

For the short-term, the stock market will be moved by key events in overseas such as US presidential election. The worst for the corporate earnings is going behind and it will be confirmed when companies announce first half earnings results for Apr-Sep period in late October to November. Risk factors are going to recede around autumn and Japanese stock market is expected to try upside supported by such factors as confirmed recovery in corporate earnings momentum and anticipation for positive effects from public spending.

- SMAM updated profit forecast for constantly covering 221 companies with severe presumption of 100 yen/dollar to continue. Even with this severe assumption, profit for 3 quarters from July to March is forecast to grow YoY by 5.2% and 11.3% for entire FY2017.
- As of September 9th, PER for TOPX was 13.5x whereas comparative PER for S&P 500 was over 17x. Relative valuation of Japanese stocks looks attractive compared to US stocks.

Outlook for Japanese Economy

SMAM economic outlook for FY16-17

- Recent statistics are showing mild recovery in the Japanese economy such as industrial production, wage payment and private consumption. Fiscal spending plan of yen 28 billion is going to be approved at the currently held National Diet session and should underpin sentiment of both consumers and businesses.
- BOJ made a shift in the set of monetary policy on 21st of September making it more endurable and probably more credible. The focus will be on how successful “yield curve controlling” can be made and whether it is really effective in achieving inflation target.

(YoY %)	FY12	FY13	FY14	FY15	FY16E	FY17E
Real GDP growth	0.9%	2.0%	-0.9%	0.8%	0.7%	0.7%
Private Consumption Expenditure	1.7%	2.3%	-2.9%	-0.2%	0.5%	0.4%
Private Housing Investment	5.7%	8.8%	-11.7%	2.4%	4.6%	-0.3%
Private Capital Investment	0.9%	3.0%	0.1%	2.1%	0.5%	1.0%
Public Consumption Expenditure	1.5%	1.6%	0.1%	1.6%	1.6%	1.1%
Public Capital Investment	1.0%	10.3%	-2.6%	-2.7%	2.0%	5.7%
Net Exports (contrib. to GDP growth)	-0.8%	-0.5%	0.6%	0.1%	-0.0%	0.0%
Exports	-1.4%	4.4%	7.9%	0.4%	-0.2%	1.6%
Imports	3.6%	6.8%	3.4%	0.0%	-0.2%	1.8%
Nominal GDP	0.0%	1.7%	1.5%	2.2%	0.9%	0.9%
GDP Deflator	-0.9%	-0.3%	2.4%	1.4%	0.1%	0.2%
Industrial Production	-2.7%	3.0%	-0.4%	-1.4%	0.4%	2.7%
CPI (excl. energy & fresh food)	-0.2%	0.8%	0.9%	-0.0%	-0.2%	0.3%

Notes: E=SMAM forecasts. SMAM views are as of Sep. 14th, 2016 and subject to updates thereafter without notice

(%, YoY except Net Exports)

Source: Cabinet Office, Bank of Japan, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, SMAM forecasts

Bank of Japan made a shift in its monetary policy to controlling yield curve

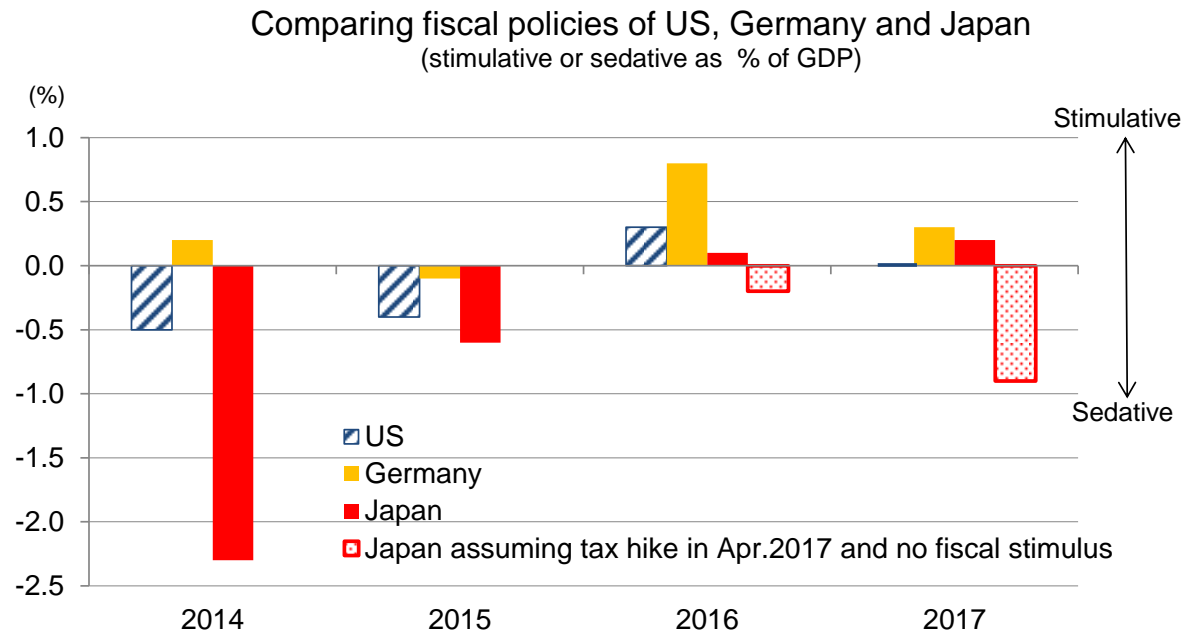
- On 21st of September, BOJ changed the set of its monetary policy to a more sustainable and enduring one. Target of increasing monetary base at a fixed high pace was withdrawn and controlling target shifted to yield curve, both short-term and long-term interest rates.
- This shift makes BOJ's monetary policy more flexible and enduring by eliminating worries of how long such high and rigid pace of purchasing JGB can be maintained.
- BOJ probably regained some credibility by this shift and now focus will be on how successful "yield curve controlling" can be made and whether it is really effective in achieving inflation target.

		Previous policy	New policy	Notes
		QQE with a negative interest rate	QQE with yield curve control	
Quantitative easing	(1) Purchasing of Japanese Government Bonds	yen 80 trillion per annum.	Used for controlling the yield of long term bonds to a target level.	Quantitative easing was changed from a "target itself" to "a tool" for controlling yield curve.
		-	Purchasing bonds at designated target price/yield.	Designated price purchasing is newly adopted.
Qualitative easing		Targeted mixture of maturities	Abolished	Guidance of average maturity of purchasing JGB was abolished.
	(2) Purchasing Equity ETF	yen 6 trillion per annum	yen 6 trillion per annum	"Unchanged", but purchases more TOPIX based ETF shifting from Nikkei 225 based ones.
	(3) Purchasing REIT	yen 90 billion per annum	yen 90 billion per annum	Unchanged
Negative interest rate	(4) Negative short term rate	-0.1%	-0.1% as the current target	Unchanged
Long term bond yield	(5) 10Y JGB yield	No clear target	Around 0% as the current target	New policy
Period for achieving 2% inflation		In around 2 years.	"Overshooting commitment" , which means BOJ continues monetary easing until 2% inflation is decisively achieved.	2 years period for achieving 2% inflation was abandoned.

(Source) Bank of Japan

Global fiscal policies are going to gain more central role in managing economy

- The chart is the re-exhibited one, which was produced for July edition.
- Global major economies are shifting from very restrictive fiscal policies to more stimulative ones.
- Monetary policies are facing difficulties in effectively stimulating economies globally, and fiscal policy is expected to increase its presence.

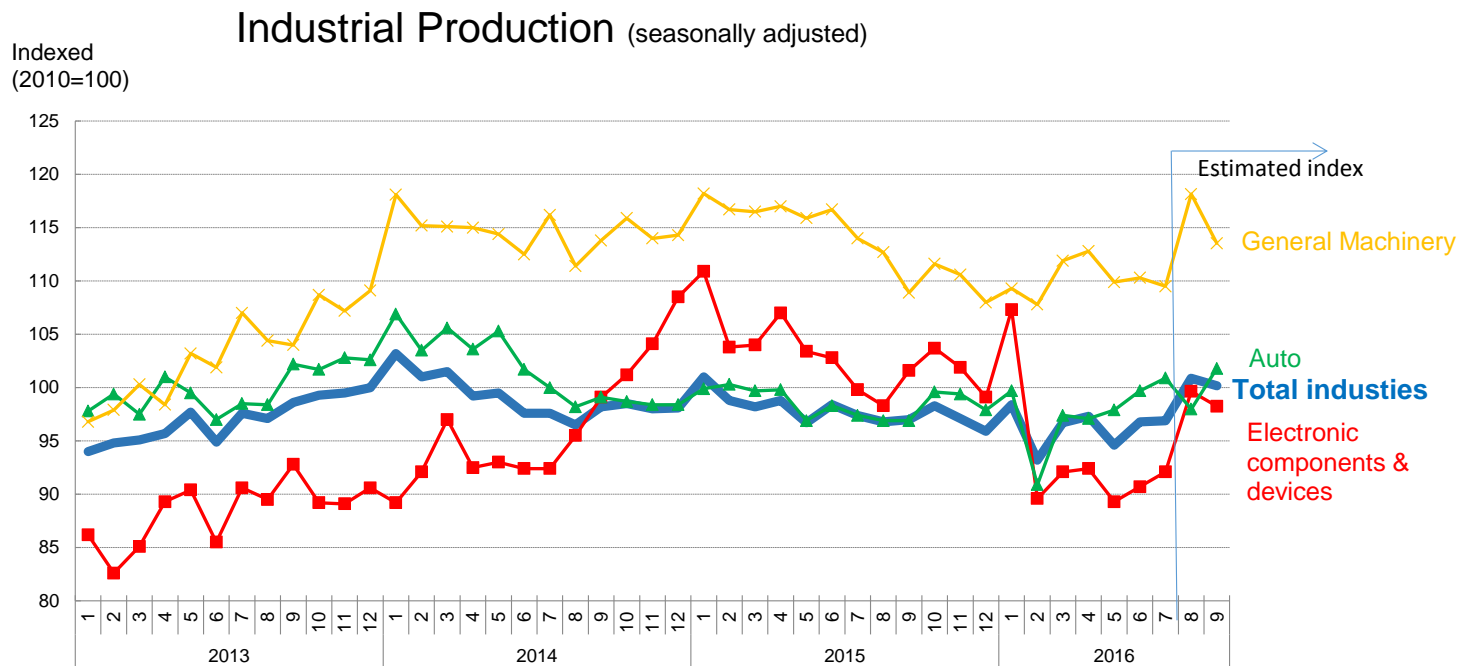


Note: YoY change of primary balance adjusted for economic cycle.

(Source) IMF, compiled by SMAM

Industrial production is in a recovering trend

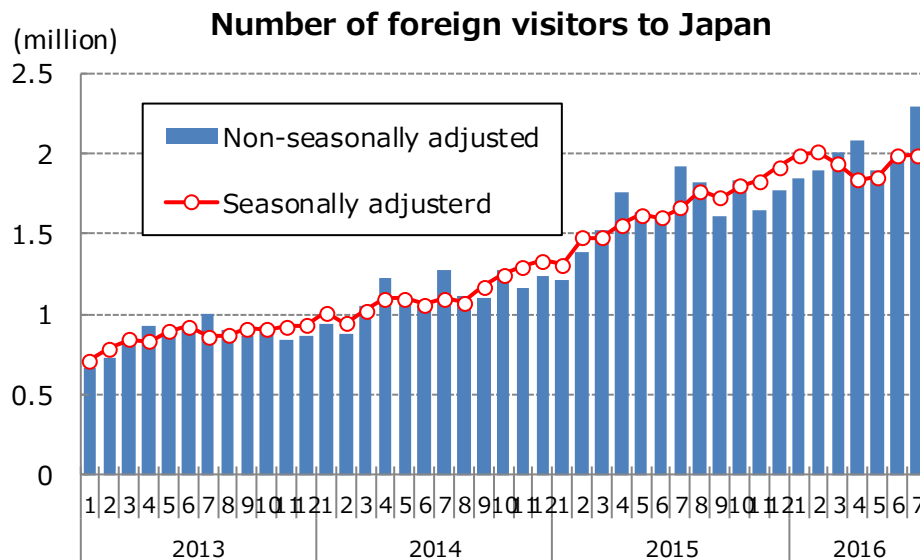
- Industrial production has been in a recovering trend since June and estimated index points to further recovery with some volatility.



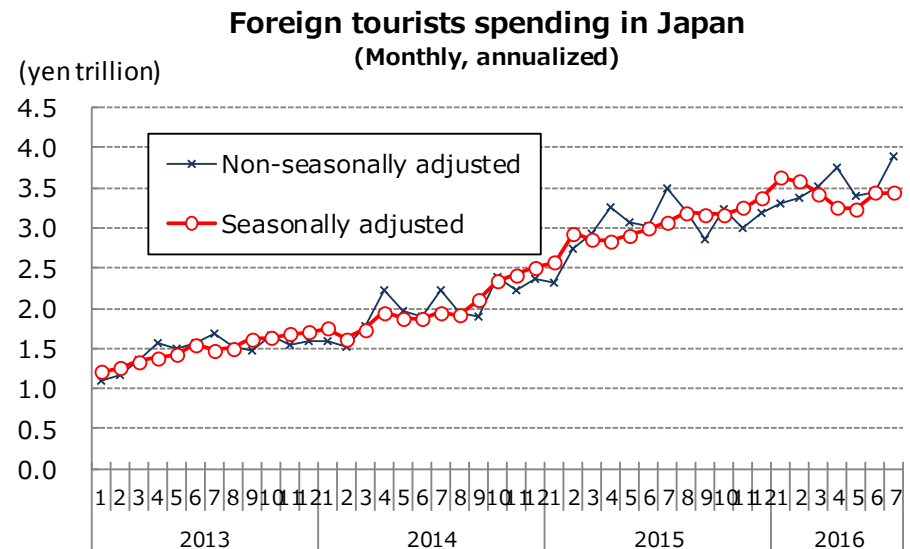
(Source) Ministry of Economy, Trade and Industry

Tourists to Japan is expected to continue growing

- Number of foreign visitors to Japan recovered in recent months after dipping in March and April partly due to stronger yen and temporarily heightened uneasiness over global economy. Increasing number of repeaters are visiting Japan again to experience Japanese cultures not only to make a sightseeing.
- Tourists spending per person has declined as explosive buying spree by Chinese tourists moderated due to strengthened custom duty at their home land and also strong yen making prices dearer.
- Tourists friendly developments are going to be taken further preparing for 2020 Tokyo Olympic games and steady increase can be expected for number of visitors and their spending.



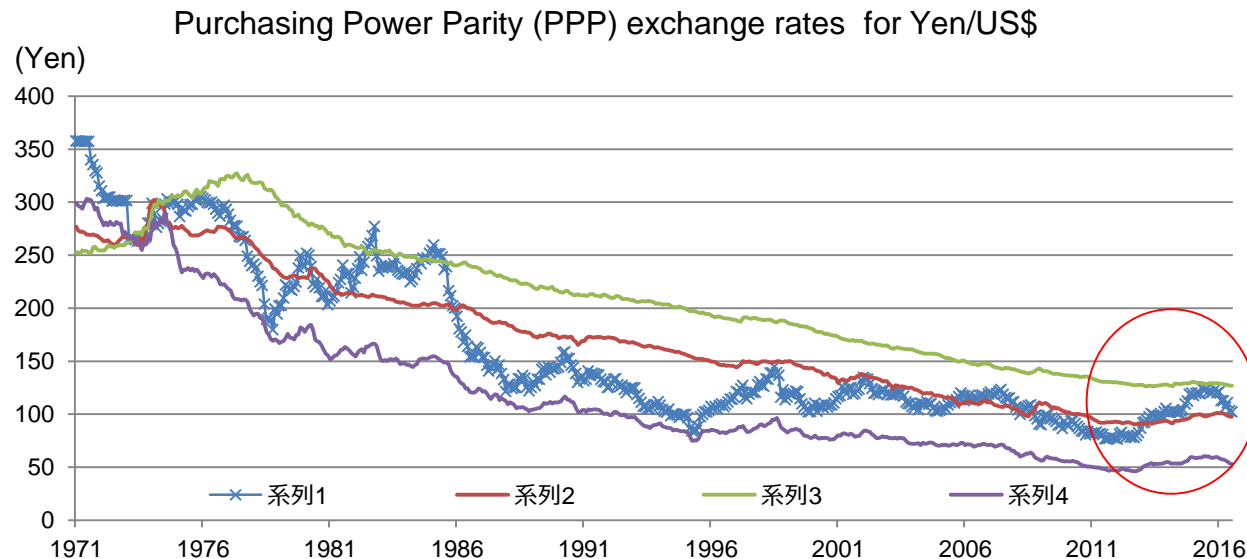
(Source) Japan National Tourism Organization, compiled by SMAM



(Source) Ministry of Finance, Bank of Japan, compiled by SMAM

Yen might have found a long term equilibrium level around 100 against US dollars

- One thing worthy of note is the fact that pressure for the stronger yen from the inflation difference has ceased. Inflation rate in Japan has risen while global inflation in general has substantially declined. This is exhibited as sideways move of PPP lines on the chart for the last several years.
- Historically, PPP based on CPI worked as the weaker end for Yen against US dollars, which was also the case this time after the beginning of Abenomics so far.
- Yen/US\$ rate seems to have been moving around PPI based PPP rate for the last 15 years and current rate is also close to it.



Note: PPP rates are calculated based on the yen/US\$ rate of 265.96 as of Mar. 1973 and each price indices in Japan and US. Data is monthly and up to July 2016.

(Source) US Department of Labor, US Department of Commerce, FRB, Bank of Japan, Ministry of Internal Affairs and Communication, and IMF, compiled by SMAM

Outlook for Japanese Stock Markets

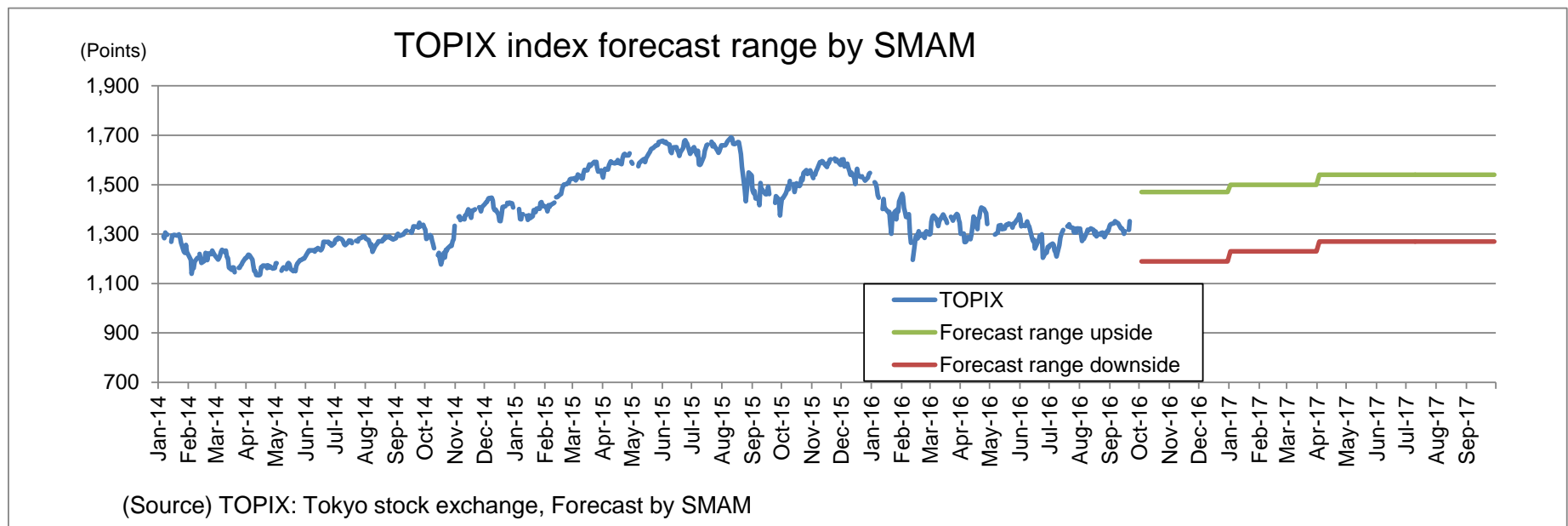
Stock market outlook: Improving earnings momentum is going to lift the market in the long-term

SMAM short-term view

- For the short-term, the stock market will be moved by key events in overseas such as US presidential election. The worst for the corporate earnings is going behind and it will be confirmed when companies announce first half earnings results for Apr-Sep period in late October to November. After FRB in US postponed interest rate hike in September, yen could temporarily move stronger providing some volatility in the stock market.

Longer-term outlook (6-months and beyond)

- Aforementioned risk factors are going to recede around autumn and Japanese stock market is expected to try upside supported by such factors as confirmed recovery in corporate earnings momentum and anticipation for positive effects from public spending. Relative cheapness of stock valuation for Japan should provide support for the stock market.



Note: SMAM's projection is as of Sep. 16th 2016 and subject to updates without notice

Base scenario & Upside / Downside risks for our forecasts

- Our **Base Scenario** is assuming the following views:
 - Global economy does not enter into a recession.
 - Japan's private consumption to grow mildly supported by wage growth.
 - Japanese corporate earnings growth to gradually recover from the negative shock of stronger yen.
 - Fiscal stimulus and further monetary easing will be made to sustain economic growth in Japan.

- **Upside Risks** include:
 - Stronger-than-expected global growth.
 - Stronger-than-expected measures by the Abe government.

- **Downside Risks** include:
 - Britain's decision to exit from EU deeply confuses politics and economies in Europe.
 - Unexpectedly large impact from the process of US monetary policy normalization.
 - Concern over emerging economies including China.
 - Falling oil price causes disastrous problem for oil producing countries.
 - Increasing geopolitical concerns.
 - Surprise coming from US presidential election.

Improving earnings momentum is expected to work positive for the stock market

- At the announcement of 1Q results, aggregated earnings guidance for FY2016 by companies* was standing at -3.5%. After the actual profits achieved in 1Q, companies were implicitly forecasting +2.5% profit growth for 3 quarters between July 2016 and March 2017.

(Note: *Numbers are for 221 companies in SMAM research coverage excluding financials.)

- SMAM updated profit forecast for covering 221 companies with severe presumption of 100 yen/dollar to continue. Even with this severe assumption, profit for 3 quarters from July to March is forecast to grow YoY by 5.2% and 11.3% for entire FY2017.

Recurring profits forecast by companies as of the end of 1Q 2016

(yen bil. %)	SMAM research coverage of 221 companies excluding financials										SMAM forecast as of Sep. 5th 2016	
	FY2015 (from Apr2015 to Mar2016)					FY2016 (from Apr2016 to Mar2017)					FY2016	FY2017
	1Q(Apr-Jun)	2Q	3Q	4Q	FY2015 total	1Q(Apr-Jun)	2Q	3Q	4Q	FY2016 total		
Recurring profits	9,066	8,264	7,695	4,348	29,365	7,541	-	-	-	28,351	28,909	32,173
YoY%	28.60%	0.40%	1.10%	-26.50%	2.50%	-16.80%	-	-	-	-3.50%	-1.60%	11.30%
2Q to 4Q tot.	20,307					20,810					21,368	-
YoY%	-6.7%					2.5%					5.2%	-
US\$/yen Month end average (actual)	121.9	121.7	121.2	115.4	120.1	106.8	?	?	?	?	102.1*	100*

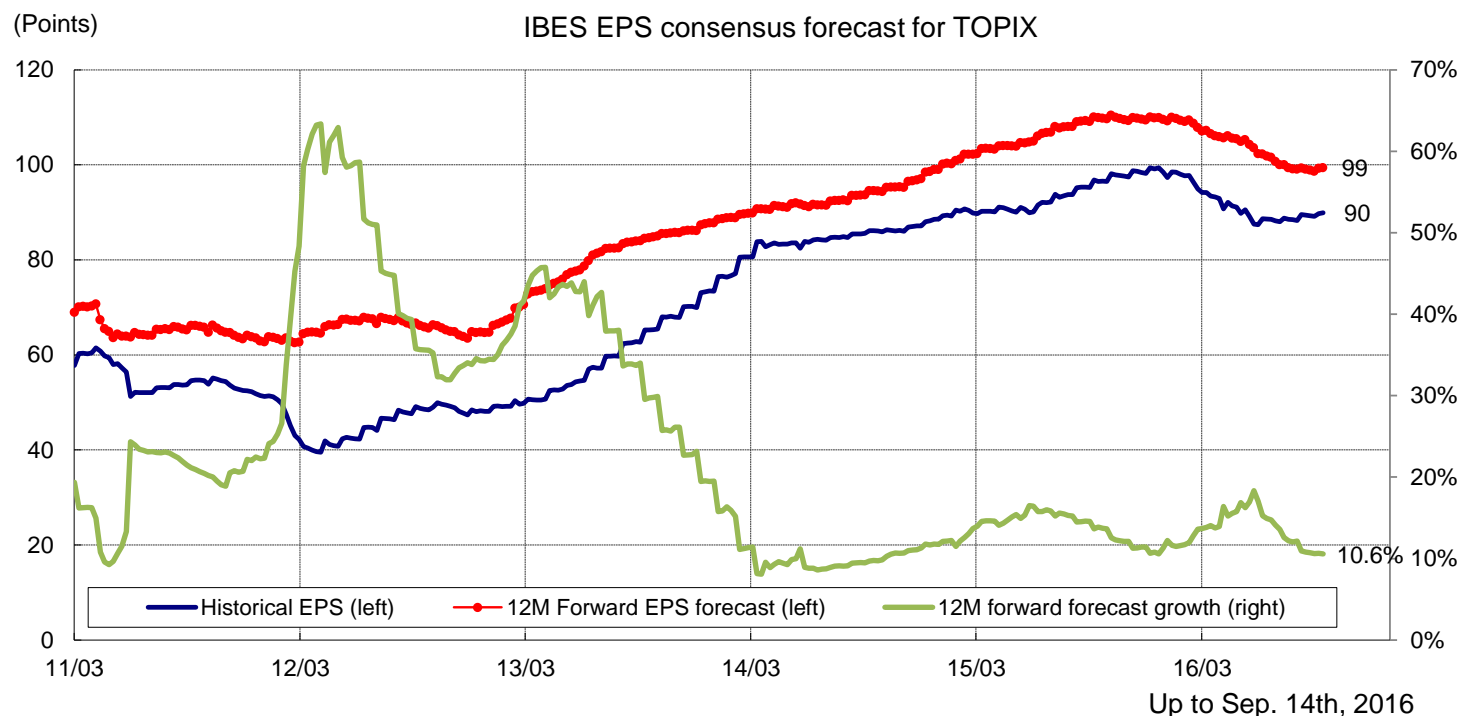
Yen appreciated by 14%

*Assumption for SMAM forecast

(Source) Toyo Keizai, announcement of each company, compiled by SMAM

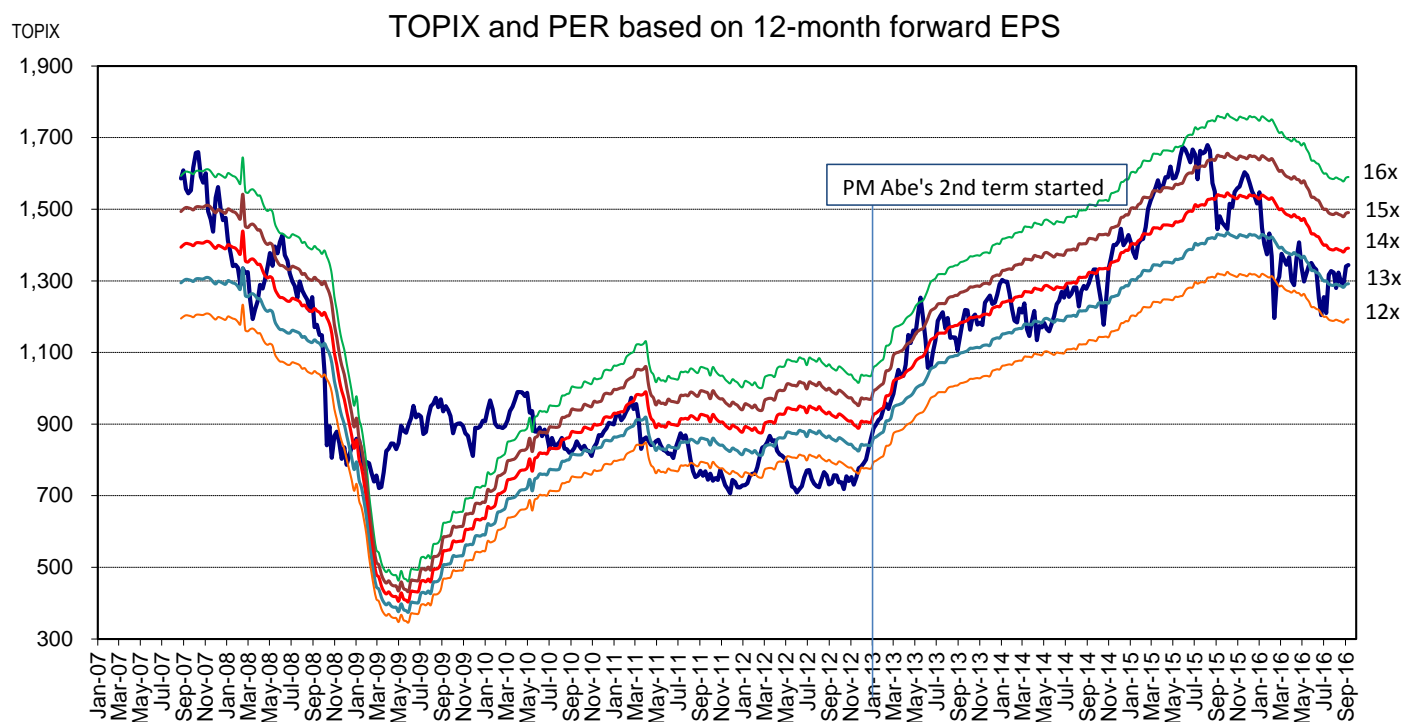
EPS forecast by analysts seems to be bottoming out

- The blue line in the chart, 12 month trailing EPS or historical EPS, has been recovering since June after the negative factors such as sharp appreciation of yen and heavy impairment costs of commodity related assets went behind. The red line, 12M forward EPS forecast, ticked up lately, which might indicate bottoming out move.
- 10.6% of 12M forward EPS growth is forecast . FY2016 growth for EPS is higher than that for recurring profit in general because extraordinary costs such as aforementioned impairment costs affects EPS but not recurring profits.



PER is in the lower half of the range for the current PM Abe's tenure

- Since Abenomics started, PER for Japanese stock market, TOPIX index-wise, has been in a range between 12x and 16x except for temporary overshooting.
- As of September 9th, PER for TOPX was 13.5x whereas comparative PER for S&P 500 was over 17x. Relative valuation of Japanese stocks looks attractive compared to US stocks.

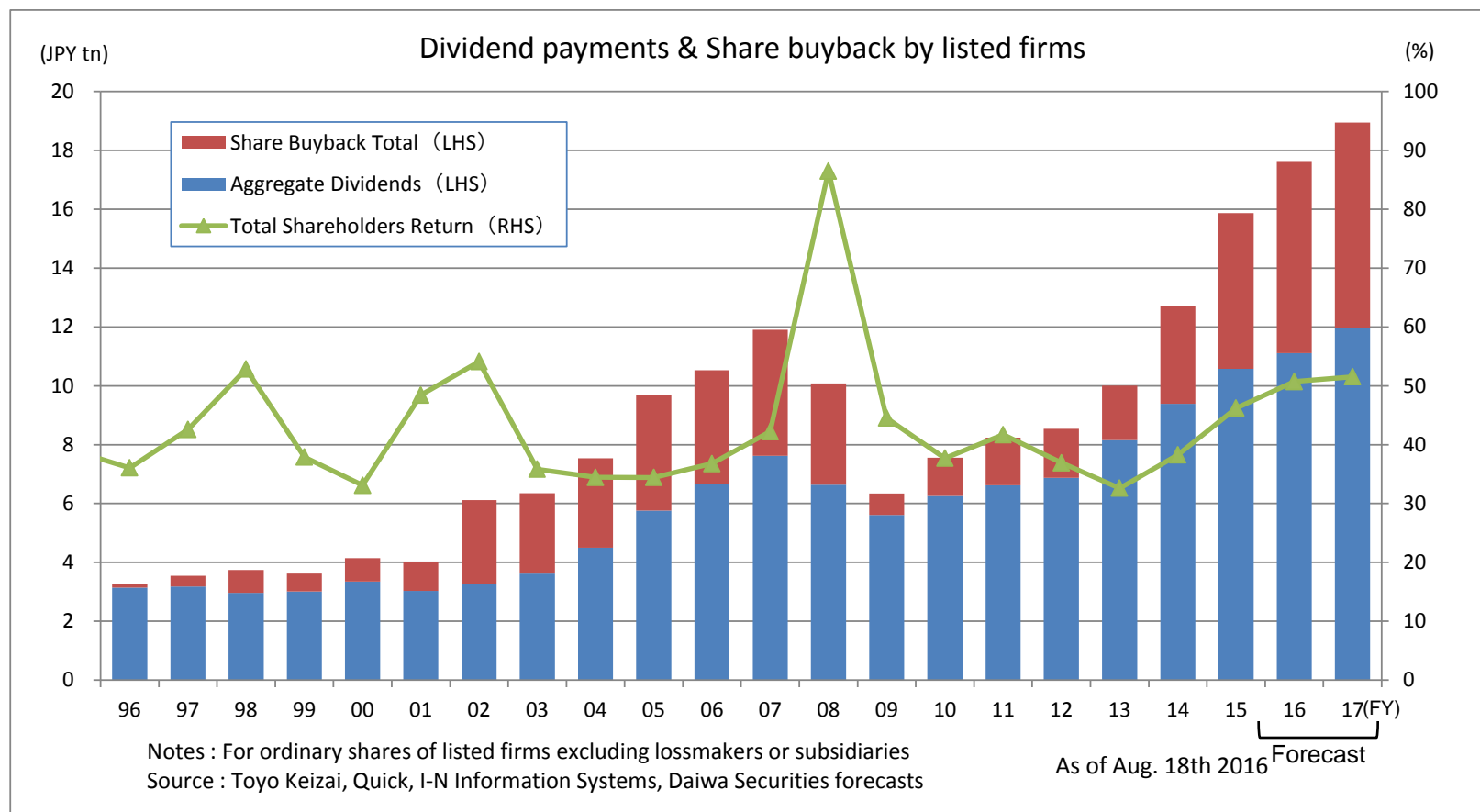


Notes: TOPIX: calendar year and week-end, P/E ratio is based on 12-month forward EPS of IBES
Source: TOPIX: Tokyo Stock Exchange, 12 month forward EPS of IBES: SMAM

Data is up to Sep.9th 2016 when TOPIX was 1343.86

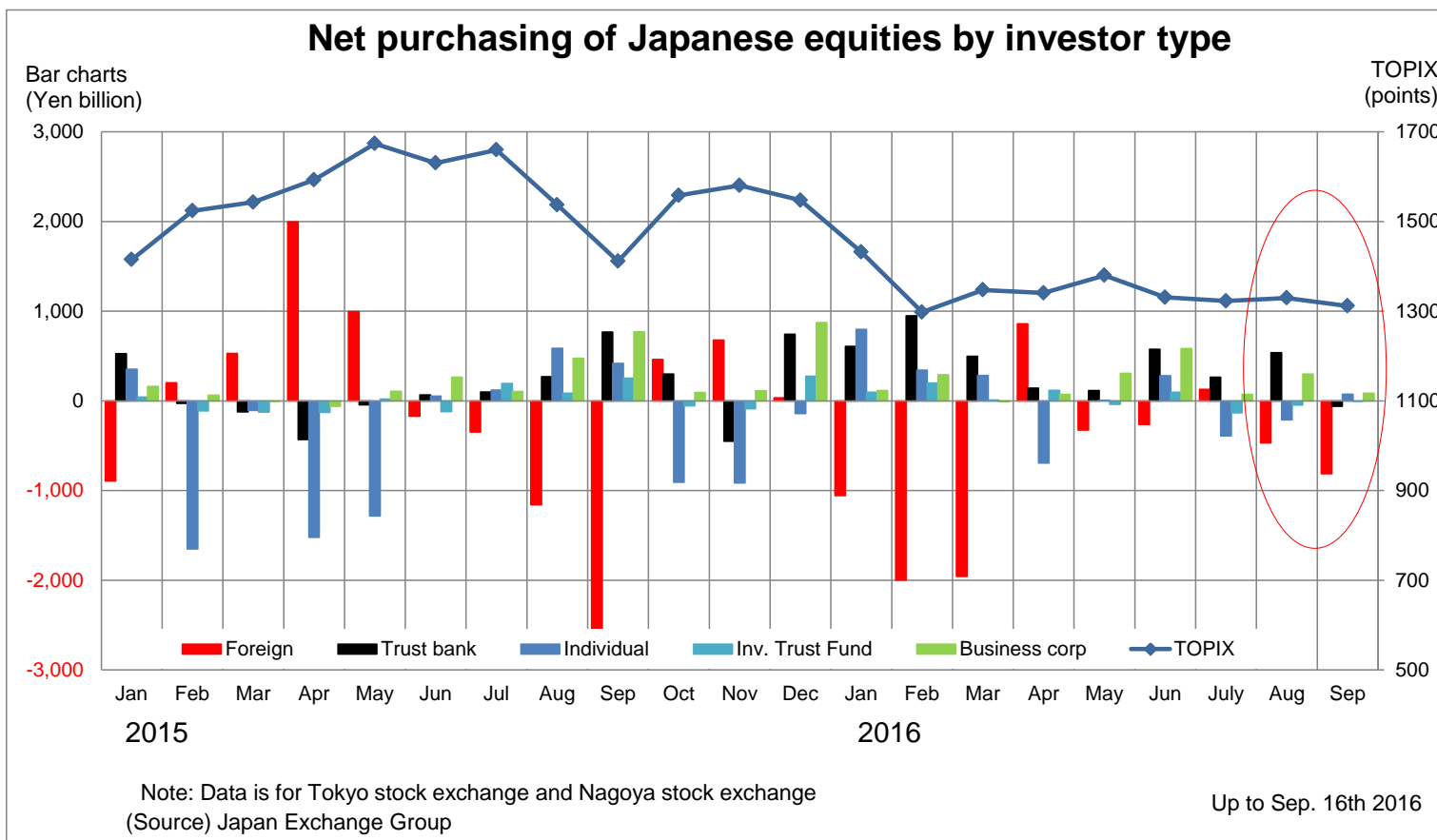
Total shareholder return is forecast to increase in FY 2016 and 2017

- Share buy-backs are continuing in a historically high pace and expected to continue.
- Total shareholder return ratio is forecast to exceed 50% in FY2016, the first time since early 2000's except for in 2008 when sharp decline in earnings temporarily spiked the ratio.



Foreign investors selling continued in September

- Japanese stock markets faced a continuing selling by foreign investors in September.
- Trust banks were not net buyers in the first half of September, however, this is supposed to be an exception as BOJ's purchasing of ETF should continue.



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