



Japanese Stock Market Outlook

SMAM monthly comments & views
-October 2018 -



Sumitomo Mitsui Asset Management

SMAM

Executive summary

➤ Japanese Economy

2Q 2018 GDP growth was up-revised from annualized 1.9% to robust 3.0% due mainly to surprisingly strong private capital investment. SMAM up-revised forecast for FY2018 from 1.1% to 1.2%. PM Abe was re-elected as the party leader of LDP. The government is expected to make fiscal spending to offset negative impact from scheduled consumption tax increase in October 2019. One of those spending programs is going to be enhancing national resilience against natural disasters.

- Japanese yen is biased to get weaker against US dollars on assumption that interest rate differential gets wider and also trade surplus of Japan between US gets smaller as a result of trade conflicts.
- After a brief fall in March due mainly to extremely cold weather, consumption activity has recovered and been showing resilience despite natural disasters, earthquake and flood damage, in western Japan. One of the supporting factors will be aggregate real wage, which is steadily rising on both increasing number of employees and higher nominal wage.

➤ Japanese Stock Markets

Japanese stock market is going to be supported by surprisingly strong US economy, resilient Japanese economy and possible upward revision in Japanese corporate earnings forecast during the second half of FY2018. Development of trade disputes and US politics surrounding midterm election in November will provide the volatility to the market.

- SMAM's forecast of FY2018 recurring profits for 227 companies in the research coverage was upgraded from previous 10.0% YOY growth to 11.1% in September, meanwhile that for FY2019 was slightly cut from 10.2% to 9.6%.
- Current slowdown in global manufacturing activities is expected to turn upwards again probably some time in the latter half of 2018, which is going to lift the earnings forecasts and also stock prices of the Japanese companies. Trade disputes are forecast to recede gradually after the mid-term election in US in November providing positive momentum to the stock market.

Notes: Macro and market views are as of Sep. 26th 2018, and subject to updates thereafter without notice.

Outlook for Japanese Economy

SMAM economic outlook for FY18-19

- 2Q 2018 GDP growth was up-revised from annualized 1.9% to robust 3.0% due mainly to surprisingly strong private capital investment. SMAM up-revised forecast for FY2018 from 1.1% to 1.2%.
- PM Abe was re-elected as the party leader of LDP. The government is expected to make fiscal spending to offset negative impact from scheduled consumption tax increase in October 2019. One of those spending programs is going to be enhancing national resilience against natural disasters.

(YoY %)	FY14	FY15	FY16	FY17	FY18E	FY19E
Real GDP growth	-0.3%	1.4%	1.2%	1.6%	1.2%	0.9%
Private Consumption Expenditure	-2.5%	0.8%	0.3%	0.8%	0.8%	0.6%
Private Housing Investment	-9.9%	3.7%	6.2%	-0.4%	-4.9%	0.6%
Private Capital Investment	3.3%	2.3%	1.2%	3.1%	4.9%	2.0%
Public Consumption Expenditure	0.4%	1.9%	0.5%	0.7%	0.5%	0.9%
Public Capital Investment	-2.0%	-1.6%	0.9%	1.4%	-0.3%	0.1%
Net Exports (contrib. to GDP growth)	0.6%	0.1%	0.8%	0.4%	0.0%	0.1%
Exports	8.7%	0.8%	3.6%	6.3%	2.9%	1.9%
Imports	4.2%	0.4%	-0.8%	4.1%	2.6%	1.4%
Nominal GDP	2.2%	3.0%	1.0%	1.7%	1.3%	2.0%
GDP Deflator	2.5%	1.5%	-0.2%	0.1%	0.1%	1.1%
Industrial Production	-0.4%	-1.4%	1.5%	4.1%	1.8%	1.8%
CPI (excl. fresh food)	0.9%	-0.1%	-0.2%	0.7%	0.8%	0.7%

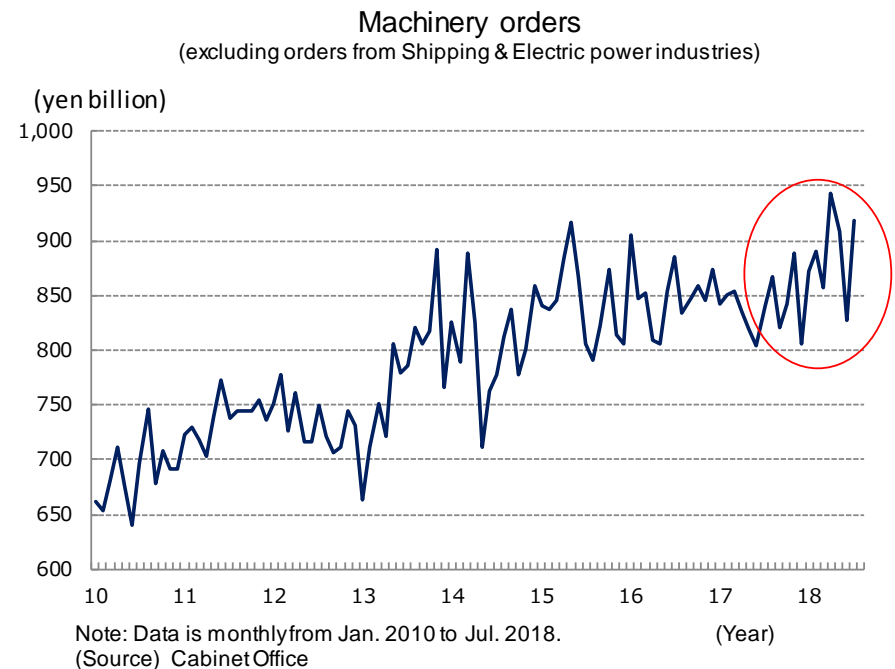
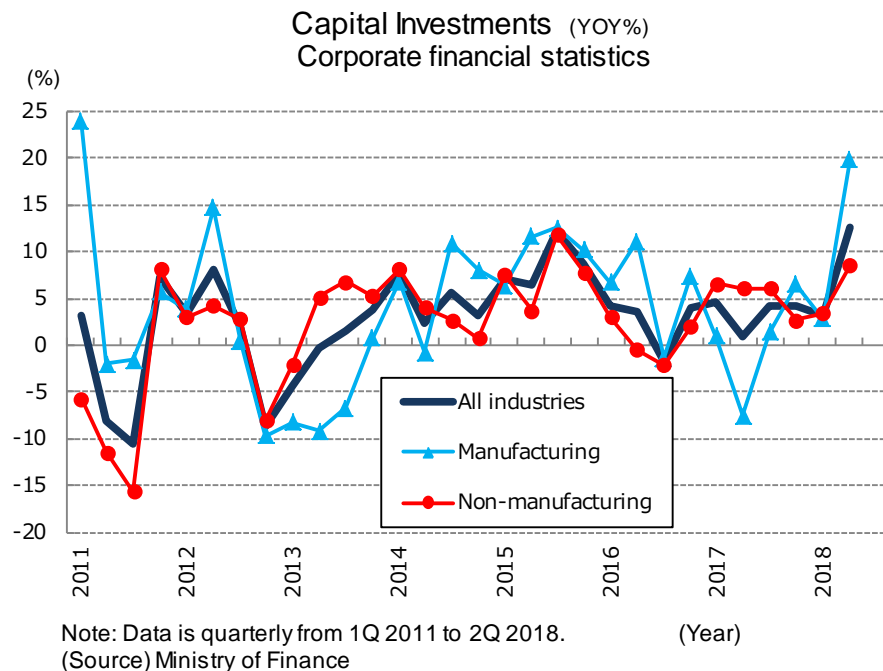
Notes: E=SMAM forecasts. SMAM views are as of Sep. 26th 2018 and subject to updates thereafter without notice

(%, YoY except Net Exports)

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

Appetite for capital investment is surprisingly strong in Japan

- Corporate financial statistics released from Ministry of Finance in September showed surprisingly strong capital investments by companies during Apr-Jun quarter.
- Machinery orders in July also exhibited strong order takings.



Private consumption activity stays resilient

- After a brief fall in March due mainly to extremely cold weather, consumption activity has recovered and been showing resilience despite natural disasters, earthquake and flood damage, in western Japan.
- One of the supporting factors will be aggregate real wage, which is steadily rising on both increasing number of employees and higher nominal wage.

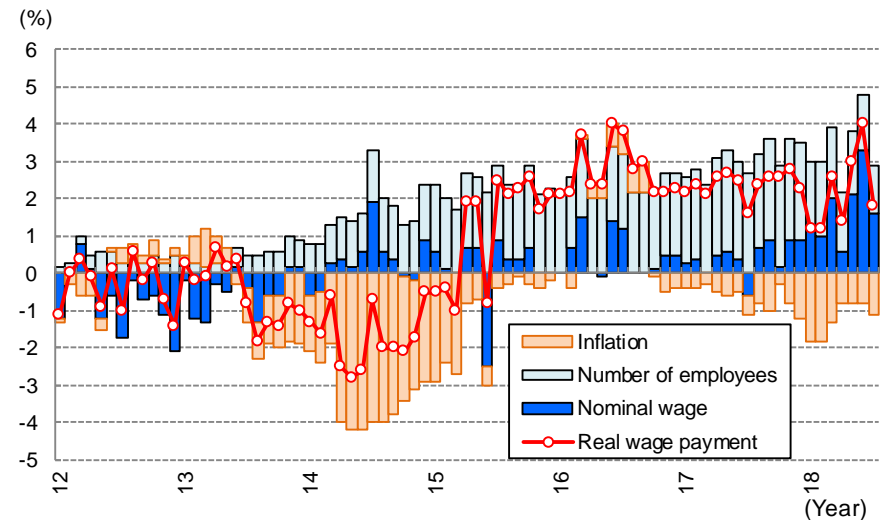
Real Consumption Activity Index (travel balance adjusted)
(2011=100)



Note: Data is monthly from Jan. 2011 to Jul. 2018.
(Source) Bank of Japan

(Year)

Real wage payment (YoY %)

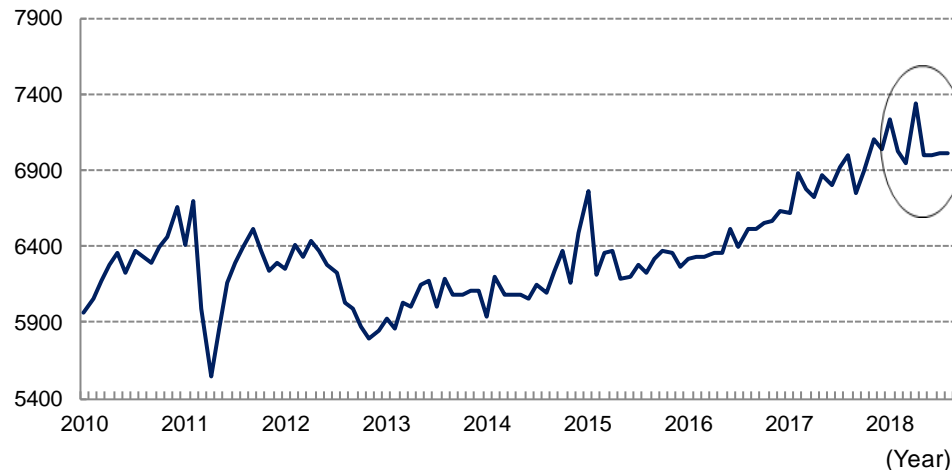


Note: Data is from Jan. 2012 to Jul. 2018.
(Source) Ministry of Health, Labour and Welfare

Export growth in August was almost flat from July

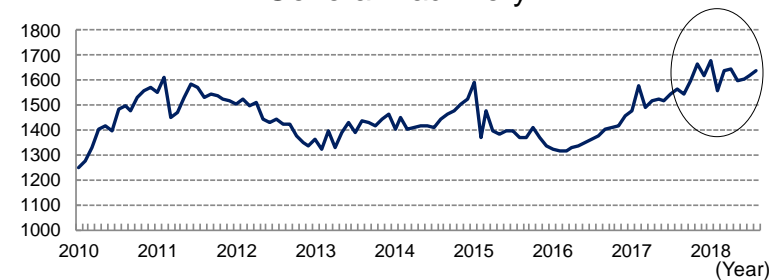
- Monthly real export volume growth was almost flat in August. Among the three largest export items, transport equipment recovered from shipping delay in July caused by a typhoon, however, which was offset by decline in electrical goods from a sharp rise in the previous month.
- So far, trade disputes initiated by US have had only limited impact on exports of such items as metal products, however, situation needs to be watched carefully.

Total export volume

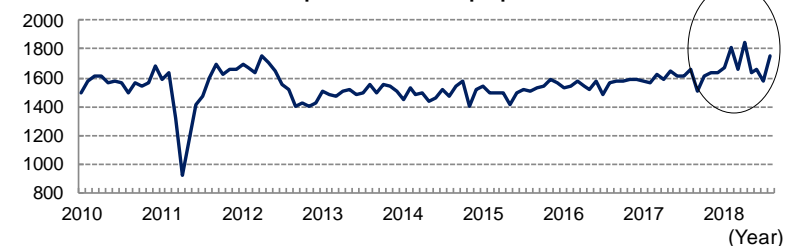


Note: Data is from Jan. 2010 to Aug. 2018.
 (Source) Ministry of Finance, Bank of Japan, compiled by SMAM.

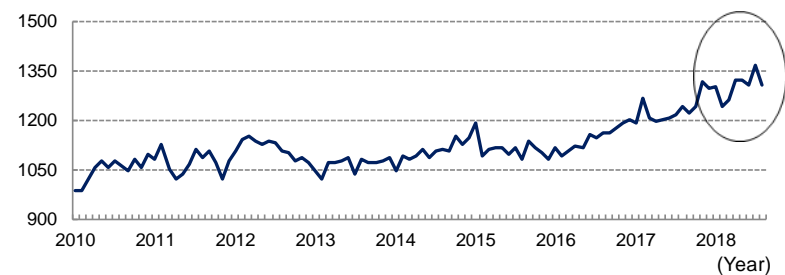
General Machinery



Transportation Equipment

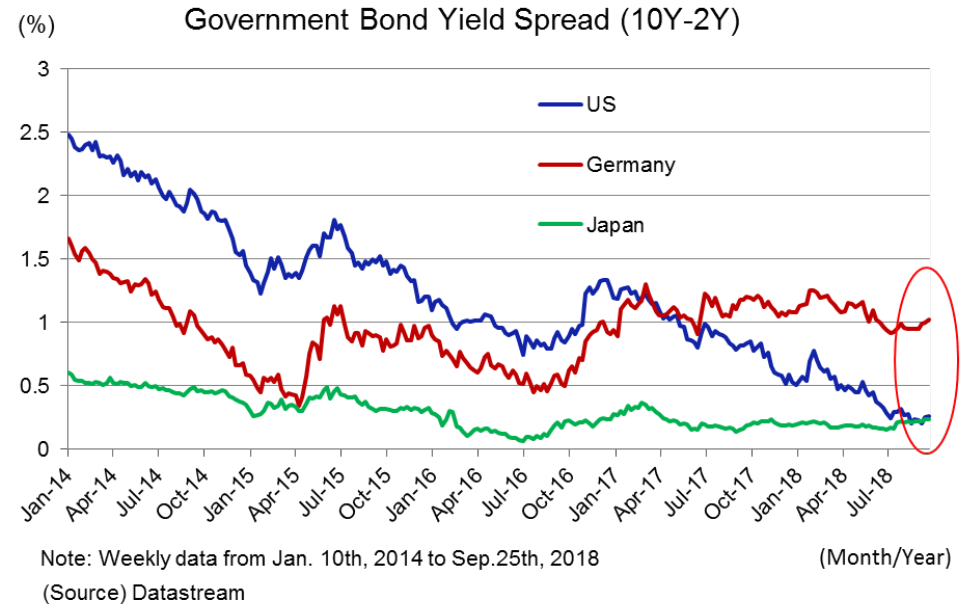
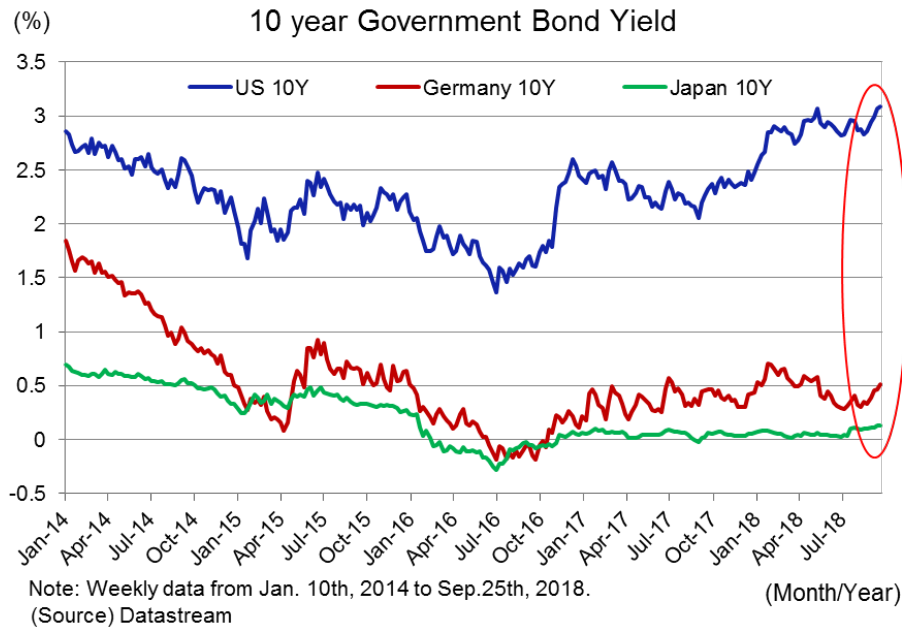


Electrical Goods



Long term bond yields are globally on the rise

- Long term interest rates started to rise recently. This is a good sign that global investors are getting more risk-on.
- Despite persistent worry of trade conflicts initiated by US, global economy has not yet had a serious impact and US economy is actually gathering more strength.
- Japanese yen is biased to get weaker against US dollars on assumption that interest rate differential gets wider and also trade surplus of Japan between US gets smaller as a result of trade conflicts.



PM Abe is expected to be the longest serving Prime Minister in Japanese history

- On 20th September, PM Abe was re-elected as the leader of the governing party, LDP. As the party leader, this is the third term in a row and also the last one with maximum 3 more years. Political stability is one of the advantages of Japan.
- PM Abe's government is planning to make extra fiscal spending, among which trillions yen are expected to be spent on enhancing national resilience against natural disasters, such as mega-earthquake and super-typhoons.
- Fiscal spending is also going to target neutralizing possible negative impact from scheduled consumption tax increase in October 2019 and after-party-hangover of 2020 Tokyo Olympic games.

Top four longest serving Prime Ministers in Japan

	Name	Days	Period
1	Eisaku Sato	2798	3 terms between 1964 and 1972
2	Shigeru Yoshida	2616	5 terms between 1946 and 1953
3	Shinzo Abe	2471*	So far 4 terms between 2006 and 2018
4	Jyunichiro Koizumi	1980	3 terms between 2001 and 2005

* Note: As of the end of Sep. 2018. Among the prime ministers after the World War II.

(Source) NIKKEI Inc., Cabinet office

US midterm election gets closer, however, trade disputes continue

- Trade disputes between US and China has shown no sign of abating.
- US politics are going to get attention as midterm election is scheduled on 6th of November.
- In Europe, confusing Brexit deal and upcoming budget negotiation between Italy and EU will be important events to be watched.

Upcoming key events

Month	Region/Country	Events	Notes
September	Japan	18-19 BOJ Monetary Policy Committee Meeting	
		20 LDP leadership election	Mr Abe was re-elected for the 3rd term as the party leader.
	US-Japan	US-Japan trade talks, 2nd round	
	EU	26 ECB Monetary Policy Meeting	
	EU/UK	30 Target date for deciding Brexit conditions	
October	Italy	15 Italy's budget plan to be presented to EC	
	US	Semiannual Report on International Economic and Exchange Rate	
November	US	6 Mid-term election for US congress	
	US-Iran	8 2nd part of US sanctions on Iran is set to begin	
	Japan	14 BOJ Monetary Policy Committee Meeting (Quarterly perspective report)	
	Asia	11-15 ASEAN summit, 17-18 APEC summit	
	Global	30- G20 meeting	
	Middle East	OPEC meeting	
December	EU	13-14 EU summit	
	US	18-19 FOMC	
2019			
April	Japan	Prince Naruhito becomes the new emperor. Japanese calendar is set for renewal.	Positive economic effect is expected from celebratory atmosphere and calendar renewal.
October	Japan	Consumption Tax is scheduled to rise from 8% to 10%	

(Source) Various publications, assembled by SMAM

Outlook for Japanese Stock Markets

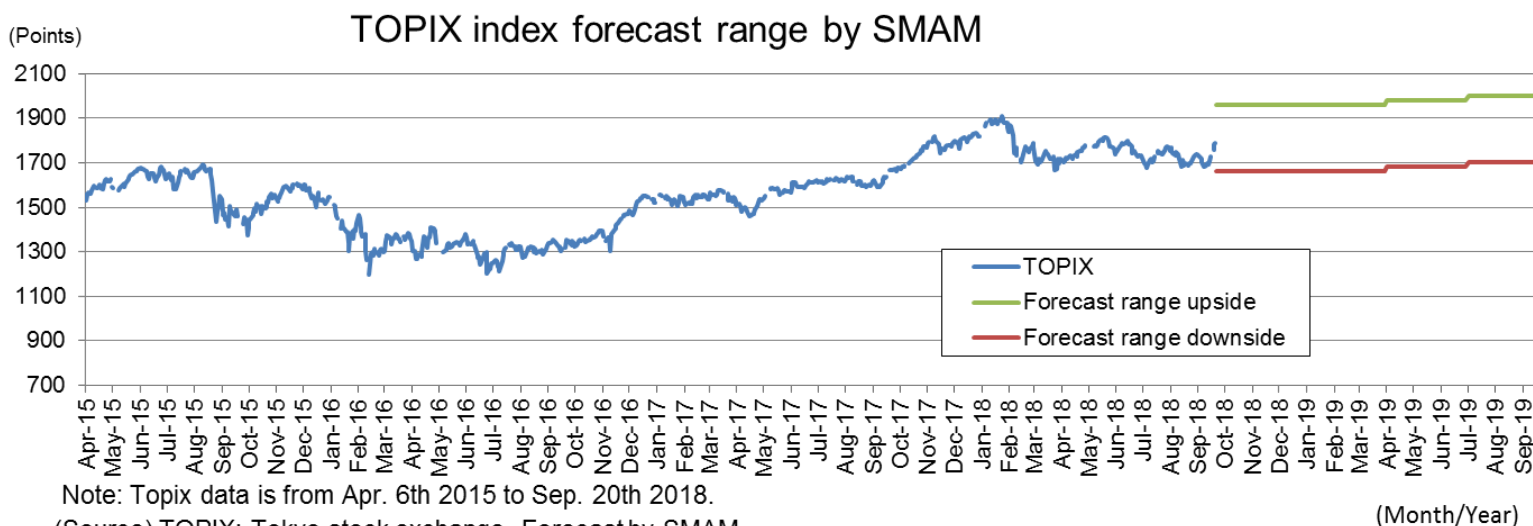
Stock market outlook: Tug-of-war between the fact (resilient global economy) and the worry (trade dispute)

SMAM short-term view

- Japanese stock market is going to be supported by surprisingly strong US economy, resilient Japanese economy and possible upward revision in Japanese corporate earnings forecast during the second half of FY2018. Development of trade disputes and US politics surrounding midterm election in November will provide the volatility to the market.

Longer-term outlook (6-months and beyond)

- Current slowdown in global manufacturing activities is expected to turn upwards again probably some time in the latter half of 2018, which is going to lift the earnings forecasts and also stock prices of the Japanese companies. Trade disputes are forecast to recede gradually after the mid-term election in US in November. Extra fiscal spending is expected in Japan in order for enhancing national resilience against natural disasters, which will work positively for the market.



Note: SMAM's projection is as of Sep. 26th, 2018 and subject to updates without notice.

Base scenario & Upside / Downside risks for our forecasts

- Our **Base Scenario** is assuming the following views:
 - Uncertainties of world trade disputes will recede post mid-term election in US in November.
 - US economy keeps growing.
 - Japan's private consumption to grow mildly supported by wage growth.
 - Japanese yen does not get extremely stronger beyond 100 yen against US\$.
 - Tension in the East Asia does not ignite a war.
 - Central banks gradually move to normalize monetary policies and avoid killing economic growth.

- **Upside Risks** include:
 - Stronger-than-expected global growth.
 - Denuclearization in Korean peninsula makes a visible progress.
 - Extremely tight labor condition in Japan finally ignite substantial wage growth leading to higher inflation.

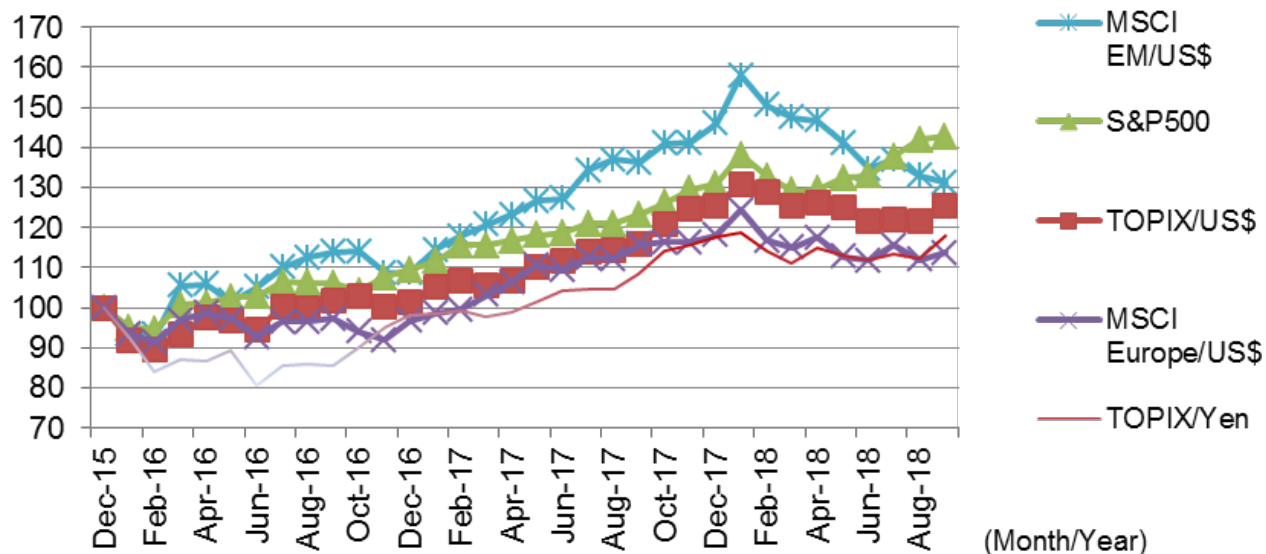
- **Downside Risks** include:
 - Seriously escalating geo-political tensions in Middle East & East Asia.
 - Rekindled concern over emerging economies including China.
 - Global monetary tightening intensifies to choke global economy.
 - Confrontational foreign policies taken by Trump presidency igniting a trade war.
 - Political turmoil flares up in US after the midterm election.
 - Populism gains in Europe further destabilizing EU.

Note: SMAM's projection is as of Sep. 26th, 2018 and subject to updates without notice.

US stocks continue rallying and Japanese stocks made a substantial rebound in September

- US stock market continues its rally by recording new highs. Repatriation of overseas retained profits probably have played a significant roll in pushing US stock prices.
- Japanese stock market made rebound due partly to short covering and the rally was led mainly by value stocks. PM Abe's win as the LDP party leader was positive. Also, trade dispute between US and Japan seemed milder than that between US and other countries, which was taken positively by investors.

US\$ based performance of stock markets (Dec 2015=100)



Notes: Data is up to Sep. 25th 2018.

(Source) Datastream, MSCI and Tokyo Stock Exchange, compiled by SMAM.

Current conservative earnings guidance by companies will be gradually up-revised

- SMAM's forecast of FY2018 recurring profits for 227 companies in the research coverage was upgraded from previous 10.0% YOY growth to 11.1% in September, meanwhile that for FY2019 was slightly cut from 10.2% to 9.6%.
- Companies' self-guidance on recurring profits for FY 2018 is still conservative 4.8% YOY growth, and this is likely to be revised upward as the time progresses.
- Net profit growth forecast for FY2018 looks slow at 3.2%, however, this is simply due to one-off extraordinary profits inflating net profits in FY2017. Recurring profits show more secular growth.

SMAM Corporate Earnings forecasts (227 Companies research coverage excl. financials)

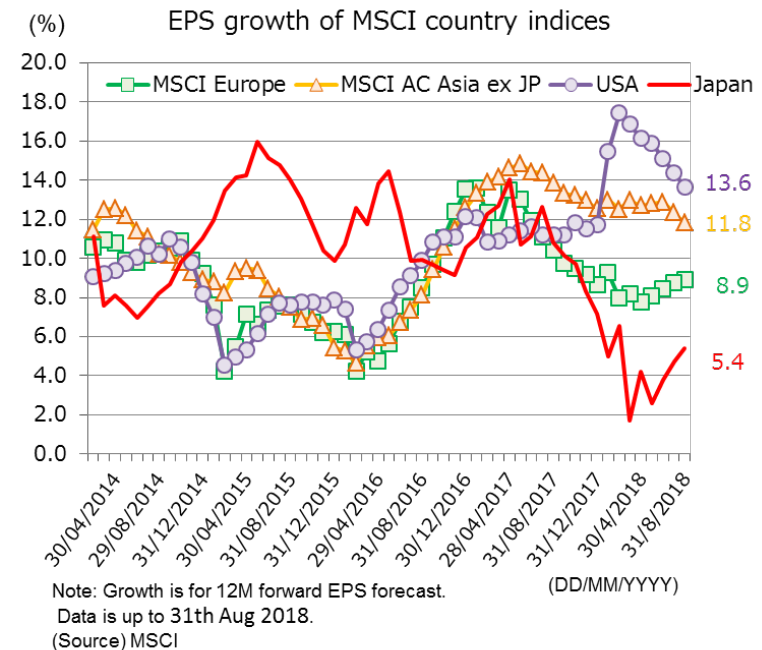
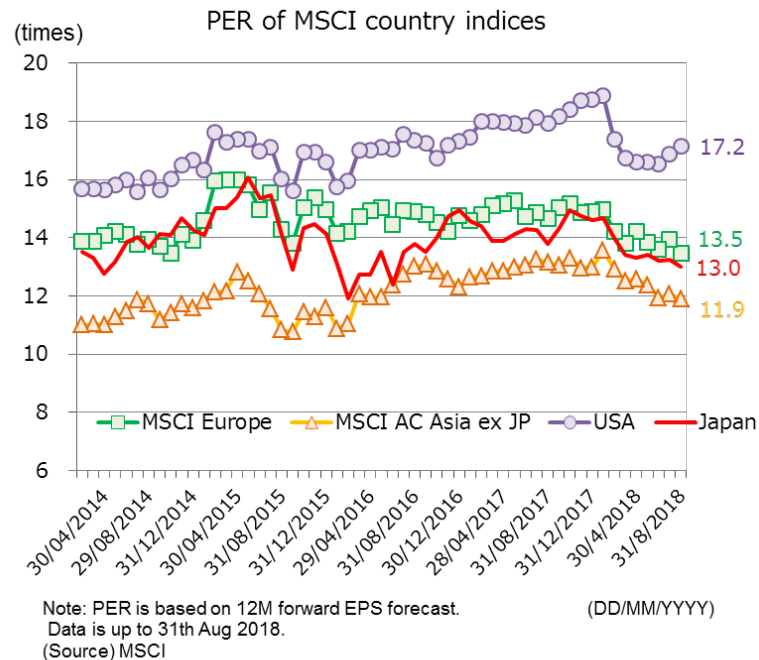
Fiscal year	FY 2016	FY 2017	FY 2018E	FY 2019E
Date of forecast	Actual	Actual	as of 7th Sep. 2018 (as of 7th Jun. 2018)	as of 7th Sep. 2018 (as of 7th Jun. 2018)
Sales (YoY %)	-3.8%	9.3%	6.0% (5.9%)	2.7% (2.7%)
Operating Profits (YoY %)	4.9%	15.6%	10.3% (10.2%)	7.1% (7.3%)
Recurring Profits (YoY %)	6.6%	17.8%	11.1% (10.0%)	9.6% (10.2%)
Net Profits (YoY %)	17.3%	35.0%	3.2% (1.7%)	5.0% (5.6%)
Recurring profits (YoY %)				
Manufacturing 132 companies	2.6%	21.3%	10.6% (9.3%)	8.1% (8.1%)
Non-manufacturing 95 companies	12.8%	12.7%	11.8% (11.1%)	11.8% (13.2%)
Self guidance by 227 companies			4.8% (3.7%)	

Note: Key assumptions for FY2018 & 19 are Yen/US\$ and Yen/EUR stay at 110 and 125 respectively after April 2018.

(Source) SMAM Corporate Research Group, Toyo Keizai

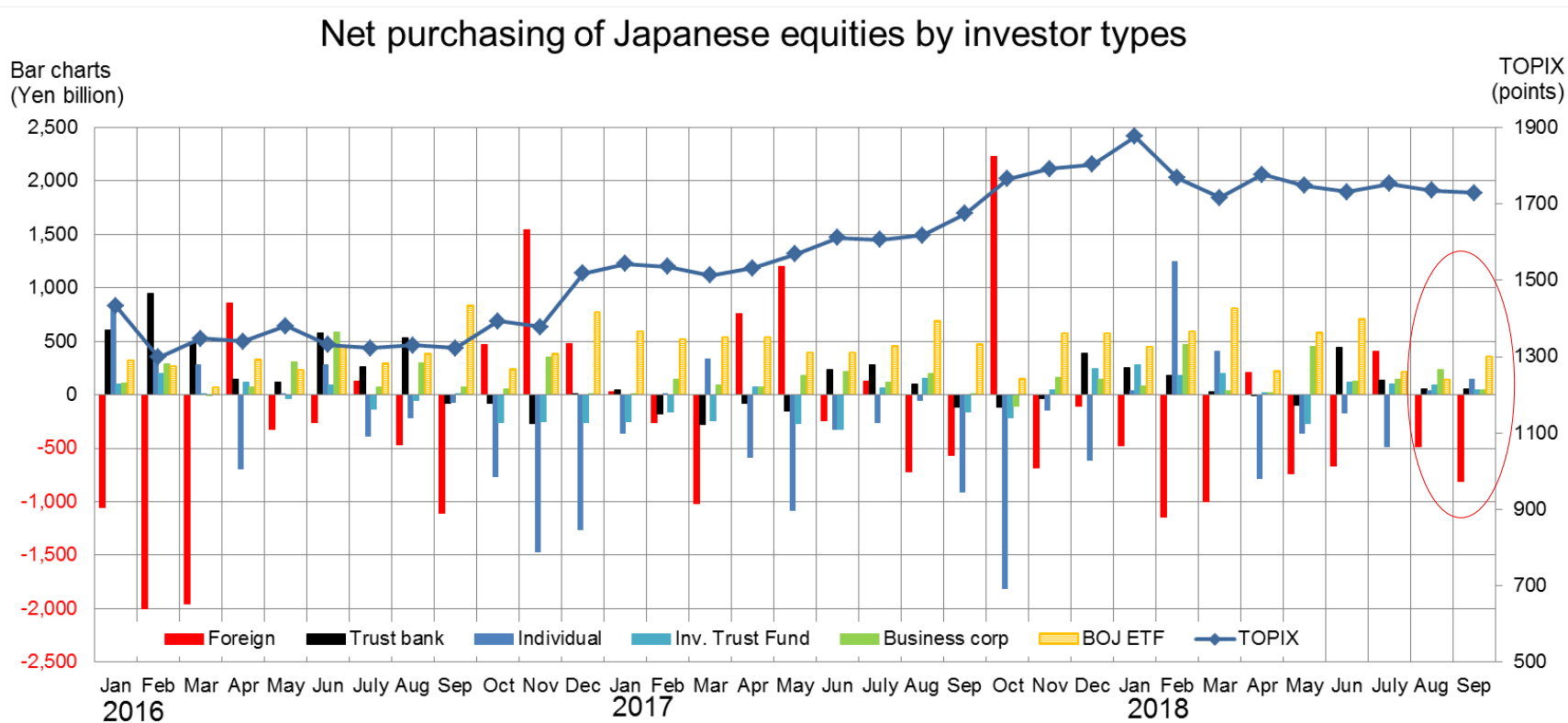
PE ratio is at reasonable level

- 12M EPS growth forecast for US is gradually declining from the peak in 1Q of 2018, when corporate tax reduction added extra growth. PE ratio for US is climbing again and the level above 17 times looks a little expensive.
- EPS growth forecast for Japan is low at 5.4%, however, as I mentioned in the slide 15, this is affected by preceding one-off extraordinary profits recorded. More secular profit growth pace will be around 10% indicated by recurring profit growth. 13 times PE ratio for Japan is in the lower zone among the historical range between 12 and 16 times shown in the left chart.



Foreign investors were selling until mid-September, which probably turned around later

- Currently available statistics is up to 14th of September, which showed selling by foreign investors.
- Anecdotal evidence shows short covering by foreign investors ignited a rally in the latter half of September.



Note: Data is for Tokyo stock exchange and Nagoya stock exchange up to Sep.14th 2018.

BOJ ETF figure is officially released data from BOJ.

(Source) Japan Exchange Group, Bank of Japan

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