



Outlook for Japanese Economy & Stock Market

Monthly comments & views by
Sumitomo Mitsui DS Asset Management (SMDAM)

-March 2020-

Executive summary

➤ Japanese Economy

Japanese real GDP growth contracted by -6.3% (QoQ annualized) in Oct-Dec 2019 quarter, which was worse than SMDAM's preceding estimate of -4%. Private consumption and private capital expenditure, especially in construction sector showed large decline, for which typhoon & flood disaster made negative impact. Forecast for Jan-Mar 2020 quarter real GDP growth was down-revised from +0.7% to -0.3% (QoQ annualized) considering negative impact of new coronavirus epidemic in China and infection cases appearing in Japan. SMDAM currently forecasts coronavirus epidemic to be contained by 2Q 2020. Positive effects of large fiscal spending will become visible from Apr-Jun quarter this year. (Page 8)

- Total wage payment in Japan keeps growing due mainly to increasing number of employees even in such a tight labor market. Number of female workers is further increasing and also elder people are extending retirement age. Strong demand for workers is encouraging people, who once gave up finding jobs, to start seeking again. (Page 11)

➤ Japanese Stock Market

Japanese stock markets are going to be affected by temporal negative factors such as spreading coronavirus infection in Japan and epidemic in China, which is causing downward pressure on private consumption as well as setback in production, especially in China. SMDAM expects that coronavirus can be contained by 2Q 2020 and global economy will resume its recovery path from 2Q 2020, which will put the Japanese stock markets back on a recovery trend too. (Page 19)

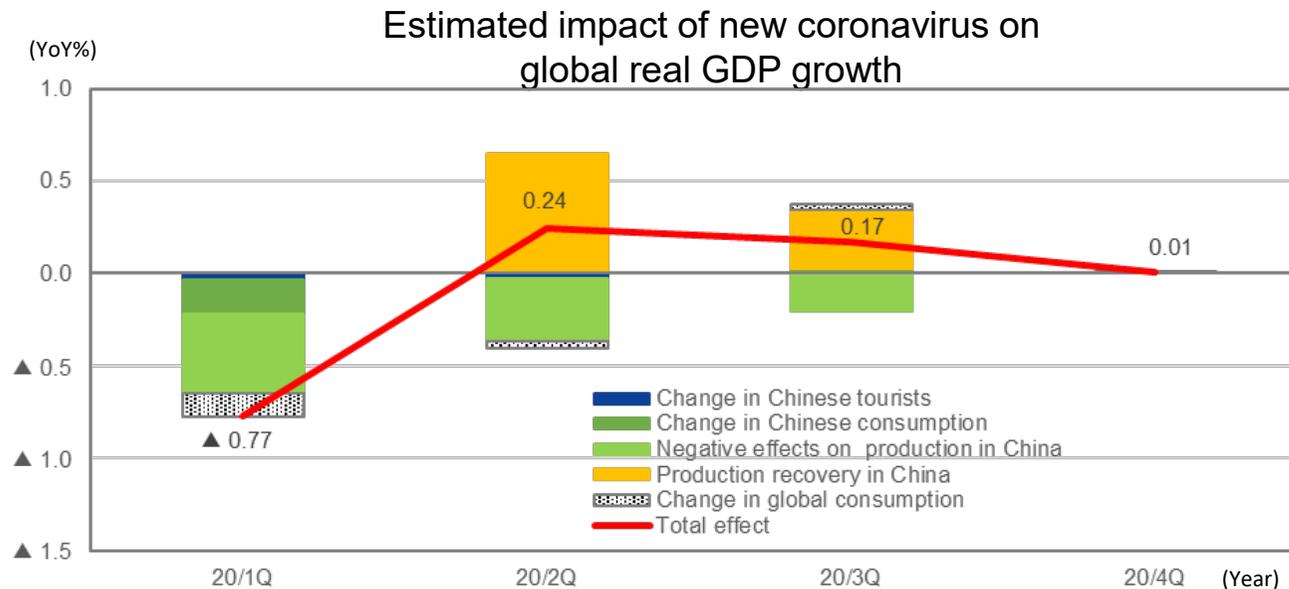
- Downward earnings forecast revision resumed lately probably due to weaker than forecast earnings results for Oct-Dec 2019 quarter and growing concern of negative effects caused by new coronavirus epidemic. However, 12m forward EPS growth forecast increased to 9.2% from 8.2% in the previous month. 12m forward EPS forecast was maintained despite declining historical EPS. (Page 23)



Outlook for Japanese Economy

Outlook for the global economy: impact of new coronavirus

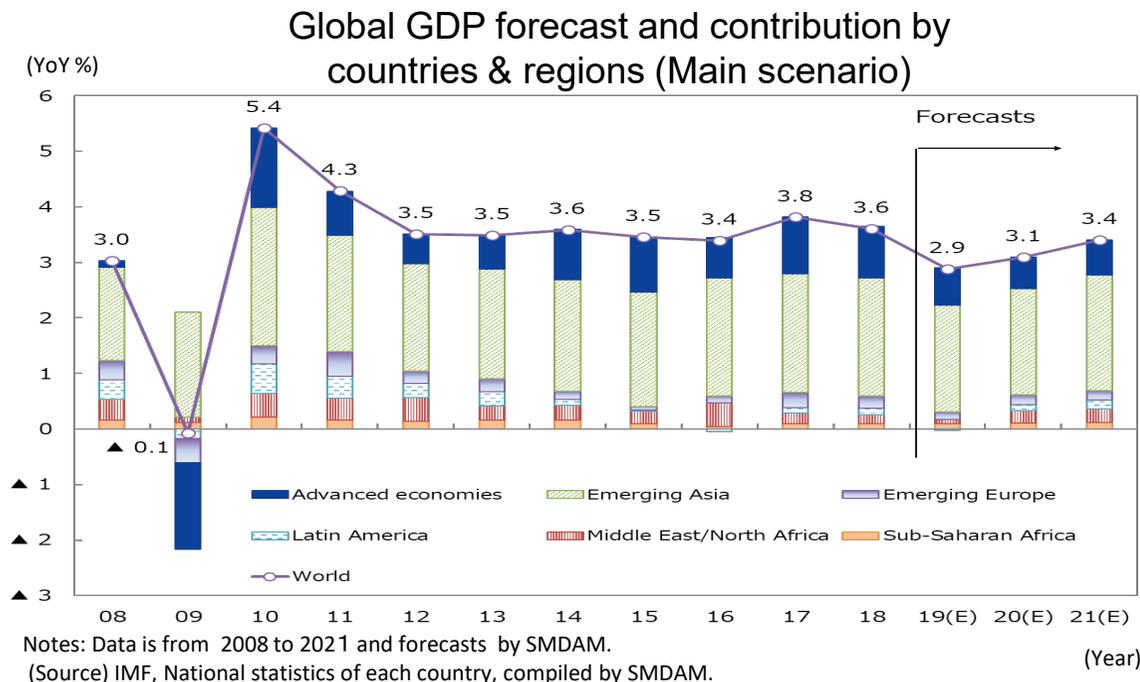
- Spreading new coronavirus is casting a shadow on the global economy, however, SMDAM currently assumes a main scenario that the epidemic is going to be contained by 2Q 2020 and its negative impact will be concentrated on 1Q 2020. Based on this scenario, global GDP is assumed to be affected by -0.77% (YoY %) in 1Q 2020, then after has positive effects of production catch-up in 2Q and 3Q of 2020.
- An important note will be the fact that this coronavirus is not as deadly as Ebola, MERS or SARS. So far observed cases are more like a little severer influenza. We should not be excessively scared.



Note: SMDAM's estimates of new coronavirus impact on global real GDP growth calculated by using OECD Input-Output Tables.
 (Source) OECD, compiled by SMDAM

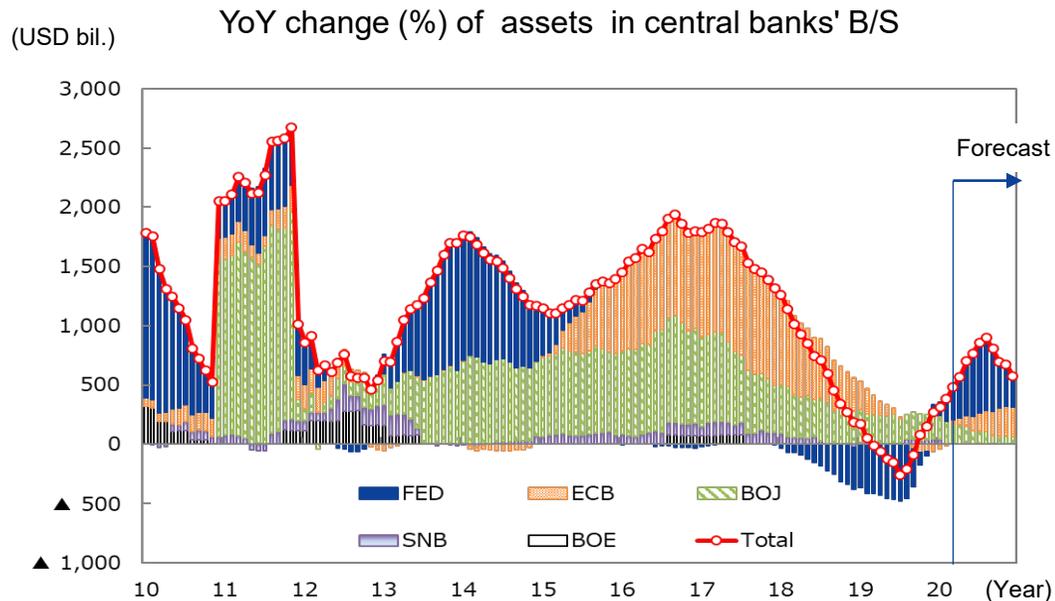
Outlook for the global economy

- SMDAM down-revised global real GDP forecast for 2020 from 3.2% to 3.1% as a main scenario. In this scenario, GDP growth in China is forecast to decelerate to just 1.4% (QoQ%, annualized) in 1Q 2020 and then rebound by 8.2% in 2Q 2020.
- The global economy has been showing signs of cyclical recovery led by US lately and this positive trend will not be broken by coronavirus scare though bottoming period could be extended.



Global quantitative easing is progressing

- FRB is expanding its balance sheet as a reserve management in order for containing volatility of FF rates, which has worked positively for the global financial markets. This expansion is expected to end in 2020.
- BOJ will keep current easing pace. Large fiscal stimulus measures in Japan amounting to JPY 26 trillion will be able to support economic growth in Japan even without extra monetary easing.

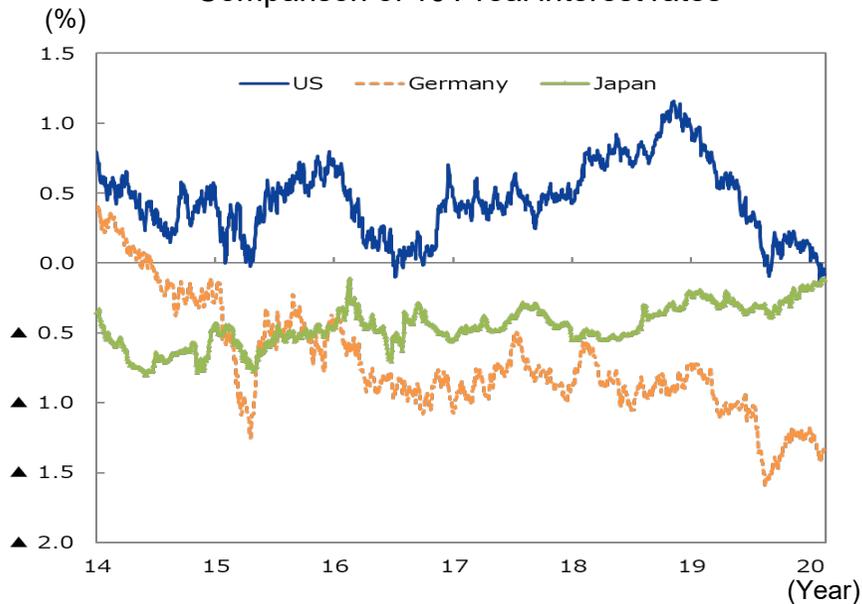


Note: Data is from Jan 2010 to Jan 2020 and SMDAM's forecasts to Dec 2020.
 Assumes that ECB restarts monthly EUR 20 bil. bond purchases from Nov. 2019 and increase the purchasing to EUR 30 bil. from Mar. 2020. FED expanse B/S as reserve management. BOJ maintains current purchasing pace.
 (Source) Bloomberg, each central bank, compiled by SMDAM.

Global capital has been flowing into US fixed income markets

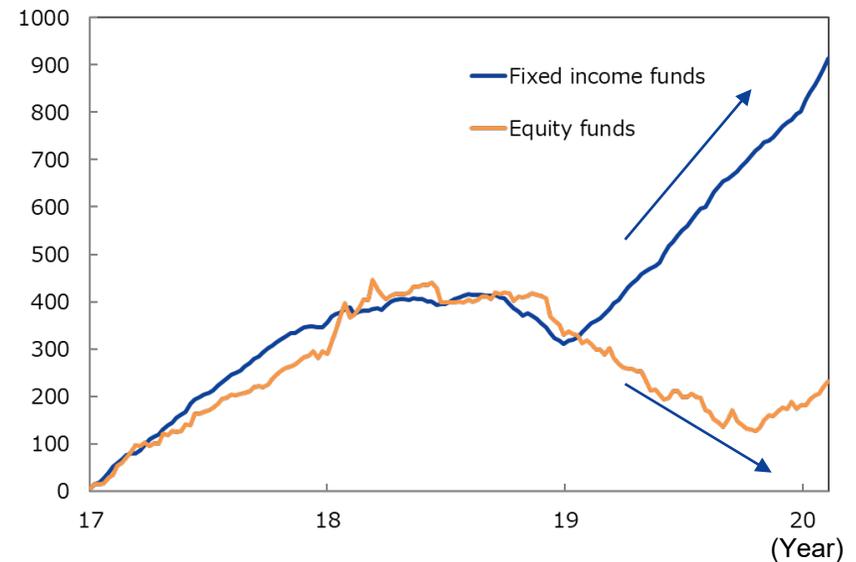
- In 2019, global economy significantly slowed down and FRB and ECB cut short term interest rates. Capital flowed out from equities and into fixed income. US has almost solely attracted this huge capital inflow, for which comparatively high real interest rate was a driver in the background, which also supported strength of US dollars. Lately, real interest rates of US and Japan is converging.
- Outflow from equity stopped lately and we need to watch if this turn-around of capital flow into equity continues.

Comparison of 10Y real interest rates



Note: Data is daily from 1st Jan 2014 to 17th Feb 2020.
Real interest rate = government bond yield – inflation rate implied by inflation linked government bond.
(Source) Bloomberg

Global cumulative capital flow for Unit trust / Investment trust funds (USD bil.)

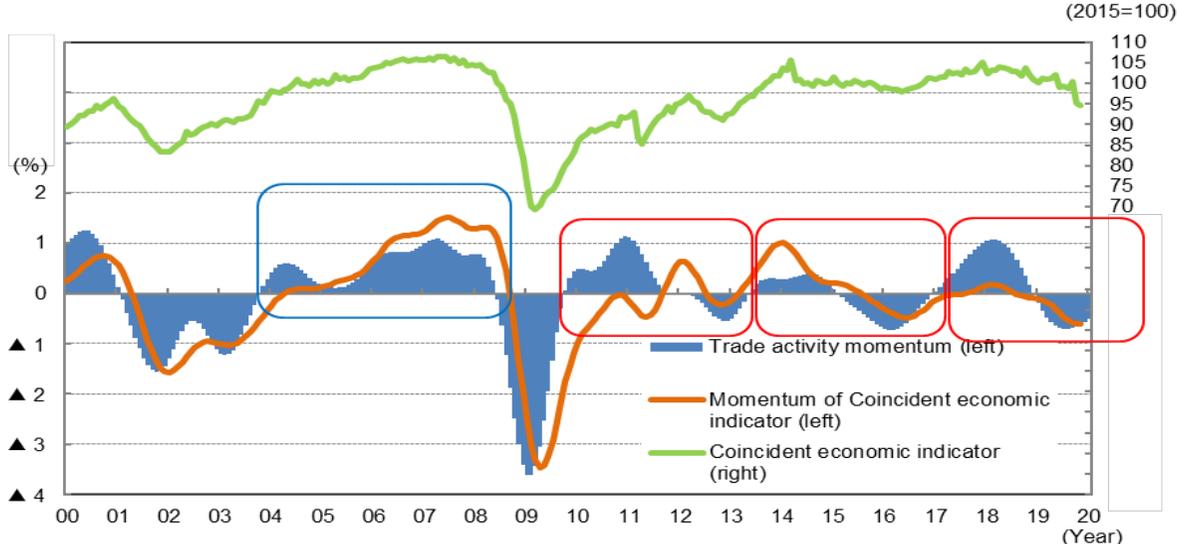


Note: Data is weekly from 4th Jan 2017 to 12th Feb 2020.
(Source) EPFR, compiled by SMDAM Economic Research Department

Bottoming period of trade activity is going to be extended by coronavirus

- SMDAM is monitoring trade activity momentum of Japan, which is composed of various related statistics supposed to work as leading indicators. This momentum has been showing a bottoming pattern, however, bottoming period is going to be extended by the epidemic of the new coronavirus.

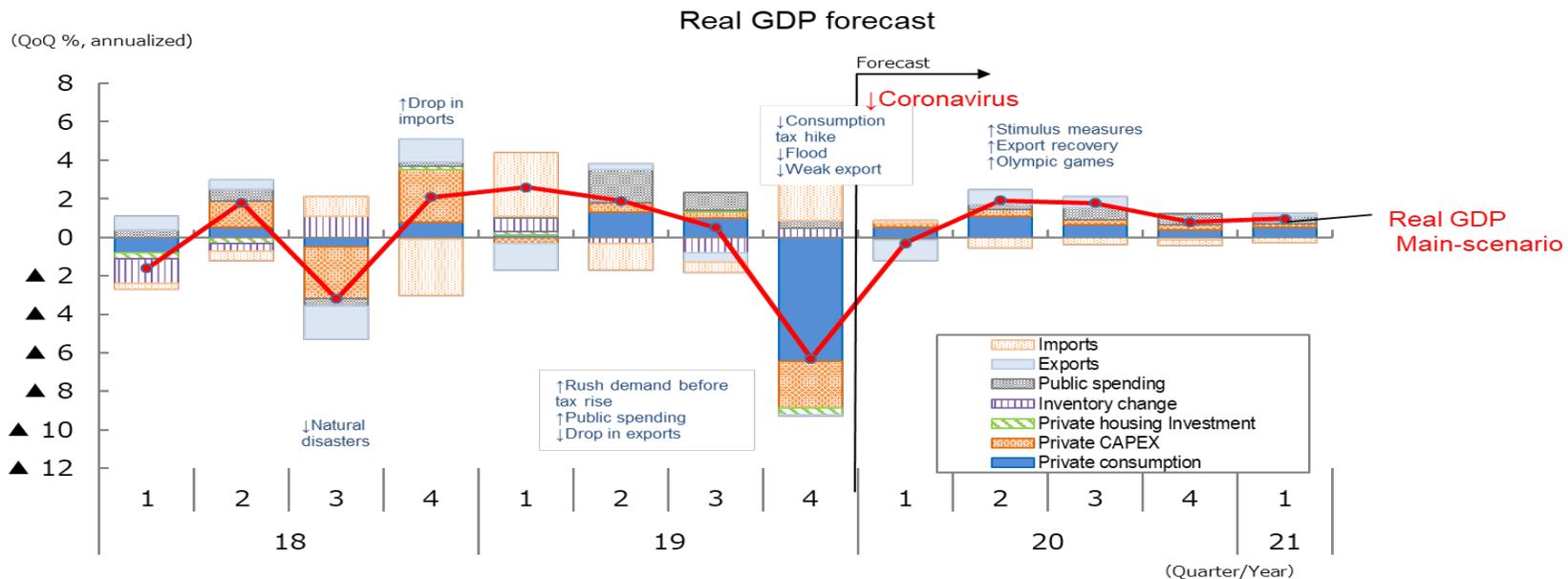
Momentum of Japanese economic indicator and trade activities



Note: Data is monthly from Jan 2000 to November 2019 for coincident economic indicator and to January 2020 for trade activity momentum. Trade activity momentum is composed by SMDAM using various trade related statistics. Momentum of coincident economic indicator was created by SMDAM using coincident economic indicator published by cabinet office.
 (Source) Cabinet Office and other various trade related statistics, compiled by SMDAM

Japanese economy was hit harder in 4Q 2019 than preceding estimate

- Japanese real GDP growth contracted by -6.3% (QoQ annualized) in Oct-Dec 2019 quarter, which was worse than SMDAM's preceding estimate of -4%. Private consumption and private capital expenditure, especially in construction sector showed large decline, for which typhoon & flood disaster made negative impact.
- Forecast for Jan-Mar 2020 quarter was down-revised from +0.7% to -0.3% (QoQ annualized) considering negative impact of new coronavirus epidemic in China and infection cases appearing in Japan. SMDAM currently forecasts coronavirus epidemic to be contained by 2Q 2020.
- Positive effects of large fiscal spending will become visible from Apr-Jun quarter this year.



Note: E=SMDAM forecasts. SMDAM views are as of 19th Feb. 2020 and subject to updates thereafter without notice

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

SMDAM Japanese economic outlook for FY19-21

- SMDAM down-revised GDP forecast for FY2019 and FY2020 by -0.6% and -0.5% respectively reflecting poor Oct-Dec 2019 GDP and estimated impact of new coronavirus.

(YoY %)	FY16	FY17	FY18	FY19E	FY20E	FY21E
Real GDP growth	0.9%	1.9%	0.3%	0.3%	0.1%	0.8%
Private Consumption Expenditure	0.0%	1.1%	0.1%	-0.3%	-0.3%	0.7%
Private Housing Investment	6.3%	-1.4%	-4.9%	1.0%	-1.8%	0.0%
Private Capital Investment	-0.4%	4.3%	1.7%	-0.0%	-0.4%	1.3%
Public Consumption Expenditure	0.7%	0.3%	0.9%	2.4%	0.9%	1.0%
Public Capital Investment	0.6%	0.5%	0.6%	3.6%	4.0%	2.5%
Net Exports (contrib. to GDP growth)	0.8%	0.5%	-0.1%	-0.2%	0.0%	-0.1%
Exports	3.7%	6.4%	1.6%	-1.8%	0.3%	1.1%
Imports	-0.9%	3.9%	2.2%	-0.5%	0.2%	1.8%
Nominal GDP	0.8%	2.0%	0.1%	1.0%	0.7%	1.2%
GDP Deflator	-0.2%	0.1%	-0.2%	0.8%	0.6%	0.4%
Industrial Production	0.8%	2.9%	0.3%	-3.0%	0.1%	1.9%
CPI (excl. fresh food)	-0.2%	0.7%	0.8%	0.5%	0.4%	0.5%

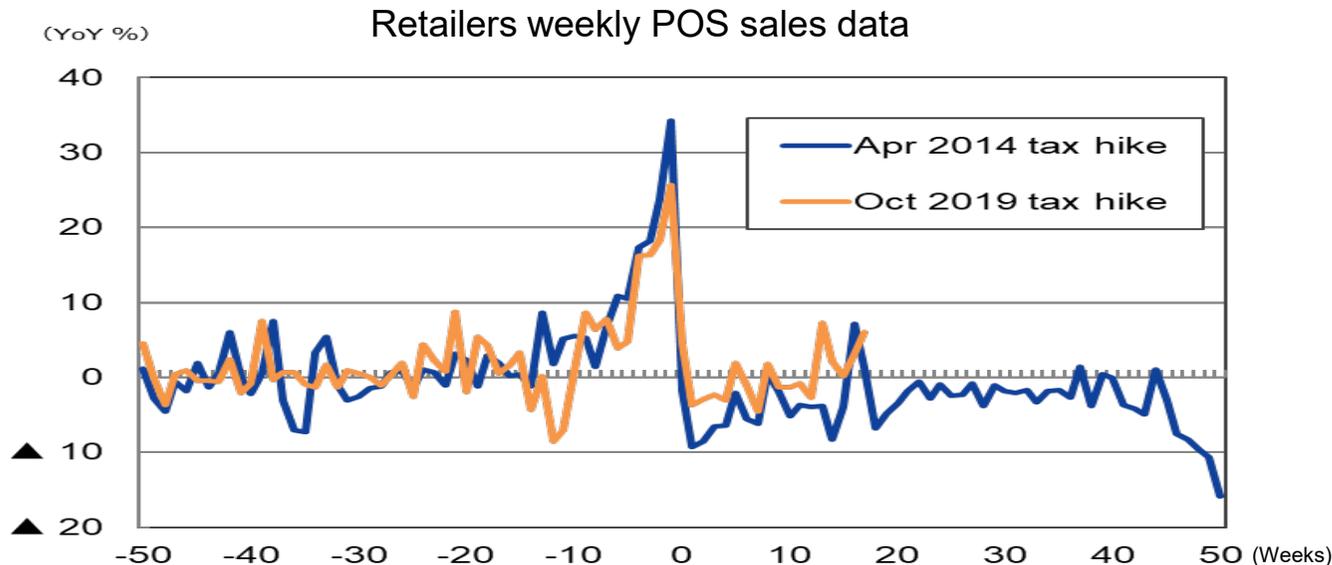
Note: E=SMDAM forecasts. SMDAM views are as of 19th Feb. 2020 and subject to updates thereafter without notice

(%, YoY except Net Exports)

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

Daily sales data shows milder impact of this time's tax hike

- Ministry of Economy, Trade and Industry provides sales data derived from POS system of retailers nationwide in Japan.
- Negative impact has been milder this time compared to the previous tax hike so far, however, negative impact of coronavirus epidemic will appear going forward due to sharp decline in sales to Chinese tourists and also due to Japanese people staying home in order for avoiding infection.
- SMDAM currently forecasts coronavirus epidemic in China to be contained by 2Q 2020.



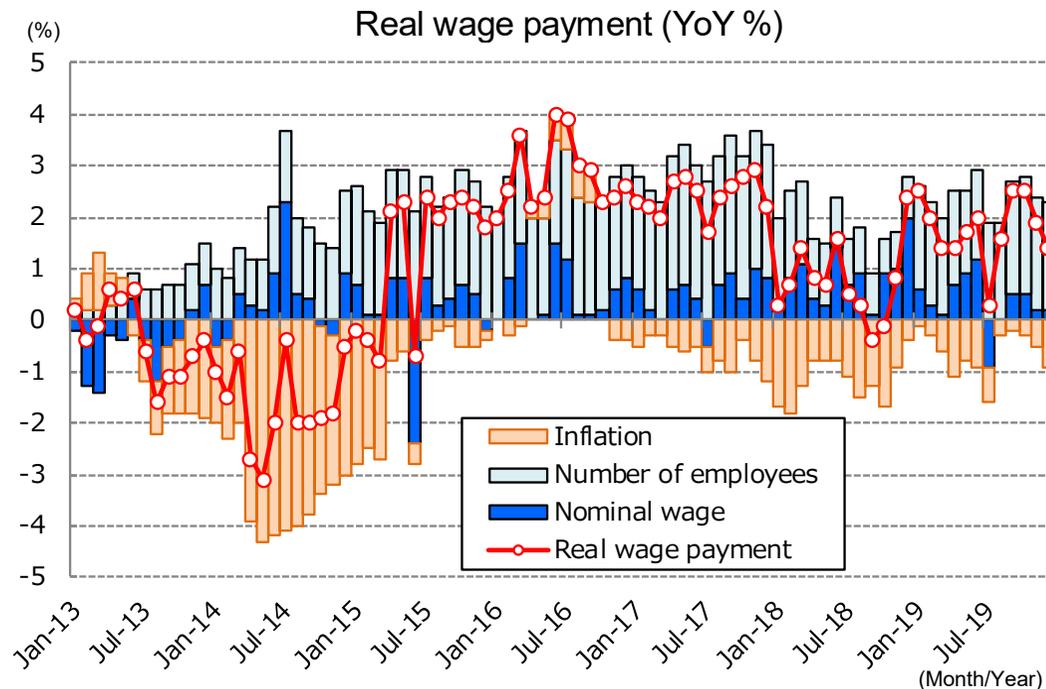
Note: YoY sales change on weeks before and after the consumption tax hike with tax hike week = 0.

Data for Oct 2019 tax hike is up to 2nd Feb 2020.

(source) Ministry of Economy, Trade and Industry

Total wage payment keeps growing due mainly to expanding workforce

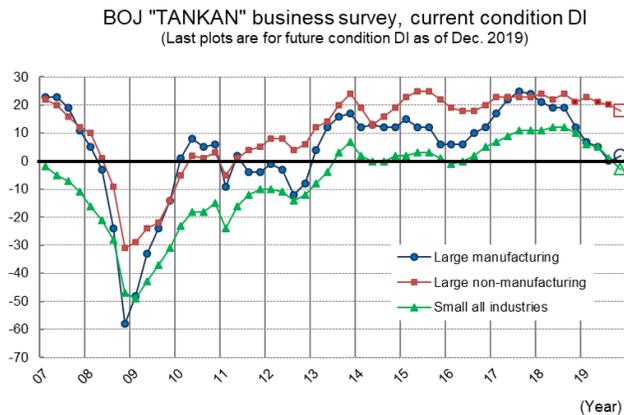
- Total wage payment in Japan keeps growing due mainly to increasing number of employees even in such a tight labor market. Number of female workers are further increasing and also elder people are extending retirement age. Strong demand for workers is encouraging people, who once gave up finding jobs, to start seeking again.
- Despite a marginal wage increase per household, feeling of job security is going to support consumers' sentiment.



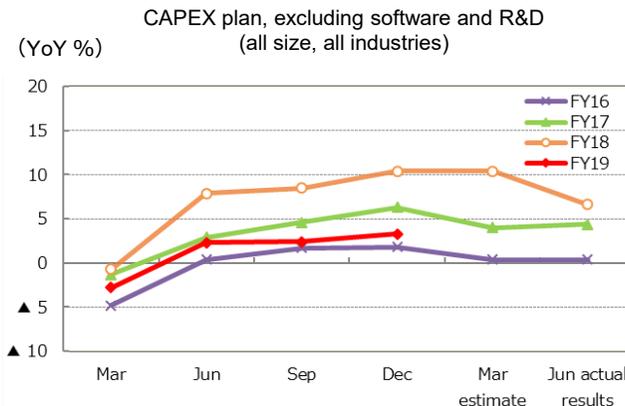
Note: Data is from Jan. 2013 to Dec. 2019.
(Source) Ministry of Health, Labour and Welfare

Appetite for CAPEX stays strong despite deteriorating business sentiment

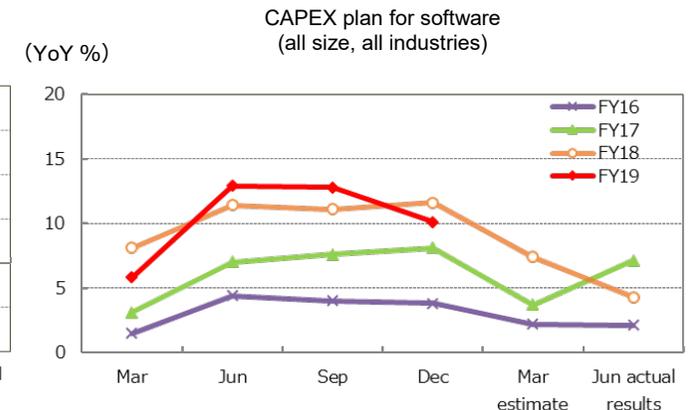
- BOJ's "TANKAN" business survey in December showed deterioration in business sentiment of manufacturing and small enterprises meanwhile sentiment of non-manufacturing enterprises showed resilience.
- FY2019 capital expenditure plan for software stayed at robust 10.1% YoY increase as the right end chart shows.
- Even excluding software, FY 2019 capital expenditure plan showed further 3.3% increase from the robust CAPEX in FY2018 as the middle chart shows.



Note: Data is quarterly from Mar. 2007 to Dec. 2019
 Diffusion Index above 0 means condition is good.
 (Source) Bank of Japan



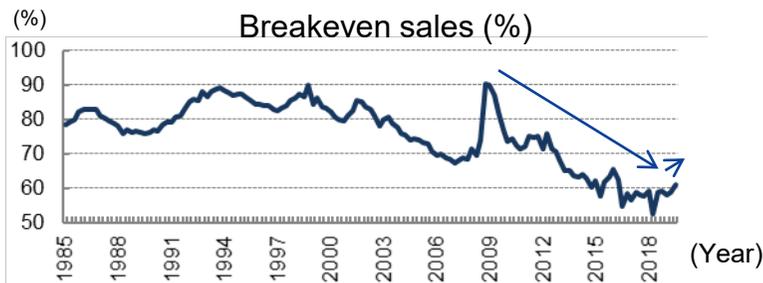
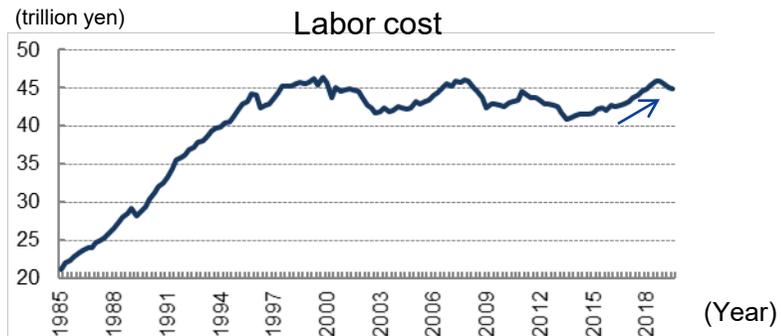
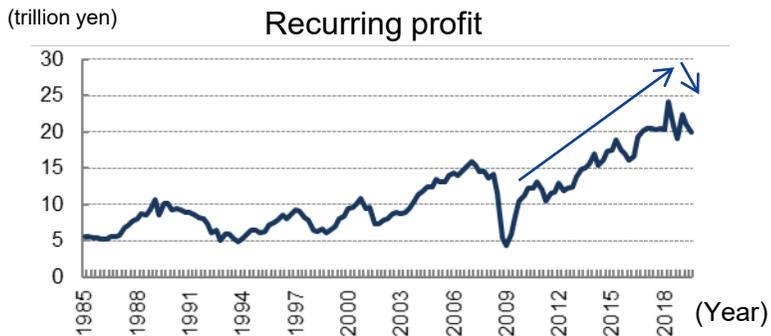
Note: The chart shows history of the CAPEX plan for each fiscal year. Mar estimate is at each fiscal year end and Jun actual results are surveyed after the end of each fiscal year.
 (Source) Bank of Japan



Japanese companies have reasonably large buffer to stay profitable

- Japanese companies have reasonably large buffer to stay profitable despite recent contraction in revenue.
- Breakeven point is quite low in more than 30 years of history exhibited. Companies are still profitable even if sales decline by 40%. Also, labor share has been kept low despite robust revenue growth.
- Labor cost has been mildly increasing due to labor shortage. From labor's side, household income could be sustained even if Japan experiences mild recession, which will be supportive for private consumption.

Corporate Financial Statement Statistics (Sep 2019, all size, all industries, seasonally adjusted)



Note: Data is quarterly from 1Q 1985 to 3Q 2019.

(Source) Ministry of Finance

Presidential election year will bring in various motives for investors

- China struggles to contain coronavirus epidemic, which is affecting political schedule relating to China.
- US presidential election is going to be the biggest scheduled event for the global financial markets.

Upcoming key events

Month	Region/Country	Events	Notes
2020 March	Japan	18-19 BOJ Monetary Policy Committee Meeting	
	US	3 Super Tuesday/ US presidential primary election 17-18 FOMC meeting	
	China	National People's Congress is rescheduled from 5th	
	Middle East	OPEC meeting	
April	Japan	Work style reform legislations. (overtime limit for mid-small businesses, same job same wage principle for large businesses) Wavering education costs, such as for universities, for low income households. 1 BOJ "TANKAN" business survey 27-28 BOJ Monetary Policy Committee Meeting/ Perspective report	
	Japan-China	(During spring time) Chinese leader Xi Jinping is scheduled to visit Japan	
	US	28-29 FOMC meeting	
May	US-China	25 Report on Hong Kong Human Rights and Democracy Act	
June	Japan	End of the government led incentive program for cash-less payments. 15-16 BOJ Monetary Policy Committee Meeting	
	US	9-10 FOMC meeting	
	G7	G7 summit meeting in US	
	Middle East	OPEC meeting	
Jul-Aug	Japan	Tokyo Olympic Games	
November	US	US presidential election	

(Source) Various publications, assembled by SMDAM

Japan is still competitive in innovation, but has some weaknesses

- According to World Economic Forum, Japan was ranked 8th in innovation among 137 economies, which is still competitive, however on a moderate declining trend. As a strength, R&D in Japan is largely led by companies and producing the largest number of patents in this ranking.
- On the weak side, however, this company led R&D tends to be “progressive” rather than “innovative” and often lacks in global collaboration. Government initiative on innovation is stronger in economies such as US, Germany Singapore and China.
- Facing with strong global competition in developing key technologies such as AI or Autonomous Driving Technology, Japanese companies are changing approach to more open and more collaborating with global partners.

Global Competitiveness Ranking of Innovation among 137 economies

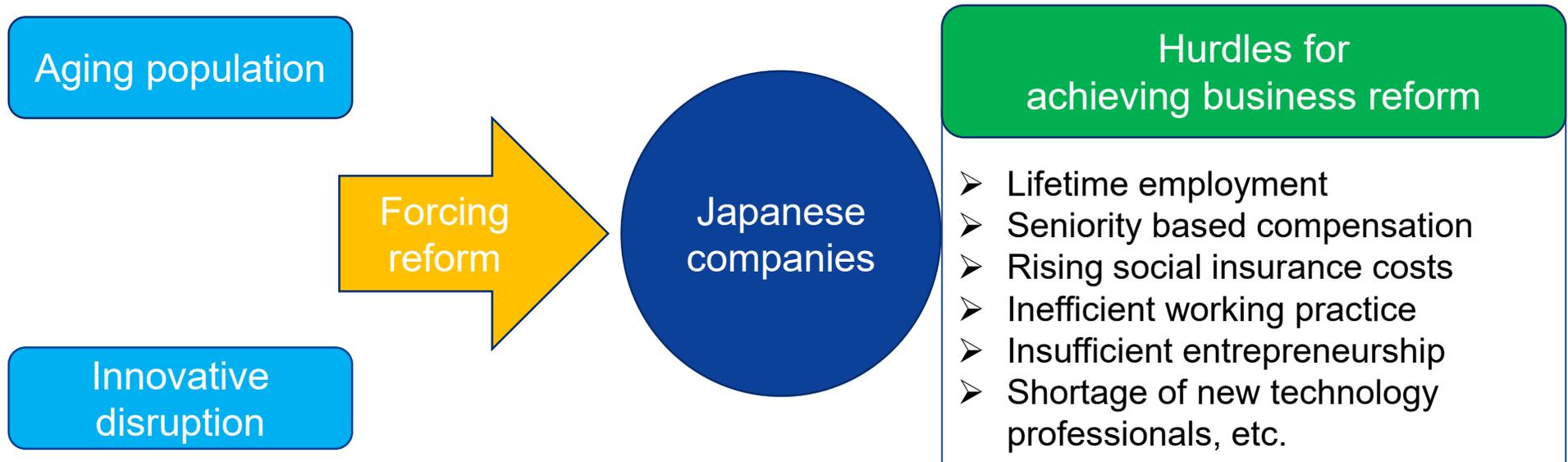
	Switzerland	U.S.	Israel	Finland	Germany	Netherlands	Sweden	Japan	Singapore	Denmark	China
Innovation total	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	28th
a) Capacity for innovation	1	2	3	7	5	6	4	21	23	16	44
b) Quality of scientific research institutions	1	5	3	8	11	4	13	14	12	16	36
c) Company spending on R&D	1	2	3	7	4	8	6	5	17	16	21
d) University-industry collaboration in R&D	1	2	3	4	7	5	10	23	8	21	28
e) Gov't procurement of advanced technology products	37	2	11	20	6	19	17	23	5	39	10
f) Availability of scientists and engineers	12	2	6	1	11	19	20	8	9	44	29
g) PCT patents	3	10	6	4	7	9	2	1	12	8	30

Note: All numbers are rankings among 137 economies. Top 10 rankings are highlighted in green. Japan's relative weakness is highlighted in orange.

(Source): World Economic Forum, The Global Competitiveness Report 2017–2018

Japanese society is changing slowly but steadily

- It may look slow or even stagnant from outside, but Japanese society is making necessary reforms.
- Many problems are stemming from deep rooted Japanese culture & social practice, which became apparent in the face of “aging population” and “innovative disruption”.
- Change of the deep rooted culture & practice should take time, however, it is making progress, and will eventually put Japan in an advantage over other advanced economies, which also have aging population lagging Japan.



Japanese society is changing slowly but steadily

■ Examples of long-term social challenges and progressing solutions

Source of problems	Challenges	Solutions
1. Aging population	a) Pension system reform	<ul style="list-style-type: none"> ● Unconventional "macro-slide" has been implemented to curb pension payment increase referring to "low birth rate" and so on. ● Encourage people to continue working into 70's. ● Encourage people to shift saving to investments. (NISA*, DC)
	b) Labor shortage	<ul style="list-style-type: none"> ● Capital investment for enhancing labor efficiency. (FA, AI, IoT, autonomous driving car, renovating software, etc.) ● Allowing more foreign workers. ● Encourage people to delay retirement. ● Support female workers. (increase nursery, etc.)
2. Weak consumption propensity	c) Clearing peoples worry for the future life	<ul style="list-style-type: none"> ● Pension system reform. ● Gradual adjustment of seniority based wage system to shift compensation from elderly to younger workers. ● Increase of new generation companies. ● Increase of young people working with non-seniority wage system.
3. Rigid employment practice	d) Encouraging business structure reform	<ul style="list-style-type: none"> ● Elder people to retire or continue working at lower wage. ● Gradual adjustment of seniority based wage system. ● More fluid labor market enabling companies to make restructuring. ● Young people are not expecting lifetime employments and focusing on building own career (already progressing).
4. Inefficient working practice	e) Enhancing labor efficiency	<ul style="list-style-type: none"> ● Work style reform to progress.
5. Insufficient entrepreneurship 6. Shortage of new technology professionals	f) Enhancing "challenge spirit" g) Education reform	<ul style="list-style-type: none"> ● Increase of successful new generation companies. ● Increase of young people with skills of new technologies. ● Young and talented people choose new generation companies rather than old & large firms (already progressing).

Note: *NISA is "Nippon Individual Savings Account". (Source) SMDAM



Outlook for Japanese Stock Market

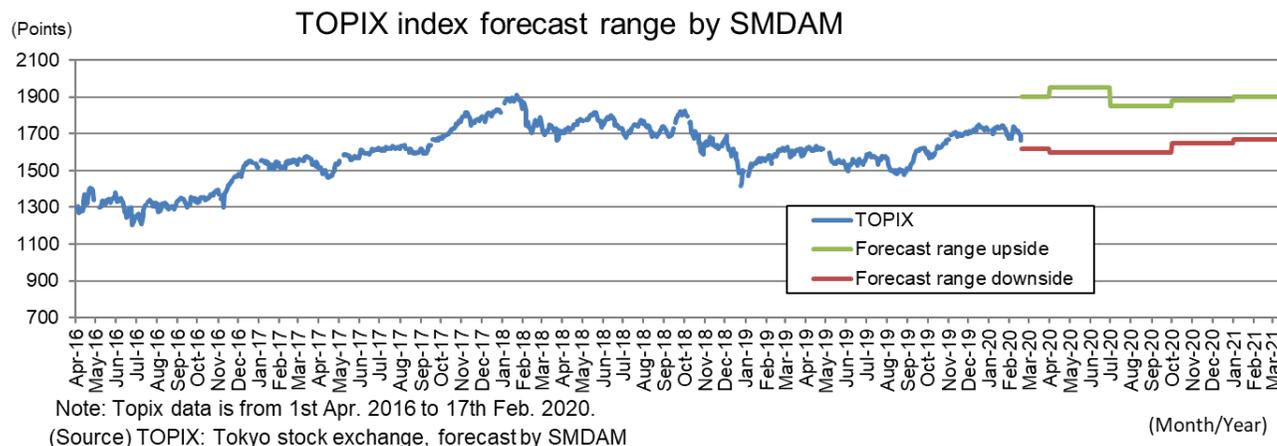
Japanese stock markets are weighed on by temporal negative events

■ SMDAM short-term view

- Japanese stock markets are going to be affected by temporal negative factors such as spreading coronavirus infection in Japan and epidemic in China, which is causing downward pressure on private consumption as well as setback in production, especially in China. SMDAM expects that coronavirus can be contained by 2Q 2020 and global economy will resume its recovery path from 2Q 2020, which will put the Japanese stock markets back on a recovery trend too.

■ Longer-term outlook (6-months and beyond)

- US presidential election is expected to keep supplying motives for investors as well as volatility in the global financial markets. Inflation is expected to stay at extremely low level and continuing easy monetary policy will support the financial markets. JPY 26 trillion economic stimulus package and robust domestic capital investment are going to support the Japanese economy and corporate earnings even if economic recovery in China remains mild. Cautiousness could be back around summer waiting for the result of the US presidential election.



Note: SMDAM's projection is as of 19th Feb. 2020 and subject to updates without notice.

Base scenario & Upside / Downside risks for our forecasts

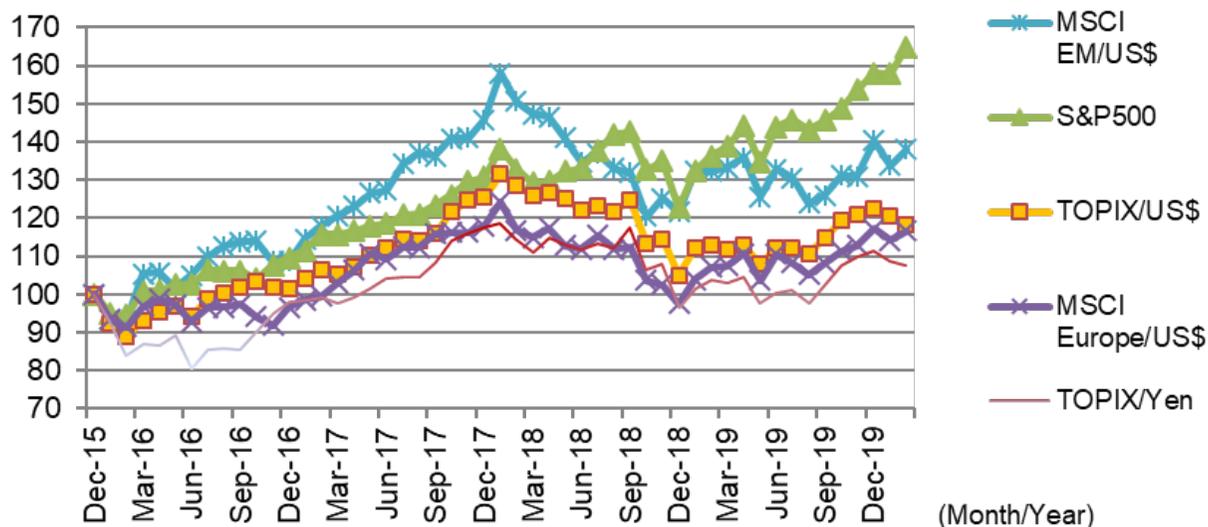
- Our **Base Scenario** is assuming the following views:
 - Severe tensions between US and China go on, however, US is going to avoid making a fatal blow to the global economy.
 - US economy keeps growing despite possible mild slowdown.
 - Consumption tax hike in Japan in October will make a limited impact on private consumption.
 - Japanese yen does not get extremely stronger beyond 100 yen against US\$.
 - Tension in the East Asia or Middle East does not get out of control.
 - Central banks continue easing monetary policies.
 - Epidemic of new coronavirus is contained by 2Q 2020.
- **Upside Risks** include:
 - US and China make significant concessions in the trade negotiations.
 - Stronger-than-expected global growth.
 - Denuclearization in Korean peninsula makes a visible progress.
 - Japanese economy gets stronger than expected boosted by large fiscal spending.
- **Downside Risks** include:
 - US economy significantly slows down and puts global economy into a recession.
 - Chinese economy falls into a significant slowdown spreading negative shock globally.
 - Trade negotiation between US and China completely breaks up igniting a decades of power struggle.
 - Seriously escalating geo-political tensions in Middle East & East Asia.
 - Political turmoil flares up in US running up to US presidential election in 2020.
 - Populism gains in Europe further destabilizing EU.
 - Japanese Consumption Tax Hike in October makes unexpectedly severe impact on private consumption.
 - Epidemic of new coronavirus continues and escalates into a global pandemic.

Note: SMDAM's projection is as of 19th Feb. 2020 and subject to updates without notice.

US was least affected by new coronavirus scare meanwhile Japan dipped

- US stock market continues to rally recording new historical highs.
- Epidemic of a new coronavirus is spreading from China, and pulled back stock prices mainly in Asia and Japan lately.

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

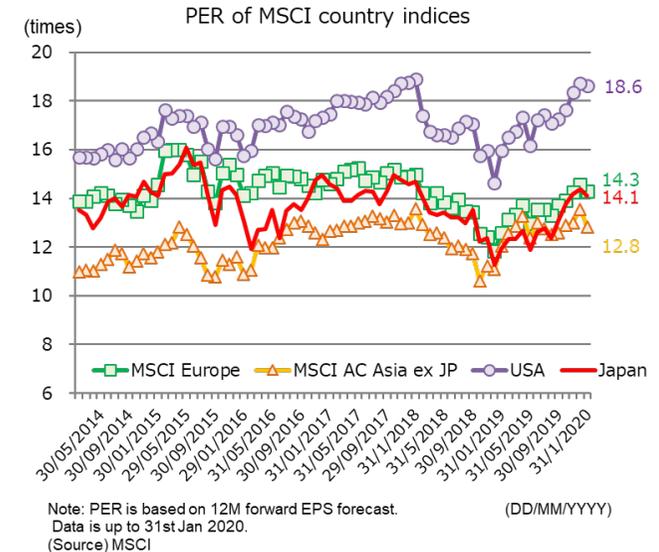
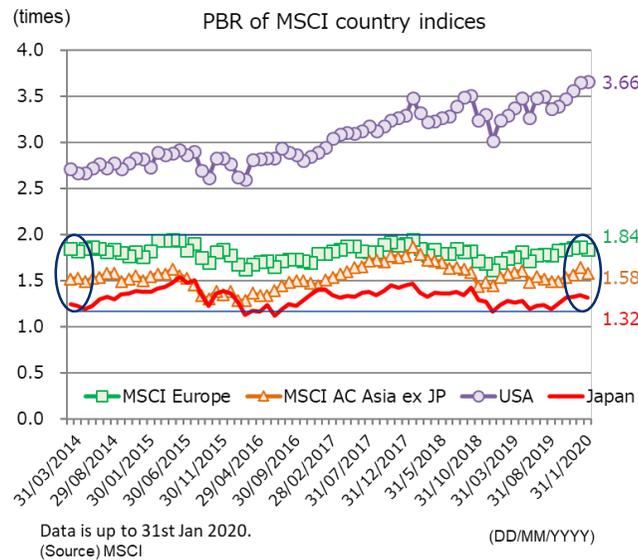
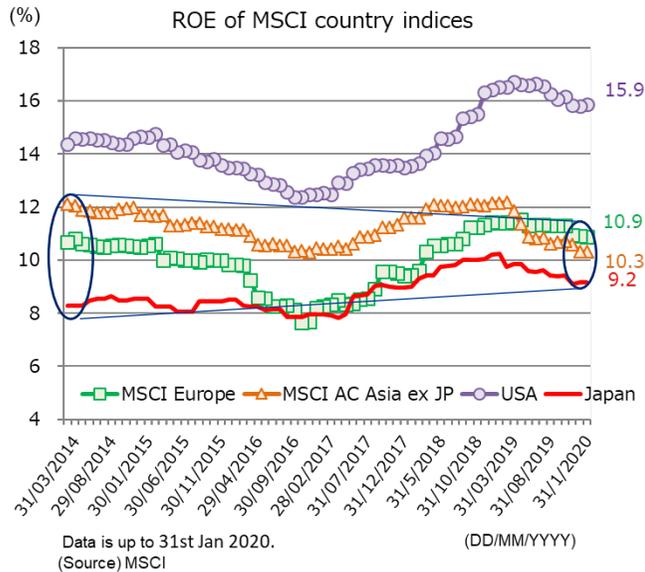


Notes: Data is up to 17th Feb. 2020.

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

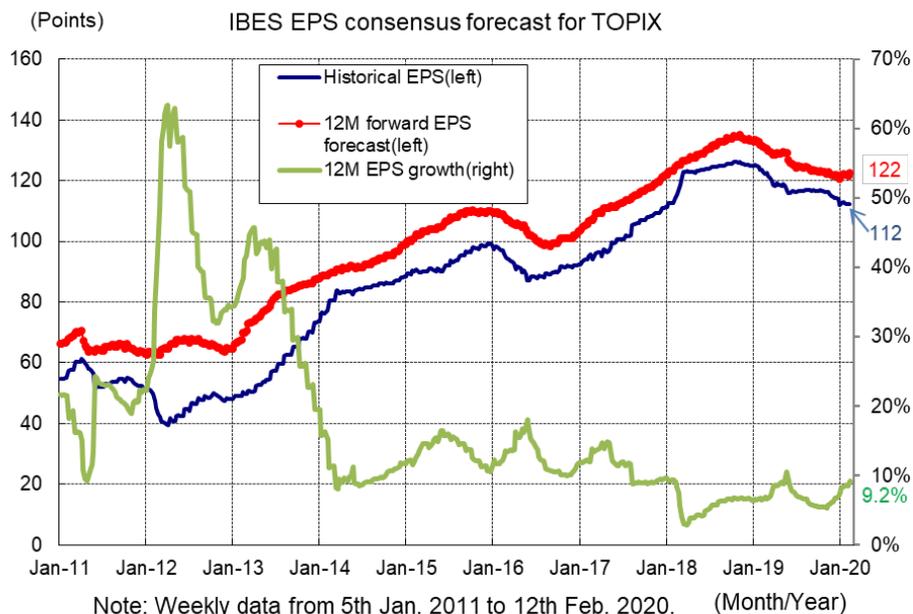
Relative stock valuation remains attractive for the Japanese stocks

- ROE gap between Japan and Europe and also between Asia got narrower in the last five years, which is exhibited on the left chart.
- However, this improvement in ROE has not been reflected on PBR (Price to Book Ratio), which stays at low level compared to other markets, which is shown in the middle chart.
- PE ratio for Japan rose to a level just below Europe, and Asia is now the lowest, which has been a normal picture in the recent history.

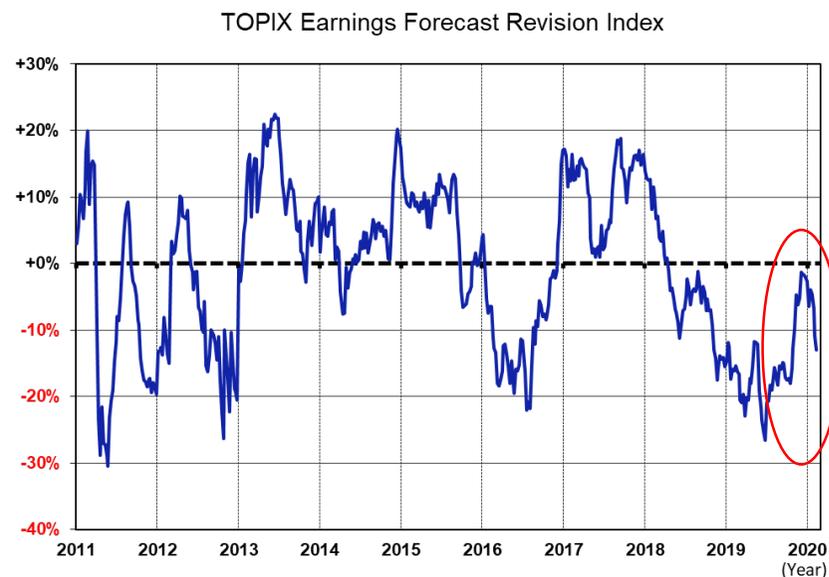


Downward earnings revision resumed for Japanese stocks

- Downward earnings forecast revision resumed lately probably due to weaker than forecast earnings results for Oct-Dec 2019 quarter and growing concern of negative effects caused by new coronavirus epidemic.
- It's a little technical, however, 12m forward EPS growth forecast increased to 9.2% from 8.2% in the previous month. 12m forward EPS forecast was maintained despite declining historical EPS.



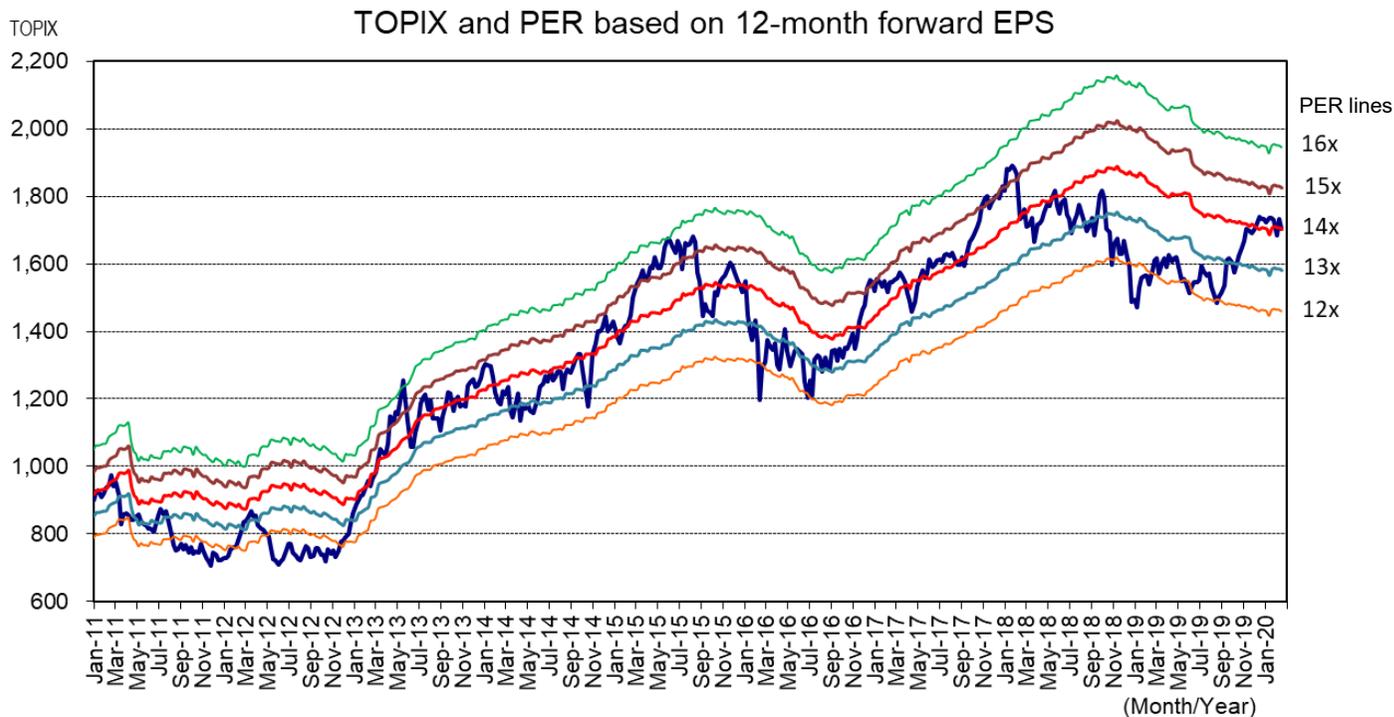
(Source) Datastream, IBES



(Source) IBES, SMDAM

PE Ratio for TOPIX entered into upper side of the historical range

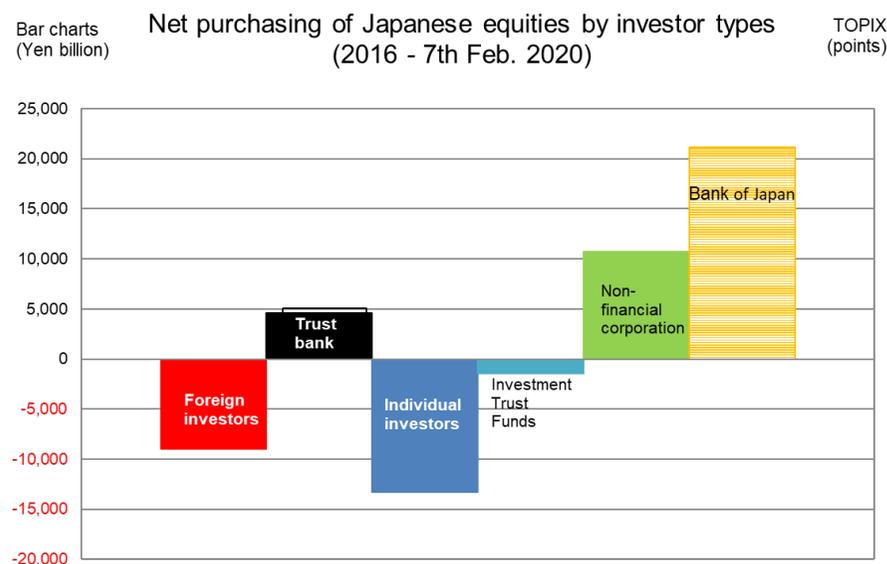
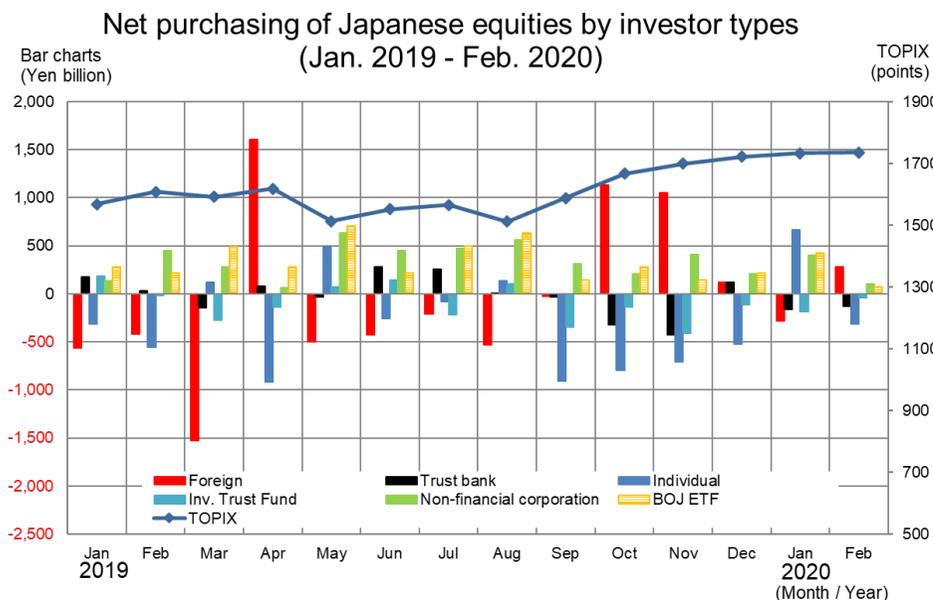
- PE ratio (PER) for TOPIX rose slightly over 14 times based on 12m forward EPS forecast, which assumes about 8% EPS growth in coming 12 months.
- 15 times PER has been the upside of the historical core range since PM Abe started expansive policy mix in 2013, and 16 times PER was the upper limit for extreme bull run such as observed in 2015.



Note: Data is weekly from 5th Jan. 2011 to 12th Feb. 2020. TOPIX was 1718.92 at the end of the period.
(Source) Tokyo Stock Exchange, Datastream and IBES, compiled by SMAM

Japanese companies keep buying-back own shares

- Since 2016, foreign investors were net sellers. Foreign investors bought Japanese equities aggressively between 2013 and 2014, however, they have sold about 75% of the cumulative net purchases afterwards. After buying-back some in late 2019, net trading activities have been relatively calm so far this year.
- Japanese companies have been continuously buying back own shares as the second largest buyer only next to BOJ.
- Individuals have been the largest seller of Japanese equities, however, purchasing via IPO is not included in this statistics and actual selling by individuals gets smaller when IPO is included.



Advancing Corporate Governance Code and Stewardship Code

- Stewardship Code (SC) was set in February 2014. Investors are taking more pro-active approach in talking to the companies and exercising proxy voting rights. Financial Services Agency discloses the name of institutional investors, which publicly accepted SC.
- After inception of Corporate Governance Code (CGC) in June 2015, pressure has been increasing on companies to improve its governance, efficiency and shareholder returns.
- These two codes have been progressively reviewed and enhanced, and making visible impact on the corporate behavior and investors' attitudes as shareholders.
- Nikkei Newspaper reported lately that SC would be reinforced in April 2020 requiring investors to evaluate ESG factors.
- In the most recent amendment of CGC, companies are required to explain the rationale of “cross holdings” or “strategic holdings” of other companies' shares, which implicitly provide protection against takeovers and hostile shareholder actions, and is often negative for achieving shareholder value.

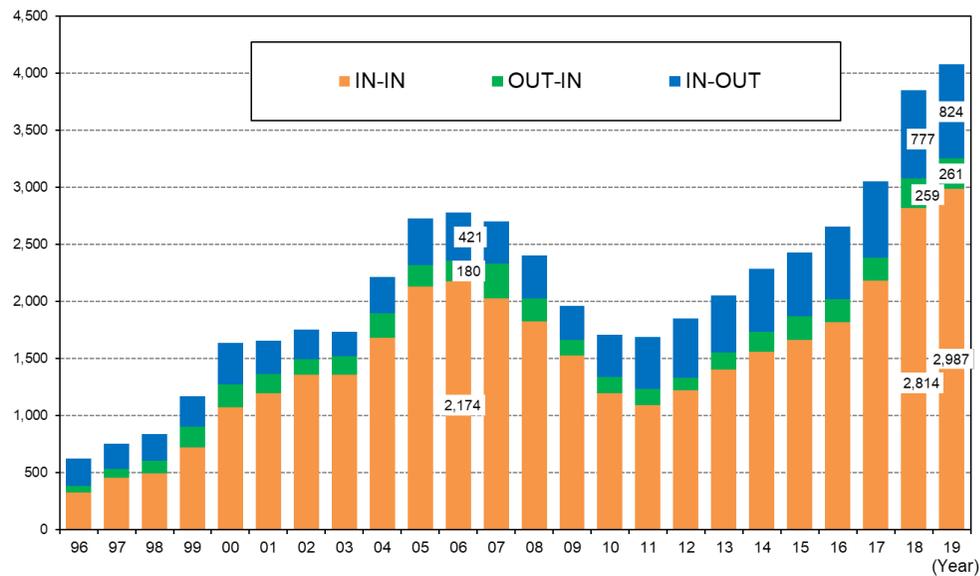
Total number of institutional investors, which publicly declared acceptance of the stewardship code	
Trust banks	6
Investment management companies	177
Insurance companies	23
Pension funds	35
Others (include proxy voting advising companies)	7
Total	248

Note: As of 8th May 2019.
 (Source) Financial Services Agency

Business restructuring is progressing for Japanese companies

- Japanese companies are getting more and more willing to make positive business restructuring.
- Number of M&A deals between Japanese companies (IN-IN) rose from 2,174 in 2006 to 2,814 in 2018 and further to 2,987 in 2019, which is an evidence that business restructuring is progressing in Japan.
- Number of the deals of Japanese companies acquiring overseas businesses (IN-OUT) also rose from 421 in 2006 to 777 in 2018 and further to 824 in 2019.

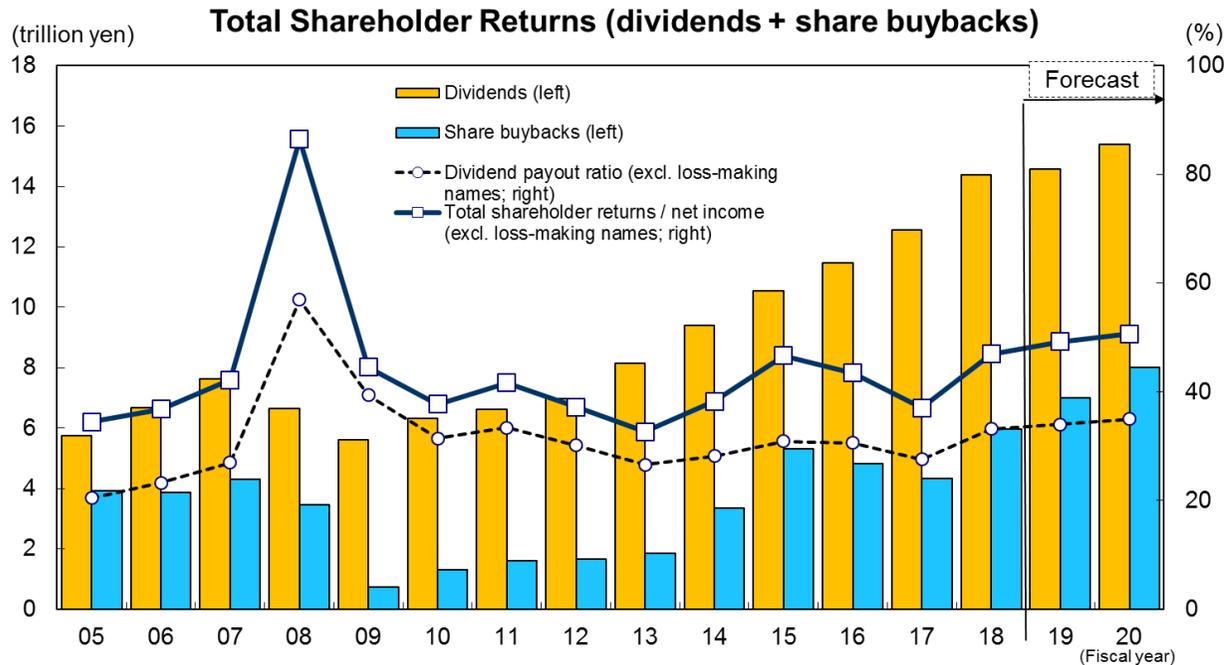
Number of M&A deals involving Japanese companies
(Excluding transactions among the same business group)



Note: IN-IN means Japanese company acquiring Japanese one, OUT-IN is for Non-Japanese company acquiring Japanese company, and IN-OUT is for Japanese company acquiring non-Japanese company.
(Source) RECOF and SMBC NIKKO Securities.

Behavior of Japanese companies are making positive changes

- Share buyback is getting popular among Japanese companies as one of the powerful tools for disposing of accumulated liquidity in the B/S and enhancing EPS growth as well as ROE.
- Dividends also renewed historical record in FY2018 and expected to increase further in FY2019.



Note: All listed firms. Dividend projections are Toyo Keizai estimates, share buybacks forecast is by Daiwa Securities. Data as of Aug 2019.
 (Source) Toyo Keizai, QUICK, INDB, compiled by Daiwa Securities.

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