

Japanese Equity – 2015 Review and 2016 Outlook

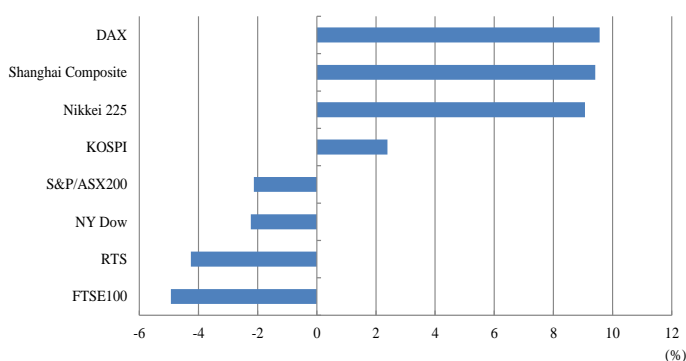
- Performance of Nikkei 225 index in 2015 was fair, despite being shaken by overseas factors.
- Fair value of Nikkei 225 index at end of 2016 is expected to be JPY 20,800, a high single digit rate of increase.
- While keeping a close watch on overseas factors, we predict the lowest and highest prices of 2016 to be JPY 18,000 and JPY 22,800, respectively.

Performance of Nikkei 225 index in 2015 was fair, despite being shaken by overseas factors.

In 2015, Nikkei 225 index started with an opening price of JPY 17,325.68 on 5th January and continued to decline to JPY 16,592.57 on 16th January. Nikkei 225 index then started to climb up to the annual high of JPY 20,952.71 on 24th June due to aggressive purchases by foreign investors who appreciated the increase in the number of Japanese companies who focused on efficient management. However, the index fell below JPY 17,000 again in September due to uncertainties such as Greece's situation, China's economic slowdown and the timing of US interest rate hike which weighed on the stock market.

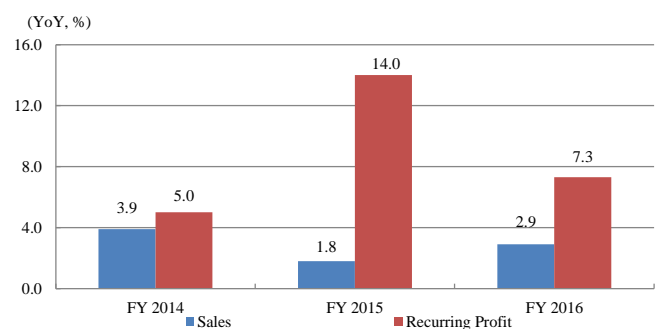
Subsequently, Nikkei 225 index regained stability discounting negative news and temporarily rose to JPY 20,000 in December, however, it was pulled down to JPY 18,000 level as weaker crude oil price progressed. Nikkei 225 index saw expansion of price volatility reflecting FRB's interest rate hike and BOJ's supplementary measures to monetary easing and finally closed at JPY 19,033.71 on 30th December for year 2015. Consequently, Nikkei 225 index rose + 9.1% for the year which is a fairly good performance compared to other major stock market indices (Diagram 1).

"Diagram 1: Percentage Change of Major Stock Indices of Year 2015"



(Note) Data period is from 31st December 2014 to 31st December 2015. Percentage change of price return.
(Source) SMAM, based on Bloomberg L. P. data.

"Diagram 2: Business Outlook of Major Japanese Corporation"



(Note) Forecast of SMAM's "Core Research Universe (216 companies)" as of 4th December 2015
(Source) SMAM, based on Bloomberg L. P. data.

Fair value of Nikkei 225 index at end of 2016 is expected to be JPY 20,800, a high single digit rate of increase.

In 2015, Japanese equity was underpinned by strong corporate earnings despite being shaken significantly by overseas factors. Although overseas factors must continuously be observed closely in 2016, there will also be some domestic factors to focus on. Majority of the market participants forecast that Japanese equity would reach its record high in the first half of 2016 with high expectations on implementation of economic-friendly measures by the government before the House of Councilors' election in July. The price will then turn to a bearish tone over the concern of negative impacts of the consumption tax hike scheduled in April 2017. I do not disagree with this forecast on domestic factors.

Real GDP growth rate of both FY2015 and FY2016 are expected to be around + 1.0% YoY, as the Japanese government and BOJ will act without hesitation once downside risk of business environments and inflation should expand. Recurring profit of major companies (SMAM's Core Research Universe of 216 companies) is expected to increase by + 14.0% YoY in FY2015 and + 7.3% YoY in FY2016 (Diagram 2). With all these factors in mind, I forecast the fair value of Nikkei 225 index in 2016 as JPY 20,800, a high single digit rate of increase which is in line with corporate earnings growth rate. Relatively low valuation and stable politics are bullish factors peculiar to Japan; foreign investors are also focusing on progression of corporate governance reform.

While keeping a close watch on overseas factors, we predict the lowest and highest prices of 2016 to be JPY 18,000 and JPY 22,800, respectively.

Overseas factors to be kept closely watched are; i) trend of crude oil price and credit market, ii) economic trend of emerging countries such as China, iii) economic growth and pace of interest rate hike in US, iv) EU referendum in UK and v) geopolitical risks such as terrorism. If crude oil price were to stabilize, even in lower levels and the pace of US's interest rate hike should be very moderate, disturbance to credit and emerging markets can be evaded, creating a favorable environment for Japanese equity.

Although I expect the lowest price of Nikkei 225 index in 2016 to be JPY 18,000, if one or multiple events from i) to v) listed above influence the market negatively, we should look out for further decline. On the other hand, I expect the highest price in 2016 to be JPY 22,800. However, if emerging market economies recover or robust growth in the US economy raises expectation of the pace of US interest rate hike to accelerate or consumption tax hike in Japan in April 2017 were to be

postponed, which is very unlikely at this moment, these can be the factors to revise the number upward.

*** Please note that this report is a translation of Japanese report written on 4th January, 2016.**

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