



Japanese Stock Market Outlook

SMAM monthly comments & views
- November 2016 -



Sumitomo Mitsui Asset Management

Executive summary

➤ Japanese Economy

Recent statistics continue to show mild recovery in the Japanese economy such as industrial production, export volume and sentiment of both businesses and consumers. CPI is expected to remain low, which put pressure on Bank of Japan. Fiscal measures are going to play a major role in stimulating economy going forward, for which low interest rate would provide low borrowing cost for the government.

- Japanese exports has been growing led by the recovery in production in Asia, which accounts for more than half of total exports from Japan. Export recovery to Asia has been broad based. Electrical, chemical, metal goods and machinery are all showing solid recovery.
- 10Y Japanese Government Bond yield once rose to the BOJ's target of zero percent yield, and then sunk back to the negative territory. Policy shift of BOJ made in September has not produced significant impact on yield curve yet. BOJ's purchasing pace of JGB has moderated a little.

➤ Japanese Stock Markets

The stock market is now going through major key events overseas such as US presidential election. Rising geopolitical risks, especially in the Middle East, could still scare the global financial markets in the short term. However, earnings momentum is improving for the Japanese companies and yen seems stabilizing above 100 yen against US dollars, which are supportive for the Japanese stock market.

- According IBES, earnings momentum is improving for Japanese companies. Historical EPS keeps recovering since June and 12M forward EPS forecast bottomed in August and moving upwards. Currently, 10.2% of 12M forward EPS growth is forecast.
- Nikkei news paper reported that share buy-backs by listed companies were record high at 4.35 trillion yen between January and September this year compared to the same period in the past. Share buy-backs are continuing at a historically high pace.

Notes: Macro and market views are as of Oct 17th and 19th, 2016 respectively, and subject to updates thereafter without notice

Outlook for Japanese Economy

SMAM economic outlook for FY16-17

- Recent statistics continue to show mild recovery in the Japanese economy such as industrial production, export volume and sentiment of both businesses and consumers.
- CPI is expected to remain low, which put pressure on Bank of Japan. Fiscal measures are going to play a major roll in stimulating economy going forward, for which low interest rate would provide low borrowing cost for the government.

(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%	0.8%	0.8%
GDP Deflator	-0.9%	-0.3%	2.4%	1.4%	0.0%	0.2%
Industrial Production	-2.7%	3.0%	-0.4%	-1.4%	0.7%	2.7%
CPI (excl. fresh food)	-0.2%	0.8%	0.9%	-0.0%	-0.3%	0.3%

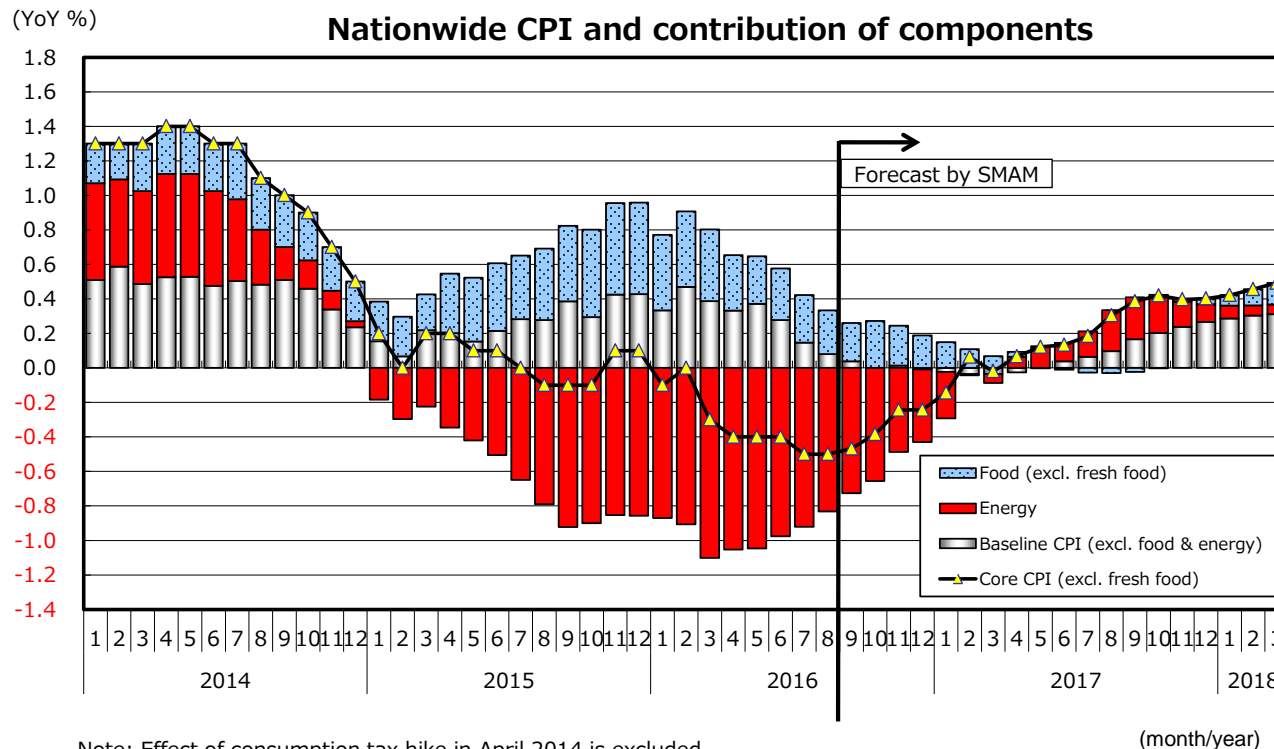
Notes: E=SMAM forecasts. SMAM views are as of Oct. 17th, 2016 and subject to updates thereafter without notice

(%, YoY except Net Exports)

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

Baseline CPI is forecast to hover around zero going into the middle of 2017

- Core CPI was -0.5% in August and forecast to stay negative until early 2018.
- CPI will be dragged down by lingering after effects from yen's sharp strengthening occurred this year and also YoY fall in energy prices going into the next year.
- Even after the contribution of energy price turns positive, CPI is forecast to stay low, which would put pressure on BOJ for further easing.



Note: Effect of consumption tax hike in April 2014 is excluded.

(Source) Ministry of Internal Affairs & Communications

Policy shift of BOJ has not made significant impact on yield curve yet

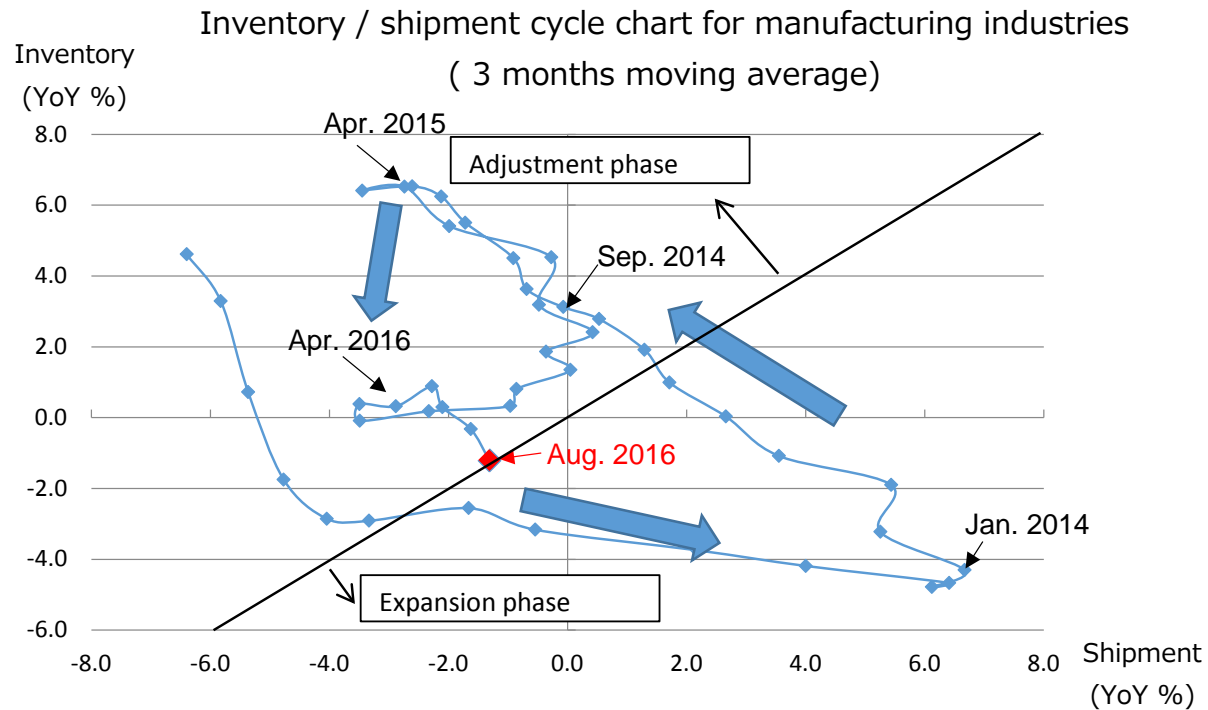
- On 21st of September, BOJ changed the set of its monetary policy to a more sustainable and enduring one. Target of increasing monetary base at a fixed high pace was withdrawn and controlling target shifted to yield curve, both short-term and long-term interest rates.
- 10Y Japanese Government Bond yield once rose to the BOJ's target of zero % yield, and then sunk back to the negative territory. BOJ's purchasing pace of JGB has moderated a little.

		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.
		Targeted mixture of maturities	Abolished	Guidance of average maturity of purchasing JGB was abolished.
Qualitative easing	(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

Inventory / shipment cycle shows the inventory adjustment has completed

- The chart is supposed to show anticlockwise movement.
- YoY Inventory growth started to fall since March 2015 and has reached the final adjustment stage, bottom left part of the chart.
- When it crosses the 45 degree line from left to right, the cycle shifts from adjustment phase to expansion phase.



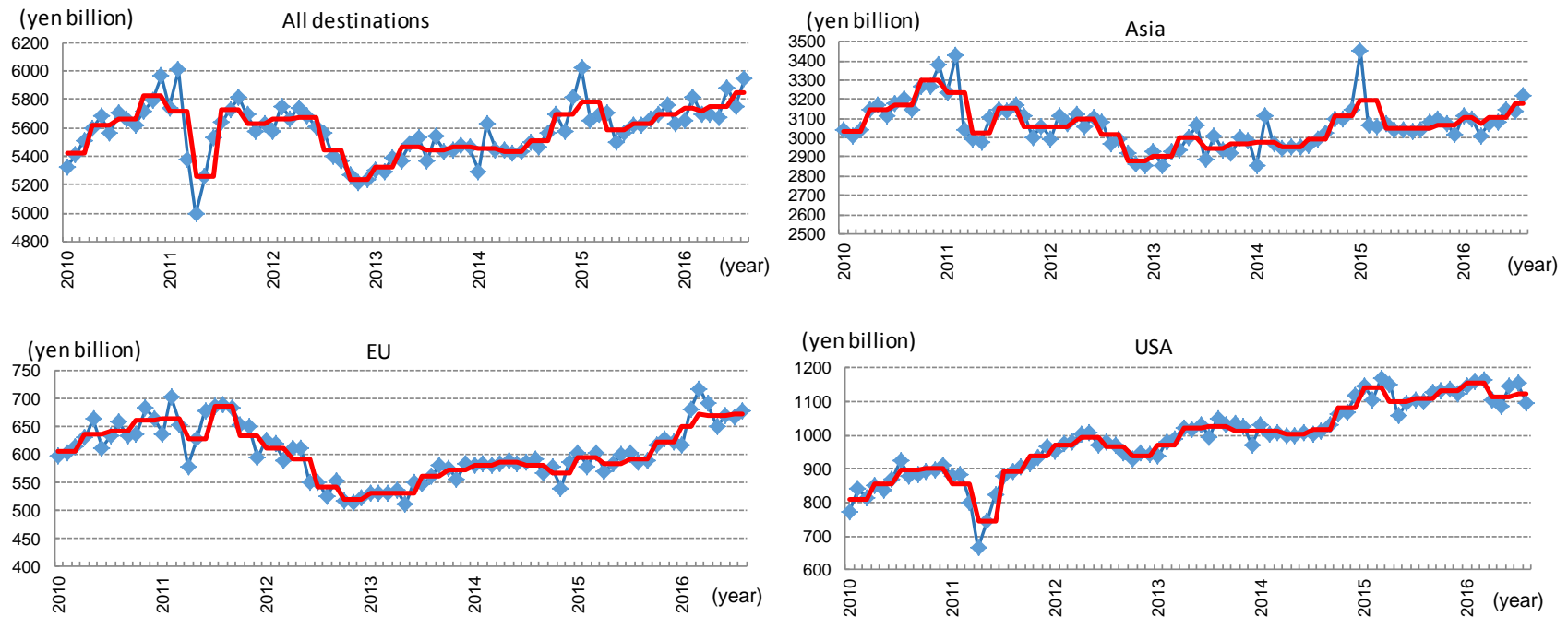
(Source) Ministry of Economy, Trade and Industry

Note: Data period from Jan. 2013 to Aug. 2016

Total export volume is recovering rather strongly led by Asia

- Japanese exports has been growing led by the recovery in production in Asia, which accounts for more than half of total exports from Japan.
- Export recovery to Asia has been broad based. Electrical, chemical, metal goods and machinery are all showing solid recovery.

Export volume



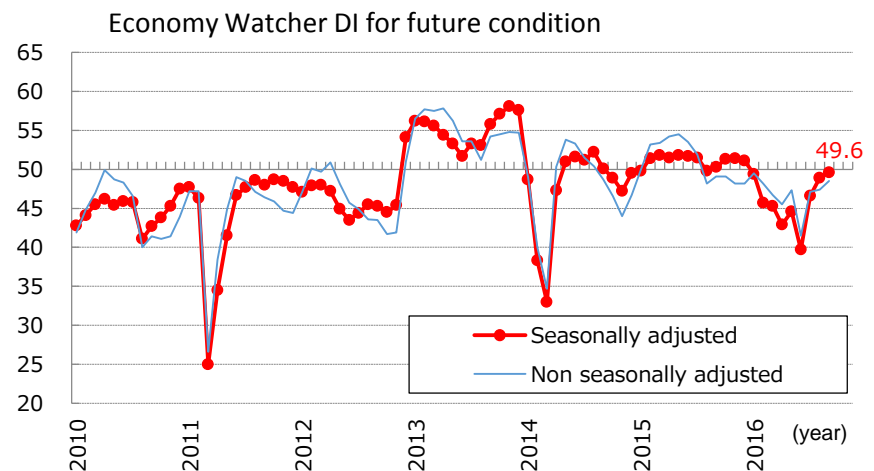
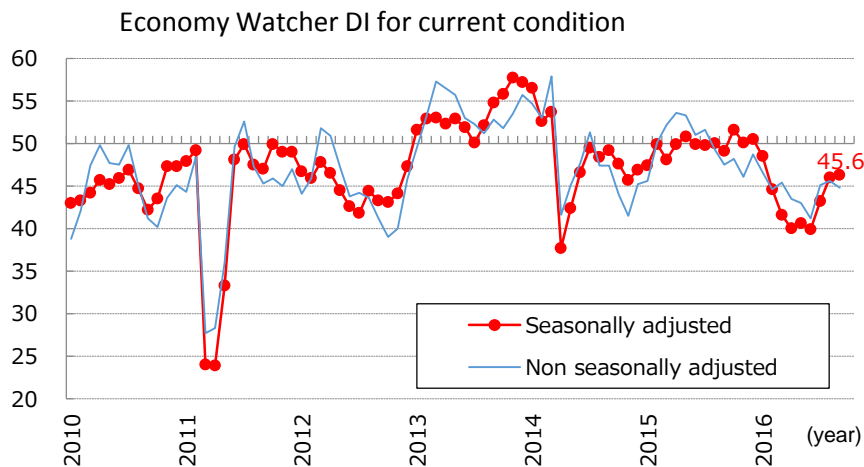
Note: Blue lines are for monthly and red lines are for quarterly data. Data is up to Aug. 2016 and 3Q 2016 data is the average of Jul & Aug.

Data is seasonally adjusted by SMAM.

(Source) Ministry of Finance, Bank of Japan

Consumer sentiment has been recovering

- Economy watchers DI is produced from a survey of people working at jobs sensitive to the condition of Japanese economy. Current condition DI compares the status at the time of survey with 3 month before, whereas future condition DI shows if future condition in 2 to 3 months is expected to be better or not. DI of 50 is the threshold.
- Both DIs have been improving in the recent 4 month from depressed levels and the seasonally adjusted future condition DI has recovered to 49.6, which is almost neutral level.



Note: Data is up to Sep. 2016.

(Source) Cabinet Office

Outlook for Japanese Stock Markets

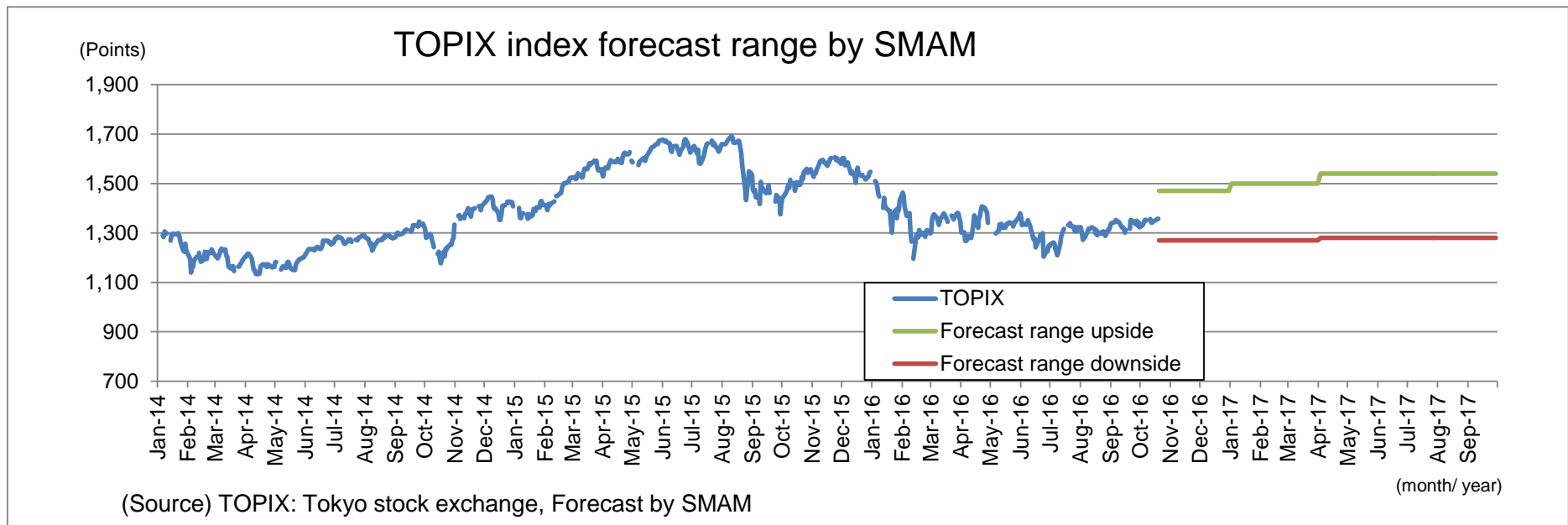
Stock market outlook: Improving earnings momentum is going to lift the market in the long-term

SMAM short-term view

- The stock market is now going through major key events overseas such as US presidential election. Rising geo-political risks, especially in the Middle East, could still scare the global financial markets in the short term. However, earnings momentum is improving for the Japanese companies and yen seems stabilizing above 100 yen against US dollars, which are supportive for the Japanese stock market.

Longer-term outlook (6-months and beyond)

- Risk factors are going to recede gradually 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.



(Source) TOPIX: Tokyo stock exchange, Forecast by SMAM

Note: SMAM's projection is as of Oct. 19th, 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.

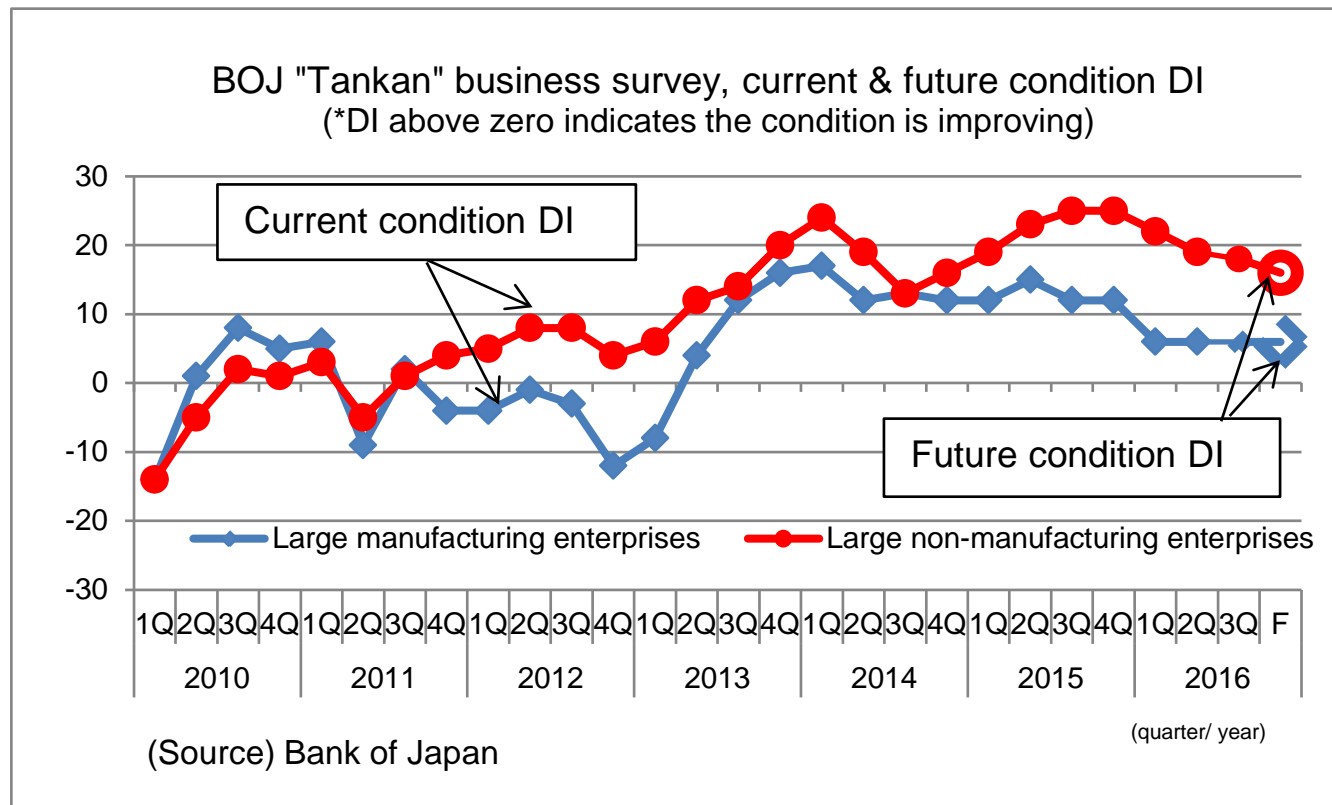
- **Upside Risks** include:
 - Stronger-than-expected global growth.
 - Stronger-than-expected measures by the Abe government.

- **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.

SMAM's forecasts as of October 2016

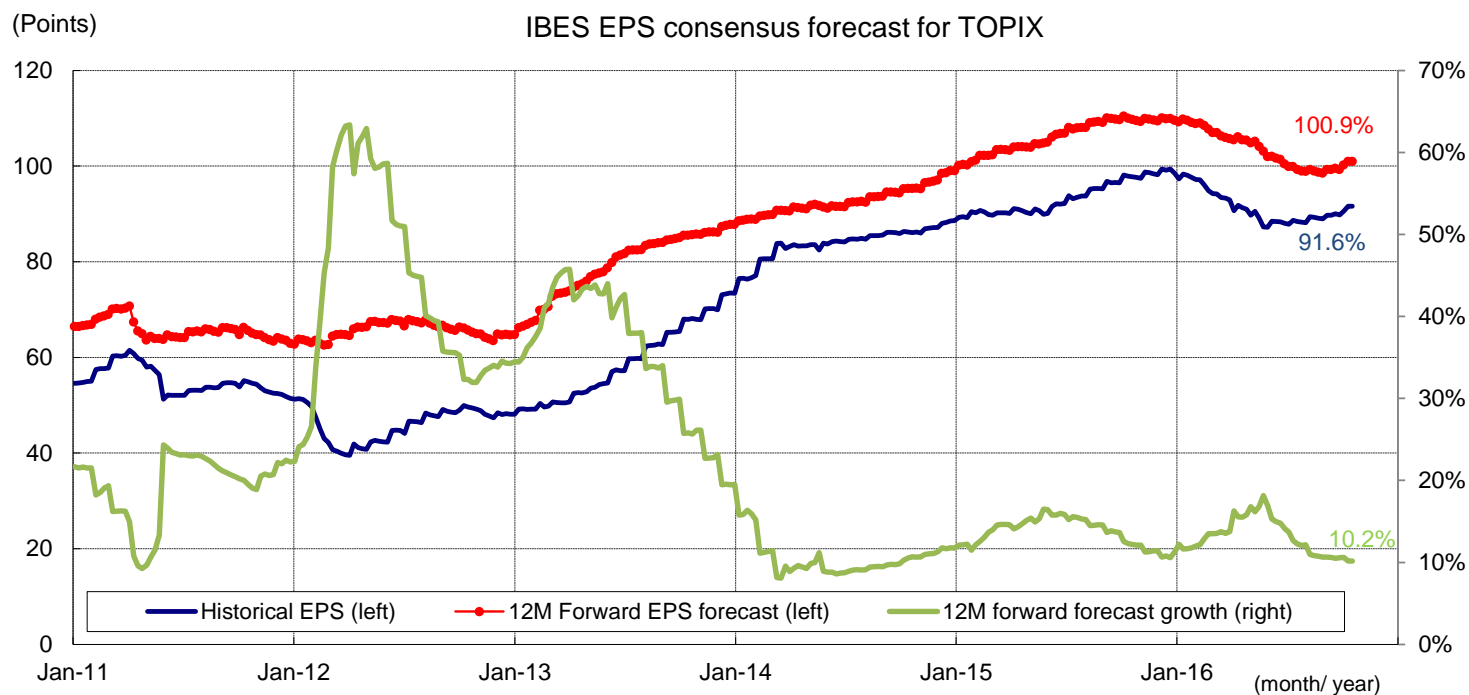
Business sentiment is holding well this year despite global uncertainties

- BOJ makes broad based business survey every quarter and releases its result in early Jan. Apr. Jul. and Oct.
- Manufacturing sector is showing resilience after the decline in 1Q this year. Recovering industrial production and export volume are positive factors behind. Despite slight decline in non-manufacturing sector, business sentiment is holding well in Japan.



Earnings momentum keeps improving

- Earnings momentum is improving for Japanese companies. The blue line in the chart, 12 month trailing EPS or historical EPS keeps recovering since June, and also the red line, 12M forward EPS forecast bottomed in August and moving upwards.
- 10.2% of 12M forward EPS growth is forecast .

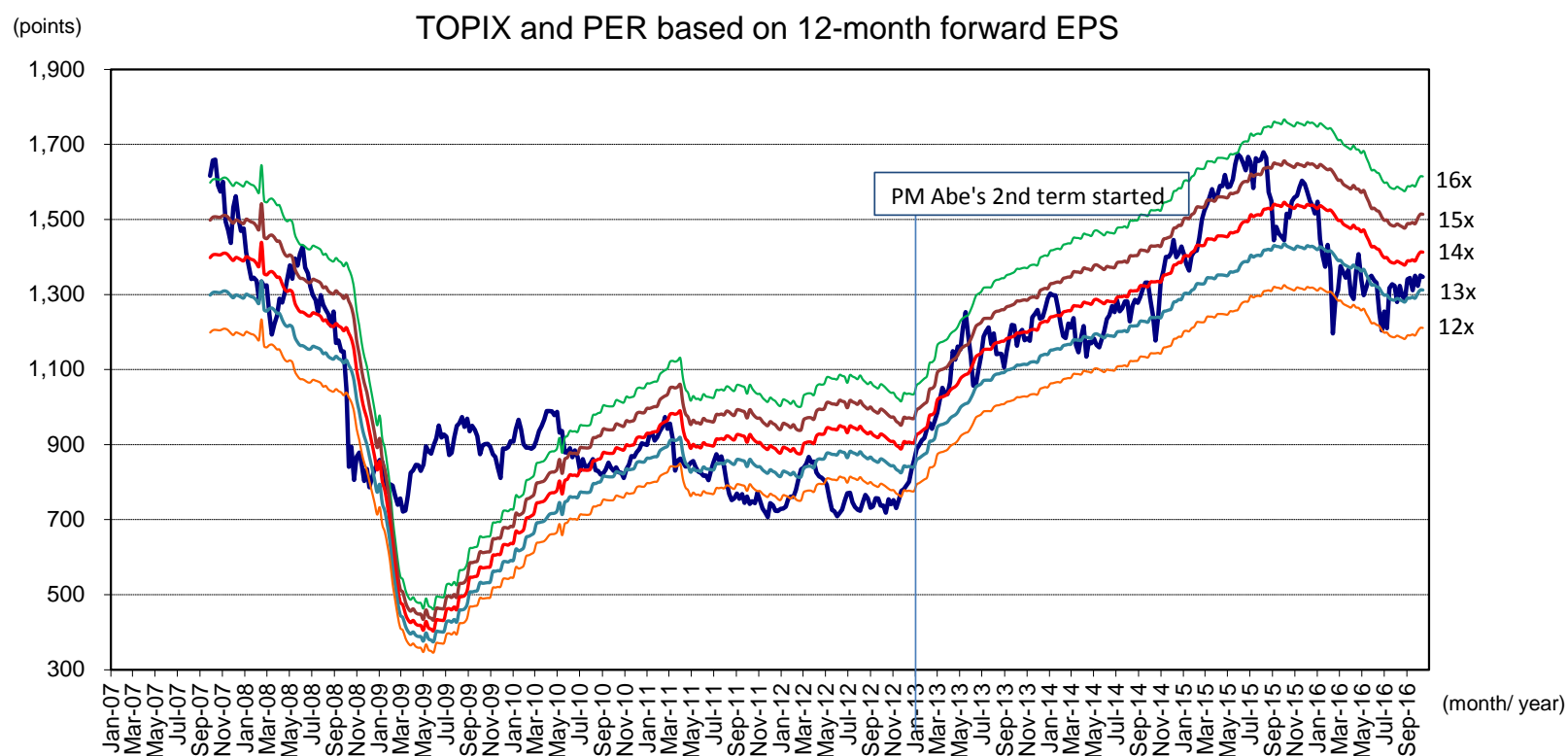


(Source) Datastream, IBES

Note: Up to Oct. 17th, 2016

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

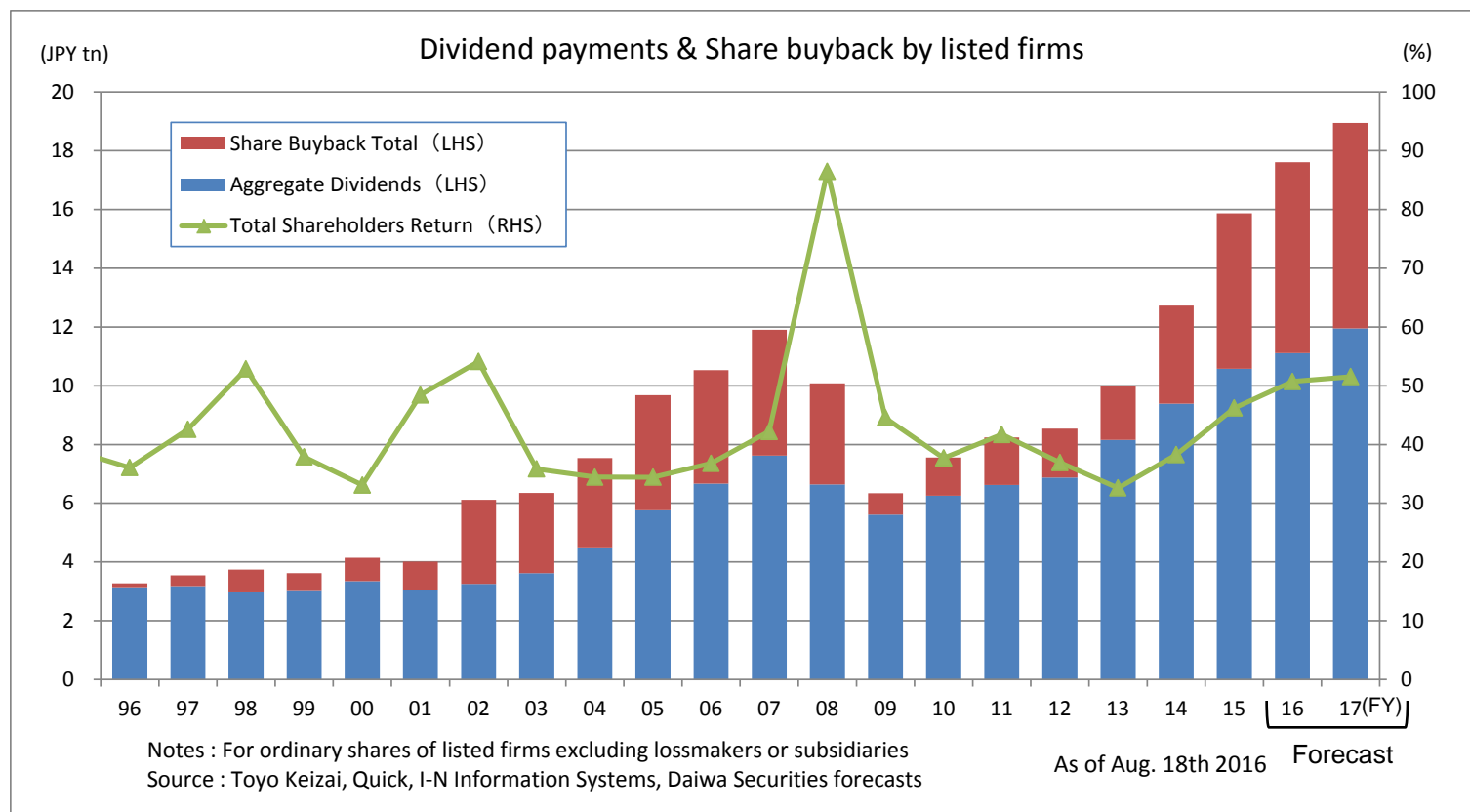
- Since Abenomics started, PER for Japanese stock market, TOPIX index-wise, has been in a range between 12x and 16x except for temporary overshooting.
- As of October 14th, PER for TOPX was 13.35x whereas comparative PER for S&P 500 was over 17x. Relative valuation of Japanese stocks looks attractive compared to US stocks.



Notes: Topix: calendar year and week-end, P/E ratio is based on 12-month forward EPS of IBES. Data is up to Oct 14th, 2016 when TOPIX was 1347.19
(Source) TOPIX: Tokyo Stock Exchange, 12month forward EPS of IBES: SMAM

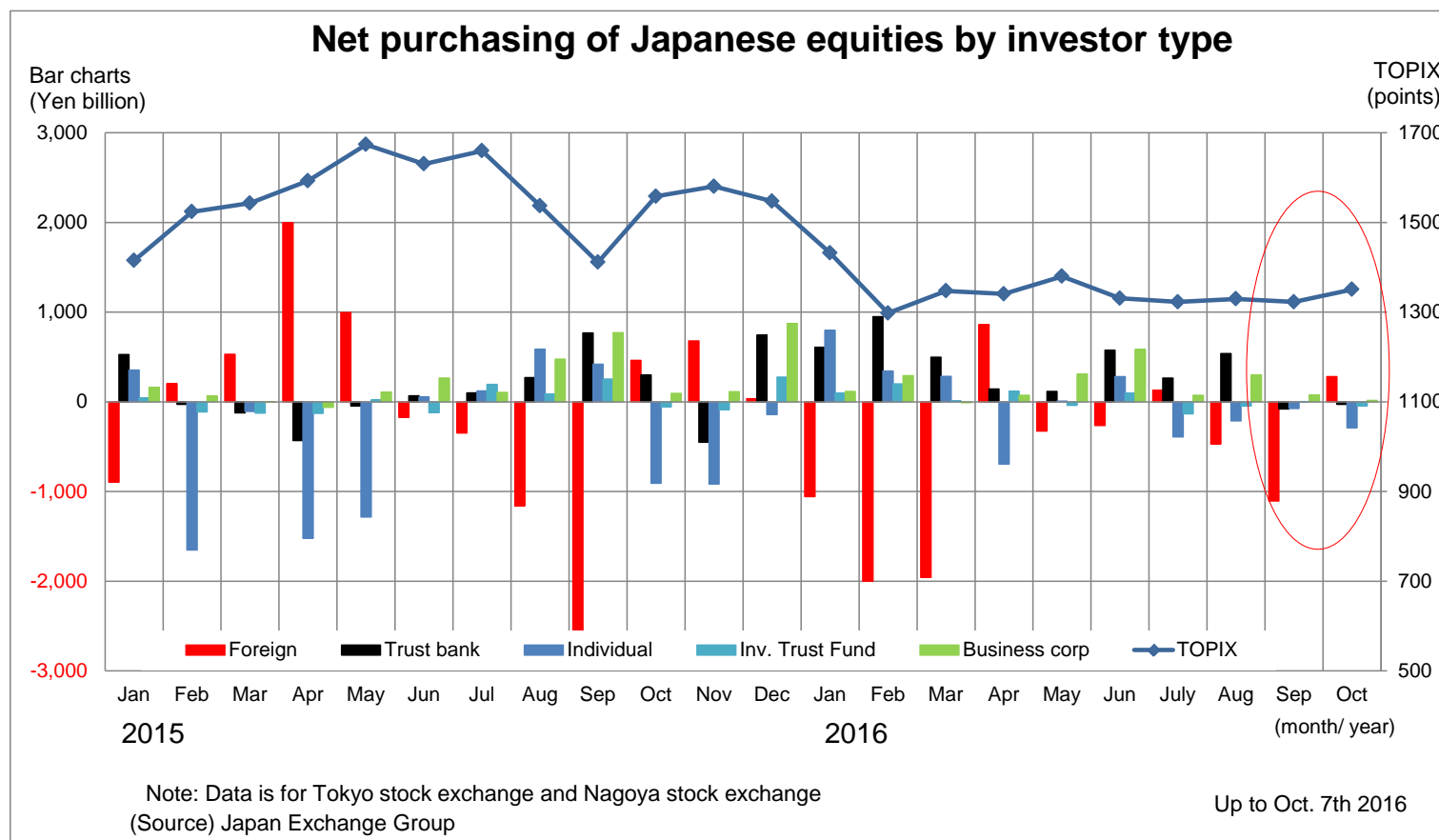
Total shareholders return is forecast to increase in FY 2016 and 2017

- Nikkei news paper reported that share buy-backs by listed companies were record high at 4.35 trillion yen between January and September this year compared to the same period in the past. Share buy-backs are continuing at a historically high pace.
- 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 stopped in October

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



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