



Japanese Stock Market Outlook

SMAM monthly comments & views
-November 2018 -



Sumitomo Mitsui Asset Management

SMAM

Executive summary

➤ Japanese Economy

SMAM down-revised forecast for FY2018 from 1.2% to 1.1% considering weak private consumption hit by repeated typhoon attacks in August and September. SMAM forecast for FY 2019 is unchanged. Strong private capital investment and mild & steady consumption growth are expected. The government is going to make fiscal spending to offset negative impact from scheduled consumption tax increase in October 2019.

- Japanese companies keep strong appetites for capital expenditure. Machinery orders in August exhibited very strong order takings.
- Private consumption was a little weak in August. It also slowed down in September as long as quickly released economic indicators suggest so far. Strong typhoons repeatedly attacked Japan and also there was a strong earthquake in Hokkaido, a northern part of Japan. However, this weakness is expected to be temporary. Aggregate real wage is growing steadily.

➤ Japanese Stock Markets

Global trade disputes started to bite global economies such as China, which now faces slower economic growth. US economy keeps growing strongly sucking in strength from abroad. Japanese economy stays resilient, however, corporate earnings might be a little affected by slowdown in China & Asia. Japanese stock market could find floor to build strength if earnings up-revision materializes at Jul-Sep quarter earnings announcements from late October to early November. Results of mid-term election and following any policy change in US are also important to watch.

- PE ratio of TOPIX index, which covers all stocks listed on Tokyo Stock Exchange 1st section, dipped below 13 times, which is at low end of the range between 12 times and 16 times since PM Abe took office. Judging from this low stock valuation, current Japanese stock market seems to have weaved in fair part of the event risks such as tough trade negotiation with US and long lasting power struggle between US and China.

Notes: Macro and market views are as of Oct. 19th 2018, and subject to updates thereafter without notice.

Outlook for Japanese Economy

SMAM economic outlook for FY18-19

- SMAM down-revised forecast for FY2018 from 1.2% to 1.1% considering weak private consumption hit by repeated typhoon attacks in August and September.
- SMAM forecast for FY 2019 is unchanged. Strong private capital investment and mild & steady consumption growth are expected. The government is expected to make fiscal spending to offset negative impact from scheduled consumption tax increase in October 2019.

(YoY %)	FY14	FY15	FY16	FY17	FY18E	FY19E
Real GDP growth	-0.3%	1.4%	1.2%	1.6%	1.1%	0.9%
Private Consumption Expenditure	-2.5%	0.8%	0.3%	0.8%	0.6%	0.6%
Private Housing Investment	-9.9%	3.7%	6.2%	-0.4%	-4.2%	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%	1.8%
Net Exports (contrib. to GDP growth)	0.6%	0.1%	0.8%	0.4%	-0.0%	0.0%
Exports	8.7%	0.8%	3.6%	6.3%	2.3%	1.5%
Imports	4.2%	0.4%	-0.8%	4.1%	2.4%	1.3%
Nominal GDP	2.2%	3.0%	1.0%	1.7%	1.0%	2.1%
GDP Deflator	2.5%	1.5%	-0.2%	0.1%	-0.0%	1.2%
Industrial Production	-0.4%	-1.4%	1.5%	4.1%	0.9%	1.7%
CPI (excl. fresh food)	0.9%	-0.1%	-0.2%	0.7%	0.8%	0.8%

Notes: E=SMAM forecasts. SMAM views are as of Oct. 19th 2018 and subject to updates thereafter without notice

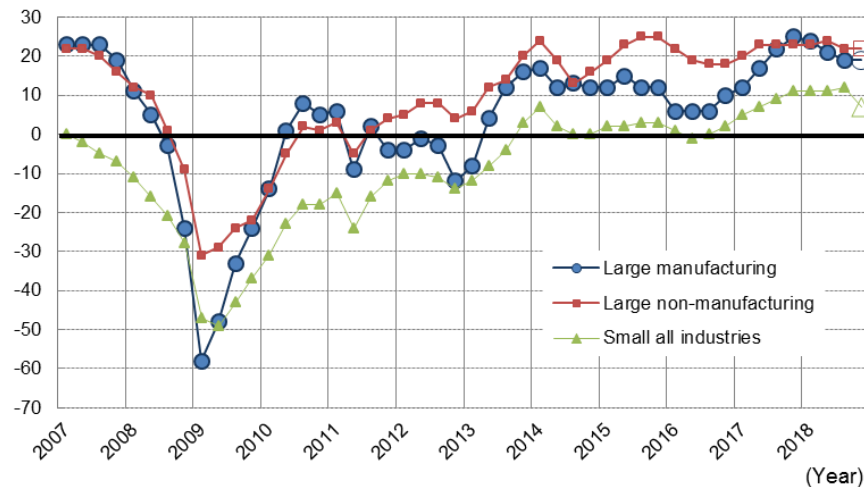
(%, YoY except Net Exports)

(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

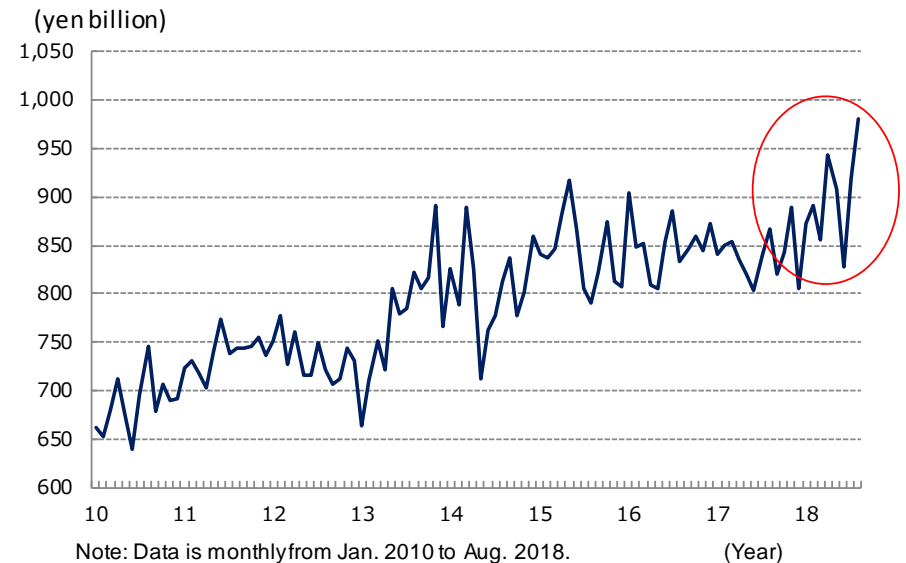
- BOJ "TANKAN" business survey in September showed resilient business sentiment. Despite slight decline in current condition DI, future condition DI of large enterprises held at the same level as current condition DI.
- Japanese companies keep strong appetites for capital expenditure. Machinery orders in August exhibited very strong order takings.

BOJ "TANKAN" business survey, current condition DI
(Last plots are for future condition DI as of September 2018)



Note: Data is quarterly from Mar. 2004 to Sep. 2018
Diffusion Index above 0 means condition is good.
(Source) Bank of Japan

Machinery orders
(excluding orders from Shipping & Electric power industries)

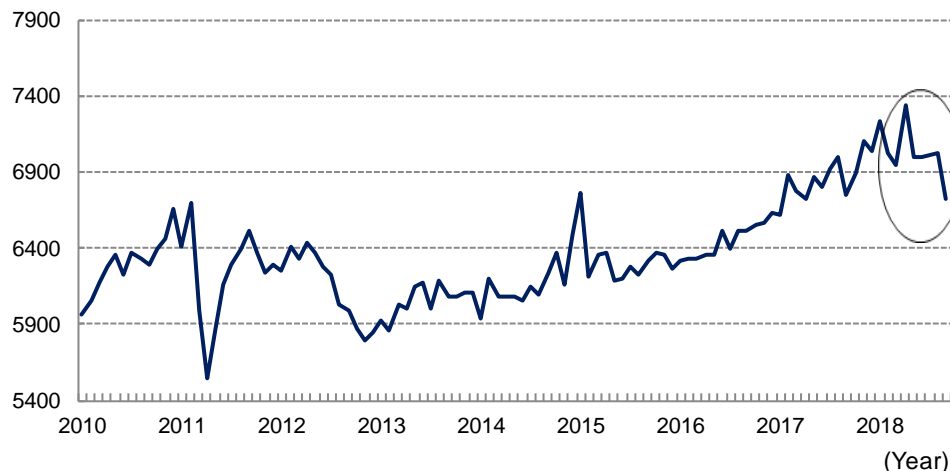


Note: Data is monthly from Jan. 2010 to Aug. 2018.
(Source) Cabinet Office

Export growth in September made a large fall due partly to typhoon damage

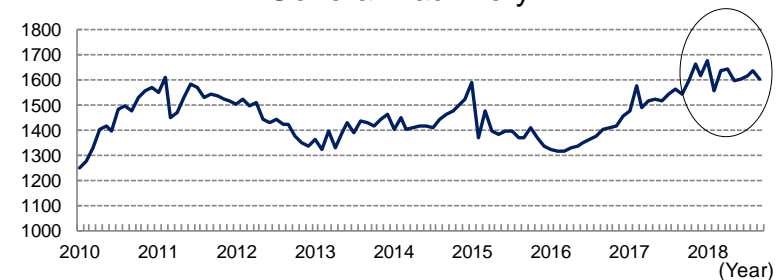
- Total export made a large decline in September. This is partly caused by the shutdown of Kansai International Airport, which was damaged by strong typhoon and negatively affected exports such as electrical goods.
- However, trade disputes seem starting to make real effects. A risk to be watched out for is a possible slowdown of Chinese economy and its negative influence spreading to Asia.

Total export volume
(seasonally adjusted, yen billion)

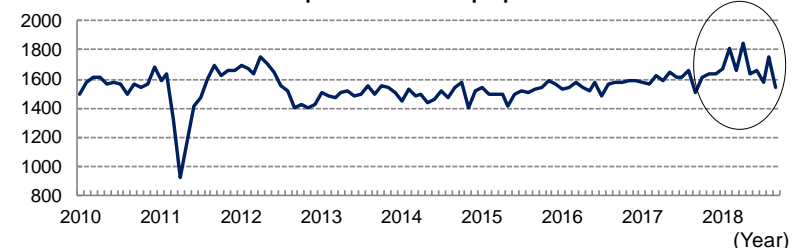


Note: Data is from Jan. 2010 to Sep. 2018.
(Source) Ministry of Finance, Bank of Japan, compiled by SMAM.

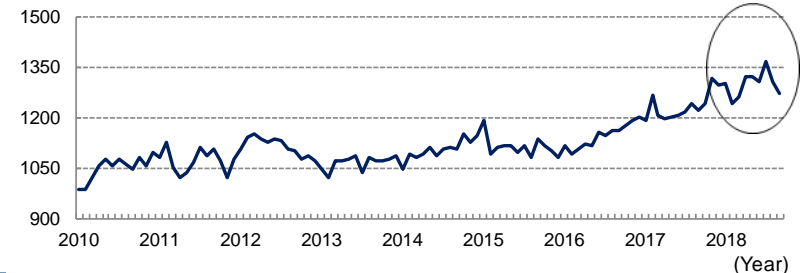
General Machinery



Transportation Equipment



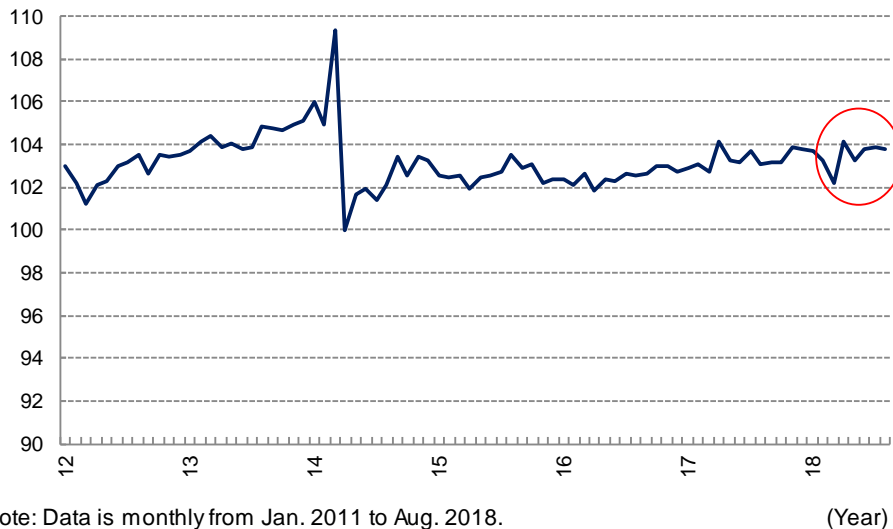
Electrical Goods



Private consumption activity was temporarily affected by typhoon attacks in September

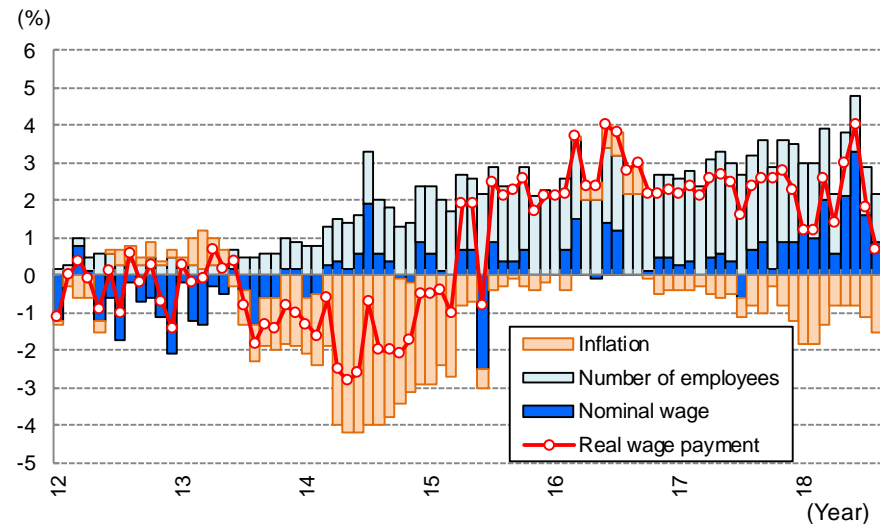
- Private consumption was a little weak in August. It also slowed down in September as long as quickly released economic indicators suggest so far. Strong typhoons repeatedly attacked Japan and also there was a strong earthquake in Hokkaido, a northern part of Japan.
- This weakness is expected to be temporary. Aggregate real wage is growing steadily. On the right chart below, real wage growth becomes steady if you smooth out the data between June and August, for which the timing of summer bonuses counted in the statistics varies year by year.

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



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

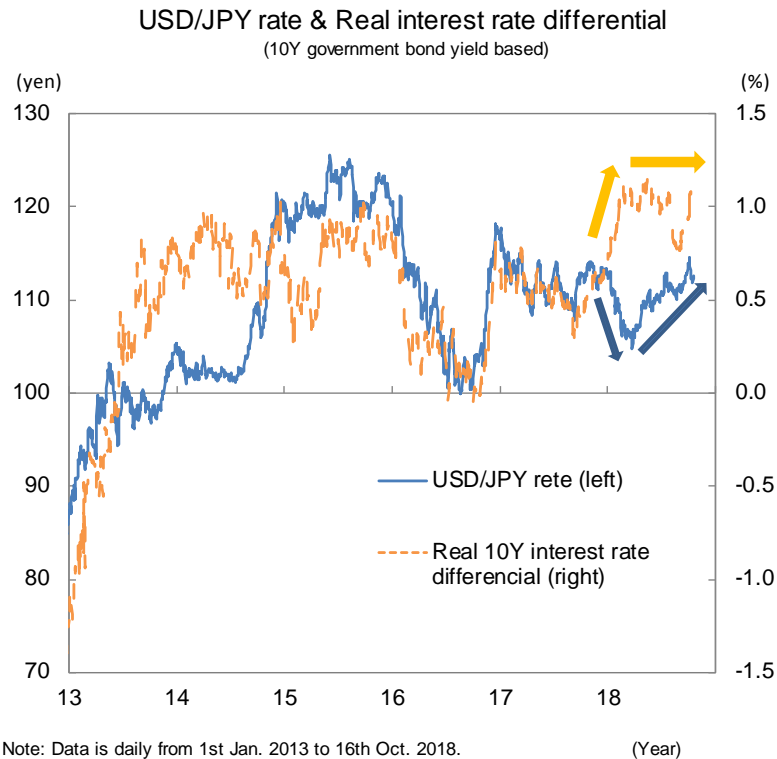
Real wage payment (YoY %)



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

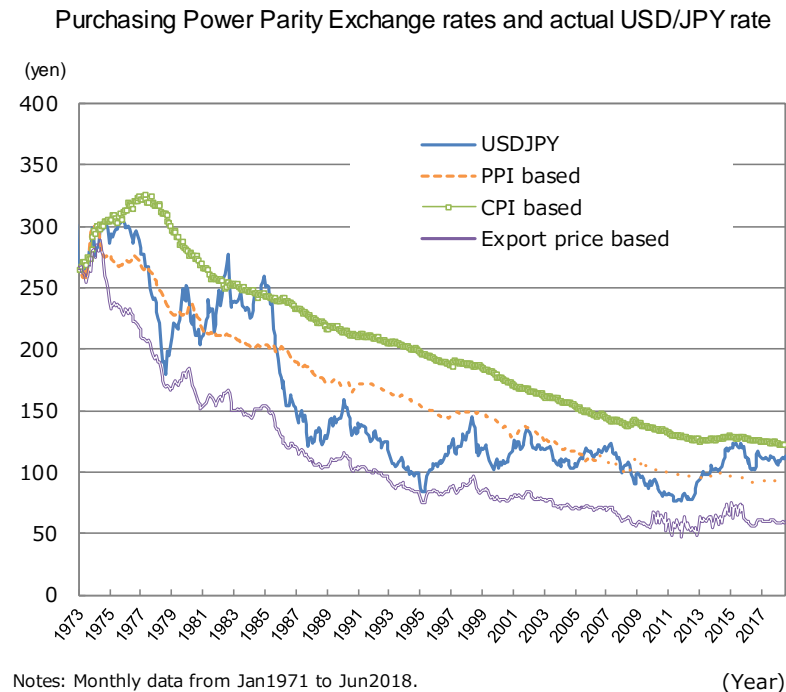
JPY is likely to stay in an established range

- After broken apart at the beginning of 2018, USD/JPY rate started to track interest rate differential again. Real interest rate differential between US and Japan is expected to widen further.
- On the other hand, Purchasing Power Parity rate indicates that JPY is in a weaker end of the appropriate range. Considering US political pressure on weak JPY, SMAM does not expect JPY to get significantly weaker from the current level.



Note: Data is daily from 1st Jan. 2013 to 16th Oct. 2018.

(Source) Bloomberg, compiled by SMAM



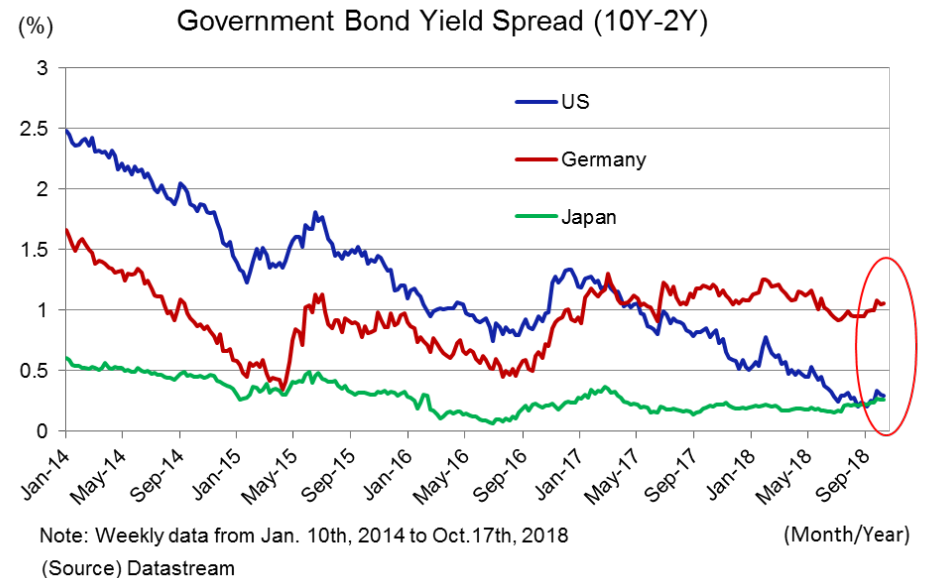
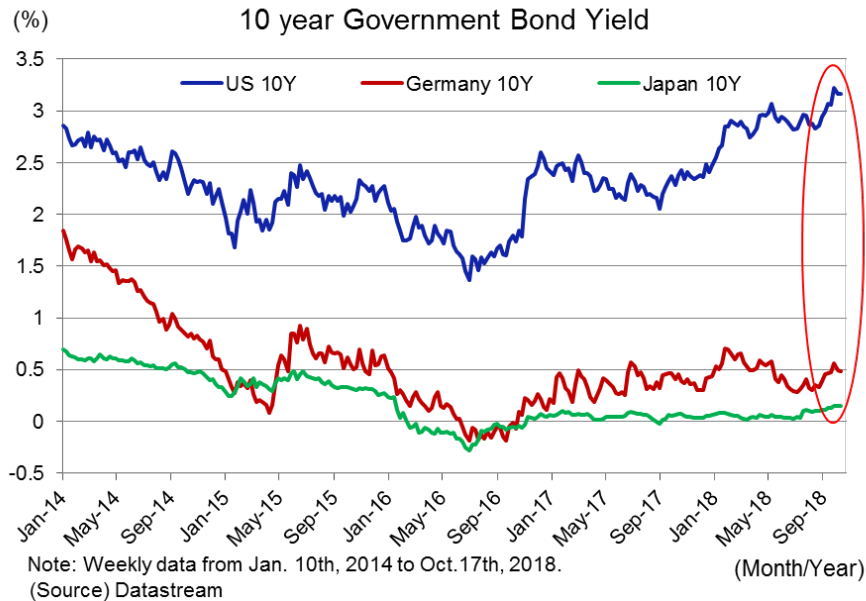
Notes: Monthly data from Jan1971 to Jun2018.

USD/JPY rate base is 265.96 at Mar. 1973 and each PPP rate was adjusted for each price index change in Japan and US.

Source: BLS, Statistical bureau, BOJ, IMF, Bloomberg

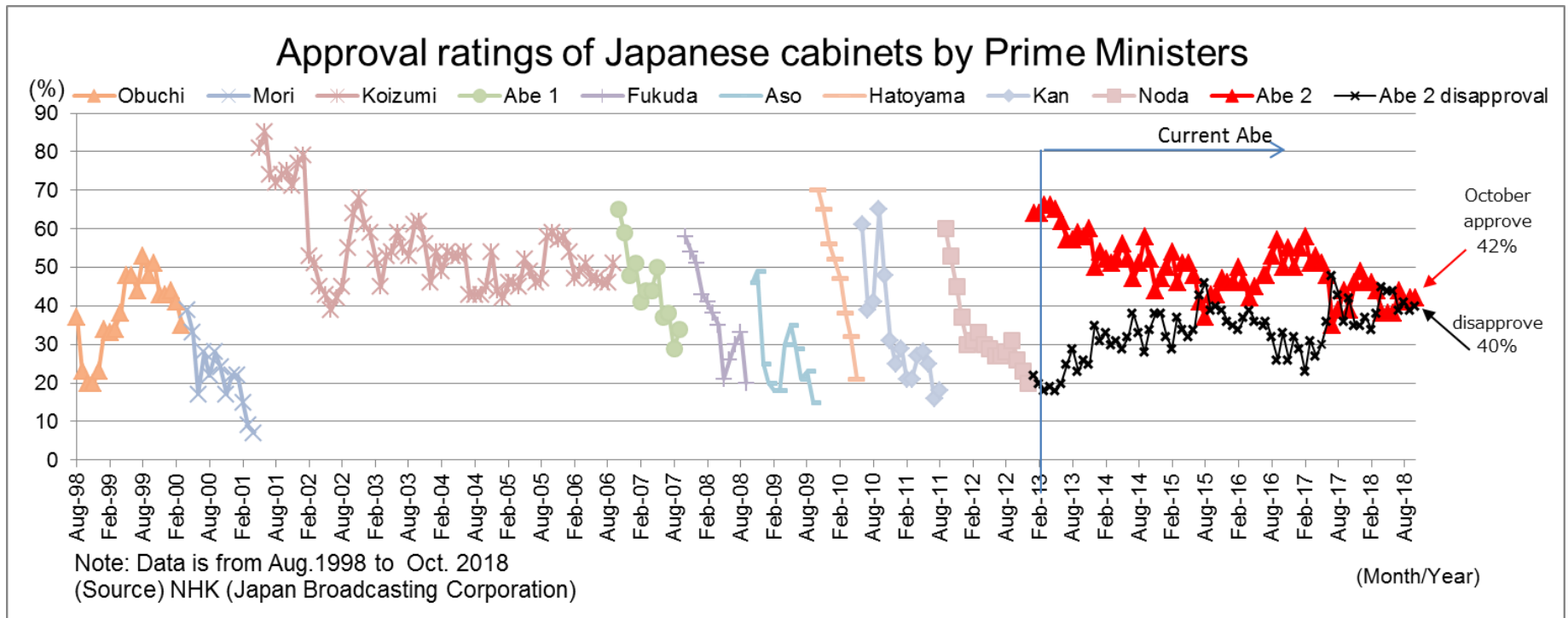
Long term bond yields are going to rise further

- Global bond yields are rising rather strongly.
- SMAM thinks that FRB in US lately talked up US long bond yields, since it wanted the financial market to more reflect FRB's tightening policy. However, FRB probably does not want to kill the current economic growth intentionally.
- Japanese long bond yield is also rising, however, the rising pace will be very moderate compared to US or Europe.



Approval rating for PM Abe's cabinet is moving sideways after securing LDP leadership

- After Mr. Abe was re-elected as the leader of LDP, the governing party, cabinet approval rating moved sideways at 42% in the latest survey made in early October.
- PM Abe led government is going to make a large fiscal spending going into next year and it will support the Japanese economy.
- However, PM Abe's biggest challenge could be diplomatic agenda such as how to steer Japan through the power struggle between US and China.



Long-term power struggle between US and China is going to linger

- Trade dispute between US and China is going to change into a long-term power struggle. China is now determined not to concede to US and getting ready for expected slowdown of its economic growth.
- Possible top meetings between US and China or US and North Korea are important events to watch although the schedule is not certain yet.
- Focus is on how mid-term election goes and if it changes US politics and global policies.

Upcoming key events

Month	Region/Country	Events	Notes
October	Italy	15 Controversial budget plan was presented to EU	Struggle between Italy & EU continues
	US	Semiannual Report on International Economic and Exchange Rate	Exchange rate maneuverer was not named.
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	
	China	Central Economics Work Conference	China is going to discuss how to endure economic slowdown and negative impact from trade sanction by US.
2019			
March	UK & EU	UK is going to exit EU.	
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

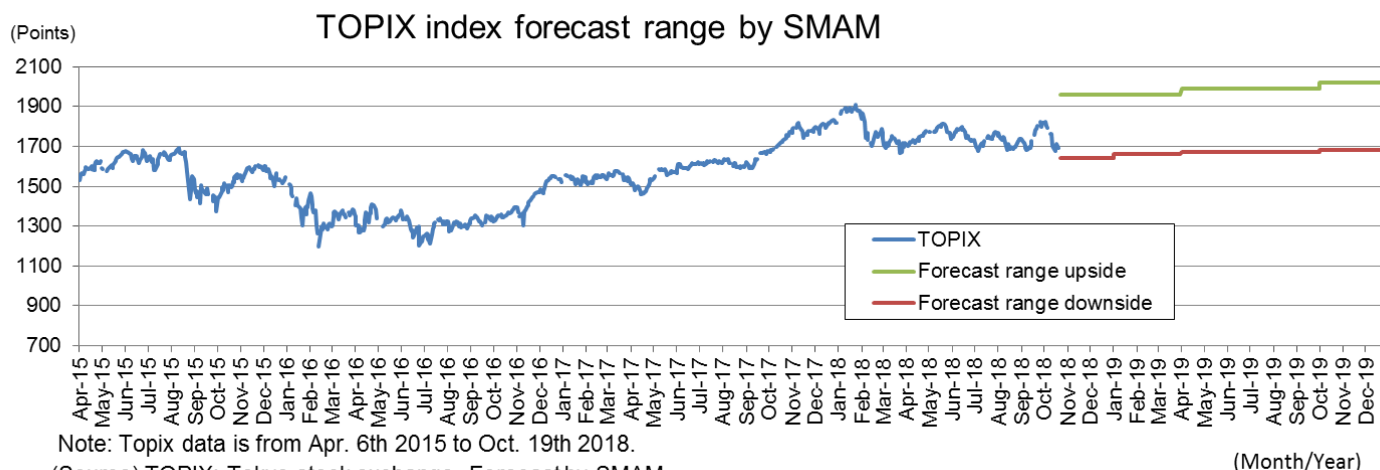
Stock market outlook: Power struggle between US and China weighs on the global stock markets

SMAM short-term view

- Global trade disputes started to bite global economies such as China, which now faces slower economic growth. US economy keeps growing strongly sucking in strength from abroad. Japanese economy stays resilient, however, corporate earnings might be a little affected by slowdown in China & Asia. Japanese stock market could find floor to build strength if earnings up-revision materializes at Jul-Sep quarter earnings announcements from late October to early November. Results of mid-term election and following any policy change in US are also important to watch.

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 FY2018, 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: Topix data is from Apr. 6th 2015 to Oct. 19th 2018.

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

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

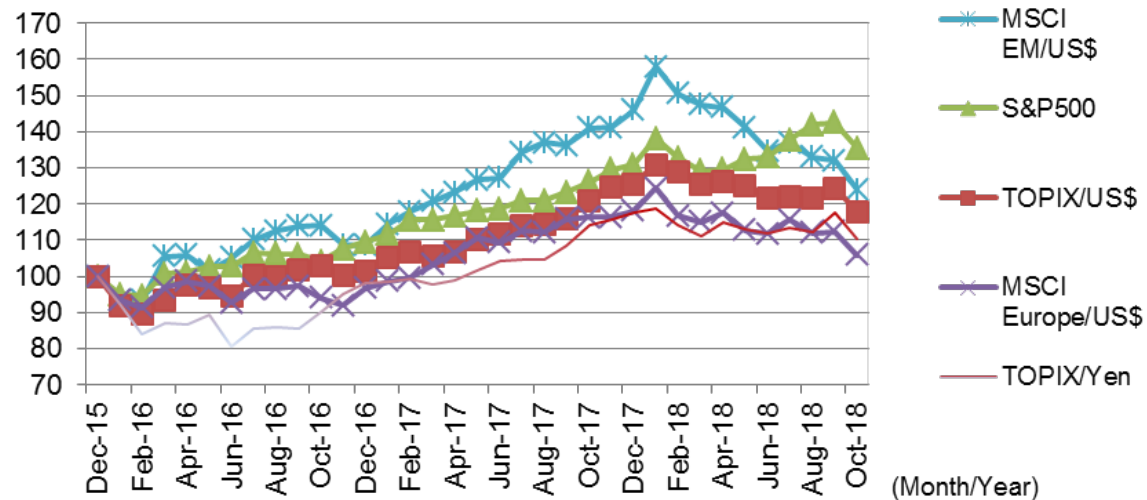
- **Downside Risks** include:
 - Seriously escalating geo-political tensions in Middle East & East Asia.
 - Rekindled concern over emerging economies including China.
 - Global monetary tightening intensifies to choke global economy.
 - Confrontational foreign policies taken by Trump presidency igniting 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 Oct. 19th, 2018 and subject to updates without notice.

Markets turned risk-off

- Rally in developed markets was short-lived and global stock markets turned to risk-off mode.
- Continuing weakness in emerging markets poses a concern. Though not exhibited separately, Shanghai stock index once dipped to 4 years low lately.
- Conflicts between US is hurting Chinese economy and negative effects could spread firstly to emerging economies and then more globally.

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

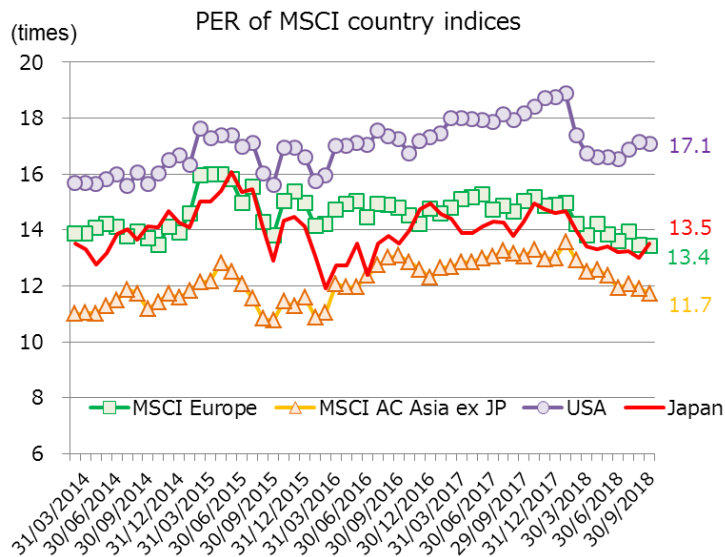


Notes: Data is up to Sep. 18th 2018.

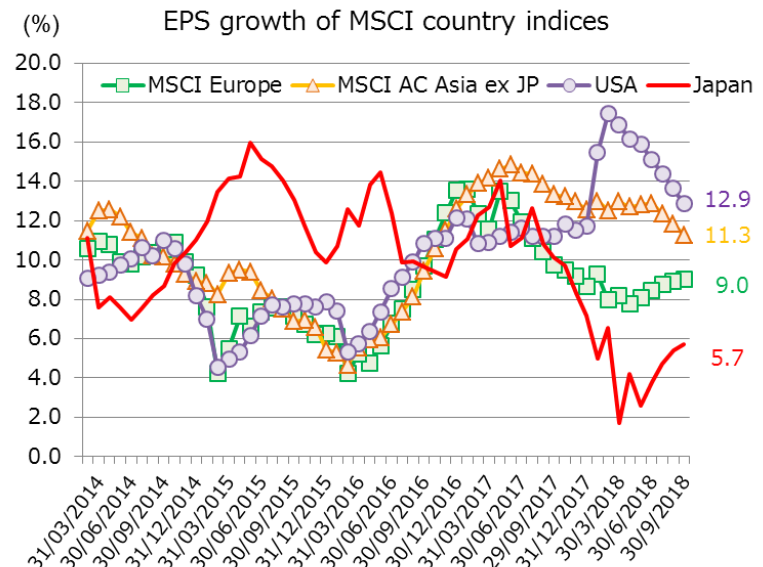
(Source) Datastream, MSCI and Tokyo Stock Exchange, compiled by SMAM.

PE ratio is at reasonable level, except for US

- 12M EPS forecast for Japan is gradually rising.
- Japan's PER temporarily rose in September due to a stock market rally larger than peer markets.
- PER for all exhibited markets declined after a fall in stock price indices so far in October.



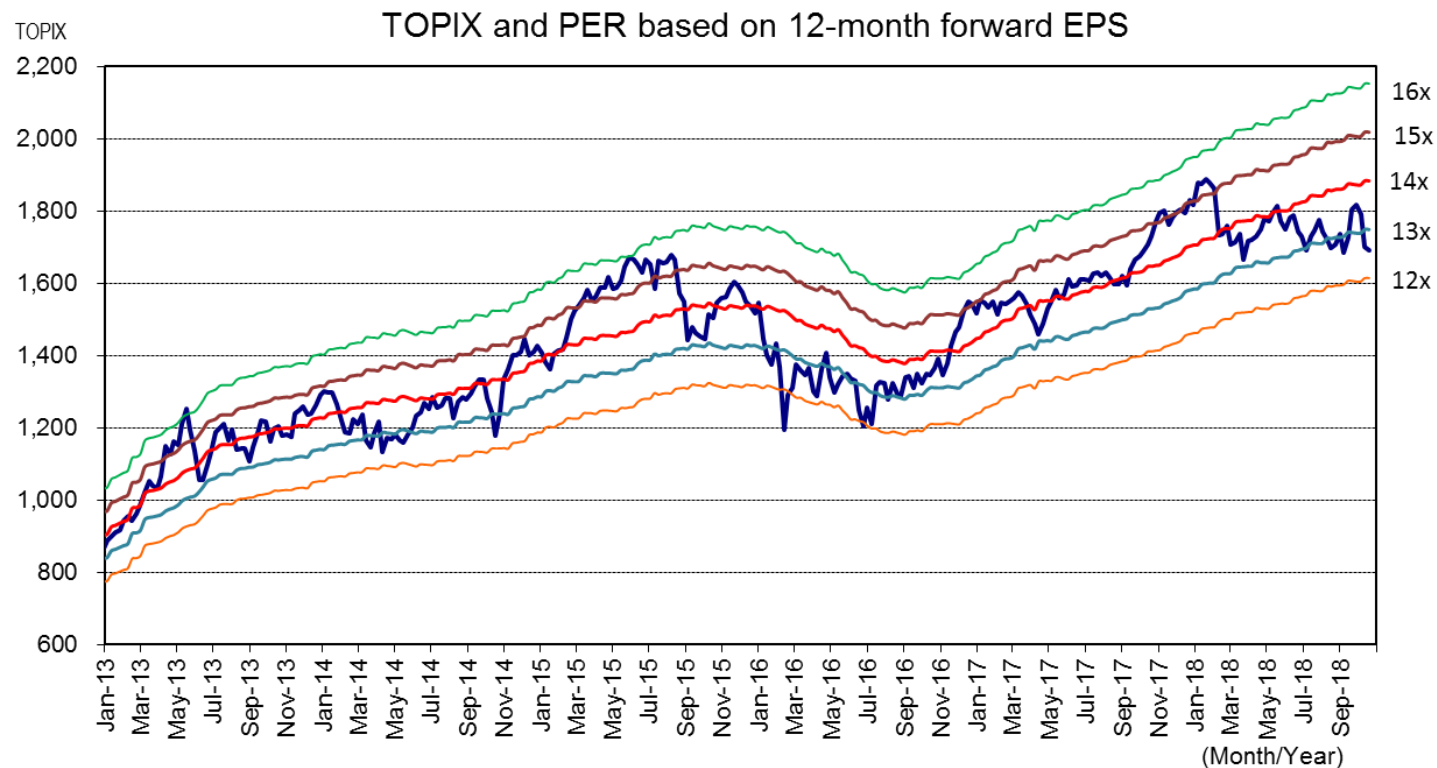
Note: PER is based on 12M forward EPS forecast. (DD/MM/YYYY)
 Data is up to 30th Sep 2018.
 (Source) MSCI



Note: Growth is for 12M forward EPS forecast. (DD/MM/YYYY)
 Data is up to 30th Sep 2018.
 (Source) MSCI

PE ratio is at low end of the historical range

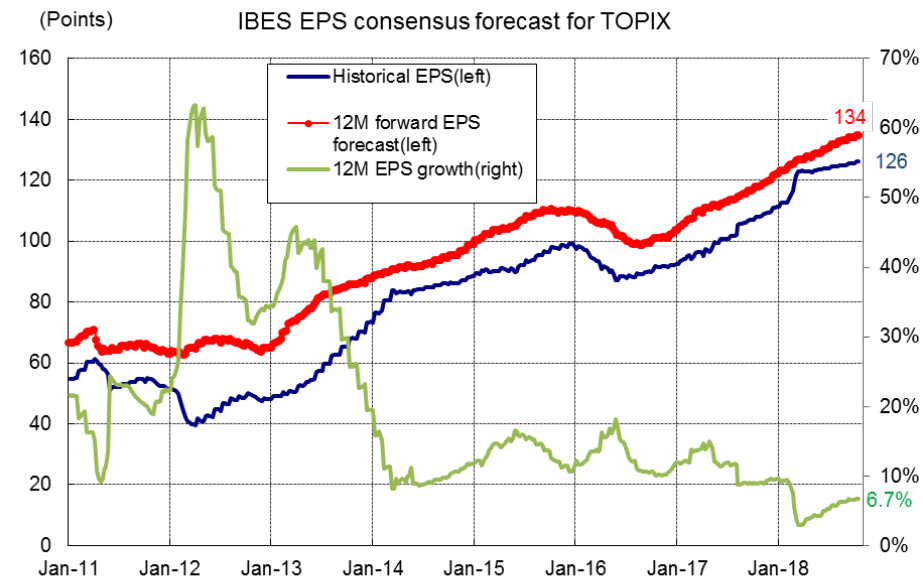
- PE ratio of TOPIX index, which covers all stocks listed on Tokyo Stock Exchange 1st section, dipped below 13 times, which is at low end of the range between 12 times and 16 times since PM Abe took office.
- Judging from this low stock valuation, current Japanese stock market seems to have weaved in fair part of the event risks such as tough trade negotiation with US and long lasting power struggle between US and China.



Note: Data is weekly from Jan.4th 2013 to Oct.19th 2018. TOPIX was 1692.85 at the end of the period.
(Source) Tokyo Stock Exchange, Datastream and IBES, compiled by SMAM

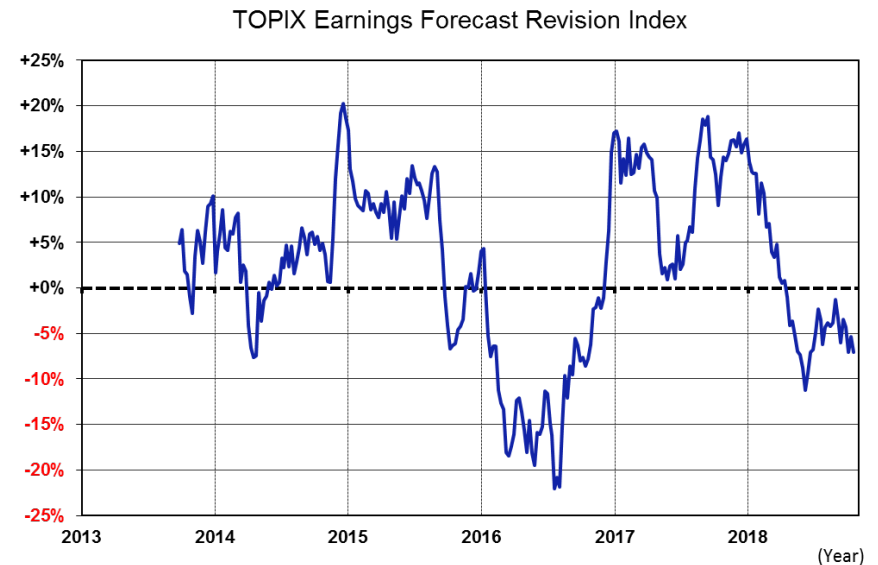
Focus is on whether earnings up-revision materializes

- 12M EPS growth forecast for Japan is gradually rising to the latest 6.7%.
- However, earnings revision index, which compares number of up-revisions and down-revisions, is drifting under water yet. Focus is on the coming earnings announcements for Jul-Sep quarter and how revisions are made.



Note: Weekly data from Jan. 5th 2011 to Oct. 17th 2018. (Month/Year)

(Source) Datastream, IBES



Notes: Revision index= % of Analyst upgrades out of total Topix firms - % of downgrades.

Data is weekly from Jan. 7th 2013 to Oct. 17th 2018.

(Source): IBES, 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)

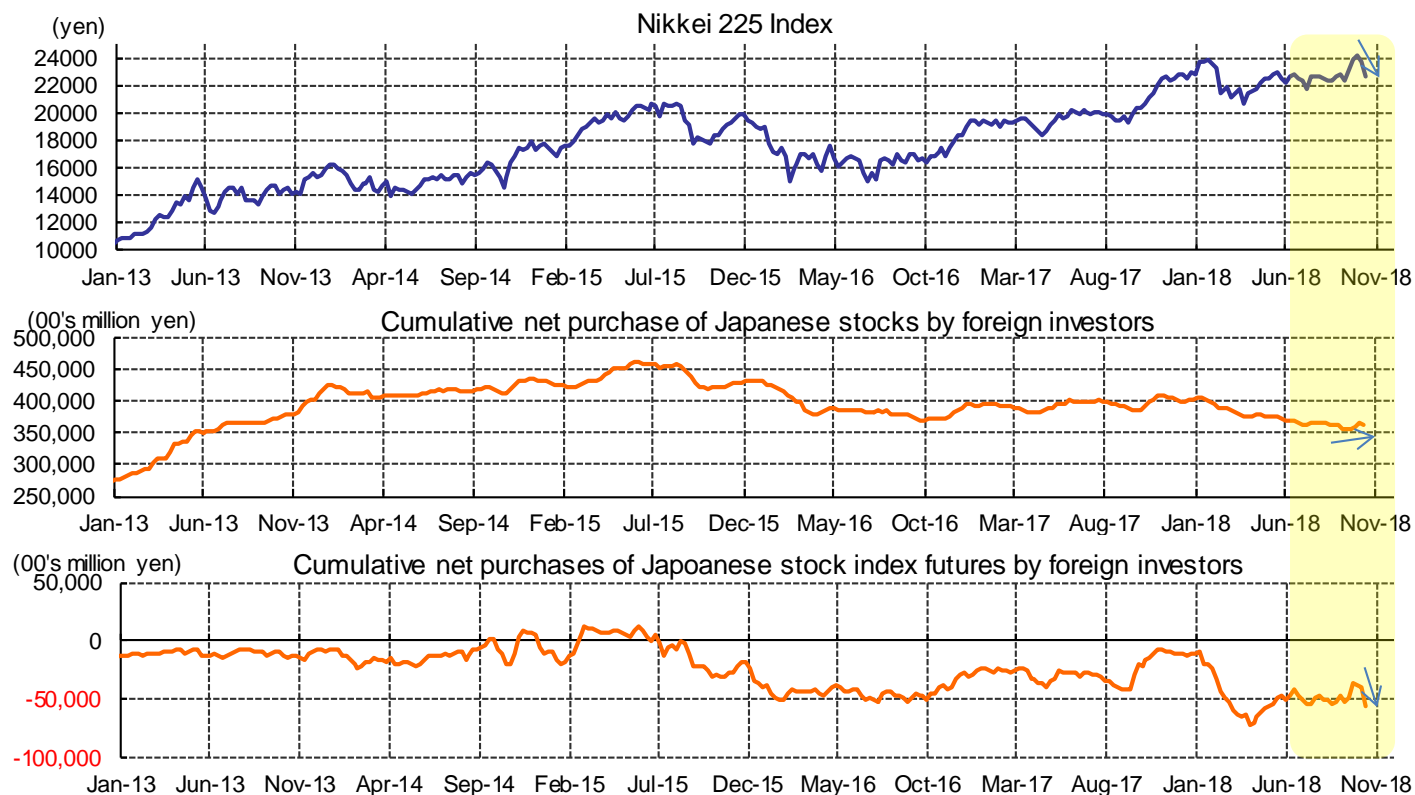
Fiscal year	FY 2016	FY 2017	FY 2018E	FY 2019E
Date of forecast	Actual	Actual	as of 7th Sep. 2018 (as of 7th Jun. 2018)	as of 7th Sep. 2018 (as of 7th Jun. 2018)
Sales (YoY %)	-3.8%	9.3%	6.0% (5.9%)	2.7% (2.7%)
Operating Profits (YoY %)	4.9%	15.6%	10.3% (10.2%)	7.1% (7.3%)
Recurring Profits (YoY %)	6.6%	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

Trading of futures by foreign investors were dominant factor behind recent market move

- For the Japanese stock market, both the rally in September and sharp fall in October were driven by future trading by foreign investors. Relatively short-term investors such as hedge funds and CTA were main players.

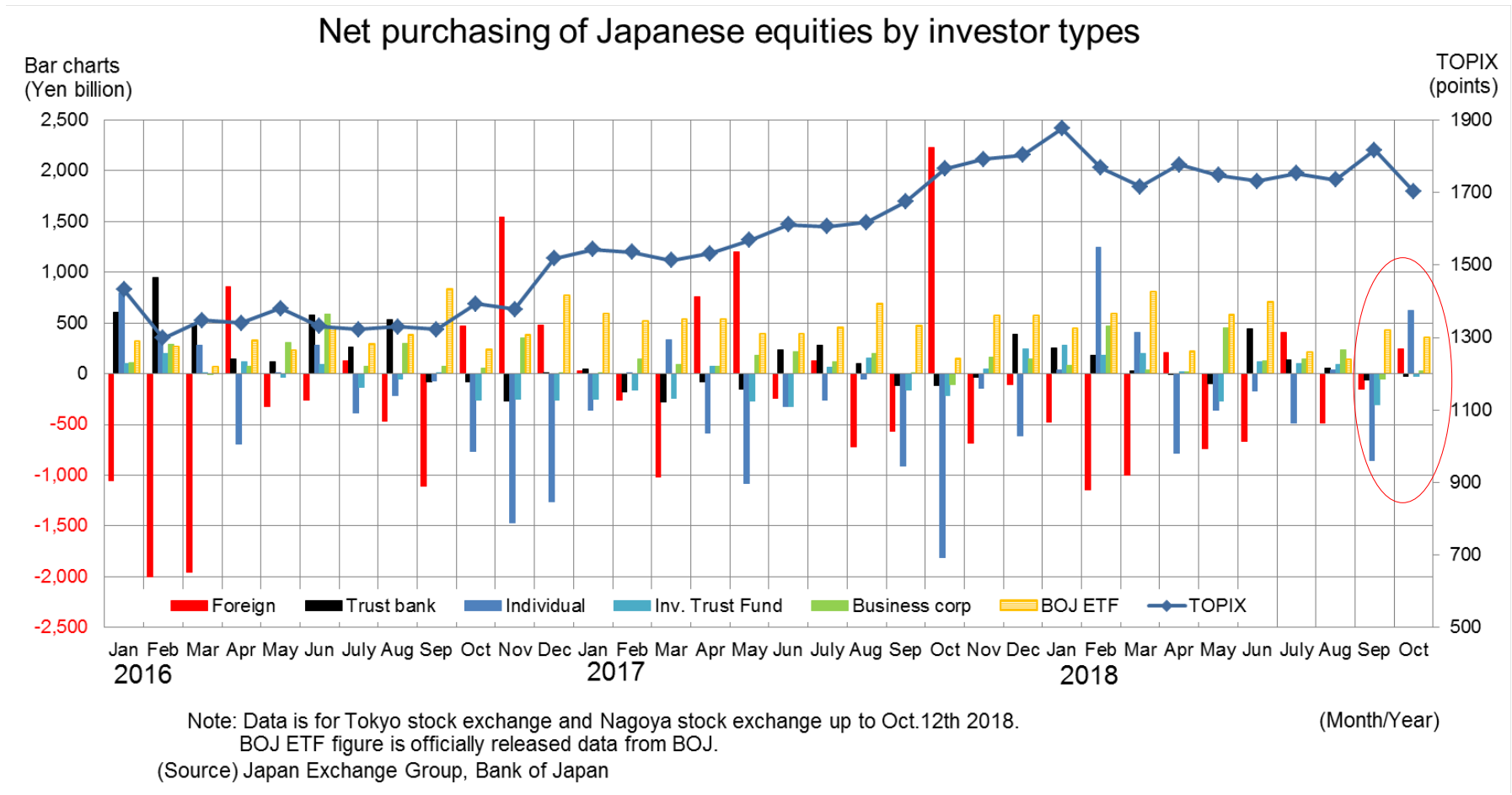


Notes: Data is from Jan. 4th 2013 to Oct. 12th 2018. Cumulative from Jan. 4th 2005.

(Source) Bloomberg, Japan Exchange Group, compiled by SMAM.

Investors activities in cash equities were relatively mild

- Japanese stock markets are mainly driven by foreign investors' trading of index futures lately. Activity in cash equities, which means real equities traded on stock exchanges and not derivatives, were relatively mild.
- BOJ kept purchasing stocks and individuals made contrarian moves in September and so far in October.



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