



Outlook for Japanese Economy & Stock Market

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

-June 2019-

Executive summary

■ Japanese Economy

1st preliminary GDP estimate for Jan-Mar 2019 showed strong headline growth of annualized 2.1 % QoQ. This quarterly GDP was lifted by weak imports and larger than expected inventory accumulation. Key domestic sectors such as private consumption and private capital investment slightly contracted, however, the total picture was better than preceding expectations.

- Possibility is rising that consumption tax hike in October might be postponed. Worsening US-China conflicts or possible no-deal Brexit could be taken as an excuse for postponing tax hike as a political strategy for upper house election in July. If tax hike is postponed, GDP is estimated to be lifted by 0.2% for both FY2019 and FY2020.
- It is not yet certain if a top meeting between US and China can be set at G20 meeting in Japan in June. Technology sanction by US could have hardened China. If the tariff war is full blown, China is simulated to suffer as much as -1.16% negative effect on its GDP, meanwhile US suffers -0.22%. This is a simple simulation for trade volume adjustments caused by tariff increase.

■ Japanese Stock Market

Uncertainties lingers on Japanese stock market as influential global events are waiting ahead, such as US-Japan trade negotiation, US-China conflict and Brexit. The focus will be on if US-China top meeting can be set at G20 meeting in Japan in July to ease tensions. Corporate earnings forecasts seem to have weaved in reasonably expected negative scenarios already. Unless technology sanction on Chinese companies intensifies and global production severely damaged, relatively cheap stock valuation could be supportive for the Japanese stock prices.

- ROE has been improving for Japanese stocks. ROE gap between Europe and also between Asia got narrower in the last five years, however, this improvement in ROE has not reflected on PBR (Price to Book Ratio), which is left at the low level compared to other markets.

Notes: Macro and market views are as of 24th May 2019, and subject to updates thereafter without notice.



Outlook for Japanese Economy

SMDAM economic outlook for FY18-20

- 1st preliminary GDP estimate for Jan-Mar 2019 showed strong headline growth of annualized 2.1 % QoQ.
- This quarterly GDP was lifted by weak imports and larger than expected inventory accumulation. Key domestic sectors such as private consumption and private capital investment slightly contracted, however, the total picture was better than preceding expectations.
- Japanese economy is forecast to keep moderate growth going into FY2020.

(YoY %)	FY15	FY16	FY17	FY18	FY19E	FY20E
Real GDP growth	1.3%	0.9%	1.9%	0.6%	0.4%	0.5%
Private Consumption Expenditure	0.7%	0.0%	1.1%	0.4%	0.3%	0.3%
Private Housing Investment	3.7%	6.3%	-0.7%	-4.2%	1.7%	-2.2%
Private Capital Investment	1.6%	-0.5%	4.5%	3.2%	1.5%	0.5%
Public Consumption Expenditure	1.9%	0.7%	0.4%	0.8%	0.8%	0.9%
Public Capital Investment	-1.6%	0.6%	0.5%	-3.8%	1.8%	0.9%
Net Exports (contrib. to GDP growth)	0.1%	0.8%	0.4%	-0.1%	-0.3%	0.1%
Exports	0.8%	3.6%	6.4%	1.3%	-1.8%	1.4%
Imports	0.4%	-0.9%	4.1%	2.0%	-0.1%	0.9%
Nominal GDP	2.8%	0.7%	2.0%	0.5%	1.0%	0.9%
GDP Deflator	1.5%	-0.2%	0.1%	-0.2%	0.6%	0.5%
Industrial Production	-0.7%	0.8%	2.9%	0.2%	-1.2%	0.3%
CPI (excl. fresh food)	-0.1%	-0.2%	0.7%	0.8%	0.2%	0.2%

Notes: E=SMDAM forecasts. SMDAM views are as of 24th May 2019 and subject to updates thereafter without notice

(%, YoY except Net Exports)

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

Impact of postponing consumption tax hike in October

- Possibility is rising that consumption tax hike in October might be postponed.
- PM Abe and government officials used to say that consumption tax hike is made as scheduled unless global shock comparable to the last Global Financial Crisis occurs. Although the magnitude is not yet comparable, worsening US-China conflicts or possible no-deal Brexit could be taken as an excuse for postponing tax hike as a political strategy for upper house election in July.
- If tax hike is postponed, GDP is estimated to be lifted by 0.2% for both FY2019 and FY2020. CPI is estimated to dip into negative territory when deflationary stimulus measures such as making education cost free for certain eligible families still to be implemented.

Simulation of impacts of consumption tax hike					
Whether consumption tax is hiked in October	FY19		FY20		
	postponed	hiked	postponed	hiked	hiked
Real GDP	0.6% ↑	0.4%	0.7% ↑		0.5%
Private consumption	0.4% ↑	0.3%	0.6% ↑		0.3%
Private Housing Investment	2.2% ↑	1.7%	-0.7% ↑		-2.2%
Private Capital Investment	1.5%	1.5%	0.5%		0.5%
Public Capital Investment	1.8%	1.8%	0.9%		0.9%
Net export (contribution)	-0.3%	-0.3%	-0.1% ↓		0.1%
Export	-1.8%	-1.8%	1.4%		1.4%
Import	0.0% ↑	-0.1%	1.6% ↑		0.9%
CPI (Excluding energy and fresh food)					
Assuming free education implemented	-0.1% ↓	0.4%	-0.1% ↓		0.3%

Note: YoY % except for net export, which is contribution to GDP. SMDAM's current forecast assumes that consumption tax hike is implemented in October.

In no-hike scenario, SMDAM expects stimulus measures including free education program to be implemented.

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

It's a crunch time for US-China conflicts

- It is not yet certain if a top meeting between US and China can be set at G20 meeting in Japan in June. Technology sanction by US could have hardened China.
- If the tariff war is full blown, China is simulated to suffer as much as -1.16% negative effect on its GDP, meanwhile US suffers -0.22%. This is a simple simulation for trade volume adjustments caused by tariff increase.
- Extra negative possibilities are such as a) confusion in global supply chain, b) global capital investments to be discouraged c) escalating technology battle centered on Huawei and d) increasing patriotism in China escalates trade war by boycotting US products.
- SMDAM's main scenario is that US would tone down current extremely hawkish stance considering protests from US companies and producers. Full blown trade war could still be avoided.

Simulation of negative effects of US-China tariff increase on global GDP (%)

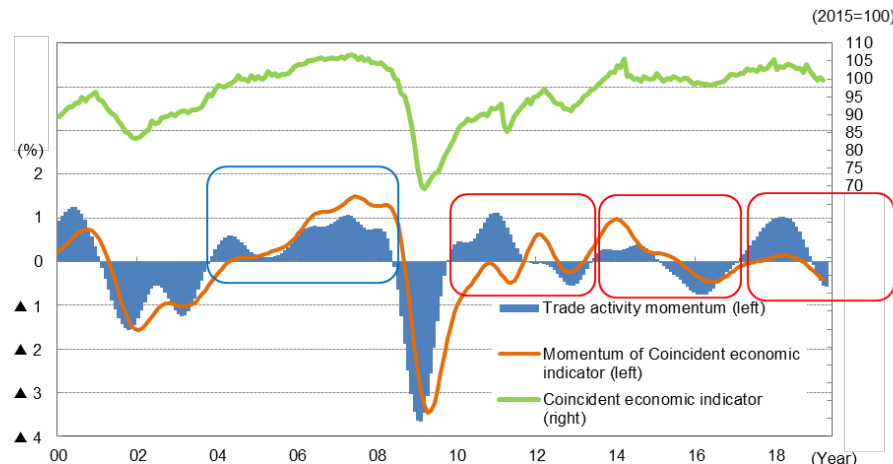
		China	US	Japan	EURO area	South Korea	Taiwan	ASEAN 6
Already imposed	a) US -China 25% mutual tariff imposition on USD 50 bil. imports from the counterpart	-0.17	-0.11	-0.01	-0.01	-0.04	-0.08	-0.02
US tariff was raised on 10 May. China's tariff is raised from 1st June.	b) US imposing 25% tariff on USD 200 bil. imports and China imposing 15% tariff on USD 60 bil. imports.	-0.65	-0.21	-0.04	-0.02	-0.14	-0.27	-0.08
Not imposed yet. US public hearing is on 17th June.	c) US imposing 25% tariff on USD 300 bil. Imports.	-1.16	-0.22	-0.07	-0.03	-0.24	-0.50	-0.13

Note: This simulation calculates change (decrease) of trading volume for each tariff increase and its impact on GDP. The impact is for all volume adjustments to be completed, and it takes approximately 1 year and a half on average. ASEAN 6 countries are Thailand, Malaysia, Philippines, Vietnam, Singapore and Indonesia. (Source) Simulation was made by SMDAM using OECD data.

Downturn in the current mini-cycle is progressing

- After the end of Global Financial Crisis, Japan has experienced 2 and a half mini cycles as indicated in red squares. According to this analysis, currently, Japanese economy is probably in a soft patch as in 2015-16 or a mini recession in 2012-13.
- Current trade momentum is expected to bottom out in the 2nd Half of 2019.
- If US-China trade conflicts flares up further, the timing of the bottom could be delayed.

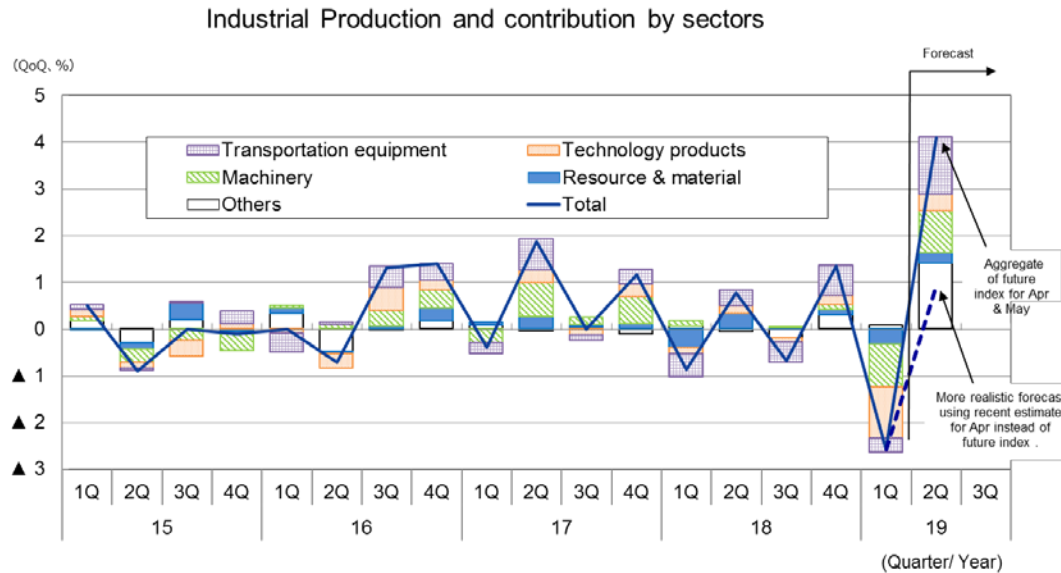
Momentum of Japanese economic indicator and trade activities



Note: Data is monthly from Jan 2000 to Mar 2019 for coincident economic indicator and to Apr 2019 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

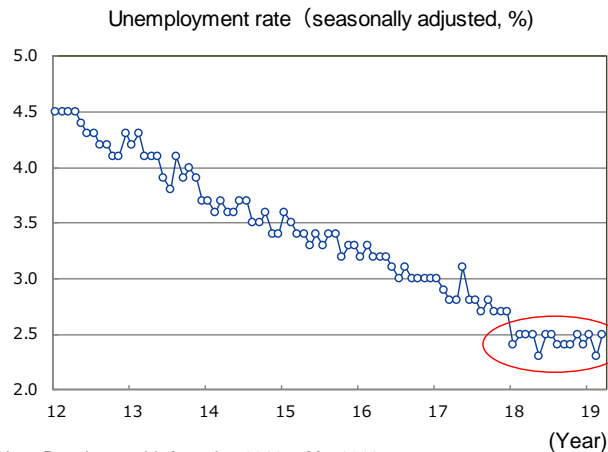
Industrial Production is forecast to make recovery in 2Q 2019

- In 1Q of 2019, Industrial Production in Japan was hit by abrupt slowdown in global economy, especially China, for which contraction in “Technology” and “Machinery” were severe.
- Future index of the Industrial Production statistics predict sharp rebound in April and May, for which “Transportation equipment” and “Machinery” are two large contributors. Rebound in “Technology” is relatively small.
- Future index tends to overstate production actually achieved. When adjusted for this experience, Industrial Production is estimated to grow by 1% instead of 4%.

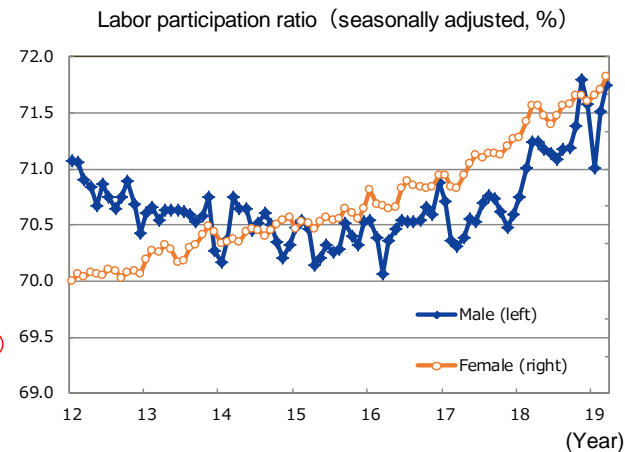


Unemployment rate seems to have reached a rock bottom

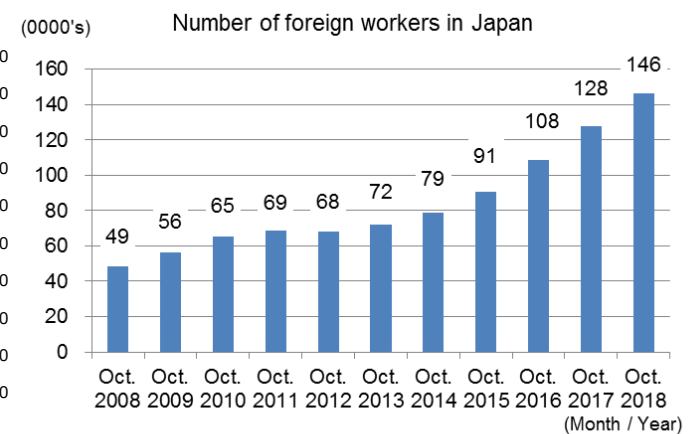
- Unemployment rate has been moving sideways for more than a year, which probably implies that it has reached the structural downside limit.
- Labor force in Japan continues to expand despite gradually declining population. Female participation is still increasing, retirement age is getting older and businesses are hiring people aggressively.
- In order for increasing labor force, new working permit for foreign workers started to be given. The government aims to add 500,000 foreign workers by this new program on top of approximate 1,500,000 people already working.



Note: Data is monthly from Jan 2012 to Mar 2019.
 (Source) Ministry of Internal Affairs and Communications



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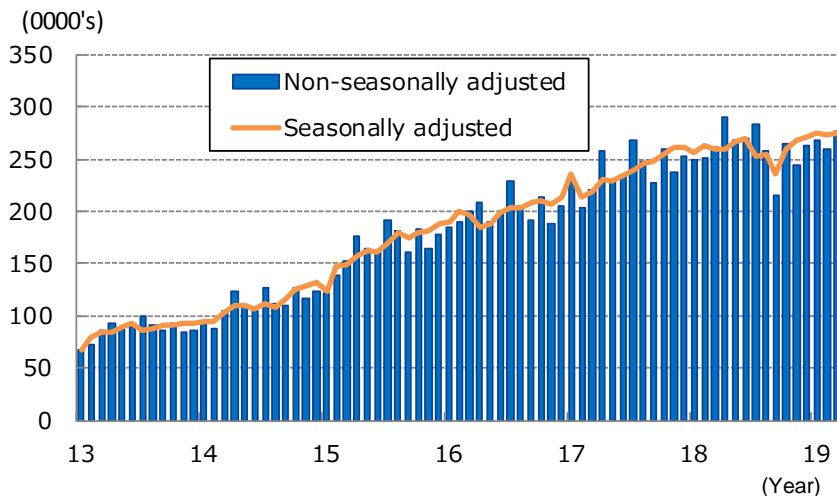


(Source) Ministry of Health, Labour and Welfare

Robust inbound tourism continues to support Japanese economy

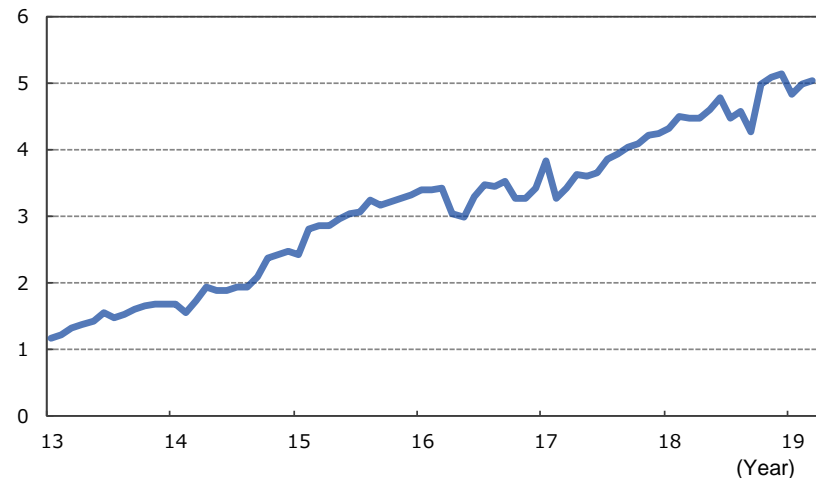
- Japan continues to be a favorite destination for tourists.
- After a temporary decline in September 2018, both number of tourists and travel revenue has been increasing to support Japanese economy. Japan had many typhoon attacks in 2018 and Kansai Airport, one of the major international airports in Japan, was temporarily closed.

Number of foreign visitors to Japan



Note: Data is monthly from Jan 2013 to Mar 2019.
(Source) Japan National Tourism Organization and compiled by SMDAM.

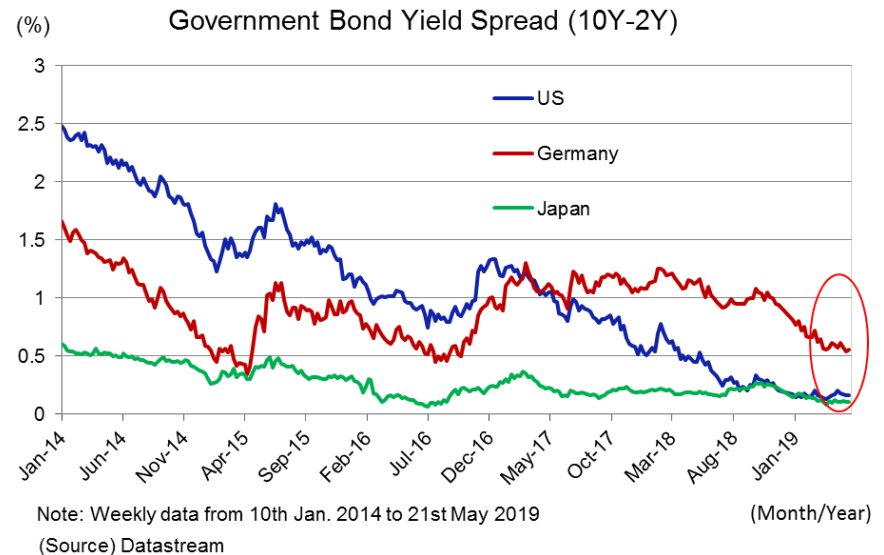
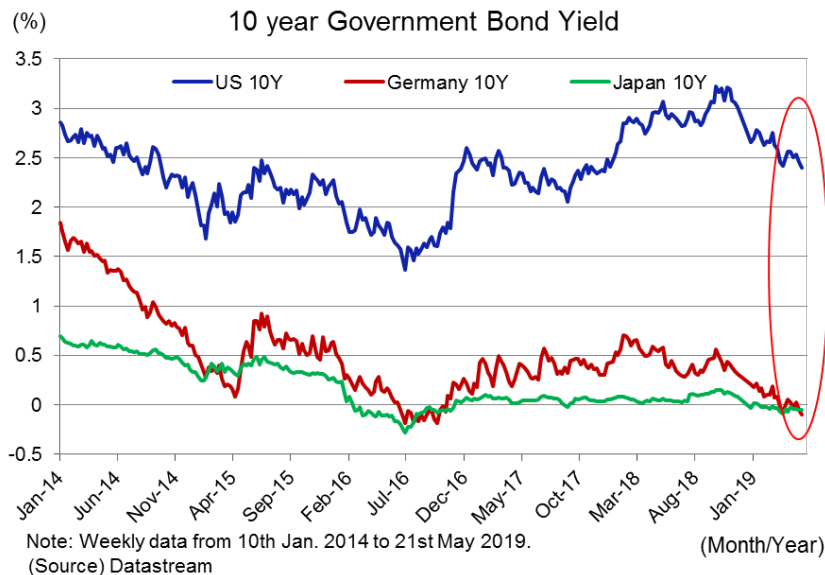
Travel revenue in trade balance
(annualized, seasonally adjusted, %)



Note: Data is monthly from Jan 2013 to Feb 2019.
(Source) Ministry of Finance, Bank of Japan and compiled by SMDAM

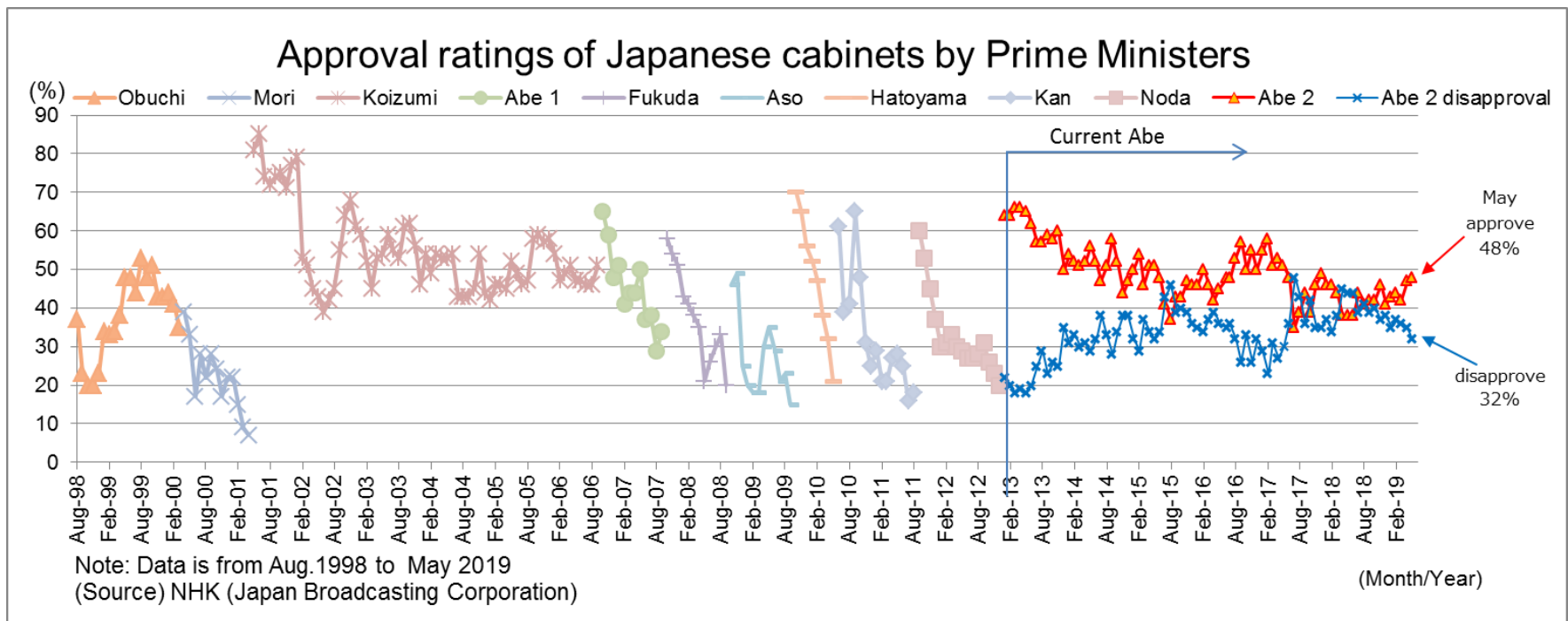
Long term interest rates continue to fall on both sides of the Atlantic

- Long term bond yields continue falling both in US and Europe. German 10Y bond yield is now negative and even lower than that of Japan.
- Yield curve flattening continues in Europe although 10 year- 2 year yield spread is still wide for Germany when compared with US and Japan.



Approval rating for PM Abe's cabinet further improved in May

- PM Abe is going through very important events such as US-Japan trade negotiation around the visit by US president Trump in May and G20 meeting scheduled on 28th and 29th in June before the important upper house election in July.
- National support for the PM Abe's cabinet will be deeply affected by how he could handle difficult diplomatic agendas.



Many important events ahead

- Schedule is quite busy with important events until July.
- How US-China conflict develops is probably the most influential event.
- For Japanese economy, other important events are such as US-Japan trade negotiation, whether consumption tax hike in October is postponed or not and Upper-house election in July.

Upcoming key events

	Month	Region/Country	Events	Notes
2019	May	US-Japan	25-28 US president Trump is going to visit Japan to be the first foreign leader to meet the new emperor.	Diplomatic agenda to be discussed.
		US	18 Limit for deciding US action on car tariffs	Postponed by 6 months.
	June	US	18-19 FOMC meeting	
		Japan	1 Mobile service price cut by DOCOMO and KDDI	Large downward impact on CPI as much as -0.3%.
			10 2nd preliminary estimate for Jan-Mar GDP	
			14-15 Bank of Japan Monetary Policy Committee Meeting	
		Global	28-29 G20 top meeting in Osaka, which PM Abe chairs	US-China top meeting happens?
	July	Japan	Upper house election	
	September	Japan	18-19 Bank of Japan Monetary Policy Committee Meeting	
	October	Japan	1 Consumption Tax is scheduled to rise from 8% to 10% Rakuten begins mobile carrier business as the 4th company in Japan	
UK-EU		31 New time limit for Brexit	PM May aims at reaching agreement in UK parliament by 1st June.	
December	Japan	18-19 Bank of Japan Monetary Policy Committee Meeting		
2020	Jul-Aug	Japan	Tokyo Olympic Games	

(Source) Various publications, assembled by SMDAM



Outlook for Japanese Stock Market

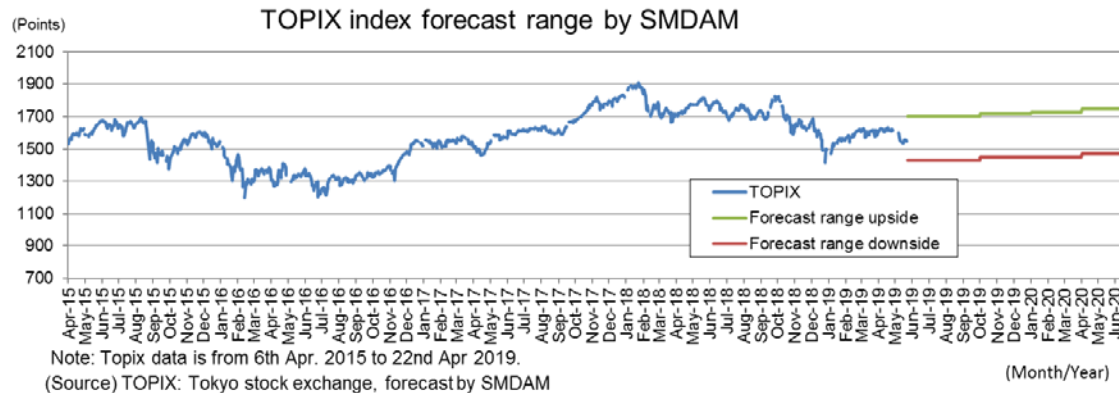
Japanese stock market is likely to seesaw on influential global events

■ SMDAM short-term view

➤ Uncertainties lingers on Japanese stock market as influential global events are waiting ahead, such as US-Japan trade negotiation, US-China conflict and Brexit. The focus will be on if US-China top meeting can be set at G20 meeting in Japan in June to ease tensions. Corporate earnings forecast seem to have weaved in reasonably expected negative scenarios already. Unless technology sanction on Chinese companies intensifies and global production severely damaged, relatively cheap stock valuation could support the downside of the Japanese stock prices.

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

➤ Assuming that Japan is currently in an economic mini cycle and not heading to a recession, Japanese stock market is expected to gather strength in the latter half of 2019 as the momentum of the corporate earnings gradually recovers. If the global economy turns to a severe downturn, consumption tax hike in October will be postponed meanwhile stimulus measures, initially planned for countering negative effects from tax hike, will be implemented. Relatively large room for swift fiscal stimulus and cheap stock valuation could be supportive for the Japanese stock prices.



Note: SMDAM's projection is as of 24th May 2019 and subject to updates without notice.

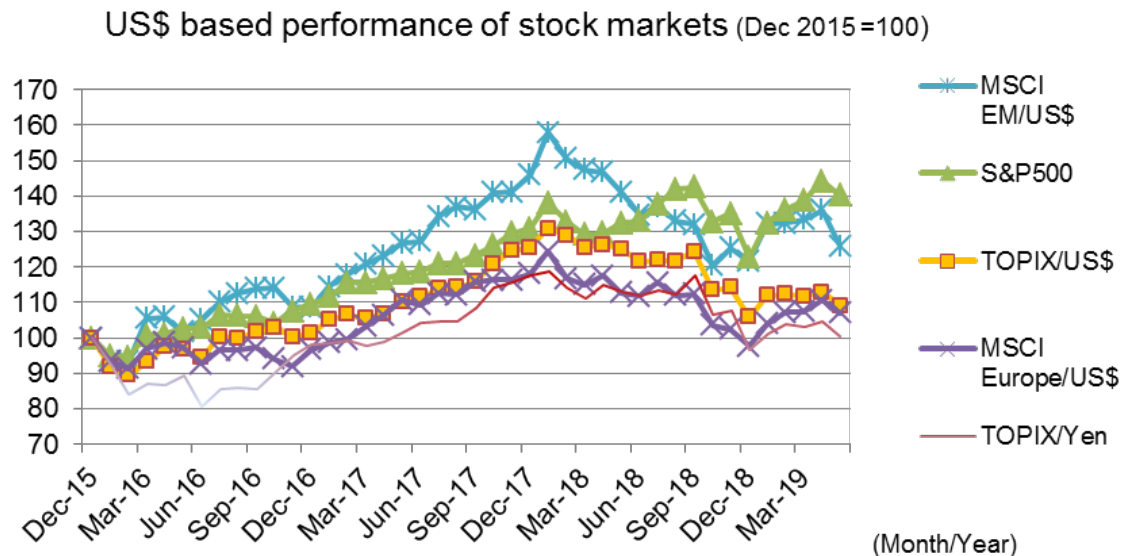
Base scenario & Upside / Downside risks for our forecasts

- 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 for the global economy.
 - US economy keeps growing despite possible mild slowdown. Recession in 2019 is avoided.
 - Japan's private consumption grows mildly supported by wage growth.
 - 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 avoid killing economic growth and adjust the pace of monetary normalization.
- **Upside Risks** include:
 - China makes significant concession in the trade negotiation with US.
 - 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.
 - Global monetary tightening intensifies to choke global economy.
 - Political turmoil flares up in US over the impeachment of the President Trump.
 - Populism gains in Europe further destabilizing EU.

Note: SMDAM's projection is as of 24th May 2019 and subject to updates without notice.

Emerging market was worst impacted by escalation of trade war

- Emerging market was worst affected by unexpected escalation of tariff war between US and China meanwhile advanced countries/ regions shared impact more evenly.

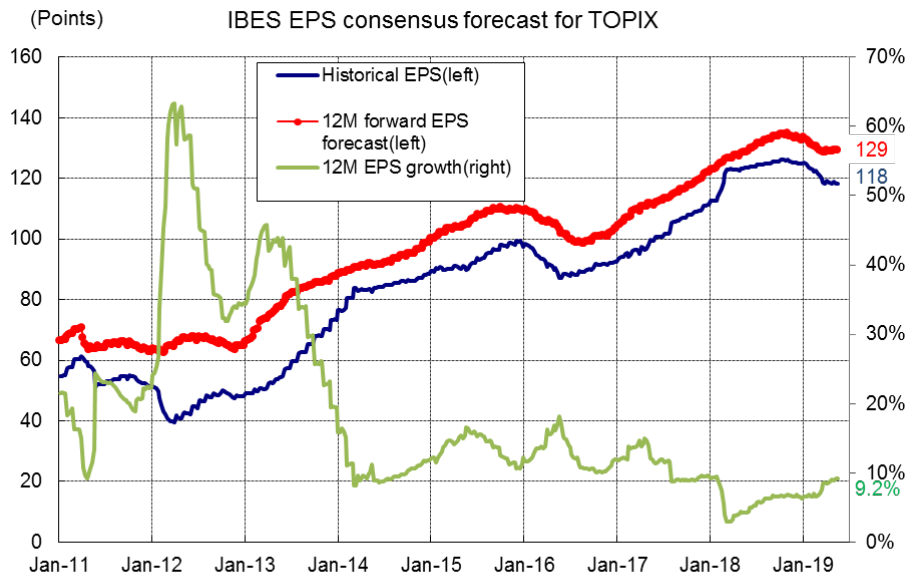


Notes: Data is up to 21st May 2019.

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

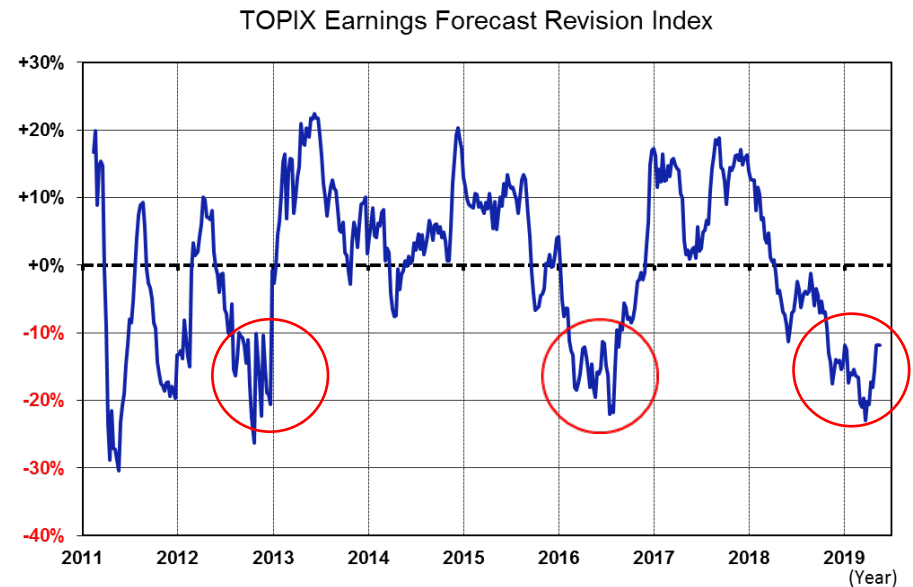
Earnings forecast is bottoming out

- According to IBES, 12m forward consensus EPS forecast for TOPIX has bottomed. Also, 12m forward EPS growth forecast has continued rising.
- Earnings forecast revision index has rebounded from the level, which were bottom of the previous contraction periods in 2012 and 2016.



Note: Weekly data from 6th Jan. 2011 to 16th May 2019. (Month/Year)

(Source) Datastream, IBES



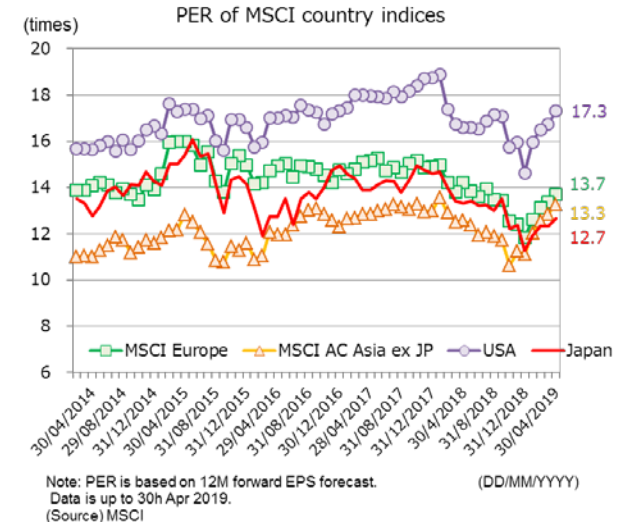
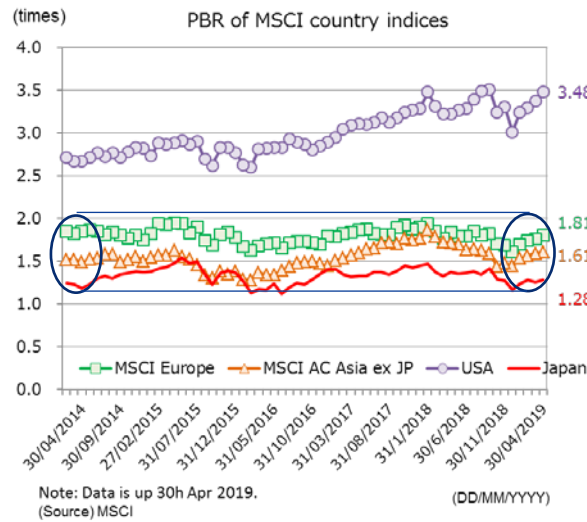
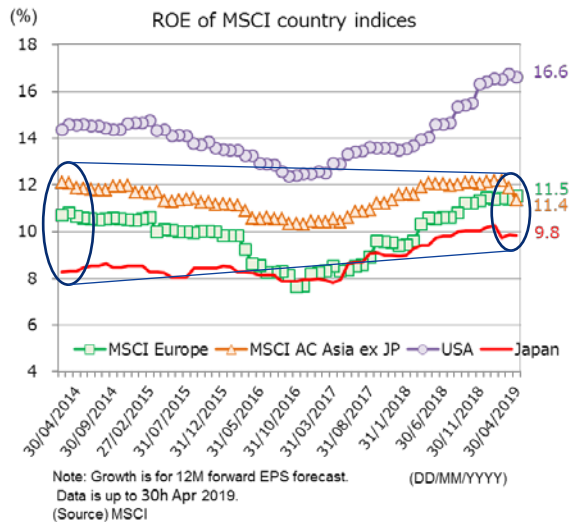
Notes: Revision index= % of Analyst upgrades out of total Topix firms - % of downgrades.

Data is weekly from 7th Jan. 2011 to 16th May 2019.

(Source): IBES, SMDAM

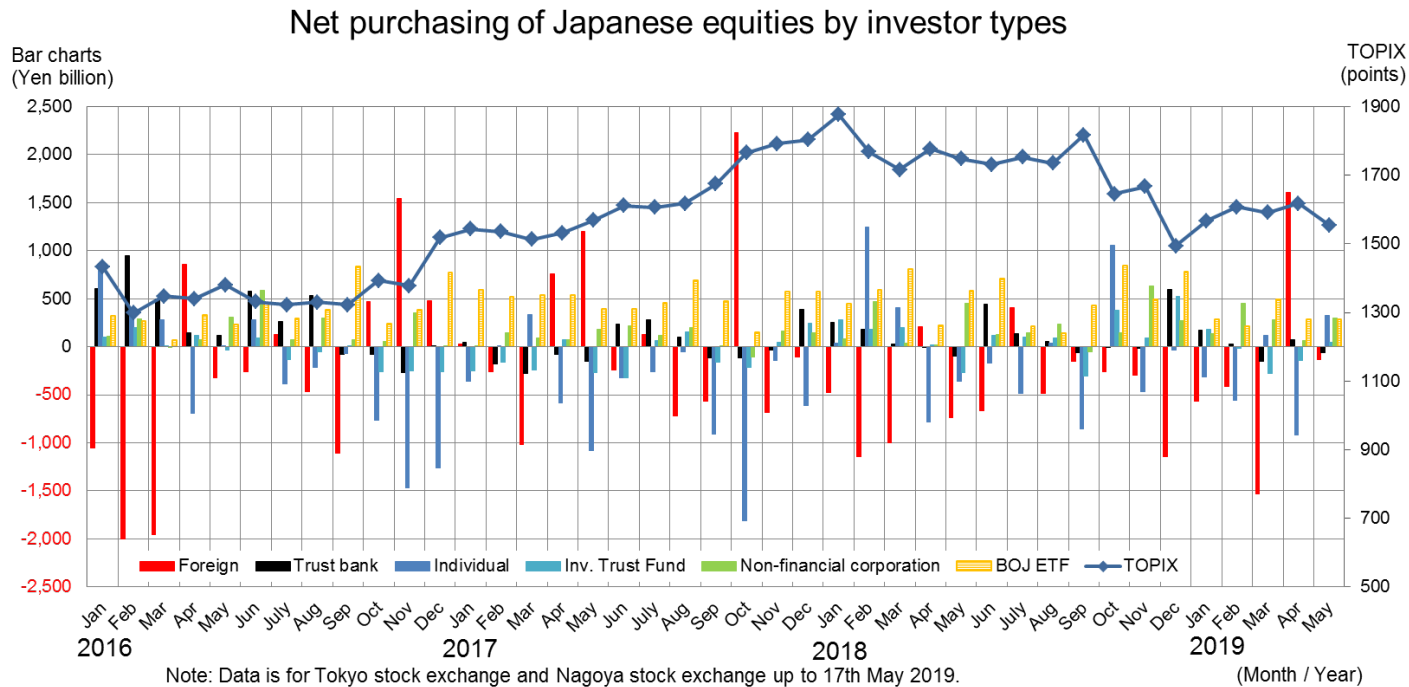
ROE for Japanese stocks has been steadily improving

- ROE has been improving for Japanese stocks. ROE gap between 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 reflected on PBR (Price to Book Ratio), which is left at the low level compared to other markets, which is shown in the middle chart.



Foreign investors bought back Japanese equities in April

- In April, foreign investors bought back almost equivalent value of Japanese equities they sold in March.
- So far in May, activities of investors have been relatively calm. Share buyback by companies, individual investors and BOJ were supporters for the Japanese stock prices.



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