



Outlook for Japanese Economy & Stock Market

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

-October 2019-

Executive summary

■ Japanese Economy

Assuming already announced trade tariffs are imposed, maximum negative effect on the quarterly global real GDP growth is estimated to be -0.14% in 4Q 2019, and then after recedes rather rapidly from 2Q 2020. If US and China make a partial compromise such as China importing US agricultural products and meats meanwhile US stops imposing tariff scheduled in October and December, Bottoming can be even faster.

- Japanese companies have reasonably large buffer for bearing labor cost despite recent contraction in revenue. Breakeven point is quite low in more than 30 years of history. Companies are still profitable even if sales decline by 40%. Also, labor share has been kept low despite robust revenue growth.(P10)
- Business & consumer sentiment is showing weakness according to Economy Watchers' Survey, however, the sentiment has been declining for nearly two years already and the bottom could be just around the corner, considering the DI around 40 became bottom levels in the last two mini-cycles in 2014 and 2016. (P11)

■ Japanese Stock Market

The global stock market is expected to try upside assuming cyclical economic recovery in the beginning of 2020. Consumption tax hike in October in Japan will have only a limited impact. Risk factors such as break up of US-China negotiation, Brexit and Middle East scare would bring volatility to the global stock markets.

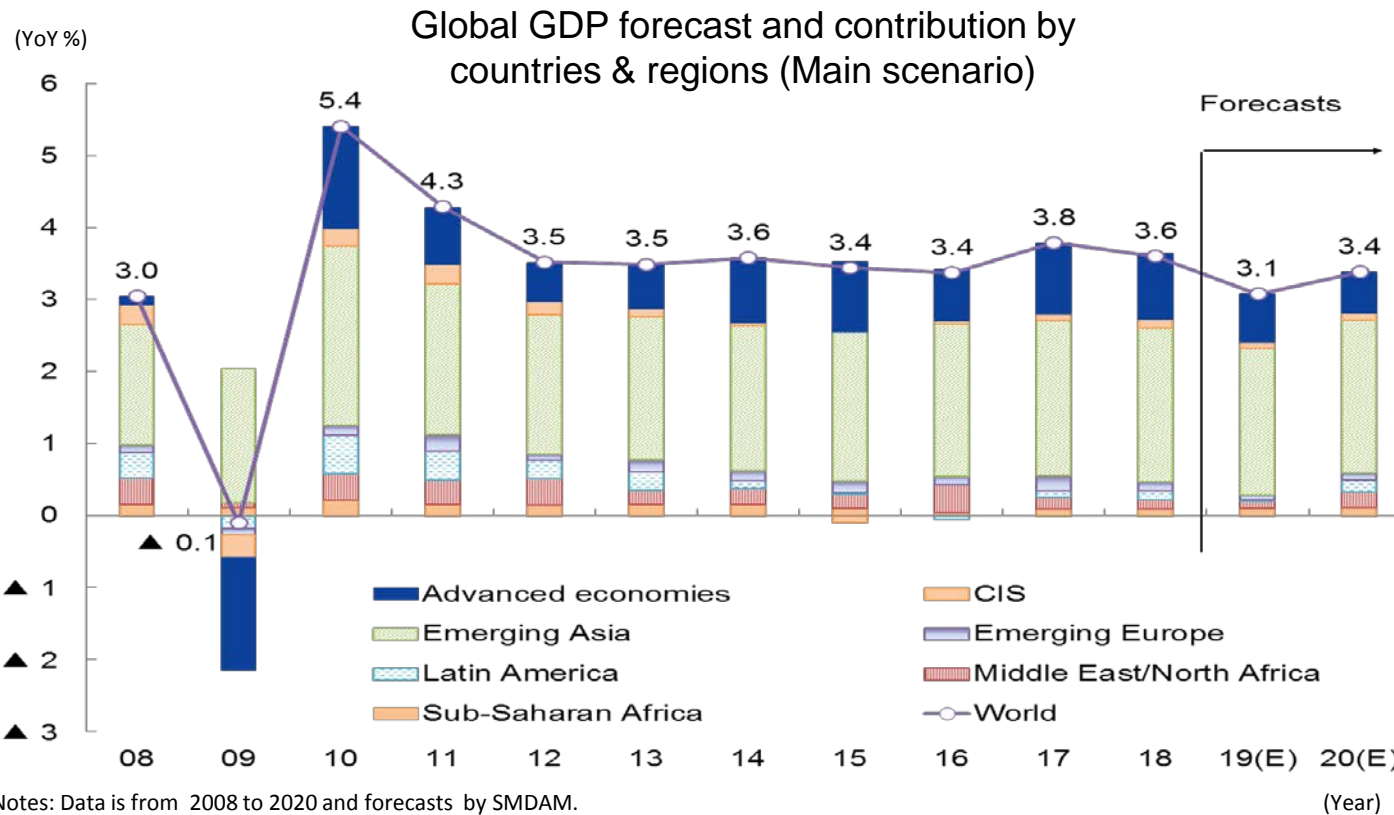
- After the last Global Financial Crisis, 12 times PE ratio has been a strong support level for TOPIX index. Unless Japanese economy is heading into a severe recession, current stock valuation looks attractive. (P22)
- In FY2018 (from April 2018 to March 2019), total upper limit of share buybacks, proposed as board of directors' resolutions, increased sharply and also actual share buybacks increased to renew a historical record. Dividends also renewed historical record in FY2018 and expected to increase further in FY2019. (P27)



Outlook for Japanese Economy

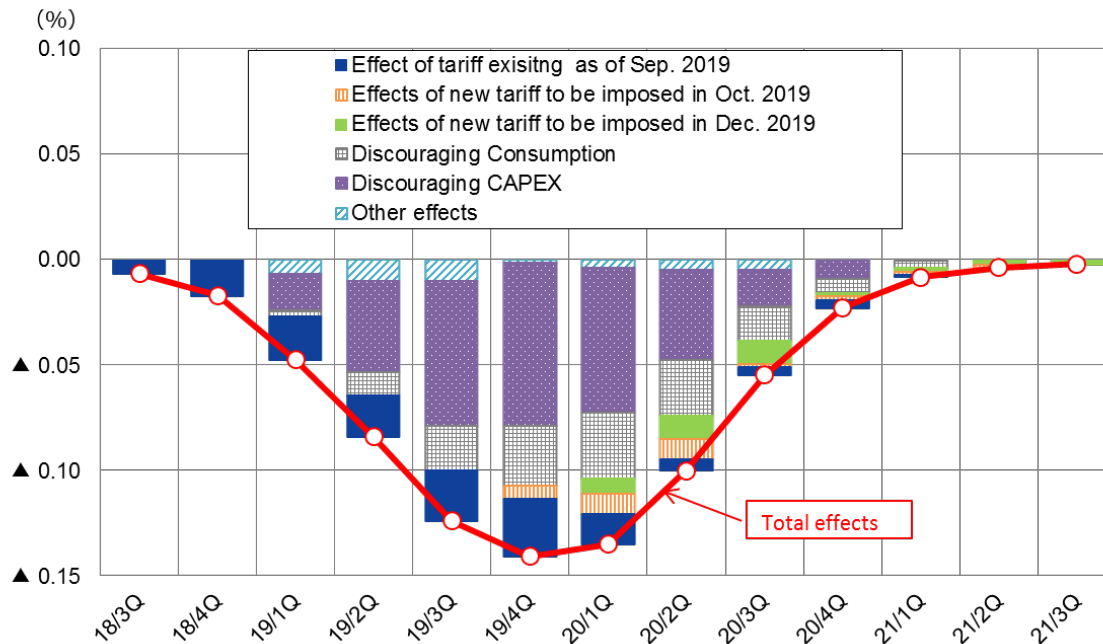
Outlook for the global economy

- SMDAM maintains forecasts for the global real GDP growth, which is expected to slows down from 3.6% in 2018 to 3.1% in 2019, and then recovers to 3.4% in 2020.



Negative effect of trade conflict is expected to bottom by 1Q 2020

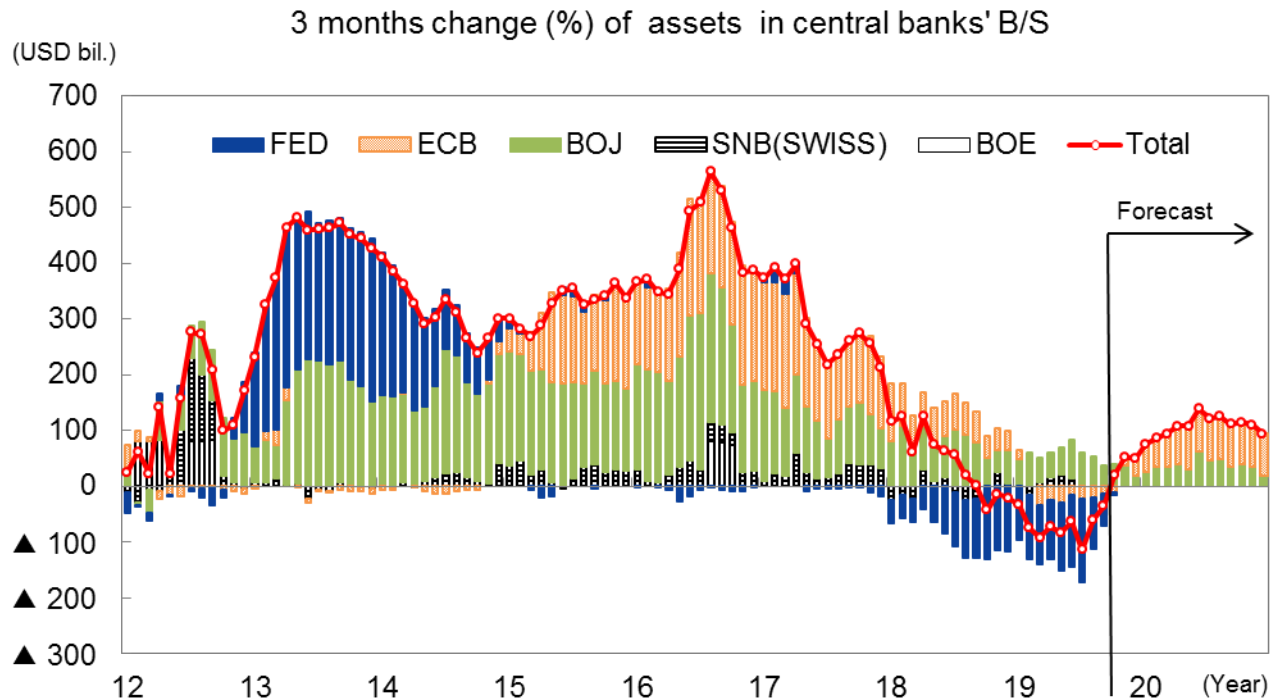
- Assuming already announced trade tariffs are imposed, maximum negative effect on the quarterly global real GDP growth is estimated to be -0.14% in 4Q 2019, and then after recedes rather rapidly from 2Q 2020.
- If US and China make a partial compromise such as China importing US agricultural products and meats meanwhile US stops imposing tariff scheduled in October and December, Bottoming can be even faster.



Note: Simulation by SMDAM. Assumes shock to be maximum in 1 to 2 quarters after the event and diminishes in 5 to 6 quarters.
 (Source) OECD and various statistics, compiled by SMDAM.

Global quantitative easing is about to start again

- ECB announced aggressive easing policy on 12th Sep. 2019. Quantitative easing is about to restart soon and continue until interest rates can be raised.
- Easing by global central banks will support global financial markets and economy.



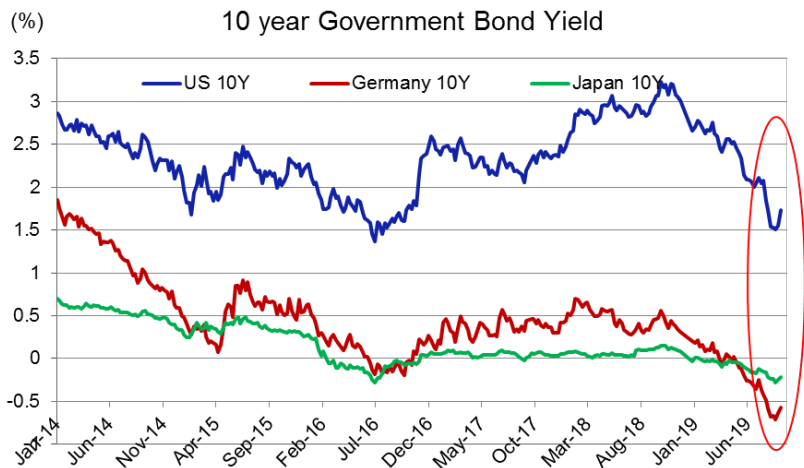
Note: Data is from Jan 2012 to Aug 2019 and SMDAM's forecasts to Dec 2020.

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 stops tapering. BOJ maintains current purchasing pace.

(Source) Bloomberg, each central bank, compiled by SMDAM.

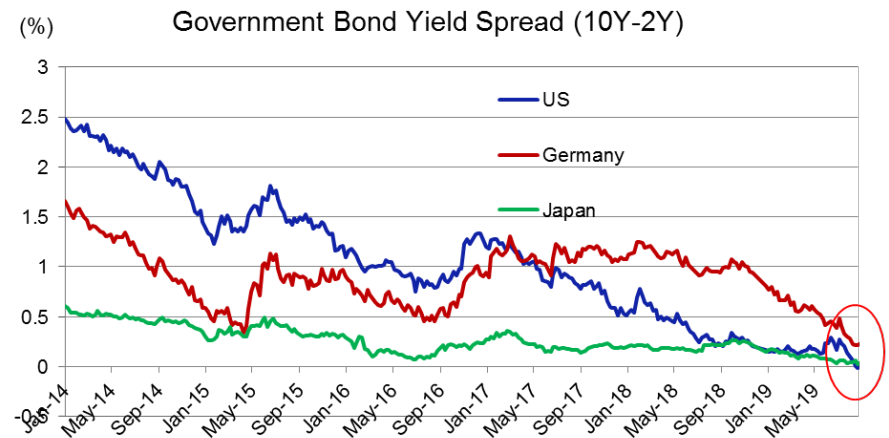
Long term interest rates rebounded as investors became risk on

- Expectation for an easing of US-China conflicts and aggressive monetary easing by central banks made investors to become risk-on.
- Long-term interest rates made a rebound and 10Y-2Y yield curve inversion in US was corrected.



Note: Weekly data from 10th Jan. 2014 to 12th Sep 2019.
(Source) Datastream

(Month/Year)

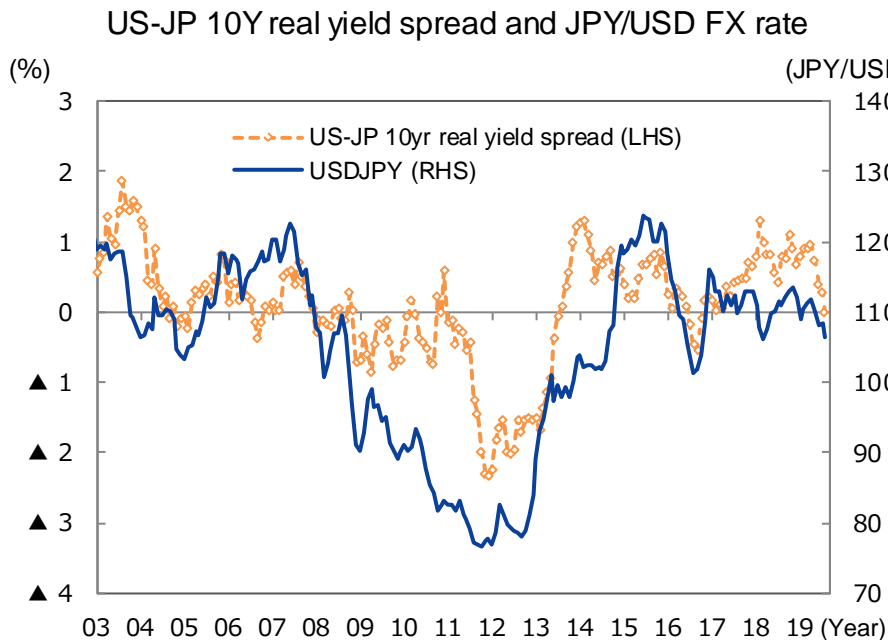


Note: Weekly data from 10th Jan. 2014 to 12th Sep 2019
(Source) Datastream

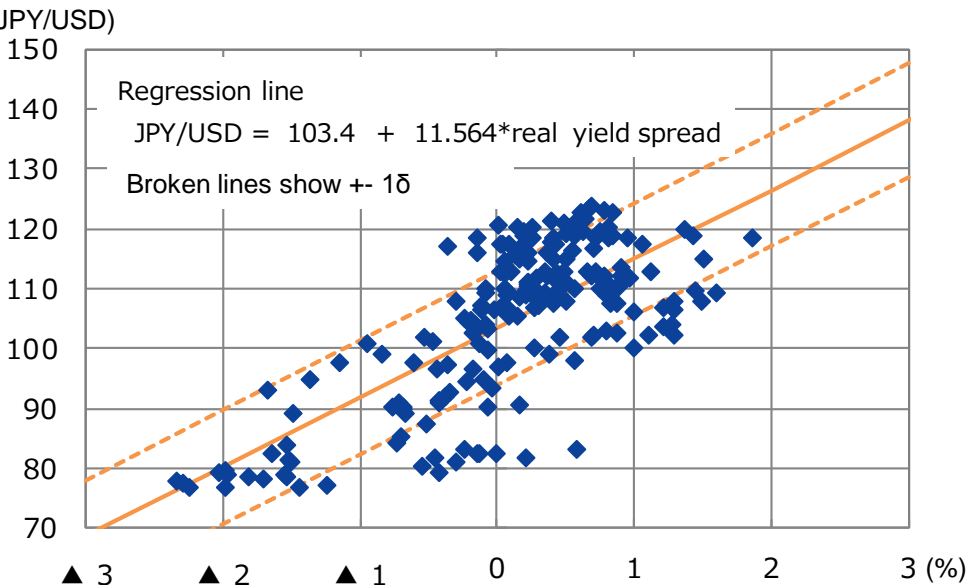
(Month/Year)

JPY could move a little stronger from the current level

- Real yield spread (US 10Y-JP10Y) as of 16th August 2019 was at -0.02%. Regression analysis indicates JPY/USD FX rate to be around 103 with the latest yield spread admitting that FX rates could wildly deviate from such theoretical level.
- In Dec. 2011, JPY/USD was 78. JPY was extremely strong. At that time, real yield spread was substantially negative at -2.34%. Higher real yield pushed JPY stronger against USD. Today, such force from real yield spread does not exist.



Regression analysis of real yield spread and JPY/USD FX rate



Notes: Monthly data from Jan 2003 to 16th Aug 2018. Yields are changed to a real basis by adjusting for CPI ex food and energy.
 (Source) US Bureau of Labor Statistics, Bloomberg

SMDAM Japanese economic outlook for FY19-20

- SMDAM revised forecast for FY2019 GDP from 0.8% to 0.6% reflecting slight down-revision for Apr-Jun quarter and weak private consumption in July, which was probably caused by cold weather.
- 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%	0.7%	0.6%	0.4%
Private Consumption Expenditure	0.7%	0.0%	1.0%	0.4%	0.3%	0.4%
Private Housing Investment	3.7%	6.3%	-0.7%	-4.3%	0.4%	-1.7%
Private Capital Investment	1.6%	-0.5%	4.6%	3.5%	0.7%	0.4%
Public Consumption Expenditure	1.9%	0.7%	0.4%	0.9%	1.6%	0.6%
Public Capital Investment	-1.6%	0.6%	0.5%	-4.0%	3.2%	1.5%
Net Exports (contrib. to GDP growth)	0.1%	0.8%	0.4%	-0.1%	-0.3%	-0.1%
Exports	0.8%	3.6%	6.5%	1.5%	-2.1%	0.1%
Imports	0.4%	-0.9%	4.0%	2.1%	-0.3%	0.5%
Nominal GDP	2.8%	0.7%	2.0%	0.5%	1.2%	0.9%
GDP Deflator	1.5%	-0.2%	0.1%	-0.2%	0.6%	0.5%
Industrial Production	-0.7%	0.8%	2.9%	0.3%	-2.7%	-0.3%
CPI (excl. fresh food)	-0.1%	-0.2%	0.7%	0.8%	0.4%	0.3%

Note: E=SMDAM forecasts. SMDAM views are as of 19th.Sep 2019 and subject to updates thereafter without notice

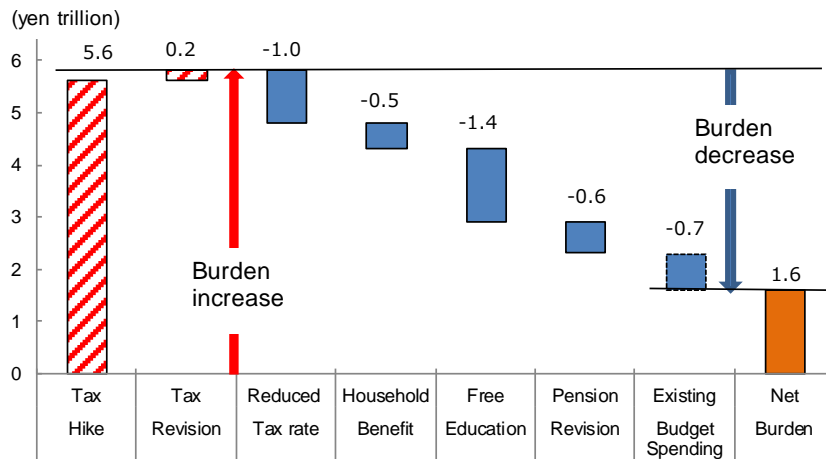
(%, YoY except Net Exports)

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

Consumption Tax Hike in October will make only a limited impact

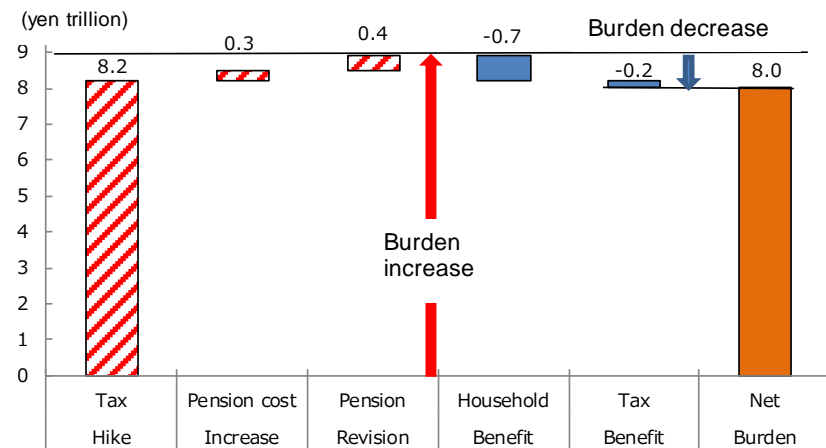
- Consumption tax is hiked from 8% to 10% as scheduled in October, however, negative effect will be limited compared to the last hike in 2014 from 5% to 8%.
- The last time in 2014, there were little counter measures and the net negative effect on Japanese households was as much as 8 trillion yen. However, this time, negative effect of 5.8 trillion yen is mostly offset by various counter measures and net negative effect is forecast to shrink to 1.6 trillion yen.
- The Japanese government is reported to be preparing tens of trillion yens of large fiscal stimulus in 2020 in order for fending off any possible recession.

Effect of consumption tax hike and counter measures on households (2019)



(Source) Bank of Japan, compiled by SMDAM

Effect of consumption tax hike and counter measures on households (2014)

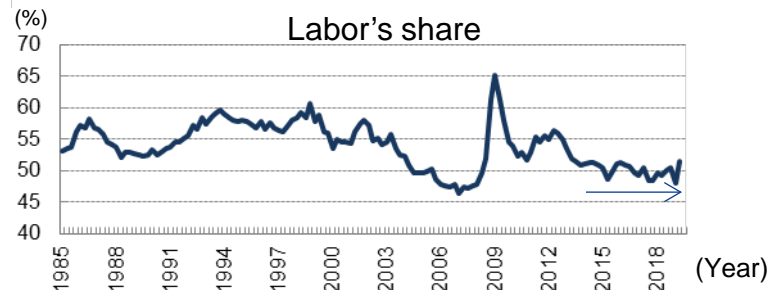
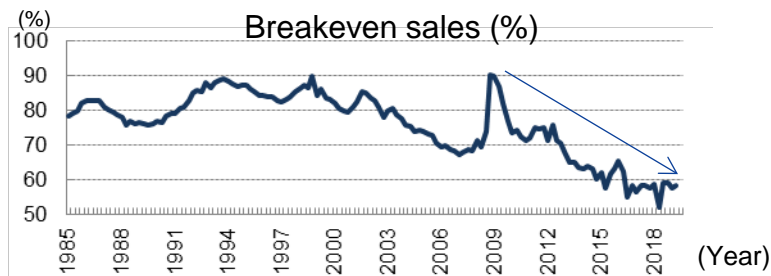
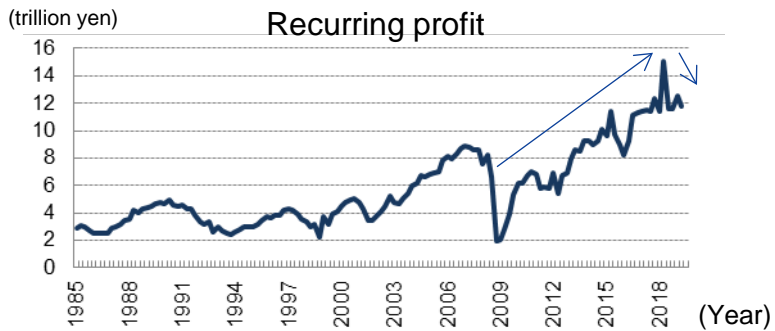


(Source) Bank of Japan, compiled by SMDAM

Japanese companies have reasonably large buffer for bearing labor cost

- Japanese companies have reasonably large buffer for bearing labor cost 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 is 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 (Jun 2019, all size, all industries, seasonally adjusted)



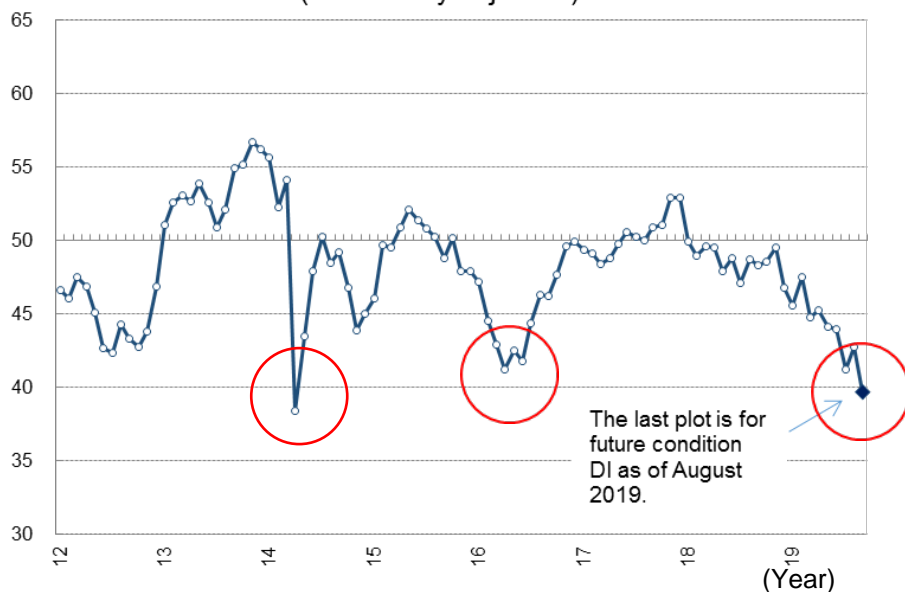
Note: Data is quarterly from 1Q 1985 to 2Q 2019.

(Source) Ministry of Finance

Business & household sentiments have declined to previous bottom levels

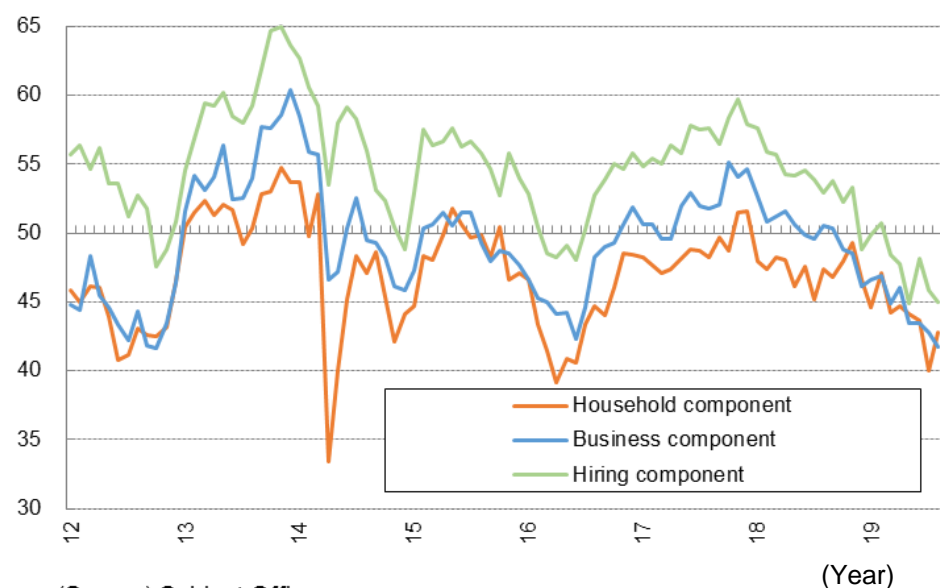
- Despite resilient wage and private consumption, Japanese people are getting worried of the future, which could lead to the decline in private consumption affecting domestic demand for Japanese companies.
- However, the sentiment has been declining for nearly two years already and the bottom could be just around the corner, considering the DI around 40 became bottom levels in the last two mini-cycles in 2014 and 2016.

Economy Watchers' Survey, total condition DI (seasonally adjusted)



(Source) Cabinet Office

Economy Watchers' Survey, current condition DI (seasonally adjusted)



(Source) Cabinet Office

Note: DI above 50 means condition is better than preceding 2 to 3 months.

Geo-political risk was highlighted again by an attack on SAUDI oil site

- Geo-political risk remains as a potential factor to derail the expected cyclical rebounds in the global economy.

Upcoming key events

Month	Region/Country	Events	Notes
2019	Japan	1 Consumption Tax is scheduled to rise from 8% to 10%	
		30-31 BOJ Monetary Policy Committee Meeting & Perspective Report	
	EU	Lagarde becomes ECB president	
		24 ECB meeting	
	UK-EU	31 Time limit for Brexit	
	China	4th Plenary Central Committee of the Communist Party of China	
Argentina	27 Presidential election		
November	US-Japan,EU	13 Limit for deciding US action on car tariffs	
December	Japan	18-19 Bank of Japan Monetary Policy Committee Meeting	
	Middle East	OPEC meeting	
	China	Central Economics Work Conference	
2020	February	US	US Presidential Primary Election Campaigns are expected to begin
Jul-Aug	Japan		Tokyo Olympic Games

(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

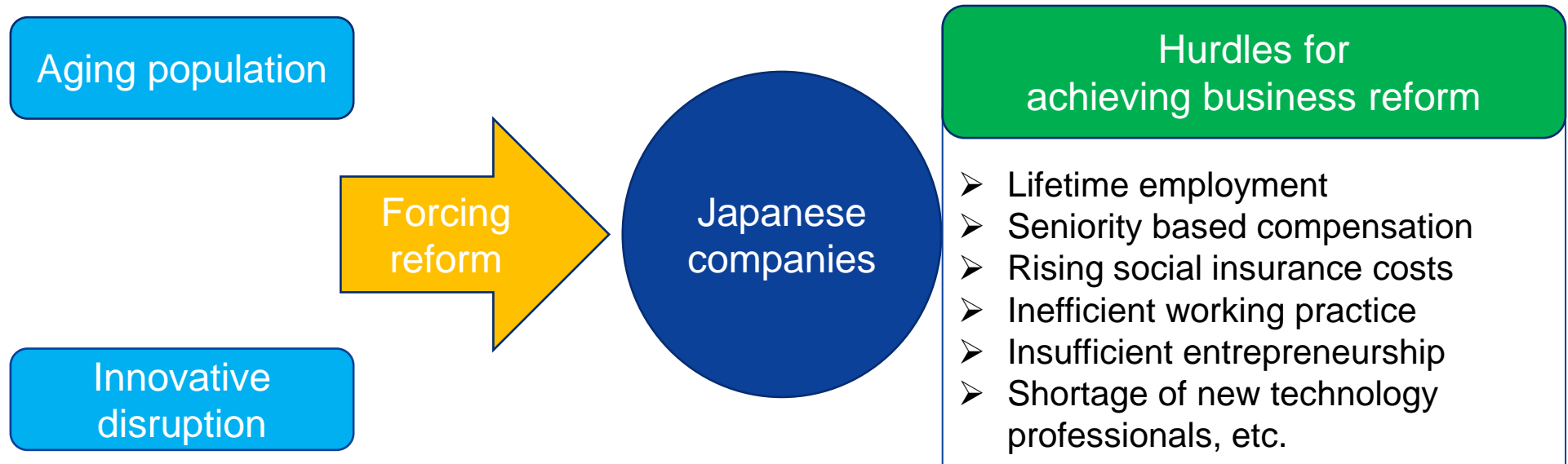
	Switzerland	U.S.	Israel	Finland	Germany	Netherlands	Sweden	Japan	Singapore	Denmark	China
Innovation total	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	28th
a) Capacity for innovation	1	2	3	7	5	6	4	21	23	16	44
b) Quality of scientific research institutions	1	5	3	8	11	4	13	14	12	16	36
c) Company spending on 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 chose new generation companies rather than old & large firms (already progressing).

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



Outlook for Japanese Stock Market

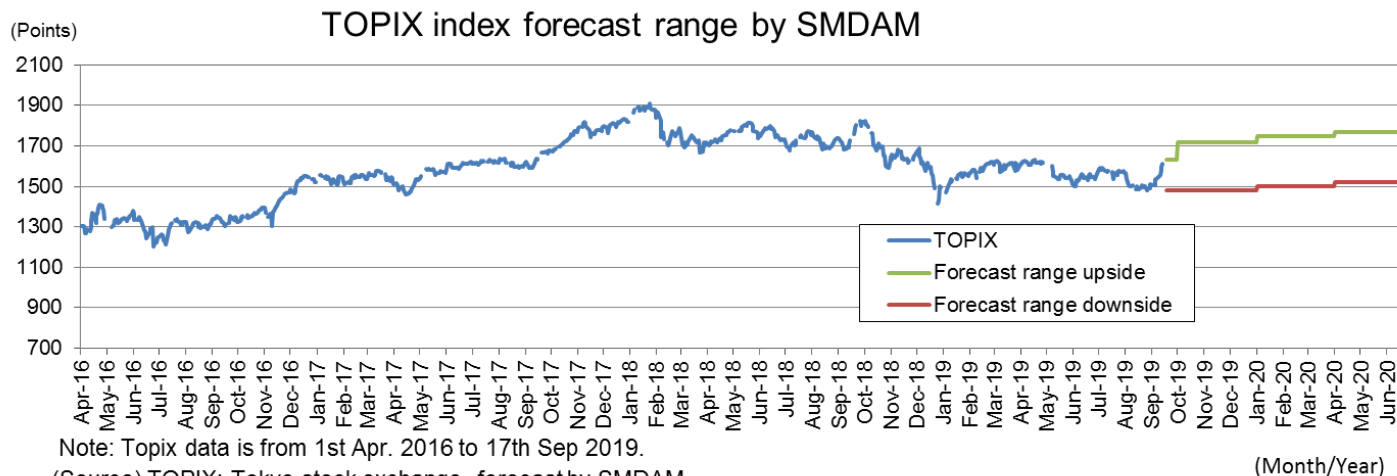
The global stock market is expected to try upside

■ SMDAM short-term view

- The global stock market is expected to try upside assuming cyclical economic recovery in the beginning of 2020. Consumption tax hike in October in Japan will have only a limited impact. Risk factors such as break up of US-China negotiation, Brexit and Middle East scare would bring volatility to the global stock markets.

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

- Consumption tax is raised from 8% to 10% from 1st October. Negative effect is going to be mostly offset by various counter measures this time. US-China trade uncertainties are discouraging global capital investments, which is a matter of concern for capital goods sector, however, domestic capital investment is still strong in the face of labor shortage and obsolete system & software. Japanese government is preparing massive budget spending when necessary. Japanese stock market is forecast to gradually gain firmness prior to the bottoming of the global economy expected in the beginning of 2020.



Base scenario & Upside / Downside risks for our forecasts

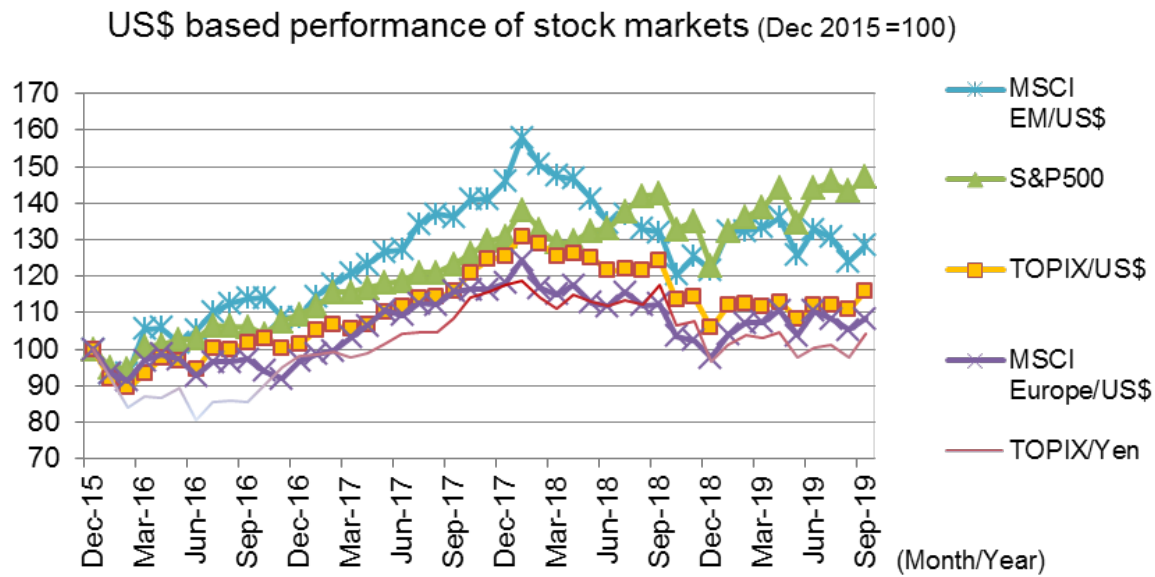
- Our **Base Scenario** is assuming the following views:
 - Severe tensions between US and China go on, however, US is going to avoid making a fatal blow to the global economy.
 - US economy keeps growing despite possible mild slowdown. Recession in 2019 is avoided.
 - Consumption tax hike in Japan in 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.
- **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.
 - 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.

Note: SMDAM's projection is as of 19th Sep. 2019 and subject to updates without notice.



Global stock markets rebounded as investors went risk-on

- Global stock markets made a rebound so far in September as investors became risk-on. Recent move by US and China eased trade tensions and also investors are partially rewinding bear positions.

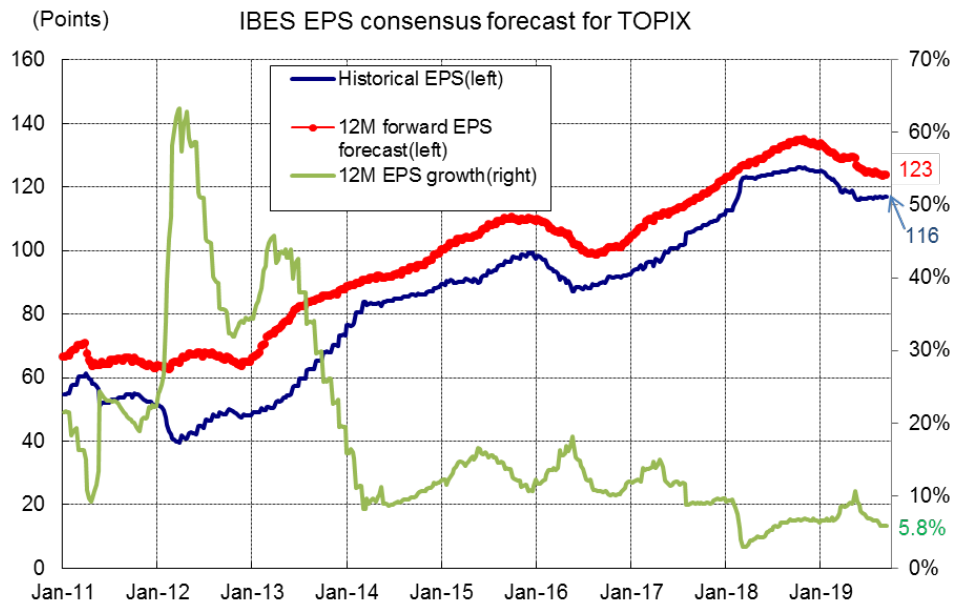


Notes: Data is up to 17th Sep 2019.

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

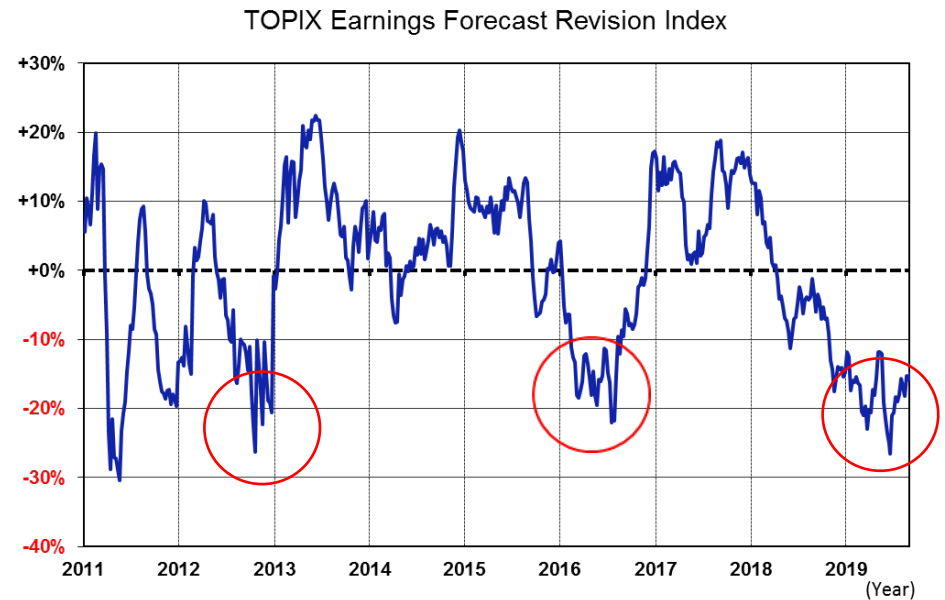
Downward earnings forecast revision is continuing

- Downward earnings forecast revision is a little getting prolonged compared to the previous setbacks in 2012 and 2016. Manufacturing sector has been hit hard by slowdown in China and prolonging trade conflicts between US and China discouraging capital investments.



Note: Weekly data from 6th Jan. 2011 to 12th Sep. 2019. (Month/Year)

(Source) Datastream, IBES



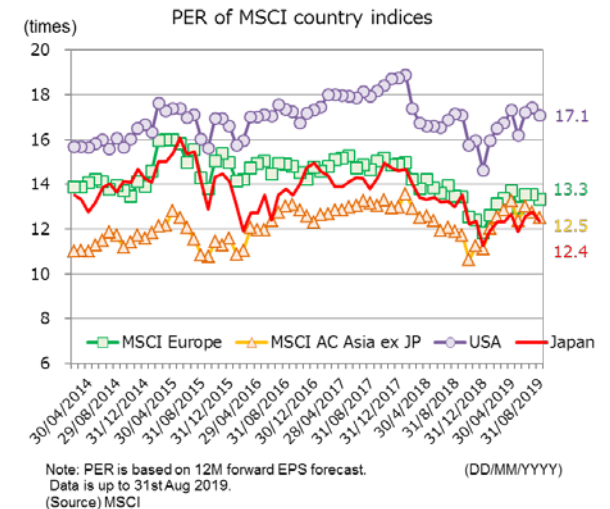
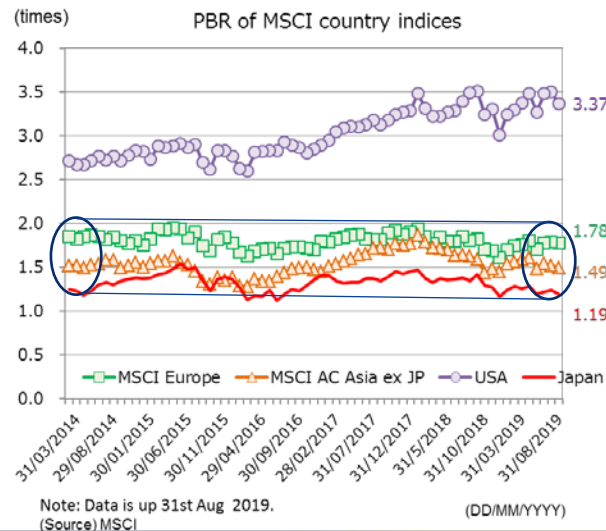
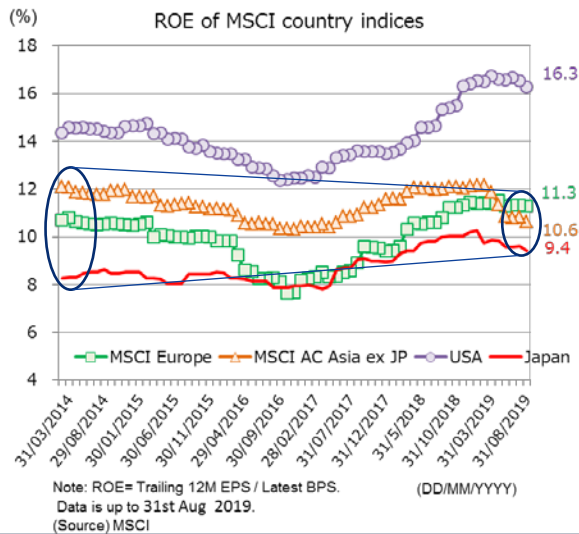
Notes: Revision index= % of Analyst upgrades out of total Topix firms - % of downgrades.

Data is weekly from 6th Jan. 2011 to 12th Sep. 2019.

(Source): IBES, SMDAM

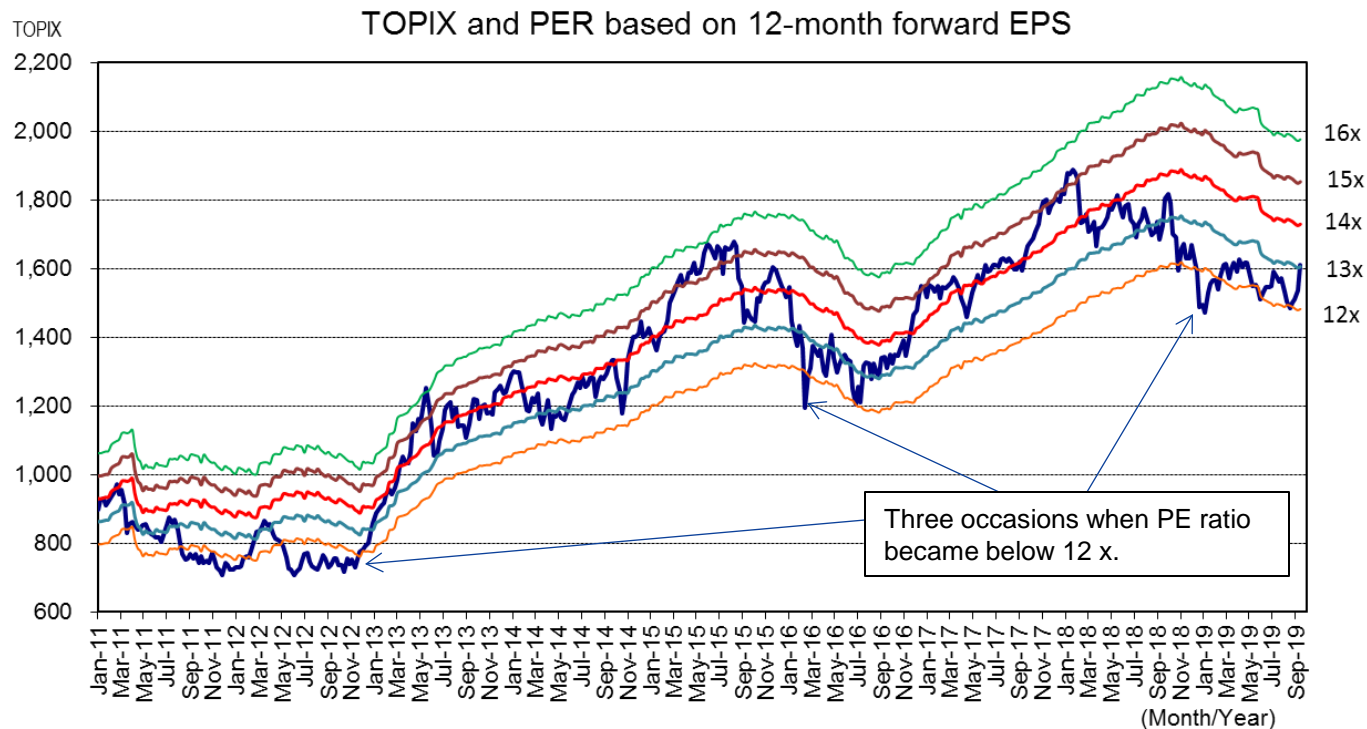
Relative stock valuation is getting attractive for the Japanese stocks

- 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 stays at low level compared to other markets, which is shown in the middle chart.
- PE ratio also shows Japan attractive compared to peer stock markets.



PE ratio of 12 times has been a support level for Japanese stocks

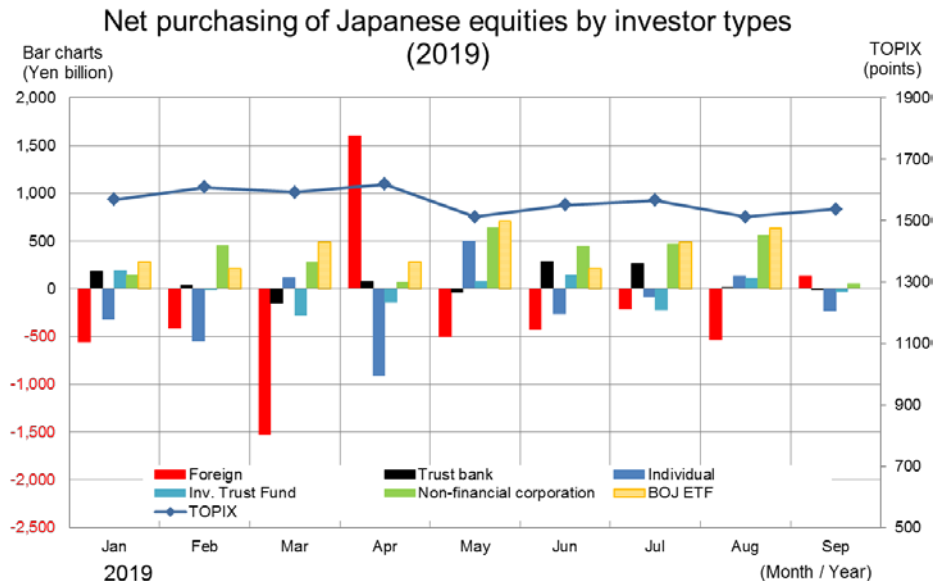
- After the last Global Financial Crisis, 12 times PE ratio has been a strong support level for TOPIX index.
- Except for a period from March 2011, when a strong earthquake hit north east Japan, PE ratio below 12 times lasted for a short period such as in 2016 and the last case from the year end 2018 to the beginning of 2019.
- Unless Japanese economy is heading into a severe recession, current stock valuation looks attractive.



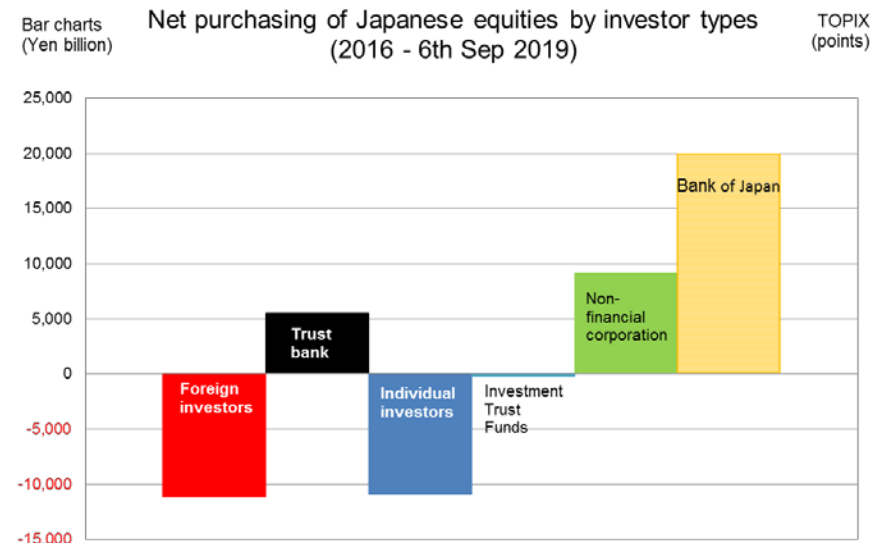
Note: Data is weekly from 6th Jan. 2011 to 30th Nov. 2018. TOPIX was 1667.45 at the end of the period.
(Source) Tokyo Stock Exchange, Datastream and IBES, compiled by SMAM

BOJ and company share buybacks are supporting Japanese stock market

- Since 2016, foreign investors were net sellers. Foreign investors has sold about 75% of the cumulative net purchases since 2013.
- Net selling by individuals should be smaller or could be slightly positive if IPO participation is considered.
- Bank of Japan now holds stakes of more than 5% of the total listed Japanese companies. Admitting controversies that BOJ is distorting the stock market, existence of such political strong buyer is surely one of the advantages of the Japanese stock market compared to its global peers when the environments get sour.



Note: Data is for Tokyo stock exchange and Nagoya stock exchange up to 6th Sep. 2019.
BOJ ETF figure is officially released data from BOJ.
(Source) Japan Exchange Group, Bank of Japan



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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.
- 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

Shareholders are putting positive pressure on companies

- Shareholders are raising voice for improving governance & management of the companies, in which they invest.
- Sumitomo Mitsui Asset Management (SMAM), which is a legacy company of current SMDAM, voted against as much as 38% of the appointment of directors in FY2017.
- As one of the guidelines relating to "Appointment of directors", SMAM voted against appointments if ROE was constantly lower than both industry average and 5% (it was raised to 7% in June 2018) for the last 3 years and the candidate had been on the board of directors for more than 3 years.

Results of exercising proxy voting rights in FY2017 (general meetings from July 2017 to June 2018)

Nature of resolutions	Total number	Supported		Opposed	
		Number	%	Number	%
Company resolutions	19,180	12,686	66.1%	6,494	33.9%
1 Appointment of directors	14,840	9,163	61.7%	5,677	38.3%
2 Appointment of auditors	1,516	1,107	73.0%	409	27.0%
3 Appointment of accounting auditors	28	28	100.0%	0	0.0%
4 Director compensation	675	572	84.7%	103	15.3%
5 Payment of retirement benefits	140	80	57.1%	60	42.9%
6 Appropriation of retained earnings	1,333	1,154	86.6%	179	13.4%
7 Matters related to restructuring	29	29	100.0%	0	0.0%
8 Matters related to anti-takeover measures	53	6	11.3%	47	88.7%
9 Matters related to capital policy	121	114	94.2%	7	5.8%
10 Amendment of the Article of Incorporation	441	433	98.2%	8	1.8%
11 Other company resolutions	4	0	0.0%	4	100.0%
Shareholder resolutions	141	20	14.2%	121	85.8%
1 Appointment of directors	23	5	21.7%	18	78.3%
2 Appointment of auditors	1	0	0.0%	1	100.0%
3 Director compensation	4	4	100.0%	0	0.0%
4 Appropriation of retained earnings	8	4	50.0%	4	50.0%
5 Matters related to capital policy	1	0	0.0%	1	100.0%
6 Amendment of the Article of Incorporation	94	5	5.3%	89	94.7%
7 Other shareholder resolutions	10	2	20.0%	8	80.0%

Note: Number of voting regarding appointment of directors and auditors are counted by individual candidates.

Data is for Sumitomo Mitsui Asset Management (SMAM) which is a legacy company of SMDAM.

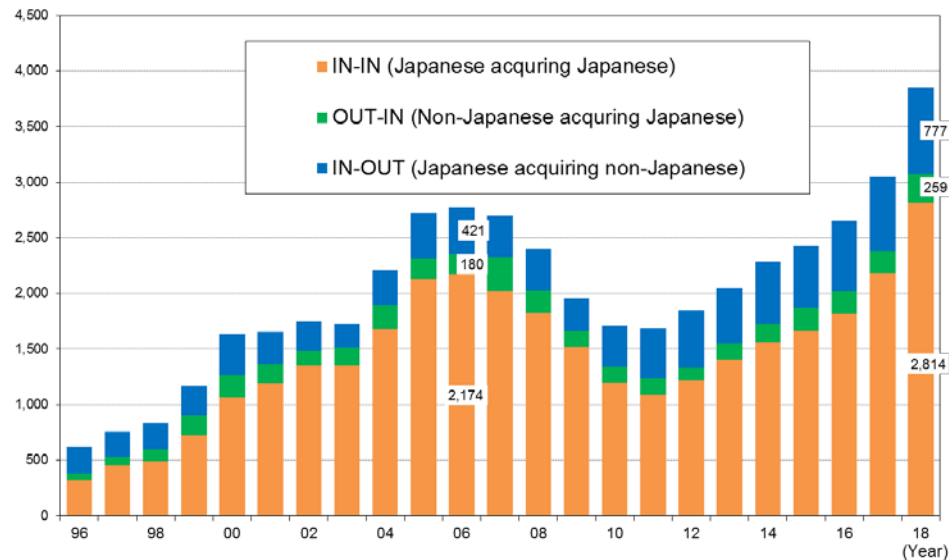
(Source) SMDAM



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 increasing by 30%, which is an evidence that business restructuring is progressing in Japan.
- Number of the deals of Japanese companies acquiring overseas businesses also rose from 421 in 2006 to 777 in 2018, increasing by 84%.

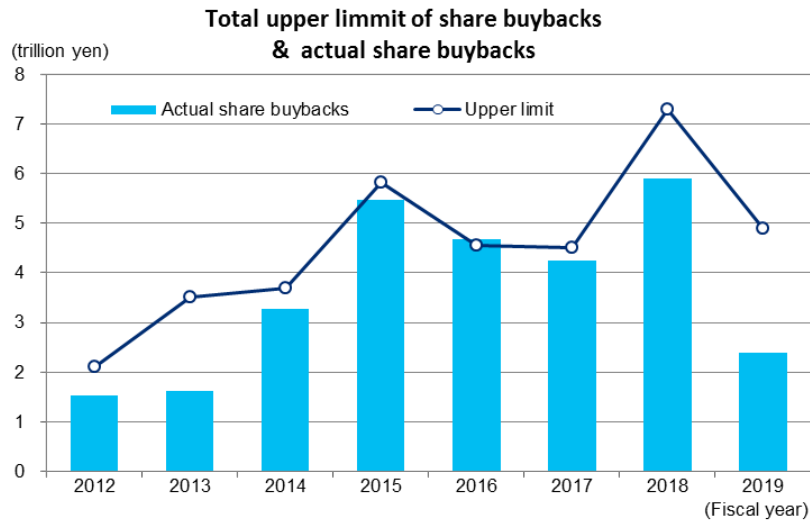
Number of M&A deals involving Japanese companies
(Excluding transactions among the same business group)



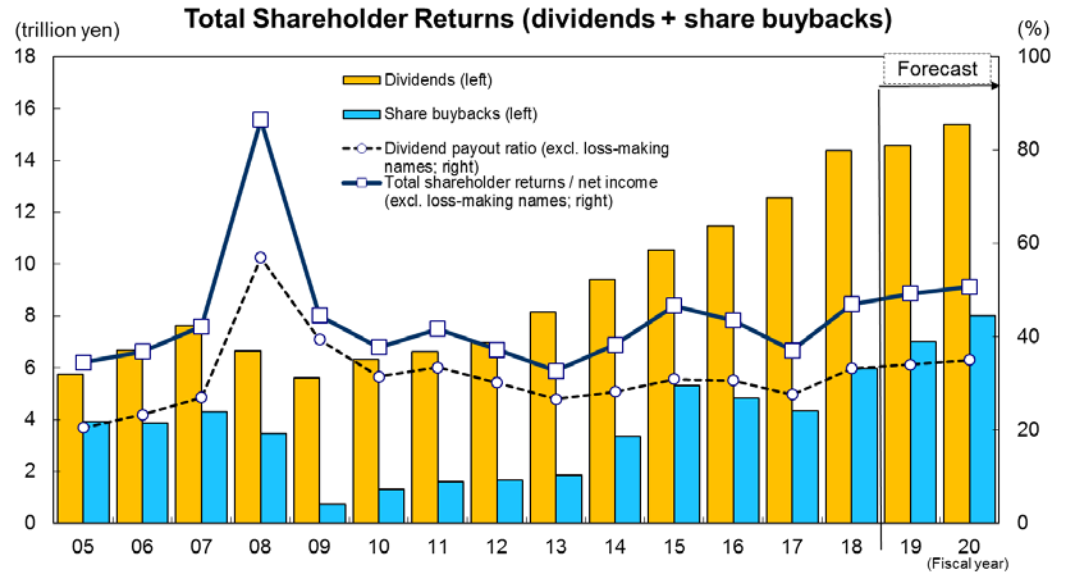
Note: IN-IN means Japanese company acquiring Japanese one, OUT-IN is for Non-Japanese company acquiring Japanese company, and IN-OUT is for Japanese company acquiring non-Japanese company.
(Source) RECOF and SMBC NIKKO Securities.

Behavior of Japanese companies are making positive changes

- Share buyback is one of the powerful tools for Japanese companies in disposing of accumulated liquidity in the B/S and enhancing EPS growth as well as ROE.
- In FY2018 (from April 2018 to March 2019), total upper limit of share buybacks, proposed as board of directors' resolutions, increased sharply and also actual share buybacks increased to renew a historical record.
- Dividends also renewed historical record in FY2018 and expected to increase further in FY2019.



Note: Share buyback proposals: As of 9th August, collected in units of one month based on the date of the Board of Directors' resolution. Share buybacks: As of end of July 2019. Universe is TSE stocks (excluding overseas firms). (Source) Astra Manager, Citi Research.



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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