PM'S MONTHLY INSIGHT
FUNDAMENTAL ACTIVE GROUP

Market Outlook and Investment Strategy

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We expect the Japanese equity market to show a solid performance during the month of May as concerns over corporate earnings for the new fiscal year recede, and valuations become gradually adjusted to reflect the fundamentals. The announcement of FY2017 results and FY2018 estimates got under way in late April. The number of companies which had already announced their results in April make up about 25% of the total, but so far many companies have reported results which exceed the consensus estimates for FY2017. However, their targets for FY 2018 are turning out to be conservative as expected, representing a YoY growth of only 3% increase in operating profit, as compared to the analyst consensus estimates of 7% YoY. We also expect that the companies will achieve 7% YoY growth in operating profit in FY2018 based on the exchange rate assumption of JPY107/USD. Some companies may see a sharp decline in share prices in response to a significant YoY decline in profits expected in FY2018 as was the case with **FUNAC**. However, in the meantime, a rally in the overall equity market has continued at a moderate pace. We believe that the following are the primary factors which provided support to Japanese equity prices; 1) since a large number of companies are assuming the exchange rate of JPY105/USD, it is highly likely that they will revise up their forecasts if the exchange rate continues to stay at the current level, 2) the volume of orders received for production in semiconductor-related and machinery industries still remains high, 3) improvement in earnings for domestic demand-driven industries such as retailers and truck manufacturers. By looking at the data on the volume of orders received for machinery tools in March, the orders for domestic production has accelerated on a YoY basis despite continued strengthening of Japanese yen during the month. The pace of investment by companies to improve productivity to cope with labour shortages shows no sign of abating amid higher yen and concerns over protectionist US trade policies. Furthermore, a serious shortage of part-time workers persists while the upward trend of average hourly wage continues at growth rate of 2% YoY. In some sectors which are highly dependent on part-time workers (such as retail, restaurant, and truck transportation) are now transferring higher cost of wages to the selling prices. These industries tend to pay relatively lower wages on average, however, salaries for permanent employees are also on the rise, leading to higher price of goods and services. Moreover, due to an increase in volume of freight in truck transportation sector on the back of economic growth, their service fees are increasing at a higher pace as compared to increase in wages. The earnings of electric power companies are also recovering by restarting the operations of nuclear power plants. Also, a greater number of companies in domestic demand oriented sectors are now enjoying recovery in their earnings. If the exchange rate continues to stay at the current level, the market should become more confident towards corporate earnings, and thus the current valuation which has been hovering around a P/E of 13x will likely be adjusted to reflect the fundamentals over time.

With regard to the monetary policy, we expect that accommodative policy will remain intact until CPI exceeds the 2% target in a stable manner. While the approval rating for prime minister Abe is declining due to a series of scandals, we still believe that the possibility of him stepping down is quite low. We believe that the Japanese equity market will resume its rally as the Golden Week comes to an end and market participants grasp more detail on earnings estimates for FY2018.

Investment Strategy

Overweight Sectors (largest first):	Underweight Sectors (largest first):
Construction & Materials	Foods
Financials (ex-Banks)	Transportation & Logistics
Commercial & Wholesale Trade	Automobiles & Transportation
Steel & Nonferrous Metals	Retail Trade

With regard to our stock selection, we continue to overweight construction & materials, financials (ex-banks), commercials and steel & nonferrous metals, while we underweight foods, transportation & logistics, automobiles & transportation, retail trade and banks sectors. Among the overweight sectors, we focus on low-valuation stocks with strong earnings forecast. Conversely, we underweight defensive sectors with high valuations. While we incorporate stocks of truck and parcel delivery companies which have benefited by higher service fees, we do not invest in marine transportation, air transportation and railway companies. As for the factory automation related names, we intend to reduce weight by taking profits off primarily on stocks that have met with slower growth in orders.

Daiwa SB Investments

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Mr Kamohara is the Lead Portfolio Manager of the Fundamental Active product. He started his career with Daiwa Securities in 1987 and transferred to Daiwa Institute of Research the following year to become a Japanese equity analyst. He was seconded to their Frankfurt office (between November 1992 and February 1995) and Hong Kong office (between February 1995 and March 1997) as an analyst for European and Asia equities respectively. He transferred to Daiwa International Capital Management, the former entity of Daiwa SB Investments, in 1998 to become a fund manager of international equities.
He became a Japanese equity portfolio manager in October 2000 and has managed the Fundamental Active product since its inception in October 2003. Mr Kamohara is lead manager on 11 accounts with USD6.2 billion under management.
Mr Kamohara graduated from Kyoto University with a BA degree in Educational Administration (1987).

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