Daiwa SB Investments

PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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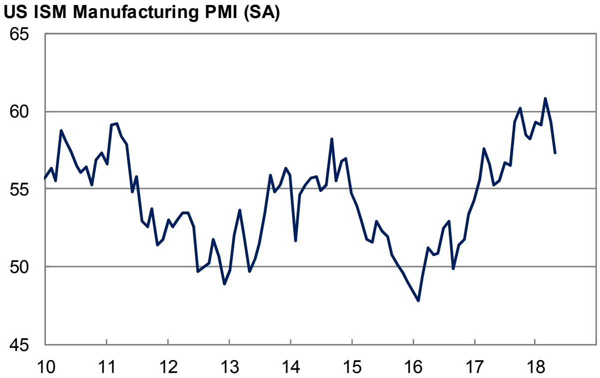
In April, the MSCI Japan index advanced on the back of easing concerns over trade wars and yen depreciation. At the beginning of the month, the MSCI Japan index rose as concerns over a trade war abated with China, with President Xi Jinping promising to cut auto tariffs and to improve intellectual property rights protection. Although the economic indicators in the US, such as the Institute of Supply Management (ISM) manufacturing purchasing managers index (PMI) and nonfarm payroll, turned out to be worse than expected. The MSCI Japan index continued to rise thereafter as the yen depreciated against the US dollar and there were no additional negative news stories released on the school scandal in Japan. The Bank of Japan's (BoJ) decision to remove the timeframe to reach its price goal had only a limited impact on the equity market. In the month of April, the TOPIX (total return) index increased by +3.6% in Japanese yen terms and US dollar denominated MSCI Japan (net total return) index rose by +0.7%.

We expect that the main topics in the Japanese equity market in May will be as follows:

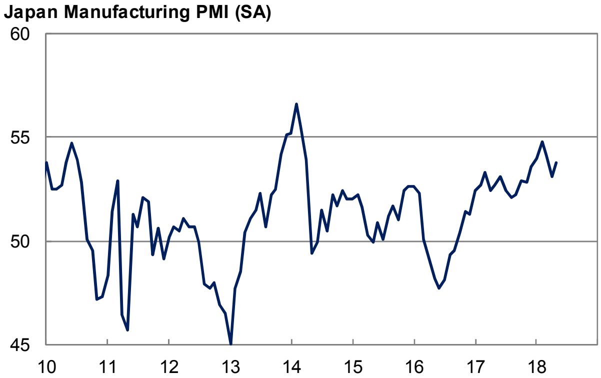
Economy: The Japanese economy has already reached its peak, but the fundamentals still look solid.

The global manufacturing PMI continues to rise from the first half of 2016 to the end of 2017, however, the manufacturing PMI has recently been following a downward trend after reaching its peak at the end of December 2017. Among the five components of ISM manufacturing PMI in the US, the new orders and production, which are the leading indicators, have both continued to decline since the end of 2017. Thus we conclude that the US ISM manufacturing PMI has also reached its peak. Furthermore, with regard to China, the Chinese economy has not been as strong as it once was. The People's Bank of China has lowered the reserve requirement ratio and some reliable statistics such as freight traffic volume and retail new passenger car sales are showing signs of weakness. However, the manufacturing PMI in major regions in China are exceeding 50, the turning point for economic decisions, which means that its economy is still strong. Indeed, the comment by the government on the manufacturing PMI gave us the impression that supply shortages in labour and materials are detrimental to demand. In conclusion, although the world economy may have peaked out, we believe it will keep up its firm trend.

US ISM Manufacturing PMI (SA)



Japan Manufacturing PMI (SA)



Source: Bloomberg, as at 1 May 2018

Similarly, while the Japanese economy has already reached its peak, it still looks solid. In the latest Tankan report, the business condition diffusion index (DI) remains at a high level, the conditions for products and services DI and the capital investment plans are both improving, the economy will not immediately enter a recessionary phase and the solid fundamentals should continue going forward.

We believe that the current economic climate is positive for the equity market. The ISM manufacturing PMI reached its peak in October 2005 during the previous cycle. However, it was not until February 2008 that the index fell below the 50 mark, which means that it consistently stayed above 50 for another two and a half years after reaching its peak. Moreover, the S&P 500 index hit an all-time high in October 2007, meaning that the equity market continued to rally for two years following October 2005, when the ISM manufacturing PMI reached its peak. Taking these factors into account, we believe that it is unnecessary to be overly concerned about the current economic cycle as long as solid fundamentals remain intact.

Corporate earnings: While companies expect +4% YoY growth in profit in FY2018, the estimates generally seems conservative in terms of currency exchange rate assumptions.

The earnings announcement season for the January-to-March quarter got under way. As of 27 March, 98 companies from the Daiwa 200, an index consisting of major TSE 1st section stocks, had announced their earnings results. Recurring profit for the January-to-March quarter increased by +0.3% YoY, according to Daiwa Securities. The results for this January-to-March quarter have left us with the impression that companies in smartphone related businesses and with high valuations generally failed to meet their targets. For the full-year FY2018, companies are planning for sales and recurring profit increases of +3% YoY and +4% YoY, respectively. Considering the exchange rate assumptions made, this is rather conservative. Notable earnings results are as follows:

Positives

Nomura Research Institute (NRI): the IT consulting company beat consensus estimates on revenues and operating profit as well as earnings guidance for FY2018. Positive results came from the current trends among Japanese companies to increase their investment in IT. NRI had also announced a share repurchase plan to buy back 2.9% of outstanding shares.

Kyocera: the electronic components company beat estimates on revenues and operating profit (OP) (excluding temporary impairment losses) as well as OP guidance. The positive results were primarily as a result of progress on its cost reduction initiatives in solar business which has been posing concerns. The company also announced that it plans to repurchase 2% of its outstanding shares.

Negatives

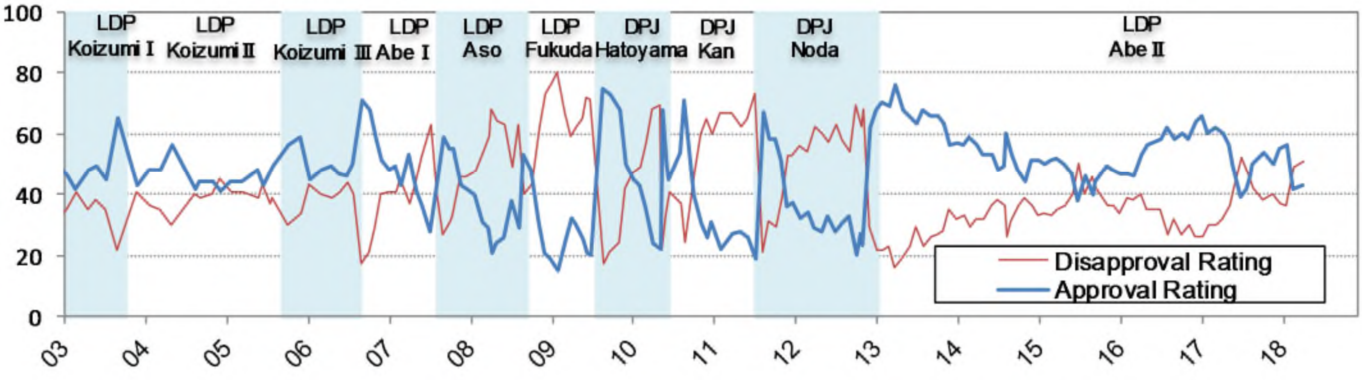
DISCO Corporation: the semiconductor production equipment company missed their targets on both revenues and OP. In addition, it revised down OP guidance for 1Q 2018. It seems that there has been a decline in inquiries from Taiwan and China, and also a slowdown in the smartphone market, which has been a primary factor for not meeting their targets.

JSR: the chemical company revenues were in-line with estimates but missed on both OP. The company saw a slowdown in shipments of materials used for semiconductors and liquid crystal displays, which is the area of business it has performed well during previous quarters. Also price appreciation in raw materials has weighed on its earnings performance.

Political risks: The risk of PM Abe to step down has abated since March.

While the current cabinet under Prime Minister Abe advocates supportive policies for the economy and the equity market, the approval rating of PM Abe's cabinet fell sharply to 42% in March, from 56% in February, according to the survey conducted by **Nikkei and TV Tokyo**. This was mainly due to the recent scandal involving the sale of public land. The slide in approval rating for the current cabinet had been one of the factors for the Japanese equities to fall in January through March this year. However, according to the latest public opinion poll taken on April 29, the most recent approval rate was 43%, essentially unchanged from the previous survey in late March. Since the drop in approval rating has slowed down for now following Abe's explanations over a series of scandals, we believe that the risk of his cabinet having to come to an end has receded.

Approval and Disapproval Ratings



Source: Nikkei and TV Tokyo, as at 29 April 2018

Investment Strategy

We can expect Japanese equities to advance with steady growth in the global economy, accommodative monetary policy by the BoJ and continuing undemanding valuations. In the long term, continuous efforts toward corporate reform will be important. Risk factors include the resignation of PM Abe and a fierce US/China trade war. Together these factors mean that we are overweight in late cyclical sectors such as materials and commercial & wholesale trade.

Daiwa SB Investments

The author's biography has been provided below:

Takuya KAMIISHI, CMA – Portfolio Manager

Mr KAMIISHI joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

Mr KAMIISHI obtained a BA degree in Economics from Keio University in Japan.

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Disclosures