PM’s Monthly Insight
Fundamental Active Group

Market Outlook and Investment Strategy

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We expect investors will look for timing to play a rebound in June. We also believe that upward earnings revisions will be the key factor that would trigger a rally in share prices. Although we had initially anticipated that sell side analysts would start revising up their forecasts by late May when they are almost done with company visits after the earnings reporting season, however, we now presume that the companies are being hesitant to change their estimates amid political turmoil in Italy, the situation surrounding North Korea, as well as strengthening of the Japanese Yen (JPY) against the US dollar (USD) due to concerns over US policies (i.e. imposing higher tariffs on automobiles, etc.).

Earnings season of the TSE 1st section companies ended recently. FY2017 earnings results and FY2018 earnings estimates are summarised as follows: the operating profit and the net profit in FY2017 increased 14% YoY and 22% YoY respectively. The earnings guidance for FY2018, however, softened with a 2% YoY increase in operating profits, and a 3% YoY decline in net profits. Companies came up with highly conservative estimates as was expected. The reason that companies are reporting lacklustre earnings forecasts is primarily due to the impact of US tax reform in 2017, which was particularly felt by companies in automobile and financials sectors, as many companies had reversed their deferred tax liabilities which were recorded on their balance sheets as a future tax payment. This meant reduced effective tax rates for those companies while substantially boosting their net profits in FY2017. In FY2018, however, effective tax rates would essentially increase and will have an adverse effect on their net profits. The reason that the companies are expecting the growth rate of operating profits to stay below our forecast and the consensus estimate of sell side analysts (both projecting 7% growth YoY) is because they are setting their targets based on highly conservative assumptions. For example, many companies are projecting the exchange rate in a range of JPY100 to JPY105/USD (our estimate is JPY107/USD). Therefore, if the exchange rate continues to stay at the current level, there is a good possibility that the companies will revise up their forecasts. The consensus estimates of sell side analysts had been revised down due to appreciation of JPY which continued until late March. However, considering that many companies have reported results above the consensus estimate and also that JPY has continued to trend lower since the end of March, we see the possibility that analysts will start revising up their forecasts when they finish company visits after the results season.

Industrial production rose 2.5% YoY in April, coming in well below the consensus estimate of 3.6% growth. Many economists point to the fact that forecasts for May are turning out to be worse than expected as inventory adjustments are currently taking place in the electronic components sector. However, a slowdown in production of electronic components was expected to continue until May due to a significant adjustment in production of smartphones (i.e. iPhones), which had already been priced in the share prices. Going forward, however, we believe that expectation for an increase in production volume of smartphones is likely to grow with the launch of new models in June.

According to Monthly Labour Survey, the total cash earnings increased 2% YoY in March. Although there have been changes in the scope and method of the Survey since January this year, growth rate of employee income is nevertheless growing higher as compared to +1.2％YoY in January and +1.0％YoY in February, implying expectation for higher consumer spending going forward. The domestic macro environment continues to improve. We expect corporate earnings forecasts should gradually be revised upward along with rebounds in stock prices.

Investment Strategy

Overweight Sectors (largest shown first):	Underweight Sectors (largest shown first):
Construction & Materials	Automobiles & Transportation
Raw Materials & Chemicals	Foods
Commercial & Wholesale Trade	Banks
	Transportation & Logistics

With regard to our sector selection, we continue to overweight construction & materials, raw materials & chemicals and wholesale trade, while we underweight automobiles & transportation, foods, banks and transportation & logistics sectors. Overall, we have increased the weight of defensive sectors such as pharmaceutical and foods on the back of concerns over the US trade policy and political turmoil in Italy. In the construction & materials sector, we overweight our positions in semiconductor material companies and parts makers which can measure against automobile emission. Among the raw materials and chemicals, we overweight our positions in semiconductor material makers, cosmetics and toiletry makers. We have been aggressive in terms of adding positions of low-valuations stocks to our portfolio with focus on companies projecting strong earnings forecasts across all sectors. Conversely, we have trimmed our exposure in automobile names such as **Subaru** amid fierce competition over auto sales in the US market. We continue to underweight foods, banks, and transportation sectors as there are relatively fewer names with strong earnings forecasts. In the financial sector, we reduced our weight in securities subsector as TSE trading volume fell below our expectation.

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.
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