

PM'S MONTHLY PERSPECTIVES VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

June 2018

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In May, the MSCI Japan decreased on the back of mounting concerns over proposed auto tariffs by the Trump administration and political turmoil in Italy. In the first half of this month, however, the MSCI Japan rose due to weaker-than-expected US inflation data, which eased concerns that inflation is accelerating in the US. The depreciation of the Japanese yen against the US dollar also contributed positively. However, in the second half of this month, the MSCI Japan declined due to the Trump administration calling for tariffs on automotive imports and investors raising concerns over political instability in Italy, which caused the Japanese yen to strengthen against the US dollar and the euro. In the month of May, the TOPIX (total return) index declined by -1.7% in Japanese yen terms, and US dollar denominated MSCI Japan (net total return) index also declined by -1.0%.

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

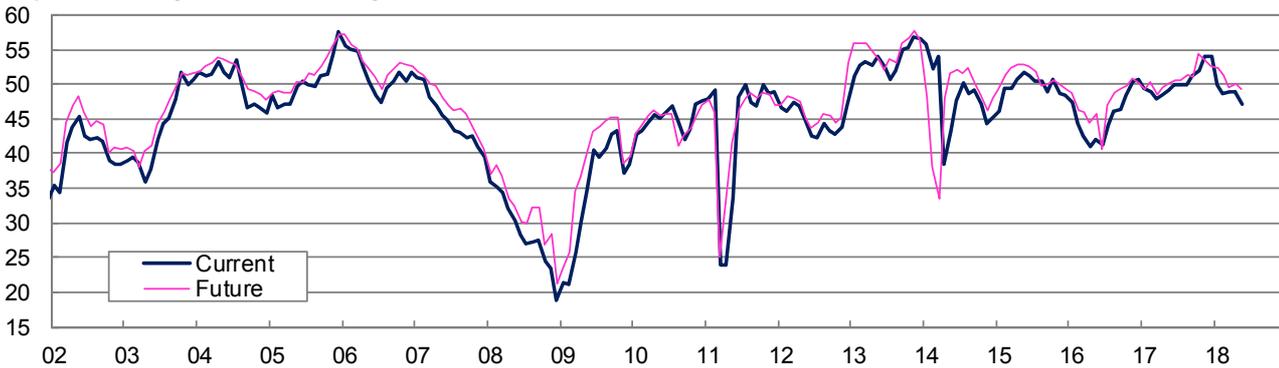
Economy: the global economy may have reached its peak, but we still believe that the current economic expansion is likely to continue.

Although the global economy may have reached its peak, we still support our view that the latter half of the current economic expansion should continue for the time being. The key indicators of economic sentiment for Japan, which have been released last week, however, showed some mixed signs. The Business Conditions Leading Composite index rose in April compared to the previous month, helped by the increase in number of new homes built and improvements in industrial inventories. On the other hand, however, the Economy Watchers Survey expectations declined due to a decrease in household spending and sentiment indicators for manufacturers. Both indicators have been following similar patterns as they peaked at the end of 2017, but nevertheless, they are still exceeding their long-term averages. Although the latest ISM Manufacturing purchasing managers index (PMI) and the ISM Non-Manufacturing PMI index have both risen this month, they also peaked at the end of 2017, while still staying above their long-term averages. Judging from the current available economic data, we do not think that it is necessary to change our forecast and we expect that while we have seen some modest declines in economic data, the current economic expansion should continue, which should provide support for positive fundamentals of the equity market.

Japan Business Conditions (Leading Composite Index, 2010 average=100)



Japan Economy Watchers Survey

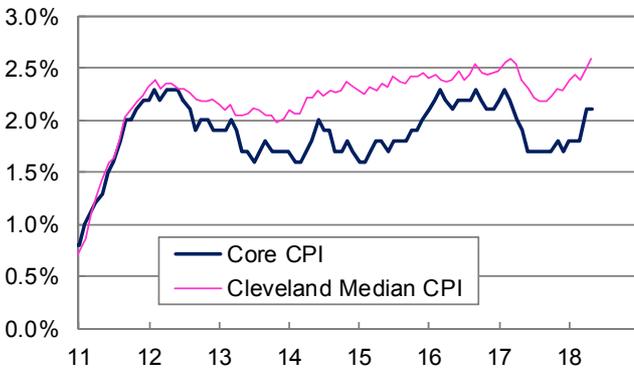


Source: The Cabinet Office, Bloomberg, data as at 6 June 2018.

Overview of US stock market: Caution on inflation data and trends in credit market.

While the US equity market advanced in May, the recent rally was mainly due to weaker-than-expected US economic data (wage and inflation) which tempered market expectations of continued rate hikes by the US Federal Reserve as mentioned above. As such, market participants have become increasingly focused on inflation data, and we therefore believe that the inflation trend in the US also has important implications for global equity markets as a whole. If we suppose that inflation takes off, it will likely lead to increased concerns over rate hikes in the US which in turn, would also have a significant impact on global credit markets. If those changes were to take place only in emerging countries, then the overall impact on the Japanese equity market should be quite limited. However, we are concerned that the possibility of higher inflation could be leading to the recent spread widening of BBB credits in the US judging by past market movements. The US stock market tends to go through a correction phase when credit spreads start to widen. We will continue to watch carefully, particularly the trends of inflation and credit markets going forward.

US CPI YoY



US Corporate Bond BBB - Treasury 10 Year Spread



Bloomberg, as at 6 June 2018

Source:

New US automotive tariffs: full implementation of new tariffs should have a significant impact on Japanese companies, but we believe the possibility of that is low.

On 23 May 2018, US President Donald Trump ordered his Commerce Department to conduct an investigation into imported vehicles under Section 232 of the Trade Expansion Act of 1962. The Department of Commerce will submit a report on findings to the president with a set of proposals within 270 days from the initiation of the investigation. The president will have 90 days to determine whether or not the results of the investigation are valid. If the Department of Commerce concludes that imports of automobiles into the US threaten national security, the department will request countermeasures against the import of vehicles. The president will then make a final decision on whether the government should take any action. After that, the administration will hold a public hearing period and then formulate and implement countermeasures. Imposing higher tariffs and quantitative restrictions on imports, for example, would be some of the expected measures. According to several media reports in the US, the Trump administration is considering a string of new policies which would increase the tariff on imported vehicles to 25% from the current level of 2.5%. If that happens, it will cause serious damage in Japan, as its economic growth has been highly dependent on automobile exports for many years.

According to the report issued by Daiwa Securities, this would not be a major inflection point as expectations for the global trading system changes on a daily basis and therefore must be addressed in an objective manner. With respect to issues over the trade friction between the US and China, both countries had initially come up with the proposals to impose USD50 billion in tariffs against imported products and the Trump administration demanded China to cut its trade deficit with the US by USD200 billion. However, after another round of talks over the trade friction in May, Vice Premier Liu He, the head of the Chinese delegation to the US, commented that “the two countries have reached consensus that there will be no additional tariffs imposed against one another”. In addition, the USD50 billion tariffs proposed by the US and China prior to the meeting will no longer be imposed. Taking these points into consideration, we believe that while there is a possibility that the US will come up with stringent measures on automotive tariffs as a part of the negotiations, implementation of new comprehensive measures is unlikely to occur after all. As a result, there will no significant impact on the mid and long-term fundamentals of the Japanese equity market.

Investment Strategy

We can expect Japanese equities to advance amid the continuation of steady growth in the global economy, accommodative monetary policy by the Bank of Japan as well as undemanding valuations in the market. Over the long term, continuous efforts toward corporate structural reforms will be important. Risk factors include a possible resignation by Prime Minister Abe and a fierce trade war between the US and China, as well as a possible acceleration of rate hikes in US. Taking these points into consideration, we maintain our overweight positions in the late cyclical sectors such as materials and commercial & wholesale trade.

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The author's biography has been provided below:

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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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