Daiwa SB Investments

PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

July 2018

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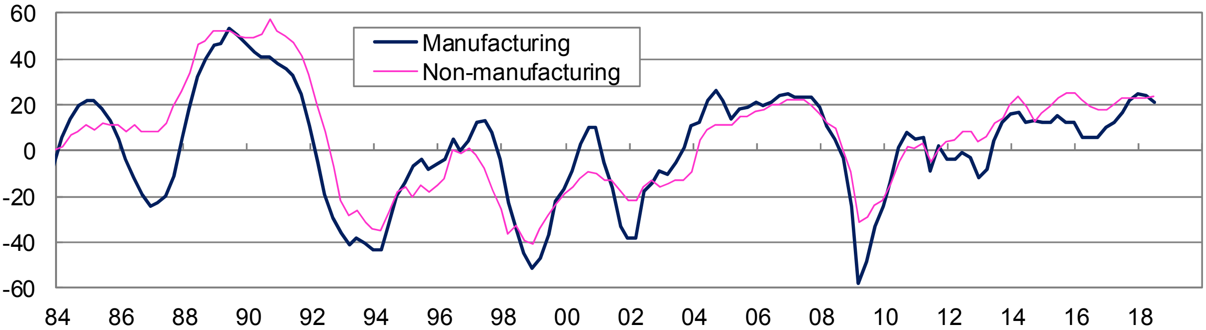
In June, the MSCI Japan index decreased on the back of mounting concerns over trade wars and monetary tightening in China while the Japanese yen continued to weaken against the US dollar throughout the period. Earlier in the month, the MSCI Japan rallied on better-than-expected manufacturing PMI and US nonfarm payrolls data. China's proposal at trade talks in Beijing to purchase USD70 billion of energy and agricultural products from the US also buoyed the index. However, during the second half of the month, the MSCI Japan continued to decline due to escalating trade tensions between the US and China after several media outlets reported that China will take countermeasures against the US in response to the action taken by the Trump administration which had reportedly ordered the Office of the United States Trade Representative (USTR) to draw up a list of USD200 billion in Chinese products on which to impose additional tariffs. Moreover, concerns about the Chinese financial system weighed on equity markets, with the new regulations on the shadow banking system, worse-than-expected aggregate financing data, and a weaker Chinese Renminbi versus the US dollar. In the month of June, the TOPIX (total return) index declined by -0.8% in Japanese yen terms, and US dollar denominated MSCI Japan (net total return) index also declined by -2.5%.

We expect that the following topics will be the key factors for the Japanese equity market in July.

Economy: The Bank of Japan (BoJ) Tankan survey suggests a continuation of steady economic growth.

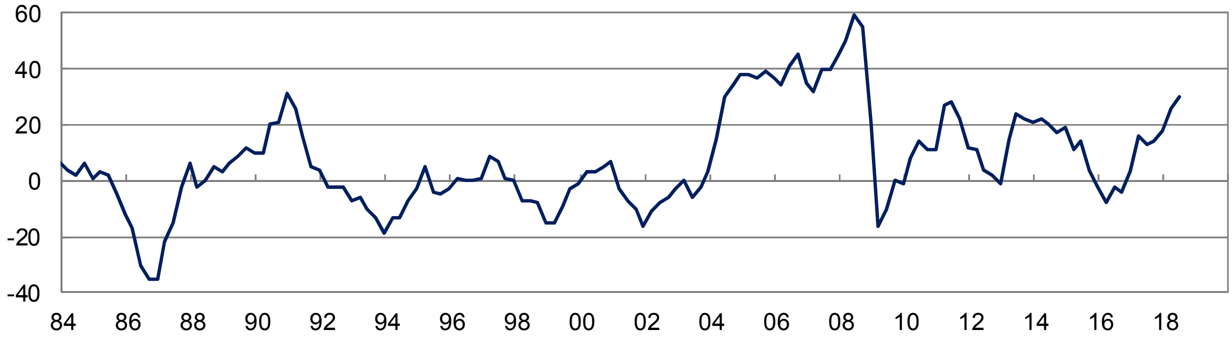
The Bank of Japan has released June Tankan survey results which is one of the most important economic indicators for the Japanese economy. While the business conditions diffusion index (DI) for large manufacturers worsened -3% points (from 24%pt in March to 21%pt) in June, DI for large non-manufacturers rose +1% point (from 23%pt in March to 24%pt). The deterioration in sentiment could be primarily due to increase in price of raw materials and wages as the projection for YoY growth in sales in FY2018 rose in manufacturers (from +1.4% YoY in March to +2.5% YoY) while on the other hand forecast for growth in recurring profits worsened (from -3.2% YoY in March to -8.6% YoY). In fact, the estimate for changes in input prices for large manufactures has worsened +4% points (from 26%pt in March to 30%pt). However, despite increasing cost pressures, the overall business conditions DI is still staying at higher levels, compared to its average historical ranges.

Japan Tankan Business Conditions (Actual Result, Large Enterprises)



Source: Bank of Japan, Bloomberg, data as at 2 July 2018.

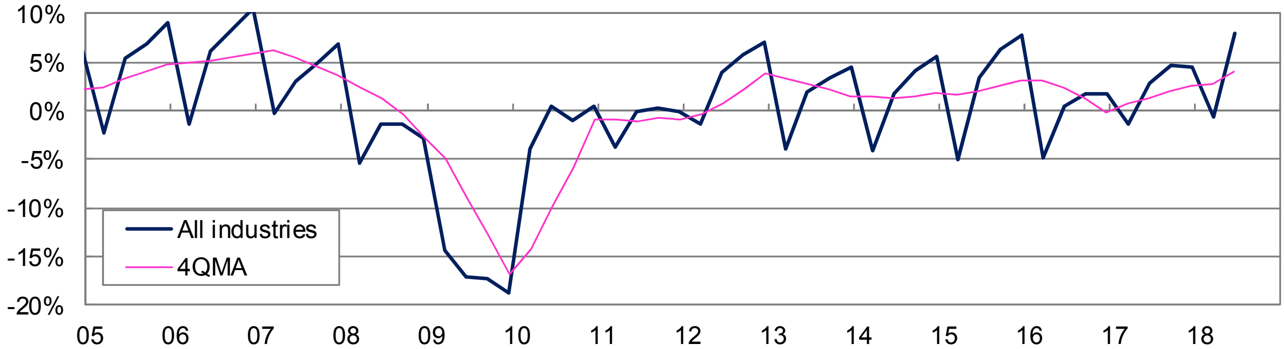
Japan Tankan Change in Input Prices (Actual Result, Large Manufacturing Enterprises)



Source: Bank of Japan, Bloomberg, data as at 2 July 2018.

We find it interesting that the survey indicates that Japanese companies are enhancing their fixed investment. The projection for fixed investment including land purchasing expenses for FY2018 has been revised up to +7.9% YoY from -0.7% YoY in March which is the highest YoY growth for June since 1997. We believe that solid economic fundamentals, labour shortage, growth in corporate earnings are the main factors behind this trend. To summarise, while certain indicators are in decline, however, the survey indicates that Japan's economy remains on a solid footing in overall which is positive for the equity market.

Japan Tankan Fixed Investment Forcast (Current Fiscal Year, All Enterprises, including Land, YoY)

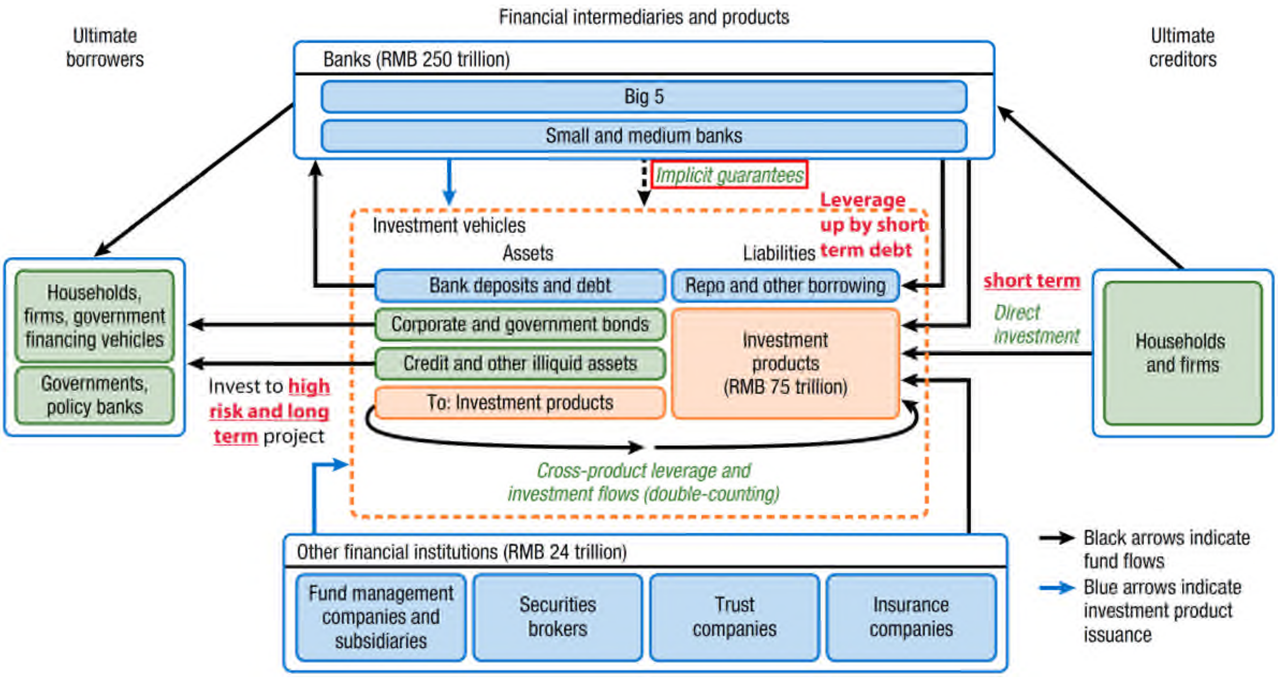


Source: Bank of Japan, Bloomberg, data as at 2 July 2018.

The Potential Risk: People's Bank of China (PBOC) has tightened monetary policy on shadow banking activities. While our main scenario is that PBOC will be able to control investments in wealth management products (WMPs), we will continue to monitor closely on actions by PBOC.

Concerns over the Chinese financial system continued to weigh on Japanese equities in June. The below figure describes the current structure of China’s financial system. The Wealth management products (WMPs) are located in the middle of the chart with orange circle around it. The WMPs are mainly comprised of relatively liquid short-term investment instruments which used to offer higher returns with implicit guarantees for principal and return of investments. The banks and other financial institutions have been able to offer higher interest rates as WMPs are comprised of highly leveraged portfolio of investments exposed to higher credit risks. Since loose lending standards were applied to WMPs, banks and other financial institutions were able to invest substantial amounts of capital on long-term higher risk assets such as real estate and infrastructure projects. Furthermore, banks were highly leveraged as they financed through short-term borrowing such as repo. Also, cross-product leverage of WMPs, 1st WMPs invest to 2nd WMPs and 2nd WMPs invest to 3rd WMPs, created huge liquidity in the Chinese banking system which enabled high risk unprofitable property project to raise money easily.

The Overview of China's financial system



Source: Daiwa SB Investments based on IMF Global Financial Stability Report April 2018

WMPs are associated with a high degree of risk as they are comprised of high-risk credit investments with layers of debt. At the same time, these products also carry a risk of maturity mismatch as they are based on "borrowing short and lending long" type of investments. The reason that WMPs still attracted large amounts of investments was because these investment vehicles were backed by implicit guarantees. Many people believed that any shortfalls would be covered by the banks. These banks were also engaged in high risk loans indirectly financed through off-balance sheet WMPs, and they believed that the central bank would turn to bailouts in case of an emergency. If investors would/would not be able to recoup the money they had put in would ultimately depend on the return on investments. However, there had been a case that a bank had actually absorbed losses on WMPs, which posed a question about state guarantee and embedded risks of these products.

Since the PBOC became increasingly concerned about rapid growth of WMPs, it had adopted more stringent guidelines to tighten rules on these products and announced its plan to launch new regulations for WMPs. These actions by the PBOC would probably make it difficult for banks to raise capital for investments on certain real estate and infrastructure projects which have been financed through WMPs. In fact, investments on infrastructure projects is currently slowing down in China, while the country is faced with an increasing number of corporate bond defaults.

We believe that developments in monetary policy by the PBOC would be the most important factor to determine the future direction of the Japanese equity market. The recent tightening monetary policy and increase in corporate defaults in the country were triggered by the decision of PBOC and the fate of WMPs should all depends on policies by the central bank.

The Chinese stock market crashed in 2015 (the so-called "China Shock"), but the country navigated their way through difficult times, and the global equity markets resumed its rally in 2016. We continue to pay close attention to developments with regulatory arrangement for the WMPs and monetary policies by the PBOC. At this point, we believe that the PBOC will be able to manage this issue as there are individual entities in China that are willing to purchase on-balance-sheet non-performing loans from financial institutions on the back of rising real estate prices which could be used as measures of investment return for ultimate borrowers. Also, WMPs have not created panic amongst investors as they have been marketed by banks. Moreover, we believe that the risk of a sharp fall in the Renminbi (RMB) is quite limited as the country has been running current account surpluses with ample foreign reserves, although its external debt continues to grow.

Investment Strategy

We expect the Japanese equity market to resume its rally 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. Major risks would include a sharp spike in the yen caused by external factors including the escalation of trade friction and the potential property bubble burst in China. Taking these points into consideration, we maintain our overweight positions in the late cyclical sectors such as the 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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