Daiwa SB Investments

PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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In July, the MSCI Japan index advanced on the back of easing concerns about China's economic slowdown and the weakening of the yen versus the US dollar. Earlier in the month, the MSCI Japan remained range-bound amid a string of news on the US/China trade war. However, once the US and China began imposing new tariffs, a sense of calm returned to the equity markets, which fuelled a higher risk appetite and weakness in the yen and caused a subsequent rebound in Japanese equities. In the latter half of the month, growing speculation that the current easing monetary policy would be altered at the Monetary Policy Meeting by Bank of Japan (BoJ) triggered a rise in bond yields, which in turn resulted in a strengthening of the yen. However, the Japanese equity market continued to move sideways towards the end of the month, supported by China, who were showing signs of monetary easing while adopting more aggressive fiscal policies. With regard to the July Monetary Policy Meeting, market participants generally perceived that the BoJ signalled its intention to continue with accommodative monetary policy which had only a limited impact on the Japanese equity market. In the month of July, the TOPIX (total return) index increased by +1.3% in Japanese yen terms, and US dollar denominated MSCI Japan (net total return) index also advanced by +0.4%.

We expect that the following topics will be the key factors for the Japanese equity market going forward.

The Monetary Policy Meeting: The BoJ remains committed to accommodative monetary policy, this was no surprise to the equity market.

The BoJ announced a set of policy changes at the Monetary Policy Meeting on 30/31 July 2018. The key changes made to its policy framework are summarised in the table overleaf. Overall, the BoJ has reiterated its accommodative policy stance which came as no surprise to the Japanese equity market.

On a positive note, the BoJ introduced forward guidance in order to enhance the sustainability of its monetary policies. While the tone of the forward guidance, which stated that "the bank intends to maintain the current extremely low levels of short and long-term interest rates for an extended period of time", remained modest as it does not specify any timeframe for achieving the inflation target. However, we realise that the BoJ could dismiss speculation in the market that it is poised for an early end to quantitative easing. We also expect that the decision to reduce the size of the policy-rate balance in current accounts held by financial institutions at the BoJ, which has been one of the factors behind the declining profitability of Japanese banks, would have positive impact on the sector.

On the negative side, at least to a certain extent, the BoJ has implemented policies which would allow greater discretion to control the 10-year bond yield and the purchase amounts of ETFs and J-REITs. The BoJ has been trying to control 10-year yield in the range of -0.10% to +0.11%. However, the target range is now expected to widen (-0.20% to +0.20%) based on the policy statement from the July meeting. Moreover, while the BoJ has conducted fixed purchase operations on ETFs and J-REITs, the central bank is now able to decrease the amount of purchases when the market is higher. Although there would not be any significant changes to the BoJ's policy on its ETF purchases. With this in mind, we need to carefully watch the pace of purchases in order to detect the early signs of "stealth tapering".

The summary of key changes to monetary policy at the BoJ July Meeting

Subject	Previous	New	Impact on equity Market
Forward guidance	Set the following guideline for market operations for the inter-meeting period.	The Bank intends to maintain the current extremely low levels of short and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019.	Positive
Long-term interest rate	the Bank will conduct purchases at more or less the current pace -- an annual pace of increase in the amount outstanding of its JGB holdings of about JPY80 trillion	The yields may move upward and downward to some extent mainly depending on developments in economic activity and prices (in case of a rapid increase in the yields, the Bank will purchase JGBs promptly and appropriately). the Bank will conduct purchases in a flexible manner.	Slightly negative
Purchase ETF and J-REIT	-	With a view to lowering the risk premia of asset prices in an appropriate manner, the Bank may increase or decrease the amount of purchases depending on market conditions.	Slightly negative
ETF purchase	TOPIX: JPY2.7 trillion	TOPIX: JPY4.2 trillion	Neutral
	TOPIX, Nikkei and JPX400: JPY3 trillion	TOPIX, Nikkei and JPX400: JPY1.5 trillion	
The size of the policy rate balance	JPY10 trillion	The Bank, under the condition that yield curve control can be conducted appropriately, will reduce the size of the policy rate balance in financial institutions' current account balances at the Bank - to which a negative interest rate is applied - from the current level of about 10 trillion yen.	Slightly positive

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

Corporate earnings: Recurring profit grew by +12% YoY in the April-to-June quarter. FY2018 earnings estimates of Japanese companies remain conservative.

Earnings announcement season for the April-to-June quarter is under way. As of 3 August, 124 companies from the Daiwa 200, an index consisting of major TSE 1st section stocks, had announced their earnings results. Recurring profit for the April-to-June quarter grew +12% YoY, according to Daiwa Securities. The April-to-June quarterly results have left us with the impression that: 1) winners and losers were mainly divided by whether the companies had managed to transfer higher prices of raw materials to their products or not, 2) several manufacturers have reported on their volume of machinery orders in June, indicating that there has been only a limited impact of trade disputes on Japanese companies at this point.

The companies expect +2% YoY growth recurring profit in FY2018 as of 29 May. Considering the exchange rate assumptions and the quarterly results in 1Q 2018, we believe that the estimate is rather conservative. Notable earnings results are as follows:

Positives

- **Marubeni:** Marubeni's earnings per share (EPS) for the quarter exceeded consensus estimates. The company reported solid earnings, supported by the rising prices of raw materials, including pulp, as well as solid performance in its core businesses, particularly in fertilizer and EPC (engineering, procurement, and construction in power business & plant). With regard to the impact of the US/China trade dispute, it had only a limited impact on its earnings while the company benefitted from selling off its steel inventories in the US at higher prices.
- **Shin-Etsu Chemical**: The company reported better-than-expected EPS in the quarter and revised up its earnings estimate and dividends for FY2018 at the same time. The company also noted that the demand for silicon wafers is likely to remain steady well into FY2020. Although the Chairman & CEO of the company has not been strongly committed to enhance shareholder returns, he made some remarks on company's dividend payout policy at the result meeting for the first time ever, which was perceived as a positive development.

Negatives

- **Ajinomoto**: The global food maker Ajinomoto reported 1Q EPS results below consensus estimates. The company lost its domestic market share in coffee and frozen food products. The earnings of the company were also weighed down by the initial investment on the establishment of a frozen food processing plants in North America, while it also reported a loss incurred on the disposal of fixed assets at the same time.

- **Nabtesco**: The machinery manufacturing company Nabtestco reported worse-than-expected EPS for the quarter. The company failed to meet its target for sales of reduction drives used for machinery production including robots as the order volume declined by -4% versus the previous quarter.

Risk: The risks to China's financial system receded with stimulating fiscal policy and the loosening of measures on the shadow banking system.

In our previous report, we have pointed out that there are risks to the financial system in China. However, we believe that those risks are abated since then as the government announced in July that the country will adopt loosening measures on shadow banking activities and easing monetary policy, while at the same time implement expansionary fiscal policy. The followings are three major factors which support our view:

Firstly, People's Bank of China (PBOC) disclosed the details of new rules for WMPs (wealth management products) on July 20, which contained a string of measures to ease the current regulatory framework, including restrictions on deleveraging. We believe that the most significant factor for economic slowdown and increase in number of WMP and corporate bond defaults in the country since the beginning of the year had been heightened concerns over new regulations on WMPs. We therefore, expect that the deregulation of the current rules on WMPs would curb risks which are prevailing in shadow banking system in the short-term.

Secondly, easing monetary policy will be another factor in reducing the risks in the financial system. With regard to the open market operations by the PBOC, it continued to absorb net funds from the financial system through open-market operations since 22 June 2018, but resumed with liquidity injections on 16 July. Also, the PBOC is currently injecting liquidity in the system by offering massive Medium-Term Lending Facility (MLF) credit for commercial banks to purchase corporate bonds with lower investment grades. Moreover, the PBOC has reportedly provided some guidelines to commercial banks and also tried to help improve their services to facilitate the issuance of new loans. In other words, China has adopted more accommodative monetary policy in order to resolve concerns over shadow banking activities and to strengthen its economy.

Finally, China is poised to implement expansionary fiscal policy. The State Council (equivalent to the Cabinet in Japan) proposed "expansionary fiscal policy" at the 23 July 2018 executive meeting in order to stimulate domestic demand. Moreover, Li Keqiang (the premier of the State Council) proposed the idea to permit local governments to issue municipal bonds within budgetary thresholds. The proposal aims to facilitate infrastructure construction as the country is leaning towards expansionary policy to stimulate economic growth.

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.

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Daiwa SB Investments

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.

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