Daiwa SB Investments

PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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In October, the MSCI Japan index dropped on the back of decline in US equities, worldwide negative earnings guidance and concerns about global economic slowdown. US 10-year bond yields rose from 3.06% on 2 October to 3.23% on 5 October due to a remark by the US Fed chairman Jay Powell "we're a long way from neutral (interest rates) at this point". With the interest rate hitting its highest level since 2011, overvalued US stocks, including IT growth stocks which had been a driving force of the rally, plunged. Undervalued Japanese stocks also followed this downturn.

Although strong corporate performances have shored up stock prices so far, an increasing number of companies are releasing slightly weaker earnings forecasts across the world these days due to a slowdown in sales of three big durable consumer goods, namely automobiles, residences and smartphones as well as a slowdown in capital investments at Chinese companies and an increase in raw material costs at US companies caused by trade frictions between US and China.

In addition, even though China started to give full consideration to the economy, this policy shift is not bearing fruits without any boom in the local economy. The Eurozone Manufacturing PMI was worse than expected, which also weighed on stock prices. Concerns over fiscal deficits in Italy as well as the yen appreciation against the US dollar also triggered equity sales.

On the other hand, the Bank of Japan (BoJ) maintained an accommodative monetary policy and continued Exchange Traded Fund (ETF) purchases. Economic indicators such as the BoJ's quarterly survey of business sentiment (Tankan) suggested an ongoing robust economy. So there were no negative factors in Japan itself.

In the month of October, the TOPIX (total return) index decreased by -9.4% in the yen terms, and US dollar denominated MSCI Japan (net total return) index declined by -8.5%.

Topics which will be important this month are as follows;

Earnings: recurring profits grew by +2% YoY in the July-to-September quarter. FY2018 earnings estimates of Japanese companies remain conservative.

Earnings announcement season for the July-to-September quarter got under way. As of 31 October, 114 companies in the Daiwa 200, an index consisting of major TSE 1st section stocks, had announced their earnings results. Recurring profits for the July-to-September quarter grew +2% YoY, according to **Daiwa Securities.**

Looking at the results by sector, automobile-related companies and machinery-related companies seem weak. The former was due to a deceleration of auto production and the latter was due to a deceleration of capital investments in China. However, more and more companies are announcing share buyback plans followed by a drop in stock prices.

As of 31 October 2018, companies expect +5% YoY growth in recurring profits for the FY2018. However, the growth rate expectation of aggregate recurring profits at companies included in the Daiwa 200 Index by Daiwa Securities is +11% YoY. And we believe this estimate by Daiwa can be realised given our exchange rate assumptions.

Major financial results are shown below:

Positives

- **Komatsu** beat the forecasts in sales and operating profit. The firm also revised up its business forecast. While competitors suffered from an increase in raw material costs and price cuts, Komatsu denied those influences. While market participants were worried about earnings topping out, it presented forecasts predicting that sales of mining machineries would increase next year and beyond.
- **TDK Corporation** also beat the forecasts in sales and operating profit, and also revised up its own business forecast. The selling price of MLCC (ceramic capacitators) went up thanks to the progress of vehicle electrification etc. It also expanded its market share in batteries.

Negatives

- **NTT Docomo** beat the forecasts in sales and operating profit. It said that it would cut telecom rates by 20-40% in reaction to a government statement that mobile communication fees can be reduced by 40%, which will lead to the flattening of operating income over the next six years. Although it announced an extensive share buyback plan, its stock price declined by -14.7%.
- **Yamaha Motor** missed the forecasts in sales and operating profit. Revised down the business forecast. Sales of motorcycles were sluggish in mainly developed countries.

SMBC Nikko Securities projects that an impact of the tax increase on the economy is limited in FY2019, as the negative impacts will be offset by fiscal spending. The 2% tax increase amounts to a JPY4 trillion increase of annual government revenue. With regard to FY2019, the government revenue will increase by JPY1.6 trillion, while the government is expected to add fiscal spending by JPY1.7 trillion in total. Its breakdown is JPY0.3 trillion to introduce reduced tax rates, JPY0.9 trillion to offer free nursery education, JPY0.2 trillion for tax breaks to those who buy houses and cars, JPY0.4 trillion for benefits to pensioners and JPY0.2 trillion to support small and mid-size retailers. If these measures continue in FY2020 and beyond, fiscal spending will increase by approximately JPY2.1 trillion per year, which is equivalent to almost 0.4% of Japan’s nominal gross domestic product (GDP).

The manifestation itself was not a surprise to the stock market. Neither the market consensus on business prospects nor earnings guidance will be revised. The tax increase won’t adversely affect Japan’s GDP in FY2019 with its negative impacts mostly offset by fiscal spending. The impact through a whole year should be neutral to the stock market. However, if we look back at the past, stock prices have declined three months leading up to a tax increase. This is because investors were discouraged by an interim economic decline after the tax hike, as a reaction to the buying rush ahead of the hike. However, after the tax rate was actually raised, stock prices turned upwards again. Therefore, even if there is a risk of price adjustments toward next July, October 2019 when the new consumption tax rate is introduced, is the time to buy Japanese stocks.

Investment Strategy

We expect the Japanese equity market will rally again while the global economy continues to grow steadily, the Bank of Japan maintains an accommodative monetary policy, and the market stays at an affordable level. Over the long term, companies need to make continuous efforts in structural reforms. Major risks will include sharp spikes in the yen caused by external factors, including the escalation of trade frictions and the risk of bubble bursting in the Chinese property market. Taking these points into consideration, we maintain our overweight positions in cyclical sectors, such as materials and industrials (commercial & wholesale trade).

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 (2009) in Japan.

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Disclosures