PM'S MONTHLY INSIGHT
FUNDAMENTAL ACTIVE GROUP

Market Outlook and Investment Strategy

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Japanese stocks are expected to rise after experiencing a double dip in January. The second bottom will likely be inevitable, as the TOPIX index declined over -20% from the peak in October to the bottom in December. We expect a rally in February 2019 because of current low valuations. The valuation of Japanese stocks has fallen to the level at the time of the Great East Japan Earthquake.

According to Bloomberg's calculations, the forward P/E for the TOPIX index has sunk to 11x. Given the favourable US economy, the budding recovery of the domestic economy from natural disasters and lower crude oil prices, corporate earnings are unlikely to decline significantly (more than 20%) for fiscal-2019. Even if Japanese companies post a drop of 25% in profits, their PER is still 15x or less, which is lower than that of US companies (17x). The dividend yield is also around 2.5%, which is attractive compared with the 10-year JGB yield (0%). When the external environment calms down, domestic investors will likely resume investing in Japanese equities.

We do not expect extreme risk aversion, as seen at the end of 2018, to continue for an extended period of time, whereby the Bank of Japan (BoJ) was the only buyer except share buybacks by companies with a 10-year JGB yield at 0%, which was the lower limit of the Bank's target. The performance of Japanese equities in 2019 will depend mostly on how the Japan-US Trade Agreement on Goods (TAG) and the consumption tax hike play out. We believe current low valuations stem largely from fear of the worst-case scenario, in which investors assume that the Japanese economy will enter into a recession, in the case of a higher US tariff to 25% on Japanese automobiles, as well as the consumer tax hike.

However, we believe market participants are overly pessimistic. By the end of 2019, we expect the Nikkei 225 and the TOPIX index to increase by roughly 20%, hitting 24,000 and 1,800 respectively, as we believe TAG negotiations are unlikely to break down, with few possibilities of an increase in tariffs on automobiles to 25%. With regard to the consumption tax hike, we should be able to avoid a recession after its implementation through economic stimulus measures. It is estimated that the tax hike itself will be postponed.

With regards to the TAG issue, the automobile sector's PER remains low despite its strong corporate earnings growth. PBR has also fallen to the same level as that of the 2008 global financial crisis. For example, Honda's PBR is at the same level as at the time of the Lehman shock, even though the company will experience a lesser impact on tariff hikes as many of its production facilities have already shifted overseas. While Japanese automakers are now open to the expansion of their overseas production, the Japanese government is simultaneously planning to accept an increase in agricultural imports. From this perspective, we see the US being able to reap the benefits from their negotiations with Japan more easily than with other major countries and therefore the TAG will most likely achieve a consensus. When the US and Japan reach an agreement on TAG, the automobile sector's share prices will likely rise dramatically.

As for the consumption tax hike, the government is supposed to introduce various countermeasures to combat the headwind. Therefore, it is unlikely that we will experience an economic downturn. Moreover, there is an Upper House election in the summer of 2019 and only half seats are up for grabs. The ruling Liberal Democratic Party (LDP) might lose many seats in parliament if they promise to raise taxes in the election campaign. It is more likely that they will scrap the tax hike ahead of the election.

The governor of the BoJ, Kuroda vowed that the bank would make every effort to achieve the price target. As such, accommodative monetary policy is likely to continue. Wages are rising, but it is unlikely to go up rapidly enough to put pressure on corporate earnings, since the government has decided to increase foreign workers.

Once TAG negotiations begin in February, we believe Japanese stock prices will rise when current worries over Japanese equities have subsided.

Investment Strategy

Overweight Sectors	Underweight Sectors
Automobiles & Transportation	Foods
Financials (Ex Banks)	Transportation & Logistics
Commercial & Wholesale Trade	Machinery
Pharmaceutical	IT & Services, Others

We will continue to overweight the automobile, financials and commercial trade sectors, while taking an underweight position in the foods, transportation and machinery sectors. We have an overweight position in the automobile sector, because their stock prices are left at low levels after having been sold on concerns over trade frictions, although their corporate earnings are mostly strong. We will also overweight trading companies that have strong corporate earnings and proactive shareholder return policies. In the financial sector, we will overweight stocks with low PB ratio, as well as possible shareholder return programs such as share buybacks. Conversely, we take an underweight position in the food sector because of lacklustre earnings expectation at many of them. As for the transportation sector, we will underweight marines and railways. We also take an underweight position in the machinery sector because of continued declining order intake.

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 graduated from Kyoto University with a BA degree in Educational Administration (1987).

Hideyuki TANIUCHI, CFA/CMA – Senior Portfolio Manager

Mr Taniuchi supports Mr Kamohara in managing the Fundamental Active product. He started his career with Yamaichi Securities in 1996. He moved to Nikko Asset Management the following year as a trader of equities, convertible bonds and FX. He became a senior portfolio manager of Japanese equity specialising in Growth stocks. He joined Daiwa SB Investments in June 2008 to support Mr Kamohara in managing the Fundamental Active product.

Mr Taniuchi graduated from Tokyo University of Science with BS/Engineering in Industrial Administration (1996).

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Disclosures