

# PM'S MONTHLY PERSPECTIVES VALUE + ALPHA GROUP

## Market Outlook & Investment Strategy

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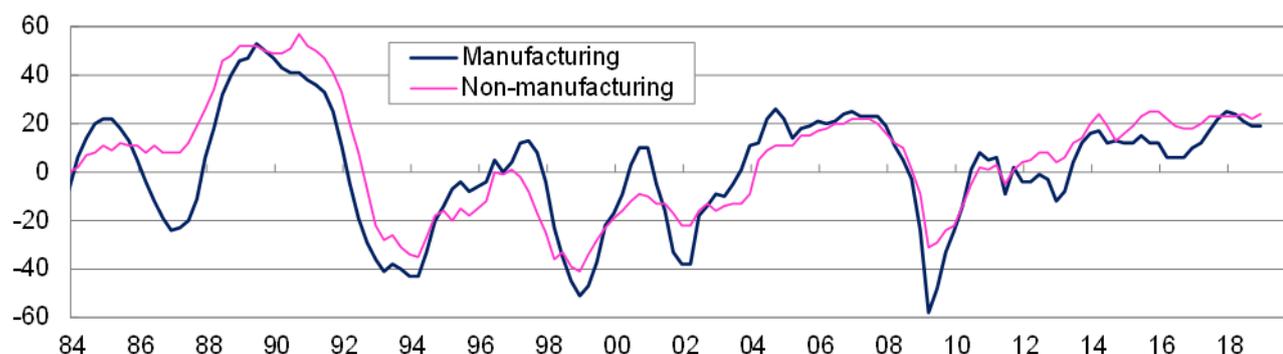
In December, the TOPIX index dropped on the back of concerns over the economic recession, the escalation of trade frictions and the appreciation of the yen. Early in the month, the arrest of **Huawei's** chief financial officer (CFO) triggered concerns over intensifying trade frictions between the US and China, leading to the fall of the TOPIX. The inverted yield curve in the US, where the yield of 3-year Treasury bonds exceeds that of 5-year Treasury bonds, and the widening US credit spreads also raised concerns about an economic slowdown. In the middle of the month, the TOPIX continued to fall due to lower-than-expected economic indicators in the US and China, the US Federal Open Market Committee's (FOMC) comment suggesting at continued rate hikes as well as yen appreciation. The downward revision of earnings forecasts by **FedEx** and the opening price of **Softbank's** stock dipping below its IPO price both weighed on the stock market. Toward the end of the month, stock prices enjoyed a very slight rebound globally as a reaction to the previous sharp fall earlier in the month. Dovish remarks by US Fed officials also supported the market, but the Japanese stocks were slow in recovery because they were weighed down by yen appreciation.

Important economic indicators such as the Economy Watchers Survey by the Cabinet Office and the Tankan survey by the Bank of Japan (BoJ) were solid, but they affected little on the stock market.

### Economy: Tankan suggests a steady economy and a moderate slowdown in the future.

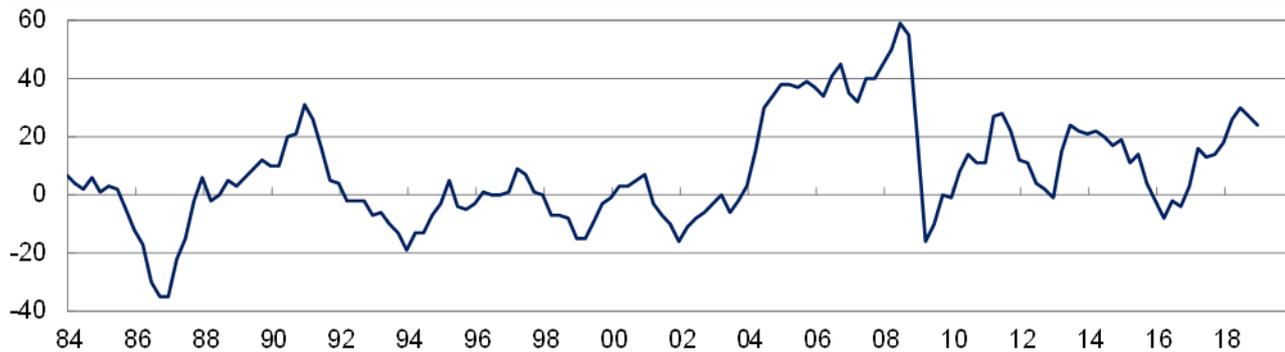
The latest results of the Tankan survey, which is one of the most important economic indicators for the Japanese economy, were released on 14 December. The business conditions DI (diffusion index) of large manufacturers did not change (Sep: 19 to Dec: 19), while the DI of large non-manufacturers increased by +2 points (Sep: 22 to Dec: 24). We imagine that the reduction of material costs contributed to DI, because input prices for large manufacturers improved by -3 points (Sep: 27 to Dec: 24). However, we think that the economy already hit a ceiling at the end of 2017 and the current increase won't last long, given that the business conditions DI guidance of both manufacturers (Sep: 19 to Dec: 15) and non-manufacturers (Sep: 22 to Dec: 20) were revised downward.

### Japan Tankan Business Conditions (Actual Result, Large Enterprises)



Source: Bloomberg, as at 14 December 2018

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



Source: Bloomberg, as at 14 December 2018

With regard to individual indicators, capital investments were very strong. The projection for fixed investments including land purchasing costs for FY2018 was revised up to +10.4% YoY from +8.5% YoY in September.

The average exchange rate prediction for FY2018 2H by large manufacturers is JPY109.26 per dollar, which is reasonable compared to the actual rate (JPY109.69 per dollar) at the end of December 2018. Therefore, we can say the current exchange rate is a neutral level for Japanese companies.

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



Source: Bloomberg, as at 14 December 2018

**Event schedule in 2019: We are bullish on Japanese stocks in the first half of 2019, but we are slightly bearish in the July-September quarter.**

Important events in Japan this year:

- March: The final deadline of administrative procedures if the consumption-tax hike is implemented.
- April: The unified local election
- May: Change of the name of era, accession of the new emperor (one of the greatest events in Japan)
- July: The Upper House election
- October: The consumption tax hike from 8% to 10% (plan)

We think that the biggest event for the Japanese stock market this year is the consumption-tax hike on 1 October 2019. However, the range of tax hike this time is smaller than that of the last one on 1 April 2014 (from 5% to 8%). In addition, fiscal expenditures will be introduced to reduce the impact on the economy. When we look back on cases in the past, the economy picks up ahead of the consumption-tax hike thanks to the spending spree, but temporarily deteriorates after the tax hike in reaction to the last-minute jump in demands. As for stock prices, the market tends to be weak during the three months before the tax hike, as stock prices usually lead the economic trend, and then starts to turn up again a short time after the tax hike. Therefore, the consumption tax hike is likely to have a positive effect on the stock price in the April-to-June quarter and a negative effect in the July-to-September quarter.

We have another big event in Japan. That is the change of the Japanese traditional era name and the accession of the new emperor on 1 May 2019. These are both likely to have a positive effect on stock prices in the first half of 2019. In Japan, the original era name is used in addition to the dominical year, and the era name changes when the new emperor takes over his father's position. The next accession is the first time in thirty years, with the current emperor having taken over the position in January 1989. The government will announce a new era name on 1 April, and has placed a 10-day holiday in May to celebrate the new emperor's accession, during which we can expect an increase in consumption. It

might be difficult for foreigners to imagine how Japanese people feel about this event. Maybe it is similar to a royal wedding in Great Britain.

Two elections are scheduled for 2019 in Japan. One is a unified local election and the other is the Upper House election. But we expect the ruling Liberal Democratic Party (LDP) to win the election meaning that the business-friendly environment is maintained given the stable approval ratings of the LDP without any strong opposition parties. Although Prime Minister Abe does not have to resign even if the LDP loses in these elections, we cannot feel relief just yet. Elections are all about luck, so if the LDP suffers a crushing defeat, Prime Minister Abe might resign voluntarily after accepting the blame, which is likely to undermine the political stability in Japan. **Investment Strategy**

We expect that the Japanese equity market will rally again while the global economy continues to expand at a moderate pace, the Bank of Japan maintains an accommodative monetary policy, and the market remains at an affordable level. Over the long term, the improvement in governance at Japanese companies as well as Japanese policies which are open to overseas funds and immigrants will receive recognition from the world. We identify the sharp yen appreciation caused by external factors, such as the escalation of trade frictions and the bursting of the bubble in the Chinese property market, as major risks. Taking these into consideration, we maintain our overweight positions in late cyclical sectors, such as materials and industrials (commercial & wholesale trade). However, if the economy slows down further than our expectations, we might raise the holding ratio of defensive stocks in preparation for any potential recession.

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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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