PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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In January, the TOPIX index advanced on the back of expectations for economic stimulus in China, easing of concerns over the US-China trade frictions and dovish comments by the US Federal Reserve Bank (FRB), despite the JPY appreciation against the USD. In the beginning of the month, the TOPIX advanced thanks to a cut in reserve deposit rates in China, a comment by the US Federal Reserve chair Jay Powell that “We will be patient and flexible in implementing monetary policies” and expectations for progress in the US-China trade negotiations. Narrower credit spreads in the US also pushed up the stock prices, while a downward revision of earnings estimates by **Apple** and worse-than-expected US/China Manufacturing PMI results weighed on the market. In the middle of the month, the TOPIX continued to rise thanks to an announcement on a tax cut by China and the depreciation of the yen. Interestingly, although **Nidec** announced a significant downgrade of its earnings estimate, the impact of the announcement on the stock price was limited. Toward the end of the month, stock prices remained flat in a tug-of-war between the bullish factor (a comment by the Fed chair Powell that “Balance sheet adjustments will come to an end earlier than expected”) and the bearish factor (the yen appreciation).

Earnings: Although recurring profits decreased by -5% YoY in the October-to-December quarter, the stock market is on the rise after all of the negative factors were already priced in.

The earnings announcement season for the October-to-December quarter got under way. As of 31 January 2019, 65 companies in the Daiwa 200, an index consisting of major TSE 1st section stocks, announced their earnings results. Recurring profits for the October-to-December quarter decreased by -5% YoY, according to Daiwa Securities.

We can name the economic slowdown in China, adjustments in smartphone production, worldwide stock market declines and an increase in raw material prices as factors of declining profits. Machinery firms suffered from an overall downturn in shipments to China, while smartphone makers reported sluggish results. Still, stock prices in the machinery and electric appliance sectors have risen sharply since the earnings announcement, as investors thought that negative factors were exhausted. While the steep decline in global stock prices is weighing on corporate earnings through valuation losses on securities, we believe that this phenomenon came to an end in the last quarter.

We still expect earnings growth for 2019 on the back of economic stimulus measures by China, the progress of production adjustments for smartphones and the low price of crude oil.

Positives

Hitachi High-Technologies: Beat the operating profit (OP) forecast. New orders for semiconductor manufacturing equipment increased by +33% YoY and +92% QoQ thanks to an increase of order intake from **Intel.** The medical system business also achieved a stable growth in both sales and profits.

Hitachi: Beat the OP forecast. Operating profits in the information & telecommunication systems business topped its forecast thanks to strong demands in IT investments. Revenue from the internet of things (IoT) platform ‘Lumada’, on which the company focuses, also exceeded its estimate.

Negatives

Nidec: Missed the OP forecast. The company downgraded its OP guidance. It couldn't meet a delivery date of orders for home electronic components and automobile parts in China, which pushed down its revenue in November and December to a large extent. However, it said at the results briefing that the revenue is likely to turn up by +10-20% MoM in January.

CyberAgent: Missed the OP forecast. The company downgraded the OP guidance. Both the internet advertising revenue and the revenue from games developed in collaboration with **Nintendo** fell below its expectations. Following these financial results, the company is going to step up its cost-cutting efforts by restraining the recruitment and so on.

Governance: a new code of corporate governance is steadily penetrating into listed companies.

The Tokyo Stock Exchange has published a flash report on "Listed Companies' Reaction to Japan's Corporate Governance Code (as of the end of December 2018)" on 28 January 2019. According to this report, the corporate governance improved over the year on the whole, which suggests reforms in governance by the Japanese government as well as Japanese companies are still underway. Please allow me to give you some more specific information below:

- Capital-costs-conscious management: the ratio of companies which have return on equity (ROE) goals set against the JPX-Nikkei 400's components was 63%.
- Nominating committee: the ratio of companies which have nominating committees in the TSE first section rose from 31.8% in 2017 to 43.1% in 2018.
- Compensation committee: the ratio of companies which have compensation committees in the TSE first section rose from 34.9% in 2017 to 45.6% in 2018.
- Advisory committee: the ratio of companies which were considering setting up advisory committees is about 30%.
- The ratio of external directors in the nominating committee: the ratio of companies in which external directors account for a majority of nominating committee votes in the TSE first section was 55.6%, up +6.9% YoY.
- The ratio of external directors in the compensation committee: the ratio of companies in which external directors account for a majority of compensation committee votes in the TSE first section was 54.8%, up +7.3% YoY.
- Unwinding of cross-shareholdings: the ratio of companies which declared a desire to reduce cross-shareholdings was 74% in the JPX-Nikkei 400's components.

Investment Strategy

We expect that the Japanese equity market will rally while the global economy expands moderately, 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 potential bursting of the bubble in the Chinese property market, as major risks. Taking these into consideration, we maintain our overweight positions in the late cyclical sectors, such as industrials (commercial & wholesale trade). However, if the economy slows down by more than our expectations, we might look to raise the holding ratio of defensive stocks in preparation for any recession.

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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.

Mr KAMIISHI obtained a BA degree in Economics from Keio University (2009) in Japan.

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Disclosures