PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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In February, the MSCI Japan index advanced on the back of receding concerns over US-China trade frictions, expectations on stimulus policies by China and depreciation of the yen. Fears about US-China trade wars eased after both sides expressed optimism that substantial progress is being made toward ending the trade war between the world's two biggest economies. We also saw a growing expectation for government stimulus package in China following higher-than-expected total social financing (TSF), plus an announcement on fiscal expansion by the Chinese government and a rebound in local stock prices. In addition, the acceleration of yen depreciation against the US dollar supported Japanese stocks. The value of JPY declined, as yields on Japanese government bonds (JGB) declined while those on US Treasuries went up. The overall market rally might be attributable to these external factors. Defensive sectors advanced due to lacklustre economic indicators and poor corporate performances.

Economy: According to the Japan Economy Watchers Survey, the diffusion index (DI) for current conditions was lower than expected while that for future conditions rose on expectations for a change of era and the accession of the new emperor.

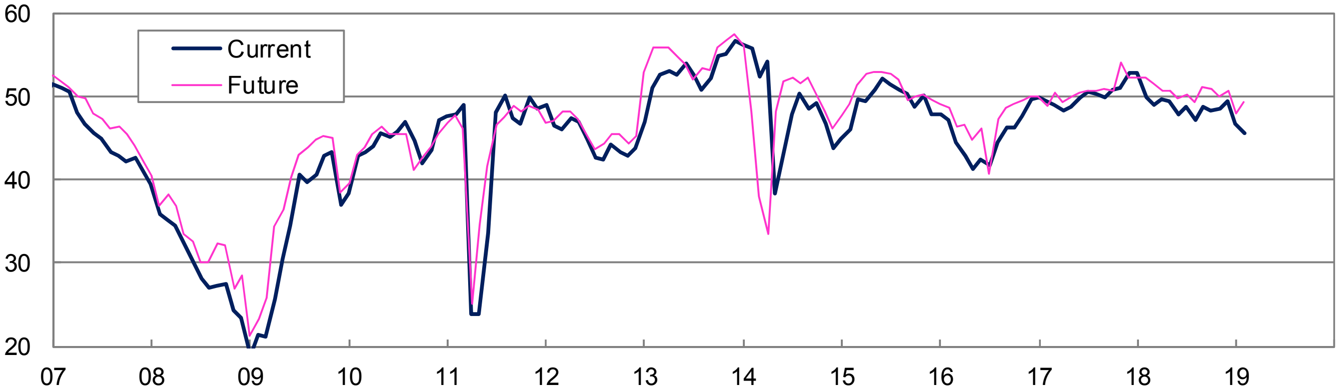
Defensive sectors outperformed the benchmark in February partly due to weaker economic indicators. According to the Japan Economy Watchers Survey, a leading indicator fund managers pay attention to, the figure (the average of current conditions 45.60 and future conditions 49.40) in January was 47.50 while the market consensus was 48.20 (current conditions 48.30, future conditions 48.10). The figure for the previous month was downgraded from 48.25 to 47.40.

Japan Economy Watchers Survey (Average of Current and Future)

Source: DSBI (Tokyo), 8 February 2019

The main cause of the current economic deterioration is a deceleration in the Chinese economy. Some companies have said that the number of Chinese buyers is dropping in terms of visitors and the purchased amount (jewellery and precious metals), at the same time demands for electronic materials and pharmaceuticals in China slightly declined (chemicals), which illustrate the impact that China has on domestic production and consumption. On the other hand, the main cause of future optimism is related to the change of era and the accession of the new emperor in May. We have noted a trend in convenience store comments, such as expecting brisk sales when the name of an era changes and that we can expect advertising contracts which are related to a change of era from advertising agencies.

Japan Economy Watchers Survey



Source: DSBI (Tokyo), 8 February 2019

We expect modest growth for the Japanese economy on the back of the change of era, the accession of the new emperor and last-minute demands ahead of the consumption tax hike. We will check whether this scenario is correct or not by monitoring economic indicators such as Economy Watchers Survey on a regular basis.

Earnings: Current profits are expected to increase by +2% with an influence from the downturn in the global economy.

According to Daiwa Securities, the current profit of Japanese companies is expected to grow by +2% in FY2019, as of the end of February 2018. One reason for the downward revision was the worsening of the global economy, particularly in China. Our analysts currently expect a similar level of growth rate.

I had an impression during interviews with companies after the quarterly results that profits are weighed down by (1) the deteriorating economy in China and elsewhere, (2) the weaker-than-expected growth rate in the volume of semiconductors, automobiles, and smartphones and (3) the increase in depreciation expenses in 2019 following a sharp increase in capital expenditures in 2018.

However, these issues are truly global. Many companies in developed countries are revising earnings forecasts. So we believe that Japanese stock prices won't underperform those of other developed countries helped by their healthy balance sheets, improved corporate governance and low equity valuations, even if the global economy enters into a phase of recession, unless the yen appreciates significantly.

Earnings for Daiwa 200

(y/y chg)	FY18 E	19 E
Recurring profit outlook	Up 8.4%	Up 2.4%
Vs. our previous estimates	1.3% downgrade	6.4% downgrade
Company recurring profit projections	Up 5.0%	-

	Exchange rate	Crude oil price (WTI basis)
Current assumptions (from Jan 2019)	Y110/$, Y125/€	$50/bbl
Previous assumptions (from Oct 2018)	Y110/$, Y130/€	$60/bbl

E: Daiwa estimates.

Source: Daiwa Securities, 28 February 2019

Investment Strategy

We expect that the Japanese equity market will rally with the Bank of Japan maintaining an accommodative monetary policy and the market staying at an affordable level, while the global economy is expected to expand moderately. Over the long term, the improvement in governance at Japanese companies as well as Japanese policies which are open to overseas funds and pro-immigration 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 late cyclical sectors, such as 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 a possible recession.

Daiwa SB Investments

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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