PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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In March, the MSCI Japan Index fell due to a lack of additional monetary policies in Japan, sell-offs by foreign investors and yen appreciation. The main reason why Japanese equities underperformed was because there were no announcements of additional monetary policies by the Bank of Japan, although there were announcements of accommodative monetary policy in the US, Europe and China. This caused yen appreciation. In addition, concerns over supply and demand conditions for small-cap stocks spread on the back of active arguments on the market reorganisation at the Tokyo Stock Exchange (TSE), pushing down Japanese stocks, particularly cash stocks thus leading to underperformance of the Japan market as compared with the overseas markets. Several issues weighed on the MSCI Japan Index. Namely, negative news on large-cap stocks, including fears that competition in the mobile communication industry would intensify with an initial public offering (IPO) of **Lyft** (ride-sharing company), largest shareholder being newcomers **Rakuten,** and fears that competition in the Japanese gaming industry would escalate with Google's entry.

Economy: Given the yield curve inversion in the US, our portfolio will have to shift to defensive-centric one at some stage.

Yields on three-month Treasury bills topped those on ten-year Treasury notes on 22 March 2019. When we look back on the past history of the relationship between the yield curve inversion and the economic cycle, it appears that the economy tumbled into recession about one year after the emergence of a yield curve inversion. Given that the S&P500 Index hit its latest peak in October 2007, the yield curve inversion is not likely to push down stock prices immediately. However, with the economy more likely to shift from the last half of an expansion phase to deceleration, we have to lean toward a defensive-centric portfolio sooner or later.

US bond yield spread between 10 Year and 3 Month

Source: Bloomberg, 8 April 2019

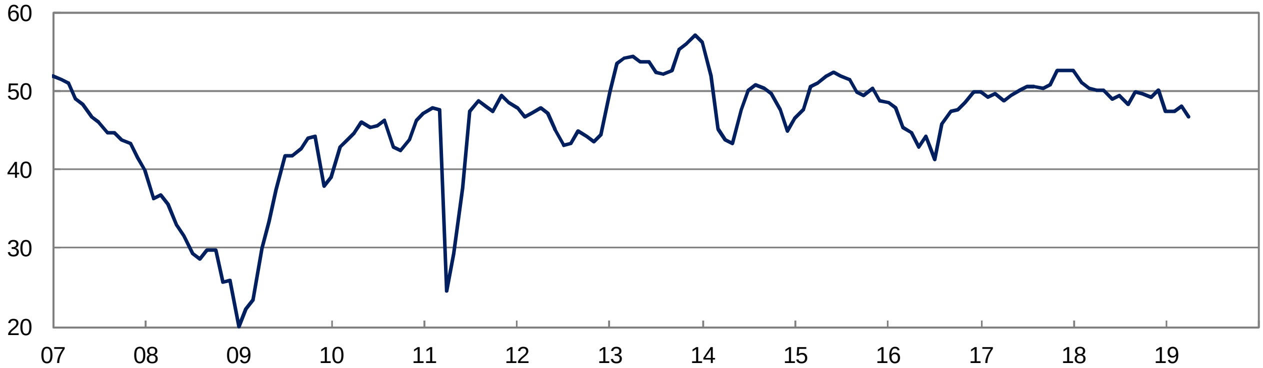
Leading economic indicators in Japan were mixed. Leading Composite Indexes February 2019 (preliminary release) improved. According to a breakdown list, the “Total Floor Area of New Housing Construction Started” improved sharply, suggesting a spending spree ahead of the consumption tax hike in October this year. This index showed an economic boom.

Japan Business Conditions (Leading Composite Index, 2015 average=100)

Source: Bloomberg, 5 April 2019

On the other hand, the Economic Watchers Survey made a turn for the worse in March. Issues which contributed positively on market sentiment include the upcoming ten consecutive day holidays, to mark the accession of the crown prince to emperor in May as well as last-minute demands ahead of the consumption tax hike. However, business sentiment in machines and employment declined mainly in the manufacturing industry. Therefore, this index showed an economic downturn.

Japan Economy Watchers Survey (Average of Current and Future)



Source: Bloomberg, 8 April 2019

We still expect a modest growth for the Japanese economy on the back of a change of era, the accession of the new emperor and last-minute demands ahead of the consumption tax hike. We will ascertain whether this scenario is correct by monitoring leading economic indicators such as Japan Business Conditions and Economy Watchers Survey on a regular basis.

Market reorganisation at the TSE: We can expect a rise in ROE and an increase in shareholder returns in the future, although the TOPIX Small (Small-cap index) Index underperformed on concerns over supply and demand conditions.

The market reorganisation at the TSE is currently a big topic among investors. The starting point was the launch of the “Advisory Panel on Market Structure” in October 2018 for the purpose of reviewing the market segmentation and listing systems at the TSE. With rising media coverage on this issue, the TOPIX Small Index underperformed the overall market from October 2018 to March 2019 amid concerns that the Bank of Japan and institutional investors may no longer buy small-cap stocks as they will be excluded from the TOPIX Index.

When we look at a report entitled "Issues Regarding the Current Market Structure (Summary of Issues)" by the TSE and a report entitled "Discussion on How to Structure the Market." by the Ministry of Economy, Trade and Industry (METI), both published in March 2019, the two entities are both trying to integrate four markets into three, to clarify the concepts of each market and set listing standards in-line with those concepts.

The TSE envisions three problems in the current system: (1) the concept of each market segment is unclear, (2) there are not enough incentives for listed companies to enhance corporate values, and (3) no indices have either functionality or market representation, while the METI sees complacency and delinquency as a problem as many companies with low PBR and low productivity remain listed.

The matter of concern among market participants now is the new minimum for the First Section of TSE in terms of market capitalisation. The higher the requirement, the bigger the damage will be for small-cap stocks. Although many people estimated the minimum at JPY50bn to JPY100bn at first, the Nihon Keizai Shimbun reported on 15 March that "the TSE would consider JPY25bn as a candidate standard". We interviewed companies listed on the First Section and found out that the majority want to stay on the First Section, because they can get benefits by being its member not only in terms of stock prices but also in terms of recruitment. Therefore, once the minimum market capitalisation is set, small-cap companies are likely to make an effort to raise ROE and increase shareholder returns to remain at the first section of the TSE.

Investment Strategy

We expect that the Japanese equity market will rally, given an ongoing accommodative monetary policy by the Bank of Japan, affordable stock prices and the moderate expansion of the global economy. Over the long term, the improvement in governance at Japanese companies, policies which are open to overseas funds and pro-immigration policies will receive recognition from the world. We identify the sharp yen appreciation is 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 ratio of defensive stocks in preparation for a recession.

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.

Note: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

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