PM'S MONTHLY PERSPECTIVES
VALUE + ALPHA GROUP

Market Outlook & Investment Strategy

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For May, the MSCI Japan index shed in response to the escalation of US-China trade frictions, worse-than-expected economic indicators and the yen appreciation. The US raised tariffs on USD200 billion of Chinese imports from 10% to 25% and China announced additional tariffs on US-made products as a retaliatory measure. When US President Donald Trump's administration has effectively barred US companies from using equipment manufactured by China's telecommunications giant **Huawei**, the Chinese media threatened to use rare earths exports as leverage in the trade war with the US. President Trump's plan to start raising tariffs on goods from Mexico also weighed down the stock market. While there was no negative news concerning the Japan-US summit meeting in May, as Donald Trump suggested that the countries would reach an agreement in August, with due consideration to the Upper House elections in Japan scheduled for July. Worse-than-expected economic indicators such as US PMI and China's PMI as well as the JPY appreciation against the USD weighed on the stock prices.

Policies: News was slightly positive on US-Japan trade negotiations in May.

There were two slightly positive factors on US-Japan trade negotiations in May, despite a stock market decline across the world following the escalation of worldwide trade frictions.

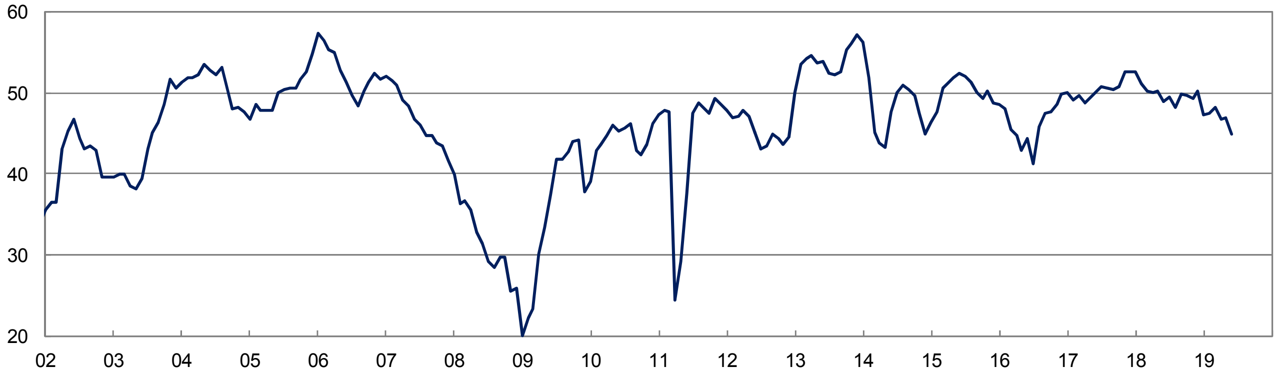
Firstly, the US postponed a judgment to levy tariffs of about 25% on imported cars and auto parts. Trump was expected to decide whether he would impose sanctions or not within 90 days after the US Department of Commerce proposed an imposition of sanctions based on survey results saying that imported cars are threatening its national security. However, President Trump postponed the judgement on 17 May and Robert Lighthizer, the US trade representative, announced that he would decide whether additional measures are necessary or not within 180 days. This means the new deadline was set on 13 November 2019.

Secondly, the US President posted a message on Twitter after the US-Japan summit meeting, saying "Great progress being made in our Trade Negotiations with Japan. Agriculture and beef heavily in play. Much will wait until after their July elections where I anticipate big numbers." This comment won't be a negative factor on at least Japanese equities, given his willingness to take time in negotiations with considerations on the Upper House elections. It also seems slightly positive that he focuses on agriculture and beef rather than automobiles and machinery, which play key roles in the Japanese economy and stock market.

We still have uncertainties over the US-Japan trade negotiations, but risks on trade frictions seem to have slightly decreased in the short term.

Economy: The government will definitely raise the consumption tax rate in October 2019. Domestic economic factors are likely to weigh down stock prices amid declines in economic indicators.
The current administration (Liberal Democratic Party) recently announced campaign promises ahead of the Upper House elections. The consumption tax hike was the biggest point of note and promises indicated a policy to raise the tax rate to 10% in October this year. Some market participants were expecting that the government would pull back from the tax hike given the worldwide economic downturn, but that forecast seems to have been overturned.
If we look back on tax increases in the past, there were spending sprees ahead of tax hikes, but the economy slowed down temporarily after the tax hikes. When we focus on stock prices, they remained sluggish for three months before tax hikes, but tend to pick up after the event. If we use this data as a reference, the consumption tax hike in October is negative news for the stock market over the July-to-September quarter.
In addition, both Economy Watchers Survey and Composite indices, which we pay attention to as leading economic indicators are continuing to deteriorate. So the domestic economy is likely to weigh down stock prices in a short term.

Japan Economy Watchers Survey (Average of Current and Future)



Data as of 10 June 2019, Created by SMDAM based on data from Bloomberg

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

Data as of 7 June 2019, Created by SMDAM based on data from Bloomberg

Investment Strategy

We expect that the Japanese equity market will rally over the long term, given the ongoing accommodative monetary policy set by the Bank of Japan, affordable stock prices and the improvement in governance at Japanese companies. Open policies to overseas funds as well as pro-immigration policies are likely to support the market as well. However, the consumption tax hike and a slowdown in the domestic economy will offset these positive factors in the short term. We identify external factors, such as the escalation of trade frictions and the worldwide recession, as major risks because they might bring about a sharp yen appreciation. Taking these into consideration, we will try to strike a balance between cyclical and defensive sectors by reducing the weighting of cyclical sectors and bringing both sectors closer to neutral positions. If the global 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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