SMAM Japan Insights (No.052)

30 October 2015
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Background of Recent Japanese Market Rally and its Outlook

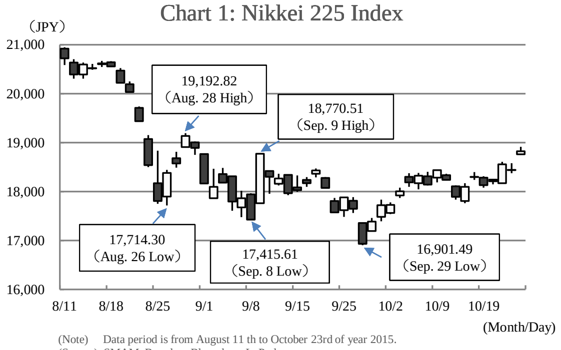
- The background of the recent Japanese stock market rally was the expectations for additional monetary easing by BOJ and ECB, and also China's rate cut.
- The downside of Japanese stocks is getting solid despite some uncertainties remaining, as the market's expectation for additional easing is very high.
- I maintain the view that the room to rebound for Japanese stock market will expand toward the end of the year, if it can weather events such as the announcements of business results.

The background of the recent Japanese stock market rally was the expectations for additional monetary easing by BOJ and ECB, and also China's rate cut.

On October 23rd, the Nikkei 225 closed at JPY 18,825.30, JPY 389.43 higher than the previous day, surpassing the recent high of JPY 18,770.51 on September 9th (Chart 1). This seems to be due to the remarks made by ECB President Draghi. President Draghi's remarks were dovish as he confirmed that "the degree of monetary policy accommodation will need to be re-examined at our December monetary policy meeting" and also that a discussion was made over a deposit rate cut, at the press conference after the ECB meeting.

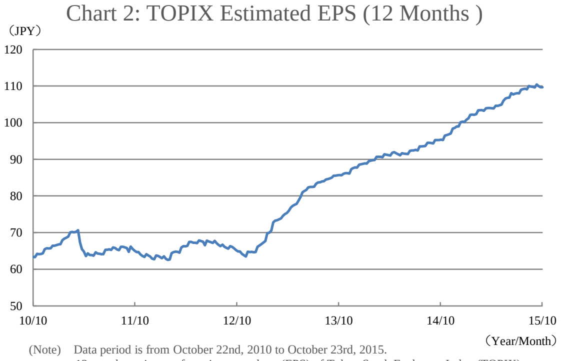
This raised an expectation for additional monetary easing by BOJ at the Monetary Policy Meeting on October 30th coordinating with the ECB. The currency market reacted with the Euro and JPY weakening against the USD and major stock markets reacted by rallying with the expectation of a liquidity-driven market expansion. Meanwhile, the PBOC (China's central bank) announced its decision to cut benchmark interest rates (either deposits or loans) by 25 basis points and the RRR (required reserve ratio) by 50 basis points, on October 23rd which was also a tailwind to both European and US stock markets.

Chart 1: Nikkei 225 Index



(Note) Data period is from August 11 th to October 23rd of year 2015.
(Source) SMAM, Based on Bloomberg L. P. data.

Chart 2: TOPIX Estimated EPS (12 Months)



(Note) Data period is from October 22nd, 2010 to October 23rd, 2015.
12 months estimate of earnings per share (EPS) of Tokyo Stock Exchange Index (TOPIX).
(Source) SMAM, based on Datastream data.

The downside of Japanese stocks is getting solid despite some uncertainties remaining, as the market's expectation for additional easing is very high.

The two uncertainties, the timing of the US rate hike and China's economic situation which caused the financial market's sharp fall this summer, have not completely diminished yet. Notwithstanding, the downside of Japanese stocks is getting solid, supported by the postponement of imminent US rate hike, expectations for additional easing in Japan and Europe, and monetary easing initiated by China. It appears that the stock market has possibly become extremely dependent on monetary easing due to a long lasting liquidity-driven market.

A liquidity-driven market certainly is comfortable for stock investments, however, it potentially involves a risk to push stock value higher than fair corporate value as ample liquidity increases investors' risk tolerance extremely higher. This was observed and proved this summer as the stock market was significantly impacted when the US rate hike came into the picture. Considering the current market environment, an exit strategy from non-traditional monetary policy may be much more difficult than the central banks' assumption.

I maintain the view that the room to rebound for Japanese stock market will expand toward the end of the year, if it can weather events such as the announcements of business results.

In this week, the announcements of the interim results of companies whose fiscal year end in March are concentrated. These events can be a turning point for Japanese stock market to shift into an earnings-driven phase after assessing the impact of China's slowdown to corporate earnings (Chart 2). FOMC from October 27th to 28th and BOJ's Monetary Policy Meeting on October 30th are also important events. Despite the majority deems no policy change this time by FOMC, one should be careful as markets could be volatile depending on the result of BOJ's policy meeting as expectation on additional monetary easing is increasing.

I have not changed my view that the chance to test the upside will increase for the Japanese stock market toward the end of the year, if the interim result announcements were to stay within market expectations and the uncertainties over US rate and China were to be discounted by markets as time passes.

*** Please note that this report is a translation of Japanese report written on October 26th, 2015.**

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