

Japanese Stock Market Outlook

SMAM monthly comments & views
-February 2019-



Sumitomo Mitsui Asset Management

SMAM

Executive summary

➤ Japanese Economy

SMAM slightly cut GDP forecast for FY2018 and FY2019 each by 0.1% due to a little slower Private Capital Investment and Exports. Japanese economy is forecast to keep moderate growth going into FY2020. Currently ongoing US-China negotiations have deep impact on the prospects for the global economy.

- In Japan, important elections are scheduled in April and in July. Nation-wide voting for local elections is in April and Upper House Election is held in July. PM Abe's government will take an extra care to keep Japanese economy going in order for avoiding any possible setback in these elections.
- BOJ "TANKAN" business survey in December showed current business condition holding well, however, future condition DI, which is for the coming 3 month, showed sizable decline. Companies are getting cautious about the future due mainly to slowdown in global trades.

➤ Japanese Stock Markets

Global stock market is on a tug of war between risk-on and risk-off. Negatives are the fears that US economy could heading to a cyclical downturn in 2019 and Chinese economy is falling into a serious trouble. Positives are any possible easing of US-China conflicts and also that central banks are getting cautious in normalizing monetary policies. Japanese stock market has upside room for further rebounds if positives win, meanwhile downside could be supported by low stock valuation.

- Downward earnings forecast revision is continuing for Japanese equity. Similarity can be found between the down-revision in 2016 and the one this time in terms of period and depth. Deteriorating Chinese economy was in the background of the both occasions. If US-China conflict eases and Chinese economy starts to strengthening again, earnings forecast for Japanese companies and also Japanese stock markets could make a sizable rebound.

Outlook for Japanese Economy

SMAM economic outlook for FY18-20

- SMAM slightly cut GDP forecast for FY2018 and FY2019 each by 0.1% due to a little slower Private Capital Investment and Exports.
- Japanese economy is forecast to keep moderate growth going into FY2020.

(YoY %)	FY15	FY16	FY17	FY18E	FY19E	FY20E
Real GDP growth	1.3%	0.9%	1.9%	0.7%	0.8%	0.6%
Private Consumption Expenditure	0.7%	0.0%	1.0%	0.6%	0.7%	0.5%
Private Housing Investment	3.7%	6.3%	-0.7%	-4.6%	0.2%	-4.8%
Private Capital Investment	1.6%	-0.5%	4.6%	2.9%	1.5%	0.5%
Public Consumption Expenditure	1.9%	0.7%	0.4%	0.7%	0.9%	0.8%
Public Capital Investment	-1.6%	0.6%	0.5%	-2.4%	1.7%	0.8%
Net Exports (contrib. to GDP growth)	0.1%	0.8%	0.4%	-0.1%	0.0%	0.1%
Exports	0.8%	3.6%	6.4%	1.5%	1.0%	1.6%
Imports	0.4%	-0.9%	4.1%	1.8%	0.8%	0.8%
Nominal GDP	2.8%	0.7%	2.0%	0.6%	1.6%	1.4%
GDP Deflator	1.5%	-0.2%	0.1%	-0.0%	0.8%	0.8%
Industrial Production	-1.4%	1.5%	4.3%	1.7%	1.8%	1.0%
CPI (excl. fresh food)	-0.1%	-0.2%	0.7%	0.8%	0.2%	0.3%

Notes: E=SMAM forecasts. SMAM views are as of 21st Jan. 2019 and subject to updates thereafter without notice

(%, YoY except Net Exports)

(Source) Cabinet Office, Bank of Japan, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, SMAM forecasts

Export to China and Asia weakened in November and December 2018

- Growth momentum of Japanese exports has weakened since 2018, for which exports to China and other Asian countries are showing decline meanwhile exports to US is showing resilience.
- US-China negotiations on trades, technology and protecting intellectual property have deep impact on global economy and Japanese exports going forward.

Total export volume
(seasonally adjusted, yen billion)



Note: Data is from Jan. 2010 to Dec. 2018.
(Source) Ministry of Finance, Bank of Japan, compiled by SMAM.

U.S.A.



China



Asia ex. China



How US-China negotiation on trade and technology goes by the end of February?

- After a top meeting between US and China on 1st December, US postponed further imposition of tariff on China until March next year. US President Trump and Chinese leader Xi Jinping agreed to continue negotiation on US claims including such as forced technology transfer and protection of intellectual property.
- US has so far imposed a) 25% tariff on USD 50 billion worth imports from China and b-1) 10% on further USD 200 billion. Additional tariff increase of b-2) raising tariff from 10 to 25% on USD 200 billion and c) new 25% tariff on USD 267 billion were postponed.
- Existing tariff is already hurting Chinese economy and the negative effect is going to become more apparent, however, this time's postponement of further imposition will slightly calm the fear that the global economy could be falling into a recession next year.
- However, working time for negotiation is limited considering holiday period in December and also Chinese new year in February 2019. Pressure is on China.

Simulation of negative effects of US-China tariff increase on global GDP (%)

		China	US	Japan	EURO area	South Korea	Taiwan	ASEAN 6	
Already imposed	a)	US -China 25% mutual tariff imposition on USD 50 bil. imports from the counterpart	-0.13	-0.11	-0.04	-0.02	-0.06	-0.11	-0.04
Partially imposed	b)	US imposing 25% tariff on USD 200 bil. imports and China imposing 15% tariff on USD 60 bil. imports.	-0.53	-0.25	-0.14	-0.06	-0.22	-0.38	-0.15
Not imposed yet	c)	US imposing 25% tariff on USD 267 bil. Imports.	-0.88	-0.26	-0.21	-0.08	-0.36	-0.66	-0.24

Note: This simulation calculates change (decrease) of trading volume for each tariff increase and its impact on GDP.

The impact is for all volume adjustments to be completed, and it takes approximately 1 year and a half on average.

ASEAN 6 countries are Thailand, Malaysia, Philippine, Vietnam, Singapore and Indonesia.

(Source) Simulation was made by SMAM using OECD data.

Private consumption activity in 4Q 2018 showed strength

- Monthly retail sales statistics have been volatile this year due to extreme weather condition.
- When October and November numbers are combined, retail sales in the 4Q 2018 shows that private consumption is still strong.

Retail sales (MOM%, seasonally adjusted)

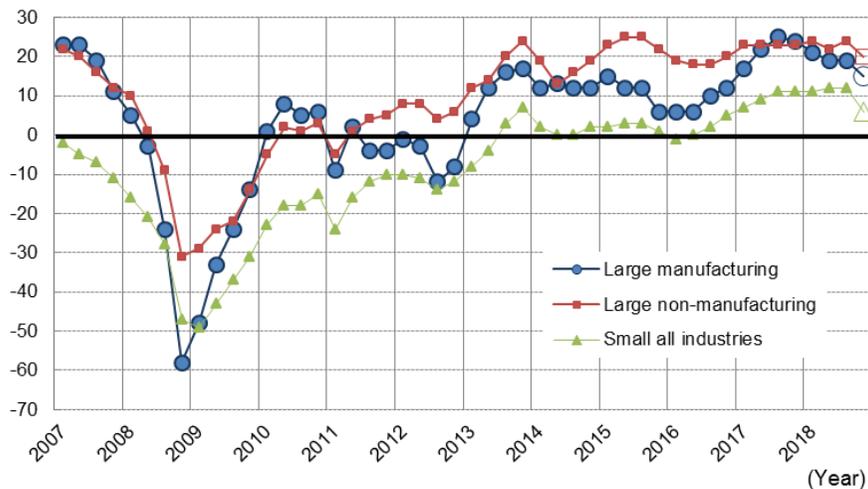
		All retail								Large scale stores		Convenience stores	
		General Merchandise	Fabrics Apparel & Accessories		Food & Beverages	Others	Motor Vehicles	Machinery & Equipment	Fuel	Medicine & Toiletry Stores	Department stores		Super-markets
(Year / Month)													
2018	1	-1.6	1.2	-3.8	0.1	-1.3	-8.4	2.0	0.4	0.5	0.2	1.9	0.7
	2	0.5	-0.9	-0.3	-0.5	-0.4	-0.6	-5.6	4.0	-1.1	-0.3	-0.6	0.1
	3	-0.6	-1.1	-0.4	0.0	-0.6	-1.8	1.0	-5.3	1.7	0.0	-2.0	0.7
	4	1.3	1.8	3.8	-0.4	2.6	5.3	0.6	3.5	2.0	1.8	1.2	0.6
	5	-1.7	-2.6	-3.8	-0.7	-1.1	-1.0	-1.3	1.8	-1.7	-3.0	-1.5	-2.5
	6	1.4	3.5	0.5	0.1	0.8	-1.2	0.6	1.9	1.4	4.7	1.8	2.0
	7	0.1	-3.5	0.0	1.0	1.2	4.1	1.3	1.9	-0.5	-8.0	2.2	0.1
	8	0.9	1.2	3.1	0.9	0.3	2.9	-1.9	-3.9	0.4	5.6	-1.7	-0.3
	9	0.1	-0.6	-0.7	-0.5	-0.7	-1.2	1.9	1.1	-1.2	-3.7	1.4	2.2
	10	1.3	0.6	1.5	0.0	3.2	3.7	-0.4	3.2	1.9	4.2	-1.6	-3.9
	11	-1.0	-1.4	1.4	-0.4	-1.9	1.4	-0.1	-1.7	-1.9	-1.4	-1.9	2.8

(Source) Ministry of Economy, Trade and Industry

Sentiment of both businesses and consumers are getting cautious for the future

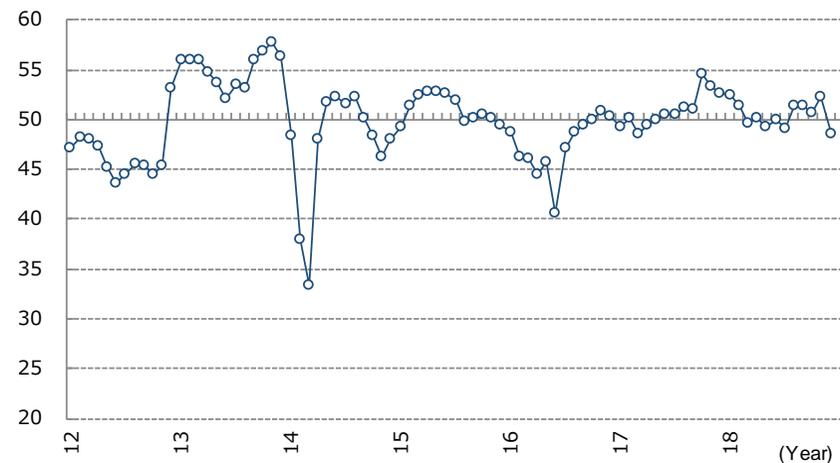
- BOJ "TANKAN" business survey in December showed current business condition holding well, however, future condition DI, which is for the coming 3 month, showed sizable decline. Companies are getting cautious about the future due mainly to slowdown in global trades.
- Economy watchers survey, which makes survey on the people with economic sensitive jobs, showed future condition DI declining below 50, meaning condition is feared to get slightly worse in two to three months.

BOJ "TANKAN" business survey, current condition DI
(Last plots are for future condition DI as of December 2018)



Note: Data is quarterly from Mar. 2007 to Dec. 2018
Diffusion Index above 0 means condition is good.
(Source) Bank of Japan

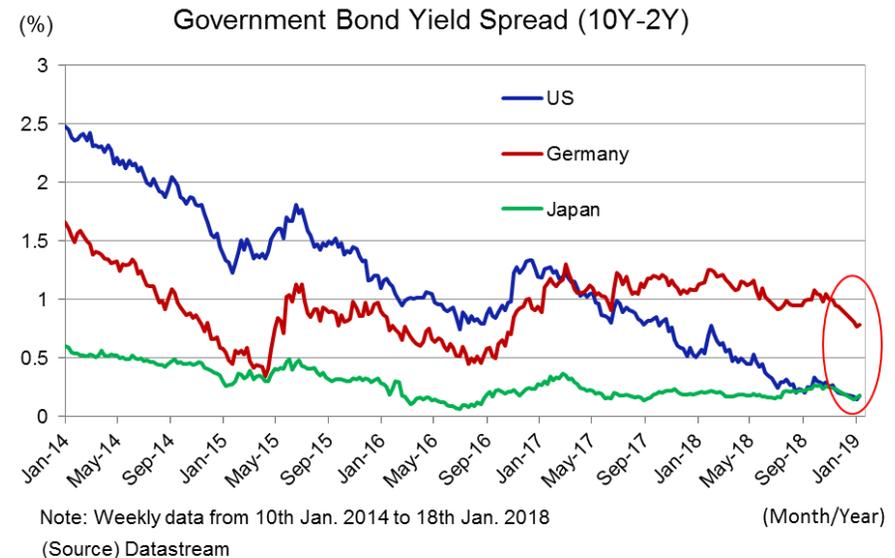
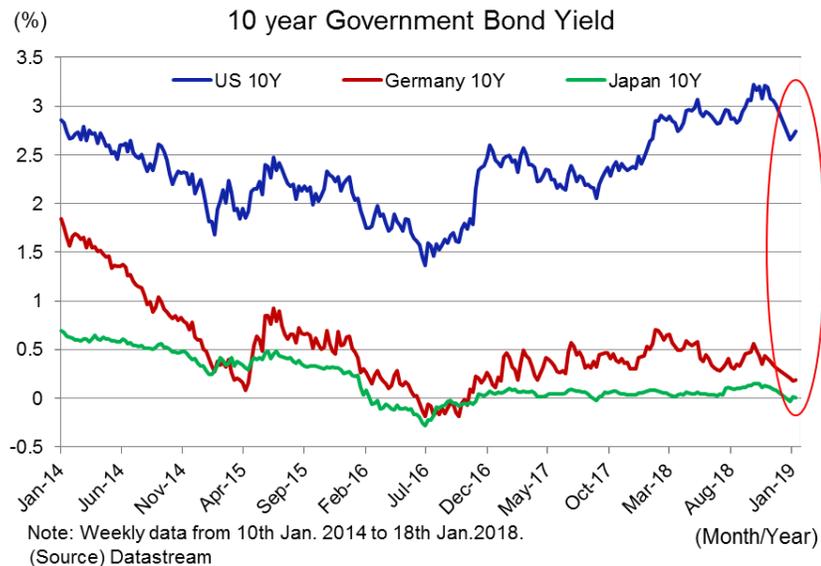
Economy watchers survey, future condition DI
(Seasonally adjusted)



Notes: DI above 50 means improving condition. Data period is from Jan. 2012 to Jan. 2019.
(Source) Cabinet Office

Deterioration of economic outlook brought long-term bond yields down

- Outlook of the global economy deteriorated lately.
- FRB in US sounds less hawkish in recent communications by monetary policy committee members.
- Falling oil price made inflation outlook even milder.
- All these factors caused the long-term bond yields to come down.
- In US, yield curve became really flat and occasionally gets inverted at some parts, which is giving negative implications for the outlook of US economy and stock markets.



How trade negotiations between US and China goes by March 2019?

- Currently ongoing US-China negotiations have deep impact on the prospects for the global economy. If further tariff increase can be avoided, it will have visible positive impacts on the global financial markets.
- In Japan, important elections are scheduled in April and in July. Nation-wide voting for local elections is in April and Upper House Election is held in July. PM Abe's government will take an extra care to keep Japanese economy going in order for avoiding any possible setback in these elections.

Upcoming key events

	Month	Region/Country	Events	Notes
2019	February	US	17 Report of tariff on auto to be presented	Action needs to be decided in 90 days from the report date.
			The president's budget message	
		US-North Korea	Two leaders are going to have the 2nd meeting at the end of the month	
		China	4-10 Lunar New Year Holidays	
March	US-China	1 US tariff on China may be imposed after 3 months' postponement	Time limit for trade negotiations between US and China.	
	US	19-20 FOMC meeting		
	China	National People's Congress	China needs to set policies for 2019.	
April	UK & EU	29 UK is going to exit EU.		
	Japan	7, 21 Nation-wide voting for local elections		
		1 Work style reform/ stricter control of overtime working		
May	Japan	Prince Naruhito becomes the new emperor. Japanese calendar is set for renewal.	Positive economic effect is expected from celebratory atmosphere and calendar renewal.	
June	US	18-19 FOMC meeting		
	Global	28-29 G20 top meeting in Osaka, which PM Abe chairs		
July	Japan	Upper house election		
October	Japan	Consumption Tax is scheduled to rise from 8% to 10%		
2020	Jul-Aug	Japan	Tokyo Olympic Games	

(Source) Various publications, assembled by SMAM

Outlook for Japanese Stock Markets

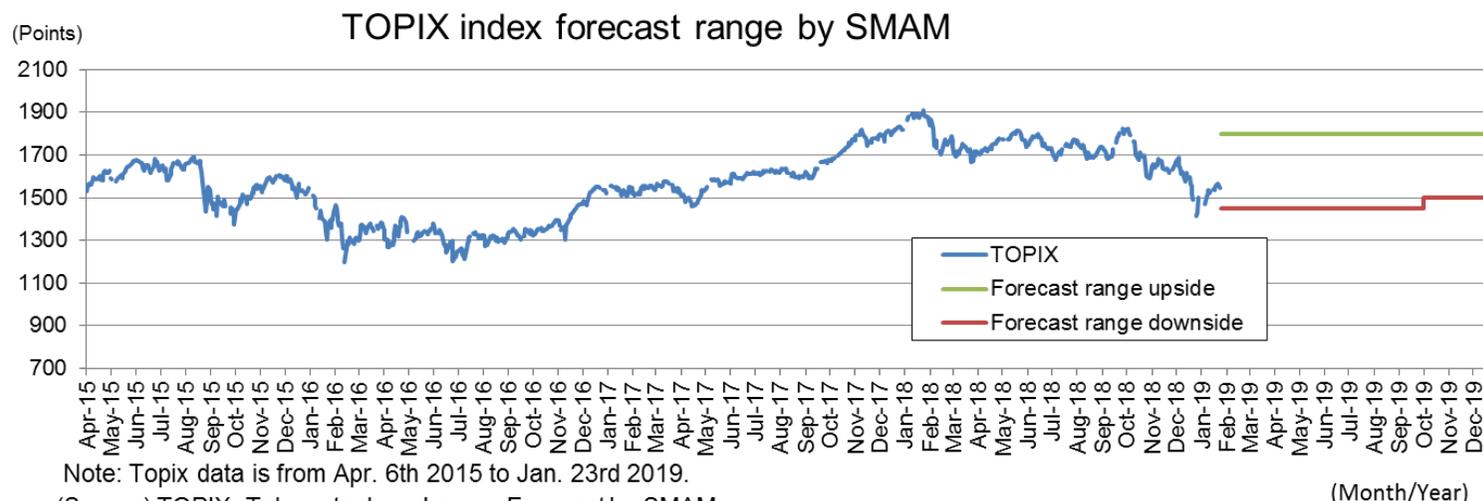
Stock market outlook: Power struggle between US and China weighs on the global stock markets

SMAM short-term view

- Global stock market is on a tug of war between risk-on and risk-off. Negatives are the fears that US economy could heading to a cyclical downturn in 2019 and Chinese economy is falling into a serious trouble. Positives are any possible easing of US-China conflicts and also that central banks are getting cautious in normalizing monetary policies. Japanese stock market has upside room for further rebounds if positives win, meanwhile downside could be supported by low stock valuation.

Longer-term outlook (6-months and beyond)

- SMAM's main scenario for the global economy expects that US economy keeps growing in 2019 despite slight slowdown. Increasing fiscal spending on infrastructure can be expected in China, Japan and US, which could extend the current global economic expansion phase. US-China trade dispute goes on and struggles in technology field intensifies, which lingers on the Japanese stock market. Current low stock valuation has room to be adjusted upwards, however, slowing global economic growth will cap the upside for a while.



Note: SMAM's projection is as of 21st Jan. 2019 and subject to updates without notice.

Base scenario & Upside / Downside risks for our forecasts

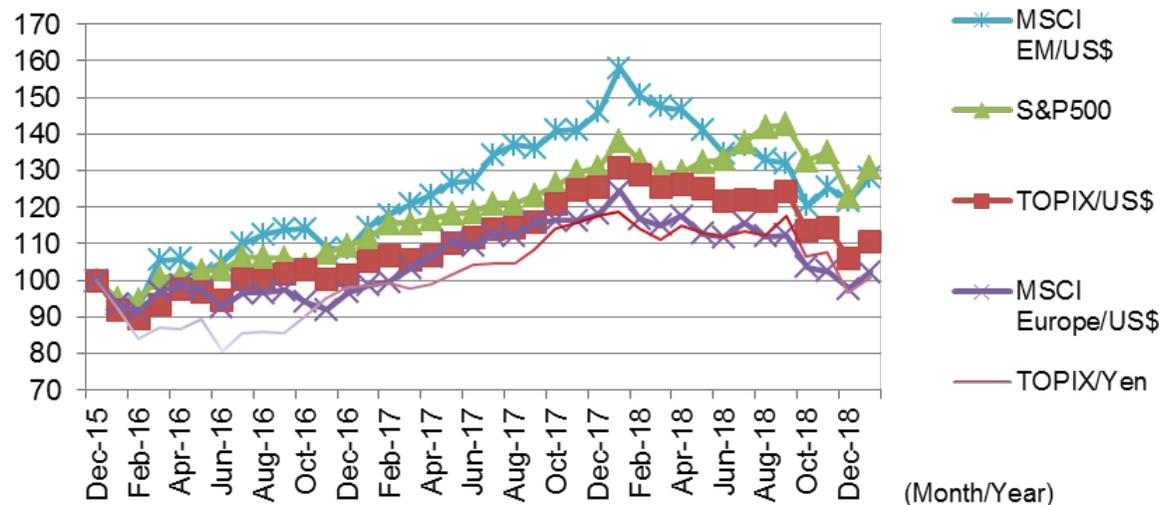
- Our **Base Scenario** is assuming the following views:
 - Severe tensions between US and China goes on, however, US is going to avoid making a fatal blow for the global economy.
 - US economy keeps growing despite possible mild slowdown. Recession in 2019 is avoided.
 - Japan's private consumption grows mildly supported by wage growth.
 - Japanese yen does not get extremely stronger beyond 100 yen against US\$.
 - Tension in the East Asia or Middle East does not get out of control.
 - Central banks avoid killing economic growth and adjust the pace of monetary normalization.
- **Upside Risks** include:
 - China makes significant concession in the trade negotiation with US.
 - Stronger-than-expected global growth.
 - Denuclearization in Korean peninsula makes a visible progress.
 - Japanese economy gets stronger than expected boosted by large fiscal spending.
- **Downside Risks** include:
 - US economy significantly slows down and puts global economy into a recession.
 - Chinese economy falls into a significant slowdown spreading negative shock globally.
 - Trade negotiation between US and China completely breaks up igniting a decades of power struggle.
 - Seriously escalating geo-political tensions in Middle East & East Asia.
 - Global monetary tightening intensifies to choke global economy.
 - Political turmoil flares up in US over the impeachment of the President Trump.
 - Populism gains in Europe further destabilizing EU.

Note: SMAM's projection is as of 21st Jan. 2019 and subject to updates without notice.

Global stock market rebounded in January so far

- Global stock market made a rebound in January 2019. US and emerging markets are leading the recovery so far. Stock markets seem to have gone too pessimistic late last year.
- FRB's monetary policy change and also increasing hope for the easing of tension between US and China are main supporting factors behind.
- How corporate financial results for Oct-Dec quarter come in and how stock markets react to the news is important for predicting direction of the stock markets in the short-term.

US\$ based performance of stock markets (Dec 2015=100)

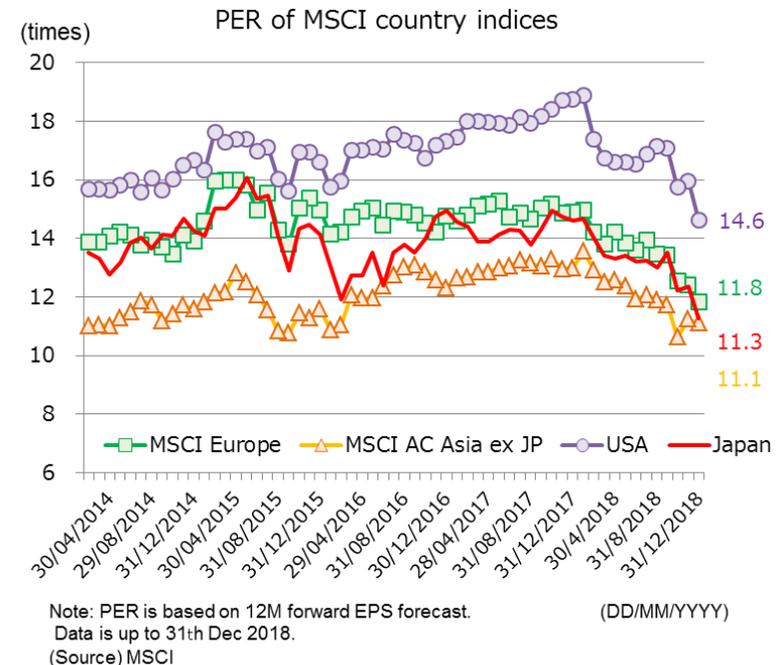
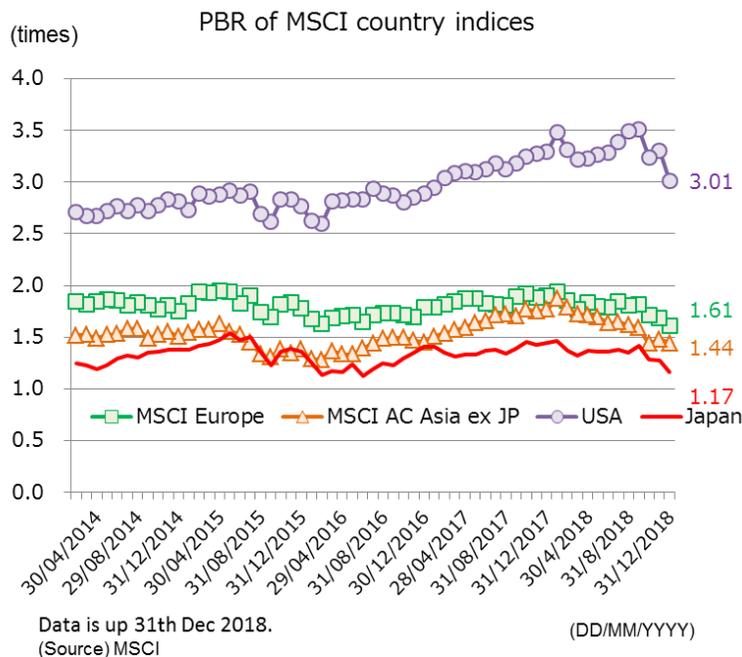


Notes: Data is up to 18th Jan. 2019.

(Source) Datastream, MSCI and Tokyo Stock Exchange, compiled by SMAM.

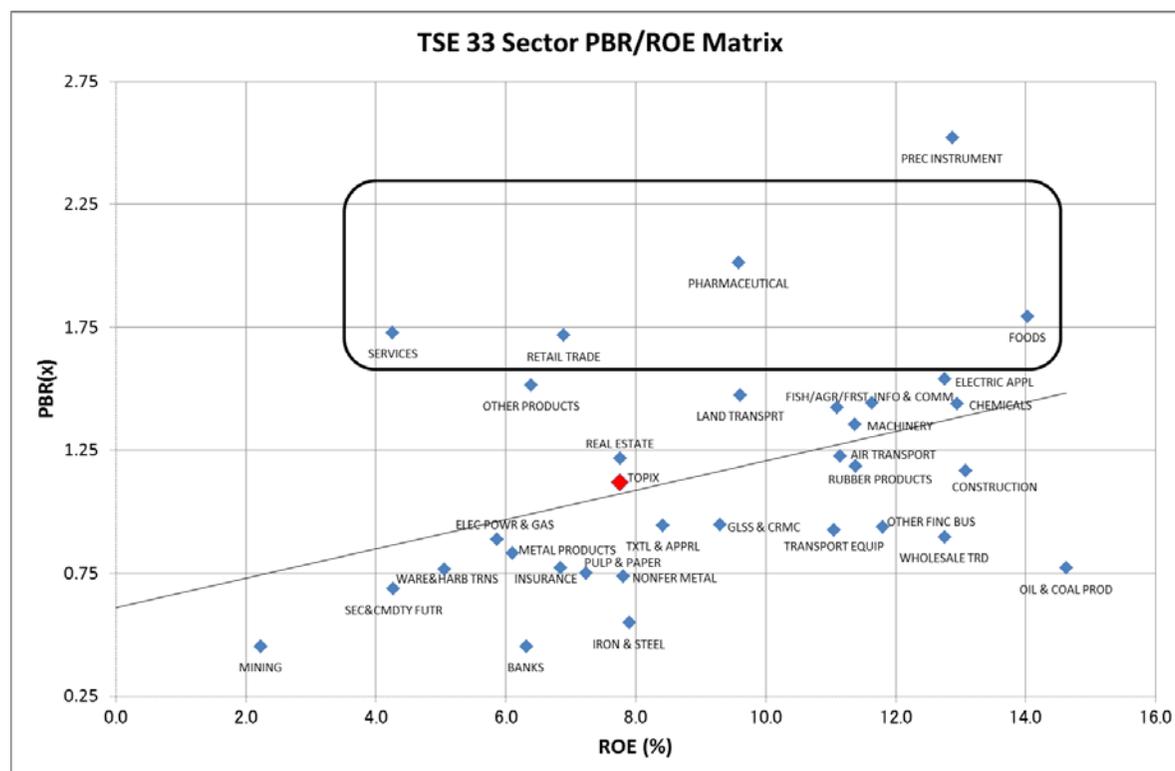
PBR for Japanese stock market is getting close to one

- Admitting that PBR (Price to Book Ratio) for Japanese stock market has been low due to insufficient ROE (Return on Equity) level, PBR could start working as a downside protection for stock prices if it dips deep below one.
- PER for major stock markets has moved down to more reasonable level and looks attractive if recession can be avoided and earnings do not collapse from the current level.



Stock valuation levels are widely dispersed among industry sectors

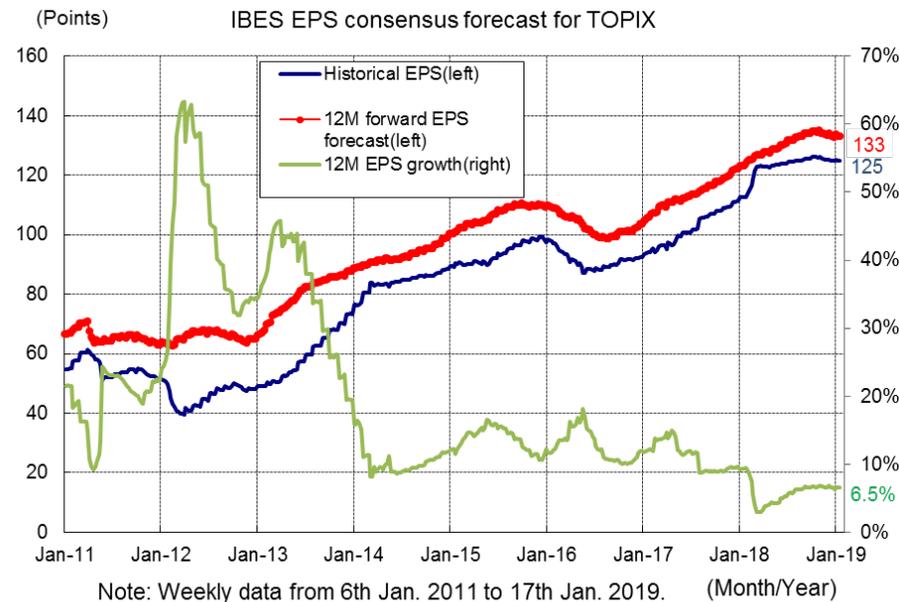
- PBR (Price to Book Ratio) for so called “defensive” sectors such as “Food” “Pharmaceuticals” “Retail trade” and “Services” are at very high levels compared to other sectors.
- This is supposed to be the result of popular Minimum Variance Portfolio Investing, which favors these low variance sectors, and also short-term portfolio shift by investors who became extreme risk-off.



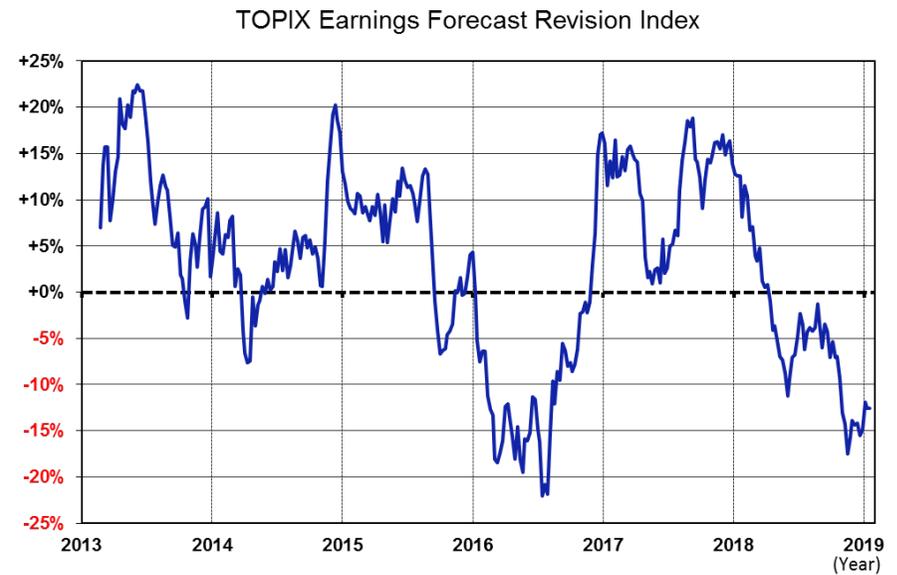
Note: Data is as of 4th Jan. 2019
(Source): Bloomberg

Consensus forecast for Japanese corporate earnings are facing down-revision

- Downward earnings forecast revision is continuing for Japanese equity. Similarity can be found between the down-revision in 2016 and the one this time in terms of period and depth. Deteriorating Chinese economy was in the background of the both occasions.
- If US-China conflict eases and Chinese economy start to strengthening again, earnings forecast for Japanese companies and also Japanese stock markets could make a sizable rebound.

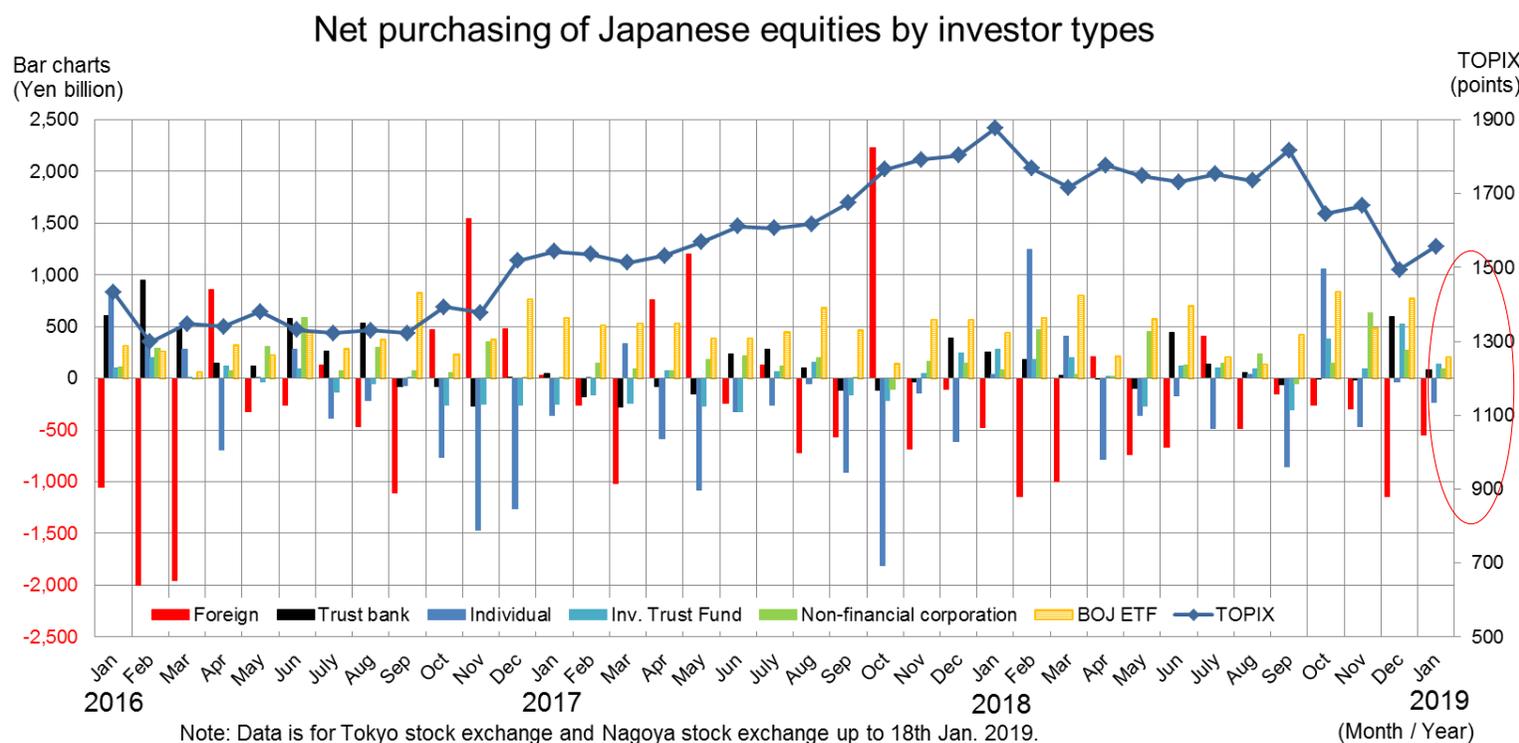


(Source) Datastream, IBES



Foreign investors keeps selling Japanese equities

- Foreign investors sold 5.4 trillion yens of Japanese equities in 2018, which was the largest annual net selling in the record since 1987.
- Domestic investors bought Japanese equities in Dec last year and so far in January this year. Considering IPO of Softbank Group's mobile business unit, which raised about 2.4 trillion yen and was not counted as buying in this statistics, domestic investors' buying was even larger.



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