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JAPAN EQUITY MONTHLY REVIEW

October 2017

Global Trade the Key for Japan

Market Review

The Japanese equity market moved upwards in September, with the TOPIX (w/dividends) climbing 4.34% on-month and the Nikkei 225 (w/dividends) rising 4.28%. Stock prices began the month lower on heightened risk aversion in response to growing geopolitical tensions after events such as a nuclear test by North Korea, as well as concerns that Japanese exporters' earnings would be negatively impacted by appreciation of the yen against the euro and the US dollar. Stock prices then moved upward from mid-month onward after better-than-expected US economic indicators spurred weakness in the yen against the dollar and prompted expectations for an additional US interest rate rise before the end of the year. In addition, stocks found further support from heightened expectations for new economic measures in Japan on news that the lower house of parliament would be dissolved and a general election called. Overall, 29 of the 33 TSE sectors posted gains during the month, including Mining, Oil & Coal Products and Rubber Products. In contrast, four sectors including Electric Power & Gas, Information & Communication and Iron & Steel declined.

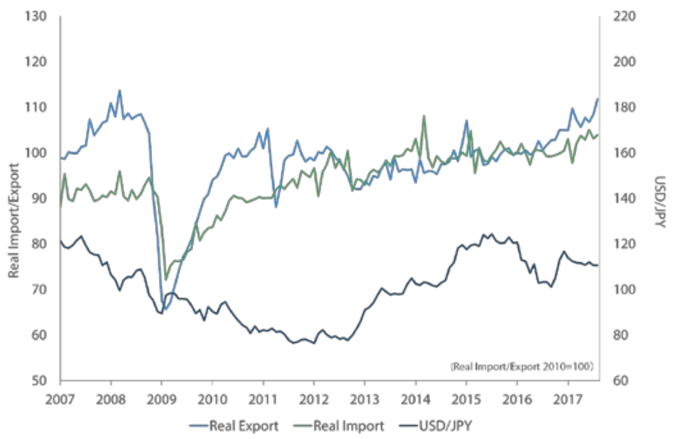
Exports improving on greater confidence

Real exports, reported monthly by the Bank of Japan (BOJ), have been increasing since 2012, with recent numbers reaching their highest levels since the 2007-2008 financial crisis.

And there is still considerable upside potential. While only production saw increases in 2016, there was a concurrent rise in inventories in the first half of 2017. This was the first time since the financial crisis that both indicators saw such growth, signifying greater confidence among corporates in their ability to sell more output.

Japanese economic indicators have improved significantly over the past few months, demonstrated through real export gains (Exhibit 1). Going forward, global aggregate demand will be a key to further progress.

Exhibit 1: Japan's real export volume growth



Source: Nikko AM, based on data from the Bank of Japan and other sources deemed reliable

Despite delays, Japan still on track to overcome deflation

Inflation growth remains somewhat slow. In 2016, Japan's consumer price index declined 0.1%. Although the forecast for 2017 currently projects positive price growth (0.3-0.4%), it falls well short of the BOJ's 2.0% target, showing what a significant challenge reaching that level will be. Japan's consumer price index for August 2017, the most recent figure available, shows that nationwide prices on all items rose 0.7% on year. While this is only a snapshot, we will closely monitor inflation over the next few months to see if the rate of growth can rise consistently.

Current trends seem to suggest that, even by late 2019, inflation will only have reached 1.5%. Japan is therefore unlikely to have surpassed the 2.0% target, and the BOJ will need to maintain its quantitative easing program for the foreseeable future.

But while price increases may be slower than in Europe or the US, Japan's economy is tangibly improving, so the inflation issue is really one of timing. We are thus confident that Japan's economic prospects for the coming year are quite solid.

From a policy standpoint, Prime Minister Shinzo Abe's recent move to dissolve the lower house of Japan's legislature and call an election unintentionally transformed the political landscape, as it resulted in Tokyo Governor Yuriko Koike launching the "Party of Hope". Some existing opposition parties quickly moved to cooperate with the new party with the goal of ousting the government. However, the ruling coalition of the Liberal Democratic Party and Komeito have long benefited from a fractured opposition, and it is unlikely that the new party will have enough time to be very effective. While the election may result in some market volatility, the intermediate impact of the government's "Abenomics" economic policies should remain as positive as it has been for the past four plus years.

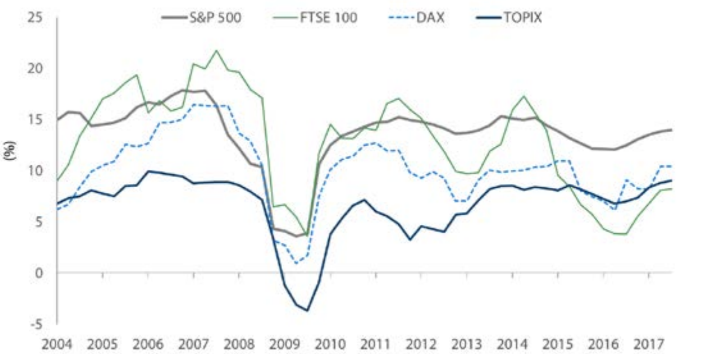
The markets are also hopeful that Haruhiko Kuroda will retain his post as BOJ Governor after his current term ends or that a likeminded official will succeed him, ensuring the maintenance of current monetary policies.

Continued corporate efforts should drive ROE higher

One major goal of Japan's revised Stewardship Code is an average return on equity (ROE) of 8%, which was already achieved in 2016. While this still falls short of ROE levels in Europe, it is clear that companies have improved their engagement with investors (Exhibit 2).

At this stage, a reasonable average medium-term ROE target is 12%, which is also the long-term average for European and US companies. However, in our view, Japanese corporates have not done enough to head toward that target, with the exception of noteworthy recent efforts of small and medium-sized companies.

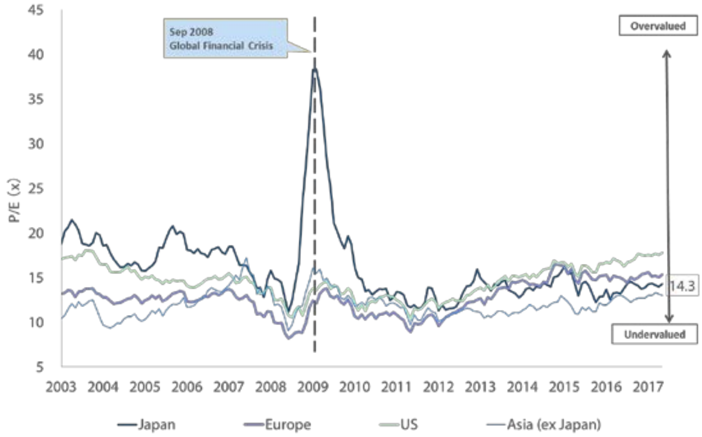
Exhibit 2: ROE comparison (1Q 2004 – 1Q 2017)



Source: Nikko AM, Bloomberg

Banks have also been making significant efforts to boost ROE, despite the adverse business climate for financial institutions. By about 2018, we should see ROE start to climb to acceptable levels. While growth in ROE may be frustratingly slow for some investors, progress is nonetheless under way. In the meantime, projected P/E ratios show that Japanese stocks remain considerably undervalued compared with those in Europe and the US, and there is considerable upside potential (Exhibit 3).

Exhibit 3: Projected P/E ratios* of Major Countries and Regions (End-May 2003 through End-May 2017)



Source: Nikko AM, Factset.
*Consensus forecast

Corporate confidence to fuel capex and wage growth

Sales and earnings will be important indicators for the near-term direction of the Japanese equity market. It is worth noting that while average sales decreased among TOPIX-listed companies last fiscal year, profits rose. This represents considerable progress, as profits had waned amid dwindling revenues in previous years. Many companies are now set to announce record earnings for the first half of this fiscal year. One important benefit of such improvements is that they drive confidence among corporate managers, which partially explains why inventories have recently been on the rise.

Greater confidence also leads to companies boosting hiring and offering more overtime work, as well as increasing capital expenditure, which was painfully sluggish in the years following the financial crisis. In our view, now is an opportune time for management to boost such spending. Japan has experienced major labour shortages in the past few years, but wages have failed to rise because confidence has been low. Expectations for improved sales and earnings figures should drive confidence and fuel higher wages. Competition for talent has already increased significantly this year. With the labour market tightening up, wages will inevitably climb in lockstep with rising confidence among managers.

And there are signs confidence is growing. At the start of October the BOJ released its "tankan" business sentiment survey for the third quarter, which showed very upbeat results. The index measuring sentiment among major manufacturers showed the confidence of these firms at its highest level since September 2007. The survey also found that large companies look to lift capital expenditure by 7.7% in the current fiscal year. Overall, survey results suggested that the underlying strength of Japan's economy is improving.

Going forward, it will be important to keep tabs on export numbers when evaluating new investments, including in the machinery, electrical parts, and electronics sectors. Investors would also be wise to look at first half results when they are released in October and November, which should provide indications of the viability of earnings forecasts for the rest of the fiscal year.

Another factor to consider is long-term interest rates, which seem more likely to move into positive territory next fiscal year.

Market impact of North Korea tensions should be limited

While North Korea's ballistic missile and nuclear weapons programs are a great concern, particularly for Japan, the market response to developments such as missile launches has resulted in a weaker US dollar (and therefore a stronger yen). This can ultimately be explained by concerns over supply shortages as missile launches interrupt marine transportation to China.

We believe that North Korea's main goal in ramping up tensions has been to get respect on the international stage. This means that missile tests will likely continue until the country is capable of launching a missile that can achieve atmospheric reentry. However, the situation is unlikely to deteriorate to the extent that it will dampen trade and global growth.

Poised for further advances

Our outlook for the TOPIX has been muted somewhat due to uncertainty related to Japan's elections. We look for the index to reach 1,720 by the end of December 2017, representing a yen-based return of 2.7%, and to reach 1,830 by September 2018, a return of 9.2%. These numbers are respectable, and fundamentals should drive even further advances. We also anticipate continued improvements in corporate governance, resulting, for example, in companies pursuing greater profitability and better shareholder returns.

Macro factors should also prove beneficial. Overall, the domestic economy is positioned to improve through 2018, particularly in the finance and retail sectors. Our outlook for the upcoming two quarters (October-December 2017 and January-March 2018) is that Japan's gross domestic product will grow an annualized 1.4%, fueled by consumer and corporate sentiment, with slower expansion in the subsequent two quarters (April-June and July-September 2018) of 0.9%. Another likely contributor will be improvements in net trade, which have started in April-June 2017, as the global economy grows.