Special Edition

For information only

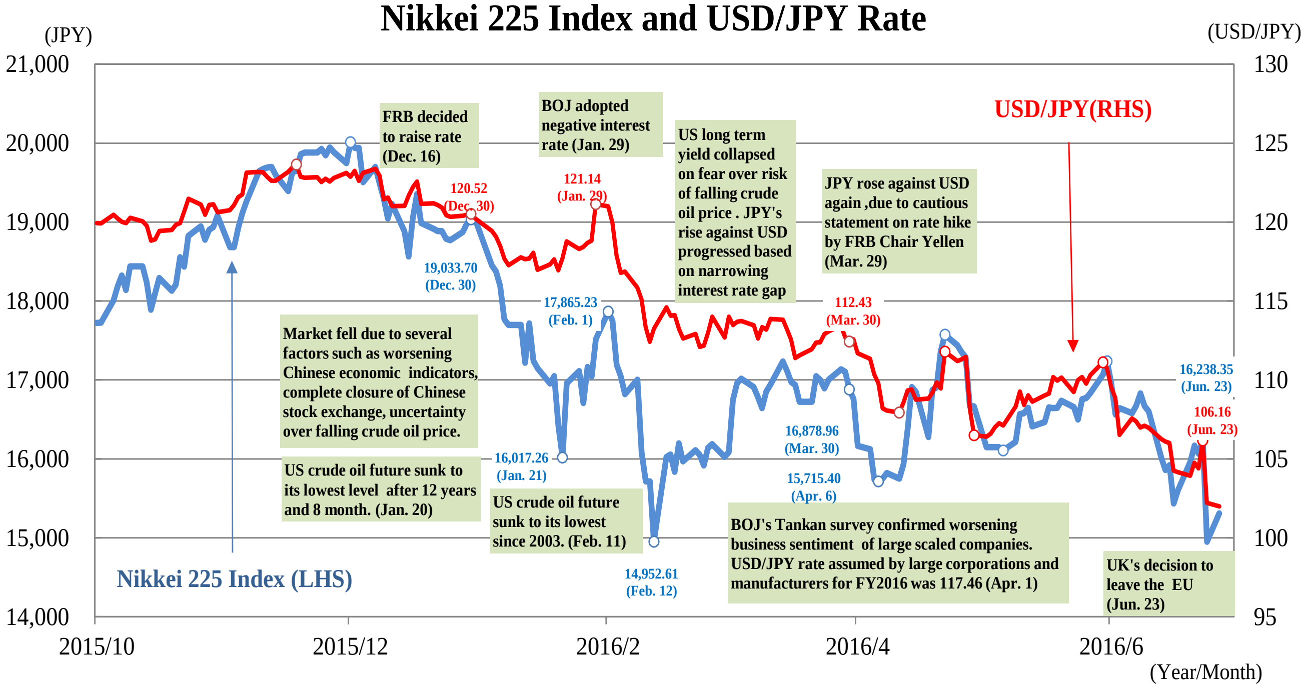
5 July 2016

Japanese Equity Market, Present and Outlook

1. Japanese equity market fell reacting to UK’s exit from European Union (EU)

- Japanese financial market was the first to be impacted amongst the global market by UK’s referendum choosing to “Remain” or “Leave” EU on 23rd June. USD/JPY rate saw a sharp appreciation of JPY, briefly fell below JPY100 reacting to mounting risk-off sentiment along with clearer predominance of “Leave” on 24th June.
- Nikkei 225 index also declined, reaching a new low of year 2016.
- In the beginning of the following week, US and European markets fell into further correction due to weaker Sterling Pound and falling stock prices led by financial companies, which deepened concerns over financial markets.

Nikkei 225 Index and USD/JPY Rate



(Note) Data period is from 1st October 2015 to 27th June 2016. (Source) SMAM, based on Bloomberg L. P. data.

2. Uncertainty over Europe is expected to continue

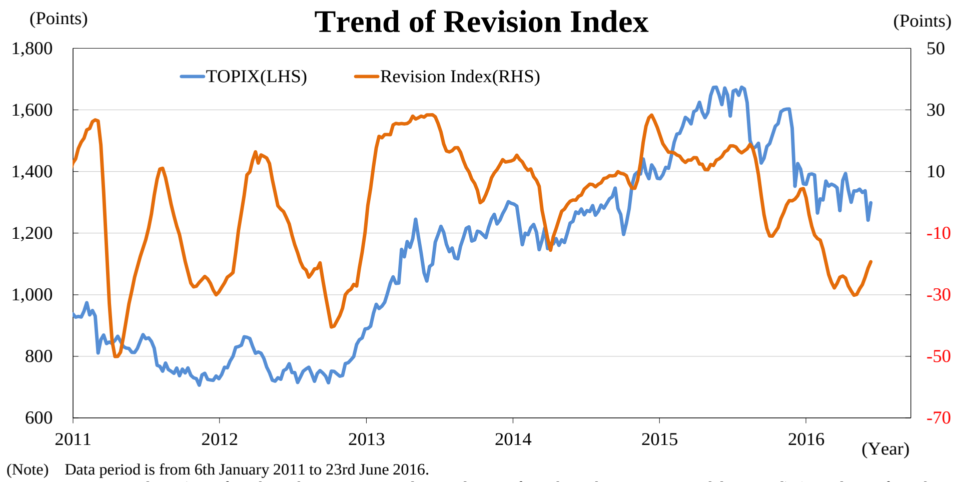
- Procedures for UK to leave the EU will be negotiated between the two parties down the road. EU indicates to toughen their stance against UK. At present, it is difficult to assess magnitude of impact on regional economies and corporate activities, as negotiation process is still not certain.
- Domestically, UK seems to be in a chaos as rifts within current government of Conservatives as well as within opposition party of Labours are rising to surface. Possibility of Scotland and Northern Ireland to seek for independence from UK may get higher. A major credit rating agency announced the down grade of UK Gilt.
- As above, uncertainly surrounding Europe will remain for sometime due to the shock of UK’s decision to “Leave” the EU.

3. The Most important issue is currency

- "Currency" is the key of Japanese equity market. This is because currency volatility is likely to affect Japanese economy and corporate earnings as well as raising the risk of lowering investors 'sentiment.
- UK's leave from the EU is considered to be a "risk-off" factor, and accordingly, JPY tended to appreciate due to capital inflow as it is considered as a safe asset. However, not only JPY but also USD will see capital inflow, as a "risk-off" this time was originally occurred in Europe. Therefore, we think the risk is not that high of JPY alone to appreciate against all the other currencies.
- In terms of USD/JPY rate going forward, US economy, especially the US employment data due on 8th July, may gather more attention. Responding to UK's leave vote from EU, market's expectation is increasing that US is unlikely to raise interest rate for a while. In addition to deteriorating external factors, if US employment data is worse than expected, uncertainty over US economy may rise and lead to further JPY appreciation against USD.
- However, we see the risk of USD/JPY rate to widely move below 100 is limited, as US economy seems to maintain its growth momentum, though in slower pace, including employment growth, and also additional easing is expected in Japan.

4. Some factors might stop free fall of Japanese equity market

- Although Japanese equity market declined sharply affected by surge of JPY and across-the-globe equity price fall, earnings momentum (Revision Index) and equity price valuation are expected to work as an anchor for Japanese equity market to some extent.
- Revision Index of Japanese equity market is still below surface, however, we can observe signs of the index bottoming out. In addition, P/E ratio of Nikkei 225 index entered into "Undervalued Zone" again, due to the sharp fall of equity prices.
- Further deterioration of corporate earnings is a matter for a concern. If JPY appreciation accelerates further, corporate earnings are most likely to be revised downwards and there is a possibility that the Japanese equity market will remain unstable for sometime.

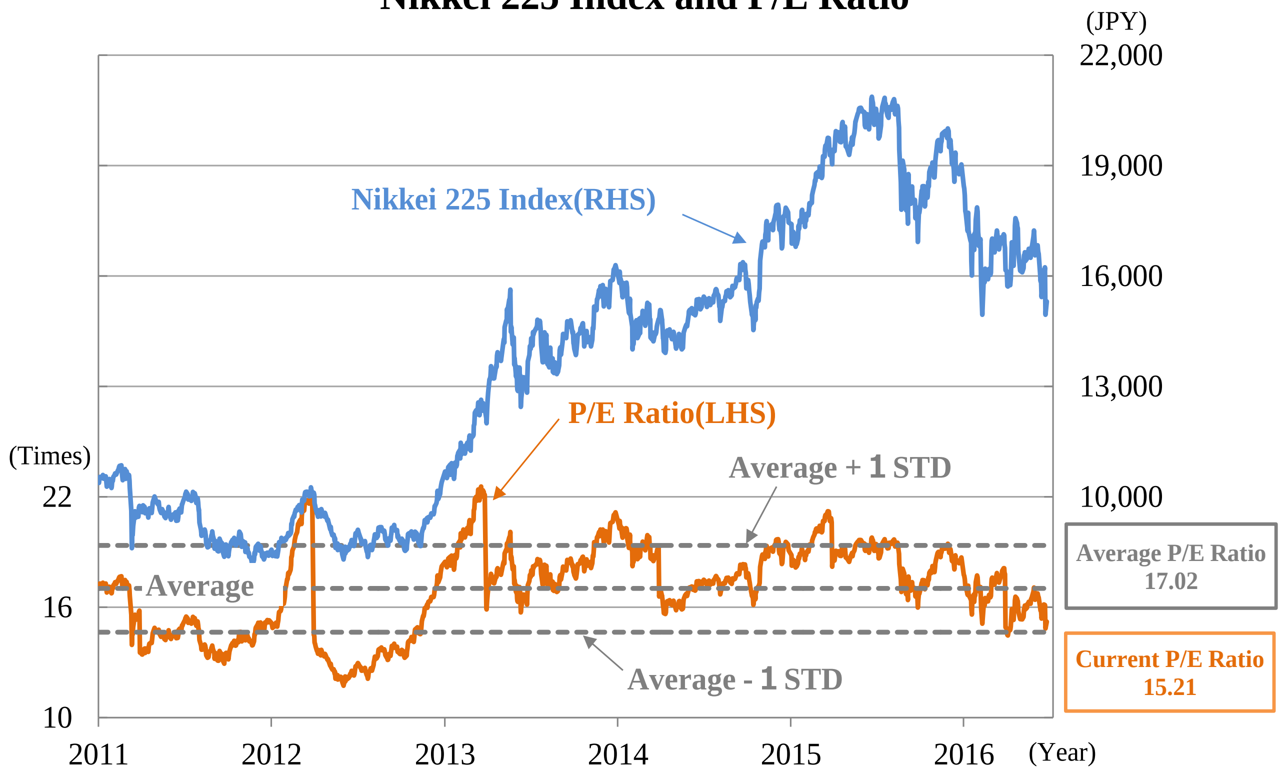


(Note) Data period is from 6th January 2011 to 23rd June 2016.
Revision Index = (No. of stocks with earnings revised upward - No. of stocks with earnings revised downward) / Total No. of stocks.
(Source) SMAM, based on Datastream data.

5. Future Outlook – The market awaits for catalysts

- Japanese equity is expected to remain range-bound for the coming few months because of uncertainty over external environment. We need to focus on economic indicators and monetary policy of both Japan and US as well as scale and contents of fiscal stimulus package in Japan.
- The chance of US interest rate hike within the current year will still remain, if US employment numbers scheduled to be announced on 8th July comes out rather solidly around 150,000. This will be a tailwind to Japanese equity, as risk of further JPY appreciation will be mitigated.
- Meanwhile, the possibility of additional easing and expansion of fiscal stimulus package is getting higher in Japan. If view on the Japanese economy and corporate earnings improves supported by these expectations, we can foresee the Japanese stock market to gradually move upward.

Nikkei 225 Index and P/E Ratio



(Note) Data period: 4th Jan. 2011 to 27th Jun. 2016. P/E Ratio = Stock price / Estimated earning per share. IBES estimate. Average P/E Ratio and Average P/E Ratio +/- Standard Deviation (STD) is calculated from Jan. 2011 to 27th Jun. 2016 (Daily basis).

(Source) SMAM, based on Bloomberg L. P. data.

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