



Japanese Stock Market Outlook

SMAM monthly comments & views
- December 2016 -



Sumitomo Mitsui Asset Management

SMAM

Executive summary

➤ Japanese Economy

SMAM revised GDP growth forecast for both FY2016 and FY2017 upward by +0.2% due to stronger than expected recent statics and considering pro-economic growth policies expected by Trump presidency. Forecast for Industrial Production in FY2017 was revised to robust +3.3% from the previous forecast of +2.7%.

- TPP is going to be scrapped at the hands of the Trump presidency, a significant blow to PM Abe's growth strategy. China is by far the largest counterpart of US trade deficit, however, extremely hawkish trade policy by US could still dent NAFTA countries, Japan, EU and emerging economies.
- Bond yields have sharply spiked almost globally after the US election results in November, which caused steepening of yield curves. Japanese government bond is also facing upward pressure on JGB yields, which Bank of Japan is trying to contain by intervening in the JGB market. Bank of Japan has placed an unlimited amount of JGB purchasing order at fixed rate for the first time on Nov. 17th.

➤ Japanese Stock Markets

Trump honeymoon rally is going on in equity markets of advanced economies and US\$ inspired by anticipated pro-business and pro-economic-growth policies. This trend could continue until the inauguration of US President Trump in January 2017. After starting Trump presidency, confrontational foreign policies and effects on global financial markets are going to be evaluated.

- Japanese equities will be supported by improving fundamentals in the long-term. Industrial production is gaining strength and private consumption is recovering. Corporate earnings momentum has turned upward in Jul-Sep quarter. Japanese companies are assuming around 102 USD/yen for FY2016, which is lower than current rate above 110 and could lead to substantial earnings up-revisions going forward.
- Japanese government started tackling notoriously long working hours and inefficient working practices in Japan. This could revive hope for social reform and PM Abe's growth enhancing strategy, which virtually lost credibility among investors.

Notes: Macro and market views are as of Nov 16th and 18th, 2016 respectively, and subject to updates thereafter without notice

Outlook for Japanese Economy

SMAM economic outlook for FY16-17

- SMAM revised GDP growth forecast for both FY2016 and FY2017 upward by +0.2% due to stronger than expected recent statics and considering pro-economic growth policies expected by Trump presidency.
- CPI forecast for FY2017 was slightly up-revised from +0.3% to +0.5%.
- Forecast for Industrial Production in FY2017 was revised to robust +3.3% from the previous forecast of +2.7%.

(YoY %)	FY12	FY13	FY14	FY15	FY16E	FY17E
Real GDP growth	0.9%	2.0%	-0.9%	0.9%	0.9%	0.9%
Private Consumption Expenditure	1.7%	2.3%	-2.9%	-0.1%	0.6%	0.5%
Private Housing Investment	5.7%	8.8%	-11.7%	2.4%	6.1%	-0.1%
Private Capital Investment	0.9%	3.0%	0.1%	2.1%	0.4%	1.0%
Public Consumption Expenditure	1.5%	1.6%	0.1%	1.6%	1.2%	1.1%
Public Capital Investment	1.0%	10.3%	-2.6%	-2.7%	0.3%	5.5%
Net Exports (contrib. to GDP growth)	-0.8%	-0.5%	0.6%	0.1%	0.3%	0.2%
Exports	-1.4%	4.4%	7.9%	0.4%	0.4%	2.3%
Imports	3.6%	6.8%	3.4%	0.0%	-1.2%	1.2%
Nominal GDP	0.0%	1.7%	1.5%	2.3%	1.1%	1.3%
GDP Deflator	-0.9%	-0.3%	2.5%	1.4%	0.1%	0.4%
Industrial Production	-2.7%	3.0%	-0.4%	-1.4%	0.9%	3.3%
CPI (excl. fresh food)	-0.2%	0.8%	0.9%	-0.0%	-0.3%	0.5%

Notes: E=SMAM forecasts. SMAM views are as of Nov. 16th, 2016 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

Effects of Trump policies on Japan

- Global financial market has switched to “Risk-on” mode after the result of US election won by Mr. Trump.
- Trump policies are pro-growth, pro-business and inflationary in US domestic side, which has boosted US stock markets and bond yields.
- Japanese stock market has received a tailwind meanwhile upward pressure on yields of Japanese government bonds has been countered by Bank of Japan trying to keep yields low.

➤ Positives

- Expansionary economic policy such as fiscal spending and tax reduction, to lift US and then global economic growth.
- Political gridlock is going to ease as the party of the President Elect takes majority of both houses in US Congress.

➤ Negatives

- Global free trade could be hampered causing downward pressure on global economic growth. TPP(Trans Pacific Partnership) is now unlikely to be ratified by US.
- Spillover of “Populism” to Europe could cause harmful effects on global economic growth.

➤ Uncertain

- Policy toward Asia region: Policy of international trade and national security. Any wobbling of US-Japan alliance could be negative. Seemingly successful first meeting between PM Abe and Mr. Trump on 17th November was positive.
- Whether US dollar strengthening, currently going on, can be admitted by Trump presidency.
- Whether political wheels of Trump presidency and US congress move in good tunes.

SMAM views as of Nov. 18th

How protectionist the US trade policy could become?

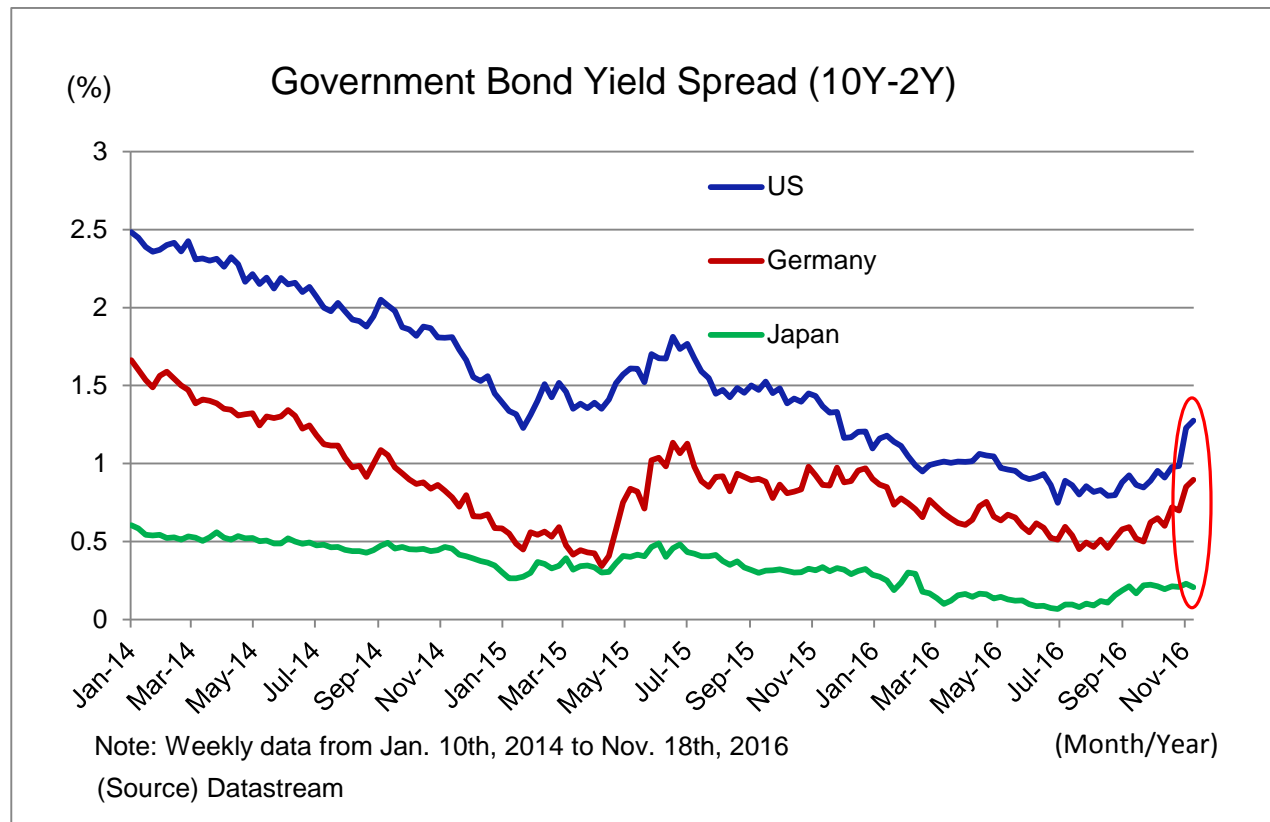
- TPP is going to be scrapped at the hands of the Trump presidency, a significant blow to PM Abe's growth strategy.
- China is by far the largest counterpart of US trade deficit, however, extremely hawkish trade policy by US could still dent NAFTA countries, Japan, EU and emerging economies.

	Counterparts	US trade deficits in 2015 (USD mil)	Share
1	China	337,014	43.8%
2	Mexico	89,259	11.6%
3	Germany	74,572	9.7%
4	Japan	62,798	8.2%
5	Canada	49,802	6.5%
6	Vietnam	30,214	3.9%
7	Ireland	29,029	3.8%
8	Italy	28,265	3.7%
9	Korea	27,616	3.6%
10	India	24,040	3.1%

(Source) IMF, Bloomberg, compiled by SMAM

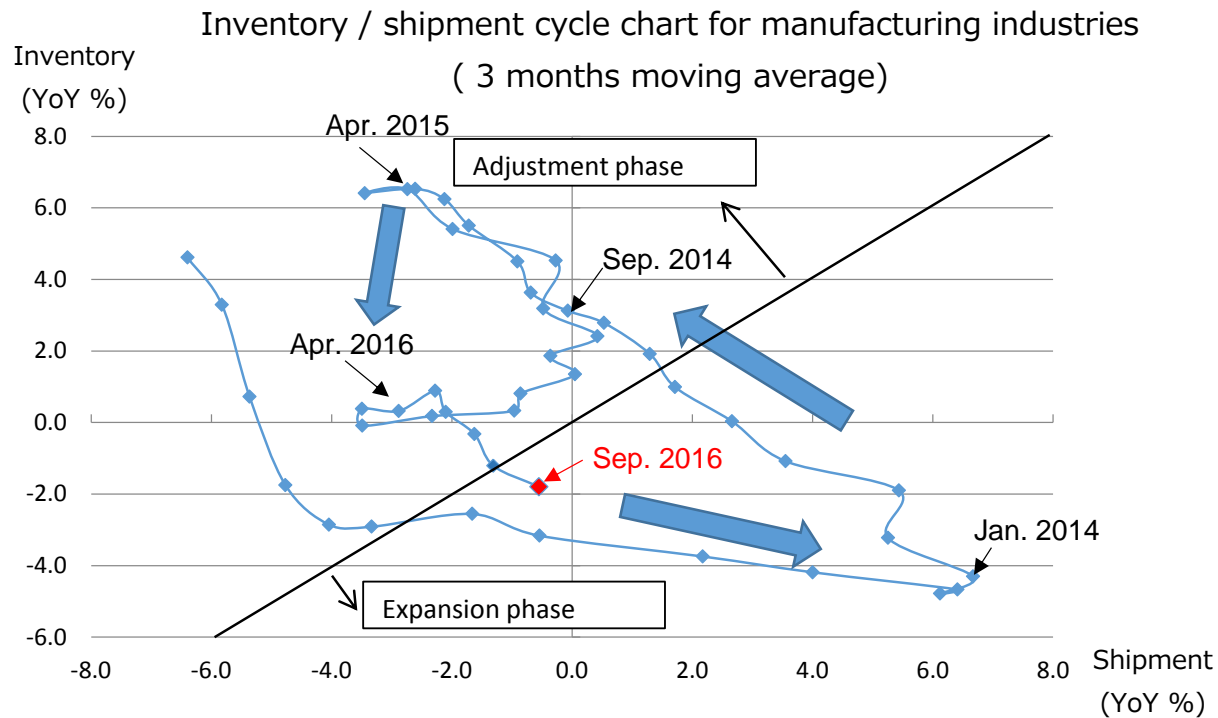
Bank of Japan is facing a test of its “yield curve control” policy

- Bond yields have sharply spiked almost globally after the US election results in November, which caused steepening of yield curves.
- Japanese government bond is also facing upward pressure on JGB yields, which Bank of Japan is trying to contain by intervening in the JGB market. Bank of Japan has placed an unlimited amount of JGB purchasing order at fixed rate for the first time on Nov. 17th.



Inventory / shipment cycle shows the production has entered in an expansion phase

- The chart is supposed to show anticlockwise movement.
- YoY Inventory growth started to fall since March 2015 and has shifted to an expansion phase by crossing the 45 degree line from left to right.

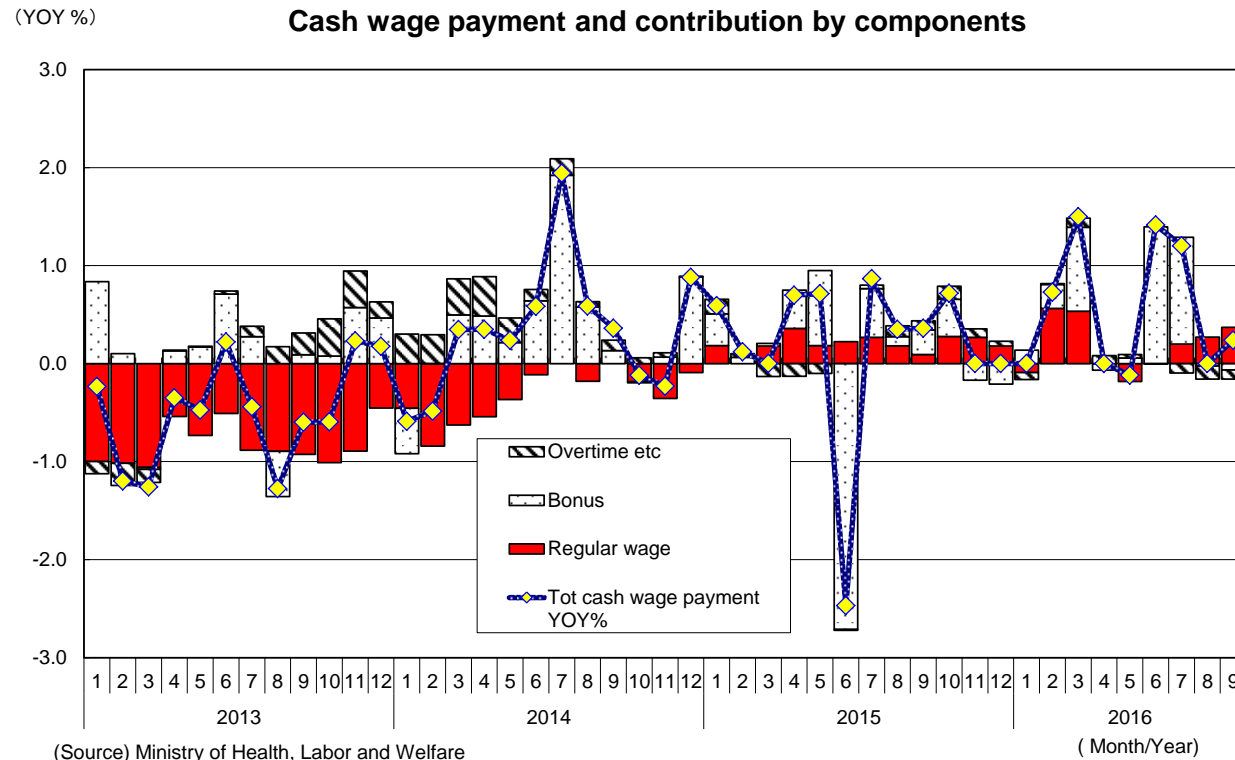


(Source) Ministry of Economy, Trade and Industry

Note: Data period from Jan. 2013 to Sep. 2016

Wage keeps mildly rising in Japan

- Since the beginning of 2015, regular wage payment has been mildly rising, which is supportive for consumer sentiment and private consumption.
- PM Abe has requested the industry leaders for raising regular wages at the Spring Wage Negotiation Rounds for FY 2017.



Outlook for Japanese Stock Markets

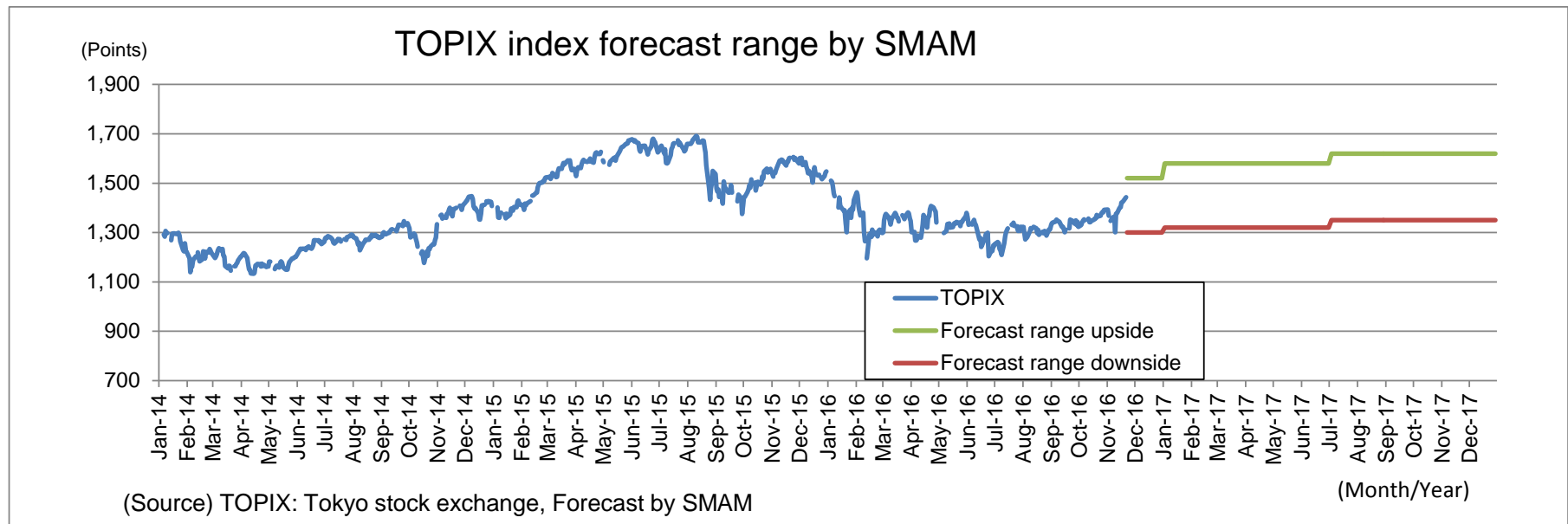
Stock market outlook: What could happen after the current Trump honeymoon rally ?

SMAM short-term view

- Trump honeymoon rally is going on in equity markets of advanced economies and US\$ inspired by anticipated pro-business and pro-economic-growth policies. This trend could continue until the inauguration of US President Trump in January 2017. After starting Trump presidency, confrontational foreign policies and effects on global financial markets are going to be evaluated.

Longer-term outlook (6-months and beyond)

- Japanese equities will be supported by improving fundamentals in the long-term. Industrial production is gaining strength and private consumption is recovering. Corporate earnings momentum has turned upward in Jul-Sep quarter. Japanese companies are assuming around 102 USD/yen for FY2016, which is lower than current rate above 110 and could lead to substantial earnings up-revisions going forward.



Note: SMAM's projection is as of Nov. 18th, 2016 and subject to updates without notice

Base scenario & Upside / Downside risks for our forecasts

- Our **Base Scenario** is assuming the following views:
 - Global economy does not enter into a recession.
 - Japan's private consumption to grow mildly supported by wage growth.
 - Japanese corporate earnings growth to gradually recover from the negative shock of stronger yen.
 - Fiscal stimulus and further monetary easing will be made to sustain economic growth in Japan.

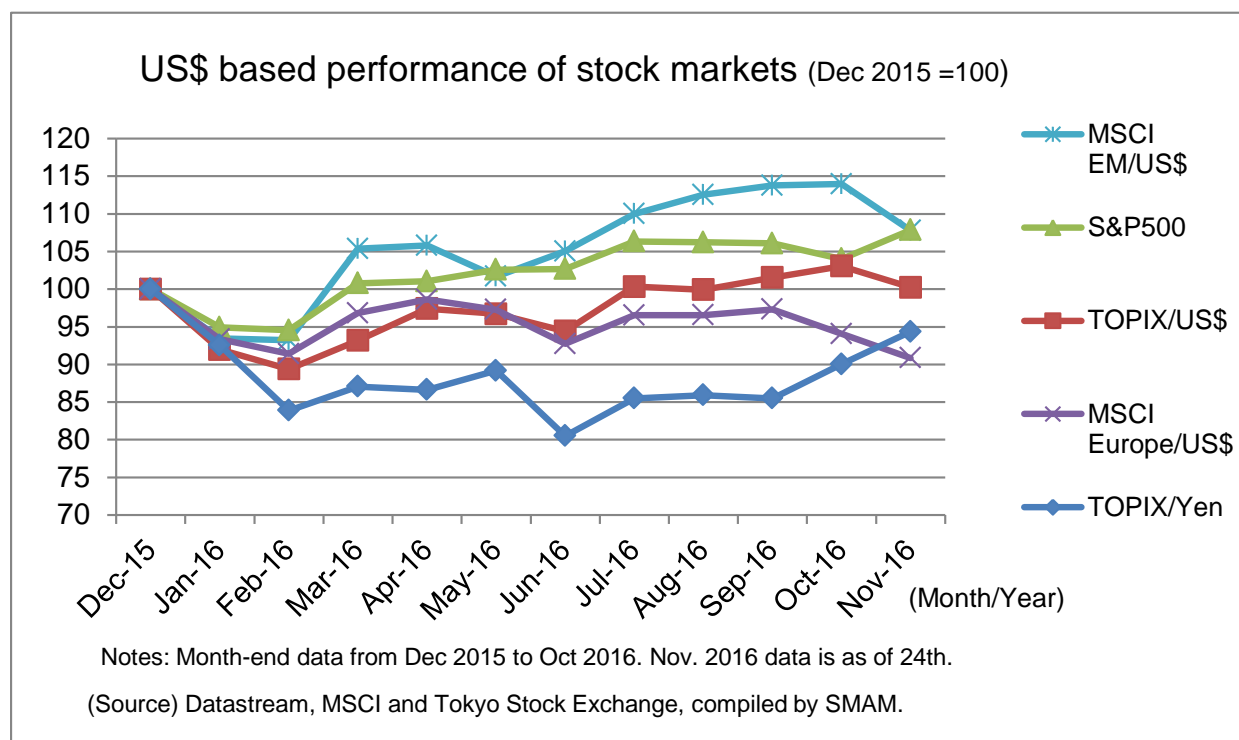
- **Upside Risks** include:
 - Stronger-than-expected global growth.
 - Stronger-than-expected measures by the Abe government.

- **Downside Risks** include:
 - Confrontational foreign policies taken by Trump presidency shake global trades and deepen geo-political tensions.
 - Populism gains in Europe further stabilizing EU.
 - Unexpectedly large impact from the process of US monetary policy normalization.
 - Concern over emerging economies including China.

SMAM's forecasts as of November 2016

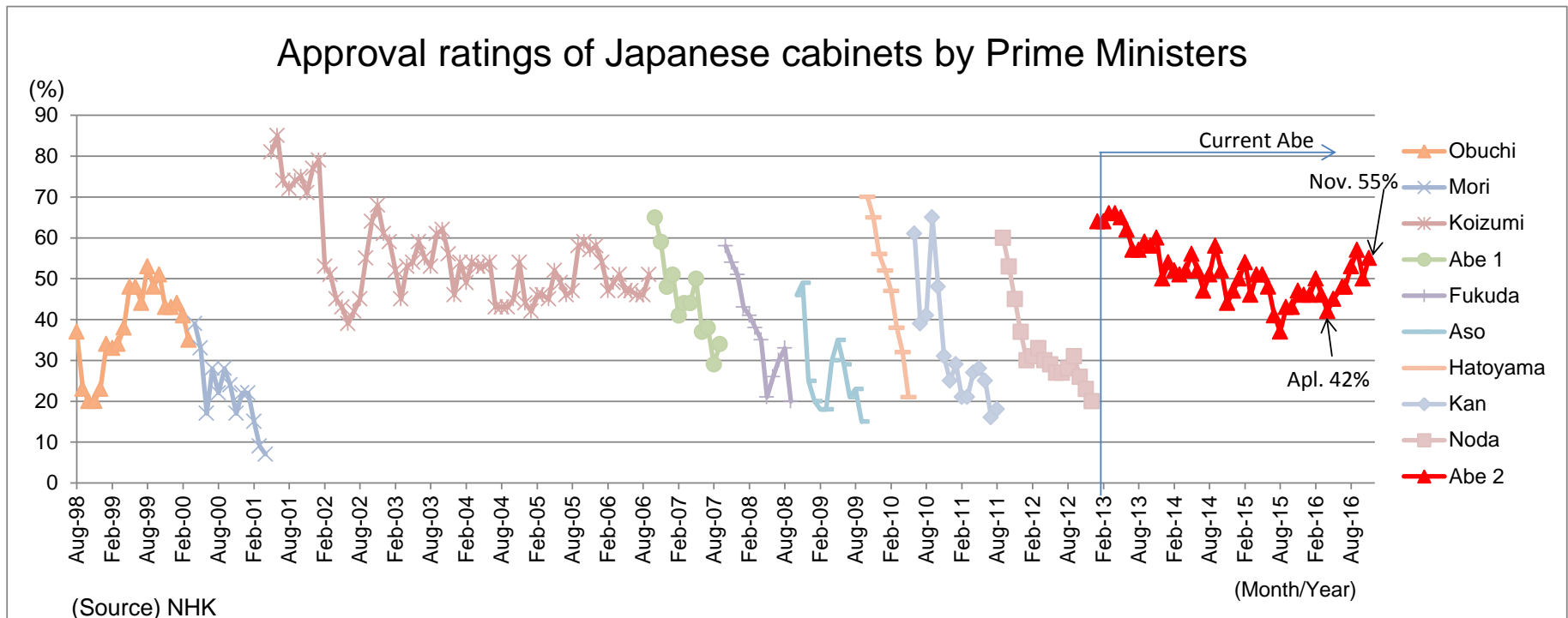
Sharp strengthening of US\$ has made US equities as the single winner in US\$ terms

- After the US presidency election won by Mr. Trump, US\$ has strengthened quite substantially. Comparing major equity markets in US\$ terms, US is the only market to have gained in November as of 24th.
- Even solid rise in TOPIX in yen terms has not been enough to compensate sharp decline of yen against US dollars. Emerging market equities are suffering from cash outflow.
- It is still uncertain how far this strong US\$ can be sustained considering hawkish trade policy expected from Trump presidency.



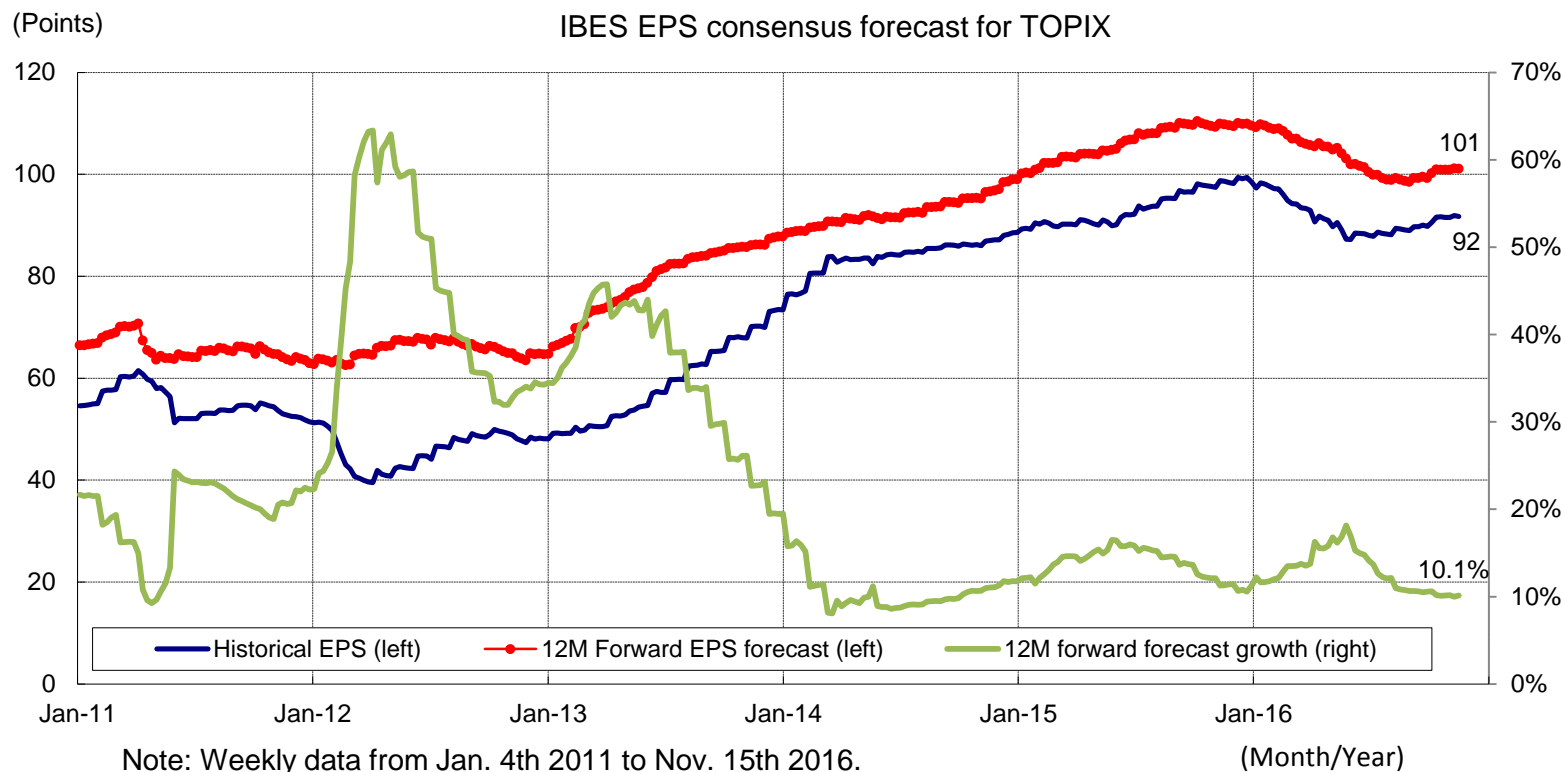
Political stability is an valuable asset for Japan

- Approval rating for PM Abe's cabinet was 55% in November, which was comfortably high when many countries are suffering political instabilities.
- Japanese government started tackling notoriously long working hours and inefficient working practices in Japan. This could revive hope for social reform and PM Abe's growth enhancing strategy, which virtually lost credibility among investors.



Earnings momentum keeps improving

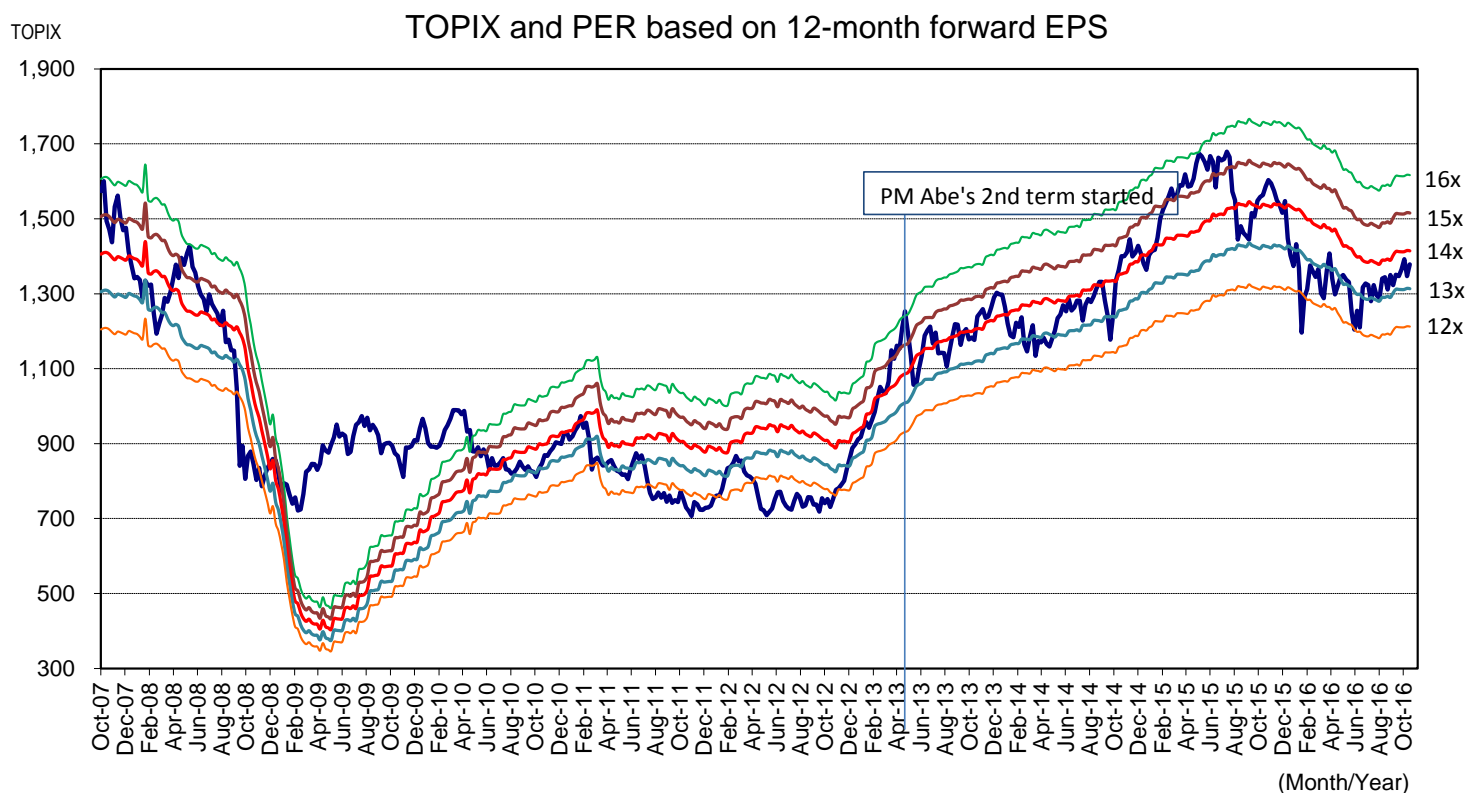
- 12M EPS forecast continues improving with the latest leading of 101 for TOPIX in November.
- 10.1% of 12M forward EPS growth is forecast .



(Source) Datastream, IBES

PER is in the lower half of the range for the current PM Abe's tenure

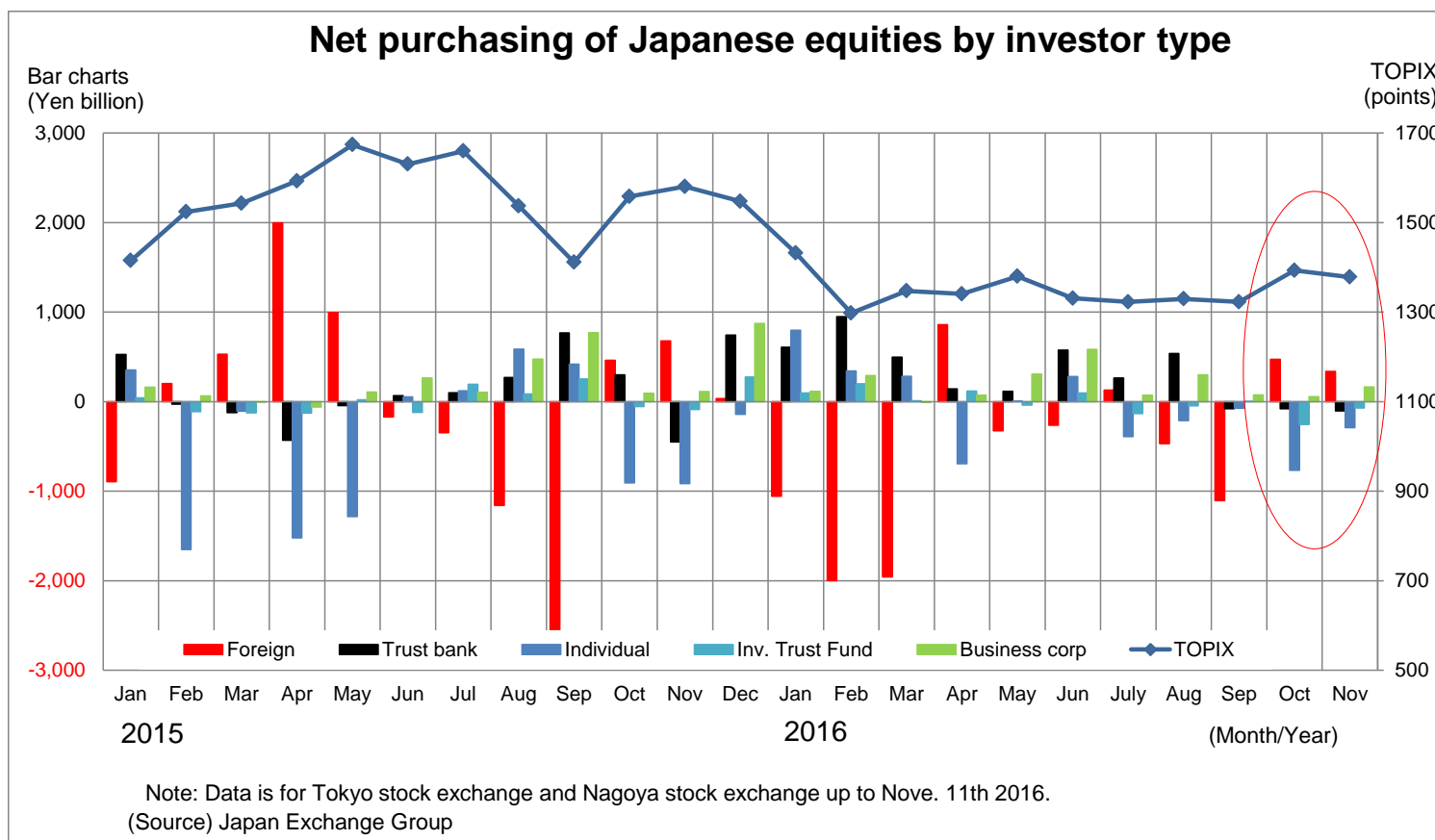
- Since Abenomics started, PER for Japanese stock market, TOPIX index-wise, has been in a range between 12x and 16x except for temporary overshooting.
- As of October 14th, PER for TOPX was 13.64x whereas comparative PER for S&P 500 was over 16x. Relative valuation of Japanese stocks looks attractive compared to US stocks.



Note: Data is weekly from Oct. 26th 2007 to Nov. 11th 2016. TOPIX was 1378.28 at the end of the period.
 (Source) Tokyo Stock Exchange, Datastream and IBES, compiled by SMAM

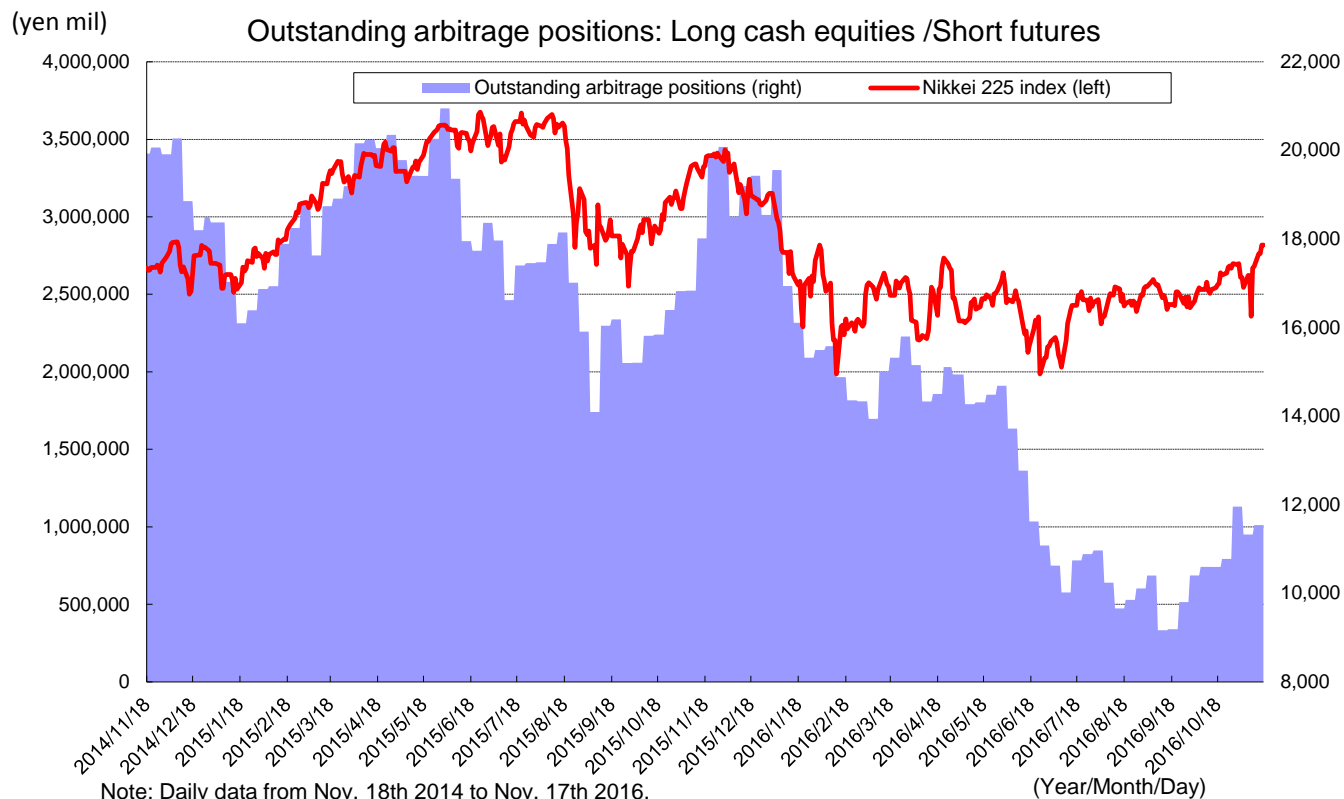
Foreign investors turned purchasing Japanese equities from October this year

- Short covering by foreign investors after the US election ignited the recovery of Japanese stock prices.
- Domestic investors have been selling Japanese equities so far except for constant share buybacks by business corporations.



Overseas investors money is flowing back to Japanese equities

- Arbitrage positions of “Long cash equity/Short futures” is referred to as an indicator of activities by overseas investors, mainly short-term ones.
- The outstanding position continued to decline since the beginning of this year, however, started to accumulate from the middle of September.



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