SuMi TRUST Monthly Commentary

July 2019

Stock Market Outlook

Four reasons why Japanese Equities should rally towards the year end

Summary
・A Sino-US clash was avoided at the G20. Global monetary easing and a rate cut by the Fed should dispel fears of a global economic recession
・Lower US rates do not necessarily mean a stronger yen; a tailwind for Japanese stocks
・Fiscal stimulus (Japan)
・Japanese equities are technically cheap
・The Nikkei 225 should test 24,000 by year end as the yen weakens gradually

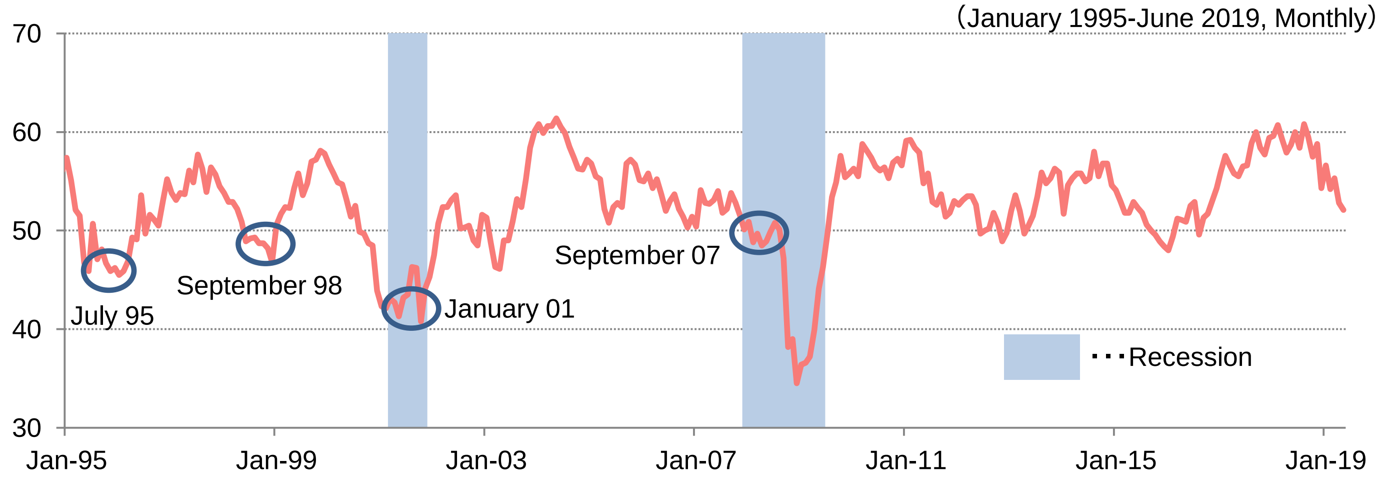
The S&P 500 hit record highs in June but Japanese equities have lagged global stock markets. The reasons for this are as follows: 1) Fears of a global economic slowdown with the Sino-US trade spat in the background, 2) Fears of a stronger yen as the US cuts rates, and 3) Fears of the Japanese economy slowing down as the consumption tax is raised. However, going forward we believe that there is a high probability that these fears will be abated.
Why we believe Japanese equities will rally in the second half of 2019:

1. Fears of a Global Economic Slowdown will be dispelled

At the G20 meeting held in June, the US held off on raising additional tariffs on Chinese goods and the two nations agreed to resume talks. The US also announced that it would lift partially its sanctions against Huawei. Thus it now appears that the worst may be over and that a further escalation may have been avoided.
Additionally, global central banks have been easing and the market anticipates a rate cut at the July 31st FOMC meeting. Recent indicators suggest that the US had not entered a recession as the latest ISM Manufacturing Report on Business held the 50 mark (a turning point in business confidence) Thus a Fed rate cut would indicate a preventive measure, as happened in 1995 and 1998 (when rates were cut 3 times) In those years, the US economy subsequently recovered. We believe the Fed will announce a rate cut as early as July and that the US economy will gain momentum towards year end, dispelling any fears of a global economic slowdown.

Figure 1. ISM Manufacturing business condition index and recession

(January 1995-June 2019, Monthly)



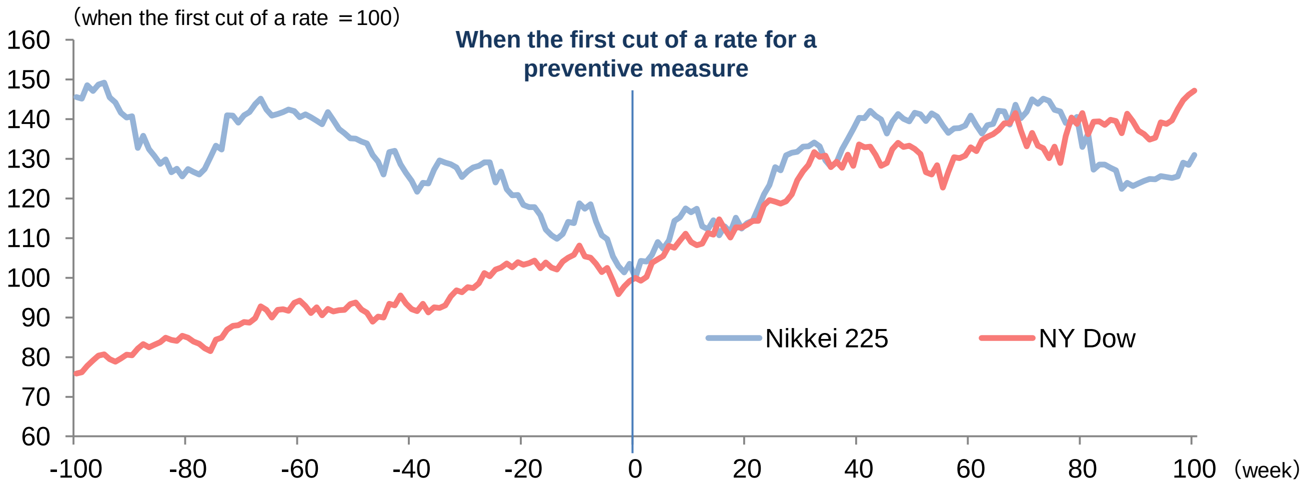
Source: Bloomberg. SuMi TRUST

2. Fears of a Stronger Yen will be dispelled

There are fears that the yen will strengthen as the US lowers its interest rates and the rate differential between the two currencies expands. However, we believe that any yen strength will be short-lived for the following reasons: (i) USD-JPY has traded in a narrow range around the 110 mark for the past 2-3 years as speculators have left the market, (ii) Short and long term rates in the US have been the highest among advanced nations. Even should the Fed lower the Fed funds by 0.5%, US rates will stay above Canada's policy rate of 1.75%, the second highest among advanced nations, (iii) JPY 60 trillion of high coupon (1% of more) JGB 10 year notes will be maturing over the next 3 years. This may exacerbate Japanese investor purchases of US fixed income securities, (iv) We expect the US economy to remain strong, (v) Receding geopolitical risks as seen in the June 30th US-N. Korea talks to resume denuclearization talks.

In reality, US (and Japanese) equities have rallied after previous preventive US rate cuts. US long term yields tend to be at their lowest before the first rate cut as the USD-JPY is left directionless. We believe that a preventive rate cut will limit the downside of long term rates and that global equities should rally as a result. Thus we believe that a sharp move upward in the yen against the dollar is highly unlikely.

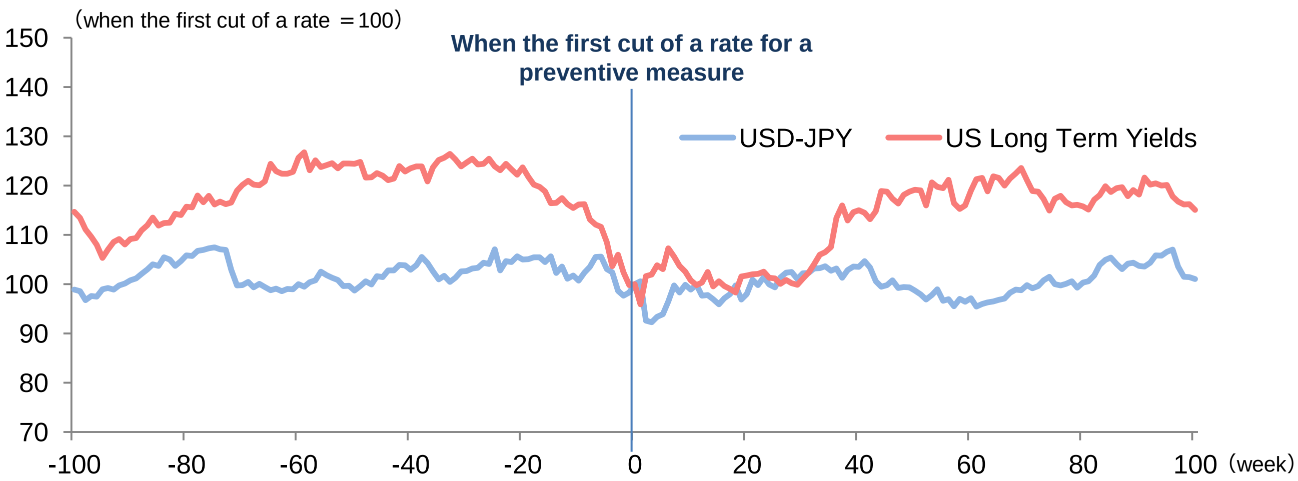
Figure 2. Japanese stocks when FF cut a rate for a preventive measure



The data is calculated based on figures of 1995 and 1998 when Fed cut a rate

Source: Bloomberg. SuMi TRUST

Figure 3. USD-JPY and Long term interest rate when FF cut a rate for a preventive measure



The data is calculated based on figures of 1995 and 1998 when Fed cut a rate

Source: Bloomberg. SuMi TRUST

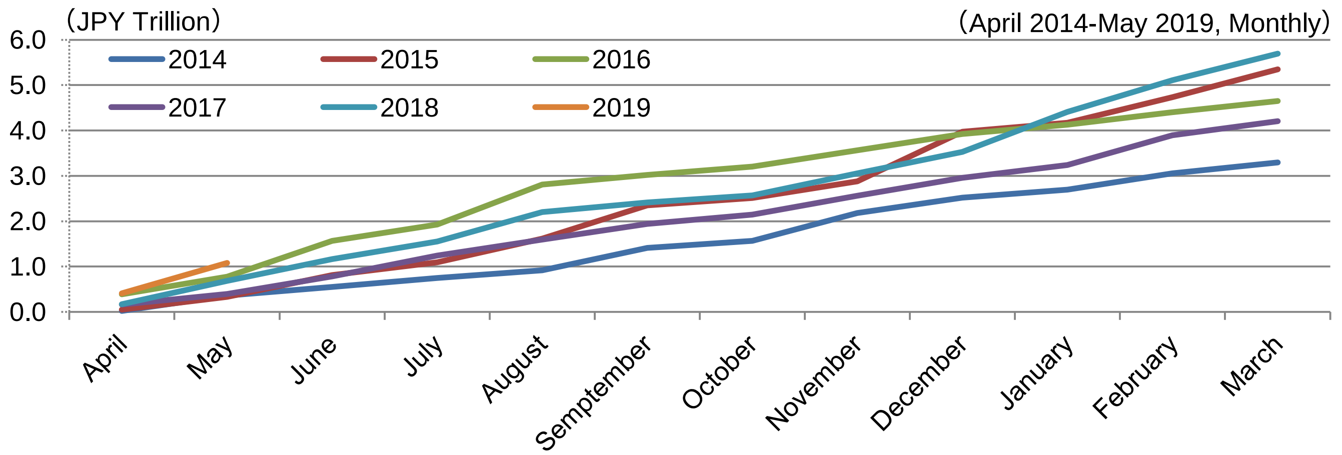
3. Japan - a large-scale supplementary budget

Japan's export sector and production have been sluggish of late. Moreover, consumer sentiment has also been experiencing a downturn. In the midst of this, the consumption tax will be raised in October. Prime Minister Abe has expressed the need for measures such as a supplementary budget to offset a recession as result of higher taxes. We believe there is a strong possibility that there will be a large-scale supplementary budget announced in late-2019.

4. Japanese equities – attractive valuations and strong technicals

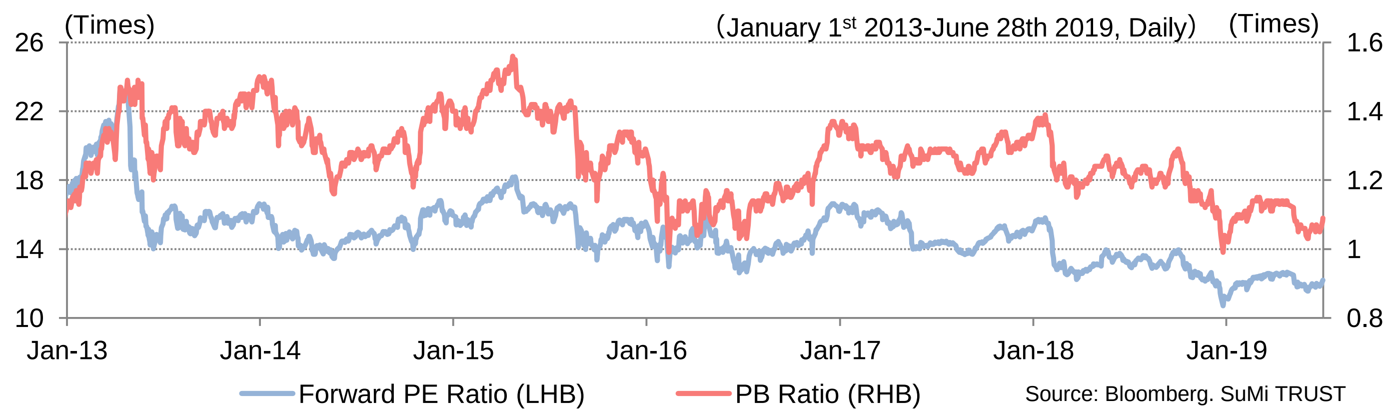
In the midst of governance reform, share buybacks by Japanese corporations have reached record levels. In addition, the Bank of Japan continues to purchase JPY 6 trillion of ETF's annually and may purchase more if needed. As such, the technical (supply-demand) environment for Japanese equities has been favorable. From a valuation standpoint, Japanese equities are very attractive with the forward PE trading at just 11.9 times and price-to-book at 1.06 times (as of 28th June)

Figure 4. Amount of Share Buy-back by TOPIX



Source: Bloomberg. SuMi TRUST

Figure 5. Forward PE Ratio and PB ratio of Nikkei 225



Source: Bloomberg. SuMi TRUST

Under the above scenario, we believe that USD-JPY will trade around the 110 level (a range of 105-112) and for the Nikkei 225 to rise to 24,000 (a range of 20,500-24,500) in the second half of 2019. We like the cyclical sectors such as Electric Appliances, Semiconductors, Precision Instruments. Whilst these sectors were looked upon with caution during the Sino-US trade spat, we believe that they will be favored towards year end as valuations are attractive and the global economy, led by the US, recovers. Conversely, we would avoid Banks. As global central banks ease, Japanese banks (especially regional banks) will bear the brunt of a prolonged period of ultra low interest rates.

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