NOMURA ASSET MANAGEMENT U.K. LTD. DECEMBER 2017

Japan – Reflections on 2017 and Market Outlook

Key takeaways:

1. Corporate earnings improving – forecast 15% growth for fiscal year 2018
2. Recovery underpins valuations despite macro / geo-political risk
3. Corporate governance change in Japan
4. Forecasting a return of 5% - 10% on Japanese equities between now and the end of 2018

Reported Earnings

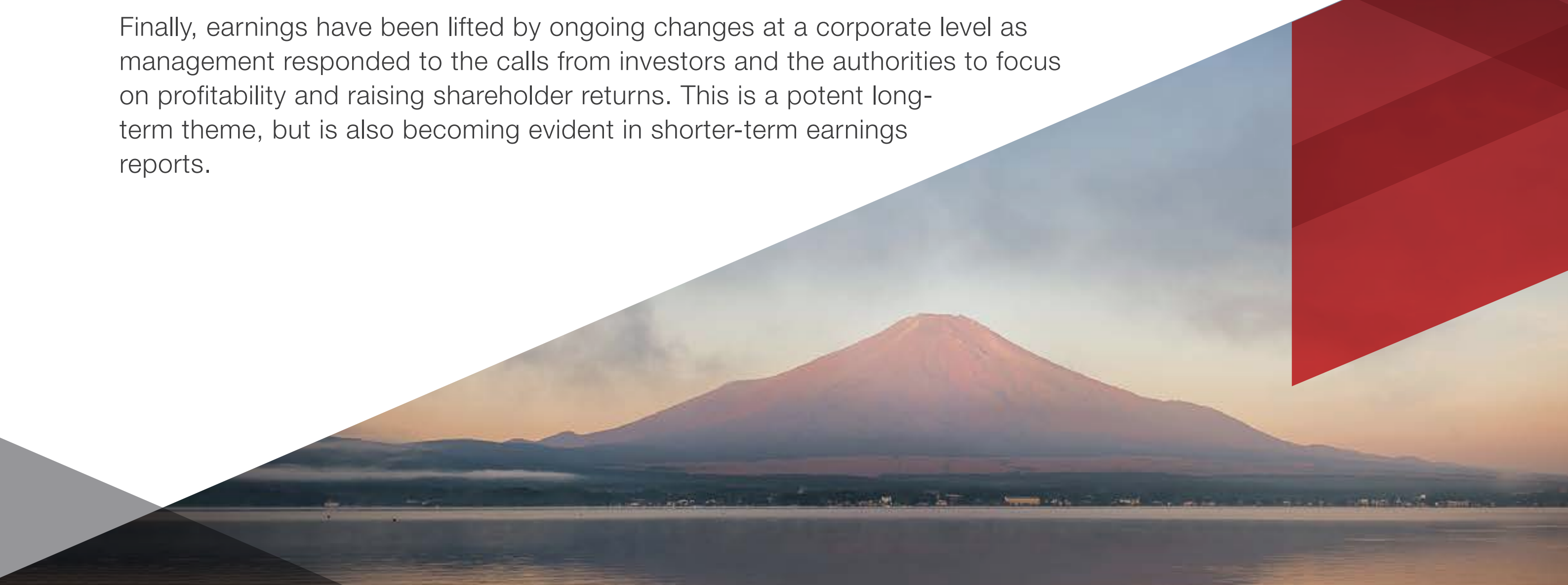
The Japanese equity market spent much of 2017 in a slow upward trajectory, punctuated by sharp corrections, most notably in April. Since September, however, helped by heavy foreign buying, the market changed up a gear and moved sharply higher.

For much of this year the market has struggled against wider geo-political concerns. These included the North Korean missile and nuclear weapons testing programmes, the uncertain outlook for global interest rates and Chinese growth, as well as domestic political concerns - at least until the resounding election victory of the ruling LDP in late October. Even in times of uncertainty, Japanese share prices have proved resilient and the correction in April proved short in duration. The key support for the market has been the positive and improving corporate earnings picture.

The recent reporting season, for the six months to September, produced interim earnings numbers that exceeded market expectations, forcing analysts to re-work their forecasts for the full fiscal year (to March 2018). Over 80% of companies reported their half yearly earnings: approximately 60% posted higher than expected revenues for April 2017 to the end of September and around 65% exceeded expectations for earnings (source: Bloomberg). For the last quarter alone pre-tax profits were up around 20%, with net profits beating consensus by around 10%. Upside surprises were concentrated in the commodity areas of the market (including the trading houses, which benefited from higher global prices), the industrials and exporters, particularly in the technology space, and selected cyclicals.

Strong overseas demand and specifically the strength of the ‘silicon cycle’ where Japanese companies are well-represented favoured Japanese earnings. An additional factor has been the relative stability of the key yen/ dollar exchange rate.

Finally, earnings have been lifted by ongoing changes at a corporate level as management responded to the calls from investors and the authorities to focus on profitability and raising shareholder returns. This is a potent long-term theme, but is also becoming evident in shorter-term earnings reports.



Earnings Outlook

Our central expectation is that the global economic recovery will continue even if there is some loss of momentum over the coming months. Therefore, we believe that any changes to monetary policy will be slow and steady with central banks keen to telegraph widely their near-term intentions to avoid upsetting foreign exchange and asset markets. Although the US Federal Reserve has begun to tighten and has now been joined by the Bank of England, the European Central Bank appears reluctant to change its stance significantly for the moment and the Bank of Japan has even less reason to change its accommodative policy position. Taken together it seems that in the absence of any unexpected inflationary spike, the excess liquidity environment, which has been so supportive to financial markets, is unlikely to change in the near-term. Looking ahead we remain optimistic on the outlook for the market.

Set against this backdrop and barring a major extraneous event, such as a spike in the yen, we expect the positive earnings trend in Japan to continue and this should support and drive equity prices for the rest of this fiscal year and beyond. For the fiscal year to next March we are forecasting year-on-year earnings growth for Japanese large caps excluding financials at around 15% with high single digit increases forecast for each of the following two years. Exporters and cyclical sectors are set to show the fastest earnings growth rates whilst domestic defensive sectors and financials are likely to report low single digit earnings growth over this period.

Valuations

We believe that the outlook for Japanese equities is positive, based on the combination of robust positive earnings momentum and attractive valuations. The forward earnings yield for the market is currently 5.8% which looks very reasonable relative to its history and also to other developed markets. The market also looks attractive on an income basis, with its forecast dividend yield approaching 2.0%, well above the 0.04% yield on 10 year Japanese government bonds. In addition, at the end of last month the market was trading at an undemanding multiple to the value of its assets, with a price to book ratio of 1.45. (Source: Nomura Research Institute, based on the TSE 1st Section).

Return Expectations

Combining the positive earnings outlook with an increasing focus on shareholder returns (which should lift the attraction of stocks beyond that of earnings progression alone), we expect a return of 5% - 10% on Japanese equities as a whole between now and the end of 2018. We feel that this is a conservative assumption without including any expansion of multiples. Indeed it is interesting to reflect that Japan is one of the few developed markets which has not seen a multiple expansion over the year as earnings have more than kept pace with stock prices. Hence in a relative sense the Japanese equity market has become more attractive. This fact alone leaves room for further upside.

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