

Fundamental Active Group PM's Monthly Insights

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Market Outlook

We expect moderate Japanese stock price rallies towards the end of the year as uncertainty over domestic political situations is disappearing, the coronavirus infection status is improving and sustainable corporate earnings growths toward FY2022 (ending March 2023) should be priced into the markets. While stock markets might suffer declines in the short term given long-standing supply shortages in the manufacturing industry, power shortages in China and the possibility of reaction to latest rallies, we believe stock prices will turn up again earlier than our initial assumption on expectations of fresh economic packages by the new Prime Minister (PM) amid receding risk of the ruling party's crushing defeat in the Lower House election on 31 October. Valuations of domestic stocks have remained low for a while, but foreign investors are likely to pump up purchases of domestic stocks from now on, becoming a net buyer of them given they have been taking underweight positions in Japanese stock.

Corporate Earnings

According to our in-house bottom-up earnings forecasts, ordinary income of domestic companies for the FY2021 and FY2022 will show a year-on-year increase of +38% and +8% respectively. Profits for the FY2021 should exceed those for FY2018, when they booked a record profit, by +13%. We upgraded our earnings forecasts from the ones set three months ago based on the view that earnings growths will continue in FY2022. The ratio of operating income to sales will hit the highest level since FY2005 with overseas demand leading the recovery and the ratio of sales and general administrative expenses restrained. The non-manufacturing sector is also expected to get back on the recovery path belatedly toward the FY2022 thanks to a progress in vaccination programs and the development of therapeutic drugs. While supply chain disruptions in manufacturing industries, such as automobiles, due to the spread of the coronavirus are sure to push down manufacturers' earnings in the near term, we assume that the impact of them on their earnings results for the full FY should be minimal.

Domestic companies are accelerating share buybacks this FY. We can expect a further increase in share buybacks toward the interim earnings season given their tendency to do so. They are also expected to increase dividends in the FY2021, up from JPY 14.2 trillion in the FY2019. We can expect an increase in shareholder returns on two fronts, namely the normalisation of shareholder returns with the reopening of the economy and the improvement of awareness on corporate governance in recent years.

Politics

Fumio Kishida formed a cabinet on 4 October after winning the ruling Liberal Democratic Party (LDP) leadership battle. The impact of the election result may look weak if we compare Kishida with other candidates, as Kono is a reform-minded politician and Takaichi upheld reflationary policies at the front. That said, we can expect a stable management of the government for a while. The LDP is likely to win a single-party majority in the Lower House election on 31 October, boosting the ability of the Kishida cabinet to implement policies. The P/E ratio tends to go up before or after the Lower House election on expectations of implementation of bold policies with the consolidated government base. The government is likely to announce additional economic packages ahead of the election given Kishida's pledge to adopt economic measures worth JPY30 trillion.

If he fulfills his promise, these measures should provide a boost to a reopened domestic economy towards the year-end. In particular, “aggressive infection control practices” by using vaccination certificates as well as “the resumption of GO TO travel campaigns (a policy in which the government subsidises up to 50% of travel expenses)” are considered as positive factors for stock markets. Currency and deposits held by domestic households reached a record high of JPY1072 trillion at the end of June, suggesting a huge potential for consumption growth at home.

Supply and Demand

Short-term players seem to have been the main buyer in the latest upward phase with the inflow of long-term funds expected from now on. While foreign investors were net buyers of domestic stocks during the rally in September, they were buying futures rather than cash stocks. We expect overseas funds will flow into Japanese stock markets, particularly into cash stock markets because we assume that long-term overseas investors still fairly underweight in Japanese cash stocks given the active weight of Japanese stocks in international equity investment funds is far below the benchmark.

Investment Strategy

Overweight sectors (largest shown first):	Underweight sectors (largest shown first):
Materials	Industrials
Information Technology	Consumer Staples
Financials	Real Estate

Sectors shown are GICS 11 sectors.

We take overweight positions in the information technology sector by investing in System Integrators (Sler) that benefit from a growth in digital investments by domestic companies and stocks whose semiconductor / healthcare segments are likely to achieve earnings growths.

We remain overweight in the materials sector as their valuations are still low and we can expect upgrades of their earnings results, while reshuffling issues in consideration of the sustainability of earnings growth. We remain underweight in the consumer staples sector while accumulating those that are likely to improve profitability by raising product prices. We also remain underweight in the industrials sector as we are concerned about the peaking-out of their order intake and shun a delay in their earnings recoveries.

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Mr Kamohara is the Lead Portfolio Manager of the Fundamental Active product. He started his career with Daiwa Securities in 1987 and transferred to Daiwa Institute of Research the following year to become a Japanese equity analyst. He was seconded to their Frankfurt office (between November 1992 and February 1995) and Hong Kong office (between February 1995 and March 1997) as an analyst for European and Asia equities respectively. He transferred to Daiwa International Capital Management, the former entity of Daiwa SB Investments, in 1998 to become a fund manager of international equities.

He became a Japanese equity portfolio manager in October 2000 and has managed the Fundamental Active product since its inception in October 2003.

Mr Kamohara graduated from Kyoto University with a BA degree in Educational Administration (1987).

Hideyuki TANIUCHI, CFA/CMA

Senior Portfolio Manager

Mr Taniuchi supports Mr Kamohara in managing the Fundamental Active product. He started his career with Yamaichi Securities in 1996. He moved to Nikko Asset Management the following year as a trader of equities, convertible bonds and FX. He became a senior portfolio manager of Japanese equity specialising in Growth stocks. He joined Daiwa SB Investments in June 2008 to support Mr Kamohara in managing the Fundamental Active product.

Mr Taniuchi graduated from Tokyo University of Science with BS/Engineering in Industrial Administration (1996).

Disclosures

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