Marketing Communication
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Value + Alpha Group

PM's Monthly Perspectives

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The MSCI Japan index went sideways as Fitch Ratings' downgrade of US Treasuries and concerns about the Chinese economy worked negatively, while the weaker yen and strong earnings results worked positively. As such, Japanese stocks were relatively firm while overseas stocks fell across the board. Fitch Ratings downgraded the US Long-Term Foreign Currency Issuer Default Rating (IDR) from AAA to AA+, which negatively impacted the Japanese market as the downgrade reminded the market of 2011, when a similar downgrade of US Treasury ratings led to a two-month sell-off of risk assets. In addition, Chinese economic indicators such as industrial production and retail sales, which missed analyst estimates, as well as prospects of bankruptcies of real estate companies, raised concerns about the Chinese economy. On the other hand, further depreciation of the Japanese yen against the US dollar and the fact that many Japanese companies announced relatively strong earnings results due to their product price hikes and cheaper raw material and fuel prices provided support for stock prices.

Economy: Japan's leading indicator declined, comments by survey participants on the deterioration of the Chinese Economy increased

The Japan Economy Watchers Survey (average of current and future), which we prioritise the most among the Japan's leading economic indicators, was 52.50 in August, down from 54.25 in July. Though the August figure is considerably higher than the average of the past and it would be one of the key reasons to judge that Japan's economic outlook is positive compared with other countries, the momentum of leading economic indicators is slowing down. According to the Japan Economy Watchers Survey comments, there are three points to explain the decline of the index, inflation, the deterioration of the Chinese economy, and the scorching heat wave.

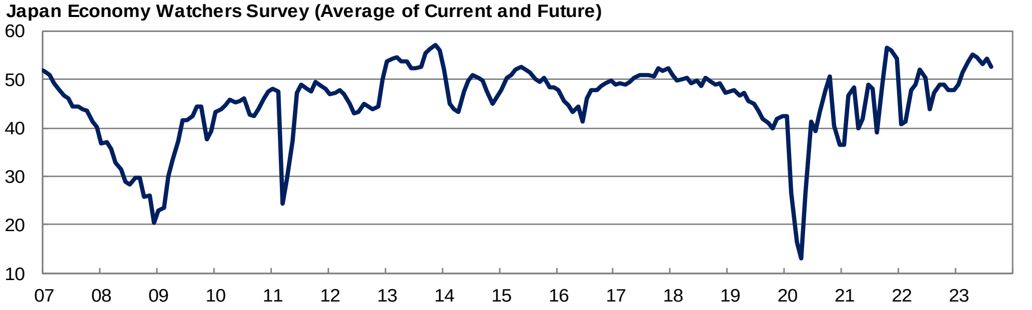
1) Inflation: Some survey participant's comments mentioned that the price hike of consumer goods, electricity, gasoline, and materials would cause consumers to reduce their consumption to protect their regular lives. Corporates may also hold back on recruitment and advertising due to increasing raw materials and fuel costs.

2) Deterioration of the Chinese economy: Comments included "We are concerned about the weak real estate market" (electrical machinery and equipment manufacturing industries), and "Shipments to China was cancelled across the board and possible further inventory adjustment is required" (transportation industry).

3) Scorching heat wave: There was a participant comment saying "Japan experienced a record-breaking heat wave in August this year, which caused elderly people to refrain from going out, that had a slightly negative impact on consumption".

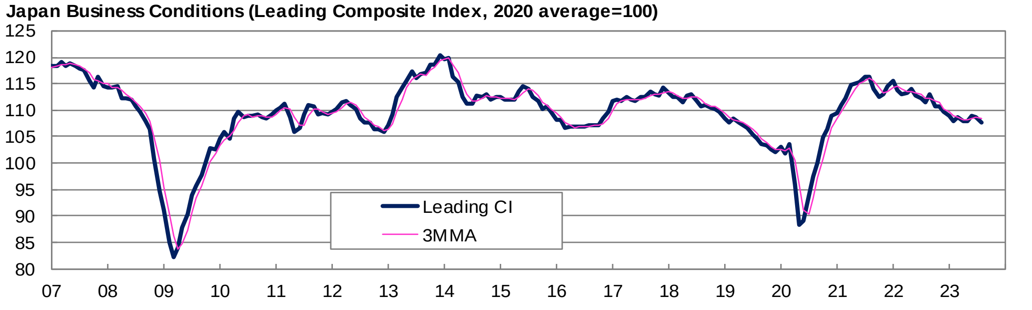
We think that 1) inflation is expected to slow down in the future and 3) the scorching heat wave is a temporary issue. But, as for 2) the deterioration of Chinese economy, it is a new phenomenon this month, which was not mentioned in previous comments. As this survey result is not in-line with the improvement on China's Manufacturing Purchasing Managers' Index (PMI) in August, we need to have a more cautious view on the future of the Chinese economy than before.

Also, regarding automobiles, we have an impression that the favourable situation continues as we see many positive survey comments such as the increase of production.

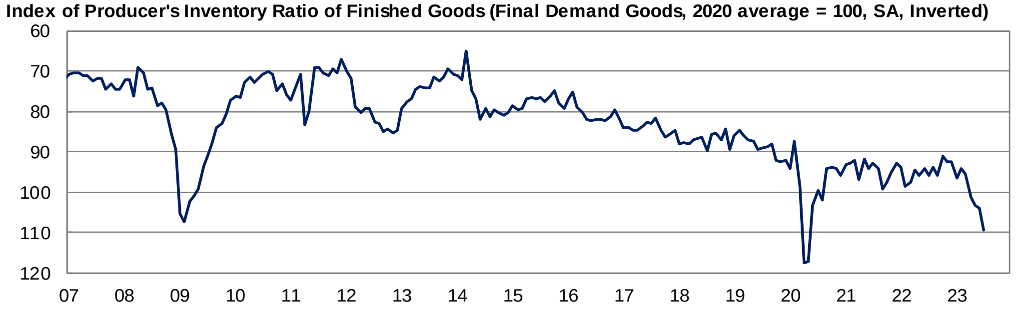


Source: Bloomberg, as of 8 September 2023.

The leading composite index of the Japan Business Conditions Survey, another Japanese economic leading indicator which is little less prompt but comprehensive, showed consecutive 2 months decline from 109.0 in May to 108.8 in June and to 107.6 in July. The main reason for the decline is the deterioration of inventory ratio of final demand goods.



Source: Bloomberg, as of 8 September 2023.



Source: Bloomberg, as of 8 September 2023.

CPI: Core CPI for Tokyo's Ku-area in August supports our view that core CPI will slow down YoY

The core consumer price index (CPI), which excludes fresh food, for the Ku-area of Tokyo rose +2.8% in August from a year earlier, slightly below the market estimates of +2.9%, slowing from a +3.0% gain for July. The core CPI had been on a decelerating trend, with some fluctuations, and came to its lowest level since September last year.

The Bank of Japan (BOJ) core CPI (all items, less fresh food and energy) for August was +4.0% YoY, in line with market expectations and unchanged from July. The BOJ core CPI had generally plateaued.

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An analysis of the YoY core CPI contributions for August versus those for July revealed that the largest monthly detractor was energy (-0.25 percentage points). The contribution of gasoline showed a rise, but the effect of falls in electricity rates and city gas rates was large. Food, less fresh food (-0.03 percentage points) and other goods (-0.02 percentage points) slightly pushed down the inflation rate. As such, cost-push pressures stemming from import prices have been gradually weakening.
In contrast, items of positive contribution include hotel charges (+0.05 percentage points) and other services (+0.01 percentage points). However, the former is affected by the institutional factor of the dissipation of the downward pressures from nationwide travel support. For the latter, changes are marginal and underlying inflationary pressures from services have subsided.
A mechanical estimation of the nation-wide core CPI based on the CPI growth in the items in the Ku-area of Tokyo and nation-wide item weights shows +2.9% YoY for August (+3.1% for July). It is below our economist estimates of +3.0%, but the difference is small and, thus, we believe the impact of the mechanical estimation on our inflation outlook is limited. Looking ahead, the core CPI is likely to follow a decelerating trend as cost-push pressures stemming from import prices further weaken. However, given the support of wage increases, core CPI is expected to take hold at the levels below +2% YoY in or after the middle of FY2024.

Investment Strategy

We expect that the Japanese equity market will move sideways in the short term due to the tug-of-war between a global economic slowdown and expectations of a change in the management policy of Japanese companies with a P/B ratio below 1x driven by TSE policy. Over the long term, policies that are more open to foreign capital, including improvement in corporate governance, as well as policies to boost the immigration intake, are likely to support the market. We identify external factors, such as the outbreak of financial crisis and global recession, as major risks, and we believe that the probability of such risk materialising is 50% or higher. Taking these into consideration, we will overweight low-P/B companies with large net-cash positions.

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Mr KAMIISHI joined Daiwa SB Investments in 2009 and covered US & European equities as a strategist from 2010 to 2013. He moved to Hong Kong in 2013 as an analyst for the auto & industrials sector in Asia Pacific ex-Japan equity. In 2015, he returned to Japan and covered the IT & services sector as a Japan equity analyst. In 2016, he became a portfolio manager in the Value + Alpha group.

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Note:
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