Marketing Communication
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Fundamental Active Group

PM's Monthly Insights

Authors

Hideyuki TANIUCHI, CMA/CFA
Senior Portfolio Manager and Group Leader

Market Outlook

We expect the stock market to be range-bound during the July to September quarter.

Having priced in many positive factors such as overcoming deflation and rising wages in the first quarter, Japanese stocks continue to lack new catalysts to boost the stock prices. Several uncertain factors are weighing on Japanese stocks, including currency volatility, cautions about a hawkish Bank of Japan's (BOJ) stance, rising domestic interest rates, weak domestic macroeconomic statistics, and national elections in major countries.

Despite these challenges, the medium- to long-term transformation story centred on overcoming deflation and reforming corporate governance remains unchanged. Therefore, we maintain our bullish stance on Japanese equities in the medium term. The BOJ is expected to raise its policy rate and start quantitative tightening, but Japan's real interest rates are currently at abnormally low levels. Although there are concerns about potential future interest rate increases, the rates will still remain sufficiently accommodative, and the impact on the domestic economy is expected to be limited.

The expected catalysts to boost stock prices are:
1. Upward revisions to corporate earnings forecasts
2. Upward revisions to capital investment plans
3. Real wage growth turning to positive and a recovery in domestic consumer spending

The corporate earnings guidance for the fiscal year 2024 are conservative as they were in previous years. The average USDJPY exchange rate in the April-June quarter was about 156, which was more than JPY10 higher than the assumption of listed companies (145 as the median). We expect the Japanese companies' April-June financial results to show solid performance, particularly among exporters. Since Japanese companies typically revise their annual forecasts following their July-September financial results, a full-scale upward revision will likely occur around in October-November. We expect the upward revision in earnings and shareholder returns to trigger a rise in share prices.

The BOJ's Tankan survey, released on July 1, revealed the companies' bullish stance on capital expenditures (capex) on the back of strong corporate earnings. Capex plans of large manufacturing companies for the current fiscal year were revised upward to +18.4% year-on-year basis. Software investment plans across all industries are expected to continue growing at a high rate of +14.8% YoY. Severe labour shortages are urging companies to invest more in digitalisation and labour-saving technologies. Companies started to invest their excess capital for their future growth, although the schedules are delayed due to labour shortages.

Note: Above stock names are for example purposes and SMDAM is not recommending or giving advice about these stocks.

Regarding real personal consumption, we have found several weak macroeconomic data. The real wage growth is said to turn positive in the second half of the fiscal year when inflation is expected to decline. Yet, there are still many concerns about whether higher wages growth will actually drive consumption. Despite these concerns, personal consumption will certainly improve from current levels. In particular, we expect an increase in consumption among the young and the affluent. The younger generation is said to have a high tolerance for inflation, as they have experienced rising stocks and real estate prices over the past decade. The wealthy are benefiting from rising asset prices. We anticipate a recovery in domestic personal consumption, adding to the expanding inbound consumption.

The entry of major foreign activists into the Japanese stock market is becoming more prominent. Improved corporate governance is also a significant factor to enhance earnings and expand the value chain of the Japanese companies. Until last fiscal year, the main topic of discussion was measures to tackle with price-to-book (P/B) ratios below 1x. However, major trading companies and **Toyota Motor Corporation**, whose P/B ratios exceeded 1x, announced large-scale share buybacks. Many industries, not only the non-life insurance sector, have been proactive in optimising their financial leverage through the sale of cross-shareholdings. If these companies accelerate their investment in growth, including the sale of unprofitable business units and the execution of overseas M&A strategies, we believe they will be able to achieve sustainable return on equity (ROE) improvement.

Investment Strategy

Overweight sectors (largest shown first):	**Underweight sectors** (largest shown first):
Communication Services	Industrials
Energy	Healthcare
Consumer Discretionary	Utilities

Source: SMDAM
Sectors shown are Global Industry Classification Standard (GICS) 11 sectors.

In the GICS sector, we keep on overweighting Communication Services, Energy, and Consumer Discretionary. Since there are no new investment themes or sectors that will drive the market, we will continue to focus on individual stock selection as we did last month.

In Information Technology sector, we will prefer semiconductor materials, electronic components, and HDD-related stocks that are expected to see earnings recovery in the future. We will also raise the weighting of IT services stocks, whose share prices have fallen due to temporary factors.

In Consumer Discretionary sector and Consumer Staples sector, we will increase the weighting of stocks with strong sales benefiting from increased inbound demand and the polarisation of domestic consumption. In Financials, we will overweight non-life insurance sector, which is expected to strengthen shareholder returns.

Meanwhile, we remain underweight Industrials and Health Care, as their profit growth rates are relatively subdued. Given our expectation that the Japanese equity market will move within a range, we will make haircuts on stocks that have rallied. Specifically, we will lower our weighting in stocks that are expected to post lower earnings for the April-June quarter.

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Hideyuki TANIUCHI, CFA/CMA
Senior Portfolio Manager and Group Leader, Fundamental Active Group, Equity Management Department
Mr Taniuchi 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 manage the Fundamental Active product and became the Group Leader in 2021.
Mr Taniuchi graduated from Tokyo University of Science with BS/Engineering in Industrial Administration (1996).

Contact Details

Business Development and Client Relations
For investors outside the EEA:
Richard HAXE: +44 (0)20 7507 6431
Alex BARRY: +44 (0)20 7507 6419
Chloé CHOQUIN: +44 (0)20 7507 6424
Email: uksales@smd-am.co.jp

Sumitomo Mitsui DS Asset Management (UK) Limited
100 Liverpool Street, London EC2M 2AT
United Kingdom
www.smd-am.co.uk

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