Company



Deutsche Bank Group

Global Markets Research

1 December 2010

## Japan Investment Strategy

# Japan set to be best performer in 2011

**Yen retreat to boost Japanese shares**
Investor sentiment should rebound with the gradual comeback in US payrolls. The degree of the profit recovery at Japanese firms remains large, and Japan looks to outperform other major markets in 1H 2011.

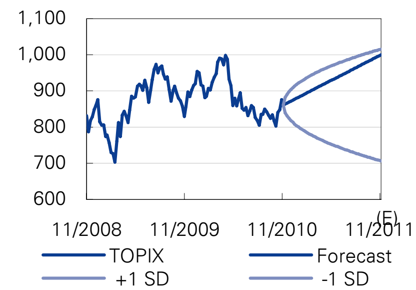
**Assuming gradual US uptrend**

**US payroll recovery should boost investor confidence**
A steady recovery in US payrolls should prompt hopes of a comeback in consumption, including housing investment. Upward pressure on the yen should also retreat and increase hopes of an expansion in exports. If indicators of a US recovery continue to emerge, TOPIX could bounce back rapidly in 1H 2011, possibly hitting 1,000 by the time of FY3/11 earnings announcements in May.

**Reasons Japanese stocks are set to be the best performers**
US job growth and rising yields should prompt an end to lagging Japanese shares. The low margins of Japanese firms should ensure higher profit growth than companies in other major countries. Japanese stocks tend to swing more widely than other markets. Moreover, Japanese shares are undervalued under our CROCI strategy, and valuations are attractive even when compared to other Asian markets. TOPIX is also undervalued based on its long-term trend. We anticipate an upward adjustment in levels in 1H 2011.

**Large cap and export-related shares likely to spearhead rise**
We believe that large cap and export-related shares will likely lead the index upward on hopes of a cheaper yen. Once the index has risen to a certain extent, investors should show greater risk tolerance and turn their attention to small caps, value and domestic-demand shares. With US rate cuts winding down and lingering concerns over rate hikes in Asia including China, we see little room for non-ferrous metals, trading firms and raw material makers to further outperform. Based on our analysts' opinions, we add Teijin and Mitsui Fudosan to the "top 10 stocks" (Figure 1) picked by our Strategist and remove Toray Industries and Mitsubishi Estate from the list.

| Our Forecasts Update | |
|---|---|
| TOPIX (30/11/2010) | 860.94 |
| 1-yr forward P/E (IBES) | 14.7 |
| 2-yr forward P/E (IBES) | 12.6 |
| P/B | 1.1 |
| Dividend Yield | 2.2 |
| TOPIX Target 12-mth | 1,000.0 |
| Est. Return to Target | 16% |




| Sector choice | For 3 mth |
|---|---|
| Consumer Discretionary | + + + |
| Health Care | - - - |
| Telecommunication Services | - - - |
| Utilities | - - - |

Note: + + += positive, - - - = negative

Source: DataStream, Deutsche Securities

| Related Recent Research | Date |
|---|---|
| *Corporate Japan in crisis: an Exit Strategy* | 26 Aug 2010 |
| *Europe, Japanese shares await US recovery* | 26 May 2010 |
| *EPS forecast changes and long-term TOPIX outlook* | 22 Jun 2010 |

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## Japanese equity market highlights

***Political and economic events***

Upward pressure on the yen has weakened since the Fed's second round of quantitative monetary easing (QE2), which suggested that US easing has reached an end. In response, the BoJ did not announce new easing measures at its subsequent extraordinary meeting. At the same time, its purchases of REITs and ETFs could occur in mid December. Yen strength has waned with the unexpected rise in US payrolls. There was little negative pressure on Japan at the G20 or APEC meetings. The annualized 3.9% growth in GDP in 3Q 2010 was a positive surprise, but the markets foresee an adverse reaction in 4Q as the effects of government stimulus measures for car and electronics purchases wear off.

September labor figures for Japan indicate that real wages, though up 1.5% YoY, were down again on a MoM basis. Similarly, the Consumer Confidence Index, up 1.0% YoY, saw a fourth successive MoM decline. Meanwhile, core machinery orders (private-sector orders excluding ships and electric power company orders) tumbled 10.3% MoM, a negative surprise.

***Corporate earnings and investment opinions***

TOPIX consensus of forecasted earnings revisions for the next 12 months [(upward revisions – downward revisions) divided by target stocks] based on IBES rose 4% in November.

Our analysts have raised their ratings on JR Tokai, IT Holdings, DIC and Astellas Pharma from Hold to Buy, while lowering Yamato Holdings from Buy to Hold. Refer to the respective analyst reports for details. 1H FY3/11 earnings reports by TSE First Section firms reveal that RP stood at 57% of full-year targets. Moreover, companies raised their RP forecasts by 5.0%.

***Investor trends***

TSE reports foreigners were net buyers in November, with individuals net sellers. The QSS (QUICK survey) in early November showed investors on average were overweight on raw materials and electrical and precision machinery shares, and underweight on utilities and financials. They rapidly retreated from underweighting autos to neutral, while becoming more underweight on utilities. They were significantly more overweight on electrical and precision machinery shares.

***This month's events***

MoF's Financial Statements Statistics of Corporations by Industry (Corporate Survey) on 2 December should show how corporations have adjusted their earnings forecasts and forex assumptions. The BoJ's quarterly Tankan survey of business on 15 December is likely to further corroborate these figures. One focus in the government's FY11 budget deliberations will be discussions over a corporate tax cut and related conditions (such as the shrinkage of current tax breaks) and a consumption tax hike. We expect a small reduction in the corporate tax and no change in the consumption tax.

**Figure 1: Top 10 stocks picked by our Strategist**

| | Stock Name | Ticker | Sector | Rating | FY1 PE | FY1 EPS Growth | FY1 ROE |
|---|---|---|---|---|---|---|---|
| 1 | Teijin | 3401.T | Textiles | Buy | 15.5 | NM | 7.9 |
| 2 | Mitsubishi Tanabe Pharma | 4508.T | Pharma | Buy | 19.1 | 28.0 | 5.8 |
| 3 | Tokai Carbon | 5301.T | Glass | Buy | 15.1 | 150.0 | 6.4 |
| 4 | Panasonic | 6752.T | Consumer Electronics | Buy | 22.5 | NM | 4.0 |
| 5 | Denso | 6902.T | Auto Parts | Buy | 15.6 | 92.0 | 7.4 |
| 6 | Honda Motor | 7267.T | Autos | Buy | 9.2 | 120.5 | 13.7 |
| 7 | Don Quijote | 7532.T | Retail | Buy | 12.6 | 30.4 | 13.2 |
| 8 | Itochu | 8001.T | Trading Companies | Buy | 6.7 | 43.2 | 16.7 |
| 9 | Mitsui Fudosan | 8801.T | Real Estate | Buy | 25.3 | -14.3 | 5.1 |
| 10 | All Nippon Airways | 9202.T | Air | Buy | 36.6 | NM | 4.3 |
| | | | | Average | 17.8 | 64.2 | 8.4 |

*Note: PE, EPS, and ROE are based on DSI estimates. Growth rate is NM (not meaningful) if FY0 EPS<0. Price as of 30 Nov..*
*Source: Nikkei Astra, DataStream, Deutsche Securities*

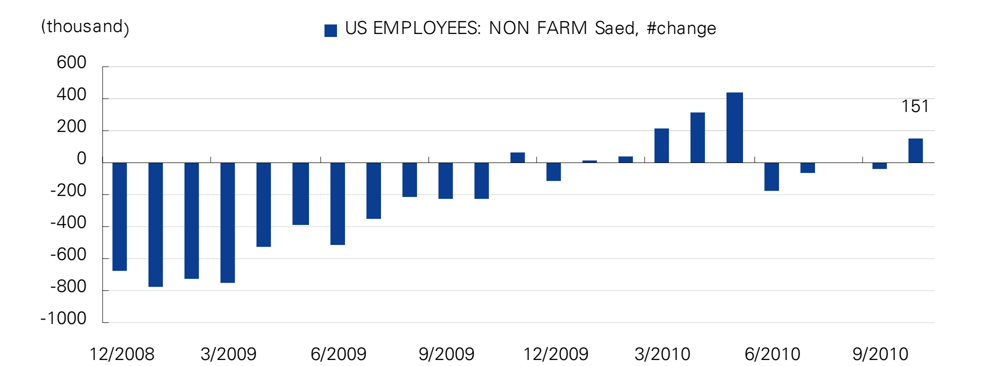
# Japanese stocks in 2011: Set to be the Best performer

## US payroll recovery should boost investor confidence

***Revival in sentiment will require 1-2 more months of payroll growth***

US payrolls have begun a slow comeback. If employment trends upward, cash will likely flow into US and Japanese stock markets as in early 2010. However, investors, after being disappointed by prospects of a comeback in 1Q 2010, will likely require at least another 1-2 months of steady figures before they regain confidence in an employment recovery.

**Figure 2: US non-farm payroll is expected to improve**

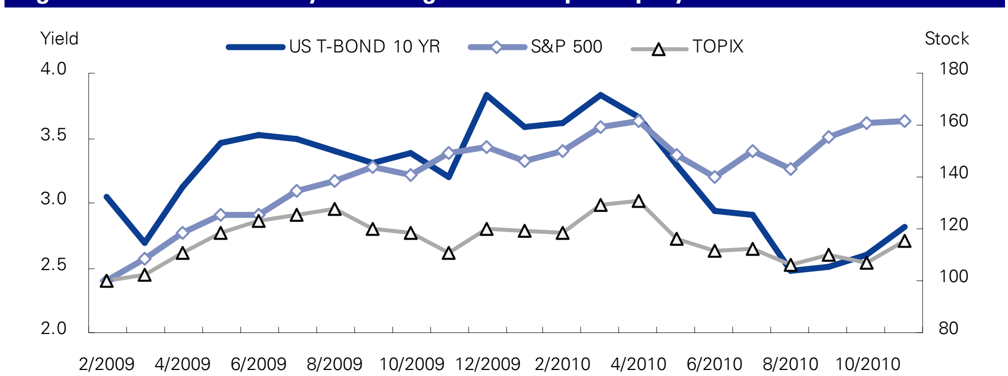



*Note: seasonally adjusted, monthly change, thousand persons*
*Source: DataStream, Deutsche Securities*

***Employee numbers must rise first***

The expansion in US payrolls should raise expectations of a recovery in housing and other consumption. A rise in retail or housing sales that does not involve higher employment is unlikely to be seen by investors as a genuine recovery. In this sense, it is crucial that employee numbers rebound before other figures.

**Figure 3: Lower US bond yield is negative for Japan equity**




*Note: Equity indices are accumulated returns (Feb. 2009=100)*
*Source: DataStream, Deutsche Securities*

Confidence in the US economic outlook can be seen not in the money markets, where the Fed's QE2 action is impossible to glean, but in 10y US Treasury yields (Figure 3). The decline in Treasury yields had led to stagnancy in Japanese stocks. Since November, we have seen the opposite phenomenon. With Treasury yields now up to 2.82% (29 November), TOPIX has risen 7.9% since the end of October. The S&P500 edged up 0.4% over the same period.

The rise in Treasury yields, of course, is also strongly linked to the dollar's gain against the yen. The relationship shown in Figure 3 between US yields and Japanese stocks is not a direct correlation but is derived via forex.

***Return to ¥90/dollar would send Japanese shares up 20%***

Once confidence in a US economic recovery has strengthened, long-term yields in particular should rise. (Short- and intermediate-term yields are being held down by the central bank.) Higher yields from US economic expectations will buoy the dollar. The rise in the yen thus far has been due not to a Japanese economic rebound but to a drop in dollar-based interest rates (higher US deflationary risk). Thus, a normalization of the US economy should bring the yen back to the ¥90/dollar level as in early 2010. We believe that would spur Japanese shares upward by more than 20%.

Investors are mulling the proper timing to shift funds from cash and bonds into credit products and stocks. Thus, given Asian rate hikes and problems with the financial system in Europe, investors will need to be convinced that US consumption is regaining strength. There are already signs of an uptrend in bond yields, but yen appreciation remains a near-term risk. A stable rise in payroll numbers will be particularly important for a recovery in confidence. We believe that stock market sentiment will waver until after the Christmas season.

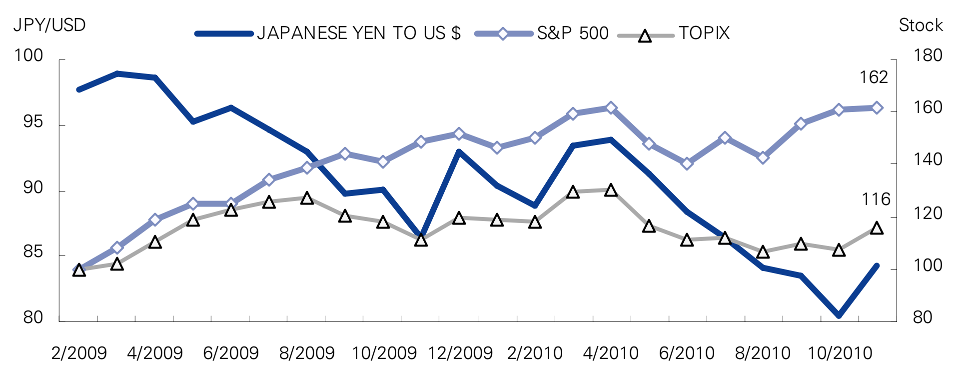
Still, once investors do begin to move into stocks, we expect Japanese shares to outperform since the extent of the profit gains in Japan are well known.

## Japan to outperform on extent of profit gains

Laggard Japanese shares are likely to close the gap with US shares, which already rallied around the time of the Fed's QE2. US stock markets have trended upward as the Fed has pushed forward with its easing policy. At the same time, many investors assumed that this easing would cause the yen to rise, adversely impacting Japanese stock markets. The expectations and implementation of QE2 have thus been negative for Japanese shares.

However, 1H FY3/11 results revealed that Japanese firms were revising their forecasts upward despite exporter assumptions of an even stronger yen. Management appears to have seen the full-year targets as eminently obtainable in light of the rise in 1H sales volume.

**Figure 4: TOPIX, S&P 500, and JPY, Yen appreciation led weak TOPIX**




*Note: Equity indices are accumulated returns (Feb. 2009=100)*
*Source: DataStream, Deutsche Securities*

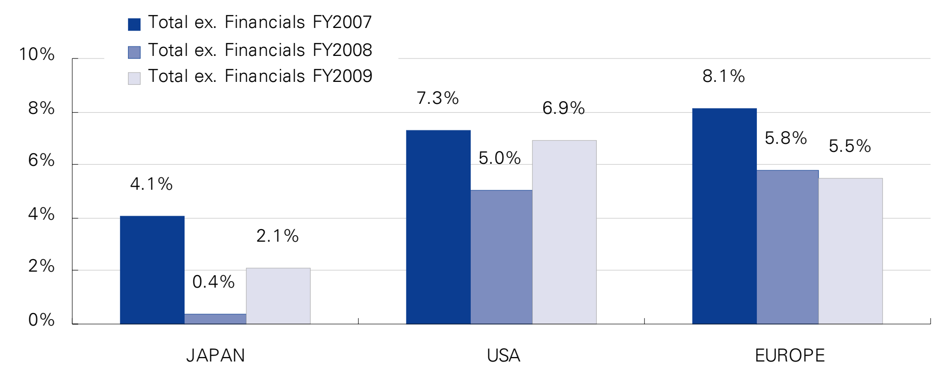
The performance gap between Japanese and US shares has widened due to the high yen (Figure 4). A spread of more than 50% has arisen between the lows of February 2009 and the end of October 2010 and the yen strengthened by around 20% during that time.

***TOPIX to be flat through yearend***

We believe TOPIX will remain basically flat through yearend. QE2 should continue to put upward pressure on the yen. It will take another few months of improvement in economic indicators before investors regain confidence in the US and global economic outlook and begin to shift their funds back from cash to stocks.

However, Japanese stock valuations are quite low, and we see little risk of a further drop. Moreover, the BoJ, like the Fed, has also turned to unconventional monetary policy. The US came under criticism from emerging nations at G20 for its monetary easing policy. Politically it will be difficult for the US to allow further easing measures and a cheap dollar for the long term. Normalization means a rise in US interest rates and the dollar. We believe that investors will soon be returning to Japanese stocks.

**Figure 5: Margin comparison**



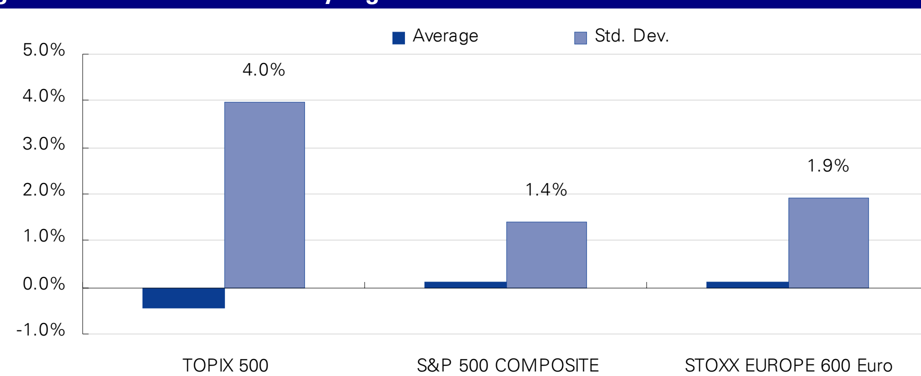

*Note: Margin is Net income without extraordinary items / sales, based on TOPIX500 for Japan, S&P 500 for USA, and DJ Stoxx 600 for Europe.*
*Sources: Capital IQ, Deutsche Securities*

***High profit growth hopes at low-margin Japanese firms***

The global economic recovery should bring about a brief acceleration in profit growth at low-margin Japanese firms (Figure 5). Japanese margins have not recovered at the pace of US and European firms (FY09). For this reason, we can still expect a faster profit recovery in Japan than elsewhere.

Expectations regarding US jobs and consumption are likely to strengthen in 2011. US stocks should thus become an earnings-driven market. Once the dollar turns around, Japanese stocks should outperform global markets. Returns on Japanese shares have much greater swings than shares on other global indexes (Figure 6). The beta is low since share price trends tend to differ from elsewhere for long periods, but once a change occurs, the Japanese response is often sharper.

**Figure 6: Relative return/risk by region to the World index**




*Note: Relative returns vs. MSCI World, monthly from Dec 1992 to Jun 2010.*
*Source: DataStream, Deutsche Securities*

If US payroll indicators continue to improve, upward pressure on the yen should weaken, prompting hopes of a rise in exports. TOPIX could quickly catch up from its laggard position in 1H 2011, possibly hitting 1,000 by the time of FY3/11 earnings announcements in May.

***Nikkei Average to hit ¥11,500, TOPIX 1,000 by mid 2011***

We believe that Japanese shares will remain in a wait-and-see stance until December, with the Nikkei Average and TOPIX trading at respective ceilings of ¥10,000 and 870. Investor confidence should return after the new year, sparking a shift of funds into stock markets worldwide. The Nikkei Average and TOPIX could climb to ¥11,500 and 1,000 by mid 2011 on expectations of higher growth momentum in Japan and a weaker yen.

**Figure 7: TOPIX trend and forecast**


*Note: ± 1SD shows the range of 1 Standard Deviation for 52 weeks of volatility.*
*Sources: DataStream, Deutsche Securities*

***Japan to be best performer in 1H 2011***

Japanese stock markets are set to be the world's best performer in 1H 2011. The US equity outlook is bullish, but 1H should mark a change from a liquidity- to earnings-driven market. The US is prone to concerns over higher interest rates and inflation. In comparison, Japanese shares barely rise in a liquidity-driven market, so a global economic upturn will link directly to hopes of higher earnings, which should attract funds into the market. However, because investors will be buying on the allure of the large potential rise in shares, they may look negatively upon the higher valuations once TOPIX hits 1,000. Japanese stocks may follow their 1H comeback with box trading in 2H.

**Many Japanese stocks are undervalued**

Our CROCI analysis, which selects shares through a valuation process concentrated on economic profit, has found that many Japanese shares appear undervalued. Shares considered as Deep Value or Value account for 17% of the total worldwide vs. 32% in Japan (Figure 8).

**Figure 8: CROCI shows many "value" stocks in Japan**

| | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| **Region (%)** | **Deep Value** | **Value** | **Fair** | **Expensive** | **Challenging** |
| Global | 7 | 10 | 47 | 27 | 9 |
| USA | 7 | 9 | 44 | 30 | 10 |
| Europe | 3 | 10 | 50 | 27 | 10 |
| Japan | 15 | 17 | 47 | 12 | 9 |
| ROW | 8 | 9 | 46 | 30 | 7 |

*Note: % Distribution of companies, as of 30 November 2010, CROCI.*
*Source: Deutsche Securities*

We believe the rapid growth in Japanese firms has not been reflected fully in their share prices. Once economic confidence returns, stocks that are cheap from a valuation standpoint should soon be picked up.

### Japanese shares versus the rest of Asia

***Requires weaker yen, rise in Treasury yield, financial sector outperformance***

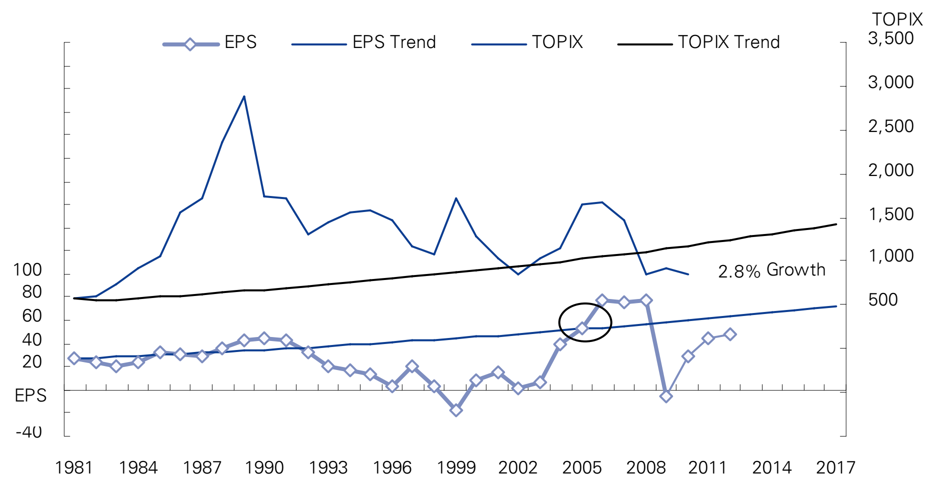
Valuations are also attractive in comparison with Asian markets. Our Asian equity strategist Ajay Kapur said in his 2 November report The Investigator, subtitled "Managing the risk of euphoria", that Japanese stocks were superior to other Asian markets from a valuation perspective but would require a cheaper yen, a rise in treasury yields and financial sector outperformance in order to take off.

We believe that the yen decline and a rise in the Treasury yield will occur because investors are confident that US payrolls are recovering, as noted above. Bank shares, which have underperformed due to tighter regulation and the accompanying risk of capital increases, should enjoy a relatively strong performance now that capital hikes have been completed and regulations have become clear.

## Japanese stocks cheap from long-term perspective

TOPIX is cheap at present based on its long-term trend. Assuming profit levels of 2005 as "normal", EPS and TOPIX are currently below the long-term trend (Figure 9). The TOPIX trend P/E from its EPS of 2005 is 19.5x. Trend here indicates a conservative estimate of 2.8% EPS growth.

**Figure 9: Estimated trend of TOPIX and its EPS for the long run**



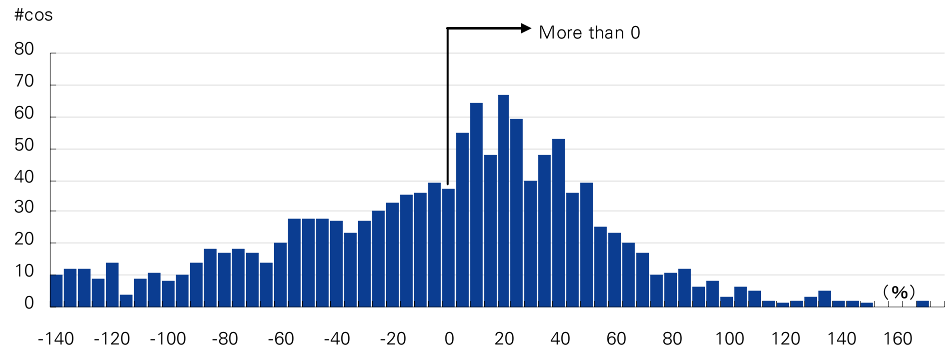

*Note: DSI estimates F2010-2012. F1981 as base year and F2005 as normal.*
*Source: Nikkei Financial Quest, Deutsche Securities*

As the economy normalizes following the Lehman shock and problems concerning sovereign risk in Europe, share prices may return in-line with their long-term trends faster than the rise in EPS forecasts, as in the equity market comeback of 2005. Based on trend alone, TOPIX could reach 1,200 by the end of next year. The IBES consensus TOPIX EPS is 68.2 for March 2012, already well above the 61.8 trend EPS for the end of 2011. (Our strategy forecast calls for a return to trend in EPS from 2014.) Even without an overshoot of this strength, TOPIX should fairly easily regain 1,000 during 1H 2011.

### Increasing number of net cash firms

The structural cheapness of Japanese shares should improve because deleveraging is completed.

**Figure 10: Nearly half of TSE1 companies are "net cash"**




*Note: 221 companies less than -150%, 7 more than +180, Oct 2010 TSE1 ex. Financials*
*Source: Nikkei Astra, Deutsche Securities*

Nearly half of TSE First Section firms are in net cash positions, i.e., they can pay off their interest-bearing debt with cash in hand (Figure 9). Companies have put more emphasis on cash flow given the poor investment opportunities in the deflationary environment and their caution after previous financial difficulties. However, we believe we are in the final stages of the reduction in leveraging at Japanese firms, which have focused on repaying debt since the financial crisis of 1998. Businesses that had posted losses in FY07-08 had raised their leverage as their cash had depleted. The subsequent wave of corporate recapitalizations has now reached its end, and the downtrend in leverage should soon halt.

***End of leveraging decline should lead to higher shareholder returns***

We believe that corporations will steadily expand their shareholder returns over the next five years. That said, funding demand for capex may also increase as the economy recovers. In the near term, we anticipate an increase in foreign acquisitions backed by the high yen. Over a longer horizon, companies will need to contribute to the aging society by increasing their shareholder benefits.

**Oversupply cutbacks to accelerate**

***Hopes for supra-group resuscitation funds***

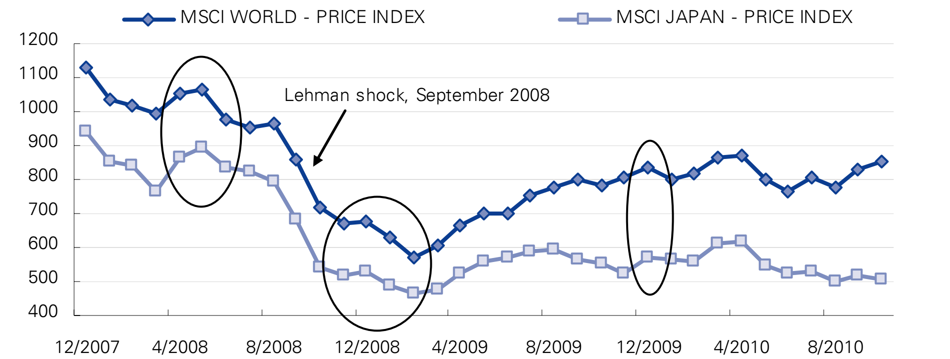
Additionally, the Yomiuri Shimbun reported on 17 November that all three megabanks along with trading firms, Deutsche Bank and others will join a corporate reconstruction fund set up by the megabanks and the Development Bank of Japan. The fund is an important step towards industrial restructuring that transcends the traditional banking and business groups.

One reason that Japan has lagged in its efforts to reduce excessive competition through foreign alliances and acquisitions is the nation's vertical social structure, prompting companies to seek to bring every industry imaginable under one large umbrella. (See Naoki Kamiyama's 1 April report, "Spirit of Japan's sushi chef capitalism".) The fact that banks and others have come to this realization and formed a framework of cooperation extending beyond their groups, which should encourage tieups and realignments involving non-group firms, could spark an improvement in Japan's corporate structure.

## Strategy sector views: Initial focus is exporters

In the initial stages of the market recovery, we believe exporters will be the focus. This was the pattern of 2Q 2009 and December 2009 to February 2010. Periods when Japanese stocks have outperformed have generally accompanied by signs that deflation will be defeated and a bank-led equity recovery. In the recent two periods, however, the outperformance has been driven by external demand (exports), a pattern we believe will dominate from here on.

**Figure 11: Periods when Japan outperformed**

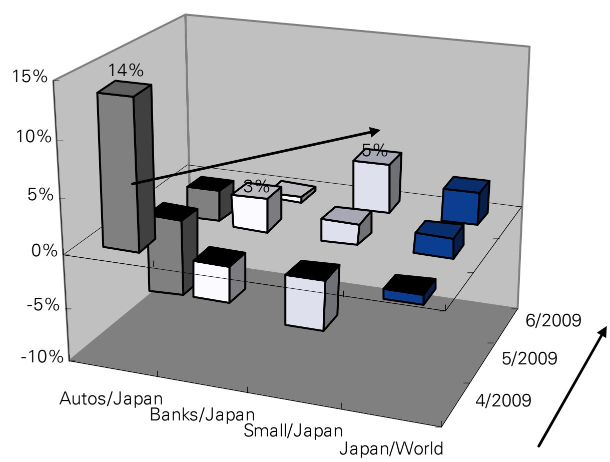



Source: DataStream, Deutsche Securities

Let us look at the last three times that Japan (MSCI Japan) has outperformed global markets (MSCI World) (Figure 11). In 2008, bond yields surged, and bank stocks propelled the uptrend. In the past two cases, yields edged gradually upward, and the auto sector played leader.

In the most recent period (December 2009 to February 2010), the auto sector comeback was especially strong. Buying then spread to banks and other sectors as expectations of a Japanese economic recovery strengthened, and cash eventually flowed into small caps as risk tolerance increased.

**Figure 12: Japan outperformed: April to June 2009**




Note: MSCI, for example, Japan/World means relative return of Japan to World.
Source: DataStream, Deutsche Securities

***Cars to banks to small caps***

If Japanese stocks do experience a rapid upswell from yearend through 2011, we believe investors will progress first from autos to banks to small caps (Figure 12). On the other hand, if signs of a quick economic recovery do not emerge, yields are likely to remain low as a result of the BoJ's long-term bond buying operations. Also, if a positive US outlook sparks a weakening in the yen, investors should turn first to automaker and other exporter shares.

Fed easing has boosted non-ferrous metals, trading firms and energy stocks on anticipation of higher dollar-denominated commodity prices, but we believe this movement has reached its end. Easing policies in G20 nations are reaching their limits and may have ended with the upturn in employment. In addition, rate hikes in Asian nations including China have reduced hopes of faster growth. Related sectors should feel the limits to their own growth.

**Figure 13: Sector stance**

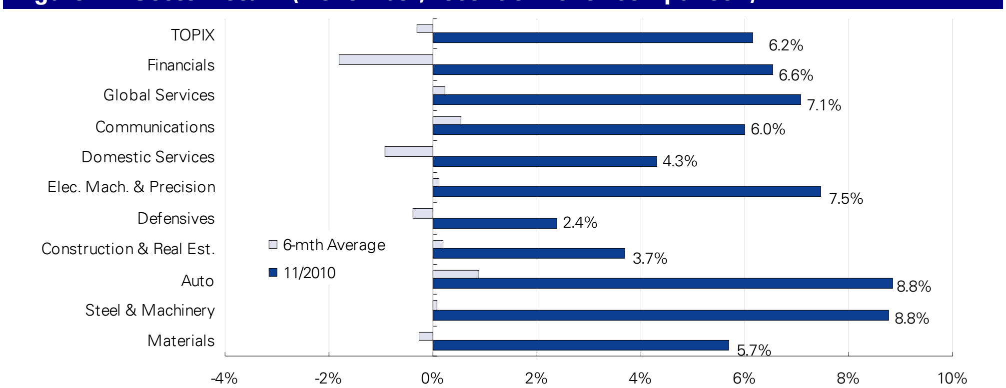
| GICS | Weight (%) | Sector Positive/Negative: For 3 mth | Sector Positive/Negative: For 1 year | Factors monitored: Export ratio (%) | Factors monitored: Yen sensitiv. | Returns: 1 month | Returns: 1 year |
|---|---|---|---|---|---|---|---|
| Energy | 1.5 | | | 16.6 | 1.2 | 7.2 | 11.9 |
| Materials | 7.7 | | + + + | 36.8 | 0.9 | 5.5 | 0.5 |
| Industrials | 20.1 | | + + + | 32.9 | 0.8 | 6.7 | 11.0 |
| Consumer Discretionary | 19.6 | + + + | - - - | 52.8 | 1.3 | 7.9 | 6.8 |
| Consumer Staples | 5.2 | | | 24.9 | 0.2 | 5.9 | 1.0 |
| Health Care | 5.6 | - - - | - - - | 36.2 | 0.1 | 4.1 | -2.0 |
| Financials | 17.0 | | | 4.1 | 0.3 | 5.6 | -9.3 |
| Information Technology | 13.7 | | | 55.1 | 1.0 | 7.6 | 11.3 |
| Telecommunication Services | 4.1 | - - - | - - - | 0.0 | -0.4 | 6.2 | 11.4 |
| Utilities | 5.6 | - - - | - - - | 0.0 | -0.3 | -0.2 | -7.6 |
| | 100.0 | | | 31.4 | 0.6 | 6.2 | 3.2 |

*Note: + + += positive, - - - = negative, Yen sensitivity is the regression coefficient of monthly return with JPY (24-mth), market cap weighted average.*
*Source: MSCI, DataStream, Deutsche Securities*

***Major exporter shares to lead index rise***

We believe the Fed's easing will boost the US economy and increase expectations of corporate earnings growth. This should relieve the upward pressure on the yen, and Japanese shares should outperform other major global equity indexes on hopes of a rebound from their long slump, rapid market growth, and yen weakness. We believe major exporter shares will drive the market rise.

**Figure 14: Sector return (November, recent 6-month comparison)**




*Note: The 10 classifications are our grouping from the 33 TOPIX sectors. For example, Global services includes marine transport and wholesale. Domestic services includes land and air transport, and warehouse. Defensives includes gas & electricity, food." The other 7 sectors are QSS classifications*
*Sources: DataStream, Deutsche Securities*

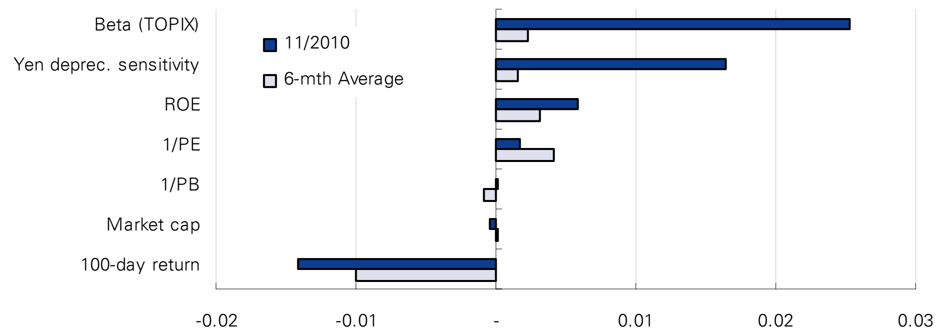
***US job rebound, dollar strength, exporter share recovery to take 1-2 months***

We predict that the US economy will stage a comeback without experiencing a double dip. We feel therefore that a correction in the high yen is just a matter of time and retain our positive (+++) outlook for Consumer Discretionary sectors (Figure 13). Nevertheless, a recovery is not likely to happen anytime soon. We do not foresee any big development through yearend. We believe it will take at least 1-2 months before US payroll figures strengthen sufficiently to prompt hopes of a higher dollar and an upturn in exporter shares.

## Style strategy: Value and major shares in 1H 2011, small caps in 2H

If hopes of a global economic recovery take hold in January, we believe the stock index will head upward led by major exporters. It will take time for earnings growth to spread domestically, and small caps are not likely to feel the benefits until the level of major firms has risen sufficiently. Risk tolerance increases when shares overall rise, so small caps should gain once the index has climbed to a certain extent.

**Figure 15: Main factor return (November, recent 6-month comparison)**




*Note: Factor return is the regression coefficient for monthly return based on a specific indicator for each stock by regression analysis.*
*Sources: Nikkei Astra, Toyo Keizai, Deutsche Securities*

We do not expect any clear style preference to take shape through the end of the year. The outlook looks to remain uncertain as to market direction and individual sectors.

# Analysts' sector views

**Figure 16: Analysts' sector views**

| Analyst | Sector | Recommendation | Reason |
|---|---|---|---|
| Ando, Seigo | Marine | Underweight | The risk of a decline in container freight rates could be much greater than the market expects |
| | Air | Overweight | OP is likely to top market expectations, primarily due to passengers switching from JAL and foreign airlines |
| | Trucking | Marketweight | OP growth should remain in the single digits for the next several years |
| | Rail | Marketweight | Passenger numbers should remain almost flat for the near term, implying that surprises are unlikely in this sector |
| Ando, Yoshio | Telcos | Overweight | Service revenue will eventually start rebounding shortly, thanks to contributions from data. Investor expectations still remain low. |
| Fujita, Takeshi | REITs | Overweight | In addition to a recovery in fundamentals, monetary easing could lift the sector |
| Higurashi, Yoshikazu | SPE | Underweight | We forecast that any short-term recovery in share prices would result in profit-taking on the view that no new capex news is likely. |
| | Precision/Imaging | Overweight | Considering that cost reductions should have a positive impact on earnings, we believe all key office equipment stocks are undervalued to some degree. |
| Ishibashi, Katsuhiko | Glass (incl Carbon Cement) | Overweight | We think the stabilization of LCD panel prices (expected to bottom in November) would be a positive catalyst for major LCD glass producers |
| | Paper | Underweight | The decline in market pulp prices could continue until next year. This is negative for Japan's paper companies' fundamentals because it erodes their competitiveness vs. Asian peers |
| | Non-Ferrous | Overweight | Higher gold and base metal prices amid monetary easing globally would push up the mid-term stock price of non-ferrous metal companies, although we have seen a rally in this sector since September |
| Kazahaya, Takahiro | Retail | Marketweight | Owing to uncertainty over consumer spending, sector ratings based on the top down approach might not be working. Selective investing is quite important right now. |
| Kikuchi, Satoru | IT Software | Overweight | Going forward, earnings are expected to increase in earnest |
| | Amusement | Marketweight | As each company is different, the overall sector appears to lack a concrete direction. |
| Masuzoe, Kenji | Pharmaceuticals | Marketweight | Major companies are facing a harsh environment, but second-tier and mid-sized companies are performing well. |
| Miyamoto, Takeo | Industrial Electronics | Marketweight | Overall, sector earnings growth will be moderate and company specific factors differ widely. |
| Moriwaki, Takashi | Auto Parts | Overweight | Shares already price in production cuts for Oct-Dec in Japan. An earnings recovery will likely be led by a rise in ASEAN and Chinese car demand. |
| | Tires | Marketweight | The recovery in tire demand in advanced countries should slow. Higher raw material costs are likely to squeeze margins. |
| Morota, Toshiharu | Machinery | Overweight | The story of the peaking of the short-term cycle is now widely known. Better to focus on companies with competitiveness. |
| | Plant Engineering & Ship Bldg | Marketweight | Stocks are sensitive to the appreciating yen and competition with Korean and European rivals, but share prices are at low levels. |
| Muraki, Masao | Securities | Marketweight | Oct-Dec results should be solid. The market will focus on European credit concerns and tightening financial regulations. Possible upside if liquidity recovers. |
| | Non-life Insurance | Overweight | Look for some recovery in auto claim ratios which saw a large rise at the start of the year. Although well equipped to deal with solvency 2, adjusted PBRs are 0.5-0.6x. |
| Nagano, Masayuki | Trading Companies | Overweight | Commodity prices are basically trending upward, driven by structural increases in production costs. Low Valuation. |
| Nakane, Yasuo | Consumer Electronics | Marketweight | Benefits from a decline in component prices could be offset by a sharp drop in retail prices for major products and unfavorable forex rates; company specific issues will likely have a greater impact on share prices. |
| | Flat Panel Displays | Marketweight | Though the bottom of the cycle is around the corner, utilization rates for panel makers are unlikely to recover soon. TV panel prices have not yet bottomed, and we expect prices of 32" TVs to fall close to cash cost levels and they may not rebound soon. In short, the bottom is likely to be deeper than recent consensus forecasts |
| Otani, Yoji | Real Estate | Overweight | In addition to a recovery for fundamentals, monetary easing should lift the sector. |
| | Construction | Marketweight | Cheap based on asset value but not cheap based on earnings expectations. |
| | Housing Equipment | Overweight | Cost cutting will produce earnings leverage as housing market recovers. |
| Sanger, Kurt | Autos | Overweight | Underlying valuation, margins firm, cash flow solid, strong balance sheets |

| | | | |
|---|---|---|---|
| Watabe, Takato | Petrochemicals | Marketweight | Short-term rebound expected, but focus on supply increases in the Middle East and China. |
| **Analyst** | **Sector** | **Recommen-dation** | **Reason** |
| Watabe, Takato | Textiles | Overweight | Better-than-expected recovery for carbon fiber utilization rates. The synthetic fiber market is also firm thanks to higher prices of raw cotton. |
| | Electronic Materials | Marketweight | Valuations are attractive, but the outlook for the LCD market is very uncertain. Wafer products weak. |
| | Industrial Gases | Overweight | Mainstay products (gasses for the steel and chemical industries) remain firm, while earnings for sub businesses are improving or expanding |
| Yamada, Yoshinobu | Banks | Overweight | Japanese banks could be excluded from the SIFIs (Systematically Important Financial Institutions) list. If so, concerns about additional initiatives to raise capital could be eliminated. |

*Source: Deutsche Securities*

## Strategy sector views

### Figure 17: Sector stance

| GICS | Weight (%) | Sector Positive/Negative For 3 mth | Sector Positive/Negative For 1 year | Factors monitored Export ratio (%) | Factors monitored Yen sensitiv. | Returns 1 month | Returns 1 year |
|---|---|---|---|---|---|---|---|
| Energy | 1.5 | | | 16.6 | 1.2 | 7.2 | 11.9 |
| Materials | 7.7 | | + + + | 36.8 | 0.9 | 5.5 | 0.5 |
| Industrials | 20.1 | | + + + | 32.9 | 0.8 | 6.7 | 11.0 |
| Consumer Discretionary | 19.6 | + + + | - - - | 52.8 | 1.3 | 7.9 | 6.8 |
| Consumer Staples | 5.2 | | | 24.9 | 0.2 | 5.9 | 1.0 |
| Health Care | 5.6 | - - - | - - - | 36.2 | 0.1 | 4.1 | -2.0 |
| Financials | 17.0 | | | 4.1 | 0.3 | 5.6 | -9.3 |
| Information Technology | 13.7 | | | 55.1 | 1.0 | 7.6 | 11.3 |
| Telecommunication Services | 4.1 | - - - | - - - | 0.0 | -0.4 | 6.2 | 11.4 |
| Utilities | 5.6 | - - - | - - - | 0.0 | -0.3 | -0.2 | -7.6 |
| | 100.0 | | | 31.4 | 0.6 | 6.2 | 3.2 |

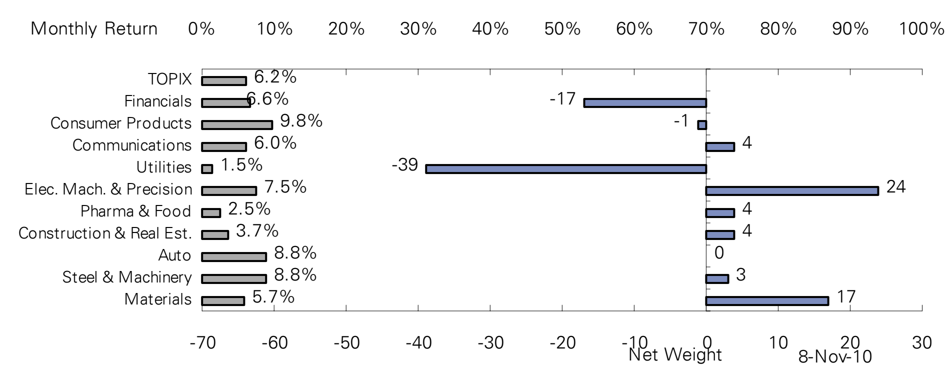
*Note: + + += positive, - - - = negative, Yen sensitivity is the regression coefficient of monthly return with JPY (24-mth), market cap weighted average.*
*Source: MSCI, DataStream, Deutsche Securities*

### Figure 18: Valuation by sector

| GICS | ROE (%) 1-yr fwd | ROE (%) 2-yr fwd | PE (x) 1-yr fwd | PE (x) 2-yr fwd | PB (x) 1-yr fwd | PB (x) 2-yr fwd | CROCI Value(%) |
|---|---|---|---|---|---|---|---|
| Energy | 10.5% | 7.3% | 7.1 | 10.2 | 0.7 | 0.7 | 0 |
| Materials | 7.3% | 8.5% | 13.4 | 11.6 | 1.0 | 0.9 | 62 |
| Industrials | 8.9% | 10.4% | 13.1 | 11.3 | 1.2 | 1.1 | 18 |
| Consumer Discretionary | 6.3% | 7.6% | 17.4 | 14.3 | 1.1 | 1.0 | 38 |
| Consumer Staples | 6.3% | 7.2% | 19.6 | 16.9 | 1.2 | 1.2 | 29 |
| Health Care | 8.7% | 9.6% | 16.5 | 15.0 | 1.4 | 1.4 | 80 |
| Financials | 5.7% | 5.9% | 13.5 | 13.0 | 0.8 | 0.7 | -- |
| Information Technology | 7.8% | 9.4% | 17.8 | 14.7 | 1.4 | 1.3 | 23 |
| Telecommunication Services | 9.4% | 10.2% | 11.8 | 11.0 | 1.1 | 1.0 | 67 |
| Utilities | 4.5% | 6.9% | 22.4 | 14.8 | 1.0 | 1.0 | 17 |
| | 7.1% | 8.1% | 15.0 | 13.1 | 1.1 | 1.0 | -- |

*Note: CROCI Value(%) is the sum of "deep value" and "value" by CROCI (cash return on capital invested), TOPIX 100 ex. Financials.*
*Source: MSCI, DataStream, Deutsche Securities*

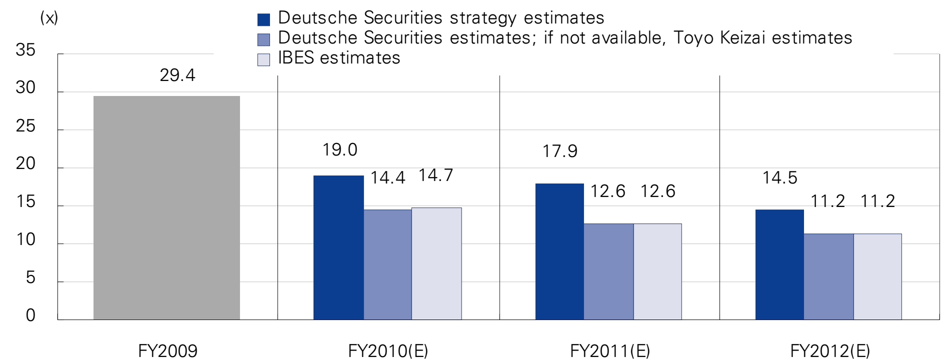
### Figure 19: Investor position, sector return by QSS research




*Note: The 10 classifications are grouped from TOPIX 33 sectors by QSS (Quick survey). For example utilities include gas & electricity, land and marine transport. Consumer products include retail and wholesale. "Net" indicates the ratio of investors who answered "overweight" deducted from the ratio of investors who answered "underweight" (% : bottom axis)*
*Sources: Nikkei Astra, Deutsche Securities*

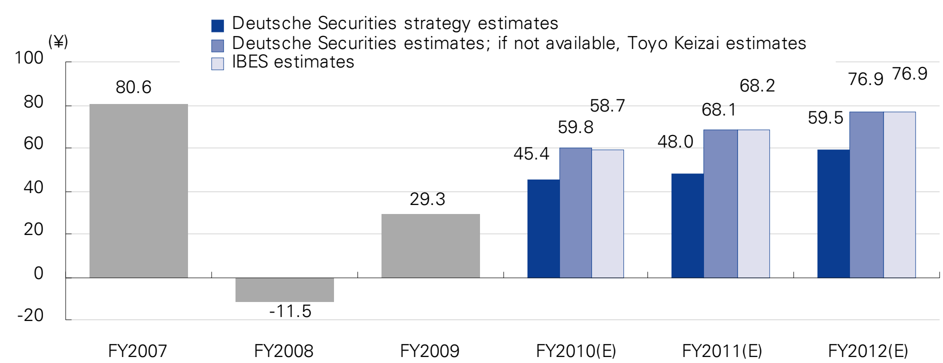
## TOPIX P/E, EPS and ROE

**Figure 20: TOPIX P/E level based on DSI estimated net profit and IBES consensus**



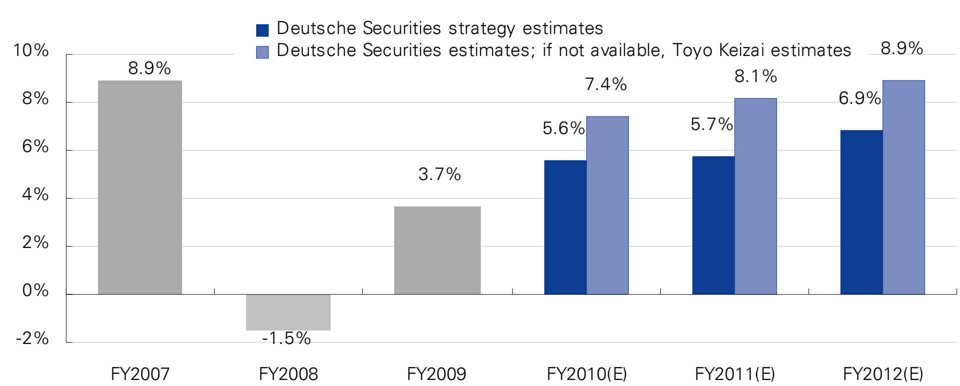

*Note: FY2012 estimate (Deutsche Securities estimate) is based on only 159 stocks.*
*Sources: DataStream, Nikkei Astra, Deutsche Securities*

**Figure 21: TOPIX EPS level based on DSI estimated net profit and IBES consensus**




*Note: Only 157 stocks are estimated for 2012. IBES EPS is calculated from IBES P/E.*
*Sources: DataStream, Nikkei Astra, Deutsche Securities*

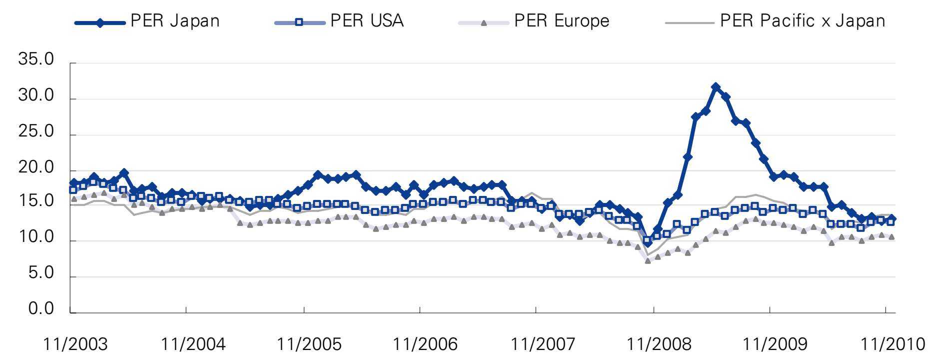
**Figure 22: TOPIX ROE level based on DSI estimated net profit**




*Note: TOPIX. Only 159 stocks are estimated for 2012.*
*Sources: Nikkei Astra, Deutsche Securities*

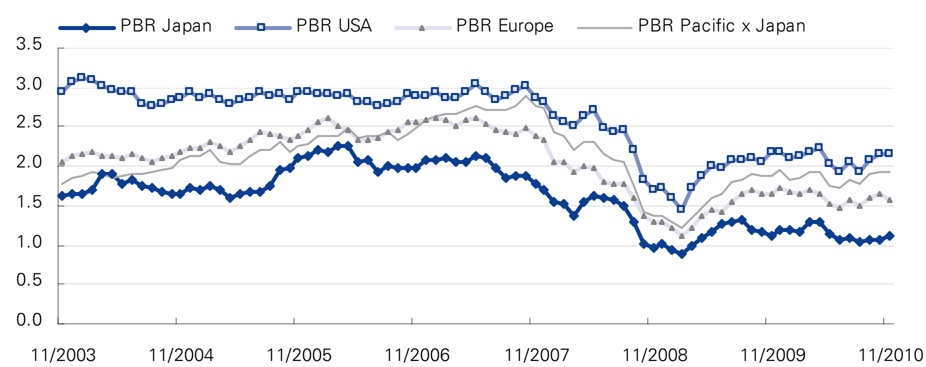
## Comparison of Japanese, US, Europe and Asian market P/E, P/B and ROE

**Figure 23: Japan, US, Europe, and Asian market PER comparison**



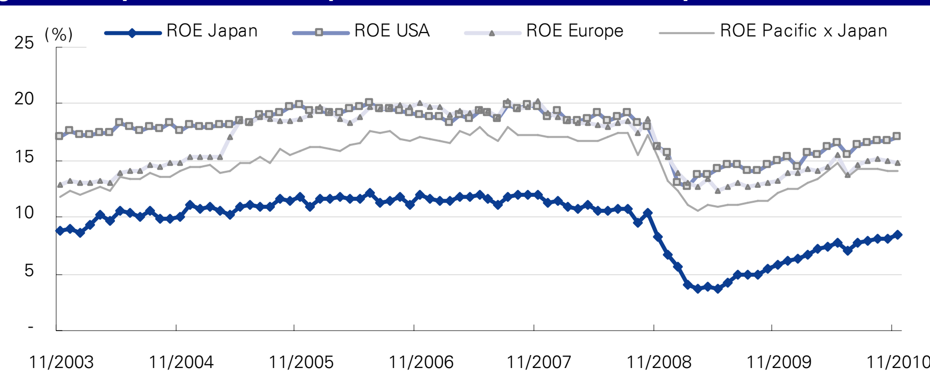

*Note: MSCI 12-month forward profit forecast basis*
*Sources: DataStream, MSCI, Deutsche Securities*

**Figure 24: Japan, US, and Europe, and Asian market PBR comparison**




*Note: MSCI basis*
*Sources: DataStream, MSCI, Deutsche Securities*

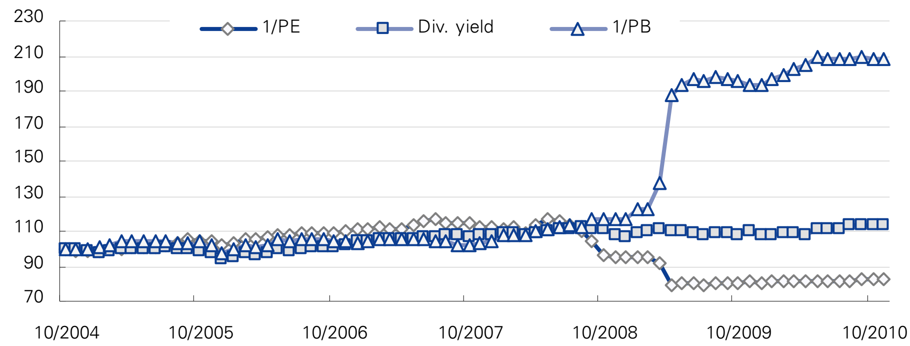
**Figure 25: Japan, US, and Europe, and Asian market ROE comparison**




*Note: MSCI 12-month forward profit forecast basis*
*Sources: DataStream, MSCI, Deutsche Securities*

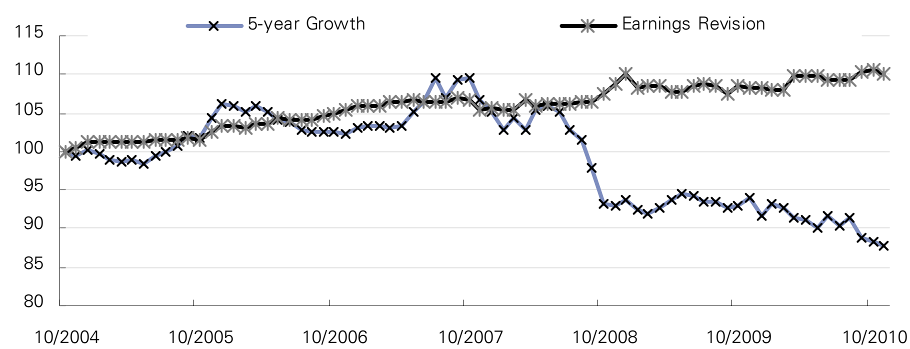
## Factor returns, long-term trend

**Figure 26: Value factors**



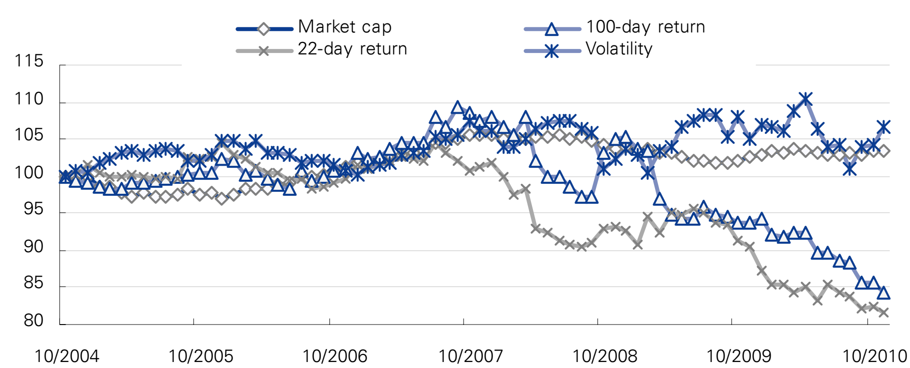

*Note: Factor return is the regression coefficient for monthly return based on a specific indicator for each stock by regression analysis. October 2004 start as 100.*
*Sources: Nikkei Astra, Toyo Keizai, Deutsche Securities*

**Figure 27: Revision and growth**




*Note: Factor return is the regression coefficient for monthly return based on a specific indicator for each stock by regression analysis. October 2004 start as 100.*
*Sources: Nikkei Astra, Toyo Keizai, Deutsche Securities*

**Figure 28: Technical factors**




*Note: Factor return is the regression coefficient for monthly return based on a specific indicator for each stock by regression analysis. October 2004 start as 100.*
*Sources: Nikkei Astra, Deutsche Securities*

**Figure 29: Valuation, growth rate, and market cap. weight by TOPIX 33 sector**

| | Valuation | | | | Growth (%) | | RP | Earnings | Market |
|---|---|---|---|---|---|---|---|---|---|
| Sector | P/E (x) | Chg (%) | P/B (x) | ROE (%) | 1-yr fwd | 2-yr fwd | Revision | Weight (%) | Weight (%) |
| Fishery, Agriculture & Forestry | 16.4 | +3.4 | 1.03 | 6.3 | 28.1 | 7.9 | -6.3 | 0.1 | 0.1 |
| Mining | 15.5 | +3.0 | 0.95 | 6.1 | -14.4 | 20.0 | -9.3 | 1.4 | 0.7 |
| Construction | 13.6 | +0.5 | 0.78 | 5.7 | 32.1 | 8.4 | +0.5 | 1.9 | 2.0 |
| Foods | 18.3 | +1.0 | 1.17 | 6.4 | 1.0 | 4.0 | +1.9 | 3.0 | 3.5 |
| Textiles & Apparel | 14.4 | +0.6 | 0.98 | 6.8 | 202.8 | 18.6 | -0.7 | 0.8 | 0.8 |
| Pulp & Paper | 10.6 | +0.3 | 0.69 | 6.5 | 2.2 | 10.2 | -0.2 | 0.5 | 0.4 |
| Chemicals | 13.1 | +0.5 | 1.13 | 8.6 | 77.0 | 11.1 | +0.6 | 6.0 | 5.7 |
| Pharmaceuticals | 14.0 | +0.4 | 1.37 | 9.8 | -7.1 | 13.2 | -0.2 | 3.5 | 4.0 |
| Oil & Coal Products | 12.2 | +1.1 | 1.87 | 15.4 | NA | 12.2 | -3.9 | 1.3 | 0.9 |
| Rubber Products | 11.4 | +0.8 | 1.04 | 9.1 | 107.2 | 11.3 | +0.2 | 0.8 | 0.7 |
| Glass & Ceramics | 10.4 | +1.3 | 1.15 | 11.1 | 111.0 | 20.8 | -2.3 | 1.5 | 1.2 |
| Steel Products | 11.7 | +1.5 | 1.00 | 8.6 | 1834.1 | 21.7 | -3.2 | 2.8 | 2.5 |
| Nonferrous Metals | 11.7 | +0.9 | 1.12 | 9.6 | 86.2 | 20.0 | -2.1 | 1.4 | 1.2 |
| Metal Products | 19.1 | +1.2 | 0.84 | 4.4 | 668.1 | 17.1 | -0.1 | 0.6 | 0.8 |
| Machinery | 16.8 | +1.9 | 1.29 | 7.7 | 101.1 | 13.8 | -0.7 | 3.7 | 4.8 |
| Electrical Machinery | 16.3 | +1.0 | 1.39 | 8.6 | 232.6 | 19.5 | +1.0 | 11.4 | 13.4 |
| Transport Equipment | 12.8 | +1.4 | 1.17 | 9.1 | 110.4 | 15.1 | -2.2 | 10.1 | 11.3 |
| Precision Instruments | 15.7 | +1.5 | 1.91 | 12.2 | 53.9 | 29.4 | -2.0 | 1.1 | 1.4 |
| Other Products | 18.5 | +1.9 | 0.79 | 4.3 | 15.0 | 19.0 | -4.0 | 0.8 | 1.1 |
| Electric Power & Gas | 19.7 | +4.7 | 1.07 | 5.4 | -1.6 | 8.9 | -14.0 | 3.1 | 4.5 |
| Land Transport | 16.0 | +0.5 | 1.16 | 7.3 | 13.4 | 2.9 | -0.1 | 2.8 | 3.3 |
| Marine Transport | 11.2 | +1.4 | 0.98 | 8.7 | NA | -26.9 | -1.6 | 0.7 | 0.6 |
| Air Transport | 15.5 | -0.1 | 1.50 | 9.7 | NA | 102.0 | -0.3 | 0.2 | 0.3 |
| Warehousing & Harbor Transport Services | 13.9 | +1.0 | 0.76 | 5.5 | 27.5 | 5.5 | -0.2 | 0.3 | 0.3 |
| Communications | 11.9 | -0.2 | 1.20 | 10.1 | 7.3 | 6.5 | +1.6 | 10.6 | 8.8 |
| Wholesale | 7.2 | +0.4 | 0.96 | 13.3 | 60.4 | 13.1 | +0.6 | 7.3 | 5.0 |
| Retail | 15.1 | +1.1 | 1.13 | 7.5 | 12.0 | 4.6 | +1.0 | 4.7 | 4.2 |
| Banks | 9.8 | +0.3 | 0.64 | 6.6 | -5.8 | 11.7 | +0.2 | 10.6 | 8.0 |
| Securities | 19.2 | +3.6 | 0.78 | 4.1 | -41.0 | 88.1 | -5.3 | 0.8 | 1.3 |
| Insurance | 21.7 | +3.1 | 1.08 | 5.0 | 16.8 | -7.1 | +0.9 | 1.8 | 2.3 |
| Miscellaneous Finance | 10.0 | +0.8 | 0.62 | 6.2 | NA | 27.9 | -1.4 | 1.1 | 0.9 |
| Real Estate | 20.1 | +0.2 | 1.31 | 6.5 | 20.5 | 2.4 | +2.3 | 1.6 | 2.2 |
| Services | 15.3 | +0.5 | 1.36 | 8.9 | 18.0 | 8.9 | +1.5 | 1.7 | 1.9 |
| Non-Manufacturing ex. Financials | 12.5 | +0.6 | 1.08 | 8.6 | 27.3 | 7.4 | -0.4 | 36.0 | 33.8 |
| Manufacturing | 14.3 | +1.2 | 1.21 | 8.5 | 92.7 | 15.6 | -0.8 | 50.7 | 54.5 |
| Total ex. Financials | 13.6 | +0.9 | 1.16 | 8.5 | 57.7 | 12.0 | -0.6 | 86.7 | 88.3 |
| Total | 13.3 | +0.9 | 1.08 | 8.1 | 45.0 | 11.9 | -0.6 | 100.0 | 100.0 |

*Note: P/E, ROE, net profit growth rate is based on DSI analysts estimates (If NA Toyo Keizai), P/E and ROE is based on 2-yr forward net profit estimates. RP revision is the monthly change in sum of DSI Estimated RPs (1-yr fwd + 2-yr fwd). Earnings weight is based on 2-yr forward recurring profit estimates.*
*"Sources: Toyo Keizai, Deutsche Securities*

# Appendix 1

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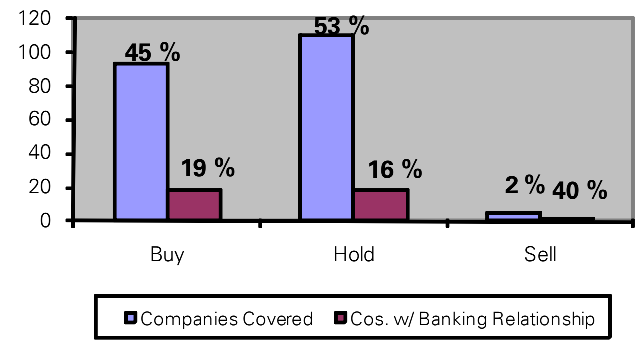


Japan Universe

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