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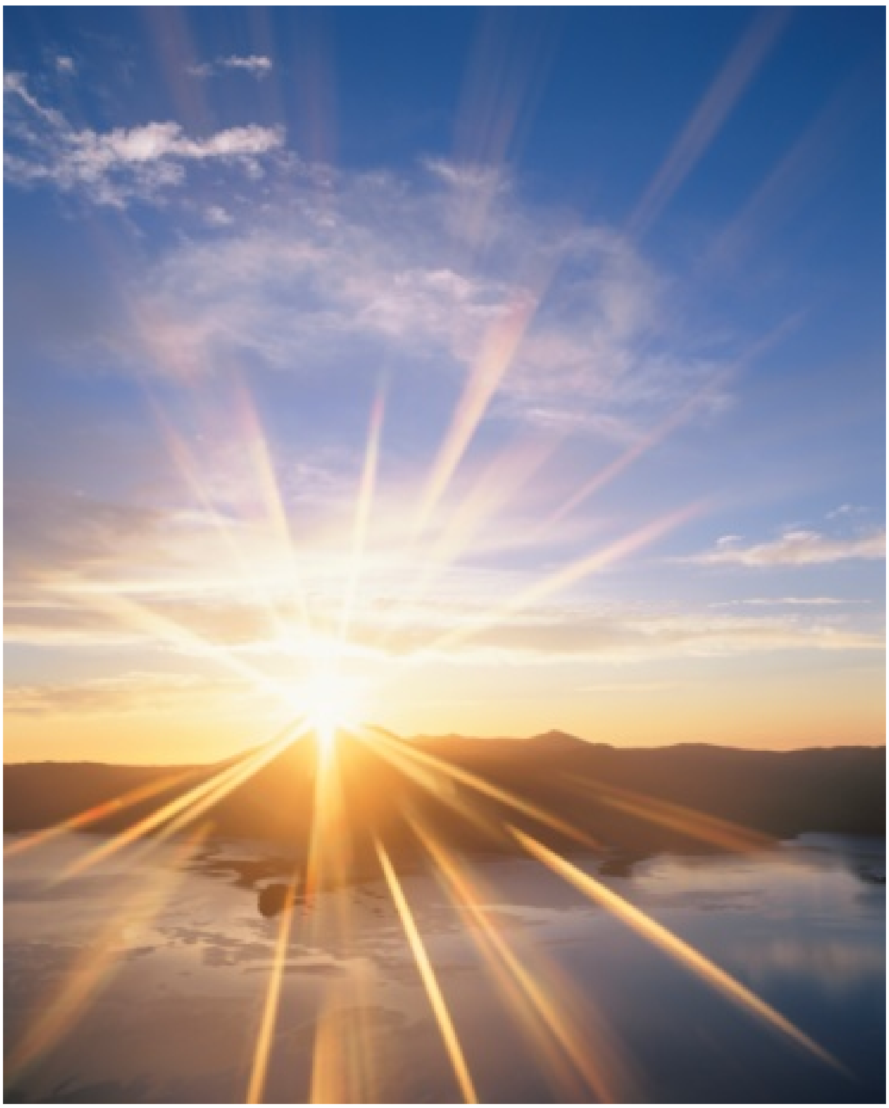
Global Markets Research

Deutsche Bank Group

4 January 2011

2011

A brighter year



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Strategy

Japanese shares get ready to outperform in 1H

Japanese shares set to surge, lifted in part by the US recovery
As we go further into 2011, we expect the global economy to undergo a moderate but firm recovery. For the Japanese economy, this should translate into an upturn in exports in 2Q 2011. Market participants will likely begin to factor these two events – the global economic recovery and the positive impact on Japanese shares – from early next year.

Japanese firms have significant profit leverage
If the global recovery continues to gain traction, Japanese corporates should see a sizeable increase in profits. We think the extent of these increases are likely to be reflected in Japanese stocks around the FY3/11 reporting season. Consequently, we look for Japanese shares to outperform other major stock markets from 1H 2011.

Valuations remain low
Japanese shares are at historically low levels based on Shiller P/E and even when compared to other global shares. We do not believe that investors have sufficiently taken into account the implications of these low valuations once the global economy recovers.

Export-related shares to lead, followed by banks and other undervalued demand-driven domestic stocks
As confidence in the global recovery heightens, we believe that the automobile, auto parts, and technology sectors (ex. Honda, Aisin Seiki, Mitsubishi Elec., NEG) will be the first to benefit. Then, once the domestic recovery gains momentum, we look for greater interest in financials, including banks and real estate. After risk tolerance increases, raw materials and capital goods sectors (ex. Teijin and Itochu), other low-P/B shares, and small caps should get a lift.

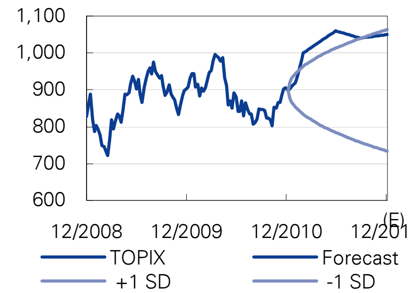
TOPIX to top 1,000 in 2011
In 1H 2011, we expect Japanese shares to overshoot, generating returns of over 20%. The rise in Japanese shares could continue into 2H if the global recovery is accompanied by greater domestic demand, higher shareholder returns, and product and pricing strategies that raise sales prices.

Figure 1 : Strategist top pick 10 stocks

	Stock Name	Ticker	Sector	Rating	FY1 PE	FY1 EPS Growth	FY1 ROE
1	Teijin	3401.T	Textiles	Buy	15.9	NM	7.9
2	Mitsubishi Tanabe Pharma	4508.T	Pharmaceuticals	Buy	19.9	28.0	5.8
3	Nippon Electric Glass	5214.T	Glass (incl Carbon Cement)	Buy	8.6	23.7	16.9
4	Mitsubishi Electric	6503.T	Industrial Electronics	Buy	14.3	350.5	13.2
5	Aisin Seiki	7259.T	Auto Parts	Buy	11.4	327.6	10.8
6	Honda Motor	7267.T	Autos	Buy	9.6	126.4	14.0
7	Itochu	8001.T	Trading Companies	Buy	7.1	43.2	16.7
8	SMFG	8316.T	Banks	Buy	11.4	2.0	7.5
9	Mitsui Fudosan	8801.T	Real Estate	Buy	27.6	-14.3	5.1
10	All Nippon Airways	9202.T	Air	Buy	52.4	NM	3.1
				Average	17.8	110.9	10.1

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

TOPIX (30/12/2010)	898.80
1-yr forward P/E (IBES)	15.3
2-yr forward P/E (IBES)	13.2
P/B	1.1
Dividend Yield	3.0
TOPIX Target 12-mth	1,050.0
Est. Return to Target	17%



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

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

Source: DataStream, Deutsche Securities

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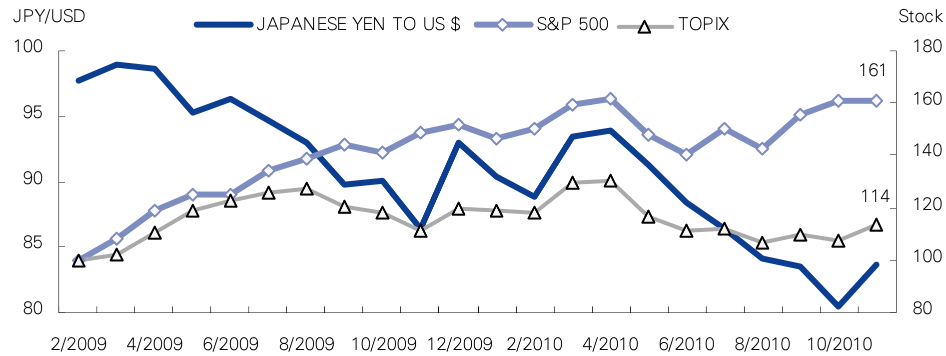
A US recovery and the Fed's QE Exit

Greater confidence in the US recovery should buoy Japanese stocks, which have underperformed due to concerns over US monetary easing and the high yen.

Figure 2: TOPIX, S&P 500, and JPY – Yen appreciation led weak TOPIX



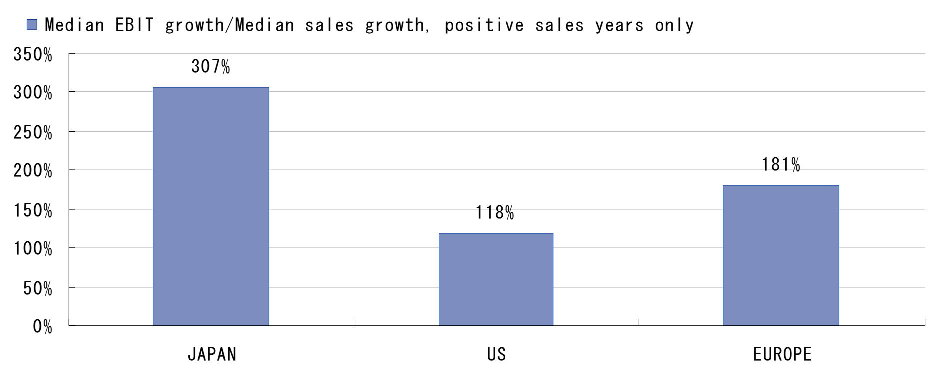
Note: Equity indices are accumulated returns (Feb. 2009=100)
Source: DataStream, Deutsche Securities

Once the global economy begins to show signs of returning to "normal," Japanese stocks should also return to normal levels; specifically, erase the gap with other major stock markets. We believe TOPIX will top 1,000 in 1H 2011. We also think that the market could overheat as profit expectations rise, propelled by FY3/11 results.

Large percentage change in Japanese profits

Japanese firms have higher profit leverage (profit growth divided by sales growth) than their US and European counterparts. The changes generated by this leverage should be reflected in equity returns as confidence in the economic recovery builds steam.

Figure 3: Earnings leverage comparison



Note: CROCI aggregate figures with comparable universe, earnings leverage = median EBIT growth/ median sales growth, positive sales growth years only, 2011 is consensus estimates of each region.
Source: Deutsche Securities

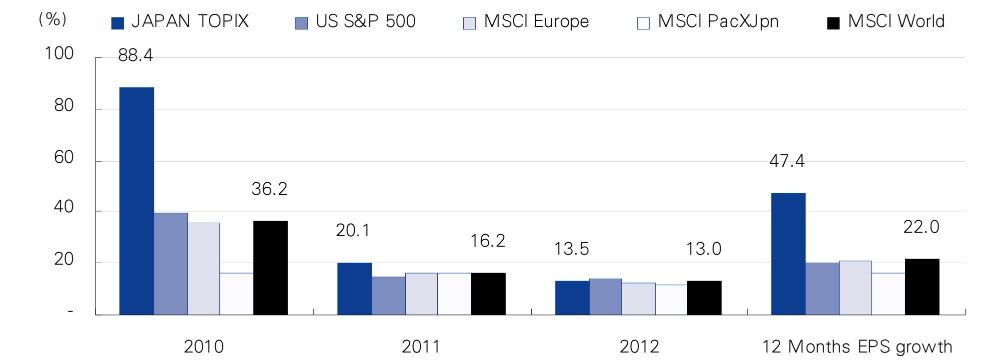
Japanese stocks to strongly outperform in 1H 2011

In our view, the outperformance of Japanese stocks relative to other global stocks should become especially evident 1H 2011. US stocks have already reacted positively in anticipation of a second round of monetary easing by the Fed (Figure 2) and, as the US economy recovers and interest rates rise, investors may temporarily become concerned over the massive liquidity in the market. In Japan, however, since liquidity has not been a driving force, we expect the rise in US interest rates to be positive.

Whether the outperformance of Japanese shares continues into 2H 2011 will hinge on the extent to which the recovery in export demand is transferred to domestic demand. If JGB yields look to test 2%, the uptrend in Japanese shares could continue in 2012.

Growth expectations reflect leverage
EPS growth forecasts reveal hopes not only for a robust recovery in Japan this year but for higher growth than other regions in 2012 as well.

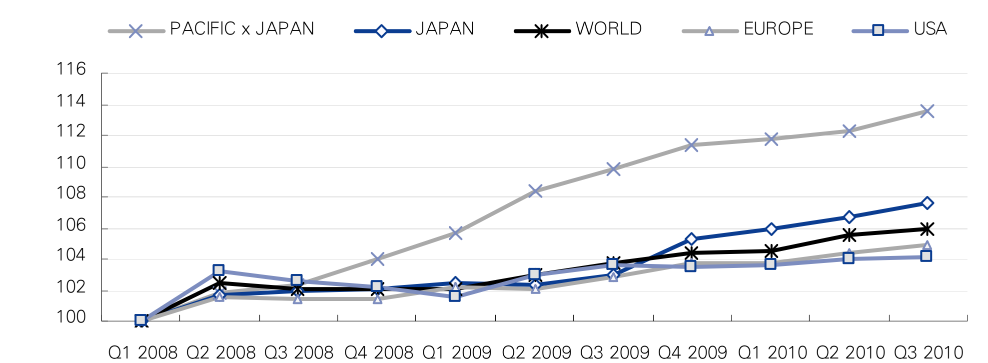
Figure 4: IBES consensus EPS growth comparison



Note: IBES consensus EPS growth estimates (calendar year and next 12 months)
Source: DataStream, Deutsche Securities

Dilution risk, already low, should decline even further post-crisis
A wave of capital increases at Japanese firms since 2008 has hurt confidence in Japanese shares. However, while companies in various regions boosted capital post-Lehman and, admittedly, even though the trend did accelerate in Japan around the end of 2009, initiatives to boost capital in Japan have been mild compared to the rest of Asia.

Figure 5: Dilution is limited in Japan



Note: Market cap.(USD based each quarter) / MSCI price, 1Q2008=100.
Source: DataStream, Deutsche Securities

Sector
We believe expectations will grow regarding the recovery overseas and the pace of profit growth at export-related firms. Therefore, not surprisingly, we expect the rise in 1H 2011 to be led by automobile, auto parts, precision machinery and consumer electronic shares.

For details on our main scenario analyzing Japanese equities from a cyclical standpoint, see Naoki Kamiyama's 1 December *Japan Investment Strategy*, "Japan set to be best performer in 2011". For a positive scenario that posits TOPIX at 2,000 by 2015, see Kamiyama's 6 December *Japan Investment Strategy*, "An Upbeat Scenario".

Figure 6: Analysts' sector recommendation

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	Marketweight	Service revenue should start rebounding shortly thanks to contributions from data. Investor expectations still remain low.
Higurashi, Yoshikazu	SPE	Marketweight	We expect 2011 capex spending for major semiconductor makers to be broadly on par with 2010. We see an emerging possibility of flat growth in order value for front-end processes, while a slowdown in back-end orders is likely to be in line with market consensus. We now see fewer downside catalysts for share prices.
	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	LCD glass momentum should improve in 2H 2011, there should be benefits from thinner LCD glass, and an expanding market for touch-panel glass and glass for automobiles in South America.
	Paper	Underweight	Domestic papermakers' fundamentals are being hurt by weak domestic demand and prospects for a continued decline in pulp prices through 2011 that could make them less competitive relative to their Asian rivals.
	Non-Ferrous	Overweight	In addition to global monetary easing, physically-backed ETFs should have an impact, the price of gold and base metals should rise, and this should boost the share prices of non-ferrous metal stocks.
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	Business Software/IT	Overweight	Growth is set to expand through 2013 on a cyclical upswing in IT investment by Japanese companies. We expect sector companies to see profit growth from 2011 on rising orders and higher profit margins.
	Amusement	Marketweight	Earnings are directionless overall and subject to company-specific factors.
Masuzoe, Kenji	Pharmaceuticals	Marketweight	Some companies face patent issues (patent risk, patent challenges), while others do not.
Miyamoto, Takeo	Industrial Electronics	Marketweight	Overall, sector earnings growth will be moderate and company specific factors differ widely.
Moriwaki, Takashi	Auto Parts	Overweight	Auto parts makers could see higher profits after domestic vehicle production bottoms and output in Asia and North America increases.
	Tires	Marketweight	Demand in developed countries has been slow to recover. A key question is the degree to which higher material prices can be offset by price hikes.
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 on the impact of more stringent financial regulations on liquidity. Upside if the market becomes very liquidity driven.
	Life Insurance	Overweight	Sensitivity is high, with adjusted BPS rising in tandem with long-term interest rates and TOPIX. We see investment appeal amid a market driven by excess liquidity. Insurance business fundamentals are stable.
	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 valuations.
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 the subsequent rebound will not necessarily occur soon. In short, the bottom should be deeper than the current market consensus.
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 the housing market recovers.
	REITs	Overweight	In addition to a recovery in fundamentals, monetary easing could lift the sector.
Sanger, Kurt	Autos	Overweight	Underlying valuations, high gearing to N. America and emerging market growth, firm margins, solid cash flow, strong balance sheets.
Watabe, Takato	Petrochemicals	Overweight	Strong cyclical conditions to continue in 2011 on robust emerging-market demand.
	Textiles	Overweight	Entering a new stage of profit growth, driven by high-performance fibers and restructuring.
	Electronic Materials	Overweight	Difficult 1Q in CY2011 could be offset over the full year by smartphone-related demand.
	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	Judging from recent Basel 3 discussions, we think the possibility of additional initiatives to raise capital by the major banks in the next few years is now low. We believe the "deep discount" will change to a "discount."

Source: Deutsche Securities

Economics
Outlook for 2011

Contraction in economic activity over next two quarters
We forecast the Japanese economy will likely register negative real GDP growth over the two consecutive quarters of 4Q (Oct-Dec) 2010 and 1Q (Jan-Mar) 2011, the clear result of a global soft patch, yen appreciation, and a negative payback in demand for consumer durables following front-loaded demand. The peak for domestic passenger car sales arrived in August 2010 and for flat-screen TVs in November. However, the rapid and dramatic decline in demand could cause an early trough, followed by an economic expansion from 2Q (Apr-Jun) 2011, albeit at a weak pace.

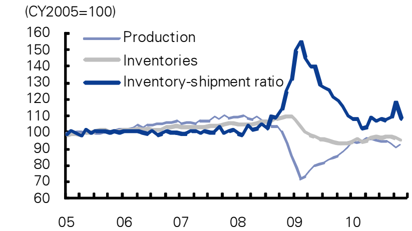
Focus on timing the peak in the inventory-shipment ratio
The key issue over the next few months is the timing of the peak in the inventory-shipment ratio. We expect the month of the peak to coincide almost perfectly with the trough in the business cycle leading index. If there is a continued improvement in the global manufacturing PMI, which has started to recover from the September 2010 trough, Japanese exports should begin expanding in roughly 3~4 months. Trends in the global economy and domestic consumer durables suggest the possibility of a peak in the inventory-shipment ratio in December 2010 or January 2011, after which we expect an improvement in supply-demand conditions to lead to a recovery in production and another economic recovery from 2Q (Apr-Jun) 2011. Even though equity prices are becoming increasingly less predictive of future economic activity, we believe they maintain a lead time of 1~3 months, and continue to reflect ongoing changes in the real economy.

Move to an export-driven recovery from 2Q (Apr-Jun) 2011
The first stage of the recovery should invariably be export-driven. We expect the second stage to be a recovery in export-related capital investment (around end-2011) and the third stage a recovery in private consumption (after mid-2012). We see a low probability of the recovery spreading to domestic demand during 2011. The largest risk to an export-driven recovery is a renewed bout of upward pressure on the yen due to external (non-Japan) factors.

Downward trend in prices to continue
Because the deflationary output gap is expected to widen again over the next two quarters, CPI inflation (excluding food and energy) seems highly unlikely to reach zero unless the subsequent economic expansion continues for at least 2-3 years. Given that the unemployment rate at which CPI inflation reaches zero is around 4% and that the unemployment rate is predicted to fall only as low as 4.7% by end-2012, price declines are likely to be even more prolonged.

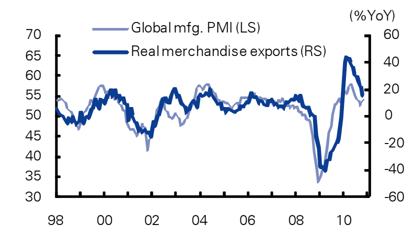
One more bout of monetary easing at most
Due to its skepticism over the stimulatory effects of quantitative monetary easing, the Bank of Japan is set to maintain the zero interest rate regime without reverting to quantitative monetary easing. We thus do not expect any aggressive quantitative easing measures in order to end deflation. That said, there is some scope for at least one more round of reactive monetary easing in 1Q (Jan-Mar) 2011 in response to two consecutive quarters of negative growth. We should focus on whether or not the purchase of ¥5trn worth of assets is accompanied by an expansion of the same amount in the BoJ balance sheet or bank reserves.

Focus on peak month of inventory-shipment ratio



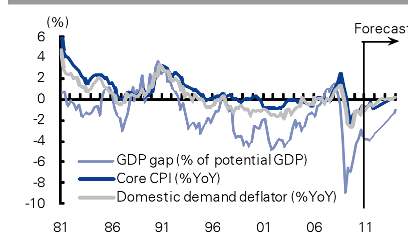
Sources: METI, DB Global Markets Research

Japanese exports follow global manufacturing PMI



Sources: MarkIt, BoJ, MoF, DB Global Markets Research

GDP gap and inflation



Notes: 1) GDP gap = (Actual GDP - Potential GDP) / Potential GDP(%). 2) Data for 4Q 2010 and later are forecast by DB. 3) Potential GDP is obtained by the Hodrick-Prescott filter. 4) Excluding effects from consumption tax.
Sources: Cabinet Office, MIC, DB Global Markets Research

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Transformation of the 'global iron hexagon' in 2011

We predict that the regime of the global real interest rate and the 'global iron hexagon' that was formed in 2003-2006 and generated a virtuous circle marked by economic growth and higher asset prices will be influenced by the following three factors:

1) Reversal of the differential between GDP growth and long-term interest rates in major advanced countries;
2) Start of a cycle of rate hikes in EM countries; and
3) Constraints on free capital mobility and a loss of confidence in the fiat monetary standard.

GDP growth in G7 countries surpassed their long-term interest rates from 2Q (Apr-Jun) 2010, and have now become a support for asset prices. However, there is a serious possibility that this difference will once again be reversed. Many EM countries have already started monetary tightening by raising interest rates and we think this will lead to currency appreciation in EM countries, a decline in commodity prices due to falling speculative demand, declines in EM countries' trade surpluses, and a rise in the global real interest rate. We must be aware of the likelihood of the earlier realization – than in previous global economic expansions – of a cycle in which EM countries' trade surpluses decline, the global real rate rises, the global economy slows, and asset prices stop rising,.

The recent move for peripheral advanced countries to abort the global real rate and the sharp rise in the price of gold relative to other commodities are indicative of constraints on the free movement of capital and of a loss of confidence in the fiat monetary standard. We expect an increase in countries unable to take advantage of the virtuous circle that allows them to finance economic growth through low real interest rates because of the global real rate regime. There may well be relatively strong upward pressure on nominal long-term interest rates in countries with current account deficits, even among the major advanced countries, which we view as the first precursor of an end to the global real rate regime. Going forward, the determinants of long-term interest rates will probably revert to traditional factors common when there is imperfect capital mobility and a closed economy. These are usually country-specific fundamental factors (such as current account balance, fiscal balance, business cycles, monetary policy, inflation, etc.) that exert a statistically significant effect (that said, this analysis is based on a time horizon of over five years or longer and abstracts business cycles).

It takes a relatively long time—several years at least—before aggressive quantitative monetary easing in advanced countries accelerates inflation since declines in the money multiplier and the velocity of money exert downward pressure on prices due to de-leveraging by companies and households (= tighter regulations on financial institutions). Inflation is likely to accelerate only after these pressures on de-leveraging alleviate and if the central bank continues to expand its quantitative easing operations by taking on more debt from the non-financial sector, even after the economic expansion continues for many more years.

Figure 1: Major economic indicators

		2010		2011				2012				FY2010	FY2011	FY2012
		Q3	Q4(F)	Q1(F)	Q2(F)	Q3(F)	Q4(F)	Q1(F)	Q2(F)	Q3(F)	Q4(F)			
Real GDP	%QoQ	1.1	-0.5	0.0	0.2	0.1	0.3	0.6	0.6	0.4	0.5	3.2	0.6	1.9
	%SAAR	4.5	-2.0	-0.1	0.8	0.3	1.4	2.4	2.3	1.7	2.1			
	%YoY	5.0	3.0	1.3	0.8	-0.3	0.6	1.2	1.6	1.9	2.1			
Domestic demand contribution	%QoQ	1.1	-0.7	-0.3	0.1	0.0	0.2	0.5	0.4	0.3	0.4	1.8	0.0	1.4
External demand contribution	%QoQ	0.1	0.2	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.6	0.5	0.5
Final sales (=GDP-inventories)	%QoQ	0.9	-1.0	-0.2	0.3	0.3	0.3	0.4	0.5	0.4	0.5	2.7	0.5	1.7
Private consumption	%QoQ	1.2	-1.5	-0.7	0.5	0.3	0.3	0.3	0.4	0.3	0.3	1.1	-0.1	1.2
Private capital investment	%QoQ	1.3	-1.6	-0.6	0.0	0.3	0.5	0.8	0.8	0.8	1.0	3.6	-0.3	3.0
Private inventories (contribution)	%QoQ	0.2	0.4	0.1	-0.1	-0.2	0.0	0.2	0.1	0.0	0.0	0.7	0.1	0.2
Exports	%QoQ	1.4	0.1	1.1	1.6	1.6	1.6	1.8	1.8	1.8	1.8	18.8	5.7	7.2
Nominal GDP	%QoQ	0.6	-0.2	-0.2	-0.4	-0.1	0.3	0.3	0.5	0.3	0.5	1.4	-0.3	1.4
	%YoY	2.5	1.9	-0.1	-0.1	-0.9	-0.3	0.1	1.0	1.4	1.6			
GDP deflator	%YoY	-2.4	-4.6	-1.0	-4.1	-0.6	-0.9	-1.1	-0.6	-0.5	-0.5	-2.6	-1.7	-0.5
Industrial production	%QoQ	-1.9	-3.4	-2.5	1.5	2.3	1.8	1.3	1.3	1.0	1.0	7.0	0.2	5.2
	%YoY	12.9	3.0	-6.2	-6.2	-2.3	3.0	6.9	6.7	5.4	4.6			
Consumer prices, overall	%YoY	-0.8	-0.1	-0.6	-0.5	-0.3	-0.9	-0.8	-0.7	-0.6	-0.5	-0.6	-0.6	-0.5
Unemployment rate	%	5.1	5.1	5.1	5.1	5.1	5.0	4.9	4.9	4.8	4.7	5.1	5.0	4.8
Current account	% of GDP	3.7	4.1	4.4	4.3	4.5	4.7	4.5	4.7	4.8	4.9	3.9	4.5	4.8
10-year JGB yield (period average)	%	1.0	1.1	1.3	1.4	1.4	1.5	1.5	1.5	1.6	1.6	1.2	1.5	1.6
USD/JPY (period average)	¥/USD	86	83	78	75	80	83	85	85	87	88	85	81	88

Note: Shaded regions indicate a business cycle phase in which stagnancy is likely to remain.Sources: Cabinet Office, METI, Bank of Japan, MIC, TSE, Deutsche Securities forecast

Economics

2011 May See Long-Awaited Political Realignment

DPJ suffers thrashing in Ibaragi election

2011 could be a year of powerful momentum towards a realignment of Japan's political world. The ruling DPJ suffered a major defeat in Ibaragi Prefectural elections on 12 December, which had been closely watched as a run-up to nationwide local elections scheduled on 10 and 24 April next year. The Kan administration's approval ratings in opinion polls have skidded below the 30% line, considered the life-or-death benchmark for a government, and the DPJ's ratings have fallen below the LDP's (the largest opposition party) for the first time since it took power. There is rising support among the opposition to dissolve the Lower House and hold general elections. We believe the government will face an uphill battle in trying to conduct policy next year. Following the censure motions against Cabinet Secretary General Yoshito Sengoku and others in the Upper House, deliberations in the Lower House are unlikely to proceed smoothly when the Diet reconvenes for its regular session next month, and we could very well see a reshuffling, the wholesale resignation of the Cabinet or a general election.

Possible Grand Coalition between anti-Ozawa forces and fiscal reformists

There is a separate fear that the DPJ could break apart, making it impossible for the present government to maintain its majority in the Lower House. The party attributes its recent slump in opinion polls primarily to the political funding scandal involving its former secretary general Ichiro Ozawa and is stepping up attempts to distance itself from his influence. This has provoked a sharp response from Ozawa and his supporters, raising fears of a split in the party into pro- and anti-Ozawa groups.

Meanwhile, there are signs of political realignment, including hints by LDP policy chief Shigeru Ishiba of a possible alliance with the anti-Ozawa members of the DPJ. Ishiba is an advocate of fiscal restructuring funded by a consumption tax hike in the near term, a view supported by a number of important DPJ members, such as Finance Minister Yoshihiko Noda and National Strategy Minister Koichi Genba. Others sharing this belief include New Renaissance Party chief Yoichi Masuzoe and Sunrise Party leader Kaoru Yosano. At this stage, the idea of political realignment is most closely associated with a Grand Coalition between Ozawa opponents and fiscal reformists.

Ozawa mulls anti-deflation stance

If this movement should take hold, there appears little option for the Ozawa group other than to join the anti-deflation adherents led by Your Party, who give top priority not to fiscal reform but to defeating deflation through reflationary policy. In a campaign speech in his unsuccessful bid for the DPJ presidency, Ozawa highlighted the need for a reflationary policy based on an inflation target, and it now looks as if he will have to pursue this goal for real if only to secure a political lifeline. To accomplish this, he will need to join hands with groups who backed the Koizumi-era structural reform program, including Your Party and the reform wing of the LDP. Ozawa is now arguing against agricultural deregulation and the Trans-Pacific Partnership scheme in order to broaden his regional support base, a position that clashes with the policy stance of Your Party. Meanwhile, Your Party, which is coming into its own as a third force in Japanese politics, has built an image since the Abe administration as the antithesis of the LDP's anti-reform tendencies. Joining hands with Ozawa, who is still associated with the old LDP guard, could damage its reputation among voters. Based on the assumption that a stock market revival will require reflationary policy starting with further quantitative easing measures, one of the key points for equity investors gauging the probability of political realignment next year will be whether Ozawa and Your Party can align their views.

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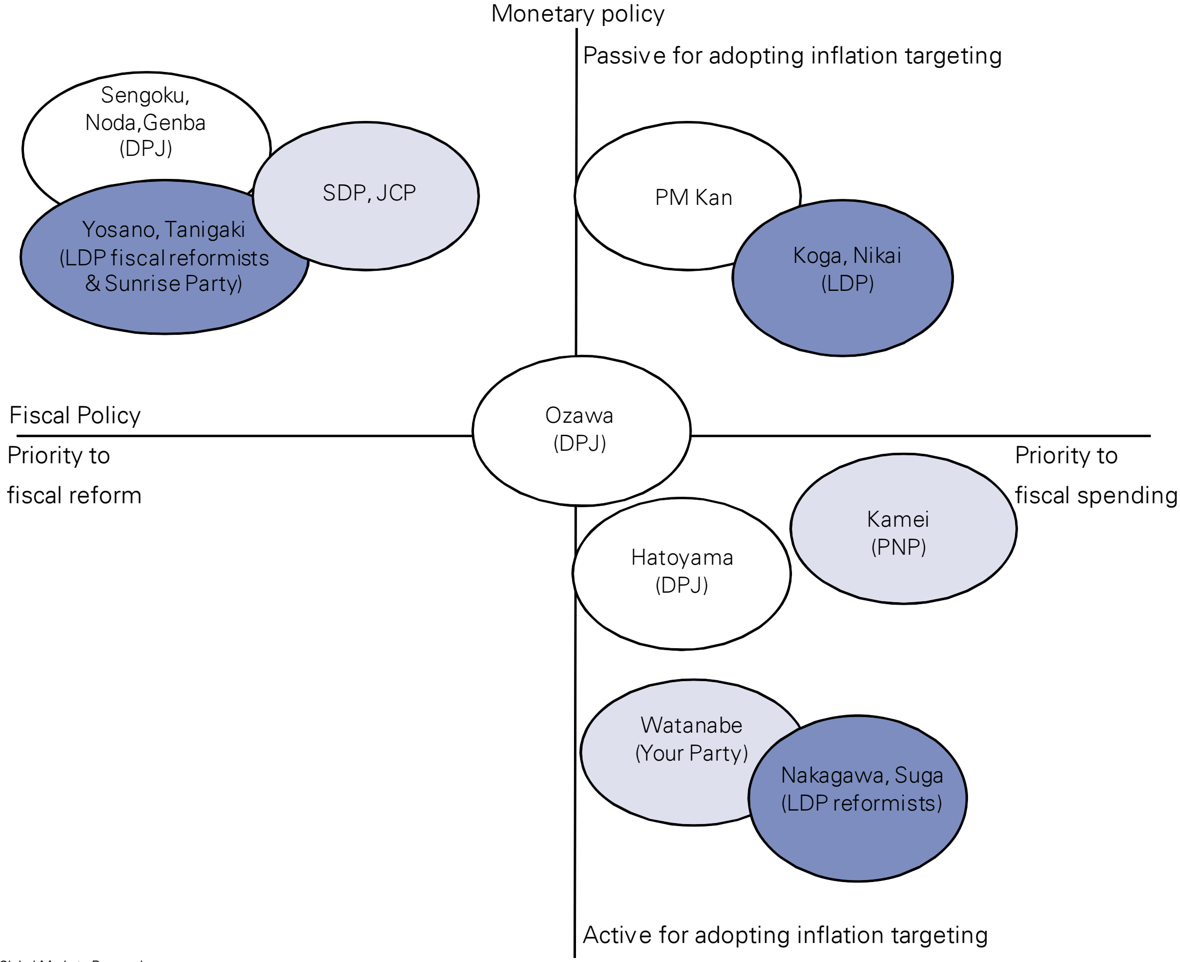
Figure 1: Economic policy stance by party and by main politician



Source: DB Global Markets Research

Japan Strategy

Japan- A Relative and absolute Value play

Japan stock valuations are close to levels discounting the Lehman crisis. A successful Bernanke targeting of US nominal growth expectations could unlock value in Japan. Watch Japanese banks relative performance, a rising US 30-year bond yield, a weaker yen/US dollar rate as catalysts.

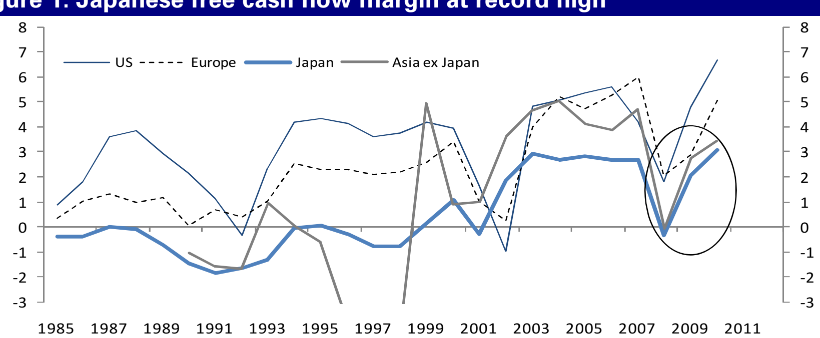
Fundamentals in corporate Japan are not as poor as consensus thinks. Figure 1 shows that Japanese corporates are generating record high free cash flow margins, having controlled capex spend in the recent recession. Indeed, the much-loved Asia ex-Japan region has free cash flow margins barely above those in Japan.

Japan is always a special case. In the late 1980s, it dominated the world's most expensive sectors on a range of valuation metrics, and was considered a special situation because of cross-holdings, a low discount rate, accounting differences, global market share etc. Now, Japanese sectors dominate the world's cheapest sectors – 19 of the cheapest 24 out of a total of 96 from the US, Europe, Japan and Asia (Figures 2 and 3). Again, it is a special case – beset by deflation, bad policy, bad margins and bad demographics. It is a case of extreme valuations manufacturing the extreme rationales, fantastically positive in the late 1980s (and very wrong), and fantastically bearish now.

Let us take a look at absolute valuations. Figure 4 shows the composite valuation index for Japan based on seven metrics. We are not far from the depths of the Lehman crisis. The world and Japan are in a much better place now. While we do not want to fall into the usual value trap that Japan represents, we are heartened by the correlation between the US 10-year bond yield and the Topix (Figure 5). As Figure 5 suggests, historically the correlation between the US 10-year bond yield and the Topix has been close, reflecting the impact of nominal growth expectations on Japanese equities. Since the 10-year tenor is partially medicated now, we use the 30-year bond yield to reflect nominal growth expectations. As we had said in earlier research, if you believe Prof. Bernanke is going to credibly raise nominal growth expectations and the US 30-year bond yield with it, this could be a catalyst for Japan. Equity Risk-Love (sentiment) in Japan remains subdued while Asia ex Japan is in neutral zone. See Figure 6.

Investment implications: If the 30-year bond yield continues to climb/stabilize, Japan bank stocks and small-caps start outperforming, as the yen/US dollar weakens, Japanese stocks are poised to do quite well.

Figure 1: Japanese free cash flow margin at record high



Source: Deutsche Bank, Factset. Free cash flow margin = Net income plus depreciation expense less capital expenditure divided by total sales.

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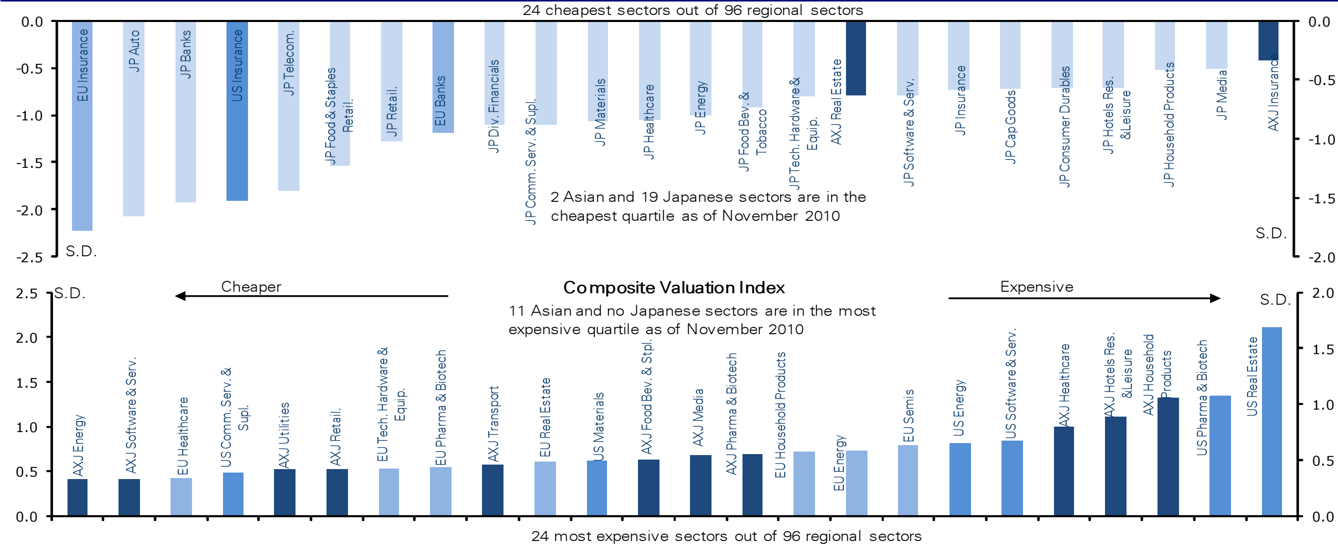
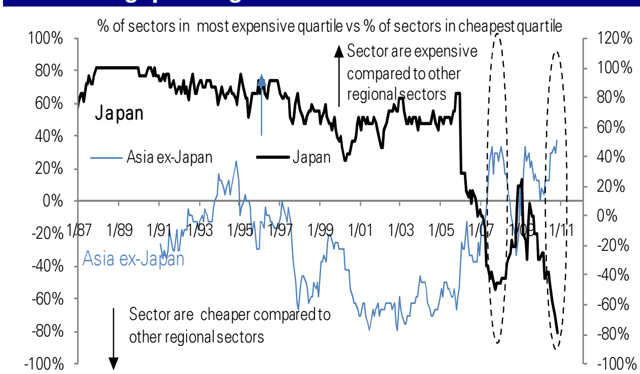
Figure 2: Japan is relatively the cheapest region in the world – with 19 of the world's 24 cheapest sectors, of a total of 96 sectors from the US, Europe, Japan and Asia ex-Japan



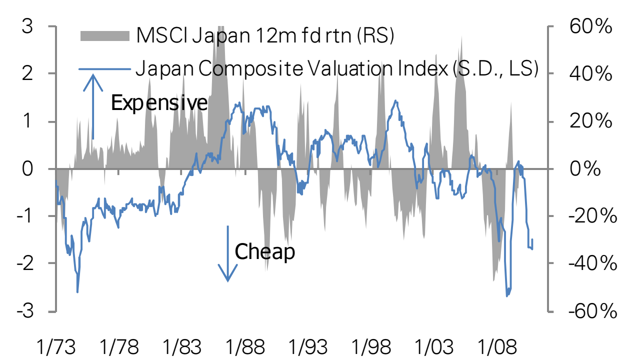
Source: Deutsche Bank, Factset. Valuation is based on forward P/E, price to operating income, price-to-book value, price to sales, price to free cash flow, EV to EBIT, EV to EBITDA, EV to sales, EV to capital employed, EV to free cash flow and trailing P/E (all median sector data). Analysis is done on 96 regional (US, Europe, Japan and Asia ex-Japan) sectors.

Figure 3: Japanese sectors dominate the world's "cheap" list, Asia ex-Japan dominates the "expensive " list. The gap is large.



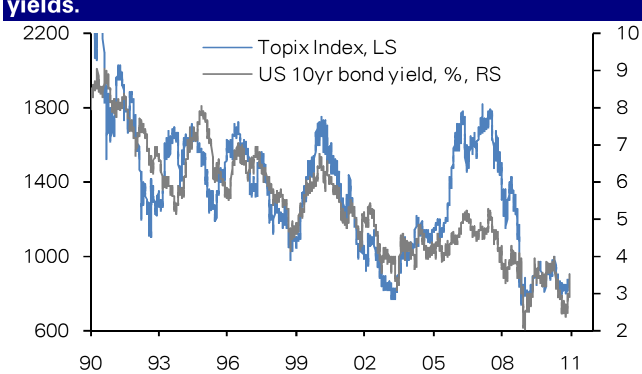
Source: Deutsche Bank, I/B/E/S, MSCI. Note: Composite valuation index is the average of trailing P/E, 12m forward P/E, P/Cash Earnings, P/BV, Dividend Yield, EV/EBITDA and EV/Sales, normalized over entire history.

Figure 4: Japan is cheap compared with its history



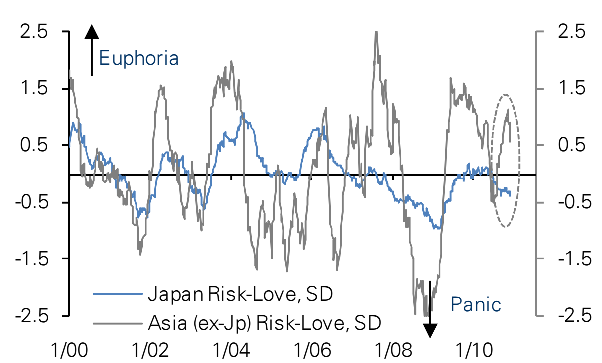
Source: Deutsche Bank, Bloomberg Finance LP.

Figure 5: Japanese equities are a global nominal GDP expectations play. Correlate well with US 10-yr bond yields.



Source: Deutsche Bank, I/B/E/S, MSCI. Note: Composite valuation index is the average of trailing P/E, 12m forward P/E, P/Cash Earnings, P/BV, Dividend Yield, EV/EBITDA and EV/Sales, normalized over entire history.

Figure 6: Divergence between Asia and Japan Risk-Love (sentiment) indicators



Source: Deutsche Bank, Bloomberg Finance LP

CROCI

Valuation & Profitability of Japan

Japan is among the most interesting markets for value investors
As we enter 2011, the focus of investors is firmly on macro dynamics in Emerging Markets, the pace of economic recovery in the US and sovereign risks in Euroland. What is absent from the discussion, in our opinion, is Japan. Yet, from a Value perspective, Japan should be among the most interesting markets to investors.

Investors appear to be giving up on Japanese equities
In this report we analyze the valuation of Japanese Equities, the drivers of profitability and what is implied in market prices. Our conclusion is that investors are giving up on Japanese equities, a view based on the following observations: first, Japan is on average on the lowest EV/NCI (economic price-to-book) of the past 20 years; second, Japan is on a similar Economic PE ratio as US and Europe, thus suggesting that investors do not expect that cash returns will improve from the current low levels; and third, the ratio of stocks trading on an economic price to book below one is as high as during the dark days of the credit crisis.

Concerns about Japanese corporates are fair, but are in the price
In the report we analyze the drivers of profitability using the CROCI® valuation framework and note that: first, the real returns on capital invested of the Japanese market are below US and Europe; and second, the reasons behind the lower returns can be found in the poor productivity of capital invested. It may be early to make a call for structural change in Japanese corporate behavior; however, we note that the market is not expecting it either.

Where there is apathy, there are opportunities
Beyond the market call, there are good value opportunities in Japan. 66% of our universe in Japan is trading on an adjusted price-to-book less than one; yet based on 2011 estimates and the average of 2006-2010, 53% and 50% will have cash returns above our Global market-implied cost of capital. A structural improvement in profitability is not required for the gap to close, just recognition that expectations are too low. In some cases, it is possible to buy at a better price Japanese companies that are better managed than their global peers (Autos); in other cases, we see sectors which face similar challenges globally at a better price in Japan (Telecoms).

While attention has been focused elsewhere, opportunities have developed in Japan that should not be ignored by investors.

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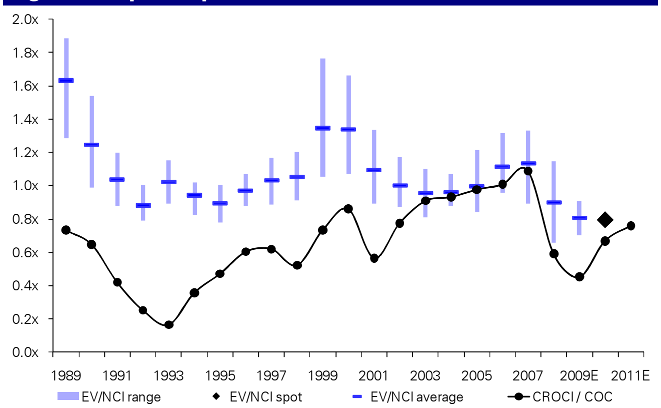
Japan is among the most interesting markets for value investors

We analyze the valuation of Japanese Equities, the drivers of profitability and what is implied in market prices. Our conclusion is that **investors are giving up on Japanese equities**:

1 – Japan is on average on the lowest EV/NCI for the past 20 years. Figure 1 plots EV/NCI, our economic P/B, against the relative profitability of the market, i.e. CROCI to COC. The line of EV/NCI ratio is downward sloping, and at 0.8x, Japan is on average on the lowest adjusted price to book of the past 20 years. Conversely, CROCI relative to COC has improved. We have now reached an equilibrium with market prices expecting no improvements in the relative CROCI.

Figure 1: Spot Japan EV/NCI is close to historical lows



Source: Deutsche Bank

Figure 2: Valuation of the Regions

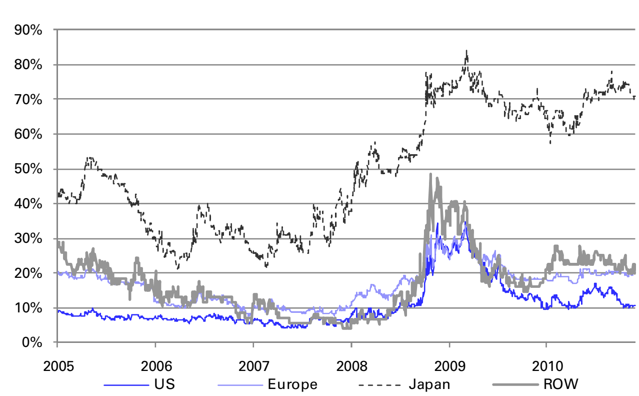
		2008	2009E	2010E	2011E
USA	CROCI	10.5%	8.2%	9.8%	10.6%
	EV/NCI	2.1x	1.7x	1.9x	1.9x
	Economic PE	19.5x	20.8x	19.9x	17.5x
Europe	CROCI	8.2%	6.3%	7.9%	8.3%
	EV/NCI	1.5x	1.3x	1.5x	1.4x
	Economic PE	18.7x	20.5x	18.6x	17.0x
Japan	CROCI	3.1%	2.5%	3.7%	4.2%
	EV/NCI	0.9x	0.8x	0.80x	0.7x
	Economic PE	29.4x	40.6x	20.7x	17.6x
GEMs	CROCI	10.0%	6.6%	8.0%	8.4%
	EV/NCI	1.7x	1.2x	1.4x	1.3x
	Economic PE	17.0x	18.7x	17.7x	15.3x

Source: Deutsche Bank

2 – Japan is on similar Economic PE ratios as US and Europe, suggesting that investors do not expect that earnings will improve from the current low levels. As economic earnings are the result of CROCI and NCI, we can measure the long term cash returns implied in market prices at unchanged NCI. In each region, Equities price in unchanged cash returns, which in the case of Japan implies that the upward trend in cash returns seen in the past decade will come to a halt and Japan will remain value destructive in perpetuity.

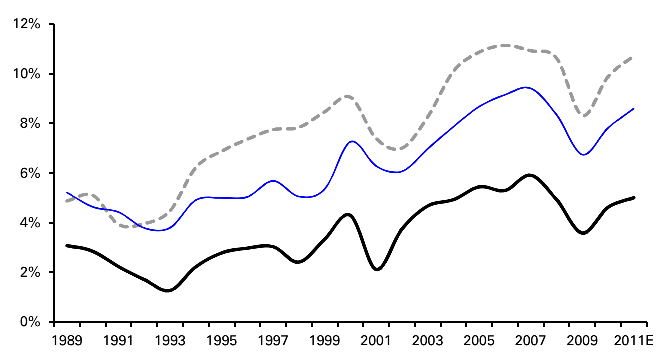
3 - The ratio of stocks trading on an economic-price-to book below one is as high as during the dark days of the credit crisis. Figure 3 shows the percentage in the three main geographic markets trading on an EV/NCI below one. Uniquely, Japan remains at crisis levels. The strength of the Yen has further dampened enthusiasm for Japan.

Figure 3: Ratio of Japan coos with EV/NCI below 1x



Source: Deutsche Bank

Figure 4: Japan's CROCI still well below other regions



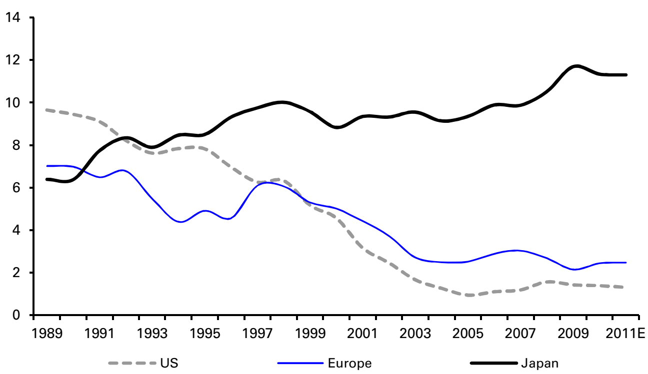
Source: Deutsche Bank

Concerns about Japanese corporates are fair, but are in the price

The reasons behind the lower cash returns for Japanese corporates can be found in the poor productivity of capital invested. Cash returns are a function of cash flow sales margins and capital intensity (Sales to Capital Invested). Figure 4 suggests that Japan was never able to regain the productivity loss experience in the early 1990s recession, but that companies were able to improve their margins.

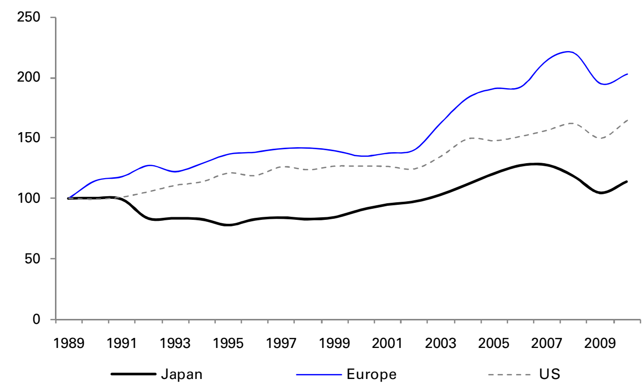
Looking at some productivity ratios (figure 5 showing NWC to sales), it appears that the productivity gains achieved in the US and Europe have completely bypassed Japan. In a low growth environment (revenues in the past 20 years have grown at 1% in nominal terms) it is logical to expect companies to focus on efficiency, but as the sales per employee data in figure 6 shows that European and US corporates have been better than Japanese companies in focusing on productivity. It is difficult to point to the precise reason behind the difference in performance. In our view, the primary reason is likely the stronger push in US and Europe towards outsourcing in low cost areas.

Figure 5: Net Working Capital to Sales by region



Source: Deutsche Bank

Figure 6: Real sales per employee by region



Source: Deutsche Bank

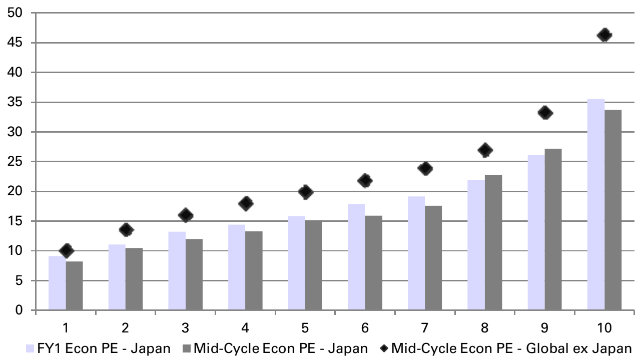
The conclusion from the above is that it may be ill-advised to make a call for structural change in Japan. The stronger yen will have forced corporates to re-think their role in the supply chain, but this is Japan and changes will take time. At this stage, what we can say is that market prices have given up on Japan ever coming out of the current doldrums.

Where there is apathy, there are opportunities

66% of our universe in Japan is trading on an adjusted price to book less than one

Beyond the market call, there are good value opportunities in Japan. Using a global implied cost of capital, 66% of our universe in Japan is trading on an adjusted price to book less than one; yet based on 2011 estimates and the average of 2006-2010, 53% and 50% will have cash returns above the cost of capital. A structural improvement in profitability is not required for the gap to close, just recognition that expectations are too low.

Figure 7: Distribution of value by docile – Japan vs Row



Source: Deutsche Bank

Figure 8: Best value stocks in Japan on adj. 5Y Econ PE

	CROCI (%)			Economic P/E (Ad)	
Name	**FY1**	**5Y**	**Implied**	**FY1**	**5Y**
Toyota Indus.	3.2%	5.1%	0.9%	3.8	3.1
Takeda Pharma	12.0%	16.4%	5.4%	8.3	6.1
Astellas Pharma	10.6%	13.8%	4.8%	8.3	6.4
Shin-Etsu Chem.	5.8%	10.8%	4.8%	15.4	8.2
Rohm	2.2%	3.8%	2.3%	11.1	9.1
Eisai	9.0%	10.0%	5.0%	10.3	9.2
Nintendo	30.1%	52.4%	27.9%	17.0	9.8
Hoya	15.3%	19.4%	10.7%	12.8	10.1
Denso	4.0%	5.2%	2.9%	11.5	10.2
Canon	7.9%	12.9%	7.2%	16.7	10.2
Yamato Holdings	5.8%	7.4%	4.2%	13.4	10.5
Nitto Denko	11.1%	11.0%	6.3%	10.5	10.5
Sharp	4.5%	5.1%	3.1%	11.3	10.7
Toppan Printing	3.2%	3.9%	2.7%	11.6	10.8
Sumitomo Elec.	6.3%	5.6%	3.3%	9.8	10.9
Dai Nippon	4.2%	5.0%	3.1%	12.0	11.0
Fujifilm	2.5%	4.4%	3.0%	13.9	11.2
Mitsui O.S.K.	6.1%	7.7%	4.7%	14.3	11.3
Suzuki Motor	4.3%	6.8%	4.2%	15.8	11.3
NTT	1.7%	2.4%	2.4%	12.6	11.5

Source: Deutsche Bank Adj. Economic P/E is calculated using the average of the actual CROCI and the COC for companies with CROCI below the COC.

CROCI is a valuation framework that was developed with the objective of enabling comparability across sectors and markets. It is therefore particularly appropriate when comparing companies and sectors on a global basis.

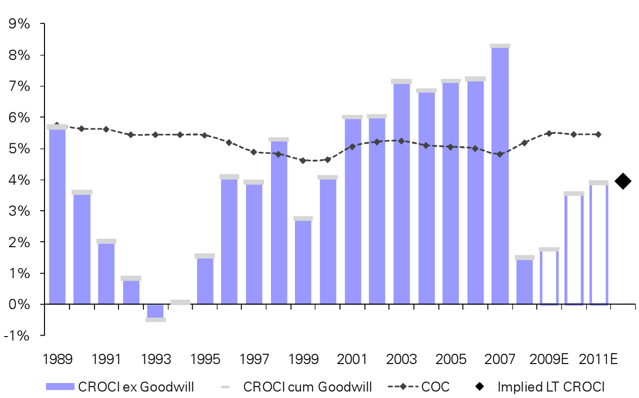
Valuation asymmetries across sectors

A comparison of the Japanese and European Auto sectors is perhaps the best example of an exception to the rule that productivity and returns on capital lag in Japan. Figures 9 and 10, compare the cash returns of the Japanese and European Auto sectors. It is the Japanese companies that appear better managed; achieving higher cash returns through the cycle.

For European Autos, cash returns (i.e what matters to investors) continue to be poor; yet it is the best performing sector in the region, having been the primary beneficiary of the devaluation of the Euro and strong demand in Asia. As a result the market is pricing significant improvement versus estimates and history (this is a sector that made the COC only twice historically). Meanwhile, the better managed Japanese autos have much higher cash returns, yet the market is pricing the excess returns to be a thing of the past.

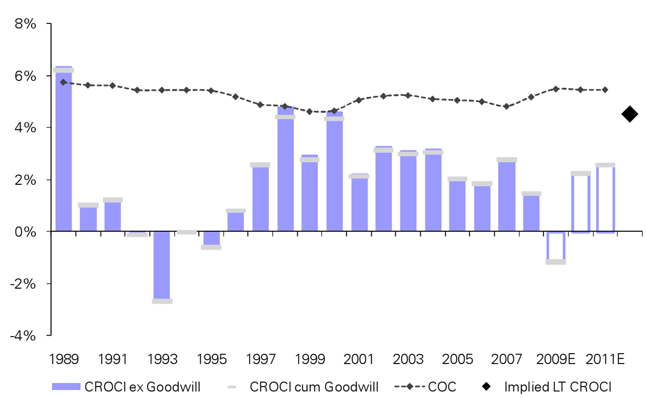
Investors looking for value in Auto will know where to find it.

Figure 7: Japan Autos: CROCI & Implied CROCI



Source: Deutsche Bank

Figure 8: Europe Autos: CROCI & Implied CROCI



Source: Deutsche Bank

Deutsche Bank Group

Industrial Electronics

Marketweight

Focus on ability to execute growth strategy

Industrial Electronics sector: Marketweight

We are Marketweight on the industrial electronics sector. Some caution is recommended, however, as businesses with short cycles, including semiconductors and digital consumer appliances, may continue to correct through mid-2011. While we believe businesses with long cycles – including heavy electrical equipment and infrastructure-related businesses – are likely to continue to recover thanks to an increase in investment in emerging countries and renewed investment in advanced countries, the contribution to earnings is likely to be from FY3/12.

A different state of readiness as companies prepare for growth strategies

Companies that pressed on with restructuring plans amidst the downturn following the financial crisis have seen their earnings recover to a certain level. Some companies also saw self-sustained rebounds as earnings recovered sharply due to a recovery in sales just as they were curbing fixed costs. Going forward, however, earnings are unlikely to expand unless sales growth is steady and companies make a sustained effort to improve their cost structures. Within the sector, some companies need to carry out additional restructuring while others are close to achieving restructuring targets. The former will invariably have to continue to divert managerial resources to dealing with loss-making businesses and solving structural problems. In 2011, we believe the earnings gap dividing these two types of companies is likely to widen further.

Mitsubishi Electric our top pick

Mitsubishi Electric had previously based its business strategies on balanced initiatives but started emphasizing growth strategies from 2010. We believe a rising share in the factory automation (FA) business, additional orders for digital control systems for nuclear power in China, and development of multiple businesses in India (although small in scale individually) have growth potential. The acquisition of a European power semiconductor company is also an indication of the company's focus on growth. Furthermore, given Mitsubishi Electric's solid financial profile and its ability to execute its strategies, we look for its more robust growth strategies to directly translate to higher earnings. We believe the firm should now be valued for its growth potential rather than its stability.

Mitsubishi Electric: valuation and risks

Our ¥1,000 target price equates to a FY3/12E P/E of 14x. We think expectations of sustainable earnings growth make profit-based valuations appropriate. 14x P/E is the weighted average of Bloomberg consensus forecasts for comparable companies in each segment. Downside risks include a delayed recovery in private-sector capex, yen appreciation, a downturn in infrastructure investment, and a decline in automobile production.

Mitsubishi Electric (6503) forecasts and ratios

Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	3,353.3	**3,630.0**	3,560.0	3,865.0	4,090.0
YoY (%)	-8.5	**8.3**	6.2	6.5	5.8
Operating profit (¥bn)	94.3	**230.0**	205.0	270.0	290.0
YoY (%)	-32.5	**143.9**	117.4	17.4	7.4
Recurring profit (¥bn)	64.3	**215.0**	195.0	255.0	275.0
Net profit (¥bn)	28.3	**127.5**	115.0	151.0	163.0
EPS (¥)	13	**59**	54	70	76
P/E (x)	50.0	**14.3**	15.9	12.1	11.2
EV/EBITDA (x)	6.8	**5.2**	-	4.3	3.8
CFPS (¥)	77	**120**	-	133	139
P/CFPS (x)	8.6	**7.1**	-	6.4	6.1

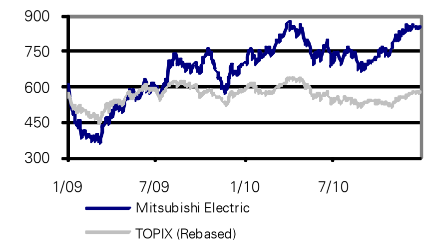
Source: Deutsche Securities Inc. estimates, company data

Mitsubishi Electric (6503)

Buy

Price at 30 Dec 2010 (¥)	**852**
Price target - 12mth (¥)	**1,000**
52-week range (¥)	**873 - 667**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*2.8*	*18.7*	*24.4*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**1,829**
Shares outstanding (m)	**2,147**
Foreign shareholding ratio (%)	**25.3**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**9.0**
BPS (¥)	**685**
P/B (x)	**1.2**
EPS growth (%)	**350.5**
Dividend yield (%)	**0.8**

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Consumer Electronics

Marketweight

Sharp at a crossroads

We are Marketweight on the consumer electronics sector

We are Marketweight on the consumer electronics and flat panel display (FPD) sector. Consumer electronics stocks are heavily undervalued based on asset based valuations such as P/B, but this is offset by a number of negatives; few companies are attractively valued on earnings-based valuations despite an improvement in earnings, and South Korean companies have taken the lead in consumer products such as TVs and LCD panels, and core components.

The sector

The key in the consumer electronics sector is to lift profits by increasing sales not by relying solely on cost cutting. Specific issues include (1) the impact of the expired eco-point program and (2) efforts to expand sales in emerging nations and B-to-B operations. We expect Panasonic (through B-to-B) and Sony (in emerging nations) to pull further ahead of Sharp as they further increase their competitive advantage. However, this scenario relies on Panasonic quickly developing restructuring plans and a strategy after the acquisition of Sanyo Electric and Panasonic Electric Works as wholly owned subsidiaries, and on Sony accelerating growth in areas with improving earnings (games and semiconductors) while enhancing performance in weak segments (TVs and DI). Among second-tier companies, we like Funai Electric (for its abundant cash) and Pioneer (which has moved beyond its recent crises). We do not expect FPD demand-supply to tighten in 2011 because we forecast low LCD demand (area) growth of only 14%. We recommend selecting stocks with exposure to areas such as OLED, LED backlights, and high performance films.

Sharp (Sell) is our top pick

We expect Sharp to struggle in FY3/12 because of its heavy dependence on the Japanese market for TVs and consumer electronics, and its focus on the LCD and PV cell markets under the severe business environment. The company's financial condition is not particularly healthy, and aggressive additional investment in areas such as G10 lines could increase funding risk. The dilemma is that doing nothing would leave it less able to compete. The stock looks relatively overvalued because it has not yet priced in these negatives.

Sharp: valuation and risk

We base our ¥730 target price on the midpoint between FY3/13E P/E of 17x and P/B of 0.85x, the average among the stocks we cover. Upside risks include: 1) quicker-than-expected improvement in demand/supply for large panels; 2) rapid yen depreciation against the euro and the dollar; 3) rapidly changing strategies and the acquisition of major new customers in the panel business; and 4) the absence of a slowdown in the domestic LCD TV market after the eco-point system is phased out and AQUOS sales that are significantly above our forecasts.

Sharp (6753) forecasts and ratios

Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	2,755.9	**3,052.0**	3,100.0	2,834.8	3,001.7
YoY (%)	-3.2	**10.7**	12.5	-7.1	5.9
Operating profit (¥bn)	51.9	**71.6**	90.0	65.5	94.5
YoY (%)	-	**37.9**	73.4	-8.5	44.4
Recurring profit (¥bn)	31.0	**43.9**	55.0	40.5	74.5
Net profit (¥bn)	4.4	**21.2**	30.0	22.5	42.9
EPS (¥)	4	**19**	27	20	39
P/E (x)	261.1	**43.5**	30.7	41.0	21.5
EV/EBITDA (x)	5.3	**3.8**	-	3.6	3.2
CFPS (¥)	228	**265**	-	270	262
P/CFPS (x)	4.6	**3.2**	-	3.1	3.2

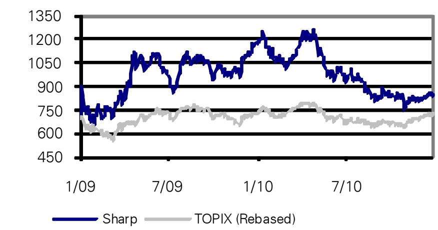
Source: Deutsche Securities Inc. estimates, company data

Sharp (6753)

Sell

Price at 30 Dec 2010 (¥)	**837**
Price target - 12mth (¥)	**730**
52-week range (¥)	**1,254 - 752**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*4.0*	*0.7*	*-28.3*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**921**
Shares outstanding (m)	**1,100**
Foreign shareholding ratio (%)	**19.7**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**2.0**
BPS (¥)	**942**
P/B (x)	**0.9**
EPS growth (%)	**381.1**
Dividend yield (%)	**2.2**

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Autos

Overweight

Further growth in 2011

Auto sector – Overweight

We continue to see momentum from emerging markets volume growth and N. America recovery in 2011. Cost control across the sector further supports this, helping offset pressure from forex and material costs. With many companies carrying record levels of cash, sector EV/EBITDA looks very attractive. Earnings growth potential and valuation leads us to rate the sector 'overweight'.

Global volume growth to be driven by N. America and emerging markets

After a 10-11% estimated volume recovery in 2010, we expect global auto demand to grow a further 6% in 2011, mainly driven by growth in N. America and emerging markets. Japan and Europe is expected to remain tough for the year. We assume a US SAAR of 12.5MM in 2011 with further recovery expected on the retail side. Several companies show positive regional exposure while US model cycle for the J3 turns positive from 2011, with Honda's the strongest.

Top Pick is Honda

Honda has the highest gearing to N. America and Asia/other market growth among the J3. These markets combined make up roughly 80% of company global sales on our numbers, while it has higher operational gearing in N. America given the highest level of localization. We expect volume support from the new Civic (Spring 2011) and CR-V (Autumn 2011) which should also help lower current elevated incentive levels. Strong finance profits and growing motorbike sales in EM are also a positive.

Honda: valuation and risk

Our target price is based on 4.5x FY3/12 EV/EBITDA. We have based our TP on average peer group multiples between 2003 and 2008 during a period of stable earnings. Expectations for further share buybacks are other positive factors. Downside risks include higher US sales expense and new product launch execution.

Honda Motor (7267) forecasts and ratios					
Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	8,579.2	**9,084.0**	9,000.0	9,779.8	10,693.7
YoY (%)	-14.3	**5.9**	4.9	7.7	9.3
Operating profit (¥bn)	363.8	**625.1**	500.0	715.1	814.5
YoY (%)	91.8	**71.8**	37.4	14.4	13.9
Recurring profit (¥bn)	336.2	**658.6**	535.0	728.0	827.1
Net profit (¥bn)	268.4	**603.9**	500.0	571.7	648.0
EPS (¥)	148	**335**	276	320	366
P/E (x)	19.6	**9.6**	11.7	10.0	8.8

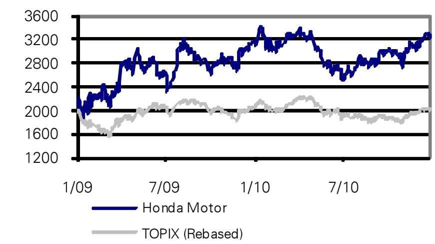
Source: Deutsche Securities Inc. estimates, company data

Honda Motor (7267)

Buy

Price at 30 Dec 2010 (¥)	**3,215**
Price target - 12mth (¥)	**4,050**
52-week range (¥)	**3,400 - 2,495**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*6.8*	*8.5*	*3.4*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**5,798**
Shares outstanding (m)	**1,803**
Foreign shareholding ratio (%)	**32.8**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**13.6**
BPS (¥)	**2,512**
P/B (x)	**1.3**
EPS growth (%)	**126.4**
Dividend yield (%)	**1.5**

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Pharmaceuticals

Marketweight

New drugs and patent cliffs

We are Marketweight on the pharmaceuticals sector
Takeda Pharmaceutical and Eisai, two of the major pharmaceutical companies we cover, face major challenges due to patent issues (that is, patent cliffs and patent challenge issues). In contrast, we forecast robust profit at Astellas Pharma, which does not have drugs facing a patent cliff, and Mitsubishi Tanabe Pharma, which has blockbuster candidates. Consequently, we recommend Astellas and Mitsubishi Tanabe as core sector investments. The prospect of restructuring is another positive for the sector. However, we are Marketweight on the sector because it tends to be impacted by market conditions (offsetting other sectors).

Discussion on 2012 drug price revisions may start in autumn
In the pharmaceutical sector it is important to select individual stocks on the basis of patents, new drugs in the development pipeline, dividends, and other factors rather than on a top-down approach. That said, the government and the Ministry of Health, Labour and Welfare may propose a range of amendments to the medical and health care system in autumn 2011, ahead of reimbursement price revisions in April 2012. We think discussions over reimbursement price revisions, expected to start around autumn 2011, could prompt concerns about the sector overall.

Mitsubishi Tanabe Pharma is our top pick
Earnings from the mainstay RA treatment Remicade remain solid. We see the prospect of a spate of positive news stories in 2011, including the sales growth of MS treatment Gilenya following FDA approval in September 2010; NDA filing for the marketing in Japan of telaprevir, a hepatitis C treatment that could become a ¥25bn blockbuster; and progress with canagliflozin, a diabetes drug that is in phase III trials overseas. The absence of a patent cliff or patent challenge risk is important as generally these are important risks to consider when investing in pharmaceuticals stocks.

Mitsubishi Tanabe Pharma: valuation and risk
We derive our target price of ¥2000 based on an average P/E of 13x (based on the FY3/15 EPS forecast for the pharmaceutical companies we cover) and an EPS forecast of ¥150.8 for Mitsubishi Tanabe Pharma. We rate the stock a Buy because we see limited downside given its P/B of roughly 1.1x and because of the prospect of a spate of positive news stories about new drugs. Risks include (1) pressure on the pharmaceuticals sector resulting from a dramatic overhaul of the medical and health care system, (2) weak sales of Gilenya caused by unpredictable side effects, and (3) the discontinuation of the development of canagliflozin.

Mitsubishi Tanabe Pharma (4508) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	404.7	**400.8**	401.0	413.0	427.7
Operating profit (¥bn)	61.5	**71.9**	67.0	82.2	91.9
YoY (%)	-14.3	**16.9**	9.0	14.4	11.8
Recurring profit (¥bn)	61.6	**72.2**	67.0	82.8	92.6
Net profit (¥bn)	30.3	**38.7**	35.5	49.1	55.0
EPS (¥)	54	**69**	63	88	98
P/E (x)	21.4	**19.9**	21.7	15.7	14.0

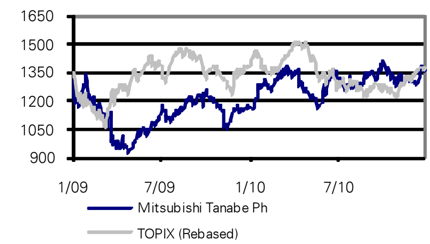
Source: Deutsche Securities Inc. estimates, company data

Mitsubishi Tanabe Pharma (4508)

Buy

Price at 30 Dec 2010 (¥)	**1,371**
Price target - 12mth (¥)	**2,000**
52-week range (¥)	**1,407 - 1,158**

Price/price relative



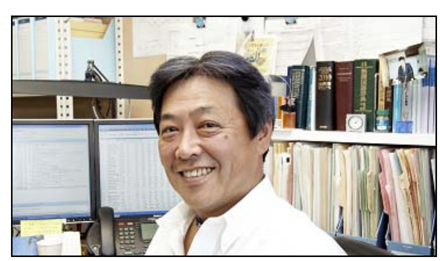
Performance (%)	1m	3m	12m
Absolute	*4.0*	*0.8*	*18.1*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**769**
Shares outstanding (m)	**561**
Foreign shareholding ratio (%)	**14.1**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**5.6**
BPS (¥)	**1,247**
P/B (x)	**1.1**
EPS growth (%)	**28.0**
Dividend yield (%)	**2.0**



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Textiles

Overweight

High performance fibers drive earnings

We are Overweight on the textiles sector
We expect the current improvement in earnings to continue over the medium term, driven by factors including (1) a recovery in carbon fiber utilization rates as demand from aircraft manufacturers expands, (2) rising prices for synthetic fibers in response to high cotton prices, and (3) improved profits in textiles divisions following restructuring. A near-term risk to carbon fiber demand is the delivery schedule for the first Boeing Dreamliner.

Further improvement in carbon fiber; PET film also set to lift profits
Carbon fiber pricing continues to improve steadily, thanks to a rise in demand from aircraft manufacturers and a recovery in demand from sports and general industrial applications. The estimated capacity utilization rate in Japan had fallen to around 30%, but appears to have improved to almost 90% on an actual basis. Unit prices are also recovering, especially for carbon fiber for sports and leisure applications. Separately, although PET film earnings had dipped in response to production cuts in the LCD market, we forecast a major contribution to earnings throughout the sector in 2011. We expect demand for synthetic fiber to remain soft in Japan due to weak apparel purchases, but we forecast increased demand overseas in response to high cotton prices and robust growth in China and other emerging nations.

Teijin is our top pick
Our top pick in the sector is Teijin, which we rate Buy. While a decline in earnings from polycarbonate resin (PC resin) is a risk, rebounds for aramid fiber and carbon fiber, growth for pharmaceuticals (including from global marketing of a gout drug), and the restructuring of polyester fiber lead us to expect an earnings improvement medium term. We forecast that OP will rise almost 40% in FY3/12, a noteworthy increase. The stock is trading at a P/E around 9x our FY3/12 EPS estimate (FY3/13E P/E of nearly 8x) and looks especially attractive.

Teijin: valuation and risk
Our target price is ¥400. We base our TP on a FY3/12 forecast P/E of 12x, with reference to the 5-year historical average of 20x, adjusted to reflect reduced market risk tolerance. Risks include (1) unexpected declines in PC resin margins following unexpectedly large additions to capacity, (2) yen appreciation against the euro, (3) reduced earnings from LCD films if the LCD market contracts heavily, and (4) delays bringing new drugs to market.

Teijin (3401) forecasts and ratios					
Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	765.8	**819.0**	820.0	857.0	891.0
YoY (%)	-18.8	**6.9**	7.1	4.6	4.0
Operating profit (¥bn)	13.4	**42.5**	42.0	58.5	68.5
YoY (%)	-25.2	**216.3**	212.6	37.6	17.1
Recurring profit (¥bn)	2.1	**42.5**	42.0	60.0	71.0
Net profit (¥bn)	-35.7	**21.5**	21.0	33.0	39.5
EPS (¥)	-36	**22**	21	34	40
P/E (x)	-	**15.9**	16.3	10.3	8.6
EV/EBITDA (x)	8.4	**6.1**	-	5.1	4.3
CFPS (¥)	19	**83**	-	90	99
P/CFPS (x)	14.7	**4.2**	-	3.8	3.5

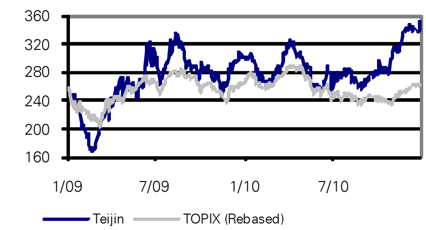
Source: Deutsche Securities Inc. estimates, company data

Teijin (3401)

Buy

Price at 30 Dec 2010 (¥)	**347**
Price target - 12mth (¥)	**400**
52-week range (¥)	**351 - 249**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*2.7*	*25.7*	*15.7*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**342**
Shares outstanding (m)	**984**
Foreign shareholding ratio (%)	**23.1**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**7.8**
BPS (¥)	**283**
P/B (x)	**1.2**
EPS growth (%)	**–**
Dividend yield (%)	**1.2**

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Deutsche Bank Group

Petrochemicals

Overweight

Positive cyclical conditions to continue in 2011

We are Overweight on the petrochemicals sector
We believe that as earnings continue to expand on a rise in capacity utilization rates for petrochemical products thanks to greater demand in emerging countries, the sector will appear undervalued. We see substantial upside to multiples given a FY3/12 forecast P/E of around 10x and P/B of 0.9x.

Global utilization rates for ethylene continue to recover
Global utilization rates of ethylene capacity bottomed at below 80% in 2010. We forecast an improvement to over 83% in 2011. While we forecast an increase in supply capacity, caused by the start of operations at new plants in the Middle East and China and higher utilization rates at existing facilities, we believe this can be absorbed by the strength of demand in China and other emerging nations. We expect sector-wide profit to recover to the record levels of FY3/07, driven by growth in FPD earnings and a contribution from LiB materials.

Mitsubishi Chemical Holdings is our top pick
Our top pick in the sector is Mitsubishi Chemical Holdings, which we rate Buy. Mitsubishi Chemical Holdings has yet to fully achieve group synergy, but we expect FY3/11 profit to top the previous record in FY3/05, driven by a substantial improvement in PTA margins, the reclassification of Mitsubishi Rayon as a subsidiary, and restructuring. We expect it to achieve the highest OP among sector companies we cover. We forecast low top-line growth in FY3/12, owing mainly to restructuring in petrochemicals as the company withdraws from the PVC business. However, we still expect OP to improve steadily as it begins to see the benefits from restructuring its petrochemicals business, demand for electronic materials (including LCD and LiB applications) grows, and its healthcare business expands. We also expect President Yoshimitsu Kobayashi to play a leading role in the petrochemical industry's realignment.

Mitsubishi Chemical Holdings: valuation and risk
We base our TP of ¥700 on a FY3/12 forecast P/E of 12x, the average of the listed petrochemical companies (using the market consensus and our forecasts). The stock is heavily undervalued at a FY3/12 forecast P/E of below 9x and P/B of 0.9x. Risks include: (1) delayed reorganization of the petrochemicals industry, (2) an unexpectedly large deterioration in FPD market conditions, (3) weaker demand of synthetic fibers if the price of cotton collapses, and (4) stock dilution resulting from equity financing to reinforce balance sheets.

Mitsubishi Chem. Holdings (4188) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	2,515.1	**3,241.0**	3,250.0	3,358.0	3,446.0
YoY (%)	-13.5	**28.9**	29.2	3.6	2.6
Operating profit (¥bn)	66.3	**208.0**	156.0	222.0	245.0
YoY (%)	711.2	**213.5**	135.1	6.7	10.4
Recurring profit (¥bn)	59.0	**195.0**	138.0	209.0	235.0
Net profit (¥bn)	12.8	**73.0**	41.0	82.0	90.0
EPS (¥)	9	**53**	29	60	66
P/E (x)	42.3	**10.4**	19.1	9.2	8.4
EV/EBITDA (x)	9.3	**5.3**	-	4.8	4.2
CFPS (¥)	104	**163**	-	176	182
P/CFPS (x)	3.8	**3.4**	-	3.1	3.0

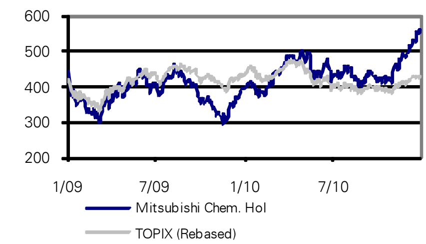
Source: Deutsche Securities Inc. estimates, company data

Mitsubishi Chem. Holdings (4188)

Buy

Price at 30 Dec 2010 (¥)	**551**
Price target - 12mth (¥)	**700**
52-week range (¥)	**559 - 369**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*14.6*	*30.0*	*39.8*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**756**
Shares outstanding (m)	**1,372**
Foreign shareholding ratio (%)	**17.3**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**10.4**
BPS (¥)	**534**
P/B (x)	**1.0**
EPS growth (%)	**470.4**
Dividend yield (%)	**1.8**

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Electronic Materials

Overweight

Difficult 1Q in CY2011, but tablet PCs, smartphones should remain strong

We are Overweight on the electronic materials sector
We expect the LCD and semiconductor markets to remain sluggish in 1Q 2011. However, we forecast the start of a recovery in early spring, followed by a sustained rise in demand for LiB materials, which should perform even better through the rest of the year. Individual stock selection will be important because we expect differences in business portfolios to impact profits.

Conditions to improve after a difficult 1Q; LiB materials a growth area
The LCD market is set to enter an adjustment phase in Jan-Mar because of weak demand for TVs in industrialized nations. We then forecast steady growth as industrialized economies recover. We forecast ongoing solid demand for semiconductors from tablet PCs and smartphones. We expect silicon wafer pricing to remain weak because of large supply-demand gaps as foreign firms aggressively increase capacity, especially for 300mm wafers.

Nitto Denko is our top pick
Our top pick in the sector is Nitto Denko, which we rate Buy. With technologies in difficult areas like bonding retardation films, we see Nitto Denko's main polarizing film business maintaining its strong competitive position over the medium term. Given a rich product lineup that includes transparent double-side adhesive sheets and transparent electro-conductive films, we look for robust growth at Nitto Denko's touch panel-related business. The company has seen a better-than-expected recovery in earnings and we forecast near-record profit in FY3/12. The stock is heavily undervalued at a FY3/12 forecast P/E of just over 10x.

Nitto Denko: valuation and risk
Our target price is ¥4,700, based on a FY3/12 forecast P/E of 13x. Our TP references the average multiple of the listed LCD and semiconductor materials companies, using consensus estimates and our forecasts. We apply a 10% discount to the sector average to reflect the medium-term risk of Nitto Denko's heavy reliance on earnings from polarization film. Downside risks include (1) a reduced share of the polarization film market due to increased competition, (2) a large fall in automobile production, and (3) further yen appreciation (every ¥1/$ move impacts full-year OP by ¥1.8-2.0bn). The company bases its 2H guidance on ¥80/$.

Nitto Denko (6988) forecasts and ratios					
Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	601.9	**640.0**	640.0	668.0	696.0
YoY (%)	4.1	**6.3**	6.3	4.4	4.2
Operating profit (¥bn)	56.1	**80.0**	75.0	88.0	93.5
YoY (%)	305.3	**42.6**	33.7	10.0	6.2
Recurring profit (¥bn)	58.8	**80.0**	75.0	89.0	94.5
Net profit (¥bn)	37.6	**53.0**	50.0	59.0	61.5
EPS (¥)	226	**323**	303	359	375
P/E (x)	13.1	**11.8**	12.6	10.6	10.2
EV/EBITDA (x)	3.9	**4.2**	-	3.6	3.2
CFPS (¥)	494	**573**	-	634	667
P/CFPS (x)	6.0	**6.7**	-	6.0	5.7

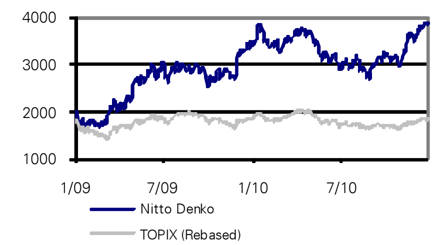
Source: Deutsche Securities Inc. estimates, company data

Nitto Denko (6988)

Buy

Price at 30 Dec 2010 (¥)	**3,825**
Price target - 12mth (¥)	**4,700**
52-week range (¥)	**3,890 - 2,694**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*10.1*	*17.2*	*15.2*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**628**
Shares outstanding (m)	**164**
Foreign shareholding ratio (%)	**42.9**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**13.2**
BPS (¥)	**2,550**
P/B (x)	**1.5**
EPS growth (%)	**43.2**
Dividend yield (%)	**2.1**

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Glass and Ceramics

Overweight

NEG is our top pick, but also monitor flat glassmakers medium-term

We are Overweight on the glass and ceramics sector

We are Overweight on the glass and ceramics sector. Short term, we expect improved momentum in LCD glass during 2H 2011. (The market has currently reached the bottom of a short-term cycle and we look for this to be followed by cyclical demand growth.) Over the medium term, we forecast that thinner LCD glass will make a full contribution to profit from 2H 2011, and that flat glassmakers will achieve growth due to demand from touch panel and solar cell applications, as well as from automotive and construction glass in South America.

Japanese glassmakers are a major presence in the world glass market

Japanese glassmakers supply large shares of the world market and are highly competitive. Asahi Glass (AGC) is the second-largest supplier of LCD glass, with 25% of the market, and Nippon Electric Glass (NEG) is third with 20%. They are also the world's two largest producers of automotive and construction glass, each with 15-20% of the world market. Nippon Sheet Glass (NSG) controls more than 50% of the world market for ITO glass, used in the growth areas of thin solar cell glass and touch panel applications.

Our top pick is NEG

NEG is our top pick over the coming 6-12 months. We forecast that the LCD market will grow 15-20% in 2011, and that a sharp increase in demand QoQ in 2H 2011 will lead to tight supplies. We also expect a move to thinner glass in 2H 2011 to have a benefit of lower costs. (We forecast that LCD glass will become thinner to enhance the transparency of LCD panels, and glassmakers can reduce costs by increasing output at existing facilities.) NEG is well positioned because it produces glass without the need for polishing, meaning that thinner glass will have only a minor negative impact on yields. We also expect the company to apply its abundant cash flow to increased shareholder returns.

NEG: valuation and risk

To obtain the multiple used to derive our ¥1,400 target price for NEG, we continue to use the low-end of the FY10 range of LCD glass manufacturers' P/E ratios (about 10x) on our FY3/11 forecast. Downside risks include a continuation of unexpectedly large production cutbacks in LCD panels if declining LCD panel prices do not stimulate demand for final products.

Nippon Electric Glass (5214) forecasts and ratios				
Year End Mar 31	2010A	**2011E**	2011CoE	2012E
Sales (¥bn)	332.4	**365.0**	-	398.0
YoY (%)	-1.0	**9.8**	-	9.0
Operating profit (¥bn)	98.4	**125.0**	-	141.5
YoY (%)	28.8	**27.0**	-	13.2
Recurring profit (¥bn)	91.4	**119.0**	-	135.5
Net profit (¥bn)	54.9	**67.9**	-	77.1
EPS (¥)	110	**137**	-	155
P/E (x)	9.4	**8.6**	-	7.6
EV/EBITDA (x)	3.5	**4.0**	-	2.7
CFPS (¥)	207	**187**	-	278
P/CFPS (x)	5.0	**6.3**	-	4.2

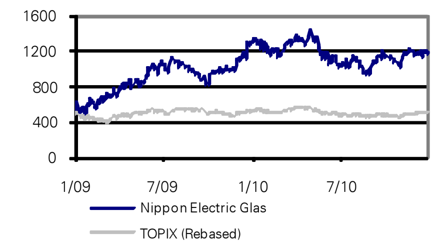
Source: Deutsche Securities Inc. estimates, company data

Nippon Electric Glass (5214)

Buy

Price at 30 Dec 2010 (¥)	**1,172**
Price target - 12mth (¥)	**1,400**
52-week range (¥)	**1,441 - 937**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-0.3*	*3.0*	*-7.8*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**583**
Shares outstanding (m)	**497**
Foreign shareholding ratio (%)	**30.7**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**15.7**
BPS (¥)	**934**
P/B (x)	**1.3**
EPS growth (%)	**23.7**
Dividend yield (%)	**1.1**

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Auto Parts

Overweight

Solid earnings in Asia to drive profit in 2011

We are Overweight on the autoparts sector
We forecast that earnings at autoparts companies will likely recover after bottoming in Oct-Dec 2010. The scaling-back of domestic production that followed the expiry of government subsidies appears to now be complete, and we expect increased motor vehicle production in Asia and North America to drive a sales recovery in 2011. Valuations are also attractive, with the major autoparts companies trading at an average FY3/12 forecast P/E of just 11x.

Growth driven by Asia
We expect increased production volumes in the high-margin markets of Asia to remain the key driver of earnings at the autoparts makers in 2011. Although car production in Japan fell in Oct-Dec 2010 after the expiry of government subsidy programs (temporarily depressing earnings at autopart makers), we look for domestic car output to recover from Jan-Mar 2011. The autoparts companies have restructured their Japanese and North American operations, and attention will be on whether the changes make it easier for a recovery in production volumes to directly translate into profits. We select stocks by examining the prospects for increased market share, either through the adoption of products in a greater number of car models or through expanded sales to non-Japanese carmakers.

Aisin Seiki is our top pick
Increased car production in Asia will have a particularly large impact on profit at Aisin Seiki because its OP margin in Asia was 15.6% in 1H FY3/11, compared with a company-wide figure of 7.3%. We also forecast increased production and sales of the company's mainstay automatic transmissions (ATs) as a result of (1) expanded exports to non-Japanese carmakers in China, (2) increased adoption of its products in hybrid vehicles in Japan, and (3) adoption of its products in a rising percentage of Toyota vehicles in North America. We expect these factors to result in more rapid sales growth than at Toyota, its largest customer.

Aisin Seiki: valuation and risk
We set our target price at ¥3,500, using a FY3/12 forecast P/E of 12x. In determining our multiple, we considered sector-wide valuations and Aisin Seiki's competitive position relative to other companies. Risks include (1) an unexpected fall in Toyota's market share, Aisin Seiki's largest customer, (2) lower selling prices as a result of pressure from customers, and (3) a temporary increase in costs resulting from quality issues or other factors.

Aisin Seiki (7259) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	2,054.5	**2,278.0**	2,260.0	2,366.0	2,460.0
YoY (%)	-7.2	**10.9**	10.0	3.9	4.0
Operating profit (¥bn)	87.5	**153.0**	140.0	177.9	200.0
YoY (%)	-	**74.8**	59.9	16.3	12.4
Recurring profit (¥bn)	94.9	**163.0**	148.0	188.9	212.5
Net profit (¥bn)	16.6	**71.0**	70.0	82.9	94.5
EPS (¥)	59	**252**	249	295	336
P/E (x)	38.3	**11.4**	11.6	9.8	8.6
EV/EBITDA (x)	2.8	**2.6**	-	2.1	1.6
CFPS (¥)	662	**799**	-	828	869
P/CFPS (x)	3.4	**3.6**	-	3.5	3.3

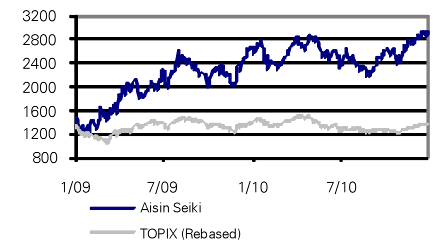
Source: Deutsche Securities Inc. estimates, company data

Aisin Seiki (7259)

Buy

Price at 30 Dec 2010 (¥)	**2,873**
Price target - 12mth (¥)	**3,500**
52-week range (¥)	**2,938 - 2,165**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*5.9*	*10.3*	*8.4*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**809**
Shares outstanding (m)	**281**
Foreign shareholding ratio (%)	**18.8**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**10.3**
BPS (¥)	**2,557**
P/B (x)	**1.1**
EPS growth (%)	**327.6**
Dividend yield (%)	**1.3**

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Machinery

Overweight

China's new 5-Year Plan signals more automation, manufacturing

We are Overweight on the Machinery sector

We look for early-cyclical stocks to bottom out in 1H 2011 and for a recovery by mechatronics companies. We, however, see a need to select companies with greater self-driven growth because some stocks appear to have started rising since 2H 2010. Of particular interest is China's 12th Five Year Plan, which is scheduled for approval by the National People's Congress in March.

The sector

METI's Industrial Structure Vision report has highlighted the declining competitiveness of digital products. However, many machinery companies have retained their ability to compete because in many respects the sector is analog in nature. The highest OP margins among sector companies we cover are at Keyence (46.7%) and Fanuc (44.4%), both based on FY3/11 company guidance. These are two of Japan's most successful manufacturers. Meanwhile, it is important to recognize the cyclical nature of capital spending, particularly spending on machine tools. Investors should also note the increasing tendency for share prices to move ahead of the cycle in recent years.

Fanuc is our top pick: a core stock for investors buying on China's new Five Year Plan

Fanuc's key drivers in FY3/11 have been robomachines and increased sales to Asia. This reflects wider use of numerical control in China and expanded sales to electronics manufacturing service companies (EMS). China's new 5-year plan – agreed to in principle in October 2010 and set for formal adoption in March – seeks to achieve "sustainable growth," and emphasizes the "expansion of domestic demand," "higher incomes," "urbanization," and "a more advanced manufacturing industry." Sustainable growth in China's manufacturing industry will likely require higher personnel expenses and an answer to its low birth rate and aging population problem. Mechanization and automation suggest opportunities for Fanuc's CNC and robots. Furthermore, increased sales of robodrills to EMSs can play an important role as a force propelling China towards "a more advanced manufacturing industry," and could make Fanuc's products the de-facto standard.

Fanuc: valuation and risk

We base our target price of ¥13,000 on a P/E of 20.3x our average EPS estimate of ¥640.7 for the coming three years. We use the S&P 500 average P/E since January 2005 (16.5x) plus two standard deviations, which equals 20.4x. Risks include (1) developments in China and changes in China's outlook, and (2) negative surprises since Fanuc has refused to meet with individual analysts at results announcements and other events.

Fanuc (6954) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	253.4	**420.0**	419.9	440.0	465.0
YoY (%)	-34.7	**65.8**	65.7	4.8	5.7
Operating profit (¥bn)	55.0	**190.0**	186.6	200.0	212.5
YoY (%)	-59.1	**245.3**	239.1	5.3	6.2
Recurring profit (¥bn)	60.1	**193.0**	191.3	205.0	218.0
Net profit (¥bn)	37.5	**117.9**	116.9	125.2	133.2
EPS (¥)	192	**602**	597	639	680
P/E (x)	41.6	**20.7**	20.9	19.5	18.3
EV/EBITDA (x)	15.4	**9.2**	-	8.4	7.6
CFPS (¥)	262	**669**	-	703	742
P/CFPS (x)	30.4	**18.7**	-	17.7	16.8

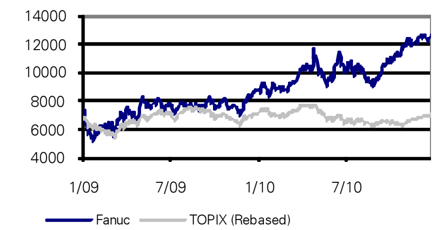
Source: Deutsche Securities Inc. estimates, company data

Fanuc (6954)

Buy

Price at 30 Dec 2010 (¥)	**12,470**
Price target - 12mth (¥)	**13,000**
52-week range (¥)	**12,620 - 8,250**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*4.0*	*17.3*	*44.5*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**2,441**
Shares outstanding (m)	**196**
Foreign shareholding ratio (%)	**46.4**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**13.8**
BPS (¥)	**4,559**
P/B (x)	**2.7**
EPS growth (%)	**214.3**
Dividend yield (%)	**1.4**

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Precision Instruments

Overweight

MFP and medical equipment drive earnings

We are Overweight on the precision instruments sector
Precision instruments companies have steadily improved margins by countering the negative impact of the strong yen with more efficient production networks and business process improvements. We are Overweight on the sector because several stocks are trading below their market averages relative to P/E and other multiples.

Consumer products struggle but demand for business equipment is robust
Demand for digital cameras and other consumer products remains weak and we see a risk that intensified price competition could depress margins for these products. In contrast, demand for industrial equipment such as Multifunction Printers (MFP) and medical equipment remains solid. Companies have become more profitable, despite the yen's strength, because they have responded to the weak economy by enhancing product design and manufacturing processes. We believe those companies that rely most heavily on industrial equipment will achieve the most rapid profit growth.

Olympus is our top pick
We forecast weak earnings at Olympus in FY3/11 because of soft demand for digital cameras. We then expect a substantial improvement in FY3/12 following the release of new models in its mainstay endoscope business. Endoscopic surgery can cut medical expenses greatly, but accurate endoscopes are essential if endoscopes are to become widespread. We expect Olympus's new models to spur demand for surgical instruments as well as for endoscopes themselves.

Olympus: valuation and risk
We use the SOTP method to calculate our target price. We use segment P/Es of 10x for imaging, 20x for medical, and 10x for both life science and information & communication, as well as for other business. All multiples are based on IFIS consensus estimates, seven-year average P/Es for TSE1-listed peers, and Olympus's competitiveness. We base our target price on FY3/13 forecast earnings. Downside risks include (1) an increase in costs due to the launch of new endoscopes, (2) intensifying competition for digital cameras, and (3) growing concerns because of the weak balance sheet.

Olympus (7733) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	883.1	**879.0**	880.0	911.0	979.0
YoY (%)	-10.0	**-0.5**	-0.3	3.6	7.5
Operating profit (¥bn)	60.1	**47.5**	53.0	75.0	97.0
YoY (%)	73.9	**-21.0**	-11.9	57.9	29.3
Recurring profit (¥bn)	45.1	**35.5**	41.0	63.0	85.0
Net profit (¥bn)	47.8	**12.5**	15.0	34.0	46.0
EPS (¥)	177	**46**	56	126	170
P/E (x)	14.1	**53.1**	44.2	19.5	14.4
EV/EBITDA (x)	10.9	**12.0**	-	8.7	7.1
CFPS (¥)	337	**194**	-	285	330
P/CFPS (x)	7.4	**12.6**	-	8.6	7.5

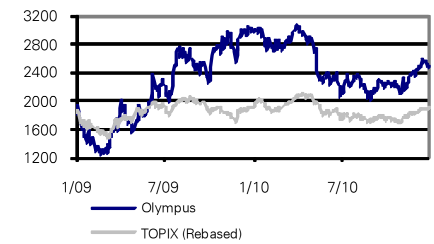
Source: Deutsche Securities Inc. estimates, company data

Olympus (7733)

Buy

Price at 30 Dec 2010 (¥)	**2,458**
Price target - 12mth (¥)	**3,270**
52-week range (¥)	**3,060 - 2,006**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*4.4*	*12.4*	*-17.5*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**664**
Shares outstanding (m)	**270**
Foreign shareholding ratio (%)	**28.0**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**5.7**
BPS (¥)	**819**
P/B (x)	**3.0**
EPS Growth (%)	**-73.8**
Dividend yield (%)	**1.2**

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Shipbuilding & Plant Engineering

Marketweight

Late cyclicals to flourish in 2011: Focus on infrastructure and energy

We are Marketweigh on the plant engineering and shipbuilding sector
We expect the market to focus on late-cyclical stocks such as the shipbuilders and plant engineering companies once the recovery for early-cyclical stocks has been fully priced-in in 1H 2011. We expect large orders, developments concerning energy and the environment, and demand for aircraft to be upside catalysts. Nevertheless, since sector companies are exposed to a wide range of industries that could nullify these positives, we are Marketweight on the sector.

The sector
Plant engineering and shipbuilding is an order-based industry. This means sales can be forecast based on orders booked at the end of the previous year. Japanese shipbuilders have become less competitive versus South Korean and Chinese yards, but we think plant engineering is one area capable of recovering. Companies with the least exposure to shipbuilding are better positioned. Average profits at shipbuilders and heavy machinery makers are not particularly high and the company with the highest OP margin is Sumitomo Heavy Industries (6.7% forecast in FY3/11). JGC has the highest margin among the plant engineering companies (10.3%). This means that the market will tend to focus on large/small earnings changes.

Kawasaki Heavy Industries (KHI) is our top pick: Large share of the China market for core hydraulic shovel parts
Strong orders for railcars and the large profit contribution from hydraulic equipment have been features of KHI's earnings in FY3/11. The International Trade Fair for Construction Machinery held in Shanghai in late November confirmed that “integration” and “hydraulic control valves” are the source of Japan's competitiveness in hydraulic shovels. KHI has a particularly large share of the hydraulic shovel market in China, making it a key stock in this area. Other KHI positives include shipbuilding (NACKS, the 50-50 joint venture with COSCO in China, is contributing), and motorcycles (rationalization has lowered the breakeven point, and sales are increasing in emerging nations).

KHI: valuation and risk
We base our target price of ¥300 on a P/E of 17.0x, derived from our average EPS estimate of ¥17.6 for the next five years. We use the S&P 500 average P/E since January 2005 (16.5x) plus one standard deviation (1.95) to reflect the three-to-five year business cycle in the plant engineering and shipbuilding sector. Downside risks include (1) a stronger yen, (2) surging machinery and material prices, (3) a delayed recovery for motorcycle demand in Europe and the US, (4) the prolongation of the poor order situation for new ships (Japan); (5) delays with the B787, (6) a contraction in the market for large defense-related equipment, (7) the postponement of construction work at plants, and (8) the emergence of additional costs. If these risks materialize, KHI’s earnings and share price may be dented.

Kawasaki Heavy Industries (7012) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	1,173.5	**1,280.0**	1,280.0	1,320.0	1,370.0
YoY (%)	-12.3	**9.1**	9.1	3.1	3.8
Operating profit (¥bn)	-1.3	**33.0**	32.0	39.0	46.0
YoY (%)	-	**-**	-	18.2	17.9
Recurring profit (¥bn)	14.3	**33.0**	32.0	40.0	49.0
Net profit (¥bn)	-10.9	**20.6**	20.0	25.0	30.6
EPS (¥)	-7	**12**	12	15	18
P/E (x)	-	**22.1**	22.8	18.2	14.9
EV/EBITDA (x)	15.6	**10.0**	-	8.2	7.7
CFPS (¥)	24	**43**	-	51	54
P/CFPS (x)	9.6	**6.4**	-	5.4	5.0

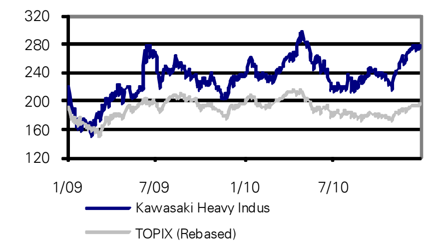
Source: Deutsche Securities Inc. estimates, company data

Kawasaki Heavy Industries (7012)

Buy

Price at 30 Dec 2010 (¥)	**273**
Price target - 12mth (¥)	**300**
52-week range (¥)	**296 - 213**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*5.4*	*15.2*	*16.7*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**456**
Shares outstanding (m)	**1,670**
Foreign shareholding ratio (%)	**14.5**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**7.1**
BPS (¥)	**177**
P/B (x)	**1.5**
EPS growth (%)	**–**
Dividend yield (%)	**1.1**

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Banks

Overweight

Discount to become less pronounced

Reasons for our Overweight view

Japanese bank stocks have stopped falling after continuously declining since 2006 due to low earnings, weak growth, and concerns over the need to raise capital to satisfy regulatory changes. However, Basel 3 rules in their current form suggest that the risk of further recapitalization in the next few years has decreased. Rising long-term interest rates and the increase in the BoJ's current account balance are also positive for the sector. That said, the lack of any substantial improvement in margins or growth suggests to us that bank stock valuations may merely go from “deeply discounted” to “discounted.” The TSE Bank Index is already 16% above its 9 November bottom, and we see another 10-15% upside. Risks to investing in the sector include lower long-term interest rates, a deterioration in the economy, and a sharp rise in claims against consumer finance companies for repayment of excess interest charges.

Signs that core earnings are bottoming

Many banks reported consolidated NP ahead of initial guidance in 1H FY3/11. The main drivers were increased gains from JGBs and other bonds, and lower credit costs. However, core earnings (excluding bond trading gains) declined YoY at both major and regional banks. Lending continued to contract and spreads narrowed throughout the sector. We believe this trend will persist in 2H FY3/11, although we expect both lending and spreads to bottom in FY3/12, provided that the economy does not deteriorate greatly.

SMFG is our top pick

SMFG is highly profitable (ROE) compared to other banks. We expect its leadership position to translate into higher share prices as the economy recovers. The stock already trades above the price of its second public offering in 2010, suggesting that selling pressure is easing.

SMFG: valuation and risk factors

We base our TP on a FY3/12 forecast P/E of 12.5x, which represents a 10% discount to the market average of 13.5x. Although the discount for the major banks has averaged 20% over the past decade, we use 10% because we believe capital raising initiatives at the major banks have peaked. Downside risks include a rise in credit costs and unexpectedly severe earnings erosion at non-bank subsidiaries following full implementation of the revised Moneylending Law.

SMFG (8316) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Adjusted NOP(¥bn)	1,075.3	**1,185.0**	-	1,220.0	1,255.0
YoY (%)	47.6	**10.2**	-	3.0	2.9
Credit cost (¥bn)	473.9	**400.0**	400.0	365.0	340.0
Recurring profit (¥bn)	558.8	**700.0**	690.0	770.0	830.0
Net profit (¥bn)	271.6	**360.0**	340.0	380.0	420.0
EPS (¥)	248	**253**	239	268	296
P/E (x)	13.5	**11.4**	12.1	10.8	9.8
P/B (x)	0.9	**0.8**	-	0.8	0.7
Dividend yield (%)	3.0	**3.5**	-	3.5	3.5

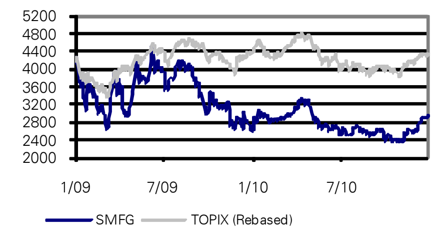
Source: Deutsche Securities Inc. estimates, company data

SMFG (8316)

Buy

Price at 30 Dec 2010 (¥)	**2,892**
Price target - 12mth (¥)	**3,350**
52-week range (¥)	**3,330 - 2,360**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*12.6*	*18.9*	*9.3*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**4,217**
Shares outstanding (m)	**1,458**
Foreign shareholding ratio (%)	**33.0**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**7.1**
BPS (¥)	**3,530**
P/B (x)	**0.8**
EPS growth (%)	**2.0**

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Insurance

Overweight

A solid global player with no need for new capital

We are Overweight on the insurance sector
The non-life insurers have little need for new capital and are undervalued at adjusted P/B multiples of 0.5-0.6x. The Japanese non-life insurance market offers little scope for profits, but we believe the deteriorating loss ratio in the automobile insurance business has been priced into sector stocks. We expect the life insurers to become increasingly attractive to investors in an excessive liquidity-driven market, given that adjusted BPS increases are in line with rises in long-term interest rates and TOPIX.

Insurers shift resources away from underperforming non-life businesses
The non-life insurers have responded to slowing growth in the Japanese market by investing heavily in overseas operations and in domestic life insurance. This has led to rapid growth. Our long-term simulation, based on a model of future demographics, suggests that growth in consolidated insurance premiums could outpace Japanese GDP growth. Two large US life insurers acquired Japanese life insurers in quick succession in 2010 and Japanese life insurance products continue to generate some of the best margins globally. The market continues to undergo a dramatic change in terms of channels and products.

Tokio Marine Holdings is our top pick
Our top pick in the sector is Tokio Marine Holdings. The key positives are (1) a robust balance sheet, which implies that the company can grow without issuing new capital, (2) its presence in both overseas markets and life insurance, (3) an adjusted P/B of around 0.6x, and (4) a shareholder-friendly management approach. Many financial institutions developed plans to strengthen their international operations in the wake of the global financial crisis, but Tokio Marine HD has spent roughly ¥800bn on M&A since 2002 and the integration of new businesses into the group is almost complete. Insurers have responded to the protracted weakness in the Japanese non-life market by raising premium rates and selling strategic shareholdings. We anticipate a continued emphasis on ROE in FY3/12 as well. We look for Tokio Marine HD to garner increased investor attention because its ability to satisfy Solvency 2 requirements will set it apart from other Asian insures, which face the heightened risk of having to issue new capital to comply with new capital regulations.

Tokio Marine Holdings: valuation and risk
We base our target price of ¥3,000 on an adjusted P/B of 0.77x and refer to valuations among overseas life insurers. We forecast (1) FY3/12 ROE that is 0.5pt below the cost of capital and (2) premium growth that exceeds GDP by 2.0pt. Downside risks include: (1) a decline in the value of shareholdings, (2) major disasters, (3) defaults on US local government bonds, and (4) an erosion in the automobile insurance loss ratio.

Tokio Marine Holdings (8766) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Ordinary Revenues (¥bn)	3,571	**3,370**	3,280	3,360	3,360
YoY (%)	2	**-6**	-	-0	0
Recurring profit (¥bn)	203.4	**211.0**	180.0	175.0	200.0
Net profit (¥bn)	128.4	**135.0**	115.0	108.0	129.0
EPS (¥)	163	**174**	148	143	175
BV/Share (¥)	2,754	**2,700**	-	2,922	3,193
Price/BV (x)	1.0	**0.9**	-	0.8	0.8

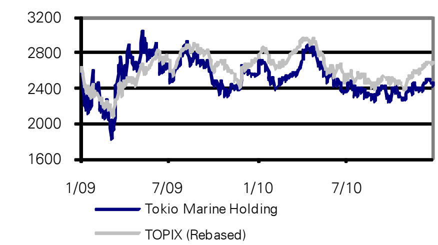
Source: Deutsche Securities Inc. estimates, company data

Tokio Marine Holdings (8766)

Buy

Price at 30 Dec 2010 (¥)	**2,427**
Price target - 12mth (¥)	**3,000**
52-week range (¥)	**2,884 - 2,243**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*2.5*	*7.8*	*-4.1*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**1,861**
Shares outstanding (m)	**767**
Foreign shareholding ratio (%)	**30.5**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**6.4**
EPS (¥)	**174**
P/E (x)	**14.0**
EPS growth (%)	**6.5**
Dividend yield (%)	**2.1**

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Retailing

Marketweight

2011 view: Greater emphasis on rigorous bottom-up investment

We are Marketweight on the retail sector
Our view reflects heightened uncertainty regarding the earnings structure in place at certain retail companies, given rising procurement costs and other potential negatives once the recovery in consumer spending peaks in 2011. We forecast (incorporating QUICK consensus forecasts for non-covered companies) that OP at the 24 major retailers will rise 15% YoY in FY10 but fall 4% in FY11. The difficulty of top-down stock selection places an even greater importance on rigorous bottom-up investment.

We anticipate deflation in Japan, inflation overseas
We forecast that private consumption will remain virtually flat YoY in 2011. We attribute the sluggish conditions to thrift fatigue due to penny pinching and the expiry of government stimulus programs. The rising cost of product procurement also highlights the uncertainty over earnings structures at specialty apparel retailers in particular. Ongoing deflation in Japan may prevent companies from passing higher costs onto product pricing, which depresses margins. We therefore regard 2011 as a time for reassessing the underlying profitability of individual companies before consumption begins a sustained recovery in 2012.

Our top pick is specialty retailer Don Quijote
Our top pick is Don Quijote. Don Quijote's growth strategy has become more transparent and is demonstrated by an improved earnings structure at the parent, thanks in part to higher earnings at Nagasakiya and strong sales. Given the recent performance of Nagasakiya, acquired in 2007, we think Don Quijote could generate operating profits in FY6/11 once it begins to benefit from restructuring and the conversion of stores to the Mega Don Quijote family discount-store format. We expect OP to advance 21% YoY to ¥25.4bn in FY6/11 followed by a solid 10% increase to ¥28.0bn in FY6/12.

Don Quijote: valuation and risk
Our ¥2,800 TP is 14.3x our adjusted FY6/11 EPS forecast of ¥194 (excluding negative goodwill and extraordinary items). We apply a 10% premium to the 13x average for specialty retailers given Don Quijote's relatively strong medium-term growth potential. Risks include a deterioration in the consumption environment, M&A-related earnings volatility and decline in the value of financial holdings.

Don Quijote (7532) forecasts and ratios

Year End Jun 30	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	487.6	**519.6**	510.0	544.5	565.6
YoY (%)	1.4	**6.6**	4.6	4.8	3.9
Operating profit (¥bn)	21.1	**25.4**	23.0	28.0	29.9
YoY (%)	22.7	**20.6**	9.2	10.2	6.8
Recurring profit (¥bn)	21.1	**24.9**	22.0	28.0	29.9
Net profit (¥bn)	10.2	**13.9**	11.6	16.4	17.5
EPS (¥)	141	**192**	151	227	242
P/E (x)	15.7	**12.9**	16.4	10.9	10.2
EV/EBITDA (x)	7.5	**6.6**	-	5.9	5.3
CFPS (¥)	272	**332**	-	372	393
P/CFPS (x)	8.2	**7.5**	-	6.7	6.3

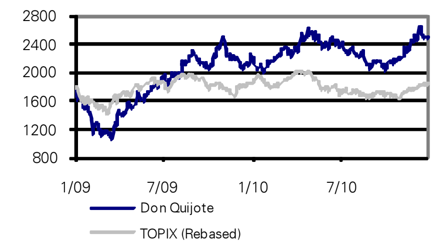
Source: Deutsche Securities Inc. estimates, company data

Don Quijote (7532)

Buy

Price at 30 Dec 2010 (¥)	**2,473**
Price target - 12mth (¥)	**2,800**
52-week range (¥)	**2,650 - 2,000**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*2.4*	*19.3*	*9.9*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**178**
Shares outstanding (m)	**72**
Foreign shareholding ratio (%)	**36.2**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**11.9**
BPS (¥)	**1,771**
P/B (x)	**1.4**
EPS growth (%)	**35.8**
Dividend yield (%)	**1.1**

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Trading Companies

Overweight

Iron ore a focus in 2011: Itochu is our top pick

We are Overweight on the trading companies sector
We remain Overweight on the trading companies sector in 2011. Positives include (1) historically low valuations relative to the major natural resource companies, (2) increased production of resources in which sector companies have resource rights (a growth driver that does not rely on resource prices), (3) expectations for a long-term rise in resource prices (a cycle of consistently rising resource prices as production costs increase steadily each year), and (4) risk diversification by effectively leveraging resource rights.

Iron ore a particular focus in 2011
We focus particularly on iron ore for reasons including (1) a rally in demand, following a period in which steel output fell because of CO2 regulations and electric power restrictions in China to meet its emissions reduction targets, (2) an end to factors adversely affecting crude steel production that were caused by lowering exports, (3) an end to factors adversely affecting crude steel production that were caused by lowering inventories, and (4) reduced quality and rising production costs in China. Itochu and Mitsui have the greatest exposure to the iron ore market.

Itochu (8001) is our top pick
We assigned a Buy rating to Itochu on three main factors. First, Itochu's business portfolio contains a diverse range of resources, including iron ore, coal, and crude oil, which minimizes the risk to earnings of changes in the price or volume of a particular resource but allows it to benefit from an increase in resource prices. Second, the company's plans to expand iron ore and coal resource rights, and to make volume a driver of profit growth. Lastly, the strength of Itochu's operational base in China, and its potential to benefit from a growing Chinese consumer market through a strategy that seeks to fuse its traditional strengths in textiles and foods.

Itochu: valuation and risk
We base our target price of ¥1,300 on a FY3/12 forecast P/B of 1.5x. We use a forecasted ROE of 18.6% and net D/E ratio of 1.6x. This equates to a FY3/12 forecasted P/E of 8.9x. This looks achievable compared to the 5-year historical average P/E of around 10x for the sector. Downside risks include (1) lower resource values (especially crude oil, iron ore, and coal) and (2) unexpectedly large fluctuations in exchange rates.

Itochu (8001) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Gross Profit (¥bn)	924.4	**1,113.0**	950.0	1,207.0	1,312.0
Net profit (¥bn)	128.2	**184.0**	130.0	231.0	259.0
EPS (¥)	81	**116**	101	146	163
P/E (x)	8.2	**7.1**	8.1	5.6	5.0

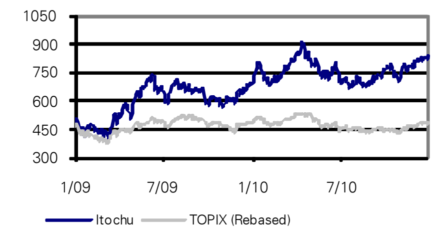
Source: Deutsche Securities Inc. estimates, company data

Itochu (8001)

Buy

Price at 30 Dec 2010 (¥)	**822**
Price target - 12mth (¥)	**1,300**
52-week range (¥)	**906 - 669**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*5.9*	*7.6*	*20.5*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**1,303**
Shares outstanding (m)	**1,585**
Foreign shareholding ratio (%)	**30.7**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**16.3**
BPS (¥)	**729**
P/B (x)	**1.1**
EPS growth (%)	**43.6**
Dividend yield (%)	**2.6**

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Construction

Marketweight

Margins set to deteriorate again

We are Marketweight on the construction sector
We expect 2011 to be the complete reverse of 2010, when the gross profit margin on completed construction work rose despite a decline in sales. In 2011, we look for sales to increase while margins deteriorate. Margins are likely to deteriorate because the reported unit price of orders has already started to fall and companies have said during results meetings that they will focus on gaining market share. Though the dynamics of 2011 and 2010 will therefore differ, we expect the end result (profit levels) to be similar. This means we see no prospect of profit improvement in the construction sector.

Obayashi is our top pick
Obayashi booked a very large loss on the subway construction order it received from Dubai's Road and Transport Authority in FY3/10. It may take up to 7 years (until September 2018) for it to recoup funds from the project, but we do not expect any new losses. From a value perspective, we think the share price is attractive at the current level because Obayashi has substantial unrealized profits on its securities and investment properties. Furthermore, even while Kajima and Taisei may book further losses on the Algerian expressway project, we see little risk of this happening at Obayashi, meaning we view the stock as having the lowest risk among the large general contractors.

Obayashi: valuation and risk
Our target prices for the sector are based on a residual income model. A residual income model is a method of assessing shareholder value. It adds the present value of NP, deducting future equity costs, to the book value of shareholders' equity at the start of a given financial year. Calculations are based on a cost of equity of 4.67% (beta value 0.905) and earnings forecasts for three years. We derive target prices by adding unrealized after-tax profits on investment properties. (which companies have been required to disclose since FY3/10) to the theoretical price derived from our residual income model. Risks include: (1) payments outstanding for foreign projects proving impossible to collect, (2) Obayashi having to take over losses for the Dubai Road and Transport Authority's subway project if J/V partner Kajima's refusal to contribute proves justified, and (3) a decline in unrealized profits on asset holdings if equity and real estate prices soften.

Obayashi (1802) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	1,341.5	**1,232.0**	1,230.0	1,335.0	1,339.0
YoY (%)	-20.3	**-8.2**	-8.3	8.4	0.3
Operating profit (¥bn)	-62.5	**24.8**	25.0	23.7	24.0
YoY (%)	-	**-**	-	-4.4	1.3
Recurring profit (¥bn)	-59.6	**25.0**	25.0	24.6	24.9
Net profit (¥bn)	-53.4	**15.0**	15.0	12.5	12.7
EPS (¥)	-74	**21**	21	17	18
P/E (x)	-	**17.9**	17.9	21.5	21.2
EV/EBITDA (x)	-10.3	**16.1**	-	16.1	15.0
CFPS (x)	-60	**36**	-	32	32
P/CFPS (%)	-	**10.5**	-	11.7	11.6

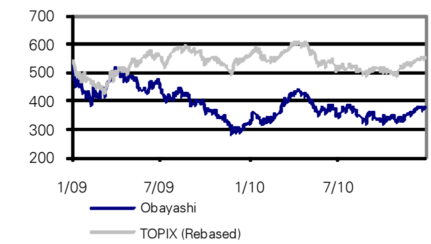
Source: Deutsche Securities Inc. estimates, company data

Obayashi (1802)

Buy

Price at 30 Dec 2010 (¥)	**374**
Price target - 12mth (¥)	**500**
52-week range (¥)	**439 - 315**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*7.5*	*12.7*	*18.4*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**269**
Shares outstanding (m)	**719**
Foreign shareholding ratio (%)	**28.4**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**4.0**
BPS (¥)	**522**
P/B (x)	**0.7**
EPS growth (%)	**–**
Dividend yield (%)	**2.1**

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Real Estate

Overweight

Hop, step, then jump: combination of positive factors set to lift shares

We are Overweight on the real estate sector
If the real estate sector is compared to the triple jump, share prices hopped higher after bottoming in 2009 as risk premiums improved, and stepped upwards in 2010 as fundamentals improved. For 2011, we forecast a large jump in share prices, driven by a combination of narrowing risk premiums and stronger fundamentals.

Risk premiums and fundamentals to improve in 2011
We forecast an ongoing improvement in fundamentals, bolstered by firm condominium sales and clearer signs of an improvement in office vacancy rates. Meanwhile, we expect risk premiums to improve as lending to the real estate industry returns to growth, property transactions pick up, and the BoJ's purchases of J-REITs provides support. We believe share prices will advance substantially in response to this combination of positive factors.

Mitsui Fudosan is our top pick
At its October board meeting, the BoJ announced that it would purchase ETFs, J-REITs and other assets. It began to implement this program on 15 December. The BoJ's purchases of J-REITs and its announcement of its intention to purchase the instruments have resulted in a firm performance by the J-REIT market. The decline in the J-REIT market's implied cap rate is pushing up the price of the underlying real estate assets. Mitsui is well positioned to benefit from this trend since it has three REITs among its group companies.

Mitsui Fudosan: valuation and risk
Our target price of ¥1,900 is based on the theoretical share price obtained from our residual income model (using a 5.12% cost of equity capital), adding net unrealized after-tax profit on investment properties, and implies about 20% upside from the current share price. The shares trade at a 25% discount to pre-tax NAV. Downside risks include (1) the recovery in the real estate investment market coming to a standstill, (2) a renewed deterioration in personal consumption and investment sentiment, and (3) a renewed effort by corporates to cut costs.

Mitsui Fudosan (8801) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	1,384.8	**1,438.6**	1,440.0	1,466.6	1,495.6
YoY (%)	-2.4	**3.9**	4.0	1.9	2.0
Operating profit (¥bn)	120.6	**123.8**	121.0	137.1	159.3
YoY (%)	-29.7	**2.6**	0.3	10.8	16.2
Recurring profit (¥bn)	93.9	**98.0**	95.0	107.8	130.2
Net profit (¥bn)	60.1	**51.5**	50.0	56.9	69.7
EPS (¥)	68	**59**	57	65	79
P/E (x)	22.7	**27.6**	28.4	25.0	20.4
EV/EBITDA (x)	17.8	**17.8**	-	16.3	14.5
CFPS (¥)	126	**116**	-	124	140
P/CFPS (x)	12.3	**14.0**	-	13.1	11.6

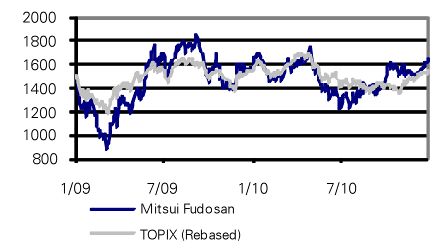
Source: Deutsche Securities Inc. estimates, company data

Mitsui Fudosan (8801)

Buy

Price at 30 Dec 2010 (¥)	**1,619**
Price target - 12mth (¥)	**1,900**
52-week range (¥)	**1,749 - 1,221**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*9.2*	*15.0*	*3.9*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**1,422**
Shares outstanding (m)	**878**
Foreign shareholding ratio (%)	**48.7**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**5.0**
BPS (¥)	**1,184**
P/B (x)	**1.4**
EPS growth (%)	**-14.3**
Dividend yield (%)	**1.4**

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Transportation (Airlines)

Overweight

ANA: Our top pick in the transportation sector

We are the Overweight on the Airline sector
Competition between the major airlines is easing rapidly as JAL halts and scales back services on both international and domestic routes. Meanwhile, though more take-off and landing slots at Narita and Haneda Airports have created greater business opportunities, there is also a new threat from overseas low-cost carriers (LCCs). We are Overweight on the sector because we believe share prices have been heavily impacted by the threat from LCCs, which have dampened opportunities for profit growth throughout the sector.

The sector
Japan is gradually moving towards open skies agreements with other countries following the expansion of take-off and landing slots at Narita and Haneda. As these unfold, we regard the agreement with US authorities to apply antitrust immunity (ATI) as positive for sector earnings because it will ease competition among alliance members. Long-term, we see the prospect of similar agreements with Asian and European nations.

ANA is our top pick
Our top pick is ANA. Overseas airlines have temporarily increased their share of passenger traffic because ANA has been slower at expanding its international route network than JAL has been at scaling back its network. We therefore think ANA could capture demand from passengers wishing to fly a Japanese airline once it purchases new aircraft to expand its international services. We believe the threat from overseas LCCs is limited by Japan's restrictions on foreign capital and other barriers to entry, as long as no LCC establishes a hub in Japan.

ANA: valuation and risk
Our target price is ¥409. Our TP is based on a stable and achievable ROE level (14.0%) and we multiply this by the TOPIX average P/E (15.1x) to arrive at the target P/B (2.1x). We apply this to our FY3/11 forecasted BPS of ¥193.6. Downside risks include coordination problems among Star Alliance members on North American routes after ATI approval, resulting in a less favorable profit structure than currently exists.

All Nippon Airways (9202) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	1,228.4	**1,389.3**	1,377.0	1,492.3	1,514.4
YoY (%)	-11.8	**13.1**	12.1	7.4	1.5
Operating profit (¥bn)	-54.2	**82.5**	70.0	127.9	159.2
YoY (%)	-	**-**	-	55.1	24.4
Recurring profit (¥bn)	-86.3	**49.5**	37.0	84.9	123.2
Net profit (¥bn)	-57.4	**14.5**	6.0	55.2	80.1
EPS (¥)	-23	**6**	2	22	32
P/E (x)	-	**52.4**	126.6	13.8	9.5
EV/EBITDA (x)	24.6	**7.3**	-	5.6	4.8
CFPS (¥)	23	**54**	-	75	87
P/CFPS (x)	12.7	**5.6**	-	4.1	3.5

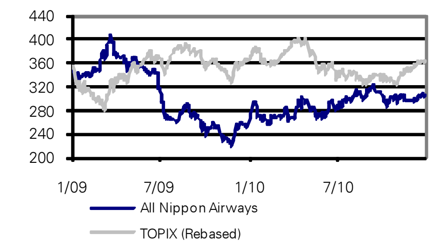
Source: Deutsche Securities Inc. estimates, company data

All Nippon Airways (9202)

Buy

Price at 30 Dec 2010 (¥)	**303**
Price target - 12mth (¥)	**409**
52-week range (¥)	**324 - 257**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*2.4*	*-1.9*	*20.2*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**760**
Shares outstanding (m)	**2,507**
Foreign shareholding ratio (%)	**8.1**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**3.0**
BPS (¥)	**194**
P/B (x)	**1.6**
EPS growth (%)	**–**
Dividend yield (%)	**0.3**

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Telecommunications

Marketweight

Smartphones to impact earnings

We are Marketweight on telecom sector
We expect the telecom sector to return to market prominence once the near-term recovery in export sectors has run its course. We expect smartphone sales to maintain the growth that started in 2010, leading to a rising percentage of smartphone usage and increased data ARPU. We also expect some companies to return to sales growth. We believe the combination of this top-line improvement and cost-cutting could result in unexpectedly strong profit growth in 2H 2011. We also anticipate positive news stories until early spring, in the form of dividend increases and share buybacks.

Smartphone users drive ARPU growth in a fundamental divergence from previous carrier-driven initiatives
The earnings improvement resulting from increased smartphone usage differs fundamentally from the traditional path of boosting earnings by encouraging wider use of mobile phones. This is because smartphone users are willingly moving to high-ARPU plans. We expect overall ARPU to bottom at carriers that seize this chance to boost data ARPU. This may enable some companies to translate rapid growth in subscriber numbers into expanded revenues.

SoftBank is our top pick
The popularity of the iPhone has enabled SoftBank to post a 12% YoY increase in subscriber numbers. This growth continues to accelerate. We forecast double-digit sales growth in the mobile services business in FY3/12, even if ARPU remains flat. We expect Android smartphones to have a substantial impact only once NTT DoCoMo begins to supply models from Japanese manufacturers in the summer. We believe SoftBank will continue to achieve solid earnings during the long time it will likely take for Android to become a major force. However, we note that while the telecom stocks are generally undervalued, SoftBank now has relatively little upside following the recent price run-up.

SoftBank: valuation and risk
Our target price for SoftBank is ¥3,050, using a 6.7% cost of equity, four-year forecasts, and a 10-year terminal DCF model, with adjustment based on PEG to reflect short-term earnings momentum. We also factor in the value of SoftBank’s Chinese and Japanese Internet investments. Risks include (1) concerns about SoftBank's high leverage, low-ARPU subscribers and churn, and (2) a potential loss of its top position in net subscriber growth.

SoftBank (9984) forecasts and ratios

Year End Mar 31	2010A	**2011E**	2011CoE	2012E	2013E
Sales (¥bn)	2,763.4	**3,199.1**	-	3,304.2	3,300.3
YoY (%)	3.4	**15.8**	-	3.3	-0.1
Operating profit (¥bn)	465.9	**575.2**	500.0	632.1	638.0
YoY (%)	29.7	**23.5**	7.3	9.9	0.9
Recurring profit (¥bn)	341.0	**471.5**	-	547.1	585.2
Net profit (¥bn)	96.7	**185.5**	-	260.7	288.4
EPS (¥)	89	**170**	-	233	255
P/E (x)	22.5	**16.6**	-	12.1	11.0
EV/EBITDA (x)	5.2	**5.9**	-	5.1	4.6
CFPS (¥)	313	**373**	-	465	514
P/CFPS (x)	6.4	**7.5**	-	6.0	5.5

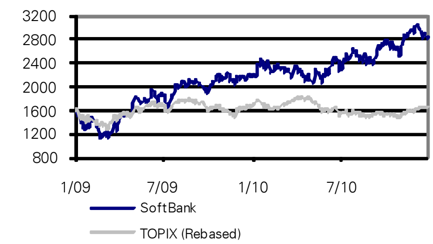
Source: Deutsche Securities Inc. estimates, company data

SoftBank (9984)

Buy

Price at 30 Dec 2010 (¥)	**2,811**
Price target - 12mth (¥)	**3,050**
52-week range (¥)	**3,030 - 2,058**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*-3.1*	*2.9*	*29.5*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**3,076**
Shares outstanding (m)	**1,094**
Foreign shareholding ratio (%)	**21.6**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**35.7**
BPS (¥)	**518**
P/B (x)	**5.4**
EPS growth (%)	**89.6**
Dividend yield (%)	**0.2**

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IT Services and Software

Overweight

Gearing up for several years of earnings growth, starting 2011

We are Overweight on the IT services and software sector
Even though IT spending by Japanese companies has traditionally been impacted by economic changes, a primary factor has been periodic investment aimed at expanding the use of IT to maintain competitiveness and improve productivity. We forecast a cyclical expansion in these investments in 2011-12 as Japanese firms tend to invest in ever more sophisticated and far-reaching IT with each major upgrade cycle. We believe growth in the IT services and software sector generated by these investments are not yet priced into stocks; suggesting substantial share price upside.

Earnings growth should accelerate in 2011
Earnings in the IT services and software sector tend to lag the economy. This has meant a slow recovery in FY10 following a slowdown in investments in FY09, although orders began to recover YoY in Jul-Sep 2010. Financial institutions have resumed spending to strengthen their IT systems. In the manufacturing industry, demand for the implementation of global supply chains is steadily growing, and at distribution services for internet order service systems. We forecast that companies in the sector will post YoY sales and profit growth in Oct-Dec 2010, and look for improved margins to drive profits higher from 2011.

NRI is our top pick
Our top sector pick is Nomura Research Institute. We forecast that earnings will recover sharply from 2011, with the start of the "STAR IV" retail brokerage system. This is a large project originally introduced by Nomura Securities for joint use by its multiple retail brokers. The company's managerial resources and client base have expanded over the last five years. We forecast that profit will rise to new record highs as NRI expands its client base to financial institutions other than Nomura Securities and to the general corporate market.

NRI: valuation and risk
We use the market-average P/E of 14x based on forecasts for the current fiscal year (TOPIX average, IBES consensus EPS) as a valuation benchmark but calculate target prices in the IT services and software sector using a P/E of 18x for the upcoming fiscal year, given both that the sector tends to lag economic trends and that we expect the IT investment cycle to drive earnings growth for at least the next two years. We base our ¥2,400 target price for NRI on a FY3/12 forecast P/E of 18x, on par with the sector, because we forecast robust profit growth through FY3/13. Risk factors include: (1) further erosion in the business environment for brokerages, its main clients, and (2) new money-losing projects.

Nomura Research Institute (4307) forecasts and ratios

Year End Mar 31	2010A	2011E	2011CoE	2012E	2013E
Sales (¥bn)	338.6	**333.0**	325.0	366.0	397.0
YoY (%)	-0.8	**-1.7**	-4.0	9.9	8.5
Operating profit (¥bn)	40.1	**38.2**	37.0	43.7	50.5
YoY (%)	-19.4	**-4.7**	-7.7	14.4	15.6
Recurring profit (¥bn)	40.9	**39.7**	38.5	45.2	52.0
Net profit (¥bn)	21.9	**23.0**	22.5	26.4	30.4
EPS (¥)	112	**118**	116	136	156
P/E (x)	17.6	**15.3**	15.6	13.3	11.6
EV/EBITDA (x)	7.1	**6.1**	-	5.4	4.7
CFPS (¥)	271	**272**	-	305	341
P/CFPS (x)	7.3	**6.6**	-	5.9	5.3

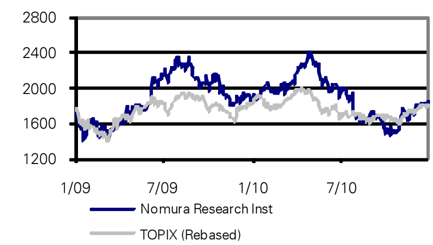
Source: Deutsche Securities Inc. estimates, company data

Nomura Research Institute (4307)

Buy

Price at 30 Dec 2010 (¥)	**1,808**
Price target - 12mth (¥)	**2,400**
52-week range (¥)	**2,411 - 1,463**

Price/price relative



Performance (%)	1m	3m	12m
Absolute	*7.1*	*15.2*	*-1.3*
TOPIX	*4.4*	*8.4*	*-1.0*

Stock data

Market cap (¥bn)	**352**
Shares outstanding (m)	**195**
Foreign shareholding ratio (%)	**20.0**
TOPIX	**899**

Key indicators (FY1)

ROE (%)	**10.2**
BPS (¥)	**1,182**
P/B (x)	**1.5**
EPS growth (%)	**5.2**
Dividend yield (%)	**2.9**

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Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

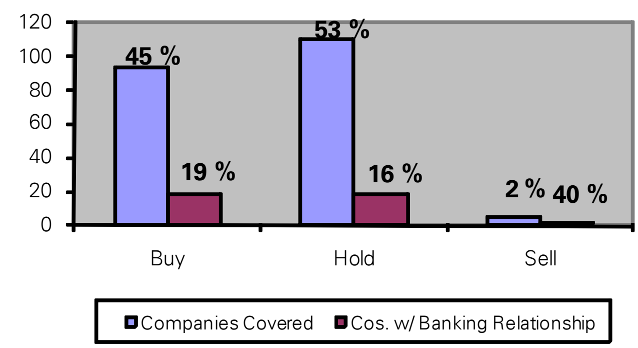
Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Naoki Kamiyama

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.
Notes:
1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:
    Buy: Expected total return (including dividends) of 10% or more over a 12-month period
    Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period
    Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Japan Universe

Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

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