The 10-second briefing

Abe government's determination to quash deflation should boost confidence and the stock market

Weekly Investment Strategy (abridged version)

- Ordinary Diet session, Abe administration measures to shake off deflation
- Focus on four major events to alleviate skepticism about a turnaround in Japanese equities: Japan-US summit, BOJ personnel changes, FY13 earnings forecasts, and upper house election
- We are revising up our share price targets, and there will be a record EPS in FY13 if the exchange rate reaches 95 yen/dollar

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■ Investment climate: Abe pushing strategies to escape deflation

The Abe government's basic stance is to put together an all-out effort to resuscitate the economy and shake off deflation. The "Abenomics" program has three major elements:

1. Aggressive monetary easing (thereby guiding the yen lower)
2. Pump priming measures, mainly in the area of developing national resilience (putting in place social infrastructure)
3. Strategies aimed at achieving growth through deregulation and market-opening measures

The first item is especially critical. The central bank has set an inflation target of 2%, and a mechanism has been established for the Council on Economic and Fiscal Policy to assess the efficacy of BOJ policy.
The next BOJ governor and deputy governors will be held responsible for achieving the 2% inflation target, so they will probably carry out aggressive easing (i.e. sharply expand the balance sheet and grow the monetary base). This kind of proactivity on the part of the BOJ will guide up the expected rate of inflation. This in turn will lead to a weaker yen, rising share prices, and an improvement in corporate and household balance sheets (and sentiment) with the attendant wealth effect. Otherwise, a decline in the yen will lead to an increase in exports and then growth in domestic manufacturing and capital investment. This in turn will propel an expansion in corporate earnings, a rise in wages and income, and increased consumer spending. This will be the route by which the output gap will be narrowed and Japan will escape from deflation.
Most investors are somewhat skeptical about a turnaround in Japanese stocks. Foreign investors (traditional long-term investors) have an especially big influence, and up to now they have had little confidence in the Japanese government and the BOJ. There are four key events that could improve the situation:

(1) Prime Minister Abe's visit to the US, Japan-US summit (reportedly being scheduled for 21-22 Feb)

(2) Appointment of next BOJ governor and deputy governors (late Feb-Mar)

(3) FY12 earnings announcements and FY13 earnings forecasts (late Apr-early May) Japanese companies are expected to post some of the fastest earnings growth among leading industrialized nations in FY13.

(4) July upper house election.

■ Stock market outlook: Upward revisions thanks to a weaker yen

Our forecast TOPIX EPS growth under various exchange rate scenarios:

- 85 yen/dollar: EPS 67 in FY13, EPS 78 in FY14
- 90 yen/dollar: EPS 73 in FY13, EPS 84 in FY14
- 95 yen/dollar: EPS 78 in FY13, EPS 90 in FY14
- 100 yen/dollar: EPS 84 in FY13, EPS 97 in FY14

If the exchange rate for FY13 is 95 yen/dollar, EPS will approach the FY07 record of 78.
At an exchange rate of 85 yen/dollar, our targets for the TOPIX had been 920 at end-Mar 2013, 960 at end-Jun, and 1,025 at end-Dec. However, we have revised the assumed exchange rate to 90 yen/dollar and our targets are now 980, 1,040, and 1,100, respectively.

■ Corporate earnings revisions

The four-week aggregate two-year forecast revision index has been in positive territory since the beginning of the year, and the one-year forecast revision index has also turned positive lately. Companies with fiscal years ending Mar have been announcing their Oct-Dec results, and they have been revising forecasts to reflect the recent weakness in the yen. Stock market rallies have typically been short-lived because the revision index has only been in positive territory for short periods of time. Going forward, the focus of attention will be on the amount of time that the two-year forecast revision index stays in positive territory.

1. Short-term market outlook

Kazuhiro Miyake

1.1 Investment climate - Abe pushing strategies to escape deflation

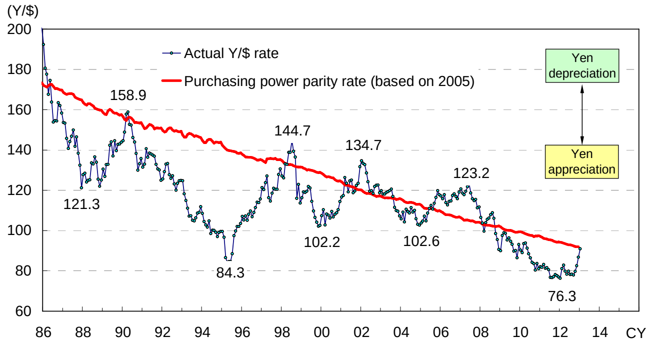
Ordinary Diet session, Abe administration measures to shake off deflation

The ordinary Diet session was convened on 28 Jan and it is slated to end on 26 Jun. The BOJ's policy board decided to adopt a 2% inflation target at its 22 Jan meeting, and at the same time the government and the BOJ jointly announced the creation of a framework for regular progress reviews by the Council on Economic and Fiscal Policy. This clarified the BOJ's responsibility in helping Japan to escape from deflation, which is something that Prime Minister Abe had asked the central bank to do. It was seen as a sign of major progress. Deflation (i.e. the vicious cycle of a rising yen and deflation) is the main factor behind Japan's protracted economic stagnation and bear market. The deep-seated expectation that the yen will appreciate is the root cause of the deflation (continually sliding prices) that is undermining the Japanese economy. These expectations for a higher yen have caused the general level of prices to decline by (1) prompting Japanese firms to keep a lid on wages and employment in order to stay competitive and (2) causing import prices to decline. Japan is trapped in a vicious cycle in which the decline in prices squeezes corporate earnings, forcing companies to cut wages and employment. This in turn reduces household income, pushing prices down even further. Furthermore, the loss of export competitiveness due to the stronger yen causes exports to shrink, capital investment to decline, and corporate earnings to deteriorate, which tends to depress GDP. The relationship between yen appreciation and deflation is something of a chicken-and-egg scenario. In order for Japan to escape from deflation, the imbalance between supply and demand (i.e. the surfeit of supply and the dearth of demand) must be fixed through a correction in the yen. In fact, when looking at the data since the mid-1980s, there is an extremely strong correlation between the yen/dollar rate and Japan's output gap (Charts 1.1 to 1.3). While the output gap tends to worsen when the yen is stronger (exacerbating deflation and causing share prices to decline), it tends to improve when the yen is weaker (easing deflation and causing share prices to rise). The Abe government's basic stance is to put together an all-out effort to resuscitate the economy and shake off deflation. His "Abenomics" program has three major elements:

1. Aggressive monetary easing (thereby guiding the yen lower)
2. Pump priming measures, mainly in the area of developing national resilience (putting in place social infrastructure)
3. Strategies aimed at achieving growth through deregulation and market-opening measures

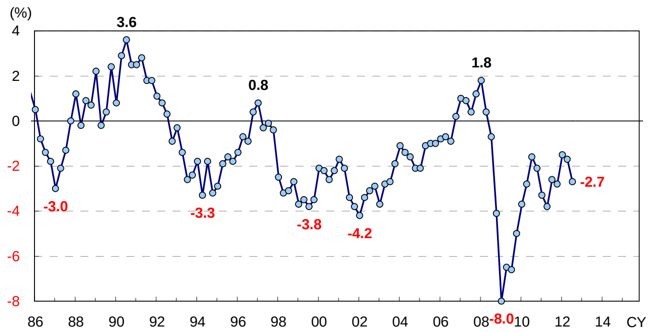
The first item is especially critical. The central bank has set an inflation target of 2%, and a mechanism has been established for the Council on Economic and Fiscal Policy to assess the efficacy of BOJ policy. The Abe government will probably move to appoint proactivists intent on achieving the 2% inflation target as the next BOJ governor and deputy governors (late Feb-Mar). The decision at the 22 Jan monetary policy board meeting to grow the BOJ's balance sheet by only 10 trillion yen was a cause for disappointment. Nevertheless, the next BOJ governor and deputy governors will be held responsible for achieving the 2% inflation target, so they will probably carry out aggressive easing (i.e. sharply expand the balance sheet and grow the monetary base). This kind of proactivity on the part of the BOJ will guide up the expected rate of inflation. This in turn will lead to a weaker yen, rising share prices, and an improvement in corporate and household balance sheets (and sentiment) with the attendant wealth effect.

■ Chart 1.1: Y/$ Purchasing Power Parity and Actual Exchange Rates



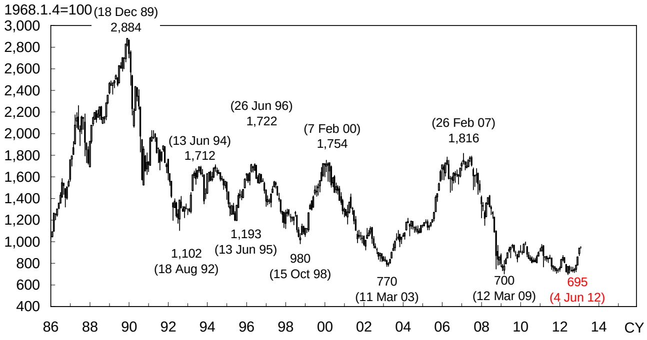
Source: Bloomberg; compiled by Daiwa.

■ Chart 1.2: GDP Gap in Japan



Source: Cabinet Office; compiled by Daiwa.
Note: GDP gap = (current GDP – potential GDP) / potential GDP.

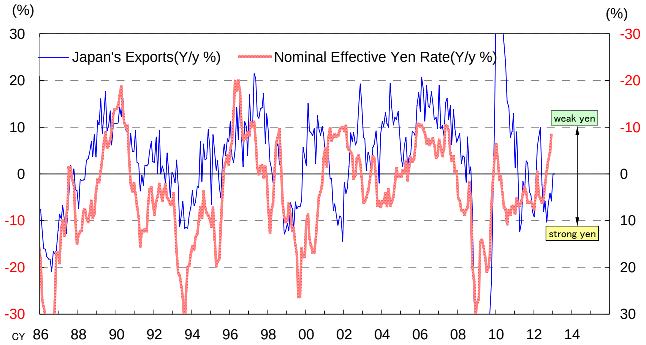
■ **Chart 1.3: TOPIX's Bearish Performance Over 22 Years**



Source: Bloomberg; compiled by Daiwa.

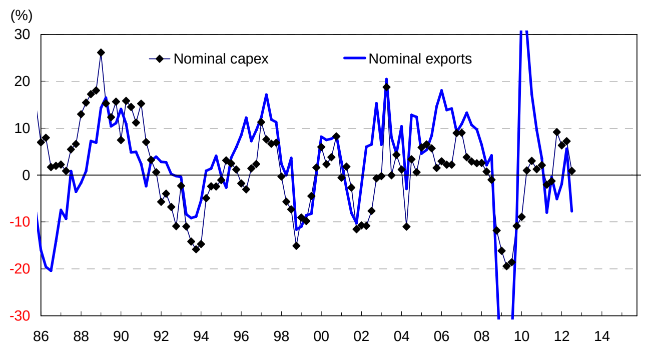
Otherwise, a decline in the yen will lead to an increase in exports and then growth in domestic manufacturing and capital investment, as shown in Charts 1.4 and 1.5. This in turn will propel an expansion in corporate earnings, a rise in wages and income, and increased consumer spending. This will be the route by which the output gap will be narrowed and Japan will escape from deflation. The BOJ's decision to adopt the 2% inflation target and the steps that it will take to make this a reality will have the effect of boosting the expected rate of inflation. This will help guide the yen lower and have a deflation-beating effect through the various routes described above.

■ **Chart 1.4: Nominal Effective Yen Rate, Japan's Exports**



Source: Cabinet office; compiled by Daiwa.

■ **Chart 1.5: Nominal Exports and Capex (y/y)**



Source: Cabinet office; compiled by Daiwa.

If Abenomics works, Japan's nominal GDP growth rate should be 3% (real growth of 1% + inflation of 2%). This will make it increasingly evident that the Japanese stock market is reaching a major turning point, shifting from the prolonged bear market to a new bull market. As long as nominal growth remains at zero or even in negative territory it will be impossible to improve Japan's fiscal situation (the government debt problem) over the medium to longer term. The 10-year JGB yield might rise, but as long as the nominal growth rate remains above the 10-year JGB yield the government's fiscal situation (enormous budget deficits) should improve over the longer term.

Stability of Abe government is critical, key events going forward

There are a number of upcoming events that could affect Japanese stocks. Most investors are somewhat skeptical about a turnaround in Japanese stocks. Foreign investors (traditional long-term investors) have an especially big influence, and up to now they have had little confidence in the Japanese government and the BOJ and they are far from certain that Japanese stocks, which have been mired in a prolonged bear market, have reached a major turning point. There are four events that could conceivably improve the situation:

(1) Prime Minister Abe's visit to the US, Japan-US summit (reportedly being scheduled for 21-22 Feb)

(2) Appointment of next BOJ governor and deputy governors (late Feb-Mar) The question is whether the ruling party (LDP-Komeito coalition), which lacks a majority in the upper house, will be able to reach an agreement with opposition parties like Your Party, Ishin no Kai, and New Renaissance Party in order to win Diet confirmation.

(3) FY12 earnings announcements and FY13 earnings forecasts (late Apr-early May) according to FactSet consensus forecasts, the earnings climate for Japanese companies is rapidly turning around. Not only is the yen falling back from its lofty heights, the global economic picture is also changing, with China increasingly appearing poised for a cyclical rebound, Europe looking like it has overcome the worst in its debt crisis, and the US economy likely to do better if it can overcome the fiscal cliff. The FY13 TOPIX earnings forecast has EBIT growing 19.3% and EPS jumping 37.4%, making Japan the leader among leading industrialized nations at this point in time (Chart 1.6). Furthermore, at this point in time the forecasts for Japanese companies are probably assuming an exchange rate in the lower 80 yen/dollar range. If the exchange rate is revised to something on the order of 90 yen/dollar,

it would result in a major upward revision for earnings forecasts. This would make foreign and domestic investors much more confident about an upturn for Japanese stocks.

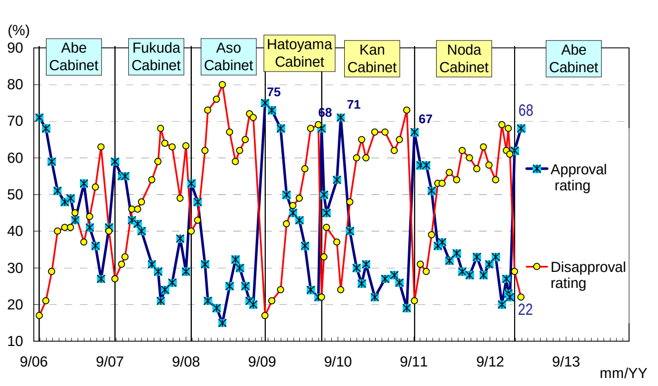
(4) July upper house election. Will Abe and the LDP be able to win and do away with the split parliament? If that happens, it would probably clear the way for Abenomics. Opinion polls that measure cabinet approval ratings serve as a barometer of the popularity of the Abe government, and an opinion poll conducted by the Nihon Keizai Shimbun on 27 Jan found that the Abe administration has strong approval rating of 68%, which is far above the disapproval rating of 22% (Chart 1.7). The main reasons behind Abe's strong approval rating are BOJ reform (including demands for aggressive easing), a weaker yen, improved business confidence, and higher share prices.

■ Chart 1.6: Sales, EBIT, EPS Growth Forecasts by FactSet Consensus for Japan, US, Europe and Asia Countries

	Sales (yoy)		EBIT (yoy)		EPS (yoy)	
	FY12	FY13	FY12	FY13	FY12	FY13
	%	%	%	%	%	%
TOPIX	1.8	2.9	1.1	20.0	18.4	37.6
MSCI Japan	1.7	2.8	0.8	20.8	18.2	39.9
MSCI USA	1.7	3.8	1.8	8.9	6.5	8.7
MSCI Germany	4.3	2.5	11.2	4.4	8.8	2.4
MSCI France	2.9	2.0	-0.4	7.7	-4.8	10.8
MSCI Italy	8.4	0.4	8.1	-0.2	12.0	7.5
MSCI United Kingdom	-1.4	1.9	-9.3	4.1	-5.1	7.2
MSCI Hong Kong	6.3	8.4	9.5	12.0	-9.4	6.7
MSCI Singapore	9.9	9.9	-2.6	6.0	4.7	-1.9
MSCI China	9.0	11.0	-2.0	11.6	-0.3	11.5
MSCI India	14.4	8.7	11.5	14.5	11.8	13.7
MSCI Indonesia	10.9	10.4	3.2	10.2	6.5	13.9
MSCI Korea	9.7	6.0	10.9	21.4	13.7	19.8
MSCI Malaysia	5.6	5.2	5.3	9.6	6.8	7.6
MSCI Philippines	17.9	9.2	8.6	12.6	11.2	11.8
MSCI Taiwan	7.3	6.8	9.1	29.2	1.9	27.9
MSCI Thailand	14.0	5.9	7.8	14.5	14.1	14.5

Source: FactSet; compiled by Daiwa.
Note: as of 5 Feb 2013.

■ Chart 1.7: Approval and Disapproval Ratings



Source: Nikkei; compiled by Daiwa.

1.2. Stock market outlook: Upward revisions thanks to a weaker yen

Record EPS in FY13 if the exchange rare reaches 95 yen/dollar

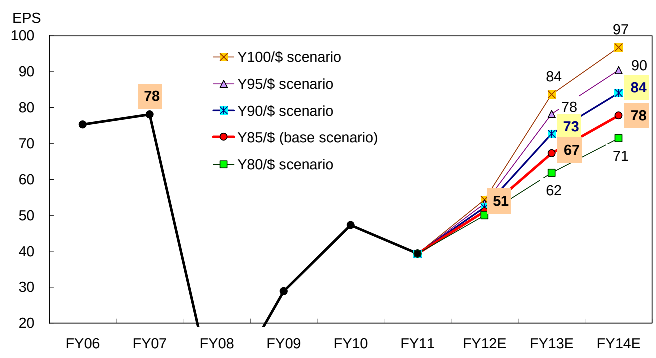
In our February Monthly Investment Strategy report (11 Jan) we presented target share prices based on EPS forecasts and other factors, presuming an exchange rate of 85 yen/dollar. However, the yen has already fallen back to 90 yen/dollar. Therefore, we are revising our EPS forecasts and share price targets using the current exchange rate. Below we have listed our TOPIX EPS forecasts for various exchange rate scenarios (As illustrated in Chart 1.8, when we looked at how a 1% decline in the nominal effective exchange rate for the yen affects the TOPIX 12-month forward forecast EPS, we estimated an elasticity of about 1.4%, and we used this figure for the following forecasts).

- 85 yen/dollar: EPS 67 in FY13, EPS 78 in FY14
- 90 yen/dollar: EPS 73 in FY13, EPS 84 in FY14
- 95 yen/dollar: EPS 78 in FY13, EPS 90 in FY14
- 100 yen/dollar: EPS 84 in FY13, EPS 97 in FY14

If the exchange rate for FY13 is 95 yen/dollar, EPS will approach the FY07 record of 78.

We think that thanks to the improved investment climate it has become more likely that the TOPIX will stage a major rally in 2013. At an exchange rate of 85 yen/dollar, our targets for the TOPIX had been 920 at end-Mar 2013, 960 at end-Jun, and 1,025 at end-Dec. However, we have revised the assumed exchange rate to 90 yen/dollar and our targets are now 980, 1,040, and 1,100, respectively, as shown in Chart 1.9. We see the Nikkei Stock Average at 13,200 at the end of 2013.

■ Chart 1.8: TOPIX EPS Scenarios by Estimated Yen Rate



Source: Compiled by Daiwa.

Chart 1.9: Outlook for Japanese stocks: Y90/$ scenario

Japan	2012	(2013)	4Q 2012	(1Q 2013)	(2Q 2013)	(3Q 2013)	(4Q 2013)
TOPIX							
At period-end	**859**	**1,100**	**859**	**980**	**1,040**	**1,070**	**1,100**
Period high	872	1,225	859	1,080	1,140	1,195	1,225
Period low	695	855	713	855	915	945	975
12-month forward P/E (x)	12.7	13.5	12.7	13.5	13.8	13.6	13.5
EPS (FY base)	52	73					
Dividend yield (%)	2.0	2.2	2.0	1.8	2.3	2.2	2.2
Return (%)	20.0	30.2	17.1	14.5	6.7	3.4	3.3
Nikkei Stock Average							
At period-end	**10,395**	**13,200**	**10,395**	**11,610**	**12,320**	**12,690**	**13,200**
Period high	10,395	14,450	10,395	12,610	13,320	13,940	14,450
Period low	8,295	10,360	8,534	10,360	11,070	11,440	11,950

Source: Compiled by Daiwa.
Note: Daiwa Securities estimates.

Translation/style check/accuracy check: Investment Strategy Department

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Benchmark index: TOPIX for Japan, S&P 500 for US, DJ STOXX 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

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"1": the security could outperform the local benchmark index by more than 15% over the next six months.
"2": the security is expected to outperform the local benchmark index by 5-15% over the next six months.
"3": the security is expected to perform within 5% of the local benchmark index (better or worse) over the next six months.
"4": the security is expected to underperform the local benchmark index by 5-15% over the next six months.
"5": the security could underperform the local benchmark index by more than 15% over the next six months.

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