

FOR SOPHISTICATED INVESTORS ONLY

# Evolving Markets

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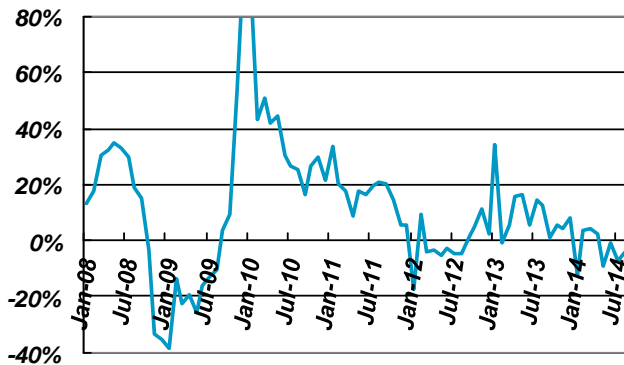
PREVIEWING THE GLOBAL INVESTMENT HORIZON FOR PROFESSIONAL INVESTORS  
SEPTEMBER 30, 2014

## The Global Backdrop Remains Net Positive

Nikko AM's Global Investment Committee (GIC) met on 26 September and chose a relatively positive global-macro scenario, implying an **increased overweight stance on global equities**. Primarily, we believe that the G-3 economies will move steadily ahead and that US monetary conditions, although moving towards tightening, will remain very accommodative (with the Bank of Japan (BOJ) and European Central Bank (ECB) being even more so), allowing equity markets to move higher.

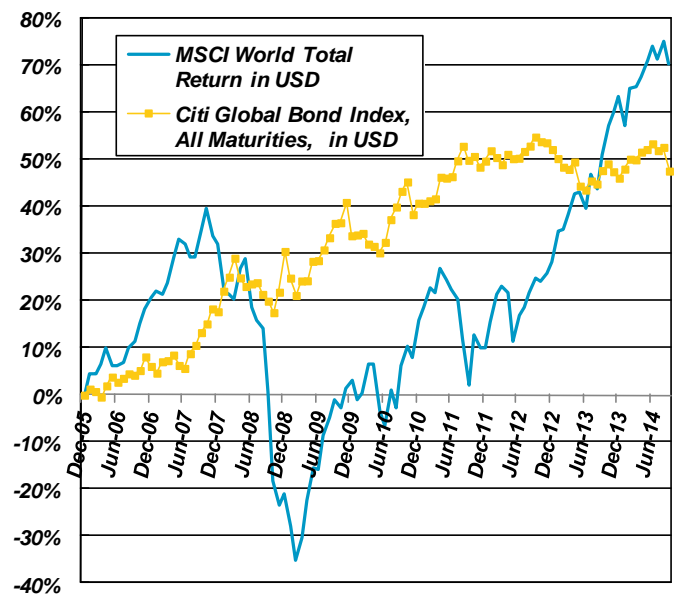
In this edition, we also update some of our Abenomics guideposts on corporate profitability, wealth effects and inflation trends. We continue to suggest that Abenomics, while not perfect, is working well, especially for corporate profits, with perhaps the most compelling recent news being the progress towards a **major corporate tax cut, which is more a bazooka than an arrow, in our view**.

### Korean Exports to China In USD YoY% terms through August 2014



Source: Bloomberg

### Global Asset Post-2005 Returns in USD terms (through 30 September 2014)



Source: Bloomberg

## MARKET WATCH

We continue to watch the export trend from Korea to China with concern. As macro-economic statistics in China are not particularly trustworthy, this indicator has strong connections to the level of consumer and business activity in the country. While many countries export commodities to China and so their data is affected by swings in commodity prices and stockpiling effects, Korean exports are primarily consumer goods, industrial components and capital goods. August's data was -4% year-on-year (YoY) and year-to-date is -3% YoY, so the declining trend continues, indicating that overall demand in China is quite soft. This could partially be due to the strong Won, but it is matched by many other countries that are also showing soft exports to China. So the Korean data, which is announced fairly early, should be a key leading indicator for China's economy.

# G-3 Economies Should Be Fine

## Introduction

Nikko AM's GIC met on 26 September and updated our house view on the global economic backdrop, financial markets and investment strategy. In sum, **there are certainly some worrying issues, as always, but we find none of them convincing enough to halt the upward momentum in equity prices. Even rising US interest rates are consensus now, so although there may be volatility as this crystallises, it may be no more problematic than the nearly completed tapering process, which many strategists were proclaiming would cause a crisis.** Indeed, global equities have risen 20% in USD terms from pre-'taper-tantrum' levels, but we only look for half of that rate in the year ahead, with valuations remaining relatively steady. The story is much the same with global bond and forex markets, which have already nearly fully priced in mid-2015 US Federal Reserve (Fed) rate hikes.

## The Global Economic Backdrop

*(Note that all dates in this report are **Calendar Year (CY)-based** and growth numbers are seasonally adjusted annual rates (SAAR) unless otherwise specified)*

In our view, the G-3 will closely match the current consensus for economic growth going forward, with the US remaining very firm and the Eurozone and Japan recovering steadily in Q4 2014 and Q1 2015, although there are certainly many doubters in the market on the latter two regions. China's economy, however, will likely be weaker (using the official statistics) than consensus. Our concern about China continues to be its property market and credit system, which the government is determined to reform even if it entails pain and which is experiencing a surge in non-performing debts. As shown on p.1, there are signs that China's import demand is declining, not just for commodities, but also for finished goods. This may indicate weakening personal consumption and factory expenditure, partly due to the wealth effect of lower property prices, but clearly also related to the anti-corruption crackdown. However, we still do not expect a hard landing in China.

The **US economy is very firm** and we agree that it will continue at the consensus rate of 2.9%-3.1% half-on-half (HoH) SAAR for Q4 2014–Q1 2015 (and the following two quarters as well), with consumer spending, capital expenditure and housing construction leading the way. As for employment, we continue to believe that payrolls will expand at a healthy rate, especially in the housing construction and related services areas, and that the **unemployment rate may overstate the problem** as the growth of employed persons in the household survey continues to greatly lag growth in payrolls. We forecast December's unemployment rate at 5.9% with further small declines through March, which will confirm the Fed's policy of removing monetary accommodation at a moderate rate.

As for wages, we still believe that the official monthly data, despite some recent acceleration, is likely understating growth, because it assumes non-hourly wage earner's average growth is only about 1.8% YoY. However, we believe it is likely to be higher than that. Meanwhile, non-supervisory wages have accelerated to **2.5% YoY, which is now quite a bit faster than the 1.7% CPI YoY rate, a fact that should certainly catch the Fed's eye. While not at panic levels, this data clearly does not warrant emergency-level policy for much longer.**

Perhaps the strongest sign of growth in the US is in auto sales, which continue to surge above pre-GFC levels. Retail spending is solid, new home sales are rebounding and ex-aircraft durable goods orders have accelerated further in recent months (and are surging if you include aircraft).

**Japan's economy** fell much more sharply in Q2 2014 than we, or consensus, expected in June. We still believe that growth is understated by low inventories and other unusual factors. For more details, see p. 6-7, but in sum, we forecast a 2.8%-2.9% HoH SAAR growth rate in Q4 2014–Q1 2015 and a 1.7%-1.9% HoH SAAR rate in the following two quarters, slightly above consensus. One area of particular strength is orders for machinery, both from the foreign and domestic sectors, which should support economic growth in the coming quarters. As for inflation, the CPI is losing momentum. While the weaker Yen will help matters, declining oil and utility prices may prevent the BOJ from attaining its 2% core CPI goal even by next northern hemisphere spring. Further helping the economy, we expect that global coordination efforts to reduce Europe's dependence on natural gas will highly motivate Japan to reduce its gas imports by restarting a few reactors in Q4 2014 and even more in H1 2015. It is hard to overestimate how much this would improve business sentiment in Japan and energy costs for the entire economy would be helpfully reduced.

In the **Eurozone**, conditions were weaker in Q2 than we or consensus expected, mainly due to the effects of the Ukrainian crisis, but should improve going forward. We forecast GDP at 1.2%-1.4% HoH SAAR in Q4 2014–Q1 2015 and 1.6%-1.8% in the following two quarters. **The weakness of the EUR and some improvement in credit conditions should help significantly—we are even seeing upward momentum in Spanish property prices**, not to mention northern European ones. The weaker EUR will likely push the CPI rate up near 1% YoY by December, **reducing fears of deflation.** We do keep in mind, however, that underneath the surface, the entire system remains quite fragile. Clearly, geopolitical conditions are key, but we continue to believe that the Ukraine situation will remain essentially a stalemate, with neither side wishing to push much further.

# China Worries Continue and Other Emerging Markets

Much as we expected, **China's economy** has continued to slow faster than consensus, but does not appear to be headed for a hard landing. We expect it to achieve a 6.7% HoH SAAR growth rate (equating to 6.8% YoY) in Q4 2014-Q1 2015, although this is below consensus of 7.3%. Inflation remains tame, as measured by the CPI, and pipeline inflation remains negative. Exports have rebounded a bit recently, while imports in value terms are suppressed mostly by lower commodity prices (but the Korean data on p.1 is also important to consider). Housing starts are declining rapidly, but the backlog of orders should support the economy, at least through this year, although next year is likely to be negative. Auto sales, on the other hand, remain quite firm and it will be crucial to watch this trend going forward.

Despite the pain its causing, the **government continues its pressure to reform the economy, as it believes imbalances must be corrected and as it tries to shift to a more modern economy. It also wants to centralise power and reduce local corruption and autonomy.** Credit defaults are increasingly commonplace now, with many firms found to have over-pledged collateral. The wealth management business of large banks remains strong, but the trust industry is struggling due to defaults and high investor risk aversion, which is **reducing credit to risky borrowers.** We still believe that the country's large hidden bad debts have yet to be fully disclosed and that China's real estate market is overpriced, **with property price declines now quite widespread.** We are not much comforted by the oft-stated supposition that debt is not officially used to a large degree for residential purchases (although there is more than USD 1 trillion of official mortgages), as this was true for Japan in the late 1980s and did not stop price declines. We also forecast that a significant amount of unofficial borrowing is behind many apartment purchases and that many companies, in a wide array of industries, have improperly speculated in the market and will be flushed out by the current reforms. Indeed, **there are large speculative holdings of vacant apartments, which will be severely tested as prices decline.** The wealth effect of such declines is negative, but so far there are no signs of panic and we expect continued government reforms to begin to excite foreign equity investors in the coming quarters.

Lastly, industrial production will continue to be constrained so as to reduce pollution and we continue to expect (as we have for several years) that huge efforts will be made, even beyond current optimistic projections, on solving this problem. This will provide many good investment opportunities for global providers of pollution control equipment of all kinds.

**Other Emerging Markets (EMs)** have continued to be relatively stable in the past few months. Fed tapering was only a moderate headwind, but we remain moderately unenthusiastic about EM economies overall, although we are positive on a few, such as India and Korea. We continue to believe that other Asian nations' economies will remain reasonably firm, as domestic demand is sturdy and external imbalances are quite small. We still have concerns about high property prices in most countries, so it will be important to guide these prices lower without hurting their banking industries.

## Central Banks

Sentiment about Fed policy remains very volatile, but Chairman Yellen has remained remarkably stable in her outlook and bond prices have remained under control during the transition away from ultra-accommodative levels. She and the Fed deserve great credit for this, although the problems in European economies, the Ukrainian situation and ECB aggressiveness clearly continued to play a role as well. There were two dissenting Federal Open Market Committee (FOMC) voters in September, but this is somewhat normal during transition periods and it should be noted that the FOMC roster will include more 'doves' next year.

The taper's completion is all but certain in October, but the 'stock type' QE (the Fed's large holdings) will remain important. **We expect the phrase "considerable period" to be removed at the December or January meeting,** with the first rate hike in June 2015 and 25 basis point (bp) rate hikes per meeting thereafter. This leaves the Fed funds channel rate at 1.25%-1.5% leading into 2016. While it is tempting to say the Fed should raise rates earlier, the strong USD and reduced commodity prices should keep inflation low and may even reduce capital spending as the US becomes a bit less competitive in international markets.

As for US inflation, the August CPI was shockingly weak, even excluding lower gasoline prices due to oil prices declining about 15% in recent months. Shelter prices are still increasing but are no longer accelerating, so core inflation will likely remain subdued as well. We estimate that the CPI will accelerate to 2.0% YoY in March with core CPI at the same rate. We then expect 1.8% and 2.1%, respectively, in June, as there is a very high base year-effect. **This is not a dangerous level of inflation,** but coupled with the moderate decline in the unemployment rate, will justify the Fed's continued gradual removal of emergency monetary accommodation.

# Central Bank, Inflation, Currency and Bond Forecasts

In Japan, the Yen's weakness has increased the prospects of inflation, which now **reduces the need for the BOJ to ease policy further** (except extending the current QE program into 2015, as is widely assumed). There has been only limited criticism by the G-20 of the weaker Yen, but this could accelerate if it weakens much further. In addition, Japan is unlikely to want the Yen to become too volatile. The weak macro data also caused Yen weakness, but this should reverse in the coming quarters, offsetting some of the weakness created by diverging monetary policies with the Fed. Meanwhile, the Core CPI is losing some momentum (it only grew at 0.4% 3M SAAR in August), and although Yen weakness should help going forward, it will be greatly offset by lower gasoline and utility prices ahead. Rent is a significant part of core inflation and although it has stabilised, it is not rising, without which, we believe it will be very difficult to hit the core target on a structural basis. In addition, **it is likely that the 2% target was chosen for its psychological effect (to boost reflationary behaviour) and that the BOJ is secretly happy with 1.5%**, which, to be honest, seems a more appropriate target to us.

The consensus (both within Nikko AM and in the markets) is somewhat mixed on the **ECB outlook, but overall, we expect it to conduct some kind of sovereign bond QE in early 2015**. It could use an indirect format/vehicle that lessens any opposition, for instance by initially sterilising purchases and then de-sterilising, much as was done with the Securities Markets Programme (SMP). The Bundesbank is very reluctant to engage in true QE and the benefits of it are highly debateable at this stage, with bond yields already exceedingly low, but ECB President Draghi seems adamant. We do suggest, however, that the QE program will be moderately sized, at least at the beginning, and if the longer-term refinancing operations (TLTRO) programme and the economy perform much better than expected, the QE programme would likely not happen at all.

As for the **Bank of England**, which is in an almost completely opposite position to the Eurozone, we, along with consensus, still expect it to raise rates in Q1 2015. The weakness of the currency associated with the Scottish 'scare' should elevate inflation expectations and high property prices remain a 'bubble' concern for a central bank with such a low policy rate.

**As for geopolitics, we still expect Ukraine to be a stalemate**, with neither side wishing to be overly-aggressive. We don't expect sanctions or reprisals to deeply affect the global economy, although reduced supplies of Russian gas during the winter could make relations very testy. **We also expect Iraq to become a stalemate**, as neither side can control its rival's areas. Other risks (including North Korea, other Middle East North Africa unrest, China's territorial claims, EM political strife) will likely occasionally instil fears in risk markets, but are not likely lead to crisis. Given this, we **expect Brent oil to remain flat at USD 97 at end March and thereafter, with overall commodity prices remaining flat**, mostly due to a weaker Chinese economy and a strong USD.

## Bond and Currency Targets

G-3 bond yields rose less than we predicted, mostly due to continued ECB easing, worries about the Chinese economy and the decline in oil prices. However, due to our view that the global economy will hold up quite well, we expect yields to rise moderately for the next two quarters. For US 10-year Treasuries, our target for March-end 2015 is 2.75%, while those for 10-year Japanese government bonds (JGBs) and German Bunds are 0.60% and 1.15%, respectively. For Australia, we expect a rise to 4.0%. This implies (coupled with our forex targets), that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -0.4% return from our base date of 24 September through December in USD terms and -1.0% through March. As a result, we are not positive on global bonds for USD-based investors. This index, however, should return 0.7% in Yen terms, due to Yen weakness, at end-December and 1.0% at end-March. We target 10-year JGBs to have a flat return in Yen terms through December (and -0.3% through year-end), so we continue to have a preference for ex-Japan bonds for Japanese investors.

Thanks to Japan's large monetary easing stance vs. a tighter Fed policy, coupled with a sharply negative trade balance and higher interest rates abroad, **we continue to expect the Yen to weaken** in the quarters ahead. We now forecast that **December will finish at 110: USD, with 111 at March-end**. The broadcasting effect of the Government Pension Investment Fund (GPIF) planning to shift more towards overseas investments is also likely to continue to weaken the Yen.

Elsewhere in Asia Pacific, we expect the CNY to be flat vs. the USD at end-December and for the AUD to weaken to 0.88 vs. the USD by then (with 0.87 by March-end).

As for the EUR, the likely increase in inflation measures and a continually high current account surplus should allow the currency to end future quarters near the present rate, although likely with much weekly volatility. Our exact estimates are 1.28: USD at end-December and 1.27 at March-end.

# GIC's Regional Equity and Asset Class Forecasts

## Equity Markets

**Although not a 'Goldilocks scenario', our forecasted macro-backdrop is quite positive for global equities.** Indeed, aggregating our national forecasts from our base date of 24 September, we forecast that the **MSCI World Total Return Index will increase 2.8%** (unannualised) through December in USD terms (+3.9% in Yen terms) and 5.6% by March-end (7.8% in Yen terms). These are **very attractive gains** in today's low interest environment, especially for Yen-based investors.

The SPX is now trading at **16.6 times NTM** (next 12-month) earnings, **which seems a bit high in a historical context, but due to interest rates remaining structurally lower than any time since the 1950s, we believe this is a fair valuation.** However, we do not believe further re-rating is possible now that bond yields are likely to rise, but we think stocks can rise along with earnings. We are slightly less optimistic than consensus about earnings, mainly due to the negative translation effect of USD strength on overseas earnings. However, we expect earnings to grow 9% in 2015, while M&A and share buybacks should also support the market in the current low interest rate environment.

The Eurozone has plenty of internal hurdles and is likely to encounter occasional jitters as it is highly exposed to China and Russia. However, after a significant equity market correction, the market is trading at 13.2 times 2015 earnings estimates and no longer seems expensive or over-owned by global investors. Clearly, we are not optimistic, but neither are we as pessimistic as the market seems to be about the European economy. We believe that stocks can rise along with earnings, which should grow in the low teens annualised rate in H1 2015 and be supported by rising M&A activity, the ECB's new QE policy and extremely low interest rates.

**Although the market has risen in recent months, this is primarily due to the weak Yen, and in truth, Japan remains under-owned and under-appreciated.** Abenomics has disappointed some investors and skepticism remains fairly high, but this is fading as more good news comes out, especially on corporate taxes and the GPIF's asset re-allocation. We believe that **Abenomics is working well, especially for corporations (with pre-tax profit margins soaring to historical highs for both manufacturing and non-manufacturing sectors—see p. 9) and equity investors, and that it will continue to do so.** Indeed, the market PER of 14.9 NTM earnings basis is very attractive and earnings estimates will likely continue to improve, partly due to the weak Yen but also due to the global economy and reduced skepticism by analysts. Regarding the Trans-Pacific Partnership (TPP), Prime Minister Abe has made it clear that he will do everything necessary for it to be successful and we estimate that it will pass the US Congress next spring, especially easily if the

Republicans win the Senate. This is perhaps the most important part of the 'third arrow' set of reforms, but a large number of other reforms have been enacted quietly due to their political sensitivity. Lastly, we forecast that an equity culture is bound to develop in Japan **as remaining risk-free will likely mean poverty in retirement, since both inflation and VAT rates are likely to rise over the short, intermediate and long term.**

We forecast that **the US will underperform in the next six months, with Europe regaining some of its lost performance, and Japan and Asia Pacific ex Japan performing the best.**

## Main Risks

Undoubtedly, geopolitics remains a significant risk factor and we will continue to be ready to react to any changes and update our view as required. Similarly, events relating to China's economy (and/or Europe's) must be watched very carefully because the tail risk of a major downturn is far from negligible. Lastly, the chance that the global bond markets might sell off more than we expect due to fears about central bank policies is not an impossible risk either.

## Investment Strategy Concluding View

We calculate that equity valuations are at fair levels with some slight undervaluation in Europe and Japan. We believe that stocks can grow along with earnings due to (1) a relatively sturdy G-3 macroeconomic backdrop; (2) some softening of geopolitical risks; and (3) other supporting factors, such as Abenomics in Japan, some relief about Europe and increased global M&A activity. Coupled with tighter Fed policy, these events will likely cause bond yields to rise moderately, so we **increase our overweight view on global equities vs. bonds, while shifting to a more aggressive stance on regional equity weightings.**

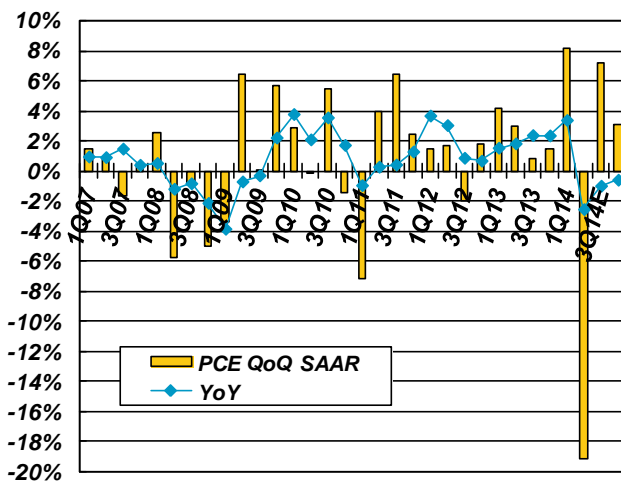
# Japan: CY14 GDP Should Exceed Consensus

(Quarters stated are calendar based)

Japan's Q2 GDP growth of -7.1% QoQ SAAR was far below June's consensus of -3.1% (and our -2.5% estimate) and we need to reduce our CY14 forecast, although not by much, and we remain more optimistic than consensus since we note that GDP is being understated by several statistical anomalies. One should also note that Q2 GDP fell to only -0.1% YoY.

Q2 personal consumption fell sharply, at -19% QoQ SAAR (vs. our -15% estimate), and -2.6% YoY, due to the post-VAT-hike effect. However, we expect this to be gradually reversed in the following quarters, so that YoY growth in Q3 and Q4 2014 will be positive on a QoQ basis and almost flat YoY.

## Real Personal Consumption (PCE)

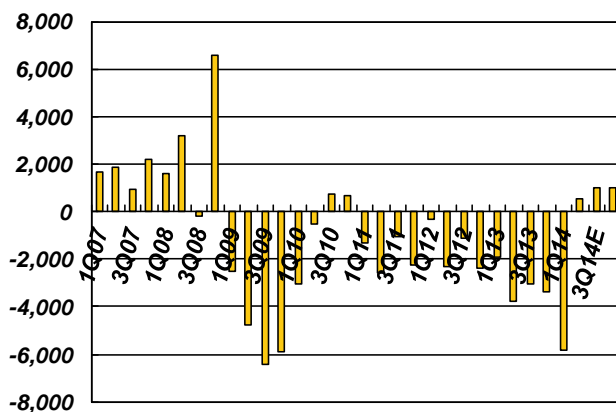


Sources: Bloomberg, Nikko AM estimates

## Inventories: Key to H2 Growth

Real inventories increased in Q2 for the first time in three and a half years. Because inventories were so weak in Q1, the Q2 result added greatly to GDP (as we expected), but inventories themselves did not rise much and if we believe

## Real Inventories (in Yen Bil.)



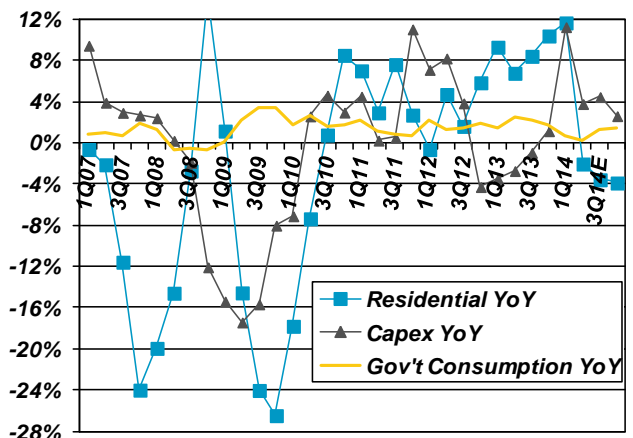
Source: Bloomberg, Nikko AM estimates

the statistics, Japan does not really have any inventories on hand at all. In contrast, inventories keep building strongly in the US despite all the same 'structural factors'. Indeed, we continue to think that Japan's inventories are too lean and should increase mildly in Q3 and Q4, creating additional economic growth through 2014.

## Residential Investment (RI)

Q2 real RI fell much faster than we expected, at -2.0% YoY, but we expect gradual recovery in H2. Orders for new homes will likely start expanding at year-end to beat the next VAT hike in Q4 2015.

## Other Japanese Real GDP components YoY



Source: Bloomberg, Nikko AM estimates

## Non Residential Investment (NRI)

Q2 real NRI fell QoQ, but we forecast it to stay positive in H2, averaging 3% YoY. The weaker Yen, improved domestic confidence and rising exports will provide the major stimuli to this growth.

## Government

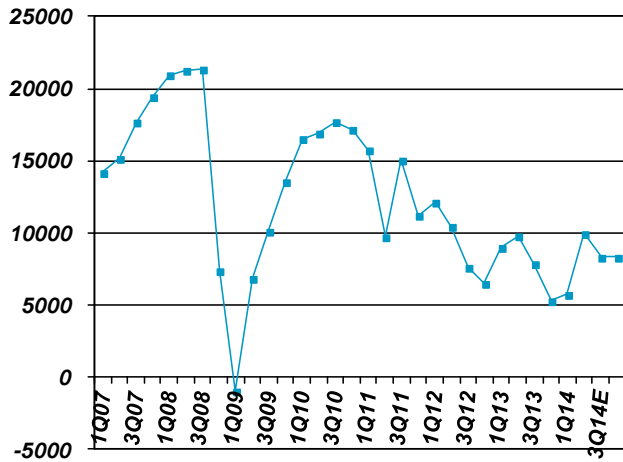
Q2 government consumption, disappointingly, was virtually flat YoY, despite the long planned boost to Q2 expenditures to offset the post-VAT recessionary effects. Public investment was approximately flat QoQ but remained strong at 5% YoY and we expect it to grow about 3% YoY in H2 2014.

## Net External Trade

The Q2 net external trade surplus (in real terms) was even stronger than we anticipated as imports plunged and exports fell only mildly QoQ. We expect some reversal in H2 as import volumes increase faster than export volumes.

# Japan: CY14 GDP Should Exceed Consensus

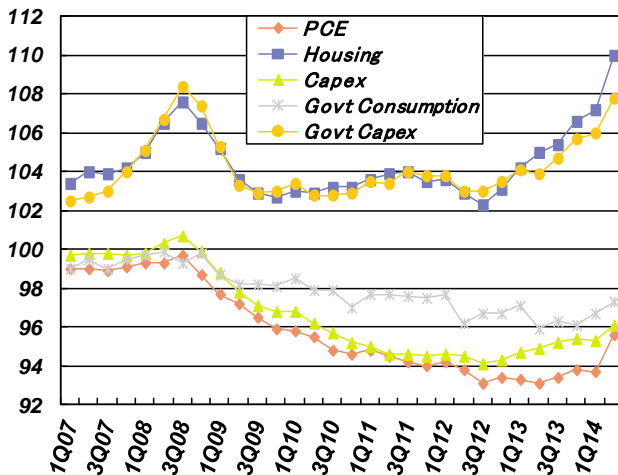
## Net Real External Trade (in Yen Bil.)



Sources: Bloomberg, Nikko AM estimates

Lastly, as a **sign that deflation is ending in Japan in a very broad fashion**, the deflators of the major GDP components continued to show continued upward movement. Deflators are the amounts by which nominal GDP components are divided by in order to show real GDP, so the higher the deflator, the higher the inflation rate.

## GDP Deflators

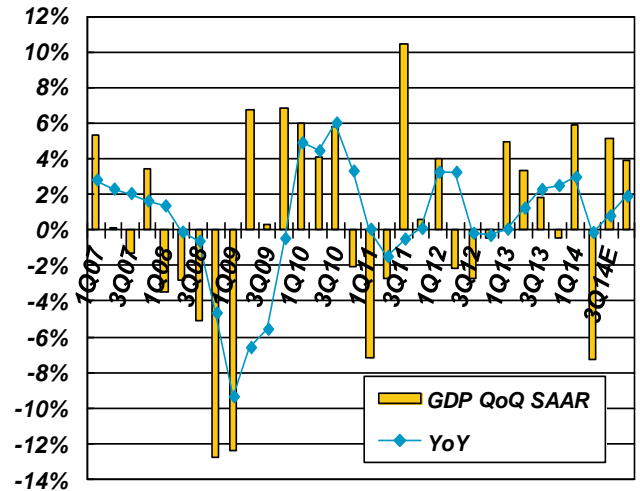


Sources: Bloomberg, Nikko AM estimates

## Summary

Japan's Q2 GDP data was much weaker than we (or consensus) expected in June, but was understated in several ways, including the negative 'statistical discrepancy factor'. **We project Q3 2014 at 5.2% QoQ SAAR (compared with consensus of 2.0%),** with every major component, except net trade, contributing.

## Japanese Real GDP



Sources: Bloomberg, Nikko AM estimates

Our CY14 forecast is now 1.35% (from 1.7% in June), compared with the consensus (as reported by Bloomberg) of 1.0% (from 1.3% in June). Our Q4 2014 estimate still equates to nearly 2% YoY growth, which is above the commonly viewed estimate of the 'potential growth' level of 1.5%.

We believe that **Japan's recovery is on track. Our positive view on inventory building and net exports is likely what sets us apart from consensus,** but our forecasts are hardly aggressive and seem logical, in our view.

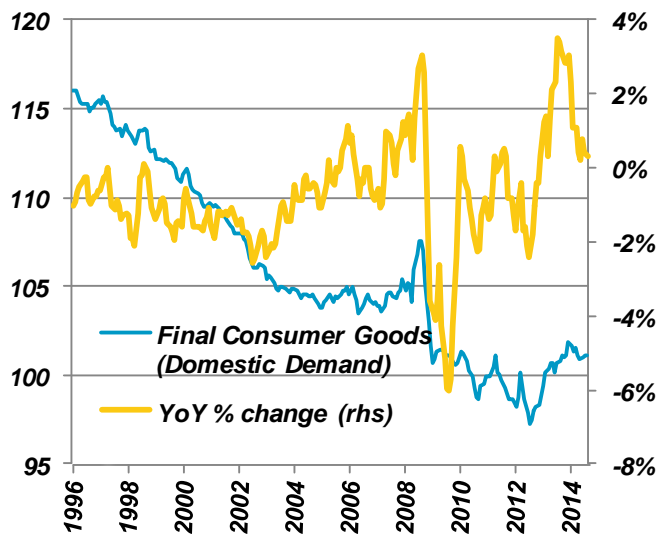
# Super-Abenomics Key Performance Indicators

## Inflation: Kuroda saved by the Yen

Japan's pipeline inflation, which we measure using the recently renamed *Producer Price Index's Finished Consumer Goods for Domestic Demand* sub-component (which includes import prices) continued to be quite depressed in August, being flat MoM and declining to -0.4% on a 6-month annualised basis and to 0.3% YoY (both excluding the VAT hike effect). Domestically produced finished consumer goods led the way down. However, the recent weakness in the Yen will push up pipeline inflation significantly, which must be a relief to the BOJ.

### Producer Price Index for Finished Consumer Goods (Domestic Demand)

YoY % growth through August 2014

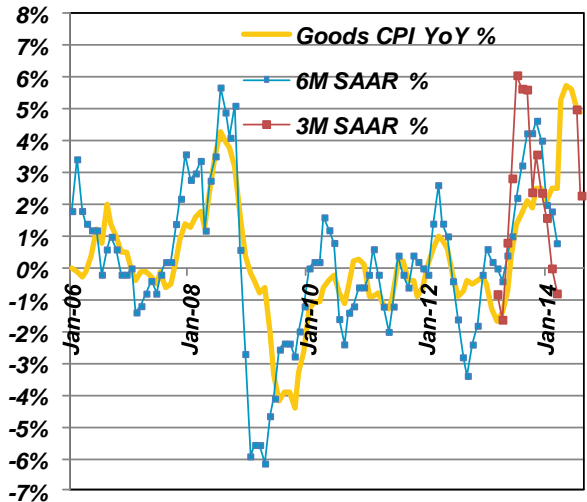


Source: Bloomberg

The August CPI data showed the goods portion of the CPI rose 0.1% MoM, but decelerated to 2.3% 3M SAAR (excluding the VAT hike), which is worrisome. Meanwhile, the 'core-core' CPI (excluding food and energy) fell 0.1% MoM (although as the right-hand chart shows, that is not too unusual) and is now only 0.4% 3M SAAR and 1.1% YoY (excluding the VAT hike), which is also worrying. The rent component remained flat MoM again, and it will need to start rising in order for the core CPI to accelerate much further. The recent Yen weakness did not truly begin until September, which should help push up the CPI in the next few months, but countering this are the falling oil price and scheduled cuts by telecoms and utility firms. **The outlook for the CPI is not too rosy**, and it will likely appear to undershoot the BOJ's 2% core target, so the BOJ may well act (beyond the widely expected expansion of its current easing plan into 2015). However, most central banks are missing their targets (if one considers the core PCE to be the Fed's target) and in order to prevent a currency war, they might just have to live with undershooting their targets.

## Japan Goods CPI

through August 2014 (some values excluded due to VAT distortion)



Source: Bloomberg

## Japan Core-Core CPI

through August 2014



Source: Bloomberg

## Conclusion

Although much of the CPI data matched consensus, the most important number, Japan's 'core' (which only excludes fresh food) disappointed at 3.1% vs. the 3.2% YoY estimate and 3.3% prior rate and **the outlook for the CPI is not too rosy**.

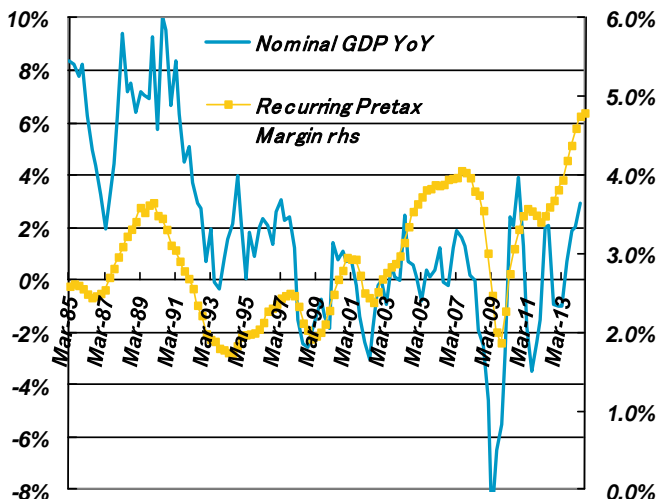
# Super-Abenomics Key Performance Indicators

## Japan's 'Show Me the Money' Corporate Governance

Improving the number of independent directors and other governance issues are very important in the intermediate term for Japan, but it is crucial for investors to understand that **much of the profitability message has already been understood by Japanese corporates for nearly a decade**. Indeed, Q2 data on overall corporate profits (not just of listed companies) showed that the pre-tax profit margin's four-quarter average hit a **new high of 4.8%**. We expect that profit margins will expand further in coming quarters, which should prove that Japan's structural profitability trend continues upward. It is also worth mentioning that forex-related profits are not the main driver of improvement since the profit margin of services industries also surged to a new record high in virtually parabolic fashion.

### Four-quarter Average of Pretax Profit Margin vs. Japanese Nominal GDP YoY Growth

(for all non-financial companies, not just listed ones)

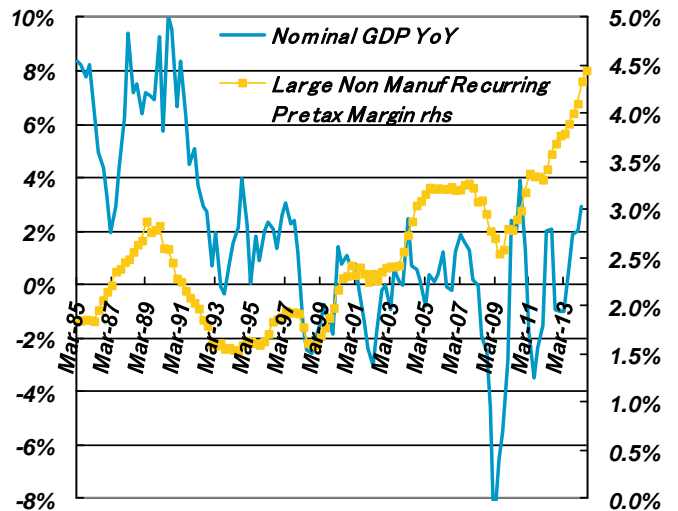


Sources: Japan Ministry of Finance, Bloomberg, data through Q2 2014

Indeed, as the chart to the right shows, service sector profitability (only non-financials are included in the survey) has been even more impressive than manufacturing. Bottom-up investors have known this for a long time, but macro-based investors are much less aware of it.

This is but one reason why investors should ignore the macro-based strategists who say that Japanese equities can only rise if the Yen weakens further. If valuations were high, this might be true, but not at their presently low levels and as large corporate tax cuts are likely to be enacted soon.

## ...and for Non-manufacturers excluding Non financials



Sources: Japan Ministry of Finance, Bloomberg, data through Q2 2014

## Conclusions

1. Years of restructuring progress was hidden due to successive crises and the gradual nature of Japan's redundancy programmes.
2. 'Show me the Money!' corporate governance: Japanese companies do care about corporate profitability.
3. The dividend paid by TOPIX is surging upward again and we expect it to double over the next five years.
4. Abenomics is having a strongly positive effect on profits due to the normalised Yen and further deregulation will gradually push profit margins higher.
5. Poor demographics are linked with GDP growth to some degree, but countries with strong automation and efficiency capabilities can offset this.
6. As these charts show, **even if GDP is flat, corporate profits can rise sharply in Japan** due to productivity increases and **gearing to global growth via multinationalisation**.
7. We are now at the stage where domestic macro-factors (including the Yen) are less important to the stock market than the bottom-up increases in corporate profits. Indeed, we still believe **equities can continue rise even if the Yen stabilises at USD 108-109**, although, of course, external factors will also be critically important.



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