

Today's Topic

Despite good earnings result, Japanese equity market is waiting for sentiment improvement

Sign of settlement of US-China trade friction is necessary

Point 1

Generally good Apr.-Jun. results Conservative annual earnings outlook stays

- Announcement of Apr.-Jun. 2018 results has almost finished (As of Aug. 16, 99.9% of Tokyo Stock Exchange 1st Section listed stocks according to QUICK). Sales, Operating Profit and Recurring Profit continued to increase by + 5%, + 10% and + 16% YoY, respectively, surpassing consensus forecast.
- In terms of recurring profit growth, Information & Communication, Electric Appliances and Transportation Equipment sectors have contributed to earnings growth and upward revision in forecast earnings. We believe reasons are 1) weaker JPY against USD from April and 2) strong export supported by expansion of global economy.
- Company forecast on recurring profit growth of fiscal year 2018 (+ 8.8% YoY) was conservative, as it was almost unchanged from that released a month ago despite slow but steady recovery of global economy. We assume this is due to deep-rooted uncertainty caused by protective US trade policy, such as how US-China trade friction is going to evolve and if tariff increase on automobile is really going to be made. US-China trade friction had entered into a game of tit for tat. Majority believes that it will end after the US midterm election. We will try to estimate impact of US-China trade friction on the business activities of the Japanese companies.

Point 2

Impact of US-China trade friction is limited

Impact will be limited as long as it stays as bilateral tariff increase

- It is difficult to measure direct impact of US-China trade friction on corporate earnings of the Japanese companies, however, impact on production activity can be estimated to some extent.

"Apr.-Jun. 2018 results were generally good"

(YoY, %)

	Sales	Op. Profit	Rec. Profit
TOPIX	5.1	10.2	16.0
TOPIX100	5.6	14.8	23.7
TOPIX Mid 400	4.3	▲ 0.1	1.5
TOPIX Small	5.7	11.8	13.6

- (Note) 1. Data as of Aug. 16 2018. Companies (ex financials) who have announced financial results for Apr.-Jun. quarter.
2. TOPIX is Tokyo stock price index. TOPIX100 is large cap index, TOPIX Mid 400 is middle cap index and TOPIX Small is small cap index.
(Source) SMAM, based on QUICK data.

"Forecast of Recurring Profit Growth Rate"

(YoY, %)

Sectors	FY 2017 (Actual)	FY 2018 (Forecast)	FY 2019 (Forecast)
All Industries (ex. Financials)	17.2	8.8	8.9
Manufacturers	23.1	10.3	8.0
Non-Manufacturers	10.5	6.8	10.1
Food	2.8	6.0	6.4
Textiles and Apparels	6.4	5.2	8.3
Pulp and Paper	-5.7	32.9	5.3
Chemicals	23.0	5.9	6.8
Pharmaceutical	6.9	2.2	3.9
Oil and Coal Products	66.8	12.5	-6.0
Rubber Products	0.8	10.7	12.6
Glass and Ceramics Products	13.7	8.6	9.8
Iron and Steel	79.3	17.5	7.6
Nonferrous Metals	38.3	10.6	8.2
Metal Products	9.6	-0.9	9.0
Machinery	26.9	17.8	11.6
Electric Appliances	31.9	21.3	8.6
Transportation Equipment	13.7	2.5	8.1
Precision Instruments	36.5	8.9	14.1
Other Products	59.7	25.0	17.4
Fishery, Agriculture & Forestry	3.1	-1.8	8.8
Mining	16.7	25.7	29.2
Construction	9.3	4.5	4.2
Electric Power and Gas	11.8	-1.3	-1.1
Land Transportation	5.7	4.1	3.7
Marine Transportation	Turn positive	-16.6	151.9
Air Transportation	6.3	2.8	4.6
Warehousing and Harbor Transport.	10.9	7.4	6.6
Information & Communication	3.3	12.0	20.5
Wholesale Trade	27.9	10.8	3.6
Retail Trade	3.9	6.8	9.5
Real Estate	7.1	3.6	5.8
Services	9.5	-4.9	7.0

- (Note) 1. Data as of Aug. 17, 2018. TSE1 March fiscal year end companies.
2. ■ shows double digit earnings growth.
Forecast based on QUICK consensus.
(Source) SMAM, based on QUICK data.

- We estimated that Japanese production output (All industry) will decrease by - 0.04%, assuming production activity of goods were to decrease in line with impact of higher tariffs imposed on relevant goods by sanctions between US and China. Even if we assume that magnitude of our estimated output fall will be 10 times of what we have calculated considering 1) bigger impact if including indirect effect and 2) growth of Chinese economy from year 2014, the output will only decrease by about 0.4%. We therefore believe that as far as tariff hike is limited to 2 countries, impact on production activities of the Japanese companies will be limited.

Future Outlook

Market awaits corporate sentiment to improve on a possible easing of US-China trade friction

“Impact of US-China trade friction on production activity of the Japanese companies”

Estimated decrease of production activity caused by economic sanctions between US and China.

Production output of Japanese companies (2014):
USD8,668.7 billion (1)

Ultimate ripple effect pushes down output by
USD -3.6 billion (2)

Production output is estimated to be lowered by - 0.04%
((2) / (1) x 100)

<Assumption>

Impact of economic sanctions;

First economic sanction by US to China: USD50 bil.

Additional economic sanction by US to China: USD200 bil.

First economic sanction by China to US: USD50 bil.

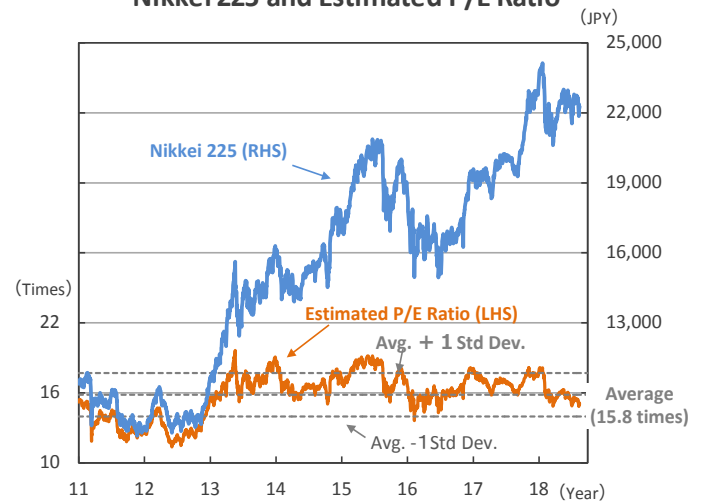
Additional economic sanction by China to US: US\$60bil.

All of the tariffs are assumed as 25%.

(Source) SMAM, based on WIDO (World Input-Output Database) data.

- Risk could be the case that Japanese companies will hold back their production and investment because of worsening sentiment due to increasing uncertainty. We need to continue paying attention to 1) the magnitude of impact of US’s protective trade policy to the sentiment of Japanese companies until the US midterm election in November and 2) whether or not improving corporate earnings trend can sustain.
- Level of Japanese equity price is not that high as estimated P/E Ratio of Nikkei 225 (12 months forecast) as of August 17, 2018 was 15.1 times which is below average since 2011 (15.8 times). We anticipate upside of the Japanese stock market is limited due to 1) concern over expansion of US-China trade friction and 2) escalation of US’s protective trade policy to continue for some time. It is possible that estimated P/E ratio may rise to its average if concern over business activity subsides with US-China trade friction showing signs of settlement. In such case, recovery of Nikkei 225 to JPY 23,000 level would be possible.

“Nikkei 225 and Estimated P/E Ratio”



(Note) 1. Data from Jan. 4, 2011 to Aug. 17, 2018.

2. Estimated P/E Ratio = Share Price / Estimated Earnings Per Share.

Estimated Earnings Per Share is based on 12 months forecast.

Estimate is compiled by Bloomberg L. P. Calculated period of

average of Estimated P/E Ratio is from Jan. 4, 2011 to Jul. 31, 2018.

(Source) SMAM, based on Bloomberg L. P. data.

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