



Outlook for Japanese Economy & Stock Market

Monthly comments & views by
Sumitomo Mitsui DS Asset Management (SMDAM)

-August 2019-

Executive summary

■ Japanese Economy

US-China trade truce is going to continue while US President Trump focuses on the preparation for the Presidential Campaign running into the next year. As a possibility, US and China might strike a partial agreement, in which US lifts part of the existing tariff on imports from China and China makes some concession such as opening-up its economy or increasing imports from US.

- Consumption tax is going to be hiked from 8% to 10% as scheduled in October, however, negative effect will be limited compared to the last hike in 2014 from 5% to 8%. The last time in 2014, there were little counter measures and the net negative effect on Japanese households was as much as 8 trillion yen. However, this time, negative effect of 5.8 trillion yen is mostly offset by various counter measures and net negative effect is forecast to shrink to 1.6 trillion yen.
- According to BOJ "TANKAN" business survey in June, FY 2019 capital expenditure plan in June showed further 3% increase from the robust CAPEX in FY2018 even excluding software. FY2019 capital expenditure plan for software rose to very strong 13% YoY in June as the right end chart shows.

■ Japanese Stock Market

Rekindled global monetary easing has boosted the price of global financial assets first, and the next step is how far the easing could boost the real economy. From a cycle analysis, trade momentum is forecast to bottom out in the 2H of 2019. Apr-Jun quarter corporate earnings announcements are expected to be still cloudy, however, Japanese economy, corporate earnings and stock market are expected to make recovery at some point during 2H 2019.

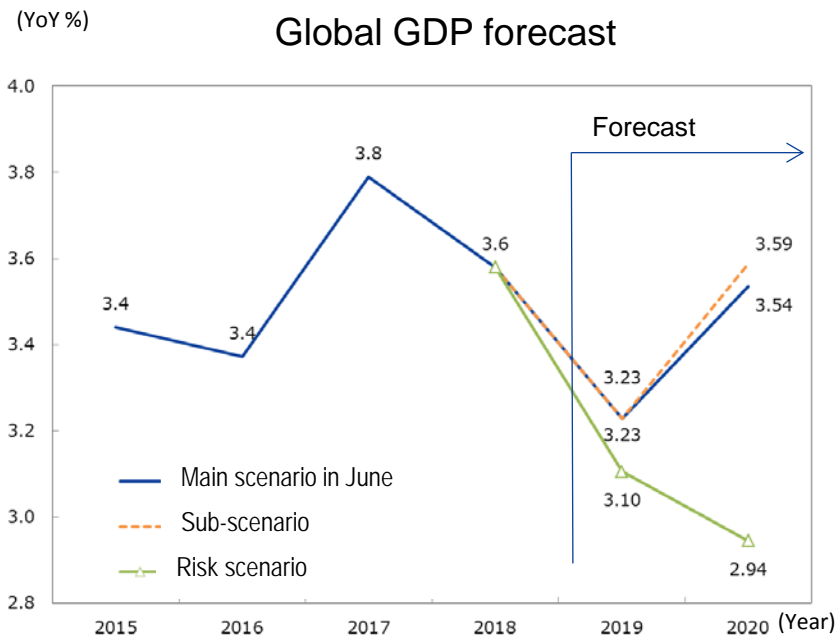
- Japanese companies are getting more and more willing to make positive business restructuring. Number of M&A deals between Japanese companies (IN-IN) rose from 2,174 in 2006 to 2,814 in 2018 increasing by 30%, which is an evidence that business restructuring is progressing in Japan. (p24)



Outlook for Japanese Economy

Outlook for the global economy

- US-China trade truce is going to continue while US President Trump focuses on the preparation for the Presidential Campaign running into the next year.
- As a possibility, US and China might strike a partial agreement, in which US lifts part of the existing tariff on imports from China and China makes some concession such as opening-up its economy or increasing imports from US.



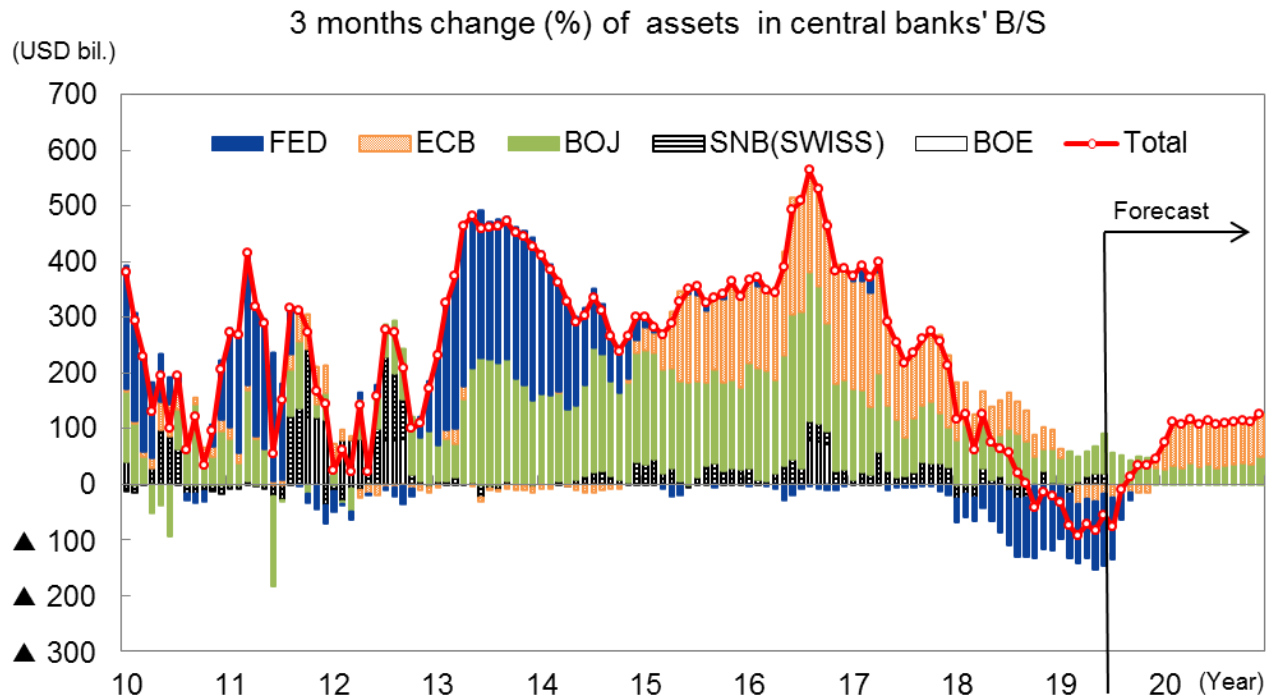
Notes: Each real GDP assumption was made for US, China, Euro-area and Japan for each scenario. Other countries' forecasts were calculated using historical propensities of GDP to these four countries & regions. Forecasts and scenarios by SMDAM.
 (Source) IMF, National statistics of each country, compiled by SMDAM.

Scenarios

	Main scenario in July	Sub-scenario in July	Risk scenario in July
US-China tariff	US 25% tariff on USD 200 bil + retaliation by China	Partial lifting of the existing tariff	US 25% tariff on USD 300 bil + retaliation by China
Huawei & Chinese tech companies	30% sales cut on Huawei	A little easing of US restrictions	30% sales cut on Huawei+5 other Chinese companies
Shock on CAPEX	CAPEX (ex. construction) down by 1%	Less shock on CAPEX (ex. construction)	CAPEX (ex. construction) down by 2.5%
Shock on consumption	Consumption in China down by 0.5%	Less shock on consumption	Global consumption down by 0.5%

Global quantitative easing is about to start again

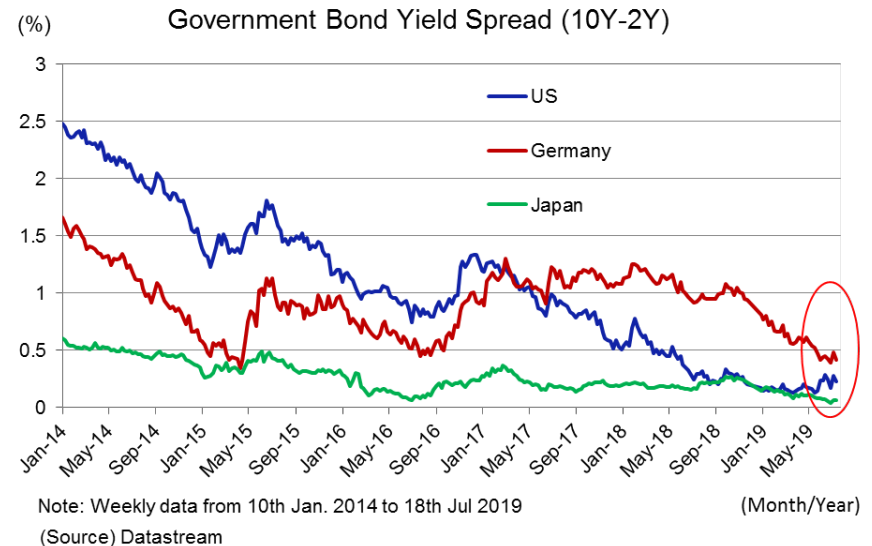
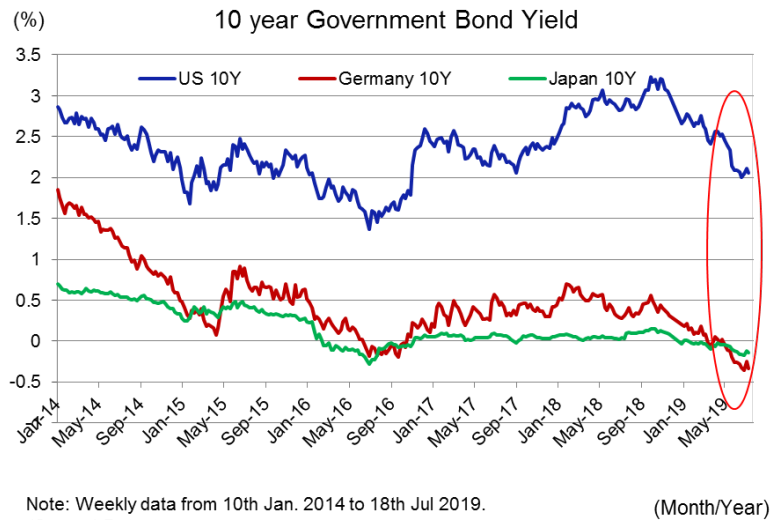
- ECB is expected to restart aggressive quantitative easing and FED to stop tapering.
- In addition to pre-emptive rate cuts, this quantitative easing will support global financial markets and economy.



Note: Data is from Jan 2010 to May 2019 and SMDAM's forecasts to Dec 2020.
Assumes FED to stop tapering in July 2019, ECB restarts monthly EUR 30 bil. of bond purchases and BOJ maintains current purchasing pace.
(Source) Bloomberg, each central bank, compiled by SMDAM.

Long term interest rates fell sharply in Europe

- Long term bond yields continue falling in Europe. Recently released US economic indicators showed resilience, which stopped further fall in bond yields for a while, however, FRB keeps its easing policy.
- US Interest rates continued falling on the shorter end of the yield curve and 10Y-2Y yield spread slightly widened.



SMDAM Japanese economic outlook for FY18-20

- SMADM maintained Japanese GDP forecast for FY19 and FY20.
- Japanese economy is forecast to keep moderate growth going into FY2020.

(YoY %)	FY15	FY16	FY17	FY18	FY19E	FY20E
Real GDP growth	1.3%	0.9%	1.9%	0.7%	0.4%	0.5%
Private Consumption Expenditure	0.7%	0.0%	1.1%	0.4%	0.3%	0.3%
Private Housing Investment	3.7%	6.3%	-0.7%	-4.3%	1.3%	-2.2%
Private Capital Investment	1.6%	-0.5%	4.5%	3.5%	1.8%	0.5%
Public Consumption Expenditure	1.9%	0.7%	0.4%	0.9%	0.9%	0.9%
Public Capital Investment	-1.6%	0.6%	0.5%	-3.9%	1.8%	0.9%
Net Exports (contrib. to GDP growth)	0.1%	0.8%	0.4%	-0.1%	-0.3%	0.1%
Exports	0.8%	3.6%	6.4%	1.3%	-2.0%	1.3%
Imports	0.4%	-0.9%	4.1%	2.0%	-0.1%	0.8%
Nominal GDP	2.8%	0.7%	2.0%	0.5%	1.2%	1.0%
GDP Deflator	1.5%	-0.2%	0.1%	-0.2%	0.8%	0.5%
Industrial Production	-0.7%	0.8%	2.9%	0.3%	-0.5%	0.3%
CPI (excl. fresh food)	-0.1%	-0.2%	0.7%	0.8%	0.4%	0.3%

Note: E=SMDAM forecasts. SMDAM views are as of 22nd Jul. 2019 and subject to updates thereafter without notice

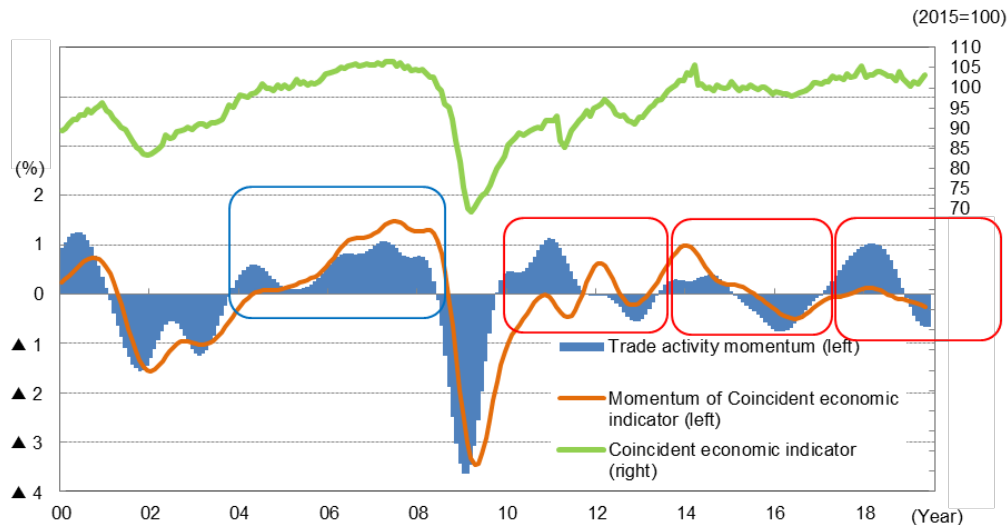
(%, YoY except Net Exports)

(Source) Cabinet Office, Bank of Japan, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, SMDAM forecasts

Downturn in the current mini-cycle is progressing

- After the end of Global Financial Crisis, Japan has experienced 2 and a half mini cycles as indicated in red squares. According to this analysis, currently, Japanese economy is probably in a soft patch as in 2015-16 or a mini recession in 2012-13.
- Momentum of deterioration is slowing down lately and expected to bottom out in the 2nd Half of 2019.

Momentum of Japanese economic indicator and trade activities

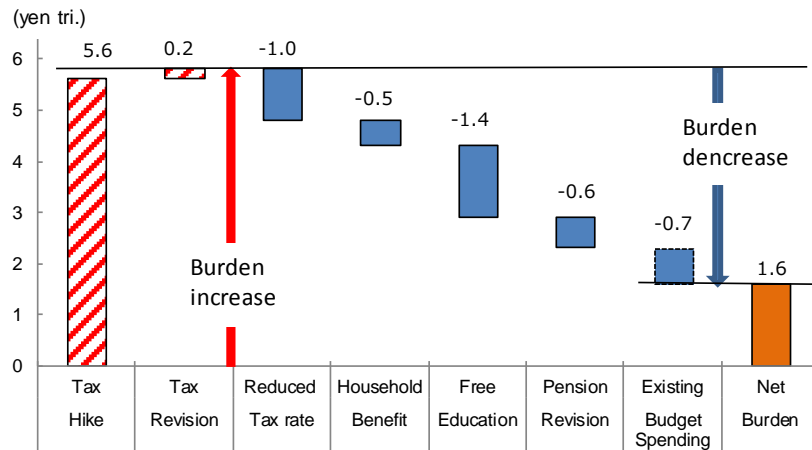


Note: Data is monthly from Jan 2000 to May 2019 for coincident economic indicator and to June 2019 for trade activity momentum. Trade activity momentum is composed by SMDAM using various trade related statistics. Momentum of coincident economic indicator was created by SMDAM using coincident economic indicator published by cabinet office.
(Source) Cabinet Office and other various trade related statistics, compiled by SMDAM

Consumption Tax Hike in October will make only limited impact

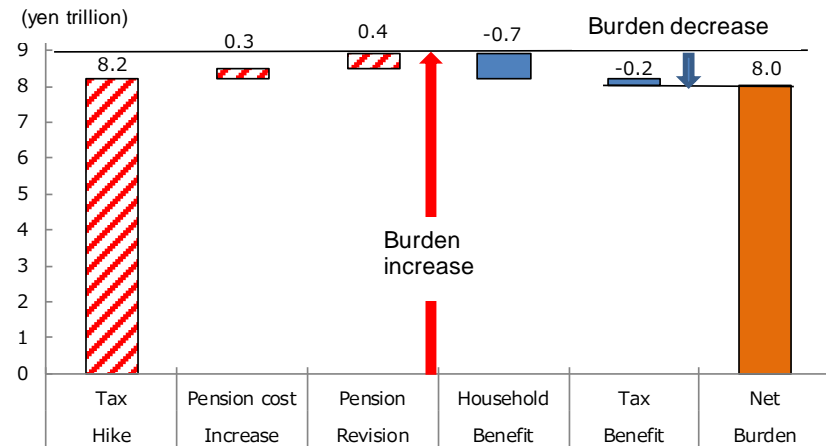
- Consumption tax is going to be hiked from 8% to 10% as scheduled in October, however, negative effect will be limited compared to the last hike in 2014 from 5% to 8%.
- The last time in 2014, there were little counter measures and the net negative effect on Japanese households was as much as 8 trillion yen. However, this time, negative effect of 5.8 trillion yen is mostly offset by various counter measures and net negative effect is forecast to shrink to 1.6 trillion yen.

Effect of consumption tax hike and counter measures on households (2019)



(Source) Bank of Japan, compiled by SMDAM

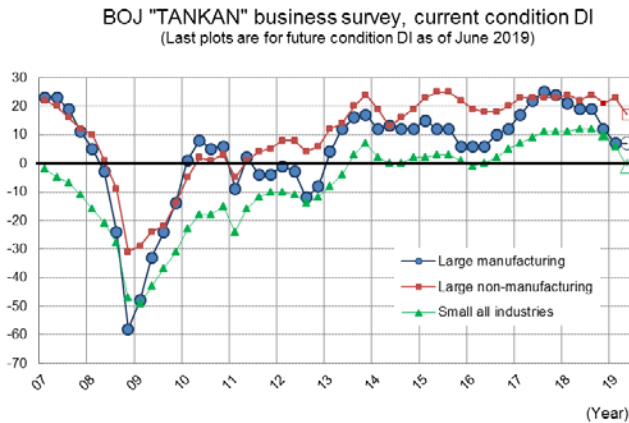
Effect of consumption tax hike and counter measures on households (2014)



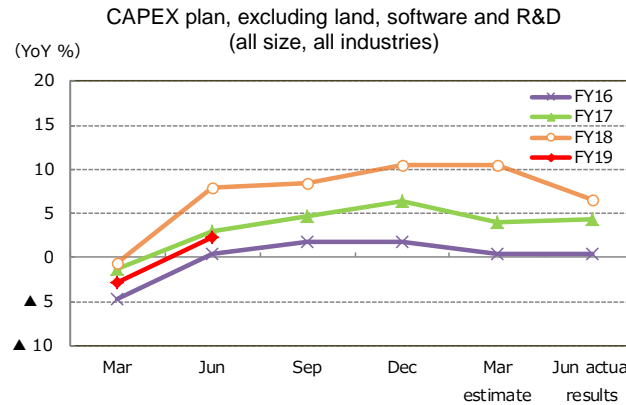
(Source) Bank of Japan, compiled by SMDAM

Robust capital expenditure despite deteriorating business sentiment

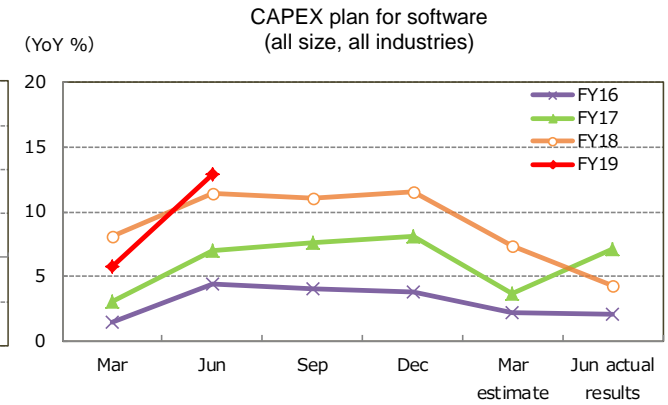
- BOJ's "TANKAN" business survey in June showed deterioration in business sentiment.
- FY 2019 capital expenditure plan in June showed further 3% increase from the robust CAPEX in FY2018 even excluding software as the middle chart shows.
- FY2019 capital expenditure plan for software rose to very strong 13% YoY in June as the right end chart shows.



Note: Data is quarterly from Mar. 2007 to Jun. 2019
 Diffusion Index above 0 means condition is good.
 (Source) Bank of Japan

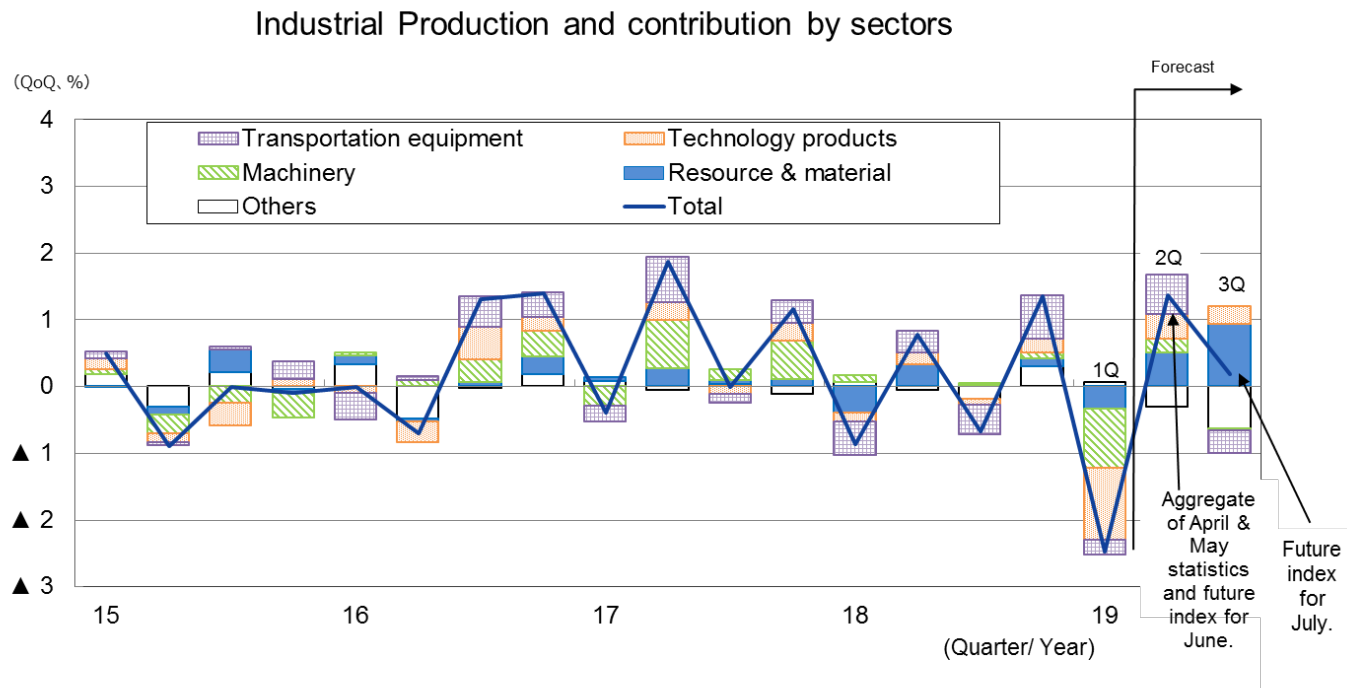


Note: The chart shows history of the CAPEX plan for each fiscal year. Mar estimate is at each fiscal year end and Jun actual results are surveyed after the end of each fiscal year.
 (Source) Bank of Japan



Industrial Production is expected to have rebounded by 1.4% in 2Q

- In 1Q of 2019, Industrial Production in Japan was hit by abrupt slowdown in global economy, especially China, for which contraction in “Technology” and “Machinery” were severe.
- Despite continuing uncertainties on demands in China, Japanese industrial production made a rebound of 1.4% QoQ in 2Q and forecast to stay mildly positive in July.



(Source) Data forecast and estimate by Ministry of Economy, Trade and Industry, compiled by SMDAM

Monetary policy and Brexit will be influential events

- US is expected to get focused on the preparation for US presidential election next year and diplomatic agendas involving US are likely to be put on hold. As an exception, trade negotiation between US and Japan is expected to restart as the upper house election in Japan is now over.
- Direction of the Brexit under the new Prime Minister will be an event to watch.
- Extent of the monetary easing by US and ECB is also an important event, though schedule of regular meetings are not included in the following schedule.

Upcoming key events

	Month	Region/Country	Events	Notes
2019	July	UK	New leader of Conservative Party is decided	
		Japan	Upper house election	Ended in a victory for the governing coalition parties.
	September	Japan	18-19 Bank of Japan Monetary Policy Committee Meeting	
October	Japan		1 Consumption Tax is scheduled to rise from 8% to 10%	
			Rakuten begins mobile carrier business as the 4th company in Japan	
	EU	Lagarde becomes ECB president		
		UK-EU	31 Ttime limit for Brexit	
	November	US-Japan,EU	13 Limit for deciding US action on car tariffs	
	December	Japan	18-19 Bank of Japan Monetary Policy Committee Meeting	
2020	February	US	US Presidential Primary Election Campaigns are expected to begin	
	Jul-Aug	Japan	Tokyo Olympic Games	

(Source) Various publications, assembled by SMDAM

Japan is still competitive in innovation, but has some weaknesses

- According to World Economic Forum, Japan was ranked 8th in innovation among 137 economies, which is still competitive, however on a moderate declining trend. As a strength, R&D in Japan is largely led by companies and producing the largest number of patents in this ranking.
- On the weak side, however, this company led R&D tends to be “progressive” rather than “innovative” and often lacks in global collaboration. Government initiative on innovation is stronger in economies such as US, Germany Singapore and China.
- Facing with strong global competition in developing key technologies such as AI or Autonomous Driving Technology, Japanese companies are changing approach to more open and more collaborating with global partners.

Global Competitiveness Ranking of Innovation among 137 economies

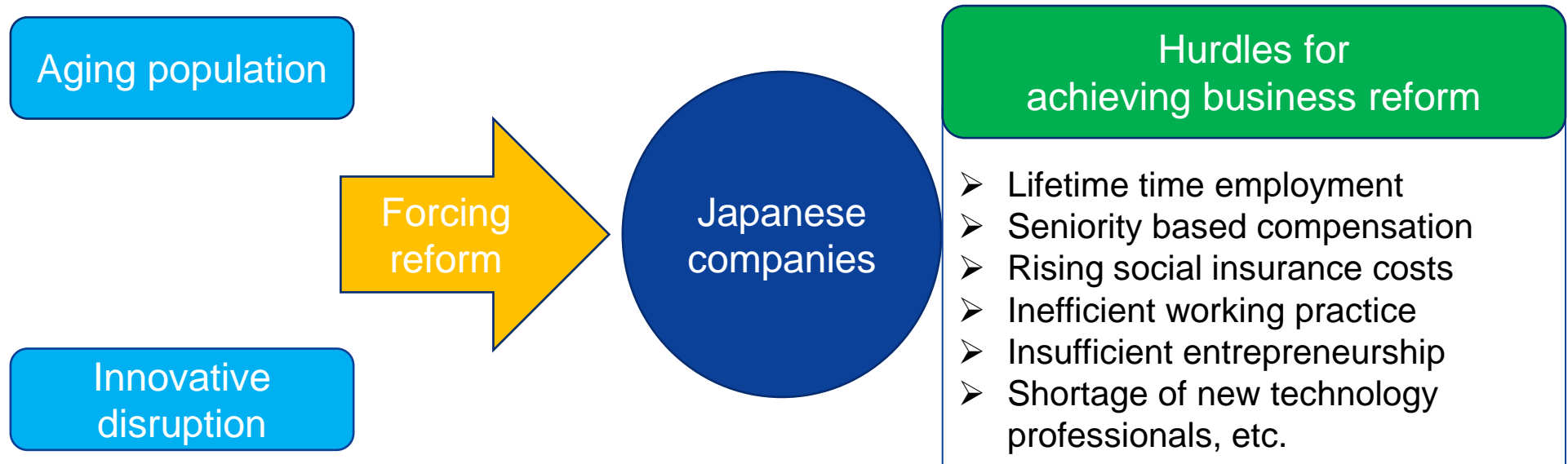
	Switzerland	U.S.	Israel	Finland	Germany	Netherlands	Sweden	Japan	Singapore	Denmark	China
Innovation total	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	28th
a) Capacity for innovation	1	2	3	7	5	6	4	21	23	16	44
b) Quality of scientific research institutions	1	5	3	8	11	4	13	14	12	16	36
c) Company spending on R&D	1	2	3	7	4	8	6	5	17	16	21
d) University-industry collaboration in R&D	1	2	3	4	7	5	10	23	8	21	28
e) Gov't procurement of advanced technology products	37	2	11	20	6	19	17	23	5	39	10
f) Availability of scientists and engineers	12	2	6	1	11	19	20	8	9	44	29
g) PCT patents	3	10	6	4	7	9	2	1	12	8	30

Note: All numbers are rankings among 137 economies. Top 10 rankings are highlighted in green. Japan's relative weakness is highlighted in orange.

(Source): World Economic Forum, The Global Competitiveness Report 2017–2018

Japanese society is changing slowly but steadily

- It may look slow or even stagnant from outside, but Japanese society is making necessary reforms.
- Many problems are stemming from deep rooted Japanese culture & social practice, which became apparent in the face of “aging population” and “innovative disruption”.
- Change of the deep rooted culture & practice should take time, however, it is making progress, and will eventually put Japan in an advantage over other advanced economies, which also have aging population lagging Japan.



Japanese society is changing slowly but steadily

■ Examples of long-term social challenges and progressing solutions

Source of problems	Challenges	Solutions
1. Aging population	a) Pension system reform	<ul style="list-style-type: none"> ● Unconventional "macro-slide" has been implemented to curb pension payment increase referring to "low birth rate" and so on. ● Encourage people to continue working into 70's. ● Encourage people to shift saving to investments. (NISA*, DC)
	b) Labor shortage	<ul style="list-style-type: none"> ● Capital investment for enhancing labor efficiency. (FA, AI, IoT, autonomous driving car, renovating software, etc.) ● Allowing more foreign workers. ● Encourage people to delay retirement. ● Support female workers. (increase nursery, etc.)
2. Weak consumption propensity	c) Clearing peoples worry for the future life	<ul style="list-style-type: none"> ● Pension system reform. ● Gradual adjustment of seniority based wage system to shift compensation from elderly to younger workers. ● Increase of new generation companies. ● Increase of young people working with non-seniority wage system.
3. Rigid employment practice	d) Encouraging business structure reform	<ul style="list-style-type: none"> ● Elder people to retire or continue working at lower wage. ● Gradual adjustment of seniority based wage system. ● More fluid labor market enabling companies to make restructuring. ● Young people are not expecting lifetime employments and focusing on building own career (already progressing).
4. Inefficient working practice	e) Enhancing labor efficiency	<ul style="list-style-type: none"> ● Work style reform to progress.
5. Insufficient entrepreneurship 6. Shortage of new technology professionals	f) Enhancing "challenge spirit" g) Education reform	<ul style="list-style-type: none"> ● Increase of successful new generation companies. ● Increase of young people with skills of new technologies. ● Young and talented people chose new generation companies rather than old & large firms (already progressing).

Note: *NISA is "Nippon Individual Savings Account". (Source) SMDAM



Outlook for Japanese Stock Market

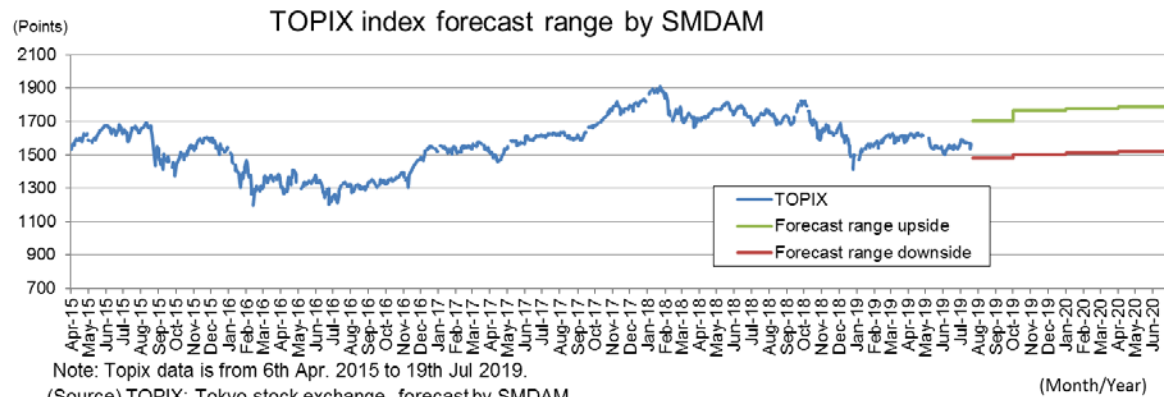
Global stock market is waiting for the recovery in the real economy

■ SMDAM short-term view

➤ Rekindled global monetary easing has boosted the price of global financial assets first, and the next step is how far the easing could boost the real economy. From a cycle analysis, trade momentum is forecast to bottom out in the 2H of 2019. Apr-Jun quarter corporate earnings announcements are expected to be still cloudy, however, Japanese economy, corporate earnings and stock market are expected to make recovery at some point during 2H 2019.

■ Longer-term outlook (6-months and beyond)

➤ Consumption tax is going to be raised from 8% to 10% in October as scheduled. Negative effect is going to be mostly offset by various counter measures this time. In the last tax hike in 2014, negative impact hit the households almost in full. Delayed recovery of capital investment in China is a matter of concern for capital goods sector, however, domestic capital investment is quite strong in the face of labor shortage and obsolete system & software. Consumer sentiment is holding rather well supported by marginally but still growing nominal wage and feeling of job security. Japanese stock market is forecast to enter an upward path in 2H of 2019 as prospect of corporate earnings start improving.



Base scenario & Upside / Downside risks for our forecasts

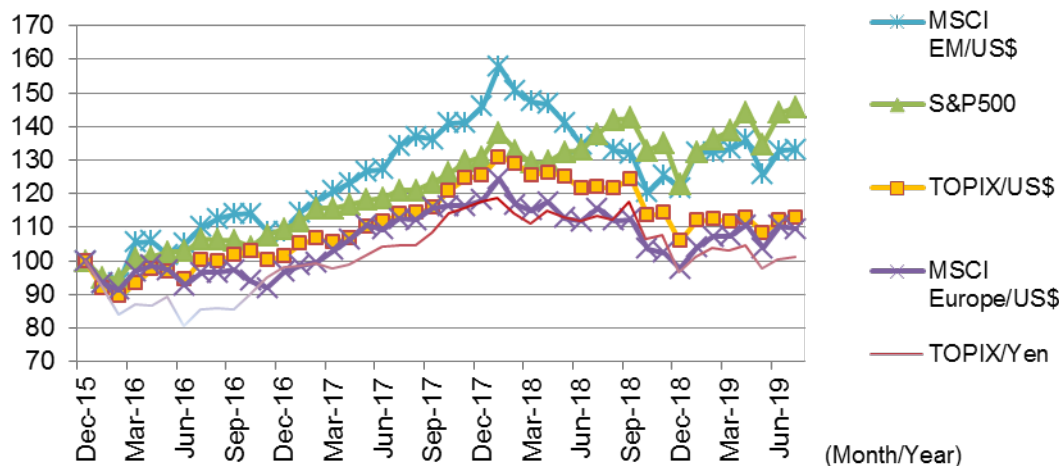
- Our **Base Scenario** is assuming the following views:
 - Severe tensions between US and China go on, however, US is going to avoid making a fatal blow for the global economy.
 - US economy keeps growing despite possible mild slowdown. Recession in 2019 is avoided.
 - Japan's private consumption grows mildly supported by wage growth.
 - Japanese yen does not get extremely stronger beyond 100 yen against US\$.
 - Tension in the East Asia or Middle East does not get out of control.
 - Central banks ease monetary policies again.
- **Upside Risks** include:
 - China makes significant concession in the trade negotiation with US.
 - Stronger-than-expected global growth.
 - Denuclearization in Korean peninsula makes a visible progress.
 - Japanese economy gets stronger than expected boosted by large fiscal spending.
- **Downside Risks** include:
 - US economy significantly slows down and puts global economy into a recession.
 - Chinese economy falls into a significant slowdown spreading negative shock globally.
 - Trade negotiation between US and China completely breaks up igniting a decades of power struggle.
 - Seriously escalating geo-political tensions in Middle East & East Asia.
 - Political turmoil flares up in US over the impeachment of the President Trump.
 - Populism gains in Europe further destabilizing EU.
 - Japanese Consumption Tax Hike in October makes unexpectedly severe impact on private consumption.

Note: SMDAM's projection is as of 22nd Jul. 2019 and subject to updates without notice.

US leads global markets' recovery

- US stock market is leading the recovery of global stock markets on the back of resilient US economy and pre-emptive easing expected for FRB.
- Europe and Japan is lagging in this time's recovery probably due to concern on economy and corporate earnings.

US\$ based performance of stock markets (Dec 2015=100)

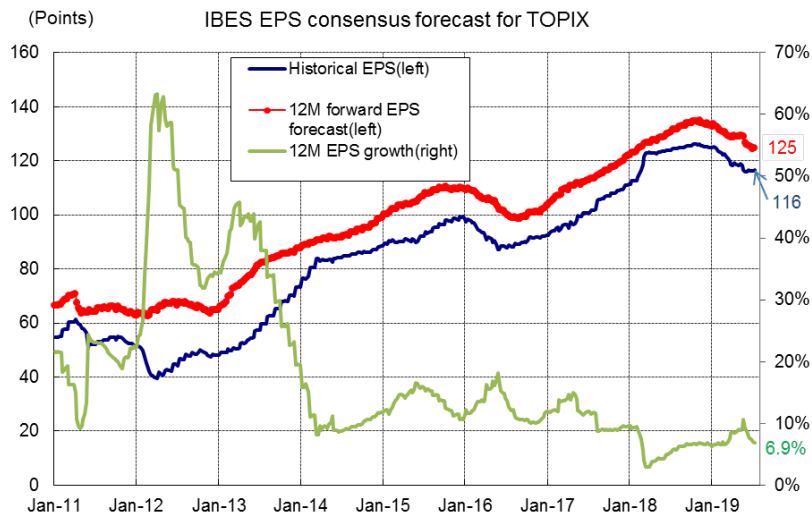


Notes: Data is up to 19th Jul 2019.

(Source) Datastream, MSCI and Tokyo Stock Exchange, compiled by SMDAM.

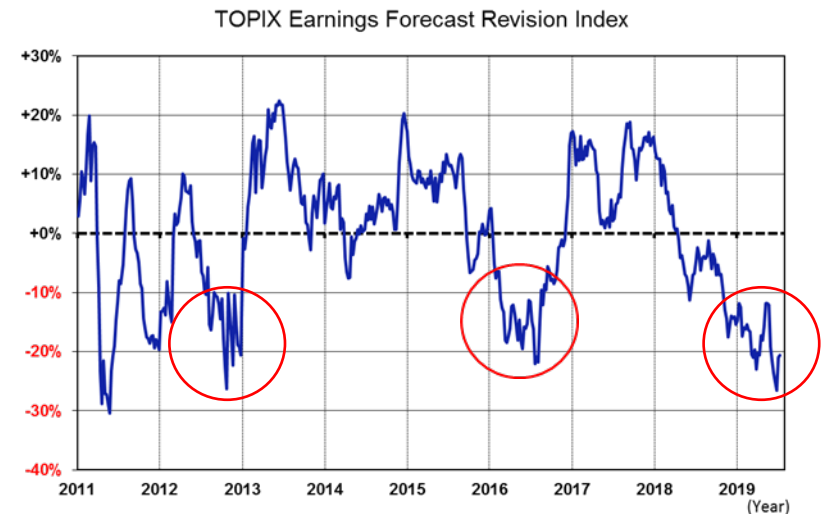
Downward earnings forecast revision is continuing

- Downward earnings forecast revision is a little getting prolonged compared to the previous setbacks in 2012 and 2016. Recovery in capital investment in China has been delayed and affecting overseas exposed manufacturing sector in Japan.
- However, trade momentum is expected to hit bottom in the 2nd half and EPS is also expected to hit bottom at a similar timing.



Note: Weekly data from 7th Jan. 2011 to 10th Jul. 2019. (Month/Year)

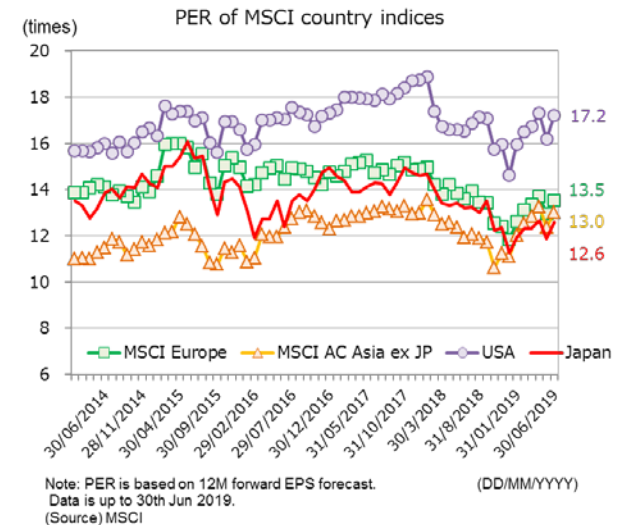
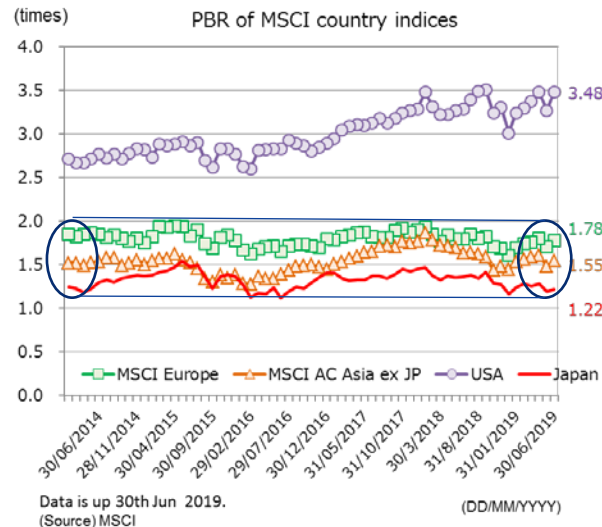
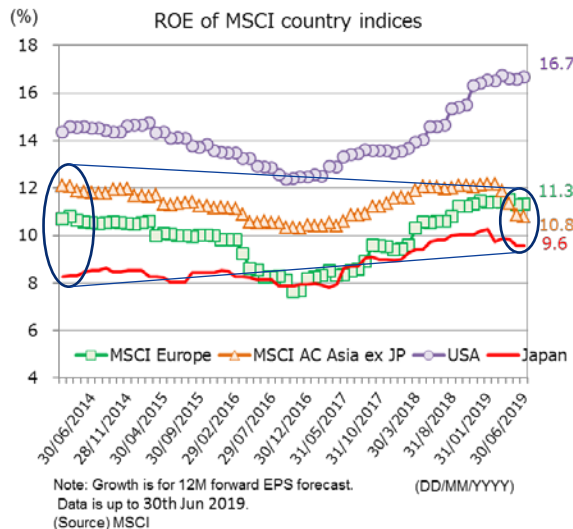
(Source) Datastream, IBES



Notes: Revision index= % of Analyst upgrades out of total Topix firms - % of downgrades. Data is weekly from 7th Jan. 2011 to 10th Jul. 2019. (Source): IBES, SMDAM

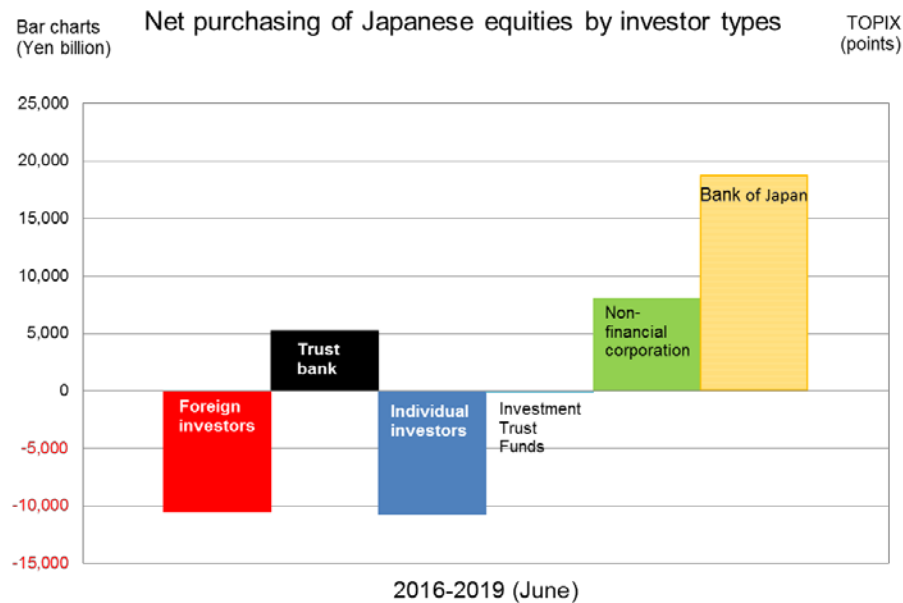
ROE for Japanese stocks has been steadily improving

- ROE has been improving for Japanese stocks. ROE gap between Europe and also between Asia got narrower in the last five years, which is exhibited on the left chart.
- However, this improvement in ROE has not reflected on PBR (Price to Book Ratio), which stays at low level compared to other markets, which is shown in the middle chart.



BOJ and company share buybacks are supporting Japanese stock market

- Since 2016, foreign investors were net sellers. Net selling by individuals should be smaller by trillions yen or could be slightly positive if IPO participation is considered, such as SoftBank Corp. and periodically made offering of Japan Post companies.
- Bank of Japan now holds stakes of more than 5% of the total listed Japanese companies. Admitting controversies that BOJ is distorting the stock market, existence of such political strong buyer is surely one of the advantages of the Japanese stock market compared to its global peers when the environments get sour.



Note: Data is for Tokyo stock exchange and Nagoya stock exchange up to 30th Jun 2019.
BOJ ETF figure is officially released data from BOJ.
(Source) Japan Exchange Group, Bank of Japan

Advancing Corporate Governance Code and Stewardship Code

- Stewardship Code (SC) was set in February 2014. Investors are taking more pro-active approach in talking to the companies and exercising proxy voting rights. Financial Services Agency discloses the name of institutional investors, which publicly accepted SC.
- After inception of Corporate Governance Code (CGC) in June 2015, pressure has been increasing on companies to improve its governance, efficiency and shareholder returns.
- These two codes have been progressively reviewed and enhanced, and making visible impact on the corporate behavior and investors' attitudes as shareholders.
- In the most recent amendment of CGC, companies are required to explain the rationale of "cross holdings" or "strategic holdings" of other companies' shares, which implicitly provide protection against takeovers and hostile shareholder actions, and is often negative for achieving shareholder value.

Total number of institutional investors, which publicly declared acceptance of the stewardship code	
Trust banks	6
Investment management companies	177
Insurance companies	23
Pension funds	35
Others (include proxy voting advising companies)	7
Total	248

Note: As of 8th May 2019.
(Source) Financial Services Agency

Shareholders are putting positive pressure on companies

- Shareholders are raising voice for improving governance & management of the companies, in which they invest.
- Sumitomo Mitsui Asset Management (SMAM), which is a legacy company of current SMDAM, voted against as much as 38% of the appointment of directors in FY2017.
- As one of the guidelines relating to "Appointment of directors", SMAM voted against appointments if ROE was constantly lower than both industry average and 5% (it was raised to 7% in June 2018) for the last 3 years and the candidate had been on the board of directors for more than 3 years.

Results of exercising proxy voting rights in FY2017 (general meetings from July 2017 to June 2018)

Nature of resolutions	Total number	Supported		Opposed	
		Number	%	Number	%
Company resolutions	19,180	12,686	66.1%	6,494	33.9%
1 Appointment of directors	14,840	9,163	61.7%	5,677	38.3%
2 Appointment of auditors	1,516	1,107	73.0%	409	27.0%
3 Appointment of accounting auditors	28	28	100.0%	0	0.0%
4 Director compensation	675	572	84.7%	103	15.3%
5 Payment of retirement benefits	140	80	57.1%	60	42.9%
6 Appropriation of retained earnings	1,333	1,154	86.6%	179	13.4%
7 Matters related to restructuring	29	29	100.0%	0	0.0%
8 Matters related to anti-takeover measures	53	6	11.3%	47	88.7%
9 Matters related to capital policy	121	114	94.2%	7	5.8%
10 Amendment of the Article of Incorporation	441	433	98.2%	8	1.8%
11 Other company resolutions	4	0	0.0%	4	100.0%
Shareholder resolutions	141	20	14.2%	121	85.8%
1 Appointment of directors	23	5	21.7%	18	78.3%
2 Appointment of auditors	1	0	0.0%	1	100.0%
3 Director compensation	4	4	100.0%	0	0.0%
4 Appropriation of retained earnings	8	4	50.0%	4	50.0%
5 Matters related to capital policy	1	0	0.0%	1	100.0%
6 Amendment of the Article of Incorporation	94	5	5.3%	89	94.7%
7 Other shareholder resolutions	10	2	20.0%	8	80.0%

Note: Number of voting regarding appointment of directors and auditors are counted by individual candidates.

Data is for Sumitomo Mitsui Asset Management (SMAM) which is a legacy company of SMDAM.

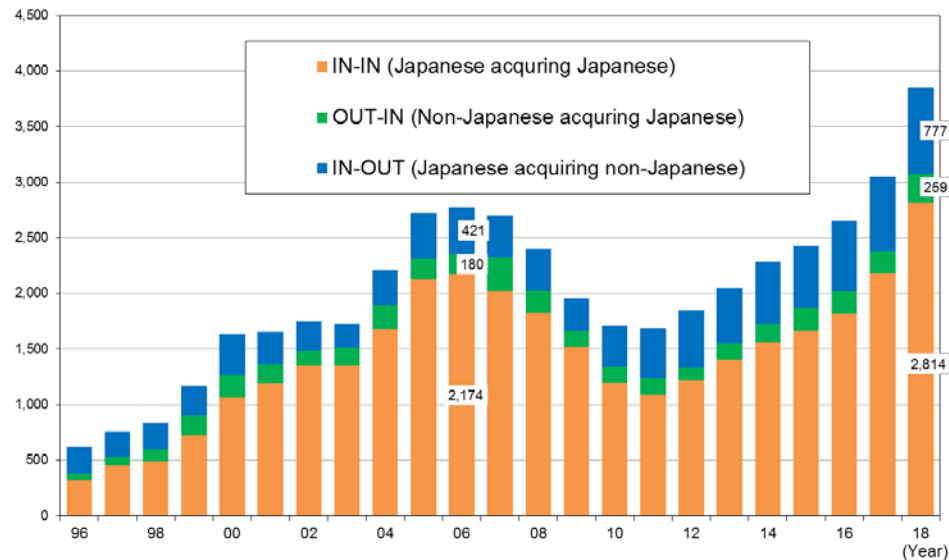
(Source) SMDAM



Business restructuring is progressing for Japanese companies

- Japanese companies are getting more and more willing to make positive business restructuring.
- Number of M&A deals between Japanese companies (IN-IN) rose from 2,174 in 2006 to 2,814 in 2018 increasing by 30%, which is an evidence that business restructuring is progressing in Japan.
- Number of the deals of Japanese companies acquiring overseas businesses also rose from 421 in 2006 to 777 in 2018, increasing by 84%.

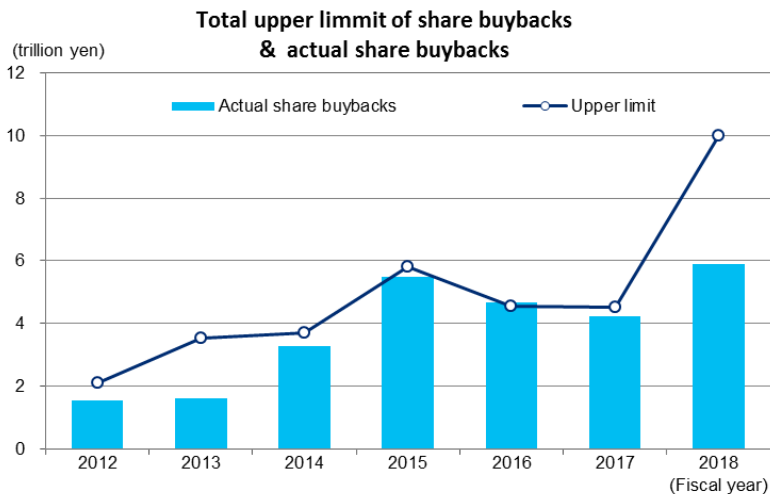
Number of M&A deals involving Japanese companies
(Excluding transactions among the same business group)



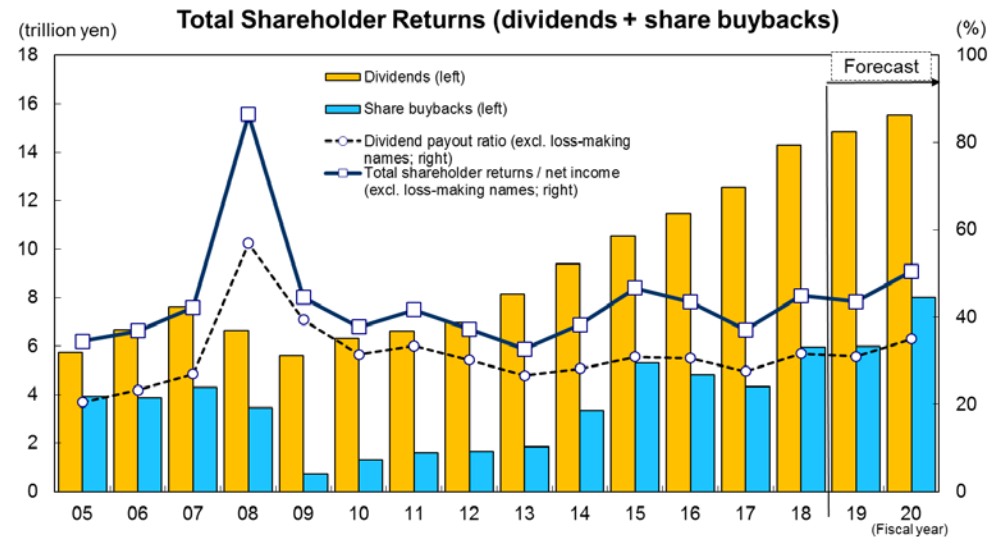
Note: IN-IN means Japanese company acquiring Japanese one, OUT-IN is for Non-Japanese company acquiring Japanese company, and IN-OUT is for Japanese company acquiring non-Japanese company.
(Source) RECOF and SMBC NIKKO Securities.

Behavior of Japanese companies are making positive changes

- Share buyback is one of the powerful tools for Japanese companies in disposing of accumulated liquidity in the B/S and enhancing EPS growth as well as ROE.
- In FY2018 (from April 2017 to March 2018), total upper limit of share buybacks, proposed as board of directors' resolutions, increased sharply and also actual share buybacks increased to renew a historical record.
- Dividends also renewed historical record in FY2018 and expected to increase further in FY2019.



Note: Share buyback proposals: As of May 14, collected in units of one month based on the date of the Board of Directors' resolution. Share buybacks: As of end-April. Universe is TSE stocks (excluding overseas firms). (Source) Astra Manager, Citi Research.



Note: All listed firms. Dividend projections are Toyo Keizai estimates, share buybacks forecast is by Daiwa Securities. Data as of June 2019. (Source) Toyo Keizai, QUICK, INDB, compiled by Daiwa Securities.

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