GENERALI INVESTMENTS

Focal Point

Topix to benefit from solid growth and weaker yen

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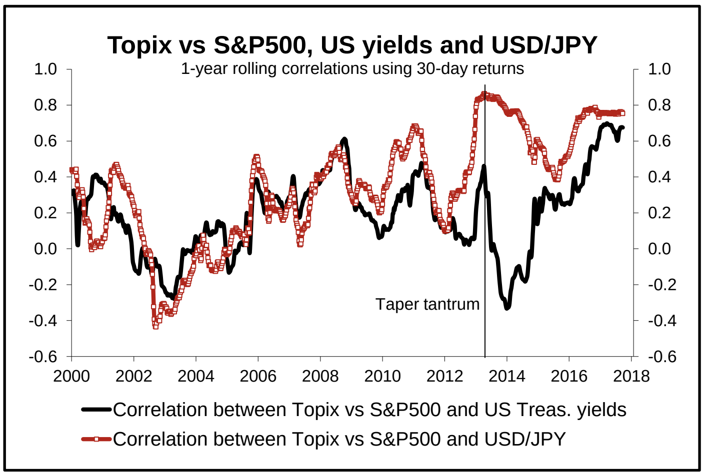
- Earlier this year, geopolitical risks and a temporarily stronger yen weighed on the Topix's relative performance. Of late, however, the index gained again markedly on domestic as well as international grounds.
- Domestically, we expect current political worries to settle again with "Abenomics" and the current monetary policy stance to remain in place. Decent growth should help Japanese earnings to improve further.
- Japanese monetary policy will remain loose; against this backdrop rising US yields will weigh on the yen thereby pushing the export-oriented Topix.
- Acknowledging the risk of setbacks in case of sudden changes in the global risk appetite, we expect the Topix to outperform, especially the S&P 500 index in hedged terms, as valuations remain affordable and earnings susceptible to positive revisions. We anticipate moderately positive absolute returns (around +5%) over the next 12 months.

While achieving a respectable total return of 11.8% year-to-date (ytd), the Topix index has underperformed global indices so far in 2017 (MSCI World +15.8%, S&P 500 +13.7%). We attribute this relative underperformance predominantly to international factors which caused the yen to appreciate (+3,9% ytd vs the USD). Meanwhile, domestic conditions tended to improve (GDP and earnings). The strength of the yen was mainly a consequence of lower-than-expected global inflation data and weak economic surprises in the US, which drove US yields lower.



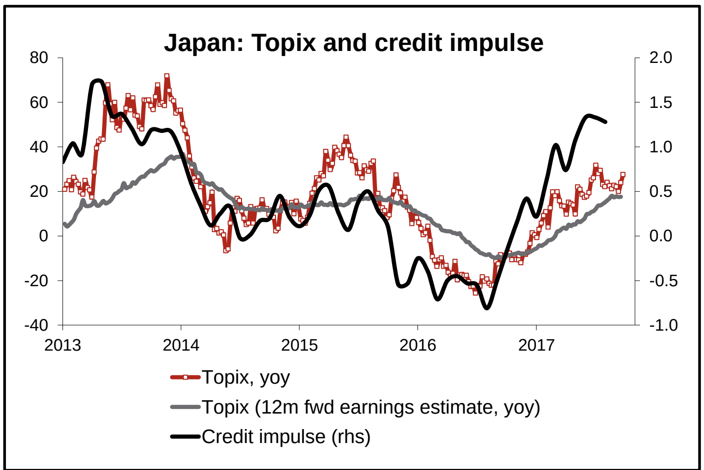
The latter shows a strong positive correlation with the USD/JPY and with the relative performance of the Topix vs. the S&P 500. In addition to this, increased geopolitical risks related to North Korea led to safe haven flows, thus supporting the yen. On the domestic side, worsening polls for PM Abe induced expectations of a possible end of "Abenomics", contributing as well to a stronger currency.

However, subsequently we highlight the reasons why investors can still expect Japanese equities (FX hedged) to pursue decent returns, with the Topix eventually overperforming the S&P 500. Our expected upside in total return terms (around 5%) is based on an improving macro backdrop and earnings, higher US yields, a dovish monetary policy, a weaker yen and, finally, affordable valuations.

Domestic factors to stay supportive

Firstly, we believe the macro picture in Japan will remain positive also in the next quarters. For this purpose, the continuation of "Abenomics" – a mix of corporate and structural reforms which act in tandem with a dovish monetary and fiscal policy – is key. On this respect, in the last months, PM Abe's public approval rating dropped amid a favoritism scandal, triggering a period of increased political uncertainty. However, in early July PM Abe decided to reshuffle his cabinet and more recently he announced snap elections to be held on October 22. This would allow him to remain in power until 2021. We consider the risk for Abe to lose his single-party majority (61%) to be moderate, given the following supportive arguments: the recent recovery in Abe government's approval ratings (following the cabinet reshuffle), the disarray within opposition parties and the North Korean threats. Of course, risk remains that Abe loses his majority, which would drive the yen higher and equities lower, at least temporarily. But such reactions could be limited as in the last months non-resident equity inflows remained contained.

Concerning GDP growth, since mid-2016 Japan strongly participated in the global manufacturing upswing via accelerating exports. Moreover, PM Abe recently ordered his cabinet to compile a fiscal stimulus package worth ¥ 2 trillion for next year (0.4% of GDP). Of late, also private consumption rose (at least temporarily). Accordingly, Ja-pan grew above its potential rate of about 1.1% in H1. Recently, exports accelerated again and historical experience suggests that business investment should start to improve after a period of a strong export performance (machinery orders already surprised on the upside). All in, we see growth at 1.5% this year and 1.1% in 2018. However, with the growth outlook broadly in line with potential, inflation is unlikely to accelerate meaningfully. Moreover, despite the tight labor market, base pay increases (excluding the seniority pay) rose only by 0.48% in 2017, after 0.44% last year. In sum after a temporary rise this autumn, core CPI inflation is likely to rise only limitedly to +0.5 this year and +0.7% in the next. This in turn will prolong the need for an ongoing monetary stimulus agenda at least for the next few quarters.



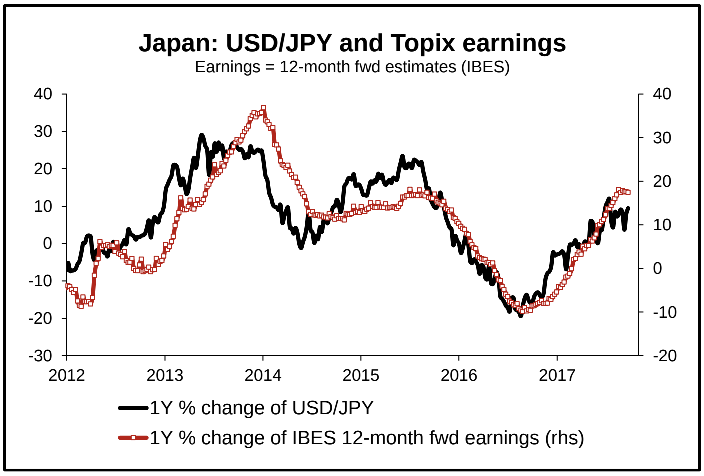
Topix strongly exposed to the USD/JPY

Secondly the Topix can benefit from the expansionary monetary policy and our expected increase of the USD/JPY to 118 over 12 months, due to monetary policy divergence between the US and Japan. A weaker yen and an upbeat credit impulse will then support the economic growth and the earnings' momentum. Assuming a LDP (liberal democratic party) election outcome, PM Abe will indeed confirm Mr. Kuroda at the helm of the Bank of Japan (BoJ), securing the continuation of the current expansionary policy.

We expect the BoJ to become the laggard among the large international central banks. The continuing fight against structurally low inflation ("qualitative and quantitative easing, QQE, with yield curve control, YCC", aimed at keeping 10-year rates at zero) will help the monetary base to GDP ratio to increase further from the current level of 92.5%. The explicit targeting of bond yields implies rising BoJ bond purchases if global yields tend to increase. As a result, the yen is currently particularly sensitive to moves in US yields (the correlation is at a historical high). Looking ahead into the next 12 months, US yields should move higher to 2.75%. Indeed, the yield control by the BoJ and raising US yields will result in an even wider yield gap. With the Fed continuing its gradual policy normalization along with the expected rise in inflation, we anticipate some further yen weakness going into the next year. This will benefit exports and the overall Japanese economy. Furthermore, steeper yield curves will mitigate the negative effects of low yields on Japanese financials.

Valuation and cyclicality are additional positives

Affordable valuations and the cyclical nature of the Topix sectors represent further reasons to expect a positive performance of the index in the next months. Indeed, the good global economic momentum has already contributed to stabilize earnings expectations this year notwithstanding a weaker USD/JPY. The Topix 12-month earnings forecasts increased more than US ones (12.8% ytd vs. 6.9% ytd). After having reached a trough in August 2016 at nearly -10% yoy, Japanese 12-month earnings' growth reached +18% yoy as of late. In the Q2 reporting season, Japan showed the highest yearly earnings' growth (21%) accompanied also by a decent sales' growth (+5%). Our expectation of a depreciating yen bodes well for a cyclical index like the Topix. For every 10% yen depreciation, earnings increase by more than 4%.



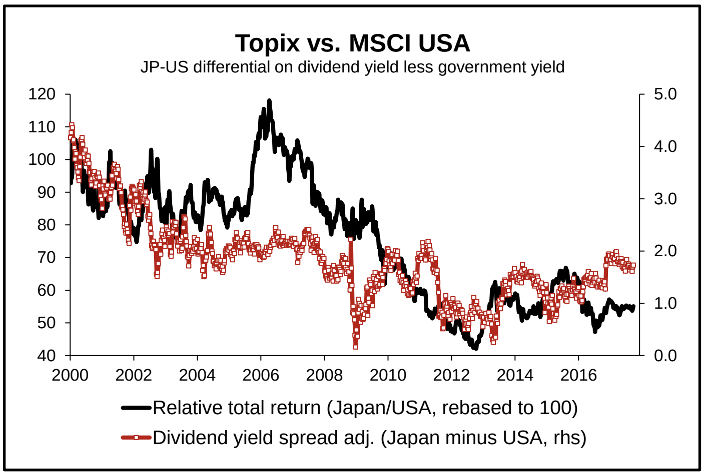
Based on our models' estimates, we expect a realized profit growth of 8 pp in 2017 versus 2016, with risks on the upside. The latter could come as the implementation of the fiscal package should partly offset factors weighing on earnings' growth like low inflation (due to limited pricing power) and increasing wage costs. Furthermore, our models tend to underestimate the positive effects of a weaker yen. With companies ready to change the USD/JPY references for their profits' guidance from 110 to 117, future earnings revisions should surprise on the upside, triggering a nearly +3% profit growth ceteris paribus. Going forward, the positive earnings' growth should help valuation to stay contained as market multiples (i.e. price-earnings, P/E) will benefit from a higher denominator (i.e. earnings).

In addition to this, as investors have been reassured by the global economic stabilization, they should continue to sell the less risky disinflation hedges ("secure" growth themes and the defensive sectors and countries) to buy "value" and riskier stocks (cyclical) like financials, industrials and materials. The Japanese index is indeed a proxy for the latter themes as it is highly cyclical. This means that an improving global cycle and higher global yields should lead to a better profitability for Japanese companies versus other less cyclical indices. Discretionary, IT and industrials account for 55% of the Topix capitalization, versus 47% for the S&P 500, while staples and utilities have a lower weight (10% in the Topix versus 12% in the S&P 500).

last available date: 27/09/17

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %
WORLD	16.6	16.0	2.2	1.9	10.6	8.6	2.6	2.7	11.9
USA	17.9	15.3	2.9	2.3	12.2	9.8	2.1	2.2	18.5
JAPAN	14.2	15.7	1.3	1.3	7.8	7.0	2.1	1.9	-2.3
UK	14.4	13.8	1.8	1.8	9.1	7.8	4.2	4.0	3.8
SWITZERLAND	16.8	15.4	2.4	2.2	12.3	11.2	3.5	3.3	4.7
EMU	14.2	14.2	1.6	1.5	8.0	6.4	3.4	3.9	11.0
FRANCE	15.0	14.3	1.5	1.5	9.0	6.8	3.3	3.8	13.6
GERMANY	13.5	15.1	1.6	1.5	8.4	6.6	3.0	3.4	9.5
GREECE	12.7	12.8	1.5	1.6	6.9	5.9	3.8	3.9	2.5
ITALY	13.5	15.4	1.3	1.2	5.7	4.6	4.1	4.7	7.0
PORTUGAL	17.3	12.5	1.8	1.7	6.7	5.8	4.3	4.5	15.6
SPAIN	13.4	13.0	1.3	1.6	5.4	5.1	3.9	5.1	3.4
EURO STOXX 50	14.2	13.2	1.6	1.5	8.1	6.1	3.6	4.3	15.7
STOXX SMALL	16.2	14.2	1.9	1.7	10.6	8.1	2.9	3.2	16.8
DENMARK	17.8	15.9	3.6	2.4	13.1	10.3	2.6	2.1	15.6
NORWAY	15.5	11.5	1.8	1.6	7.7	6.1	4.4	4.3	17.7
SWEDEN	16.6	15.3	2.1	2.0	12.5	10.1	3.6	3.8	10.9
EM, $	12.3	14.6	1.5	1.6	7.7	7.7	2.7	3.1	-2.1
BRAZIL	12.4	8.9	1.6	1.7	7.8	14.3	3.5	4.3	2.2
RUSSIA	6.0	7.1	0.6	0.9	3.6	4.6	6.0	3.5	-35.1
INDIA	18.0	14.3	2.7	2.7	12.1	11.5	1.6	1.6	7.7
CHINA	13.3	13.0	1.7	1.7	8.3	7.5	2.1	3.1	10.6

Note: The first four markets (ex. World) are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003.
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.



As far as valuations are concerned, the (12-month forward) PE shows a slight discount at 14.2X, not representing an obstacle to future performance. The dividend yield (2.1% plus 1% buyback yield) adjusted for the government bond yield is currently more attractive compared to that of the US. Looking to history, this in turn should back a future positive performance of the Topix versus the S&P 500. Of course, higher US yields represent a precondition for a better performance together with contained volatility: both will help the yen to stay weak in presence of a dovish monetary policy. Another positive factor is represented by the increasing payout ratio (dividend/earnings). This is due to the new governance regulation and increasing competitive pressure, both inducing firms to adopt a friendlier attitude towards shareholders. As the cash in the Japanese balance sheets is high on a global comparison, we expect companies to have enough ammunition to deliver such policies.

Finally, as EMs have already substantially outperformed global indices, the US market valuations stay high and the BoJ will lag the ECB and the Fed in reducing the past monetary stimulus, the Topix can enjoy a kind of positive scarcity effect: it remains one of the few choices left.

Conclusions

Overall, the Topix index represents a good instrument to play the global recovery trend. The dovish BoJ, the weaker yen and the probable fiscal stimulus for corporates represent positive triggers going forward. Topix valuations are still affordable at 14.2X PE with a dividend yield of 2.1% and buybacks at 1%. We are of the view that further positive earnings' revisions will sustain the investors' appetite on this market as the yen will depreciate further. Possible trade threats (from President Trump's policy) are mitigated by the weak yen and Japanese firms producing in the US. An improving governance and rising payouts in presence of abundant cash in the balance sheet (among the highest globally) reassure about the sustainability of the cash distribution policy. We remain overweight on this market and foresee a 12-month return of 5%.

We see the main risks to our call related to global factors which could derail the positive performance. We refer to lower US yields and to possible spike in volatility (starting from a cyclical low) induced by a sudden shift in investors risk appetite. Both would induce the USD/JPY to depreciate and the Topix to underperform the S&P 500.

Imprint

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