

1. Outlook for the Japanese economy as well as the impact of the 2019 consumption tax hike

This year, we saw serious damage in Japan from disasters such as heavy snowfalls, heavy rains, typhoons, and earthquakes. Looking forward to next year, we expect the next consumption tax hike will be implemented in October 2019 as planned. Some people are concerned over how much these factors will impact the Japanese economy. However, our outlook for the Japanese economy remains positive, and we expect to see a gradual recovery.

2. Market Review

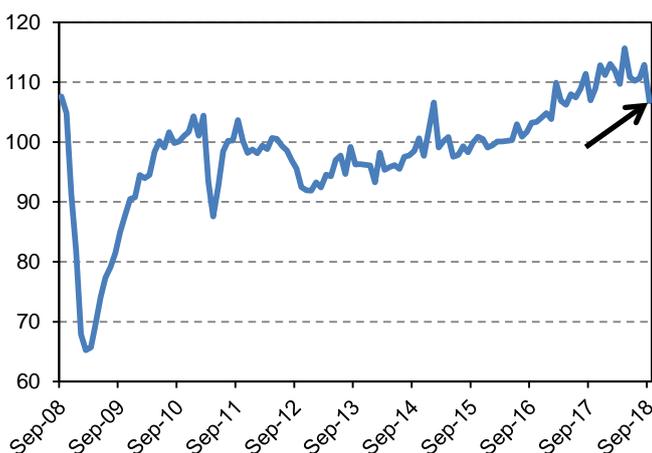
1. Outlook for the Japanese economy as well as the impact of the 2019 consumption tax hike

First, we would like to talk about the current Japanese economy. Looking at the manufacturing sector, September trade figures revealed weak export numbers to the US and EU for transportation equipment, but that general machinery exports were resilient, showing no signs of impact from US-China trade disputes (Figure 1). On the other hand, from July to September, Japan's distribution network came to a grinding halt after heavy rains in western Japan, several typhoons, and the Hokkaido earthquake. Manufacturing sentiment may have deteriorated as a result, but strong corporate earnings and the underpinning of exports should keep the manufacturing sector Diffusion Index unchanged.

In addition, from August's Indices of Tertiary Industry Activity for the non-manufacturing sector, we saw that information and communication services performed well, and living and amusement related services improved. On the other hand, with major typhoons in September, the Hokkaido earthquake and their impact on distribution, we fear that sentiment, especially among the personal services industries, has weakened. As a result, we forecast a weak Diffusion Index number for the non-manufacturing sector. However, we see improving sentiment in the December 2018 survey and thereafter due to recovery in manufacturing activity and reconstruction demand. We believe that any weakness in sentiment as result of the typhoons and Hokkaido earthquake should be temporary.

Figure 1: Real Exports

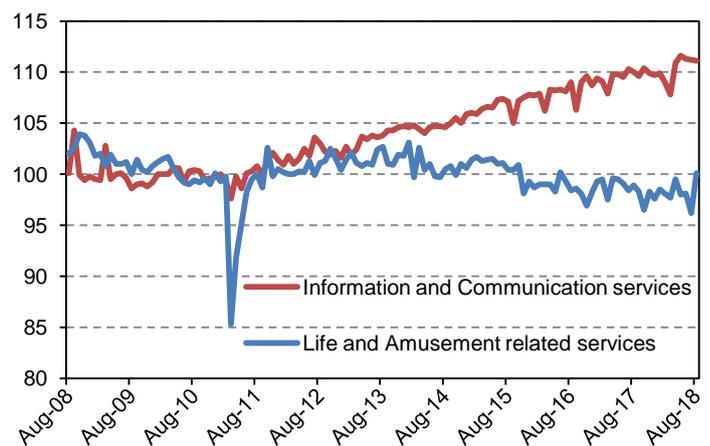
(seasonally adjusted figures, Year2015=100)



Source: Bank of Japan, SuMi TRUST

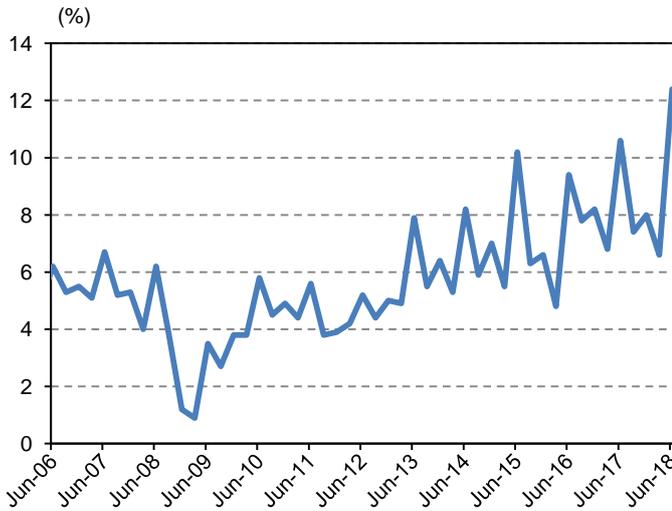
Figure 2: Indices of Tertiary Industry Activity

(seasonally adjusted figures, Year 2010=100)

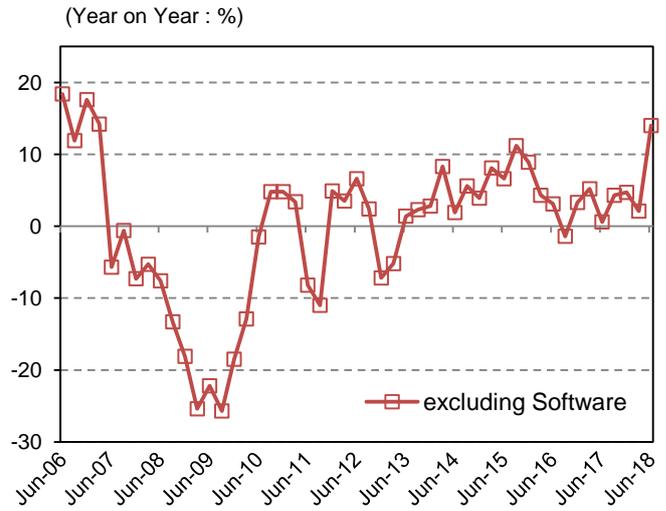


Source: Ministry of Economy and Trade Industry, SuMi TRUST

On the earnings front, according to 2018 Q2 corporate statistics, ordinary profits grew by double digits year on year in both the manufacturing and non-manufacturing sectors (Figure 3). Total capital expenditure including software was up 12.8% year on year, and excluding software, it was up 14.0% (Figure 4), which were the highest numbers seen since before the 2008 financial crisis (2007 Q1; excludes financials and insurance). Individual consumption also grew by 2.8% in 2018 Q2, in spite of the negative figure in the previous term. Compared to last year, scheduled wages increased approximately 1% due to the labour shortage, and fringe benefits increased, raising total cash earnings. Thus, we expect that individual consumption will keep growing slowly thanks to this positive income environment.

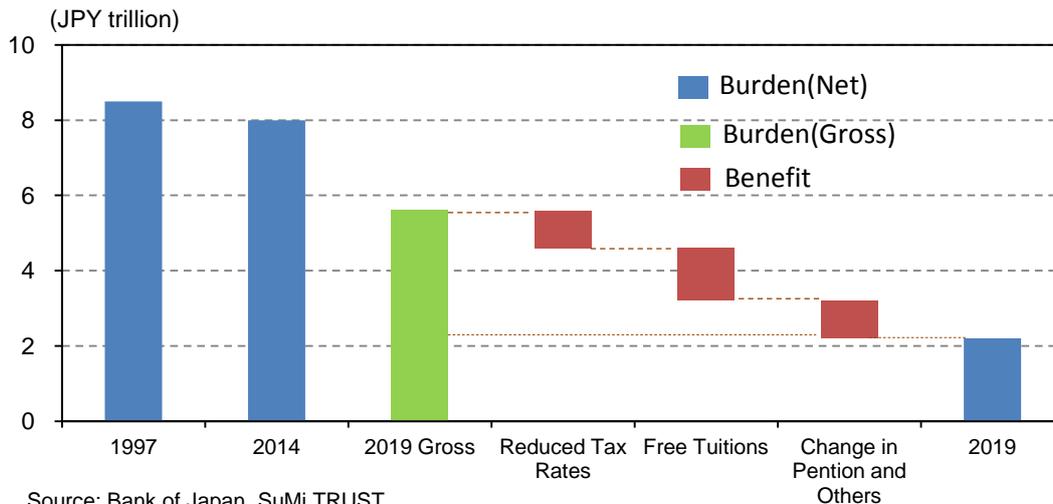
Figure 3: Ratio of Current Profit to Sale


Source: Ministry of Finance, SuMi TRUST

Figure 4: Investment in Plant and Equipment


Source: Ministry of Finance, SuMi TRUST

Next, we would like to highlight the consumption tax hike as well as its impact on the Japanese economy. Prime Minister Abe won the Liberal Democratic Party presidential election and he will continue his role until autumn 2021, which means the Japanese economy may continue to recover due to political stability. Although there were some delays before, Abe finally announced that he would implement the consumption tax hike as planned. The 2% tax hike (raising the tax from 8% to 10%) was announced during the administrative term of 2013, and it was planned to be implemented in April 2017. However, this implementation was delayed for 2.5 years due to the economic crisis, a total delay of six years from the original planned implementation. Looking back on previous consumption tax hikes, the 2% increase in 1997 saw a tax increase of JPY 5.2 trillion and placed a net JPY 8.5 trillion burden on households, and in 2014, the 3% increase saw a tax burden of gross JPY 8.2 trillion and net JPY 8.0 trillion on households, based on a trial calculation. According to the BOJ's calculation, the impact from the next hike is expected to be gross JPY 5.6 trillion and net JPY 2.2 trillion, benefitting from mitigation measures such as reduced tax rates as well as free tuition (Figure 5). Therefore, other government policies are as important as tax hikes in terms of economic impacts, and we believe the influence of the next hike will be limited.

Figure 5: Burden of Consumption Tax Hike on Households


Source: Bank of Japan, SuMi TRUST

To summarize, our outlook on the Japanese economy remains positive as we believe gradual recovery will continue, supported by the two pillars of domestic demand: namely capital expenditure and personal consumption. Should the current recovery continue, we believe that the consumption tax hike of October 2019 will go ahead as scheduled. In this scenario, we forecast that real GDP will grow by 1.2% in FY 2018, and by 0.8% in FY 2019 with the slowdown due to the higher consumption tax, which we consider quite bullish.

2. Market Review

In September, the Japanese equity market rallied, outperforming its major global peers and recovering all its losses of 2018. The TOPIX closed +4.72% on the month before. Investor sentiment improved significantly, as concerns over the escalation of trade frictions between the US and China temporarily receded following the announcement of the third round of US tariffs on Chinese goods. Another major driver of the upswing was a weaker yen amid higher US yields, boosting expectations for upward earnings revisions among exporters. US stocks recording all-time highs also provided a tailwind for the market. The impact of the natural disasters that hit Japan has been limited. In terms of sectors, resource-related stocks drove gains on rising crude prices, whilst semiconductors lagged amid concerns about their earnings outlook.

Figure 6: TOPIX and USD/JPY in 2016-2018

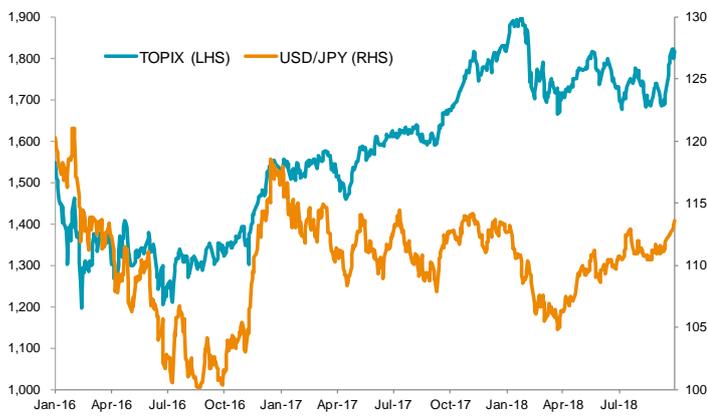


Table1: Global Equity Market Performance

(as of the end of September 2018)

Index		September	YTD
TOPIX	USD	2.23%	-0.84%
	JPY	4.72%	-0.02%
S&P500	USD	0.43%	8.99%
Eurofirst 300	USD	0.45%	-4.92%
	EUR	0.62%	-1.70%
MSCI AC Asia (ex. Japan)	USD	-1.61%	-8.14%

Source: Bloomberg, SuMi TRUST

All enquiries regarding the report should be made to:

Global Business Development Department
 Sumitomo Mitsui Trust Asset Management Co., Ltd.,
 1-4-1 Marunouchi, Chiyoda-ku
 Tokyo-to 100-8233 Japan
 Tel: +81-3-6256-3449
 e-mail: fundservices@smtb.jp

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Any enquiries regarding the products should be made to:

Kei Ohashi

Head of Investment Management Department

Sumitomo Mitsui Trust International Limited

155 Bishopsgate, London EC2M 3XU, United Kingdom

Direct: +44 (0)20 7562 8412

Email: imd@smtil.com

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