Japanese Equity Market Outlook

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<Market review from May to June>

The equity market plunged in May. The TOPIX tumbled 10.54%, and the Nikkei 225 average dropped 10.27%. The release of lower-than-expected U.S. employment statistics on 4th of May, the victory of Mr. Hollande in French presidential election on 6th of May, and the defeat of the ruling coalition party in the Greece parliamentary elections caused investors to take a more risk averse stance and resulted in decline of share prices. Thereafter, continuing negative news such as the result of the second Greek election, the downgrading of several Spanish banks by rating agencies, and the request for financial support from the Spanish government by Catalonia State led the market down further. However, at the end of the month, the downward pressure on the market started to lessen due to support from low valuations on a P/E and P/B basis.

In June, a continuation of weaker-than-expected economic data releases by the U.S. caused stock prices to fall further. However, the G7 telephone conference held on 5th June increased expectations for further policy responses and as a result, stock prices rebounded. Later, the announcement of an interest rate cut in China, the Euro 100 billion lifeline given to Spanish banks, and the victory of the ruling coalition in 17th June Greek election caused stock prices to advance. As of June 18, the TOPIX was up 2.69%, and the Nikkei 225 Index was up 2.09% from their levels.

< The possibility that Prime Minister Noda's consumption tax hike proposal might lead to a reorganization of the political world>

The ruling Democratic Party, of which Prime Minister Noda is a member, the Liberal Democratic Party and the New Komeito Party have agreed on some social security reforms and an increase in consumption taxes. If all goes as planned, the enactment of tax raising bill will be passed by the House of Representatives in a few days, followed by the ratification of the bill in July or August by the House of Councilors after a period of deliberation. If the bill is enacted, the consumption tax rate will be raised from the current 5% to 8% in April 2014 and then again to 10% in October 2015. It is not unusual to raise value-added taxes in Europe, but in Japan, the raising taxes and the introduction of value-added tax has been a huge political issue, often forcing the bill to be abandoned or resulting in defeat in the following election. Given the fiscal situation of Japan, raising taxes is a necessity. The consumption tax rise will be a positive factor for Prime Minister Noda. Although the Democratic Party is in power, there are many forces within the same party who oppose the tax hikes, and they may vote against the bill. Even if this happens, the bill can still be passed with the cooperation of the opposition party, but that may cause a split in the Democratic party.

As Prime Minister Noda intends to hold an election after the bill is enacted, there is the potential for political realignment. After the election, the Liberal Democratic Party, a part of the Democratic Party and the New Komeito Party might consider forming a coalition. Looking at the current investors surveys, investors view politics as a factor that impacts negatively against the stock market. If there is a change in the political situation as explained above, then investors expectations on politics might become more positive.

<Outlook>

Looking forward a year from now, we expect the equity market will remain range bound in 3Q of 2012, before rising in 4Q, and then range bound again in 1Q and 2Q of 2013.

In 3Q of 2012, the European situation and the global economic slowdown are likely to prevent stock prices appreciating. The victory of the ruling party in the second Greek election may bring stability to the market in the short-term. However, the victory doesn't mean that the situation has improved. However, it means that we have only returned to the previous situation in May when the first election was held. Also, it is likely that there will be no easy solution to the Spanish banks' problems. Judging from the experience of Japan, in a deteriorating economic environment, finding a panacea for the banks' bad debts and bringing financial stability is in fact an extremely complex issue. In addition, the current economic slowdown in Europe, the U.S. and the BRICs is likely to continue to put pressure on the stock market. However, based on the current P/E and P/B valuations, further declines in the market might be limited.

In 4Q of 2012, it is anticipated that there could be further policy responses and seasonal statistics, and the global economy worldwide could recover, causing stock prices to rally. The U.S. presidential election result might reduce the uncertainty and expectation for an improvement in domestic corporate earnings could help stock prices to rise.

However, it is expected that a rally in the 4Q of 2012 may not continue into 2013. In both the U.S and Japan, the pace of growth in 2013 might slow compared to 2012. Reduced reconstruction demand in Japan and the financial cliff in the United States will be the causes for this slowdown. In spite of all this, we are not expecting an economic recession in Japan, and not expecting a further downward move in stock prices, although the upside potential will also be limited.