Japanese Equity Market Outlook

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Daiwa Asset Management Co. Ltd.

<Market review from June to July>

The TOPIX rose 7.03% and the Nikkei 225 average gained 5.43% in the month of June. Equity prices started the month weak after the release of lower than expected employment data in the U.S. However, expectation of policy responses to the European debt problems at the G7 telephone conference, and the European Central Bank's (ECB) additional monetary easing measures, helped to lift equity prices. In addition, the agreement by Eurozone countries to provide financial assistance to Spanish banks, the victory of fiscal austerity proponents in Greek re-election and the easing of anxiety over Greece exiting or being forced out from the euro, resulted in a rebound in equity prices. Later, German Chancellor Angela Markel's stance against the introduction of joint euro bonds led to a temporary decline in equity prices. However, consensus by the European leaders on active implementation of European Stability Mechanism (ESM) as a policy measure lifted the equity prices a step further by the end of the month.

At the beginning of July, expectation for an improvement in European debt problems continued which caused equities to rally. However, heightened concerns of global economic slowdown and downward revisions in earnings of some American companies drove the markets downwards. As of July 13, TOPIX was down 3.08%, and the Nikkei 225 average was down 3.14% from their levels at the end of June.

<A possibility of gradual change in BOJ >

In June, names of two new candidates for BOJ policy board membership were presented by the Japanese government to the Diet. These two candidates were Mr. Takahide Kiuchi, Chief Economist of Nomura Securities, and Mr. Takahiro Sato, Chief Economist of Morgan Stanley MUFG Securities. Their candidacy was approved by the Diet, hence these two vacancies which were open since April 5th were filled. These two candidates are supposed to be formally appointed some time soon, and expected to participate in August Monetary Policy Board meeting. It is for the first time that two economists who belonged to securities companies were appointed simultaneously to the BOJ policy board membership positions. Mr. Kiuchi is deeply concerned and would like to find a solution to the deflationary trend in the Japanese economy due to the strength of the yen. He stated that the BOJ may choose to purchase foreign currency denominated bonds to limit the yen appreciation. Though the BOJ appears to be reluctant to change its basic stance on further monetary easing, this might gradually change considering the replacement period of BOJ governor and deputy governor, which falls on next March and April.

<Outlook>

Looking forward a year from now, we assume that the equity market in 3Q of 2012 will remain volatile, advance in 4Q, experience a correction in 1Q of 2013, and it is expected to rebound in 2Q of 2013.

In 3Q of 2012, we believe there is a downward risk through August. The continuation of global economic slowdown might negatively impact earnings of companies and a downward revision appears to be inevitable. If the recurrence of the European problem and growing concerns of U.S fiscal cliff continues, equity prices might reach the low levels of June. However, we expect the equity market to pickup gradually after September. Equity prices could receive support from seasonal improvement of economic indicators and additional policy responses. Uncertain factors such as the U.S. Presidential election, the imminent fiscal cliff will be gradually factored in, and the forces that tend to push the equity prices down will dissipate. Domestically in Japan, there are heightening possibilities of a dissolution of the House of Representatives and an increased chance of a general election. Once the chaotic political conditions settle, it is anticipated to provide a positive impact on the equity market. It is likely that some sort of mitigation measures will be taken to control the fiscal cliff or possibly postpone the measures for a year which would lead to a pick-up in positive sentiment and shares could rally in the 4Q of 2012. In the1Q of 2013, we expect specific adverse effects related to the fiscal cliff in the U.S. economy will gain attention, and there is a possibility that wariness might spread and impact the future. However, once there is realization that the above mentioned adverse effects are not going to negatively influence the economy, equity prices are expected to rise once again in 2Q of 2013.

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