SuMi TRUST
SUMITOMO MITSUI TRUST GROUP

SuMi TRUST Monthly Commentary

March 2019

Economic Outlook for FY 2019
In this month's report we describe our Economic Outlook for FY 2019. SuMi TRUST has updated its real GDP forecast for Japan for the next fiscal year ending March 2020 (FY 2019). Finally**,** we will introduce capital expenditures related companies that SuMi TRUST is paying close attention to.

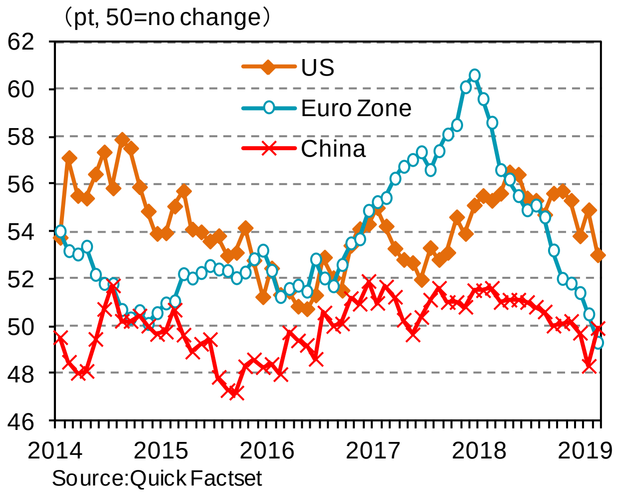
1. October-December 2018 GDP

Japan's real GDP growth rate in the October-December quarter of 2018 rose 1.9% QoQ annualized, and returned to positive territory from the -2.6% QoQ annualized growth in the previous quarter. Looking at the breakdown by demand item, in addition to personal consumption and capital expenditures, which are the pillars of domestic demand, exports turned positive. This confirms our opinion that "the growth rate in the July-September period turned negative largely due to natural disasters, such as typhoons and earthquakes, and that the economic growth trend has not stopped." In addition, although no definitive announcement has been made by the government, the result is consistent with the view that Japan's economic expansion, which began with the trough in November 2012, has been the longest in the postwar period.

2. External demand - current status and outlook

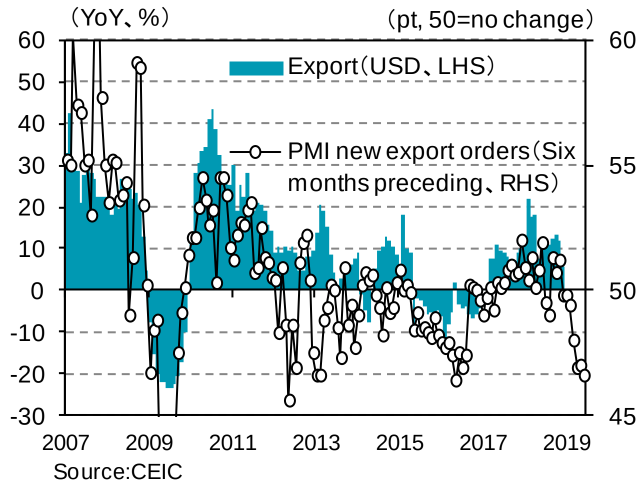
Looking at overseas economies to forecast future export trends, the US manufacturing PMI is still clearly above 50 (Figure 1). However, it is below 50 in China, and moreover, its real growth rate for the period of October-December 2018 came in the low 6% range YoY. As with the past, it is quite normal to see a decline in growth rates as structural reforms eliminate excess capacity and debt, and to see a shift in growth drivers from fixed asset investment to consumption. In the US and China, exports have been sluggish due to Sino-US trade frictions, and weak corporate sentiment has been exacerbated by the declining business sentiment (Figure 2).

Figure 1. Manufacturing PMI of the major economies



Source:Quick Factset

Figure 2. China's new export orders PMI and exports growth rate



Source:CEIC

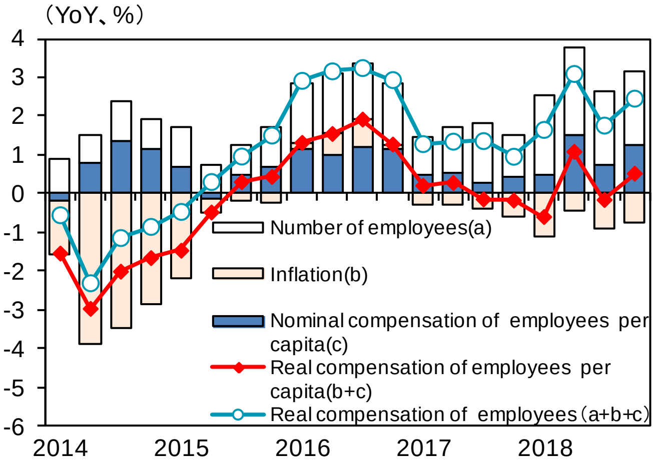
In addition, when viewing the manufacturing PMI, economic slowdown in the Euro zone has also become noticeable. The IMF cited Italy's financial problems and delays in responding to new environmental regulations in Germany's auto industry as factors. But given the relatively high dependence on Germany's exports to China, we believe that the effects of China's economic slowdown has only just begun to emerge.

As for our outlook on the overseas economies, China's growth rate will continue to decline unless its government pushes through its structural reform policy. In the US, whose economy has remained firm, the annual growth rate over the past year was 3%, which is much higher than the potential growth rate of around 2%. But the impact of rate hikes so far is expected to slow down the growth rate. We expect the global economy to avoid a slowdown throughout fiscal 2019, assuming that the US economy will maintain its current strength, and that China will implement accommodative measures such as large scale fiscal spending and interest rate cuts should the economy rapidly deteriorate. Although we think that a global recession can be avoided, the slowdown in growth is inevitable. Exports from Japan are also unlikely to grow, and the YoY increase from 6.4% in FY 2017 to 1.9% in FY 2018, will further erode to 1.6% in FY 2019.

3. Outlook for personal consumption

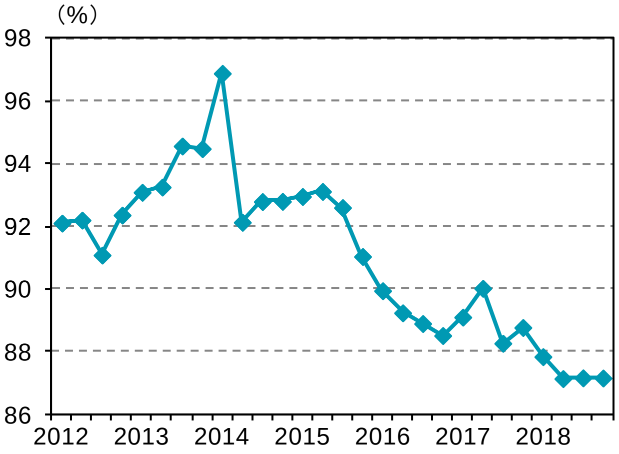
The environment for consumption is generally good. Looking at the breakdown of real employment compensation from the perspective of the household income (Figure 3), price increases have depressed real income since 2017 (b in Figure 3) Wage growth has not been stable (b + c in Figure 3), but due to the higher number of employees (a in Figure 3), real total employee compensation has continued to grow steadily by 2-3% over the previous year.
The consumption propensity as seen by the ratio of household consumption to employee compensation excluding imputed rent has stopped declining although at a low level (Figure 4), indicating that a positive cycle from corporate earnings to household income, and household income to consumption has continued.

Figure 3. Breakdown of real employee compensation growth



Source:Cabinet Office, Ministry of Internal Affairs and Communications

Figure 4. Change in propensity to consume (Spending excluding imputed rent/Compensation of employees)



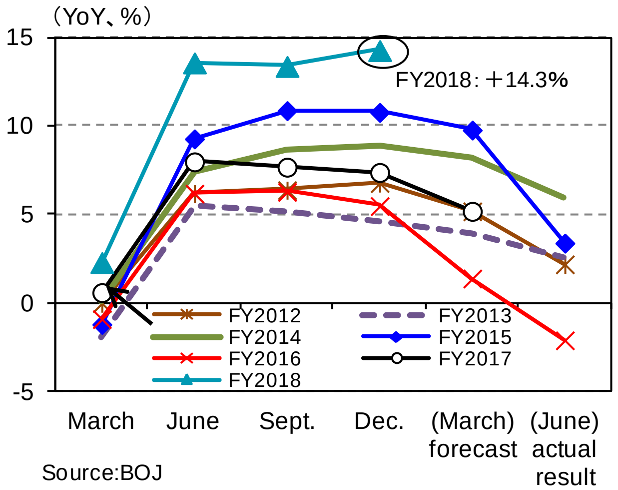
Source:Cabinet Office

We forecast that the unemployment rate should remain tight in the mid-2% range, and that the labor market equilibrium to remain unchanged throughout FY 2019, and that household income should increase due to both higher wages per employee and the number of employees, which in turn should continue to increase consumption. There will be last minute demand followed by a reactionary decline before and after the October 2019 consumption tax hike, but personal consumption will continue to increase over the period up to FY 2019.

4. Outlook for capital expenditures

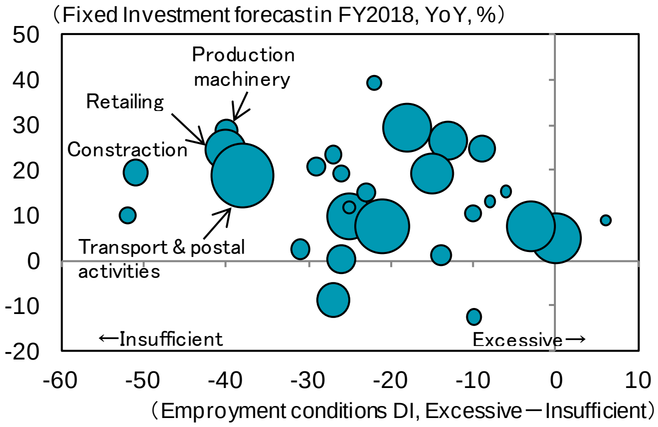
The environment for capital expenditures is also favorable at the moment. As of December 2018, the fixed investment forecast for large enterprises in the BOJ Tankan sees a rise of 14.3% YoY, the highest growth rate in recent years (Figure 5). Looking at the fixed investment forecast for large enterprises by industry and in conjunction with the employment conditions DI, we see a trend for increased fixed investment in sectors with a high degree of labor shortage, such as transport, postal services and retail (Figure 6). While cash flow is abundant, the cautious stance on capital expenditures has not changed significantly, but we can see that capital expenditure has increased as a response to labor shortages. It is also expected that capital expenditure growth should continue until FY 2019 on the premise that the labor shortage will not change.

Figure 5. Fixed investment forecast according to Bank of Japan's Tankan (for large enterprises)



Source:BOJ

Figure 6. Relationship between labor shortage and fixed investment growth rate viewed by industry(large enterprises)



※The size of the bubble indicates the amount of fixed investment.
Source:BOJ

5. Economic Outlook - Summary

Summarizing the above, we expect that a recession in Japan in FY 2019 should be averted, together with the overseas economies. Personal consumption and capital expenditures will support the economy, although it will lose its strength mainly due to the slowdown in export growth. Our basic view is that the growth of the entire economy should be moderate and close to the lower limit of the potential growth rate range of 0.5% in FY2018 and 0.6% in FY2019.

6. Capital expenditures related stocks

We are focusing on the trend for increased investments in automation of production as well as logistics equipment. We believe this to be a long term global trend and will focus on stocks which should benefit from such equipment investment as labor supply remains tight and demand stays steady. For example, Keyence (6861 JP) boosts the productivity for its customers by introducing more efficient production facilities. Daifuku (6383 JP) produces machines which sort goods in the warehouse, and optimizes transport to achieve a more efficient delivery in e-commerce. In addition, we are also following Nomura Research Institute (4303 JP) and NTT Data (9613 JP) which should reap the benefits of expanding information system investments with the aim of improving labor efficiency and costs as well as promoting work style reform.

All enquiries regarding the report should be made to:

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