Asset Management One Co., Ltd.

Global Outlook 2023

January 2023

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Asset Management One

Creating a sustainable future through the power of investment

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Forecast Summary

Economic Forecast Summary for 2023

Calendar Year		2021 (Actual)	2022 (AMO Estimate)	2023 (AMO Forecast)
US	Real GDP (YoY%)	5.9	*1.9*	*0.2*
	Core CPI (YoY%)	3.6	*6.2*	*3.9*
Eurozone	Real GDP (YoY%)	5.3	*3.3*	*-0.1*
	HICP (YoY%)	2.6	*8.4*	*6.3*
China	Real GDP (YoY%)	8.1	*2.9*	*5.2*
	CPI (YoY%)	1.5	*2.3*	*2.3*
Japan	Real GDP (YoY%)	1.6	*1.5*	*1.6*
	Core CPI (YoY%)	-0.2	*2.2*	*2.1*

Stock Market Forecast Summary for 2023

Calendar Year		2021 (Actual)	2022 (AMO Estimate)	2023 (AMO Forecast)
US	S&P500	4779	*3950*	*4100*
	YoY%	28.0	*-17.3*	*3.8*
Eurozone	Eurostoxx50	4306	*3800*	*3900*
	YoY%	20.6	*-11.8*	*2.6*
China	Shanghai Composite	3619	*3150*	*3500*
	YoY%	6.0	*-13.0*	*11.1*
Japan	TOPIX	1992	*2050*	*2300*
	YoY%	10.4	*2.9*	*12.2*

Bond Market Forecast Summary for 2023

Calendar Year	2021 (Actual)	2022 (AMO Estimate)	2023 (AMO Forecast)
UST 10-Year Yield (%)	1.51	*3.80*	*3.70*
Germany 10-Year Yield (%)	-0.18	*2.10*	*3.70*
JGB 10-Year Yield (%)	0.07	*0.25*	*0.20*

Source: Bloomberg, FactSet, AMOne

ESG Outlook:
2023 the first year of biodiversity

Yoshihito Edamura
Economist

Holding of COP15 and Adoption of the GBF

In December 2022, the second round of COP15 (15th Conference of the Parties to the Convention on Biological Diversity) was held in Montreal, Canada. At the conference, the Kunming-Montreal Global Biodiversity Framework (GBF) was adopted, which will serve as a framework for future global biodiversity targets.

23 Action Targets

The GBF consists of various elements, but one of those elements, a set of 23 targets to be achieved by 2030, is especially important. This is because, on the basis of these 23 targets and others, adopting member states will develop national biodiversity strategies and other relevant national laws and regulations. We believe that Targets 7 and 15 are particularly noteworthy in terms of their impact on companies among others.

GBF's 23 Action Targets for 2030

Reducing threats to biodiversity		Meeting people's needs through sustainable use and benefit sharing		Tool and solutions for implementation and mainstreaming	
1	Land- and sea-use planning	9	Sustainable us and benefit-sharing (food security, medicines, livelihoods)	14	Mainstreaming biodiversity
2	Ecosystem restoration	10	Sustainable management of agriculture, aquaculture and forestry	15	Sustainable business, production and supply chains
3	Protect/conserve land and sea	11	Regulation of air, water, hazards and extreme events	16	Eliminate unsustainable consumption
4	Active management of species and biodiversity	12	Increase access to green and blue spaces	17	Manage biotechnology impacts
5	Harvest, trade and use of wild species	13	Access and benefit-sharing (genetic resources)	18	Eliminate harmful incentives
6	Invasive alien species (IAS)			19	Financial resources
7	Reduce Pollution			20	Capacity building
8	Minimize impact of climate change			21	Knowledge
				22	Indigenous people and local community (IPLC) participation in decision-making
				23	Gender

Source: CBD (Convention on Biological Diversity) website
Note: The list doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Target 7 is a target associated with pollution. It aims to prevent the release of pesticides and other environmentally harmful chemicals, eutrophication caused by the release of phosphorus and other substances, and plastic pollution. It may lead to the strengthening of relevant regulations at national level of the adopting member states in the future. With regard to plastic pollution, apart from international negotiations under the Convention on Biological Diversity, it was agreed at the UN Environment Assembly in 2022 that a legally binding international agreement on plastic pollution should be developed by 2024. In this context, we anticipate that plastic pollution will be one of the central agenda items in the environmental area, including biodiversity, moving forward.

Target 15 is a target that covers the business activities of companies, which is likely to affect more companies compared to Target 7. It requires companies to disclose the status of biodiversity in their own operations and in their supply chains, and is expected to make the relationship between companies and biodiversity more visible. The target also requires companies to reduce the negative impact of their business activities on biodiversity.

Significant progress is expected in corporate initiatives

The Nature Action 100 (NA100), a collaborative engagement initiative by institutional investors, will encourage the 100 companies selected to work on biodiversity conservation and restoration in spring 2023. With its official launch scheduled for spring 2023, the pressure on companies to intensify their biodiversity efforts is expected to intensify in 2023, even through channels other than legal instruments such as the GBF.

Nature Action 100

1	Map sector pathways and identify a list of 100 focus companies for investor engagement
2	Support engagements between investor teams and focus company executives and board members around initiative priorities
3	Identify corporate actions that need to be undertaken to protect and restore nature
4	Track the progress of focus companies against key indicators and provide annual progress updates
5	Support investor and corporate advocacy efforts with relevant policymakers on nature-focused policies

Source: Nature Action 100 website
Note: The list doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Methodologies and tools to support corporate biodiversity efforts are already steadily being developed. Guidance on Science-Based Targets (SBTs) for Nature for target setting is due to be published in March 2023, while the Taskforce on Nature-related Financial Disclosures (TNFD) for disclosure framework is due to be published in September 2023. In this context, we do expect 2023 to be the year in which companies take their first steps towards biodiversity initiatives.

US Economic Outlook

Naoki Murakami
Senior Economist

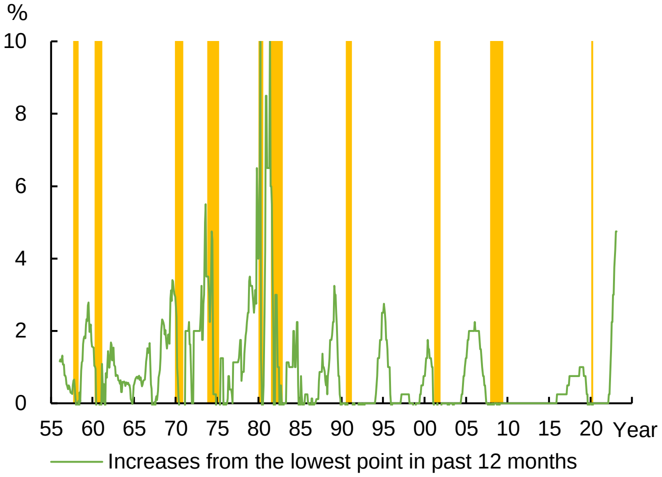
Economic outlook

The Federal Reserve System (Fed) has been raising interest rates aggressively in 2022, and it is expected that the policy rate will reach 5 percent by March 2023 – just one year into the hiking cycle (Figure 1). The effect of the monetary tightening on growth will intensify in 2023. We expect the economy to begin contraction by mid-2023 and enter recession. The labour market, which had been overheated until late 2022, will begin to cool down due to job cuts and the unemployment rate will rise to the 5 percent level.

The Fed aims to achieve moderate corrections in the economy and inflation. However, it is expected to raise interest rates sharply and significantly to stop inflation pushed up by supply shocks. The move is likely to result in a more restraining effect on aggregate demand. The interest rate hikes have already led to a significant correction in the construction sector, particularly in the housing market. Furthermore, the tightening effect is expected to be reinforced by a stricter stance from banks on lending, which is expected to curb capital investment across a wide range of companies (Figure 2). In addition, while post-Covid revenge consumption has almost run its course in 2022, the reverse asset effect of falling house prices is expected to curb private consumption in 2023.

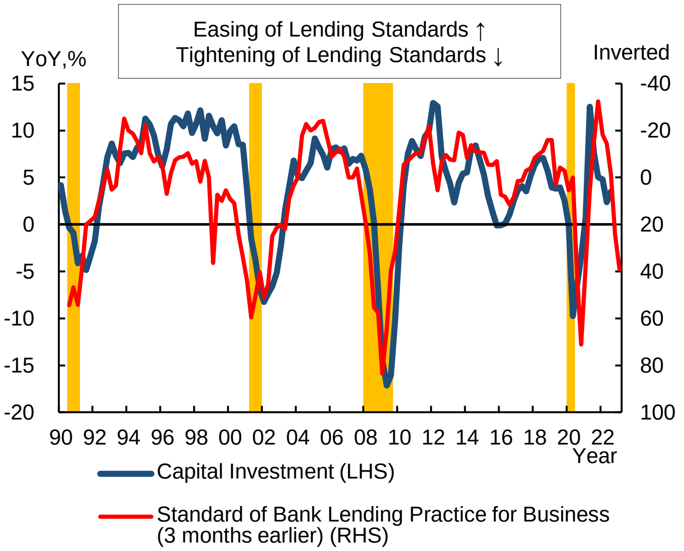
As the supply-demand balance loosens following economic stagnation, high inflation is expected to subside in 2023 and the core CPI is expected to come down to around 3 percent by the end of the year.

Figure 1: Increases in Federal Funds Rate



Sources: Refinitiv and Bloomberg
Period: Monthly data from Jan. 1956 to Apr. 2023
Note: -Data before 1970 is Federal Funds effective interest rates, and after 1971 is the upper limit of the guidance target.
-Our forecast from Dec. 2022 to Mar. 2023.
-Shaded areas indicate recessionary phase.
-The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Figure 2: U.S. Capital Investment and Lending Standards of Financial Institutions



Sources: Refinitiv and Bloomberg
Period: Quarterly data from 1Q 1990 to 4Q 2022 (Capital Investment to Q3 2022)
Note: -Shaded areas indicate recessionary phase.
-The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

US Market Outlook

Monetary Policy and Political Outlook

The Fed is expected to continue raising interest rates until the early spring of 2023, with an intention to raise the policy rate above 5 percent, which is considered restrictive. With economic growth stalling from around the middle of the year, it will be difficult for the central bank to move quickly and aggressively to cut rates while maintaining vigilance against high inflation. Once inflation is confirmed to have subsided, the Fed is likely to begin cutting interest rates by around the end of 2023. However, it is difficult to expect a boost from monetary easing without a significant fall in real interest rates.

Risk Scenarios

Amid a decelerating economy, when the effect of labour shortage is significant, wage inflation would take longer to subside and the Fed's interest rate increases become prolonged, resulting in the risk of damaging the economy significantly.

On the political front, if the Biden administration leans towards the left within the party and tightens regulations on the financial sector and high-tech companies, there is a risk that the effect of monetary tightening on suppressing economic activity will be even stronger.

Eurozone Economic Outlook

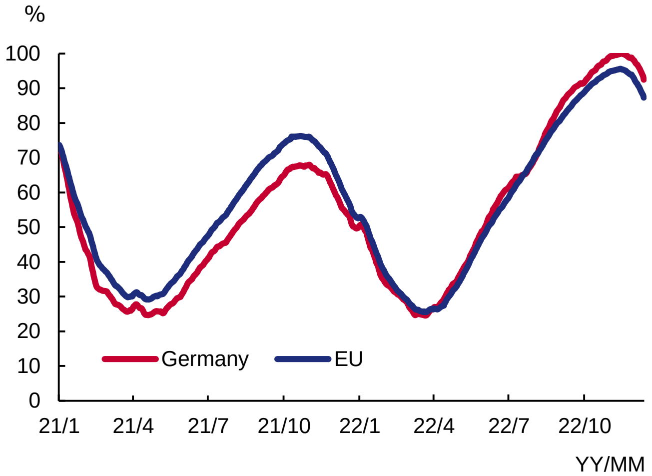
Taichi Kadowaki
Economist

Economic and Inflation Outlook

We expect real GDP to contract and the economy to enter recession in the January-March quarter in 2023 due to (i) the end of post-Covid revenge consumption, (ii) gas shortages restraining corporate production activity, and (iii) negative impact of soaring inflation curbing consumption. However, the recession will not be a serious one in our view, given government measures to mitigate high energy prices, and the high level of gas storage (Figure 1). We believe the economy will begin to recover from around the middle of the year - albeit slowly - as inflation subsides, interest rate increases end and concerns over gas shortages are likely to recede.

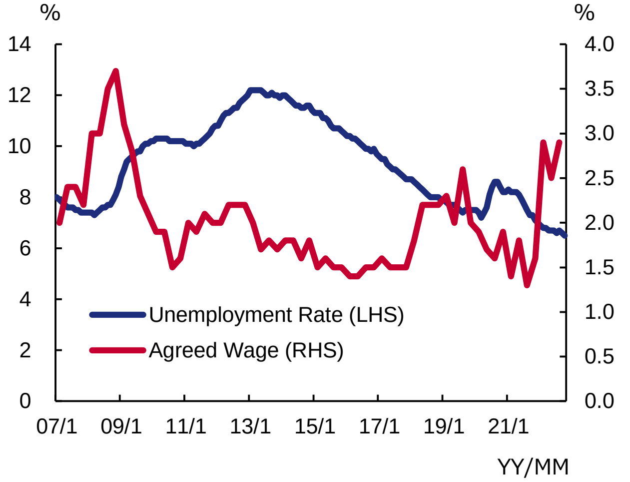
In terms of inflation, we believe energy prices may have hit the peak and expect them to fall further in the future given government and EU measures to curb soaring energy prices and a fall in wholesale electricity prices spreading to retail prices over time. However, high wage growth may be protracted against the backdrop of labour shortages and continue to add on to inflationary pressure (Figure 2). Therefore, it will take some time for the core HICP to subside, and the HICP is expected to remain above the ECB's price target of 2 percent through 2023.

Figure 1: Gas storage rate



Source: AGSI
Period: Daily data from Jan 1, 2021 to Dec 12, 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Figure 2: Unemployment Rate and Agreed Wage in Euro area



Sources: Eurostat and Refinitiv
Period:
Unemployment Rate - Monthly data from Jan. 2007 to Oct. 2022
Agreed Wage - Quarterly data from 1Q 2007 to 3Q 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Eurozone Market Outlook

Monetary and Fiscal Policy

The ECB is likely to be concerned about the risk of current high inflation leading to excessive wage pressures and a prolonged period of high price inflation. With the core HICP likely to remain near 5 percent until mid 2023, reflecting a strong labour market, we believe the ECB will continue to raise interest rates until May, with the terminal Central Bank deposit rate reaching 3.25 percent. Thereafter, we expect the core HICP to gradually decline from the second half of the year due to interest rate hikes and recession, but we believe the ECB will maintain its policy rate at least throughout the year to keep inflation expectations in check.

Risk Scenarios

The risk of gas shortages this winter has receded as European countries have taken steps to diversify their gas supplies and promoted gas savings. However, we consider the most worrying risk is that energy prices will continue to rise in 2023, as European countries will have to stockpile gas in preparation for winter gas demand in the absence of gas supply from Russia. We believe investors should continue to monitor government energy policies and gas prices going forward

China Economic Outlook

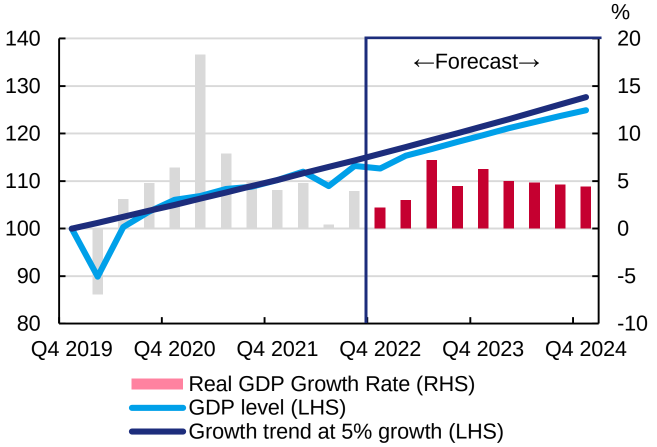
Yukinari Sukada
Economist

Economic Outlook

In 2022, the Chinese economy came under significant downward pressure from the zero-Covid policy and property market correction. On the political front, the five-yearly National Communist Party Congress was held and President Xi entered an unprecedented third term of leadership. After the Party Congress, the new Xi leadership took the helm in easing the zero-Covid policy. It may have been wary of the spread of anti-Zero Covid policy demonstrations. Given that the vaccination rate of the elderly population, which the authorities are likely to be watching closely, was still low at end-November 2022, and that it takes a minimum of four months to complete the process to booster vaccination, the Chinese economy is expected to begin a full-scale transition to coexistence with Covid from the April-June 2023 period onwards.

With the resumption of economic activity, we expect the Chinese economy to recover through the second half of 2023, growing by +5.2 percent for the full year (Figure 1).

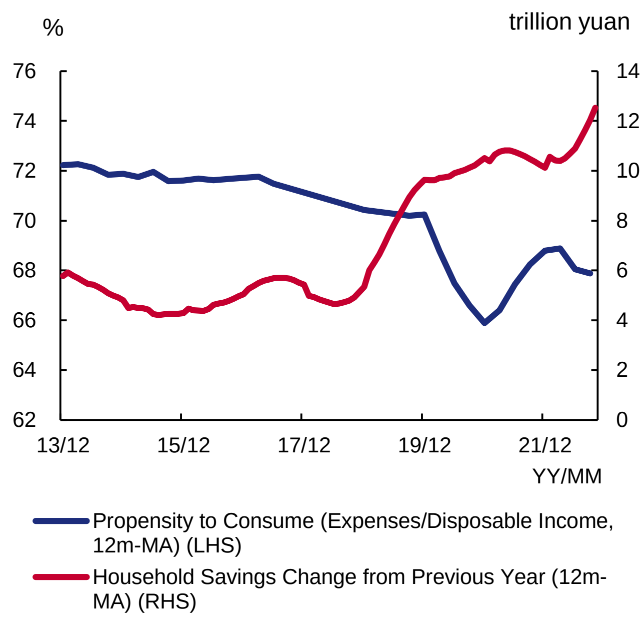
Figure 1: Real GDP Growth Rate Forecast



Source: Refinitiv
Period: Quarterly data from 1Q2020 to 4Q2024
Note:
-GDP level is estimated by taking 4Q2019 as 100 and multiplying by seasonally adjusted YoY growth rate.
-The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

The first half of 2023 will be a transition period to coexistence with Covid, but it should be noted that this process could lead to a re-emergence of the outbreak, which could strain healthcare facilities, and slower reopening. As the reopening progresses from mid-year onwards, consumption, particularly service consumption, is expected to recover. A recovery in international tourism to Japan is also expected. However, unlike major developed countries, Chinese households' savings have not increased as much as in other countries, as no direct transfers to households, such as cash transfers, were provided during the pandemic period in China. While a recovery in consumption is expected, it is unlikely to trigger high inflation (Figure 2).

Figure 2: Changes in Propensity to Consume and Household Savings



Source: Refinitiv
Period:
Consumption Propensity - Quarterly data from 4Q 2013 to 3Q 2022
Household Savings - Monthly data from Dec. 2013 to Oct. 2022
Note:-GDP level is estimated by taking 4Q2019 as 100 and multiplying by seasonally adjusted YoY growth rate.
-The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

We believe that the risks to the Chinese economy in 2023 include a prolonged adjustment of the property market and a slowdown in external demand, as well as a strengthening of the communist-tinged common prosperity policy by Xi's leadership on the political front. The authorities are increasing their support for property developers. Nonetheless, given that housing demand is unlikely to increase amid a declining population, and developers need to change their management style of highly leveraged and aggressive investments, property investment may continue to slow down gradually. In addition, exports are expected to slow amid a deceleration in external demand, particularly from the U.S. If, after the economy recovers, Xi's leadership once again tightens the common prosperity policy, we think that the headwinds for sectors of a highly public nature such as services and real estate may intensify.

Prospects for fiscal and monetary policy in 2023

In 2022, the People's Bank of China (PBOC) has taken a cautious stance on further monetary easing even as the economy continued to deteriorate. We assume that it has taken into account the fact that the economic downturn was caused by tighter restrictions on action, as well as concerns about an acceleration in the depreciation of the yuan.
However, we believe that the PBOC may move to additional monetary easing to support the economy as economic activity is expected to resume and demand for funds is likely to pick up. We also believe that the PBOC easing will be supported by the fact that major central banks are slowing the pace of interest rate hikes and fears of a weaker yuan are fading. In addition, the authorities are expected to continue supporting the economy through fiscal policies, particularly infrastructure investment and tax cuts.

Japan Economic Outlook

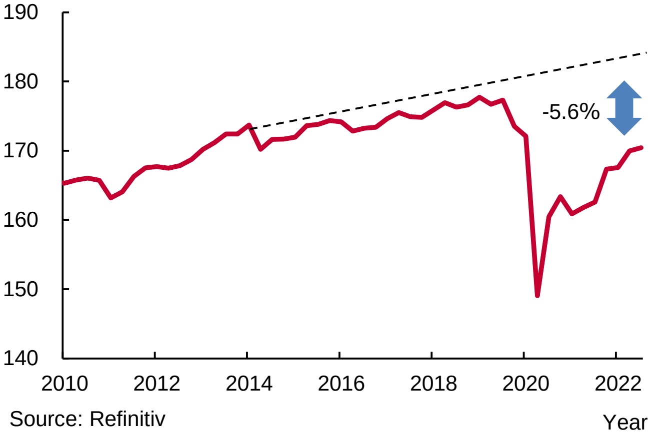
Yuko Iizuka
Economist

Real GDP growth was unexpectedly negative in the July-September quarter in 2022, although this was due to a sharp increase in imports on the back of strong domestic demand. Relative to the U.S. and Europe, Japan has more room to recover from the economic stagnation caused by the Covid pandemic. We expect the Japanese economy to continue growing in 2023 against the backdrop of reopening and normalisation of economic activity. Although the effects of recession in the U.S. and Europe, and a sluggish Chinese economy will weigh upon the Japanese economy, we expect it will avoid dropping into negative growth or entering recession. We expect the Japanese economy to grow in the mid 1 percentage point range, outpacing the negative to zero growth in the U.S. and Europe. We expect the Japanese economy to be supported by (i) strong domestic capital investment demand, partly due to pent-up demand accumulated during the Covid pandemic, (ii) government price control measures in response to rising prices, (iii) easing terms of trade as resource prices retreat, and (iv) increased consumption on the back of surplus savings accumulated during the Covid pandemic.

"Japanese economy has greater room for recovery after Covid pandemic compared with US and Europe"

Real Service Consumption

CY2015 Chain-weighted prices, Trillion yen



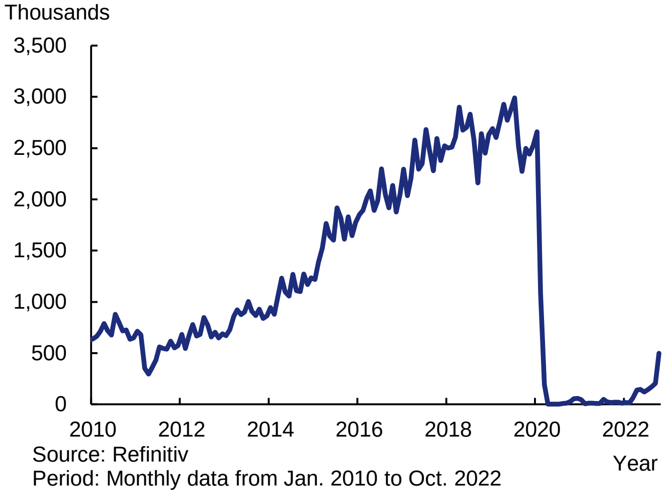
Source: Refinitiv
Period: Quarterly data from 1Q2010 to 3Q2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Forecast Summary

Calendar Year	Actual 2020	Actual 2021	Estimate 2022	Forecast 2023
Real GDP (YoY, %)	-4.6	1.6	1.5	1.6
Core CPI (YoY, %)	-0.2	-0.2	2.2	2.1
JGB 10-Year Yield (%)	0.02	0.07	0.25	0.20
USD/JPY	103	115	140	135
TOPIX EPS	80	127	150	157
YoY, %	-25.3	58.2	17.8	4.7
TOPIX	1805	1992	2050	2300
YoY, %	4.8	10.4	2.9	12.2

Source: Bloomberg, Factset
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

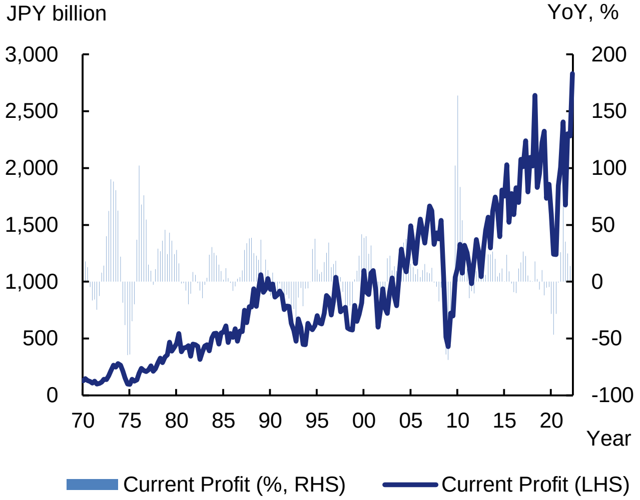
Foreign Visitors Arrivals



Source: Refinitiv
Period: Monthly data from Jan. 2010 to Oct. 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

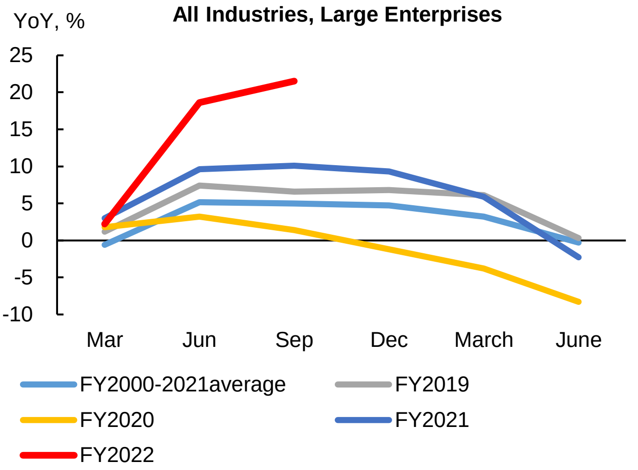
"Japanese companies have posted their greatest profits in history. Capex has recovered strongly partly because of pent-up demand

Corporate Profit (ex-financials)



Source: Refinitiv
Period: Monthly data from 1Q1970 to 2Q2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

CAPEX plan



Source: BOJ
Period: Quarterly data from Mar. 2019 Survey to Jun. 2022 Survey
Note: -The horizontal axis represents the results of surveys from the initial survey (March) to the June survey of the following year (when the actual results are finalized), and the graph shows the year-on-year change (revision pattern) in the capital investment plan for each survey period.
-All industries are included in the survey.
-The graph shows the amount of capital investment including land investment and excluding software and research and development. The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Prices as represented by CPI excluding fresh food reached the mid 3 percent level in the October-December quarter of 2022, and are expected to peak out going forward, although year-on-year volatility is expected to increase slightly due to the effects of government measures to support travel and curb energy and gas price rises. Wage trends are becoming more important, with much focus on the extent of wage increases at the coming Shunto – literal meaning 'spring battle' - annual wage negotiations between major labour unions and large corporations that take place every spring. We believe that there is a good possibility of wages rising by 3 percentage points in 2023, accelerating from growth of 2 percentage points in 2022. Whilst questions remain over possibility of maintaining price inflation of 2 percent, we believe we can safely assume sustained price increases of 1 to 2 percent will be achieved, without falling back into the deflationary environment again.

Japan Monetary and fiscal policy outlook

We may be able to confirm improvement in price momentum; specifically, output gap, inflation expectations and wage growth, which the Bank of Japan (BOJ) attaches importance to, in the first half of 2023, but with the Fed ending interest rate hikes and fears of recession in the U.S. and Europe growing, we believe the BOJ will not change monetary policy, partly due to concerns over making a policy mistake. Under the new Governor and Deputy Governors after April 2023, the central bank will need to confirm both (i) the start of a virtuous cycle in prices and wages and (ii) the emergence from a global recession, particularly in the U.S., before making changes to its monetary policy. If any, we expect the bank to delay them until 2024 or later.

This autumn's economic stimulus measures and supplementary budgets will have only limited effects, with the exception of measures to curb price hikes and some public works projects. However, now that the deflationary mindset of firms and households has begun to change, fiscal measures will play a major role in starting a virtuous cycle of wage and price increases, including (i) investment support measures to raise domestic growth expectations, (ii) raising publicly regulated prices and (iii) encouraging wage increases.

The government has announced a plan to double asset. This aims to increase investment by encouraging a shift from cash and deposits, which accounts for over 50 percent of Japan's household financial assets of approximately JPY2,000 trillion. The plan included to expansion and perpetuation of existing Nippon Individual Savings Account (NISA), a tax exemption program for small investments, and raising the eligible age limit for iDeCo membership, an optional defined contribution pension plan for individuals, and establishing a new organisation to promote financial literacy education. NISA is a fixed term tax exempt investment program currently allowing 5 years of tax exemption for investments up to JPY1.2 million per year or 20 years of regular investments up to JPY400 thousand per year, along with 5 year of tax exempt investments up to JPY800 thousand per year for minors. The program will transfer to a 5 year double decker program; (i) up to JPY200 thousand per year in regular investments and (ii) up to JPY1.02 million per year for investments, beginning from 2024. Possible enhancements include expansion of monetary limits and perpetuation of the program and removal of current fixed term limits. The eligibility age limit for iDeCo was initially set at 60 years old, and has been raised to 65 years old from May 2022. Discussions have begun towards increasing it again to 70 years old to enhance incentives for working people.

Kishida Cabinet's plan to formulate "Doubling Asset-based Incomes Plan"

In order for households to become financially more comfortable, it is necessary to create a virtuous cycle by redirecting some household deposits into investments so that households can receive the benefits of sustained increases in corporate value.

- **Significant expansion of NISA** (tax exemption program for small investment)

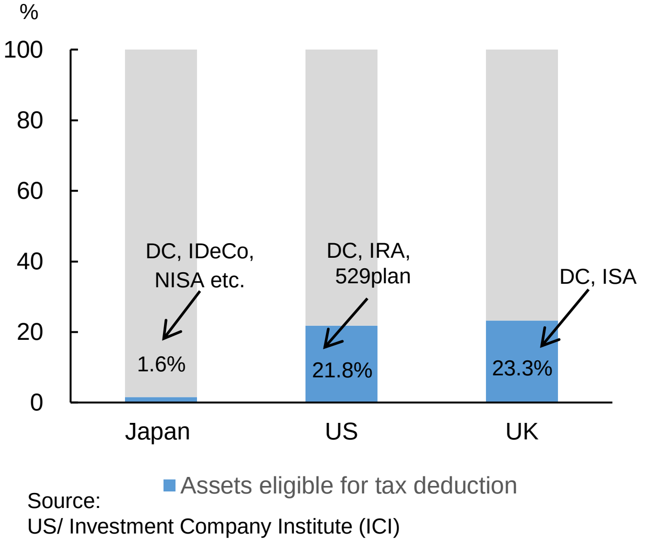
- **Reform of iDeCo** (individual-type DC pension plan)

- Establish a forum for these initiatives

- Formulate **the comprehensive "Doubling Asset-based Incomes Plan" by the end of 2022.**

Source: Cabinet Secretariat
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Household Financial Assets eligible for tax deduction



Source:
US/ Investment Company Institute (ICI)
UK/ Office for National Statistics (ONS), Investment Association, HMRC
Japan/ Liaison Committee for Defined Contribution Pension Plan Operational Management Institution, Ministry of Health, Labour and Welfare, Financial Services Agency
Note: Regarding the data of assets eligible for tax deduction, US is as of the end of 2021, UK is as of the end of 2021 (NEST and ISA is as of 2020), Japan is as of the end of Mar. 2021 (NISA is as of 2020). 1 USD = JPY113.0, 1GBP = JPY154.8 (as of the end of Dec.2021)
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Japan Market Outlook

Hitoshi Asaoka
Senior Strategist

Japanese equity, interest rate and currency exchange rate outlook for 2023

Japanese equities remained within a range in 2022, but were also noticeably resilient among developed markets. The firmness of Japanese equities was attributable to milder inflation than in the U.S. and Europe, despite the rapid depreciation of the yen. While the U.S. and Europe experienced high inflation and volatile interest rate environment, the BOJ maintained monetary easing and, unlike in the U.S. and Europe, high interest rates did not damage the economy and markets to the same extent. However, the yen's persistently weak outlook has kept foreign investors away from buying Japanese equities actively, restraining the upside of the market.

In 2023, corporate profits are likely to continue to increase due to the relatively strong domestic economy, securing a small increase in profits despite the recession in the U.S. and Europe.

The Fed's interest rate hike cycle is expected to end in the first half of 2023, and the outlook of the yen's weakness is likely to recede. A resurgence in buying of Japanese equities by foreign investors, who had previously avoided the asset class to stave off a decline in the value of their dollar-denominated assets, is also expected.

We expect TOPIX earnings per share (EPS) to increase by 4.7 percent year-on-year in 2023 although slowing down from 17.8 percent growth in 2022. The year-end price-to-earnings ratio (PER) is expected to recover mid-14x, which is the long term average level, due to a pause in interest rate hikes in the U.S. and Europe and expectations for a bottoming out of the global economy. Based on our EPS growth assumptions and the long term average PER multiple, we forecast the TOPIX index to reach 2,300 points by the end of 2023. However, we expect the index to remain below 2,000 points, in the range of 1,800 and 2,000 points which it has been trading since early 2021, during the first half of 2023, mainly due to concerns about monetary tightening and economic recession in the U.S. and Europe. We may see the index to temporarily fall below the lower end of the range when risk aversion intensifies due to the economic slowdown in the U.S. and Europe. Then we expect it to turn higher and break above the 2,000 mark as investor risk appetite improves globally with a pause in the Fed's interest rate hikes and high inflation subsiding.

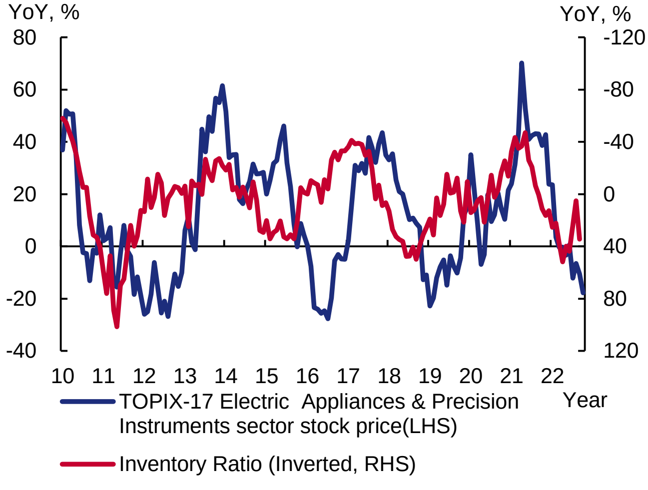
In 2022, the economic slowdown in China has partly weighed on the Japan's economy, but from next year onwards, if the zero-Covid policy is eased as a result of a pause in the spread of the virus or changes in the leadership, a recovery in inbound tourism demand from China can also be expected. Due in part to the yen's depreciation to date, travel demand to Japan is considered to be potentially extremely large, and a significant recovery is possible. Domestic labour costs may increase on the back of rising wages, but if this leads to increased consumption, it should contribute to a recovery in the domestic demand structure.

Japanese equities are perceived as highly cyclical in the global financial markets and are likely to attract buying as expectations for a bottoming out of the global economy strengthen over the second half of 2023. Share prices of the electric appliances and precision instrument sectors, which have large weightings in the TOPIX index, have recently been weak due to concerns a prolonged inventory adjustment phase in semiconductors. The recent rise in the inventory levels of electronic components and devices is expected to come to a halt, which would also contribute to a bottoming out of share prices in those sectors.

Alongside the cyclical perspective, the trend of global divide over key issues such as energy and semiconductor technology, due to the U.S.'s hardline stance against China and the situation in Ukraine, may lead to increased demand for capital investment to boost production capacity, which has been restrained globally, and will benefit Japanese equities.

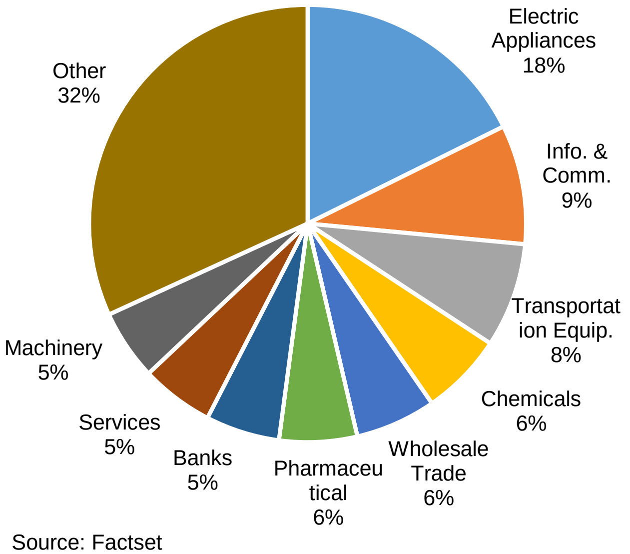
"Electronic components and devices seen to be approaching the end of inventory adjustment phase. Share prices bottomed out? "

Electronics & Precision Instruments Sector



Source: Refinitiv
Period: Monthly data from Jan. 2010 to Oct. 2022
Note: The Inventory ratio is for electronic parts and devices. The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

TOPIX sector weight



Source: Factset
Period: As of Nov 24, 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Even if the BOJ makes changes to its monetary policy, interest rates are likely to remain in a range, as incremental upward pressure on interest rates originating from overseas is likely to have receded by then.

If the U.S. and European Central Banks remain in a rate hiking cycle at the timing of the BOJ governor change in April 2023, speculation over the BOJ's yield curve control (YCC) target hike may intensify. In such event, the yield on Japan's 10-year government bonds (JGBs) may temporarily rise well above 0.25 percent due to foreign selling and other factors, but, in principle, we expect no change in its monetary policy. In the second half of 2023, we expect a decline in 10-year JGB yields to the 0.1 to 0.2 percent range as upward pressure on interest rates originating from overseas recedes given a pause in interest rate hikes in the U.S. and Europe.

The USD/JPY exchange rate is expected to favour a somewhat stronger yen as the Fed pauses its hikes. However, as the interest rate differential between the U.S. and Japan will remain wider than before the Covid pandemic, the risk of the yen turning sharply stronger is low. We expect the USD/JPY exchange rate to remain in the range of JPY130 and JPY140.

Risk Factors

Risk factors for 2023 are (i) prolonged global recession, (ii) rapid appreciation of the yen, (iii) prolonged effects of high costs and (iv) domestic political instability.

i. A prolonged recession in the U.S. and Europe or a further delay in the easing of China's zero-Covid policy would, needless to say, weigh on Japanese equities.

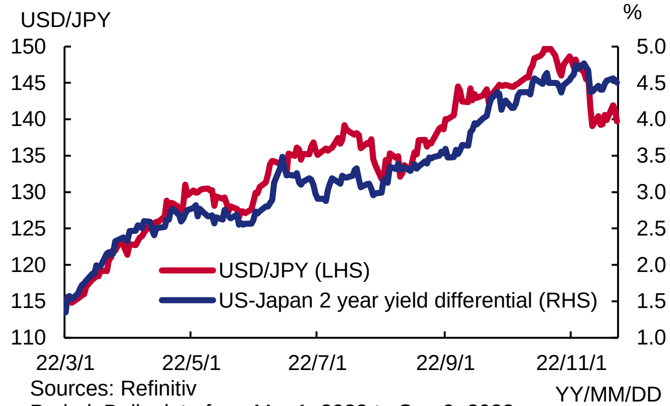
ii. Although some are wary of the risk of the yen strengthening due to the current round of the Fed rate hikes coming to an end and a shift to rate cuts, the yen is expected to remain at around JPY130 to JPY140, a weaker level than before the Covid pandemic, as the Fed is unlikely to return to a zero-interest-rate policy and the interest rate differential between the U.S. and Japan is expected to remain wide.

iii. Looking at the change in producer prices (referred to as domestic corporate prices in Japan), export prices appear to have successfully passed through rising import costs to selling prices to a considerable extent, while the growth of domestic producer prices has been restrained. This suggests that domestic demand-based industries have not yet been able to pass on higher prices, and caution should be exercised over the possibility that the impact of higher costs stemming from import inflation will remain through the first half of 2023.

iv. The Kishida government's approval rating has fallen significantly, and there is a risk that it will be unable to take bold steps on economic policy. If the decline in support does not stop, Kishida’s political capital within the party may decline further and the possibility of a snap election under the Prime Minister's authority, which would cause a certain amount of uncertainty for Japanese stock markets, cannot be ruled out.

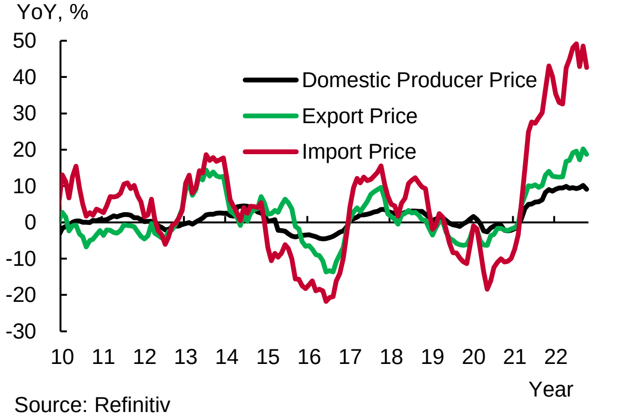
“USD/JPY is sensitive to US-Japan yield differentials, this differential is likely to remain even after the Fed begins to cut rates” Pass through of import price inflation to sales prices has been improving in overseas demand related companies but domestic demand related companies yet to show progress.”

USD/JPY and US-Japan yield differential



Sources: Refinitiv
Period: Daily data from Mar 1, 2022 to Sep 9, 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

Producer Price



Source: Refinitiv
Period: Monthly data from Jan. 2010 to Oct. 2022
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

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