

## Japan Equity Strategist

### Japan equity outlook: What holds the key to TOPIX 900+ in 2014?

#### ■ Equities

- **Neutral near term, optimistic long term** — We summarize our outlook for Japanese equities in response to the additional BoJ easing. We expect TOPIX to be rangebound between 700 and 800 for the rest of the year, with weak momentum in the domestic economy weighing down the index. We see TOPIX rising in the New Year, however, as the domestic economy bottoms out, the US fiscal cliff is avoided, and expectations mount for monetary easing by the new BoJ governor. If the US economy reaches sustained growth so that the market can expect the FRB to start the rate-hike cycle in mid-2015, then we would see TOPIX rising further as the yen weakens against the dollar in a sustained manner from mid-2013. Our TOPIX targets are 810 for March 2013 and 940 for March 2014.
- **What is lacking is business-cycle momentum** — Many valuation metrics suggest that Japanese equities are undervalued and supply/demand conditions and the market environment are also improving, with foreigners net buyers. We feel the environment is being steadily put in place for gains for Japanese equities. However, we cannot deny that momentum in the domestic economy is weak. We feel a downturn in the economy is virtually certain and that there is a pronounced lack of visibility on when the bottom for the cycle will come. We feel that we need to see signs of a bottom for domestic business-cycle momentum and further yen weakening for Japanese equities to rise.
- **TOPIX to rise as yen weakens** — What we would expect to engender further yen weakening would be easier monetary policy moves by the new BoJ governor and the start of the FRB rate-hike cycle from mid-2015. A strong correlation exists between the market's forecast for the policy rate in 24 months' time and the dollar/yen rate. If expectations mount for the FRB to enter a rate-hike cycle of 25bps/quarter from mid-2015, then we would not be surprised to see the dollar/yen rate reach ¥85/\$-¥90/\$ in March 2014. the TOPIX PBR has been more closely correlated with the dollar/yen rate than with RoE. We see TOPIX rising as the yen weakens and reaching 900-1,000 in 2014.
- **Lower sales and earnings in FY3/13, higher sales and earnings in FY3/14** — We expect lower sales and earnings in FY3/13 as the economy enters a contraction but higher sales and earnings in FY3/14 on a demand spike prior to the consumption tax hike and a pickup in overseas economies.
- **Timing of FRB rate-hike cycle, new BoJ governor's monetary policy the key** — The key to our outlook above is sustained growth in the US economy, such that the US enters a rate-hike cycle from mid-2015, and a more accommodative monetary policy from the new BoJ governor, resulting in sustained weakening of the yen versus the dollar. We will be focusing on how the US economy fares and who is appointed as the new BoJ governor.

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## Chapter 1: Japan equity market outlook

It became clear from the July industrial production statistics that firms were beginning to correct production levels in response to rising inventory, and concerns about the Japanese economy mounted. Then, relations between Japan and China deteriorated, triggered by the nationalization of the Senkaku islands in September, and sales of Japan's manufactured goods, notably autos, plunged in China. It is becoming more and more certain that the Japanese economy has entered a downturn.

On the other hand, we are beginning to see positive developments, such as additional easing from the BoJ, signs of a bottom to Chinese business-cycle momentum, and a further recovery in US housing demand.

In this report, we look afresh at the current trends in the Japanese equity market and summarize our outlook, as a mixture of negatives and positives emerge.

Here we outline our conclusions.

**TOPIX to be rangebound between 700-800 through year-end**

**Hopes for the new BoJ governor to rise after the New Year**

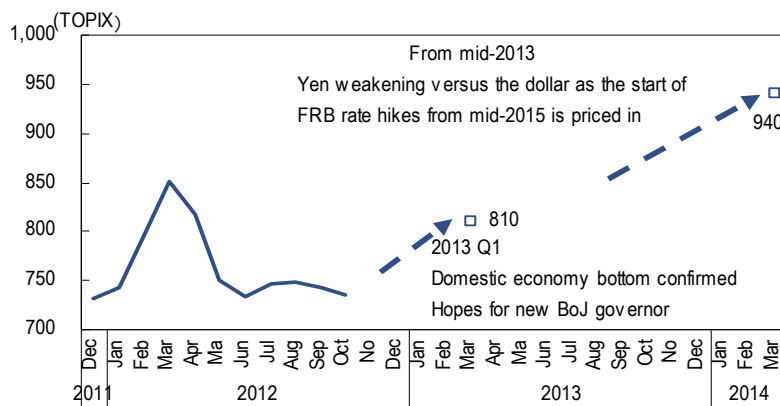
**If the market expects the FRB's rate-hike cycle to begin in mid-2015, the yen could continue to weaken versus the dollar and TOPIX rise further**

**TOPIX targets: 810 in March 2013 and 940 in March 2014**

1. We expect TOPIX to be rangebound between 700 and 800 for the rest of the year, with weak momentum in the domestic economy weighing down the index.
2. After the New Year we expect momentum in the domestic economy to bottom and the US to avoid its fiscal cliff. We see the yen weakening versus the dollar and TOPIX rising on expectations for the new BoJ governor's monetary policy.
3. If the US economy reaches sustained growth such that FRB begins the rate-hike cycle in mid-2015, then we would expect the market's policy rate forecasts for 24 months' time to rise from mid-2013, the yen to weaken versus the dollar on a sustained basis, and TOPIX to rise further.
4. We set our TOPIX targets at 810 in March 2013 and 940 in March 2014.

Holding the key to our outlook above are sustained growth in the US economy such that the US enters a rate-hike cycle from mid-2015 and a more accommodative monetary policy from the new BoJ governor, resulting in sustained weakening of the yen versus the dollar. We will be focusing on how the US economy fares and who is appointed as the new BoJ governor.

Figure 1. Our picture of TOPIX from here on



Source: Citi Research.

## Chapter 2: Japan equity market trends

### Summary of market trends

**Valuations are low, foreigners are net buyers of Japanese equities, and we are seeing signs of a pickup in overseas economies**

Figure 2 summarizes market trends by three areas: valuations, the macroeconomy and corporate earnings, and the supply/demand market environment. We discuss each in more detail later. Many valuation metrics suggest that Japanese equities are undervalued and we are also seeing signs of improvement in supply/demand conditions and the market environment, with foreigners net buyers of Japanese equities for instance. Furthermore, we are seeing pickups in overseas economies, including China.

**Domestic economic momentum weak**

We cannot deny, however, that momentum in the domestic economy is weak. We are almost certainly in a downturn and we note a marked lack of visibility on when the bottom will come. Then yen weakened in October but we think the weakening is likely to pause for the near term after the BoJ's decision on additional monetary easing on October 30.

**Equity gains need signs of a bottom for domestic economic momentum and further yen weakening**

We think the environment is gradually coalescing for equity advances. We do need to see signs of a bottom for domestic business-cycle momentum and further yen weakening, however.

Figure 2. Summary of market trends

		Positive	Neutral	Negative	Comment
Valuations	CAPE	○			Undervalued
	PBR	○			Undervalued
	Dividend yield	○			Undervalued
	Earnings yield gap	○			Undervalued
Macroeconomy and corporate earnings	Domestic industrial production			○	Inventories have risen to on par with the last recession. Companies are engaging in production corrections
	Domestic sentiment			○	Current DI in the economy watchers' survey is falling
	Global PMI		○		Global PMI below 50 but showing signs of bottoming
	Forex rate		○		Yen weakened versus euro, dollar, but weakening pausing
	Revision index	○			In bottom zone
Supply/demand and market environment	Spanish, Italian sovereign yields	○			Fell after the ECB announcement of outright monetary transactions
	VIX	○			At lowest level since 2008
	Foreigner net buying/selling	○			Net buying
	Risk factors		○		On a gradual uptrend, albeit one with temporary reversals
	Domestic seasonality		○		Japanese equities may enter seasonal uptrend from November
	Credit margin loss ratio		○		Neither near a low or a high

Source: Citi Research.

### Valuations

#### Japanese equities still undervalued even though the PBR recovered to over 0.9x

In response to the slump in auto sales in China, TOPIX fell to 713.95 on October 11, at which point the TSE1 listed company PBR sank to 0.88x. As we noted in our October 12 report, [Japanese Equity Strategist - TOPIX downside risk](#), periods when TOPIX has been below a PBR of 0.9x have not lasted long. On October 19, TOPIX rose as far as 754.39, for a PBR of 0.93x. The market still strikes us as cheap at a PBR below 1x but we can say that the period of exceptional undervaluation has been erased (Figure 3).

#### CAPE, dividend yield, etc., suggest undervaluation on par with post-Lehman lows

Japanese equities are very undervalued, whether we take as our valuation metric the cyclically adjusted PER (CAPE), the gap between the dividend yield and the

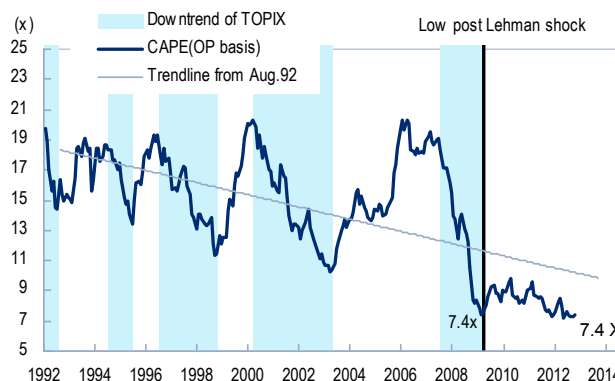
long-term JGB yield, or the gap between the dividend yield and the long-term JGB yield. All the metrics suggest that TOPIX undervaluation is as pronounced or even more pronounced as it was in February 2009, when TOPIX hit its low on the monthly data (Figures 4, 5, and 6).

Figure 3. TSE1 companies: PBR



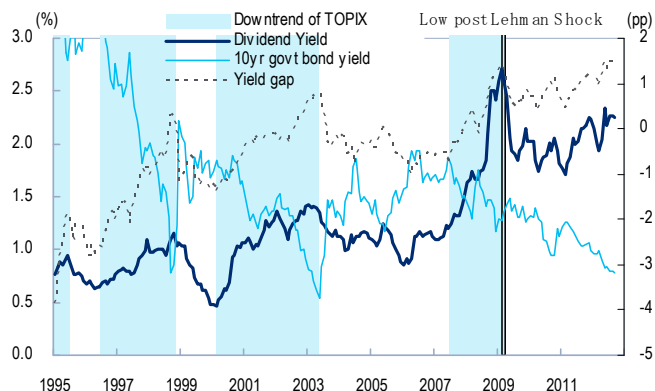
Source: Bloomberg, Citi Research.

Figure 4. CAPE



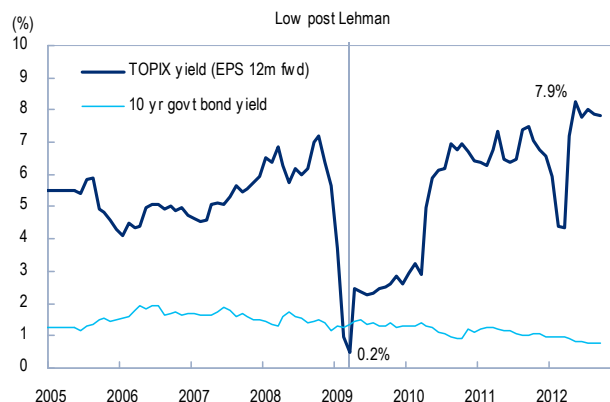
Source: Astra Manager, Citi Research.

Figure 5. Gap between the dividend yield and the long-term JGB yield



Source: Bloomberg, Citi Research.

Figure 6. Gap between the dividend yield and the long-term JGB yield



Source: Bloomberg, Citi Research.

## Business cycle and corporate earnings

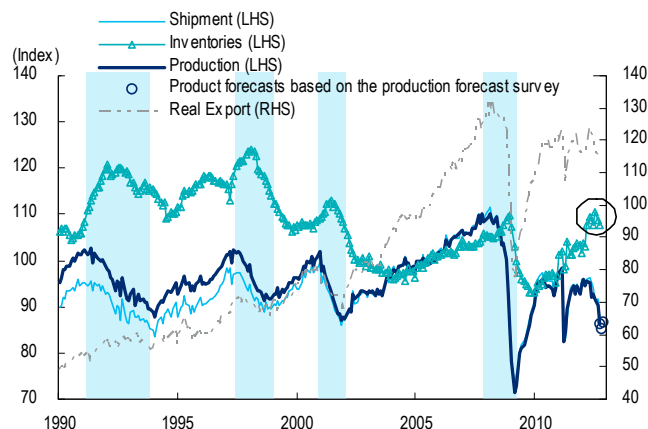
### Likelihood rising that the domestic business cycle has entered a downturn

It became clear from the July industrial production statistics that firms were beginning to correct production levels in response to rising inventory, and concerns about the Japanese economy mounted (Figure 7). Then, relations between Japan and China deteriorated, triggered by the nationalization of the Senkaku islands in September, and sales of Japan's manufactured goods, notably autos, plunged in China. Business cycle momentum is weakening further.

Sentiment indexes, too, which are leading indicators of the domestic economy, particularly the economy watchers' survey, are deteriorating (Figure 8). It has become almost certain that the Japanese economy has entered a downturn (see

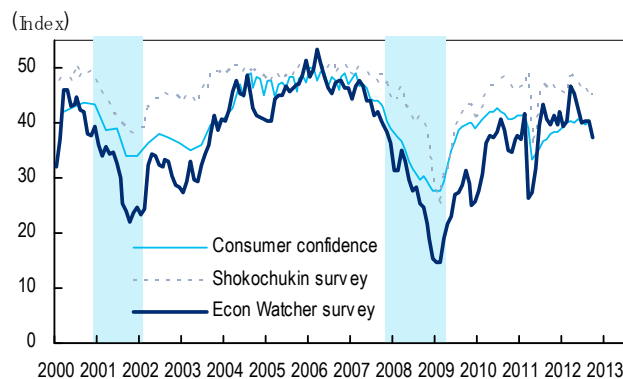
our October 19 memo, [Japan Economics Weekly - How long and how deep will the current downturn be?](#), for more details).

Figure 7. Industrial production, inventory, and exports



Note: Shaded portions are recessionary periods.  
Source: METI, BoJ, Citi Research.

Figure 8. Sentiment indices



Note: Shaded portions are recessionary periods.  
Source: Cabinet Office, Shoko Chukin Bank, Citi Research.

The Japanese business cycle is almost wholly defined by trends in industrial production. Since the late 1990s, production has bottomed within six months of the inventory peak (Figure 9). After the Lehman Brothers bankruptcy, the bottom came in two months, which followed a rapid reduction in production alongside the global financial crisis. We think the current production correction is likely to follow the other two cyclical downturns. In the industrial production numbers through September, the inventory peak came in July. We would not be surprised if the production bottom occurred by January 2013. It looks as if we may be able to confirm a production bottom in the statistics as early as the January–March quarter.

Figure 9. Inventory peak and production bottom

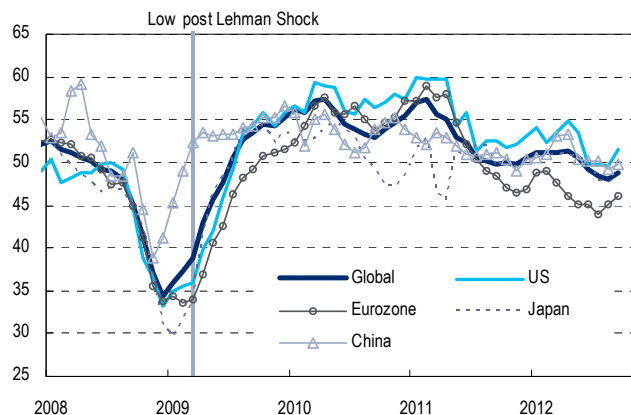
Inventory peak	Production bottom	Difference
Feb 1998	Aug 1998	Six months
Jun 2001	Nov 2001	Five months
Dec 2008	Feb 2009	Two months

Source: METI, Citi Research.

### Signs of a pickup in global economic momentum

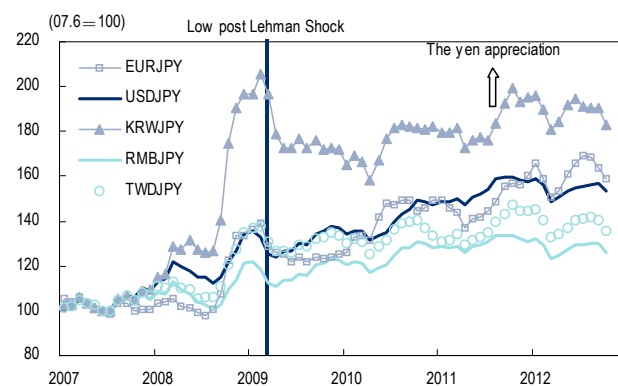
The Chinese PMI rose for the first time in five months in September and is expected to rise again in October (Figure 10). It appears that monetary easing and other steps are finally beginning to have an effect. The US manufacturing ISM Index rebounded significantly in September. The global PMI rose for the first time in five months in September, too. We see signs of a pickup in the global economy. The yen also weakened against many currencies in October, albeit modestly (Figure 11). Improvement in the external environment, aside from the deterioration in Japanese-Chinese relations, may have begun.

Figure 10. Global PMI



Source: Markit, Citi Research.

Figure 11. Forex rates



Source: Citi Research.

### Revision index: In negative territory but signs of a bottom

There has been a rapid increase in downward revisions to company earnings estimates, on reports of slumps in sales of autos in China, etc. (Figure 12). The revision index fell to -0.62 on October 5 and TOPIX fell as low as 713 at one point on October 11. The revision index then improved to -0.50 on October 26. Overall, we think that H1 results will see many companies undershooting their estimates and we expect momentum for downward revisions to continue but forecast that the pace will fall back and that the revision index will improve.

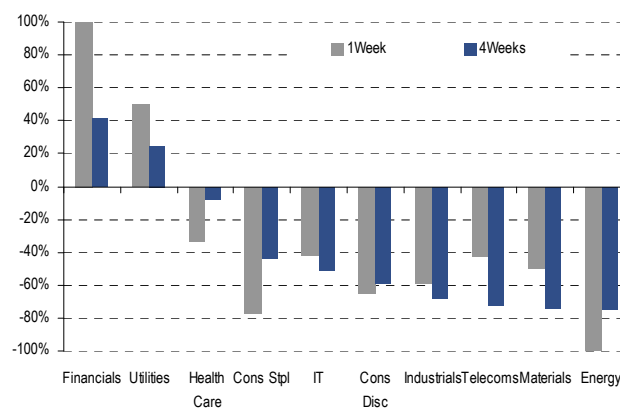
By sector, the revision index is relatively good for financials (Figure 13). Next best are defensives such as healthcare and consumer staples. Cyclical sectors such as basic materials and energy have been worst, relatively.

Figure 12. Japan revision index and TOPIX



Source: Bloomberg, Citi Research.

Figure 13. Revision index by sector



Source: FactSet, Citi Research.

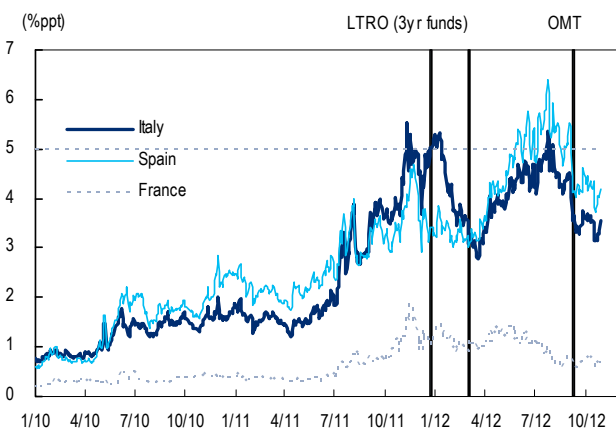
## Supply/demand conditions and the market environment

### Foreigners again net buyers of Japanese equities

After the outright monetary transactions announcement by the ECB, the sovereign yield spread of major eurozone countries versus the German yield fell (Figure 14). We consider this as suggesting concerns about the eurozone debt problem have abated. The VIX Index is also at close to its lowest level since the Lehman Brothers bankruptcy (Figure 15). US equities are at close to their highest levels since the Lehman Brothers bankruptcy and we think the environment is one in which overseas investors find it easy to take on risk. Indeed, they were substantial net buyers of Japanese equities in the third week of October (Figure 16).

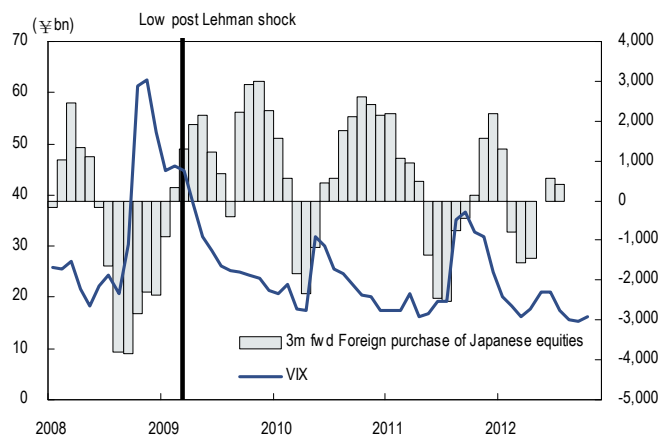
In factor analysis, risk and value are on a moderate uptrend, even though they pull back from time to time (Figure 17). It may be that investors are beginning to take risks and select equities that have become undervalued in the corrections to date.

Figure 14. Major eurozone countries: Sovereign spread over Germany



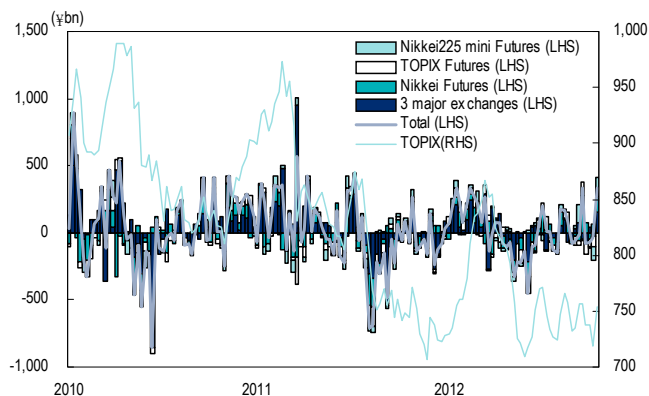
Source: Bloomberg, Citi Research.

Figure 15. VIX and foreigner net buying/selling of Japanese equities



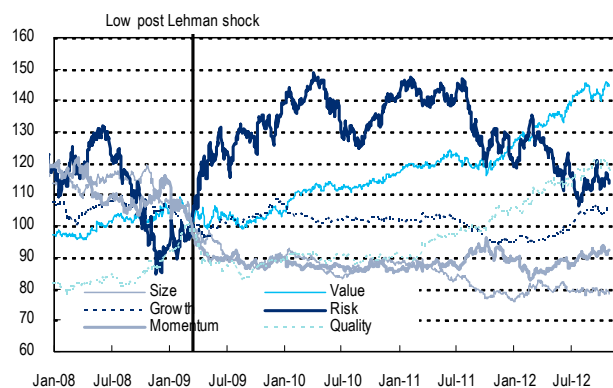
Source: Bloomberg, Astra Manager, Citi Research.

Figure 16. Foreigner net buying of Japanese equities and TOPIX



Source: Citi Research.

Figure 17. Citi style index trends



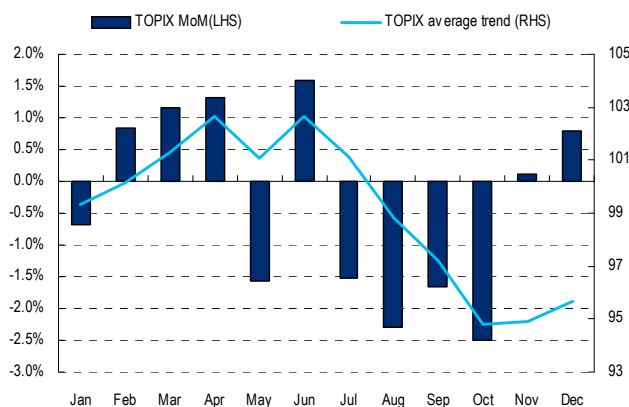
Source: Citi Research.

The summer-autumn period, when the average performance of Japanese equities has been worst, seasonally, from 1997 to date, is over (Figure 18). We will now be

entering the winter-spring period, when the performance of Japanese equities has been best.

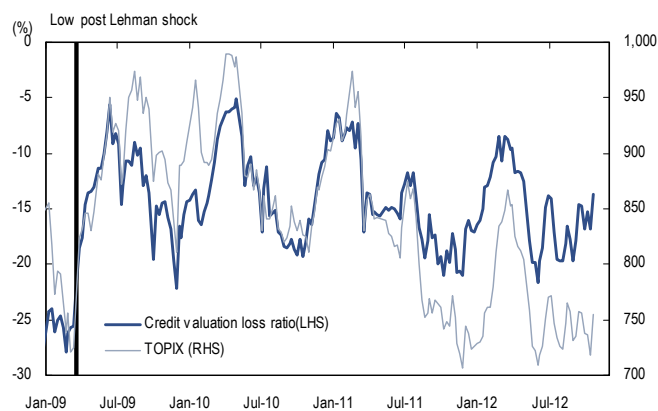
The credit margin gain/loss ratio is far from both the peak and the trough, and we do not think it has major implications for the direction of share prices moving forward (Figure 19).

Figure 18. TOPIX seasonality



Note: Monthly average rate of rise/decline since 1997.  
Source: Datastream, Citi Research.

Figure 19. Credit margin gain/loss ratio and TOPIX



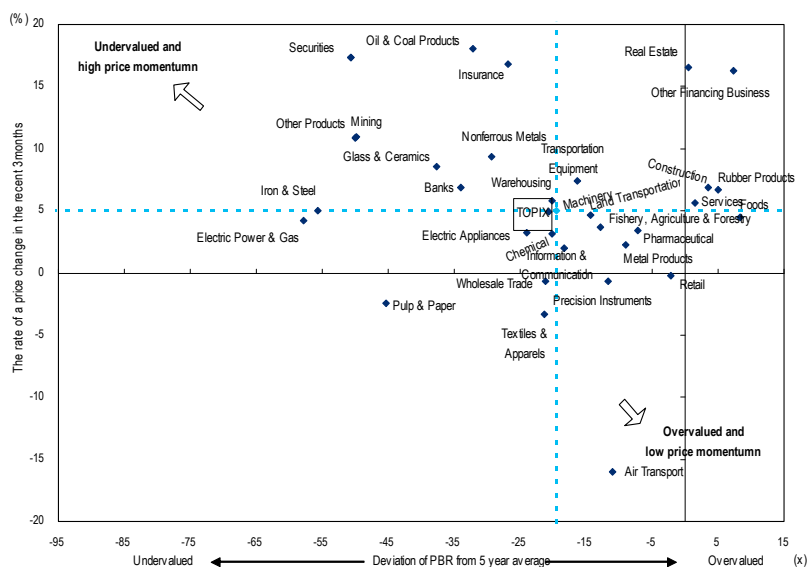
Source: Bloomberg, Citi Research.

## Sector performance

Looking at performance over the last three months, financials—other financials, real estate, insurance, and securities and commodities futures—have been performing well (Figure 20). We discussed the attractiveness of financials in terms of both earnings momentum and valuations in our August 27 memo, [Japan Equity Strategy - The Return of Financials](#), and this appears to have been reflected in share prices. However, banks have been laggards.

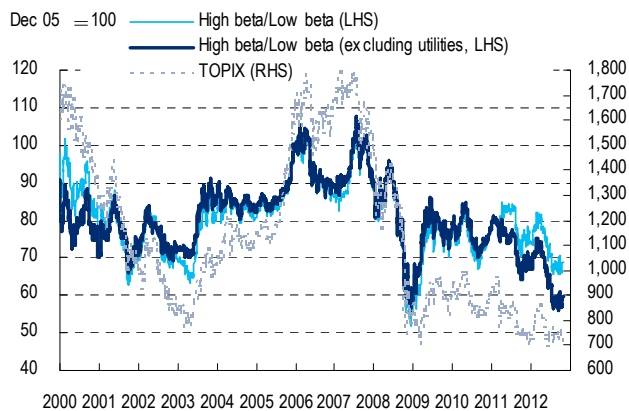
We are also witnessing a pickup in sectors that look very undervalued in terms of their downside rate of deviation from the five-year PBR average. In contrast, the performance of domestic demand and defensive sectors that look relatively expensive in terms of upside rate of deviation from the five-year PBR average are beginning to peak (Figure 22).

Figure 20. Value and momentum by sector



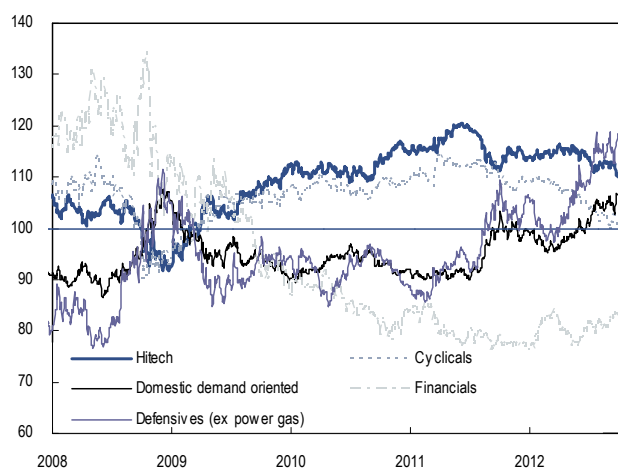
Source: DataStream, Astra Manager, Citi Research.

Figure 21. Relative prices for high-beta and low-beta names



Source: Datastream, Citi Research.

Figure 22. TOPIX-relative prices for five major sectors



Source: Datastream, Citi Research.

## Chapter 3. Factors making for further yen depreciation

### Three reasons for dollar appreciation against the yen in October

The yen-dollar rate was around ¥77.5/\$ at end-September, but in late October it temporarily rose above ¥80/\$. We see three reasons for this: 1) the market bringing forward its forecast of when the FRB will next raise interest rates due to improvement in US economic indicators; 2) mounting expectations for easing by the BoJ in response to economic weakness in Japan; and 3) a deteriorating trade balance in Japan.

**Yen depreciation seems to have stopped for now**

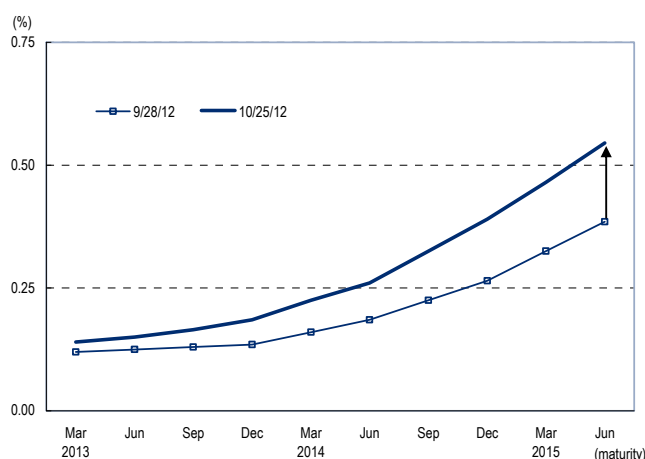
The additional easing measures announced by the BoJ on October 30 were not significantly larger than the market had expected. We believe yen depreciation is likely to pause for now.

#### Market brings forward its forecast for when the FRB will raise rates

The market's expectation for US policy rate movements shifted upward between end-September and late October due to improvement in US housing- and consumer spending-related indicators (Figure 23). The market had expected as of end-September that the initial rate hike by the FRB would come in the second half of 2015, but on October 15 this was brought forward to around May 2015.

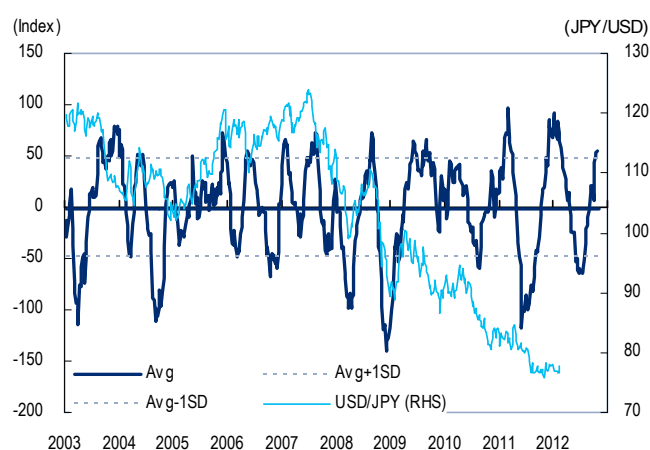
It looks likely that the FRB will maintain ZIRP through mid-2015 at the very least, and the US surprise index appears to be near its ceiling. In our view, it is unlikely that there will be further positive surprises for US economic indicators, which could result in the market further bringing forward its forecast for when the FRB will next hike rates. If this happens, contrary to our expectations, and the yen were to weaken further against the dollar, we think depreciation would be temporary and that the yen would subsequently rebound.

Figure 23. Market's expectation for US policy rate movements



Source: Bloomberg, Citi Research.

Figure 24. US surprise index



Source: Bloomberg, Citi Research.

#### Mounting expectations for further easing by the BoJ

Due to deterioration in Sino-Japanese relations, sales of Japanese products fell off sharply, making a recession for Japan even more certain. This resulted in mounting expectations that the BoJ would implement further easing measures. Media articles

before the BoJ monetary policy meeting put the market consensus for the BoJ's extension of its asset purchasing program at about ¥10trn.

At its monetary policy meeting, the BoJ decided to expand its asset purchasing program by ¥11trn. As this was not well above the market consensus, stocks declined and the yen advanced against both the euro and dollar.

**Figure 25. Details of the asset purchasing fund**

	Oct 2010	Mar 2011	Aug 2011	Oct 2011	Feb 2012	Apr 2012	Jul 2012	Sep 2012	Oct 2012	Recent balance
Total (¥trn)	35	40	50	55	65	70	70	80	91	62.7
Long-term JGBs	1.5	2.0	4.0	9.0	19.0	29.0	29.0	34.0	39.0	19.4
Treasury discount bills	2.0	3.0	4.5	4.5	4.5	4.5	9.5	14.5	19.5	7.7
Commercial paper, etc.	0.5	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.2	1.4
Corporate bonds	0.5	2.0	2.9	2.9	2.9	2.9	2.9	2.9	3.2	2.9
ETFs	0.45	0.9	1.4	1.4	1.4	1.6	1.6	1.6	2.1	1.4
J-REIT	0.05	0.10	0.11	0.11	0.11	0.12	0.12	0.12	0.13	0.10
Fixed-rate funds supply	30.0	30.0	35.0	35.0	35.0	30.0	25.0	25.0	25.0	29.7
Target completion date	End- 2011	End-Jun 2012	End- 2012	End- 2012	End- 2012	End-Jun 2013	End-Jun 2013	End- 2013	End- 2013	

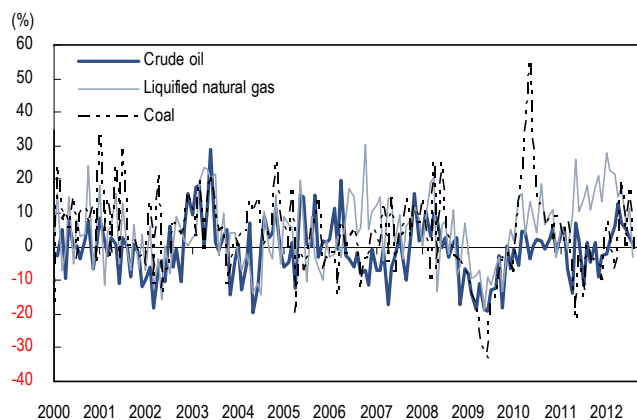
Source: BoJ, Citi Research.

### Deterioration in the trade balance

Japan has increased its LNG imports as most of its nuclear facilities are idled, and this has resulted in deterioration in its trade balance (Figures 26, 27). At the same time, overseas economies have slowed and relations with China have soured, resulting in a decline in exports. We estimate that a ¥1trn increase in the trade deficit would push the yen down by 0.5%-1.3% over the next one to two years.

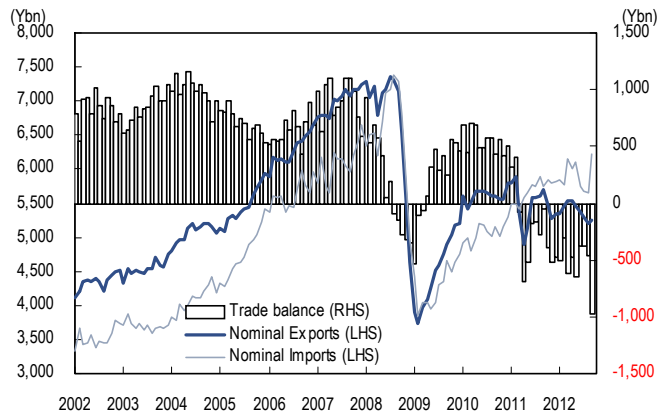
Exports to China in FY3/12 came to ¥12.5trn, and we estimate that a ¥2trn increase in the current account deficit due to lower exports to China would push the yen down by ¥1/\$-¥2.6/\$. In our view, there is room for the yen to fall further against the dollar should the trade deficit increase further due to an even larger decline in exports to China. As such, we think one needs to keep an eye on trade statistics.

Figure 26. YoY change in fuel and raw material imports



Source: MoF, Citi Research.

Figure 27. Japan's trade balance



Source: MoF, Citi Research.

## What could cause the yen to fall further versus the dollar

### Potential changes in monetary policy framework under a new BoJ governor

What could cause the yen to weaken further against the dollar? The first thing that springs to mind is a change in BoJ governor, which is set to happen next spring. We think a change in governor could result in a significant change in the BoJ's monetary policy framework. For example, the inflation target could be lifted to 2% and the Bank could announce an open-ended asset purchase program that continues until this target is achieved. A strong commitment to an inflation target could change inflation expectations among market participants, and this could push the yen down against the dollar.

The new BoJ governor will be chosen by whatever administration is in power at the time, and the appointment must be ratified by the Diet. We intend to keep a close eye on when the Lower House election might be held and what comments PM Noda and LDP head Shinzo Abe make regarding monetary policy.

With its additional easing measures on October 30, the BoJ has said that it is aiming for a 1% YoY increase in the CPI, and that it will work hard to keep the money supply loose until it looks as if this goal can be met via measures like keeping the interest rate at effectively zero and continuing to purchase financial assets. Expectations for easing are likely to mount again prior to monetary policy meetings, which could push the yen down versus the dollar, but we think any depreciation would likely be no larger than what happened this time.

### Deterioration in the trade balance

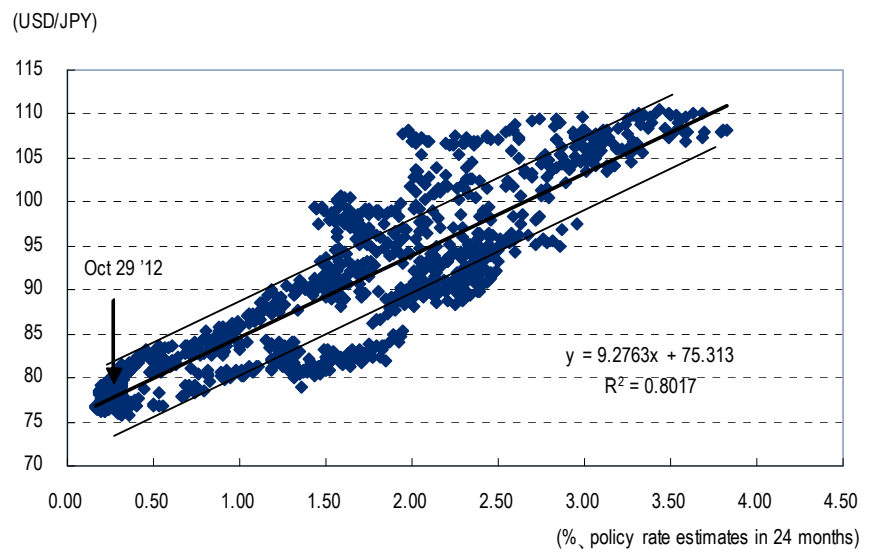
In addition, as discussed above the yen could depreciate versus the dollar due to deterioration in the trade and current account balance. We see room for depreciation as trade statistics make it clear how much exports to China have fallen.

### The market's forecast for the US policy rate 24 months out could rise to factor in an FRB rate hike

The market's forecast for the US policy rate 24 months out is highly correlated with the yen-dollar rate (Figure 28). If the US economy continues to improve and the market's policy rate forecast for 24 months out rises to factor in a rate hike, then the yen could weaken further against the dollar.

However, FRB statements suggest that ZIRP will continue until at least mid-2015, and so we believe the market will not factor the initial FRB rate hike into its forecast for the policy rate 24 months out until mid-2013. As such, yen depreciation driven by US economic recovery and the start of an FRB rate hike cycle is unlikely before this time.

Figure 28. Forecast for policy rate 24 months out and forex rates



Note: Forecast for policy rate 24 months out as per FF rate futures.  
Source: Citi Research.

## Chapter 4: TOPIX outlook

### Outlook for the rest of 2012

In Chapter 2, we note that the environment for share price growth is increasingly in place, but domestic economic momentum is weak and it is likely that it will be 2013 before a bottom can be confirmed for the domestic economy.

In Chapter 3, we noted three reasons for yen depreciation during October: 1) the market bringing forward its forecast for the timing of the next FRB rate hike, 2) expectations for additional easing by the BoJ, and 3) a deteriorating trade deficit in Japan. Aside from further deterioration in the trade balance, we do not believe these factors will continue to weigh on the yen. As such, we believe yen depreciation is likely to pause for now.

**TOPIX likely to remain around 700-800 in 2012**

We believe TOPIX will remain between 700 and 800 in 2012. A real rise for TOPIX is unlikely before 1) a bottom for the domestic economy becomes more clear in 2013 and 2) expectations start to mount regarding the monetary policy framework of the new BoJ governor.

Below we estimate the TOPIX EPS, BPS, and PBR for end-FY3/13 and end-FY3/14.

### Earnings forecasts

Figure 29. Earnings forecast assumptions

	IIP YoY (%)	JPY/USD	JPY/EUR	Corporate Goods Price Index YoY(%)	Price crude imports(JPY/kl)
FY2012	-3.0	80.0	101.0	-0.5	57,231.7
FY2013	1.7	85.0	97.7	-0.4	53,180.8

Source: Citi Research.

While it looks as if Japan has slipped into recession in FY3/13, we think rush demand prior to a hike in the consumption tax will result in recovery in FY3/14. We believe industrial production will decline 3.0% YoY in FY3/13 and rise 1.7% in FY3/14.

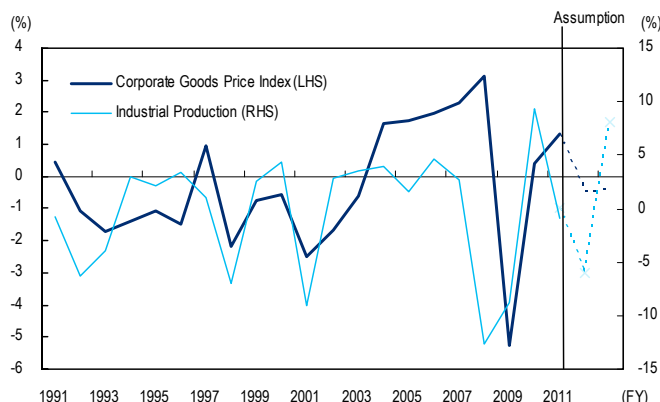
### Yen likely to continue falling versus the dollar if the FRB rate hike cycle begins in mid-2015 or later

We assume a ¥/\$ rate of ¥80/\$ in FY3/13 and ¥85/\$ in FY3/14. In addition, we assume that from the latter half of 2015 the FRB will raise its policy rate once every quarter. The median forecast among FOMC members for the end-2015 policy rate is 1.0%. Assuming the rate is hiked to 0.5% at end-June 2015, we would look for a rate hike of 25bp per quarter.

**¥85/\$-¥90/\$ would not surprise in FY3/14**

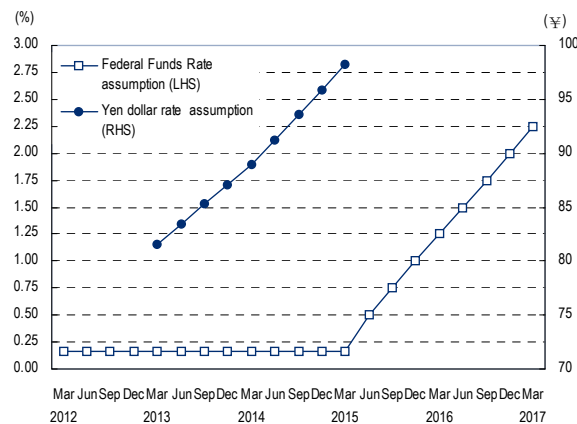
We use the relationship between the market's forecast for the policy rate 24 months on and the yen/dollar rate (as per Figure 28) to estimate the yen/dollar rate, while also adding in yen depreciation on expectations for the monetary policy framework under a new BoJ governor and a deteriorating trade balance (Figure 31). It would not surprise us were the yen to depreciate to ¥85/\$-¥90/\$ in FY3/14 and ¥95/\$-¥100/\$ in FY3/15.

Figure 30. Industrial production and corporate goods price index



Source: Datastream, Citi Research.

Figure 31. US policy rate assumptions and yen/dollar rate assumptions



Source: Bloomberg, Citi Research.

## We look for fall in sales/profits in FY3/13, rise in sales/profits in FY3/14

In FY3/13 we model a 21.0% decline in RP, followed by a 26.4% rise in FY3/14

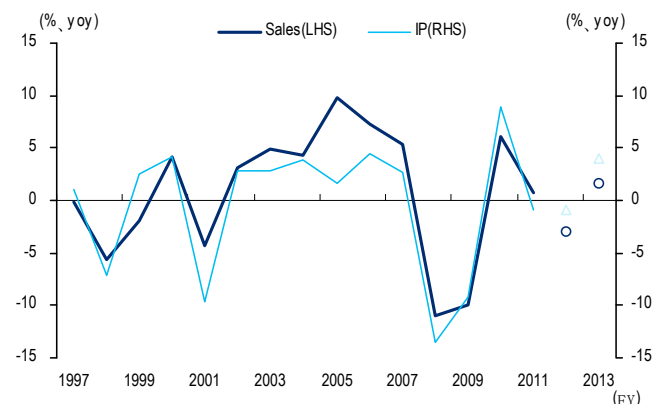
Based on the assumptions in Figure 29 and the past relationship between industrial production, sales, RP, and crude prices, we estimate sales and RP for FY3/13 and FY3/14. For FY3/13 we anticipate a decline in sales and profits, followed by a rise for both in FY3/14. We estimate a 21.0% decline in RP for FY3/13 and then a rise of 26.4% for FY3/14 (Figures 32, 33, 34).

Figure 32. Earnings forecasts for FY3/13 and FY3/14

	Sales (YoY%)	RP (YoY%)	NP (YoY%)
FY11 (A)	0.8	-9.0	-19.0
FY12(E)	-1.0	-21.0	-3.6
FY13(E)	4.1	26.4	26.4

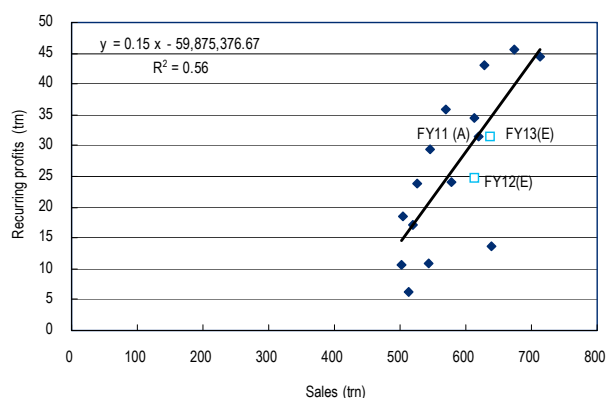
Source: Citi Research.

Figure 33. Industrial production and sales



Source: METI, Astra Manager, Citi Research.

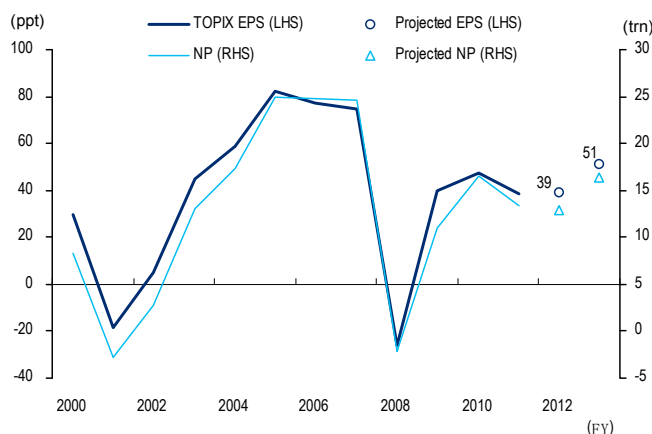
Figure 34. Sales and RP



Source: Astra Manager, Citi Research.

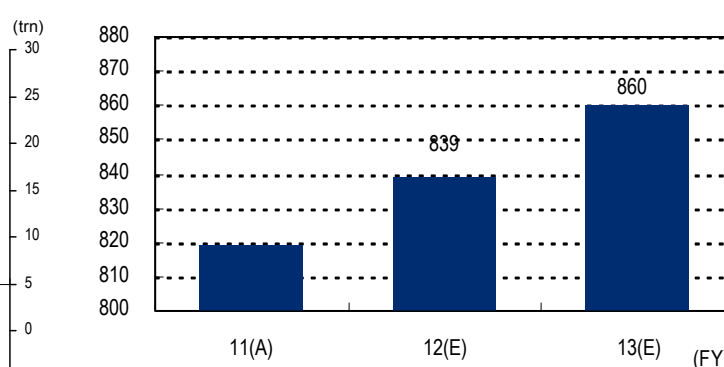
Using the past relationship between NP and TOPIX EPS, we estimate TOPIX EPS at 39 in FY3/13 and 51 in FY3/14 (Figure 35). As holdings by foreign shareholders have increased, dividends paid out by Japanese firms have increased as well. The foreign shareholder ratio has been around 26%-27% since FY3/10, so assuming DPS growth is small, as in FY3/12, we estimate TOPIX BPS at 839 for FY3/13 and 860 for FY3/14 (Figure 36).

Figure 35. TOPIX EPS



Source: Astra Manager, Citi Research.

Figure 36. TOPIX BPS



Source: Bloomberg, Citi Research.

### PBR likely to rise as yen depreciates against the dollar

PBR tends to rise when RoE improves at a given level of PER. Since FY3/10, the relationship between RoE and PBR has not been strong (Figure 37). On the other hand, the relationship between the yen/dollar rate and PBR has been strong (Figure 38).

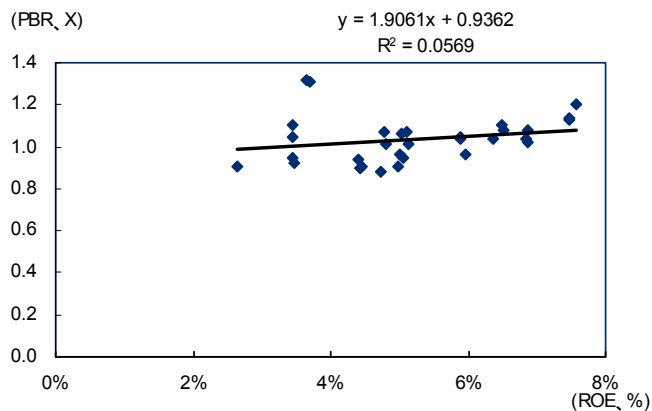
We estimate PBR using the relationship between RoE over the past 12 months and the yen/dollar rate.

$$\text{PBR} = -0.69 + 2.69\text{RoE} + 0.019\text{yen/dollar rate}$$

**We estimate TOPIX at 790-830 at end-FY3/13 and 920-970 at end-FY3/14**

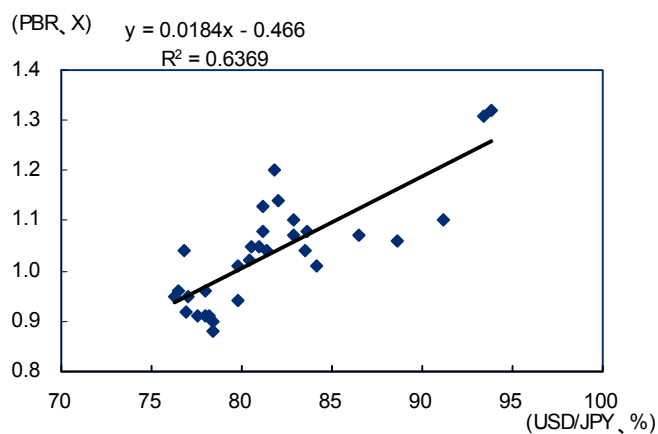
To account for estimation error, we use a PBR lower than that suggested by the past relationship. We estimate TOPIX BPS including changes in valuation due to share price of forex fluctuation at 830 for end-FY3/13 and 880 for end-FY3/14. For TOPIX, we forecast 790-830 at end-FY3/13 and 920-970 at end-FY3/14.

Figure 37. RoE and PBR



Source: Bloomberg, Citi Research.

Figure 38. Yen/dollar rate and PBR



Source: Bloomberg, Citi Research.

Figure 39. FY3/13 TOPIX target

BPS FY12E	830		
PBR	0.95	0.98	1.00
TOPIX	789	813	830

Source: Citi Research.

Figure 40. FY3/14 TOPIX target

BPS FY13E	880		
PBR	1.05	1.08	1.10
TOPIX	924	946	968

Source: Citi Research.

The key to TOPIX recovering above 900 in FY3/14 as per our above scenario is yen/dollar rate movements. The most important factors in this regard are 1) whether the US economy can recover steadily enough for the FRB to continue hiking rates after mid-2015 and 2) whether the new BoJ governor can move the monetary policy framework significantly toward easing.

## Appendix A-1

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