

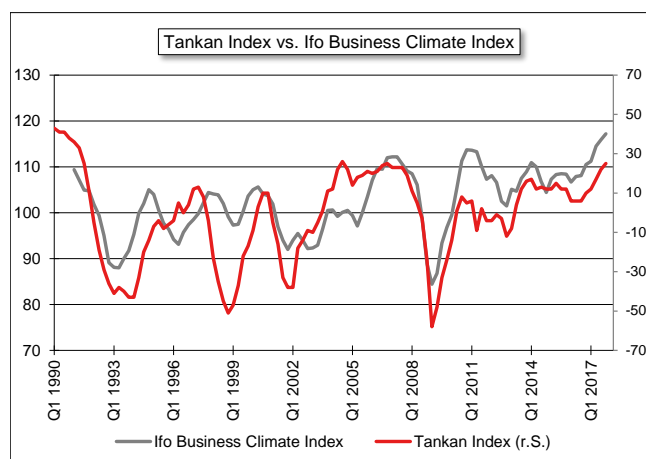
ECONOMIC SITUATION AND STRATEGY

Played out or still lucrative – economy and capital markets in Japan

Practically all available data now point to a continuing globally synchronized upswing. Stable, slightly above-average growth, moderate inflation pressure, cautious normalizing of monetary policy by central banks, and earnings rising faster than stock prices add up to a generally ideal "Goldilocks scenario" and hence a constructive environment for investors. Small differences between individual regions and economic areas become evident on closer inspection. While the United States finds itself at least in a late phase of the upswing despite impetus that may still be expected from the Trump tax reform, the trend in other parts of the world is picking up additional momentum. That includes not only the euro zone and several emerging countries, but also especially Japan.

How's that? Japan? Everyone knows it is an aging and deflation-stricken economy that refuses to implement genuine reforms, hopes to achieve competitive advantages and imported inflation with a cheap currency, and has the highest ratio of government debt to gross domestic product of all industrialized countries. Not interested!

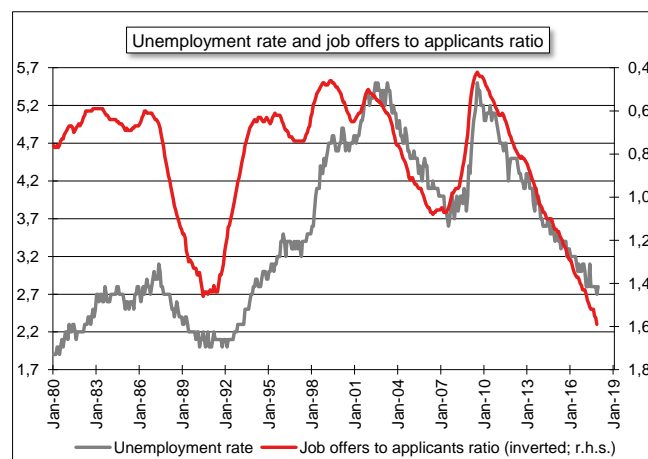
But wait, not so fast. Thanks to high productivity and a whopping labor force participation rate, Japanese growth is comparable to that of other industrialized countries. The Tankan index (similar to Germany's Ifo index) has risen to the highest level since 1991, and stock market valuations remain below historical averages. So, it is probably worth taking a second look.



The Japanese economy has grown the last seven quarters in a row, its most sustained positive trend in the last 20 years. Given the yen's weakness (less against the US dollar than against the euro), exports were the strongest pillar of the economy last year. With a current account surplus of USD 203 billion, Japan was significantly behind world champion Germany (USD 287 billion) but clearly in second place ahead of China (USD 135 billion). Furthermore, despite justified criticism for failing to implement reforms, the current administration can also take credit for a significant increase of industrial production and clear improvement of the competitiveness of Japanese businesses. In

particular, the earnings of export-oriented companies have grown appreciably, and margins have improved.

The economy is doing well and could do even somewhat better if it were not for the limitations of the labor market. Shortages of workers are becoming more conspicuous (recent statistic: 159 job offers for every 100 job seekers) and are to be overcome without significant immigration. Among other things, expansion of care for children and the elderly is supposed to facilitate entry into the labor market for women. The decline of employable persons relative to the total population continues to enlarge and last year amounted to more than 800,000. Macroeconomic impetus from employment is therefore hardly to be expected in Japan. The participation rate is already 78%, a level unparalleled in other industrialized countries. One in five Japanese retirees over the age of 65 and more than 50% of women are now working. The tight labor market is also leading to cautious wage and salary increases, as sought by the central bank and Prime Minister Abe. The foreseeable acceleration of these trends will lead to a gradual rise of prices and cessation of purchasing restraint as well as an improvement of retail sales and capital spending.



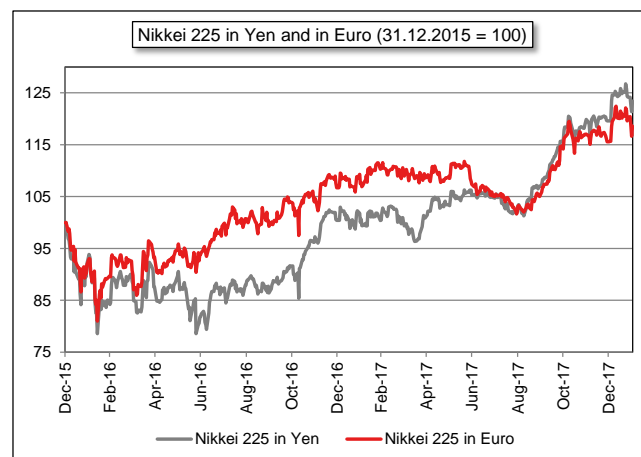
Besides the new directions in macroeconomics and monetary policy, there have been unmistakably positive changes in Japanese corporate governance affecting investors. The discovery of shareholder value as a competitive advantage in seeking favor with investors globally has come late, but not too late. The old conspiratorial approach to investor relations has been replaced with open communication emphasizing dividends and returns. Since 2012, dividend yields have increased by almost 60% on average of the 2,000 stocks in the broad Topix index. In addition, Japan's companies are buying back stock on a large scale. They accumulated huge liquidity reserves in the wake of the last financial crisis. Not taking into account banks and insurance companies, the national finance ministry estimates those at a record EUR 1.5 trillion. That is a great deal of money increasingly being used in ways friendly to shareholders. Profitability has also grown more than proportionately in recent years thanks to numerous rationalization measures. The average return on equity of Japanese companies has risen significantly to over 8%. Despite the stock

market's ascent to the highest level since the early 1990s, valuation is comparatively moderate and below the long-term average at a price-earnings ratio of 14.5 and price-book value ratio of 1.3. Over 50% of Japanese companies are now trading below intrinsic value and have reduced debt by half in the last ten years. The stable upward trend of Japanese stocks has been partly due to large-scale purchases by the Bank of Japan, which also uses quantitative easing to reduce long-term interest rates and supply additional liquidity. But in contrast to Europe and the United States, quantitative easing in Japan involves purchasing not only bonds, but also stocks amounting to almost USD 60 billion. The central bank's balance sheet is nearing 100% of Japan's gross domestic product.

Besides the foregoing, structural factors might also drive stock prices. In view of the described "mixed bag," we should keep an eye on the continuing exposure of large Japanese institutional investors as well as growing interest on the part of previously underexposed international investors. From the beginning of 2016 to last autumn, foreigners were net sellers of Japanese stocks. Now, there are more than a few who dream of reaching the old peaks around 40,000 points on the Nikkei index and are rediscovering the Kabuto-chō (Tokyo stock exchange center), not solely as a possible means of diversification.

It is evident that the government and central bank are now relying additionally on fiscal policy measures due to the diminishing effect of monetary policy tools. Already put off several times before, the second stage of the value-added tax increase has been postponed until 2019. The government is apparently no longer dependent on the tax revenue, and new debt actually brings income now due to negative interest rates. It intends, on the contrary, to invest directly in infrastructure, education, and social service systems by way of supplementary budgets and various special programs. At the same time, monetary policy will remain expansionary longer there than in the United States and Europe, so this is nothing but continued direct financing of the government by the central bank.

On the one hand, Japanese government debt is already twice the amount of gross domestic product and thus higher than in other countries. However, the debt load is comparatively easy to handle in view of continuing low interest rates. More than 95% of government debt is financed by the Japanese themselves, and dependence on foreign sources of money is traditionally very low. Furthermore, businesses and households have huge reserves, and the government has still impressive foreign assets. Half of Japanese companies are virtually debt-free, and cash reserves are above the international average.



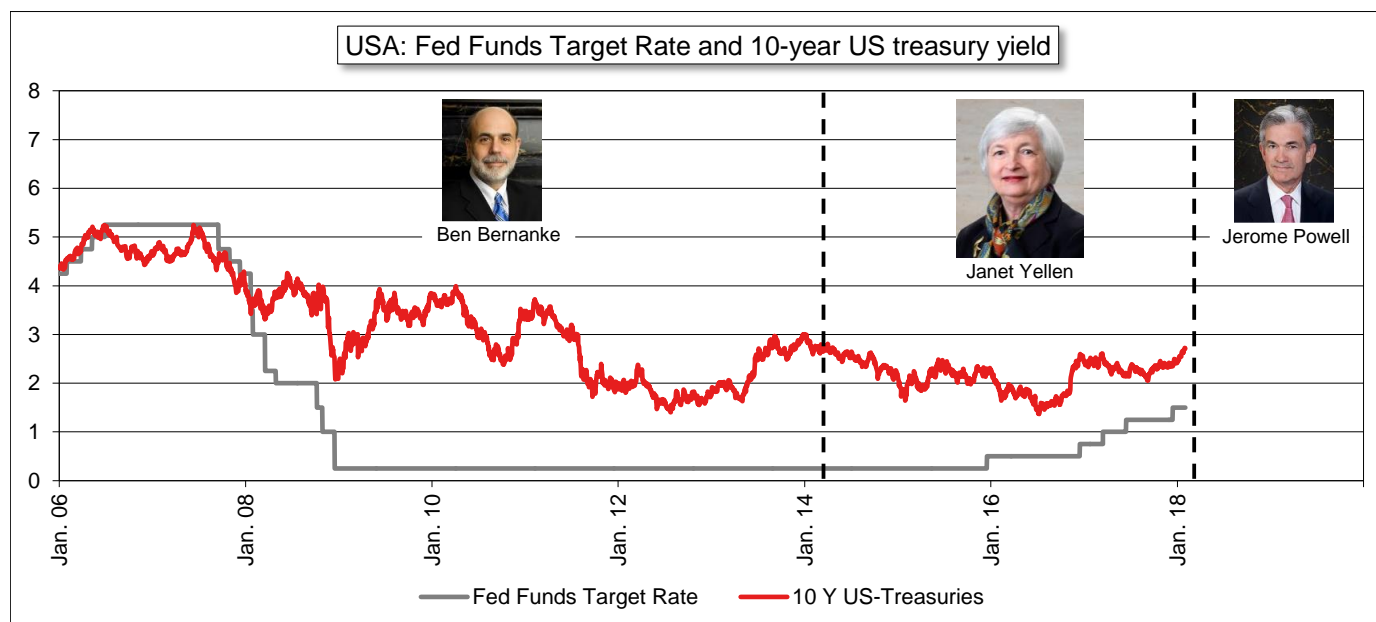
Our justified pessimism regarding the Japanese economy's long-term outlook remains intact given the described mixed bag. The outcome of the economic experiment solely by way of monetary and fiscal policy without opening markets or making genuine, radical reforms is still unclear. However, to a very limited extent, conclusions may be drawn from this regarding trends on the capital market in the Far East. Considered in isolation, rising profits, increasing dividends, and low valuations argue in favor of investing in Japanese stocks both in comparison with their own history and in considering alternative assets. In addition to a rigorous sector selection focusing on export and technology companies and in some cases neglected small and medium-sized market segments (the central bank only purchases in the top segment with high market capitalization), the currency component remains the significant parameter of investment success from a European standpoint. The Japanese yen is now deemed one of the most undervalued currencies in the International Monetary Fund's basket, which could offer additional opportunities by way of currency gains in case of normalization. However, experience of the past 20 years on the Tokyo stock market would urge caution. All too often, good price gains without appropriate hedging have fallen victim to currency losses. Otherwise, it would perhaps be too easy. For, as a Japanese proverb aptly states, "Anyone can easily take the helm in calm weather."

Weekly outlook for February 5-9, 2018

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: PMI, services – final	55.6	54.7	54.3	55.8	57.0		February 5
DE: New orders, m/m	1.3%	0.7%	-0.4%	0.6%			February 6
DE: New orders, y/y	9.8%	7.2%	8.7%	3.1%			February 6
DE: Industrial production, m/m	-1.1%	-1.2%	3.4%	-1.6%			February 7
DE: Industrial production, y/y	4.1%	2.8%	5.7%	5.9%			February 7
DE: Exports, m/m	-0.4%	-0.3%	4.1%	-1.8%			February 8
DE: Exports, y/y	7.6%	6.6%	8.0%	8.0%			February 8
DE: Imports, m/m	-1.1%	1.8%	2.2%	-0.7%			February 8
DE: Imports, y/y	7.4%	8.3%	8.2%	7.0%			February 8
EUR19: PMI, services – final	55.8	55.0	56.2	56.6	57.6		February 5
EUR19: Sentix	28.2	29.7	34.0	31.2	32.9	31.9	February 5
EUR19: Retail sales, m/m	0.8%	-1.1%	1.5%	-1.4%			February 5

MMWB estimates in red

Chart of the Week: Bye-bye, Janet!



The US Federal Reserve pursues three monetary policy goals: high employment, stable prices (2% inflation), and moderate long-term interest rates. As of Fed Chair Janet Yellen's recent departure, those goals, established in the Federal Reserve Act of 1913, have been impressively achieved. Nearly full employment exists, with the unemployment rate at 4.1%, the inflation rate is near 2%, and long-term interest rates are "moderate," with the yield on 10-year US Treasuries at 2.7%. However, not only is the outcome correct, but also the path leading to it. When Yellen took office, the Fed was struggling with the aftermath of the financial crisis. Ben Bernanke, her predecessor, had lowered the key interest rate to zero and expanded the Fed's balance sheet to an unprecedented extent with a quantitative easing program to stimulate economic recovery. It was then Yellen's task to reverse that ultra-expansionary monetary policy without choking off the recovery and triggering panic in the financial markets. The "taper tantrum" of 2013 is still remembered today. Bernanke's an-

nouncement that the Fed intended to reduce its bond purchases sent a shock wave through financial markets worldwide. It also fell to Yellen to avoid such panic with good communication and steady policy. And her skill in that led to success. Smart forward guidance made it possible to raise key interest rates after 2015, in tentative steps at first, and to start reducing the Fed's balance sheet in the second half of 2017. At the same time, important long-term interest rates were kept relatively constant. Stock and bond prices saw no great volatility, and the S&P 500 advanced by over 12% p.a. The "small lady with a large I.Q." (New York Times) has left an impressive legacy. It is now up to Jerome Powell – medium build, with unknown I.Q. – to follow in her footsteps. However, we are hopeful about that. Powell has been a member of the Fed's Board of Governors since 2012 and has consistently supported Yellen. So, big changes in US monetary policy are not to be expected.

	As of	Change versus			
	02.02.2018 11:05	25.01.2018 -1 week	29.12.2017 -1 month	31.10.2017 -3 months	29.12.2017 YTD
Stock markets					
Dow Jones	26187	-0,8%	5,9%	12,0%	5,9%
S&P 500	2822	-0,6%	5,5%	9,6%	5,5%
Nasdaq	7411	0,0%	7,4%	10,2%	7,4%
DAX	12822	-3,6%	-0,7%	-3,1%	-0,7%
MDAX	26170	-2,6%	-0,1%	-1,8%	-0,1%
TecDAX	2614	-0,8%	3,4%	2,7%	3,4%
EuroStoxx 50	3542	-2,4%	1,1%	-3,6%	1,1%
Stoxx 50	3158	-2,7%	-0,6%	-2,1%	-0,6%
SMI (Swiss Market Index)	9231	-2,7%	-1,6%	-0,1%	-1,6%
Nikkei 225	23275	-1,7%	2,2%	5,7%	2,2%
Brasilien BOVESPA	85495	2,2%	11,9%	15,1%	11,9%
Russland RTS	1286	-2,0%	11,4%	15,5%	11,4%
Indien BSE 30	35030	-2,8%	2,9%	5,5%	2,9%
China Shanghai Composite	3463	-2,4%	4,7%	2,1%	4,7%
MSCI Welt (in €)	2213	-1,6%	1,1%	1,3%	1,1%
MSCI Emerging Markets (in €)	1249	-1,8%	3,6%	4,0%	3,6%
Bond markets					
Bund-Future	163,14	309	146	39	146
Bobl-Future	130,42	-48	-119	-136	-119
Schatz-Future	111,84	-5	-13	-42	-13
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,26	-1	-1	0	0
3 Monats \$ Libor	1,78	2	8	40	8
Fed Funds Future, Dec 2017	1,29	-71	-59	-38	-1
10 year US Treasuries	2,80	17	38	42	38
10 year Bunds	0,74	19	31	38	31
10 year JGB	0,09	0	4	2	4
10 year Swiss Government	0,16	16	28	23	28
US Treas 10Y Performance	567,16	-0,8%	-2,5%	-2,5%	-2,5%
Bund 10Y Performance	598,86	-0,8%	-1,9%	-2,4%	-1,9%
REX Performance Index	475,35	-0,7%	-1,1%	-1,8%	-1,1%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,76	5	8	13	8
IBOXX BBB, €	1,28	6	4	17	4
ML US High Yield	6,16	9	1	14	1
JPM EMBI+, Index	832	-0,2%	-0,5%	-0,7%	-0,5%
Convertible Bonds, Exane 25	7399	-0,2%	0,0%	0,4%	0,0%
Commodities					
CRB Spot Index	443,44	0,9%	2,5%	3,7%	2,5%
MG Base Metal Index	364,30	0,0%	1,5%	5,7%	1,5%
Crude oil Brent	69,76	-1,4%	4,7%	14,1%	4,7%
Gold	1345,73	-1,0%	3,2%	6,0%	3,2%
Silver	17,23	-1,9%	1,3%	3,4%	1,3%
Aluminium	2219,00	-0,8%	-1,6%	3,6%	-1,6%
Copper	7078,75	-0,3%	-1,8%	3,8%	-1,8%
Iron ore	71,40	-6,3%	0,2%	18,4%	0,2%
Freight rates Baltic Dry Index	1114	-8,5%	-18,4%	-26,8%	-18,4%
Currencies					
EUR/ USD	1,2483	0,6%	4,1%	7,3%	4,1%
EUR/ GBP	0,8785	0,5%	-1,0%	0,1%	-1,0%
EUR/ JPY	137,11	1,5%	1,6%	3,9%	1,6%
EUR/ CHF	1,1595	-0,7%	-0,9%	-0,2%	-0,9%
USD/ CNY	6,2805	-0,7%	-3,5%	-5,4%	-3,5%
USD/ JPY	109,19	-0,2%	-3,1%	-3,9%	-3,1%
USD/ GBP	0,70	0,7%	-4,8%	-6,5%	-4,8%

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