Economic Research View

Background of Japanese Equity Market Strength and Its Sustainability

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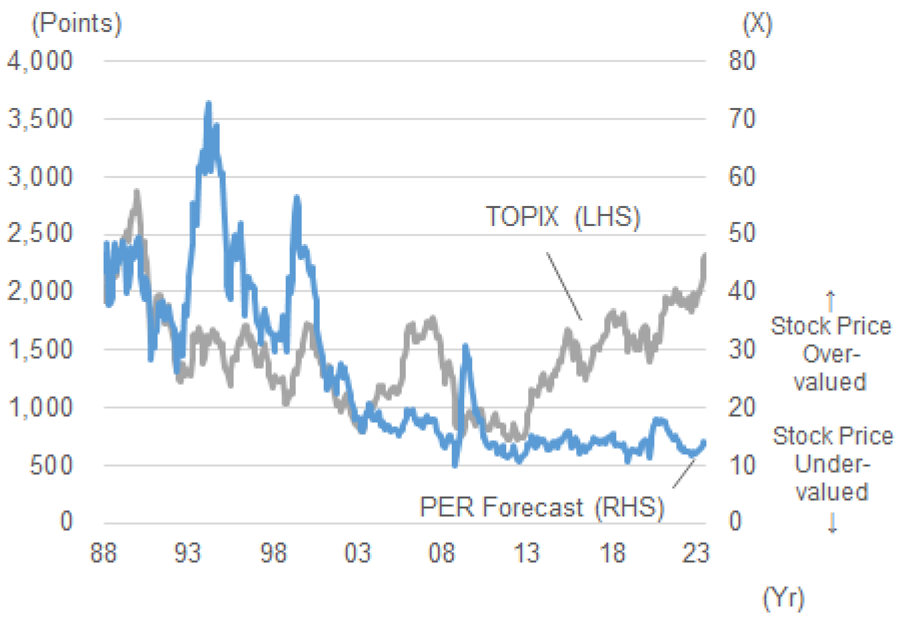
The Japanese equity market has shown significant strength, with TOPIX rising for seven straight months this year. The share price growth rate was the highest among major countries and regions, supported by a wide range of domestic and international factors contributing for the period.

Numerous factors appears to have contributed to the persistence of the rise in stocks in a wide range of industries. While the rise in U.S. stocks seems to have been concentrated in high-tech stocks, Japan's domestic demand-related stocks and undervalued stocks also remained firm.

The rise in share prices so far has been largely driven by expectations for higher wages and governance reforms, such as measures to improve price-to-book ratio (PBR). The sustainability of such policies will be a focus hereafter.

Figure 1. Long-Term Trends in TOPIX and Price/Earnings Ratio (PER)



Note: Nomura Asset Management based on Refinitiv Datastream and Bloomberg data.

Number of upside factors observed in the first half of 2023

- The Japanese stock market has shown significant strength, with TOPIX rising for seven straight months this year. By the end of July, the Nikkei Stock Average and TOPIX had risen more than 20% this year, making it one of the strongest markets in the developed world.
- The background to the market's strength consists of a wide range of factors concentrated during this period. In addition to global factors such as improvement in the global economic and financial environment, there are also several factors specific to Japan (Figure 2).
- A significant part of the global rally is attributed to the calming of global inflation and the consequent expectation of the end of the rate hike phase. In spite of continued policy rate hikes in the U.S., the global stock market has been on the rise since the second half of last year when the pace of the rate hikes slowed.
- One factor that gave Japanese stocks a relative advantage was that Japanese financial institutions were judged to be largely out of the picture when several banks in the United States and elsewhere began failing in March. The downturn in Chinese equities and the acceleration in Japanese equities at the same time suggest that investors have shifted to Japanese equities because of various political and economic risks in China.
- A number of factors specific to Japan contributed particularly to the rise in the period. A wide range of companies increased wages this year, breaking a long-standing trend of near stagnation. Global investors appreciated the positive aspect of boosting the domestic economy rather than the negative aspect of rising labor costs. The Tokyo Stock Exchange's request for companies with a PBR below 1 to improve their market capitalization was also a new initiative, which is expected to have an effect on companies' efforts to raise their market capitalization.

Share prices are likely to show resilience to downward pressure

- Other factors specific to Japanese stocks may also have been effective in sustaining the rise in stock prices. For example, there is not a strong correlation between the easing of coronavirus restrictions and the expectation of increased consumption due to wage increases. In other words, a structure resilient to downward pressure of share prices could have built up, where the effects of one factor would continue even if the effects of the other factors were diluted. Industry and individual stock diversification also have benefited from such effects.
- In fact, the year-to-date gains in Japanese stocks have been more balanced than in the U.S. For this time, the rise in U.S. stocks has been fueled by tech stocks, many of which are growth stocks that significantly gained compared to value stocks. On the other hand, a wide range of Japanese stocks, including value stocks, rose (Figure 3). If Japan had fewer factors leading to higher stock prices and was similar to the U.S. market with a greater focus on tech stocks, the market would have been more sensitive to U.S. market trends. On the other hand, it is fair to say that the rise in share prices of low-PBR, domestic demand-oriented companies was caused amid the simultaneous developments of wage increases and stronger improvement measures against low-PBR companies.
- The outlook for the remaining period of 2023 is also contrasting for Japanese stocks that are balanced relative to U.S. stocks that tend to favor growth. Forecasts for US stocks in 2023 continue to trend downward on expectations that tech earnings will slow. Japanese corporate earnings, on the other hand, have been on an upward revision since late last year, seemingly making up for the slowdown in tech stocks (Figure 4).

Figure 2. Main factors behind the rise in Japanese stocks

Global Factors

Common factors in global stocks

- Slowing global inflation
- Speculation on the halt of U.S. rate hikes
- Avoidance of the U.S. debt ceiling issue
- Rapid evolution of AI
- Demand supported by excess savings

Factors in Japan's relative

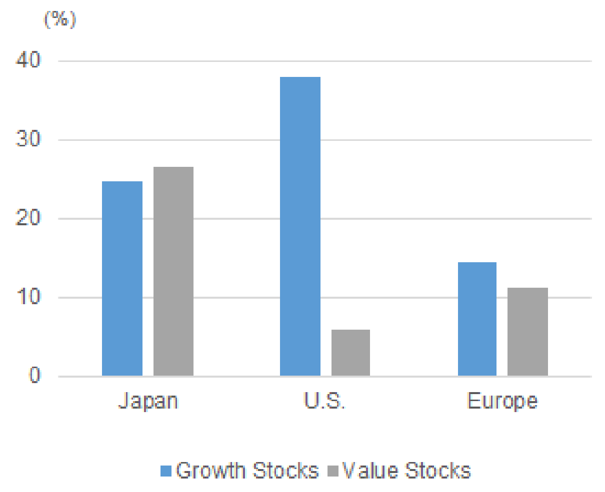
- Credit risk of U.S. and European financial institutions
- China's political and economic risk against the United States and Taiwan

Japan Specific Factors

- Sharp decline in import prices
- Economic reopening
- Easing coronavirus restrictions
- Expectations of increased consumption through wage increases
- Governance reform
- TSE's request for improvement on Low-PBR companies
- Bank of Japan's accommodative policy and the yen's depreciation
- Improvement in corporate earnings forecasts

Source: Nomura Asset Management based on various reports

Figure 3. Year-to-date return of growth and value stocks



Note: MSCI based. As of the end of July 2023 (total return, in local currency.
Source: Nomura Asset Management

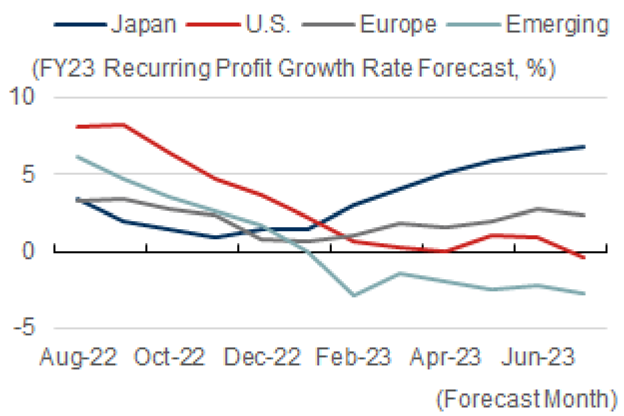
Risks of the Bank of Japan's (BOJ's) monetary policy

- Japanese stocks appear to have room to rise in a wide range of industries and individual stocks, but BOJ's monetary policy will remain a risk for the foreseeable future.
- At the BOJ Monetary Policy Meeting in July, three months after the launch of the new Governor Ueda's regime, the central bank decided to increase the maximum yield on 10-year government bonds from 0.5% to 1.0% allowing greater flexibly to its yield curve control (YCC) policy. In response to the policy decision that allowed a de facto move towards tightening, the stock market fell sharply. Japan's inflation rate has remained at the highest level in recent years, with the year-on-year rate of increase in the consumer price index (CPI) exceeding that of the U.S. in June. This sustained high inflation is expected to allow policy adjustments to continue.
- In the medium- to long-term, however, these negative impacts are not expected to be significant. Although the stock market has been rising at a high rate, the P/E ratio has never been high. A low P/E ratio indicates firm performance relative to the stock price level. In the current market environment, it can easily be compared to the bubble period in 1989, but there is an obvious difference in the soundness of share prices between then and now (Figure 1). Moreover, even if monetary policy changes to tightening, should corporate earnings maintain their strength, a market adjustment could only be temporary.

Continuity of various policies is called into question

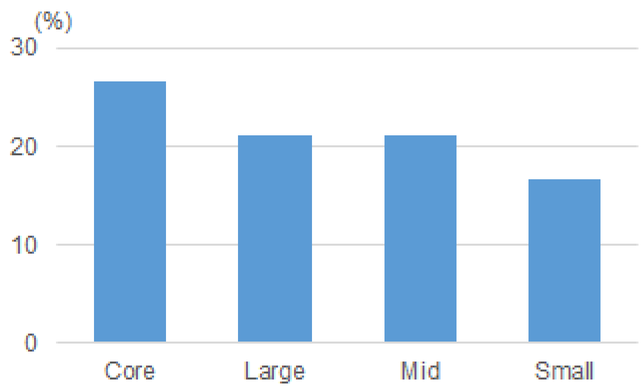
- Whether Japanese stocks can remain strong in the future would largely depend on whether or not Japanese companies would be able to take measures to raise wages and improve PBR over the long-term, instead of merely temporarily.
- This year's wage increase appears to have largely reflected the government's intention. For companies, on the other hand, wage increases are increases in labor costs, meaning that profits will decline unless corporate profits theoretically increase more than the rise in labor costs. Some companies may have been burdened by the increase in such costs. It will be a major focus in the future whether a wide range of companies will be able to continue to increase wages in such environment.
- With regard to measures to improve low-PBR, in the U.S., capital policies are widely implemented not only to increase the stock price (or market capitalization), which is the numerator of PBR, but also to decrease the net worth (or net asset) per share in the denominator. These include dividends and share buybacks, but it will be necessary to see whether such policies will take root in Japanese companies.
- In addition, large companies seem to have more capacity to adopt these new measures. Investors seem to be aware of this, and the rise of small-cap stocks has been less than that of large-cap stocks (see Figure 5). One of the points to be noted in the future is whether there will be a polarization in the remaining corporate capacity to effectively adapt to the measures taken.

Figure 4. FY 2023 month end earnings forecast



Note: MSCI based. The year-on-year profit growth is the fiscal year ending March 2024 in Japan and the fiscal year ending December 2023 in the others. Forecasts are based on I/B/E/S.
Source: Nomura Asset Management based on Refinitiv Datastream data.

Figure 5. Year-to-date growth rate of TSE stock indexes



Note: The TSE stock indexes are classified into core (30 stocks), large (70 stocks), medium (400 stocks), and small (other than those on the left) based on market capitalization.
Source: Nomura Asset Management

*This commentary is based on personal views of the author and does not necessarily represent Nomura Asset Management house view.