Economic Research View

Japanese Equity Market Trends and Outlook

Nomura Asset Management Co., Ltd. Published December 7, 2023

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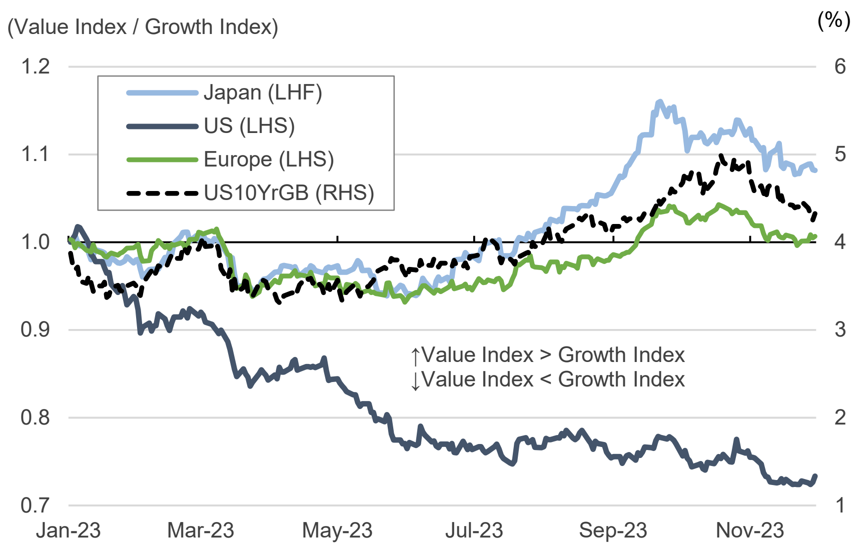
One factor that has contributed to the sustained growth of Japanese stocks since the beginning of the year is the stable performance of value stocks (undervalued stocks). Japanese value stocks, in particular, have shown a high correlation with long-term US interest rates and have greatly benefited from the current interest rate environment.

In contrast to Japanese stocks, US value stocks have not received much positive impact from long-term US interest rates. This is believed to be due to a few large-cap technology stocks driving up growth stocks.

Considering the macroeconomic environment, there is a high possibility that long-term US interest rates will continue to decline. On the other hand, Japanese value stocks could be supported by policy measures and positive corporate earnings, suggesting potential for growth in the future.

Figure 1. Value Stock Effects and U.S. Long-term Interest Rates by Region



Note: Value Index/Growth Index in each region. End of 2022 = 1.
Source: Nomura Asset Management based on Bloomberg data.

Value market in line with US long-term interest rates

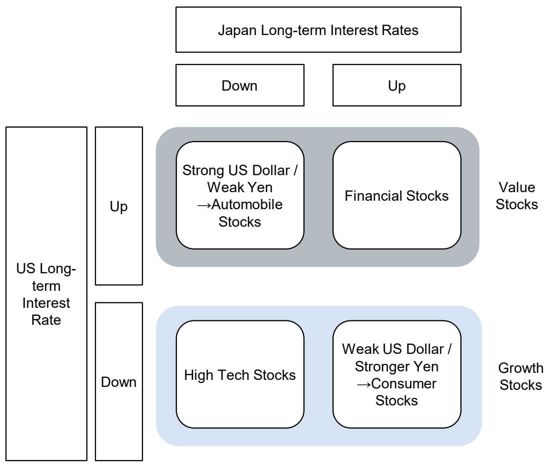
- One of the reasons why Japanese stocks have maintained their strong performance since the beginning of the year is the stable trajectory of value stocks (undervalued stocks).
- The perspective focusing on value and growth stocks has become highly important in this year's stock market. This is influenced by the increased volatility in interest rates among major countries. Among them, Japanese stocks show a tendency to be more susceptible to the impact of fluctuations in long-term US interest rates when compared to global stocks. When long-term US interest rates rise, value stocks tend to perform relatively well, while growth stocks tend to perform relatively well when rates decline. Despite being tied to US interest rates, this correlation is stronger in the Japanese stock market than in the US stock market (Figure 1).
- This year, US long-term interest rates have generally been on an upward trend, and Japanese value stocks have greatly benefited from this trend. As of the end of November, the year-to-date MSCI indices for Japan and the MSCI World Index were +29% and +18%, respectively, while the respective value stock indices were +34% and +6%. Against this backdrop, the sustainability of the value investing trend in the Japanese stock market in the future is likely to be strongly influenced by the interest rate environment in the US.

Why US interest rate trends matter

- US long-term interest rates have started to decline since around October, driven by expectations of a weakening employment environment and a subsequent slowdown in inflation rates. Almost simultaneously, Japanese value stocks have also hit an apparent ceiling in terms of share price, following this movement.
- The strong connection between Japanese value stocks and the interest rate environment in the US can be attributed to the sector composition of value stocks (Figure 2). Japanese value stocks have a higher representation of sectors such as financials and automobile, both of which are directly or indirectly influenced by US interest rates.
- Financial stocks are a sector directly impacted. The increase in long-term interest rates generates a spread between lending and deposit rates, which leads to significant benefits in terms of performance improvement. Therefore, financial stocks are likely to be positively affected not only by the long-term interest rates in the US but also by the rise in long-term interest rates in Japan. On the other hand, automobile stocks are a sector indirectly affected. In recent years, the yen exchange rate against the US dollar has shown a trend that directly reflects the difference in long-term interest rates between the US and Japan (Figure 3). In other words, when the difference in long-term interest rates between the US and Japan increases, it leads to a stronger US dollar and a weaker yen, which especially benefits automotive stocks with significant earnings improvement effects. From these points, while the sectors that become advantageous depending on the trend of long-term interest rates in Japan may differ, in terms of value stocks versus growth stocks, value stocks are more likely to become favorable in situations where US long-term interest rates rise.
- On the other hand, many sectors in Japan's growth stocks tend to benefit from declines in long-term interest rates in the US. Technology stocks, which are representative of growth stocks, generally show weakness when long-term interest rates rise both domestically and internationally. This is because the long-term growth expectations embedded in stock prices are larger compared to other sectors, and during periods of interest rate increases, those expectations are more likely to be reduced. In fact, this year's stock market has witnessed multiple instances of technology stocks declining during periods of rising long-term interest rates in both the US and Japan. Additionally, it is important to note that growth stocks include not only technology stocks but also domestic demand-oriented and defensive stocks

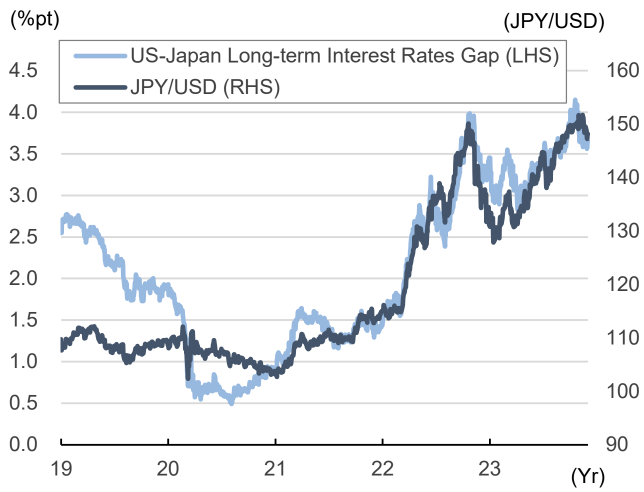
such as consumer-related stocks. When the interest rate disparity between the US and Japan narrows, leading to a stronger yen, economically sensitive stocks may falter while domestic demand-oriented and defensive stocks tend to show relatively stronger performance. Therefore, growth stocks have a biased composition towards sectors that tend to be relatively advantageous during periods of declining long-term interest rates in the US.

Figure 2. Relationship between Interest Rates in the US and Japan and Favorable Sectors



Note: A combination of the direction of long-term interest rates in the US and Japan, which indicate sectors that have favorable tendencies.
Source: Nomura Asset Management based on historical analysis.

Figure 3. US-Japan Long-term Interest Rate Differentials and Yen Exchange Rate against US Dollar



Note: US-Japan long-term interest rate differentials is based on 10 year government bonds. As of the end of November 2023.
Source: Nomura Asset Management based on Bloomberg.

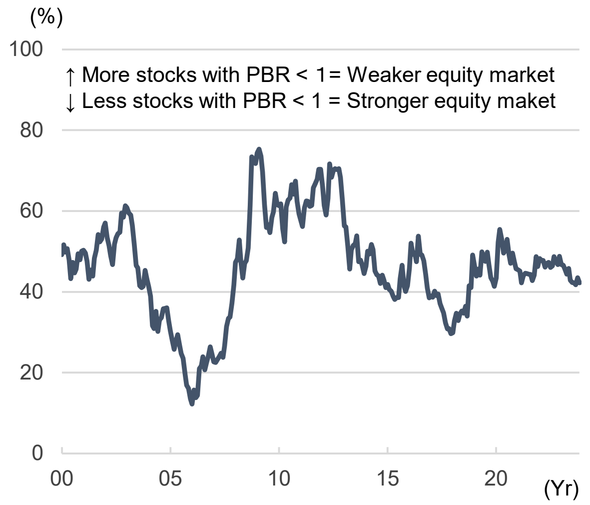
Large caps are less relevant in the US

- The lesser degree of correlation between interest rates and US value/growth stock trends compared to the Japanese stock market can be attributed to the strong resilience of some growth stocks to interest rate increases. In the case of US stocks, the rise has been led by a few large-cap technology stocks since the beginning of the year, the majority of which belong to the growth stock category. These stocks have maintained strong performance even in an unfavorable interest rate environment, resulting in the sustained dominance of growth stocks. On the other hand, if we look beyond these large-cap stocks, we find that mid-cap and small-cap value/growth stocks have shown a certain degree of correlation with long-term interest rates.
- Therefore, even in the US stock market, we expect mid-cap and small-cap growth stocks to benefit from declining long-term interest rates, similar to the Japanese stock market. On the other hand, we expect large-cap stocks to be influenced primarily by their specific environment, and thus the correlation with long-term interest rates will be less significant for the overall US stock market moving forward.

Remaining upside potential for value stocks in Japan

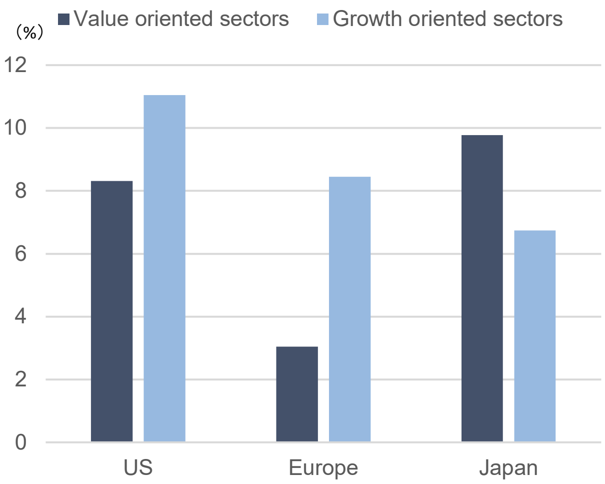
- While the current Japanese stock market environment is becoming increasingly favorable for growth stocks, there is still potential for value stocks to remain resilient. One key factor supporting this is the expectation that efforts to improve companies with a price-to-book ratio (PBR) below 1, known as PBR reform, will continue in the future. PBR reform, which started this fiscal year, has provided tailwinds for value stocks alongside the favorable interest rate environment. However, while many companies have made progress in improving their PBR, there are still many with PBR below 1. The TOPIX index has experienced a 25% increase and eight consecutive months of growth since the beginning of the year, but the proportion of stocks with PBR below 1 has not significantly improved, decreasing from 49% to 42% during that period (Figure 4). This suggests that many companies in question will continue their efforts to improve PBR in the future.
- The second point supporting the possibility of a continued value market in Japanese stocks is the solid earnings outlook for value sectors. Growth sectors in US and European stocks, even when considering that classification is based on price levels, tend to have higher expected earnings growth rates compared to value sectors (Figure 5). This indicates that stock prices are generally supported by fundamentals. On the other hand, the relationship of "growth sectors = good earnings" is not commonly observed in Japanese stocks. From the perspective of value sectors, there are some companies within the same group that are expected to deliver strong earnings, which suggests that there is still ample upside potential for value stocks in the future.
- Furthermore, there is a possibility that long-term interest rates in the US may not decline as much as expected. Since the beginning of the year, the economic growth outlook in the US has been revised upward multiple times due to positive economic indicators. As a result, long-term interest rates have remained at high levels. If the macroeconomic environment in the US continues to stabilize, it could become more challenging for long-term interest rates to decrease, potentially prolonging the value market trend.

Figure 4. Proportion of Companies with a PBR Below 1



Note: The data is calculated based on TOPIX constituent stocks until March 2022, and from April 2022 onwards, it is based on the stocks listed on the Tokyo Stock Exchange Prime Market. As of the end of November 2023.
Source: Nomura Asset Management based on proprietary database. .

Figure 5. Year-to-date growth rate of TSE Stock Indexes



Note: The data is based on MSCI's forecasted price-to-earnings ratio (PER) by industry in the aforementioned regions. It categorizes sectors as value or growth based on whether they are trading at a discount or premium to the market average. The data is then aggregated based on the median of the 12-month forward earnings growth rate. All calculations are based on values as of the end of October 2023. .
Source: Nomura Asset Management based on FactSet.

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

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