

CIO's View on Japan Equity Market

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Since entering August, the Japanese equity market has experienced wild fluctuations, with TOPIX plunging 20% during the first three business days and rebounding 12% in the following two. Whereas TOPIX's valuation as of the end of July stood at PER 16x, it dipped to PER 12x over the three days. The market appears to have shifted its main scenario for the US economy from a soft landing (mild recession) to a hard landing (rapid recession), abandoned expectations for upward revisions to Japanese corporate performance due to appreciating yen, and quickly turned from optimism to pessimism. However, the index has recovered approx. half of its decline, with PER recovering to 14x, and returned to the average post-Abenomics level. The market's sharp decline was likely driven by supply and demand factors, while concerns outran any evidence to justify the pessimism.

There is no denying the conspicuous market volatility seen in Japan. During this same period, the US (S&P 500) and German (DAX) markets saw a decline of 6% before a 2-3% rebound. We believe the discrepancy with Japan can be attributed to the Bank of Japan's monetary policy and the foreign exchange market. While the yen's depreciation fuels expectations of upward revisions of Japanese corporate performance, after a certain point it drives concerns of rising costs due to increased import prices, leading to a negative impact from inflation. Furthermore, an overly depreciated yen cuts into the local currency gains of foreign investors. On the other hand, while the yen's appreciation negatively impacts corporate profits, it does have a dampening effect on the aforementioned inflation. In particular, at present, a recovery of private consumption is necessary for the normalization of monetary policy, and thus there is increased need for a correction to the weak yen. The market fluctuations have also been influenced by the focus on accelerated interest rate hikes since BOJ's announcement at the end of July, which in turn has accelerated the pace of the yen's appreciation as investors close their yen carry trade positions. Additionally, the strengthening yen has lowered incentives for earlier and larger rate hikes.

We believe that the facts of the past week, including US and other economic factors and yen exchange factors, have been priced into the market. Therefore, the focus moving forward will be on the direction of the fundamentals. Determining this direction will require a certain amount of time, during which further volatility is unavoidable. The Japanese market is seeing gradual improvement in the corporate governance of listed companies thanks to TSE-led reforms (promoting management that is conscious of the cost of capital

and share prices). Though PBR dropped to a low point of 1.1x on August 5, the average market ROE is improving toward 10%, and there is low risk of further PBR decline given growing efforts to improve shareholder returns, including a significant jump in stock buybacks since last year. We believe the recent dip was the floor for the near future. Share prices are likely to stabilize around the current level for the time being, offering a chance to calmly and objectively evaluate the fundamentals and price levels of individual companies and seize any investment opportunities.

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

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