Registration No.: Director of Kanto Local Finance Bureau (Financial Instruments Firms) No.324
Commodity Trading Advisor License #(1) No.24, the Minister of Agriculture, Forestry and Fishery & the Minister of Economy, Trade and Industry
Member of Japan Investment Advisers Association
Member of The Investment Trusts Association, Japan

Awaiting performance improvement in the stock market

28 July 2023

- While Japanese stocks, which have been rising under the influence of overseas investors, experienced a decline in July, U.S. stocks have continued to rise, driven by expectations of a soft landing in the economy.
- The Japanese stock market is believed to have reached a turning point due to a slowdown in overseas investor buying and a shift in the dollar yen exchange rate towards yen appreciation. On the other hand, U.S. stocks were supported by increasing positive economic indicators and expectations of improved corporate earnings, amid stabilisation in inflation and interest rate expectations.
- Both the Japanese and U.S. stock market's previous upward movements can be explained by an expansion in forward price-to-earnings. Further rises are dependent on continued improvement in corporate earnings and a sustained accommodative financial environment.

Takeru Ogihara
Chief Strategist

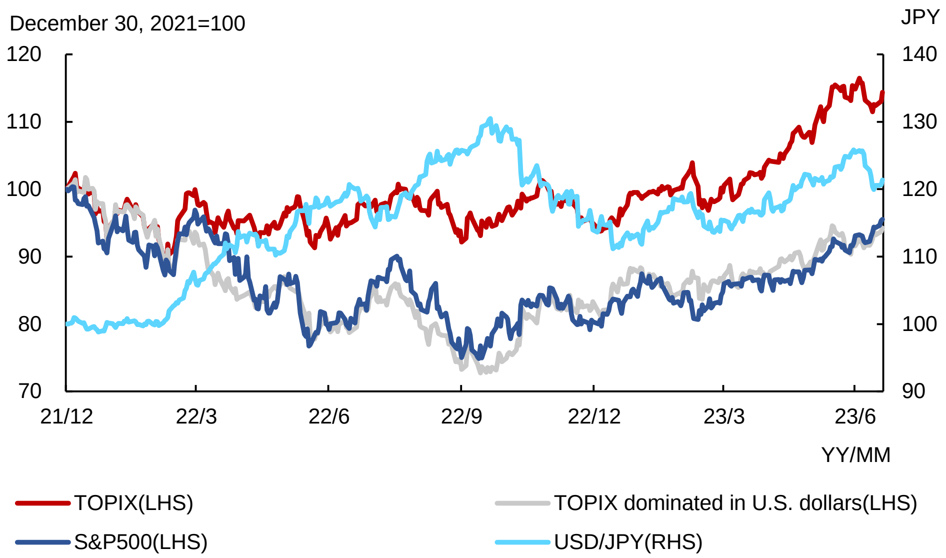
"Japan's stock markets is prone to exchange rates while U.S. market continues to rise"

Looking back at the stock price movements from early 2022 until October 2022, the period when U.S. stocks experienced a correction, Japanese stocks performed relatively better. However, since then there has been an upward trend in both Japan and U.S. stock prices. Additionally, during this period, the USD denominated TOPIX closely followed the movements of the S&P 500, suggesting a high correlation of stock prices in both markets.

In 2023, the shift in the dollar yen exchange rate towards yen depreciation strengthened the correlation between the Japanese stock market and the exchange rate. In July, Japanese stocks entered a correction period off the back of the yen's appreciation while U.S. stocks began to chase the upside due to expectations of a soft landing in the economy (Figure 1).

The market currently reflects a high correlation between a weak yen (versus a strong dollar), rising Japanese stock prices, and increasing U.S. 2-year bond yields. As of 18 July 2023, the correlation coefficients of the past 90 days displayed 0.95 for the dollar yen exchange rate versus TOPIX and 0.92 for the exchange rate versus U.S. 2-year bond yields.

Figure 1: US & Japanese Equity Market Performance and USD/JPY



Source: Bloomberg
Note: Daily data from 30 December 2021 to 19 July 2023

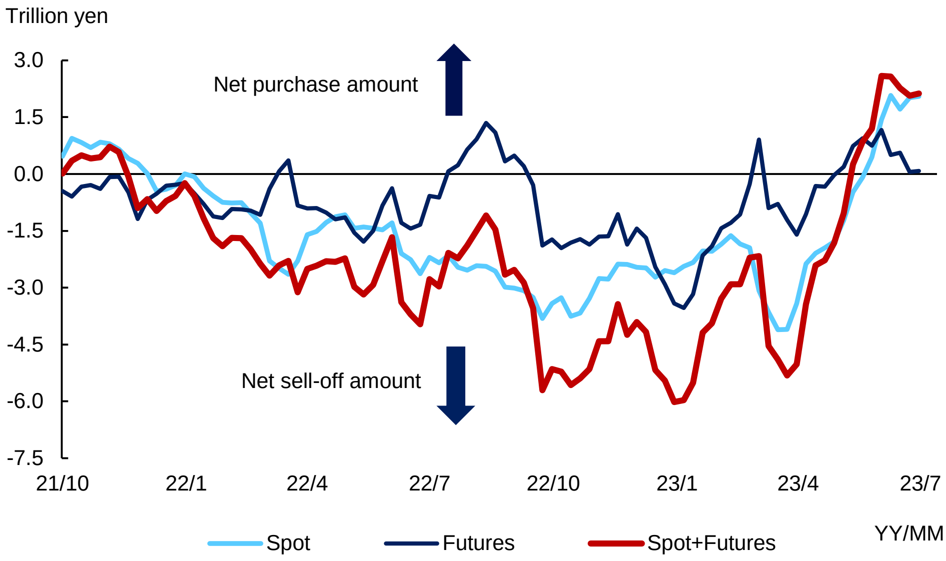
The interest in Japanese stocks grew as foreign investors anticipated improved capital efficiency in Japanese companies, which became the driving force behind the rise in Japanese stocks. From the first week of April to the first week of June, overseas investors purchased around 7.9 trillion yen worth of Japanese stocks, including both cash equities and futures, for ten consecutive weeks (Figure 2).

While purchases have slowed down since then, with some weeks showing more selling in futures markets, cash equity buying remains on an upward trajectory.

Expectations for Japanese companies are bolstered by improvements in capital efficiency, especially for companies with a price-to-book ratio (PBR) below 1, following the Tokyo Stock Exchange’s request to address the issue. However, achieving improved capital efficiency is a long-term theme, and it is crucial for companies to present effective plans and execute them consistently. Several companies have already shown intentions to formulate plans for improvement and have provided concrete strategies. These factors have contributed to the rise in Japanese stock prices, specifically between the period from October 2021 until the first week of July 2023.

“Although overseas investors’ buying of Japanese stocks have eased off, their interest in Japanese stocks is likely to persist. ”

Figure 2: Cumulative Trading by Foreign Investors under the Kishida Administration



Source: Bloomberg and Japan Exchange Group
Note: 1. Weekly data from the week of 4-8 October 2021 to the week of 3-7 July 2023
2. Futures are the sum of Nikkei 225 Futures, Nikkei 225 mini, TOPIX Futures, mini TOPIX Futures, JPX400 Futures, and Mothers Index Futures

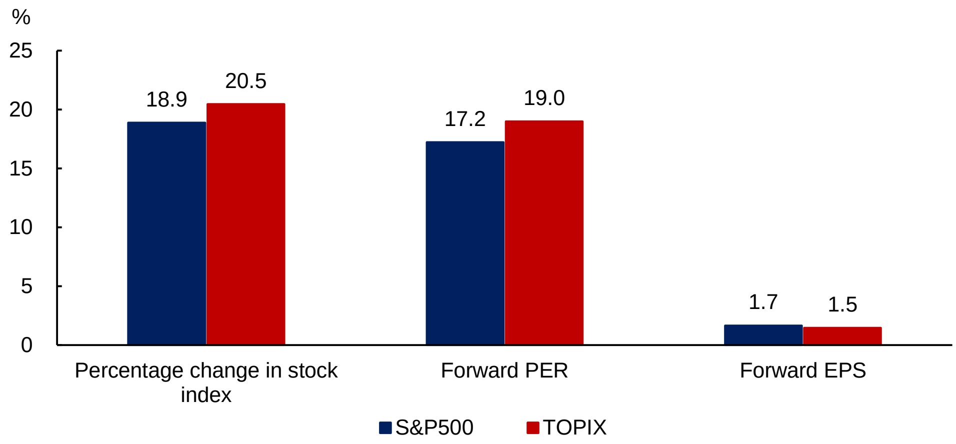
The percentage change in stock price for Japan and the U.S. in 2023 were almost at the same level as of July 19. Breaking down the percentage change in stock price into price-to-earnings ratio (forward PER) and profit (forward EPS), stock prices in both Japan and the U.S. are rising as the forward PER expands (Figure 3).

The expansion of the forward PER is likely due to the easing of financial conditions. In the U.S., with consumer prices peaking, the end of interest rate hikes is expected, and there is optimism about future rate cuts. In Japan, the Bank of Japan is seen to be maintaining long-term financial easing. As a result, interest rates have fallen from their peaks in both countries and trading sideways thereafter.

However, since stock prices have risen by about 20% from the beginning of the year, and forward PERs have expanded, the undervaluation has diminished. A further rise in stock prices would require an expansion of corporate earnings.

"The recent rise in Japanese and U.S. stock prices can largely be attributed to an expansion of forward PER. "

Figure 3: Factor Breakdown of US & Japanese Percentage Change in Stock Price



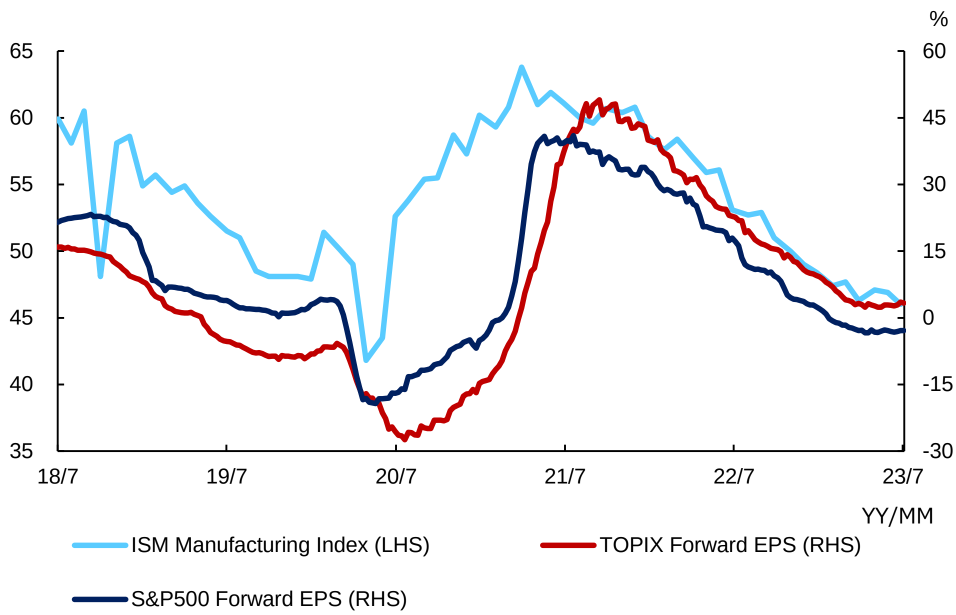
Source: Refinitiv
Note: 1. Comparison as 30 December 2022 and 19 July 2023
2. Forward EPS : Forward EPS for the next 12 months
Forward PER : Forward PER for the next 12 months
Stock Index=Forward EPS*Forward PER

When comparing the forward earnings-per-share (EPS) for Japan and the U.S. year-on-year, there were significant fluctuations during the Covid-19 pandemic. After that, they continued to decline along with the drop in the U.S. ISM manufacturing PMI, which is a measure of the business sentiment in the U.S. manufacturing industry (Figure4).

Recently, they have been mostly flat, staying around the same level as a year ago. There is no clear direction for earnings revisions in both the S&P 500 and TOPIX according to Refinitiv's 4-week average data as of 19 July, 2023. This indicates that the outlook for corporate earnings in Japan and the U.S. lacks direction.

"The outlook of corporate earnings is currently uncertain. "

Figure 4: US & Japanese Forward EPS and ISM Manufacturing Index



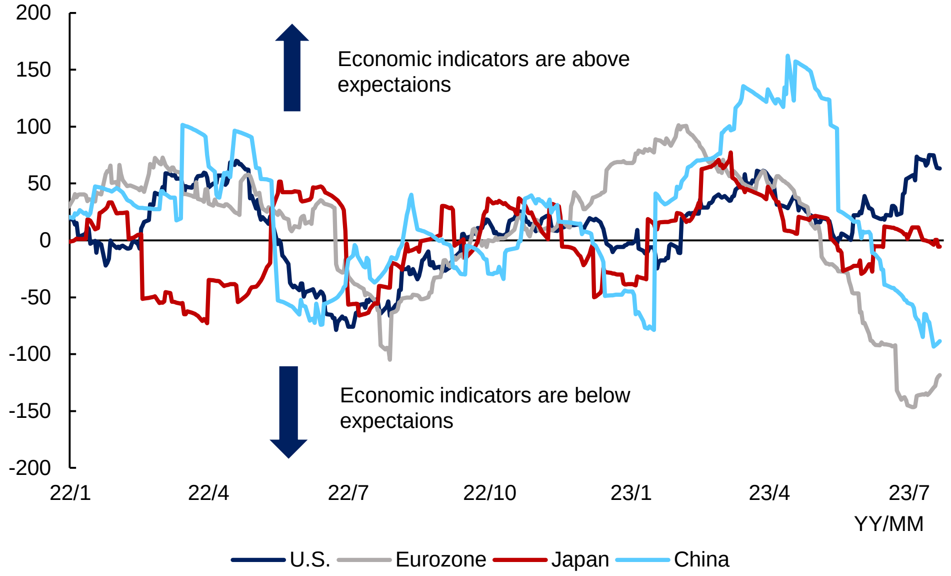
Source: Refinitiv
Note: 1. Forward EPS : Weekly data from 17 July 2018 to 19 July 2023
ISM Manufacturing Index : Monthly data from June 2018 to June 2023
2. Forward EPS is the one compared to last year

Economic Surprise Index (ESI) have different directions in the major four regions (figure5).

In the U.S., recently published economic indicators have mostly exceeded expectations, leading to an increase in ESI, which reflects expectations of a soft landing in the economy. Japan's ESI remains close to zero, indicating a lack of strong economic momentum. Nevertheless, the real GDP growth rate for the first quarter of 2023 was revised upward to 2.7% (quarter-on-quarter annualised). On the other hand, China's economy is continuing to decline which is reflected in the downward trend in its ESI, indicating a slowdown that will likely have negative effects on the global economy and corporate earnings. In Europe, the real GDP growth rate has been near zero for two consecutive quarters since the last quarter of 2022. From the perspective of corporate earnings, expectations of a soft landing are high for the U.S., while Japan is experiencing an economic normalisation. This will likely lead to increased expectations for improvement in corporate earnings. Observing the predictions made by the companies will be crucial, as upward revisions in earnings are likely to increase. Additionally, the central banks' monetary policy decisions in major countries, which will take place in late July, are essential to watch as rising interest rates and the maintenance of an accommodative financial environment are vital conditions for the rise in stock prices.

"The momentum of the economy is expanding the regional disparities.
In the U.S., expectations of a soft landing are high "

Figure 5: Economic Surprise Index



Source: Refinitiv
Note: Daily data from 1 January 2022 to 19 July 2023

Disclosures

Indices are used solely for comparison purposes. There are limitations in using indices for comparison purposes because, among other reasons, such indices may have different volatility, diversification, and other material characteristics (such as number or type of instrument or security). Indices are unmanaged and you cannot invest directly in an index.

TOPIX:
Tokyo Stock Price Index (TOPIX) Index Value and the Index Marks are subject to the proprietary rights owned by the JPX Market Innovation & Research, Inc. and/or its affiliates (hereinafter the "JPX") and the JPX owns all rights and know-how relating to the index such as calculation, publication and use of the Index Value and relating to the Index Marks. The JPX shall accept no liability or responsibility for any loss or damage arising from errors, delays, or termination of the calculation or publication of the Index Value. No Product is in any way sponsored, endorsed or promoted by the JPX and the JPX shall not be liable for any damages arising from the establishment, distribution and promotion of the Product.

S&P 500 Index:
The copyrights, intellectual property rights and any other rights of S&P 500 Index belong to Standard&Poor's (S&P). S&P shall not guarantee the accuracy or completeness of the indices which are published by S&P and the data included in the indices. S&P shall not accept any responsibilities for the results related to the indices and the data.

ISM Manufacturing Index:
Copyright and all intellectual property rights of ISM Manufacturing Index belong to Institute for Supply Management.

Economic Surprise Index:
Copyright and all intellectual property rights of Economic Surprise Index belong to Citigroup Global Markets Inc.

.

Disclaimer

For this Presentation Material

- This documentation was prepared by Asset Management One Co., Ltd.
- This documentation is required to be used only by the investor to whom it is distributed.
- This documentation is only for the purpose of providing information and is not intended to be used to solicit investments.
- This documentation was prepared using data that Asset Management One Co., Ltd. has judged to be reliable including data from third-party sources. However, Asset Management One Co., Ltd. does not guarantee its completeness or accuracy. Additionally, the published data is only indicative of past performance and does not provide a guarantee of future performance.
- The contents included in this documentation are only current as of the date this documentation was prepared (July 28, 2023) and are subject to change without notice.
- The intellectual property and all other rights pertaining to the data published in this documentation including benchmark indices shall remain the property of the publisher and licensor.