

## Conspicuously lagging Japanese equities, time to play a catch up?

8 June 2021

- ▶ Since April, Japanese, U.S. and European share prices have been somewhat sluggish, with Japanese stocks lagging behind in particular.
- ▶ It will be interesting to see whether a significant rise in inflation in the U.S. will lead the Fed to bring forward the timing of its monetary policy change and raise interest rates further, but the Fed seems to consider the current inflation to be temporary.
- ▶ In the United States and Europe, where Covid-19 vaccinations have progressed, economic activity is expected to normalise and business confidence has improved significantly. We expect Japanese stock prices to catch up with U.S. counterparts as the pace of the Japanese vaccination rollout accelerates.

Stock prices in Japan, the United States and Europe have recovered since last year, peaked in March and April, and since been somewhat sluggish. Japanese equities, in particular, have lagged behind peers since reaching highs on 19 March before falling sharply together with U.S. stocks, after the end of the Golden Week Holiday season in early May.



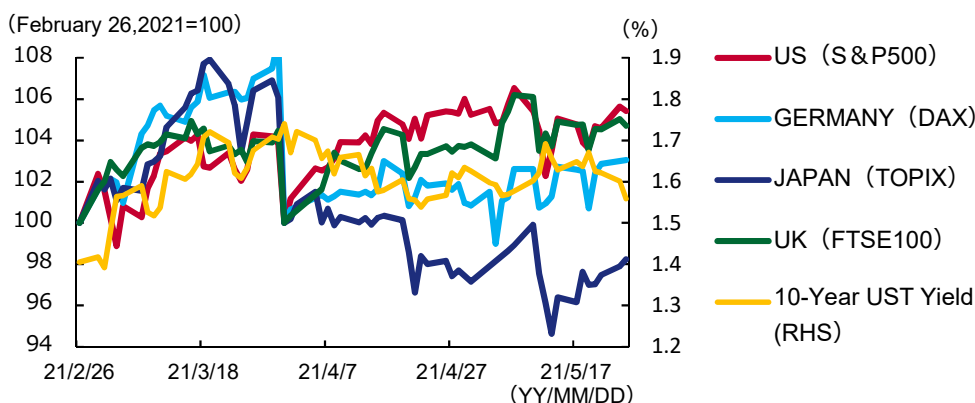
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One of the reasons for the lacklustre performance of Japanese and U.S. equities has been rising inflation expectations in the U.S. Fears that the Federal Reserve will expedite the timetable for a shift in monetary policy and that interest rates will rise further have held down the upside.

However, U.S. 10-year Treasury bond yields have remained below 1.72% since hitting this level on 19 March, and the Fed maintains its opinion that the rise in inflation caused by the Covid-19 pandemic and is temporary (Chart 1).

**“Since April, Japanese, U.S. and European share prices have been somewhat sluggish, with Japanese stocks lagging behind in particular”**

**Chart 1 : 10-Year UST Yield vs Stock Index**



Data : From February 26,2021 to May 25, 2021 (Daily)  
Source : Bloomberg

There are a number of reasons why Japanese stocks have not kept pace with peers. Rising inflation expectations in the U.S. are seen as a factor behind the recent stagnation of stock prices in many countries. However, stock prices began to stagnate after U.S. 10-year Treasury bond yields peaked in March, and the underperformance of Japanese stocks also started at around the same time. Stock markets may be more concerned about the effect of higher costs due to rising inflation on earnings.

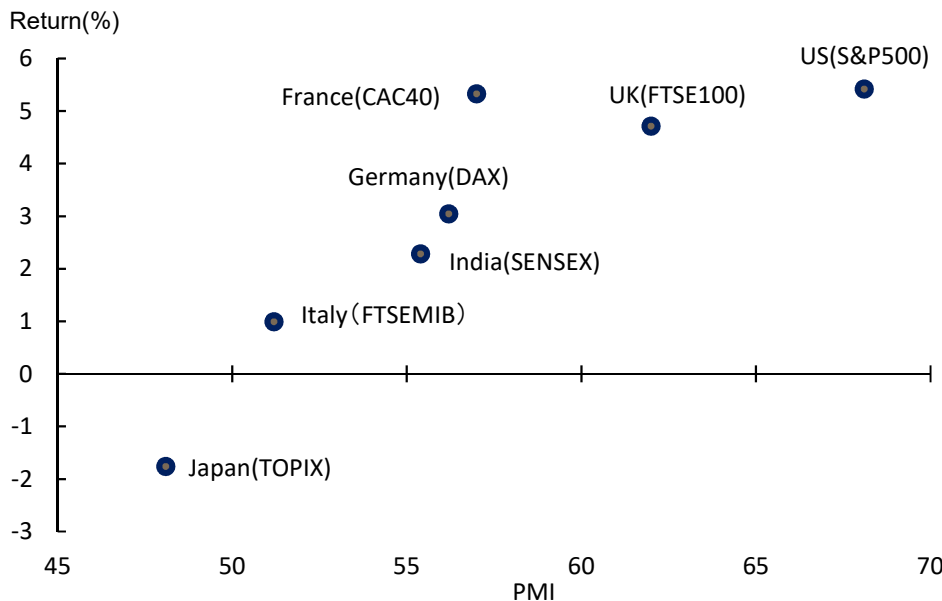
In the United States, where Covid-19 vaccinations are progressing, the economy has fully reopened, and in Europe, a gradual reopening is in sight. The improvement in business confidence since February has been linked with progress in vaccination rollouts, whereas in Japan, where vaccination has been delayed, business confidence has been slower to improve, particularly in the service sector, and this is reflected in the difference in share price returns (Chart 2).

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**“Delayed roll-out of Covid-19 vaccination is the prime reason for the slow recovery of the Japanese stock market.”**

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**Chart 2 : Major stock index returns & IHS Markit PMI**

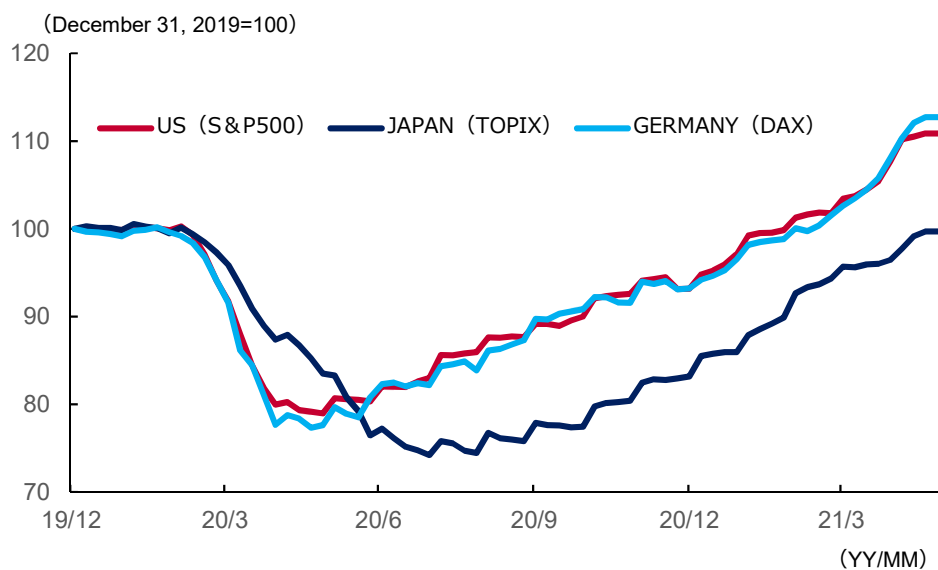


Data : Share Price Return = March 31, 2021 vs May 25, 2021  
 PMI = Composite data. India and Italy as of April 2021, other countries as of May 2021  
 Source : Bloomberg, IHS Markit

In terms of corporate performance, Japanese corporate earnings are improving, but at a slower pace than that of European and U.S. counterparts, which is likely to have weighed on share prices (Chart 3).

The Tokyo Olympics and Paralympics, scheduled to start on 23 July, is another source of uncertainty unique to Japan. The fall in the approval rating of Prime Minister Suga and his cabinet, mainly due to the poor handling of the pandemic, is also fueling political uncertainty in Japan.

**Chart 3 : 12 months Forward EPS**



Data : From December 31,2019 to May 26, 2021  
Source : Refinitiv

**“Japan's corporate earnings are improving but lag behind counterparts in Europe and the U.S. in terms of timing and the level of recovery”**

According to data compiled by the Nikkei Newspaper, Japanese companies in aggregate reported a 7% decline in sales and a 26% increase in net profits for the financial year ended March 2021. This marked the first increase in net profits for the last three years.

This means corporate earnings have recovered to around 80% of pre-pandemic levels of the financial year ended in March 2019. However, a deep dive beneath the headline number reveals a mixed picture, with SoftBank Group posting the highest net profits ever for a Japanese company, while many companies in the air and land transportation industries, which were severely affected by the Covid-19 pandemic, posted their largest ever losses. The number of companies in the red accounted for around 17% of the total, the highest proportion in 11 years.

For the financial year ending March 2022, companies are guiding 30% increase in net profit in aggregate. While Japanese companies typically provide conservative earnings guidance at the beginning of the year, earnings recovery remains uncertain, particularly in industries strongly affected by the pandemic.

A comparison of the improvement in earnings between Japanese, U.S. and German companies in chart 3 shows that U.S. and German companies bottomed out around May last year, while Japanese companies fell further before bottoming out. In addition, profit forecasts of U.S. and German companies have risen further since the beginning of 2021, exceeding the level at the end of December 2019, while Japanese companies are still lagging behind.

We believe delay in vaccination rollout is the main reason why the Japanese stock market is lagging behind peers. According to Our World in Data, the number of vaccinations per 100 people in Japan as of 25 May was 5.6 compared with 49.2 in the U.S. and 40.7 in Germany. The number of vaccinations in Japan has accelerated slightly since mid-May. The pace of vaccinations is expected to gain momentum with the addition of large-scale vaccination sites. It will still take a considerable amount of time to vaccinate 70% of the population and achieve collective immunity. However, even before society achieves herd immunity, expectations for economic reopening are likely to rise as the vaccination rollout progresses to a certain level.

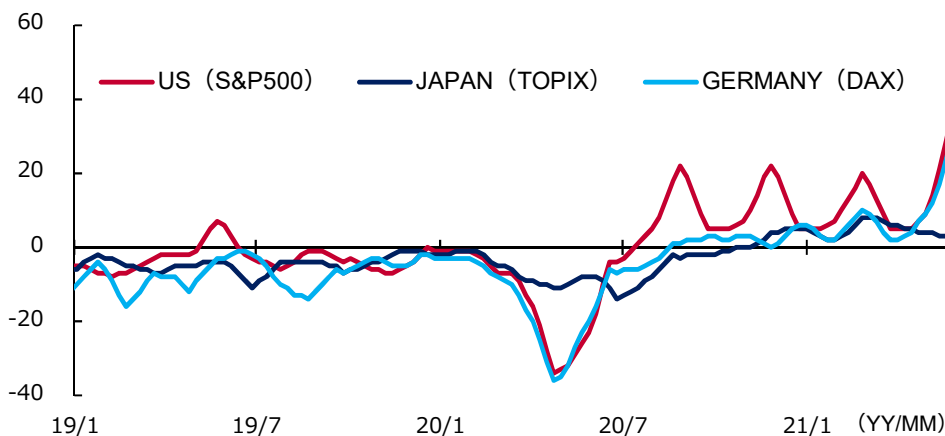
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**“Preconditions needed for catch up”**

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The improvement in corporate earnings in the U.S. and Europe has accelerated since the beginning of 2021. Upward revisions to earnings forecasts have exceeded downward revisions in Japan, but the number of upward revisions remains lower than global peers in the U.S. and Europe (Chart 4). In the U.S. and Germany, both the manufacturing and service sectors are expected to recover, while in Japan, the impact of the Covid-19 pandemic is still making it difficult to forecast earnings in some sectors. Albeit depending on the status of Covid-19 infections going forward, expectations for economic reopening are likely to increase as vaccinations progress, and the gap between Japan and the U.S. and Europe may narrow as conservative earnings guidance is revised upward over time.

**Chart 4 : Revision Index**



Data : From January 1,2019 to May 26, 2021 (4-week Ave.)  
Revision index = (upward revisions - downward revisions) / total number of estimates  
Source : Refinitiv

The Japanese government does not have the right to decide whether or not to host the Olympic and Paralympic Games in July. However, the political implications are immense. With Prime Minister Suga's approval rating on the decline, the political landscape in Japan will remain uncertain for some time until the upcoming House of Representatives elections in early autumn. It may take some time before Japanese equities catch up, but we expect business confidence to improve and the outlook for corporate earnings to improve as vaccinations progress. We believe the preconditions for Japanese stocks to catch up with global front runners are almost in place.

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