Asset Management One Co., Ltd.

Japan Outlook 2024

December 2023

Contents

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Creating a sustainable future through the power of investment

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23-041 GBDG

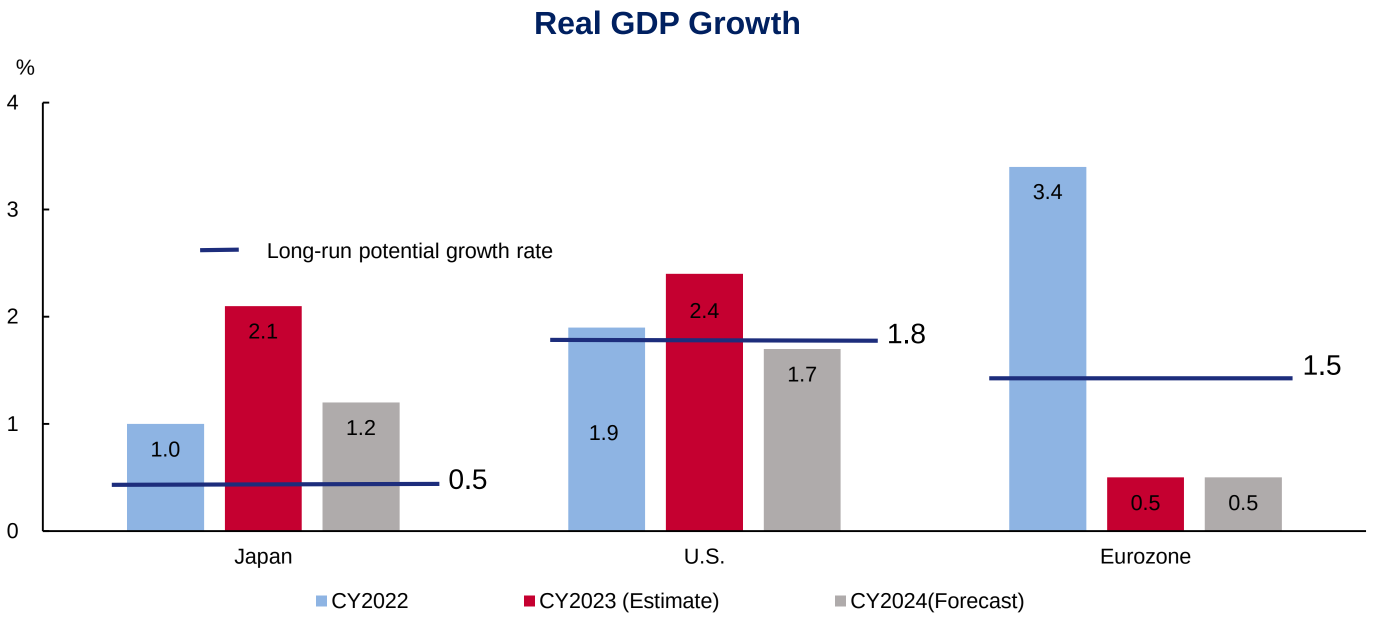
Japan Economic Outlook for 2024

In the recent July-September quarter of 2023, Japan's real GDP growth rate turned negative for the first time in three quarters. Both consumption and capital investment decreased for two consecutive quarters, but this was due to temporary factors such as a slowdown in consumption recovery, which had been propelled by the resumption of economic activities, and temporary delays in capital investment.

Although momentum has slowed from the initial phase of economic normalization, Japan's economy is expected to continue on a recovery track in 2024. It is anticipated that a positive cycle of price and wage increases will begin, surpassing the potential growth rate, leading to a gradual inflationary trend and avoiding deflation.

The driving forces of the Japanese economy include (i) consumption underpinned by the government's energy price control measures, cash benefits to households, accumulated savings during the pandemic, and wage increases, (ii) capital investment driven by expansion of digital transformation (DX) and investment to enhance operational efficiency against the backdrop of solid corporate earnings and labor shortages, and (iii) further recovery of inbound tourism demand. Unlike the U.S. and Europe, which have been impacted by rate hikes, it is expected that Japan's real GDP growth rate will continue to exceed the potential growth rate next year.

"Japanese real GDP growth will continue to exceed the potential growth rate unlike the U.S. and Europe."



Source: Japan Cabinet Office, U.S. BEA, Eurostat
Note: Figures for CY2023 and CY2024 were estimated and forecasted by AMO

Forecast Summary

Calendar Year	Actual 2021	Actual 2022	AMO's Estimate 2023	AMO's Forecast 2024
Real GDP (YoY, %)	2.6	1.0	2.1	1.2
Core CPI (YoY, %)	-0.2	2.3	3.1	2.5
JGB 10-Year Yield (%)	0.07	0.42	0.90	1.00
USD/JPY	115	131	150	140
TOPIX EPS	135	146	160	172
YoY, %	82.8	7.9	9.5	7.5
TOPIX	1992	1892	2470	2650
YoY, %	10.4	-5.1	30.6	7.3

Source: Bloomberg, Factset
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

While the Bank of Japan (BoJ) is likely to proceed with the normalization of monetary policy as the economy emerges from deflation, long-term interest rate increases are expected to be restrained compared to the U.S. and Europe, and an accommodative monetary environment is expected to continue.

The core consumer price index (core CPI), excluding fresh food items, has risen 2.8% in September from a year ago, and has remained at a high growth rate above 2% for the past 18 months. It is projected that this trend will continue in the coming year, with the core CPI remaining above 2%. While the growth in prices of goods are expected to slow down following the peak-out of import prices, the increase in service prices supported by wage hikes will lead to a rise in inflation rates from the previous zero percent range to around 1%. The goal set by the late Prime Minister Shinzo Abe's administration of achieving a nominal GDP of 600 trillion yen by 2020 is expected to be achieved, albeit with a few years of delay.

Japan Monetary and fiscal policy outlook

The BoJ under the new governor Kazuo Ueda has gradually relaxed the yield curve control (YCC) in 2023. The full normalization of monetary policy, i.e. simultaneous termination of YCC and negative interest rates, is expected to take place in early 2024, between January and April. While some market participants anticipate the normalization to occur in January, considering that the BoJ gives importance to the positive transformation of the output gap, an economic measure of the difference between the actual output of an economy and its potential output, which is increasingly likely to be delayed, it is more likely to occur in April 2024. The removal of the negative interest rate, which is considered as a shift towards monetary tightening, is expected to take place simultaneously with the termination of YCC. Although the upward pressure from overseas interest rates is expected to weaken, it is possible that new forward guidance may be introduced to restrain a potential sharp increase in long-term interest rates.

Nevertheless, the BoJ is expected to maintain low interest rates and refrain from further raising interest rates considering the impact on government bond interest payments and the economy. In addition to the environment surrounding prices and wages, attention needs to be paid to the direction of personal consumption at the high price levels and the analysis results of the BoJ's policy review scheduled to be announced from December 2023, as well as changes in the international situation.

As changes in corporate pricing behavior and household's tolerance for price increases have begun to emerge, fiscal policy plays a significant role in initiating a positive cycle of wage and price increases. This can be achieved through (i) implementing a capital investment support program to increase domestic growth expectations and improve productivity, (ii) raising regulated prices, which account for a large portion of service prices, and (iii) supporting small and medium-sized enterprises (SMEs) transferring increases in input prices to selling prices and ultimately achieve wage increases. The comprehensive economic measures for complete eradication of deflation, which were decided by the cabinet in November 2023, are estimated to have a push-up effect on the growth rate of 1.2% per year. However, the consumption stimulus effect resulting from tax cuts for high-income earners, who possess surplus savings, is perceived to be low. Additionally, the recent subpar implementation of public investment has led to limited anticipated impact from this economic measure, with potential gains estimated to reach only about 0.3%.

Japan Market Outlook

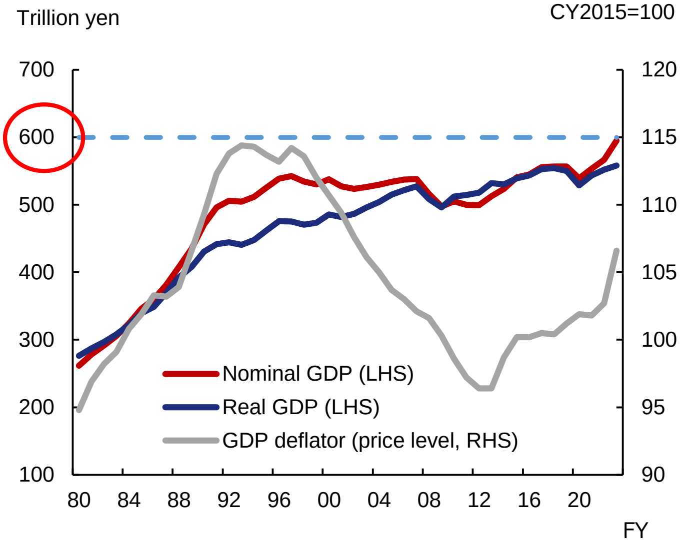
Japanese equity, interest rate and currency exchange rate outlook for 2024

In 2023, Japanese stocks experienced a significant increase. This can be attributed to factors such as the progress in resuming economic activities, the continuation of accommodative monetary policies despite concerns about the impact of interest rate hikes in the U.S. and Europe, the depreciation of the yen which led to improved earnings prospects for exporting companies, and the expectations for management response to the Tokyo Stock Exchange's focus on capital costs and stock prices. In addition, heightened expectations for deflation eradication played a significant role in driving stock prices to new levels. Short-term cyclical positive factors, along with secular positive factors, coincided and provided support for stocks.

In 2024, it is anticipated that the trend of increased profits will continue based on the background of deflation eradication, and Japan is expected to maintain an advantage over the U.S. and Europe in terms of the stock market environment. Although the growth rate of earnings per share (EPS) of the TOPIX index is expected to slow down compared to the previous year, down to around 7%, a continuous increase in profits while maintaining revenue growth is projected.

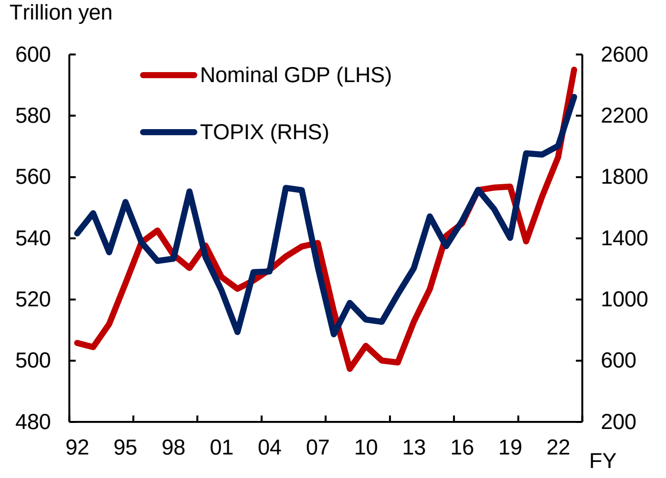
"Deflation eradication is facilitating the stock market "

Japan's Nominal and Real GDP



Source: Japan Cabinet Office
Note: 1. Annual data from FY1980 to FY2023
2. Nominal and Real GDP for FY2023 represent estimated data as of end 3Q

Nominal GDP and TOPIX



Source: Japan Cabinet Office, ,LSEG Data & Analytics
Note: 1. Annual data from FY1992 to FY2023
2. Nominal GDP and TOPIX for FY2023 represent estimated data as of end 3Q

Although the BoJ will proceed with monetary normalization, long-term interest rate increases will be restrained, and valuation adjustments are not expected. The forecast price-to-earnings ratio (PER) for TOPIX is expected to remain in the range of the upper limit of the historical average, around 15 times, and the year-end forecast for the TOPIX index is around 2650. With the expectation of deflation eradication, the index may approach its all-time high of 2884.80 by the end of the year.

Corporate responses to the Tokyo Stock Exchange's (TSE) requests are also expected to make further progress. Towards the end of August, the TSE published statistics pertaining to companies' adherence to the requests made in March 2023. These requests urged companies to disclose initiatives pertaining to capital efficiency and stock price valuation. Notably, companies with a price-to-book ratio (PBR) below 1 or a large market capitalization were prominent in showcasing progress. Beginning from early 2024, the TSE plans to disclose the list of companies that are in compliance with the requests.

Moreover, an increase in personal investor funds is expected due to the expansion of NISA (individual savings account) including an increase in the annual investment limit and the permanent extension of the tax-exempt period. The majority of funds from individual investors are expected to flow into U.S. stock indexes, with limited expectations for inflow into domestic stocks. However, the permanent extension of the tax exemption period presents the potential for individual investors to adopt a long-term investment approach. Furthermore, the anticipation of a temporary pause in the depreciation of the yen, along with the possibility of a breakthrough in the long-term upper limits of stock prices, may lead to some level of inflow into domestic stocks as well.

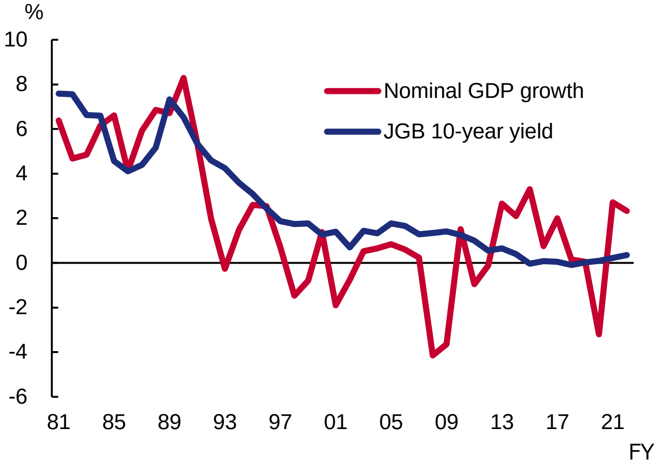
In 2023, long-term interest rates in Japan experienced a temporary rise to around 1% due to an increase in long-term interest rates in the U.S. This development has triggered concerns in the market about potential further increases in domestic long-term interest rates as the BoJ continues to normalize its monetary policy. However, it is worth noting that the BoJ could introduce measures, such as new forward guidance, to curb interest rate hikes even after the discontinuation of YCC. Additionally, it is anticipated that long-term interest rates in the U.S. reached their peak in 2023, which lead to the projection that long-term interest rates in 2024 will stabilize around 1%.

Looking ahead, it is expected that the long-term interest rates in Japan will not see significant increases similar to those witnessed in the U.S. and Europe. This is primarily because the long-term nominal GDP growth rate is expected to serve as an upper limit for long-term interest rates in the medium to long term.

The USD/JPY exchange rate is anticipated to undergo a shift towards a strengthening of the yen as a result of the pause in interest rate hikes by the Federal Reserve. However, given the persistent wide interest rate differential between Japan and the U.S. compared to pre-pandemic levels, the likelihood of a substantial appreciation of the yen is considered to be low. Instead, it is expected to remain within the 130-140 yen range.

“Limited room for long-term interest rates to rise, and the continuation of accommodative monetary policies”

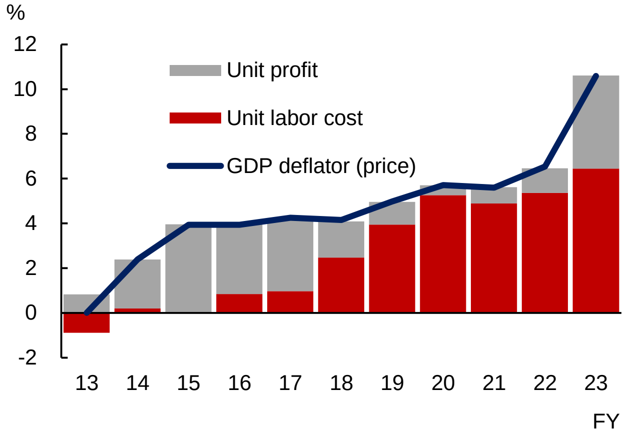
Nominal GDP growth and JGB 10-year yield



Source: Japan Cabinet Office, LSEG Data & Analytics
Note: 1. Annual data from FY1981 to FY2022
2. JGB 10-year yields are at the end of each FY.

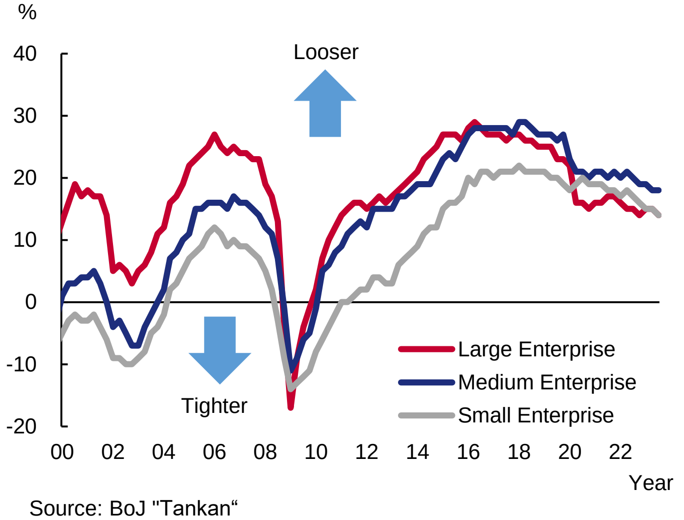
“Firming inflation benefits businesses, and capital investment plans are also strong”

GDP deflator decomposition



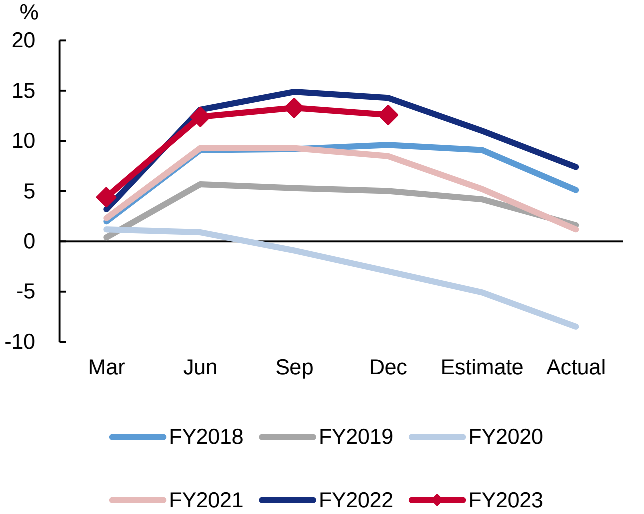
Source: Japan Cabinet Office
Note: 1. Annual data from FY2013 to FY2023
2. Figures for FY2023 represent estimated data as of end 3Q

Bank Lending Attitude (Tankan)



Source: BoJ "Tankan“
Note: 2000/1Q-2023/3Q

Capex Plan



Source: BoJ "Tankan"
Note : Quarterly data from March FY2018 to September FY2023

Risk Factors

In the short term, the Japanese economy faces various risks. These include a potential decline in corporate earnings and a reduction in the purchasing power of households due to the rise in prices of imported raw materials. Additionally, there is a possibility of a slowdown in exports and production due to a downturn in overseas economies and inventory adjustments.

Furthermore, although efforts to eradicate deflation are ongoing, it remains uncertain whether the established "norms" related to pricing behavior by corporations and acceptance of price increases by households have truly shifted from the deflationary phase. If the slowdown in domestic and international economies intensifies, there is a risk that deflationary tendencies may resurface. This is considered the most significant risk for Japan's economy and market.

Focus in 2024: Initiating Positive Cycle of Prices and Wages - Complete Escape from Deflation

The price increases that began with cost-push factors in 2022 are now reflecting endogenous movements such as wage and service price increases. The situation indicates that the 2024 Spring Wage Bargaining will likely see high wage increases surpassing those of 2023, leading to a positive cycle of prices and wages.

The economic measures formulated in November, although facing challenges in effectiveness, incorporate measures that support the transition to an employment income environment responsive to price inflation and address the challenges posed by population decline.

In this context, the BoJ considers it highly likely that policy normalization, such as the discontinuation of YCC and lifting of negative interest rates, will be implemented in early 2024. However, low interest rates are expected to be maintained for a while even after monetary policy normalization.

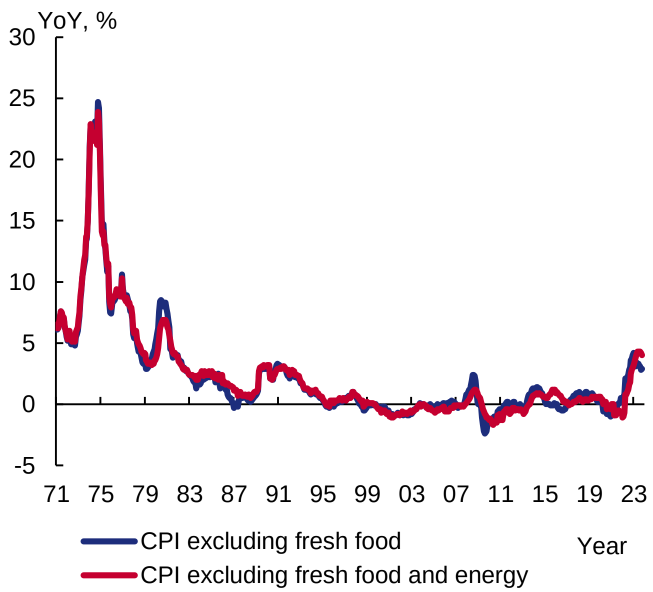
Such cautious measures will contribute to the complete escape from deflation and facilitate the transition to an economy with increasing nominal GDP that has long been awaited.

"Continued inflation exceeding 2% in Japan "

Since April 2022, the Core Consumer Price Index (CPI), excluding fresh food, has consistently exceeded the target inflation rate of 2% set by the BoJ. The rise in Core CPI has been mitigated by government measures to restrain prices of energy, such as gasoline, electricity, and gas. However, the CPI excluding fresh food and energy categories (Core-Core CPI) has surpassed 4% compared to the previous year, marking the highest increase in over 40 years.

The initial phase of price increases since 2022 was driven by cost-push resulting from increased import costs. Although it was initially expected that the inflation rate would slow down due to stabilization in crude oil prices, there is currently no clear evidence of a significant slowdown in the inflation rate. In fact, the expansion of inflation has become evident in many categories of CPI. The proportion of items in CPI that have increased compared to the previous year has expanded from around 20% in 2010 to nearly 90% at present. The BoJ has repeatedly revised its outlook for Core CPI upwards in its quarterly reports on economic and price trends. The October 2023 report projected that the inflation rate would exceed the price stability target of 2% for three consecutive years from the fiscal year 2022 to 2024.

Consumer Price Index



Source: Ministry of Internal Affairs and Communications
Note: 1. Monthly data from January 1971 to September 2023
2. Consumption tax adjusted

Outlook of the Majority of BoJ Policy Board Members

	Real GDP	CPI (excluding fresh food)	Reference: CPI (excluding fresh food and energy)
FY 2023	+1.8～+2.0 <+2.0>	+2.7～+3.0 <+2.8>	+3.5～+3.9 <+3.8>
Outlook as of July	+1.2～+1.5 <+1.3>	+2.4～+2.7 <+2.5>	+3.1～+3.3 <+3.2>
FY 2024	+0.9～+1.4 <+1.0>	+2.7～+3.1 <+2.8>	+1.6～+2.1 <+1.9>
Outlook as of July	+1.0～+1.3 <+1.2>	+1.8～+2.2 <+1.9>	+1.5～+2.0 <+1.7>
FY 2025	+0.8～+1.2 <+1.0>	+1.6～+2.0 <+1.7>	+1.8～+2.2 <+1.9>
Outlook as of July	+1.0～+1.2 <+1.0>	+1.6～+2.0 <+1.6>	+1.8～+2.2 <+1.8>

YoY,%

Source: BoJ

Note: 1. Figures in < > are the median of the Policy Board members' outlooks

2. The "Outlook of the Majority of BoJ Policy Board Members" is the range of outlooks that each policy board member considers most probable, excluding the one maximum and one minimum. The range does not mean the upper and lower limits of the outlook based on forecast errors and other factors

"Structural changes in the price environment in Japan "

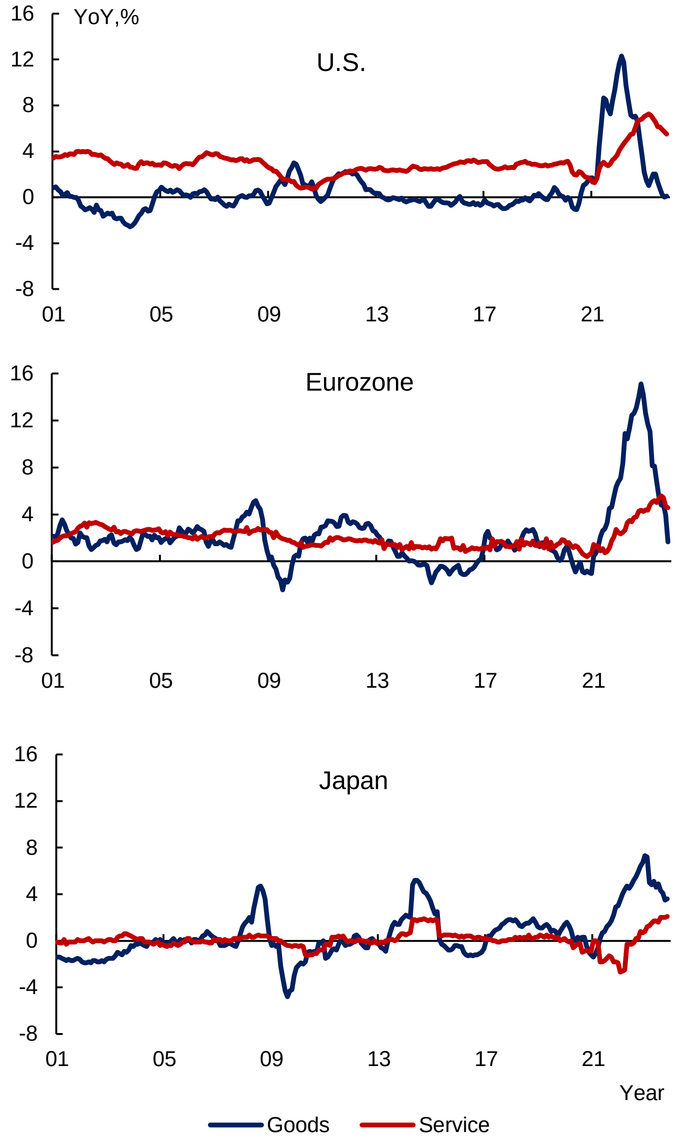
In the past, the prevailing belief in Japan was that "prices do not increase even with rising raw material costs," based on the notion that price pass-through was not possible. However, it appears that this norm is changing in the current phase of price increases.

The most notable aspect of the current price increases in Japan is the rise in service prices. When comparing CPI between goods and services in Japan, the United States, and Europe, the tendency for goods prices to fluctuate in line with international commodity markets remains consistent to varying degrees. However, in Japan, service prices have remained stagnant at around 0% since 2001, excluding the impact of consumption tax rate hikes and reductions in mobile phone communication fees. However, in October 2023, service prices rose 2.1% and exceeded 2% compared to the previous year, marking a continuous four-month increase.

The breakdown of service prices in Japan's CPI in September 2023 reveals that public services (weighted at 12.2% in CPI) increased by 0.9% compared to the previous year, while general services (weighted at 37.4%) increased by 2.4%. Although the growth of public services, which includes many regulated fees, has been limited, the increase in general services exceeding 2% is the first time since 1995, excluding the impact of consumption tax rate hikes. Increases can be seen in external dining (5.8%), household-related services (such as repairs and cleaning, 3.3%), and communication, education, and entertainment-related services (6.4%). While the rise in costs of raw materials contributes to the increases in dining and household-related services, the increases in educational and entertainment services are also believed to reflect the effects of increased demand and labor costs due to labor shortages.

To achieve sustainable and stable price increases after breaking free from deflation, a sustained rise in service prices is necessary. Former BoJ Governor Haruhiko Kuroda mentioned in a June 2022 speech that achieving an annual inflation rate of around 2% in Japan would require a sustained 2% contribution from service price increases, with cyclical variations in goods prices around that level. Incumbent Governor Kazuo Ueda also emphasizes the importance of rising service prices. He defines the "first force" as the transmission of import price increases to domestic prices, and the "second force" as the positive cycle of rising wages and prices, which will further push up prices, especially service prices. The focus on breaking free from deflation is narrowed down to wages and service prices.

CPI in U.S., Eurozone and Japan -Goods and Services-



Source: LSEG Data & Analytics, Ministry of Internal Affairs and Communications

Note: 1. Monthly data from January 2001 to October 2023
2. The data for U.S. includes Goods (excluding food and energy) and Services of CPI
3. The data for Eurozone includes Goods and Services of HICP and it shows EA-19 countries data
4. The data for Japan includes Goods (excluding fresh food) and Services of CPI

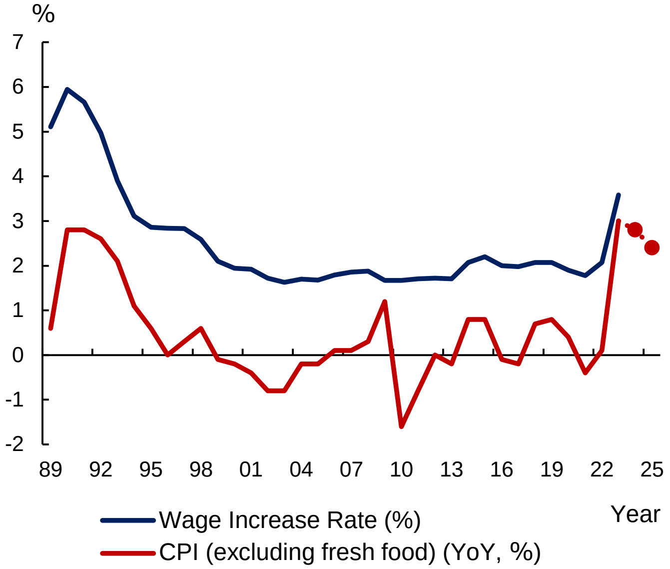
"Expectations of high growth in the 2024 Spring Wage Bargaining "

Under Governor Kazuo Ueda's leadership, the BoJ added the phrase "accompanied by wage increases" to its forward guidance on monetary policy, aiming to achieve the target of "stable and persistent realization of 2% price stability." Wage increases play a crucial role in breaking free from deflation for two reasons. Firstly, they promote price increases in services, where labor costs constitute a significant proportion of total costs. Secondly, they help maintain consumers' real purchasing power, increasing their tolerance for price hikes.

In the 2023 Spring Wage Bargaining, high wage increases were realized due to the need to maintain real purchasing power amid price inflation and secure labor force amid labor shortages. According to the aggregate data from the Japanese Trade Union Confederation, the Rengo, the average wage increase rate reached approximately 3.6% including regular wage increases and base salary increases, marking the highest growth since 1993.

Attention is now focused on whether wage increases will continue in 2024. The situation suggests that the wage increase rate in 2024 could exceed the level achieved in 2023. Taking into account the growing labor shortages, high expectations for the inflation rate outlook, and the solid performance of companies, it can be concluded that the possibility of wage increases surpassing those of 2023 in the 2024 Spring Wage Bargaining is high. The Rengo has revised its wage policy from "around 5%" for 2023 to "above 5%" for 2024, reflecting more aggressive demands for wage increases. In response to the Rengo's policy, various labor unions have also raised demands for significant wage increases, while reports of companies announcing wage increase policies exceeding those of 2023 have increased.

Wage Increase Rate in Spring Wage Bargaining and Core CPI



Source: Ministry of Internal Affairs and Communications, Rengo
Note: 1. Annual data from 1989 to 2023 for Wage Increase Rate, and annual data from 1989 to 2024 for CPI
2. CPI: Consumption tax adjusted, one year ahead, and AMO's outlook

"The growing importance of the government's role"

To achieve complete recovery from deflation and establish a sustainable positive cycle of wage and price increases, the government plays a significant role in facilitating appropriate price pass-through by companies, promoting wage increases, improving domestic growth prospects, and enhancing productivity.

The Comprehensive Economic Package, "Comprehensive Economic Measures for Complete Deflation Escape - Toward a New Stage of the Japanese Economy," approved by the Cabinet on 2nd November, consists of five pillars: (i) measures to counter high prices, (ii) wage increases and regional growth, (iii) promoting domestic investment, (iv) societal reforms to cope with population decline, and (v) strengthening national resilience. In evaluating these economic measures and the associated supplementary budget, much attention is typically given to their impact on annual growth rates. By totalling specific items such as the tax cuts for individuals, cash benefits for low-income households, and public works, the GDP growth rate is expected to be around 0.3%, limited in its magnitude. Moreover, criticisms have been raised about the similarity in content with past economic measures.

However, it is worth noting that the inclusion of similar items in successive economic measures reflects the elimination of non-essential measures and a focus on addressing the challenges posed by population decline and Japan's growth strategy. In a society facing a declining population, a decrease in potential growth rate is inevitable without intervention. Broadly speaking, the potential growth rate is determined by three factors: capital, labor, and productivity. Despite efforts to counter labor reductions through the increased participation of elderly and female workers, labor shortages have become more severe. The service industry is particularly affected, leading to business restrictions. The so-called "income wall," which has long been recognized as a problem in terms of working hours, requires institutional reforms, but the inclusion of emergency measures represents a certain level of recognition. The term "income wall" refers to a situation where dependents experience decreased take-home income when their earnings exceed a certain threshold, leading to increased burdens of social insurance premiums and loss of spousal allowances. In response, individuals tend to adjust their working hours when wages increase. There have been suggestions that wage increases may inadvertently exacerbate labour shortages.

Supporting the digital transformation of small and medium-sized enterprises and service industries will contribute to alleviating labour shortages and promoting capital accumulation and productivity improvement.

In the short term, as the transition to an employment income environment responsive to price inflation occurs, measures to alleviate the burden of price increases and support wage increases will continue to be important. Amid a decline in the Cabinet's approval ratings, Prime Minister Fumio Kishida has announced plans to implement income tax reductions targeting many households. The impact of tax reductions, including households that are believed to have savings from consumption restraint during the spread of the COVID-19 pandemic, is expected to have limited effects on boosting consumption. Moreover, if effective, there is a potential risk that it could lead to further price increases as the negative output gap, which is the difference between actual production and capacity representing the level of aggregate demand in comparison to aggregate supply, is almost eliminated. There are also concerns about the consistency of such measures with the planned tax increases in upcoming years, which are intended to finance the expanding defense budget. Nevertheless, while challenges exist in the effectiveness of economic measures, the approximately 4 trillion yen in income tax reductions accounts for about 1.5% of the approximately 300 trillion yen in nominal disposable income, undoubtedly supporting real disposable income amid price increases.

Comprehensive Economic Measures

trillion yen

Five Pillars of the Comprehensive Economic Measures	Financial Expenditure	Project Scale
Measures to protect the livelihood of the people from the current high prices of goods and services	6.3	12.8
Sustainable wage increases, income growth and regional growth, including local and small and medium-sized enterprises	3.0	9.1
Promoting domestic investment that contributes to strengthening and upgrading growth potential	4.7	7.5
Launching and promoting social reforms to cope with population decline and make change into a force	1.6	1.7
Ensuring the safety and security of people, such as strengthening national resilience, disaster prevention and mitigation	6.1	6.3
Total	21.8	37.4

Source: Japan Cabinet Office

Main Political Schedule

2023	
20, Nov	FY2023 supplemental budget proposal went into deliberations
13, Dec	End of the extraordinary session of the Diet
Around late Dec	FY2024 budget proposal and tax reform guidelines will be finalized
2024	
Jan	Prime Minister arranges visit to Brazil and other South American countries
Jan	Ordinary session of the Diet
Early in the year	Prime Minister will visit the U.S. as the guest of honor
Spring	Spring Wage Bargaining (Shunto)
Jun	Starting flat-rate tax reductions for income and inhabitant taxes
Sep	Liberal Democratic Party president's term expires
2025	
Jul	House of Councilors election
Oct	End of the term of the House of Representatives

Source: Media reports

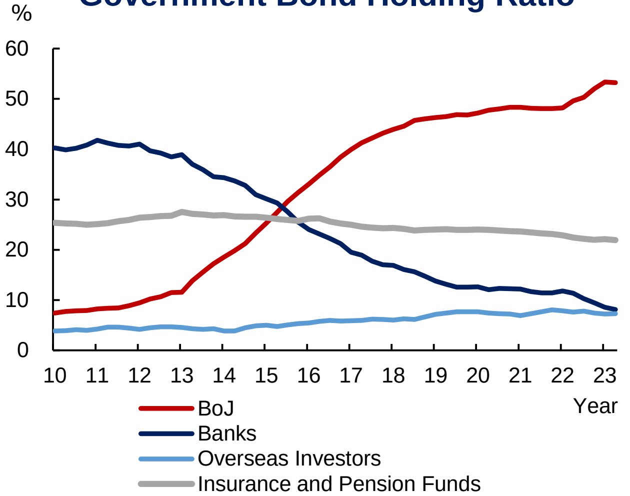
"The Bank of Japan's desire to avoid repeating past mistakes"

In July and October, the BoJ decided to introduce more flexibility in its current monetary policy, such as phasing out the YCC. This effectively allows for an increase in long-term interest rates, which had been maintained around zero percent as the target of long-term interest rate operation, using 10-year government bond rates. By allowing interest rates to rise, the BoJ aims to avoid the expansion of government bond purchases and consider the functioning of the bond market while mitigating the pressure for yen depreciation stemming from interest rate differentials with other countries.

The BoJ is highly likely to implement policy normalization, such as the cessation of YCC and negative interest rates, in early 2024. Considering the intentions of the government, the Ministry of Finance, and the BoJ, it is believed that the government is eager to demonstrate achievements in "complete deflation escape" to increase the timing flexibility for dissolving the Lower House and calling for a general election. The BoJ, on the other hand, has a strong recognition of wanting to dissolve the framework of unconventional monetary easing measures as soon as the achievement of the price stability target becomes foreseeable. Also, Governor Kazuo Ueda may be concerned about losing trust in the Bank's policies if the Bank does not adhere to the policy management based on the forward guidance, which “aims for the realization of the 'price stability' target and continue 'quantitative and qualitative monetary easing with YCC' until the necessary point to achieve and sustain this stability," while the inflation rate remains above the target rate of 2%.

However, low interest rates are expected to be maintained for a while even after monetary policy normalization. The government is likely to consider the impact on households, companies, and the cost of servicing government bonds. The BoJ strongly recognizes the need to avoid repeating past failures of returning to deflation immediately after normalizing monetary policy, thus approaching interest rate hikes with caution.

Government Bond Holding Ratio



Source: BoJ

Note: 1. Quarterly data from 1Q 2010 to 2Q 2023

2. Percentage of government bonds and fiscal investment bonds holdings

Speculation on Monetary Policy

BoJ

- **Want to dissolve the unconventional monetary easing measures**
  - Restoring the functionality of the deteriorating bond market
  - Want to avoid holding a large amount of government bond (over 50% is held by the BoJ)
  - Concerned that the BoJ may lose credibility if it does not normalize policy in accordance with forward guidance as prices continue to exceed the 2% target
- **Trying to be cautious in making decisions on interest rate hikes**
  - Have been adversely impacted by past failures, and want to avoid reversion to deflation after normalization
  - While interest rate hikes are expected to increase interest payments to current accounts, dividend income from ETF holdings will support the BoJ's finances.

Government

- **Declaration of complete end to deflation**
  - Want to declare the complete end of deflation as an achievement in order to secure flexibility in the timing of the general dissolution election
  - If nominal GDP growth rate increases due to the end of deflation, tax revenues can be expected to increase
- **The economic recovery will be maintained, and the fiscal administration will be formed**
  - Want to keep mortgage and corporate borrowing rates at low levels
  - Wary of increasing trend of foreign investors' holdings of government bond, and conscious of fiscal consolidation. Want to restrain increases in long-term interest rates, which affect the cost of servicing government bonds.

Source: AMO

“Japan after breaking free from deflation ”

Japan’s nominal Gross Domestic Product (GDP) is approaching 600 trillion yen. In July, the Cabinet released a mid-year estimate of economic outlook, setting a reference value for the nominal GDP for the fiscal year 2024 at 601.3 trillion yen. In 2015, the Abe administration introduced the "New Three Arrows" economic policy and set the target of achieving a post-war record nominal GDP of 600 trillion yen as the "New First Arrow." It is believed the realization of this goal is within sight.

Examining the long-term trend of GDP since 1980, both nominal and real values increased rapidly towards the peak of the bubble economy around 1990. However, after the collapse of the bubble economy, while real GDP continued to experience gradual growth, nominal GDP's growth stagnated. The divergence between real and nominal GDP growth can be attributed to the decline in the GDP deflator caused by deflation.

Nominal GDP consists of real value reflecting the transaction volume of economic activity and the deflator reflecting price. Sales revenue of companies, reflecting both transaction volume and price, serves as a representative example of nominal values. The sluggish growth of nominal GDP and the modest growth of real GDP after the burst of the bubble economy can be interpreted as a business model adopted by companies to maintain transaction volume by limiting price increases. However, following the COVID-19 pandemic, companies started demonstrating a proactive attitude towards appropriate price pass-through in response to increased costs of raw materials. An expansion in sales revenue, accompanied by an increase in nominal GDP, and securing profitability are expected. With an increase in nominal GDP, companies are expected to expand sales revenue while securing profitability.

Focus in 2024: Requests from Tokyo Stock Exchange (TSE) Prompt Response Regarding Sub-par PBR

Although Japanese equities have experienced a slowdown in buying momentum from foreign investors, demand remains strong.

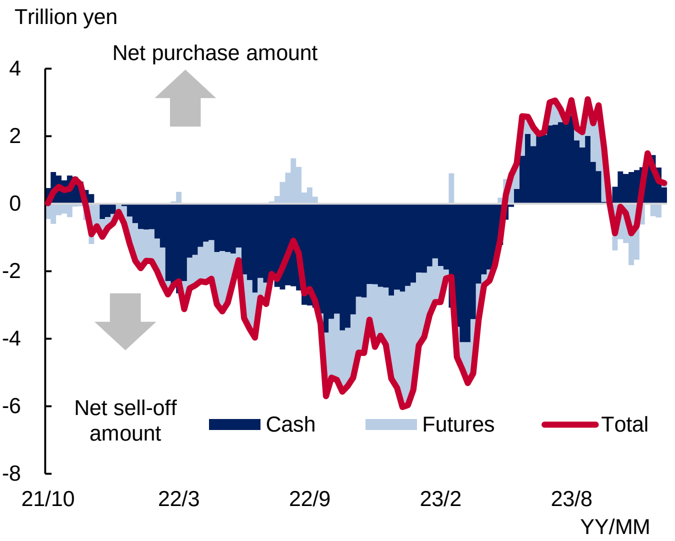
There is a possibility that Japanese equities will see renewed preference as there is an expectation for increased disclosure of specific efforts by companies in response to the TSE's request.

40-year highs in the rate of price increases and 30-year lows in the yen may provide the final push to start a virtuous economic cycle of higher wages and domestic capital investment.

Following the TSE's request in late March 2023 for listed companies to achieve capital cost and stock price-conscious management, expectations have risen for companies to respond, particularly among low PBR (price-to-book ratio) stocks. This has led to increased buying from foreign investors. While the momentum has somewhat slowed, there remains strong demand for Japanese equities.

While the overall PBR for TOPIX has increased, it has remained within the range of past fluctuations, with the "mean +1σ" functioning as an apparent upper limit. To further increase PBR, it is believed that companies need to demonstrate improved capital efficiency, which garners higher evaluations from investors.

Cumulative Net Purchases of Japanese equities by Foreign Investors



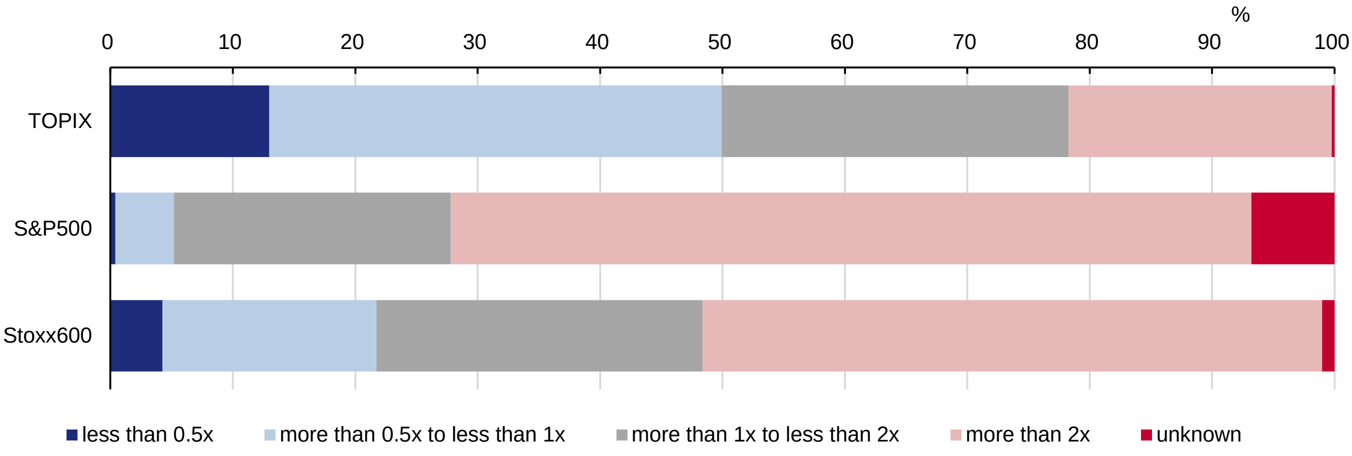
Source: Bloomberg
Note: 1. Weekly data from the week of 4-8 October 2021 to the week of 4- 8 December 2023
2. The cumulative net purchase amount of Japanese equities, total of two markets, excluding Nikkei 225 micro Futures

TOPIX PBR

Source: Bloomberg
Note: 1. Daily data from 4 January 2019 to 24 November 2023
2. The 12 month trailing PBR as compiled by Bloomberg

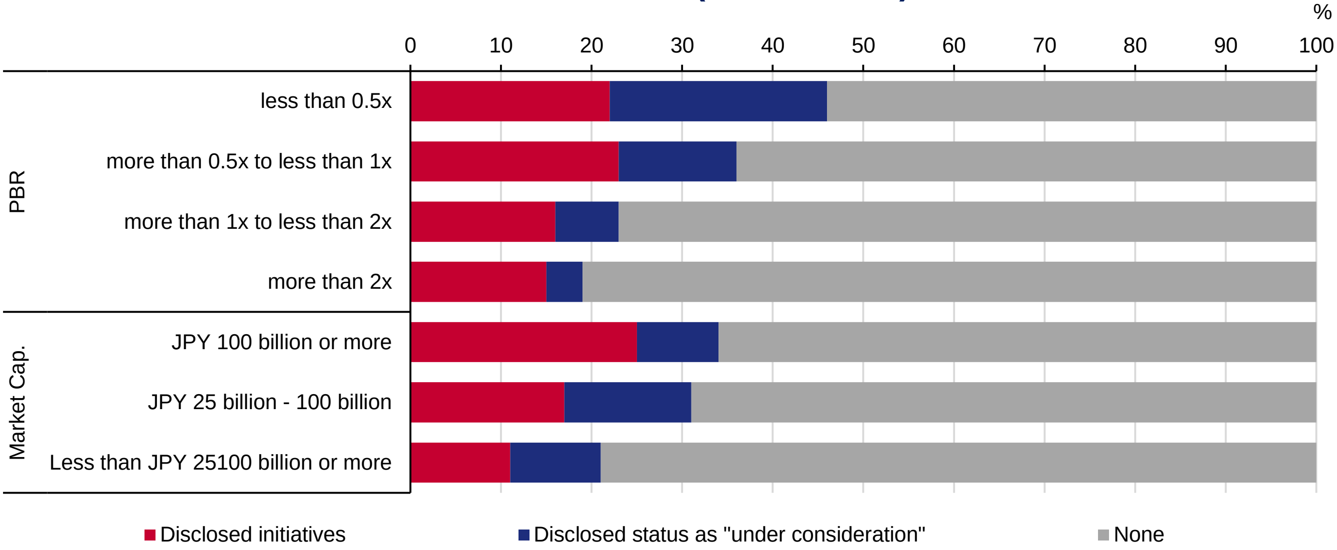
In late August, the TSE disclosed the aggregated results of companies' response to the request, focusing on listed companies with fiscal year-end in March on the TOPIX Prime Market. The disclosure ratio varied, with greater disclosure seen among companies with significantly lower PBR or larger market capitalization. The TSE clarified misconceptions by stating companies that already had a PBR above 1 still need to respond, and emphasized their dedication to promoting disclosures.

PBR Distribution



Source: FactSet
Note: As of 16 November 2023

Disclosed Initiatives (TOPIX Prime)



Source: TSE
Note: As of 14 July 2023

The TSE plans to start releasing a list of companies that have disclosed their efforts based on the request starting early next year, with monthly updates. They will also disclose exemplary cases that have gained high support from investors. With expectations of increased disclosure from companies, coupled with growing optimism for Japan's exit from deflation, there is a high possibility of renewed foreign investor-led buying of Japanese equities.

Furthermore, there has been an increase in large companies considering delisting through management buyouts (MBOs) in 2023. This decision is not driven by a desire to escape shareholder pressure but rather by the assessment that maintaining listing status while achieving significant capital efficiency improvement through resource reorganization is challenging. In Japan, where there is a perception of an excessive number of listed companies, there is a possibility of more companies choosing delisting as an option. Such movements are expected to contribute to overall market revitalization.

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