Asset Management One

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

What the ongoing yen depreciation means for Japanese equities

28 April 2022

- The yen has weakened rapidly, driven by rising U.S. interest rates and shows no signs of halting.
- Japanese equities have traditionally rallied when the yen has weakened against the dollar, but the relationship has not been so conspicuous this time. Similarly, the correlation between a weaker yen and higher stock prices appears to be fading in the long term.
- Trading positions of overseas investors, who typically have strong influence on the performance of Japanese stock markets, has remained relatively light over the past few years. Policy uncertainty surrounding the Kishida administration needs to be cleared before overseas investors begin to buying Japanese equities.

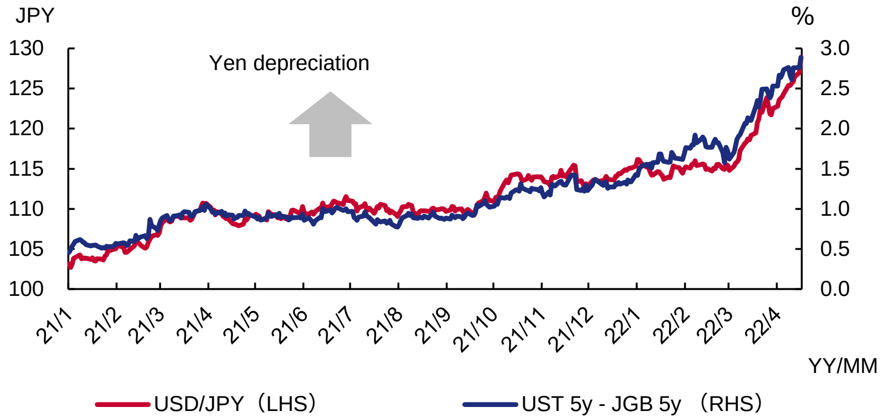
Hitoshi Asaoka
Senior Strategist

The yen is depreciating rapidly in the foreign exchange market. As the chart illustrates, we see the driving factor as the widening gap between U.S. and Japanese interest rates due to rising U.S. interest rates (Figure 1). A number of statements by Finance Minister Suzuki are seen as a warning against a weaker yen. However, market participants seem to maintain the view that the BOJ and the Government are unable to take effective policy measures and that even if they do take measures such as intervening in the currency market to buy the yen, it will be difficult to halt the move due to rising U.S. interest rates. There are no signs of a halt to the weakening of the yen.

"Rapid depreciation of the yen"

Japanese equities rose from early March to the end of the month as the yen weakened, but there are signs of a change in the relationship between Japanese equities and the exchange rate, with the yen's weakness in April accompanied by stock market weakness. We believe this is due to persistent concerns about the impact of import inflation caused by the rapid depreciation of the yen and high commodity prices on domestic demand and corporate earnings.

Figure 1: Yen’s weakness vs Interest Rates Gap Between U.S. and Japan



Source: Bloomberg
Period: Daily data from 4 Jan. 2021 to 19 Apr. 2022

“Has the correlation between the weak yen and Japanese equities declined in recent years?”

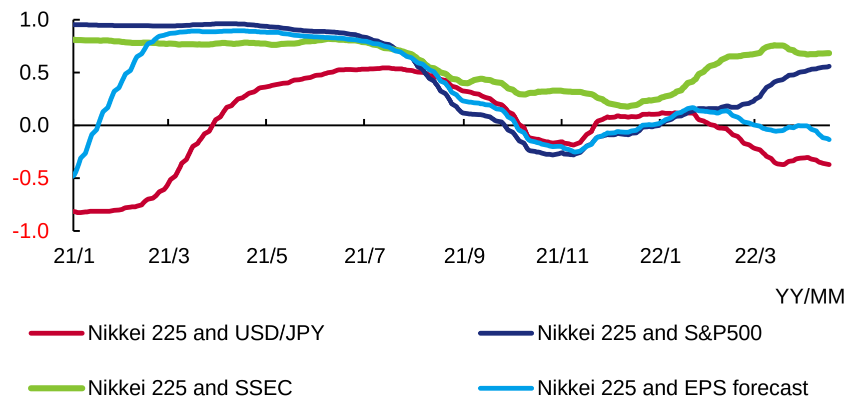
Japanese equities have traditionally rallied when the yen weakens against the dollar. This is contrary to the more common convention, particularly in emerging countries, where the depreciation of a currency results in a decline of share prices due to concerns over capital outflows.

Japan has been different, partly because of its status as a net creditor nation, which has been seen to afford its economy protection from the direct impact of capital flight, and partly due to expectations for improved corporate profits arising from (i) increased export price competitiveness of goods and services and (ii) a rise in yen-denominated exports. When export prices are contracted in foreign currency in a manner not linked to exchange rates, a weaker yen increases the yen-denominated export price and the yen-denominated export value increases even if the volume is unchanged.

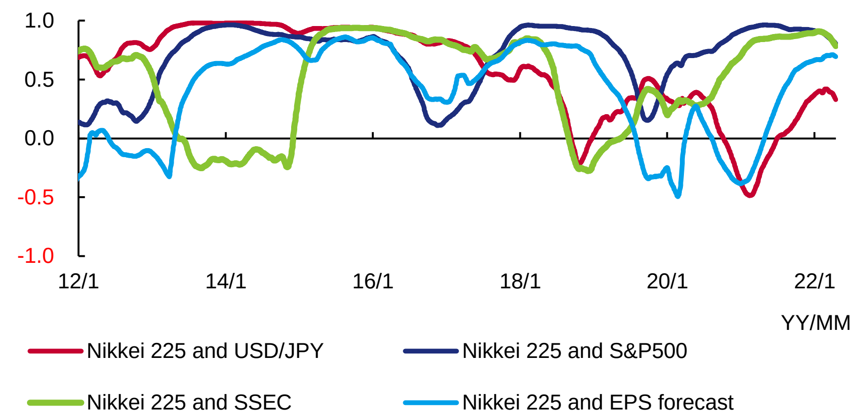
The yen weakened and stock prices rose at the start of the Bank of Japan‘s extraordinary easing in the early stages of Abenomics. At that time, we believe that overseas hedge funds built positions of short yen and long Japanese stock futures.

However, looking at the correlation coefficient between the Nikkei 225 and the dollar/yen, the 200-day correlation coefficient has recently turned negative in mid-April (upper part of Figure 2), while the 500-day long-term correlation coefficient shows a stable and high positive correlation between a weaker yen and stronger stocks until around 2017, a clear positive correlation has not been observed since this period (lower part of Figure 2). This may be due to a reduction in exports of finished products from Japan as a result of adjustments to supply chains, and corporations having made progress in building earnings structures less susceptible to exchange rate movements.

Figure 2: 200-Day and 500-Day Correlation Coefficient



Period: Daily data from 4 Jan. 2021 to 19 Apr. 2022

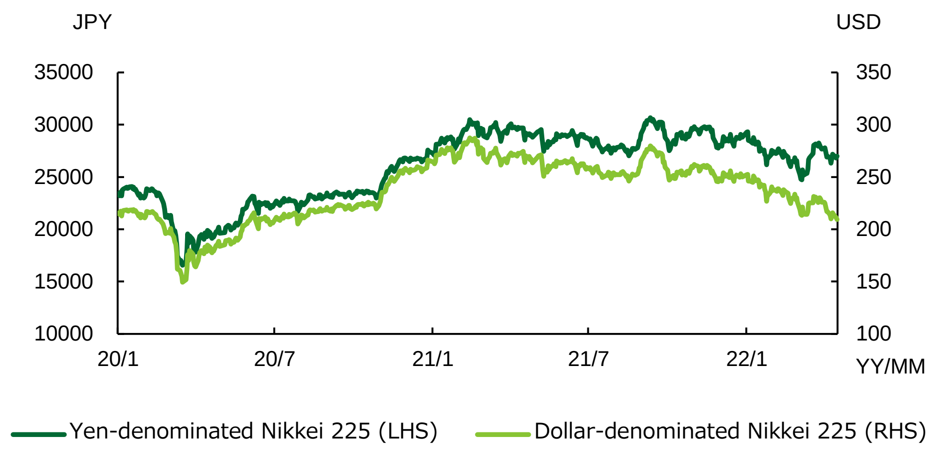


Period: Daily data from 4 Jan. 2012 to 19 Apr. 2022
Source: Bloomberg
Note: EPS forecasts are based on the Nikkei average for the next 12 months EPS complied by Bloomberg

The ongoing depreciation of the yen has pushed down the dollar-denominated Nikkei 225 index more than the yen-denominated index (Figure 3). For overseas investors, who are major players in the Japanese stock markets, whilst on the one hand a depreciating yen makes Japanese equities more undervalued, they are also seen as an asset at risk with the yen likely to depreciate further in the future. According to TSE trading statistics, overseas investors' purchases of Japanese cash equities in the first week of April reached the highest levels seen in almost seven years. This may have been due to a sense of undervaluation.

"What is the stance of overseas investors towards Japanese equities now?"

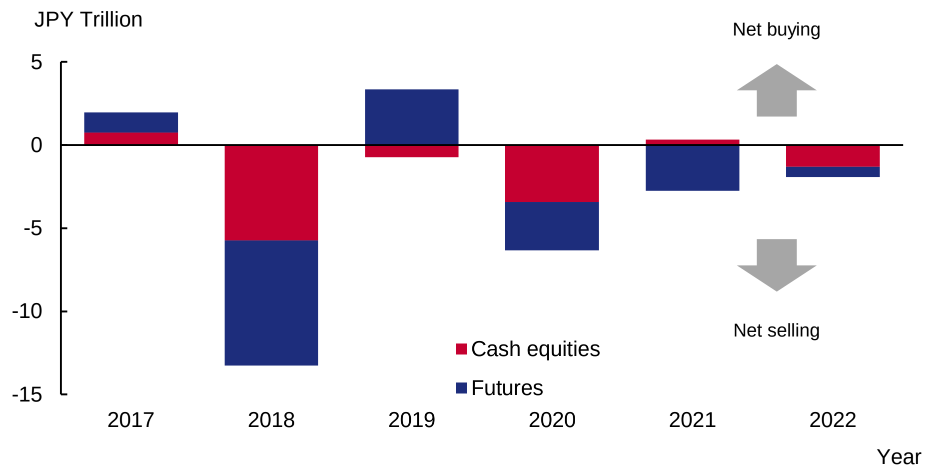
Figure 3: Nikkei 225 Index by Currency Denomination



Source: Bloomberg
Period: Daily data from 4 Jan. 2020 to 19 Apr. 2022

Looking at investment trends of overseas investors in Japanese equities over the past few years, there has been a lack of active build-up of trading positions (Figure 4). From last year to this year, the cumulative buying and selling positions by overseas investors has remained small compared to that of 2018 and other years. This infers a relatively light position in Japanese equities by overseas investors.

Figure 4: Trends in Japanese equity investment by Foreign investors



Source: Bloomberg
Period: Weekly data from 6 Jan. 2017 to 8 Apr. 2022
Note: Weekly data aggregated by calendar year; for 2022 cumulative up to 8 April.

One factor that may be contributing to the relatively light position of overseas investors in Japanese equities is the possibility that they lack indigenous catalysts to invest in Japanese equities. Some suggest that uncertainty surrounding the Kishida Government's policies is a factor holding back active trading.

"Factors that discourage foreign investors from actively trading Japanese equities"

We see five broad categories of concern for overseas investors: (i) uncertainty over the overall picture of the 'new capitalism' that the Kishida Government is trying to promote, (ii) possible restrictions on share buybacks, (iii) issues surrounding quarterly disclosure, and (iv) concerns over the strengthening of financial income taxation (Figure 5). Regarding (i) uncertainty over the overall picture of the 'new capitalism' that the Kishida Government is trying to promote, the Council for the Realisation of 'New Capitalism' has met a total of five times so far, but the overall picture for 'aiming for the revival of the middle class through a virtuous cycle of growth and distribution' has not been clearly presented. It remains to be seen whether the 'Honebuto no Hoshin', basic policies for economic and fiscal management and reform, to be formulated in June this year, will present a scenario that strengthens Japan's medium- to long-term growth expectations.

With regard to (ii) possible restrictions on share buybacks, Prime Minister Kishida denied the introduction of uniform regulations in his parliamentary reply in December last year, but suggested that guidelines should be drawn up and that emphasis should be placed on a more diverse range of stakeholders. Perhaps influenced by the negative market reaction at the time, subsequently, there has been no indication of concrete progress, and it seems unlikely that a clear policy will be formulated in the run-up to the Upper House elections this summer.

With regard to (iii) issues surrounding quarterly disclosure, in April, the Financial Services Agency announced its intention to abolish mandatory quarterly reports and unify them with financial statements based on stock exchange rules. If discussions proceed smoothly, it is expected that a draft amendment to the law will be submitted in 2023 and that the law will come into force in 2024. However, the final outcome will depend on developments in the U.S. and because it is essential to give shareholders and investors confidence that sufficient material information will be provided prior to implementation, depending on how the issue progresses it is possible that this may be postponed.

The need for consideration of (iv) the strengthening of financial income taxation was clearly stated in the ruling party's 2022 tax reform programme. However, discussions are clearly lagging behind, and given the nature of the Kishida Government (an administration which tends seek a wide range of opinions in policy consideration), there is a strong possibility that it will not be strongly promoted.

One reason for the lack of visibility in the overall direction is the cautious attitude of the Kishida Government and the Liberal Democratic Party (LDP) in the run-up to the Upper House elections in the summer. If clarification is forthcoming in the formulation of pledges for the election campaign, the negative attitude of overseas investors towards Japanese equities may partially recede.

Figure 5: Uncertainty over the Kishida Government's policies

Policies	Concern for overseas investors
"New capitalism"	Uncertainty over the overall picture for 'aiming for the revival of the middle class through a virtuous cycle of growth and distribution' remains.
Restrictions on share buybacks	Prime Minister Kishida's suggestion of formulating guidelines and remarks to emphasis on diverse stakeholders. Negative on uniform regulation.
Issues surrounding quarterly disclosure	The FSA intends to abolish mandatory quarterly disclosure and unify them with 'financial statements' based on stock exchange rules. However, the FSA intends to require disclosure of material information relating to corporate value on an as needed basis, as well as disclosure of non-financial information.
Strengthening of financial income taxation	The ruling party's 2022 tax reform programme clearly states the need to examine the taxation of financial income from the perspective of ensuring the fairness of the tax burden.

Source: Various news reports

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.

The Nikkei Stock Average (Nikkei225) :
The Nikkei Stock Average is a copyrighted material calculated in a methodology independently developed and created by Nikkei Inc. ("Nikkei") and Nikkei is the sole exclusive owner of the copyright and other intellectual property rights in the Nikkei Stock Average itself and the methodology to calculate the Nikkei Stock Average.

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.

Shanghai Stock Exchange Composite :
The Shanghai Stock Exchange Composite Index (SHCOMP) is the index to reflect the performance of the whole Shanghai securities market, which includes the whole listed A shares and B shares stocks on the Shanghai Stock Exchange (SSE) and is calculated based on total market capitalization of these listed stocks. All rights to calculate, publicize, disseminate and use the indices are reserved by SSE.

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 are only indicative of past performance and do not provide a guarantee of future performance.
- The contents included in this documentation are only current as of the date this documentation was prepared (April 28, 2022) 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.