

## Upside Potential for Japanese Equities

23 June 2023

- ▶ Foreign investors have driven the surge in Japanese equities, with the cumulative net purchase amount since the inauguration of the first Kishida Government showing a positive shift. At this stage, we should contemplate if this trend will continue.
- ▶ In this report, we examine the upside potential in the Japanese equity market based on the forward PE (price-to-earnings) ratio and trailing PB (price-to-book value) ratio from a historical perspective, putting aside fundamental factors. Our study shows that if share prices rise to 1x PB for all constituents of the TOPIX with a PB ratio below 1x, which accounts for about 50% of companies in the index, there would be significant upside potential.
- ▶ Return on capital, which the Tokyo Stock Exchange (TSE) has requested listed companies to improve, won't inherently increase in the short term, although investors will need to carefully assess how companies respond to this agenda.

Japanese equities have been on an upward trend since April this year, with the TOPIX surging by 14.5% from the end of March to 14 June. Meanwhile, the MSCI AC World Index (excluding Japan), a global equity index comprising developed and emerging economies, only rose by 4.7% (Figure 1). We believe the key factors behind the outperformance of the Japanese market include; (1) the TSE requesting listed companies with underperforming stocks to demonstrate better use of capital (for more on this, see our Opinion Report titled “Response to the Tokyo Stock Exchange’s Request to Listed Companies with below par Price-to-book Ratio”, 28 April 2023\*1), (2) a prominent US investor announcing their investment in Japanese stocks, (3) the growing expectation that the Japanese economy might break out of the long-term deflationary environment.

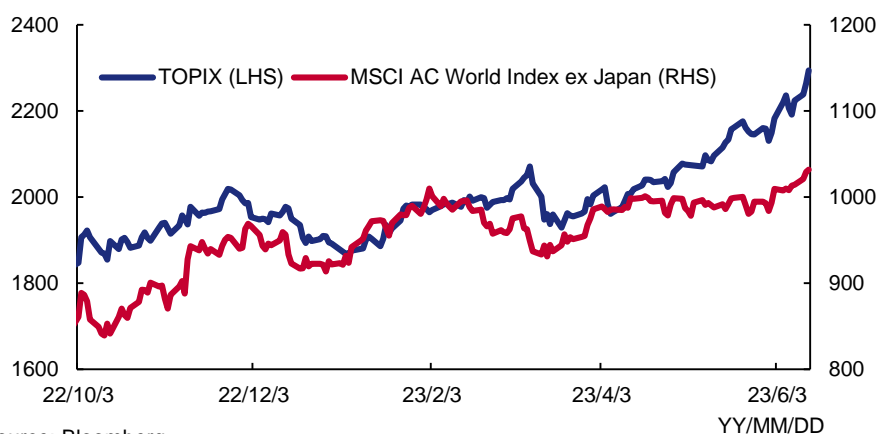
\*1Note: [http://www.am-one.co.jp/pdf/english/113/AMO\\_Opinion\\_Report\\_230428.pdf](http://www.am-one.co.jp/pdf/english/113/AMO_Opinion_Report_230428.pdf)



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**“Significant rises in Japanese equities”**

**Figure 1: Japan and Global (ex Japan) Stock Price Indexes**



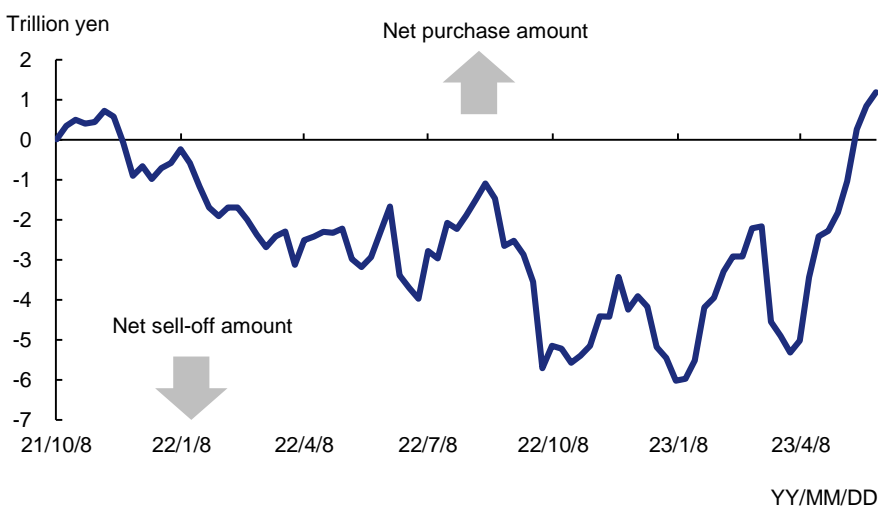
Source: Bloomberg  
 Period: Daily data from 3 October 2022 to 14 June 2023

Since the year 2000, there have been several occasions when Japanese stocks rallied regardless of short-term economic trends and corporate earnings. These events include; (1) the injection of public funds into major banks in 2003, (2) the “dissolution and privatization of Japan Post” under Prime Minister Koizumi in 2005, and (3) the introduction of “Abenomics” from the end of 2012 to 2013. In each case, expectations of economic stimulus policies and structural reforms were thought to be behind the rise in stock prices. More recently, the Kishida administration has introduced new initiatives such as childcare support. Nevertheless, doubts persist, particularly in Japan, regarding how comparable the influence of economic policy is to previous years that lead to an upswing in the market.

The recent rally in Japanese equities has been led by foreign investor purchases. As shown in Figure 2, when the first Kishida Government was formed in October 2021, the cumulative net purchase amount of Japanese equities (cash and futures combined) by foreign investors stayed in negative territory until around mid-May this year. The rise in Japanese equities from the beginning of April to mid-May appears to have been due to foreign investors buying back into the market after a “sell-off”. Given the recent shift to cumulative net purchases, we would have to consider whether foreign investors' buying will continue.

**“Led by foreign investor buying”**

**Figure 2: Cumulative Japanese Equity Trading by Foreign Investors (under the Kishida Administration)**



Source: Bloomberg

Period: Weekly data from the week of 4-8 October 2021 to the week of 29 May - 2 June 2023

Note: The cumulative net purchase amount of Japanese equities (cash and futures combined), total of two markets, excluding Nikkei 225 micro Futures

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**“What is the upside potential for Japanese stocks in terms of PE and PB?”**

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Here, we consider the upside potential of TOPIX premised on the 12 month forward PE (price-to-earnings) ratio and the trailing PB (price-to-book) ratio to judge the appropriate level of share prices, putting fundamentals such as macroeconomic and corporate earnings on the back burner.

The 12 month forward PE ratio for TOPIX stood at 15.9x as of 14 June\*2. This is considered to be a relatively high level when looking at the past 10 years (since 2013), excluding the Covid-19 period. The upper limit of the 12 month forward PE ratio before the pandemic was around 18x (Figure 3). If the 12 month forward PE ratio is to rise to 18x moving forward, based on share price growth alone, this would mean that there is room for the TOPIX to rise by approximately 13% compared to the closing price on 14 June.

The trailing PB ratio stood at 1.38x as of 14 June\*2 with the average over the past 10 years being 1.28x, and the level is already at  $+1\sigma$ \*3 (Figure 4). Given that the  $+2\sigma$  level has been the upper limit for share prices over the past 10 years, applying the above theory, the trailing PB ratio would rise to 1.48x. In this instance, share prices are estimated to increase by approximately 7% compared to the closing price on 14 June.

Note: \*2 Source: Bloomberg  
\*3 standard deviation

**Figure 3: 12 Month Forward PE for TOPIX**



Source: Bloomberg  
Period: Daily data from 4 January 2013 to 14 June 2023  
\*Note: The 12 month forward PE as compiled by Bloomberg

**Figure 4: The PB for TOPIX**

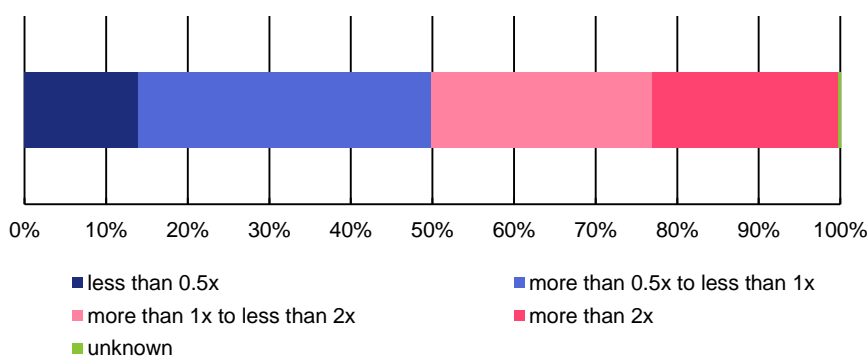


Source: Bloomberg  
 Period: Daily data from 4 January 2013 to 14 June 2023  
 Note: Trailing PB as compiled by Bloomberg.  
 The average and standard deviation ( $\sigma$ ) are for the above period.

Looking at the distribution of PB ratios across the TOPIX as a whole, the proportion of stocks with a ratio below 1x amounted to approximately 50% of the total as of 14 June (Figure 5). Investors are raising expectations that companies with low valuations will respond appropriately to the request made by the TSE to improve their return on capital. If the PB ratios of all companies currently below 1x were to increase to 1x (and assuming no change for companies with PB ratios already above 1x), the TOPIX would appreciate by approximately 13% compared to the closing price on 14 June.

**“What would the share price be if all companies with PB ratios below 1x were to increase to 1x?”**

**Figure 5: The Distribution of the PB in TOPIX**



Source: Bloomberg  
 Period: As of 14 June 2023  
 Note: Share of all stocks is calculated by the number of stocks (number of companies) that fall into each category related to the trailing PB ratios.

While we have hitherto examined the potential upward movement of share prices through mechanical calculations, we believe that future significance lies in management’s actions to enhance return on capital. The TOPIX RoE (Return on Equity) has remained largely unchanged over the years, and even now there are no signs of a major rise (Figure 6). Ideally, a correlation should exist where higher RoE leads to increased corporate valuations, elevated share prices, and higher PB ratios.

We believe that investors should not only assess short-term share price trends, but also carefully examine company management reforms aimed at improving the return on capital.

**“RoE does not increase in the short term - it would take time to assess the effectiveness of corporate measures”**

Figure 6: The RoE for TOPIX



Source: Factset

Period: Monthly data from January 2003 to May 2023

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