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

Key Focus Areas in Response to the Sharp Decline in Japanese Stocks

16 August 2024

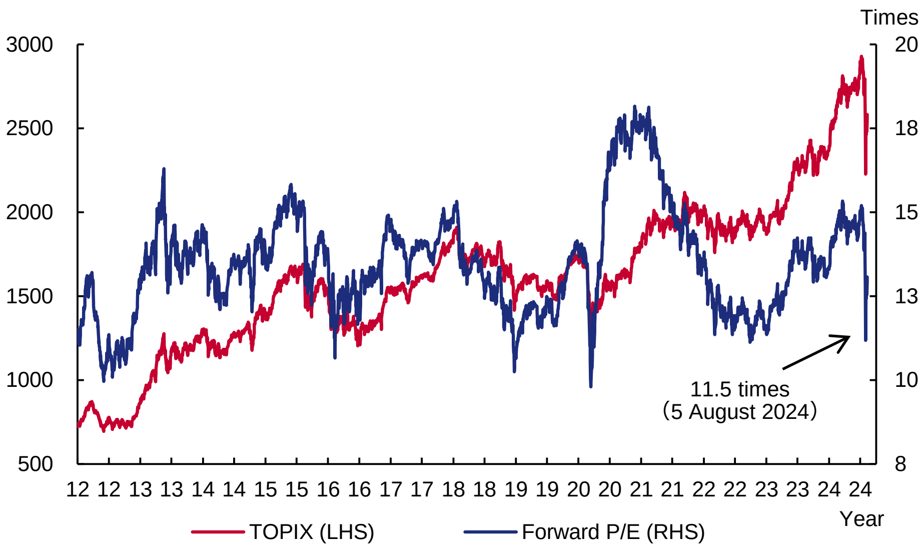
- Following a significant adjustment in early August, Japanese stocks have remained in an unstable situation.
- After falling to levels factoring in a potential economic recession in the US and Japan on August 5th, Japanese stocks have shown signs of rebound but with a cautious outlook due to the volatile dollar-yen exchange rate.
- It is expected to take some time for the market to stabilize, with particular attention on communication from the Bank of Japan (BOJ) and volatility in the dollar-yen exchange rate. The direction of the US economy, which was one of the triggers for the recent stock market decline, will also be closely monitored.

Hitoshi Asaoka
Senior Strategist

<u>The valuation of stock prices adjusted to a level factoring in a recession</u>

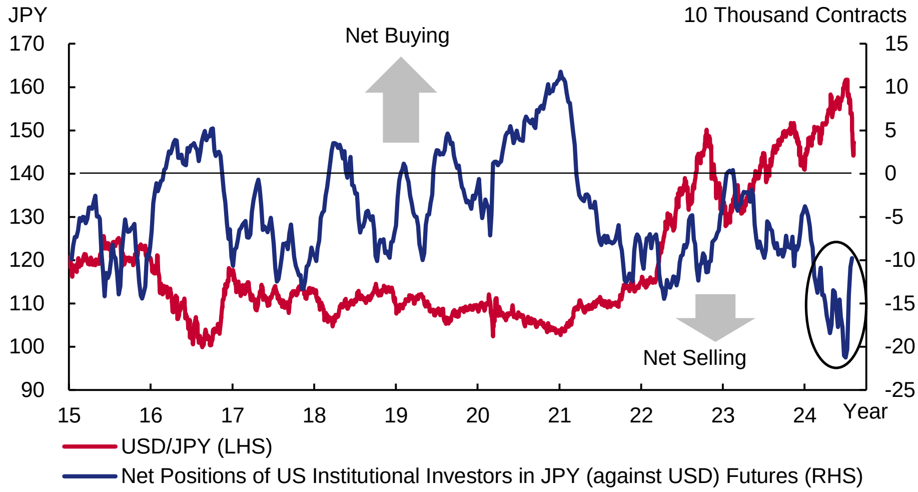
In just two days, August 2nd and 5th, both the Nikkei Average and TOPIX experienced significant declines of over 17% in terms of daily closing prices (Figure1). The 5-day drop in the Nikkei Average was the largest on record, and overseas stock markets also underwent substantial adjustments as risk aversion increased. Although there was a sharp rebound on the 6th, significant volatility continues. Market participants widely speculate that the appreciation of the yen may be attributed to foreign investors unwinding their short yen futures positions, leading to short-term fluctuations (Figure 2, next page).

Figure 1: TOPIX and Forward P/E



Source: LSEG Data & Analytics
Note: 1. Daily data From 4 January 2012 to 8 August 2024
2. The Forward P/E is the forward 12-month PER (Price-Earnings Ratio) estimate

Figure 2: USD/JPY Exchange Rate and Net Positions of US Institutional Investors in JPY Futures



Source: Bloomberg
Note: 1. USD/JPY: Daily data From 1 January 2015 to 8 August 2024
2. Net Positions of US Institutional Investors in JPY futures: Weekly data from 6 January 2015 to 30 July 2024

Looking at the valuation of TOPIX, based on the forward price-to-earnings ratio (PER), it dropped sharply from around 14.1x on the day before the decline to the 11x range on the 5th. Forward P/E since 2012 has generally ranged from 12x to 16x. The level of around 11x on the 5th appears to have factored in the worst case scenario of an economic downturn in both Japan and the US, along with deteriorating corporate performance due to yen appreciation, and is considered to be an excessive adjustment.

It is estimated that major Japanese companies assumed a USD/JPY exchange rate of around 145 yen in their fiscal year plans. Market forecasts, including those among analysts, ranged from 145 to 150 yen. However, some also assumed levels over 150 yen following the yen's depreciation in early July. If the USD/JPY remains at around 140 yen going forward, the average USD/JPY rate for this fiscal year would be calculated at around 145 yen. Regarding earnings per share, the market had expected an increase of approximately 8% compared to the previous year for this fiscal year. Even after considering the recent appreciation of the yen, achieving this increase is still believed to be possible if there is no economic downturn in Japan and the US.

Did BOJ governor press conference trigger the turbulence?

It is argued that the recent appreciation of the yen and the sharp decline in stock prices were triggered by the BOJ’s monetary policy decision at the end of July, as well as the US ISM Manufacturing Index and employment statistics. The press conference held by Governor Ueda at the BOJ had an unexpectedly hawkish tone, leading some market participants to speculate that interest rate hikes could be accelerated, possibly on a quarterly basis. This, in turn, contributed to the strengthening of the yen and the decline in stock prices. Furthermore, concerns about a deteriorating US economy fueled speculation of rate cuts by the Federal Reserve (FRB), further bolstering the yen and adding to the downward pressure on stock prices.

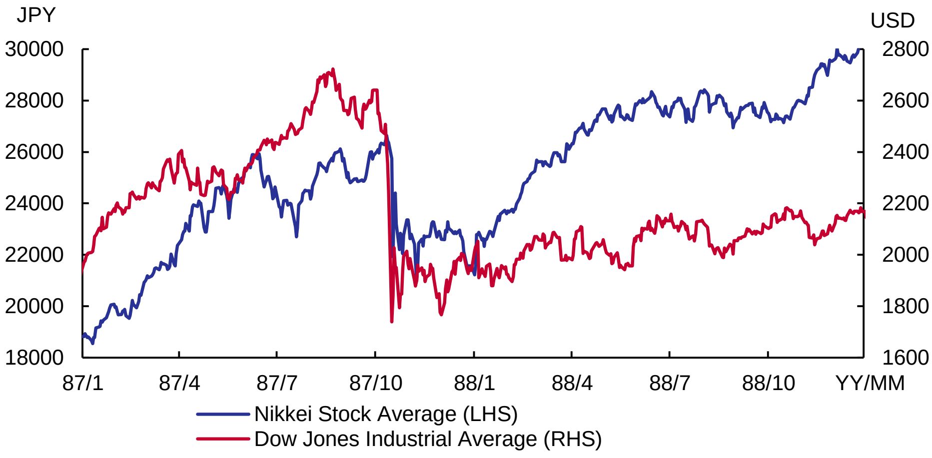
In response to the market's reaction to the BOJ's decision, Deputy Governor Uchida stated on the 7th that interest rate hikes would not be implemented in a volatile financial market, expressing a cautious stance towards additional rate hikes. This statement, however, significantly differed from Ueda's remarks. Given the challenges the BOJ faces in effectively communicating with the market, it is expected to take some time for market psychology to stabilize.

As the LDP leadership election approaches in September, it is important to be attentive to the possibility of increased statements regarding domestic interest rates and yen depreciation from the candidates for the next Prime Minister. During the Abenomics era, there was a clear policy direction focused on massive monetary easing by the BOJ and yen depreciation to overcome deflation. However, this time, there are concerns about inconsistencies in policy as some candidates call for normalization of the BOJ's monetary policy while expressing a desire for inflation stability.

<u>Market stabilization is expected to take a certain period of time</u>

At the time of the Black Monday of 1987, it took several months for stock markets, including those in Japan and the US, to recover an upward trend (Figure 3). It is important to note the possibility that periods of high market volatility may persist. With the Japanese stock market being sensitive to exchange rate movements, it would be crucial to confirm a stabilization of volatility in the USD/JPY exchange rate (Figure 4,next page).

Figure 3: The Stock Prices Before and After Black Monday in the US and Japan

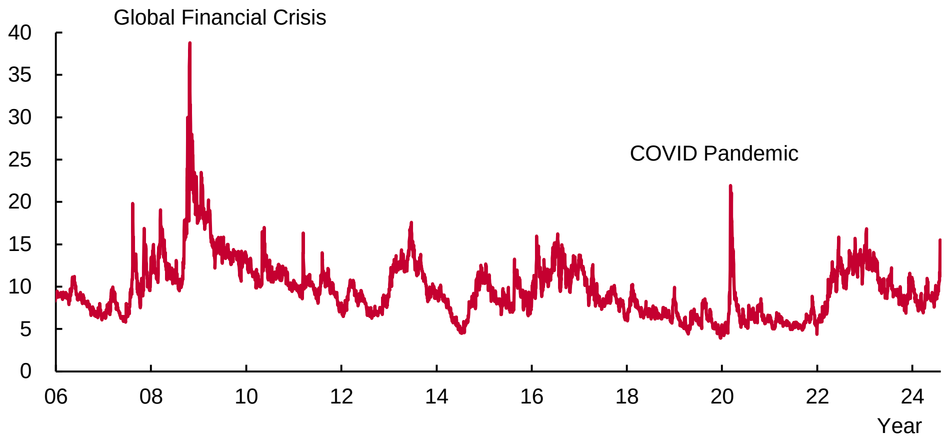


Source: LSEG Data & Analytics
Note: Daily data From 4 January 1987 to 31 December 1988

<u>Also, keeping an eye on the US economic trends</u>

Both Japan and the US have not shown strong indications of entering an economic downturn based on their economic indicators, including employment statistics. In the absence of tight conditions in the short-term financial markets, the possibility of emergency interest rate cuts or liquidity supply by the FRB is low. In particular, US stock valuations currently remain at a high level compared to the past.

Figure 4: Implied Volatility of USD/JPY (Monthly)

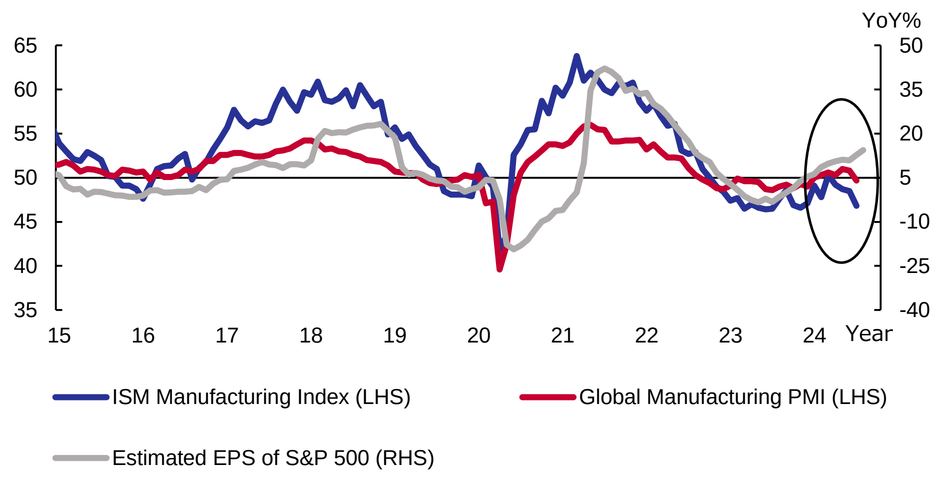


Source: LSEG Data & Analytics
Note: Daily data From 4 January 2006 to 8 August 2024

The direction of the global economic outlook, including the US, will also hold the key to improving investor sentiment and the recovery of the US stock market trend. In the US, there has been hesitancy in the sentiment of the manufacturing industry. However, when examining individual series within the manufacturing sentiment index, there are no signs of excessive inventory and no strong indications of production adjustments.

Traditionally, it is known that the estimated EPS (earnings per share) of S&P 500 constituent companies and the ISM Manufacturing Index show similar movements (Figure 5). However, recently there have been some divergent trends. This gap may be influenced by the strong expansion of profits in AI-related companies that do not depend on the economic cycle, but the near-term trend will be observed closely.

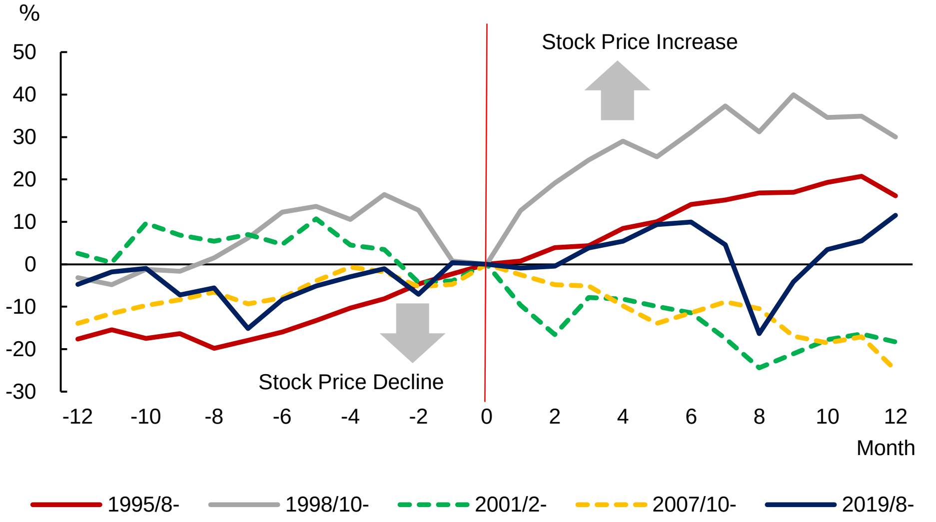
Figure 5: EPS Estimate of S&P 500, US and Global Manufacturing Sentiment



Source: LSEG Data & Analytics
Note: Monthly data From January 2015 to July 2024, estimated EPS valued until August 2024

As the Federal Reserve's interest rate cuts approach, let's take a look at the performance of US stocks during past rate cuts. Concerning US stocks (S&P 500), they initially showed a lack of direction after the start of rate cuts, and the performance differed between rate cuts accompanied by economic downturns and those that didn't (Figure 6).

Figure 6: S&P 500 Changes Before and After FRB Rate Cuts



Source: LSEG Data & Analytics

Note: 1. Monthly data From August 1994 to August 2020 (Beginning-of-month data)

2. The month that the FF interest rate turned to negative is set as the zero point to graph the rate of change (compared to the zero point) for the 12 months before and after
3. The dates in the legend are set as the year and month of zero point
4. The solid line represents preventive interest rate cuts in the US during periods when there was no economic downturn (including the rate cuts in 2019 before the COVID)
5. The dashed line represents interest rate cuts during periods of economic downturn

During rate cuts accompanied by economic downturns, stock prices continued to decline even after the start of rate cuts. On the other hand, during rate cuts that were not accompanied by an economic downturn, stock prices increased significantly (although they declined after an initial increase in 2019 due to the COVID-19 pandemic). From this perspective, it can be concluded that the direction of the US economy remains a crucial factor in stock market trends rather than the decision to cut interest rates.

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 Index:
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.

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. The product is solely established and managed by Asset Management One Co., Ltd. and Nikkei does not give any warranty, nor is it responsible for any and all financial instruments and the like, which are based on, or other wise refer to, the Nikkei Stock Average.

S&P500 Index, Dow Jones Industrial Average:
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.

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 (August 16, 2024) 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.

24-012 GBDG