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Key Points to Watch in Japanese and U.S. Stocks

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U.S. Tech Stocks and Small-Cap Stocks Hit New Highs

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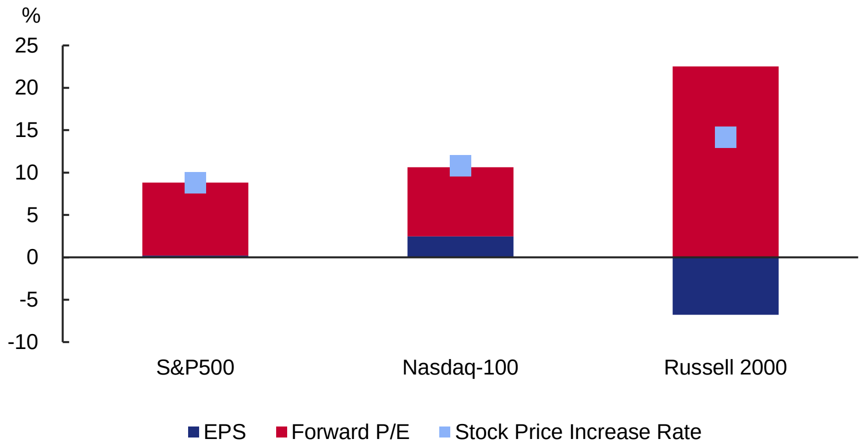
Broad U.S. stock indices have recently reached new highs. This follows the significant corrections triggered by U.S. reciprocal tariffs in April, which have since subsided. Figure 1 shows the subsequent performance of U.S. stocks from July onwards, broken down by earnings outlook and valuation for the S&P 500 Index, Nasdaq-100 Index (heavily weighted towards large-cap tech stocks), and Russell 2000 Index (small-cap stocks).

All indices recorded significant gains driven by valuation expansion amid expectations of Federal Reserve (Fed) rate cuts. However, the Nasdaq-100 Index also benefited from improved earnings outlook, likely reflecting heightened expectations for accelerated investment in Artificial Intelligence (AI) related investment. On the other hand, for the Russell 2000 Index, whose earnings are seen as more susceptible to U.S. domestic demand trends, earnings outlook is a negative contributor. This suggests persistent concerns about the U.S. domestic economy.

Figure 1: Breakdown of U.S. Stock Price Increases



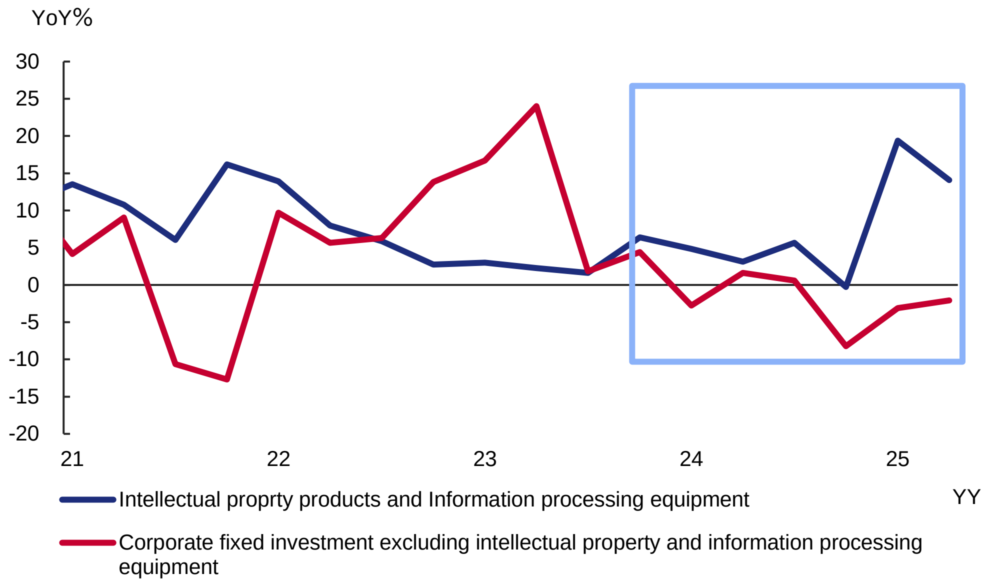
Source: Bloomberg, Asset Management One Co., Ltd.
Note:1. Change rate from 30 June to 8 October 2025
2. EPS is the earnings per share forecast, Forward P/E is the 12-month forward price-to-earnings ratio

The lack of breadth in capital investment persists

U.S. real GDP growth rate for the April-June quarter reached an annualized rate of +3.8% compared to the previous quarter, driven by consumption and capital investment. However, examining the breakdown of capital investment reveals a polarizing trend (Figure 2). Capital investment in intellectual property and information processing equipment is experiencing high growth. For example, AI-related investments such as software are driving the expansion of intellectual property investment.

On the other hand, capital investment in conventional structures and equipment other than intellectual property and information processing equipment, has remained sluggish since the second half of 2023. In 2022, capital investment accelerated following the enactment of the Inflation Reduction Act. The effects of this have largely run their course, and more recently, large-scale capital investments requiring borrowing appear to be constrained by the high-interest-rate environment.

Figure 2: U.S. Corporate Fixed Investment (Real Basis)

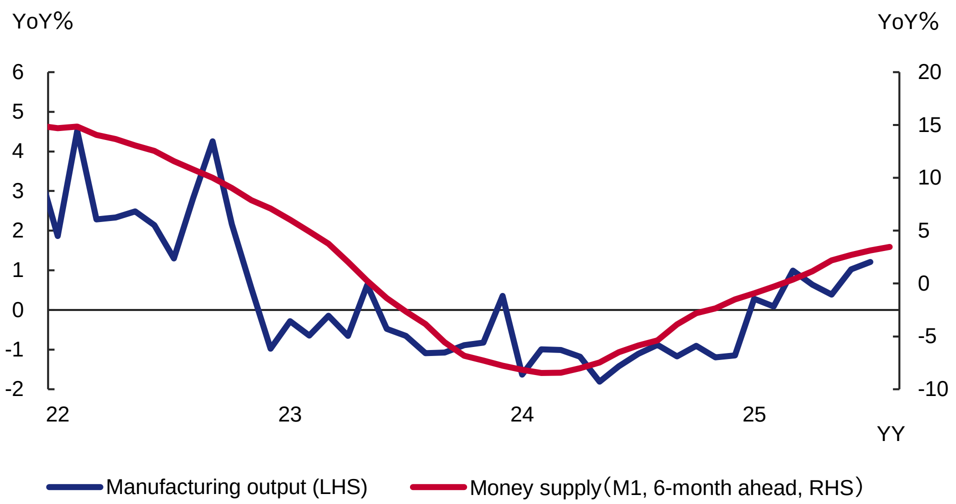


Source: Bloomberg, Asset Management One Co., Ltd.
Note: Quarterly data from Q1 2021 to Q2 2025

Continued expectation regarding the broadening base of recovery

The Federal Reserve cut interest rates in September, making the first time since December last year. Since last year, rate cuts have progressed in Europe and other regions. This has led to a broad expansion in global money supply, which has contributed to the recent in global stock market rally. Going forward, the macro environment is expected to support not only further asset price appreciation but also a recovery in traditional capital investment and increased manufacturing production activity (Figure 3). As a result, we can expect a broadening of investment in the stock market, beyond high-tech stocks.

Figure 3: OECD Money Supply and Manufacturing Output



Source: LSEG Data & Analytics, Asset Management One Co., Ltd.
Note: 1. Monthly data from January 2022 to July 2025
2.Both manufacturing output and money supply for all OECD (Organization for Economic Cooperation and Development) member countries combined
3. Money supply is recorded six-month ahead of actual month

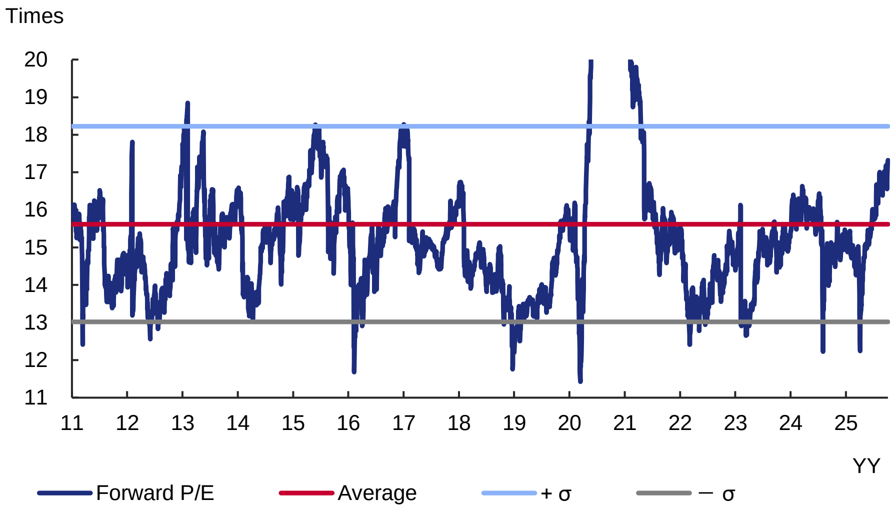
Japanese Stocks Poised for Further Gains

Japanese stocks have risen significantly since the summer and have continued to perform strongly. This momentum has been driven by factors such as, reduced concerns over tariff impacts following the Japan-U.S. trade agreement, as well as expectations for accelerated U.S. investment in Artificial Intelligence (AI). In October, Japanese stocks rose further following Ms. Takaichi's victory in the LDP leadership election.

Bloomberg data shows that the 12-month forward Price/Earnings (P/E) ratio for the TOPIX Index has reached the 17x range (Figure 4). For Japanese stocks, there have been instances where the forward P/E ratio expanded significantly due to factors specific to Japan, such as heightened expectations for domestic policy, rather than overseas influences. Excluding the COVID-19 pandemic, this occurred in 2013, 2015, and 2017, when the P/E ratio deviated one standard deviation above the long-term average, reaching the low 18x range.

While market concerns about overheating simmered following the surge, the current level remains below that threshold.

Figure 4: TOPIX Forward P/E Ratio



Source: Bloomberg, Asset Management One Co., Ltd.
Note:1. Daily data from 4 January 2011 to 8 October 2025
2. Forward P/E is the 12-month forward price-to-earnings ratio
3. Periods during the COVID-19 pandemic when the P/E exceeded 20 times are not displayed
4. σ is the standard deviation for the same period

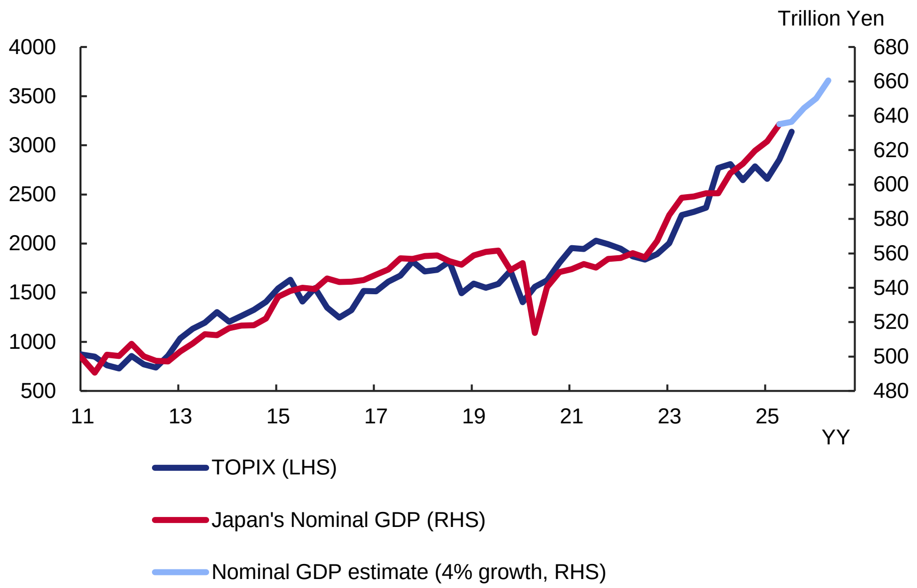
Nominal GDP expansion outlook may justify stock gains

Uncertainty remains regarding the future framework of the coalition and the feasibility of the "responsible proactive fiscal policy" is expected to be advanced by Ms. Takaichi. Specifically, the scale of the supplementary budget to be deliberated toward year-end may disappoint.

Concerns also exist regarding corporate earnings, particularly in manufacturing, as reflected in interim results.

However, when examining the relationship between Japan's nominal GDP and the TOPIX Index since 2011, it does not appear that stock prices have recently risen excessively relative to the pace of GDP expansion (Figure 5). While fiscal expansion policies may fall short of expectations, a continuation of the recent year-on-year growth rate of around 4%, could still support further upside potential for Japanese stocks.

Figure 5: : Japan's Nominal GDP and TOPIX



Source: Bloomberg, Asset Management One Co., Ltd.
Note:1. Quarterly data from Q1 2011 to Q2 2025 for GDP
2. Quarterly data from Q1 2011 to Q3 2025 for TOPIX
3. The nominal GDP estimate indicates the trajectory if the GDP grows at a 4% yoy rate starting from Q3 2025

When is the time to be cautious?

Global stock market gains have fuelled ongoing concerns about a bubble, particularly in the U.S. However, as long as the Fed continues cutting interest rates and liquidity expansion persists, any sharp decline is expected to result in a short adjustment period. The period around next year when interest rate cuts cease and liquidity expansion pauses is considered a time requiring greater caution.

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