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Market Environment Outlook in the Wake of the US Midterm Elections

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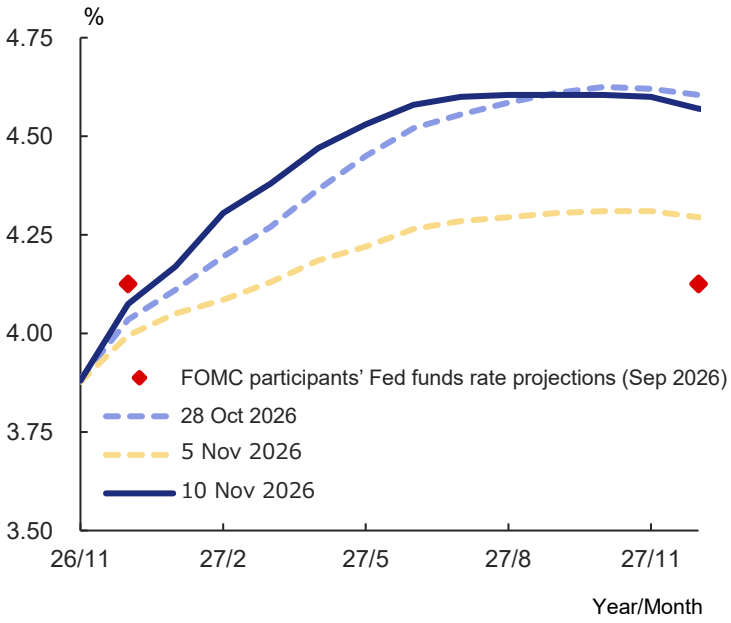
Room for Japanese equity valuations to re-expand

The US midterm elections were held on 3 November, with the Democratic Party securing a majority in both the House and the Senate. Thereafter, remarks by Governor Waller suggesting the Fed should consider a 50-basis-point rate rise in December, together with a strong October US CPI (Consumer Price Index) print, led markets to rapidly price in further rate increases (Figure 1), and US yields rose sharply. In assessing how the midterm election outcome affects interest rates, we see two key points: (1) fiscal policy and (2) AI data-centre investment.

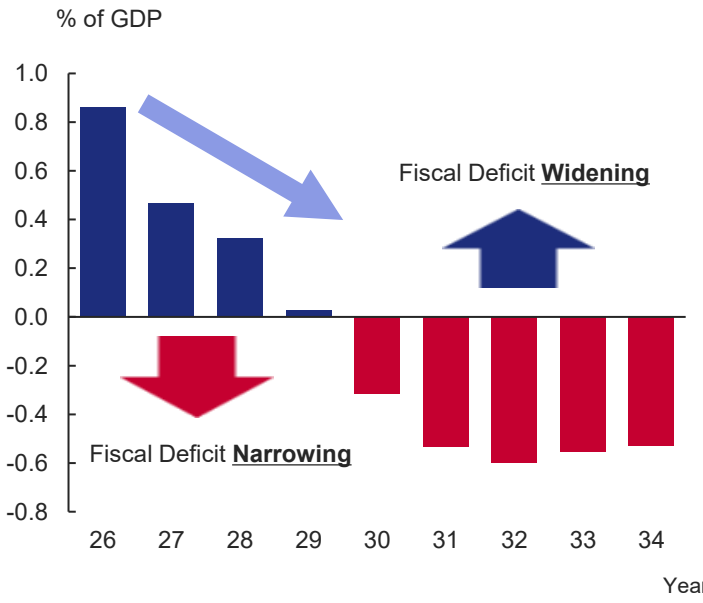
First, regarding fiscal policy, the prospects for large-scale fiscal legislation, such as the cash handouts advocated by President Trump, have receded. With the risk of a significant fiscal deterioration avoided, the adverse supply–demand impact associated with increased US Treasury issuance, should ease, along with upside risks to growth and inflation stemming from stronger aggregate demand. We therefore expect downward pressure on interest rates. In addition, the growth-boosting effect of last year's large fiscal package (OBBBA) is expected to gradually diminish from next year onwards, which should also act to restrain interest rates (Figure 2).

Figure 1: Fed Funds Futures Rates and FOMC Participants' Fed Funds Rate Projections



Source: FRB, Bloomberg, Asset Management One Co., Ltd.
Period: Monthly Data from November 2026 to December 2027
Note: Fed funds (FF) rate futures are used.

Figure 2: OBBBA's Fiscal Impact



Source: US Congressional Budget Office (CBO), Asset Management One Co., Ltd.
Period: Annual Data from 2026 to 2034
Note: CBO assessment at the time of the Senate's deliberations on the OBBBA.

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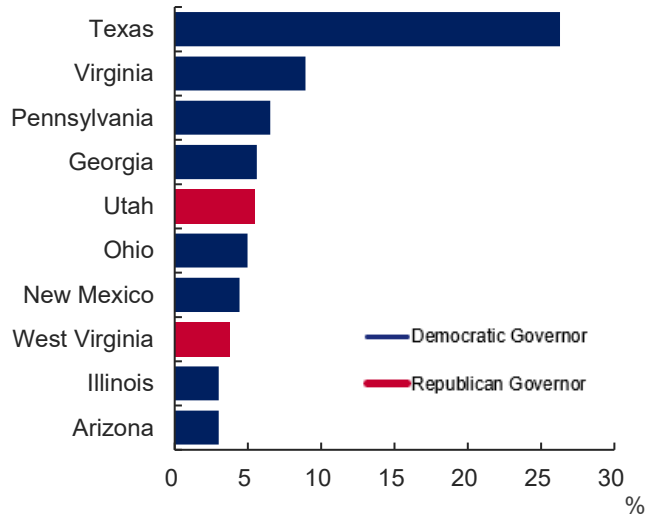
Second, regarding AI data-centre investment, the victory of Democratic candidates in gubernatorial elections in states where many data-centre construction plans are concentrated (Figure 3) has strengthened the view that tighter construction regulations will curb investment. However, given that (1) the winning candidates are not calling for an outright ban on construction, (2) regulation is not at the federal level and developers can shift plans to states with more permissive rules, and (3) AI is strategically important for national security and demand remains strong, we expect an extreme slowdown in investment to be avoided. Meanwhile, as corporate fundraising via bond issuance is likely to slow, upward pressure on interest rates should ease.

As for foreign exchange, immediately after the midterm elections there were episodes in which the yen strengthened against the US dollar, driven by a fall in US yields and a sharp decline in US equities. More recently, however, the yen has weakened into the high 159s yen per dollar, reflecting the rise in US yields noted above. That said, market wariness of coordinated yen-buying intervention by Japan and the US appears to remain strong, and we expect conditions to persist in which it is difficult for the yen to weaken substantially beyond the key 160yen level. Looking ahead, expectations that the Bank of Japan will maintain a pace of rate rises of roughly once every three months through next spring should lend support to the yen. Communication at the BoJ's December Monetary Policy Meeting will be closely watched.

External backdrop likely to weigh on Japanese equity valuations

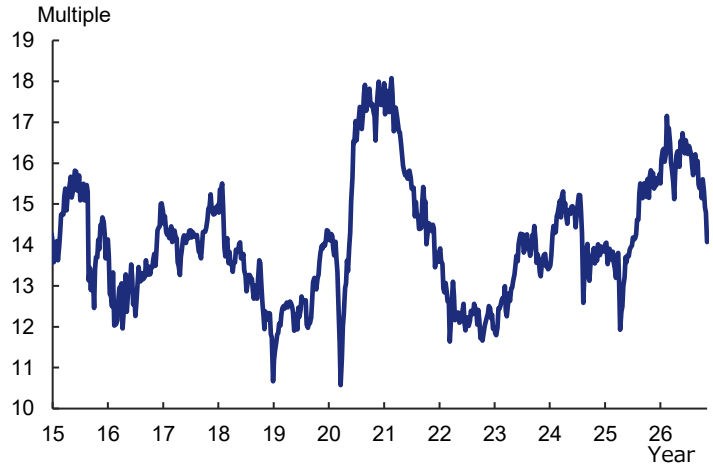
During the sharp sell-off in Japanese equities on 6 November following the midterm elections, TOPIX's valuation (forward PER/price-to-earnings ratio) fell to around 14x (Figure 4). This represents a decline of roughly 12.5% from about 16x in early September. If we interpret the fall in the PER as the market pre-emptively pricing in downward revisions to future EPS (earnings per share), it would be broadly consistent with a view that TOPIX earnings growth over the next year will be flat to negative. Given that profit growth has continued even in sectors outside AI and semiconductors, this appears to be an excessive concern.

Figure 3: Share of Power Capacity by State in Data Centre Projects Under Construction or Planned Across the United States



Source: dcmap.us, Asset Management One Co., Ltd.
Note: Political party affiliation of governors reflects election results rather than incumbent governors. For Virginia, Utah and West Virginia, where no gubernatorial elections were held this time, the party affiliation shown is that of the incumbent governor

Figure 4: Forward P/E Ratio of the TOPIX



Source: LSEG Datastream, Asset Management One Co., Ltd.
Period: Weekly data from January 2, 2015 to November 6, 2026

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Looking at expected ROE (return on equity) for Japanese equities, it has remained on an upward trend, reaching 12.2% for the MSCI Japan Index and 11.2% for TOPIX. Based on the relationship between ROE and PBR (price-to-book ratio) implied by MSCI's country indices, when ROE is 12%, a PBR of roughly 2x appears to be a "fair" level (Figure 5). In that case, the implied PER (= PBR ÷ ROE) would be approximately 16x. Even as at 12 November, the forward PER remains in the low-14x range; however, provided there is no recession in Japan or the US, we believe there is scope for valuations to re-rate.

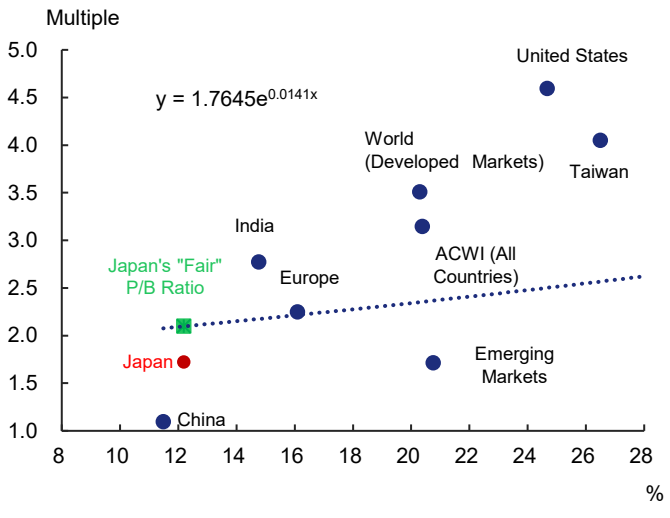
However, the external backdrop is likely to weigh on Japanese equity valuations for the time being.

As noted on the previous page, AI-related capital expenditure, particularly data-centre construction still faces the risk that the explosive growth in construction spending could moderate due to tighter regulations at the state level and elsewhere.

That said, regulatory tightening could lead AI-related capex to become more levelled and drawn out over a longer period, potentially easing inflationary pressures. While this would be a factor pushing interest rates lower, it is worth noting that for areas such as memory semiconductors—where profits have continued to expand amid sharp price increases driven by tight supply–demand conditions—earnings expectations could come under some downward pressure.

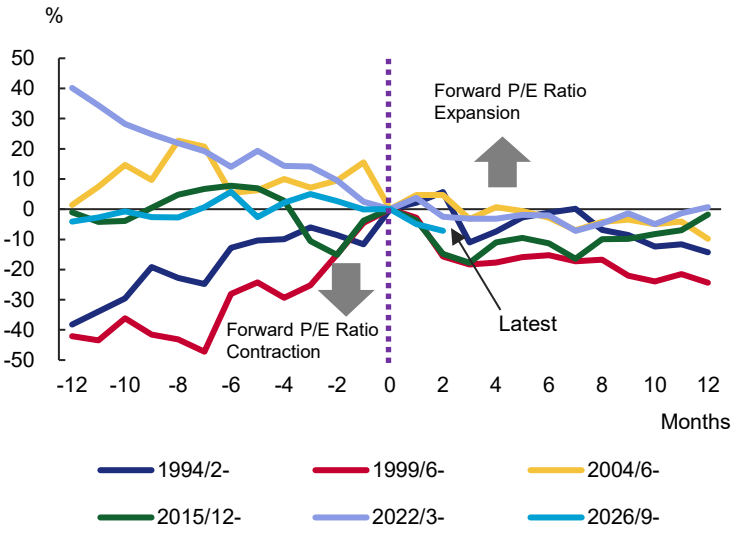
In addition, developments in US rate rises warrant close attention for the time being. Even if crude oil prices move sideways from here, they are still likely to remain elevated on a year-on-year basis at least through February next year. Against this backdrop, the BoJ, the Fed and the ECB are likely to maintain a hawkish stance into the first half of next year. This is a risk factor that could weigh on valuations not only for US equities but also for Japanese equities (Figure 6).

Figure 5: International Comparison of P/B Ratios and ROE



Source: LSEG Datastream, Asset Management One Co., Ltd.
Note: 1. Forecast ROE on the x-axis and forecast PBR on the y-axis
2. Dotted line indicates an exponential trendline
3. Based on MSCI country and regional equity indices

Figure 6: TOPIX Forward P/E Ratio During U.S. Rate-Hiking Cycles



Source: LSEG Datastream, Asset Management One Co., Ltd.
Note: 1. The chart shows percentage changes (relative to the starting point) over the 12 months before and after the beginning of each Fed rate-hiking cycle since February 1994
2. Dates in the legend indicate the month in which each rate -hiking cycle began
3. For the most recent rate-hiking cycle, forecast PER is based on estimates as of November 10, 2026

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