



Summary

- After a very strong period, Japanese equity markets have paused, absorbing the impact of weaker-than-expected company guidance.
- In light of conservative company forecasts, any progression in earnings rates should boost investor sentiment in the months ahead.
- Some headwinds have developed for Japanese equities, including rising political uncertainty, which we believe will balance the tailwinds in the short term.
- Longer term, we think the market has underestimated the potential in the structural changes underway in Japan, and we see the current pause as an opportunity.

While the end of June represents a midpoint for many global investors, for Japanese management teams, it is more like a beginning: Most companies report along the government fiscal year of April to March. So far, Japan's new fiscal year has brought some changes.

The fiscal year ending in March was a strong one for Japanese companies, characterized by high-teens earnings growth, partially driven by the weaker Japanese yen; an acceleration in positive governance developments; and the symbolic end of deflation, with the Bank of Japan (BoJ) ending negative interest policy in March. Not surprisingly, Japanese equities, with total returns of 41% in local currency and 24% in US dollar terms, outperformed most markets globally—with the notable exception of the United States, which was fueled by strong sentiment surrounding artificial intelligence and technology.

Also unsurprising in our view, Japanese equity markets have paused over the past three months to digest companies' weaker-than-expected guidance for the new fiscal year. In aggregate, companies in the Tokyo Price Index (TOPIX) have forecasted low-single digit revenue growth and a low-single digit decline in earnings for the fiscal year ending in March 2025. Japanese management teams tend to give conservative guidance, with last year being a case in point: Their assumptions of a flat or modestly strengthening yen compare to current levels that are ¥14 weaker relative to the dollar than the average for fiscal 2023.

Although we don't forecast aggregate earnings at the index level, consensus expectations of mid-to-high single-digit earnings growth seem reasonable in our estimation. We believe positive earnings progression rates after the fiscal first quarter could help overall market sentiment in the short term.

Short-Term Balance

Over the rest of the calendar year, we see a balance of potential headwinds and tailwinds for the market.

Potential headwinds until now have primarily been the risks associated with the US economic outlook as well as the Federal Reserve's interest rate path. Lately, though, rising political uncertainty has created a new headwind for Japanese equities. Political volatility in Europe has already begun, and in our view, the US presidential election will soon start to weigh on investor sentiment. In Japan, the Liberal Democratic Party (LDP) election

in September will also generate concerns about policy continuity if Prime Minister Fumio Kishida is unable to secure another term as LDP president. Lastly, the recent depreciation of the yen from 150 to 160 relative to the US dollar has also dampened investor sentiment.

On the other hand, there are many potential tailwinds for the market, including positive surprises to earnings given the recent reset in expectations. Positive governance developments have resulted in a sharp acceleration in share repurchase announcements year to date. In addition, as overall inflation continues to moderate from high levels, we could see nominal wage gains overtaking inflation, resulting in real income growth that would support real consumption growth from late 2024 or early 2025.

We would also note the positive attitude toward risk from Japanese retail investors: They have fully embraced recent changes to the NISA program—Japan’s tax-free individual savings accounts—by approximately tripling their contributions compared to last year. Another rate hike by the BoJ would also be a positive development, in our view, as it would represent another step toward economic normalization and possibly support the yen. Lastly, actual fundamentals remain firm for many industries, based on our analysis, and inventory corrections, which have dogged many businesses for well over a year, are now making headway.

Long-Term Progress

This balanced near-term outlook may result in sideways movement in Japan’s equity market, similar to what we have observed over the past few months. However, we remain upbeat over the medium and long term for Japanese equities because we see two key themes continuing to play out: corporate governance improvement driving better capital efficiency and higher shareholder return, and the shift from deflation to inflation gradually transforming consumer behavior.

We believe the market is still underestimating the potential of these two secular tailwinds. While price-to-earnings valuations have reverted to their 10-year average, the enterprise value (EV)-to-EBITDA ratio is still significantly lower than in other developed markets, and in our view, this is a better indication of the potential of improved capital efficiency.

Market skepticism has grown recently as strong performance has moderated, but we view periods such as this as an opportunity for investors to revisit their strategic weighting to Japanese equities.

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Originally published on 15 July 2024. Revised and republished on 29 July 2024.

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