Japan Investment Commentary and Market Outlook

Shares pulled back on fears

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In October, the Japanese stock market declined along U.S. equities due to higher U.S. interest rates and increasing geopolitical risks.

The TOPIX 12-month forward Price-to-Earnings (PER) remained below 14x, while the 12-month forward Earnings Per Share (EPS) continued to rise.

At the end of the month, the Bank of Japan adjusted the yield curve control (YCC) operations again, causing the 10-year Japanese Government Bond (JGB) yield to rise. However, this did not prevent the yen from depreciating against other currencies, reaching a year-to-date low of 151 yen versus the dollar.

Market Movement	As at 31/10/2023
TOPIX Index	2,253.72 - 69.67 points (-3.00%)
Nikkei 255 Stock Average	30,858.85 yen - 998.77 yen (-3.14%)
Exchange rate	1 USD = 151.68 JPY

Market Review

In October, the Japanese stock market declined along U.S. equities due to higher U.S. interest rates and increasing geopolitical risks.

The stock market started the month weak due to rising U.S. interest rates after hawkish remarks by Federal Reserve Board officials. However, it rebounded as fears of prolonged high interest rates eased with the reveal of a less hawkish tone in the FOMC minutes.

In the middle of the month, Federal Reserve Chairman Jerome Powell stated that "inflation is still too high", which restrained the notion that the interest rate hike would end and raised expectations for another rate hike this year. This led to the benchmark 10-year Treasury yield crossing the 5% threshold for the first time in 16 years. This coupled with Israel's military build-up around the Gaza Strip raised concerns of escalating tensions in the Middle East. These factors prompted investors to become risk-averse and contributed to the market's downturn.

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The TOPIX index closed at 2,253.72 points, down 69.67 points (-3.00%) from the end of the previous month and the Nikkei 225 Stock Average index closed at 30,858.85 yen, down 998.77 yen (-3.14%). The Japanese yen closed at 151.68 yen per U.S. dollar, depreciating 1.6% from the previous month.

Among the TSE 33 industrial sectors 4 sectors advanced led by Foods, Pulp & Paper, Banks, and Insurance while 29 sectors declined led by Pharmaceuticals, Machinery, Iron & Steel, Transportation Equipment, and Nonferrous Metals.

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In terms of style, there were little disparities between value and growth in the large and mid-cap space. However, in the small-cap space, value stocks outperformed growth stocks. Notably, small-cap growth stocks listed in the Mothers index extended losses with a decline of 11.14%.

Politics

In October, the approval ratings for the Cabinet hit a new low since Prime Minister Fumio Kishida took office two years ago. According to a poll conducted by Kyodo News between 3rd and 5th November, the approval rating fell to 28.3%, dropping below 30% for the first time since the end of the Aso administration in 2009. This outcome has shaken Nagatacho, the country's political centre. Despite the recently announced economic stimulus plan, which includes a proposed 40,000 yen (approximately US$266) income tax cut and a 70,000 yen (approximately US$466) cash distribution to low-income households, concerns about future tax hikes remain. These concerns are cited as the main reason for the decline in public support. As a result, the anticipated dissolution of the House of Representative has reportedly been delayed.

Inbound tourism

In September, the number of visitor arrivals reached 96% of the pre-COVID level, showing signs of recovery. The increase in the number of visitors to Japan from South East Asia and the Americas boosted the recovery.

The anticipation of an increase in Chinese tourists to Japan was initially boosted by the Chinese government's announcement of the resumption of guided tours. Guided tours to Japan were initially reported to be popular during the Golden Week holiday season. However, this positive trend changed when the Japanese government decided to release treated water from the Fukushima Nuclear Reactor. This decision faced opposition from Beijing, leading to a ban on seafood imports from Japan and an increase in travel booking cancellations.

Corporate earnings

As of 9th November, over 70% of companies listed on the TSE Prime Market have reported their interim financial results. Overall, top-line revenues have increased by a low single digit, and operating profits have increased over 20% in the July-September quarter compared to the same period last year. Electric Power & Gas companies and Transportation Equipment companies have reported favourable results, contributing to the growth.

BOJ and monetary policy

At the end of the month, the Bank of Japan made further adjustments to its yield curve control (YCC), resulting in a rise in the 10-year JGB yield. However, despite these adjustments, the yen continued to depreciate against other currencies, reaching its lowest point for the year at 151 yen against the dollar.

On 31st October, the central bank made the decision to remove the previous upper bound hard limit of 1.0% in its yield curve control operations. Instead, it implemented a reference rate of 1%, providing the bank more flexibility in conducting the operations.

The bank has also published its Outlook for Economic Activity and Prices, in which it has upgraded the consumer price index (CPI) outlook. The bank now expects that core CPI, excluding fresh food and energy, will rise by 1.9% year-on-year in both FY2024 and FY2025. This is an increase from the previous projections of 1.7% and 1.8% for those respective years.

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2023	+1.8 to +2.0 [+2.0]	+2.7 to +3.0 [+2.8]	+3.5 to +3.9 [+3.8]
Forecasts made in July 2023	+1.2 to +1.5 [+1.3]	+2.4 to +2.7 [+2.5]	+3.1 to +3.3 [+3.2]
Fiscal 2024	+0.9 to +1.4 [+1.0]	+2.7 to +3.1 [+2.8]	+1.6 to +2.1 [+1.9]
Forecasts made in July 2023	+1.0 to +1.3 [+1.2]	+1.8 to +2.2 [+1.9]	+1.5 to +2.0 [+1.7]
Fiscal 2025	+0.8 to +1.2 [+1.0]	+1.6 to +2.0 [+1.7]	+1.8 to +2.2 [+1.9]
Forecasts made in July 2023	+1.0 to +1.2 [+1.0]	+1.6 to +2.0 [+1.6]	+1.8 to +2.2 [+1.8]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

Source: "Outlook for Economic Activity and Prices (October 2023)", the Bank of Japan, https://www.boj.or.jp/en/mopo/outlook/gor2310a.pdf

Market Outlook

Our positive stance on the stock market is rooted in several key factors. Firstly, corporate earnings display remarkable resilience and show potential for further expansion. This is complemented by stock valuations that remain reasonable, positioning the market for growth. The reopening of the economy has invigorated domestic consumption, while heightened domestic capital expenditure underlines companies' efforts to bolster productivity and secure supply chains.

Furthermore, the Japanese government's collaboration with the United States and Europe to attract semiconductor investment within the country's borders is gaining momentum, which could establish an independent supply chain.

Corporate indicators are notably strong, with earnings, dividend payouts, and share buybacks reaching unprecedented heights, providing a favorable tailwind for the market. Furthermore, the global macroeconomic landscape appears more optimistic, with resilience in the U.S. and European economies, though the Chinese economy remains subdued due to a heavily indebted property sector

Efforts by the Tokyo Stock Exchange to enhance capital efficiency in companies with below-par price-to-book ratios are prompting strategic reviews that could augment shareholder returns in the near future and long-term profitability. This prospect is attracting interest from global investors.

Nonetheless, certain potential challenges loom. Rising interest rates across the U.S., Europe, and Japan, along with inflationary pressures linked to supply chain disruptions, labor shortages, elevated resource prices, and tensions with China have the potential to cause market fluctuations. The ongoing Russia-Ukraine conflict and growing China-West tensions also carry inherent risks, with the potential to impact the global economy and corporate earnings negatively. Additionally, the conflicts between Israel and Hamas in the Middle East destabilise geopolitical power balance in the Middle East and put upward pressure on crude oil prices, potentially hindering global growth.

With regards to currency dynamics, considering the potential for a halt in U.S. interest rate increases and a rising likelihood of rate cuts next year, coupled with a rising likelihood of the Bank of Japan's lifting of a negative interest rate regime, we anticipate a reversal in the trajectory of the Japanese yen. As such, we expect the yen to appreciate against the U.S. dollar, marking a shift from its previous decline. However, in the near-term, the yen may temporarily fall on the back of rising yields that may prompt interventions from the Ministry of Finance to stem the fast fall of the currency.

Upcoming Major Events

- APEC summit in San Francisco on 12-18 November
- COP28 in UAE from 30 November to 12 December
- FOMC on 12-13 December
- BOJ MPM on 18-19 December

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