

## Latest Focus Points of Japanese Equities

7 June 2024

- ▶ We will discuss two hot topics regarding recent Japanese stocks.
- ▶ The stagnant performance of the Japanese equity market for "emerging companies" may see a turnaround due to the potential easing of the yen's depreciation against the dollar and the realization of a positive cycle of wage increases and consumption. This could lead to a recovery in domestic demand.
- ▶ It has been about a year since the Tokyo Stock Exchange (TSE) requested capital efficiency improvements from listed companies, yet ROE (Return on Equity) of the TOPIX index remains relatively flat. This can be attributed to an expansion of both earnings (the numerator) and equity (the denominator). However, there is a growing trend regarding the declaration of DOE (Dividend on Equity) by companies.

A slump in the Japanese stock market for emerging companies has been prolonged; the TSE Growth Market 250 Index (formerly known as the TSE Mothers Index) experienced a noticeable decline in late May, reaching its lowest level since April 2020. While the index had witnessed a significant surge during the stock market rally amidst the COVID-19 pandemic in 2020, it has been declining since around autumn 2021 and has remained relatively stagnant since mid-2022. On the other hand, the TOPIX100 (large-cap stocks) has performed remarkably since 2023, resulting in a significant disparity in performance between the two indices (Figure 1).



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**“1. Will Japanese emerging companies rebound?”**

**Figure 1: Trend of TSE Growth Market 250 Index and TOPIX 100**

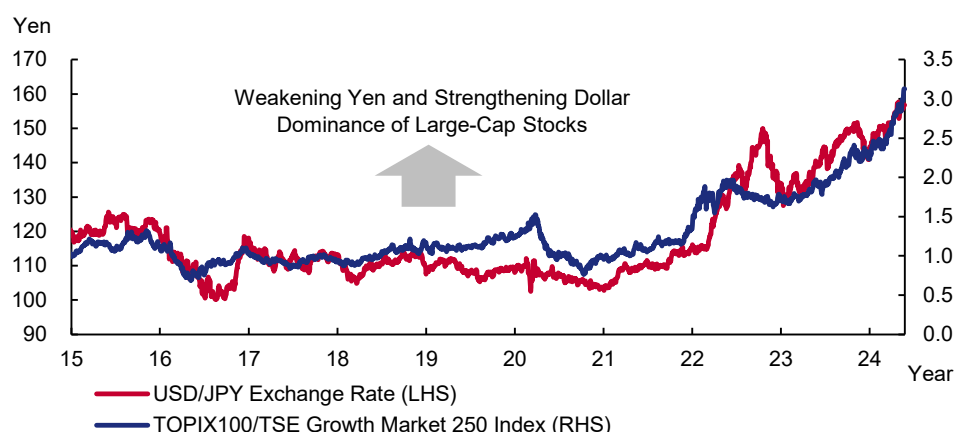


Source: LSEG Data & Analytics

Note: Daily data from 5 January 2004 to 27 May 2024

The rise in the TOPIX100 since 2023 can be attributed to expectations of escaping deflation and the progress of a weakening yen and a strengthening dollar in light of the Federal Reserve’s interest rate hikes. When examining the long-term trends of the relative performance between the TOPIX100 and the TSE Growth Market 250 Index alongside the USD/JPY exchange rate, it is evident that the TOPIX100 tends to outperform the Growth Market 250 Index during periods of a weaker yen (Figure 2). While there has been further depreciation of the yen recently, the prolonged phase of dollar strength seems to be nearing its end as speculation about a potential interest rate cut by the Federal Reserve increases. This is anticipated to mitigate the growing divergence in performance between Japanese emerging company stocks and large-cap stocks.

**Figure 2: Relative Performance of the USD/JPY Exchange Rate and the TOPIX100/TSE Growth Market 250 Index**



Source: LSEG Data & Analytics

Note: Daily data from 4 January 2015 to 27 May 2024

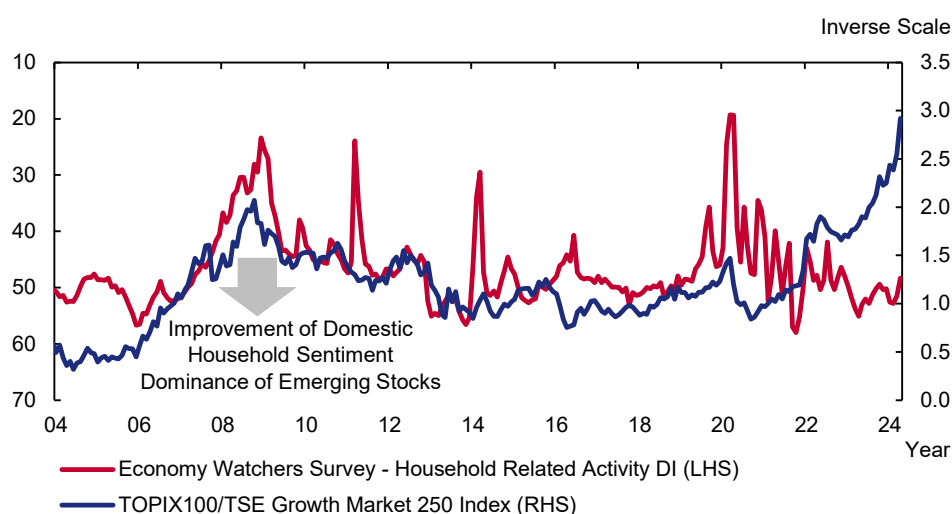
The recent rise in large-cap stocks has been driven by purchases from foreign investors, which we believe is contributing to the widening performance disparity.

The Growth Market 250 Index, which consists of emerging companies in Japan, is largely influenced by the transactions of Japanese domestic individual investors and may have been less affected by the benefits of foreign investors buying Japanese stocks.

The rise of Japanese stocks has been influenced by significant expectations for improved capital efficiency. However, a request for improvement made by the TSE in late March 2023 specifically targeted listed companies on the Prime and Standard Markets, and those listed on the Growth Market were excluded. As a result, while companies with longer operating histories and ample cash liquidity (cash-rich) have seen increased expectations for capital efficiency improvement, these investment themes do not directly apply to emerging companies.

It is worth noting that before 2020, the TSE Growth Market 250 Index showed relatively better performance during periods of improving domestic household sentiment (Figure 3). While the linkages may have weakened since the outbreak of the COVID-19 pandemic, domestic demand trends still play a significant role in determining the profitability of domestic emerging companies.

**Figure 3: Relative Performance of Domestic Household Sentiment and the TOPIX100/TSE Growth Market 250 Index**



Source: LSEG Data & Analytics

Note: 1. Monthly data from January 2004 to April 2024

2. The relative stock prices are calculated based on the end of month values.

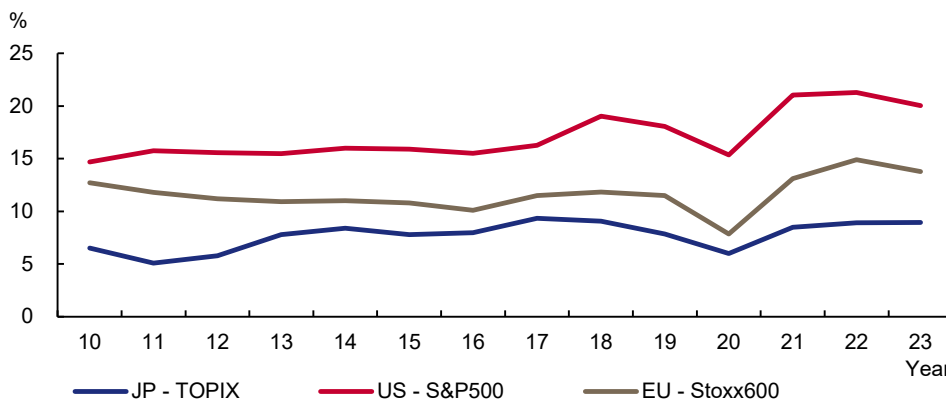
Recently, domestic household sentiment has shown a pause in its improvement due to factors such as high prices. However, if the impact of the large increase in spring wage negotiations is reflected in salaries, and the virtuous cycle between rising wages and domestic consumption gradually strengthens, investor sentiment towards domestic emerging companies can be expected to improve.

As mentioned above, following the TSE's announcement at the end of March 2023 for all listed companies on the Prime and Standard Markets to adopt management measures mindful of the cost of capital and share price, companies are taking steps to improve capital efficiency. The policy of share buy-backs, reduction of policy-based investments (cross-shareholdings) and dividend increases, which have been announced in the most recent domestic corporate results, are seen as part of these initiatives.

**“2. With TOPIX ROE remaining flat, there has been a push to set DOE targets among companies”**

However, a closer look at the ROE for the entire market reveals that it remained in the low 8% range in 2023, showing only a small increase from the previous year. In comparison to the US and Europe, the ROE in Japan is still relatively low (Figure 4). Improvements in ROE can be achieved through various means such as increasing sales, achieving higher return on sales, enhancing shareholder returns through dividends and share buybacks, and reducing policy shareholdings. Over the long term, there has been a soft correlation between ROE and inflation, with ROE expected to rise as inflation takes hold. In recent times, as corporate profits have grown, the equity (also known as net assets or shareholders' equity) has also expanded due to the accumulation of retained earnings (Figure 5). However, despite these developments, the ROE has remained largely unchanged.

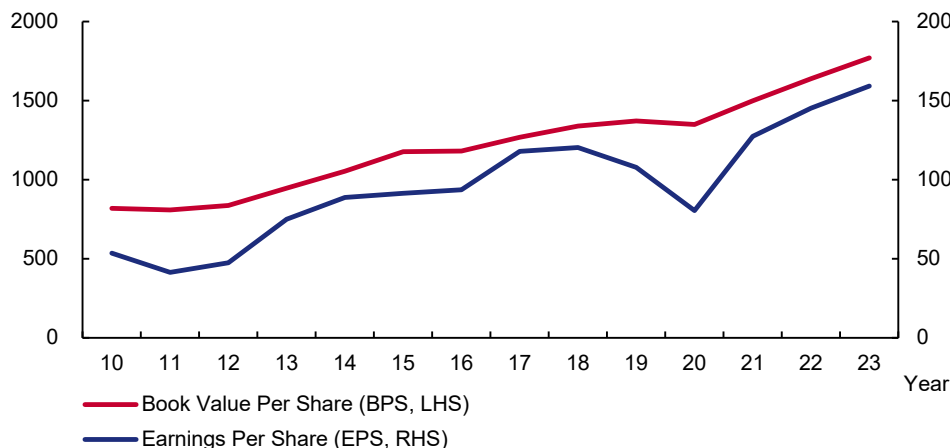
**Figure 4: ROE of Listed Companies in Japan, the US, and Europe**



Source: FactSet

Note: Annual data from 2010 to 2023

**Figure 5: Trend of the Denominator (BPS) and Numerator (EPS) of TOPIX's ROE**



Source: FactSet

Note: Annual data from 2010 to 2023

Against this backdrop, companies are setting targets for DOE (Dividend on Equity) as well as dividend payout ratio (total annual dividends divided by net profits).

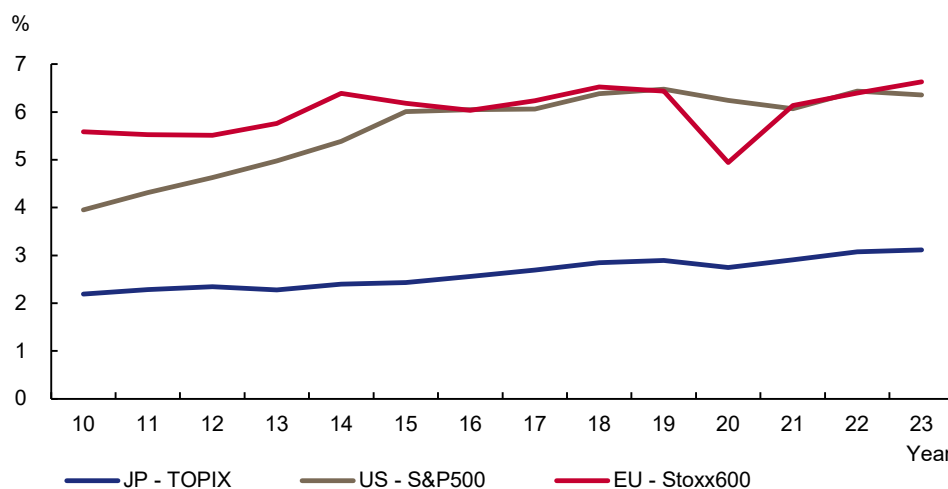
The DOE is defined as “annual total dividend amount divided by equity” and can be rewritten as “dividend payout ratio (annual total dividend amount divided by net profit) multiplied by ROE (net profit divided by equity).” By setting the DOE, a shareholder return strategy is implemented aiming to distribute dividends based on equity, regardless of short-term fluctuations in net profit.

For shareholders, this provides the prospect of stable dividends, while for companies, it can help restrain the expansion of equity (the denominator of ROE) resulting from the accumulation of retained earnings.

The DOE for TOPIX has been gradually increasing recently and reached the 3% range in 2023. However, it remains at about half the level compared to the US and Europe (Figure 6).

Improving ROE has become a renewed medium to long-term theme for companies, particularly due to requests from the TSE. Various corporate actions aimed at improving ROE will continue to be closely monitored.

**Figure 6: DOE of Listed Companies in Japan, the US, and Europe**



Source: Factset

Note: 1. Annual data from 2010 to 2023

2. DOE is calculated by multiplying the dividend payout ratio by ROE.

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