

## US stock market adjustment and Japanese equities

3 June 2022

- ▶ Since April, US equities have corrected significantly. The Dow Jones Industrial Average has fallen for eight consecutive weeks for the first time in 90 years, while the Nasdaq Composite Index, which is composed of many growth stocks, has entered an adjustment phase, having fallen around 30% from its high. We would attribute these corrections to valuations adjustments associated with rising interest rates in the US.
- ▶ Higher global inflation, concerns about the pace of US monetary policy, as well as caution about economic conditions, have led to a strong sense of uncertainty around the equity markets. High market volatility may persist for some time.
- ▶ Japanese equities have performed relatively well against the global downward trend. We think that this outperformance has been based on lower valuations as well as expectations of corporate earnings growth supported by a weaker yen.

Since April 2022, the magnitude of corrections in the US markets has been large, accompanied by higher volatility: as of 25 May, the Dow Jones Industrial Average was down about 13% from its recent high (4 January this year), the S&P 500 was down about 17% from its high (3 January this year) and the Nasdaq Composite was down about 29% from its high (19 November 2021). The S&P 500, seems poised to follow the Nasdaq Composite into a “bear market” - characterised by a 20% decline from near-term highs.

On the other hand, downside of the Japanese Nikkei 225 and TOPIX indices has been relatively restrained, as at 25 May the two indices have lost 13% and 11% respectively since highs of 14 September 2021. Relative resilience versus US peers has been particularly significant since April, when the US equity market dropped sharply (Figure 1).

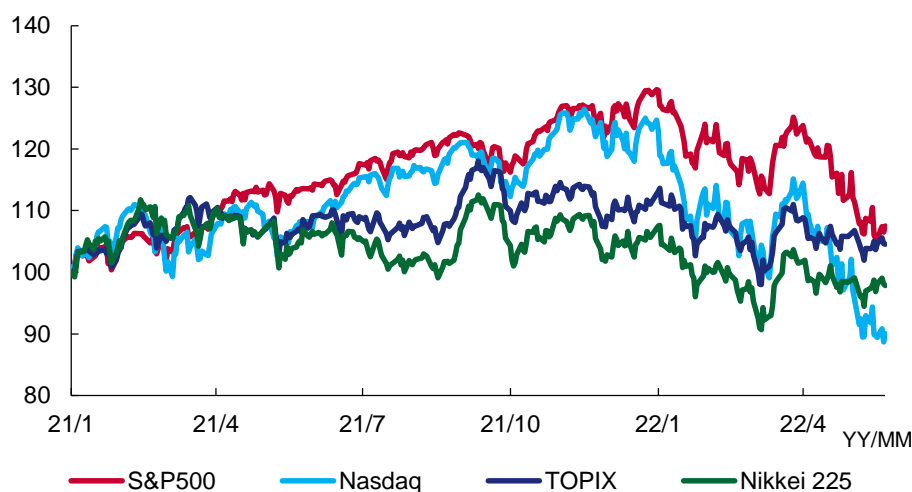


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**“Japanese equities resilient  
amid major US equity  
selling”**

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**Figure 1: US & Japanese Equity Market Performance**


Source: Bloomberg

Period: Daily data from 4 Jan. 2021 to 25 May. 2022

Note: 4 Jan. 2021 = 100

Apparently, corrections in the US equity markets since April have been mainly due to progressive valuation adjustments in line with rising interest rates. In particular, the Nasdaq Composite, which is composed of growth stocks, has been severely affected.

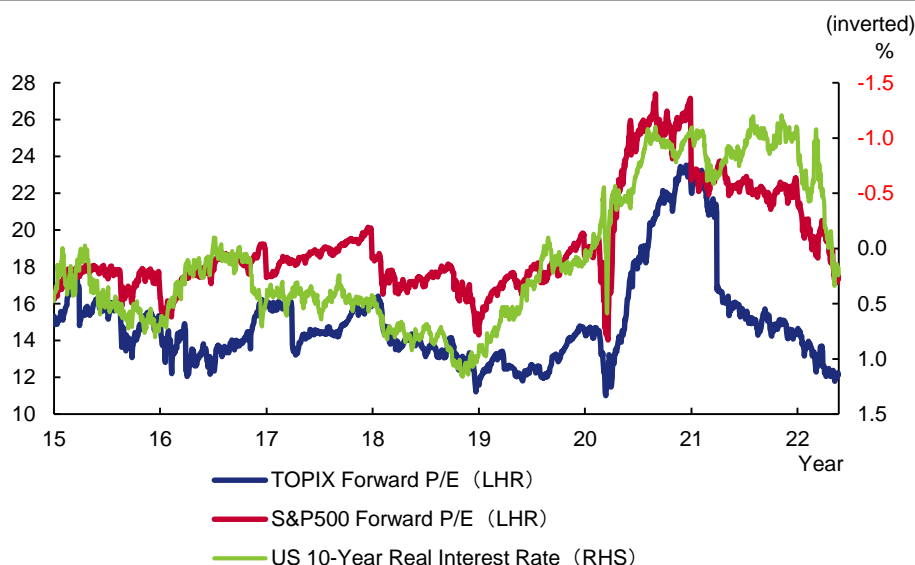
While the US Federal Reserve has become hawkish amid rising inflation worldwide, there is little clarity in the path for rate hikes and US interest rates have risen with volatility, pushing down valuations.

In addition, earnings results of some US companies have fallen short of expectations, reflecting a drop in demand for some goods significantly during the Covid pandemic as well as the impact of higher costs due to inflation. These types of companies have seen their share prices fall sharply.

12-month forward P/E of the S&P 500 fell to approximately 17x as of 25 May and is now entering its pre-pandemic normal range. During this normal phase, forward P/E for the S&P 500 has generally remained in the range of 15-17x, a level that reflects economic and monetary conditions before the pandemic and does not appear to have factored in a potential recession. Meanwhile the TOPIX P/E ratio has fallen to around 12x, which is at the lower end of the normal range. One of the reasons why the downside of Japanese equities has been restrained during the sharp fall in US equities from April onwards is that valuation adjustments have progressed ahead of those in the US. As long as the global economy does not enter a full-blown recession in the future, the scope for share price declines in Japanese equities from here onwards is considered to be limited (Figure 2).

**“Valuation adjustments  
progress in line with rising  
interest rates amid growing  
uncertainty”**

**Figure 2: Forward P/E and US Real Interest Rates**



Source: Bloomberg  
 Period: Daily data from 4 Jan. 2015 to 25 May. 2022

The recent high volatility in stocks and interest rates can be attributed to the fact that the path of the Fed's interest rate hikes has not been set due to uncertainty over inflation trends, and speculation is mixed. In addition, there are rising risks that a more hawkish path for interest rate hikes could suppress the economy too much, leading to a recession.

The sharp fall in US stocks from late April was accompanied by a decline in long-term US interest rates and a weakening of the US dollar. This can be seen as a reaction to concerns about the economic outlook. Inflationary concerns have weighed on stock markets, accompanied by fears of economic slowdown.

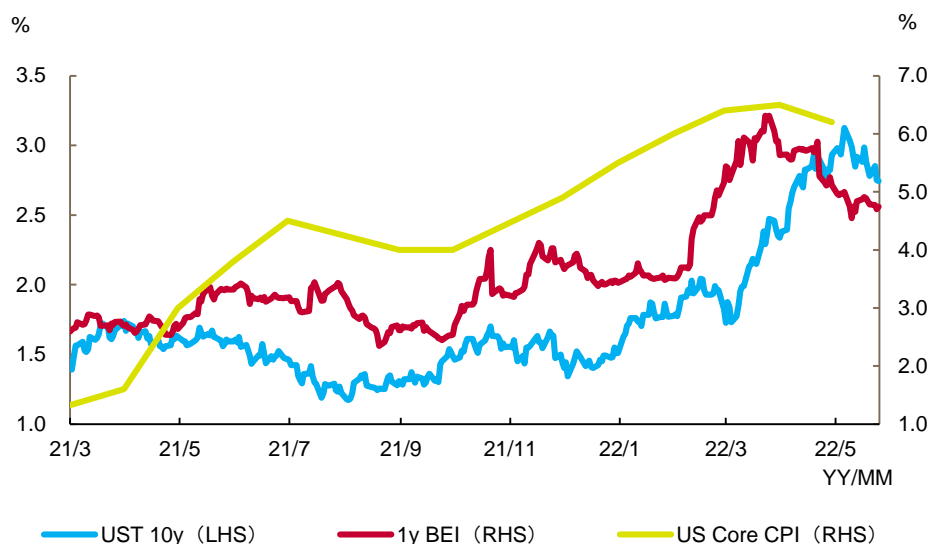
Inflation trends in the US are a key factor in stabilising global stock markets. The April data for core consumer prices (CPI) in the US showed a slight slowdown YoY, but the indicator remain high (Figure 3).

One-year expected inflation has peaked and declined after the Fed started raising interest rates, but the level remains high.

Recent statements from Fed officials suggest that the policy of raising interest rates by 50 basis points at the upcoming US Federal Open Market Committee (FOMC) meetings in June and July seems to be largely settled, but the path for a rate hike from September onwards remains uncertain. Market volatility is expected to remain high for some time now, as it will still take some time for the rate hike path to become clearer, as it will depend on future inflation data.

**“US inflation trends and concerns about economic slowdown key - market volatility to remain elevated”**

Figure 3: UST 10y, BEI, CPI



Source: Bloomberg

Period: Daily data from 1 Mar. 2021 to 25 May. 2022 (CPI data to Apr.2022)

Note: BEI represents the expected inflation rate factored into inflation-linked bonds.

Since March, the yen has weakened rapidly in the foreign exchange market, as a result of the Fed starting to raise interest rates at the FOMC meeting in March, as well as the growing belief that interest rates will be raised rapidly in response to higher commodity prices following the Ukraine crisis. The yen-dollar rate has moved roughly in tandem with the five-year government bond yield differential between the US and Japan (Figure 4).

Meanwhile, the Bank of Japan has been conducting fixed-rate bond-buying operations to strongly restrain the rise in long-term interest rates and has made its easier monetary policy stance clear.

From the perspective of the US-Japan interest rate differentials, if interest rates in Japan remain unchanged, it is unlikely that the current interest rate differentials will narrow significantly, and the trend towards a weaker yen is expected to take hold.

According to Nikkei, aggregate recurring profits are expected to decline by 4.1% YoY in the manufacturing sector, whereas the figure for all industries is likely show an increase of 1.8% YoY. Amid an uncertain environment, companies are believed to have adopted more conservative assumptions in compiling earnings guidance.

Many companies have set their yen-dollar rate assumptions at around 110-120, and if the current weakening trend of the yen takes hold, there will be more room for upward revision, especially among export-oriented manufacturers, to absorb cost increases.

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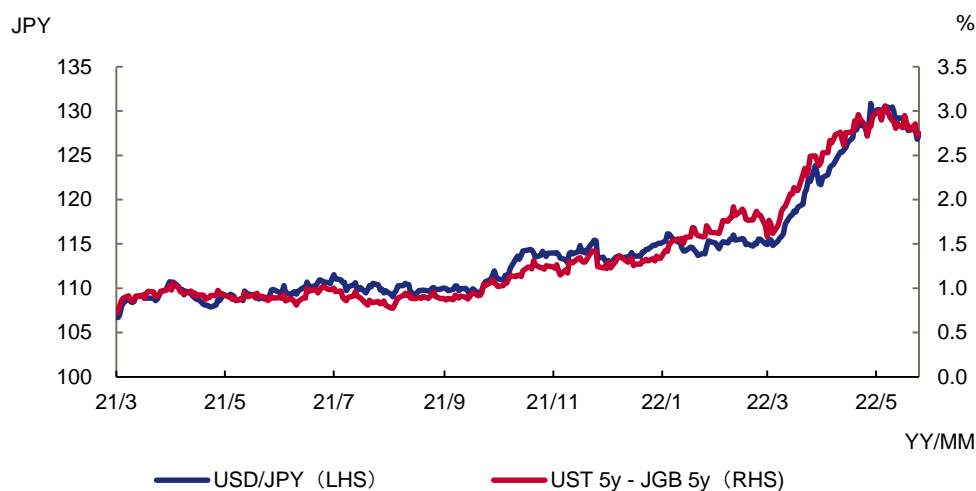
**“Weakening of the yen is positive for Japanese corporate earnings. Japanese equities showing strong potential to outperform peers”**

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In Japan, the non-manufacturing sector, which is still in the process of recovering from the pandemic, will also have room for upward revision.

Although concerns of a global recession remain, being caused by uncertainty over US inflationary trends, we expect that Japanese equities will perform relatively well moving forward, as valuation adjustments have been frontloaded they are in an undervalued range, and there are strong expectations of upward revisions to corporate earnings.

Figure 4: USD/JPY and Interest Rate Differential



Source: Bloomberg  
Period: Daily data from 1 Mar. 2021 to 25 May. 2022

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