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Chief Investment Office

CIO Viewpoint
Equity

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Japan Equities: Structural reforms to drive rerating, but range-bound in the near-term

Key takeaways

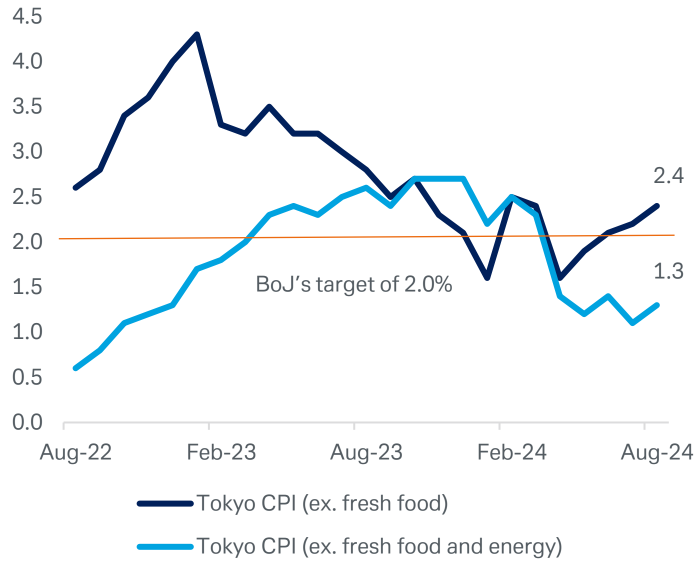
- The BoJ is likely to remain in "wait and watch" mode amid mixed macro signals and the Fed starting its easing cycle.
- Given the government's recent response to events and the replacement of prime minister Fumio Kishida being underway, the preference may be for stability, not risking a replay of recent volatility.
- Ongoing corporate reforms continue to drive positive rerating for Japanese equites despite JPY pressure.
- However, the short-term outlook for equities may be more of a stable sideways movement rather than continuing to post gains.

Mixed macroeconomic signals in July-August

Japan released a series of macroeconomic data last Friday including the Tokyo CPI and the unemployment rate. The Tokyo core CPI (ex. fresh food) rose 2.4% YoY in August, its third straight month above the 2% mark and ahead of the 2.2% consensus estimates. The uptick was largely due to the removal of subsidies on utility bills and higher rice prices on the back of supply constraints. However, the super core CPI (ex. fresh food and energy), a key metric tracked by the BoJ, at 1.3% remained below the 2% mark, indicating that demand-side inflation is yet to pick up (refer Chart 1). Retail sales growth of 2.6% YoY in July also came in weaker than expectations of 2.9%. Rising wage growth is expected to drive up consumer demand which would support normalisation of policy rates. Super core inflation will be one key metric to watch for in this regard.

The labour market also seemed to indicate some weakness with the unemployment rate unexpectedly rising to 2.7% in July from 2.5% in the previous month, worse than estimates of 2.5% and the highest level in a year (refer Chart 2). However, this could be a temporary blip as Japan's job market is undergoing structural change amid rising wages, labour shortages and an ageing population. The labour market has become more dynamic with the notions of lifetime employment and experience-based salary hikes changing rapidly and young people being more open to job changes. One possible explanation for the uptick in the unemployment rate could be that more people quit their jobs in July to look for better career opportunities, three months after the end of the fiscal year in April when companies start to hire more staff. The unemployment rate of 2.7% in July is still considered low and those that are unemployed may soon be rehired given the structural issue of labour shortages.

Chart 1: Core CPI (ex. food and energy) still below BoJ's 2% target



Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

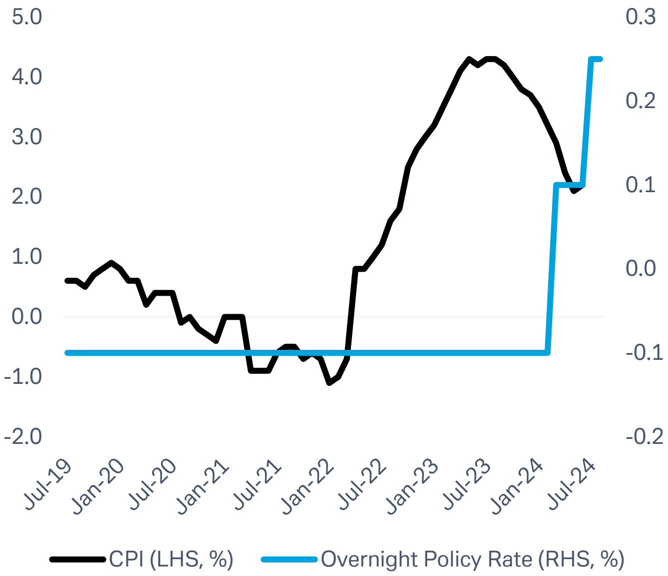
Chart 2: Unemployment rate range-bound given tight labour market

Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

The BoJ may apply extra caution to its next rate move; rate pause likely for now

The lower core inflation and slightly higher unemployment rate indicate that the Bank of Japan could adopt a "wait and watch" approach for now. The JPY has already appreciated more than 10% compared to early July and import inflation may ease from here. Therefore, lower inflationary pressure may mean that there is no urgency for the BoJ to raise rates in the near term. The rate hike and the BoJ's hawkish stance in July combined with weaker-than-expected macro data from the U.S. led to a wild market reaction on August 5, "The Manic Monday", when Japanese equities plunged sharply amid a global equities selloff. It was an indication of relatively weak market sentiment and any hawkish rate action from the BoJ could trigger another market sell-off, especially as the BoJ meeting on September 20 will follow the ECB and Fed meetings on September 12 and 18, respectively, at which both central banks are expected to cut rates, putting upward pressure on the JPY.

Chart 3: BoJ hiked rates twice in 2024



Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

The BoJ had attracted criticism, highlighting that Ueda's post-BoJ decision hawkish commentary to continue raising rates if conditions allow, might have played an important role for the outsized volatility in Japanese markets on August 5. These concerns prompted lawmakers to arrange a hearing of Ueda in parliament on August 23, at a time when the parliament is not usually in session. Whilst Ueda re-iterated his stance and cited markets' concerns over the U.S. economy as the main driver that day, he confirmed that it is important to carefully communicate the BoJ's thinking to ensure market participants are not taken by surprise. The extraordinary hearing demonstrates that the government has responded to recent events.

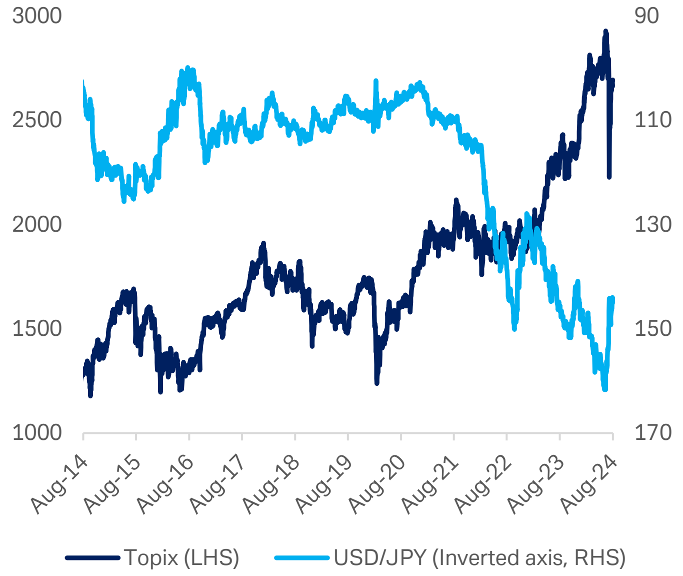
Japan's ruling party meets on September 27 for a leadership vote to determine who will be Japan's next prime minister, since Fumio Kishida resigned. We therefore expect the BoJ will keep its policy unchanged when the board meets in September – also to avoid any market volatility when Japan's ruling party LDP chooses its new leader.

Having said that, it is much likelier that the BoJ may continue to raise rates later this year or in early 2025, once it gets a clearer view on the direction of the domestic economy and the global economy. Japan's economic growth may improve in H2 this year, driven by higher household consumption following the wage hikes earlier this year. Corporate investments may also show some upside as business sentiment remains positive. The capital spending of Japanese companies increased 7.4% YoY in Q2 this year, an acceleration from the 6.8% growth of the previous quarter. Capital spending on electricity production/distribution, properties and transportation equipment increased rapidly, indicating that Japanese corporates were more willing to invest given the improving macro outlook. Once uncertainty over the Fed's rate cuts and financial market volatility subside over the coming months, the BoJ may reconsider normalising interest rates. Even then we expect the BoJ to take smaller steps and hike rates by 10 bps if needed.

Positive rerating of Japanese equities continues despite JPY appreciation

The potential for further JPY appreciation could impair market sentiment on Japanese equities in the near term, in our view. Movements in Japanese equities and the JPY are inversely correlated (refer Chart 4). With several Japanese companies significantly exposed to overseas markets, a weaker JPY leads to higher overseas corporate revenue and earnings in JPY terms. Further JPY appreciation may therefore raise investor concerns regarding its negative impact on corporate earnings.

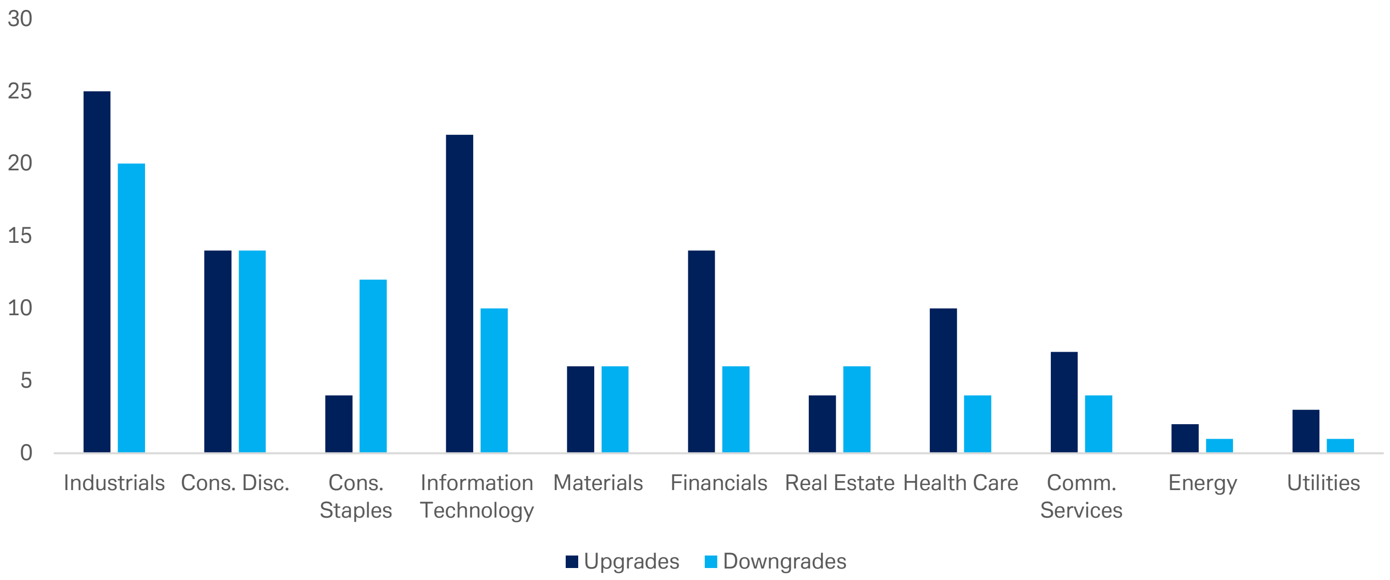
Chart 4: Topix is inversely correlated with the USD/JPY



Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

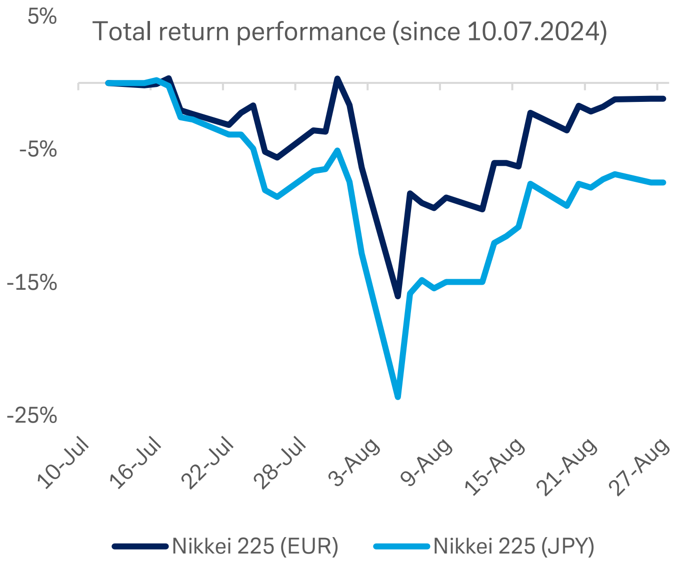
In this context, let us look at the changes in the companies' EPS expectations over the past one month following a sharp spike in the USD/JPY to 145 from 162 in July. Overall, we see more upgrades than downgrades in the EPS estimates over the past one month on the back of the Q1 2025 earnings releases (refer Chart 5). The sectors for which EPS upgrades exceed EPS downgrades include Industrials, IT, Financials, Healthcare, Communication Services, Utilities and Energy. Management guidance for full-year sales and profits growth for the companies listed on Topix have also improved to +2.4% and -4.5% in this quarter from +2.1% and -8.0%, respectively. The upward revision is mainly driven by industries including electric appliances, precision instruments, machinery and services. A total of 7.5% of Topix-listed companies raised their full-year FY 2025 guidance along with the Q1 2025 earnings. Hence, we believe that ongoing corporate announcements of their intentions to improve profitability, increase share buybacks and dividend payouts, rationalise balance sheets and simplify corporate structures should continue to drive rerating in Japanese equities, partly offset in the near term by a spike in the JPY. Given the upward pressure on the JPY, we expect unhedged investments to provide higher returns (refer Charts 6 and 7).

Chart 5: More upgrades than downgrades in EPS estimates over the past one month



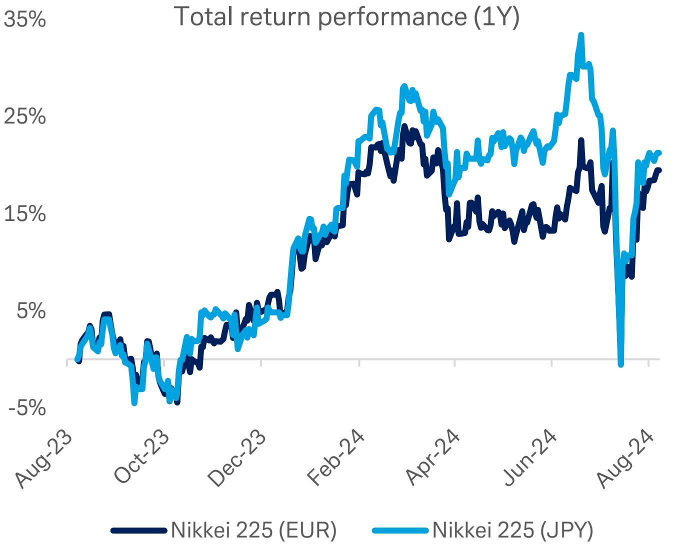
Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

Chart 6: "Manic Monday" sell-off effect



Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

Chart 7: Strong annual returns despite the sell-off



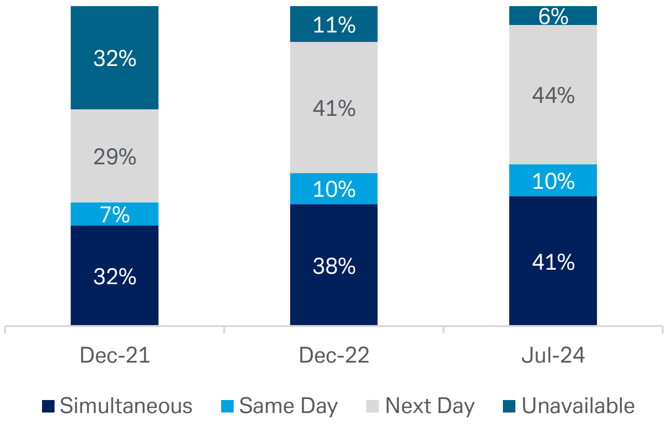
Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

TSE reforms progress to drive continued rerating

Looking at the progress of the reforms kick-started by the Tokyo Stock Exchange (TSE) and the Financial Services Agency (FSA), several milestones have been achieved so far. Activist investment is picking up strongly with investments in Japanese companies amounting to USD318bn in H1 2024, more than double the market value for the full year 2023. Amid rising activist investment, Japanese companies received a record number of shareholder proposals during the AGM season in June this year with proposals ranging from plans to raise valuations, reducing cross shareholdings and increasing management access for investors.

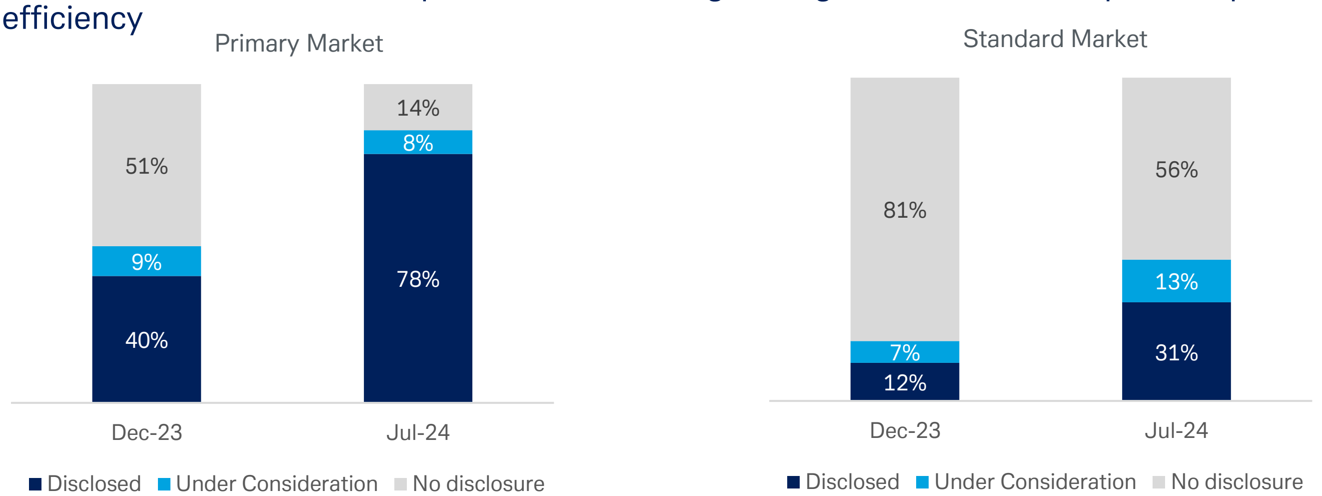
Other initiatives such as TSE's "Name and shame" is showing good progress with more and more companies being pushed to improve capital efficiency and stock price valuation. As of July 31, 86% of Prime Market companies and 44% of Standard Market companies have either disclosed or are considering disclosure of management action in this regard (refer Chart 9). After the TSE made disclosure in English mandatory for all listed companies, 94% of the Prime Market and 24% of the Standard Market companies reported their earnings in English as of July 31.

Chart 8: Companies in the Prime Market reporting earnings in English by timing of disclosure



Source: Japan Stock Exchange, Deutsche Bank AG. Data as of September 2, 2024.

Chart 9: More and more companies are disclosing management action to improve capital efficiency



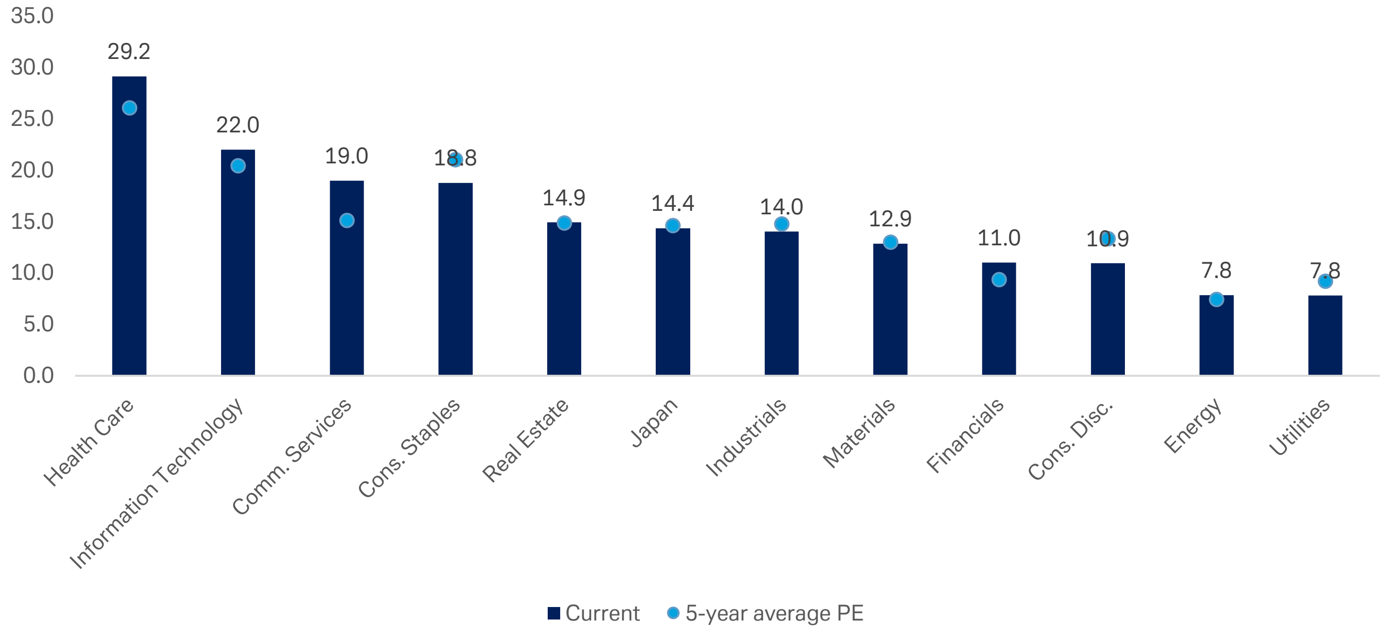
Source: Japan Stock Exchange, Deutsche Bank AG. Data as of September 2, 2024.

Conclusion: Long-term drivers intact, however near-term price action expected to be sideways

While the TOPIX P/E is trading broadly in line with its 5-year average, sectors including consumer discretionary, consumer staples and utilities are trading at a discount (refer Chart 10). We expect continued fundamental re-rating on the back of corporate reforms to be partly offset by any potential JPY appreciation. However, we remain cautious in the near term given the domestic political uncertainty and the volatile JPY. Given the expectation of broad-based improvement in ROE, investors with a medium to long-term outlook could use any potential correction to add high-quality names across sectors with a focus on balance sheet strength and a balanced revenue mix.

We reiterate consumer discretionary, IT and banks as our top picks and also add industrials to the list, given its considerable weightage on the MSCI Japan Index, leading market position in the global industrials sector and overall positive ripple effects from the semiconductor and EV boom. In the near-term, domestic-focused, defensive sectors such as consumer staples and communication services are likely to remain largely immune to JPY appreciation but still benefit from the broad-based rerating.

Chart 10: 1 year forward P/E by sector



Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

Glossary

The Bank of Japan (BoJ) is the central bank of Japan.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

Earnings per share (EPS) is a financial ratio, which divides net earnings available to common shareholders by the average outstanding shares over a certain period of time.

The Financial Services Agency (FSA) is a Japanese government agency and an integrated financial regulator responsible for overseeing banking, securities and exchange, and insurance sectors in order to ensure the stability of the financial system of Japan.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

JGB stands for Japanese government bonds.

JPY is the currency code for the Japanese yen, the Japanese currency.

Nikkei 225, or the Nikkei Stock Average, more commonly called the Nikkei or the Nikkei index, is a stock market index for the Tokyo Stock Exchange.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Jibun Bank).

The price-to-earnings (P/E) ratio measures a company's current share price relative to its per-share earnings.

Tokyo Stock Price Index, commonly known as TOPIX, along with the Nikkei 225, is an important stock market index for the Tokyo Stock Exchange in Japan, tracking all domestic companies of the exchange's Prime market division.

USD is the currency code for the U.S. Dollar.

YoY refers to year-on-year which compares data in a given month from the immediately preceding year.

Appendix

Performance	30.8.2019 - 30.8.2020	30.8.2020 - 30.8.2021	30.8.2021 - 30.8.2022	30.8.2022 - 30.8.2023	30.8.2023 - 30.8.2024
Topix	6.2%	21.5%	0.9%	17.5%	17.3%
Nikkei 225	10.5%	21.4%	1.5%	14.7%	19.5%
USD/JPY	-0.8%	4.3%	26.2%	5.3%	0.1%
10-Year Japan Treasury	-2.9%	0.8%	-1.1%	-0.4%	-0.7%
MSCI Japan	6.8%	22.2%	1.2%	17.0%	18.5%
MSCI Japan Energy	-12.4%	6.2%	53.3%	7.5%	32.2%
MSCI Japan Materials	7.7%	29.6%	-4.9%	19.3%	12.5%
MSCI Japan Industrials	5.9%	24.5%	-0.1%	18.1%	20.8%
MSCI Japan Cons. Disc.	7.7%	23.5%	5.2%	12.3%	8.3%
MSCI Japan Cons. Staples	1.6%	7.7%	-0.3%	8.3%	-0.1%
MSCI Japan Health Care	34.2%	5.1%	-1.3%	0.5%	15.7%
MSCI Japan Financials	-3.6%	20.3%	12.7%	33.4%	45.3%
MSCI Japan Information Technology	22.8%	40.9%	-4.5%	17.9%	22.1%
MSCI Japan Comm. Services	25.7%	5.3%	6.4%	5.7%	16.0%
MSCI Japan Utilities	-9.9%	-4.4%	18.1%	23.3%	19.7%
MSCI Japan Real Estate	-18.1%	17.1%	2.0%	0.5%	17.6%

Source: LSEG Datastream, Deutsche Bank AG. Data as of September 2, 2024.

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