Sumitomo Mitsui DS Asset Management

Welcome to Japan's new inflationary era: Why the weaker yen could keep driving equity gains

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SMDAM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

Highlights:

- Japan's real exchange rate remains exceptionally weak, suggesting inflation is likely to persist and the yen is unlikely to strengthen materially over the medium term.
- The recent Nikkei correction was largely driven by profit-taking in AI and semiconductor-related stocks rather than a deterioration in Japan's broader market outlook.
- Despite Japan's current account surplus, much of the surplus comes from overseas investment income that is reinvested abroad, limiting support for the yen. Meanwhile, trade and services balances remain under pressure.
- Structural factors, including overseas investment by Japanese households and companies, suggest continued medium-term yen weakness.
- While coordinated currency intervention can temporarily strengthen the yen, it is unlikely to reverse underlying trends without a meaningful change in economic fundamentals.
- A sharp correction in US equities could trigger temporary yen appreciation through capital repatriation, but it would likely coincide with broader global equity weakness.
- Japanese equities remain attractive as a hedge against rising domestic inflation. If the yen's real undervaluation is corrected through higher Japanese inflation rather than nominal currency appreciation, corporate earnings and equity valuations could benefit.
- Japanese stocks may also continue outperforming in US dollar terms. Many Japanese companies generate a growing share of revenues and profits overseas, making them beneficiaries of yen depreciation through the increasing yen value of foreign assets and earnings.

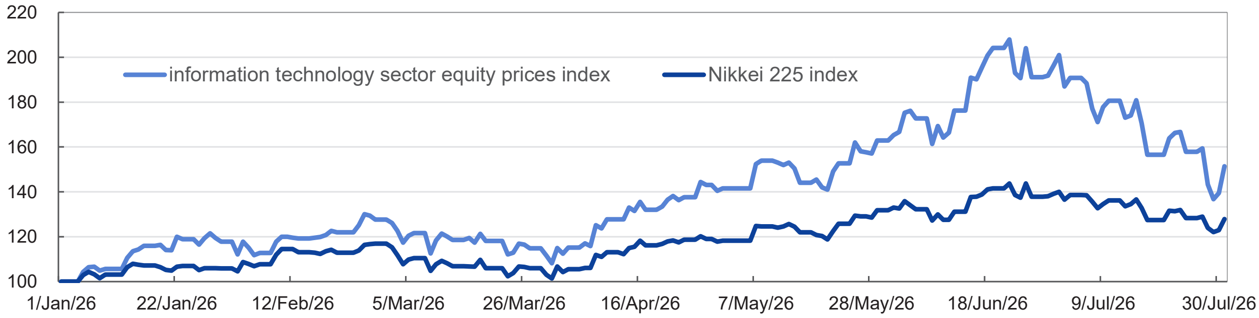
The return of inflationary pressure to Japan has created a new market dynamic. Our view is that the consequences of this have not been priced in by investors who still view Japan through the old lens of structural deflation. In this report, we cover what has changed in Japan's monetary conditions, what this means for equity markets, and the causes and consequences of recent yen weakness..

The correction in Japanese technology stocks does not alter the broader investment case for Japan. An exceptionally weak real yen, persistent inflation pressures, and Japanese companies' increasing overseas exposure support further upside for Japanese equities. While short-term volatility remains possible, particularly if US markets weaken sharply, Japanese stocks appear well positioned to deliver gains both as an inflation hedge and potentially in US dollar terms.

Interpreting the Nikkei 225 movements

The Nikkei Stock Average underwent a correction from late June through July 2026. This was driven by declines in several large-cap AI and semiconductor stocks (classified as "Information Technology" by Bloomberg), reflecting a negative backlash to previously excessive expectations for the sector's share prices (Figure 1). The natural question is whether the Nikkei can continue rising given the pause in the AI and semiconductor rally. However, we believe the Japanese stock market still has significant medium- to long-term upside potential as an inflation hedge. We view the July decline in the Nikkei as a temporary correction and believe further gains remain possible.

(Figure 1) Nikkei 225 Index & Information Technology Equity Index

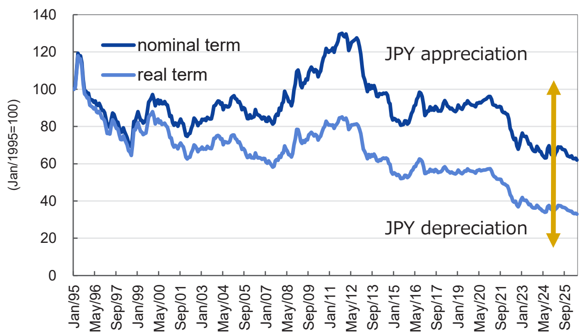


The data cover the period from Jan 2026 to Jul 2026. Prepared by SMDAM and Bloomberg.

Untangling real vs nominal yen dynamics

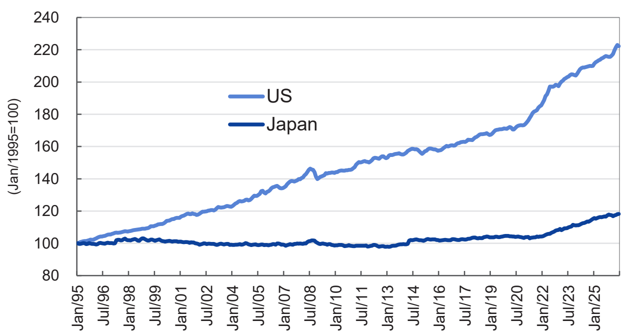
When the US dollar/yen exchange rate is indexed to January 1995 = 100, a lower index value indicates a stronger US dollar against the yen. The index stood at 62.0 in June 2026, indicating a 38% depreciation of the yen against the dollar (Figure 2). Similarly, the consumer price-based real exchange rate index stands at 33.0 in June 2026, representing a 67% depreciation of the yen (Figure 2). The much larger decline in the real exchange rate reflects the widening price gap between the United States and Japan (Figure 3). In June, US consumer prices rose 3.5% year-on-year, compared with a 1.7% increase in Japan.

(Figure 2) JPY Index Against USD



The data cover the period from Jan 1995 to Jun 2026.
Prepared by SMDAM based on Bloomberg data.

(Figure 3) CPI of US and Japan

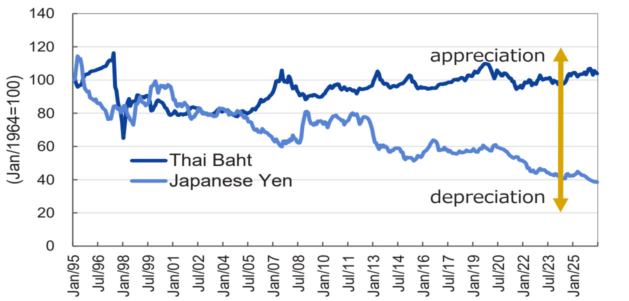


The data cover the period from Jan 1995 to Jun 2026.
Prepared by SMDAM based on CEIC data.

Return to 1965

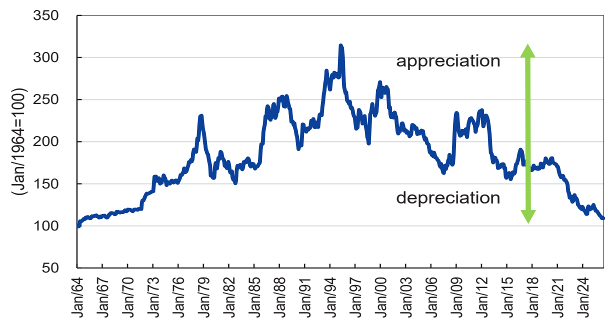
The real effective exchange rate is a weighted average of the real exchange rates of a country's trading partners. Using an index with January 1995 = 100, the Japanese yen's real effective exchange rate fell by 61.5% to 38.5 by June 2026, while the Thai baht, whose depreciation triggered the 1997-1998 Asian currency crisis, rose by 4.0% to 104.0 (Figure 4). When the yen's real effective exchange rate is indexed to January 1964 = 100, it stands at 109.1 in June 2026, nearly unchanged from its 1965 level (Figure 5). This illustrates the extent of the yen's relative decline.

(Figure 4) Real Effective Exchange Rate Index



The data cover the period from Jan 1995 to Jun 2026. Indexed based on Jan 1995; weighted average of 64 currencies. Prepared by SMDAM based on BIS data

(Figure 5) Japanese Yen Real Effective Exchange Rate



The data cover the period from Jan 1964 to Jun 2026. Indexed based on Jan 1964; weighted average of 27 currencies. Prepared by SMDAM based on BIS data.

How does the yen relate to the Japanese current account surplus?

Japan's current account remains in surplus, but most of this surplus comes from the primary income balance, which measures dividend and interest receipts from Japanese investments abroad less payments on foreign investments in Japan (Figure 6). Although this surplus means receipts exceed payments, it does not support the yen because much of the income earned overseas is reinvested locally. Meanwhile, commodity prices surged following the Russia-Ukraine war in 2022, leaving the trade balance in deficit on an annual basis from 2022 onward. The trade balance is also expected to remain in deficit in 2026, as the Iran-US war, which began on February 28, 2026, restricted navigation through the Strait of Hormuz and pushed up crude oil prices.

Although the travel balance continues to post a surplus thanks to inbound tourism, the overall services deficit has widened due to shortfalls in areas such as insurance (reflecting reinsurance payments on foreign-currency-denominated policies), digital services (including cloud computing and video content), and business services (including specialized and management consulting) (Figure 7). Given continued net inflows into foreign equity investment trusts through schemes such as NISA (Figure 8), together with US dollar strength driven by expectations of higher US interest rates, the yen's weakening trend against the dollar is likely to persist over the medium to long term.

Can intervention work in the long run?

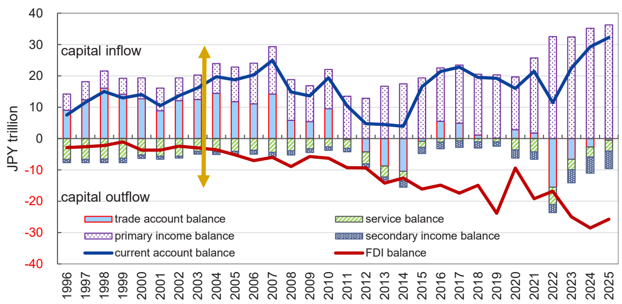
On 31 July 2026, Japanese and US monetary authorities intervened to buy yen, leading to a temporary appreciation of the yen against the US dollar as US authorities showed a willingness to support efforts to counter yen depreciation. However, the intervention is generally viewed as a measure to address the excessive weakness of the yen that concerned Japanese authorities. According to the Bank of Japan's June 2026 Tankan survey, Japanese companies assumed a USD/JPY exchange rate of 152.57 for FY2026, compared with 150.10 in the March survey.

Given this assumption, the earnings outlook for many Japanese companies is likely to deteriorate in July-September 2026. The Tankan is the Bank of Japan's quarterly survey of corporate sentiment and business outlook. In the absence of major changes in economic fundamentals, intervention alone is unlikely to generate sufficient yen appreciation to reverse the decline in either the real yen-dollar exchange rate or the yen's real effective exchange rate.

Is the tail wagging the dog?

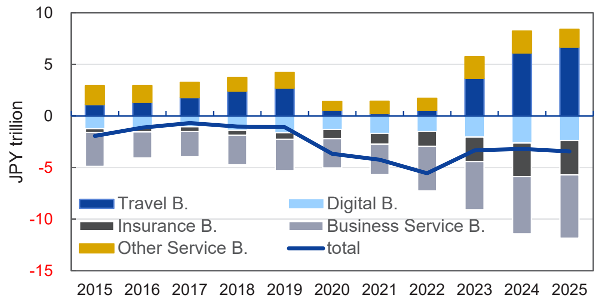
Although Japanese authorities appeared to intervene by buying yen in late July, resulting in a temporary appreciation of the yen against the US dollar with support from US authorities, the move is widely viewed as a measure to correct excessive yen depreciation. As economic fundamentals remain unchanged, yen-buying intervention alone is unlikely to trigger a sustained shift toward a stronger yen and a weaker dollar. Japanese investors continue to use the NISA framework to invest in foreign equity mutual funds, particularly those focused on US stocks, a trend that supports yen weakness and US dollar strength. Conversely, a significant correction in the US stock market could prompt fund redemptions and capital repatriation to Japan, potentially causing a rapid appreciation of the yen against the dollar. However, such a scenario would likely coincide with a balance-sheet adjustment in the US household sector, increasing the risk of a global equity market correction that would also affect Japan. In the United States, equities and investment trust funds account for a major share of household assets.

(Figure 6) Japanese Current Account Balance & FDI



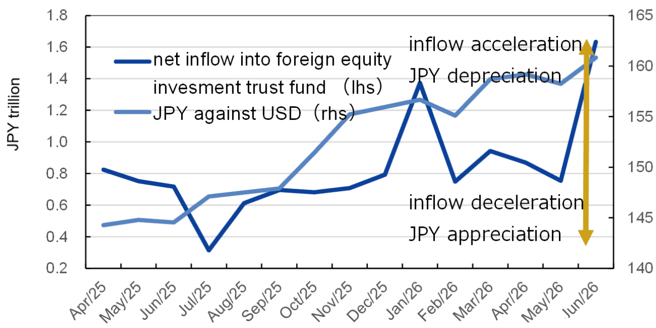
The data cover the period from Jan 1996 to Jun 2026.
Prepared by SMDAM based on Bloomberg data

(Figure 7) Composition of Japan's Service Balance



The data cover the period from 2015 to 2025. Prepared by SMDAM based on CEIC data.

(Figure 8) Inflow Pace Into Foreign Equity Investment Trust



The data cover the period from Jan 1995 to Jun 2026.
Prepared by SMDAM based on CEIC data.

Are Japanese equities an inflation hedge?

Real exchange rates tend to revert to an equilibrium level over the medium to long term. Before the Thai baht devaluation that began on 2 July 1997, Thailand effectively pegged the baht to the US dollar, keeping the nominal exchange rate stable. However, because Thailand's inflation rate exceeded that of the US, the baht's real exchange rate appreciated. As a result, the Bank of Thailand was forced to devalue the nominal baht-dollar exchange rate to stabilize the real exchange rate.

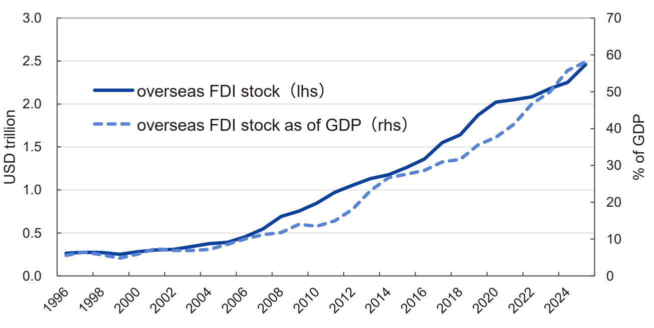
By contrast, although the yen's real exchange rate has declined relative to its nominal rate, there are no signs of the fundamental changes discussed earlier that would trigger a sustained appreciation of the yen against the US dollar. If a significant real exchange rate adjustment through nominal appreciation is unlikely, the main remaining mechanism for raising the real exchange rate would be for Japan's inflation rate to consistently exceed that of the US. Given our view that Japan's inflation rate has room to rise, we believe Japanese equities retain upside potential as a hedge against this scenario.

Could Japanese equities even rise in USD terms?

Following the Plaza Accord of 22 September 1985, in which five major economies, including the US and Japan, agreed to address US dollar overvaluation, the yen appreciated while the dollar weakened. In response, Japanese manufacturers expanded overseas production to offset the loss of export competitiveness. Consequently, Japanese firms' foreign direct investment and its share of GDP have steadily increased (Figure 9). The overseas dependency ratio of Japanese companies, defined as overseas and export sales combined, has also risen, creating a corporate structure that benefits from yen depreciation (Figure 10). When the yen weakens, the yen value of overseas assets increases, improving corporate fundamentals and often supporting stock prices.

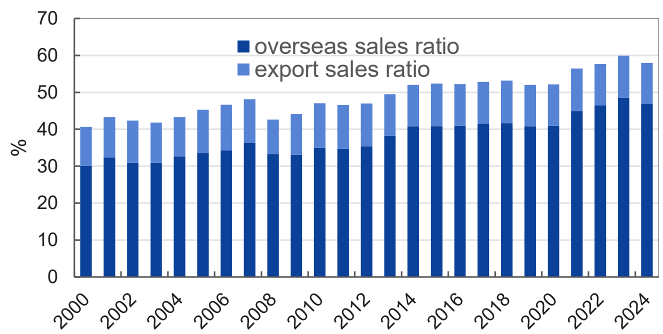
As Japanese equities tend to rise alongside yen depreciation, the gap between yen- and US dollar-denominated returns, including those of the Nikkei Stock Average, has remained small. We therefore believe Japanese equities retain upside potential even in US dollar terms. With indices set at 100 on 1 January 2025, the figures on 31 July 2026 were almost identical: 161.3 in yen terms and 161.2 in US dollar terms (Figure 11). This suggests that a weaker yen is unlikely, by itself, to cause a sharp decline in US dollar-based returns.

(Figure 9) Japanese FDI To Overseas



The data cover the period from 1996 to 2025. Prepared by SMDAM based on CEIC data

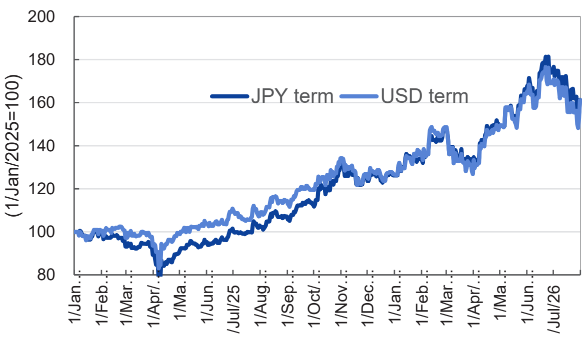
(Figure 10) Japanese Companies Dependency On Overseas



The data cover the period from FY2000 to FY2024. Calculated as overseas sales ratio=overseas sales ÷ (headquarter sales+overseas sales). Export sales ratio=export ÷ (headquarter sales+overseas sales). Prepared by SMDAM based on “Basic Survey on Overseas Business Activities”.

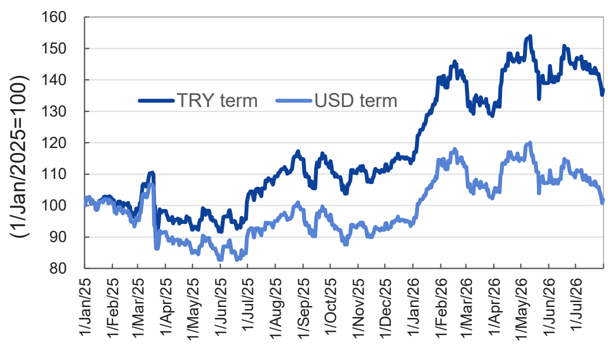
This contrasts with Turkey, where stock prices have been heavily influenced by hyperinflation, or a rapid acceleration of inflation over a short period. Although the BIST100 index rose in Turkish lira terms, a large gap emerged in US dollar terms. Using the same index methodology, the figures on 31 July 2026 were 136.9 in lira terms versus 101.9 in US dollar terms, a divergence of more than 30% (Figure 12). Turkey consistently runs a trade deficit and, as a net recipient of direct investment, also records a primary income deficit. Currencies linked to persistent current account deficits are more vulnerable to speculative selling, which can constrain stock market gains when measured in US dollar terms.

(Figure 11) Nikkei 225 Index



The date cover the period from 1 Jan 2025 to 31 Jul 2026.
Prepared by SMDAM based on Bloomberg data.

(Figure 12) Turkey BIST 100 Equity Index



The data cover the period from 1 Jan 2025 to 31 Jul 2026.
Prepared by SMDAM based on Bloomberg data.

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