



# Japanese equities in the context of the Middle East crisis

Japan Macro Commentary - March 2026

## 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.*

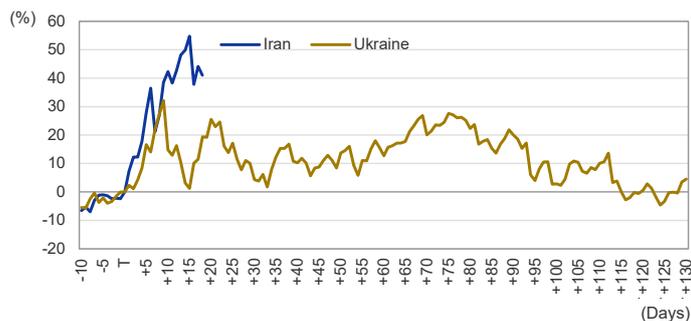
### The state of play as at 25 March 2026

- The ongoing conflict in the Middle East represents a fundamental supply shock to the energy market, comparable in scale to that seen in 2022 following the outbreak of war between Russia and Ukraine.
- The resulting shift from expectations of rate cuts to rate hikes in the US and other developed markets indicates a potentially challenging period for equities; however, we regard monetary conditions as secondary to rising energy input costs.
- The crisis is likely to lead not only to elevated energy prices in the short term but also to significant structural implications in the medium and long term, where both energy efficiency and energy substitution techniques come into play.
- Whilst Japan faces notable headwinds in the short term from high energy prices, we remain highly optimistic about the Japanese market on a forward-looking basis, given Japan's industrial strengths and proven ability to adapt to previous supply-side shocks.
- With respect to Japanese corporate earnings, under our base scenario we estimate a decline of around 2% in TOPIX EPS and expect the impact on valuations to be limited. However, in the worst-case scenario of a prolonged conflict and persistently higher energy prices, we estimate that TOPIX EPS could fall by as much as 17%, which we believe would lead to both lower earnings and lower valuations.
- Taking these factors into account, under our main scenario as outlined below, we see the probability of stagflation at around 5–10%.

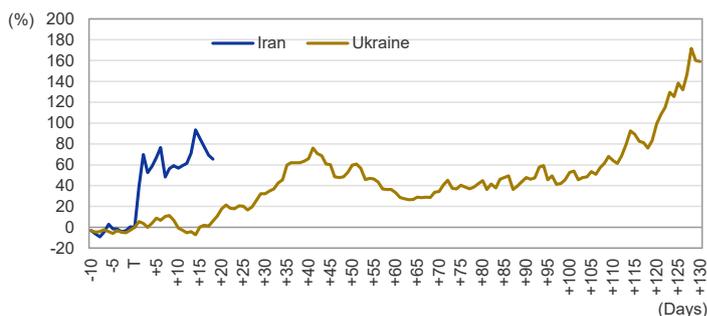
### Three short-term scenarios we are modelling

In comparison with the supply shock generated by the war in Ukraine, the impact of the current conflict in the Middle East on oil and gas prices is extreme. As the chart below illustrates, the recent price spikes have already far exceeded those seen in 2022.

**Brent crude oil price:**  
around the Ukraine war / start of the U.S. strike on Iran



**European natural gas price:**  
around the Ukraine war / start of the U.S. strike on Iran



X: business days around T (Ukraine: 23 Feb 2022; Iran: 27 Feb 2026).  
Y: cumulative change from T (=0).  
Source: SMDAM and Bloomberg

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Looking ahead, we are currently modelling three key scenarios:

1. A retreat to around USD 75 within a few months (base case)
2. Prices remaining elevated at USD 100–120 (risk case)
3. A spike to USD 150–200 (tail case)

In scenario 1, our current base case, in which the oil price falls back and consolidates at around USD 70–80, we estimate a drag of -1.24 to -2.48 points on TOPIX EPS. This would be of only marginal significance for Japanese equities, and we would therefore expect the market to absorb deterioration of this magnitude with relative ease. Under scenario 2, where a price range of USD 100–120 becomes entrenched, the drag is estimated at -4.95 to -7.43 points. Under scenario 3, with prices reaching and remaining at USD 150–200, a drag of -11.14 to -17.33 points is forecast. In either scenario 2 or 3, we would expect this to put pressure on valuations and to lead to a period of difficult trading for the Japanese market. However, while there are many moving pieces and multiple outcomes remain possible, we see scenario 1 as the most likely level at which the market could settle in the months ahead.

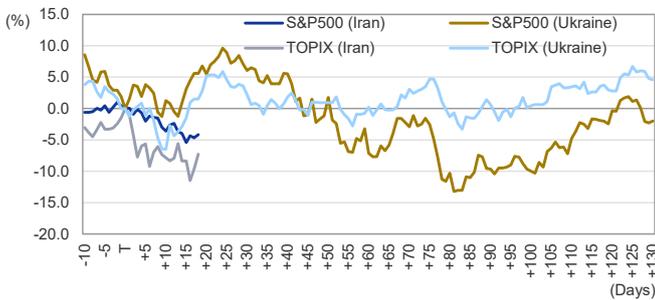
Under scenario 2, we assume markets would begin pricing in US rate hikes, and equities would likely see further drawdowns. We are already seeing signs that this risk case is being priced in. At the outbreak of the conflict, we indicated a global equity drawdown guide of roughly 6–9% under a prolonged scenario, with the possibility of markets overshooting this range depending on news flow, particularly regarding damage to regional export-supporting infrastructure. Markets have now moved close to that range, and we see the risk of further near-term declines.

It is difficult to estimate how far equities may fall, but during the second dip phase of the Ukraine war, cumulative declines from pre-event levels reached 13.0% for the S&P 500 and 11.2% for the Stoxx 600. Using “a bit over 10%” as a basic estimate derived from previously observed declines, US and European equities may still have downside potential under scenario 2.

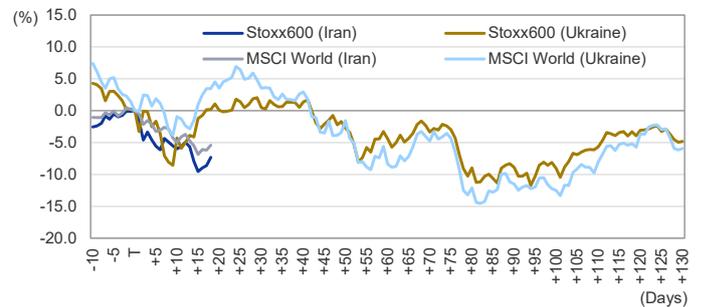


Japanese equities could also see cumulative declines exceeding 10% if energy prices remain elevated. The comparative charts below illustrate how these indices moved in response to the war in Ukraine and thus hint at the contours of what may lie ahead.

**Japan & U.S. equities:**  
around the Ukraine war / start of the U.S. strike on Iran



**Europe & global equities:**  
around the Ukraine war / start of the U.S. strike on Iran

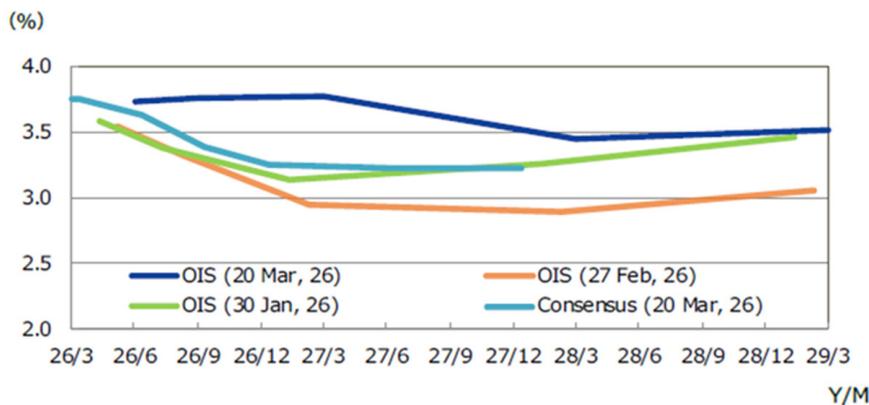


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The outlook for oil prices and the probability of each scenario remains extremely difficult to model, given the fast-moving situation and real-time market reactions to strategically significant headlines. Over the weekend, reports that Iran might establish a “safe corridor” for approved vessels in the Strait of Hormuz raised hopes of a shift towards scenario 1. However, prospects dimmed considerably after President Trump stated on 20 March that the US would begin strikes on Iranian energy facilities if the Strait was not reopened within 48hrs, and Iran responded by threatening to fully close the Strait. The timeline has since been revised, adding further unpredictability. Given these factors, we expect elevated volatility in financial markets. Equity markets are also adjusting to the consensus that rate cuts in the US and elsewhere have become materially less likely. As of 20 March, rate expectations have shifted substantially higher, as can be seen in the chart below.

**Market implied FRB's policy rate**



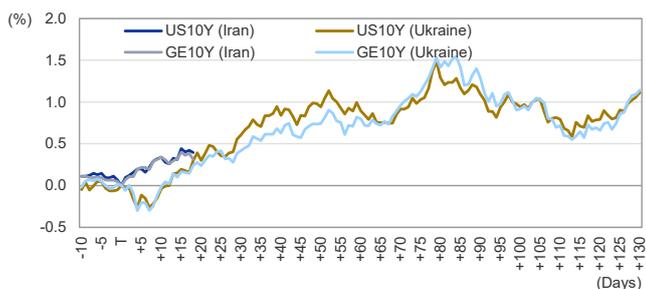
Note: OIS pricing and Economist Consensus at each point in time.



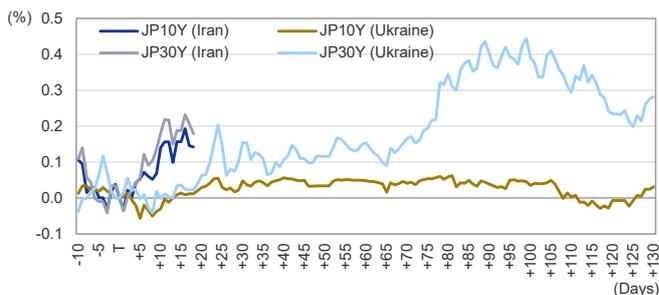
Across all three scenarios, we see a bias towards higher interest rates and a compression in P/E multiples. In the bearish scenario, rate hikes would be associated with economic slowdown, and we therefore expect a larger contraction in valuations.

Fiscal pressures in advanced economies are also becoming a more important factor: as can be seen below, German, Japanese, and US yields have all risen sharply since the conflict began, in some cases exceeding levels seen in 2022.

**U.S. & Germany 10Y yields:**  
around the Ukraine war / start of the U.S. strike on Iran



**Japan 10Y & 30Y JGB yields:**  
around the Ukraine war / start of the U.S. strike on Iran



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Taking these factors into account, in our main scenario we see the probability of stagflation at around 5-10%. Even under a risk scenario where an oil price of USD 100 persists for one year, we estimate the downward impact on growth at around 0.5% (with global real GDP growth remaining in the 2% range). Accordingly, in our view, the probability that we enter a state of stagflation, meaning both persistently high inflation and a sharp rise in unemployment, is around 20%.

## How are we reacting?

In the base scenario, we assume that passage through the Strait of Hormuz will be possible again in about one month; in the bearish scenario, we assume that closure of the Strait will be prolonged; and in the bullish scenario, we assume that passage will resume quickly. Given that we currently see the base scenario as most likely, we remain optimistic on Japan given the strong corporate fundamentals and the ongoing fiscal reform agenda championed by Prime Minister Sanae Takaichi. The same factors that made Japan attractive prior to this crisis are still present, namely monetary normalisation, corporate reform, and fiscal expansion, and when the near term crisis begins to recede, we expect the Japanese market to rebound strongly.

In such a fluid context, however, the need to be flexible and willing to adjust portfolio positioning and rotate names as conditions evolve is essential. We believe this is precisely the sort of environment in which active management can add value over an index tracking approach, especially as the impacts will be felt differently across sectors.

If it became more likely, in our view, that either scenario 2 or scenario 3 were to occur, we would move to sell cyclicals such as chemicals and materials, where the risk of costly production stoppages is rising, while increasing exposure to domestic demand names that would benefit from logistics disruptions and higher market prices, such as shipping, mining, trading companies, and retailers with low correlation to oil.

At this point, we expect to maintain an overweight position in the construction sector, which is relatively insulated from geopolitical risk, and in the financial sector, where, despite concerns over credit costs, we anticipate continued strong earnings supported by rising interest rates. Similarly, we also expect to maintain an underweight position in pharmaceuticals, where valuations remain relatively expensive.

The fact that Japan offers such a rich and diverse investment universe enables active managers to rotate across the full spectrum of sectors in search of opportunities that can be expected to weather the storm relatively well, as well as to provide rebound possibilities after the crisis has abated. Compared with the period before the outbreak of the war, there are arguments in favour of slightly increasing the weights in sectors such as energy, games, retail, and software, areas that are expected either to benefit from higher crude oil prices or to suffer relatively less deterioration in earnings. We intend to continue adjusting sector weights dynamically in line with how the situation evolves.

### **How might corporate Japan react?**

The near closure of the Strait of Hormuz increases pressure on energy intensive industries. Companies are now strongly incentivised to substitute away from fossil fuels and to seek efficiency gains wherever possible. Japan has important advantages in this regard:

- It is further advanced than most economies in deploying hydrogen as a fuel source.
- The management philosophy of kaizen enables rapid efficiency improvements through continuous incremental optimization.

Japan retains substantial heavy industrial capacity, including chemicals, steel, aluminium, and cement, which will face immediate cost pressures. Where efficiencies cannot be achieved, companies may consider temporary shutdowns, downsizing, or relocation. However, we view these responses as less likely, given the presumed transitory nature of the shock.

These strategic choices, including efficiency gains, production cuts, relocation, or reduced investment, will also confront producers in Europe and Asia. We view the challenges as more acute in Japan due to the higher weight of heavy industries, but we remain optimistic about Japan's capacity for adaptation over the medium term.

We also expect a gradual increase in the weight of low energy intensity sectors in Japan. If global energy prices remain elevated, industries such as AI, cloud computing, software, and semiconductor design, which rely primarily on human and knowledge capital, may see margin expansion and increased capital inflows. Japanese firms hold significant market share in several niche high technology segments, making these sectors attractive under a high energy price regime.



## Looking ahead – SMDAM’s view

The Japanese market has seen considerable drawdowns since the conflict began. This is an understandable reaction to the exogenous energy price shock we have examined above. However, despite the short-term disruption corporate Japan will face, our forward-looking view remains that Japanese companies possess the flexibility, technological prowess, and organisational dynamism required to adapt in response to this supply shock.

As outlined above, our portfolio managers are responding to the evolving situation by adjusting exposures where necessary in line with the active, multi-layer risk management framework embedded across our Japan equity platform. As such, whilst downside risks remain as long as energy supply disruptions persist, we remain confident in the ability of corporate Japan to continue delivering the earnings growth that drove the market higher last year.

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