JAPAN MACRO ALERT

Further Sharp Decline of Nikkei Stock Average

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In response to the decline in the Japanese stock market, we would like to share our SMDAM view on the background and future outlook. Today's market crash was triggered by (1) concerns about the U.S. economy and (2) Japan's interest rate hike and hawkish statements. These factors led to the unwinding of positions by short-term speculative CTA (long Japanese stocks, short yen), which caused a cascade of selling. However, the following points should be noted:

- Regarding concerns about the U.S. economy, employment statistics do not indicate a significant deterioration, and the probability of a recession is low. There are no scenarios in which the GDP of the U.S. or Japan is expected to deteriorate dramatically.
- The fundamentals of the Japanese economy have not changed. An exchange rate in the 140 yen range is favorable for the Japanese economy. There seems to be no return to deflation, and the risk of the CPI exceeding 2% are low, which is healthy in the long term.
- Additionally, the Bank of Japan may adjust the pace of interest rate hikes (to be slower) depending on the market situation.

Twofold cause of stocks falling: A deteriorating EPS outlook and declining PER

On 5 August, the Japanese stock market experienced a significant drop, primarily due to unexpectedly weak US employment statistics released last Friday. These statistics led to heightened concerns about a potential slowdown in the US economy. Stock prices are influenced by multiplying (1) EPS (earnings per share) and (2)PER (price-earnings ratio). The sharp decline in the market can be summarized as follows:

(1) Deteriorating EPS Outlook

- Concerns about a global economic downturn and a worsening business environment due to the US economic slowdown.
- Concerns about the performance of Japanese export companies deteriorating due to the yen's appreciation, which is exacerbated by the narrowing interest rate gap between Japan and the US.

(2) Declining PER

- A declining PER due to risk aversion in the market and an increased equity risk premium (expected shareholder return) due to anticipated successive interest rate hikes by the Bank Japan.
- A declining PER due to concerns about a slowdown in the performance of Japanese companies.

The simultaneous occurrence of these factors has negatively impacted the stock market, resulting in a significant decline. Although these factors are certainly negative for stock prices, it seems that the market's current reaction might be "overdone" given their impact. For instance, while the rapid appreciation of the yen affects the performance of exporting companies, a 1 yen fluctuation in the exchange rate impacts overall operating profits of major Japanese companies by only about 0.4%. Considering the exchange rate assumptions behind this year's earnings forecasts for Japanese companies (e.g., Toyota's exchange rate is 145 yen to the dollar), the recent yen appreciation does not seem to justify the significant drop in stock prices since last week.

Impact of US Federal Reserve rate cuts

Over the past three Fed rate cut pivots, the TOPIX dropped an average of around 11%. The Japanese stock market is likely to have factored in the upcoming Fed rate cut, which is expected on 18 September. TOPIX plunged more than 20% from 18 June to 5 August 2024. In comparison to the past three US pivots, we believe the latest drop of 18% is much more oversold.

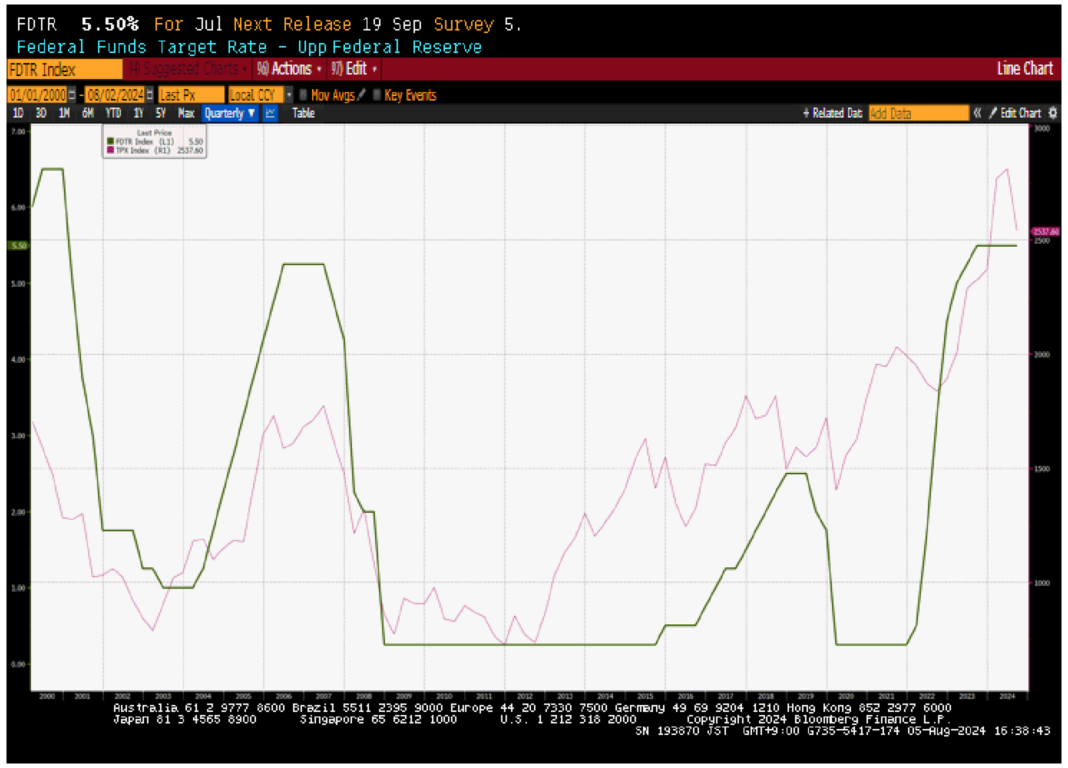


Chart 1: Chart 1: US Federal Reserve rate cuts on 3/1/2001, 18/9/2007 and 31/7/2019.
Source: Bloomberg, compiled by SMDAM, August 2024.

Furthermore, the US has already raised the policy interest rate (FF rate) to the range of 5.25 to 5.5% through repeated hikes.

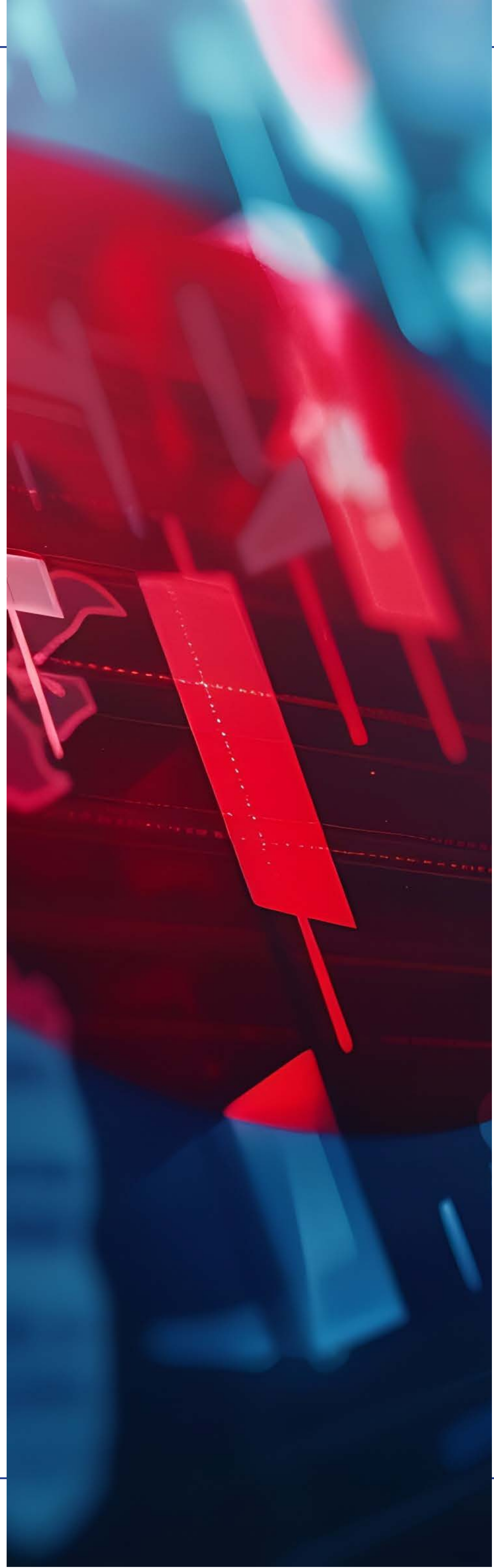
In the event of an economic downturn or market turmoil, the Fed is likely to lower interest rates, which may prevent a severe economic downturn or excessive market turmoil.

Historically, the Fed has navigated crises through bold monetary easing in emergencies, such as the 2001 terrorist attacks and the 2020 coronavirus shock. Thus, excessive pessimism about the US economy seems unwarranted.

	Past three times FED rate cut	TOPIX return
2000/10/3	2001/1/3	Past 3M return
1500.71	1283.67	-14.5%
2007/6/18	2007/9/18	
1788.39	1510.95	-15.5%
2019/4/30	2019/7/31	
1617.93	1565.14	-3.3%
Average		-11.1%
	Expected FED rate cut 2024/9/18	
2024/6/28	2024/8/5	
2809.63	2227.15	-20.7%

Table 1: TOPIX 3 month return prior to the FED's rate-cut pivot

Source: Bloomberg and SMDAM, August 2024.



Positive Outlook for Japanese Equity once volatility subsides

Regarding future monetary tightening by the Bank of Japan, the excessive depreciation of the yen has been significantly reversed, and political pressure will likely ease. This may reduce the need for additional tightening amid concerns about a global economic slowdown. Consequently, the significantly lowered PER is expected to reverse once excessive concerns about corporate performance subside.

As of today (5 August), the 12-month projected PER calculated based on the TOPIX closing price (2,227.15) has fallen to 11.9 times. This is not only significantly lower than the 10-year average of 14.5 times but has also reached a "rock-bottom" level of 12 times since 2010. Therefore, the downside potential for Japanese stocks in terms of PER appears extremely limited. Based on this, Japanese stocks are expected to bottom out as market volatility decreases following supply-demand-driven selling, such as margin trade liquidations.

Additionally, it is anticipated that share buybacks will become more active due to the large correction in stock prices, which should support Japanese stocks.Conversely, in the US, some tech stocks are overheated in terms of valuation, and it may take considerable time for the correction to run its course. However, given the rapid adaptation of US companies to changes and the potential support from Fed interest rate cuts in emergencies, it is likely that as the US stock market, a key anchor of the global market, recovers, Japanese stocks will also return to a long-term upward trend.

Our watchword is vigilance

Looking ahead, it may be necessary to pay attention to trends in financial stocks. The recent decline in stock prices appears to have diverged from fundamentals and may be excessive. However, if volatile market fluctuations impact hedge funds and other institutions engaged in speculative trading, the crisis could extend to major domestic and foreign financial institutions that provide funds to these speculators.

The share prices of major financial institutions have fallen sharply on the Tokyo Stock Exchange today, so it is important to closely monitor the trends of major financial stocks both domestically and internationally. It is worth noting, the Nikkei Volatility Index (VI) has risen to levels not seen since the Lehman Shock in October 2008. While no specific cases have been identified so far, we will remain vigilant.

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