Marketing Communication
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Fundamental Active Group

PM's Monthly Insights

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Market Outlook

In last several months, we have expected a range bound movement for the Japanese stock market. In August, however, we anticipate a volatile movement at the lower side of that range. In the near term, we expect to see some choppy price movements, driven by the foreign exchange rate and the mixed speculation about the international political landscape. Yet, we foresee a gradual recovery later in the month as lower levels solidify.

Our bullish view for the medium-to-long term remains intact. We believe the global economy will generally stay robust and that domestic corporate earnings will continue to improve. Looking forward, we expect the market to digest the earnings announcements by domestic companies and factor in the upward revisions and sustained improvement in their earnings. We expect the favourable supply and demand for stocks to persist as Japanese companies maintain a high level of share buybacks in this fiscal year. Moreover, the anticipated inflow of investment funds from foreign investors, who appreciate this change in Japanese companies' focus on capital efficiency, will also support Japanese stocks in the medium term.

The reasons for the decline of Japanese equities since late July are as follows:
- Weak earnings from major U.S. technology companies
- Media reports of U.S. export regulations on semiconductor related products to China
- Concerns of U.S. economic downturn triggered by a slowdown in U.S. CPI
- Speculation of additional rate hikes by the Bank of Japan and accelerating yen appreciation

The Bank of Japan's (BOJ) rate hike in July was a surprise, as we expected it to be in October. The fact that the BOJ did not rule out multiple rate hikes in the future accelerated the yen's appreciation. Precisely predicting the central bank's policy rate changes is difficult, and the foreign exchange rate is heavily influenced by supply and demand. But given the interest rate differential between Japan and the U.S., the fair value of the yen seems to be around JPY150 per dollar.

The strong yen will negatively impact Japanese companies' earnings, yet, a 10-yen drop will only reduce their ordinary profits by about 4%. Moreover, the median exchange rate assumption for the FY 2024 forecast is JPY145, which is lower than the current rate.

We can't rule out the possibility that the recent decline in stock prices is due to position adjustments and loss cutting by foreign speculators, rather than concerns about the fundamentals of Japanese companies. We believe that the sell-off by CTAs and other short-term momentum investors was triggered by rising stock market volatility.

Note: Above stock names are for example purposes and SMDAM is not recommending or giving advice about these stocks.

Japanese corporate earnings are expected to remain strong. April-June earnings announcements are in full swing, and in many cases, earnings have exceeded expectations. We anticipate that many companies will raise their full-year earnings forecasts around the time of the July-September results announcement. The analyst forecast of revision index remains positive. The 12-month forward P/E ratio of the TOPIX has fallen to around 13.8x, already much lower than the 10-year average of 14.5x. Given that valuations are also low, we maintain our bullish medium-term view.

Investment Strategy

Overweight sectors (largest shown first):	**Underweight sectors** (largest shown first):
Consumer Discretionary	Industrials
Energy	Healthcare
Communication Services	Utilities

Source: SMDAM
Sectors shown are Global Industry Classification Standard (GICS) 11 sectors.

In the GICS sector, we remain overweight in consumer discretionary, energy, and communication services. Without new investment themes or sectors to drive the market, we will continue to focus on individual stock selection, as we did last month.

Considering the Bank of Japan's recent policy shift to raise key interest rates, we revised our foreign exchange forecast toward a stronger yen, and we will increase our weighting in domestic demand sectors such as banks and IT services. Conversely, we will trim our weight in sectors heavily influenced by foreign exchange rates.

Given the expected volatility in stock prices, our strategy is straightforward: buy stocks with medium- to long-term growth potential during price dips.

In the technology sector, we favour semiconductor materials, electronic components, and HDD-related companies, where we anticipate earnings to recover in the future. Additionally, we will consider raising weights for content-related companies, which will be less affected by macroeconomic policies and have strong intellectual properties.

On the other hand, we will maintain our underweights in industrials and health care, where profit margins are relatively weak.

Risk Warning: Past performance is not a reliable indicator of future performance and may not be repeated. An investment's value and the income deriving from it may fall, as well as rise, due to market fluctuations. Investors may not get back the amount originally invested.

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