Letter from SuMi TRUST - Prospects for the Japanese Stock Market After Its Major Shakeup

Written by Oki Shiozawa, Investment Director

Japanese Stock Market Faces Stormy Weather

The Japanese stock market recorded a historic plunge in the first few days of August, with the Nikkei 225 Index falling -19.5%. During this period, the yen appreciated sharply against the dollar and U.S. tech stocks fell significantly. Over the next two days, Japanese stocks rebounded sharply, rising +11.5%. With the foreign exchange market also reverting to previous levels, the extreme panic selling seems to have passed as quickly as it started. In this column we will take a step back and review what happened in the Japanese stock market, then take a look ahead to what is to come in August and beyond.

We believe that such a significant drop was caused by market participants taking an extreme risk-off stance in response to several events coinciding at the same time: concerns about a U.S. recession, a correction in high-tech stocks, and a rapidly appreciating yen. The market's dramatic decline then rattled investors, and the stock market slid further and further down as they rushed to respond.

The signs that a market correction could occur were all there in July. Previously high-flying U.S. high-tech stocks fell in July following earnings announcements that failed to meet market expectations. The yen had been depreciating to over 160 yen to the dollar but reversed after the Japanese government and Bank of Japan (BOJ) intervened in the currency market on July 11.

BOJ Both Triggered and Calmed the Upheaval

In fact, the BOJ's Governor Kazuo Ueda may have triggered the market turmoil in August. The BOJ decided to raise interest rates to 0.25% on July 31st, with Governor Ueda showing an unexpectedly hawkish stance at an evening press conference stating that he would not hesitate to raise rates further. At the same time on the other side of the Pacific Ocean the Fed was suggesting a rate cut in September, underlining the stark difference in monetary policy between Japan and the U.S. As a result, not only did the yen appreciate against the dollar, but it also triggered the unwinding of existing positions such as the yen carry trade, and risk assets including Japanese stocks were suddenly sold off.

Amid worsening market sentiment, the release of U.S. employment data fell short of market expectations spiking fears of an economic downturn being on the cards. At the same time, U.S. interest rates fell and resulted in the yen appreciating against the dollar. Both events added fuel to the fire, driving yet even more selling in the stock market. With investors spooked and engaging risk-off mode, the Nikkei 225 plunged -12.4% on August 5th, an extreme level which is only comparable to Black Monday (-14.9%) in 1987.

Yet it was also the BOJ that brought a surprise to calm the rough waters after stock prices rebounded to some extent on August 6th. In a speech, BOJ Deputy Governor Shinichi Uchida said, "We will not raise interest rates under unstable conditions in financial and capital markets," effectively reversing Governor Ueda's hawkish comments. The BOJ's market-friendly stance gave great relief to struggling market sentiment, and the exchange rate reversed to a weaker yen and Japanese stocks rebounded sharply in response.

In retrospect, we believe that the significant correction was largely due to profit-taking and position unwinding combined with an extremely rapid deterioration in market sentiment.

Structural Changes in the Japanese Economy Continue

Despite the rollercoaster ride for market participants at the start of August, there has been no change in the solid performance of Japanese companies and the structural improvement of the Japanese economy as it overcomes its old deflationary tendencies.

Although there are concerns about the impact of foreign exchange rates on earnings, Japanese companies are already operating on an assumed exchange rate of around 145 yen to the dollar, so the current foreign exchange volatility is not something that would lead to a major downward revision of their original plans. If corporate performance remains strong, then we can say that the current Japanese stock market is notably undervalued compared to the past, with a Price to Earnings (P/E) ratio of around 13x. In addition, Japanese companies are increasingly willing to return profits to shareholders as part of efforts to improve corporate governance. Market sentiment has been buoyed after the volatility earlier this month by the announcement of share buybacks by many major companies, including SoftBank Group (9984JP), Nippon Telegraph Telephone (9432JP), Canon (7751JP), and Itochu (8001JP).

In macroeconomic terms, there is also good news as real wages turned positive for the first time in 27 months in June of this year. This is expected to stimulate personal consumption through increased purchasing power. The correction of the excessively weak yen is a boon for domestic demand, which had been suffering from rising import prices. We expect that the long-awaited virtuous cycle between prices and wages is about to be realised.

What Lies Ahead?

While the factors above should support the market in the mid- to long-term, Japanese stocks prices are likely to swing up and down for the near future simply due to the sheer scale of the volatility seen at the start of August. If stock prices rise a little, we may see some selling of shares from investors who were late to the market. With regards to the U.S. economy, we expect it to have a soft landing, but it may take some time before concerns about the economy are completely dispelled.

Once the market has calmed and rationally assessed the current economic situation, it should rediscover the opportunities offered by the solid performance of Japanese companies and the Japanese economy, which is undergoing major – and positive - structural changes. We believe that Japanese equities will therefore regain their upward momentum soon.

About Writer

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Oki Shiozawa is an investment director at SuMi TRUST AM. With over 30 years of experience working in the investment industry, he is well-versed in the financial markets and Japanese companies.

Oki joined the firm in 2006 and served as a portfolio manager of Japanese equity active strategies from 2006 to 2023. Prior to this he began his investment career in 1994 as an equity research analyst and managed Japanese equity active portfolios from 2001 to 2005 at a major asset management firm.

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