Japan Equity Market Outlook

Ending deflation and sustaining corporate reform efforts will be the key variables

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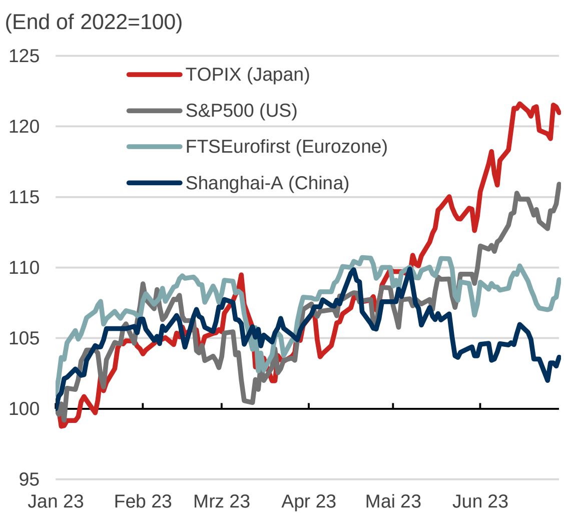
Japan's stock market returns have outpaced all other countries in the first half of 2023

As of the end of June, the Japanese stock market was up 21.0% for the year in local currency terms, outperforming the U.S. S&P500's 15.9% and the China A Share market's 3.7%. By industry, precision electronic components suppliers, mainly semiconductor-related stocks, led the market rally amid strong earnings growth expectations backed by investments in emergent cutting edge technologies such as generative AI. Trading company stocks, which have benefited from positive comments from prominent foreign investors, also recorded strong returns. Meanwhile, financial stocks, which had rallied late last year amid rising overseas interest rates and expectations that the Bank of Japan (BOJ) would revise its accommodative monetary policy, posted the weakest year to date performance. The incoming BOJ governor has instead left the existing easy monetary policy settings unchanged, while turmoil among U.S. regional banks in March has continued to unsettle the overall banking sector.

Performance of Major Equity Markets
(Local Currency Base)
(December 30, 2022 to June 30, 2023, daily)



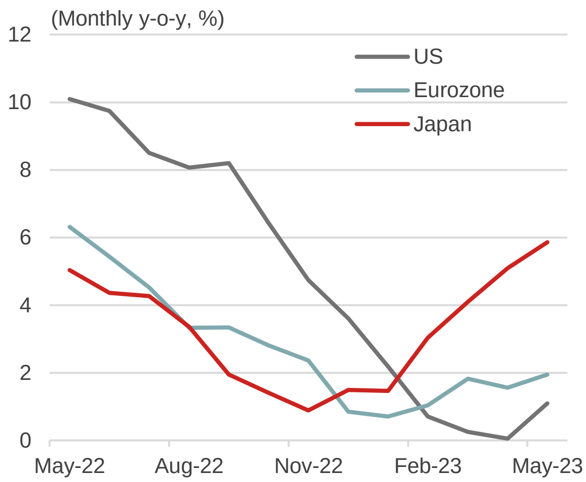
Source: Nomura Asset Management based on Datastream data.

Corporate earnings trends

Corporate earnings momentum in Japan appeared to hit the bottom toward the end of last year after seeing a modest downtrend due to the appreciation of the yen, following the yen's sharp depreciation through the second half of last year, as well as the expected deterioration in business sentiment against a backdrop of monetary tightening in most major economies. In fact, the actual business results of the Russell/Nomura Large Cap Index (all industry ex financials) for FY2022 exceeded previous forecasts.

For fiscal year 2022 revenue, operating profits, and recurring profits grew by 17.2%, 6.9%, and 7.7%, while for fiscal year 2023 (ending March 2024), these figures were 0.3%, 11.1%, and 4.2%, respectively. As a result, the market's overall ROE is likely to remain stable around 9% over an approximately three-year period.

Earnings Growth Forecasts for Major Equity Markets
(Local Currency Base)
(May 2022 to May 2023, monthly)



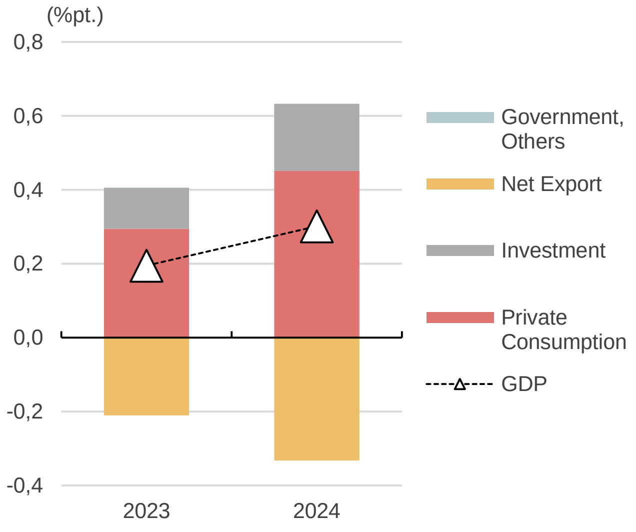
Note; US: MSCI US Index, Eurozone: MSCI Europe, Japan: MSCI Japan Index.
Source: Nomura Asset Management based on Datastream data.

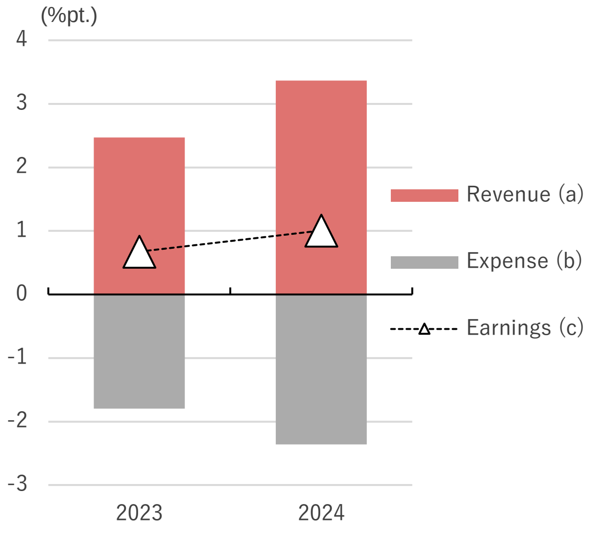
Impact of wage rises on corporate earnings and the macro-economy

Although Japan's inflation is still moderate compared to inflation rates in many other countries, the BOJ's long-targeted 2% inflation is still a reality. However, these price pressures have mainly been caused by temporary external factors such as supply chain disruption due to the impact of the pandemic, rising resource prices, and sharp depreciation of the yen. For this reason, investors' attention will focus on domestic wage trends as to whether inflation can remain consistently above the BOJ target going forward. This year's spring wage negotiation ended with a broad 3.7% rise in wage remuneration, a rate of increase not seen in recent years. Moreover, given that Japan's working age population and therefore its labor force will decline in the coming years, it is increasingly likely that labor shortages will underpin wage growth. On the other hand, higher wages mean higher employment costs for companies, and if those increased costs are not accompanied by higher productivity or effectively passed through to prices of goods and services, then it could have a negative impact on corporate earnings.

Based on estimates by Oxford Economics, our analysis suggests that a wage increase of around 3% would result in a positive impact on corporate earnings through increased sales. Similarly, we estimate that wage increases would boost GDP growth in the entire economy. The economic environment that the BOJ is aiming for can only be realized if a virtuous circle is created in which rising wages stimulate domestic consumption through increased disposable income, and drive robust demand. This in turn should lead to steadily rising prices and improved corporate earnings, which feeds back into further wage increases. Thus, in light of this potential positive feedback loop, the pace of wage increases next year will be a vital focus for investors.

The impact of a 3% wage increase on GDP growth and corporate profit growth
(Estimates using Oxford Economics Model, 2023-2024, annually)



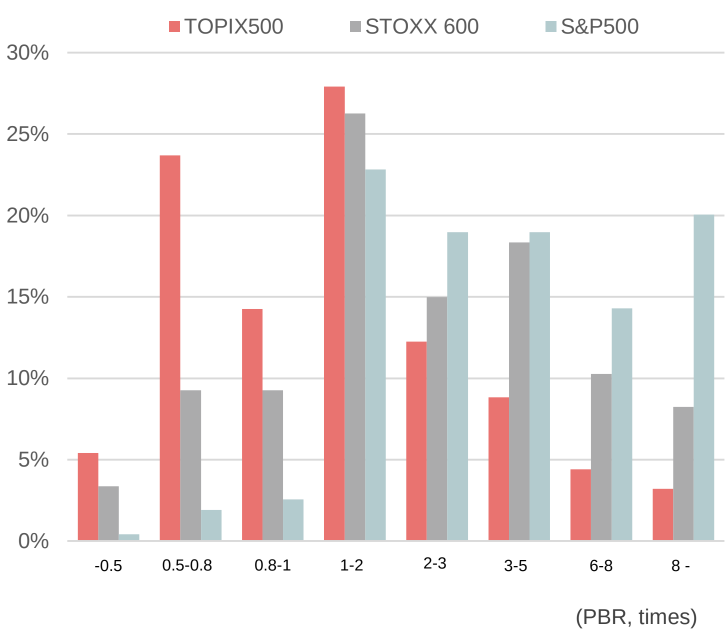


Source: Nomura Asset Management based on Oxford Economic Modela.

Tokyo Stock Exchange applies pressure on companies with PBR of less than 1.0

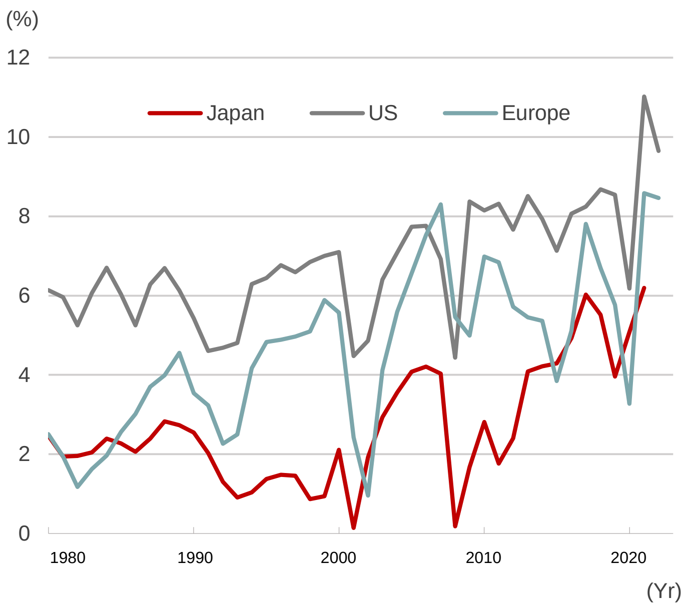
In March 2023, the Tokyo Stock Exchange required companies whose shares were trading at a PBR of less than 1 (i.e. trading below book value) to disclose business plans that take into account how their management perceived this situation, how they estimate their cost of capital, and how they might achieve a return on invested capital that exceeds it. Given that around half of TSE-listed companies trade at a PBR of 1 or less means that the ROE of nearly 900 companies is below the rate of return demanded by investors. One way to improve ROE is to return excess cash to shareholders in the form of dividend increases and share buybacks. This would achieve the objective by increasing the company's financial leverage. The TSE's emphasis this time, however, is not on improving ROE through such temporary financial strategies, but on rethinking longer term management policies, such as sales growth and operating margins, that can generate sustainable growth in a company's core business. The TSE also explains that PBR is only one indicator that recognizes these challenges and is used to inspire companies to action and to help them develop a response. At the time of the financial results announcement in May of this year, more than 50 companies referred to PBR as a metric in their medium-term plans. Although this is a welcome start, we hope, through applying a variety of indicators in addition to PBR, that the dialogue between Japanese companies and investors, on whether companies are generating the business profits that investors seek and how to improve their growth and profitability if they are not, will lead to a better understanding and assessment of the overall valuation of the Japanese stock market.

PBR of Listed Companies in Major Equity Markets
(As of April 14, 2023)



Source: Nomura Asset Management based on Quick and Factset data.

ROE of Listed Companies in Major Equity Markets
(1980 – 2022, annually))



(Note)U.S.: MSCI U.S. stocks, Eurozone: MSCI Europe stocks, Japan: TOPIX500 (excluding financial and trading companies)
Source: Nomura Asset Management based on Quick and Factset data.

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