

Japan Equity Market Outlook



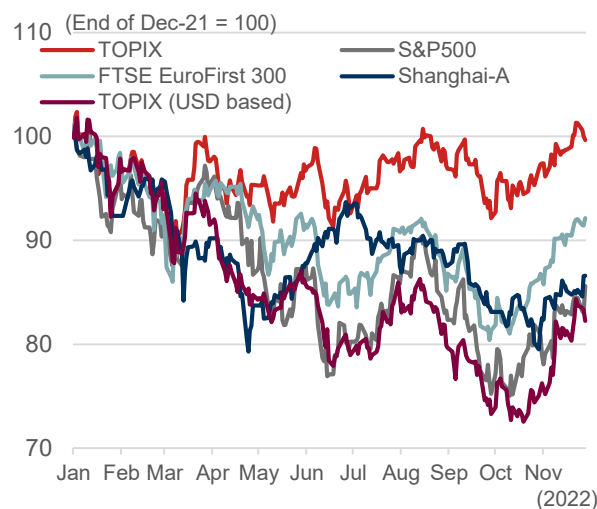
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Investment environment for Japan could remain relatively favorable during a global slowdown

Difference in returns between local currency and dollar

In 2022, global financial markets were undermined by the monetary tightening policies of central banks in the face of higher than expected inflation, leading to severe declines in prices of both bonds and stocks. In this environment, the Japanese stock market performed relatively well in local currency terms, supported by the continuing application of loose monetary policy by the Bank of Japan, solid corporate earnings supported by the weak yen, and expectations of economic normalization following the pandemic. On the other hand, dollar-based returns, which represent returns to foreign investors, have been affected by the sharp depreciation of the yen, resulting in returns close to those seen in other major markets. In order for the Japanese stock market to attract attention from foreign investors, it is necessary to see the currency market stabilize as well as an improvement in corporate earnings.

Performance of Major Equity Markets
(Local Currency Base)
(January 3, 2022 to November 30, 2022, daily)



Source: Nomura Asset Management based on Datastream data.

Relatively robust business outlook

The earnings forecast for fiscal 2022, based on the Russell/Nomura Large Cap index, suggested that Japanese corporate earnings would increase by approximately 9.6% on a recurring basis (as of December 5, 2022). The forecast for profit growth of around 10% has not changed significantly from the previous forecast, which means that in real terms there has been a downward revision. This is because the sharp depreciation of the yen over the current fiscal year has contributed to an increase in nominal earnings. While some trading companies and resources-related industries benefited from buoyant commodity market conditions, the deteriorating outlook for automobiles follows the impact of prolonged supply constraints on components such as semiconductors. The same applies to smartphones, PC, and other electronics focused manufacturing industries, where inventory adjustments are expected to lead to downward revisions to overall earnings.

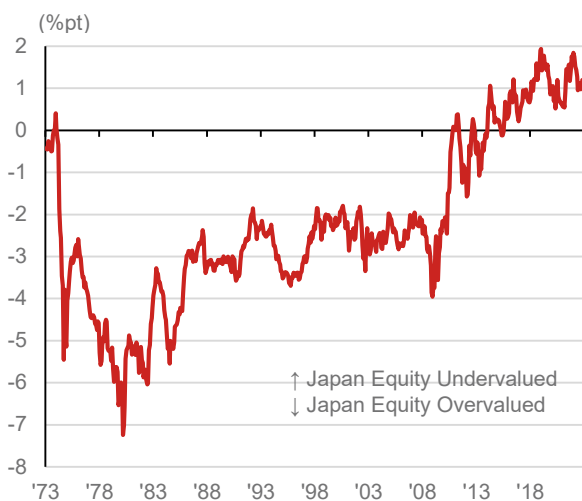
For fiscal 2023, we expect recurring profits to increase by about 6.2%. However, the exchange rate assumption is set at 140 JPY/USD for the fiscal year ending 3/2024 compared with 137 for FY3/2023, and the exchange rate will act as a negative drag on reported earnings if the yen is stronger than this assumption. While we should bear in mind the risk of such a strong yen, comparisons of the 2023 earnings outlook across Europe, the United States and emerging markets shows that only Japan has been revised upward from its forecast at the beginning of the year. Against the backdrop of an increase in the number of foreign visitors entering Japan after travel restrictions were eased (an increase in inbound demand) and robust capital investment, domestic demand is expected to support the Japanese economy as a whole for the next fiscal year. Corporate earnings growth in Japan is therefore expected to be superior compared to other countries.

Will there be adjustment to Japan's relatively cheap valuation?

There is no change in the fact that Japanese stocks are currently undervalued compared to other major markets in Europe and the United States. One factor, is that the overall Japanese market continues to underperform other markets in terms of return on equity (ROE). However, even when we select and compare groups of companies with similar ROE levels (15% or higher) from among listed companies in both the Japanese and U.S. markets, the Japanese stocks have lower P/E ratios than their U.S. peers (lower right). There are many possible interpretations, but one of the main reasons is that U.S. companies achieve high ROE while actively investing in their core businesses, while Japanese companies achieve high ROE through shareholder returns while profit margins have hit their ceilings, resulting in lower expectations for future sales growth. Based on this finding, Japanese companies will need to achieve high growth and high ROE through active

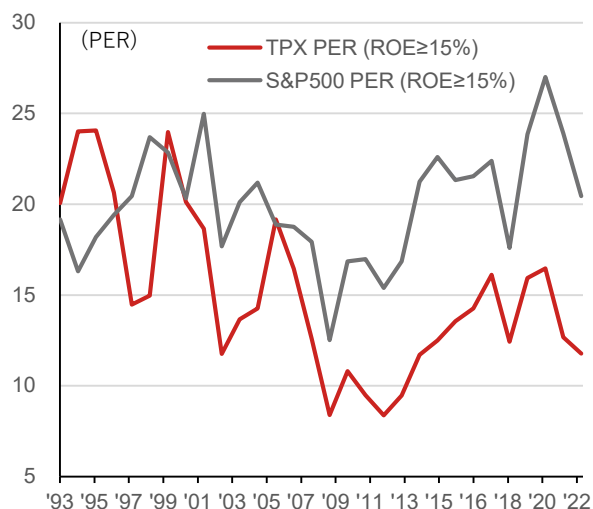
investment in order to raise their equity valuations from undervalued levels. From this perspective, the effectiveness of many of the "investments" included in the policy announcements from the Kishida administration in the name of its "new form of capitalism" will be of particular interest. The four investment areas listed are "people," "science, technology and innovation," "start-ups," and "GX and DX" (Green Transformation and Digital Transformation). In order for private companies to make effective investments in public-private partnerships, it is considered essential to enhance the predictability of the business operating environment as a national strategy and to redesign regulations to encourage investment.

Earnings Yield (Japan vs. Global)
(January 1973 to November 2022, monthly)



Source: Nomura Asset Management based on Datastream data.

Stock Valuation of High ROE Companies
(1993 – 2022, annually)



Note: Fiscal year based from TOPIX, calendar year for S&P500, as of November for 2022.

Source: Nomura Asset Management based on Factset data.

Assessment of non-financial information and institutional investor engagement activities

Analysis of non-financial information in addition to financial information is increasingly important in corporate valuations. In the environmental, social, and corporate governance (ESG) fields, assessment of whether a company is being managed to capture risks and opportunities in corporate management and to increase sustainable corporate value is linked to the medium-term stock valuation. With regard to climate change, in accordance with the framework of the Task Force on Climate-related Financial Disclosures (TCFD), companies have been required to disclose their efforts related to transition risks, physical risks, etc. toward the realization of a decarbonized society. Taskforce on Nature-related Financial Disclosures (TNFD) is currently developing a disclosure framework to demonstrate how companies can address risks and opportunities related to biodiversity and the conservation of the natural environment. Human resource strategies linked to corporate growth strategies and human capital disclosure are also becoming important topics. In order to develop and bring out the best in employees, it is important to utilize human resources with diverse values, regardless of gender, nationality, race or age. It is also important to create a corporate

culture that embraces diversity and inclusion. We believe that creating an environment where people can work with a sense of satisfaction and "well-being", with increased employee engagement will lead to sustained increases in corporate value.

Institutional investors are expected to engage in constructive dialogue (engagement) in pursuit of active commitments from companies regarding natural and human capital and information disclosure. Nomura Asset Management has conducted a quantitative analysis of how our own engagement activities have affected corporate management and stock valuations. The results were a mix of statistically significant and insignificant effects. One important fact about this result is that we continue to evaluate whether the effects observed externally are actually linked to an increase in corporate value, and that we persevere in urging companies to make efforts to increase the value of intangible assets such as natural and human capital, which can take a while to materialize, essentially as corporate value.

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