The Japan equity market fell by over 20% in the first three days of August. The sell-off reached a crescendo on Monday, 5 August, with a 12% decline in one day. Edward Ritchie, Head of Japan Equities, explains the causes of the sell-off and provides our outlook for the equity market and the Bank of Japan (BoJ) rate path.

The Japan equity outlook after the market sell-off

Fears of a US-led global recession

In our view, the main cause of the market rout was a sudden change in global investors' expectations for a US-led global recession. This view was driven by some investors' belief that the US Federal Reserve (Fed) had made a policy error by not cutting rates in late July – a perspective supported by weaker US employment and industrial-demand data. This change in opinion led to a large amount of de-risking. One of the most significant risk trades globally was the so-called 'yen carry trade', where global investors were shorting the yen and investing in the Japan equity market. The de-risking, or unwinding of this trade, has been the primary cause of the sharp strengthening of the yen and the decline of the Japan equity market.

Japanese exporters' profit outlook doomed by rate hike

Several other causes helped strengthen this sentiment change and exacerbate the sell-off. On 31 July, the Bank of Japan (BoJ) raised interest rates from 0-0.1% to 0.25%, which led to a strengthening yen[1]. This policy move is expected to weaken the profit outlook for Japanese exporters. However, the impact of the yen on aggregate Japanese earnings is not as large as it has been historically.

Indeed, many Japanese manufacturers now produce from overseas. Hence, the currency effect tends to be more translational (translating overseas earnings back into yen) than transactional (selling Japan-produced products with a Japanese-yen cost base into overseas markets). Some commentators also see the risk of a domestic economic slowdown in Japan due to the interest rate increase, but, in our view, this is not a major risk.

Global technology sell-off

Another cause was the change in sentiment towards global technology stocks that began earlier in July. The concern originated from comments by the current US administration that it would further tighten the rules on selling semiconductor equipment by the US and its allies to mainland China. Worries about the growth outlook for technology stocks increased when a leading technology company announced that it would cut 15% of its staff. This following a weak earnings announcement on 1 August, which revealed that quarterly profits had plunged by 85%.

Geopolitics remains an ongoing risk for investors as tensions appear to be rising again in the Middle East. However, we do not believe this has been a significant factor driving the rapid change in sentiment experienced in the early days of August.

[1] Nikkei Asia, 31 July 2024: Bank of Japan raises interest rate to 0.25%, open to further hike this year - Nikkei Asia

Which sectors and factors have been hardest hit, and which have shown the greatest resilience?

The sell-off was fairly consistent across the board, with all sectors declining by over 10%[2]. The weakest sectors were financials (banks, insurance and brokers), followed by trading houses and autos. The best-performing sectors were mainly domestic and defensive segments, such as retail and healthcare, as well as railways and telecoms.

Despite the lack of yen exposure, financials were the hardest hit due to the market's changing view regarding further rate hikes and the decline in 10-year bond yields (the 10-year Japanese government bond fell from over 1% to below 0.8%). In addition, the market began pricing in a 50% chance of a further 25 basis point rate hike by the Bank of Japan before the end of 2024 – by the end of July, this had fallen to an almost 0% chance. These moves changed investor sentiment towards financial stocks.

The better-performing sectors were domestic and generally defensive names. This gives us some confidence that the outlook for the domestic economy remains solid. Japanese consumers have been struggling with higher prices and have only recently seen real wage growth turn positive. The positive impact for domestic companies from lower import prices due to a stronger yen should help support Japan's domestic economy companies.

In factor terms, growth and momentum companies have been hardest hit, while businesses with high-quality scores and high free cash flow yields have seen less severe share price declines.

Market outlook and investment implication

It is difficult to know how much further the 'yen carry trade' unwind may go and what impact this will have on the Japan equity market. However, based on previous sharp sell-offs, such as post-Fukushima disaster in March 2011 or the Covid-related sell-off in March 2020 (on both occasions, the market fell by 16-18% in less than a week and was followed by some recovery), such market declines can be short and sharp

The Japanese market is now trading on a very reasonable 12 times price-to-earnings(P/E) multiple, and companies have conservatively forecast flat earnings in 2024/25 based on an average yen/dollar exchange rate of 140. The US market is trading on a much higher 22 times P/E multiple[3].

The Japanese market is also well supported by its dividend yield and a commitment by companies to share buybacks over the coming years. We estimate the combined shareholder returns for the Japanese equity market in 2024/25 will be over 5%.

Investors will continue to focus on high-quality companies with strong pricing power and efficient capital allocation. They will look for opportunities to add to some high-conviction names if significant upside emerges and stocks reach investors' fair-value targets because of the market sell-off.

There is no change in our view that Japan is going through a period of transition from a deflationary to an inflationary environment and that companies with pricing power will be able to raise prices consistently. This will allow Japanese firms to grow their earnings and free cashflows more consistently and help drive a sustained rerating of the Japanese equity market.

Outlook for Bank of Japan's rate path

Before the market sell-off, we believed that the BoJ would make one or two rate hikes in 2024 and some further rate rises in 2025 to bring interest rates towards normalisation. The BoJ has not been explicit on the 'normalised' interest rate level, but in our view, it should be higher than the current level of 0.25%.

The market no longer expects any further rate hikes in 2024. A further BoJ rate rise would be driven by the inflation rate remaining high (Japan's Consumer Price Index currently stands at 2.8%). The recent yen strength may help keep a lid on higher inflation as import prices start to decline.

The unwinding of the 'yen carry trade' means that investors are no longer heavily geared to further

[2] 5 August 2024, Manulife Investment Management.

[3] Based on one-year consensus forecast.

sharp movements in the Japanese currency. This will remove a major concern for the BoJ and give it more freedom to act (i.e., take further action on raising rates) in the future without worries about the knock-on impact on financial markets.