

Summary

- We may see continued market choppiness over the next three-to-six months, but our outlook for Japanese equities remains positive due to two key themes: corporate governance improvements and the shift from a deflationary period to an inflationary one.
- We do not believe the surprise rate hike in late July was the sole cause of market volatility in August. In our opinion, the price volatility following the rate hike should be viewed through the lens of market liquidity.
- Regardless of the outcome, we view the proposed takeover of Seven & i Holdings—the first large M&A announcement following the government’s revamp of corporate takeover guidelines in August of 2023—as a significant milestone, pointing to increased interest in Japanese companies and a period of heightened M&A activity.

We believe that August’s pronounced market volatility should be viewed as a liquidity event rather than a reflection of any changes in overall fundamentals. In fact, aggregate earnings for the June quarter came in ahead of expectations with double-digit year-over-year growth compared to full-year aggregate guidance pointing to a small year-over-year decline. While the weaker yen was a tailwind to earnings, in general, excluding forex, earnings are on track to exceed initial targets. In addition, Japan finally saw positive real wage growth for the first time in well over two years—ahead of our expectations for real income growth to turn positive in late 2024 or early 2025.

Our conclusion is that Japan, as with the rest of the world, will continue to be impacted by the US economic outlook in the near term. We believe that the recent 50 basis point rate cut by the Federal Reserve has probably improved the odds of a soft landing for the

US economy, but by no means is this assured, and an exceptionally tight US presidential election adds yet another layer of uncertainty. Accordingly, our balanced near-term outlook remains unchanged, but we continue to reiterate that the medium- and longer-term structural changes Japan is experiencing remain in place. Thus, we believe investors should reassess their longer-term equity positioning in Japan to take advantage of short-term volatility.

While some believe the surprise rate hike by the Bank of Japan (BoJ) in late July triggered August’s volatility, we think this idea is somewhat misplaced. Even though the rate hike did turn the tide on the Japanese yen, short-term positioning of the yen and the Nikkei already appeared stretched. In our opinion, the subsequent price volatility should be viewed through the lens of market liquidity. Moreover, we believe the softer US employment data in July was the real reason for the overblown global reaction and that more rate hikes by the BoJ, until Japan achieves its neutral rate, should be viewed as positive steps toward economic normalization. While the stronger yen will probably be a headwind to export earnings in the short term, it could help domestic sentiment over time as the weaker yen has been weighing on confidence. It is also worth mentioning that the BoJ recently upgraded its assessment of private consumption from “resilient” to “projected to increase moderately, mainly reflecting the rise in wage growth.” While the US presidential election and subsequent potential policy changes under any new administration remain the focus of global markets, Japan’s Liberal Democratic Party (LDP) presidential election to replace Prime Minister Fumio Kishida has resulted in short-term volatility due to the stark differences between the finalists. As the

runoff between Ms. Sanae Takaichi and Mr. Shigeru Ishiba had been finalized in the afternoon on the last Friday of September, the market anticipated a Takaichi win with the equity market rallying into the close on a sharply weaker Japanese yen. Mr. Ishiba, who had been the leading candidate in opinion polls, has historically fared well in initial balloting due to his strong grassroots appeal, but has always lost momentum in final balloting when parliamentary votes carry a heavier weight, given his lack of popularity inside the Diet. Ms. Takaichi, a protégé of former Prime Minister Abe, is well known for her position that the BoJ should pivot and take a more aggressive monetary easing position. In the end, Mr. Ishiba surprised markets by winning the runoff. Not surprisingly, the yen reversed sharply from 146 to 142 and we saw a resulting sharp sell-off in Nikkei futures in the aftermarket. Mr. Ishiba, a former defense minister, is better known for his military expertise as an advocate for an Asian version of NATO but it is well known that he supports the normalization path the BoJ has embarked upon.

It is still premature to make any conclusions about Prime Minister Ishiba's future policy directions, but we do not believe he would represent a significant change to the current mainstream LDP agenda. We are likely to see more emphasis on the revitalization of local economies, perhaps a more assertive Japan from a foreign policy perspective, and a focus on winning back voter trust following various political funding scandals within the LDP. However, the true strength of the Prime Minister's political mandate will be determined in the future by the success or failure of the LDP in the next general election. He is likely to dissolve the Diet and call for general elections before the end of the calendar year.

While the market's focus moved toward politics at the end of the quarter, we believe the more important market development of recent months was the proposed takeover of Seven & i Holdings by Alimentation Couche-Tard of Canada in August. This was the first large M&A announcement following the government's revamp of guidelines for corporate takeovers in August 2023.¹ The board of Seven & i rejected the surprise bid due to the low price, which they believed did not fairly value the company. But regardless of the outcome, this event could represent a new chapter for corporate Japan. Although the market for corporate control is still not completely open in Japan, an uptick in M&A would have positive implications for corporate valuations as well as overall corporate efficiency.

The Japanese equity market has nearly recovered in US dollar terms from the sharp sell-off in early August, but increased market volatility could occur due to ongoing forex volatility. We may see continued market choppiness due to ongoing concerns about the US economy over the next three-to-six months, along with continued political uncertainty in the United States and Japan. However, this does not change our positive outlook for Japanese equities over both the medium and long term. We expect the regulatory reforms of the past year to continue to drive corporate governance improvements, better capital efficiency, and higher shareholder return, and we expect the gradual shift from a deflationary period to an inflationary one to drive a transformation of the Japanese economy.

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Notes:

1. [METI Formulates Guidelines for Corporate Takeovers \(Ministry of Economy, Trade and Industry, August 2023\)](#)

Important Information

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