

Japan Equity Strategy

**Dynamics shift to inflationary economy:
Raise year-end forecast**

Investment Strategy

Unexpectedly strong rally backed by earnings recovery

Japan equities could correct in the near term after rising beyond expectations but we have no major concerns about the outlook. First, although the one-sided aspect of the market looks risky, it reflects differences in earnings strength. Second, there is evidence of incipient rotation in stock selection. Third, the number of companies reporting an earnings recovery is likely to increase from the Apr-Jun quarter.

Broader stock selection likely from around FY3/24 results

Real wage growth is the first support we cite for earnings from the Apr-Jun quarter. To date, earnings in high-end consumption have been strong amid cost-push inflation but now recovery in earnings could extend to service sectors, restaurants, apparel, consumer durables, and convenience stores. For sectors geared to overseas demand, cyclical recovery in the manufacturing cycle is a significant factor. Theoretically, the recovery underway in early-cycle semiconductors should spread to other product categories one by one – the order that springs to mind is network infrastructure (servers, data centers), automotive-related, and FA/industrial machinery. Also, the YoY bar should be low for China's economy, a major influence on manufacturing, which slowed in Apr-Jun 2023 post-reopening and fell rapidly in Jul-Sep. Exhibit 8 shows names where ROE and recurring profit are higher than in FY15 - before negative interest rate policy (NIRP) was introduced - but P/B is below 1.7x.

Dynamics shift to inflationary economy: Raise year-end forecast to Nikkei 225 43,500, TOPIX 2,950

We take the above scenario into account in raising our year-end forecast to 43,500 for the Nikkei 225 (from 41,000), and to 2,950 for TOPIX (2,850). Advances in P/E multiples tend to come to a halt in EPS recovery phases where recovery slows, but no slowdown has occurred. We think the likelihood of earnings recoveries extending to a larger number of companies is another justification for raising our P/E assumption. That said, there are risks to the upbeat scenario above.

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Investment Strategy
Japan

Masashi Akutsu >>
Strategist
BofAS Japan
+81 3 6225 7754
masashi.akutsu@bofa.com

Tony Lin, CFA >>
Equity Strategist
BofAS Japan
+81 3 6225 8123
tony.y.lin@bofa.com

Tetsuhiro Tokuyama
Strategist
BofAS Japan
+81 3 6225 8499
tetsuhiro.tokuyama@bofa.com

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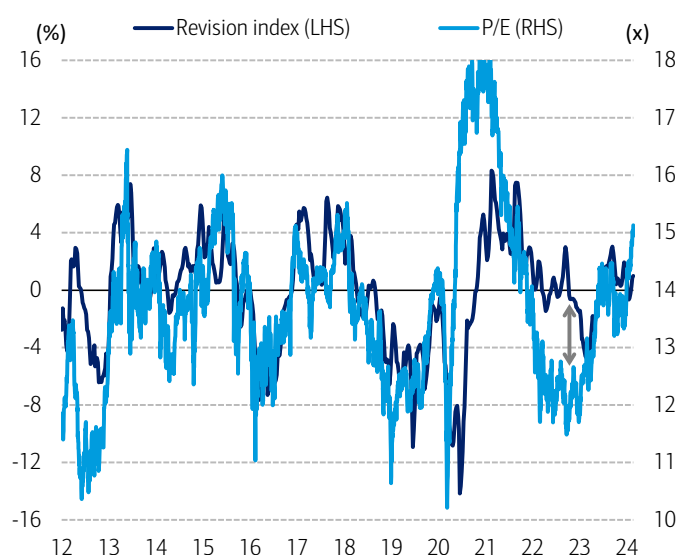
Japan equity rally: Firmly grounded in earnings recovery

Starting the year at 33,000 levels, the Nikkei 225 raced past 40,000 in little over two months, outpacing our bullish assumption. We take this opportunity to review the scenario ahead.

Given that the current TOPIX P/E of just over 15x is below the peak since 2010 (just over 16x, Exhibit 1) and the remarkable rise in stock prices is firmly grounded in recovery in earnings, we would not call this a bubble. On the other hand, P/E deviation from the closely-correlated earnings revision index suggests there could be a speed correction in the near term. March is typically a season for net sales by overseas investors (followed by net buying in April, Exhibit 2), and pension fund rebalancing (selling) is likely toward the end of the quarter.

Exhibit 1: TOPIX revision index and 12-month forward P/E

TOPIX P/E, albeit far from the historical peak level, appears to have surpassed the level that earnings revision implies



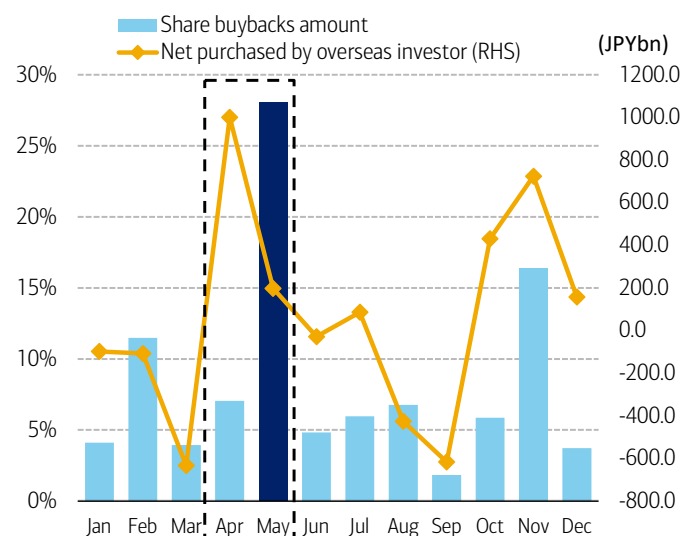
Source: Refinitiv, BofA Global Research

Note: The revision index (4 weeks moving average), P/E is based on I/B/E/S consensus estimate for 12-month forward EPS.

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Exhibit 2: The seasonality of share buybacks and net purchases by overseas investors

Overseas investors tend to purchase Japan stocks in Apr, but sell in March



Source: QUICK, BofA Global Research

Note: Based on TOPIX constituents. Share buy backs amount and Net purchased by overseas investors are averaged for each month from 2011 to 2022, to 2023, respectively.

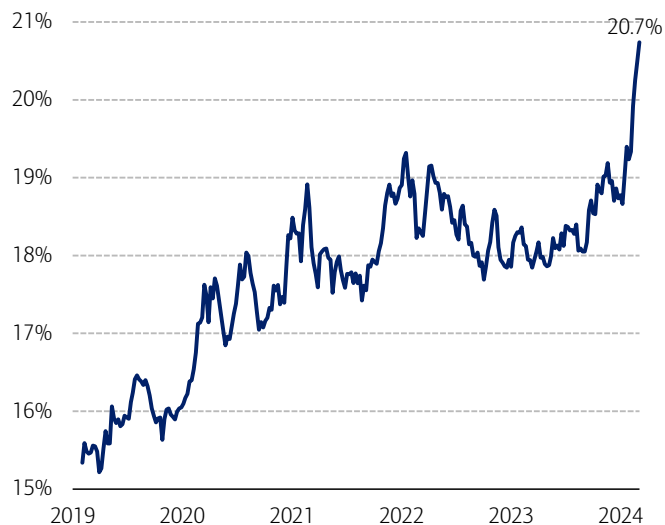
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We turn to the driving force behind the rapid ascent. The fundamental factor was structural change – the shift to inflation, and cutbacks in corporate surplus capital – but there was also influence from a skew towards stocks with a high index weighting (Exhibit 3). The latter is something of a risk but we have no major concerns about the outlook.

First, there is no contradiction between the market skew and the fundamentals. It results from increased earnings contributions from a number of large corporations (Exhibit 4). Second, there is recent evidence of incipient rotation in stock selection with brisk activity in undervalued stocks rather than buying focused on limited names such as semiconductor related companies (Exhibit 5). Third, the number of companies reporting an earnings recovery is likely to increase from the Apr-Jun quarter.

Exhibit 3: Share of market cap of top 10 stocks to market cap of TOPIX

The share of market cap of top 10 stocks suddenly increased

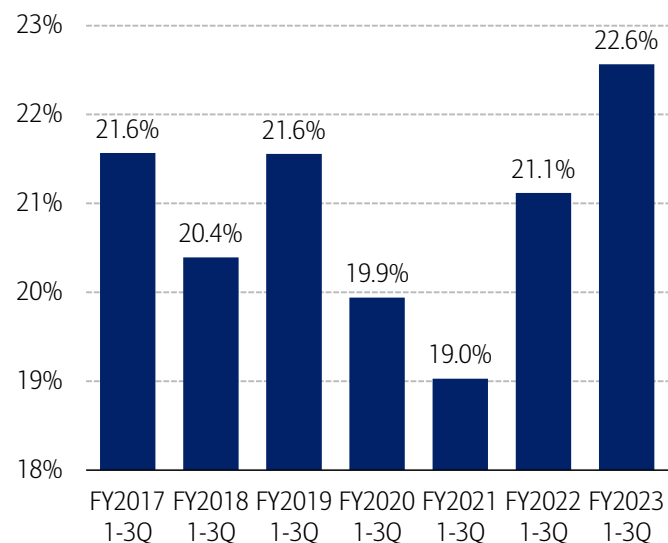


Source: QUICK, BofA Global Research

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Exhibit 4: Percentage of cumulative RP (1Q-3Q) contribution from top 10 companies in terms of mkt cap

FY23 saw larger earnings contribution from top 10 mkt-cap companies



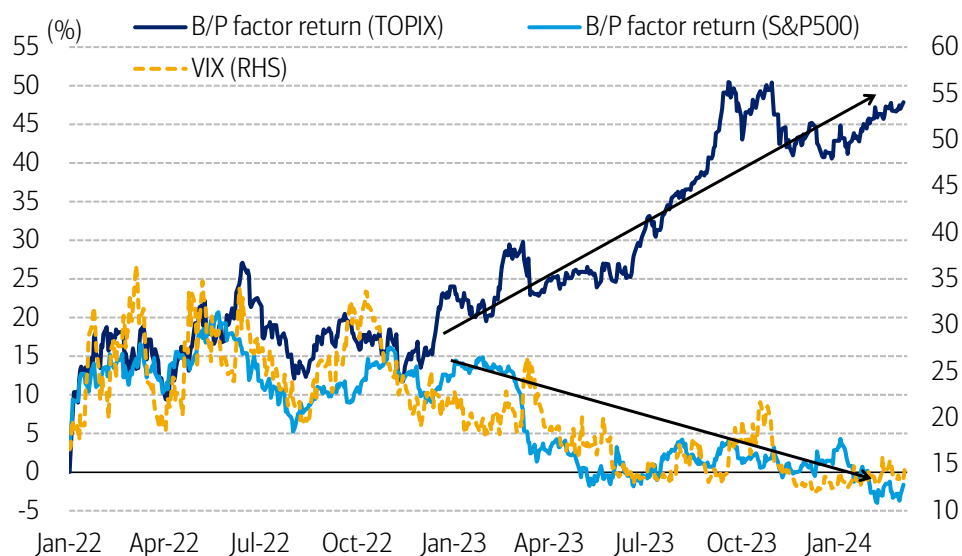
Source: QUICK, BofA Global Research

Note: Based on TOPIX companies with fiscal year ending in March. Excluding SoftBank Group among top 10 mkt cap companies.

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Exhibit 5: US, Japan B/P (reciprocal of PBR) factor return and VIX (Volatility Index)

Japan value stocks outperformed



Source: FactSet, BofA Global Research

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Broader stock selection likely from around FY3/24 results

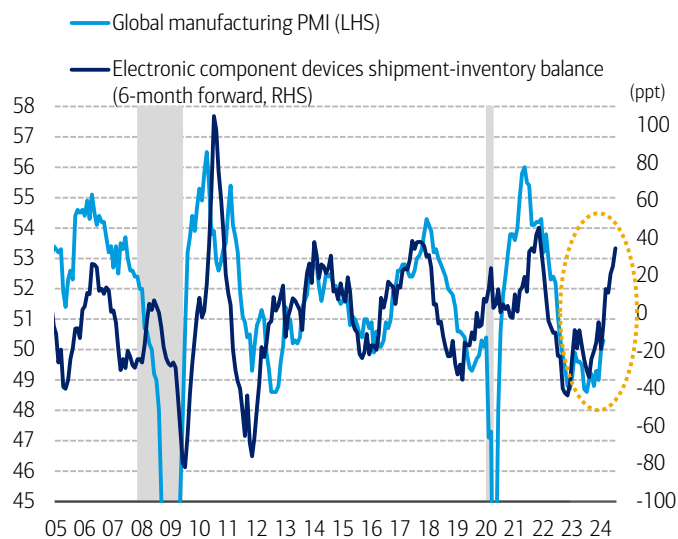
What are the supports for recovery in earnings from the Apr-Jun quarter? Macro cycles are generally positive for Japanese stocks. Sectors geared to domestic demand have potential for earnings boosts from real wage growth if the Shunto wage negotiations produce substantial wage hikes. Given a higher real wage trajectory in Apr-Jun, growth could turn positive by the latter half of the Jul-Sep quarter (according to the BOJ), the Shunto outcome will be fully reflected in the monthly wage data around the summer). Our economists raised their already upbeat Shunto base-up estimate to c3.5% in light of Rengo's summary of unions' wage demands (see our 7 March [Japan Watch report](#)). Realization implies the starting point for a break with deflation.

To date, the weak yen has drawn in inbound spenders and high-end consumption (or discounted consumer goods) has been strong owing to low impact from the cost-push inflation. Given improvement in real wages, recovery should extend out to service sectors, restaurants, apparel, consumer durables, and convenience stores for example. Also, labor shortages accompanying recovery in the domestic economy represent a business opportunity for IT services. This could attract funds to small- and mid-caps, which are numerous in service sectors and IT services.

For sectors geared to overseas demand, cyclical recovery in the manufacturing cycle is a significant factor (Exhibit 6). Theoretically, the recovery underway in early-cycle semiconductors should spread to other product categories one by one – the order that springs to mind is network infrastructure (servers, data centers), automotive, and FA/industrial machinery. Also, the YoY bar should be low for China's economy, a major influence on manufacturing, which slowed in Apr-Jun 2023 post-reopening and fell rapidly in Jul-Sep (Exhibit 7).

Exhibit 6: Global manufacturing PMI and the shipment-inventory balance of electronic components

Manufacturing cycle (every 3-4 years) could be in the bottoming phase



Source: Refinitiv, S&P Global, BofA Global Research

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Exhibit 7: China economic surprise index and China composite PMI

Chinese economic slowed down in last Apr-Jun and Jul-Sep.



Source: Bloomberg, S&P Global, BofA Global Research

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Based on the above, we see a scenario where the market firms up as the corporate earnings recovery extends its base in the Apr-June and Jul-Sep quarters. From the stock selection standpoint, this should encourage diversification when investors have ascertained guidance with full-year results – or even before.

Developments around the cutbacks in surplus capital that full-year results are expected to show are also a significant catalyst. Additionally, we note companies with real estate holdings (for details, see our 26 February Japan Equity Strategy report) and P&C insurers that have started to unwind cross shareholdings, along with attendant potential business opportunities for brokerages (see our 27 Feb Japan Financial Sector report). Other focuses are the healthcare sector with high activity in MBO and corporate acquisitions beginning in 2023 plus growing consolidation momentum in the dispensing pharmacy sector (see our 6 March Healthcare Sector report). We expect the combination of inflation and the TSE's P/B reform agenda to pressure companies into abandoning deflation-oriented operating practices.

From a strategy viewpoint, we maintain our focus on quality cyclicals (p.16 in 27 February [Japan Insight](#)) while also noting laggard stocks. Value stock valuations dropped in a deflationary economy without interest rates after the BOJ introduced NIRP in January 2016. Now that termination is likely in March or April, in Exhibit 8 we show names that have higher ROE and recurring profit than they did in pre-NIRP FY15 combined with a P/B of less than 1.7x and P/E of under 20x.



Exhibit 8: Stocks with P/B upside if the BoJ removed NIRP (reversing RP earnings/ ROE changes post the introduction of NIRP in FY2015)

P/B below 1.7, FY2 P/E below 20, RP growth (FY2) surpassed that in FY15 by 30%, ROE (FY2) > ROE in FY15, FY2 RP revisions above -2%

Code	Name	Sector	Mkt cap (bn JPY)	Current P/B	P/B as of end-2015	% FY2 RP vs FY2015	Current ROE	P/E (FY2,x)	RP revision (FY2, vs. 3 months prior, %)	YTD return (vs. TOPIX, %)
7203	TOYOTA MOTOR CORP	Transportation Equipment	61,491	1.6	1.4	113.9	13.8	13.5	7.2	30.1
8306	MITSUBISHI UFJ FINANCIAL GRO	Banks	19,358	1.0	0.7	36.6	7.7	13.2	1.7	17.3
9432	NIPPON TELEGRAPH & TELEPHONE	Information & Communication	16,362	1.7	1.1	48.6	13.7	12.6	-0.0	-9.7
8058	MITSUBISHI CORP	Wholesale Trade	13,657	1.6	0.6	1595.6	11.1	13.7	2.4	30.5
8031	MITSUI & CO LTD	Wholesale Trade	10,161	1.4	0.7	4520.0	11.8	11.6	2.6	13.9
7267	HONDA MOTOR CO LTD	Transportation Equipment	9,615	0.7	1.0	148.9	8.8	9.1	1.2	8.8
3382	SEVEN & I HOLDINGS CO LTD	Retail Trade	5,726	1.5	2.1	48.7	8.5	18.5	-0.2	1.5
6201	TOYOTA INDUSTRIES CORP	Transportation Equipment	5,062	1.0	1.0	84.0	5.8	19.6	1.7	21.9
8053	SUMITOMO CORP	Wholesale Trade	4,346	1.0	0.6	356.0	11.1	8.7	7.4	1.2
6301	KOMATSU LTD	Machinery	4,261	1.5	1.2	167.7	13.0	11.4	4.6	8.5
8002	MARUBENI CORP	Wholesale Trade	4,199	1.3	0.7	540.6	14.1	8.9	0.8	-1.1
4901	FUJIFILM HOLDINGS CORP	Chemicals	4,114	1.3	1.1	78.7	8.1	16.7	-1.5	1.9
8725	MS&AD INSURANCE GROUP HOLDIN	Insurance	4,107	1.0	0.8	66.2	10.8	11.8	2.0	22.8
8801	MITSUI FUDOSAN CO LTD	Real Estate	3,882	1.3	1.6	58.4	7.2	16.3	0.4	8.2
8015	TOYOTA TSUSHO CORP	Wholesale Trade	3,597	1.6	0.9	554.2	14.0	10.5	3.4	8.2
5401	NIPPON STEEL CORP	Iron & Steel	3,587	0.7	0.8	261.0	10.0	7.2	3.4	1.4
6752	PANASONIC HOLDINGS CORP	Electric Appliances	3,496	0.8	1.5	121.8	9.2	9.2	-0.2	-10.8
4578	OTSUKA HOLDINGS CO LTD	Pharmaceutical	3,391	1.4	1.4	100.1	8.7	14.8	-1.1	-1.5
8802	MITSUBISHI ESTATE CO LTD	Real Estate	3,075	1.4	2.3	79.2	7.9	17.4	1.9	11.5
8630	SOMPO HOLDINGS INC	Insurance	2,989	1.2	1.0	75.4	11.9	10.9	4.3	15.9
1925	DAIWA HOUSE INDUSTRY CO LTD	Construction	2,868	1.2	2.0	73.4	11.3	10.3	-1.6	-13.7
6701	NEC CORP	Electric Appliances	2,778	1.6	1.2	166.8	8.9	18.0	3.4	6.5
2502	ASAHI GROUP HOLDINGS LTD	Foods	2,602	1.1	2.0	145.3	8.7	12.5	8.8	-16.1
8604	NOMURA HOLDINGS INC	Securities & Commodity Futures	2,589	0.8	0.9	68.6	5.8	13.6	9.7	28.6
9101	NIPPON YUSEN KK	Marine Transportation	2,407	0.9	0.6	398.7	13.0	9.1	27.2	-9.6
1928	SEKISUI HOUSE LTD	Construction	2,201	1.3	1.4	73.7	11.1	11.0	-1.5	-5.7
5020	ENEOS HOLDINGS INC	Oil & Coal Products	1,960	0.6	0.7	207.9	7.2	8.9	5.1	2.0
2503	KIRIN HOLDINGS CO LTD	Foods	1,870	1.5	1.9	84.3	9.9	13.1	5.6	-15.5
9104	MITSUI OSK LINES LTD	Marine Transportation	1,843	0.8	0.5	663.9	13.7	7.4	21.9	-4.9
5802	SUMITOMO ELECTRIC INDUSTRIES	Nonferrous Metals	1,766	0.9	1.0	37.4	7.1	12.5	4.9	10.6
9107	KAWASAKI KISEN KAISHA LTD	Marine Transportation	1,644	1.1	0.6	5472.2	12.9	10.0	42.4	1.1
5411	JFE HOLDINGS INC	Iron & Steel	1,610	0.7	0.6	389.7	9.2	7.1	8.6	-0.4
9202	ANA HOLDINGS INC	Air Transportation	1,537	1.5	1.5	38.0	12.9	12.1	11.5	-12.0
2587	SUNTORY BEVERAGE & FOOD LTD	Foods	1,486	1.4	2.8	102.8	8.6	15.3	9.6	-12.0
7272	YAMAHA MOTOR CO LTD	Transportation Equipment	1,458	1.2	2.0	125.8	15.0	7.6	9.2	-5.2
5019	IDEMITSU KOSAN CO LTD	Oil & Coal Products	1,412	0.8	0.5	1105.5	8.8	9.1	10.6	12.5
7912	DAI NIPPON PRINTING CO LTD	Other Products	1,344	0.9	0.7	81.1	6.8	17.5	2.7	-12.6
5201	AGC INC	Glass & Ceramics Products	1,163	0.8	0.7	108.2	6.7	11.3	11.3	-13.5
1911	SUMITOMO FORESTRY CO LTD	Construction	892	1.2	1.2	524.5	13.4	7.7	14.9	-12.5
2768	SOJITZ CORP	Wholesale Trade	867	1.0	0.6	220.4	10.7	8.1	1.2	9.1
5334	NITERRA CO LTD	Glass & Ceramics Products	817	1.6	2.1	87.9	13.7	9.6	2.8	24.9
5406	KOBE STEEL LTD	Iron & Steel	805	0.8	0.6	351.3	8.8	8.5	1.6	-2.1
3289	TOKYU FUDOSAN HOLDINGS CORP	Real Estate	722	1.0	1.1	102.6	9.3	10.2	3.4	-1.6
6448	BROTHER INDUSTRIES LTD	Electric Appliances	669	1.0	1.0	38.7	8.3	11.9	0.4	2.8
2002	NISSHIN SEIFUN GROUP INC	Foods	635	1.3	1.6	91.0	7.9	18.1	6.1	-8.3
6113	AMADA CO LTD	Machinery	591	1.1	1.0	40.8	8.2	14.1	-0.9	1.9
8227	SHIMAMURA CO LTD	Retail Trade	577	1.3	1.7	45.6	8.6	13.9	-0.4	-13.8
8060	CANON MARKETING JAPAN INC	Wholesale Trade	564	1.3	0.9	105.1	8.5	14.1	2.1	-12.9
7013	IHI CORP	Machinery	552	1.7	1.6	1012.6	20.1	6.9	0.7	13.9
5444	YAMATO KOGYO CO LTD	Iron & Steel	550	1.0	0.7	231.3	10.0	9.9	1.7	-2.8
2282	NH FOODS LTD	Foods	542	1.1	1.4	36.5	6.3	16.4	6.3	-4.3
4613	KANSAI PAINT CO LTD	Chemicals	542	1.5	1.9	48.4	11.3	15.8	1.1	-24.4
9142	KYUSHU RAILWAY COMPANY	Land Transportation	542	1.3		83.7	9.9	12.3	2.7	-1.5
9008	KEIO CORP	Land Transportation	539	1.3	2.0	38.2	8.4	16.7	46.4	-21.6
8253	CREDIT SAISON CO LTD	Other Financing Business	532	0.7	0.8	73.9	7.9	10.1	3.1	1.7
4088	AIR WATER INC	Chemicals	531	1.2	1.6	118.3	10.6	10.6	4.2	7.0
3405	KURARAY CO LTD	Chemicals	523	0.7	1.0	36.9	7.8	9.0	4.8	-11.4
1944	KINDEN CORP	Construction	523	0.9	0.9	38.7	6.3	15.1	7.9	-8.1
8804	TOKYO TATEMONO CO LTD	Real Estate	458	1.0	1.0	196.9	9.2	9.4	1.6	-8.4
5105	TOYO TIRE CORP	Rubber Products	445	1.5	1.0	281.0	18.9	8.4	5.5	-12.0
6481	THK CO LTD	Machinery	421	1.1	1.9	50.9	13.8	7.0	15.1	0.3
5471	DAIDO STEEL CO LTD	Iron & Steel	413	1.2	1.1	71.1	6.2	17.7	15.1	8.6

Source: QUICK, BofA Global Research

Note: Universe consists of TOPIX stocks with mkt cap above 400 bn JPY, screened based on the following conditions: P/B below 1.7, FY2 P/E below 20, FY2 RP growth surpassed that in FY15 by 30%, FY2 ROE > ROE in FY15, FY2 RP revisions above -2%; listed in descending order of mkt cap. Estimated value is based on QUICK consensus.

This is a screen and not a recommended list either individually or as a group of stocks and options. Investors should consider the fundamentals of the companies and their own individual circumstances / objectives before making any investment decisions.

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Dynamics shift to inflationary economy: Raise year-end forecast to Nikkei 225 43,500, TOPIX 2,950

We raise our year-end forecast for Japanese equities again based on the above scenario, acknowledging the possibility of a speed correction but judging that the current environment justifies a higher P/E assumption (we raise our P/E assumption from 14.8x to 15.4x). Our Nikkei/TOPIX multiplier assumption is 14.7x. We put the Nikkei 225 at 43,500 at the year-end, and TOPIX at 2,950 (previously 41,000, 2,850), implying record market highs in 2024. Change in economic dynamics on the shift from deflation to inflation plus accompanying corporate reforms are significant influences.

Exhibit 9: TOPIX and Nikkei forecasts

We expect TOPIX/Nikkei 225 to reach 2,950pt/¥43.5k in 2024

	TOPIX EPS	TOPIX EPS (YoY)	TOPIX (pt)	Nikkei225 (yen)
Mar '23 (A)	145.0	3.7%	2,004	28,041
Dec '23 (E)	166.3	14.7%	--	--
Dec '24 (E)	--	--	2,950	43,500
Dec '24 (previous)	--	--	2,850	41,000
Mar '25 (E)	181.2	9.0%	--	--
Mar '26 (E)	196.3	8.3%	--	--

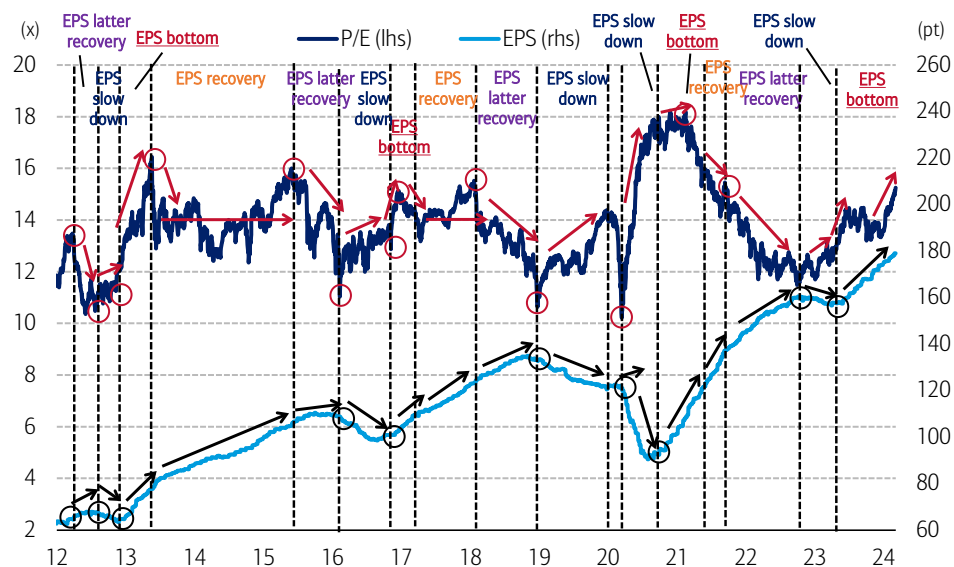
Source: BofA Global Research

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Turning to the relationship between EPS and P/E, theory holds that both improve when EPS bottoms out, providing a double engine for rapid market gains (Exhibit 10). In the subsequent EPS recovery phase when EPS recovery slows, the P/E trends at around 14x, the midpoint of the range. We thought the EPS recovery phase was close at hand but as yet there has been no slowdown. A high P/E also seems likely given a broader base of companies reporting recovery in earnings. Also, net buying by overseas investors tends to increase in recoveries in the earnings revision index, and since this is tracked by the Nikkei/TOPIX multiplier, comparatively high multipliers follow.

Exhibit 10: Correlation between TOPIX 12-month forward EPS estimate and P/E

P/E multiples decline in the latter stages of an EPS recovery and rise during periods of EPS deterioration; the stock prices tend to rise significantly during "EPS bottoming" period, when both P/E and EPS rise



Source: Refinitiv, BofA Global Research

Note: EPS and P/E based on 12-month forward I/B/E/S consensus estimates.

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There are risks to the bullish scenario above. First, the Fed might be pushed into aggressive rate cuts. On the other hand, if rate cuts do not materialize in 2024 there could be a risk of global deterioration in financial conditions. Net buying by overseas investors tends to increase under easy financial conditions. In addition, if sharp yen depreciation keeps cost-push inflation alive, the real wage growth scenario presumably would break down (if this stopped the BOJ raising rates, there could be a negative spiral that fostered further yen depreciation). Second, a fizzling out in the cyclical recovery in manufacturing. This could be a consequence of China's economy deteriorating more than expected, for example.

Disclosures

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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