

Japan Equity Strategy

BoJ's YCC flexibilization: Limited impact on Japan equities; value preference intact

Investment Strategy

BoJ's YCC tweak: Value preference intact

The Bank of Japan (BoJ) decided to increase flexibility in its yield curve control (YCC) policy. In its statement, the BoJ scrapped language about allowing 10-year JGB yields to fluctuate around plus and minus 0.5ppt from the target, stating the 1.0% cap on 10-year JGB yields will now be a reference upper bound rather than a strict ceiling in its market operations. Although the BoJ did not explicitly increase the upper bound to 1.5% as anticipated by our economists, we do not see this change in policy as negative for value stocks in the sense that interest rates will be allowed to move more flexibly along with economic conditions. In particular, the BoJ's outlook for the core core CPI (all items less fresh food and energy) is 3.8% (3.2%) for FY23, 1.9% (1.7%) for FY24 and 1.9% (1.8%) for FY25 (figures in parentheses indicate its outlook, as of July), settling around 2%. This outlook suggests the time may be near for the BoJ to lift negative interest rates, with more news in store for value stocks.

Limited overall impact on Japanese equities

We believe the overall impact on Japanese equities will be light. Firstly, in the bank and insurance sector, which has a 10.2% weighting in TOPIX, the BoJ's policy change will likely provide tailwinds to value stocks, which form the bulk of Japanese equities. Secondly, the yen is unlikely to rapidly appreciate because the large gap in interest rates between the US and Japan is likely to remain, as pointed out by our FX strategist. There is still room for 10-year JGB yields to move closer to the upper bound, and if interest rates were to suddenly increase, the BoJ would probably intervene. Thirdly, TOPIX P/E has already fallen to 13.4x. A P/E lower than its long-term median value of 14x implies that earnings estimate revisions are about to worsen from positive to negative territory, but there is no clear sign of earnings deterioration in this cycle now (Exhibit 1).

Mixed stock selection if US interest rates peak

The fact that Japan's inflation and the BoJ's policy normalization are one step behind that of other countries has underpinned the outperformance of value names in Japan, but if US interest rates reach a peak, stock selection is likely to become a mixed bag. In this scenario, we would consider cyclical growth stocks as long candidates in light of the strengthening signs of a bottom in the manufacturing cycle (Exhibit 2). However, as long as the term premium is increasing in the US and monetary policy is tight, we look for low-volatility stocks to be at an advantage, at least in the near term (see our 31 October 2023 Japan Insight: [BofA Strategy Monthly report](#)).

31 October 2023

Investment Strategy
Japan

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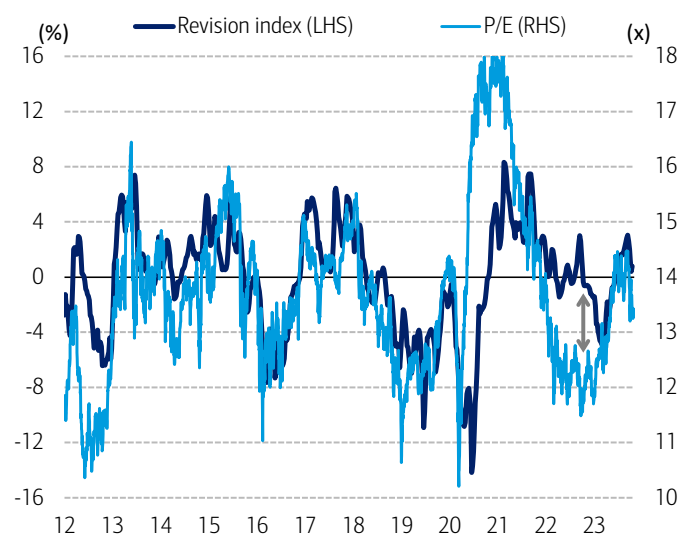
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Exhibit 1: TOPIX revision index and 12-month forward P/E

TOPIX P/E will not drop below 14x substantially unless earnings revision turns into negative territory



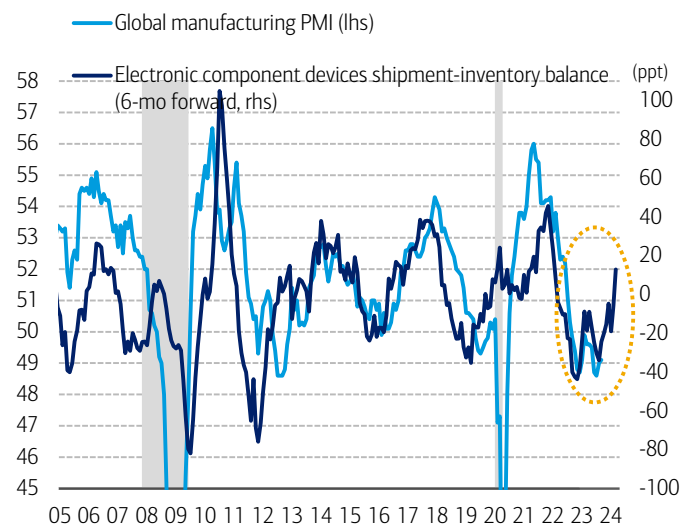
Source: BofA Global Research, Refinitiv

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

Manufacturing cycle could be bottoming vs. history

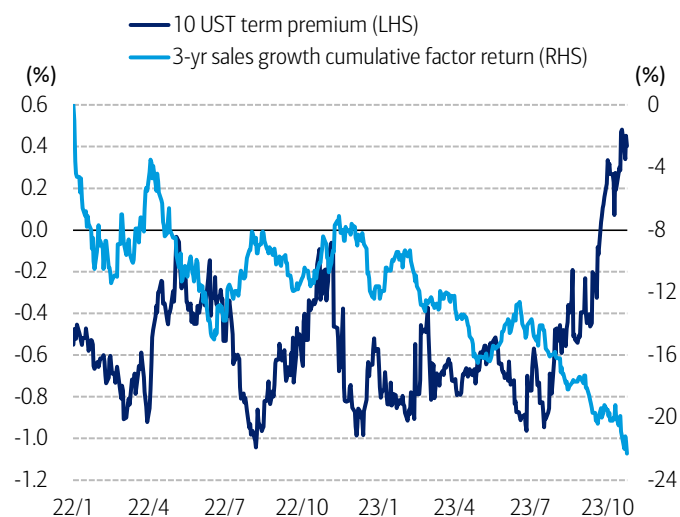


Source: BofA Global Research, Refinitiv, S&P500 Global

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Exhibit 4: 10 UST term premium and 3-yr sales growth cumulative factor return

A higher 10 UST term premium means headwinds for growth stocks

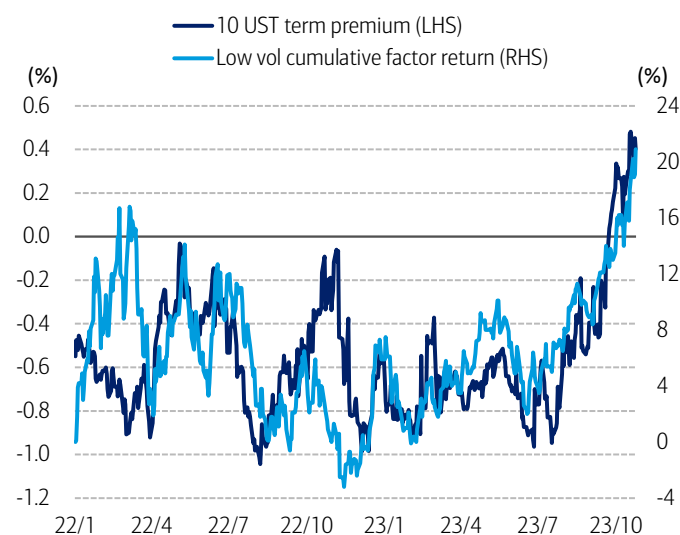


Source: BofA Global Research, Bloomberg

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Exhibit 5: 10 UST term premium and low vol cumulative factor return

A higher 10 UST term premium favors low vol factor



Source: BofA Global Research, Refinitiv, Bloomberg

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