Japan Equity Strategy

2024 market trajectory and Jan-Mar stock selection

Investment Strategy

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Japan

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2024 path: Rise in 1H, range-bound Jul-Sep, rally year end

Our overall outlook for 2024 is for the market to rise in 1H, trade range-bound in Jul-Sep, then rise again after the US presidential election in Nov. The prime catalyst in 1H will probably be growth in real wages. In the US, we believe near-term disinflation will likely open the way for Fed rate cuts.

However, there is a risk that disinflation will lose momentum and political events will weigh on the market in 2H. In Japan, increasing political uncertainties may make market participants hesitant to buy, as it will become more difficult to gauge which candidate will win in the LDP presidential election in Sep if the Diet is not dissolved in June. After the LDP presidential election, market volatility will likely rise before the US presidential election in Nov, likely inhibiting risk-taking until the dust settles, if history is any guide.

Mixed investment style; stock selection will be key

Value stocks have outperformed to start the year, and we believe they have some potential upward catalysts: 1. A stabilization in US interest rates following the rapid decline. Value stocks correlate more highly with domestic interest rates than with US interest rates, but Japan-US rates have increasingly been moving together since Oct-Dec quarter last year. 2. The dividend factor tends to work more effectively in Jan-Feb from a seasonality perspective, likely being amplified since the introduction of NISA tax-deferred investment accounts. 3. The TSE publishing its list of companies with plans to lift their value on 15 Jan, a list that will be updated on a monthly basis. For now, it probably makes sense to hold value stocks, particularly those with high dividend yields.

Meanwhile, while high-dividend names may do well near term, we believe there is unlikely to be a stark divide between value and growth in Jan-Mar, and this probably necessitates continuing to hold tech stocks and other core growth stocks. For example, any rebound in US interest rates is likely to be limited, with the Fed expected to cut rates. In addition, the tech stock cycle is turning positive. Rising real wages are a boost to value stocks and can also be a reason for revaluing SME growth stocks with significant exposure to domestic demand.

2024 path: Rise in 1H, trade range-bound in Jul-Sep, before year-end rally

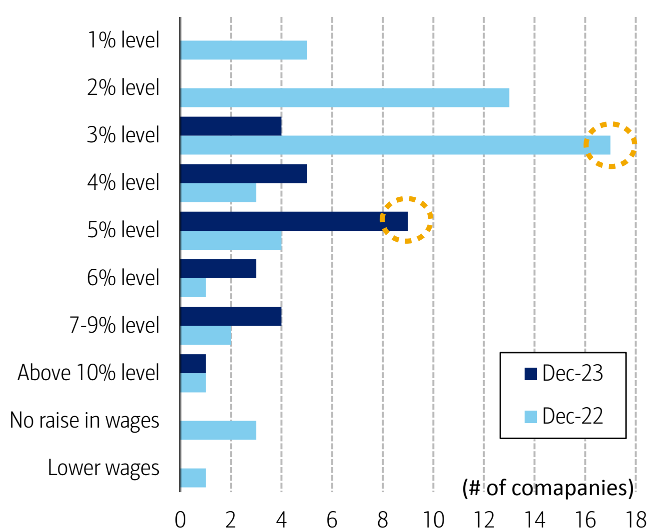
The opening bell for the 2024 market has been rung. Numerous elections are scheduled throughout 2024, starting with the election of a new leader of Taiwan in Jan and ending with the US presidential election in Nov. This will make for a difficult year to put together accurate projections. That said, we will summarize our current thoughts on the market's trajectory and near-term stock selection. Our overall outlook for 2024 is for the market to rise in 1H, box trade in Jul-Sep, then rise again after the US presidential election in Nov.

The prime catalyst in 1H will probably be growth in real wages. Wage increases in the pivotal spring wage negotiations (*Shunto*) this year are likely to surpass last year's increase, which was the highest in 30 years. In fact, in the Nikkei Shimbun's survey of 100 corporate presidents, the *Shunto* wage increase forecast chosen by the highest number of respondents was 5%, well above last year's 3% (Exhibit 1).

Meanwhile, cost-push inflation is expected to ease. The expectation is for upstream inflation, a leading indicator, to show a significant weakening of goods inflation but increases in services inflation in step with rising wages, hence a change in the nature of inflation (Exhibit 2; see the 9 Jan report Japan Watch for our economist's inflation forecast). This is likely to be repeated for inflation at the consumer level, while a rise in real wages should be forthcoming. Rising real wages are leading to a recovery in consumer sentiment, making it easier for companies to raise their prices and contributing to improving margins and ROE (Exhibit 3, Exhibit 4). We also expect upcoming full-year results and medium-term business plans to include measures for improving capital efficiency and P/B.

Exhibit 1: "Survey of 100 corporate presidents": expectations of Spring wage negotiation rate

"5%" answers most concentrated in Dec-23, surpassing "3%" in Dec-22



Source: BofA Global Research, Nikkei Shibum

Note: Survey period from Dec 7- 21, 2023.

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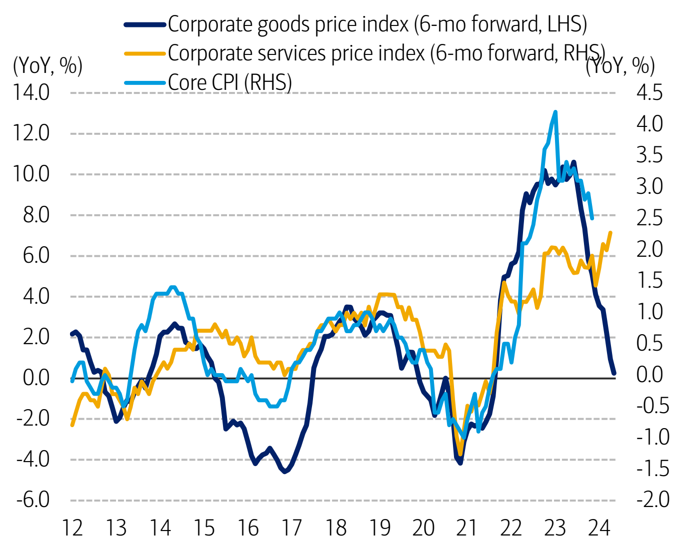
Exhibit 2: Corporate goods price index, corporate services price index and core CPI

Upstream inflation slowed, while services inflation picked up



Source: BofA Global Research, INDB, BoJ

Note: excluding consumption tax impact

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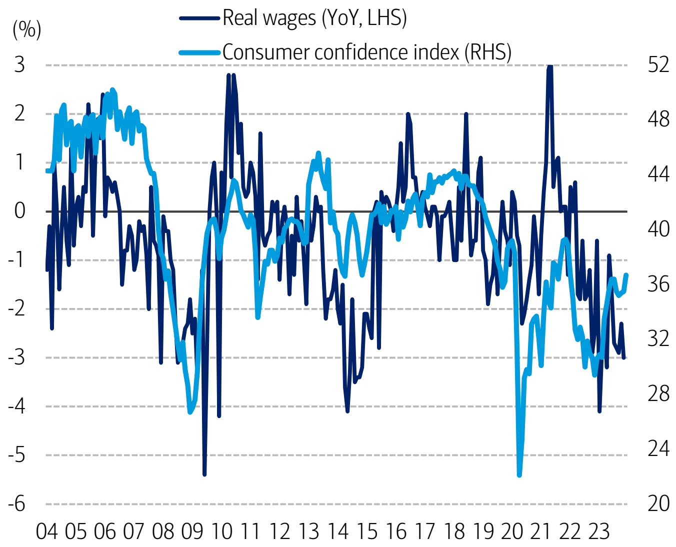
Exhibit 3: Real wages and consumer confidence index
Real wage growth helps improve consumer confidence



Source: BofA Global Research, Bloomberg

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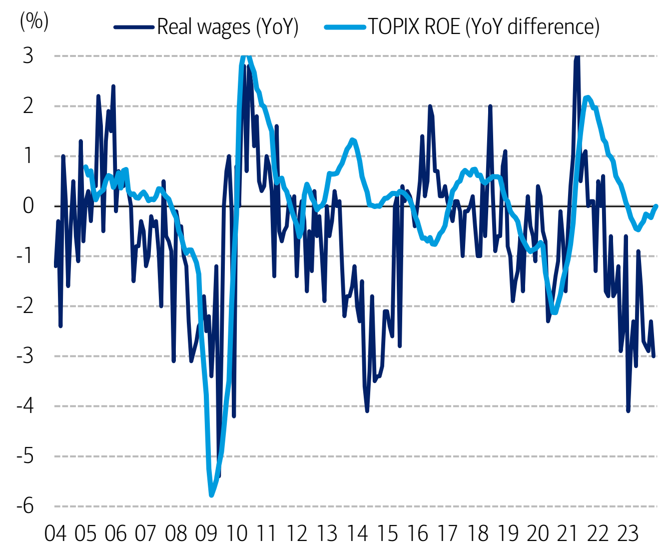
Exhibit 4: Real wages and TOPIX ROE (YoY difference)
ROE improvement may require real wage growth



Source: BofA Global Research, Refinitiv, Bloomberg
Note: the ROE is based on I/B/E/S 12-month forward consensus estimate

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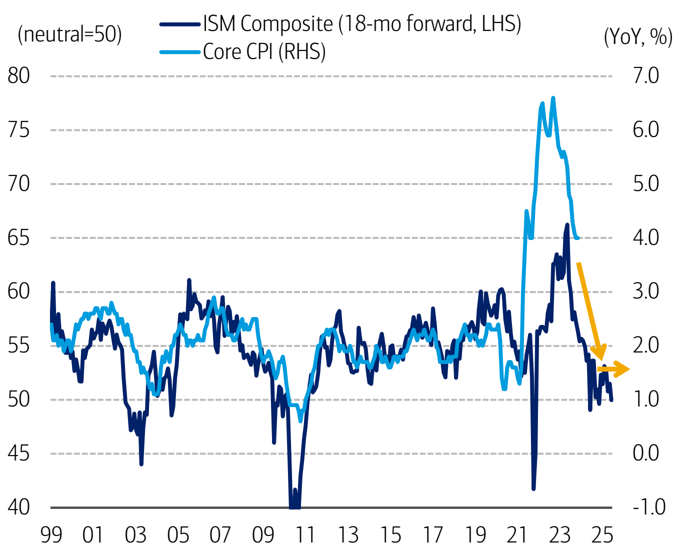
In the US, we expect the disinflation trend to continue for the time being. Inflation is a lagging indicator that tends to lag the ISM component indices and financial conditions index by around 18 months, although the divergence has lasted for a sustainable period of time over the last decades (Exhibit 5, Exhibit 6). If disinflation continues successfully, it will open the way for the Fed to cut rates (our US economist expects rate cuts to begin in March; for details, see our 8 Jan report [Morning Market Tidbits]). Conversely, if inflation gradually becomes sticky, as the leading indicators suggest, it could turn into a negative catalyst for the market, starting likely in Jul-Sep or earlier.

Exhibit 5: ISM Composite (18-month forward) and US core CPI
ISM Composite points to a near-term disinflation, before disinflation moderates



Source: BofA Global Research, Bloomberg

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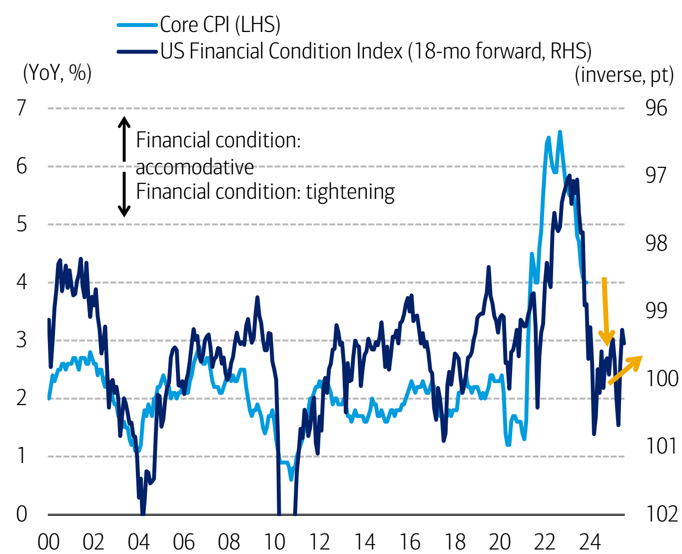
Exhibit 6: US core CPI and Financial Condition Index
US Financial Condition Index also points to a near-term disinflation, before disinflation moderates



Source: BofA Global Research, Bloomberg

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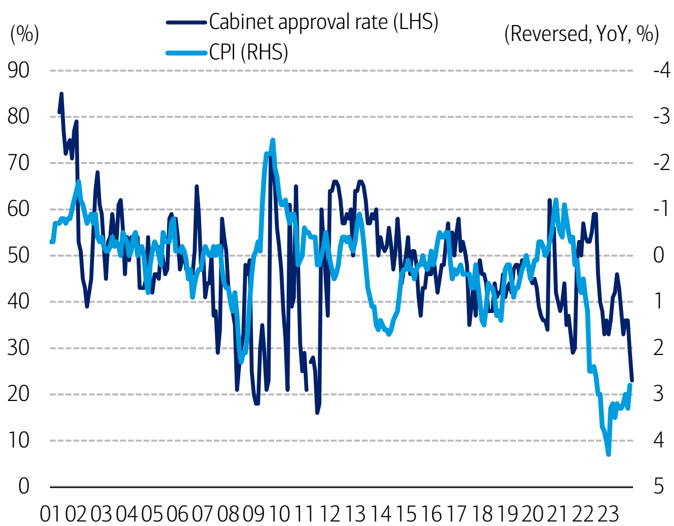
It is also likely that political events will make market participants more hesitant to buy stocks from Jul-Sep. If Prime Minister Fumio Kishida wants to dissolve the Diet prior to the LDP presidential election scheduled for Sep, June may be his last opportunity to do so, given that is when (1) the Diet session ends; (2) income tax cuts go into effect; and (3) the Cabinet's approval rating, which correlates inversely with the inflation rate, may increase (Exhibit 7). If that doesn't happen, it will become more difficult to gauge which candidate will win in the LDP presidential election in Sep, and this may increase political uncertainties for the market.

After the LDP presidential election, there is the US presidential election in Nov. History shows market volatility tends to rise before the US presidential election rather than after (Exhibit 8). Market participants will probably become less likely to take on risks around when the televised debates begin in Sep. However, after the market prices in the uncertainty surrounding the presidential election, it should turn upward in anticipation of a rebound of the global economy in 2025, regardless of the election results.

Exhibit 7: Cabinet's approval rate and CPI (reversed)
The two series tend to be negatively correlated



Source: BofA Global Research, NHK

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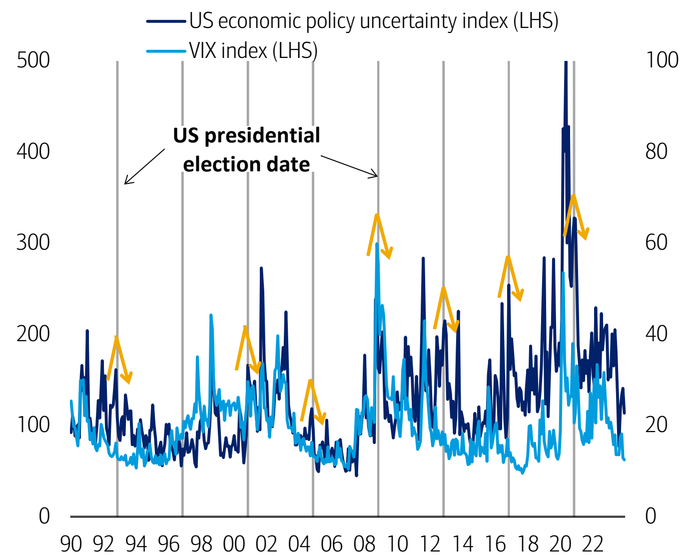
Exhibit 8: US economic policy uncertainty index and VIX index
Market volatility tends to rise before US elections and fall afterwards



Source: BofA Global Research, Bloomberg

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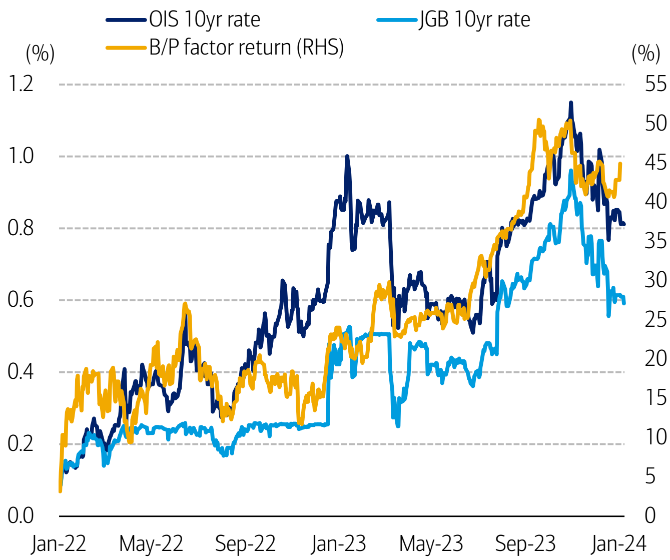
Dividend factor should be effective in 1Q

Turning to stock selection, value stocks began rebounding in January. The first upward catalyst for value stocks is a stabilization in US interest rates following the rapid decline. This is because the minutes of the December FOMC meeting (which deliberately left out any discussion of rate cuts) and the strong December jobs report lessened somewhat the market's expected probability of an early rate cut (although an overall cooling down continued and the data were not so strong as to prevent rate cuts; see our 5 Jan report US Watch). Of course, although Japan's value stocks correlate more highly with domestic interest rates than with US interest rates, Japan-US rates have increasingly been moving together since Oct-Dec 2023. Domestic interest rates have been declining, likely reflecting the view that Fed rate cuts will narrow BoJ's future scope for raising rates.

For domestic rates to diverge from US rates and start rising would probably mean that the US economy avoided a recession because of Fed rate cuts, thereby solidifying the view that the door has been open for BoJ rate hikes (our economist expects the BoJ to raise its policy rate to 0.5% by 2025). If this materialized, there would likely be a full-fledged rebound of value stocks.

Exhibit 9: OIS 10 years, JGB 10-yr rate and B/P cumulative factor return
Value performance tends to track JGB rate



Source: BofA Global Research, Bloomberg, FactSet

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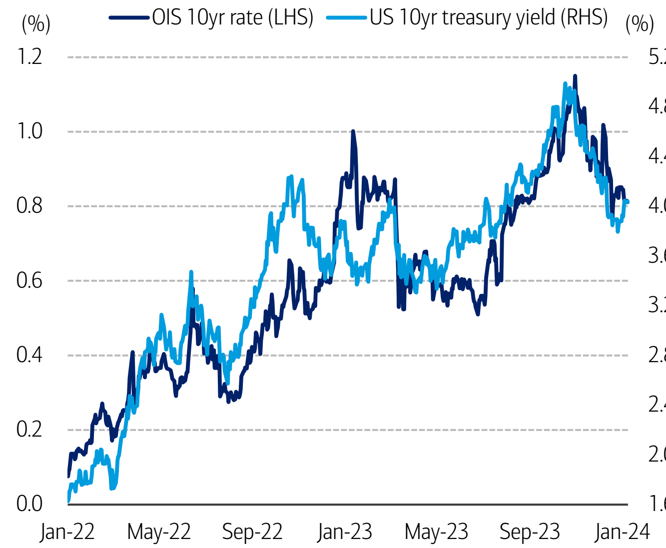
Exhibit 10: OIS 10 years and 10-yr UST
Japan rates followed the UST moves since last Oct-Dec



Source: BofA Global Research, Bloomberg

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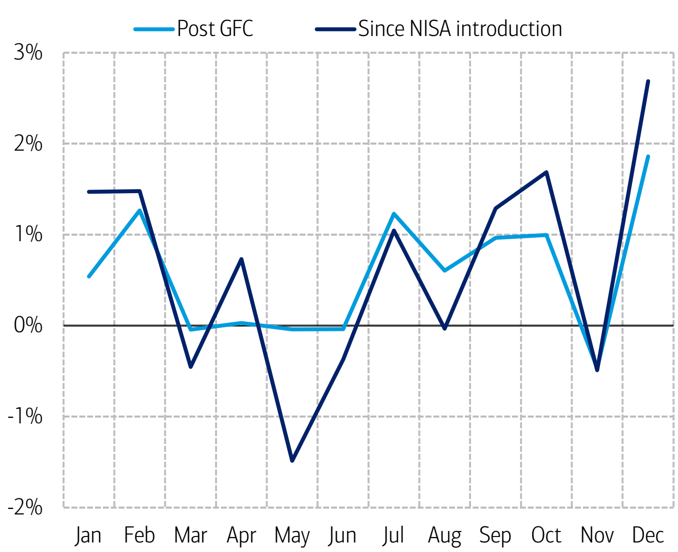
The second catalyst is the strong seasonality for dividend yield effectiveness in Jan-Feb. That seasonality may have been amplified with the introduction of NISA tax-deferred investment accounts (Exhibit 11), and the NISA expansion going into effect should help even more (attracting younger generations to NISA accounts, providing inflation hedge amid asset accumulation should jointly favor the dividend factor, in our view). More specifically, we expect dividend yield to remain effective until around 10 March (Exhibit 12). The release of the preliminary results of *Shunto* in mid-March should garner considerable market attention.

Exhibit 11: Monthly seasonality of dividend factor return
Dividend factor return tends to work in Jan-Feb, likely amplified by NISA introduction



Source: BofA Global Research, FactSet
Note: Post GFC: 2019; NISA introduction: 2014

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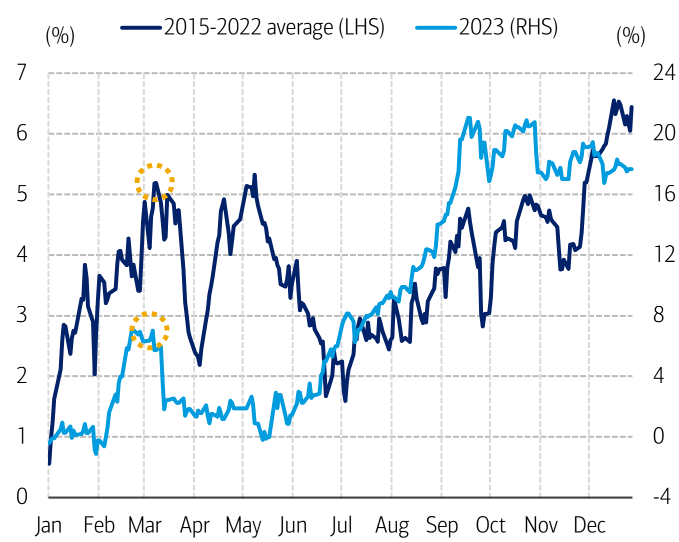
Exhibit 12: Daily seasonality of dividend factor return
Dividend factor return tends to peak around 10 March



Source: BofA Global Research, FactSet

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The third catalyst for value stocks should be the TSE publishing its list of stocks with plans to lift their value on 15 January and updating the list on a monthly basis.

Given the above, it probably makes sense to hold value stocks with high dividend yields for the time being. Exhibit 13 shows stocks with a dividend yield of at least 3% and relatively strong earnings. With the new NISA limits going into effect, individual investors will probably limit their interest to the more easily investable stocks with minimum investment units of less than ¥1.0mn.

Exhibit 13: Stocks with shareholder returns

Dividend yield above 3%, unit investment below JPY1mn, FY2 ROE above 6%, FY1 RP revision above -3%

Code	Name	Sector	Mkt cap (bn JPY)	ROE (FY2,%)	P/E (FY2,x)	RP revision (FY1, vs. 3 months prior,%)	Unit investment (mil JPY)	YTD relative return (vs. TOPIX)
8306	MITSUBISHI UFJ FINANCIAL GRO	Banks	14,577	7.7	10.0	5.4	0.12	19.7
9433	KDDI CORP	Information & Communication	10,157	13.6	13.9	0.8	0.44	-9.4
8058	MITSUBISHI CORP	Wholesale Trade	9,718	10.7	10.2	5.1	0.23	38.3
8316	SUMITOMO MITSUI FINANCIAL GR	Banks	8,901	7.0	9.3	6.4	0.67	15.6
9434	SOFTBANK CORP	Information & Communication	8,613	21.1	17.7	0.7	0.18	-6.6
8031	MITSUI & CO LTD	Wholesale Trade	8,102	11.6	9.6	3.5	0.53	14.2
7267	HONDA MOTOR CO LTD	Transportation Equipment	7,880	8.9	7.3	8.4	0.15	27.0
8766	TOKIO MARINE HOLDINGS INC	Insurance	6,909	15.1	11.9	3.3	0.35	5.5
8411	MIZUHO FINANCIAL GROUP INC	Banks	5,967	7.0	8.7	3.0	0.24	12.9
7751	CANON INC	Electric Appliances	5,140	9.3	16.7	3.7	0.39	5.2
8002	MARUBENI CORP	Wholesale Trade	3,723	13.5	8.0	1.1	0.22	28.0
8053	SUMITOMO CORP	Wholesale Trade	3,713	10.6	7.8	0.0	0.30	17.4
6301	KOMATSU LTD	Machinery	3,583	12.2	10.0	5.0	0.37	6.3
8591	ORIX CORP	Other Financing Business	3,251	10.1	8.4	-1.7	0.26	3.1
5401	NIPPON STEEL CORP	Iron & Steel	3,038	9.8	6.4	7.8	0.32	26.1
1925	DAIWA HOUSE INDUSTRY CO LTD	Construction	2,744	11.5	9.7	3.2	0.42	13.0
1605	INPEX CORP	Mining	2,738	9.1	7.4	10.3	0.20	23.8
1928	SEKISUI HOUSE LTD	Construction	2,032	11.6	10.0	3.6	0.31	4.6
8309	SUMITOMO MITSUI TRUST HOLDIN	Banks	1,963	7.3	9.0	0.4	0.27	-4.9
2503	KIRIN HOLDINGS CO LTD	Foods	1,904	12.2	14.4	1.9	0.21	-20.9
7270	SUBARU CORP	Transportation Equipment	1,847	13.8	5.4	27.8	0.24	5.6
5020	ENEOS HOLDINGS INC	Oil & Coal Products	1,771	7.6	8.0	1.7	0.06	4.8
8308	RESONA HOLDINGS INC	Banks	1,673	6.2	10.2	-1.3	0.07	-16.8
8601	DAIWA SECURITIES GROUP INC	Securities & Commodity Futures	1,510	6.8	15.6	7.2	0.10	39.1
3407	ASAHI KASEI CORP	Chemicals	1,450	6.7	12.4	-1.6	0.10	-17.2
7259	AISIN CORP	Transportation Equipment	1,431	8.9	8.7	9.0	0.49	29.4
7202	ISUZU MOTORS LTD	Transportation Equipment	1,411	12.9	7.6	0.1	0.18	-2.7
4528	ONO PHARMACEUTICAL CO LTD	Pharmaceutical	1,348	14.3	11.3	2.8	0.26	-34.7
5411	JFE HOLDINGS INC	Iron & Steel	1,342	8.8	6.3	8.0	0.21	19.5
4188	MITSUBISHI CHEMICAL GROUP CO	Chemicals	1,338	7.1	10.7	10.6	0.09	13.8
8795	T&D HOLDINGS INC	Insurance	1,242	9.4	12.1	-1.2	0.23	-5.8
1812	KAJIMA CORP	Construction	1,217	11.1	10.1	2.6	0.23	27.0
3003	HULIC CO LTD	Real Estate	1,168	12.2	12.4	1.1	0.15	13.3
5019	IDEMITSU KOSAN CO LTD	Oil & Coal Products	1,146	8.6	8.1	3.0	0.38	5.0
4704	TREND MICRO INC	Information & Communication	1,070	20.7	33.2	21.1	0.76	-7.1
7261	MAZDA MOTOR CORP	Transportation Equipment	981	12.4	4.7	30.1	0.16	39.3
3092	ZOZO INC	Retail Trade	956	48.9	20.9	0.0	0.32	-27.0
4204	SEKISUI CHEMICAL CO LTD	Chemicals	907	9.5	12.0	1.4	0.20	-11.2
1802	OBAYASHI CORP	Construction	877	6.9	12.5	1.8	0.12	2.9
1911	SUMITOMO FORESTRY CO LTD	Construction	809	13.3	7.9	5.0	0.39	38.6
6305	HITACHI CONSTRUCTION MACHINE	Machinery	785	13.6	7.4	10.9	0.37	7.0
8439	TOKYO CENTURY CORP	Other Financing Business	732	9.3	9.2	3.3	0.59	7.1
2651	LAWSON INC	Retail Trade	722	16.1	14.9	28.3	0.72	21.4
5406	KOBE STEEL LTD	Iron & Steel	705	8.6	7.4	10.2	0.18	151.7
7752	RICOH CO LTD	Electric Appliances	689	6.7	10.9	1.2	0.11	-9.7
5334	NITERRA CO LTD	Glass & Ceramics Products	678	13.5	8.2	9.9	0.33	15.3
3231	NOMURA REAL ESTATE HOLDINGS	Real Estate	664	9.4	9.4	1.4	0.36	2.9
3289	TOKYU FUDOSAN HOLDINGS CORP	Real Estate	644	9.2	9.3	2.7	0.09	24.6
8354	FUKUOKA FINANCIAL GROUP INC	Banks	637	7.0	9.6	2.7	0.33	-5.6
2181	PERSOL HOLDINGS CO LTD	Services	545	20.6	13.7	0.1	0.02	-36.9
1808	HASEKO CORP	Construction	536	12.4	8.7	-0.7	0.18	-2.6
8572	ACOM CO LTD	Other Financing Business	534	9.2	8.7	0.4	0.03	-19.0
6113	AMADA CO LTD	Machinery	530	8.1	12.9	11.9	0.15	15.1
5021	COSMO ENERGY HOLDINGS CO LTD	Oil & Coal Products	485	11.7	7.3	5.3	0.55	41.2
5444	YAMATO KOGYO CO LTD	Iron & Steel	479	10.7	8.6	10.2	0.74	41.6
6417	SANKYO CO LTD	Machinery	473	14.5	9.3	2.9	0.76	-9.8
8253	CREDIT SAISON CO LTD	Other Financing Business	456	7.9	8.7	10.4	0.25	18.3

Source: BofA Global Research, QUICK

Note: Universe consists of TOPIX stocks with mkt cap above 450 bn JPY, screened based on the following conditions: Dividend yield above 3%, Unit investment below 1mln JPY, FY2 ROE above 6%, FY1 RP revision above -3%; listed in descending order of mkt cap. 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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Mixed investment style; stock selection to be key

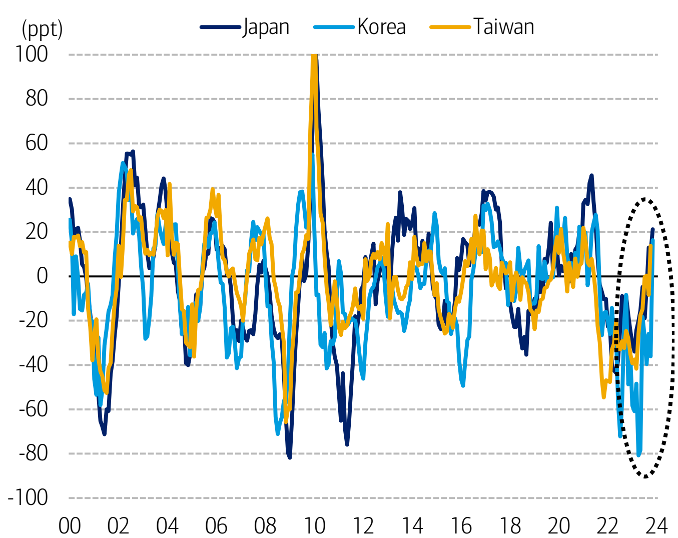
Meanwhile, value stocks, particularly the ones with high dividend yields, should perform well given their underperformance in Oct-Dec 2023, but we believe there is unlikely to be a clear divide between value and growth in Jan-Mar. For example, with the Fed expected to cut rates, any rebound in US interest rates will probably be limited. We expect the 10yr Treasury yield to trade around 4% (see our 5 January US Rates Viewpoint). The Fed releases its Summary of Economic Projections (SEP) at its FOMC meetings in March, June, Sep, and Dec, so if the Fed elects not to cut rates in March (when our US economist expects the first Fed rate cut), we believe it would most likely do so in June on the assumption that it would want to avoid making its initial rate cut in Sep, right before the presidential election. Once the Fed starts laying the groundwork for cutting rates in June or earlier, growth stocks should start doing well.

Additionally, at his press conference following the December FOMC meeting, Fed Chair Jerome Powell seemed to indicate there has been a change in the balance of risks between inflation and employment (the economy). Although Fed members subsequently rushed to put out the fire that caused, the market continued to suspect the possibility that this was what Mr. Powell really thinks. When US interest rates are rising, dip-buying is likely to pick up.

Additionally, the cycle for tech stocks, the quintessential growth stocks, is likely to turn up (Exhibit 14, Exhibit 15). The rise in real wages is likely to provide a boost to value stocks to the extent that it triggers a change in BoJ monetary policy, but it could also trigger a revaluing of SME growth stocks with heavy exposure to domestic demand (Exhibit 16, Exhibit 17).

Exhibit 14: The shipment-inventory balance of electronic components in Japan, Korea and Taiwan

The cycle of electronic components appears to have bottomed



Source: BofA Global Research, Refinitiv

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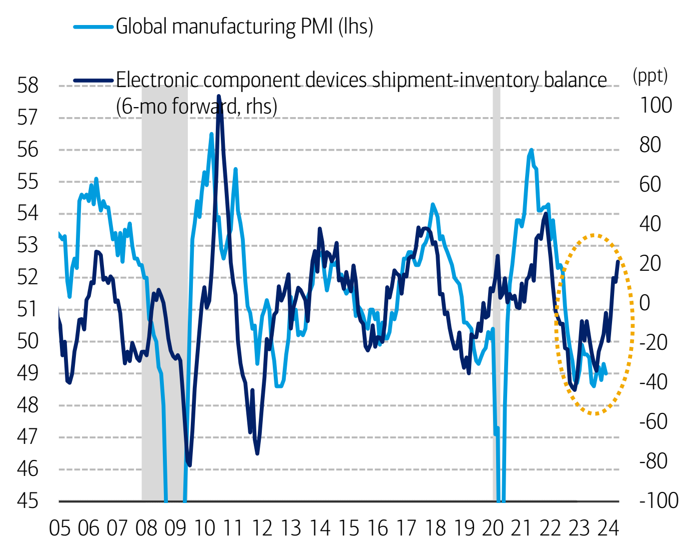
Exhibit 15: Global manufacturing PMI and the shipment-inventory balance of electronic components

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



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

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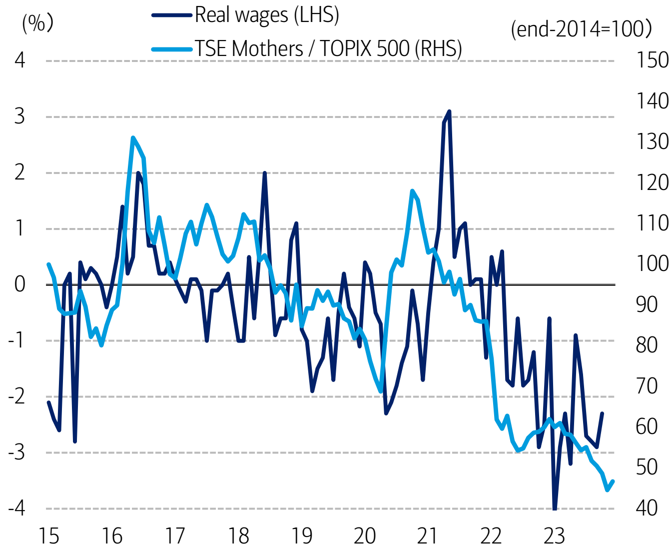
Exhibit 16: TSE Mothers/ TOPIX 500 and real wages
The two series are positively correlated



Source: BofA Global Research, Bloomberg

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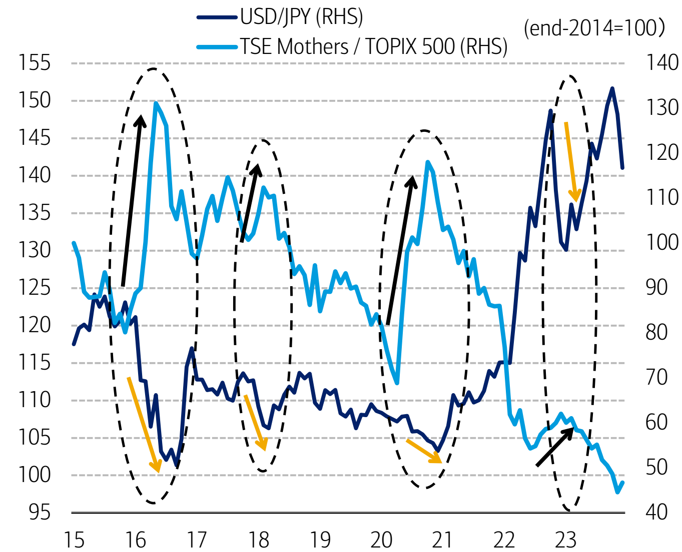
Exhibit 17: TSE Mothers/ TOPIX 500 and real wages
The two series are negatively correlated



Source: BofA Global Research, Bloomberg

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There should therefore be a mix of positive catalysts benefiting both value stocks and growth stocks, making a clear divide in investment style unlikely. 2024 is likely to be a good year to capture alpha through stock selection. For the time being, we recommend holding tech and other core growth stocks, as well as stocks with high dividend yields.

Disclosures

Important Disclosures

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R1]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R1] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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