

Japan Event Flash

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Chisato Haganuma

Mitsubishi UFJ Trust and Banking
Corporation

Chief Strategist

A member of MUFG, a global financial group



The risk of falling US equities and investing in Japanese equities

In the US, equities declined in the second half of February due to concerns over the Trump administration's tariff policy and weakening demand for semiconductors. There is a downside risk to US equities this year, which should be considered when making investment decisions on Japanese equities.

The tariff policy is a direct cause of the decline in equity prices, but the underlying concern is that the US economy may be faltering. Consumer spending is expected to continue to drive the economy this year, but since the beginning of the year car sales and consumer confidence indices have shown weakness. Price inflation is currently rising again, and real underlying consumption is not as robust as nominal consumption. Consumer credit has grown strongly over the past two to three years, but the pace of growth is likely to slow in the coming years as delinquency rates rise. Turning to the labour market and asset prices, which have supported consumer spending, the unemployment rate will remain low, but there are signs of a slowdown in the employment situation, with the number of job openings falling. If equity prices were to fall, the positive effect on assets would also diminish.

Moreover, raising tariffs would have a similar effect as raising taxes and would also constrain monetary easing by driving up inflation in the short term. While Trump administration is unlikely to impose universal tariffs and is likely to use them as a bargaining tool, companies may become cautious about capital investment and hiring if the economic outlook grows more uncertain. The US Economic Policy Uncertainty Index is at a high level (Exhibit 1). The US budget deficit has become a permanent issue following the COVID-19, limiting the scope for additional government spending even in the event of a significant economic slowdown.

In this environment, US equities appear overvalued. The S&P 500 is still trading at a forward P/E ratio of 21.7x as of February 28 (Exhibit 2), and bullish positions have been building as equity prices have risen strongly over the past two and a half years. The cash ratio of equity funds dropped to a record low of 1.60% at the end of last year. The Fed may ease monetary policy if stock prices decline, but historical experience from 2000–2002 and 2007–2009 suggests that if corporate earnings deteriorate, equity prices are likely to continue falling, even in the face of policy rate cuts (Exhibit 3).

This time, mega-cap stocks, led by the Magnificent 7, have driven the rise in share prices, with the top 1% of stocks by market capitalization accounting for 29.9% of the total as of June last year, well above the level in the spring of 2000 during the so-called dotcom bubble. The mega-cap stocks have been growing earnings strongly, and while this cannot be classified as a bubble, their share prices appear to be based on the assumption of significantly high future earnings growth. NVIDIA's share price fell despite reporting strong financial results for the period November 2024–January 2025.

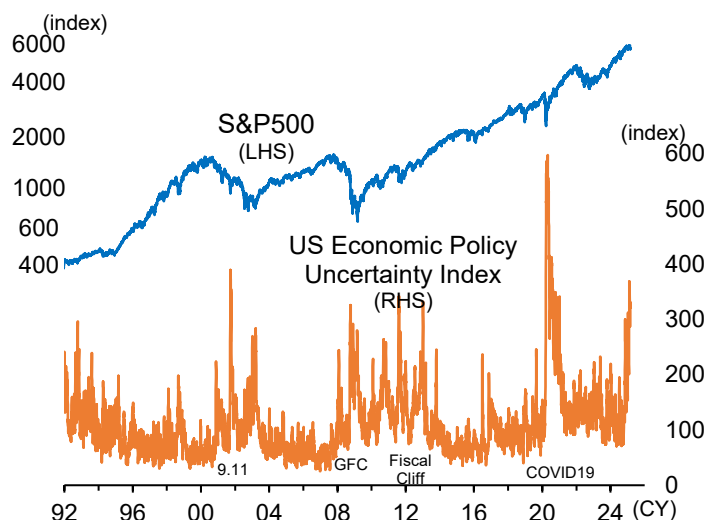
If US equities decline, the Yen is likely to appreciate against the dollar, and Japanese equities will be forced to adjust. However, we expect Japanese equities to deliver relatively good returns compared to other major markets. Corporate earnings are underpinned by the end to deflation and improved corporate governance, with room for

long-term growth. Analysys' current forecasts are being revised upward.

Furthermore, Japanese equities are undervalued with a forward P/E ratio of 13.6x (Exhibit 2). The total amount of share buyback budgets in FY2024 stands at JPY17.6 trillion (end-February), which is about 1.8 times the amount set aside for the same period last fiscal year. It would be desirable to increase the exposure of Japanese equities in the event of a global equity market correction.

While the correlation of equity returns among major developed economies has been increasing, Japanese small-cap stocks are considered to have a relatively low correlation, making them an attractive investment. Small-cap stocks, which have a high proportion of IT and service sector companies, tend to be more dependent on domestic demand than large-cap stocks. Their supply and demand are more heavily influenced by domestic investors. Retail investors account for 44% and 54% of the trading value in the standard and growth markets respectively, which are composed of small-cap and micro-cap stocks, compared with 18% in the prime market (Exhibit 4).

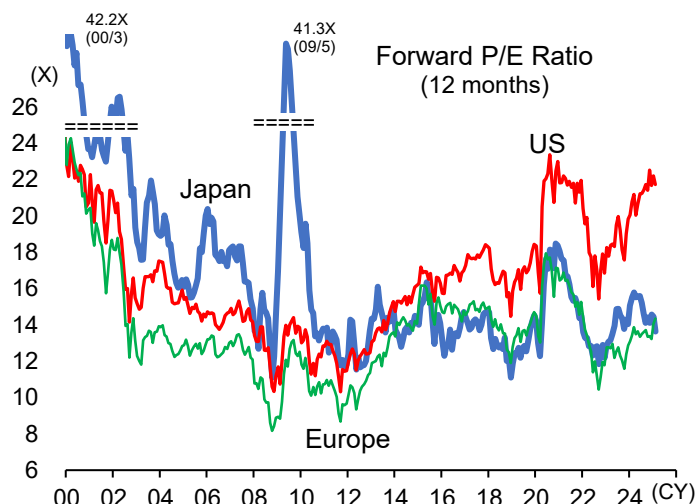
Exhibit 1: Policy Uncertainty Index in the U.S.



Note: Data as of February 28, 2025.

Source: Economic Policy Index website, S&P, MUFG: Trust Bank

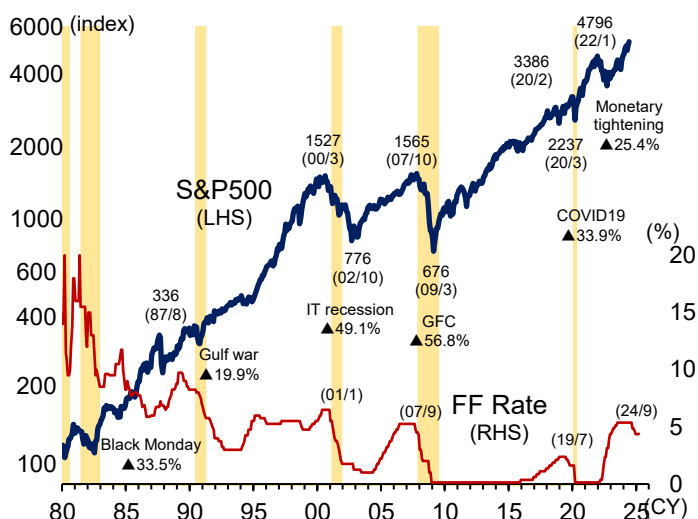
Exhibit 2: P/E Ratio in the U.S., Europe and Japan



Note: Universe is companies included in MSCI USA, MSCI Europe and MSCI Japan Index; data as of February 2025.

Source: FactSet, MUFG: Trust Bank

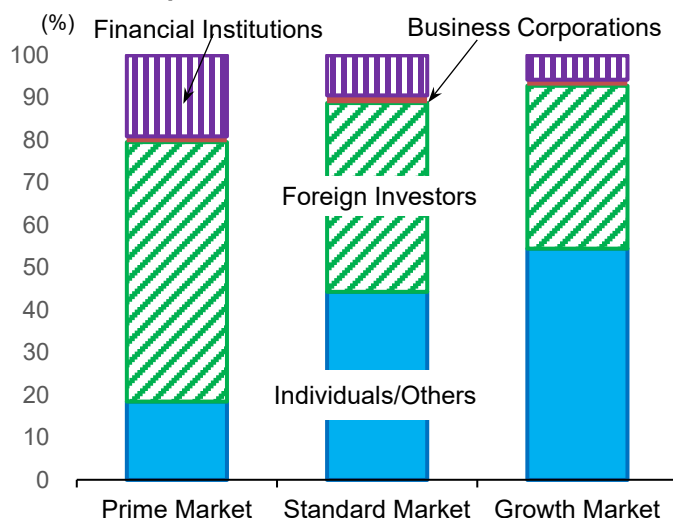
Exhibit 3: Equity Market and Policy Rate in the U.S.



Note: Values in brackets for the FF rate are the year/month in which the rate cut began, and for the S&P 500 are the year/month of the high and low; shaded areas indicate recessions; data as of February 2025.

Source: FRB, S&P, MUFG: Trust Bank

Exhibit 4: Breakdown of Trading Value by Investor by Market in Japan



Note: Financial institutions include regular banks, trust banks, life insurance companies, investment trusts and securities firms; data as of 2024..

Source: TSE, MUFG: Trust Bank

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