



# Turbulence in Japan equities: assessing the recent downturn and prospects for recovery

Unpacking the recent market slide and looking at the factors to focus on

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Extreme turbulence hit Japanese equities this week, with the Nikkei Stock Average on Monday suffering its deepest single-day slide on record in yen terms due to a confluence of factors including a rally by the yen versus the dollar and concerns about a weakening US economy. Although the Nikkei has retraced some of its losses as of this writing—it closed Tuesday at 34,727, up 3,217 yen, after dropping 4,451 yen the previous day—it had hit a record high above 42,000 just last month. We assess the factors that led to the downturn from its peak and consider what could be in store for the Japanese equity market.

There were four main factors, in our view, that propelled the Nikkei to that record high in July: (1) robustness of the semiconductor-related sectors, (2) prospects of the US overcoming inflation and eventually embarking on monetary easing, (3) dollar/yen strength on the back of expectations for the Federal Reserve (Fed) keeping interest rates “higher for longer” and (4) hopes for a post-COVID recovery by the Japanese economy supported by higher wages and increased consumption.

Of these four factors, (2) and (3) could not coexist for long. That became apparent when the dollar/yen plummeted recently in the wake of soft US employment data. We think that the reversal of dollar/yen strength and the realisation by the market of the incompatibility of US easing hopes and “higher for longer” US interest rates were the main reasons behind the recent slide seen in Japanese equities.

Domestic factors that have been supportive of Japanese equities, however, remain relatively unchanged. The narrative of Japan fully shaking off deflationary pressures thanks to rising real wages is still intact. Latest data showed that wages are continuing to rise, which is leading to increased consumption. Regarding the impact of the recent yen appreciation on corporate earnings, listed Japanese companies are seen to be assuming an average dollar/yen rate of 144 for the current fiscal year. Considering that dollar/yen was considerably stronger than 144 through much of the period (it was above 160 early in July), their earnings are expected to remain roughly in line with their forecasts if the currency pair is able to remain at current levels of around 145.

As for monetary policy, some have blamed the Bank of Japan (BOJ)’s interest rate hike late in July as being ill-timed. We do not subscribe to such views, although we think that the BOJ could push back its next rate hike following recent developments in the market.

Elaborating further on the impact the soft US economic data had on the broader market, we need to keep in mind that the downturn in Japanese equities was seen to be led in part by macro trend-following index players such as commodity trading advisors. The downturn they induced could eventually pave the way for others, notably retail investors, to tip-toe into the market once volatility shows signs of settling down. The Nikkei has essentially gone back to where it started 2024, prior to the market rise which was driven by a combination of US monetary easing prospects and “higher for longer” US interest rates. The current level, however, appears to be where the market looks to build a toe-hold for a path back to recovery. Domestic demand remains strong, supported by the continuing rise in wages, which we believe could be the catalyst for a recovery by Japanese equities.

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