Letter from SuMi TRUST AM - Japanese stocks can coexist with a strong yen

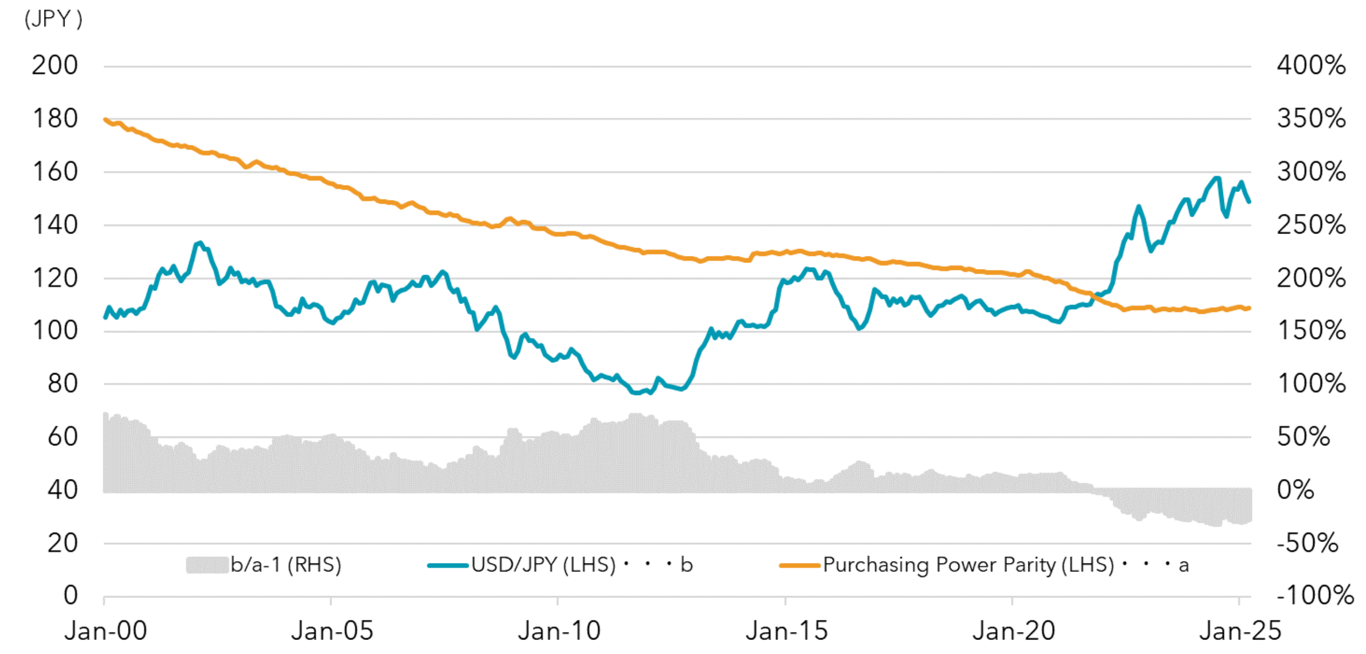
By Oki Shiozawa, Investment Director

Following President Trump's announcement of reciprocal tariffs in early April, financial markets fell into turmoil on fears of a global economic slowdown. However, the temporary suspension of additional tariffs by the Trump administration and hopes for progress in trade negotiations led global stock markets to recover to pre-announcement levels by the end of April. Meanwhile, the yen has appreciated against the dollar since late March. Even if the impact of reciprocal tariffs remains limited due to government negotiations, some market participants believe the yen's appreciation could weigh on the recovery of Japanese stocks. Japanese stocks have risen in tandem with the yen's depreciation over the past three years, leading to the perception that a stronger yen is a negative for Japanese stocks. It is worth revisiting the relationship between foreign exchange rates and Japanese stocks.

Historically excessive yen depreciation

Firstly, the yen has been excessively low against the US dollar. Since the turn of the century, the USD/JPY exchange rate has fluctuated mostly between 100 and 120 yen per dollar. Thus, today's exchange rate of 140 yen is a significant deviation from historical levels. There is a measure known as purchasing power parity (PPP) that assesses whether a currency is over- or undervalued based on price levels. While the actual exchange rate does not strictly align with PPP, it can provide insight into valuation. Over the past few decades, the yen has typically traded at a premium to its PPP, but post-2022 it has been undervalued. Exchange rates affect the Japanese economy in various ways, and the recent yen depreciation has delayed the full recovery in consumer spending due to higher import prices. The Japanese government could not ignore this situation and intervened by selling US dollars (buying yen) in 2022 and 2024. From a longer-term perspective, the yen's appreciation over the past few months can be seen as a correction of the excessive depreciation.

Figure 1. Exchange rate trends over the past 25 years

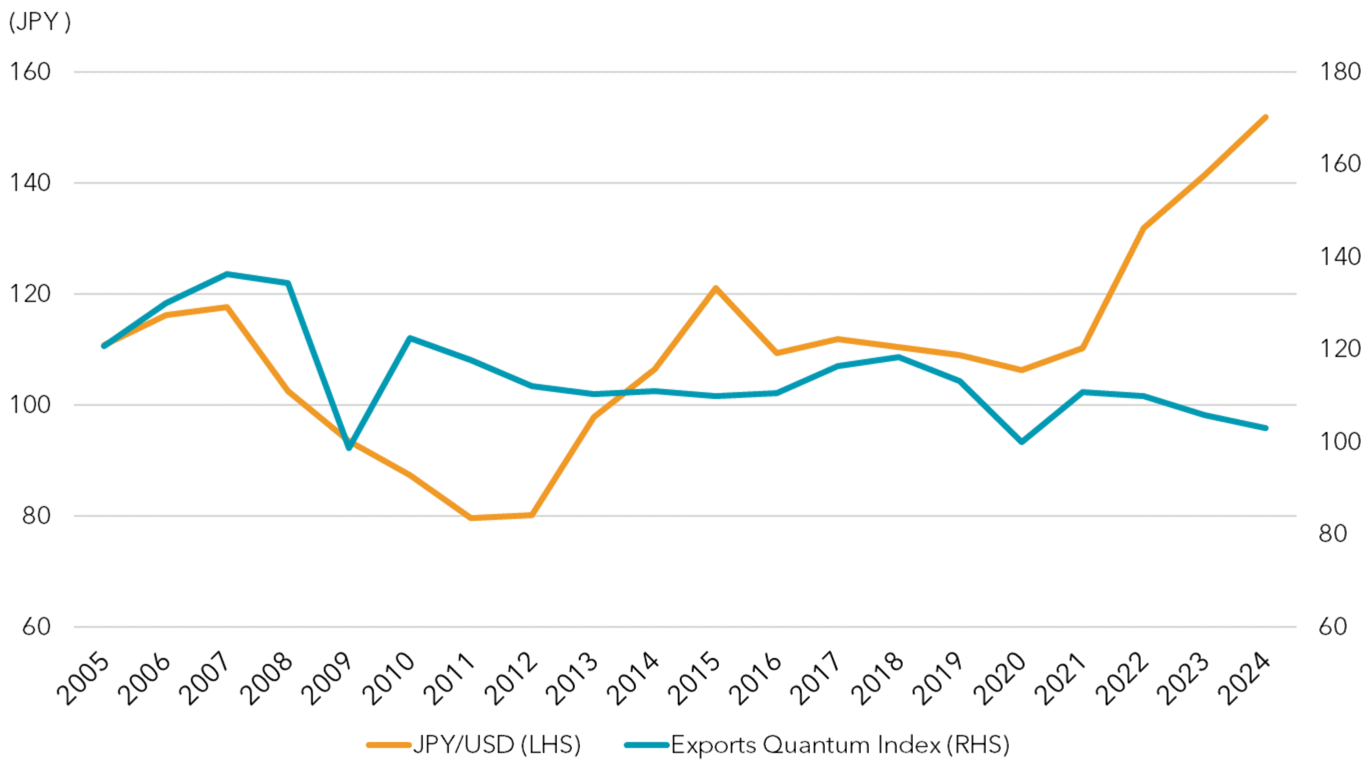


Source: Institute for International Monetary Affairs

The impact of exchange rates on corporate performance

While a correction in yen depreciation offers some benefits to Japanese consumers through stable import prices, it undeniably has a negative impact on the performance of publicly listed companies. A large proportion of Japanese listed companies are internationally competitive, export-oriented multinational corporations, such as those in the automotive sector. This means that the positive effects of yen depreciation have historically had a more pronounced impact on corporate earnings than on the Japanese economy as a whole. However, the positive effects of yen depreciation on exporters have shifted in recent years. As shown in Figure 2, export volumes from Japan have not increased despite the continued weakening of the yen in recent years. This is due to electronics manufacturers shifting production bases to low-wage countries such as China and those in Southeast Asia, and automotive manufacturers increasing local production in consumption-heavy regions like the U.S. Lessons learned from past events such as the Global Financial Crisis (GFC) have led exporters to build business structures more resistant to exchange rate fluctuations. Thus, the current benefits of yen depreciation for exporters are limited to increases in yen-denominated exports and the conversion of overseas subsidiaries' profits into yen.

Figure 2. Changes in export volume



Source: Ministry of Finance of Japan, Bloomberg

In the past when Japan served as the world's factory, yen depreciation triggered increases in export volumes, which led to higher capital investments to expand production capacity, boosting the overall economy, including personal consumption, through higher employment and income. Conversely, rapid yen appreciation negatively impacted domestic demand, as seen in 1995 after the bubble burst and in 2008 during the GFC, causing a severe economic impact. However, today, exchange rates have a limited knock-on effect on the domestic economy.

The impact of exchange rates on stock prices

It is said that Japanese stock performance can be explained by the movements in U.S. stocks and foreign exchange rates. Figure 3 illustrates the sensitivity of Japanese stocks to U.S. share prices and exchange rates over time, showing the percentage change in Japanese share prices for each 1% movement in the S&P 500 or USD/JPY. The sensitivity to exchange rates has trended downward over time, reflecting changes in Japan’s economic structure, where export volumes no longer increase with yen depreciation, and the decreasing impact of exchange rates on corporate earnings.

In the short term, as seen in August 2024, Japanese stocks may experience significant declines alongside rapid yen appreciation. However, in the long term, the impact of exchange rates on Japanese stocks should become more limited. Going forward, even should the yen appreciate moderately due to diverging Japan-U.S. monetary policies, fundamentals such as corporate earnings and economic conditions should outweigh its effects unless market panic sets in or a risk-aversion-driven rapid yen appreciation occurs.

Figure 3. Sensitivity to US stocks and exchange rates

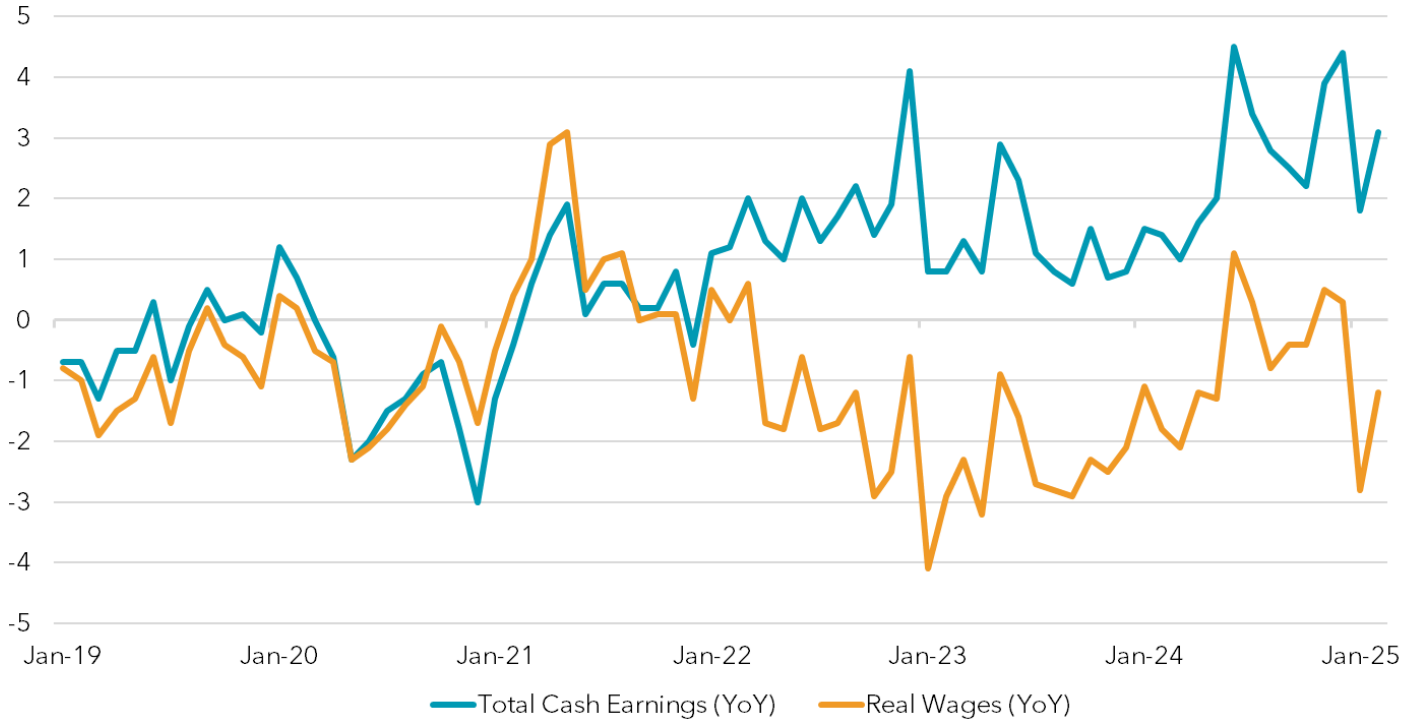
Source: SuMi TRUST AM, Bloomberg

Japan's autonomous recovery process

The historic rise in Japanese stocks since the pandemic is not solely attributed to yen depreciation. It reflects fundamental structural changes in the Japanese economy and corporate governance reform, leading to a new all-time high after 34 years.

Currently, Japan is at a turning point, transitioning from decades of deflation to moderate inflation. Inflation expectations by the consumer have risen sufficiently, allowing businesses to set appropriate prices. While price increases initially outpaced wage growth, wages are catching up. Higher positive real wage growth is expected to stimulate personal consumption. Labor shortages are also prompting companies to revise production lines for further efficiency and to invest in digital transformation. These trends represent a self-sustaining movement with continued progress.

Figure 4. Virtuous cycle of prices and wages



Source: Ministry of Health, Labour and Welfare of Japan, SuMi TRUST AM

Corporate governance has garnered significant attention, particularly the initiative to raise the Price-to-Book Ratio (PBR) by the Tokyo Stock Exchange. In reality, Japan's corporate governance reform is a multifaceted effort to enhance corporate value, promoted by various bodies such as the Financial Services Agency, the Ministry of Economy, Trade and Industry, and the securities industry. Recently, we have seen progress in the unwinding of cross-shareholdings, and there has been an increase in shareholder proposals at general shareholder meetings, reflecting positive results.

Outlook for Japanese stocks

The financial market turbulence in early April has subsided for now. While the outcome of tariff negotiations remains uncertain, the impact of the Trump administration’s policies, including tariffs, on the global economy and corporate earnings will become clearer in the latter half of the year. Once visibility improves and the investment environment stabilises, market participants are expected to focus on fundamentals again. Even in the event that the yen continues to appreciate gradually, we believe the Japanese stocks will remain attractive, driven by structural changes in the Japanese economy and recovery in corporate profitability.

About Writer

Oki Shiozawa, Investment Director

Oki Shiozawa is an investment director at SuMi TRUST AM. With over 30 years of experience working in the investment industry, he is well-versed in the financial markets and Japanese companies.

Oki joined the firm in 2006 and served as a portfolio manager of Japanese equity active strategies from 2006 to 2023. Prior to this he began his investment career in 1994 as an equity research analyst and managed Japanese equity active portfolios from 2001 to 2005 at a major asset management firm.

He holds a BA in law from the University of Tokyo and is a Certified Member Analyst of the Securities Analysts Association of Japan (CMA).