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Japan's selloff and rebound: what to do now

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Japanese stocks rebounded early Tuesday after losing over 20% in the first three days of August. We expect the market to stay volatile in the near term until global risk sentiment recovers and the USDJPY stabilizes around 145-150. But the longer-term structural dynamics will remain important investment considerations for the Japanese market, and drive share price recovery into next year.

Japanese stocks plunged at the start of the week amid further appreciation of yen, as weak US labor data raised recession fears and expectations of deeper rate cuts by the Federal Reserve. The USDJPY fell to the lowest level since the start of this year, with the pair hitting 141.66 at one point. Following a decline of over 20% in the first three days of August alone, the broad Japanese stock benchmark TOPIX has rebounded strongly on Tuesday morning at the time of writing.

We maintain the view that the US economy will avoid a recession. But we think the US central bank is likely to cut rates more swiftly than previously expected, and we now pencil in a total of 100 basis points of Fed rate cuts this year. The fed funds futures market is pricing in 120-130 basis points of cuts.

Given the sensitivity to yield differentials of the USDJPY currency pair, and the strong correlation between the movement of the yen and Japanese equities, we provide our view on the exchange rate and the stock market, and what the outlook means for investors.

The USDJPY should stabilize toward 145-150. We have advised investors against chasing the USDJPY higher and to avoid taking yen loan exposure for the past several months, though the speed of the USDJPY decline has exceeded market expectations. However, with markets currently pricing in more Fed easing than our expectations, we see potential for the USDJPY to stabilize around 145-150 in the coming months. In addition, US-Japan yield differentials suggest that 140 is a strong support level for the currency pair, and we estimate that the bulk of the net short yen positions have been cleared

by now. Separately, we expect the Bank of Japan to refrain from further rate hikes for the rest of this year, particularly after the latest bout of yen strength versus the US dollar. Japanese officials have also started to push back on the recent sharp yen moves, with Finance Minister Shunichi Suzuki on Monday saying that “stable currency moves are desirable” and that he “will continue to watch FX market moves and (equity) markets with strong sense of urgency.”

We have kept our USDJPY forecasts on a downward trajectory, given the Fed’s upcoming easing cycle. For investors who are still holding legacy long-yen positions, the current drop in the USDJPY offers an opportunity to reduce exposure. For investors looking to tactically go long USDJPY, or take yen loans, we advise waiting for a stabilization in US data and global risk sentiment before initiating such positions.

Japanese equity volatility is likely to continue in the near term. We expect near-term Japan stock market volatility to continue until the global risk sentiment recovers and the USDJPY stabilizes. But following the deep correction, equity valuations suggest that they may be close to the support level for Japanese equities, with the price-to-book-value multiples trading at just 1.1x. The only times the TOPIX’s price-to-book-value went below 1x were in 2020 amid the pandemic, and in 2016 amid fears of China’s economic slowdown.

For investors with existing exposure to Japanese stocks, we would advise against exiting the market at this stage as Japan’s structural changes, i.e., inflation, wage increase, and corporate governance reforms, remain intact. We expect volatility to stay until after Japanese corporations report their first-half results in October and when the uncertainty around the US presidential election settles later in the year. But the longer-term structural dynamics will likely remain important investment considerations for the Japanese market, and drive share price recovery into next year.

Within Japanese equities, banks remain our preferred sectors, and we see them as core stocks that can be held for the long term. They are key beneficiaries from Japan’s structural drivers, and they are less sensitive to exchange rates. Real estate is also appealing as a relatively defensive sector, while select domestic-oriented stocks could offer some shield due to their unique earnings drivers.

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