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# Not time yet to upgrade Japan equities

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Japan equities have enjoyed a strong run over the past four weeks thanks to a combination of external and domestic factors. We think that this strong climb has somewhat stretched the Topix's valuation given that corporate earnings are likely to remain soft through 1Q26 at least. For now, we maintain our preference for high-quality cyclicals in Japanese stocks. We would continue to sell USDJPY upside for yield pickup, and see the pair sliding to 136 by the mid-2026. Within Asia, we see China tech, India equities, and Singapore equities as Attractive.

After remaining essentially flat since the middle of May, the Topix embarked on a sustained climb on 22 July and is currently up 9.6% in under a month. Notably, the S&P 500 has only risen 2.2% over this same period. The recent dovish shift in Federa Reserve expectations undoubtedly contributed, in addition to the conclusion of Japan's fairly benign trade deal with the US, and expectation of a potential LDP leadership change election. With 2Q25 GDP growth beating expectations, should investors go with the flow and take a more positive view on Japan equities?

For now, however, patience and selectivity remain the mainstays of our recommended approach, as the current rise might have already overshoot what is warranted by the recent positive developments. For starters, the 25bps Fed rate cut in September that we are expecting is mostly priced in. Also, almost 80bps of cuts have been priced in for March 2026, by which time we expect 100bps of cuts. As such, external support for further growth in risk appetite might taper off.

**Topix valuation warrants caution.** While optimism over the potential for a positive change in the ruling Liberal Democratic Party's (LDP) leadership could provide support for the Topix into late-August, we would not chase that rise. Aside from the potential for disappointment on that front, we are also uncomfortable with the Topix's current valuation. At 16.3 x P/E, its 27% discount to the S&P 500's P/E has lulled investors into a false sense of comfort, in our view. Our

concern is that Topix corporate profits fell 11% y/y in 1QFY25 (April-June) due to tariffs and JPY strength—consensus earnings forecasts have started to trend lower from that time. This aligns with our expectation of only modest growth for FY25 (ending March 2026) and a real recovery only in FY26.

For now then, we maintain our preference for high-quality cyclical stocks. Despite rising strongly over the last two weeks, we do not see their valuations as stretched. Many of these stocks continue to offer dividend yields above the market average, which reduces the reliance on price rises for returns. Specifically, we see attractive opportunities in the machinery sector, which is well positioned to benefit from an eventual global manufacturing recovery. These include select health-care, medtech, and automotive stocks that have lagged the broader market; financials that look poised to gain from the Bank of Japan's earlier-than-expected rate hikes; and IT services with resilient earnings momentum.

**USDJPY upside risks still a sell for yield.** The USDJPY has drifted lower amid rising expectations of an imminent Fed rate cut. Domestically, media reports have also suggested that the Bank of Japan (BoJ) is facing pressure to turn more hawkish to curb inflation. Upcoming inflation data will be key in this regard; but for now, we continue to expect the BoJ to hike by 25bps in December, with markets only having priced in a 15sbp rise. We maintain our preference for selling USDJPY upside for yield pickup, and see the pair sliding to 136 by the middle of 2026.

**Elsewhere in Asia, China tech, India and Singapore equities are favored.** We remain Neutral on China equities but still expect the technology sector to outperform. We believe that improved access to leading-edge chips will likely accelerate the development and deployment of DeepSeek R2. This might well serve as the next key catalyst for the sector. Meanwhile, we also favor entertainment platforms over e-commerce within China's internet sector. Meanwhile, India's robust economic growth outlook is a key factor supporting our Attractive view on India equities. India's relatively closed economy, double-digit earnings growth, RBI rate cuts, and reasonable valuations should outweigh the near-term drag of elevated tariff rates and increased volatility. Singapore equities are also Attractive, in our view, as they offer a defensive bulwark against the ongoing geopolitical uncertainty. Key positives include a stable currency, generous dividend yields, and a steady earnings outlook.

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