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Japan equities: Wait for good entry levels amid tariff tensions

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The FY24 corporate earnings results reaffirm our view that corporate reforms make Japan equities an attractive investment, albeit not just yet. The FY24 results also showed that the tariff damage remains insufficiently accounted for, and it might take till 3Q25 for this to be rectified. In the meantime, tariff negotiations will likely continue, and could hold disappointments, which might well generate volatility in equity markets. For now, we maintain a balanced Japanese equity portfolio of high-quality cyclical stocks and domestically-oriented stocks with solid earnings performance.

The FY24 (2Q24-1Q25) corporate results surprisingly affirmed the view that corporate reforms will underpin the longer-term attractiveness of Japanese equities. While we have held this view for some time, the degree to which this was demonstrated by the FY24 results was surprising, with the pace of share buybacks outpacing even the previous year's record amount. Long-term investors should definitely keep their eye out for opportunities to take on exposure to Japan equities.

But investors will also need to exercise patience given that in the interim, trade tensions with the US continue to loom, notwithstanding the Trump administration's recent setbacks regarding the legal justification for reciprocal tariffs. We would not consider the tariff threat over just yet, and it is worth recalling that the volatility in April highlights how sensitive the market can be to potentially disruptive changes in policy positions.

Tariff talks likely to drag on. There are other legal avenues open to the Trump administration; so in all likelihood, the trade talks will continue. The US and Japan have already held multiple ministerial-level talks, and US President Donald Trump and Japanese Prime Minister Shigeru Ishiba look set to meet on the sidelines of the G7 meeting during 15-17 June, which could see some sort of interim agreement that cements a bilateral de-escalation. Still, much remains in the air, and Trump's initial threat to levy 50% tariffs on the EU even as talks were still going on highlights the administration's propensity for surprises. Japan's large holdings of US Treasuries and Trump's longstanding perception that the JPY is artificially weak could also complicate matters.

In the short term, trade policy remains a key driver of both upside and downside risks for stock prices. Any de-escalation—such as a reduction of the 25% auto tariff—would be viewed positively. Conversely, if tariffs remain in place for an extended period and global economic growth slows, there could be pressure on both share prices and corporate earnings. The potential for volatility in stock markets ahead of the 9 July tariff negotiation deadline could provide better entry levels for long-term investors.

Tariff impacts not yet factored into earnings projections. For Japanese corporations, the FY24 results showed that Japanese companies did not factor in the impact of tariffs into their guidance as much as anticipated, leaving some uncertainty in their earnings outlooks. While we do expect stock prices to break out of their current range and resume an upward trajectory once the upcoming wave of downward earnings revisions subsides and forecasts have bottomed out, this might not happen until after the 2Q25 results, or possibly following 3Q25. We forecast a 1% year-over-year earnings decline in FY25 and 4% y/y growth in FY26.

Bide your time and wait for attractive entry levels. In the meantime, we maintain a balanced Japanese equity portfolio of high-quality cyclical stocks and domestically-oriented stocks with solid earnings performance. While the near-term outlook for export-oriented cyclical sectors remains challenging, high-quality companies with high ROE that are improving shareholder returns through share buybacks and capital policies offer attractive entry points amid recent share price declines. In particular, we see select investment opportunities in sectors such as machinery, health care, and technology, where share prices have lagged over the past year.

On a related note, while we expect the USDJPY downtrend to persist through 2Q26 to 136, we expect this to be fairly gradual, which should moderate the impact on Japanese firms and their earnings.

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