NEUBERGER BERMAN

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Japanese Equities in 2025: Goldilocks Would Approve

We believe a combination of macroeconomic, geopolitical and regulatory tailwinds could bode well for Japanese equities in 2025 and sustain a broader-based rally than in recent years, especially among companies that generate the bulk of their revenues from the domestic economy.

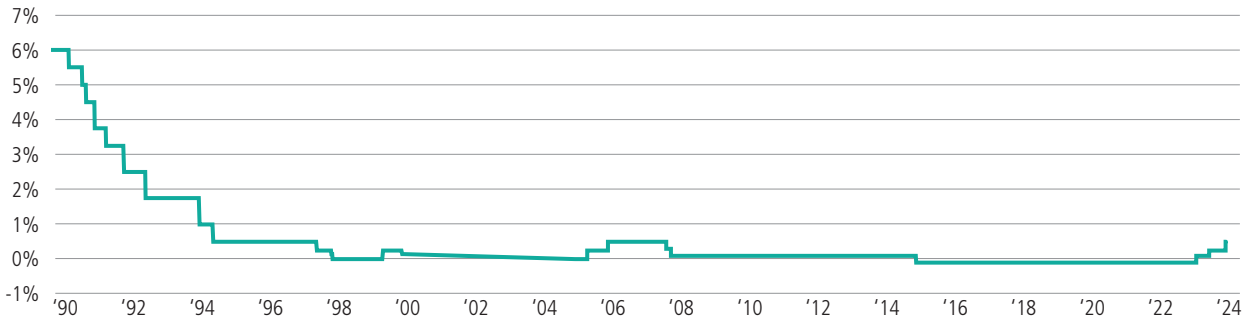
While near-term risks remain, including volatile currency swings from monetary policy adjustments (which roiled equity markets back in August 2024), we believe near-term pullbacks can provide opportunities to invest in high-quality Japanese companies primed for long-term growth at attractive valuations.

Macroeconomic Tailwinds

The Bank of Japan (BOJ) kicked off 2025 with a much-anticipated interest rate hike, pushing its unsecured overnight call rate (similar to the U.S. federal funds rate) to 0.5%, a 17-year high (see figure 1). This was the first increase in six months and the third under Governor Kazuo Ueda, who was appointed to the top spot in April 2023. We believe the Japanese central bank is gradually normalizing monetary policy in a manner consistent with our long-held view that the country is finally emerging from its "lost decades" of deflation (for more detail, see Japan Enters a New Era).

FIGURE 1: JAPAN MAINTAINS ITS PATH TO MONETARY POLICY NORMALIZATION

Bank of Japan Unsecured Overnight Call Rate



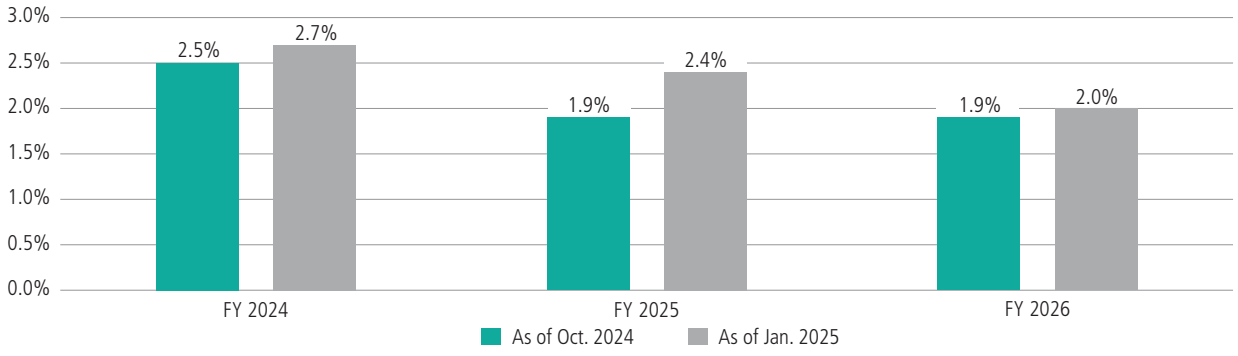
Source: Neuberger Berman, Bloomberg, data as of January 2025.

The BOJ's inflation outlook (announced the same day as the rate hike) further confirmed our view: As shown in figure 2, the core Consumer Price Index (ex-fresh food) was expected be at or above the BOJ's 2% target through 2026.[1]

The increasing likelihood of rising wages over the medium to long term would appear to support those projections. During the last three rounds of wage negotiations, Japan's labor federation has called for wage hikes of approximately 5% for large-cap companies and 4% for small- to mid-cap companies.[2] To help close the gap and broaden income growth across the economy, the federation recently proposed that larger firms continue to raise base pay by 5% year-over-year while encouraging smaller ones to raise it by 6%.[3] We believe such moves could lead to broader sustainable real wage growth not seen in more than three decades.

FIGURE 2: ARE JAPAN'S "LOST DECADES" FINALLY COMING TO AN END?

Bank of Japan CPI (ex-fresh food) Outlook, YoY% Growth Rate



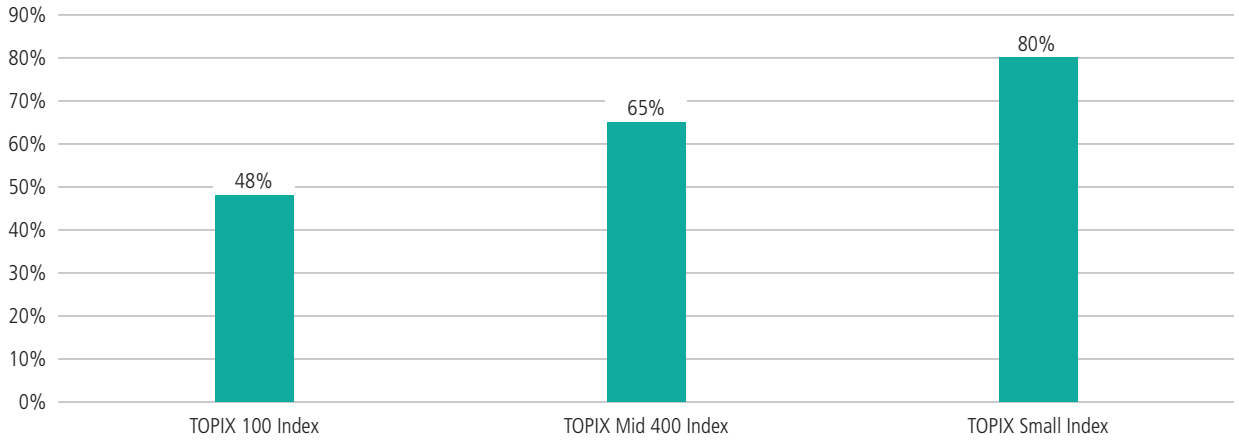
Source: Neuberger Berman, Bloomberg, Bank of Japan, data as of January 2025.

[1] "Outlook for Economic Activity and Prices", Bank of Japan, January 2025.
[2] "2024 Shunto: The first wage increase above 5% since 1991 with an urgent need to spread the trend to SMEs", *Japan Labor Issues*, Winter 2025.
[3] "Japan annual wage talks begin amid high hopes for sustained pay hikes", *Kyodo News*, January 22, 2025.

Against this backdrop, we believe the BOJ will stay on its normalization path even as the U.S. Federal Reserve aims to adjust monetary policy in the face of uncertain inflation projections. While we anticipate near-term volatility as both central banks react to the latest economic data, we expect the interest rate differential to narrow over the longer term, pushing the Japanese yen higher versus the U.S. dollar. Stronger currencies reduce import costs, and we believe a rising yen could be a boon for household consumption in Japan, as well as for smaller to midsize companies that generate most of their revenue from the domestic Japanese economy (see figure 3).

FIGURE 3: JAPAN'S SMALLER COMPANIES HAVE STRONGER DOMESTIC EXPOSURE

Ratio of Revenues Generated from Japan's Domestic Economy



Source: Neuberger Berman, Goldman Sachs, data as of August 2024.
Note: The TOPIX 100 Index is a capitalization-weighted index composed of the 100 most liquid stocks with the largest market caps in the TOPIX Index. The TOPIX Mid 400 Index is a capitalization-weighted index composed of the next 400 most liquid and highly capitalized shares after the TOPIX 100 Index. The TOPIX Small Index in a capitalization-weighted index that measures the performance of the TOPIX Index, omitting the TOPIX 500 constituents and non-eligible stocks.

Geopolitical Tailwinds

We believe potential fiscal stimulus and enduring ties with key geopolitical allies will likely provide support for Japanese equities over the longer term.

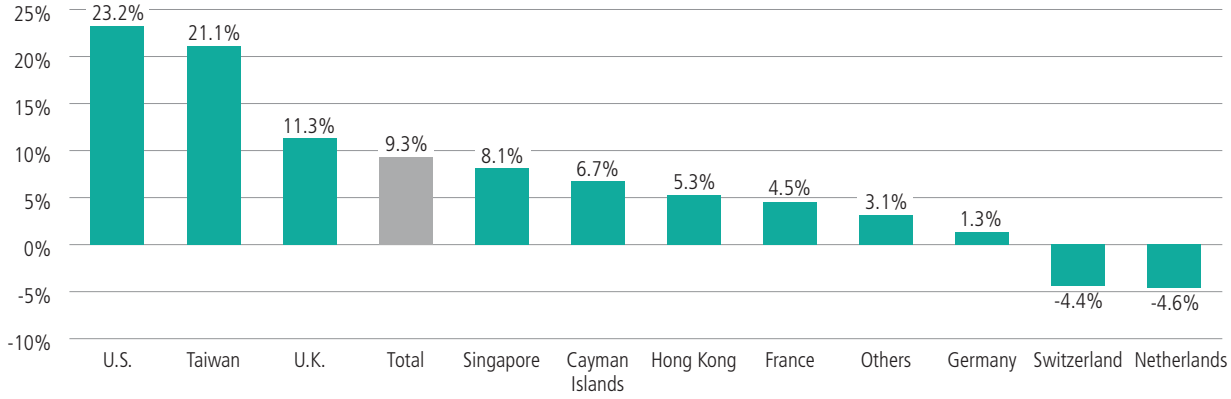
In 2024, Japan's ruling Liberal Democratic Party (LDP) and its coalition partner lost their majority in the lower house of parliament for the first time since 2009. (Upper house elections loom later this year.) While newly elected Prime Minister Shigeru Ishiba will be challenged to build bonds with opposition parties, we think there's a good chance the LDP will maintain its leading position in the government, perhaps by introducing new fiscal stimulus to garner broader political support. If so, we believe looser fiscal policy could provide a tailwind for the Japanese economy and its equity markets.

Another important factor, in our view, is Japan's standing in international trade and investment, especially with respect to the new U.S. administration and other key allies. In recent years, Japan has enjoyed strong foreign direct investment (FDI) from its allies, notably in crucial sectors such as semiconductor manufacturing. As shown in figure 4, FDI in Japan's semiconductor industry rose 9% year over year in 2023, thanks to double-digit increases from regions including the U.S., U.K. and Taiwan.[4]

[4] "Invest Japan Report 2024", Japan External Trade Organization, December 26, 2024.

FIGURE 4: FOREIGN INVESTMENT IN SEMICONDUCTOR MANUFACTURING HAS BOLSTERED JAPAN'S GROWTH

2023 Japan Foreign Direct Investment (FDI) Stock by Geography, YoY% Growth Rate



Source: Neuberger Berman, Japan External Trade Organization, data as of December 2024.

While near-term uncertainty remains in light of U.S. President Donald Trump's "America First" stance and his call for broad-based trade tariffs to support it, we believe Japan's strategic partnership with the West and other allies will likely hold firm over the medium to long term. Since the end of World War II, Japan has enjoyed a fruitful economic and military alliance with the U.S. and Europe. In light of China's ongoing rise, we believe this foundational cooperation between Japan and the West—regardless of a temporary trade spat—will likely help support the Japanese equity market over the long term.

Regulatory Tailwinds

Since the turn of this decade, Japanese regulators have been turning up the heat on Japanese companies to improve corporate governance and capital returns, culminating in a 2023 flagship report from the Tokyo Stock Exchange (TSE). In it, the TSE stressed the connection between poor capital management and low stock valuations, and urged Japanese executives to achieve higher return on equity (ROE) to unlock Japan Inc.'s true economic potential.

In our own coverage (in 2021 and 2023), we argued that such efforts, by regulators and shareholders alike, were potential tailwinds for Japanese stocks. Those forecasts materialized in 2023 and the first half of 2024 as Japanese equities touched new historical highs (see figure 5).

FIGURE 5: JAPANESE EQUITIES: ARE THE "LOST DECADES" FINALLY IN THE REAR VIEW?

TOPIX Index (JPY)

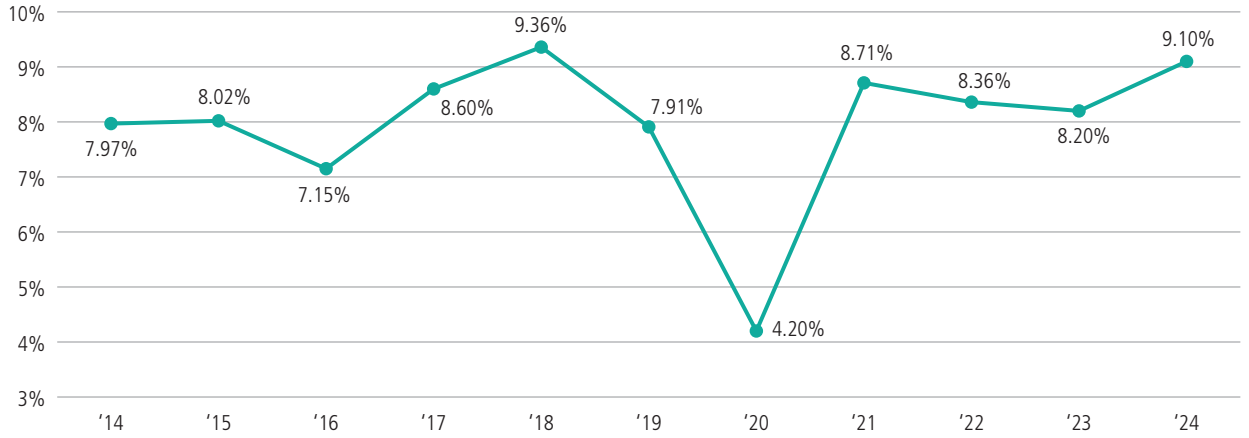
Source: Neuberger Berman and Bloomberg, data as of January 2025.

Then, in the second half of 2024, momentum began to wane. Currency volatility (from monetary policy normalization) and political strife were partly to blame, in our view, but we believe stalling ROE growth also played a role (see figure 6).

Specifically, while Japanese companies posted record earnings on the post-Covid 19 recovery and the weak yen, shareholder equity *also* rose due to inflated balance sheet items, such as currency translation adjustments from the yen's depreciation and net unrealized gains on securities from strategic investments, including cross-shareholdings booked at market value.[5] In terms of ROE, as the numerator (earnings) and denominator (equity) rose in tandem, growth stalled.

FIGURE 6: WILL JAPANESE COMPANIES CONTINUE TO IMPROVE THEIR RETURN ON EQUITY?

TOPIX Index Return on Equity (%)



Source: Neuberger Berman and Bloomberg, data as of January 2025.

Over the next several years, we believe pressure on ROE should abate, paving the way for potentially higher equity valuations.

On profitability, we think Japanese companies should be able to manage foreign-currency headwinds as long as yen appreciation remains gradual—a likely scenario, in our view, given the BOJ's phased approach to normalizing monetary policy. Meanwhile, we believe economy-tracking businesses should see improved profits thanks to higher domestic demand and lower import costs.

On capital efficiency, we expect currency-inflated balance sheets will shrink over time as the yen gradually appreciates. We also expect Japanese companies to accelerate the sale of strategic investments and cross-shareholdings—unlocking capital for new growth initiatives—driven by pressure from shareholders and ongoing regulatory reforms.

For example, in October 2026, the TSE plans to implement proposed changes to the inclusion criteria for the benchmark TOPIX Index. A new liquidity guideline will require new entrants to be among the top 96% of the TOPIX Index by free-float-adjusted market capitalization, and existing constituents must be within the top 97%.[6]

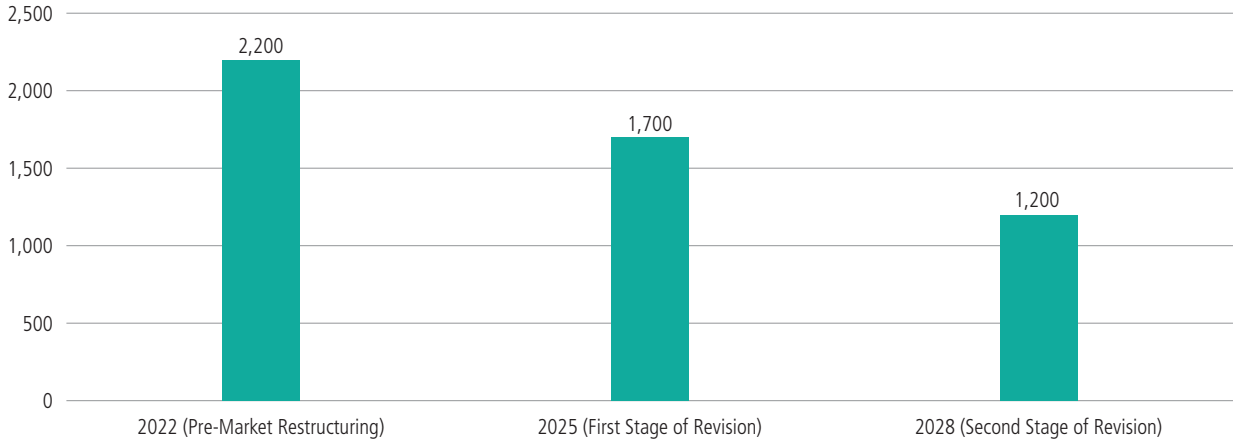
The TSE's new free-float requirement seeks to omit shares held by strategic investors and cross-shareholdings, thereby encouraging the sale of these stakes, increasing broader capital efficiency and appeasing market critics. As the TSE declared in an August 2024 report: "*[The new rules] may result in more companies choosing to go private as the cost of maintaining a public listing increases. TSE, however, will respect these decisions. In order to improve the attractiveness of the Japanese market, TSE is focusing on quality (realizing corporate value enhancements that meets investors' expectations) rather than the number of listed companies.*"[7]

[5] "2024 – 2025 Corporate Earnings Outlook (December 2024)", SMBC Nikko Securities, December 20, 2024.
[6] "Overview of Revisions of TOPIX and Other Indices", Japan Exchange Group, October 2024.
[7] "ACGA Open Letter: Strategic Shareholdings in Corporate Japan", Asian Corporate Governance Association, April 2024.

Furthermore, we believe the unwinding of these holdings could accelerate in coming months as the TSE calculates the first round of free-float ratios based on fiscal 2025 annual corporate reports. The TSE expects its new rules will cut the number of TOPIX Index constituents nearly in half—to 1,200 from approximately 2,200—by July 2028, as shown in figure 7.

FIGURE 7: JAPAN'S BENCHMARK INDEX WILL INCREASINGLY FOCUS ON QUALITY OVER QUANTITY

Estimated Impact of Tokyo Stock Exchange's TOPIX Index Revision on Number of Constituents



Source: Neuberger Berman, Tokyo Stock Exchange, data as of October 2024.

These changes have heightened the sense of urgency among corporate management teams to increase ROE and stock liquidity—important steps that, in our view, could enhance shareholder value over the long term.

Finally, we believe these changes could further polarize winners and losers across the broader Japanese equity market, creating an increasingly attractive environment for active stock selection over the medium to long term.

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Index Definitions

TOPIX, also known as the Tokyo Stock Price Index, is a capitalization-weighted index of all the companies listed on the First Section of the Tokyo Stock Exchange. The First Section contains the larger companies in the index (about 2000), while the Second Section is comprised of smaller companies. TOPIX is widely regarded as a broad benchmark for Japanese stock prices.

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