Economic Research Group

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Macro View

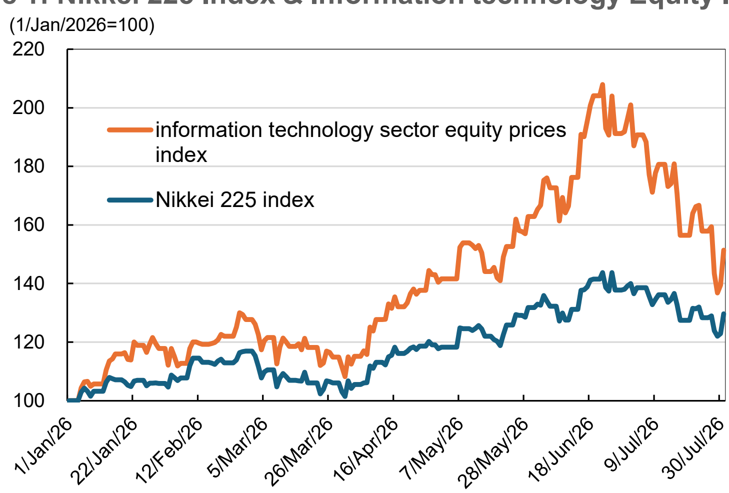
Japanese Equity Markets Are Expected to Continue Rising In Medium & Long Term
～More Room For Upside Even In USD Term～

- Japanese Inflation to last for real JPY to stabilize in medium and long term
- More room for Japanese equity markets in JPY term as hedge for inflation
- More room for Japanese equity markets even in USD term via more evaluation of overseas assets in a case of JPY depreciation

Nikkei 225 Index Fell Due To Correction Of Information Technology Sector

The Nikkei Stock Average underwent a correction phase from late June through July 2026. This correction was driven by a decline in the stock prices of several large-cap stocks in the category the AI and semiconductor sector (classified as "Information Technology" by Bloomberg) as a negative backlash from the previous excessive upside expectation of equity prices in the category (Figure1). The question that naturally arises is whether the Nikkei should cease to rise given suspension of equity rally of AI & semiconductor sector. However, we believe there should remain significant room for the Japanese stock market to rise over the medium to long term as a hedge against inflation. We view the July decline in the Nikkei as a temporary correction, and believe there is potential for further gains.

【Figure 1: Nikkei 225 Index & Information technology Equity Index】

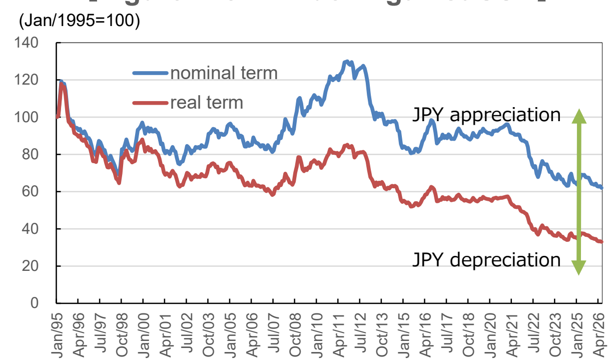


*Note: The data cover a period from 1 Jan 2026 to 31 Jul 2026.
*Note: Information technology equity prices are mean of respective company's equity prices.
*Source: Prepared by SMDAM based on Bloomberg data

JPY rate against USD in real terms has depreciated further than that in nominal term

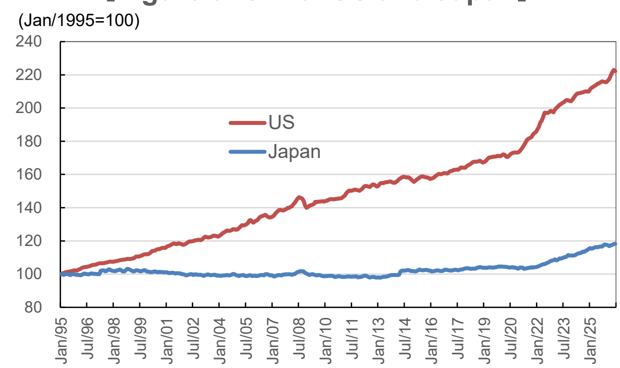
When we make the US dollar/yen exchange rate index—with the value falling as the dollar strengthens against the yen (depreciation of the yen)—and set at 100 for January 1995, the figure stands at 62.0 as of June 2026, indicating a 38% depreciation of the yen against the dollar (Figure2). Similarly, when the real exchange rate is indexed using consumer prices, the figure is 33.0 as of June 2026, representing a 67% depreciation of the yen against the dollar (Figure2). The reason the yen's real exchange rate declined significantly more than its nominal exchange rate is the widening gap between price levels in the United States and Japan (Figure3). Looking at the consumer price inflation rate for June (year-on-year), the US recorded an increase of 3.5%, whereas Japan recorded 1.7%.

【Figure 2: JPY Index Against USD】



*Note: The data cover a period from Jan 1995 to Jun 2026.
*Source: Prepared by SMDAM based on Bloomberg data

【Figure 3: CPI of US and Japan】

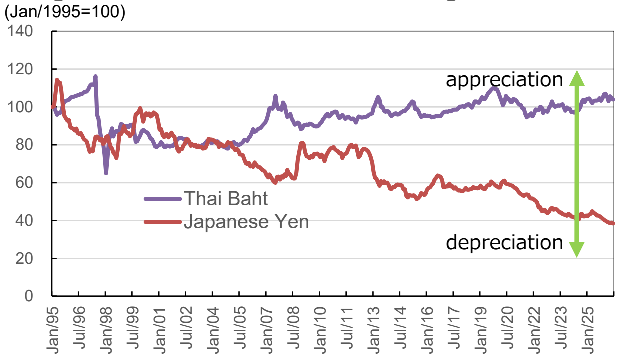


*Note: The data cover a period from Jan 1995 to Jun 2026.
*Source: Prepared by SMDAM based on CEIC data

Real Effective JPY Rate in Jun 2026 fell to that in 1965

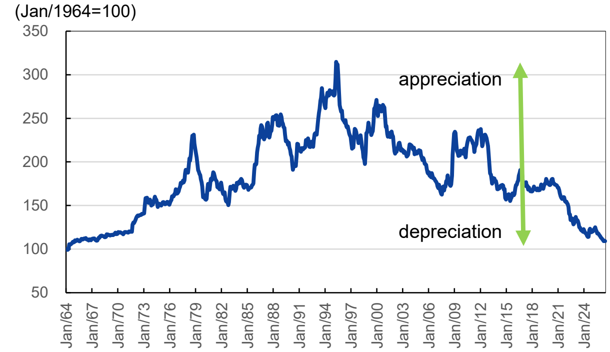
Real effective exchange rate is a weighted average of trading countries & areas' real exchange rate. Looking at the real effective exchange rate index (100 in January 1995) of the Thai baht, which triggered the Asian currency crisis of 1997-1998, and the Japanese yen, as of June 2026, the Japanese yen has fallen by 61.5% to 38.5, while the Thai baht has risen by 4.0% to 104.0 (Figure4). If we look at the real effective exchange rate of the Japanese yen as an index with January 1964 as 100, it will be 109.1 in June 2026, almost the same level as in 1965 (Figure5). It is easy to see how the Japanese yen has fallen in relative terms.

【Figure 4: Real Effective Exchange Rate Index】



*Note: The data cover a period from Jan 1995 to Jun 2026.
*Note: Indexed based on Jan 1995; weighted average of 64 currencies.
*Source: Prepared by SMDAM based on BIS data

【Figure 5: Japanese Yen Real Effective Exchange Rate Index】



*Note: The data cover a period from Jan 1964 to Jun 2026.
*Note: Indexed based on Jan 1964; weighted average of 27 currencies.
*Source: Prepared by SMDAM based on BIS data

JPY Tends To Depreciate Despite Of Current Account Surplus Trend

Japan's current account balance remains in surplus, but the majority of this surplus stems from the primary income balance (calculated by subtracting dividend and interest payments made on foreign investments in Japan from dividend and interest receipts earned on Japanese investments abroad) (Figure6). While a primary income balance surplus indicates that receipts exceed payments, it does not exert upward pressure on the yen, as most of the income received overseas is reinvested locally. Conversely, triggered by the Russia-Ukraine war in 2022, commodity prices surged, causing the trade balance to remain in deficit on an annual basis from 2022 onwards. The trade balance for 2026 is also projected to end in a deficit, as the Iran-US war—which began on February 28, 2026—restricted navigation through the Strait of Hormuz and drove up crude oil prices. Meanwhile, although the travel balance continues to show a surplus driven by inbound tourism, the overall services trade deficit has widened caused by deficits in other areas, such as the insurance balance (reflecting reinsurance payments linked to foreign-currency-denominated insurance), the digital balance (reflecting spending on services like cloud computing and video content), and the "business services" balance (reflecting spending on specialized and management consulting) (Figure7). Given the trend of net inflows into foreign equity investment trust funds—facilitated by schemes like NISA (Figure8)—and the appreciation of the US dollar driven by expectations of US interest rate hikes, the trend of a weaker yen against the dollar is expected to persist in the medium to long term.

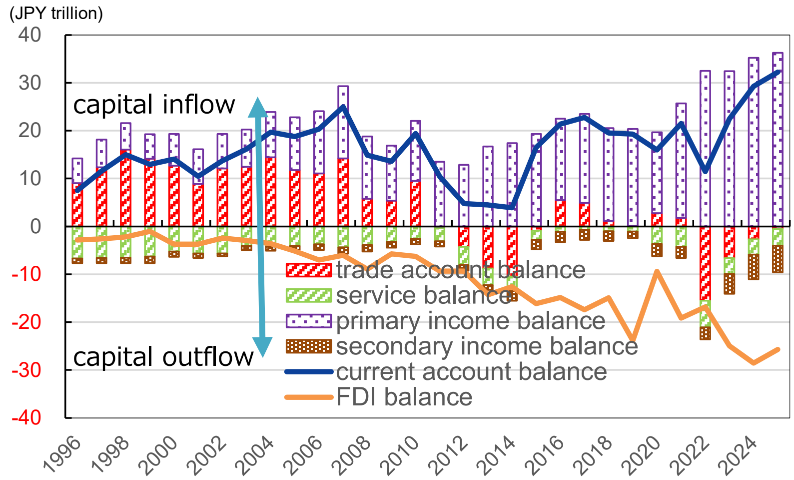
Doubts Remain Regarding the Sustainability of Yen Appreciation Driven Solely by Intervention

On 31 July 2026, Japanese and U.S. monetary authorities intervened to buy yen; as U.S. authorities demonstrated a cooperative stance toward correcting the yen's depreciation, the yen temporarily appreciated against the U.S. dollar. However, such intervention is viewed primarily as a measure to rectify the excessive yen depreciation deemed problematic by Japanese authorities. In addition, according to “Tankan” June survey by Bank of Japan, Japanese companies had assumed Japanese yen rate against US dollar at 152.57 for FY2026, more depreciation from 150.10 in March survey. Given the JPY assumption, financial results of many Japanese companies should deteriorate for July-September 2026. “Tankan” is a quarterly business survey on corporate sentiment and outlook compiled by Bank of Japan. Given the absence of significant changes in economic fundamentals, it is considered unlikely that intervention alone would sustain yen appreciation to a degree sufficient to reverse the downward trend in the real yen-dollar exchange rate or the real effective exchange rate of the yen.

Drastic US Equity Correction May Cause Rapid JPY Appreciation/Japanese Equity Correction

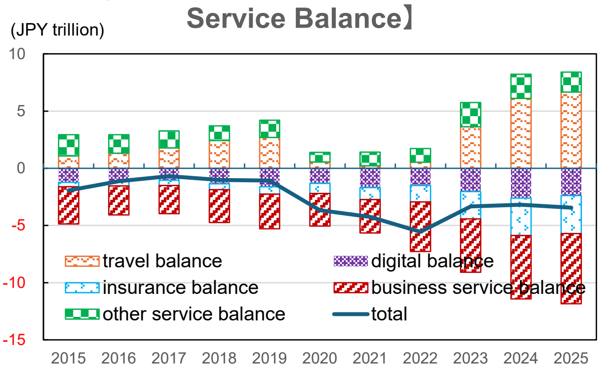
Although Japanese financial authorities appeared to intervene by buying yen in late July—leading to a temporary appreciation of the yen against the dollar, aided by a cooperative stance from US authorities—this move is viewed merely as a measure to correct excessive yen depreciation. Since economic fundamentals remain unchanged, it is considered unlikely that yen-buying intervention alone would trigger a shift toward a stronger yen and a weaker dollar. Japanese investors are actively using the NISA framework to invest in foreign equity mutual funds—such as those focused on US stocks—a trend that tends to drive a weaker yen and a stronger US dollar. Conversely, should the US stock market undergo a significant correction, the redemption of these funds could trigger a repatriation of capital to Japan, potentially leading to a stronger yen against US dollar at a rapid pace. However, in such a scenario, the US household sector would likely face a downturn due to balance-sheet adjustments, raising the possibility of a global stock market correction that would affect Japan as well. In US, the major item in household sector is equity and investment trust fund.

【Figure 6: Japanese Current Account Balance & FDI Balance】



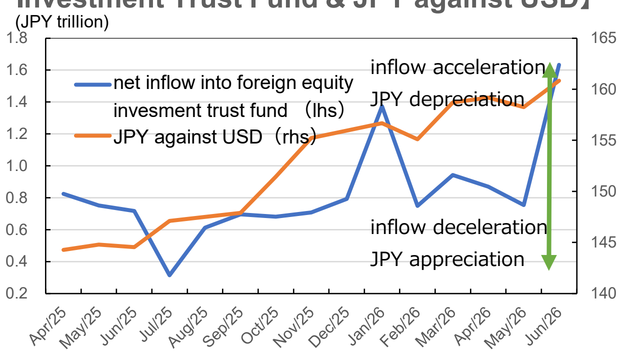
*Note: The data cover a period from 1996 to 2025.
*Source: Prepared by SMDAM based on CEIC data

【Figure 7: Composition of Japanese Service Balance】



*Note: The data cover a period from 2015 to 2025.
*Source: Prepared by SMDAM based on CEIC data

【Figure 8: Inflow Pace Into Foreign Equity Investment Trust Fund & JPY against USD】



*Note: The date cover a period from Apr 2025 to Jun 2026. Monthly average for JPY rate.
*Source: Prepared by SMDAM based on Bloomberg and Investment Management Association of Japan

Room for Japanese Equity Prices To Rise In JPY Term As Hedge for Inflation

Real exchange rates tend to revert to a certain level over the medium to long term. Prior to the devaluation of the Thai baht that began on 2 July 1997, Thailand maintained a de facto peg to the US dollar, stabilizing the baht's nominal exchange rate against the dollar; however, because Thailand's inflation rate exceeded that of the US, the baht's real exchange rate appreciated. Consequently, the Bank of Thailand was forced to devalue the nominal baht-dollar rate to stabilize the real exchange rate. In contrast, although the yen's real exchange rate has fallen relative to its nominal rate, there are no signs of fundamental shifts—such as those mentioned earlier—that would trigger an upward trend in the yen's nominal rate against the US dollar.

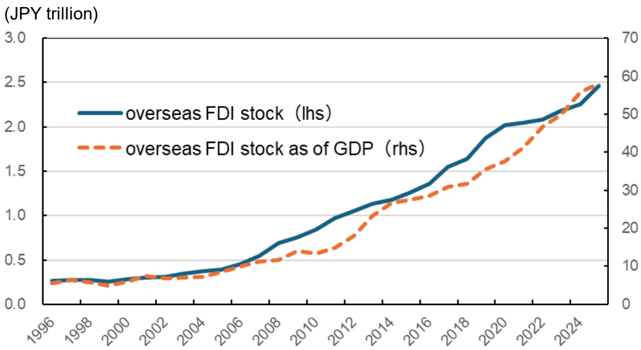
In a situation where a significant real exchange rate adjustment driven by a trend of nominal appreciation is unlikely to occur, the only remaining mechanism to drive up the real exchange rate would be for Japan's inflation rate to consistently exceed that of the US. Based on our assessment that there is room for Japan's inflation rate to rise, we believe that Japanese stock prices offer upside potential as a hedge against this scenario.

Room for Japanese Equity Prices To Rise Even In USD Term

Following the Plaza Accord on 22 September 1985—in which five major nations, including the U.S. and Japan, agreed to correct the appreciation of the U.S. dollar—the yen had appreciated while the US dollar had depreciated. Japanese companies, particularly in the manufacturing sector, have expanded overseas facilities to hedge against the decline in export competitiveness caused by yen appreciation. Foreign direct investment (overseas assets) by Japanese firms has been on the rise, as is the ratio of such investment to GDP (Figure 9). The overseas dependency ratio of Japanese companies—comprising the sum of overseas sales ratio and export sales ratio—has increased, creating a corporate structure that is well-positioned to benefit from a weaker yen (Figure10). When the yen depreciates, the yen-denominated value of these overseas assets rises, improving the companies' fundamentals and often acting as a driver for higher stock prices. Because Japanese stock prices tend to rise alongside yen depreciation, the divergence in returns between yen-denominated and U.S. dollar-denominated figures—such as for the Nikkei Stock Average—should remain relatively small. Thus, we believe Japanese stocks retain room for rising even in U.S. dollar terms. Comparing indices set at 100 on 1 January 2025, the figures for July 31, 2026, were nearly identical: 161.3 in yen terms and 161.2 in U.S. dollar terms (Figure11). This characteristic means that, as Japanese stocks tend to rise in response to a weaker yen, the U.S. dollar-denominated stock price is unlikely to plummet solely due to currency exchange effects.

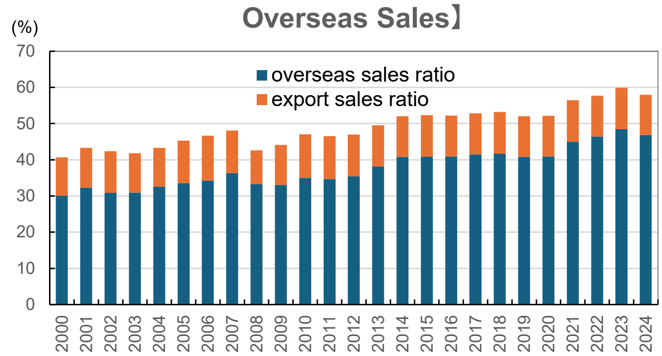
This characteristic of Japanese stock prices stands in contrast to the situation in Turkey, where stock prices have been influenced by hyperinflation (a scenario involving a rapid acceleration of inflation over a short period). While the BIST100 index (Turkey's benchmark stock index) rose in Turkish lira terms, there is a significant divergence from the U.S. dollar-denominated index. Using the same index methodology as above, the figures for 31 July 2026, showed a divergence of over 30%: 136.9 in lira terms versus 101.9 in U.S. dollar terms (Figure12). Turkey consistently runs a trade deficit and, as a net recipient of direct investment, also records a deficit in its primary income balance. Currencies associated with current account deficits are prone to intense speculative selling, which can prevent stock markets from rising when measured in U.S. dollar terms.

【Figure 9: Japanese FDI To Overseas】



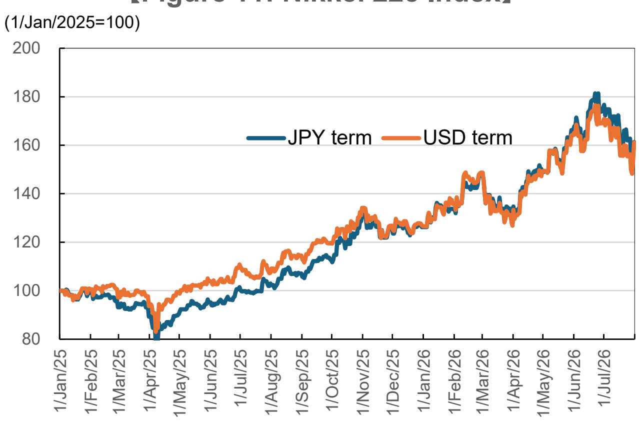
*Note: The data cover a period from 1996 to 2025.
*Source: Prepared by SMDAM based on CEIC data

【Figure 10: Japanese Companies Depend On Overseas Sales】



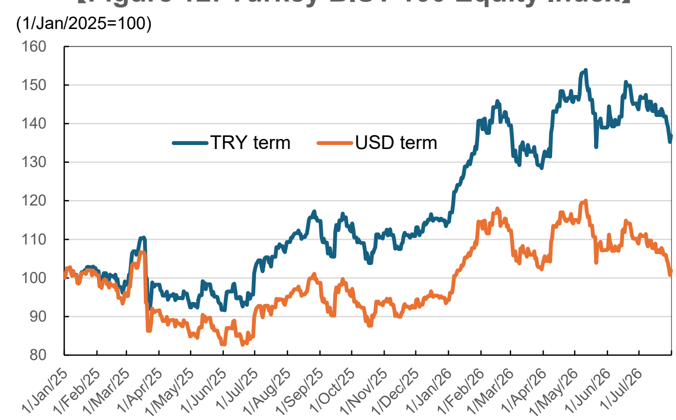
*Note: The data cover a period from FY2000 to FY2024.
*Note: overseas sales ratio = overseas sales÷(headquarter sales＋overseas sales)
Export sales ratio = export ÷ (headquarter sales + overseas sales)
*Source: Prepared by SMDAM based on “Basic Survey on Overseas Business Activities” compiled by METI

【Figure 11: Nikkei 225 Index】



*Note: The date cover a period from 1 Jan 2025 to 31 Jul 2026.
*Source: Prepared by SMDAM based on Bloomberg data

【Figure 12: Turkey BIST 100 Equity Index】



*Note: The date cover a period from 1 Jan 2025 to 31 Jul 2026.
*Source: Prepared by SMDAM based on Bloomberg data