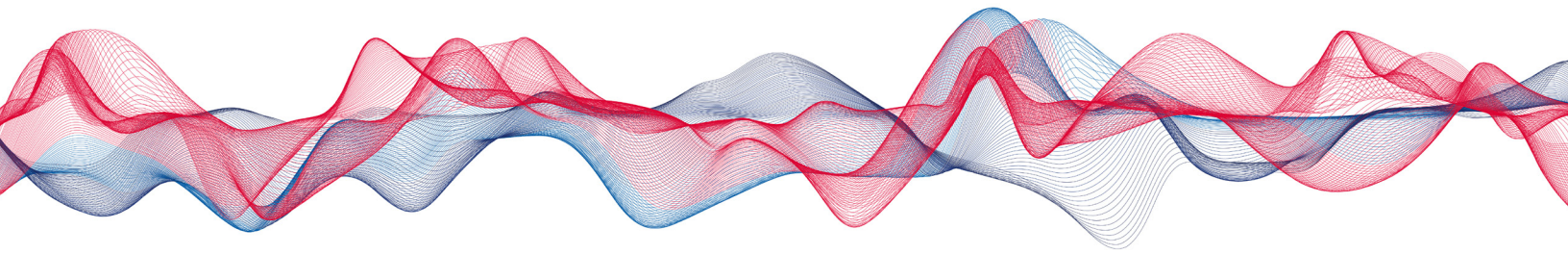


AUGMENTING OPPORTUNITY

What's Driving Japanese Markets to New Highs



Japan's stock market has captured the attention of investors eager to profit from the potential upsides of a revitalized economy, propelling the benchmark Nikkei Stock Average to close 2024 at its highest level ever.¹ Our Global Research Analysts expect 2025 could be another pivotal year for Japan—marking the first significant turning point in Japanese stocks in three decades. Inflation, corporate reforms, and shifting supply-demand dynamics are reshaping the landscape, signaling that the “new normal” is taking root. The question is, how durable are these factors and what will sustain Japan's market performance for the years to come?

Counting the gains from corporate reforms

Optimism surrounding corporate governance reforms has been the primary catalyst behind the recent surge in interest in Japanese equities. The Japan Exchange Group efforts to encourage companies to enhance price-to-book (PB) ratios and capital efficiency are yielding tangible results, with over 80% of prime market companies voluntarily taking action.

The growing volume of share buybacks is a clear sign that these reforms are beginning to take hold. These buybacks can lead to an increase in earnings per share and return on capital. Additionally, the unwinding of Japanese companies' complex strategic shareholdings—another key area of reform—is seen as a major driver of improved capital efficiency as companies divest of non-core businesses interests.

As more Japanese companies take these reforms on, expectations are high that changes will lead to a prolonged period of market gains.

“The current momentum is built not on a one-time event, but the continual effort made by all Japanese stakeholders, and so the tide will continue,” Hiromi Yamaji, Group CEO of Japan Exchange Group, told the audience at BofA Global Research Japan Conference.

Inflation-led optimism

Aside from exchange-led requirements to increase shareholder value, inflation is also fueling corporate reforms as companies adjust their capital utilization strategies to rising prices—for instance, by raising capital expenditures (capex). If inflation proves persistent and funding costs rise, it will no longer be sustainable for companies to sit on their excess cash, retain low-margin businesses, or hold assets losing nominal value. This shift could provide a significant tailwind for Japanese equities in the years ahead, says Masashi Akutsu, Chief Japan Equity Strategist, BofA Global Research. Historically, Japanese equity total returns moved in tandem with inflation.²

Izumi Devalier, Head of Japan Economics Research, BofA Global Research, thinks inflation is here to stay, given the added secular factor of Japan's rapidly aging and declining population, which will exert continued upward pressure on wages as the labor market tightens further.

“The headwinds to labor supply are really starting to intensify at a degree that we haven't seen over the past couple of decades,” she adds.

¹ <https://asia.nikkei.com/Business/Markets/Equities/Japan-stocks-finish-turbulent-2024-at-highest-ever-year-end-close>

² https://www.lseg.com/content/dam/ftse-russell/en_us/documents/research/what-has-led-to-japan-comeback.pdf

A new generation of investors comes to market

Japan’s demographic reality is not only translating into new bargaining power in the workplace, but also changes in the market’s investor profile.

For decades, Japanese savers had little incentive to invest in equities because inflation was very low. Older generations tended to be risk averse after experiencing losses during the stock market upheavals in the 1980s and 1990s. That is why half of the US\$14.5 trillion in household financial assets in Japan are in bank deposits, with only 14.2% invested in equities.³

That is now changing because of the need to protect household purchasing power from inflation. Through the revamped NISA (Nippon Individual Savings Account) tax-free investment program, Japanese households are pouring savings into higher yielding assets such as stocks, driven by investors in their 20s, 30s and 40s who do not share the asset bubble trauma as their elders. In the first six months of 2024, at least ¥7.5 trillion (US\$52 billion) have been invested in NISA accounts, almost four times more than over the same period last year.⁴

Yamaji of Japan Exchange Group says the younger generation’s more positive attitudes toward equity investing will help keep the market’s revitalization on track for an extended period.

“I think this is a small start, but it will become bigger and bigger.” Akutsu foresees retail investors as a “potential main driver of Japanese equities.”

A very different future?

Greater confidence among domestic retail investors in the stock market can be a powerful force in deepening liquidity, which is critical to capital market activities such as large initial public offerings (IPOs), which recently made a comeback.⁵

Yamaji sees capital market activity as indicative of economic strength, and vice versa. “A very active capital market is the core of a very active economy,” he says. “At the same time, the Japanese economy’s good condition will help us become a very active market.”

With Japan undergoing profound changes economically and demographically, the equity story of the next 30 years is likely to be very different, and much more optimistic, than that of the previous three decades. As BofA Global Research’s Akutsu notes, the outlook for Japanese equities in the near-term rests on sustained corporate reforms, a positive inflation story and the changing market demand and supply structure.

“As long as these things continue, I don’t worry about Japan’s equity trajectory from the medium-term perspective,” he says.

³ As of March 2024. https://www.jsda.or.jp/en/about/annual-report/JSDA2024_web.pdf
⁴ <https://www.japantimes.co.jp/business/2024/08/06/markets/japan-retail-investor-resiliency>
⁵ <https://www.wsj.com/business/japan-gears-up-for-more-than-3-billion-of-ipos-in-october-70aa7b18>

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