

Value in Japan amid yen strength and higher yields

Japanese markets have jumped to the forefront of global investor concerns in response to Japanese Prime Minister Takaichi's call for early elections, rapidly rising government bond yields, and a surge in the yen vs. the US dollar since last Friday. We explain below why we are positive on Japanese equities, and particularly value equities, even with expectations for a further recovery in the yen and rise in longer term bond yields.

Japan's Topix index is down 2.0% as we write, cutting its year-to-date return to 4.3% in yen terms, but 6.0% in USD terms. That's still well ahead of the 1% rise in US markets so far this year. Today's drop appears to be almost entirely a response to the 2.8% rally in the yen vs. the US dollar since last Friday. The rally has come following official warnings about yen weakness and price checks by both the Bank of Japan (BoJ) and the Federal Reserve Bank (Fed) on Friday.

While we agree that yen strength will trim Japanese earnings estimates, this should not be by enough to drive underperformance of well structured, currency neutral portfolios. For the market overall we estimate, roughly, that a 10% fall in USDJPY would lower the market's outlook for Japanese equity earnings by about 5%. However, we need to be cautious in how we apply estimates such as these because we cannot be certain what exchange rate the market incorporated into earnings estimates before any change in the yen happens.

Our bias is to guess that markets had come to expect a USDJPY rate of 155 -157 prior to the BoJ and Fed rate checks of late last week. This implies, again very roughly, that if the yen were to rally to 145 to the US dollar and sustain this rate it would trim about 3.5% - 4.5% off market earnings estimates relative to expectations a week ago. Yet, that would probably prove to be an overestimate over the course of the year, in our view.

One reason is that the outlook for Japan's economy has improved over the past two quarters, leading us to expect nominal GDP growth of about 4% this year.

- Japan's PMIs and the Tankan survey point to real growth of about 1%;
- core machinery orders have risen to their highest levels in about five years and point to good growth in capex;
- robust US and European growth suggest a recovery in exports and the worst impact of US tariffs has passed;
- fiscal policy may provide a mild stimulus over the next year.

Another key reason is that the chart below shows that return on equity (RoE) is rising. We think this is a direct result of ongoing corporate governance reform. Importantly, this increase in RoE is not just due to yen weakness. MSCI Japan's RoE has risen from 9.5% in mid-2024 when USDJPY rose to just over 161 to 10.3% with USDJPY below this prior high.



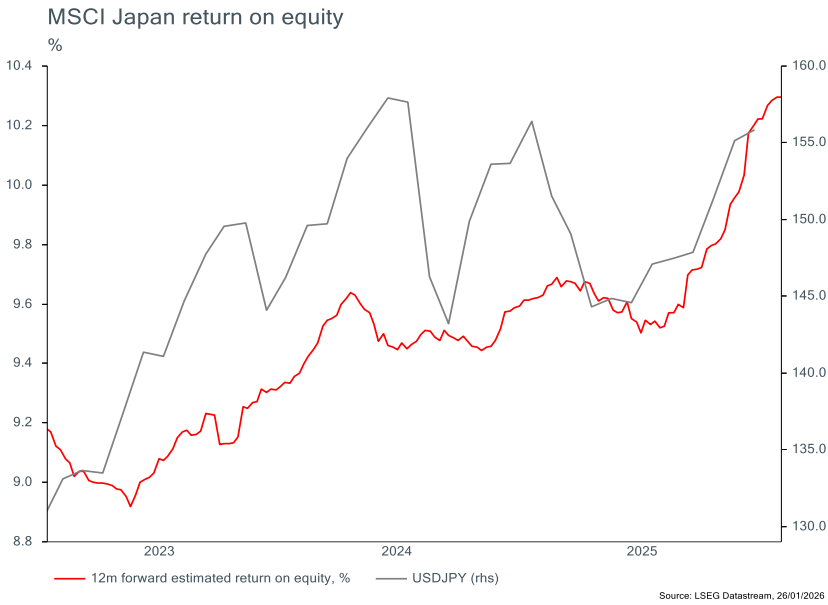
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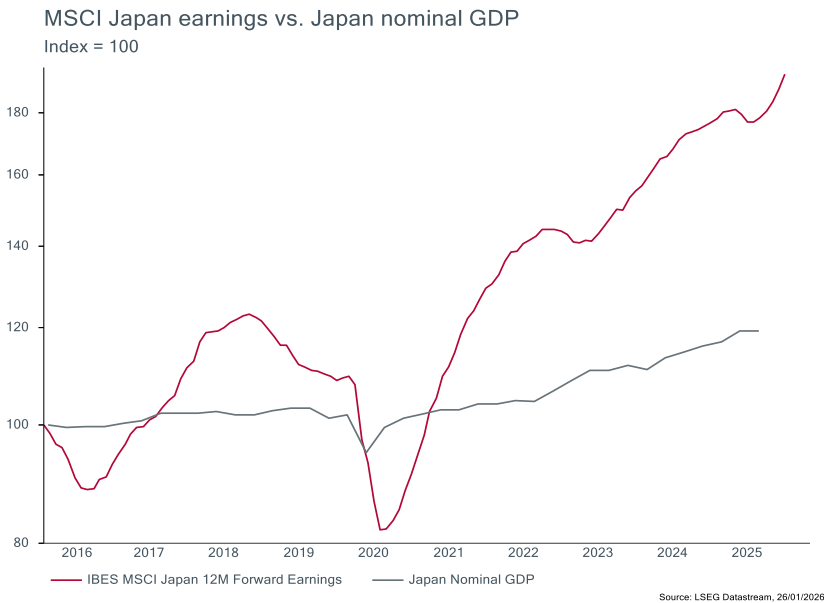
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A key result of the rising return on equity is that Japanese equity market earnings growth is far outstripping GDP growth (chart below).



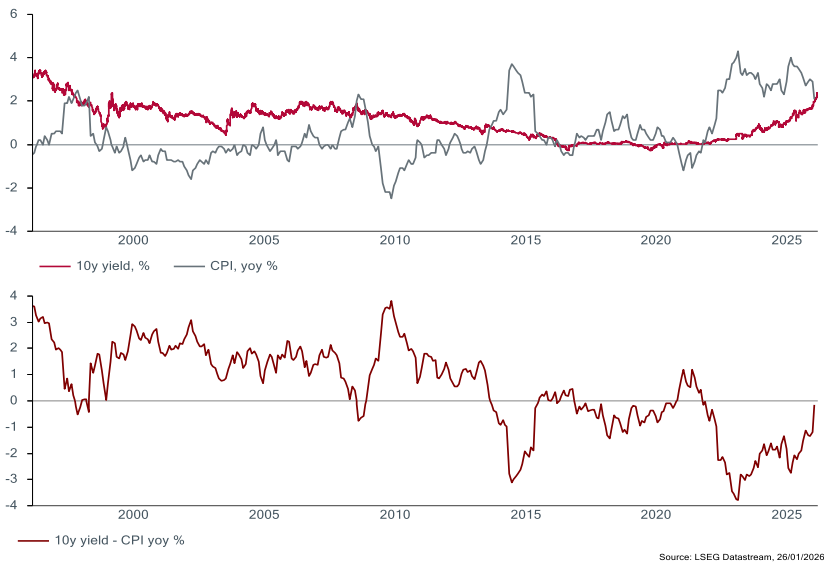
Within this, “value” as an investment style is outperforming. Bloomberg estimates that active returns to the value style have been 61% in yen terms over the past three years, far outpacing the 38% return to the second-best style, “dividend yield”. Active returns to value have been 5.6% since PM Takaichi was elected in October last year.

But what about rising Japanese government bond yields? We argued in November last year that Japanese yields had further to rise and hold to this view. Yet we are less concerned about the implications of higher yields than many in the market.

As we noted last year, we view rising long term bond yields as a needed market adjustment to now higher Japanese inflation.

The chart below shows that JGB yields traded close to current levels and 1% - 2% above inflation in the period before the BoJ began large, sustained purchases of JGBs in April 2013. We expect Japanese inflation to be about 2% this year, the BoJ to increase its policy rate 50bps to 1.25%, and for the 10y JGB yield to rise to close to 2.8%.

Japan 10y yield vs. inflation

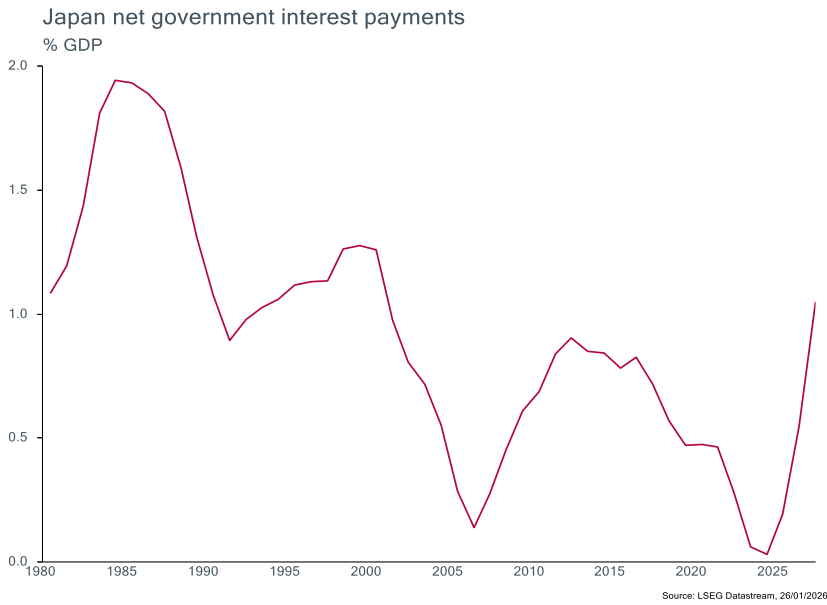


Nonetheless, the chart below shows that Japanese equities are rising in tandem with the increase in government bond yields. This is because rising yields reflect the recovery in Japanese nominal GDP growth and the improvement in Japanese corporate profitability.

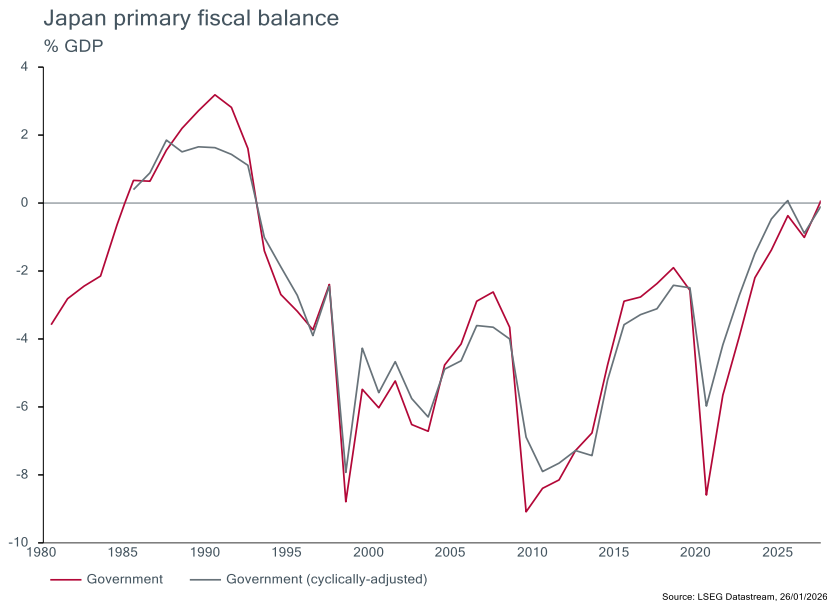
MSCI Japan vs. 10y yields



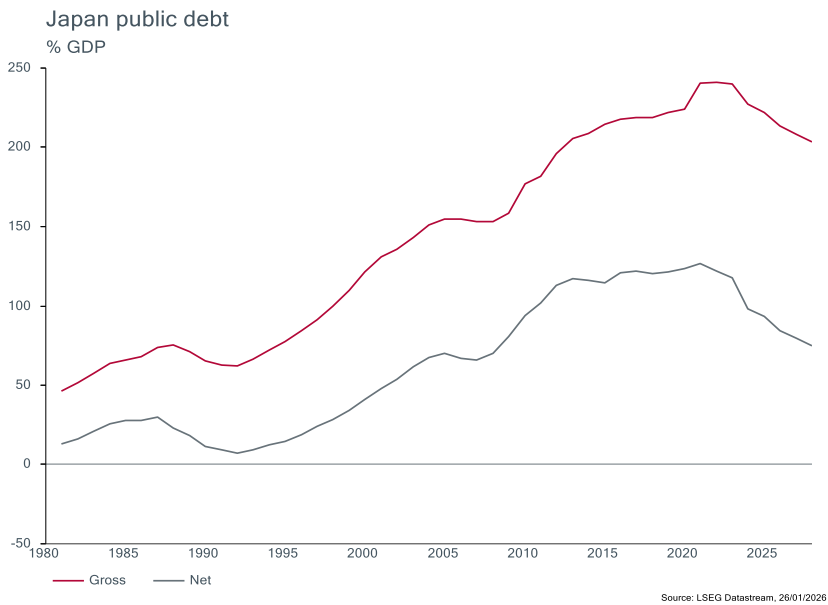
We also push back against concerns by some that rising yields will create a fiscal crisis in Japan. First, government net interest payments as a share of GDP remain well below peak levels in the early 1980s (see chart below).



Second, the sharp reduction in Japan's primary deficit – the fiscal balance before interest payments - over the past several years has improved long-term fiscal sustainability greatly. Crucially, the FY26 budget the Takaichi cabinet has already approved would produce Japan's first narrow primary surplus in 28 years, keep new government bond issuance below ¥30tn for a second consecutive year, and cut the bond dependence ratio to 24.2%, the lowest in over a decade.



A result of faster nominal GDP growth and smaller primary deficits is that Japanese gross and net public debt have fallen 37% of GDP and 51% of GDP respectively since their peak in 2000. We expect further gradual reduction in debt/GDP over the next several years.



Viewpoints from the Japan equity team

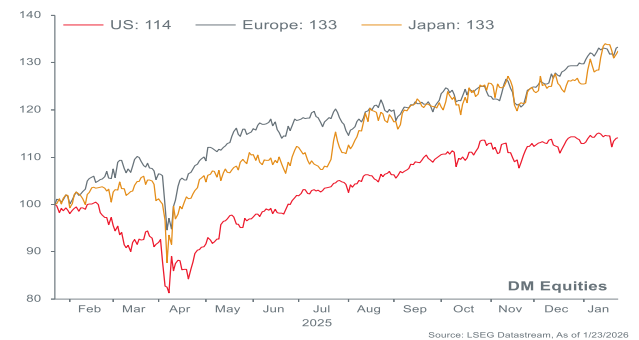
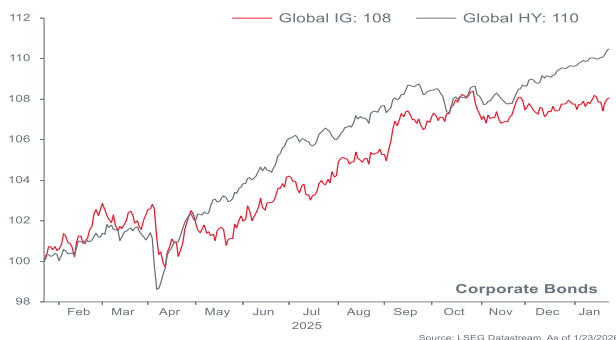
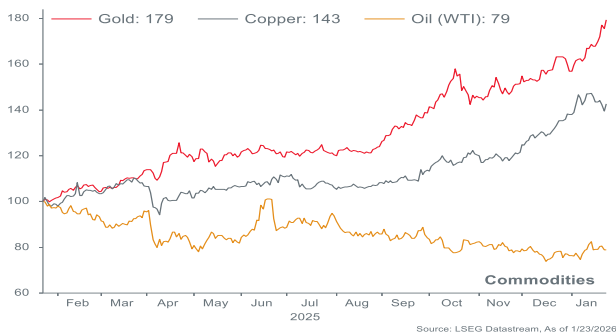
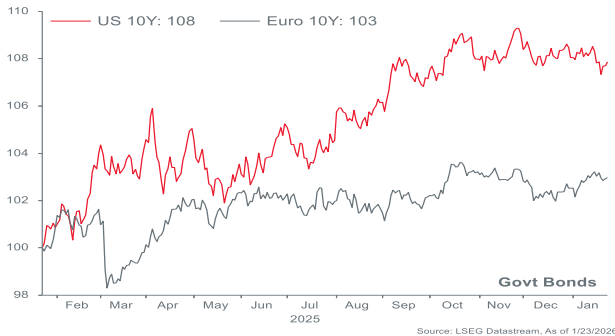
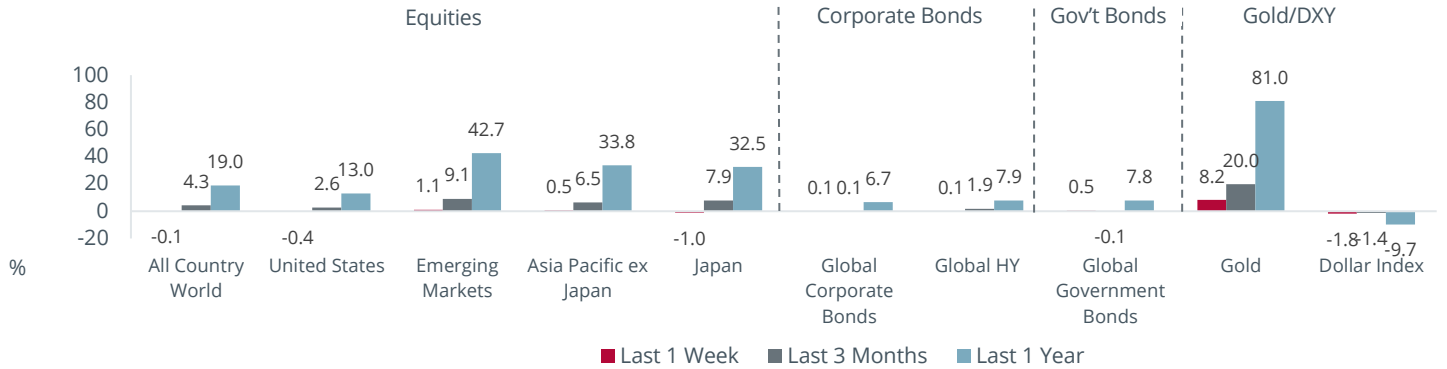
Overall, the market impact of the snap election is likely to be concentrated in the near term and remains difficult to predict both in terms of election outcome (as demonstrated by Prime Minister Takaichi's surprise victory last October) and long-term market implications. In our view, the broader backdrop for Japan equities remains constructive, with the potential for real wage growth to turn positive later in 2026, corporate return on equity continuing to improve, and ongoing corporate governance reforms expecting to support shareholder returns. Some of our holdings in the Industrials sector can stand to benefit from Takaichi's growth policies, while we also have selective exposures to food staples and resilient retail companies.

Market Review

The equity markets showed signs of volatility during the shortened trading week (in observance of the Martin Luther King Jr. Day in the US), which was impacted by the heightened geopolitical tensions stemming from President Trump's assertive stance on acquiring Greenland. During the week, the MSCI ACWI declined by -0.1%. In the US, both the S&P 500 and the tech-heavy Nasdaq indices posted weekly declines, falling by -0.4% and -0.1%, respectively; Europe equities rose by 0.3% (in USD). Elsewhere, emerging markets and the Asia Pacific ex-Japan region saw gains of 1.1% and 0.5% (both in USD), respectively.

In the fixed income markets, US Treasury yield movements were mixed across the curve. The 10-year yield was relatively unchanged during the week, closing at 4.24%; the yields on the 20-year, and 30-year maturities both declined by 1 basis point (bp) to end at 4.78% and 4.82%, respectively. Global government bonds, as proxied by the FTSE World Government Bond Index (WGBI), registered a 0.5% gain, outperforming US Treasuries and global credits. The US dollar (DXY) declined 1.8% during the week, while gold continued its rise.

Asset Performances



Market Data

Government Bonds	Close	1 week change (%)	1 month change (%)	3 month change (%)	1 year change (%)	YTD change (%)	52 week high	52 week low
US Treasury Yield (%)								
10 Year	4.24	0.19	1.68	6.27	-8.58	2.07	4.64	3.95
10 Year Bond Yield (%)								
Japan	2.26	3.57	10.78	36.14	87.55	9.18	2.34	1.12
China	1.83	-0.70	-1.77	2.86	9.90	-1.61	1.96	1.61
Australia	4.81	2.21	0.92	16.44	7.39	1.01	4.81	4.10
Singapore	2.13	-2.65	-7.38	18.11	-27.62	-4.05	2.95	1.75
Malaysia	3.51	-0.93	-0.73	0.95	-8.04	0.49	3.83	3.36
Indonesia	6.42	3.00	4.51	7.07	-9.20	4.87	7.21	5.92
	Close	1 week change (%)	1 month change (%)	3 month change (%)	1 year change (%)	YTD change (%)	52 week high	52 week low
Bond Indices								
Bloomberg Global Aggregate USD	94.54	-0.10	-0.02	-1.05	1.20	-0.12	95.66	93.25
Bloomberg U.S. Aggregate USD	93.95	0.03	0.02	-0.76	4.20	-0.13	94.92	90.16
Equity Indices	Close	1 week change (%)	1 month change (%)	3 month change (%)	1 year change (%)	YTD change (%)	52 week high	52 week low
World								
MSCI AC World Index (USD)	1,037.55	-0.07	1.71	4.27	18.97	2.26	1,038.38	742.96
North America								
US S&P 500 Index	6,915.61	-0.35	0.08	2.63	13.02	1.02	6,986.33	4,835.04
US Nasdaq Composite Index	23,501.24	-0.06	-0.26	2.44	17.19	1.12	24,019.99	14,784.03
Europe								
MSCI Europe	2,715.30	0.31	3.04	6.92	29.14	2.74	2,715.30	1,976.06
Asia Pacific								
MSCI Asia Pacific ex Japan	763.20	0.50	6.83	6.55	33.77	5.68	763.20	513.60
Japan Nikkei 225	53,846.87	-0.17	6.81	10.70	34.76	6.97	54,487.32	30,792.74
Shanghai Stock Exchange Composite	4,136.16	0.84	5.52	5.45	28.05	4.22	4,190.87	3,040.69
Hong Kong Hang Seng	26,749.51	-0.36	3.78	3.01	35.78	4.37	27,381.84	19,260.21
Taiwan TAIEX	31,961.51	1.76	12.90	16.09	35.86	10.35	32,042.44	17,306.97
Korea KOSPI	4,990.07	3.08	21.20	29.76	98.37	18.41	5,021.13	2,284.72
India NIFTY 50	25,048.65	-2.51	-4.31	-3.25	7.94	-4.14	26,373.20	21,743.65
Australia Stock Exchange 200	8,860.10	-0.49	0.73	-1.91	5.75	1.67	9,115.20	7,169.20
Indonesia Jakarta Composite	8,951.01	-1.37	4.27	8.18	23.76	3.52	9,174.47	5,882.61
Thailand SET	1,314.39	3.04	3.40	0.92	-2.22	4.34	1,362.00	1,053.79
Malaysia FTSE Bursa KLSE	1,719.99	0.42	2.59	6.96	9.05	2.37	1,723.41	1,386.63
Philippines Stock Exchange PSE	6,333.26	-2.03	4.82	4.61	-0.72	4.63	6,591.94	5,584.35
Singapore FTSE Straits Times Index	4,891.45	0.87	5.44	10.76	28.50	5.28	4,895.15	3,372.38
Currencies (vs USD)	Latest	1 week Change	1 Month Ago	3 Months ago	1 Year Ago	YTD	52 week high	52 week low
Developed Markets								
EUR	0.61	1.97	0.27	1.80	13.55	0.69	1.19	1.03
GBP	1.07	1.94	0.92	2.38	10.44	1.25	1.37	1.24
CHF	-1.12	-2.84	-0.95	-1.87	-13.99	-1.54	0.91	0.78
JPY	-1.70	-1.51	-0.32	2.05	-0.22	-0.60	159.12	140.85
Asia								
CNY	-0.14	-0.07	-0.92	-2.23	-4.46	-0.43	7.35	6.96
HKD	-0.01	-	0.24	0.32	0.09	0.18	7.85	7.75
INR	0.11	1.07	2.50	4.44	6.05	2.01	91.66	84.27
MYR	-0.87	-1.28	-1.40	-5.32	-9.88	-1.31	4.49	4.00
KRW	-1.23	-1.85	-2.30	0.66	0.82	0.38	1,485.83	1,352.45
SGD	-0.73	-1.35	-1.07	-2.08	-6.20	-1.10	1.36	1.27
TWD	-0.76	-0.82	-0.32	1.94	-4.17	0.05	33.25	28.90
IDR	-0.41	-0.41	0.27	1.17	3.29	0.84	16,945.00	16,106.00

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Sources

Asset performances: (bar charts) Eastspring Investments, Refinitiv, as at 23 January 2026. Equities: using MSCI indices in USD, United States is using the S&P 500. Corporate Bonds: using ICE BofA indices in USD. Government Bonds: using the FTSE Global Sovereign Bond index, in USD. Gold is London Bullion Market US Dollar per Metric Tonne. DXY is US Dollar Index. **(line charts)** Eastspring Investments, Refinitiv, as at the end of the prior week, rebased to 100 as at 1 year ago. Equities: MSCI indices, in USD. Corporate Bonds: using Bloomberg indices in USD. Government Bonds: using ICE BofA US 10 Year US Treasury and ICE BofA 7-10 Year Euro Government indices. Commodities: Gold is London Bullion Market US Dollar per Metric Tonne Ounce. Copper is LME Copper Grade A Cash US Dollar per Metric Tonne. Oil is Crude Oil WTI Spot Cushing US Dollar per Barrel. US Dollar is US Dollar Index.

Market data: Eastspring Investments, Refinitiv, as at 23 January 2026. Equities: MSCI indices in USD, other indices in local currency. Other indices or assets as stated. Please note that there are limitations to the use of such indices as proxies for the past performance in the respective asset classes/sector. The historical performance or forecast presented in this slide is not indicative of and should not be construed as being indicative of or otherwise used as a proxy for the future or likely performance of the Fund.



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