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Japan equities can ride the China wave

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Chinese policymakers' ongoing attempt to rekindle an economic revival has sparked a surge in the country's equities, and in turn concerns about investor rotation out of Japanese equities. We think these concerns are somewhat overblown as Japanese corporations are still fairly exposed to China's manufacturing supply chain and should benefit from a revival in China's economy. This could add to the impetus from Japan's domestic reforms, which should start to manifest after November's US election, and spark a sustained share price recovery. We recommend a diversified stock selection across both domestic and exporter stocks to position for this recovery phase.

China's flashy ongoing equity market rebound has sparked investor concerns about the potential for rotation out of Japanese equities and into their resurgent Chinese stocks. The recent outperformance of the latter certainly makes quite a compelling case: since 23 September, the MSCI Japan has fallen 1% compared to MSCI China's (MXCN) 21% rise. To be clear, the fears are not completely unfounded: there have been previous episodes of short-term investors moving from non-China Asian stocks to China shares in August 2022, January 2023, and May 2024. Additionally, China's Ministry of Finance over the weekend promised more enduring policy support for an economic recovery.

Notwithstanding the promise of a China recovery sometime down the road, investors would do well to remember that Japan's own recovery story is intact, albeit likely after November. Additionally, a tandem recovery in China and Japan is not out of the question. Against the backdrop of an improving outlook for China, investors should bear in mind that the rebound in Chinese equities means that at least part of that recovery is getting priced in, while any potential selloff in Japanese equities would create more attractive entry levels to position for a sustained price recovery in the medium term. A sharply stronger JPY though would pose a risk to such a recovery.

Japan's exposure to China's supply chains might be understated. The notion that investor interest in Chinese and Japanese equities is largely mutually exclusive might be based on the perception that Japanese companies have very limited exposure to China's economy. Ostensibly, only about 3.4% of total sales revenues of Japanese corporations comes directly from China. However, this ignores the indirect exposure through the supply chain—such as machine tools, semiconductor equipment, auto parts/components, and chemical/material supply—which in total would raise the exposure to nearly 10%. The machinery sector, for example, has direct sales exposure to China of under 10% while China actually accounts for over 20% of Japan's machinery tool orders. The growth of the Chinese economy could thus significantly impact the profit growth of selective sectors and the earnings of Japanese stocks overall, given that these industrial sectors include large-cap stocks.

Multiples expansion in China has positively impacted Japan. This very real corporate and economic linkage was borne out in highly correlated movement between TOPIX and MXCN before COVID. Since then though, supply chains disrupted during the pandemic have likely not been restored. Nevertheless, episodes of strong rises in MXCN P/E multiples over the past three years have been associated with mild but meaningful rises in the TOPIX. We thus believe that if Chinese government policy stimulus successfully revitalizes the economy and boosts earnings growth, Japanese equities will benefit over the medium term.

TOPIX still on track for a sustained recovery after November. We remain Neutral on Japanese equities in our global strategy amid short-term uncertainty. Although we expect Japanese equities to be range-bound and volatile until the US presidential election, structural reforms could start to manifest in 2025. On that note, we expect the continuation of Shunto wage increases and new inflows from the Nippon Individual Savings Account (NISA) program to boost Japanese equities from early 2025. NISA is a savings program that incentivizes Japanese households to invest their savings in the stock market by making these tax free. We thus recommend investors to diversify their stock selection across both domestic and exporter stocks to capture the recovery phase.

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