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Plummeting stock prices on the shock of rising US interest rates, a rare favorable condition for investing in Japanese stocks

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What to make of the sudden drop in the stock market

A global stock market correction is underway. The Japanese stock market, which had by the end of the year surged 68% from its post-Covid-19 lows and has continued its rapid rise of 11% this year, plummeted 1,600 yen, or 6%, in one week from its high on February 16. In the US, the NY Dow 30 dropped $1,000, or 3% from its all-time high, in two days at the end of February. The Nasdaq is down 8% from its all-time high, and the S&P 500 is down 4% from its all-time high. For some time now, speculative factors such as concentrated investments by individual investors in GameStop stocks, the run-up of specific stocks such as Tesla and EV-related stocks, and the rapid growth of Bitcoin have been increasing, and there have been wide assertions of there being a stock price bubble. The expected correction is here, but we do not think there is need for concern. This should be the perfect time for buyers who have been waiting for the market to adjust to enter the market. We may see a sudden buyback and sharp recovery.

No blind spots in the fundamentals

The arrival of a global economic boom is almost certain as the vaccination program to control Covid-19 takes shape. Once Covid-19 is under control, we can expect to see a full expression of pent-up demand and savings. Signs of this are evident in the surge in commodity prices, such as iron ore, copper, oil, and shipping charges, as well as in shortages of semiconductors and containers. We are also seeing an acceleration of innovation in the medium term. The pandemic has successfully aligned the three conditions for innovation: technology, markets (needs), and capital (risk capital). The technology to digitize all human activities online already existed, and there was plenty of capital, but the needs were lacking. However, COVID-19 brought about the need for most business and daily life to be conducted on the internet, such as working from home, online classes, and home medical examinations, and a market need was quickly formed. As a result, the trend toward DX (digital transformation) has become visible, and investment competition in the digital net revolution is developing. The move toward decarbonization and the shift to EVs is further accelerating this trend. Thus, there are no blind spots in the global economic expansion scenario.

If the stock market rally were to be interrupted, it would be due to economic stagnation or a shift in fiscal and monetary easing measures, but it is hard to imagine any policy shift. The Biden administration is likely to launch a barrage of fiscal policies, including a $1.9 trillion COVID-19 stimulus package and $2 trillion in environmental and infrastructure investments. US Treasury Secretary Janet Yellen has won the support of economists and markets by arguing that "fiscal policy is the most prudent course of action at a time when interest rates are at historic lows, and the benefits of economic stimulus far outweigh the costs in the long run," although large economic stimulus will increase debt. The Fed under Mr. Powell's leadership will respond with QE (bond buying) and promote fiscal and monetary easing (effectively MMT).

The shock of rising US long-term interest rates will not linger

The rise in interest rates has given this confident market a "shock". Long-term interest rates, which had bottomed out at 0.5% in August last year, soared to 1.6% on February 25, changing the market sentiment. The only thing that could happen if market-friendly economic policies fail is inflation with a sharp rise in interest rates. The question is whether the current rise in interest rates is a bad one that will darken the market or a temporary one; but this rise is unlikely to be a bad one that lasts a long time.

Points to note include:

1. The yield curve between short- and long-term interest rates is steepening, which will improve the earnings of financial institutions and encourage them to take risks.
2. The Fed can effectively control the yield curve not only by directing the short end but also the long end with QE, and bad interest rate hikes can be stopped with QE.
3. The full employment recovery will take time, and the labor participation rate remains low as Chairman Powell has stated, so we are not in a situation where there will be a sudden supply shortage or inflation.
4. The overshooting of long-term interest rates in the early stages of the economic recovery is a rite of passage, and although there will be a large temporary upturn in a counter-reaction to the continued low interest rates, this will not last for long.

Stock price adjustments triggered by rising interest rates will be transitory, and a sharp appreciation of the dollar seems unlikely. As for the dollar market, the US economy is clearly leading the world, including in the rollout of vaccinations, and it can be said that the weak dollar trend is over. Emerging non-resource countries may suffer. In addition, the stock market is approaching a transition period from a financial market (low rate and liquidity driven stock boom) to a performance market (earnings driven stock boom). The shift from growth stocks to economy-sensitive value stocks is likely to take hold.

Alignment of favorable conditions for investing in Japanese stocks

The favorable conditions for Japanese stocks are all aligned:

1. Being a global economically sensitive sector
2. Benefiting from of a weak yen
3. Japan having the world's hottest semiconductor supply chain (60% share of materials, 35% share of manufacturing equipment)
4. Unusually low valuations (Comparing P/B ratios for Japan and other countries, 4.1x in the US, 1.7x in the UK, Germany, France, and 1.2x in Japan, makes Japan extremely undervalued)
5. Both Japanese and foreign investors being significantly underweight Japanese stocks, and there is an urgent need to buy more Japanese stocks.

There may never have been a time in the past when all these favorable conditions have come together at once. We believe that this provides a good entry point.