Market & Investment Insights

Helped by a weaker yen, Japanese stocks may see further gains

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Article Highlights

- Japanese stocks have risen by double digits in 2015 to date, far outperforming U.S. stocks.
- The stock market rally has been aided by the weak Japanese yen, which has made large Japanese exporters more competitive and more profitable since income abroad is worth more in yen terms.
- The yen could fall further if the U.S. dollar continues to strengthen ahead of the Federal Reserve's expected interest-rate increase.
- Japanese stock prices are not completely tied to the yen, however, and other factors could influence values this year.

April 20, 2015

2015 has been a good year so far for Japanese stocks—outpacing stocks globally and in the U.S. As of April 9, the Nikkei 225 was up 14.3%, while the S&P 500 was barely in positive territory for the year. Japanese stocks have also outpaced emerging market and global stocks by a healthy margin in the first quarter (see figure 1 below). The rally means Japan is on pace for a fourth consecutive year of positive returns. But with such an impressive run, many investors wonder if further gains are possible or if the rally has played itself out.

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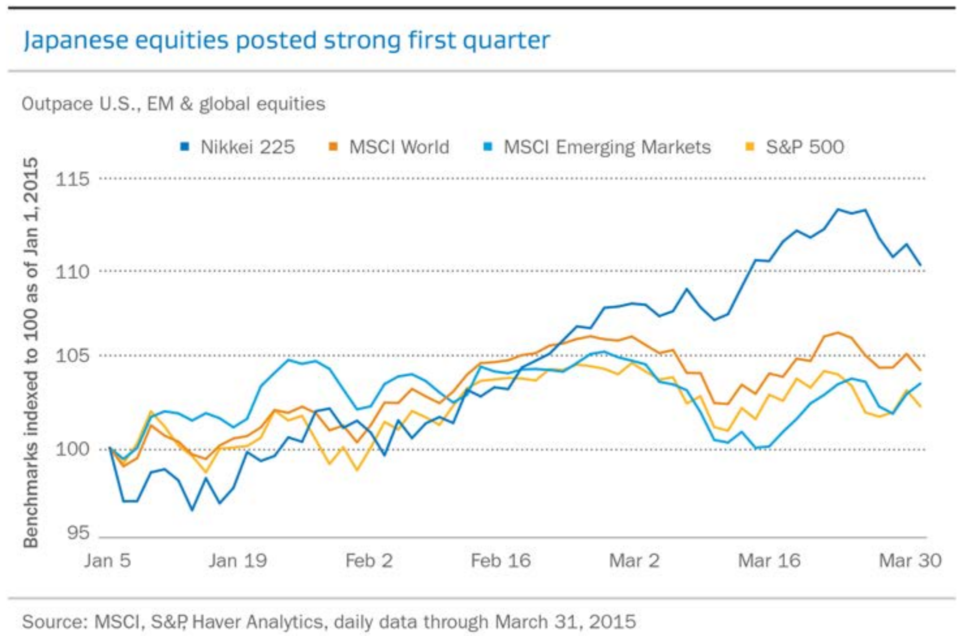
Figure 1: Japanese stocks outpace the U.S., global and emerging markets



Rising stock prices are benefitting from the declining value of the Japanese currency, the yen, which has fallen in value against the dollar over the past year by 20%, from about 100 yen to the dollar to 120 yen. This has been particularly good news for big Japanese exporters, since the weaker yen makes Japanese exports cheaper on the world stage, driving demand and stock prices.

If the yen were to fall further, Japanese stocks prices could continue their advance. In the near to medium term, there are two primary factors that could continue to depress the value of the yen and boost Japanese stocks. The first is the strengthening of the U.S. dollar. The economic momentum in the U.S., combined with the likelihood of an interest rate increase by the Federal Reserve later this year has lifted the dollar against most other currencies. If the dollar continues to strengthen, the value of the yen could drop again.

The second significant factor that could push down the yen is future action by the Bank of Japan (BOJ). Back in the fall, the BOJ surprised the markets by expanding its asset-buying program, pledging to spend 80 trillion yen ($659 billion) per year on government bonds, stocks and real-estate funds. These policies are intended to stimulate the economy and avoid deflation. The BOJ may take additional measures later this year because growth is stalling and inflation is at zero—well below the BOJ's stated goal of 2%.

It's not just exporters such as automotive manufacturers and suppliers that benefit from a cheaper yen. Japan has traditionally been a relatively closed society and a very expensive place to visit, but more recently, relaxed visa rules and the weaker currency have allowed tourism to surge, particularly among wealthy Chinese. Luxury retailers in Tokyo are benefiting, as well as hotel and hospitality companies.

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Are Japan stock values currency-dependent? Not entirely.

Japanese stock prices have also risen in response to higher corporate profits and a shift in asset allocation strategies of Japanese pension funds. Both of these factors could continue to influence equity prices in the near-term. There is potential for further Japanese corporate earnings growth as profit margins are low compared to other developed markets. Should Japanese corporate margins move toward international levels of profitability, stock prices could rise whether the currency dips further or not.

Equities are also benefitting from shifting pension allocations. Some of the country's largest pension funds have in recent months, allocated more to stocks. Notably, the $1.1 trillion Japanese government pension fund announced late last year that it will shift roughly $181 billion into stocks, including about $86 billion into Japanese equities. The large amounts being allocated to stocks and away from JGBs is another trend that could continue to influence prices regardless of the yen's direction.

Japanese equities are an important component of a well-diversified portfolio

Overall, Japan bears continued attention in the coming months. It is the world's third-largest economy and represents 22% of the MSCI EAFE developed markets index, bigger than the UK, France, and Germany. Japanese stocks are an integral part of any well-diversified investment portfolio. If you are interested in learning more about how international equities, including Japanese equities, fit into a well-diversified portfolio, consult your TIAA-CREF advisor.
