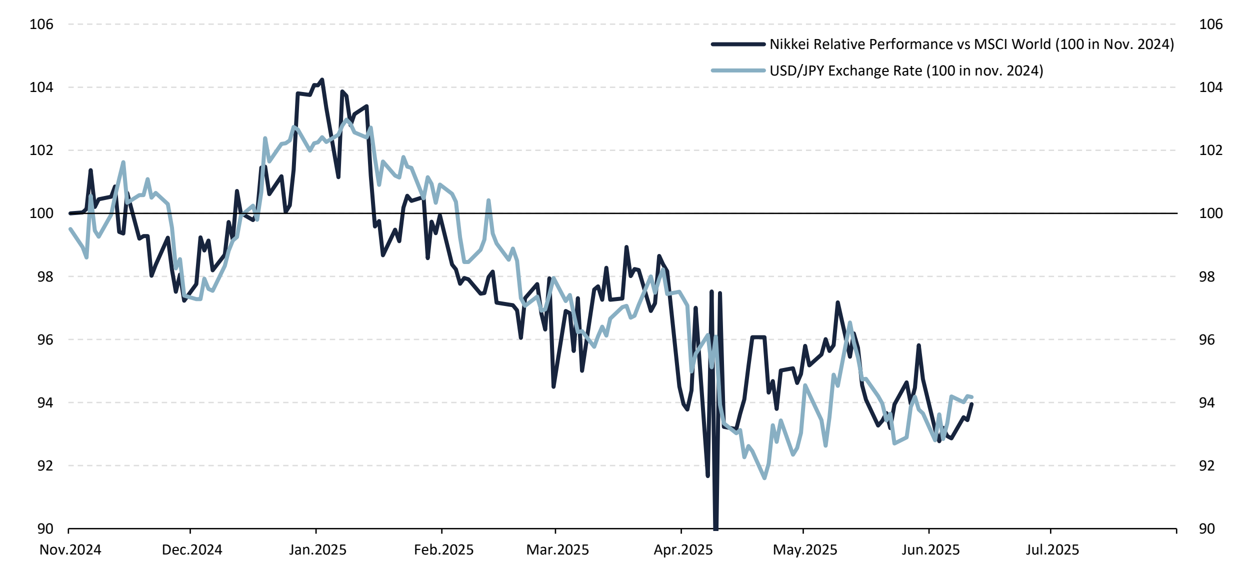
weekly investment focus

The flexiweekly that reaches new heights - published on 16 June 2025

"YEN WEAKNESS WILL GIVE JAPANESE EQUITIES A MAJOR BOOST"

- Investors are looking for alternatives to US equities, without excessive exposure to Europe
- Can the Japanese Nikkei outperform the main world indices?
- The answer can be found in the corridors of the Bank of Japan... and it's a "yes"
- But in order to benefit, it will be necessary to hedge against the depreciation of the yen

CHART OF THE WEEK: "85% correlation between the Nikkei and the exchange rate"

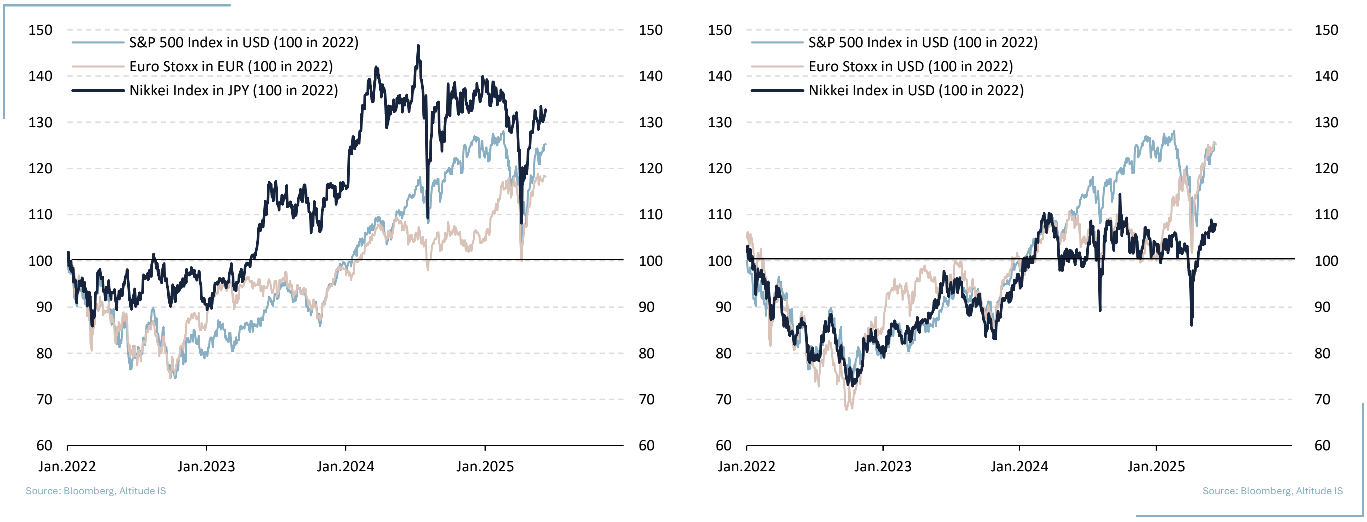


Source: Bloomberg, Altitude IS

FINANCIAL MARKETS ANALYSIS

In 2022 and 2023, Japanese equities significantly outperformed global stock markets. The Nikkei, Japan's main index, reached its highest level for 33 years. **Since January 2024, yen-denominated securities seem to have stagnated.** They are treading water, while the S&P 500 and the Euro Stoxx have risen by almost 20% (see Fig. 2). There are several reasons for this underperformance, such as the government's desire to reduce debt, the increase in key interest rates and the reduction in the Bank of Japan's (BoJ) balance sheet. All these factors have contributed to **the yen's rebound** (see Chart of the Week). The appreciation of the currency, by making exports less competitive, has dampened the prospects for earnings growth and **prevented Japanese companies' share prices from rising.**

Fig. 2 & 3 - Performance of global equities, without and with currency adjustment



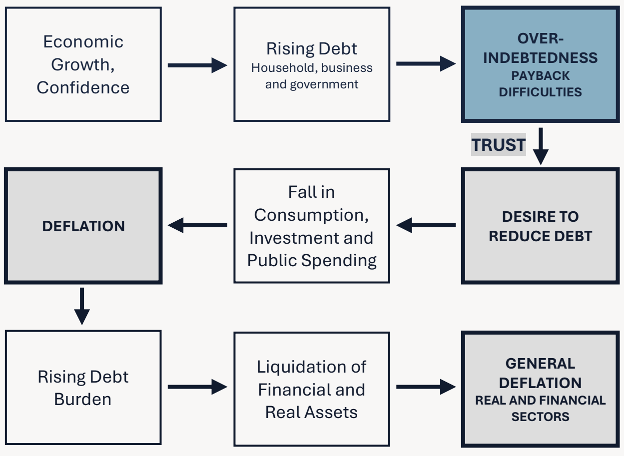
Exchange rate movements are crucial, but they do not explain everything. In common currency terms, the Nikkei has underperformed the S&P 500 and Euro Stoxx by 15% over the past 18 months (see Fig. 3).

- The Japanese macroeconomic context is far less buoyant than it might appear. While the companies that make up the Nikkei are highly dependent on industry, the confidence of Japanese purchasing managers continues to contract for the eleventh month in a row. This sluggishness is weighing on earnings, whose expectations for 2025 have been lowered by 3% since February.
- The sectoral composition of the Japanese index reveals that almost 50% of stocks are directly or indirectly linked to Tech, but that these are mainly manufacturers of hardware and consumer electronics. These companies are much more cyclical than the software platforms that drive Wall Street. While the Magnificent Seven are capturing most of the artificial intelligence boom, the semiconductor cycle in Japan remains sluggish.
- The supply of shares has increased since the Tokyo Stock Exchange ordered Prime companies to reduce their cross-shareholdings and improve their price-to-book ratio. Block sales are on the increase. With more paper to absorb, the Nikkei's multiple has fallen to 18.6x earnings, compared with over 26x for the S&P 500.

To decide whether to overweight Japan in their asset allocation, investors therefore need to keep an eye on these various points, but also make forecasts for the yen. If the currency were to appreciate further, Japanese stocks would continue to underperform. Conversely, if the yen were to fall, Japanese equities would deliver higher returns (provided that exposure to the yen is hedged). This analysis inevitably leads to two key concepts: debt deflation and unconventional money creation by the Bank of Japan (BoJ).

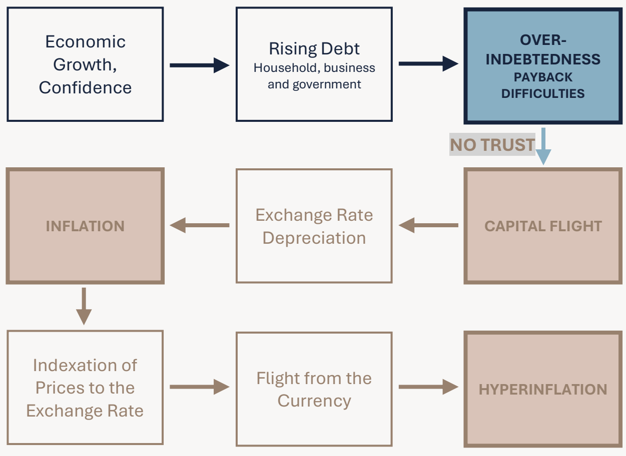
In 1933, four years after the Great Depression, the economist, Irving Fisher, identified the problem of debt deflation. He demonstrated how a process of debt reduction led to a sharp fall in consumption, investment and public spending, and therefore in growth, and how this process was likely to plunge the economy into a deflationary recession. A vicious circle is set in motion because, in a deflationary situation, the real burden of debt mechanically increases, leading economic agents to redouble their efforts to reduce their debt. Then, everything depends on their confidence in the sustainability of this debt. As long as confidence remains, debt deflation will continue (see Fig. 4). If it collapses, the scenario of hyperinflation and devaluation sets in (see Fig. 5).

Fig. 4 - Deflation through debt



Source: Altitude IS

Fig. 5 - Hyperinflation through devaluation



Source: Altitude IS

Deflation: Japanese-style scenario between 1992 and 2020

- Investors continue to have confidence in the State, buying up public debt on a massive scale
- Deflation is sustainable because income is saved rather than invested or consumed
- Growth is stalling, fuelling deflation and the burden of debt
- The currency appreciates, thanks to Purchasing Power Parity (PPP)
- Savers end up liquidating their assets when they themselves become indebted

Devaluation: "emerging country", "1929 crisis", or "Japanese-style since 2021" scenarios

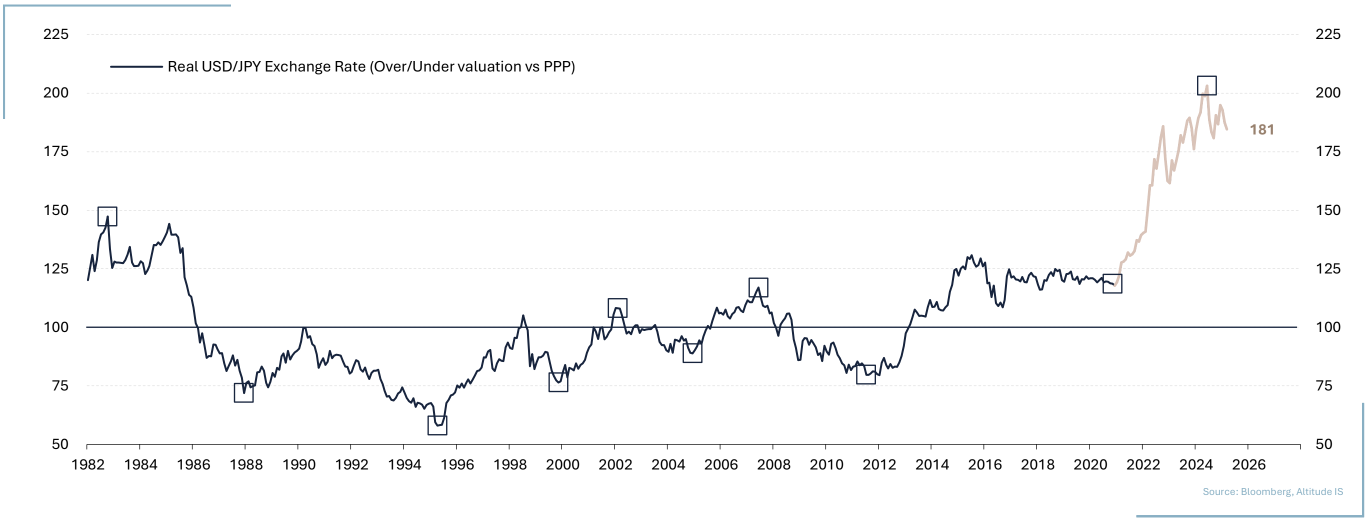
- Investors lose confidence in the State, preferring foreign assets (capital flight)
- The central bank becomes the main buyer of public debt
- The national currency depreciates massively or is devalued
- Hyperinflation is generated by rising import prices and economic uncertainty
- Growth finally rebounds but savers have been cheated

Above a certain level of debt, investor confidence breaks down. They feel that they are running too great a risk of non-repayment, and move away from sovereign bonds (JGBs in the case of Japan). The result of this weak demand is a rise in interest rates. The Japanese Treasury is forced to pay investors more if it hopes to find takers for all its bonds. This rise in the risk premium and the associated rise in interest rates is putting the brakes on the economy: the government is trying to reduce its deficit, companies are no longer borrowing to invest, and households are saving rather than consuming. Recession and deflation set in, making the debt problem even worse.

To remedy this inevitability, the central bank has no choice but to intervene, as its mandate is to keep inflation in positive territory. To do this, it **artificially lowers interest rates through "Yield Curve Control"**. The BoJ prints yen and, thanks to this, buys all Japanese sovereign bonds with yields above a predefined level, 0.1% between September 2016 and March 2021 for example. By doing this, it makes the debt sustainable and encourages investment and consumption rather than savings. In this way, it avoids defaulting on payments while supporting growth in economic activity and prices. The disadvantage of this policy is that it creates major distortions in the markets. **Excessive money printing depreciates the value of the yen.** If, as the saying goes, "everything that is rare is expensive", the opposite is also true, that everything that is abundant is of little value.

Usually, when debt and deflation are self-perpetuating, the currency appreciates. This is what happened between 1992 and 2020 in Japan. The theory of PPP stipulates that the prices of goods and services must be the same everywhere on the planet, otherwise currencies will move to compensate. So, the lower inflation is in a country, the more its currency appreciates. And vice versa. Historically, with price growth lower in Japan than elsewhere, the yen has a natural tendency to appreciate. **This has not been the case since 2021.** If the theory were to continue to apply, then the dollar/yen exchange rate would be 80. Today, the greenback is trading at 145 yen. The exchange rate seems a long way from its equilibrium value (81% above, see Fig. 6). The gap is so wide as to be impressive. **<u>Either this is the opportunity of the century for forex traders, or something has broken in the valuation of the yen.</u>**

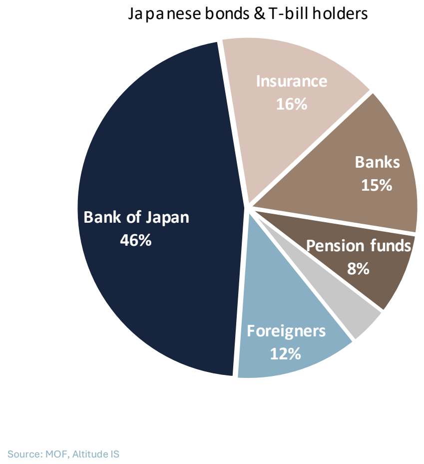
Fig. 6 - Over/undervaluation of the USD/JPY exchange rate

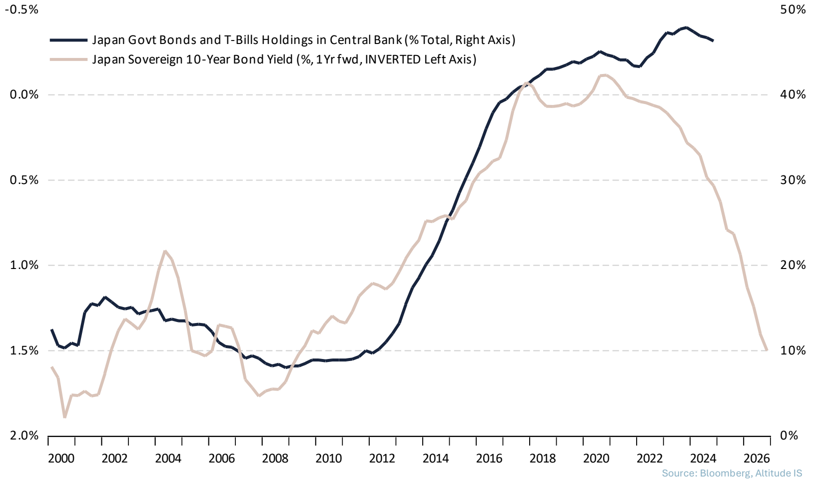


With investors no longer willing to buy Japanese debt, the central bank had to become the buyer of last resort. To do this, it applied an unconventional monetary policy of debt monetisation. Between 2013 and 2023, the BoJ bought a very large proportion of new government issues. In total, it now holds 46% of all Treasury bills and bonds (see Fig. 7), compared with 'just' 10% in 2012. For some years now, it has been seeking to curb or even halt this strategy. Initially, it allowed yields to rise, from 0.1% to over 1.5% for 10-year bonds. This higher return should have attracted private investors: insurance companies, banks, pension funds, investment funds, etc. This did not really work (see Fig. 8). Secondly, the government sought to reduce its public deficit, thereby curbing its need for financing. This has enabled the BoJ to offload some of its Treasury bonds over the past 18 months. As a result, its holdings of JGBs have fallen from 48% to 46%.

The intention to normalise the situation is laudable, but the tensions on the bond market were directly felt, reminding investors that there is nothing natural about the balance on the Japanese market. Without purchases by the BoJ, a veritable "whale" in this ocean of debt, the market is unable to absorb all the sovereign bonds issued on its own. On 20 May, the 20-year auction was so poorly subscribed by bond investors that it triggered a selling rush. Long rates at 20, 30 and 40 years hit all-time highs. A week later, the tension was rekindled when the 40-year auction recorded a bid-to-cover of just 2.21, well below expectations, confirming the mistrust of super-long maturities.

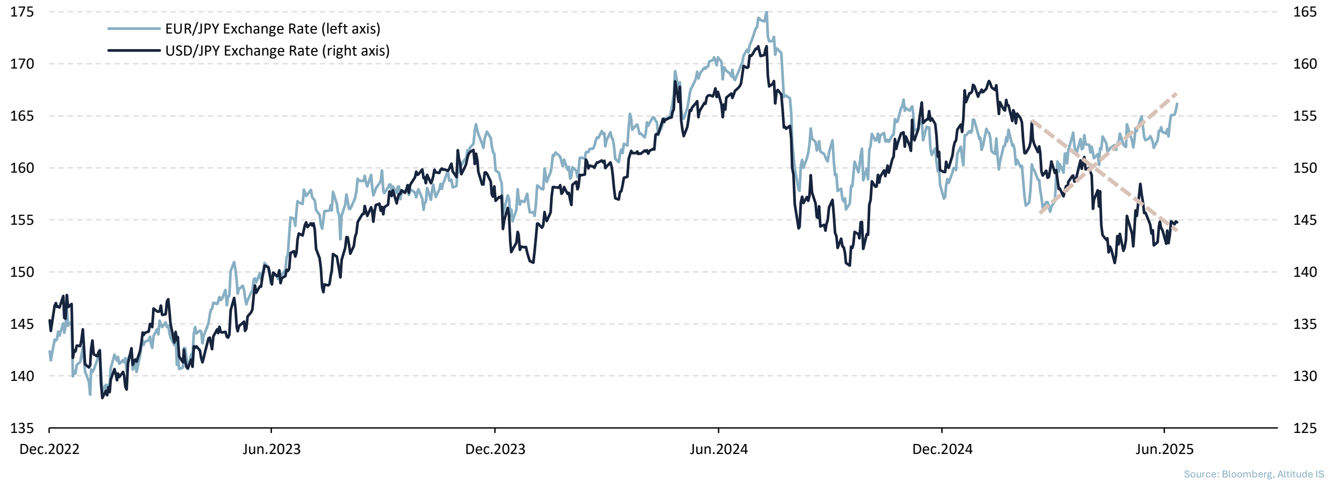
Figs. 7 & 8 - Japanese public debt held by the BoJ and 10-year rates (inverted)s





Faced with this crisis of confidence, the Ministry of Finance has suggested a number of measures. From July, it plans to reduce the quarterly volume of bond issues with maturities of between 20 and 40 years. It is also planning to buy back old bond issues made at low rates. Finally, it wants to launch a new floating-rate bond, indexed to the short-term rate, in the hope of increasing domestic demand. In a recent statement, the Minister stressed "the importance of ensuring a variety of investors as BoJ reduces its purchases". He is bound to succeed because, with debt approaching 250% of Gross Domestic Product (GDP) and an average interest rate of 0.85%, interest charges already account for 9% of government expenditure. If interest rates remain at their current levels, that figure will rise to 15%!

Fig. 9 - Exchange rate of the yen against the dollar and the euro



The Bank of Japan (which is meeting today and tomorrow) will soon have no choice but to reactivate its extraordinary monetary policy tools: quantitative easing and yield curve control. **Without further monetisation of sovereign debt, the probability of a Japanese default and volatility on the bond market**

will continue. This is inconceivable. The time for "fiscal dominance" has come. In this highly likely scenario, the yen will again depreciate sharply. Indeed, traders will have noted that it has not recently appreciated against the dollar, which is intrinsically weakened by the Trump administration's back-and-forth decisions, but that it has already started to fall again against other currencies such as the euro (see Fig. 9).

Conclusion:

Contrary to what it regularly communicates, the BoJ will not be able to normalise its monetary policy by permanently relaxing the "yield curve control" (YCC). Debt monetisation will soon resume. The yen will then embark on a new and powerful phase of depreciation. At that point, we will even have to talk about devaluation. Ironically, Japanese equities (hedged) will therefore have every chance of outperforming global stock indices.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	889.7	61.40	-0.2%	2.4%	6.9%	18.0%	22.8%
USA (S&P 500)	5 977	58.68	-0.4%	1.7%	2.2%	25.0%	26.3%
USA (Dow Jones)	42 198	50.36	-1.3%	0.4%	0.0%	15.0%	16.2%
USA (Nasdaq)	19 407	59.33	-0.6%	2.2%	0.8%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	558.7	44.34	-2.2%	-0.4%	13.4%	10.2%	19.5%
UK (FTSE 100)	8 851	65.00	0.2%	3.3%	10.4%	9.6%	7.7%
Switzerland (SMI)	12 146	44.63	-1.8%	0.1%	7.9%	7.5%	7.1%
Japan (Nikkei)	38 274	54.23	0.2%	-0.9%	-4.3%	21.3%	31.0%
Emerging (MSCI)	1 190	61.20	0.8%	3.3%	12.2%	8.0%	10.2%
Brasil (IBOVESPA)	137 213	53.15	0.8%	-1.3%	14.1%	-10.4%	22.3%
Mexico (IPC)	57 439	49.64	-1.1%	0.9%	18.5%	-11.0%	22.4%
India (SENSEX)	81 634	49.15	-1.3%	0.3%	4.5%	9.6%	20.3%
China (CSI)	3 867	49.77	0.0%	-0.4%	-1.0%	18.2%	-9.1%
Com. Services (MSCI World)	136.4	64.39	-0.6%	5.4%	9.9%	31.9%	38.1%
Cons. Discretionary (MSCI World)	412.5	49.62	-0.4%	-2.0%	-1.5%	20.7%	29.5%
Cons. Staples (MSCI World)	295.7	46.03	-0.7%	2.3%	9.8%	4.7%	3.2%
Energy (MSCI World)	254.3	72.64	5.2%	4.7%	7.9%	2.9%	6.0%
Financials (MSCI World)	199.1	50.98	-1.8%	0.8%	12.6%	25.1%	16.4%
Health Care (MSCI World)	354.7	60.40	1.4%	4.7%	2.6%	1.5%	4.1%
Industrials (MSCI World)	425.6	61.53	-0.9%	2.7%	14.2%	12.8%	22.5%
Info. Tech. (MSCI World)	785.8	64.03	0.0%	2.9%	2.5%	31.9%	51.4%
Materials (MSCI World)	334.5	58.92	0.2%	2.5%	10.8%	-7.7%	12.6%
Real Estate (MSCI World)	993	55.28	-0.1%	2.0%	4.4%	-0.4%	5.3%
Utilities (MSCI World)	180.5	58.09	0.9%	4.0%	14.2%	13.0%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.58%	61.76	0.8%	2.1%	6.1%	-1.7%	5.7%
USA (Sovereign)	4.23%	53.64	0.6%	0.7%	2.6%	0.6%	4.1%
Euro Area (Sovereign)	2.72%	52.82	0.1%	1.0%	0.6%	1.9%	7.1%
Germany (Sovereign)	2.28%	53.50	0.3%	1.1%	-0.4%	0.6%	5.6%
UK (Sovereign)	4.49%	60.37	0.7%	1.0%	2.9%	-3.0%	5.6%
Switzerland (Sovereign)	0.42%	55.42	0.4%	0.9%	0.8%	5.4%	7.9%
Japan (Sovereign)	1.16%	59.28	0.4%	0.4%	-1.1%	-2.1%	0.9%
Emerging (Sovereign)	6.80%	65.39	0.4%	1.2%	4.0%	7.0%	11.0%
USA (IG Corp.)	5.20%	58.04	0.5%	1.0%	2.7%	2.1%	8.5%
Euro Area (IG Corp.)	3.13%	58.61	0.1%	0.6%	1.6%	4.7%	8.2%
Emerging (IG Corp.)	6.63%	67.07	0.3%	0.9%	3.2%	7.0%	6.7%
USA (HY Corp.)	7.42%	71.70	0.1%	0.7%	3.2%	8.2%	13.4%
Euro Area (HY Corp.)	5.62%	71.67	0.0%	0.8%	2.7%	8.2%	12.1%
Emerging (HY Corp.)	8.35%	66.76	0.3%	1.0%	3.9%	14.9%	13.1%
World (Convertibles)	475.6	62.55	-0.4%	1.5%	8.0%	9.4%	12.3%
USA (Convertibles)	622.2	55.05	-0.8%	0.0%	4.0%	10.1%	14.6%
Euro Area (Convertibles)	281.4	61.45	-0.9%	3.6%	20.9%	14.7%	7.3%
Switzerland (Convertibles)	278.9	55.00	0.5%	2.8%	15.8%	-10.5%	5.8%
Japan (Convertibles)	229.0	50.21	-0.5%	0.3%	1.0%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 635	76.88	n.a.	2.2%	1.6%	11.1%	7.8%
Macro	1 321	59.77	n.a.	-0.4%	-1.6%	7.4%	1.6%
Equity Long Only	2 250	66.03	n.a.	5.2%	1.8%	12.0%	15.9%
Equity Long/Short	1 716	74.51	n.a.	3.4%	2.4%	14.0%	7.7%
Event Driven	1 744	74.82	n.a.	2.1%	1.1%	8.7%	7.3%
Fundamental Equity Mkt Neutral	1 695	92.60	n.a.	2.1%	2.6%	12.4%	6.6%
Quantitative Equity Mkt Neutral	1 750	87.18	n.a.	4.5%	5.2%	9.8%	7.8%
Credit	1 633	96.14	n.a.	0.9%	2.3%	8.5%	8.1%
Credit Long/Short	#N/A N/A	100.00	n.a.	0.5%	1.4%	10.0%	11.2%
Commodity	1 899	93.17	n.a.	2.9%	6.1%	14.7%	7.3%
Commodity Trading Advisors	1 275	46.76	n.a.	-1.0%	-5.0%	7.9%	-3.6%
Volatility							
VIX	20.82	53.90	24.2%	14.3%	20.0%	39.4%	-42.5%
VSTOXX	21.73	57.83	24.7%	31.2%	27.8%	25.3%	-35.0%
Commodities							
Commodities (CRB)	560.0	n.a.	-0.2%	2.2%	4.4%	5.1%	-8.0%
Gold (Troy Ounce)	3 422	n.a.	2.9%	6.8%	30.4%	27.2%	13.1%
Silver (Troy Ounce)	36.28	n.a.	-1.3%	12.3%	25.5%	21.5%	-0.7%
Oil (WTI, Barrel)	72.98	n.a.	13.0%	14.6%	1.8%	0.1%	-10.7%
Oil (Brent, Barrel)	75.19	n.a.	10.3%	13.7%	1.5%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	98.10	38.56	-0.9%	-3.0%	-9.6%	7.1%	-2.1%
EUR	1.1557	63.67	1.2%	3.5%	11.6%	-6.2%	3.1%
JPY	144.04	51.15	0.4%	1.2%	9.1%	-10.3%	-7.0%
GBP	1.3570	59.03	0.1%	2.2%	8.4%	-1.7%	5.4%
AUD	0.6495	54.26	-0.3%	1.4%	5.0%	-9.2%	0.0%
CAD	1.3584	71.70	0.9%	2.8%	5.9%	-7.9%	2.3%
CHF	0.8112	62.98	1.3%	3.3%	11.9%	-7.3%	9.9%
CNY	7.1837	57.61	-0.1%	0.4%	1.6%	-2.7%	-2.8%
MXN	18.934	66.19	0.6%	2.8%	10.0%	-18.5%	14.9%
EM (Emerging Index)	1 835.3	71.17	0.2%	1.4%	6.2%	-0.7%	4.8%
XBT	106 551	n.a.	-2.2%	2.7%	13.7%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions — Total Return by asset class (Negative \ Positive Performance)

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