Market Letter

Is TOPIX Overvalued at the Upper Bound of Its PER Range?

It may be justifiable when viewed through the lens of the market cycle

October 17, 2025

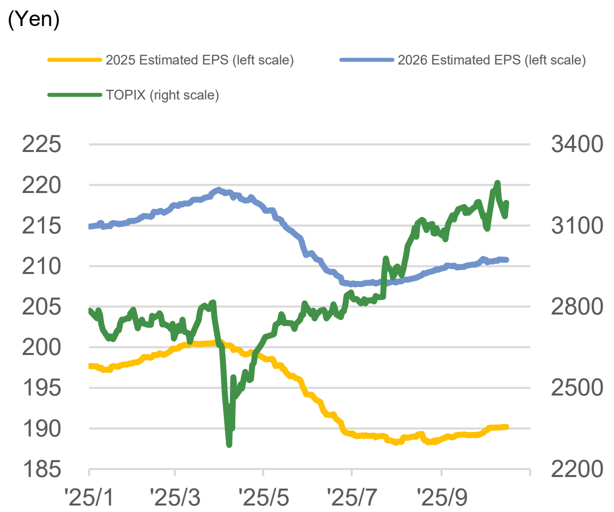
Driven by the recent equity rally, TOPIX valuations have reached the upper bound of their historical range

The rise in Japanese stocks continues, driven by the expansion of PER. During the recovery phase following the sharp decline in early April, stock prices rebounded despite downward revisions in TOPIX estimated EPS. Although estimated EPS bottomed out in July, its recovery remained sluggish, and the estimated EPS for this fiscal year was flat compared to the previous year (with company projections indicating a decline in profits). Nevertheless, stock prices continued to rise unabated. Since September, expectations for domestic politics, coupled with positive news related to AI, have pushed stock prices even higher, with TOPIX estimated PER breaking through the upper range limit. While we are still swayed by political developments, it is time to take a step back and consider the current valuation levels.

Despite the lackluster corporate earnings, stock prices are rising and hitting new highs, raising the question of whether this situation lacks justification. Should the valuation at the upper range limit be seen as a signal that future upside is limited or that downside risk is high?

High valuation levels are vulnerable to shocks, posing significant downside risks; however, there is no need for excessive caution. It is essential to consider the forward-looking nature of the stock market and its market cycles when evaluating PER. Depending on the market environment, stock prices may have a high correlation with current corporate earnings or look ahead to future prospects.

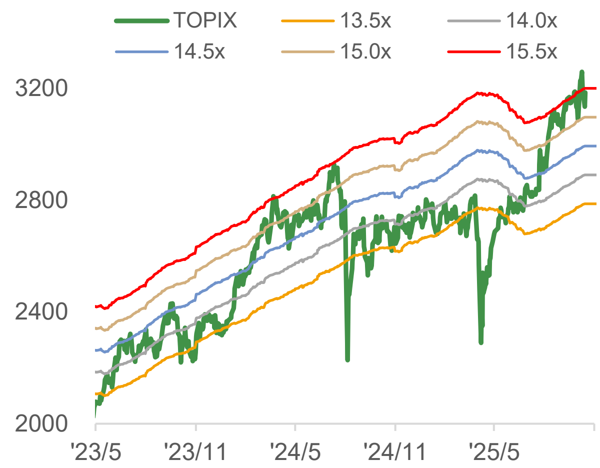
Despite the downward revision of EPS forecasts from April to June and sluggish recovery from July onwards, TOPIX has continued to rise



※Latest value as of October 15

Source: FactSet; Compiled by Daiwa Asset Management

TOPIX is surpassing the upper limit of the estimated PER range



※ 12-month forward PER valuation band, latest value as of October 15

Source: FactSet; Compiled by Daiwa Asset Management

In Turning Points, Stock Prices Recover Amid Continued Downward Revisions to Earnings Outlook

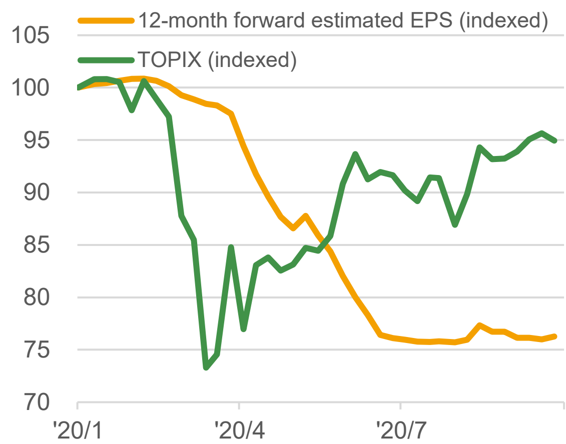
Just as in April–June this year, it is not unusual to see equities recover even when near-term corporate earnings are lackluster. When the market transitions from a sell-off accompanied by deteriorating earnings to a sustained uptrend, it is actually typical for share prices to rebound on a valuation-led basis even as earnings forecasts are being revised downward. Because equity markets are forward-looking, even if near-term earnings are weak, once confidence in the subsequent earnings recovery strengthens, the market begins to price in post-recovery earnings. As a result, the commonly used 12-month forward estimated PER can move outside its usual range, but that does not necessarily imply the market is expensive.

For example, in 2020, TOPIX plunged from early February through mid-March due to COVID-19 but then rebounded and continued to rise even as 12-month forward estimated EPS was repeatedly revised downwards. The post-Lehman recovery phase in 2009 showed the same pattern.

By contrast, during the Abenomics rally from autumn 2012 onward, estimated EPS was revised up gradually—unlike the prior two episodes—yet the market swiftly priced in economic and earnings improvements driven by the "three arrows," and estimated PER rose well above its usual range.

In every case, the advance in share prices was led by expansion of the estimated PER; after rising beyond the range, the PER normalized and returned to within the range. During that normalization, PER contracted, but increases in estimated EPS provided support, allowing prices to maintain their upward trend. At present, TOPIX's 12-month forward estimated PER is in the mid-15x area; using FY2026 estimated EPS, the PER remains in the 14x range. If this simply reflects the typical market cycle during a recovery phase, there is little need to be overly concerned about the current valuation level.

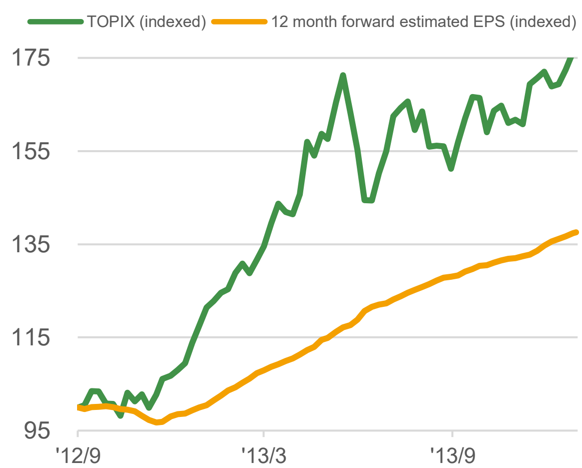
In the case of 2020, TOPIX rebounded despite downward revisions in estimated EPS



※ TOPIX and TOPIX estimated EPS indexed with January 2020 as 100

Source: FactSet; Compiled by Daiwa Asset Management

In the case of 2012-13, TOPIX rose driven by PER in anticipation of forecasted EPS improvement



※ TOPIX and TOPIX Estimated EPS are indexed with September 2012 as 100.

Source: FactSet; Compiled by Daiwa Asset Management

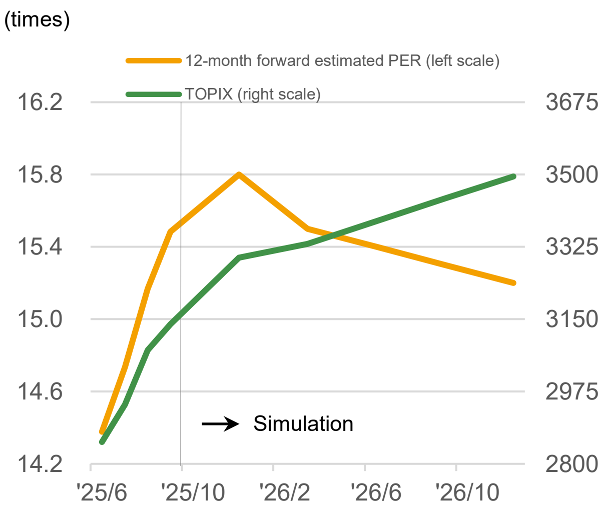
Simulating the Price Movements of TOPIX and Estimated PER

Some may question whether share prices can rise even as the estimated PER compresses. Assuming the EPS growth envisaged by consensus is realized and that the PER gradually reverts toward its historical range, we simulated how TOPIX would evolve under such a path.

Provided macroeconomic, political, and geopolitical uncertainties do not intensify, and taking into account expectations for domestic reforms, we view a 15.0–15.5x range for TOPIX's PER as reasonable. Conditional on solid interim results and a strengthening of confidence in next-fiscal-year earnings forecasts, we assume the 12-month forward estimated PER edges up modestly into year-end, reaches the upper end of the range (15.5x) by end-March 2026, and then eases to 15.2x by end-2026. Under this assumption set, TOPIX would be around 3,300 / 3,500, implying a gentle upward trajectory in prices. If macro or earnings uncertainty were to rise, it would be difficult to maintain an estimated PER of 15x; and if earnings forecasts are disappointing, downward revisions to EPS would translate into lower prices. Thus, this analysis does not guarantee gains. However, based on a scenario that appears relatively reasonable at present, it suggests that even as the PER normalizes, a healthy rise in share prices remains plausible.

There is also a more constructive interpretation of the recent expansion in the estimated PER. Against the backdrop of structural changes—domestic inflation and governance reforms—investor perceptions of Japanese equities may be shifting, lifting TOPIX's PER trading range. We frame this as an upside risk scenario, but if positive developments in domestic politics persist, governance reform continues to advance, TOPIX's ROE—stagnant in recent years—improves, foreign investors grow less skeptical about Japan's changes, and household financial assets keep rotating from deposits into equities, this outcome is not out of the question. If the PER were to reach 16.3x by end-2026—the peak seen in 2015 during the early Abenomics phase (excluding 1H 2013)—TOPIX could climb to near 3,800. While this may look somewhat optimistic at present and warrants further confirmation of these shifts, it is a right-tail risk worth keeping in mind.

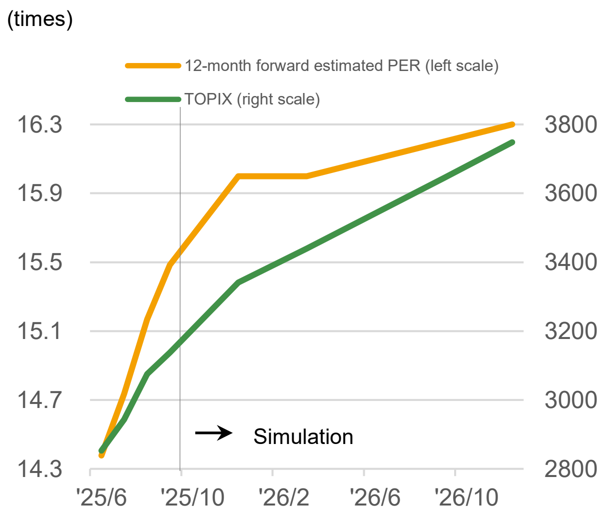
TOPIX Simulation Anticipating Normalization of Estimated PER



※ Simulation projecting up to December 2026

Source: FactSet; Compiled by Daiwa Asset Management

TOPIX Simulation Assuming Upward Shift in Estimated PER Range



※ Simulation projecting up to December 2026

Source: FactSet; Compiled by Daiwa Asset Management

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