Chief Strategist
Kazunori Tatebe

Middle East Situation and the Outlook for Japanese Equities

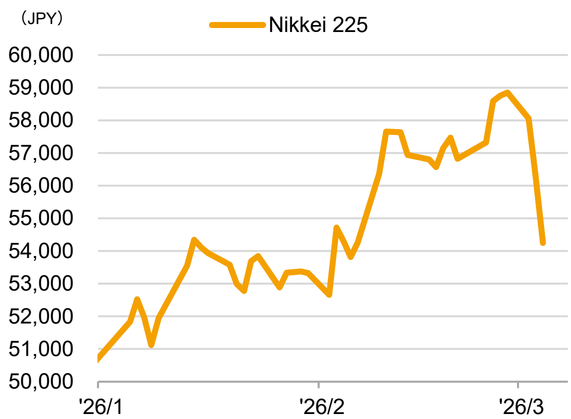
Two-Sided Short-Term Risks, Improving Medium-Term Risk-Reward

Japanese Stocks Slide Sharply as Middle East Tensions Escalate

The Japanese stock market continues to experience high volatility amid worsening Middle East tensions.The Nikkkei 225 fell 7.8% over three trading days from the start of the week through Wednesday, March 4, before rebounding 1.9% on Thursday. The price movements were historically significant: the March 4 decline of ¥2,033 ranked as the fifth-largest single-day drop on record, while the three-day decline rate was the 17th-largest since 2010, placing it in the 0.4th percentile for stock returns over that period.

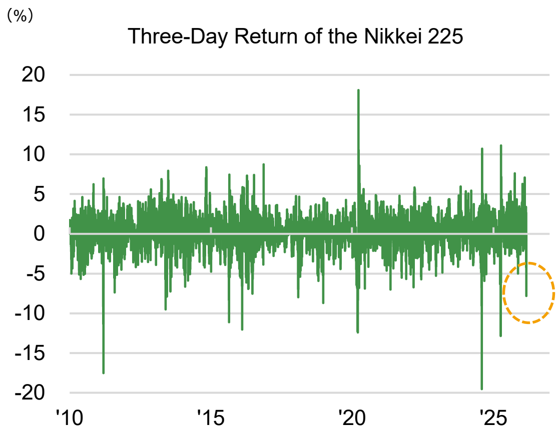
Despite reports over the weekend of the US and Israel (hereafter, the US and its allies) launching attacks on Iran, prompting retaliatory action by Iran, and the effective blockade of the Strait of Hormuz, Japanese stocks opened the week lower but surprisingly resilient. However, they plunged sharply on Tuesday. Initially, the market seemed to favor a scenario where the conflict would resolve quickly, likely influenced by the US-led decapitation operation targeting Supreme Leader Khamenei and military leaders, along with the overwhelming military strength and progress of the operation. However, it now appears the market is increasingly anticipating a scenario where the conflict becomes more protracted. Simultaneously, the recent sharp stock decline appears significantly influenced by position adjustments.

Nikkei 225 Records Its Fifth-Largest Single-Day Decline on March 4



※ Latest value: March 4, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Early-Week Market Moves Rank Among the Largest on Record



※ Latest value: March 4, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

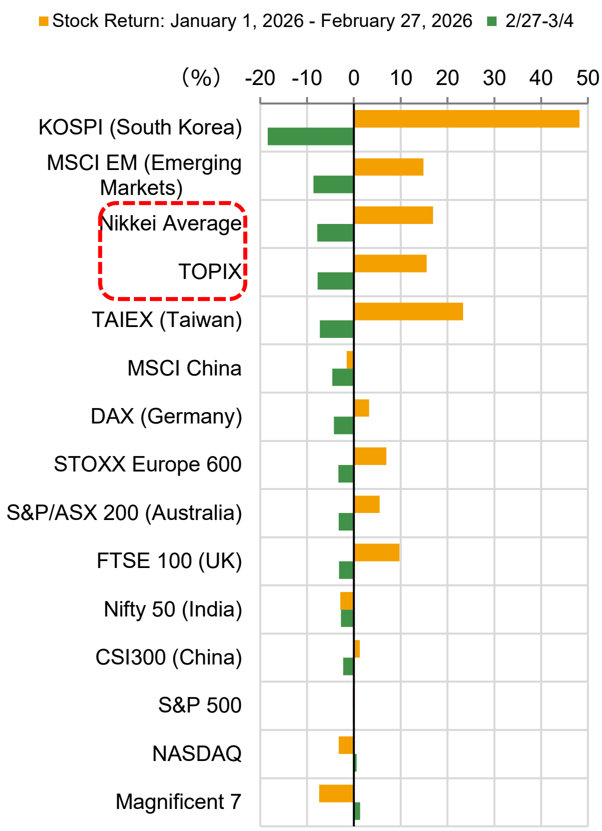
Positioning Also a Major Factor Behind the Sharp Sell-Off

If the prolonged scenario becomes reality, it is bad news for Japanese stocks, which tend to underperform during periods of high crude oil prices. However, the sharp decline in Japanese stocks over the past few days could also be interpreted as not necessarily reflecting the market anticipating a severe situation.

Looking at major stock indices, those with larger year-to-date gains saw steeper declines in the first half of this week. The Japanese stock market also saw a significant negative stock price momentum factor, indicating a pronounced reversal. This means stocks that had risen sharply previously were sold off most aggressively. Amid heightened uncertainty and accelerating declines, investors holding unrealized gains likely moved to lock in profits, while others reduced their positions.

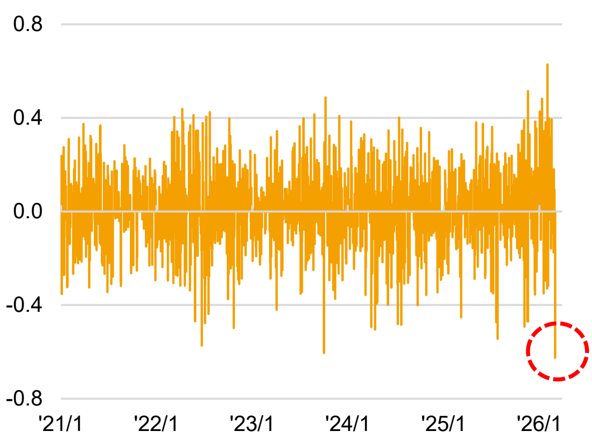
This can also be confirmed by comparing the price movements of Nikkei futures and Brent crude oil futures. The price movement of Nikkei futures on the 3rd was significantly larger than that of crude oil futures, indicating a decline exceeding the impact of fundamentals. Following the decline through the 4th, investor positions in Japanese stocks are likely to have been somewhat cleaned out.

Higher YTD Performers Suffered Larger Early-Week Losses



Source: Bloomberg; Compiled by Daiwa Asset Management

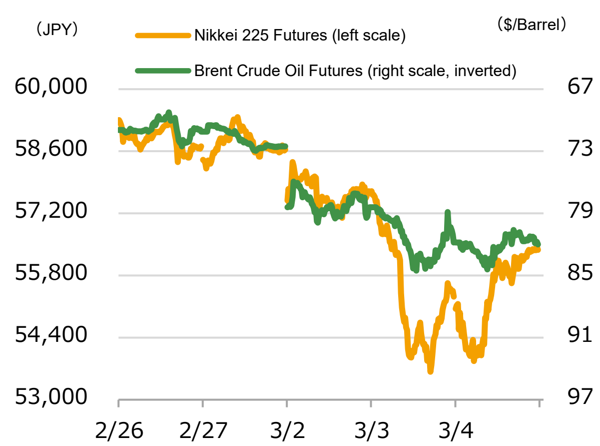
6-Month Momentum Daily IC Turns Most Negative Since 2021



※ IC = Information Coefficient, Latest value: March 4, 2026

Source: FactSet; Compiled by Daiwa Asset Management

Nikkei 225 Futures vs Brent Crude Oil Futures



※ Latest value: March 5, 6:00

Source: FactSet and Bloomberg; Compiled by Daiwa Asset Management

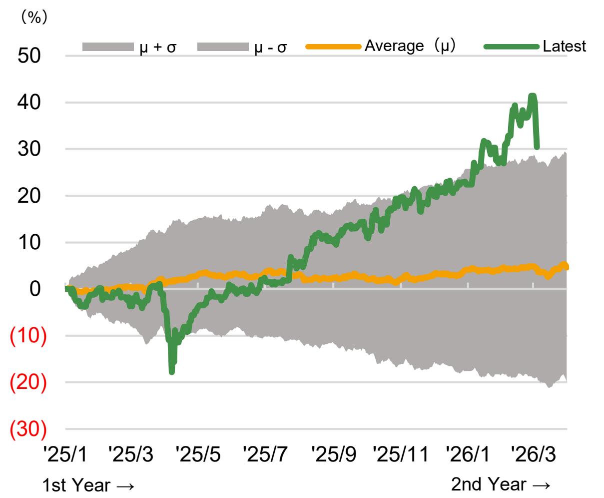
Rising Japanese Stock Prices and Valuation Re-Rating

The steeper the year-to-date gain, the harder the sell-off In the global equity markets earlier this week, Japanese stocks, which had shown strong gains since the start of 2026, saw particularly sharp declines. It should be noted, however, that this year is not the only one in which Japanese stocks have shown robust gains. The TOPIX's year-to-date gain since early 2025 stood at 41% as of February 27, just before the US-led attack on Iran, representing strong stock performance even by the standards of the past 35 years. Its gain since early 2023 reached 108%, suggesting profit-taking pressure was likely to build.

During the stock rally since late last year, the TOPIX valuation continued to expand, surpassing the upper limit of its historical range. We believe it is reasonable for the TOPIX valuation range to shift upward, considering structural changes such as the shift to inflation and governance reforms. Furthermore, considering the Liberal Democratic Party's landslide victory in the House of Representatives election in early February and the accompanying positive political developments, we also believe even higher valuations are justified. However, as we have pointed out in past reports, high valuation levels also imply vulnerability to unexpected shocks, which is likely one reason for the larger decline.

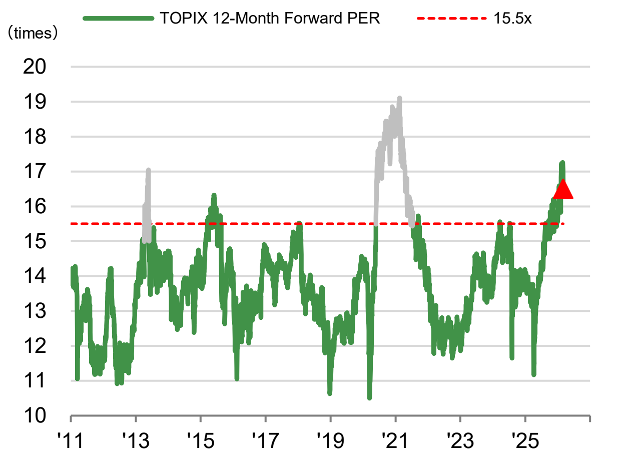
Our view on TOPIX valuations remains unchanged. Amid high expectations for the government's growth strategy, if structural changes progress at the macro, micro, and supply-demand levels, the premises for considering valuations will change from before, justifying higher valuations than previously. While valuations are likely to face pressure amid ongoing tensions in the Middle East, we expect them to recover towards pre-conflict levels when tensions ease.

TOPIX Stock Performance Over the Past 35 Years



※ The most recent data is from January 2025 onwards, with the latest value as of March 4, 2026
σ represents standard deviation
Source: FactSet; Compiled by Daiwa Asset Management

Rerated Japanese Stocks Valuations Left Markets Vulnerable to Shocks



※ The gray lines indicate the unique environments of the early Abenomics period and the COVID-19 period. The red ▲ marks the latest value as of March 4, 2026.
Source: FactSet; Compiled by Daiwa Asset Management

Japanese Stocks in a High Oil Price Environment

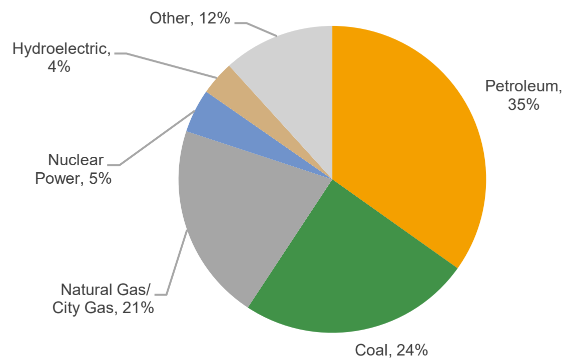
During periods of high crude oil prices, Japanese stocks often face strong headwinds and tend to underperform other major stock indices. Japan, which is poor in natural resources, relies heavily on imports for its energy supply, with an energy self-sufficiency rate of 13% (FY2022), making a price hike in energy prices a significant downward pressure on the economy. Oil accounts for 35% of Japan's primary energy supply mix, but the country relies on imports for 99.7% of its crude oil, with approximately 95% sourced from the Middle East.

In the stock market, sectors benefiting from a price hike in energy prices represent a small share of the market in terms of both market cap and profits. Consequently, price hikes generally act as a headwind for corporate earnings. Beyond industries directly impacted by rising fuel and input costs, a broad range of companies face headwinds from higher electricity costs, logistics expenses, and inflationary pressures. Furthermore, a 10% increase in Brent crude oil is expected to reduce Japanese companies' net profits by approximately 1-2%.

When Russia's invasion of Ukraine occurred in 2022, the Yen weakened in tandem with a price hike in crude oil prices in the foreign exchange market, supporting Japanese stocks. However, the situation is different now, with the Yen at historically weak levels. Concerns about currency intervention are heightened, and the negative economic impact of Yen depreciation is more readily recognized. Not only will the shift to positive real wages be delayed, but concerns about the Bank of Japan's delayed policy response due to upward inflation pressures could also rise, posing risks of accelerating long-term interest rates and further Yen depreciation.

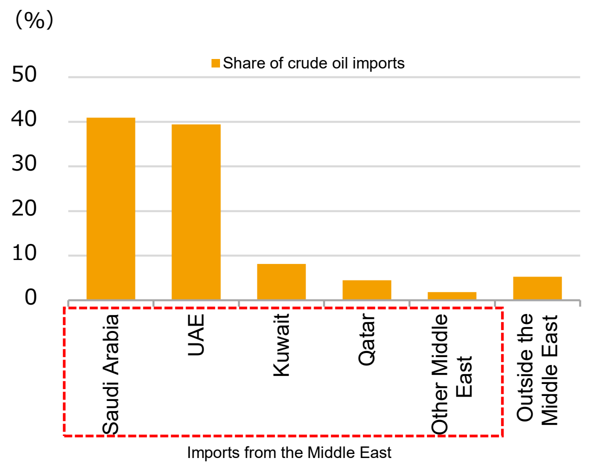
If the conflict prolongs and crude oil prices remain persistently high, headwinds for Japanese stocks will intensify.

Japan's Primary Energy Supply Mix



※ FY2024 Preliminary Figures
Source: Ministry of Economy, Trade and Industry; Compiled by Daiwa Asset Management

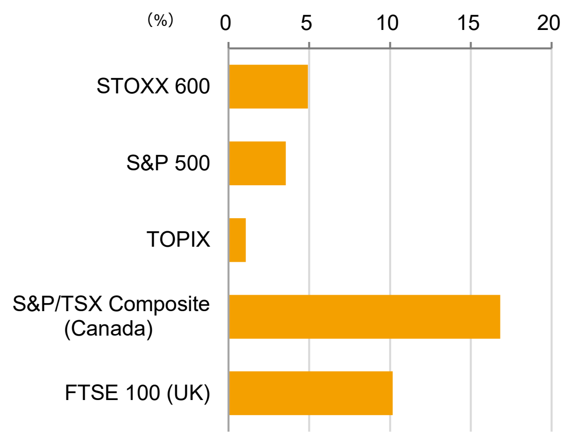
Crude Oil Import Dependence: 99.7%



※ Fiscal Year 2023

Source: Ministry of Economy, Trade and Industry; Compiled by Daiwa Asset Management

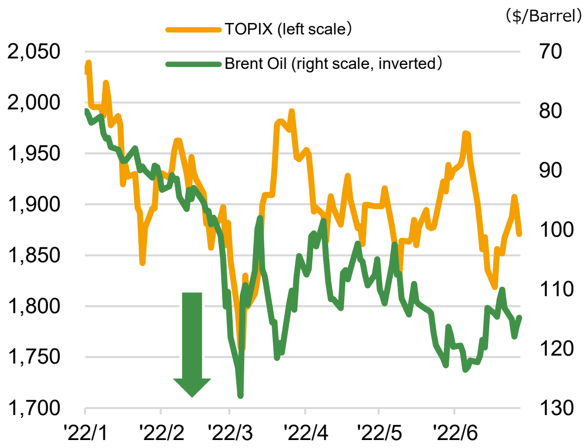
Energy Sector Weight in Stock Indices



※ As of March 4, 2026

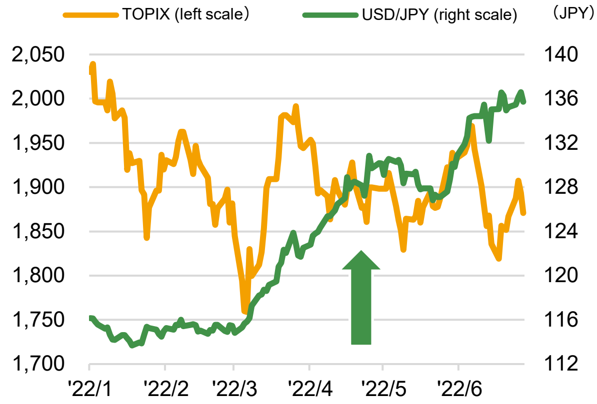
Source: Bloomberg; Compiled by Daiwa Asset Management

Yen Weakness Supported Japanese Equities in 2022—But Not This Time



※ January 1 - June 30, 2022

Source: Bloomberg; Compiled by Daiwa Asset Management



※ January 1 - June 30, 2022

Source: Bloomberg; Compiled by Daiwa Asset Management

Outlook for Japanese Stocks: Short-Term Resolution Scenario vs. Prolonged Conflict Scenario

From the perspective of the Japanese stock market, the key factors to consider regarding the Middle East situation are crude oil prices and the escalation of the conflict. A price hike in crude oil prices acts as a headwind, but its impact remains limited in the short term. Ultimately, the focus is on whether the conflict will resolve quickly or escalate further and become protracted.

In the near term, both the possibility of the conflict calming down and the possibility of it intensifying exist, requiring careful monitoring of developments. Depending on news headlines, stock prices could rebound sharply or resume testing lower levels. Short-term risks exist on both sides, making predictions difficult. High volatility is likely to persist. Even assuming an optimistic scenario of short-term resolution, the timeframe is likely weeks rather than days. Naturally, uncertainty surrounding this timeframe remains high, and the situation is fluid.

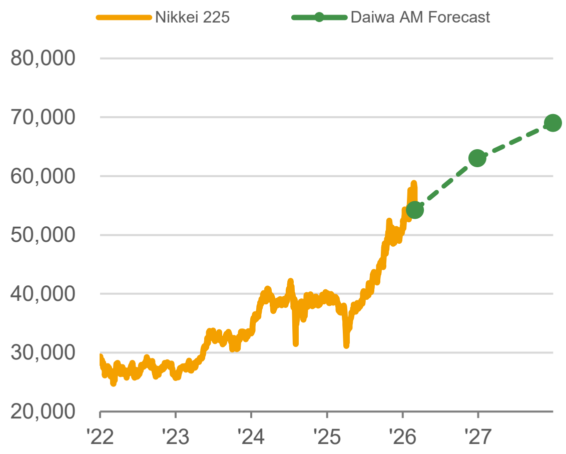
On the other hand, we believe the medium-to-long-term risk-reward balance has improved following this week's sharp decline. While predicting the conflict's outcome is difficult, the likelihood of it resolving within a few weeks appears higher than the prospect of intense fighting lasting several months. Reports suggest Iran's stockpile of ballistic missiles and drones is diminishing, while the US and others are also reported to have limited weapon reserves, making it difficult to sustain attacks at the current pace over the long term. While the apparent lack of a clear exit strategy for the US is a cause for concern, the reluctance to deploy ground troops, coupled with the negative stance of President Trump's MAGA supporters towards foreign conflicts, suggests a high probability that the conflict will be brought to a close within the next few weeks, with the timing carefully chosen..

A scenario involving prolongation and intensification remains possible. However, even in such a case, unless we assume prolonged high crude oil prices will trigger a global recession, we expect the medium-to-long-term bull market for Japanese stocks to continue, supported by positive factors like structural changes and the government's growth strategy. While risk scenarios, such as Brent crude rising to $130/barrel, are also projected, vigilance against tail risks remains essential.

Japan holds 254 days' worth of oil reserves, including both government and private stocks, ensuring no immediate concerns regarding crude oil supply. The global crude oil market is considered to have significant excess production capacity. Therefore, unless the conflict prolongs, the impact on the global economy and global stock markets via high crude oil prices will remain limited.

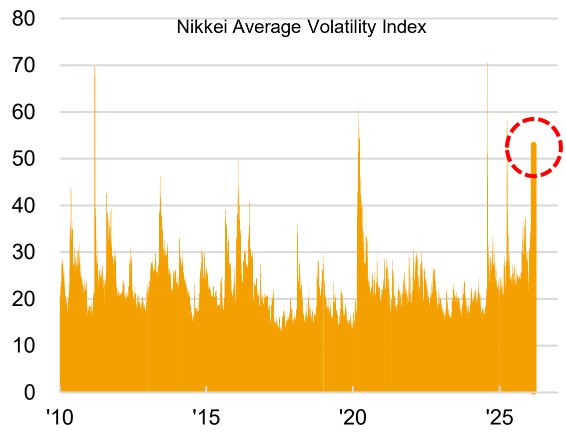
While developments in the Middle East could prompt a reassessment, at this point, we believe Japanese stocks will resume their upward trajectory as tensions ease. We therefore maintain our Nikkkei 225 forecasts of ¥63,000 for the end of 2026 and ¥69,000 for the end of 2027. While the timing of de-escalation needs to be monitored, medium- to long-term conditions are increasingly approaching a potential buying opportunity.

Nikkei 225 Forecast Maintained Despite Fluid Conditions



※ Latest actual value: March 4, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Nikkei 225 VI Jumps Sharply—Post-Spike Rebounds Are Common Historically



※ Latest value: March 4, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Important Information

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