

Chief Strategist  
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## Update on the Middle East Situation and the Japanese Stock Market

Assessing Upside and Downside Risks

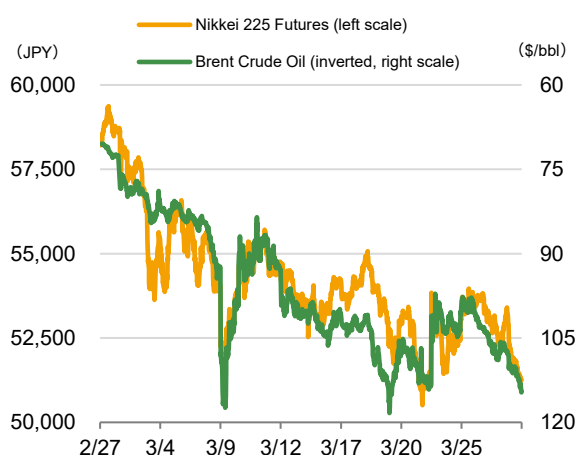
### Volatile Trading Conditions Persist

Japanese stocks have continued to move in tandem with crude oil prices, resulting in an unstable trend. The Nikkei 225 fell to 50,688 Yen during trading on March 23, with the decline since the start of the month reaching 13.9%. Subsequently, as signs of de-escalation began to emerge, the index briefly recovered to the 54,000-Yen level, but during the morning session on March 30, it fell below 51,000 Yen once again. The Nikkei Volatility Index continues to hover at a high level around 40 points, indicating that the market remains on high alert.

In the Japanese stock market, not only the indices but also sector-wise stock selection trends are fluctuating significantly in response to developments in the Middle East and shifts in risk sentiment. Factor performance, particularly in areas such as stock price momentum and beta, has been highly volatile, with frequent movements of 3-5 standard deviations ( $\sigma$ ). Based on daily data since 2012, movements of  $3\sigma$  or  $4\sigma$  represent large price swings that occur only once every 1.5 years or 60 years, respectively. When the situation in the Middle East deteriorates and stock indices plummet, stocks that have shown notable gains in recent months, as well as high-beta and cyclical stocks, are heavily sold off. Conversely, when stock indices rebound due to positive news, these same groups of stocks tend to see the highest price increases.

A comparison of changes in Brent crude oil prices and the TOPIX since the beginning of the month shows that for every 10% increase in crude oil prices, the TOPIX tends to fall by roughly 2%. We estimate that a 10% rise in Brent crude oil prices would reduce the net profits of Japanese companies by approximately 1–2%. Although stock price volatility is high, the price movements themselves can generally be assessed as aligning with fundamentals. That said, given the presence of both upside and downside risks relative to these estimates, it is important to monitor the impact closely.

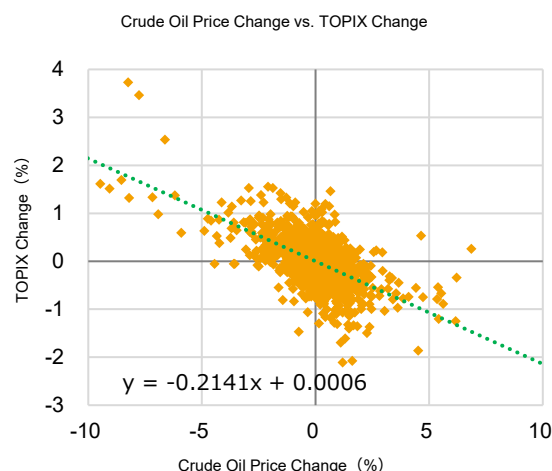
#### Japanese Stocks Remain Highly Volatile in Tandem with Crude Oil Prices



※ Latest figure as of March 28, 2026, 6:00 a.m.

Source: Bloomberg; Compiled by Daiwa Asset Management

#### TOPIX Tends to Fall by 2% for Every 10% Increase in Crude Oil Prices



※ Hourly price changes from February 27 to March 27, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

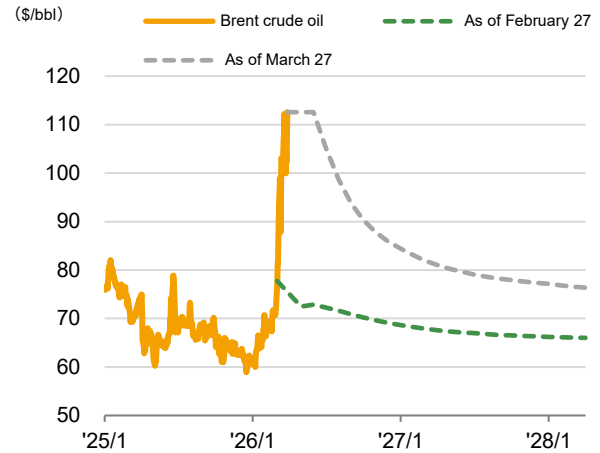
## Analysis of the Impact on FY2026 Earnings

As mentioned earlier, we estimate that a 10% increase in Brent crude oil would reduce the net profits of Japanese companies by approximately 1–2%; however, this estimate assumes that oil prices remain at that level. In other words, from the perspective of corporate earnings, it is the annual average price—not short-lived spikes—that is significant.

The chart on the upper right shows the future price trends (pricing) implied by the crude oil futures market as of the end of February 2026 and as of the present (March 27). While prices are significantly higher at both points in time compared to last month, a decline in crude oil prices is priced in toward year-end. However, this is merely the current pricing, and there is a high probability that, as conditions deteriorate, the entire forward curve will shift to price in higher levels and a more prolonged period of elevated crude oil prices.

Brent crude oil, which averaged \$78/bbl in FY2024, was expected to fall to around \$68 in FY2025, remain at that level in FY2026 as of the end of February, and decline slightly further in FY2027. Under this assumption, the projected EPS growth rate for the TOPIX in FY2026 was 14%. Based on the current Brent crude oil forward curve, the average for FY2026 is \$91. Under this assumption, the projected EPS growth rate for the TOPIX declines to 5%. If the average Brent crude oil price is \$100, projected EPS would show a slight year-on-year increase; if \$120 is assumed, it would result in a decline of approximately 5%. We assume a crude oil price of around \$80—slightly below current market pricing (as of mid-March)—in which case we expect earnings growth of just under 10%.

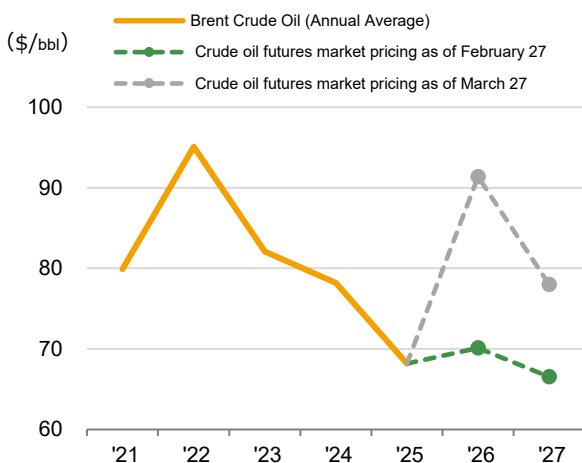
### Oil Price Outlook Implied by the Futures Market



※ The most recent actual figure is as of March 27, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

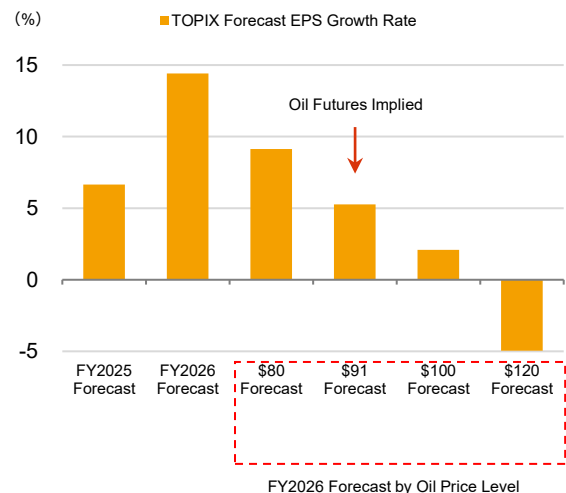
### Average annual Brent crude oil price



※ FY2025 figures are year-to-date averages as of March 27, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

### Brent Crude Forward Curve Implies 5% EPS Growth for TOPIX in FY2026



※ FY2025 and FY2026 consensus forecasts

Source: FactSet; Compiled by Daiwa Asset Management

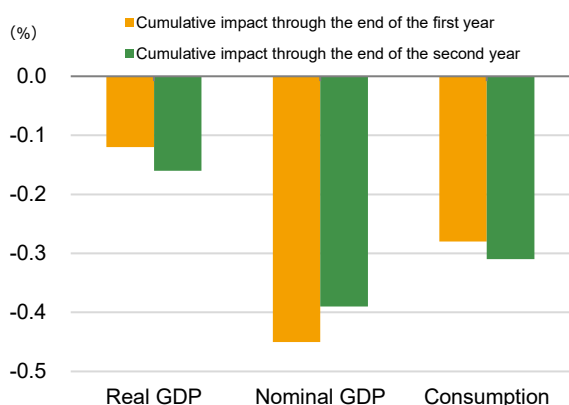
## Downside Risks to Earnings Simulations

The projected TOPIX EPS growth rates for FY2026 by Brent crude oil price level discussed in the previous section are based on a linear simulation using our estimated sensitivities; however, in reality, as the rate of price increase in crude oil prices rises and as conflicts and supply constraints persist over the long term, the impact may expand in a non-linear manner. Moreover, this simulation assumes all other conditions remain constant; if crude oil prices were to rise sharply, a wide range of conditions would likely change, making the overall impact more complex.

For example, higher crude oil prices would be expected to erode real disposable income through inflation, putting downward pressure on the economy as consumption slows. According to the Cabinet Office's macroeconomic model, if crude oil prices (in US Dollars) increased by 20%, consumption will decline by 0.28% after four quarters and by 0.31% after eight quarters, while real GDP will decline by 0.12% after four quarters and by 0.16% after eight quarters. An economic slowdown will dampen corporate top-line growth and weigh on earnings. The government's resumption of subsidy measures to curb gasoline prices provides some degree of support. On the other hand, while companies were previously reluctant to pass on higher costs to prices in a deflationary environment, their pricing behavior has become more aggressive in recent years, raising the possibility that the headwinds to consumption could be stronger than in the past. Although real wages are expected to turn positive and stabilize this year, a prolonged period of elevated crude oil prices would represent a yellow flag.

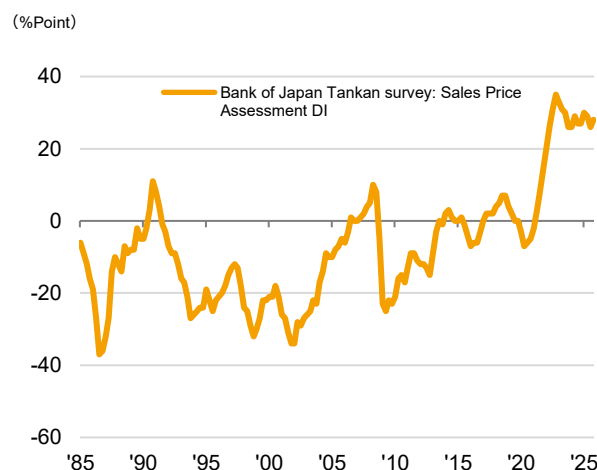
Furthermore, with supply currently constrained by the de facto closure of the Strait of Hormuz, as the conflict drags on, the issue will shift from soaring prices to production constraints. In the near term, responses are expected to rely on inventory and the release of strategic reserves, however, over time, physical production constraints could emerge, potentially forcing companies into production cuts or shutdowns. Beyond crude oil, the Middle East holds 40% of the global market share for urea, 40% for naphtha, and 30% for helium. Regarding petroleum, as of the end of February 2026, Japan held a combined total of 254 days' worth of oil reserves across government and private-sector stockpiles, suggesting no immediate cause for concern; however, inventory and reserve levels vary significantly depending on the product (note that the release of 45 days' worth of crude oil has been decided). Domestic inventory days for naphtha—a basic raw material derived from crude oil, 40% of which is sourced from the Middle East—are estimated to be around 20 days, and petrochemical companies are reducing ethylene production, which uses naphtha as a feedstock (however, the government expects to secure approximately two months' worth of inventory through the release of strategic petroleum reserves and imports from outside the Middle East).

### Impact on the Japanese Economy of a 20% Increase in Oil Prices (USD Terms)



※ Based on the Cabinet Office's macroeconomic model  
Source: Cabinet Office data; Compiled by Daiwa Asset Management

### More Aggressive Corporate Pricing Behavior



※ Large enterprises; all industries; actual results. Latest data as of December 2025  
Source: Bank of Japan; Compiled by Daiwa Asset Management

Inventories of crude oil-derived intermediate materials, such as resins, are sufficient for about two months; if the conflict drags on until around June, it could affect the production of a wide range of products, including daily necessities. Since resins are widely used in the automotive industry, there are also concerns about the impact on finished vehicle output. Petroleum-derived raw materials are also used in detergents, food packaging, plastic products, apparel, home appliances, tires, and building materials.

Asian countries are particularly vulnerable to supply constraints resulting from a de facto blockade of the Strait of Hormuz. While they rely heavily on the Middle East for energy supplies, many do not maintain oil reserves as substantial as Japan's, raising the possibility of earlier disruptions to energy supplies. There are also concerns that Japanese companies' local factories may be unable to operate, or that disruptions in the operations of local business partners could lead to supply-chain disruptions. Furthermore, if the local economy slows down, sales to the region would decline.

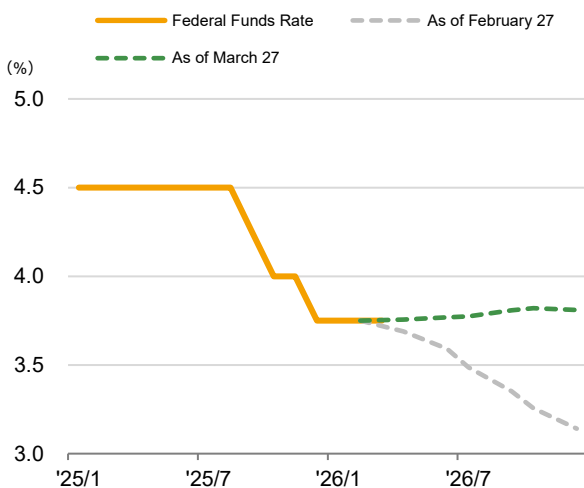
On the other hand, the fact that navigation through the Strait of Hormuz is currently possible, albeit on a limited basis, together with the availability of alternative routes and supplies from other regions, serves as a positive factor relative to a scenario in which navigation through the Strait of Hormuz and the broader Middle East region is completely cut off

## Inflation-Driven Hawkish Shift by Central Banks and Recession Risks

Concerns are growing over stagflation, a scenario where inflation and economic slowdown occur simultaneously. In mid-March, major central banks, including the Federal Reserve (the Fed), held a series of monetary policy meetings. While all kept their policy rates unchanged, the central banks expressed caution regarding inflation. Market pricing for FRB monetary policy, which at the end of February had anticipated two to three interest rate cuts within the year, has shifted significantly toward expectations of a slight rate hike.

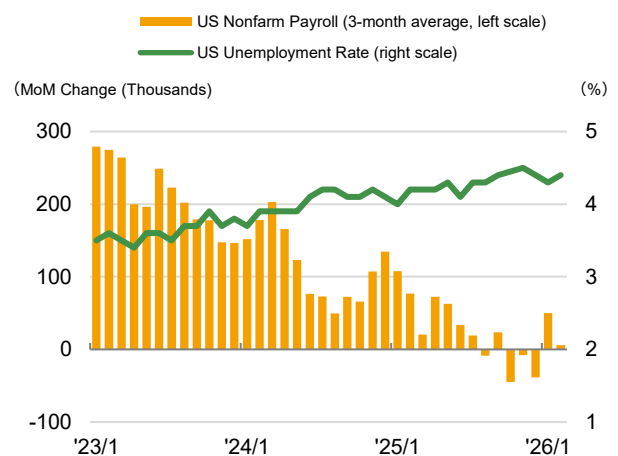
Although the US labor market lacks strength, the risk of a recession has been considered low due to the Fed's significant room for interest rate cuts. While the probability remains relatively low at this point, headwinds will intensify as the conflict drags on, since prolonged high crude oil prices make interest rate cuts more difficult. The impact on the US credit market is also a point to watch closely. In the US, which is in the late stage of its economic cycle, the credit market could be hit if there is a significant deterioration in financial conditions. While this is currently a tail risk, caution is warranted regarding the various transmission channels stemming from the situation in the Middle East.

### The Market Has Priced Out Fed Rate Cuts



※ Federal Funds Rate (Upper Bound) and Market Expectations  
Source: Bloomberg; Compiled by Daiwa Asset Management

### US Labor Market Losing Strength



※ Latest figure: February 2026  
Source: US Department of Labor; Compiled by Daiwa Asset Management

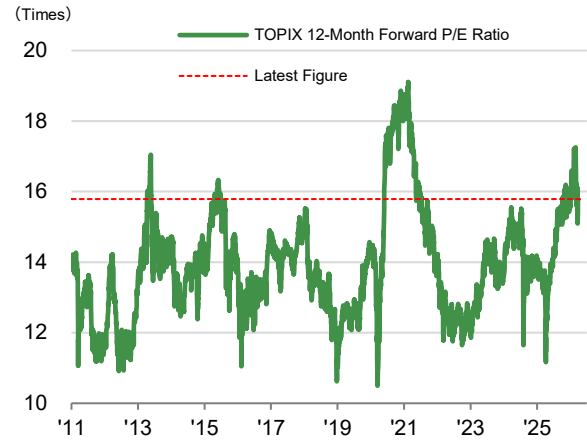
## Ultimately Dependent on Developments in the Middle East: De-escalation or Prolonged Conflict

As we have seen, the impact of deteriorating conditions in the Middle East has expanded beyond the initial focus on rising costs driven by a surge in crude oil. As the conflict intensifies and drags on, it has extended to supply-driven disruptions affecting domestic production and the operations of overseas manufacturing facilities and could even lead to tighter monetary policy by central bank, as well as economic slowdowns both domestically and abroad.

Although the likelihood is not high at this stage, there is a possibility that this could lead to serious consequences such as a recession in the US and globally, and economists have begun raising their estimates of recession probabilities. Given the wide range of possible outcomes, the extent to which these impacts should be factored in ultimately depends on a simple question: whether the supply constraints caused by high crude oil prices and a blockade of the Strait of Hormuz will persist.

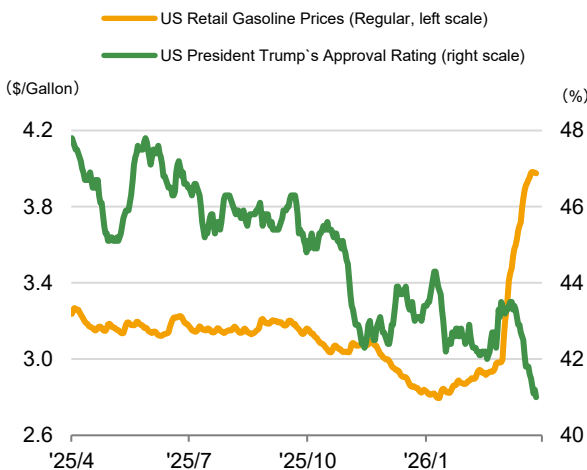
We believe the risk of a prolonged conflict has increased since the start of hostilities, but we expect supply disruptions to last for about three months, with crude oil prices peaking between March and May. In the US, low public support for attacking Iran, combined with the country's car-dependent society—where a price hike in gasoline easily fuels public discontent—means the administration, with midterm elections approaching, will likely want to avoid a prolonged conflict. The crude oil futures market has already priced in a decline in crude oil prices in the second half of the year, and at this stage, a full-scale production cut or shutdown due to supply constraints, as well as a recession, are viewed strictly as risk scenarios. While the stagnation in Japanese stocks could persist depending on developments in the Middle East, we expect the medium- to long-term bull market for Japanese stocks to continue, supported by positive factors such as structural changes and the government's growth strategy.

### Elevated TOPIX Valuations Leave Room for a Sharp Downside



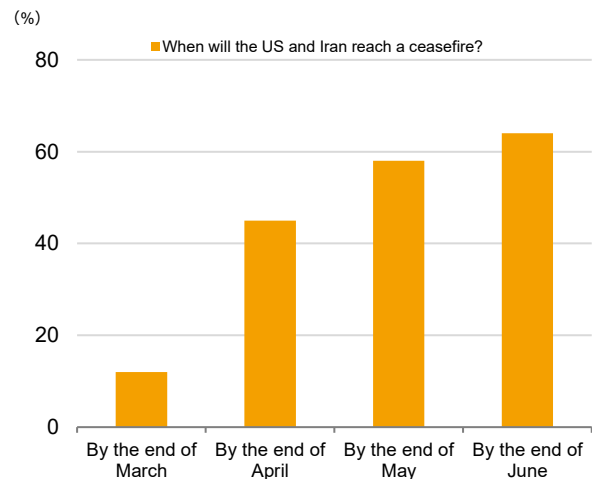
※ Latest figure as of March 27, 2026  
Source: FactSet; Compiled by Daiwa Asset Management

### Rising Gasoline Prices Coincide with a Sharp Drop in President Trump's Approval Rating



※ Latest figure as of March 27, 2026  
Source: RealClearPolitics, Bloomberg; Compiled by Daiwa Asset Management

### Most in Prediction Markets Expect a Ceasefire by End-May

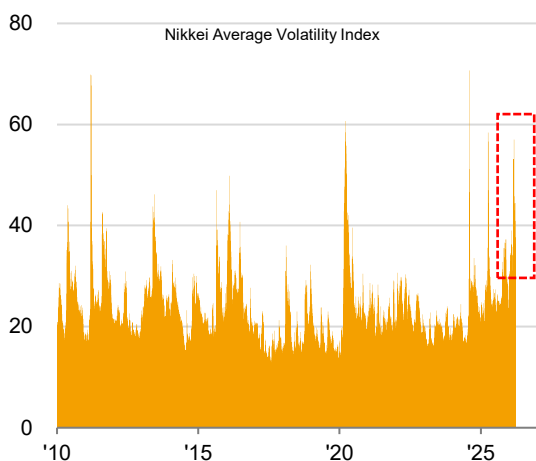


※ As of March 25, 2026  
Source: Polymarket; Compiled by Daiwa Asset Management

If moves toward a ceasefire accelerate, a stock market is likely to be swift. Even if it takes time for supply to fully recover and corporate earnings are weighed down, the stock market tends to look ahead and price in post-recovery earnings. While “guidance risk” (the market’s aversion to weak initial forecasts) is a particular concern this year during the full-year financial results season, an improvement in the situation in the Middle East would likely lead equity markets to look through this as a temporary factor.

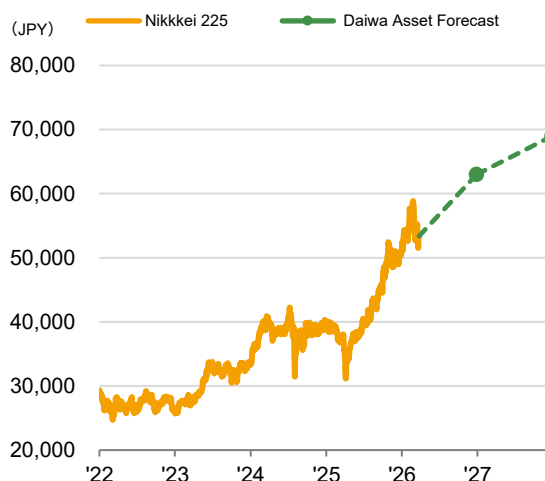
On the other hand, it is true that there is a significant gap between the ceasefire conditions set by the US and Iran, no clear path to a compromise is currently visible. Some view that Iran, seeking to increase the costs to Gulf nations and the global economy through a prolonged conflict and thereby strengthen its negotiating position, does not necessarily prioritize a short-term resolution. The US military is deploying additional forces, such as marines and airborne divisions, to the Middle East. With reports suggesting preparations for ground operations are underway, the immediate outlook remains highly uncertain. Should the US proceed with ground attacks targeting Iranian infrastructure, retaliation by Iran is expected to escalate further, increasing the likelihood of medium- to long-term damage to the supply of crude oil and petroleum products. In such a scenario, the impact on stock markets could also become more prolonged.

## Elevated Nikkei Volatility Index Signals High Market Caution



※ Most recent figure as of March 27, 2026  
Source: Bloomberg; Compiled by Daiwa Asset Management

## Near-Term Uncertainty Is High, but Japan’s Medium- to Long-Term Uptrend Is Intact



※ The most recent actual figure is from March 27, 2026  
Source: Bloomberg; Compiled by Daiwa Asset Management

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