Market Letter June 30, 2026

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The Outlook for Japanese Stocks Remains Favorable

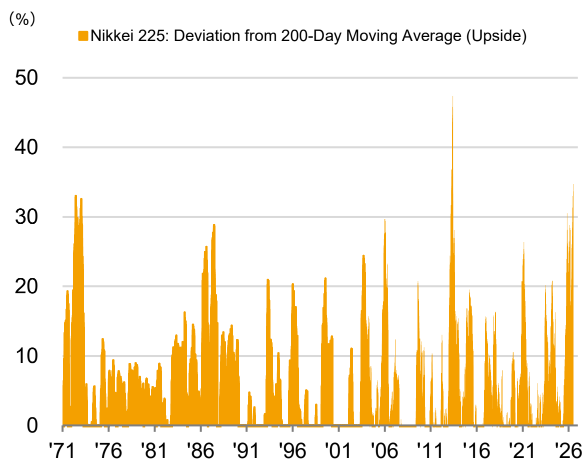
Rising Volatility Reflects Market Overheating and Supply-Demand Dynamics; Bullish Stance Remains Unchanged

Rising Volatility in the Nikkei 225

Volatility (price fluctuation) in the Nikkei 225 is increasing. On Monday, the 15th, the index rose by 3,297 Yen (+5.0%), marking the second-largest single-day gain in history. However, last week, on Tuesday the 23rd, it plummeted by 2,565 Yen (-3.5%), the fifth-largest single-day drop on record at that time. On Thursday, the 25th, it rebounded sharply, rising 3,191 Yen (+4.6%)—the fourth-largest single-day gain on record—but on Friday, the 26th, it plummeted again, falling 3,005 Yen (▲4.2%), marking the third-largest single-day decline on record. While each price movement was triggered by specific news events, the magnitude of the declines is believed to have been largely influenced by market overheating. From March 31 to June 22, the Nikkei 225 rose 42%, and its deviation from the 200-day moving average exceeded 30%—a historically rare level. When the market is perceived as overheated, it is prone to profit-taking, and even the slightest negative news can trigger sharp declines.

During the downturn, selling pressure has been concentrated on AI and semiconductor-related stocks. AI and semiconductor-related stocks, which have attracted investor funds since last summer, saw concentrated buying during the stock market rebound starting in April, causing their share prices to surge. Reflecting this concentration of investor funds, the Nikkei 225—which has a high weighting of AI and semiconductor-related stocks—has seen a marked increase in volatility compared to the TOPIX, which more closely reflects overall market movements. Volatile conditions are likely to persist until market overheating subsides. Concerns about deteriorating supply-demand conditions are also being felt. Since the stock market rose sharply from April to June, end-of-quarter rebalancing selling may also be weighing on stock prices. In the near term, ETF dividend payments in early July and the inclusion of US-based SpaceX in the index are also expected to act as headwinds. That said, supply-and-demand factors and seasonality are temporary; when looking at fundamentals, the medium-term outlook for Japanese stocks remains favorable.

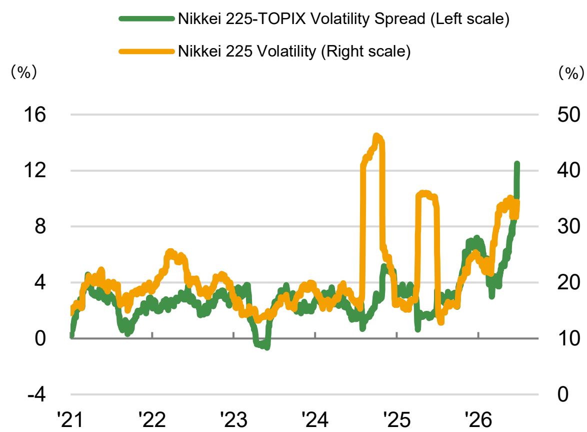
The Nikkei 225 Shows Signs of Technical Overheating



※Latest figure as of June 26, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

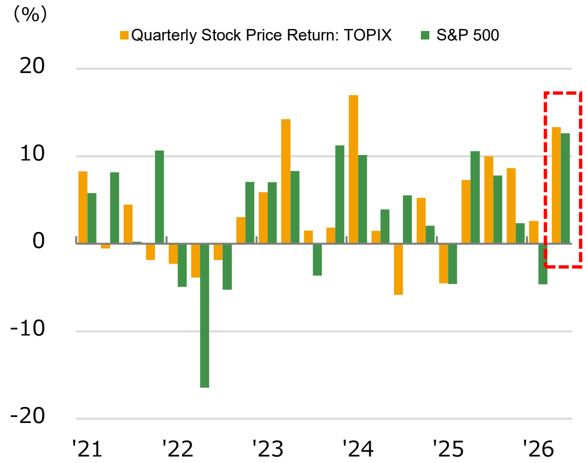
Compared to the TOPIX, the Nikkei 225's volatility has risen significantly



※Latest figure as of June 26, 2026

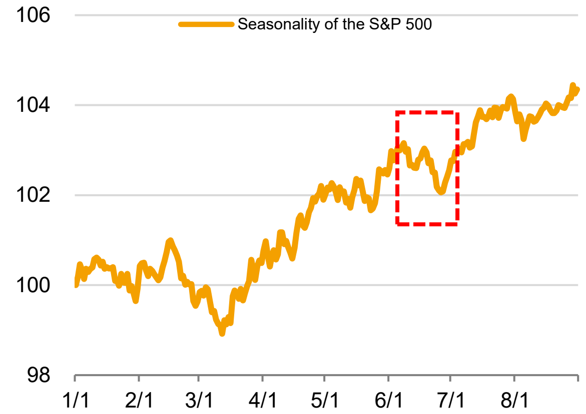
Source: Bloomberg; Compiled by Daiwa Asset Management

Quarter-End Rebalancing Sales Likely After Strong April–June Equity Rally



Source: Bloomberg; Compiled by Daiwa Asset Management

Late-June Weakness in US Equities Could Act as a Headwind for Japanese Stocks

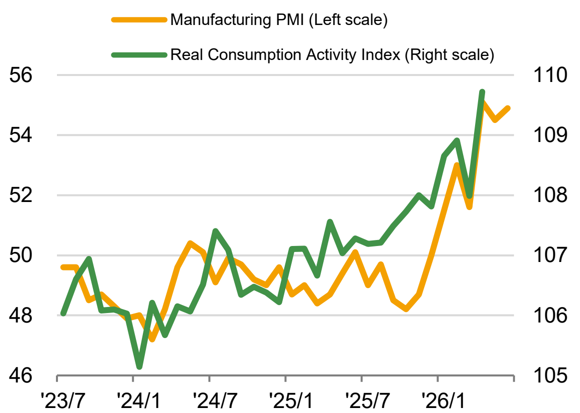


※Indexed to 100 at the Start of the Year; 2000–2025 Average
Source: Bloomberg; Compiled by Daiwa Asset Management

Domestic Economy Remains Resilient Despite Deteriorating Conditions in the Middle East

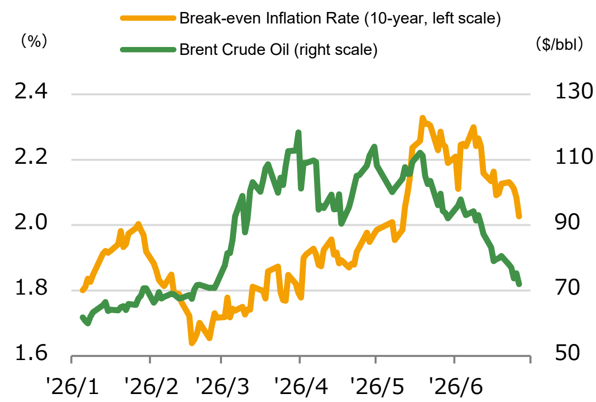
Although uncertainty has increased due to the deterioration of the situation in the Middle East and rising crude oil prices since late February, the domestic economy remains resilient. While some weakness is evident in certain sectors of production, the overall economy has held up, supported by AI-related investment. The Manufacturing PMI and other indicators also remain at high levels. Consumption remains resilient. Although sentiment has weakened, easing rice prices and government support appear to be containing inflationary pressures, while robust wage growth continues to underpin consumer spending. Furthermore, as efforts to secure alternative sources of supply are progressing, the adverse effects of supply constraints have not yet become significantly apparent. The agreement on the memorandum of understanding between the US and Iran reduces the risks of upward pressure on prices and a recession. While we should bear in mind the possibility that future negotiations could stall and the situation could rapidly deteriorate, for the time being, the market is likely to focus on the benefits brought about by the resumption of navigation through the Strait of Hormuz.

Domestic Economy Remains Resilient



※Latest figure as of April 2026 for the Real Consumption Activity Index and June 2026 for the Manufacturing PMI
Source: Bank of Japan and S&P Global; Compiled by Daiwa Asset Management

Easing Middle East Tensions Lead to Lower Oil Prices and Break-Even Inflation Rate (BEI)



※Latest figure as of June 26, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Upward Earnings Revisions Drive Stock Price Gains

The TOPIX continues to rise, trading above the highs seen before the Iran conflict. However, because estimated EPS is rising, the estimated P/E ratio is below the level seen just before the conflict, so the market does not appear significantly overvalued. This can be described as a healthy, earnings-driven rise in stock prices rather than a valuation-driven one.

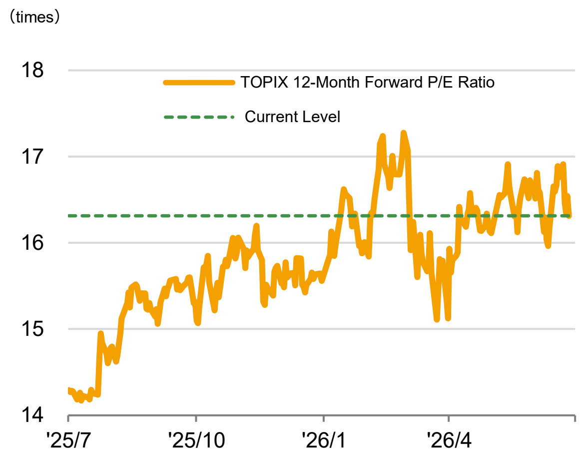
Earnings momentum for Japanese companies remains strong. Although the TOPIX's estimated EPS for fiscal year 2026 declined from March through mid-April due to the Iran conflict and rising crude oil prices, the decline was limited, supported by AI-related sectors that continued to see upward revisions even as the situation in the Middle East deteriorated .Since May, earnings forecasts for sectors other than AI-related have also begun to be revised upward, driven by the strengthening earnings momentum in the AI sector as well as the announcement of solid full-year FY2025 financial results. Against the backdrop of improving conditions in the Middle East, falling crude oil prices, high nominal GDP growth driven by the shift to an inflationary economy, and the expansion of the AI-related market, moderate upward revisions to earnings forecasts are likely to continue.

With crude oil prices falling to pre-conflict levels, attention is turning to the first-quarter financial results for the fiscal year ending March 2026, which will be released from late July through mid-August.

Earnings are expected to post solid year-on-year growth this quarter, reflecting the low base in FY2025 Q1 when profits were pressured by tariffs introduced by the Trump administration. Consensus earnings growth forecasts have recently been revised upward, indicating that expectations are continuing to build.

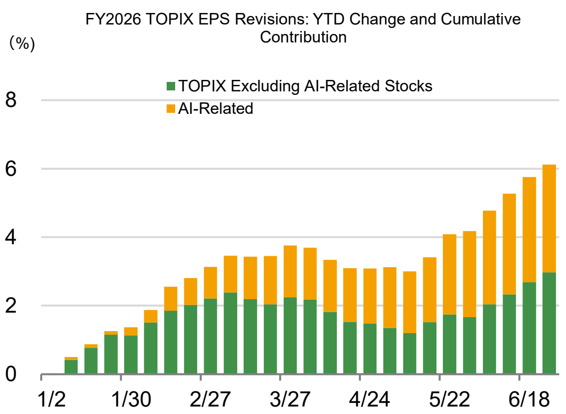
If the financial results alleviate concerns about a downturn in performance due to the situation in the Middle East and further raise expectations for fiscal year 2026, the stock market will likely return to an upward trend.

TOPIX P/E Remains Below Pre-Conflict Levels Despite Equity Gains



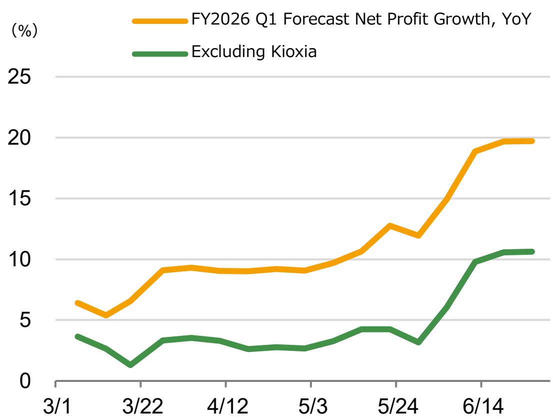
※Latest figure as of June 26, 2026
Source: FactSet; Compiled by Daiwa Asset Management

Corporate Earnings Outlook Continues to Improve



※Latest figure as of June 26, 2026
Source: FactSet; Compiled by Daiwa Asset Management

Strong Q1 Earnings Could Drive Further Upside in Stock Prices



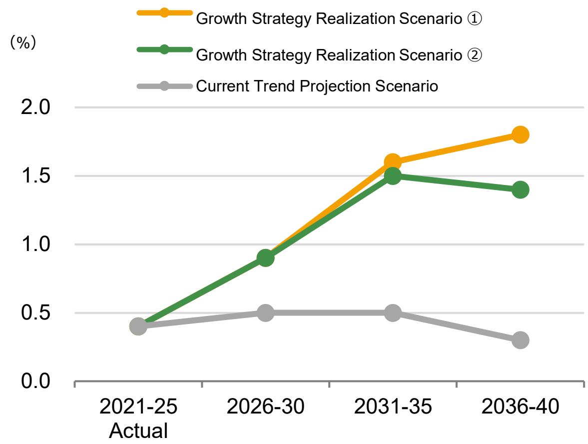
※ Companies in the TOPIX with financial results for the March fiscal year; latest figures as of June 26, 2026
Source: FactSet; Compiled by Daiwa Asset Management

The Takaichi Administration's Growth Strategy

On June 24, at a joint meeting of the Council on Economic and Fiscal Policy and the Japan Growth Strategy Council, the government announced a roadmap for public and private investment totaling over 370 trillion Yen by fiscal year 2040 across 17 strategic sectors.

Regarding the impact of investments based on this roadmap on the economy, projections were released indicating that, if the effects of the investments materialize, the potential growth rate—which represents the economy's supply capacity—will rise to 1.4% between 2036 and 2040, compared to 0.3% under the current projection scenario. Furthermore, if the effects of the investments, combined with the full realization of benefits such as R&D investment and more efficient allocation of production resources, are fully realized, the potential growth rate is projected to rise to 1.8%. Nominal GDP growth rates are also projected to rise to 3% and the mid-3% range, respectively, over the medium term. Factors driving the increase in TFP (Total Factor Productivity) growth include the adoption of AI, large-scale capital spending, foreign direct investment into Japan, investment in human capital, science, technology, and innovation, and the efficient allocation of production resources.

Government Projects Potential Growth Rising to the Upper 1% Range Under Its Growth Strategy



※ Projections on the Medium- to Long-Term Economic and Fiscal Outlook under Japan's Growth Strategy (June 24, 2026)

Source: Cabinet Office; Compiled by Daiwa Asset Management

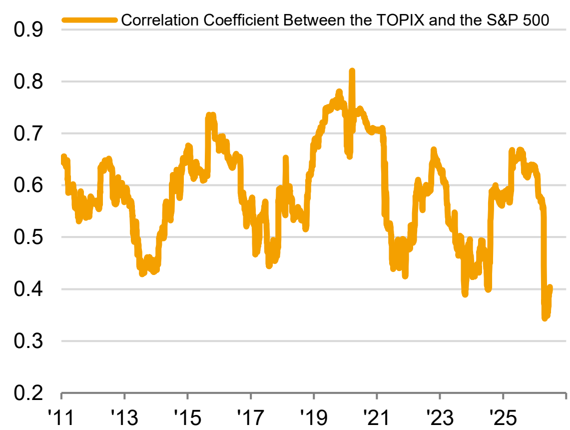
Accelerating Financial Inflows from Foreign Investors

The financial inflow from foreign investors into the Japanese stock market continues. Since Japan relies on the Middle East for energy, Japanese stocks tend to be viewed negatively when the situation in the region deteriorates; conversely, when conditions improve, they tend to be relatively favored.

This trend is also seen as being driven by structural changes at both the macro and micro levels in Japan, as well as expectations for the Takaichi administration's growth strategy. As Japan-specific factors are driving stock prices higher, the correlation between the TOPIX and the S&P 500 has declined significantly, enhancing the diversification benefits relative to US stocks.

The improvement in the US Dollar-denominated returns of Japanese stocks is also considered a contributing factor. We anticipate that the strong Yen will continue, and we expect that the US Dollar-denominated financial inflows into Japanese stocks—which are outperforming the S&P 500 in US Dollar terms—will continue.

Lower TOPIX–S&P 500 Correlation Improves Diversification Benefits



※Latest figure as of June 26, 2026

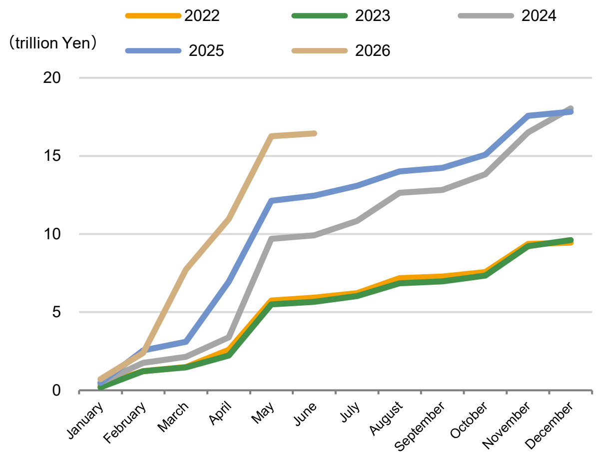
Source: Bloomberg; Compiled by Daiwa Asset Management

Year-to-Date Share Buyback Authorizations Hit a Record High

Corporate entities, which have been the largest buyers of Japanese stocks for five consecutive years since 2021, have recorded a net purchase of 4.1 trillion Yen year-to-date in 2026 (cash equities). The total authorized share buyback limit launched year-to-date stands at 16 trillion Yen, a significant expansion from the levels during the same period in 2024 and 2025 (10 trillion Yen and 12 trillion Yen, respectively)—which were already nearly double those of 2022 and 2023—and is expected to continue supporting the Japanese stock market through the second half of the year.

This year marks the first revision to the Corporate Governance Code in five years, and the draft revision includes new provisions regarding the "appropriate allocation of management resources." Reference materials state that "when allocating management resources," companies should "consider resource allocation strategies that include diverse investment opportunities and shareholder returns," raising expectations for further expansion of shareholder returns in addition to growth investments.

Japanese Corporate Authorized Share Buyback Limit Programs Increase Sharply Year on Year



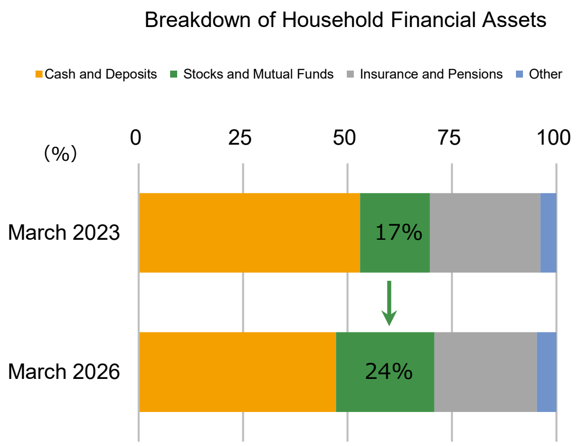
※ Cumulative announced amount since the beginning of the year, as of June 26, 2026

Source: QUICK; Compiled by Daiwa Asset Management

Cash and Deposits Fall Below 50% of Household Financial Assets

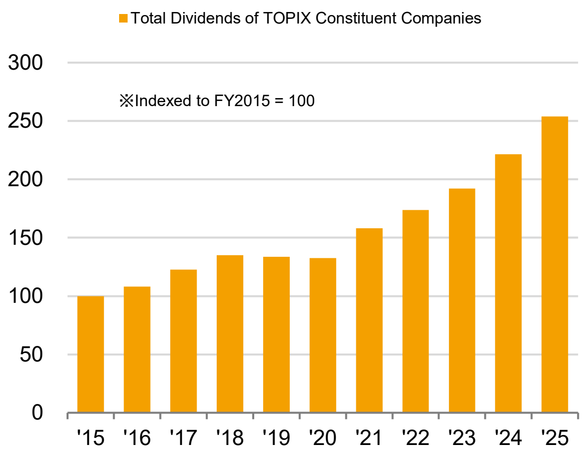
The proportion of cash and deposits in Japanese households' financial assets has declined, falling below 50% for the first time in 18 years in the July–September 2025 Flow of Funds Statistics, and has continued to trend downward since then. Meanwhile, the share of risk assets—such as stocks and investment trusts—is on the rise. While an increase in market value due to rising stock prices is one factor, financial inflows into risk assets, particularly investment trusts, also continue. Amid the transition from deflation to inflation, the shift from savings to investment is still in its early stages. The stance of companies actively pursuing shareholder returns is also likely to bolster this trend.

Growing Allocation to Stocks and Investment Trusts Among Household Financial Assets



Source: Bank of Japan; Compiled by Daiwa Asset Management

Japanese Companies Are Stepping Up Shareholder Returns



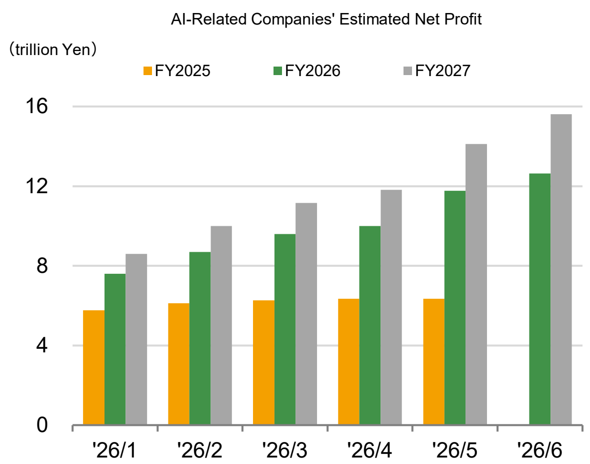
※ Data compiled for companies for which data is available from FY2015 through FY2025

Source: FactSet; Compiled by Daiwa Asset Management

AI and Semiconductor Sectors: Short-Term Volatility Expected, but Significant Upside Potential Remains in the Medium Term

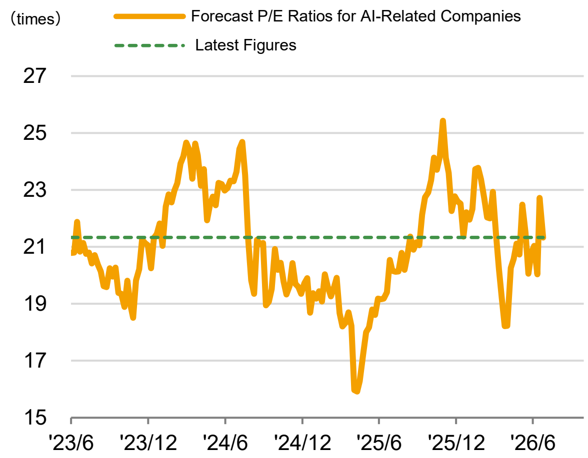
AI and semiconductor-related stocks are showing strong signs of overheating, and with concerns about deteriorating supply-demand conditions, they are likely to face pressure from profit-taking in the near term, and volatile price movements may continue. On the other hand, given the high growth potential of the AI sector, we believe there remains significant upside potential in the medium term. While there are skeptical views regarding AI's growth potential and benefits, the so-called "AI arms race"—in which AI start-ups and Big Tech companies are vying fiercely for AI development and capital spending—is expected to continue, and growth in AI semiconductor sales is likely to accelerate further. Although stock prices of Japanese AI and semiconductor-related companies have risen significantly, there has been a substantial upward revision in earnings forecasts, so valuations do not appear overvalued. Furthermore, of the total 370 trillion Yen in public-private investment announced by the government for its 17 strategic sectors, 101.6 trillion Yen is allocated to AI and semiconductors, adding a tailwind from the government's growth strategy.

For AI and semiconductor-related companies, the upward revisions to earnings forecasts are significant…



※ As of June 26, 2026
Source: FactSet; Compiled by Daiwa Asset Management

…Despite the sharp rise in stock prices, the valuation does not appear overvalued



※Latest figure as of June 26, 2026
Source: FactSet; Compiled by Daiwa Asset Management

Growth Strategy: Amount of public-private investment in "AI and Semiconductors" among the 17 strategic sectors

Major Products and Technologies, etc.	Public and Private Investment (Estimated)	Quantitative Impact: Economic Effects from Investment
Physical AI (particularly AI robots)	By fiscal year 2040: 10.5 trillion Yen	By fiscal year 2040: 144.4 trillion Yen
Semiconductors, which form the core of physical intelligent systems	By fiscal year 2040: 68.0 trillion Yen	By fiscal year 2040: 443.3 trillion Yen
Vertical AI (Domain-Specific AI)	By fiscal year 2040: 23.1 trillion Yen	By fiscal year 2040: 222.0 trillion Yen

※ From the (Draft) Public-Private Investment Roadmap for "Major Products, Technologies, etc." in the 17 Strategic Sectors
Source: Cabinet Office; Compiled by Daiwa Asset Management

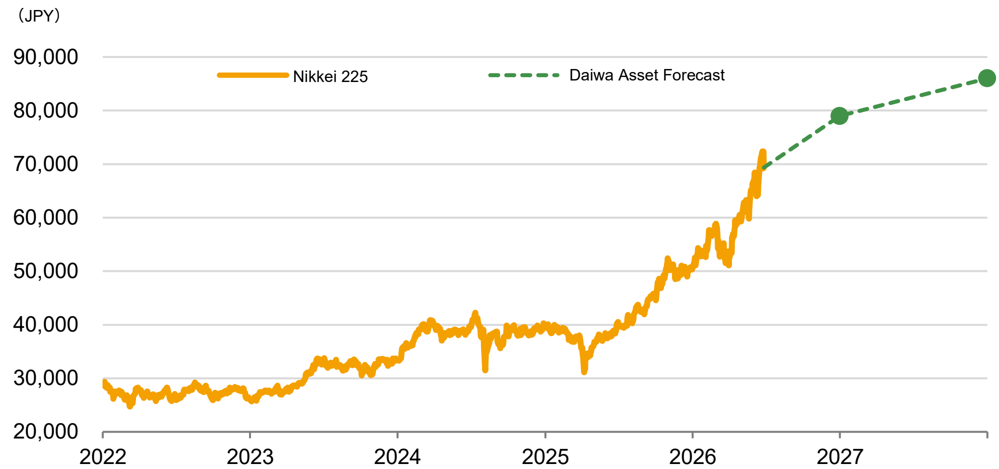
Japanese Stocks Poised for Further Gains

Although the Japanese stock market has been somewhat volatile recently, a look at the fundamentals reveals that both the economy and corporate earnings remain solid amid improving conditions in the Middle East. In our "Investment Environment Outlook (July 2026 Issue)" (published June 25), we raised our forecasts for the TOPIX and the Nikkei 225.

The assumed P/E ratio for the TOPIX remains unchanged at 17x compared to our previous forecast; the upward revision reflects an upward adjustment to the TOPIX's projected EPS, driven by a reduced risk of earnings misses due to improving conditions in the Middle East and upside surprises in AI and semiconductor-related earnings. The forecast values for the end of 2026 and 2027 are 4,400 and 4,800, respectively, indicating upside potential of 11% and 21% from the closing price on June 26. We have raised our forecast values for the Nikkei 225 at the end of 2026 and 2027 to 79,000 Yen and 86,000 Yen, respectively.Reflecting a positive outlook on AI and semiconductor-related sectors, we have raised the assumed NT multiple to 18x.

The structural changes in macroeconomic, microeconomic, and supply-demand conditions—which we consider key factors in the Japanese stock market—continue to progress steadily, and the details of the government's growth strategy have become increasingly concrete. We continue to believe that Japanese stocks are in the midst of a medium-term bull market and maintain our bullish outlook on Japanese stocks.

Our New Nikkei 225 Forecast



※ Latest value as of June 26, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Important Information

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