Market Letter

July 10, 2026

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Japanese Corporate Value Unlocking Accelerates Further

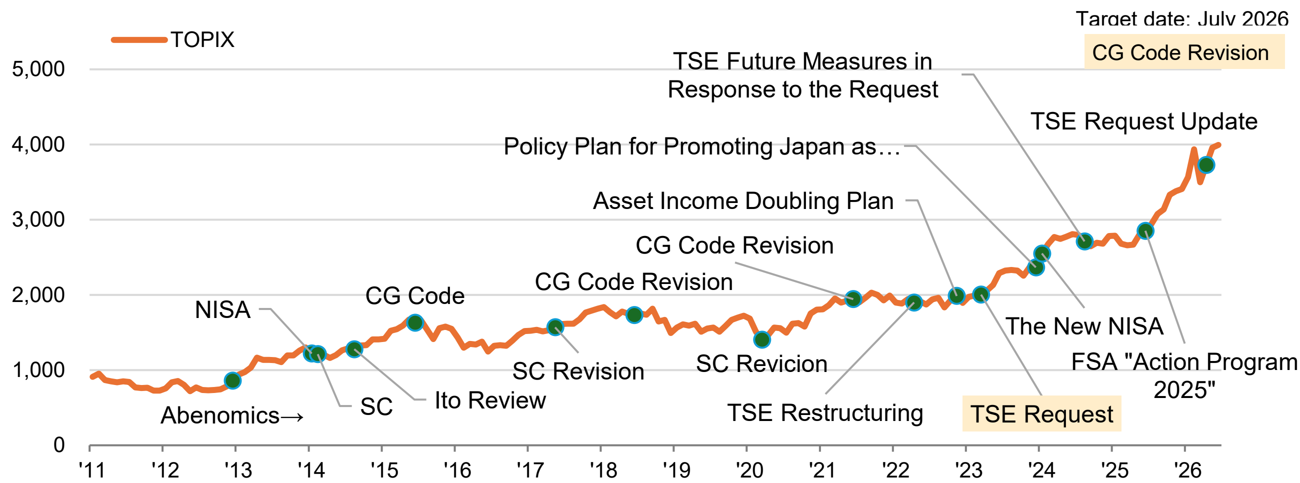
Governance-Driven Re-rating Fuels Share Price Gains

Corporate Governance Reforms Are a Key Driver of Japanese Equity Gains

The TOPIX (including dividends) has risen by more than 20% for four consecutive years since 2023 (year-to-date as of July 6, 2026), and has surged 136% since the beginning of 2023—a remarkable performance—with corporate governance reform serving as the primary driving force. In particular, since the “TSE Request” (a request by the Tokyo Stock Exchange regarding “management mindful of capital costs and stock prices”) in March 2023, progress in governance reform in the Japanese stock market has attracted significant attention not only in Japan but also among foreign investors, leading to a revaluation of Japanese companies that had previously been shunned on the grounds that “there is a reason they are undervalued.” Furthermore, in response to the changes and reevaluation of Japanese companies, other Asian countries—such as South Korea and Taiwan—have introduced measures to enhance corporate value modeled after Japan’s approach, while similar efforts to improve governance are also underway in China, Singapore, and elsewhere.

Three years have passed since the TSE’s request, but governance reform is still evolving. The focus this year is on the first revision of the Corporate Governance Code (CG Code) in five years, and it is expected that this will serve as a catalyst to reignite the momentum of reform. Furthermore, the TOPIX’s ROE—which had been stagnant for several years—is projected to begin rising, and the trend toward the revaluation of Japanese companies is expected to gain even more momentum. From an investment opportunity perspective, since the governance reforms were initially referred to as the “sub-1x PBR reforms,” companies with low PBRs attracted significant attention in the early stages of the reforms. However, as the reforms have progressed, disparities have emerged in the initiatives and progress of individual companies, shifting the focus from a phase where simply undervalued companies were valued to a phase where careful selection has become more critical.

Japanese Equities Have Continued to Rise as Governance Reforms Progress



※ CG = Corporate Governance, SC = Stewardship Code; latest figures as of the end of June 2026

Source: Daiwa Asset Management

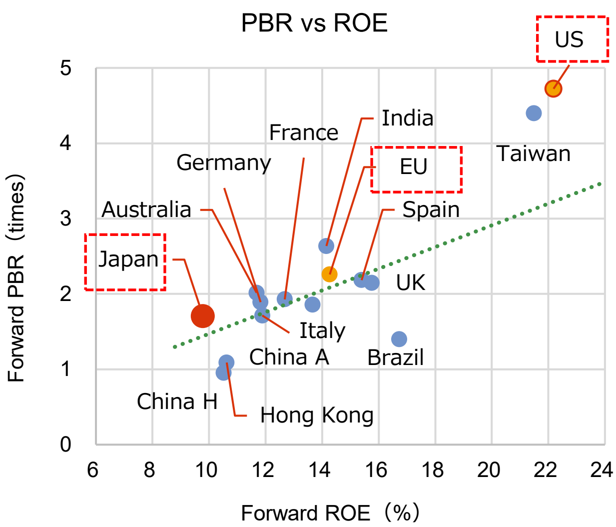
Significant Progress Has Been Made, but Ample Room for Improvement Remains

In fact, progress on corporate governance reform in the Japanese stock market has been remarkable. On the Prime Market, 93% of companies, and on the Standard Market, 52% of companies have disclosed their compliance with TSE requirements (as of the end of May 2026). Shareholder returns have expanded significantly in recent years, and the sale of policy-held shares and the dissolution of parent-subsidiary dual listings are also proceeding. Tension surrounding annual general meetings of shareholders is also rising, creating pressure to encourage management that is more mindful of shareholders. Among TOPIX-constituent companies, the proportion of firms with a PBR below 1 has fallen significantly, from 51% as of the end of December 2022 to 38% as of the end of June 2026.

On the other hand, it is also true that there is still considerable room for improvement. The proportion of companies with a PBR below 1 remains quite high compared to Europe and the US, and ROE remains at the lowest level among major countries. This is also one of the reasons why some overseas investors remain skeptical about Japan's corporate governance reforms.

However, looking at it another way, it can be said that there is still considerable room for Japanese stocks to be revalued, and we believe that corporate governance reforms will drive the Japanese stock market upward over the medium to long term. What is important is that the mindset of companies, shareholders, and investors has changed over the past few years. Low capital efficiency is now recognized as an issue that needs to be addressed, and while dialogue with shareholders and efforts to enhance corporate value have become key management priorities, it is also becoming the norm for shareholders to actively seek improvements in corporate value and to influence management through engagement and Proxy Voting. We look forward to further progress in these reforms.

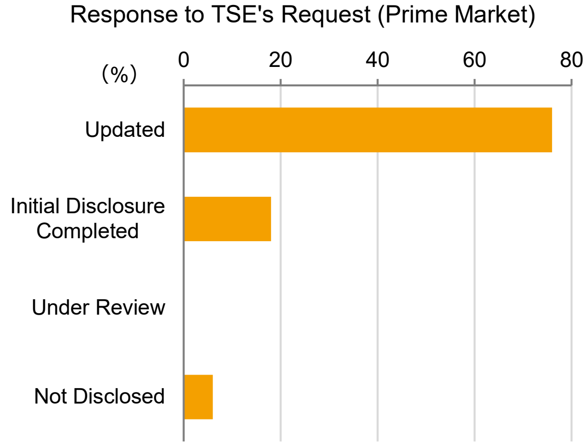
Japan’s ROE Remains the Lowest Among Major Countries



※ As of July 3, 2026

Source: Bloomberg; Compiled by Daiwa Asset Management

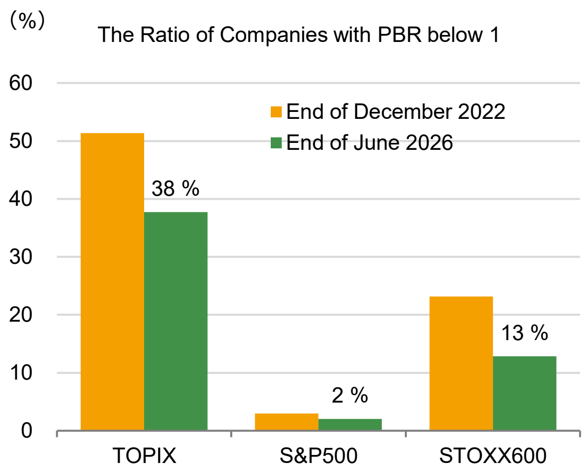
Governance reforms have shown significant progress, but…



※ Updated = The disclosure content has been updated since the initial disclosure, as of the end of May 2026

Source: Tokyo Stock Exchange; Compiled by Daiwa Asset Management

There Is Still Room for Japanese Equities to Catch Up with US and European Markets



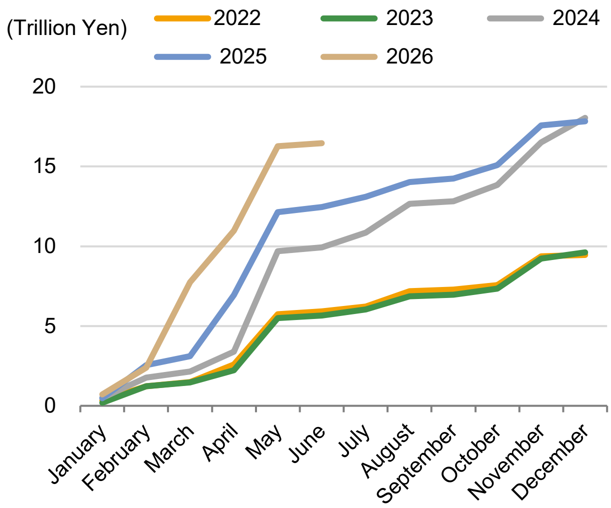
Source: FactSet; Compiled by Daiwa Asset Management

Governance Reforms Extend Beyond Enhanced Shareholder Returns

A notable outcome of the corporate governance reforms—which accelerated in response to requests from the Tokyo Stock Exchange—is the substantial expansion of shareholder returns. The sharp increase in share buyback limits launched in 2024 attracted significant market attention. While the 2023 buyback limit reached a record high of 9.6 trillion yen for the second consecutive year, the 2024 limit reached 18 trillion yen—nearly double that amount. As of the end of June 2026, the total had already reached 16.5 trillion yen, representing a further significant increase from the same periods in 2024 and 2025 (10 trillion yen and 12 trillion yen, respectively). Dividends are also continuing to grow strongly.

Expanding shareholder returns is relatively easy to implement, and in the early stages of reform, dividend increases and share buybacks took the lead and attracted significant attention. However, the essence of governance reform lies not in expanding shareholder returns, but in improving capital efficiency, achieving sustainable growth, enhancing corporate value over the medium to long term, and the initiatives required to realize these goals.

A Sharp Increase in Share Buybacks Is One of the Outcomes of Governance Reform



※ Share buyback limit programs and cumulative amounts announced year-to-date, as of the end of June 2026

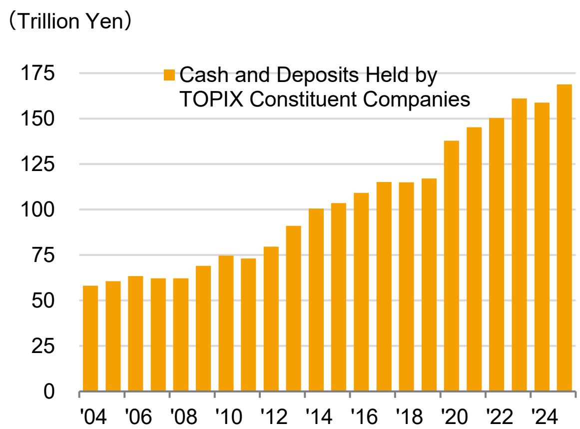
Source: QUICK; Compiled by Daiwa Asset Management

Corporate Governance Code Revisions Expected to Accelerate Cash Deployment

It has been pointed out that one factor contributing to the low return on capital among Japanese companies is the underutilization of cash and deposits. The "Action Program 2025 for Substantive Corporate Governance Reform," published in June 2025, identified the issue of whether Japanese companies are accumulating more cash and deposits than necessary (the "cash hoarding" problem) as a matter for consideration, given that their holdings of cash and deposits have continued to increase over a long period.

The draft revision of the Corporate Governance Code, released on April 10, includes new provisions regarding the "appropriate allocation of management resources" and the "promotion of growth investments," stating that companies should "continuously verify" whether **they are "effectively utilizing management resources—such as financial assets (including cash and deposits) and tangible assets—for growth investments and other purposes**. "Furthermore, the reference materials state that "when allocating management resources," "it is necessary to consider **a resource allocation strategy that includes diverse investment opportunities and shareholder returns**."

Corporate Cash Holdings Have Continued to Increase Over the Long Term



※Cash and cash equivalents, excluding financial assets; most recent figure is for FY2025

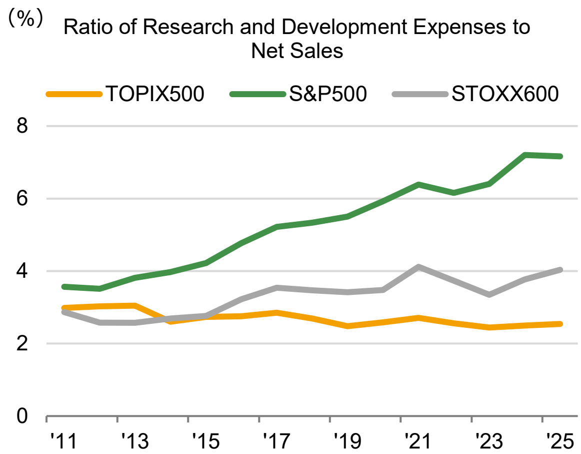
Source: FactSet; Compiled by Daiwa Asset Management

Both Growth Investment and Balance Sheet Optimization Need to Accelerate

Although shareholder returns have increased significantly in recent years, the total return ratio (the proportion of dividends and share buybacks relative to net income) still lags behind that of European and U.S. stock markets. Cash and deposits held by TOPIX constituent companies also continue to rise, suggesting that companies have yet to take sufficient action. The revision of the Corporate Governance Code is expected to serve as a catalyst to further encourage companies to utilize their cash.

Discussions at the expert panel on the revision of the Corporate Governance Code are taking place within the context of improving earning power and the appropriate allocation of management resources; they are not merely aimed at encouraging increased shareholder returns. The panel pointed out that, compared to companies in Europe and the United States, the ratios of capital spending and research and development expenses to sales are low, indicating a lack of investment necessary for sustainable growth. The reference materials accompanying the proposed revisions to the Corporate Governance Code identify growth investments—including capital expenditures, R&D, human capital investments, and investments in intangible assets such as intellectual property—as key examples of capital allocation. This highlights that the revisions are primarily aimed at fostering sustainable growth.

Japanese Companies Lag Behind in Growth Investment

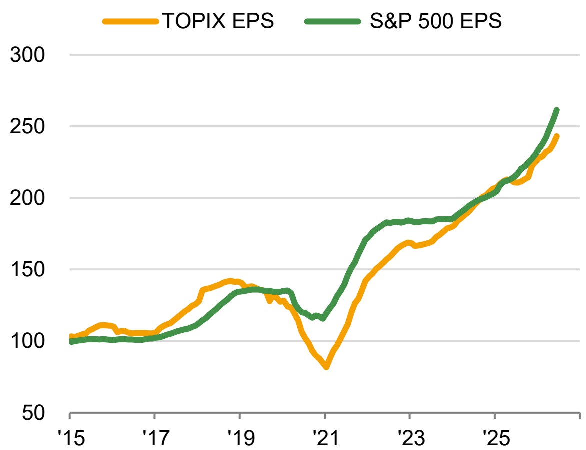


※ Most recent figure is for fiscal year 2025

Source: FactSet; Compiled by Daiwa Asset Management

At the same time, balance sheet reform remains important. Since 2015, the TOPIX has achieved EPS growth on par with the S&P 500, but in terms of BPS, the TOPIX's growth has outpaced that of the S&P 500, indicating that bloated BPS is one factor contributing to Japanese companies' low ROE. We believe that the revisions to the Corporate Governance Code will mark a turning point, with both balance sheet optimization and earnings growth driving a sustained rise in the ROE of Japanese companies. Balance sheet reform will help reduce the denominator, while profit growth will expand the numerator.

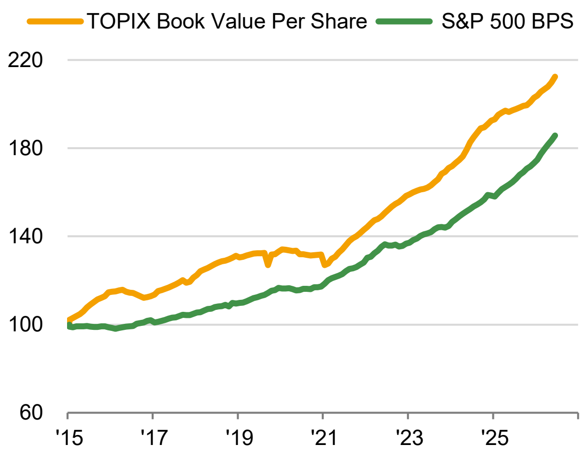
The TOPIX shows EPS growth on par with the S&P 500, but…



※ Indexed with early 2015 set to 100; most recent figure is as of the end of June 2026

Source: FactSet; Compiled by Daiwa Asset Management

…BPS has ballooned, contributing to the low ROE



※ Indexed with early 2015 set to 100; most recent figure is as of the end of June 2026

Source: FactSet; Compiled by Daiwa Asset Management

Are Japanese Companies Holding Excess Cash?

It is difficult to determine the optimal ratio of cash and deposits for a company. Financial stability is important, and maintaining a certain level of cash is necessary to prepare for contingencies. The proposed revisions to the Corporate Governance Code (Reference Material) also state that “holding these assets, including cash and deposits, should not always be viewed negatively” and that “maintaining an appropriate level of cash and deposits can be considered part of the allocation of management resources.”

That said, as cash and deposit balances continue to rise, pressure on companies intensifies. In a survey by the Life Insurance Association of Japan, 72% of companies responded that their cash on hand was at an appropriate level or insufficient, whereas 80% of investors responded that it was at a comfortable level. Moreover, in an inflationary environment, holding excessive cash and deposits that are losing value is not economically rational, and companies should adapt their capital management strategies to the changing macroeconomic environment.

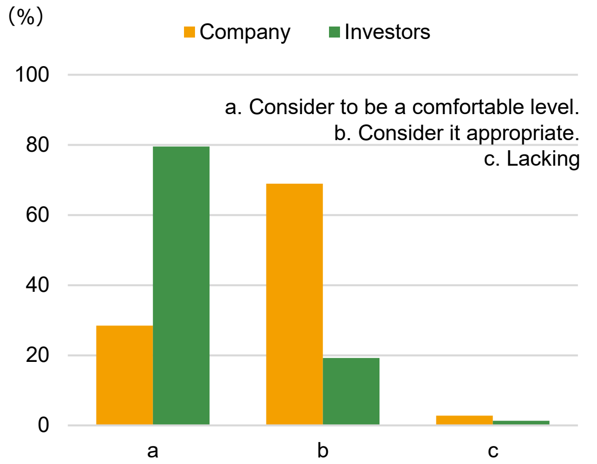
We should also take into account the fact that the profitability of Japanese companies has increased significantly over the past 10 to 20 years. The break-even ratio for companies has fallen to a level well below that of the 1980s or the period immediately preceding the Lehman Shock. If Japanese companies have become more resilient to shocks, it stands to reason that the required level of cash and deposits is not as high as it once was.

A Broad Range of Assets Set to Come Under Greater Scrutiny

The effective utilization of assets is not limited to cash and deposits. The proposed revisions to the Corporate Governance Code also state, “Are financial assets such as cash and deposits, as well as ‘tangible assets,’ being effectively utilized as management resources for growth investments and other purposes?”

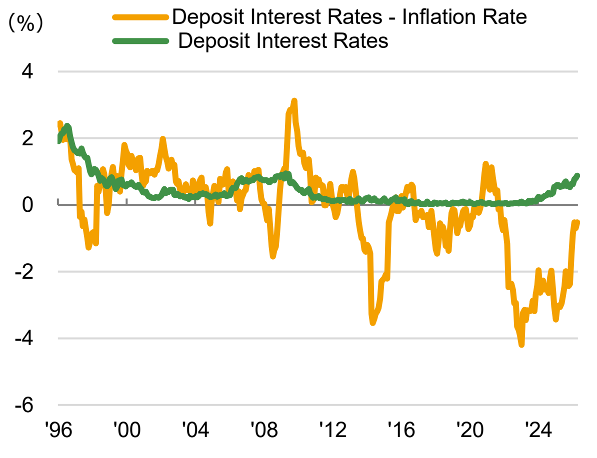
A diverse range of assets—including held stocks and real estate that is not easily liquidated, as well as their unrealized gains—are now subject to scrutiny. Companies are increasingly being evaluated from the perspective of how they utilize their assets, including through sales, to achieve growth.

Perception Gap Between Companies and Investors Regarding Cash on Hand



※Survey Results on Initiatives to Enhance Corporate Value (FY 2025 Edition)
Source: Life Insurance Association of Japan; Compiled by Daiwa Asset Management

Holding Excess Cash in an Inflationary Environment Is Economically Inefficient



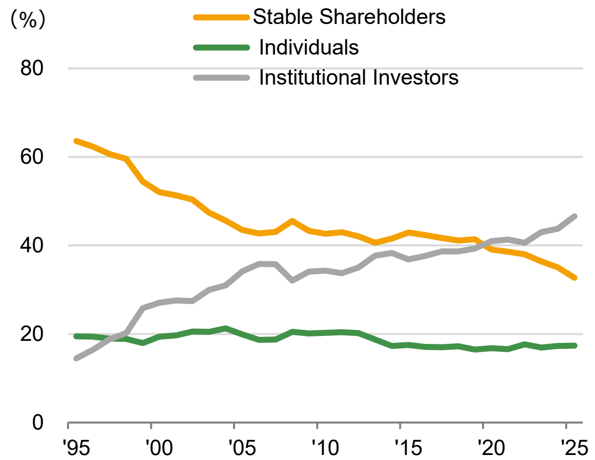
※Average interest rate on time deposits (5 years or more but less than 6 years),
Most recent figure: April 2026
Source: Bank of Japan and the Ministry of Internal Affairs and Communications; Compiled by Daiwa Asset Management

Pressure on Corporate Management Continues to Mount

The key question is whether the momentum for reform will continue. Three years after the Tokyo Stock Exchange's request, shifts in the mindset of companies, shareholders, and investors (see P2) have led the reform to evolve into a structural change, and we are increasingly confident in its progress.

June saw a concentration of annual general meetings for companies with fiscal years ending in March. Amid intensifying activist investor activity, institutional investors and proxy advisory firms are tightening their Proxy Voting criteria. Furthermore, as policy-held shares are being divested, the number of stable shareholders is declining, heightening the tension surrounding shareholder meetings. The approval rate for the appointment of CEOs and other executives at shareholder meetings is trending downward, and the range of fluctuation is widening, creating pressure on companies to adopt management practices that are more mindful of shareholders. Additionally, the number of companies receiving shareholder proposals continues to rise, and the trend of shareholders driving change through dialogue and engagement with companies is steadily expanding.

Declining Stable Shareholders Increase Pressure on Management



※Equity Holdings by Investment Category: Stable Shareholders = Government & Local Governments + Banks + Insurance Companies + Corporate Entities; Institutional Investors = Investment Trusts, Investment Funds + Pension Funds + Foreign Investors

Source: Tokyo Stock Exchange; Compiled by Daiwa Asset Management

Japan's Equity Re-rating Enters a New Phase Driven by Rising ROE

While remarkable progress has been made in corporate governance reform, what came as a surprise—and even a slight disappointment—to investors was that, despite such significant efforts to improve capital efficiency, the TOPIX's ROE has not improved much. And because ROE has not improved, some skeptical foreign investors have viewed governance reform as merely a stock-picking theme, arguing that Japanese companies as a whole have not actually changed, or that it merely leads to increased shareholder returns.

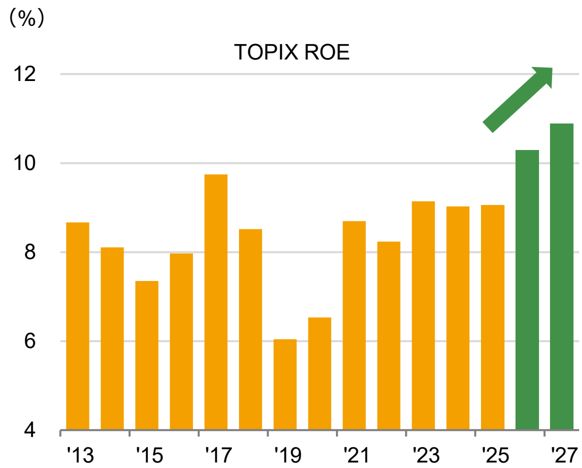
A key factor behind the slow improvement in ROE has been the expansion of shareholders' equity, the denominator of the ratio. In addition to the underutilization of cash and cash equivalents discussed earlier, the weaker Yen and stronger equity markets in recent years have boosted foreign currency translation adjustments and unrealized gains on securities holdings, leading to a further increase in shareholders' equity.

This situation is expected to change this year. With the sale of policy-held shares and the gradual strong yen that we anticipate, the effect of foreign currency translation adjustments and valuation differences on other securities on boosting shareholders' equity is expected to diminish going forward. Furthermore, revisions to the Corporate Governance Code will drive balance sheet reform (reducing the denominator of ROE) and earnings growth (increasing the numerator of ROE).While the consensus forecast projects that the TOPIX ROE will exceed 10% in FY26 and continue to rise through FY27, we believe there is a strong possibility that the rise will accelerate beyond consensus expectations. As the TOPIX ROE, which had been stagnant, enters an upward trend, the revaluation of Japanese stocks will move into a new phase.

When the TOPIX's ROE is 8% or lower, the correlation with PBR is weak; however, when it exceeds 8%, PBR tends to rise in tandem with the increase in ROE, and a rise in ROE from current levels will lead to an expansion in valuations. Furthermore, this relationship is not linear; there is a tendency for the expansion in PBR to accelerate as ROE rises. If the TOPIX enters a phase of rising ROE, the P/E ratio range will also shift upward.

There is a clear tendency for foreign investors to favor companies with high ROE. While Japan's ROE has consistently remained at a lower level compared to overseas (developed) markets, financial inflows of foreign capital have been observed during periods when this gap narrows. If confidence grows that Japanese companies are breaking free from their low capital profitability and entering a phase of sustained ROE growth, financial inflows from foreign investors are likely to accelerate further.

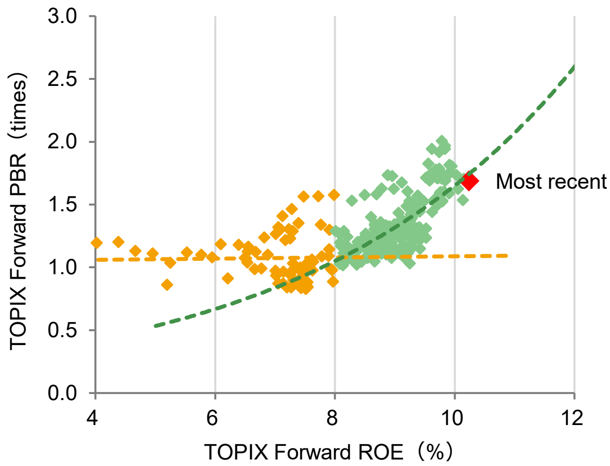
TOPIX ROE Set to Rise After Years of Stagnation



※ FY26–27 figures are FactSet consensus forecasts; as of July 7, 2026

Source: FactSet; Compiled by Daiwa Asset Management

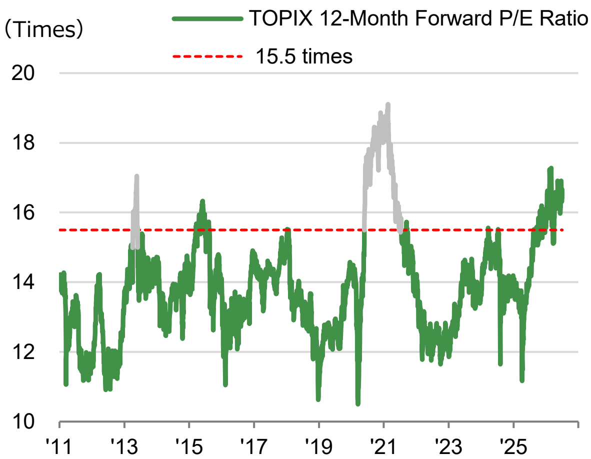
PBR Expansion Accelerates Once ROE Exceeds 8%



※ Monthly data since 2003; most recent figure is as of the end of June 2026

Source: FactSet; Compiled by Daiwa Asset Management

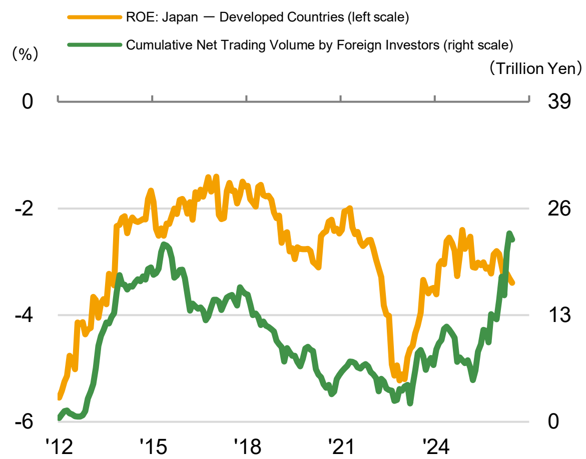
TOPIX P/E Range May Shift Upward



※ Latest figure as of July 3, 2026

Source: FactSet; Compiled by Daiwa Asset Management

Sustained ROE Growth Could Accelerate Foreign Inflows into Japanese Equities



※ Most recent figure is as of the end of June 2026

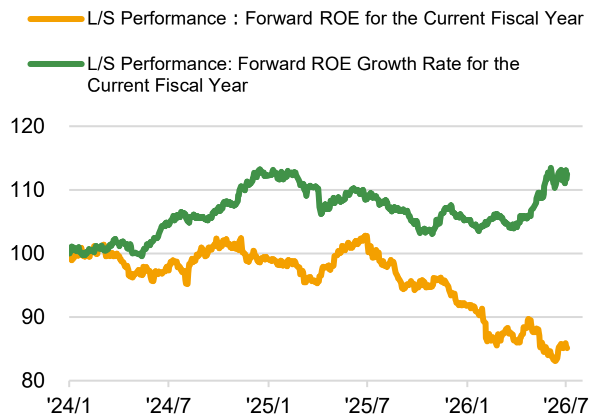
Source: FactSet; Compiled by Daiwa Asset Management

Companies That Improve Governance Earn Higher Market Valuation

Just as corporate governance reforms have led to a re-rating of the Japanese equity market as a whole, individual companies are also benefiting from improved market recognition of governance enhancements, which has contributed to share price appreciation and outperformance relative to the broader market.

This trend is also reflected in market valuations. While ROE is a key metric for investors, the market tends to place greater emphasis on the improvement in a company's ROE rather than on the absolute level of ROE itself. In fact, while the stock price performance of stocks with high ROE is not necessarily strong, stocks with high projected ROE growth rates—which indicate the degree of improvement in ROE from the previous period to the current one—continue to show relatively robust performance. Companies that are expected to improve their ROE through governance reforms are likely to continue generating attractive stock returns in the years ahead..

The Market Is Assessing Companies Based on the Degree of ROE Improvement

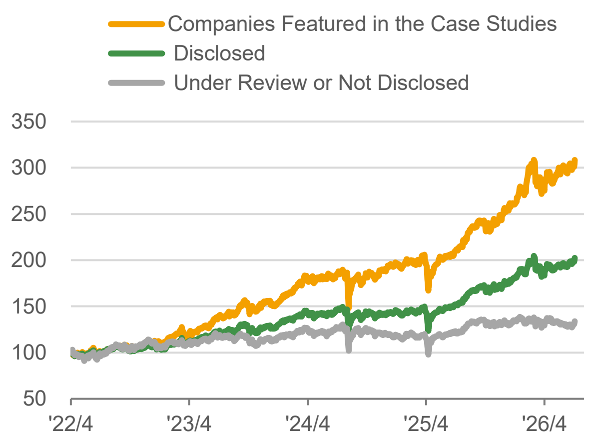


※TOPIX 500 constituents were ranked by projected ROE for the current fiscal year and projected ROE growth rate for the current fiscal year; the top one-third were selected for long positions and the bottom one-third for short positions, indexed with early 2024 set to 100; latest figure as of July 3, 2026

Source: FactSet; Compiled by Daiwa Asset Management

The fact that improved corporate governance leads to strong stock price performance is also reflected in TSE materials. The TSE classifies companies into "companies featured in the case studies," "companies that have disclosed information," and "companies under consideration or that have not disclosed information," based on their response to requests regarding "management that takes capital costs and stock prices into account.""Companies featured in the case studies" are those that the TSE has highlighted as best practices for addressing these requests. "Companies that have disclosed" refers to those that have publicly announced policies and initiatives aimed at enhancing corporate value in line with the TSE's requests. On the other hand, "companies under consideration or not yet disclosed" are those that are currently considering how to respond or have not yet announced specific policies. It is evident that differences in attitude toward governance reform and the degree of progress are reflected in differences in stock performance.

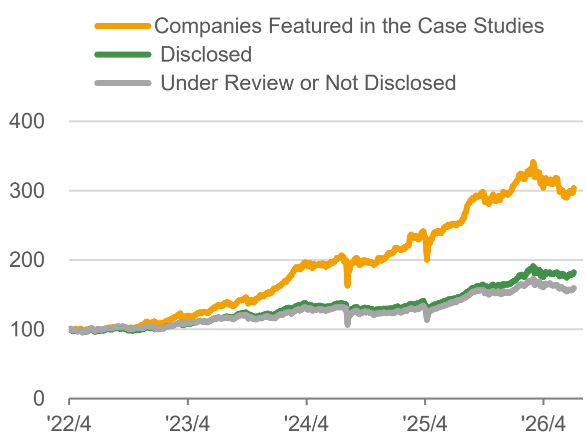
Stock Price Trends Following Market Reform (Prime Market)



※ Indexed with early April 2022 set to 100; latest figure as of July 3, 2026

Source: Tokyo Stock Exchange; Compiled by Daiwa Asset Management

Stock Price Trends Following Market Reform (Standard Market)



※ Indexed with early April 2022 set to 100; latest figure as of July 3, 2026

Source: Tokyo Stock Exchange; Compiled by Daiwa Asset Management

Japan’s Structural Bull Market Remains Intact

The rise in Japanese stocks is not driven by temporary business cycles or thematic trading. In addition to corporate governance reforms, several significant structural changes are underway, including the shift to an inflationary economy and the growing influence of domestic investors. Against this backdrop, we believe Japanese stocks are in the midst of a medium- to long-term bull market.

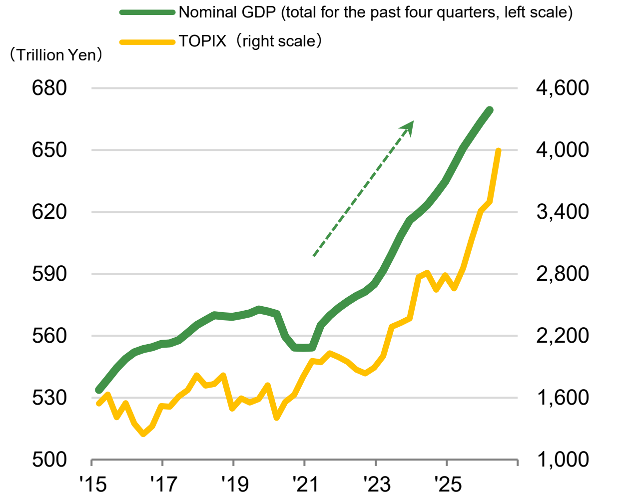
Inflation leads to higher corporate sales and profits through rising nominal GDP growth, providing a significant tailwind for Japanese stocks. Furthermore, real wages are currently trending upward, and households and companies are gradually shaking off their deflationary mindset. Consumers are becoming more receptive to corporate price hikes, and companies are regaining the pricing power they had long lost. A virtuous cycle is expected, in which improved profit margins will spur further wage increases and expanded consumption.

The Takamasa administration’s growth strategy—which the stock market views with high expectations—is also taking shape. The government has announced a roadmap for public-private investment totaling over 370 trillion yen by fiscal year 2040, targeting strategic sectors. Such investment is expected to enhance the Japanese economy’s supply capacity and boost its potential growth rate.

The expansion of AI and semiconductor-related markets is also a tailwind for Japanese stocks. While there are some skeptical views regarding AI, given its high growth potential, we believe that related stocks still have significant room for growth over the medium to long term.

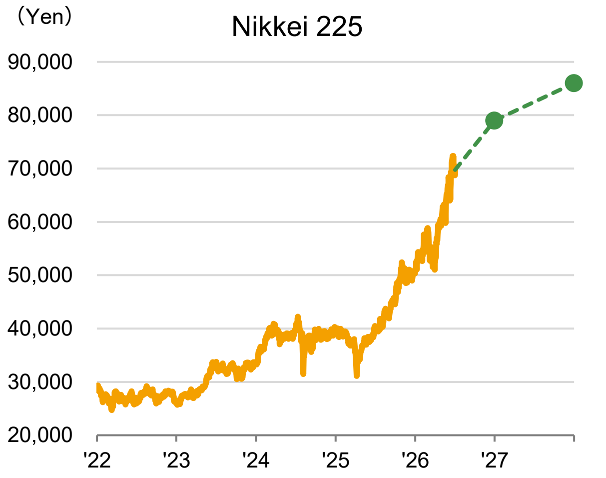
Although the Japanese stock market has been somewhat volatile recently, a look at the fundamentals reveals that both the economy and corporate earnings remain solid amid improving conditions in the Middle East.Since upward revisions to earnings forecasts are driving stock price gains, the TOPIX’s forward P/E ratio is below the level seen just before the Iran conflict, and the market does not appear significantly overvalued. We forecast that the Nikkkei 225 will reach 79,000 yen by the end of 2026 and 86,000 yen by the end of 2027.

Inflation is Providing a Tailwind for the Stock Market



※ The most recent nominal GDP figure is for the January–March 2026 quarter; the TOPIX figure is as of the end of June 2026
Source: Cabinet Office and Bloomberg; Compiled by Daiwa Asset Management

We Expect the Nikkei 225 to Rise to 86,000 Yen by the End of FY2027



※ The green line represents Daiwa Asset’s forecast; the most recent actual figure is from July 3, 2026
Source: Bloomberg; Compiled by Daiwa Asset Management

Important Information

Daiwa
Asset Management