

Multi-Asset Insights

Granular portfolio considerations to
support returns

January 2025

For professional investors only

Table of contents

Foreword	3
In a nutshell	4
Nuances of small-cap investing	5
Are Japanese equities at an inflection point?	12
Important information	19

This commentary provides a high-level overview of the recent economic environment and is for information purposes only. It is a marketing communication and does not constitute investment advice or a recommendation to any reader of this content to buy or sell investments nor should it be regarded as investment research. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. The views expressed above were held at the time of preparation and are subject to change without notice. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Foreword



Navigating complexities in today's investment landscape requires a granular approach to asset allocation. Embracing this, we outline why small-cap markets are not alike, examining structural and regional nuances, while separately considering the case for Japanese equities amidst a resurgence.

Welcome to the latest edition of our Multi-Asset Insights series, where we present the findings of our quarterly Strategic Forum.

In a 'multi-polar' world characterised by evolving geopolitical tensions and economic landscapes, the need for a meticulous approach to global investment allocations will remain important to portfolio returns. In this edition of the publication, we explore the regional and structural nuances of small-cap investing. Separately, we take a look at the state of Japanese equities, where an economic resurgence has supported a return to index levels last seen over three decades ago.

Small-cap stocks have typically been viewed as vehicles for outsized growth potential, presenting a high-beta play. However, an examination of the data shows a complex picture in which market characteristics differ greatly across countries and regions. In the US, for instance, small caps have demonstrated muted beta levels, contributing to recent underperformance against large caps. We evaluate structural differences across markets alongside trends in profitability, growth and valuations, which ultimately point to potential opportunity in approaching small-cap exposure tactically, on a region-by-region basis that considers the impact of trade tensions today.

Related to consideration of regional allocations, Japanese equities are experiencing a renaissance, driven by structural changes encapsulated in the '4R' framework. These shifts are promoting revitalisation in the local economy while enhancing the outlook for earnings growth. Yet, even amidst an escape from decades of lacklustre performance, a valuation discount for Japanese equities persists. We explore the historical drivers of stock market returns for the country, weighing the merits of recent momentum and arguments for seemingly overdue multiple expansion against challenges that may continue to weigh on sentiment ahead. Geopolitical developments may prove to be one of these challenges, as the success of Japan's economy and equity market has proven to be closely related to developments in the US, China and elsewhere.

As always, I trust you will find our insights both informative and applicable to your investment strategies in the coming months.



Jean Charles Bertrand
Global CIO, Multi-Asset
HSBC Asset Management

In a nutshell

Nuances of small-cap investing

- ◆ While small-cap stocks can exhibit higher growth potential than their larger peers, capturing this potential at the index level has proven challenging. Studies indicate that size itself has limited standalone strength in alpha generation as a factor, and requires the influence of other factors such as value or momentum.
- ◆ Regional differences in small cap characteristics are significant, supporting the argument for considering tactical small cap allocations on a region-by-region basis, instead of globally.
- ◆ Additional challenges for small-cap investors include fewer smaller companies entering public markets, and declining profitability of the remaining universe, which has dragged on performance in recent years.
- ◆ While there are potential catalysts for a rebound, such as favourable shifts in trade dynamics or policy changes in the aftermath of the US elections that could benefit smaller companies, individual market nuances will require a mindful approach for blending small-cap exposure in well-diversified portfolios

Are Japanese equities at an inflection point?

- ◆ Japan is in the midst of an economic resurgence, driven by the 4R structural changes—Reflation, Restructuring, Reshoring, and Reforms—which are reshaping investor sentiment and propelling the MSCI Japan Index to levels not observed since 1989. The momentum suggests a potential departure from decades of stagnation and deflation.
- ◆ Economic indicators reveal a strengthening economy, characterised by rising wages, low unemployment, and increased capital expenditure, all contributing to a better consumer environment and enhanced corporate pricing power, which bolsters sustainable earnings growth outlooks.
- ◆ Corporate governance reforms are making notable strides, which have correlated with enhanced performance metrics and a paradigm shift toward prioritising shareholder interests.
- ◆ Relatively cheap valuations support the argument for Japanese equities, but challenges, such as an increasingly complex global context that is changing the dynamics of external geopolitical tensions and competition, should be understood.

Diversification does not ensure a profit or protect against loss. The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Nuances of small-cap investing



Small-cap stocks present intriguing options for tactical asset allocations today, although not necessarily from a global perspective, but on a region-by-region basis.

Small-cap stocks have long been viewed as a promising avenue for investors seeking growth and higher potential returns. Consisting of many earlier-stage companies, small caps often exhibit higher growth potential compared to their larger counterparts. However, small-cap investing is complex and multifaceted, influenced by regional and structural factors that must be considered as part of portfolio construction.

Capturing the desired benefits

The effectiveness of 'size' as a factor is often debated. Studies have typically emphasised that small caps exhibit characteristics closely tied to beta exposure, with limited standalone strength in alpha generation as a factor. This conclusion remains consistent regardless of alternative measures used to define the size factor, as observed across multiple countries.

The research broadly finds that small-cap stocks often fail to outperform without the influence of other factors, such as value or momentum. These findings point to small caps catalysing other factors, highlighting the importance of integrating small-cap investing into broader, multifactor strategies rather than relying on them in isolation.

Of course, small caps are known for their higher skewness in returns, with smaller companies presenting outsized growth and risk potential. Figures 1 and 2 on the following page show the more frequent occurrences of exceptionally high individual stock returns. However, this 'lottery effect' seldom translates effectively at the index level. Only 3% of US small caps transition to large caps annually, highlighting the difficulty in capturing widescale gains at the index level.

It is clear that the efficacy of the size factor depends significantly on how it is incorporated. For instance, outcomes are deeply shaped by regional market idiosyncrasies – such as the high beta nature of European small caps versus the atypical, low beta dynamics found in the US. This underscores the importance of a localised approach to integrating size alongside complementary factors to maximise its contribution within portfolios.



Philippe Declerck
Multi-Asset Fund Manager and
Head of Multi-Asset Research
(France)



Boris Albert
Global Head of Active Allocation
and Head of Multi-Asset Core
(France)

Figure 1: S&P 500 stock return distribution (%)

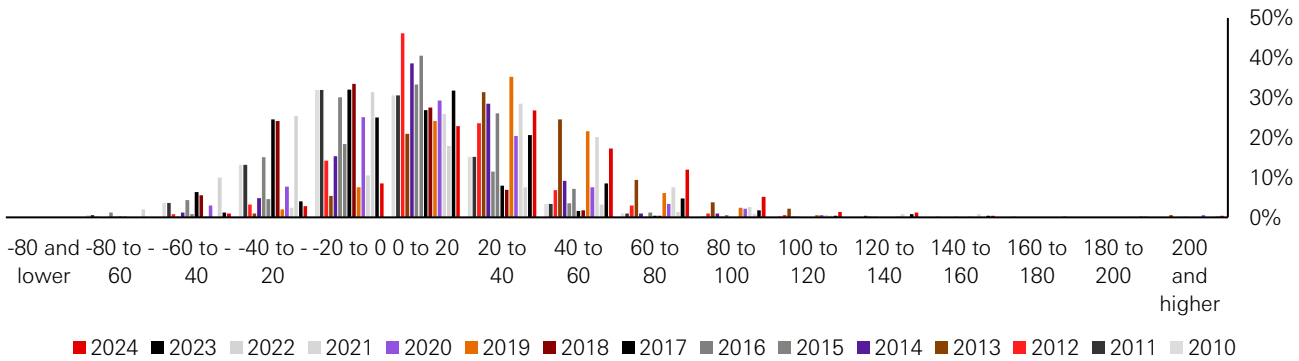
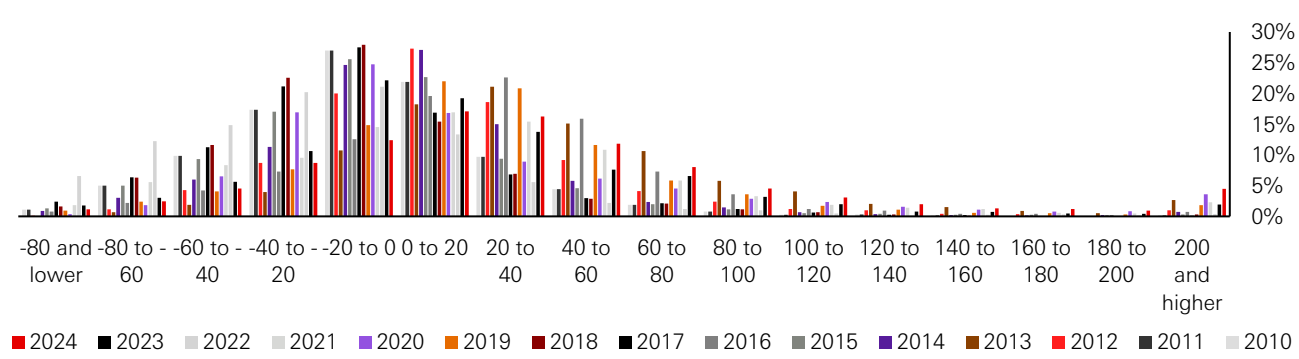


Figure 2: Russell 2000 stock return distribution (%)



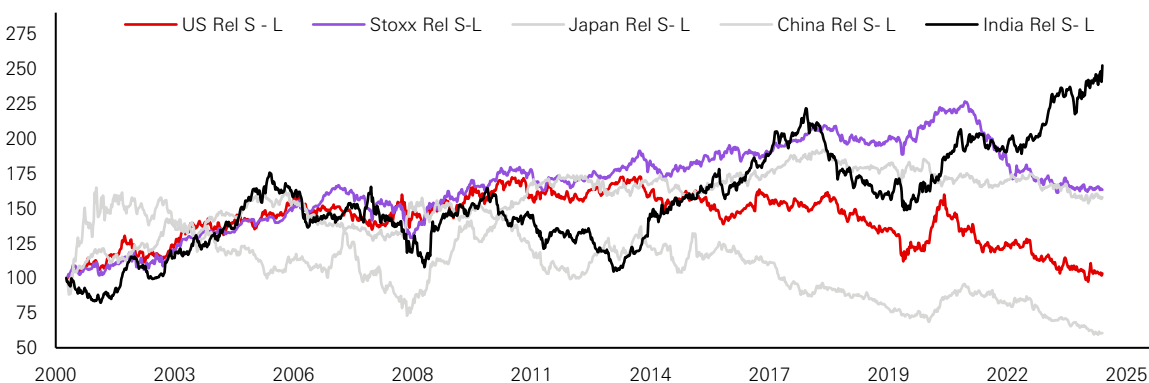
Source: HSBC AM, Bloomberg. Data as of November 2024.

Regional trends

A review of differences in the regional performance of small caps vs large caps over the last two decades demonstrates that a one-size-fits-all approach is not appropriate, with local factors certainly at play.

For instance, the stark contrast between China and India reflect differences in local economic momentum. And, the muted beta levels shown by US small caps runs counter to the common assumption of small caps being high-beta plays wherever they are. Low beta for US small caps has translated to massive underperformance in recent years – the Russell 2000’s cumulative return of roughly 50% from 2009 to 2021 pales in comparison to the S&P 500’s 300% return.

Figure 3: Small vs large cap returns per region



Source: HSBC AM, Bloomberg. Data as of November 2024.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. Past performance does not predict future returns.

Unlike the US, European small caps have exhibited a classic high-beta characteristic, with performance closely tied to macroeconomic cycles and activity. This cyclicality can also be linked to their higher operating leverage and sector distribution, resulting in more volatility but also opportunities during economic recoveries.

Yet, periods of economic stress expose vulnerability to external shocks. The onset of the Covid-19 pandemic was one, which revealed weaknesses across the board for small caps that has continued to date. Indian small caps have been an exception, benefitting from world-leading economic growth and domestic fund inflows. Over the past three years, the Nifty SmallCap 100 Index has outperformed the Nifty 50 Index by approximately 20%.

In Europe, small caps historically outperformed large caps until the onset of the pandemic, and now trade below their long-term average P/E, having given up their prior valuation premium versus large caps. This may signal a compelling entry point, particularly if uncertainties around inflation, interest rates and trade policies diminish – uncertainties to which European small caps have been particularly sensitive to historically, given their cyclicality.

In the US, valuation divergence between large cap and small cap has reached historical extremes. The current price-to-book ratio for large caps stands at around 5, compared to approximately 2 for small caps. This gap – a ratio of 2.5 – is about the highest it has ever been. Return on equity (ROE) is an important contributing factor, with a 15% spread in ROE having opened up in favour of large caps in recent years.

Figure 4: Price-to-book vs return on equity (%)

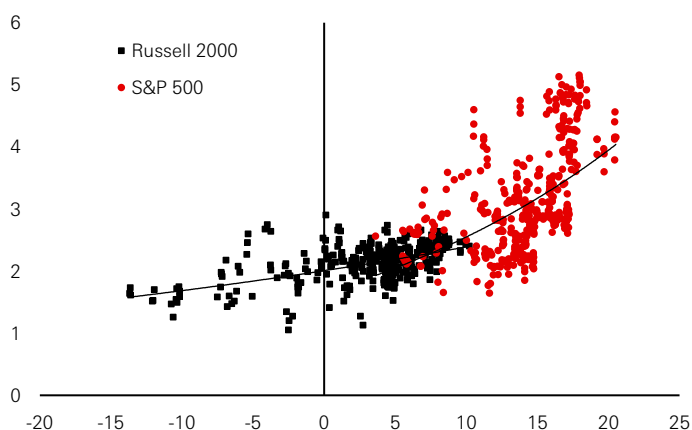
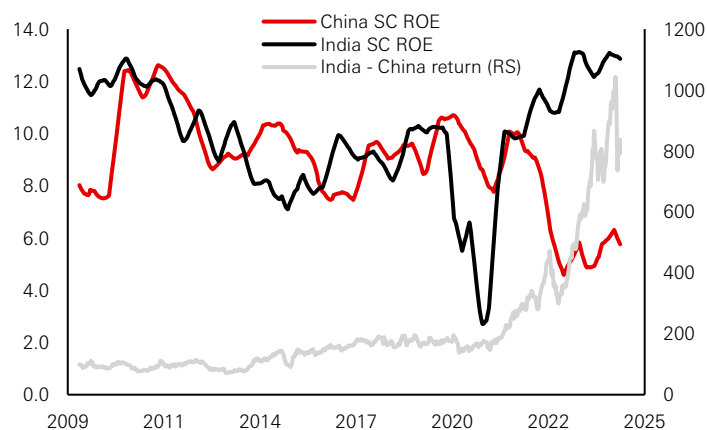


Figure 5: Performance for China and India small caps



Source: HSBC AM, Bloomberg. Data as of November 2024.

As it should in functioning financial markets, ROE trends help tell the story of what has played out. When we examine the contrast of China and India small cap performance over the last 15 years, ROEs moving in opposite directions in each market coincide with the performance dispersion. Chinese small caps have struggled to maintain profitability, reflected in the MSCI China Small Cap Index's decline of around 30% since 2015. Broad economic uncertainty alongside previously tight fiscal policy has stifled the recovery of smaller enterprises.

Additionally, unlike their large-cap counterparts, Chinese small caps have struggled to attract sustained capital flows, with foreign investors preferring large caps for broader exposure to the Chinese economy. Domestically, limited retail participation in equities and a preference for low-risk investments has impeded growth of inflows to small caps. Without capital support, these firms faced low liquidity, higher volatility, and constrained access to growth-enabling financing. Furthermore, stimulus-driven surges in large cap flows following policy announcements have shown an inverse correlation with small-cap flows, indicating that Chinese small caps have been losing out as part of capital reallocation within the market.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. Past performance does not predict future returns.

Sensitivity to Economic Factors

Some of the variations in regional performance can also be explained by the differing impact of macroeconomic factors on small and large caps. Small caps, for instance, have a higher sensitivity to interest rates, market volatility and currency fluctuations than their large cap counterparts. A closer examination of these factors reveals that:

- Rising interest rates – as inflationary pressures mount – disproportionately affect small caps due to their higher financial leverage and reliance on floating-rate debt structures. While large caps often secure fixed-rate financing, small caps are exposed to refinancing risk and higher interest expenses during periods of monetary tightening. Additionally, these firms face mounting pressures from input cost inflation, which is less easily offset than in large, multinational companies capable of hedging or passing costs onto a global customer base. This was evident in 2022, when rising inflation and real rates hurt the relative performance of small caps globally, especially in the US and Europe. Although, US small caps mitigated some impact through post-Covid refinancing in the low-rate environment, they still suffered.

Figure 6: Interest rate sensitivity for small and large caps

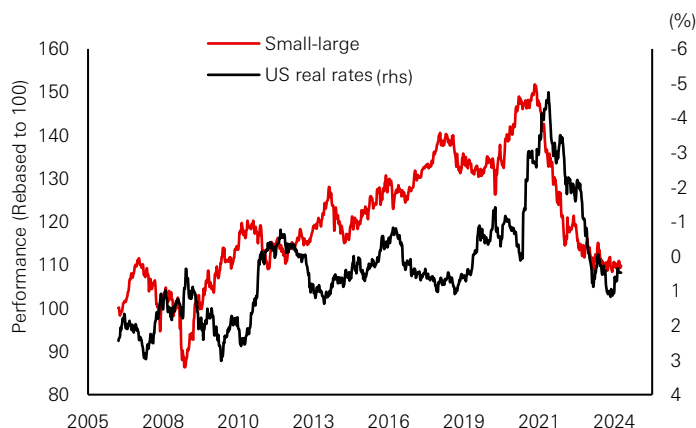
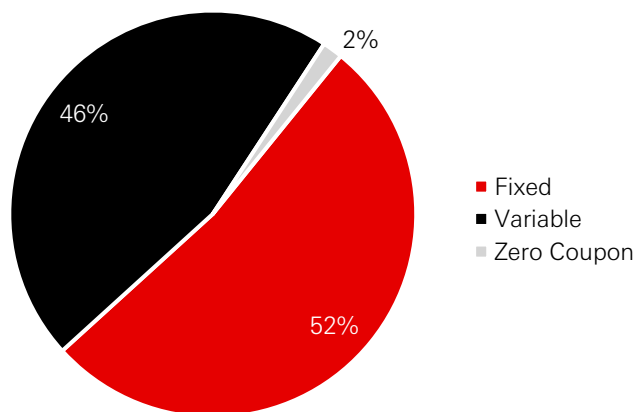


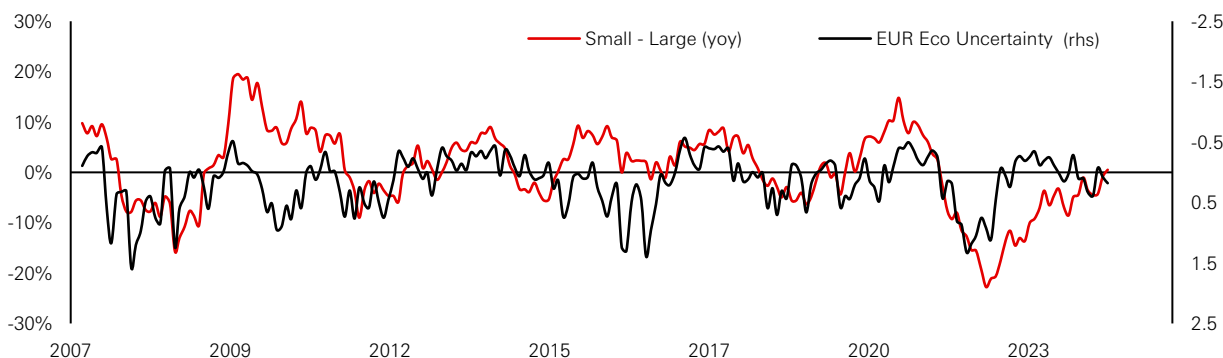
Figure 7: Type of debt for small cap segment



Source: HSBC AM, Bloomberg. Data as of November 2024.

- Small caps often lack the financial buffers of large caps to support high dividend yields or share buybacks, making them more susceptible to market stress. This limits their ability to absorb economic shocks and uncertainties stemming from policy shifts or geopolitical events. Moreover, small caps' relatively low liquidity makes them vulnerable to market sentiment swings during periods of heightened volatility. For instance, the Eurozone debt crisis and the Russia-Ukraine conflict caused significant stress in small-cap equities when amplified volatility dampened investor sentiment.

Figure 8: Sensitivity to market uncertainty for small and large caps

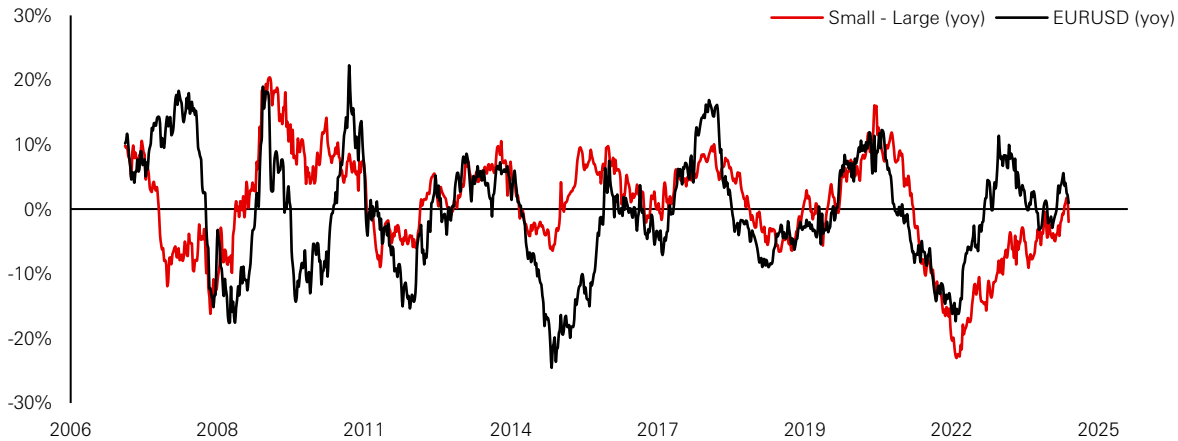


Source: HSBC AM, Bloomberg. Data as of November 2024.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

- In regions like Europe, the relative returns of small caps versus large caps are closely linked to currency dynamics. Small caps typically generate more domestic revenues, making them vulnerable to input cost pressures from currency depression. Conversely, large caps with international exposure can mitigate these effects through foreign revenue streams or repatriation gains. Hence, small caps disproportionately experience erosion of profit margins during periods of weak currency performance.

Figure 9: Sensitivity to currency fluctuations for small and large caps



Source: HSBC AM, Bloomberg. Data as of November 2024.

Challenges and strategic considerations

As large-cap firms have increasingly dominated the market, small caps have also struggled to attract investor attention. The number of initial public offerings peaked in the 1990s, while the value of IPOs is now materially higher. This trend points to fewer smaller companies entering public markets, limiting the opportunities available to small-cap investors. Contributing to this has been the absorption of smaller companies by private equity firms.

Figure 10: Private equity AUM and inflows

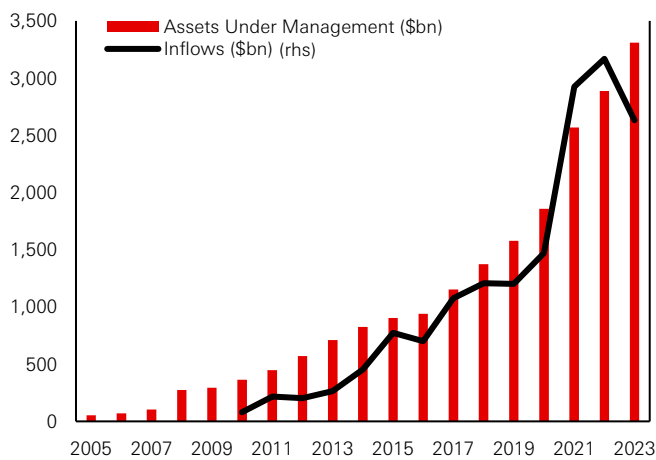
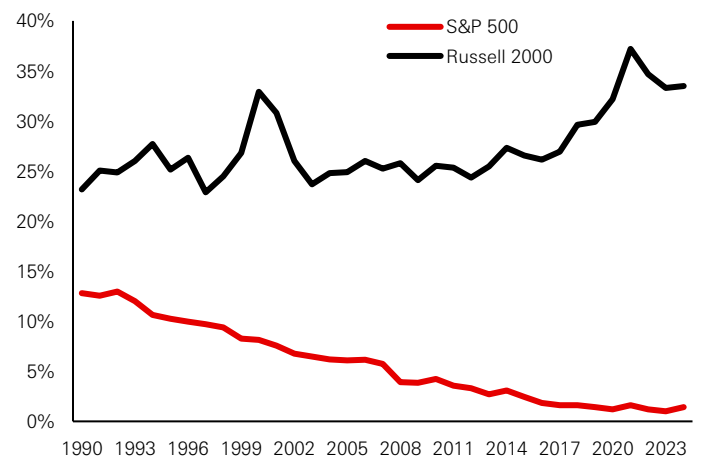


Figure 11: Share of companies posting negative EPS



Source: HSBC AM, Bloomberg. Data as of November 2024.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Implications are evident in the US. The earnings and cash flows of US small caps has deteriorated over the last few decades, while the opposite has occurred for the S&P 500. Of course, profitable small firms are better candidates for removal from the market by private equity firms. We now see a concentration of wealth within a small number of larger companies – the largest 320 stocks in the Russell 2000 account for 50% of the index's market capitalisation.

Figure 12: Share of companies with more expenses than cash flows

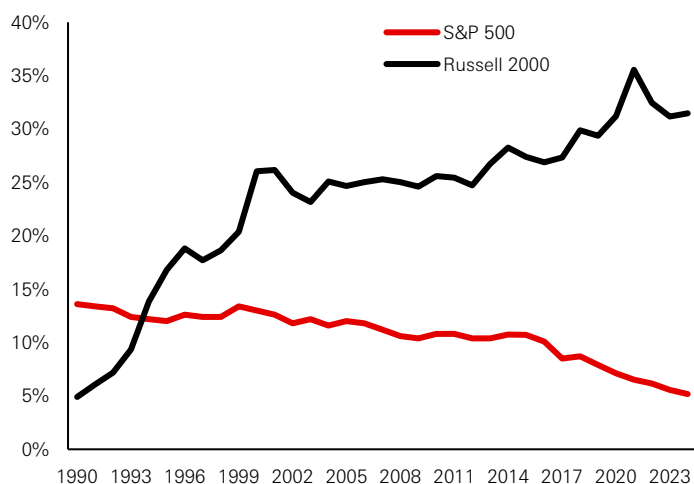
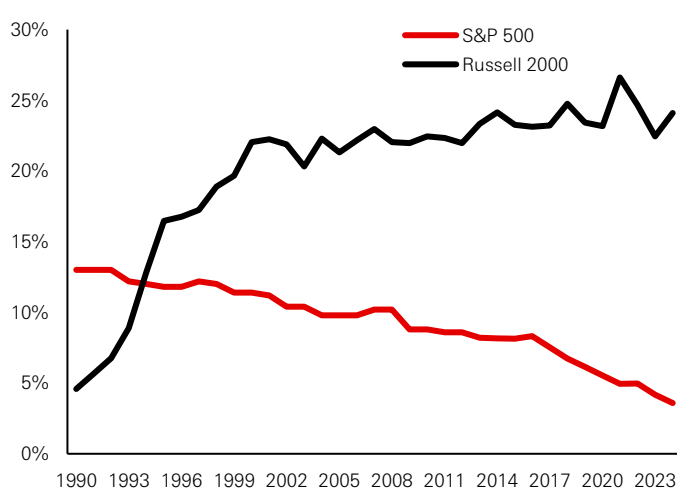


Figure 13: Share of companies with higher interest expense than EBIT



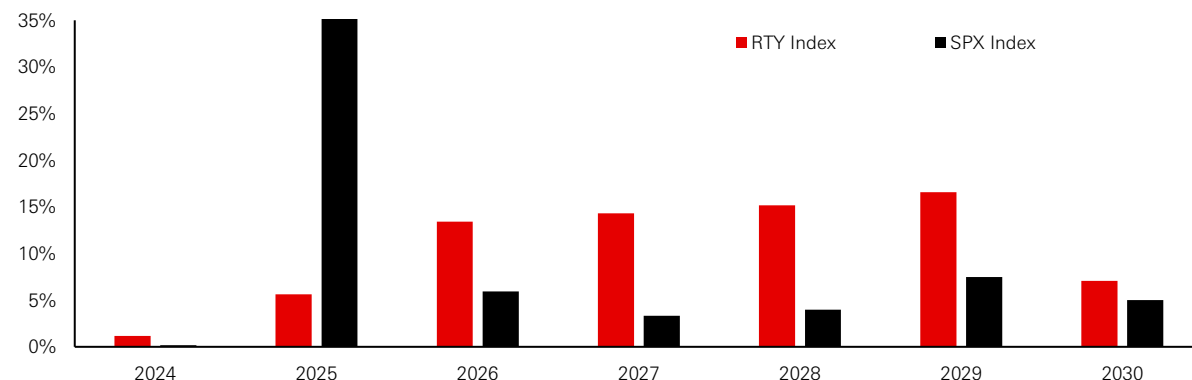
Source: HSBC AM, Bloomberg. Data as of November 2024.

Again, this situation is not replicated across markets. Less concentration in Europe means small-cap investors there benefit from significantly reduced concentration risk compared to large-cap indices.

Such differences and nuances are key to why small caps can be useful for playing tactical themes within a portfolio - not necessarily from a global perspective, but on region-by-region basis.

Small caps today may present compelling opportunities due to significant valuation resets. A higher-for-longer environment is not supportive for market sentiment and will continue to pose challenges, given small caps reliance on floating rate debt and the sensitivity of their profitability to financing costs. However, there is not a massive refinancing wall ahead for 2025 to pose additional obstacles.

Figure 14: Russell 2000 vs S&P 500 refinancing risk



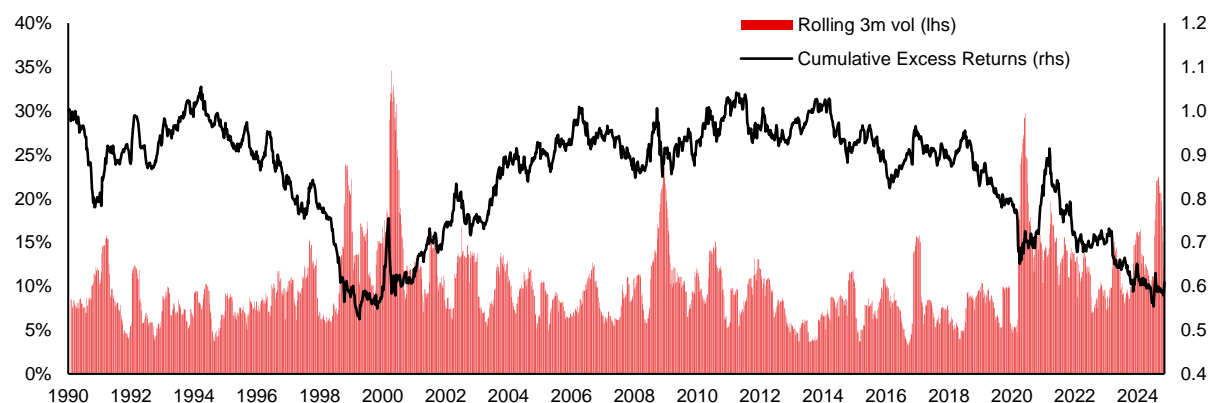
Source: HSBC AM, Bloomberg. Data as of November 2024.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Potential catalysts for a rebound

Structural challenges must be considered for small caps, but several potential catalysts could drive a rebound. One is the aftermath of the US elections. Both previous turnarounds in small cap performance occurred during periods of heightened volatility – in the late 1990s and the initial pandemic recovery. The recent spike in three-month rolling volatility, which surpassed 20% in August and September, may indicate that we could be on the cusp of another significant shift.

Figure 15: Russell 2000 vs S&P 500 volatility and excess returns



Source: HSBC AM, Bloomberg. Data as of November 2024.

US small cap strength in November follows a historical trend that has seen the Russell 2000 outperform the S&P 500 by nearly 4% historically during election weeks – placing it in the 98th percentile of weekly performance since 1990. Favourable policy changes under the new US administration could support a longer-lasting reversal for the US small caps.

Other catalysts could include a reduction in global economic uncertainty and favourable shifts in trade dynamics that benefit smaller companies. For instance, locally-oriented manufacturers would be less impacted by tariffs. Separately, improved policy coordination and effective stimulus in markets like China can restore investor confidence in downtrodden small caps there.

Portfolio implications and outlook

Small-cap stocks offer distinct characteristics that can be useful to implement regional views within a portfolio, while also offering diversification benefits when contrasted with the characteristics of large cap indices – this includes lower concentration risks compared to large caps in certain markets. This characteristic is particularly evident in Europe, where small caps provide a broader sector spread. However, this advantage comes with the trade-offs we have outlined, supporting our stance for why small cap allocations can be effective on a tactical basis, depending on market developments.

Importantly, the path for small caps appears set to remain regionally divergent. While there are potential entry points for European and Chinese small-cap equities, which could get support from a rebound in growth and removal of uncertainty, US and Indian small caps face profitability challenges and stretched valuations, respectively. Overall, small-cap investing is not a one-size-fits-all approach. The new US government, sector compositions, and the debt landscape will necessitate a tactical approach for blending small caps in well-diversified portfolios.

Source: HSBC AM, November 2024. The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Are Japanese equities at an inflection point?



Following decades of stagnation and deflation, recent developments raise questions about the long-term prospects and strategic importance of Japanese equities in global portfolios.

Over the past few decades, Japanese equities have faced unique challenges. Of these, Japan's protracted period of economic stagnation, often referred to as 'lost decades', has profoundly influenced its equity markets.

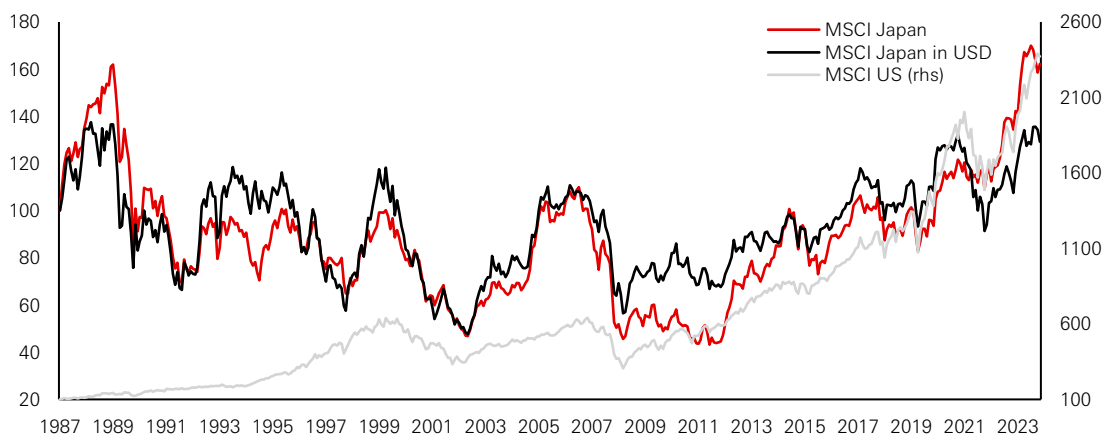
In the 1990s, post the debt financed asset bubble collapse, Japan grappled with consistent deflationary pressures amid stagnant corporate earnings, minimal wage growth, a declining work force, and local debt rising to 140% of GDP, from 40%. This environment resulted in balance sheet recession and a liquidity trap weighing negatively on equity performance.

Despite near-zero interest rates introduced under Yield Curve Control (YCC) to stimulate the economy, households and corporations prioritised debt reduction over spending or investment, rendering monetary policy ineffective.

In 2012, the introduction of 'Abenomics' under Prime Minister Shinzo Abe propelled a macroeconomic shift. Together with the YCC, the three-arrow strategy of monetary easing, fiscal stimulus, and structural reforms aimed to break the deflationary spiral. While initially met with scepticism, these reforms laid the groundwork for Japan's economic resurgence. The subsequent Value-Up Program furthered these efforts, emphasising corporate governance, sustainability, and innovation.

This resulted in Japanese equities beginning to keep pace with global markets and returned around 11% annually post-2012 in local currency. However, these returns are lower in USD terms given a weaker Yen.

Figure 1: A period of recovery in Japanese equities in local currency terms



Past performance is no guarantee of future returns.

Source: HSBC AM, Bloomberg. Data as of October 2024. Index values rebased to 100 as of December 1987.



Yigit Onat
Head of Asia Multi-Asset



Yuanfang Ma
Portfolio Manager, Multi-Asset

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Today, Japan’s economic resurgence owes much to the 4R structural adjustments (i.e. Reflation, Restructuring, Reshoring, and Reforms). These forces have spurred meaningful changes in the trajectory for Japanese equities which are garnering renewed interest. Recent data shows the MSCI Japan Index revisiting levels unseen since 1989, highlighting a potential turning point. However, it is necessary to closely examine these structural reforms, market positioning and external factors for understanding the dynamics at play.

Reflation

Japan has long struggled with stagnant economic growth, but recent developments suggest that Japan may finally be breaking free from its deflationary trap. Various macroeconomic indicators point to this shift, with stronger wages, a low unemployment rate, and increased capital expenditure. There are also signs of a labour market regaining strength and a rise in consumption activity, which is empowering companies to increase prices and achieve sustainable earnings growth.

The combination of all these factors has significantly lifted investor confidence, as the return of inflation is viewed as a critical component for a sustained economic recovery in Japan. As the country navigates this pivotal moment, sustaining the reflationary momentum will be essential to avoid any setbacks undermining market confidence.

Figure 2: Core CPI vs Unemployment

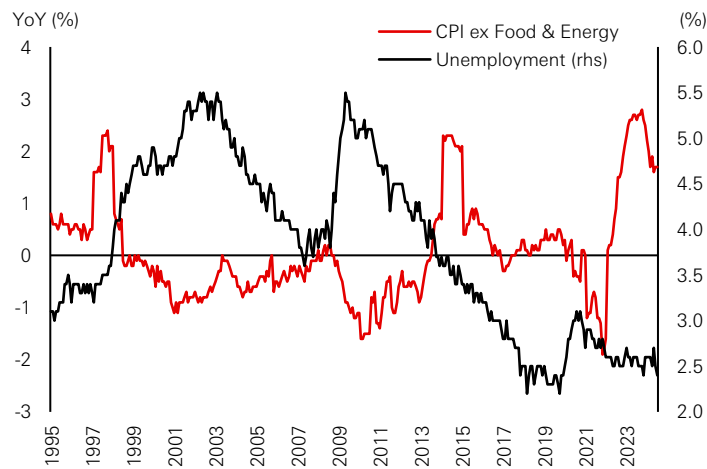
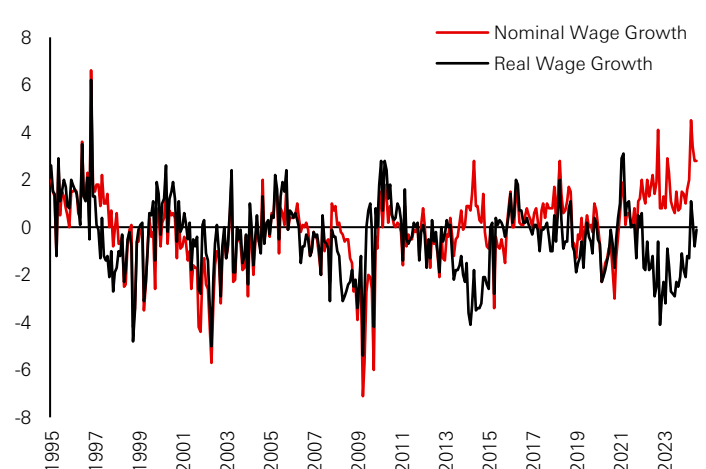


Figure 3: Japan YoY wage growth (%)



Source: HSBC AM, Bloomberg. Data as of November 2024.

Restructuring

The Tokyo Stock Exchange (TSE) has taken steps to actively promote better corporate governance practices among Japanese companies. TSE has indirectly ‘named and shamed’ those that do not demonstrate solid plans for enhancing capital efficiency. This initiative has successfully resulted in significant changes: more than 90% include at least one female board member, and over 70% of boards now have over a third as independent board members. During the past 5 years, these governance improvements have correlated with enhanced performance — the top quintile in proportion of independent board members have outperformed their peers by an average of 1.6% annually. On the contrary, the lowest quintile has underperformed by 1.5% annually.

As corporate restructuring initiatives gained momentum across Japan, conglomerates recognised the incentives for implementing substantial reforms. These reforms have concentrated on optimising capital allocation, enhancing return on equity (ROE), and prioritising shareholder value.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

In response, companies have undertaken various initiatives, including aggressive share buybacks, dividend increases, and compliance with governance standards, which have subsequently driven earnings per share (EPS) higher.

Figure 4: MSCI Japan EPS

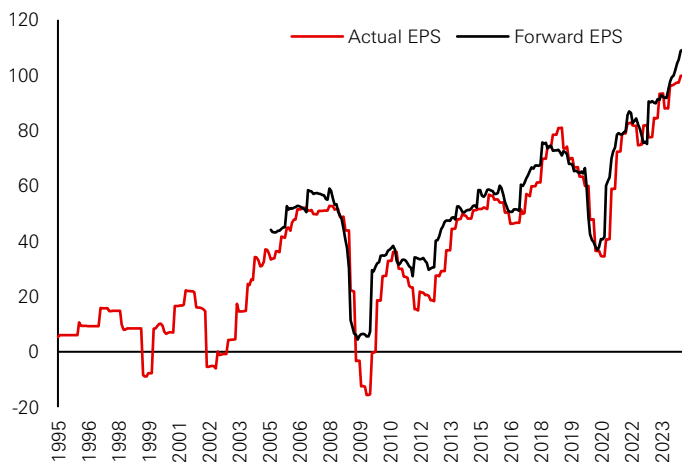
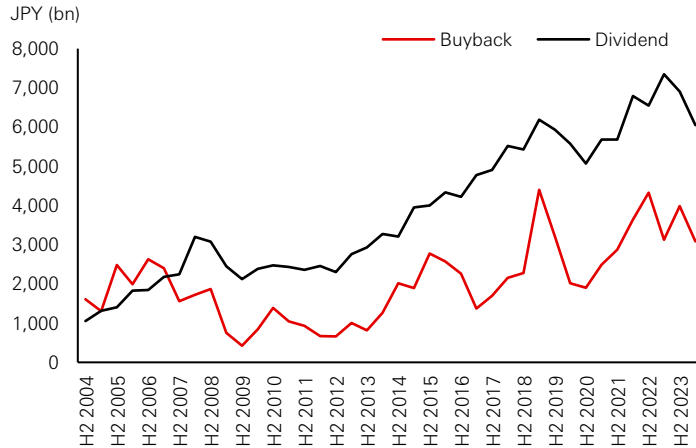


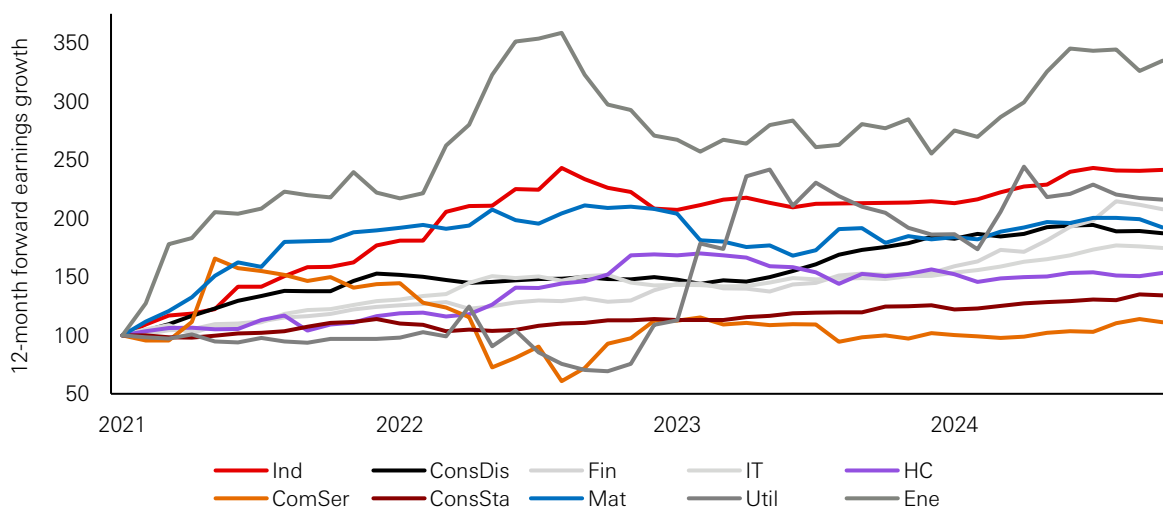
Figure 5: MSCI Japan share buyback and dividend



Source: HSBC AM, Bloomberg. Data as of November 2024.

These developments have unlocked potential in domestic sectors such as financials, energy, and utilities, which have historically attracted less investor interest and profitability compared to export-driven industries. Currently, these domestic sectors are experiencing enhanced profitability and stronger fundamentals, characterised by rising forward earnings growth and improved profit margins. As a result, domestic industries are becoming more competitive and resilient, aligning their growth trajectories with the broader goal of Japan’s economic revival.

Figure 6: 12-month forward earnings growth of Japan sectors



Source: HSBC AM, Bloomberg. Data as of November 2024.

A systematic evaluation of sectors in Japan through value, quality, and momentum frameworks reveals that domestic sectors may offer considerable prospects for appreciation. Notably, these sectors currently trade below their book value, partly because of the long-term investor neglect and structural inefficiencies. This underappreciated potential has now transformed into a tailwind as domestic industries stand to benefit from the TSE’s ‘value-up’ reforms.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target.

Similarly, the quality signal for the domestic sector has been bolstered by these sectors' resilience to macroeconomic shifts. For example, the financial sector has benefitted from favourable interest rate environments, while energy and utilities have leveraged price adjustments and operational efficiencies. Moreover, unlike export sectors which are heavily tied to global trade and foreign exchange fluctuations, domestic sectors have been more responsive to internal economic stimuli like wage growth and improved consumer spending.

Lastly, the ongoing rally seen in domestic sectors, as they catch up after years of underperformance, reflects increasing investor confidence in the fundamental shifts. This rising momentum along with strong valuation and quality metrics, points to a shift in focus from export-heavy portfolios to a more balanced inclusion of domestic industries.

Reshoring

Japan has historically been dominated by export-oriented giants. Despite some sectoral shifts with domestically-oriented sectors gaining traction, Japan's semiconductor and auto industries are being bolstered by a weaker yen and geopolitical realignments, including 'friendshoring'.

The semiconductor sector, in particular, has significantly enhanced Japan's status as a high-tech hub. The resurgence of the 'made in Japan' trend has catalysed the reshoring of high-value add manufacturing, thereby revitalising its semiconductor ecosystem.

Amid an acceleration of momentum in artificial intelligence, the Japanese government has been facilitating investments to support the opportunity. The government had established a ¥200 billion domestic chip-making fund alongside a ¥2 trillion green innovation fund. Through these funds, allocations of over ¥490 billion were made for the development of new chip-making facilities and chip packaging test lines.

Reforms

Japanese equities remain notably underrepresented in global investment portfolios, positioning the market as one of the least crowded among major economies. While foreign inflows into the Japanese market increased in 2022, totalling approximately \$30 billion, this amount is still low compared to historical peaks.¹ Additionally, domestic equity allocations are also relatively low, highlighting an opportunity for growth.

A significant factor contributing to this situation is the astonishingly high household wealth in Japan currently held in cash and deposits, at approximately ¥1,100 trillion (51% of total financial assets). This contrasts sharply with UK and US households, which hold only 31% and 13% of their financial assets in cash, respectively. This substantial cash allocation indicates a significant potential for increased investment in riskier assets such as equities.

Historically, retail investors played a prominent role in Japan's equity market, accounting for about 40% of market participation in the 1970s. However, this figure has dwindled to just 20% since the 1980s. In response to this decline, the Nippon Individual Savings Account (NISA) reform has emerged as a pivotal initiative aimed at revitalising retail investment. The reform extends the tax-exempt period to a lifetime, significantly raises annual investment limits, and introduces the ability to recycle investment limits through sell-offs. Collectively, these changes are expected to facilitate an estimated influx of US\$125 billion in retail money into equities, with a notable portion likely directed toward Japanese markets.

Moreover, improving corporate fundamentals and the potential for wage growth are anticipated to further encourage domestic and foreign investment in equities, presenting a promising outlook for Japan's investment landscape.

¹ Source: Goldman Sachs, HSBC Asset Management. Data as of November 2024.

The views expressed above were held at the time of preparation and are subject to change without notice. For informational purposes only and should not be construed as a recommendation to invest in the specific country, product, strategy, sector or security. Any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. Past performance does not predict future returns.

Valuations and style factor trends

Valuation metrics reinforce the case for Japanese equities. Between 2014 and 2017, Japanese equities had valuation metrics comparable to US markets, with a similar equity risk premium and price-to-earnings (PE) ratio.

Figure 8: P/E ratio

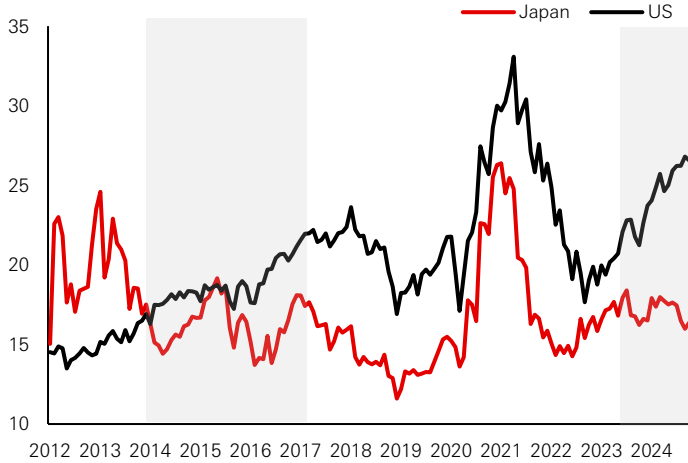
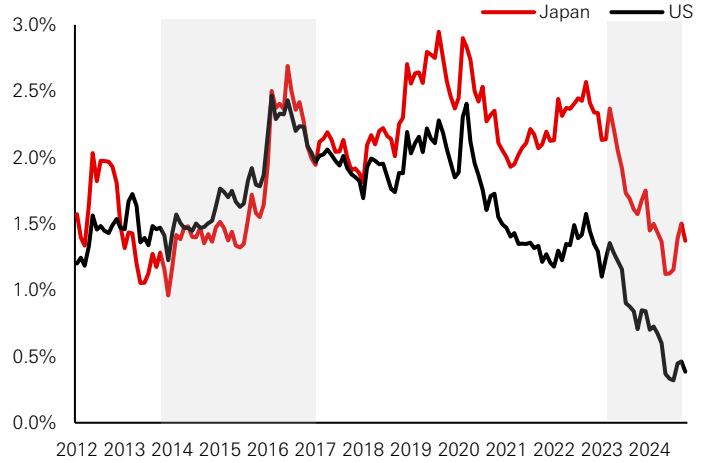


Figure 9: Equity risk premium



Source: HSBC AM, Bloomberg. Data as of November 2024. Equity risk premium = Equity dividend yield – 10Y government yield

However, Japan has outpaced most developed markets in earnings-per-share (EPS) growth over the past decade, yet Japanese stocks trade at a significant discount relative to both US equities and global peers. The trend of discounted valuations has accelerated in the past year. Importantly, earnings growth remains a primary driver of returns, with surprises in revenue and earnings results seen in the past two years. Clear signs of undervaluation, with an extended lack of multiple expansion, presents an attractive entry point with the potential for re-rating ahead.

Figure 10: 12-month forward earnings growth index

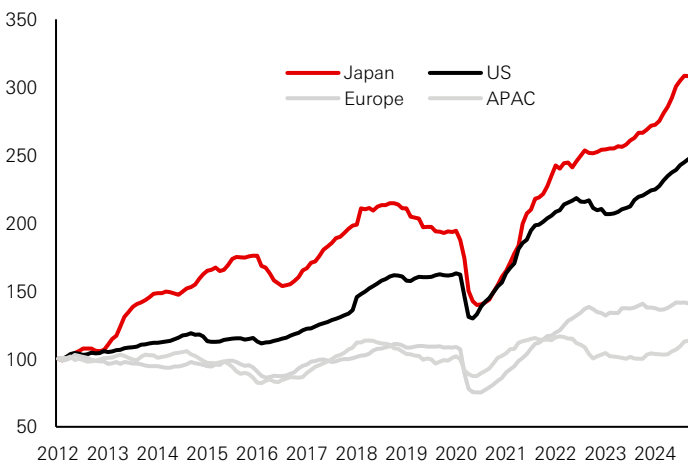
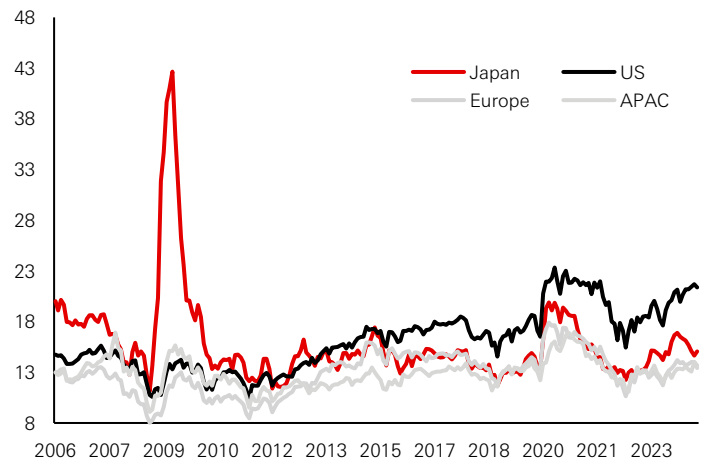


Figure 11: 12-month forward P/E ratio



Source: HSBC AM, Bloomberg. Data as of November 2024.

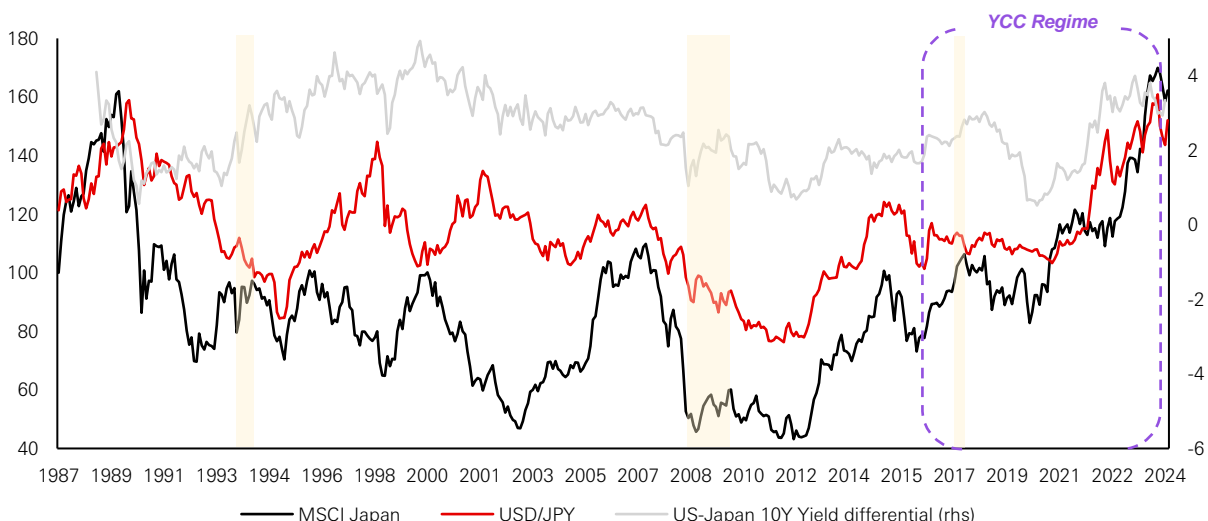
Influence of the external environment

Japan's equity market remains heavily influenced by external factors, notably Japan's trade dynamics with the US and China. These two nations represent Japan's largest trading partners, each accounting for approximately 20% of Japan's trade flows, but their impacts are distinct and multifaceted.

The impact of trade relations with the US can be directly seen through the dollar-yen exchange rate. Historically, Japanese equity performance has shown a strong correlation with the dollar-yen exchange rate, which itself is closely tied to interest rate differentials. To quantify, approximately 60% of Japanese equity performance can be accounted for by dollar-yen movements. This link underscores the importance of US monetary policy on Japanese markets.

For instance, a loosening monetary stance in the US often strengthens the Yen, which negatively impacts Japanese exporters, as a stronger Yen makes their goods less competitive globally. Conversely, when US rates are higher than Japan's, the dollar-yen pair tends to favour the dollar, benefiting Japanese exporters and boosting equity markets. While a weaker yen has traditionally supported exporters, recent data suggests diminishing sensitivity. Nonetheless, the relationship highlights the sensitivity of Japan's trade and equity performance to US economic policies and the broader macroeconomic environment.

Figure 12: USD-JPY correlation with Japan equities and 10Y US-Japan yield differential



Source: HSBC AM, Bloomberg. Data as of November 2024.

Japan's trade with China is marked by both collaboration and competition. On one hand, China's growth supports Japanese exports, particularly in technology and industrial goods, bolstering Japan's overall economic health. On the other hand, both nations compete for foreign investment inflows, which can significantly affect Japanese equities. For example, large stimulus-driven inflows into Chinese equity markets often divert investments away from Japan, creating a competitive dynamic.

Furthermore, China's economic cycles have a direct impact on Japan's trade performance. A slowdown in China or policy uncertainty—such as unclear fiscal stimulus—can pose challenges for Japan, given their intertwined supply chains. Notably, Japan's technology and semiconductor industries compete with China for market share, and geopolitical tensions or trade barriers could influence this relationship further.

Outlook and challenges ahead

Japanese equities present a compelling investment case rooted in inexpensive valuations and a reflating economy, supported by improving governance standards aligned with shareholder interests. However, despite trading at a 40% discount to US markets, challenges loom due to their cyclical nature and relatively lower profit margins. The turbulence experienced this summer during the unwinding of the Yen carry trade highlights the necessity for vigilance in navigating this complex market landscape.

Structural reforms in Japan are progressing slowly, raising pertinent questions about the efficacy of measures implemented to tackle persistent deflationary pressures, especially in light of ongoing negative real wage growth and political volatility. A potential sharp appreciation of the Yen, driven by a hawkish stance from the Bank of Japan, could exacerbate deflationary challenges and pose significant headwinds for Japanese equities as it undermines export competitiveness.

In the broader Asian context, Japan faces formidable competition from economies such as Taiwan, which holds a commanding position in semiconductor manufacturing. Although shifts in global supply chains may offer opportunities within high-tech sectors, Japan must proactively enhance its innovation and sustainability to remain relevant.

As the world transitions towards a multi-polar structure, Japan's trajectory will increasingly depend on its relationships with the US and China, alongside competition from regional players like Taiwan and South Korea. A fragmented global economy could heighten competition for foreign capital inflows, as China and other Asian economies vie for investment.

Moreover, Japan remains exposed to geopolitical risks, particularly those stemming from US-China tensions, which may necessitate careful navigation of heightened trade rivalries. The potential introduction of broad tariffs on exports to the US could further erode Japanese business confidence.

Ultimately, Japan's significant dependence on cyclical markets and limited domestic demand renders it vulnerable to global economic slowdowns. To ensure ongoing competitiveness on the global stage, Japan must exhibit strategic agility and adaptability, embracing innovation while effectively navigating the complexities of a rapidly evolving economic environment.

Important information

For Professional Clients and intermediaries within countries and territories set out below; and for Institutional Investors and Financial Advisors in the US. This document should not be distributed to or relied upon by Retail clients/investors.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. The performance figures contained in this document relate to past performance, which should not be seen as an indication of future returns. Future returns will depend, inter alia, on market conditions, investment manager's skill, risk level and fees. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up. Investments in emerging markets are by their nature higher risk and potentially more volatile than those inherent in some established markets. Economies in Emerging Markets generally are heavily dependent upon international trade and, accordingly, have been and may continue to be affected adversely by trade barriers, exchange controls, managed adjustments in relative currency values and other protectionist measures imposed or negotiated by the countries and territories with which they trade. These economies also have been and may continue to be affected adversely by economic conditions in the countries and territories in which they trade.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorised reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views and opinions expressed herein are those of HSBC Asset Management at the time of preparation, and are subject to change at any time. These views may not necessarily indicate current portfolios' composition. Individual portfolios managed by HSBC Asset Management primarily reflect individual clients' objectives, risk preferences, time horizon, and market liquidity. Foreign and emerging markets. Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets. This commentary is for information purposes only. It is a marketing communication and does not constitute investment advice or a recommendation to any reader of this content to buy or sell investments nor should it be regarded as investment research. It has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. This document is not contractually binding nor are we required to provide this to you by any legislative provision.

All data from HSBC Asset Management unless otherwise specified. Any third party information has been obtained from sources we believe to be reliable, but which we have not independently verified.

HSBC Asset Management is the brand name for the asset management business of HSBC Group, which includes the investment activities that may be provided through our local regulated entities. HSBC Asset Management is a group of companies in many countries and territories throughout the world that are engaged in investment advisory and fund management activities, which are ultimately owned by HSBC Holdings Plc. (HSBC Group). The above communication is distributed by the following entities:

- in Australia, this document is issued by HSBC Bank Australia Limited ABN 48 006 434 162, AFSL 232595, for HSBC Global Asset Management (Hong Kong) Limited ARBN 132 834 149 and HSBC Global Asset Management (UK) Limited ARBN 633 929 718. This document is for institutional investors only, and is not available for distribution to retail clients (as defined under the Corporations Act). HSBC Global Asset Management (Hong Kong) Limited and HSBC Global Asset Management (UK) Limited are exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the financial services they provide. HSBC Global Asset Management (Hong Kong) Limited is regulated by the Securities and Futures Commission of Hong Kong under the Hong Kong laws, which differ from Australian laws. HSBC Global Asset Management (UK) Limited is regulated by the Financial Conduct Authority of the United Kingdom and, for the avoidance of doubt, includes the Financial Services Authority of the United Kingdom as it was previously known before 1 April 2013, under the laws of the United Kingdom, which differ from Australian laws;
- in Bermuda by HSBC Global Asset Management (Bermuda) Limited, of 37 Front Street, Hamilton, Bermuda which is licensed to conduct investment business by the Bermuda Monetary Authority;
- in Chile: Operations by HSBC's headquarters or other offices of this bank located abroad are not subject to Chilean inspections or regulations and are not covered by warranty of the Chilean state. Further information may be obtained about the state guarantee to deposits at your bank or on www.sbif.cl;
- in Colombia: HSBC Bank USA NA has an authorized representative by the Superintendencia Financiera de Colombia (SFC) whereby its activities conform to the General Legal Financial System. SFC has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Colombia and is not for public distribution;

Follow us on:

LinkedIn:
[**HSBC Asset Management**](#)

Website:
[**assetmanagement.hsbc.com**](http://assetmanagement.hsbc.com)

- in Finland, Norway, Denmark and Sweden by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Stockholm branch of HSBC Global Asset Management (France), regulated by the Swedish Financial Supervisory Authority (Finansinspektionen);
- in France, Belgium, Netherlands, Luxembourg, Portugal, Greece by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026);
- in Germany by HSBC Global Asset Management (Deutschland) GmbH which is regulated by BaFin (German clients) respectively by the Austrian Financial Market Supervision FMA (Austrian clients);
- in Hong Kong by HSBC Global Asset Management (Hong Kong) Limited, which is regulated by the Securities and Futures Commission. This video/content has not be reviewed by the Securities and Futures Commission;
- in India by HSBC Asset Management (India) Pvt Ltd. which is regulated by the Securities and Exchange Board of India;
- in Italy and Spain by HSBC Global Asset Management (France), a Portfolio Management Company authorised by the French regulatory authority AMF (no. GP99026) and through the Italian and Spanish branches of HSBC Global Asset Management (France), regulated respectively by Banca d'Italia and Commissione Nazionale per le Società e la Borsa (Consob) in Italy, and the Comisión Nacional del Mercado de Valores (CNMV) in Spain;
- in Malta by HSBC Global Asset Management (Malta) Limited which is regulated and licensed to conduct Investment Services by the Malta Financial Services Authority under the Investment Services Act;
- in Mexico by HSBC Global Asset Management (Mexico), SA de CV, Sociedad Operadora de Fondos de Inversión, Grupo Financiero HSBC which is regulated by Comisión Nacional Bancaria y de Valores;
- in the United Arab Emirates, Qatar, Bahrain & Kuwait by HSBC Global Asset Management MENA, a unit within HSBC Bank Middle East Limited, U.A.E Branch, PO Box 66 Dubai, UAE, regulated by the Central Bank of the U.A.E. and the Securities and Commodities Authority in the UAE under SCA license number 602004 for the purpose of this promotion and lead regulated by the Dubai Financial Services Authority. HSBC Bank Middle East Limited is a member of the HSBC Group and HSBC Global Asset Management MENA are marketing the relevant product only in a sub-distributing capacity on a principal-to-principal basis. HSBC Global Asset Management MENA may not be licensed under the laws of the recipient's country of residence and therefore may not be subject to supervision of the local regulator in the recipient's country of residence. One of more of the products and services of the manufacturer may not have been approved by or registered with the local regulator and the assets may be booked outside of the recipient's country of residence.
- in Peru: HSBC Bank USA NA has an authorized representative by the Superintendencia de Banca y Seguros in Perú whereby its activities conform to the General Legal Financial System - Law No. 26702. Funds have not been registered before the Superintendencia del Mercado de Valores (SMV) and are being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This document is for the exclusive use of institutional investors in Perú and is not for public distribution;
- in Singapore by HSBC Global Asset Management (Singapore) Limited, which is regulated by the Monetary Authority of Singapore. The content in the document/video has not been reviewed by the Monetary Authority of Singapore;
- in Switzerland by HSBC Global Asset Management (Switzerland) AG. This document is intended for professional investor use only. For opting in and opting out according to FinSA, please refer to our website; if you wish to change your client categorization, please inform us. HSBC Global Asset Management (Switzerland) AG having its registered office at Gartenstrasse 26, PO Box, CH-8002 Zurich has a licence as an asset manager of collective investment schemes and as a representative of foreign collective investment schemes. Disputes regarding legal claims between the Client and HSBC Global Asset Management (Switzerland) AG can be settled by an ombudsman in mediation proceedings. HSBC Global Asset Management (Switzerland) AG is affiliated to the ombudsman FINOS having its registered address at Talstrasse 20, 8001 Zurich. There are general risks associated with financial instruments, please refer to the Swiss Banking Association ("SBA") Brochure "Risks Involved in Trading in Financial Instruments";
- in Taiwan by HSBC Global Asset Management (Taiwan) Limited which is regulated by the Financial Supervisory Commission R.O.C. (Taiwan);
- in Turkiye by HSBC Asset Management A.S. Turkiye (AMTU) which is regulated by Capital Markets Board of Turkiye. Any information here is not intended to distribute in any jurisdiction where AMTU does not have a right to. Any views here should not be perceived as investment advice, product/service offer and/or promise of income. Information given here might not be suitable for all investors and investors should be giving their own independent decisions. The investment information, comments and advice given herein are not part of investment advice activity. Investment advice services are provided by authorized institutions to persons and entities privately by considering their risk and return preferences, whereas the comments and advice included herein are of a general nature. Therefore, they may not fit your financial situation and risk and return preferences. For this reason, making an investment decision only by relying on the information given herein may not give rise to results that fit your expectations.
- in the UK by HSBC Global Asset Management (UK) Limited, which is authorised and regulated by the Financial Conduct Authority;

Follow us on:

LinkedIn:
[**HSBC Asset Management**](#)

Website:
[**assetmanagement.hsbc.com**](https://assetmanagement.hsbc.com)

- and in the US by HSBC Global Asset Management (USA) Inc. which is an investment adviser registered with the US Securities and Exchange Commission.
- In Uruguay, operations by HSBC's headquarters or other offices of this bank located abroad are not subject to Uruguayan inspections or regulations and are not covered by warranty of the Uruguayan state. Further information may be obtained about the state guarantee to deposits at your bank or on www.bcu.gub.uy.

Copyright © HSBC Global Asset Management Limited 2025. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, on any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of HSBC Global Asset Management Limited.

Content ID: D038379_V2.0; Expiry Date: 31.12.2025

Follow us on:

LinkedIn:
[HSBC Asset Management](#)

Website:
assetmanagement.hsbc.com