Japan Event Flash

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Mitsubishi UFJ Trust and Banking Corporation

A member of MUFG, a global financial group

Naoya Oshikubo, Chief Market Economist

Global Asset Management Business Office

Japanese Market Outlook Amid Middle Eastern Conflict

Japanese stocks have been volatile, temporarily falling sharply due to concerns over the Middle East situation (Exhibit 1). Bloomberg reported on 8 March that President Trump was considering deploying special forces on the ground as an option to seize Iran's stockpile of highly enriched uranium. Furthermore, the appointment of Ayatollah Mojtaba Khamenei, the second son of Iran's Supreme Leader Ayatollah Khamenei, known as an anti-American conservative hardliner, has increased the likelihood that resolving the Middle East situation could take considerable time. Meanwhile, on March 9, President Trump stated that the war with Iran was almost over, raising expectations for an early resolution to thesituation. WTI crude oil futures surged sharply, temporarily soaring well above the key $100 mark, but fell back to the $80 range following remarks by President Trump (Exhibit 2).

One factor behind Japanese stocks significantly underperforming among developed market equities is likely the perception that Japanese economy, heavy reliant on Middle Eastern crude oil, will suffer substantial adverse economic effects from high oil prices resulting from a closure of the Strait of Hormuz. The Middle East accounts for a highly significant, 95.9% of Japan's crude oil imports, with countries directly affected by a Strait of Hormuz blockade (UAE, Saudi Arabia, Qatar, Kuwait) alone representing 94.3% of this total (Exhibit 3). According to Prime Minister Takaichi, Japan has 254 days' worth of oil reserves, ensuring energy supply is maintained for the time being. However, should the closure of the Strait of Hormuz persist long-term, the adverse effects would become apparent: pressure on corporate profits due to high crude oil prices and negative impacts on consumption via high petrol prices. Although the closure of the Strait would also damage Iran's economy, leading to assumptions that ceasefire talks between the US and Iran will begin and the blockade will be lifted, significant uncertainty remains. Given that the G7 is considering coordinated releases of oil reserves and that the U.S. government has commented on supporting allies in securing crude oil supplies, we do not currently anticipate the current high crude oil prices becoming prolonged. Nevertheless, we believe it remains necessary to closely monitor whether the impact on crude oil prices from the closure of the Strait of Hormuz and the destruction of energy production facilities will persist over the long term.

Looking at the Nikkei's price movement around the start of previous U.S.-led Middle East conflicts the index typically bottomed out after 2-3 weeks of decline (Exhibit 4). When measured from the start of U.S. military attacks, the Nikkei's average decline often remained below 10%. While we must consider the materialization of risk scenarios such as the Strait of Hormuz blockade this time, given that Japanese stocks have already fallen approximately 8% since the commencement of U.S. military action, we believe there is limited scope for further declines from here.

Looking ahead, the Japanese stock market is expected to remain volatile in the short term due to uncertainty in how the current situation may play out. However, once the rise in crude oil prices stabilizes, we anticipate a significant rise in Japanese market. This is underpinned by the Takaichi administration's expansionary fiscal policies, robust corporate earnings, and the revision of the Corporate Governance Code, which will facilitate the effective use of cash by Japanese companies (including further proactive shareholder return policies). Against the backdrop of instability in US politics, if capital outflows from the US accelerate, Japanese stocks could potentially benefit from positive capital flow.

Regarding stock selection, assuming Middle East concerns persist for the time being, resource stocks, oil wholesalers, and trading companies are likely to outperform. Furthermore, as heightened global geopolitical risk drives increased defense spending, the defense industry is expected to outperform, benefiting from substantial policy support from the Takaichi administration. Conversely, concerns over the Middle East have reduced the likelihood of the Bank of Japan raising interest rates in the spring, leading us to maintain a neutral stance on financial stocks for now. Growing concerns surrounding private credit also pose a short-term risk. Against the backdrop of concerns about AI-driven substitution, we expect software stocks to continue underperforming.

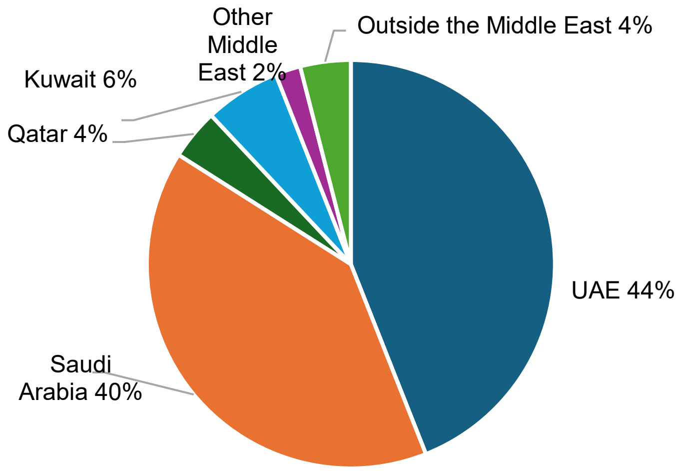
Exhibit 1: Nikkei

Source: Bloomberg, MUFG: Trust Bank

Exhibit 2: Oil Price (WTI)

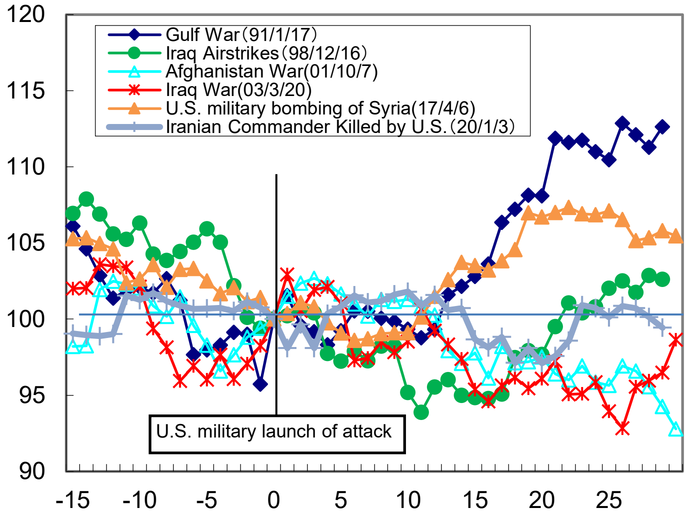
Source: Bloomberg, MUFG: Trust Bank

Exhibit 3: Japan's Crude Oil Import Volume Weight (by Country)



Source: Agency for Natural Resources and Energy, MUFG: Trust Bank

Exhibit 4: Movements in the Nikkei Around the Time of the Attack (Daily)



Note: The business day immediately preceding the start date of the U.S. military attack = 100

Source: Bloomberg, MUFG: Trust Bank