

Japan Investment Commentary and Market Outlook

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Market Movement	As at 31/10/2025
TOPIX Index	3,331.83 (+6.2%)
Nikkei 255 Stock Average	52,441.34 (+16.6%)
Exchange rate	1USD = JPY153.99

Note: Rates of increase and decrease are reflected in the performance of stock indices.

Japanese equities rose in October, supported by strength in AI-related stocks and improved sentiment following Prime Minister Sanae Takaichi’s appointment. While early profit-taking briefly weighed on performance, futures-led buying and a US rate cut helped lift investor confidence. Solid corporate earnings also contributed, with major indices ending the month near record highs.

The domestic economy remains resilient, driven by rising wages and labour-saving investments, despite external headwinds. Although exports and housing investment have softened, overall growth momentum continues. Inflationary pressures are steady, reinforcing expectations of potential monetary tightening after the Bank of Japan’s upcoming meeting.

The Takaichi administration has introduced fiscal measures including cost-of-living support, tax cuts, and wage increases for medical workers. While broader reforms—such as changes to social security and healthcare—may face political hurdles, Japan’s shift away from deflation and continued corporate governance improvements are expected to support equity markets.

Against this backdrop, we maintain a constructive medium-term view on Japanese equities. Structural changes in the macroeconomic environment and corporate behaviour are likely to provide a favourable foundation for sustained market performance.

Market Review

In Japanese equities rallied strongly in October, propelled by AI-related stocks and positive sentiment following Sanae Takaichi's election as Prime Minister. The Nikkei 225 surged by 16.6% month-on-month, while the TOPIX gained 6.2%. Early in the month, profit-taking and portfolio rebalancing created downward pressure, but AI-linked stocks supported a rebound. Futures-driven buying accelerated after Ms Takaichi assumed leadership of the Liberal Democratic Party (LDP), despite the Komeito Party's withdrawal from the coalition. The LDP formed a new government with the Japan Innovation Party, solidifying Ms Takaichi's premiership.

Market sentiment faced temporary headwinds from concerns over US-China relations and stress in US regional banks. However, softer-than-expected US inflation data boosted expectations for rate cuts, lifting US tech stocks and, in turn, domestic AI names. The Federal Reserve cut rates by 25 basis points, while the BoJ maintained its policy stance at 0.5%. Towards the end of the month, strong corporate earnings further supported gains, with both the Nikkei and TOPIX closing at record highs.

Macroeconomic Circumstances

Japan's domestic economy continues to demonstrate resilience, supported by rising wages and capital investment driven by labour shortages, despite external challenges. Real GDP expanded by 2.2% annualised in Q2, marking five consecutive quarters of growth. Export growth contributed positively during this period; however, exports are projected to decline in Q3 due to the full implementation of reciprocal tariffs by the United States. Monthly data also indicate stagnation in private consumption, while housing investment is expected to pull back following a surge ahead of mandatory energy efficiency standards introduced in April 2025.

As a result, real GDP for Q3 is likely to contract modestly. Nevertheless, sentiment in the Economy Watchers Survey improved for the fifth consecutive month as of late September, reflecting optimism about both current and future conditions. Wage growth, including increases to the minimum wage, is expected to support consumption despite concerns over rising prices and US trade policy. While US tariffs on Japanese imports pose a downside risk, strong wage growth and labour-saving investments are anticipated to sustain domestic demand, helping the economy maintain a broadly stable trajectory.

Monetary Policy Outlook

The Bank of Japan is widely expected to raise interest rates following its December policy meeting, driven by persistent inflationary pressures. Core CPI (excluding fresh food) rose 2.9% year-on-year in September, remaining above the BoJ's 2% target for the second consecutive month. Energy prices accelerated as the impact of last year's subsidies faded, while food inflation (excluding fresh produce) showed signs of moderation. At its October meeting, the BoJ voted to maintain the policy rate at around 0.5%, although two board members proposed raising it to 0.75%. The central bank has indicated that further rate hikes will be considered if its economic and price projections are met. With the Japanese Trade Union Confederation (Rengo) targeting wage increases of over 5% in the 2026 spring negotiations, and assuming limited domestic impact from US tariff measures, stronger wage growth and stable inflation could provide the basis for a rate hike after the December meeting.

Formation of the Takaichi Administration

The coalition government formed by the Liberal Democratic Party and Japan Innovation Party marks the beginning of the Takaichi administration. During the upcoming extraordinary Diet session, a supplementary budget is expected to include measures such as abolishing the provisional petrol tax, raising wages for medical and care workers, providing cost-of-living support, expanding local grants for municipalities, and accelerating defence spending to reach 2% of GDP. Markets are closely watching whether the budget will exceed last year's ¥14 trillion, as the administration seeks to balance fiscal responsibility with proactive spending.

Looking ahead, the coalition is likely to pursue policies agreed upon with the Japan Innovation Party, including a two-year suspension of consumption tax on food, refundable tax credits for low-income households, social security reforms to reduce contributions for working-age individuals, and measures to ease household financial burdens such as free secondary school tuition and meals. However, politically sensitive reforms, such as reducing the number of Diet members and changes to the healthcare system, may face resistance and potentially slow parliamentary proceedings.

Market Outlook

Japan Equities: A Constructive Pause in a Structural Uptrend

Japanese equities posted strong gains in October, supported by AI-related momentum and renewed optimism following the appointment of Japan's first female Prime Minister, Sanae Takaichi. The emergence of "Sanaenomics" has contributed to a shift in sentiment, with investors responding positively to the prospect of policy change. While the pace of the rally suggests a technical pause may be natural, we believe the market has entered a medium-term upward phase, underpinned by structural improvements.

One key driver is Japan's gradual departure from its deflationary mindset, which has shaped corporate and consumer behaviour for over three decades. As nominal GDP begins to rise, companies are likely to benefit from stronger revenue and earnings growth. Stable inflation supports EPS expansion and provides a structural tailwind for equity valuations.

Another important factor is the continued progress in corporate governance reform. The Tokyo Stock Exchange and the government remain committed to improving capital efficiency, with the next revision of the Corporate Governance Code scheduled for 2026—the first in five years. Capital allocation is expected to be a central theme, and more proactive use of cash reserves could help lift ROE and support equity prices. Japanese companies tend to move collectively, and once a trend is established, it often spreads gradually, as seen during the 2023 PBR reform.

The Takaichi administration has signalled a shift toward "responsible expansionary fiscal policy," aiming to balance growth with fiscal discipline. Her October 24 policy speech outlined measures to stimulate the economy while maintaining long-term sustainability. Although implementation risks remain, stronger political leadership and a focus on inflation control may continue to support investor confidence.

Valuation Perspective

TOPIX's 12-month forward price-to-earnings (PE) ratio has historically ranged between 12x and 16x. As of early November, during the Q3 earnings season, more companies appeared to be exceeding expectations than missing them. According to IBES consensus forecasts at that time, TOPIX earnings per share (EPS) were projected to grow by 1.3% in FY2025, 13.4% in FY2026,

and 9.4% in FY2027.

If we extend the current trajectory and apply the historical upper bound of 16x PE, a level of around 3,470 points for TOPIX appears reasonable. That said, investors may wish to remain mindful of the possibility that Japan's evolving macroeconomic and corporate environment—particularly the shift away from deflation—could lead to upward revisions in earnings expectations for FY2026 and beyond, as well as a reassessment of what constitutes a fair valuation multiple.

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