Japan Investment Commentary and Market Outlook

December 2025

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Market Movement	As at 31/12/2025
TOPIX Index	3,408.97(+0.2%)
Nikkei 255 Stock Average	50,339.48 (+0.9%)
Exchange rate	1USD = JPY 156.41

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

Japan's equity market appeared to finish December on a slightly firmer footing, supported at different points by resilient global risk appetite, a late rebound in US technology shares, and a largely steady yen into year end. Macro signals were mixed but did not point to pronounced weakness: private demand seems to retain some resilience, helped by wage settlements, labour saving investment and targeted government measures. Monetary policy has started to normalise, yet financial conditions may remain broadly accommodative as inflation shows signs of easing.

Policy developments could provide a tailwind into 2026. The tax reform is set to incentivise capital investment and R&D in strategic technologies, which, in our view, may encourage a more active use of corporate cash reserves. The initial budget under the current administration appears to prioritise growth while acknowledging higher debt service costs, with issuance guidance suggesting some caution around very long maturities.

Looking ahead, we are inclined to think that Japan's medium term equity trend could remain constructive, underpinned by a gradual entrenchment of inflation after a prolonged deflationary phase and ongoing improvements in corporate governance and management. IBES TOPIX EPS consensus currently indicates multi year earnings expansion—+6.3% (FY2025), +11.1% (FY2026), +9.6% (FY2027)—which, if realised, would support a more positive stance. Even so, some doubt valuations are rich in the past range, and we would be mindful of near term constraints; that said, a re rating could still be possible if confidence builds and the structural shift gains further traction.

Geopolitics remains a swing factor. Rising China–Japan tensions—alongside indications of tighter export controls on dual use items—introduce uncertainty and may cap upside in the near term. At this stage, it seems premature to quantify industry specific impacts. There is a view that the impact could be smaller than in the past, aided by recycling and rare earth free technologies, with corporate and public stockpiles offering an additional buffer. We would continue to monitor developments closely.

Market Review

Japan's equity market closed December in positive territory, supported by a combination of global and domestic factors. Early in the month, equities advanced despite concerns over rising domestic long term yields. Sentiment was buoyed by reports that the US administration may provide support for the robotics sector, alongside expectations of continued Fed rate cuts, which reinforced risk appetite.
Mid month, the market faced headwinds as US technology shares weakened following AI related earnings announcements, while heightened caution over a potential BOJ rate hike weighed on investor confidence. However, these losses were partially reversed as US tech stocks staged a rebound and the yen depreciated, providing a tailwind for exporters.

Towards month end, trading activity slowed as market participation thinned ahead of the year end. The yen stabilised amid intervention concerns, leaving price action largely range bound and the market flat in the final days.

Macro Economic Environment

Japan's real GDP contracted −2.3% annualised QoQ in Q3 2025, the first decline in six quarters, driven by housing investment, net exports and inventories. Business investment fell modestly, while private consumption posted a third consecutive small gain, signalling resilience. Excluding the sharp housing drop—largely regulatory—domestic private demand remains broadly firm despite US tariffs.
Sentiment softened: the November Economy Watchers Survey worsened for both current conditions and outlook. While respondents cited positives such as wage hikes and government support, concerns over persistent price pressures—especially housing and rents—and weaker inbound tourism from China remain.
Even so, the outlook is not one of outright weakness. Growth should be underpinned by three forces: income gains from strong wage settlements, labour-saving investment amid chronic shortages, and government measures including price relief and capex tax incentives. These factors support guarded optimism: despite temporary GDP softness and inflation concerns, private consumption and investment appear resilient, assuming external risks do not escalate.

BOJ Policy and Inflation Trends

The BOJ raised its policy rate to 0.75% in December 2025, the first hike since January and the highest level in 30 years. The move reflects reduced uncertainty around US tariffs and expectations of solid wage growth in 2026. While real rates remain deeply negative, keeping conditions accommodative, the BOJ signalled a gradual normalisation, with further hikes likely at roughly two per year, guided by Tankan and regional surveys. Inflation is still elevated but moderating: November core CPI rose 3.0% year-on-year, down from the upper 3% range, with food price pressures easing. Concerns persist over housing and rents, but overall price momentum is softening. Looking ahead, domestic demand should underpin growth. Key drivers include income gains from strong wage settlements, labour-saving investment amid chronic shortages, and government support through price-relief measures and capex tax incentives. These factors should sustain consumption and investment even as monetary policy tightens gradually.

Japan's 2026 tax reform and record-breaking budget proposal

In the 2026 tax reform, measures were introduced to provide tax incentives for capital investment and for corporate research and development in strategically important technological fields. We think these changes will strengthen incentives for companies to deploy their cash reserves, and government initiatives are expected to encourage corporate investment throughout 2026. While there is an effort to streamline less effective tax measures, funding remains insufficient, and some adjustments have been deferred to the 2027 tax reform.
The first budget proposal under the Takaichi administration sets a new record for initial general account spending at ¥122.3 trillion. Price increases have been reflected across various expenditures, and debt-servicing costs have risen against a backdrop of higher interest rates. On the revenue side, buoyed by nominal economic growth driven by inflation, tax receipts are projected to exceed ¥83 trillion, marking an all-time high.
Debt-servicing costs for the redemption and interest payments on government bonds will exceed ¥31 trillion, marking a record high. This increase reflects the rise in the assumed interest rate used to calculate bond interest payments to 3.0%, up from 2.0% in FY2025, following recent upward moves in long-term yields. In its FY2026 issuance plan, the Ministry of Finance signalled a reduction in super-long-term bonds (maturities over 10 years), as concerns over fiscal deterioration and weaker demand have made such bonds more vulnerable to rising yields.

Market Outlook

In 2025, TOPIX rose 22.4% and the Nikkei 225 26.2%, making Japan the standout performer among developed markets. We think this strength was supported by a gently appreciating yen and a rebound in FY2025 earnings—initially feared to decline—which recovered to a 6% year-on-year increase on market consensus.

As we enter 2026, rising China Japan tensions have emerged as a headwind. Even so, we think Japan's medium term equity uptrend remains underpinned by two structural drivers: entrenched inflation and improved corporate governance. These factors make a sudden reversal unlikely. Consensus TOPIX EPS forecasts (IBES, end December) are +6.3% for FY2025, +11.1% for FY2026, and +9.6% for FY2027, reinforcing expectations of sustained growth. As of 8 January, TOPIX's 12 month forward P/E is 15.8x—near the upper bound of its 10 year range—prompting concerns that upside may be limited. However, we think a re rating is possible if confidence strengthens. However, we think that given the current trend is anchored in a structural shift away from three decades of deflation and improved corporate management, a scenario in which the P/E range re rates higher should not be dismissed if confidence strengthens.

That said, escalating tensions are adding uncertainty and capping upside. We think markets are taking seriously China's 6 January plan to tighten export controls on items with military potential. At this stage, we think it is too early to quantify the impact on industries. Japan still relies on rare earth imports from China, so some negative effect is unavoidable. However, we think the impact could be smaller thanks to recycling and rare earth free technologies.

Both companies and the government (e.g., Japan Organisation for Metals and Energy Security) appear to have built stockpiles, and some firms reportedly hold up to one year of inventory. While we do not expect these measures to materially affect earnings, risks would rise if the situation worsens or becomes prolonged, so we shall continue to monitor developments closely.

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