Japanese Equities

Investment comment

July 31, 2025

Document intended mainly for professional investors

The facts: With the parliamentary election now behind, Tokyo reached a trade deal with the USA. Since the Japanese economy has felt relatively little impact from the tariff war so far, attention turned to earnings, which started off relatively strong.

The election for the House of Councillors, or the Upper House of the Japanese Diet, which usually has little weight since the House of Representatives can override it, was pivotal this time. As the government already lacked a majority at the Lower House, it was crucial for them to maintain their grip on the other chamber. However, this did not happen. **Prime Minister Ishiba's Liberal Democratic Party and its coalition partner became minority leaders in both Houses for the first time since the LDP was established in 1955**. While Ishiba-san indicated his intention to remain the Prime Minister, mounting pressure from within and outside his party called for his resignation. Conversely, an unusual demonstration in support of his continuation followed the election. Some media outlets viewed this support as a sign of concern over the rise of populism, as some opposition parties had promised tax cuts, welfare spending and measures against immigration. However, the presence of non-LDP supporters at the demonstration suggested that the opposition parties could consider they had a better chance to push their policies through under a weakened Ishiba-led government.

Another highlight of the month was the trade deal with the USA. Three days after Japan's election, President Trump announced on his Truth Social account that the tariff rate on imports from Japan would be reduced from 25% to 15%. **This came in exchange for Japan's commitment to invest $550bn in the US, increase rice and other products purchases, and drop additional testing requirements on imports of US-made cars**.

On the macroeconomic front, things were more or less unchanged, with overall inflation neither accelerating nor receding, and thus putting a cap on real wage growth. Sentiment, on the other hand, was more mixed. The April-June Tankan survey by the Bank of Japan indicated that corporations were not as weak as expected, despite the trade concerns. **Their capital expenditure plans (including software but excluding land) were up 8.7% year-over-year**, a 4.8 points improvement from the last survey. Their earnings, however, were expected to decline in fiscal year 2025 on the back of a stronger yen assumption (¥145.7/$). The June release of the Economy Watchers survey by the Cabinet Office showed an improved outlook for the second consecutive month, with the services sector and households becoming more optimistic about consumer spending during summer, while corporate trends were slightly down. However, **the same source found that consumer confidence was softer in July after two months of improvement, as food prices continued to rise** despite the stabilization of rice at a lower level.

Against this backdrop, the BoJ's decision-makers unanimously agreed to maintain their policy rate at 0.5%, while raising their 2025 CPI ex-fresh food forecast (which had been cut in April) from +2.2% to +2.7%, to reflect the current inflation rate. This was not a significant change, and the forecasts for fiscal years 2026 and 2027 were revised up by only 10bps. Nevertheless, the message was interpreted as if the central bank was preparing for a rate hike. On the contrary, Governor Ueda's explanation at the subsequent

press conference was found to be dovish, which dampened expectations of an early rate hike. **His comments suggested that the BoJ would wait to see the tariff impact** on the domestic and global economies before taking an action.

The first part of the earnings season started on a relatively strong note. As of the end of the month, 32% of companies had reported their June quarter results and according to LSEG-Refinitiv, respectively 57% and 60% of them exceeded sales and earnings consensus forecasts. This was all the more encouraging as many exporters had already been affected by US tariffs. For instance, eight major Toyota Motors-affiliated companies, including Denso and Aisin, reaffirmed their full-year profit forecasts. **In addition to cost cutting efforts through a review of supply chain, logistics, and production sites, they intend to pass on part of the tariff impact to their customers**. However, a few companies, such as Tokyo Electron and Disco, two manufacturers of semiconductor production equipment, disappointed the market with guidance cuts due to weaker demand prospects.

The effects: The Topix index finished the month up 3.16%. The index remained relatively quiet until the trade deal was achieved, bringing strong relief to investors and letting the market reach a new high on July 24. The earnings announcements prompted some profit-taking, but the impact was limited overall.

In response to the trade agreement, exporters' share prices shot up, led by automakers, including Toyota Motors which gained more than 14%. **The market was relieved to see tariffs on automobiles drop from 27.5% to 15%**, and taxes on other goods rise only moderately from the current 10% rate.

All in all, except for the two days following the deal, when the index gained 5%, all other daily sessions produced returns in a +/-1% range, as investors started taking profits from stocks that had outperformed ahead of results announcements. The month ended with the market resuming its ascent, despite the lack of action from the Federal Reserve and the BoJ. Strong results and economic figures released in the US and Japan revived some investor interest.

As regards sectors, Utilities and Resources & Basic Industries led the outperformance. The former benefited from a study by the Federation of Electric Power Companies of Japan on the future electricity supply-demand balance, which predicted a continuing growth in demand, driven by the construction of data centers and increased electrification. **It stressed the need to restart existing nuclear power reactors and to develop new capacities beyond the 2040s**. Moreover, political opponents to nuclear energy did not gain support in the election, and Kansai Electric Power confirmed that it is considering building a new nuclear power plant. **The Resources & Basic Industries sector was led by three optical fiber producers**, Fujikura, Furukawa Electric and Sumitomo Electric. Their performance accelerated after the strong earnings announced by Corning in the USA and Sumitomo Electric in Japan, which were supported by strong demand for AI-related investments.

The financial sector also did well, on the back of Japan's deficit expansion and merger stories among regional banks up to the election. Then, there was relief from smaller tariff damage to the SMEs that these institutions cater to. Industrials obviously reacted to the lower tariffs, but also benefited from better-than-expected results at many companies.

On the other hand, sectors with limited sensitivity to tariffs, like Consumer Goods, Communication, and Distribution & Services, underperformed. Technology was a little soft too, as **ASML's published results and forecast sparked further concerns about the growth outlook in 2026 for Japanese semiconductor equipment specialists**.

The outlook: We believe it is too early to assess the true impact of tariffs. For now, at least, more clarity on the trade deal will enable companies to adapt to the new environment. Although the weak yen, if sustained, may somewhat cushion the impact, slower demand may still be on the horizon.

Although the lower tariff rate for Japan is a relief, **some other Asian countries where Japanese corporations produce goods for export to the USA will be subject to higher taxes**. Meanwhile, China, a key trade partner for Japan, is still in discussion. An impact on Japan's competitiveness is therefore likely. Further out, sector-specific tariffs on drugs and semiconductors may be imposed. At least, according to the agreement, Japan will not be treated less favorably than other countries.

Following the president's tweet, the White House released a factsheet on the "US-Japan Strategic Trade and Investment Agreement". **The deal includes several areas on which the two countries did not agree** yet, including the additional annual purchases of US defense equipment. Japan has made it clear that there are no plans for additional purchases and that the agreement does not include any content related to defense spending. Furthermore, the factsheet mentions a $550bn investment by Japan, directed by president Trump, and in which the US will retain 90% of profits. However, the Japanese cabinet appeared to have a different interpretation, and many details of the agreement are yet to be clarified and finalized.

Amid this confusing situation, the political landscape remains unclear. **Although Prime Minister Ishiba is likely to step down, he may want to stay until the loose ends of the trade agreement are tied, or until the tax reform outline for fiscal year 2026 (which should include consumption tax cuts) is discussed** towards the end of this year. Despite the limited improvement (a 6.5pts rise from the last comparable vote, to 58.5%) in the participation rate for the election , which fell on a three-day weekend, the emergence of opposition parties with more radical views attracted new voters who previously were not interested in politics. While we welcome this interest, the resulting political instability is not positive for diplomacy, which has to deal with trade and defense negotiations. **A change in administration may revive concerns about the deteriorating fiscal condition**, whereas the market likes stability and new growth strategies.

Turning to individual companies, they face many other challenges, including labor shortage as well as currency and interest rate trends. The earnings season has just begun, and 70% of companies have yet to report, with many of them newly incorporating the tariff impact. **Competitive companies will be able to tolerate a 15% tax, as they managed to generate a profit even when the yen was 25% stronger against the dollar**. However, things were tougher for smaller and less competitive corporations. Incidentally, Nissan Motor, which is undergoing restructuring, reported its quarterly results, and posted a loss for the fourth consecutive quarter. After closing production facilities, Nissan recorded a 10% decline in unit sales. Other automakers will follow with their reporting in the first weeks of August, revealing their plans. In other sectors, we received encouraging comments from companies, such as Toto, a bathroom fixture manufacturer, and Fanuc, which sells industrial robots. Both companies expressed confidence in passing on tariffs into prices.

Interestingly, the Nikkei reported that, according to a study by the Ministry of Finance, Japanese corporations' retained earnings increased by 10% YoY to reach a historical high of ¥636trn at the end of fiscal year 2024. However, the newspaper's calculations based on the same data show that the labor distribution rate, which measures the distribution of the added value created by companies to employees in the form of compensations, declined to its lowest level in 51 years. The caveat is that the rate for SMEs was up 0.1pps and was much higher than average. Now, the companies are under pressure to use their funds wisely to weather the headwinds while increasing corporate value.

For the moment, Japan will commemorate the 80th anniversary of the Hiroshima bombing in August amid nuclear war concerns following the military strikes on Iran in June and Russia's ongoing aggression against Ukraine. This reminds us that **geopolitical uncertainty also remains an important factor to monitor**.

Important information: *The views expressed herein are for information purposes only. They should not be interpreted as a recommendation to adopt or modify an investment stance, or purchase or sell a financial instrument. They reflect Graphene Investments' analysis as of the specific date stated at the top of this document, based on information that was available at that time. Such information, and the resulting opinions and assumptions, are subject to change without notice. Graphene Investments does not guarantee their completeness and accuracy.*

Any reference to market, financial instrument or strategy returns is for information purposes only. Past performance should not be considered as an indication of future performance. Unless stipulated otherwise, any reference to investment returns relates to the gross return of the Japan Essential Value strategy, and not to any fund in particular. Gross returns are obtained from the actual return of an account managed according to the strategy, denominated in yen, and without any currency hedging. Calculation details are available upon request to Graphene Investments. The return actually generated by the same strategy in each investment vehicle where it is implemented may differ, depending on the characteristics of that vehicle as well as implementation conditions.

Before making any investment decision, investors should carry out their own analysis, based on up-to-date information, to form a personal opinion about the suitability and risk of that investment.

Graphene Investments

AMF license #GP-16000022
75 Bd. Haussmann 75008 Paris (France)
T: +33.1.70.82.44.50
F: +33.1.70.82.44.49
E: contact@graphene-investments.com
W: www.graphene-investments.com