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The facts: With the trade deal officially signed with the USA, Prime Minister Ishiba resigned, giving the Bank of Japan another excuse to keep its rates unchanged. Meanwhile, new headlines around AI spending revived enthusiasm in the theme.

The month started on a rather positive foot, as Donald Trump finally signed the executive order setting tariffs on imports from Japan at 15% for most products including automobiles. With the trade deal now behind, Ishiba-san finally announced his resignation. **An election at the ruling party was thus scheduled on October 4th. Among the five candidates, former Economic Security Minister Sanae Takaichi, current Agriculture Minister Shinjiro Koizumi, and Chief Cabinet Secretary Yoshimasa Hayashi** were seen as the top contenders, ranging from the most dovish/expansionist to the most conservative.

Given the political uncertainty, the Bank of Japan kept its rates unchanged in September, a decision which, for a change, was not unanimous as two committee members supported raising them. **The BoJ however announced that it would pursue its normalization**, in a different manner, **by firming up its strategy to unload its ETFs and REITs holdings** at a measured pace of respectively ¥330bn and ¥5bn per year.

In fact, **the inflation rate has been above the central bank's target for quite some time, but its pace is decelerating**, according to official data. Headline inflation dropped from 3.1 to 2.7% YoY between July and August, which was the slowest pace in nine months as government subsidies and free high school tuition gradually helped. This, along with recent wage hikes and bonus distribution, helped real

wages climb in July, for the first time in seven months. In the meantime, research firm Teikoku Databank reported that a total of 1,422 food products and beverages made by 195 major makers will become more expensive in September, a number accelerating from the 1,010 items identified in August.

Meanwhile, Japan's economic growth was revised up from 1.0 to 2.2% for the June quarter due to a greater contribution from inventories and consumption. The capital spending component was revised lower, though, and so were its estimates for the full FY25 (from 7.3 to 6.8% YoY), according to the September business outlook survey from the Ministry of Finance.

Japan's exports fell for the fourth straight month in August. **Elevated tariffs took a toll on shipments to the US, which dropped 13.8% YoY. The decline was steeper than the 10.1% contraction seen in the prior month, and was the largest drop since February 2021.** Yet exports to China also fell slightly. Both trading partners were facing their own challenges. In the USA, the Federal Reserve cut its rates by 25bps as a risk management in face of greater unemployment risk. In China, the government tried to stimulate domestic consumption while the manufacturing activity had shrunk for the sixth consecutive month in September, according to official surveys.



In the end, artificial intelligence was the source of optimism worldwide. Several new large spending plans were announced in September, mainly by US companies. In particular, Nvidia decided to spend \$100b in OpenAI, while Oracle reported a huge backlog and described the demand

for AI servers as unprecedented. This had significant implications for Japanese IT suppliers.

The effects: The Topix index posted its sixth consecutive monthly gain, adding another 2% in September and reaching new record highs. Expected changes in leadership and a cut from the Federal Reserve boosted sentiment, but the AI-related categories particularly stood out.

Volatility remained low in September. The index advanced regularly throughout the month and there were no daily session with a variation greater than +/-1% (except on September 29th, when dividend were distributed). All in all, the price index gained 2% in September and 3% after the bi-annual dividend payment, which is less negligible than it used to be. The index thus reached new record highs. The Nikkei even surpassed the psychologically important 45,000 level. Japanese equities gained right after Ishiba-san announced his resignation. Investors expected the new leader, possibly Takaichi-san, to enforce pro-growth policies. The Federal Reserve also became a little less restrictive. Yet the main market driver in September was AI, following the several announcements by large US companies.

As a consequence, **the technology category finished at the top.** The continued spending on artificial intelligence infrastructure primarily benefitted **semiconductor equipment manufacturers**, which **gained 23%** in September, and to a lesser extent, chipmakers which went up nearly 5%. Other specific names like SoftBank Group went up 15%, as the conglomerate is invested in OpenAI and ARM Holdings. More impressively, Kioxia, which is the global leader in flash memory, saw its stock price skyrocket by an outstanding 88%! Electronic components outperformed as well. Apple suppliers enjoyed rumors that the iPhone maker had asked its manufacturers to increase daily output by at least 30%, following the success of new products. Lastly, the AI theme supported the **non-ferrous**

metals sector, which ended up 10% as it includes optical fiber specialists.

Banks and Real estate also outperformed slightly, although to a much lesser extent. Banks are seen as beneficiaries of the BOJ's tightening monetary policy, and even if the Federal Reserve cut rates, its speech did not sound too dovish either. As contradictory as it may seem given its general opposite reaction to tighter monetary policies, Real Estate also benefitted from strong domestic fundamentals. Condominium sales in Tokyo surged by 78% in August even though prices were up by a high single digit percentage. Builders seemed confident about the final demand, with more and more foreign buyers.

Among the laggards were other exporting categories like Transportation Equipment (mainly car makers) and Iron & Steel **for which the relief rally ended as tariff rates seemed final.** Even Pharmaceuticals finished lower despite the preferential treatment granted by the US administration to Japanese players (with tariff lowered from 100% to 15%). **Other domestic and defensive categories were also left behind. Marine Transportation however was the worst sector amid falling spot rates on Asia-North America routes as well as an expected decline in volume.**



The outlook: Whoever the next Prime Minister may be, we believe that the opposition parties will make it difficult for him or her to initiate bold reforms. With the uncertain global context, we thus expect the BoJ's continuing normalization to remain slow.

Takaichi-san is the most dovish and pro-growth candidate and appears to be the most popular candidate among the public, as per opinion polls by media outlets. If elected, she would become the first female Prime Minister in Japan's history. Yet, this is an election inside the LDP rather than a national election, and a candidate's popularity among the public is not a reliable gauge of his popularity inside the party. In fact, the Asahi Shimbun's **last poll of LDP Diet members showed Shinjiro Koizumi and Yoshimasa Hayashi ahead with none of them being able to secure a majority in the first round of voting. However, many voters were still undecided.** Moreover, because the LDP lost its majority at the Lower House, its new leader will not necessarily become the Prime Minister. Nevertheless, we do believe he or she will as, with its 196 seats (out of 465), the LDP remains the largest voting bloc in the Chamber. Attention will then shift to Cabinet appointments, coalition talks, and the unveiling of economic measures, likely focused on inflation control rather than long-term growth. In any case, we expect **the lack of majority to make it hard for the next leader to pursue key reforms that the country needs.**

In the meantime, **the new government should not let its guard down on the trade front.** We cannot rule out the risk that the Trump administration will now use industry-specific tariffs to expand the scope of current duties. In fact, after it had agreed on the purchase of US Steel by Nippon Steel, the White House invoked its "golden share" and blocked the acquirer's plan to close a US Steel facility to boost productivity.

As for the monetary policy, the Bank of Japan may take the time to accumulate more data as regards the tariffs' impact, and let the new government take the reins. It is however interesting to note that two board members supported a resumption in interest rate hikes, after every policymakers

supported stable rates in July. We however think that the central bank's move is consistent with normalization rather than tightening. **The decision to unload its ETF holdings makes sense.** The bank owns about 7% of the domestic equity market, which has recently reached new highs. Yet, **at the indicated pace, it would need ... 137 years to sell it all.** This signals that it is in no hurry and it does not represent a major risk of selling pressure. Moreover, the Japan Government Pension Investment Fund indicated it would buy REITs.

All in all, **we feel the major catalyst for the market remains the impact of changes around corporate governance.** This year marks the tenth anniversary of the introduction of the Corporate Governance Code in Japan. Correcting the lack of outside directors to strengthen management oversight was one of its major targets. According to the Tokyo Stock Exchange, only 6.4% of companies in the First Section had at least one third of their directors who were independent in 2014, but the figure jumped to nearly 100% last year in the top-tier section, now called the Prime Section. Next, **the FSA will begin revising the Corporate Governance Code, targeting issues such as corporate cash-hoarding, with implementation planned for 2026.** Under the growing pressure from the regulator and investors, we expect Japanese corporations to continue to improve their capital allocation, as Sony recently did (and investors welcomed) by spinning off its financial unit.

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