Japanese Equities

Investment comment

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Document intended mainly for professional investors

The facts: October was an eventful month for Japan, with the unexpected election of a woman as the country's leader. In a context of continued domestic inflation pressure and a tense political trade environment, the market was happy to see a more proactive candidate win.

The month began with significant political uncertainly following the US government shutdown on October 1. In Japan, however, Sanae Takaichi's against-odds election as the new Liberal Democratic Party leader changed the mood on October 4. The Komeito Party, which has been the LDP's coalition partner since 1999, however made things more complicated by announcing the dissolution of the coalition and its refusal to vote for Takaichi-san to lead the government. She quickly moved to convince the Japan Innovation Party to work with her and, on October 21, she became the first female Prime Minister in Japan's constitutional history.

According to a survey by Nikkei and TV Tokyo, **the new leader's cabinet started with a very high support rate of 74%, 37 points higher than the previous Ishiba cabinet in September.** Notably, the new government gained support from the working generation, who had turned their back on the LDP at the Upper House election. While there were concerns about the new administration's excessive rightward shift, the lineup did not confirm this. Takaichi-san seemed to have chosen the people for the job, prioritizing their qualifications over their political inclinations. Even gender considerations were kept out of the process and only two women were appointed, when some media expected as many as six to be picked.

The new Prime Minister reinforced the cabinet with politicians experienced in trade negotiations with the US. For Foreign Minister, she appointed former LDP secretary-general Toshimitsu Motegi, who was responsible for trade negotiations with the US during the first Trump administration. For the Ministry of Economy, Trade and Industry, her pick was former Minister of Economic Revitalization Ryosei Akazawa, who was responsible for US-Japan negotiations in the latest government. Satsuki Katayama, who had been the first woman to serve as Director-General of the Budget Bureau at the Ministry of Finance, became the Finance Minister.

Just over six days after taking the job, **Takaichi-san held a successful meeting with the US President**, who visited Japan for the first time in six years. As a protégée of the late Shinzo Abe, whom Donald Trump considers a very close friend, she successfully tapped Abe's legacy to forge a bond with her visitor. Being well aware of his soft spots, she secured a rare meeting with the Emperor, and a meal made with US-grown rice and beef, among other gestures.

As part of hailing "a new golden age of the Japan-US alliance", as Sanae Takaichi calls it, the two governments released a "Joint Fact Sheet on Japan-US Investment" worth approximately $400bn. The sheet lists energy, including nuclear power generation, power source development for AI, strengthening AI infrastructure and critical minerals. Eight Japanese companies, including SoftBank Group, Hitachi, and Panasonic, expressed interest in forming projects.

Elsewhere, the US-China trade negotiations remained a concern throughout the month. However, optimism following the two leaders' meeting on October 30th reduced the likelihood of an additional 100% tariff on Chinese exports. The deal came in exchange for China's commitment to postpone rare earth export restrictions and resume substantial soybean purchases.

Against this political backdrop, **economic sentiment remained relatively strong. The Bank of Japan's September Tankan Survey showed optimism among corporations, suggesting that tariffs would have a manageable impact.** More recent data, such as the October release of the Economy Watchers Survey and the Consumer Confidence Index, showed an even stronger sentiment. The latter pointed to improvements in all areas, including overall livelihood, income growth, employment, and willingness to buy durable goods.

Regarding the real economy, the METI calculated that Japan's inventory-to-shipment ratio had deteriorated in August for the third consecutive month. On the bright side, however, exports rebounded after four months of decline following the implementation of US tariffs. Consumption seemed to be holding up, even when excluding special factors such as an easier year-over-year comparison. Meanwhile, the inflation rate based on the core CPI (ex-fresh food), which had softened slowly since the beginning of the year, re-accelerated marginally in September.

The September quarter earnings season began late in October. As of the end of the month, 27% of companies with quarters ending in August or September had announced earnings, according to LSEG-Refinitiv, and 52%of them had exceeded consensus estimates. The first results suggested that domestic companies with strong demand, such as those involved in construction and engineering, were faring well, while many in the services sector were suffering from cost inflation and weaker demand. **Many technology and industrial companies, which benefit from AI and automation trends, managed to offset tariff-related costs and delivered strong results.** They also raised their full-year guidance. In particular, Advantest, a producer of semiconductor testing systems, stood out with a significant guidance hike.

Nevertheless, at its monetary policy meeting, **the Bank of Japan decided to remain cautious and maintained its policy rate at 0.5%.** Like last month, two committee members supported raising it to 0.75%. One stated that the bank had largely achieved its price stability target and the other one that rates should be close to the natural rate amid growing inflation risk.

The effects: In October, the Topix index posted its sixth consecutive monthly gain, adding another 6.2% and reaching new record highs. The election of Sanae Takaichi and the resulting policy expectations fueled optimism while a weakening yen provided an additional boost to exporters.

Starting with political uncertainty following a US government shutdown, the equity market experienced great volatility and profit-taking. Then, investors were excited by the unexpected election of Sanae Takaichi as the new LDP leader because of her dovish objectives focused on economic growth. They bought back companies in sectors related to public spending, such as defense, space, nuclear energy, and construction.

The market temporarily lost ground when the Komeito party withdrew from its coalition with the LDP, lowering the likelihood that Takaichi-san would become Prime Minister.

However, the market recovered when an agreement was reached with the Japan Innovation Party.

In addition to the new government's accommodative fiscal policy, which kept the yen weak against the dollar, **several developments supported the technology sector and AI-related categories**. In the US, OpenAI announced the completion of a deal valuing the company at a record $500bn. Not only Japan's SoftBank Group participated in funding this deal, but it also announced the acquisition of ABB's robotics business. The announcement of the "Joint Fact Sheet on Japan-US Investment" which focused on AI, and Advantest's strong outlook also fueled excitement.

Consequently, the Non-Ferrous Metals sector, which includes cable and infrastructure companies that will benefit from the expected investments in data center capacity and energy supply, was the best performer over the month. It was more than 20 percentage points ahead of the index. The Electric Appliances and Information & Communication sectors followed suit.

Despite the optimism surrounding fiscal stimulus, defensive and domestic sectors lagged significantly as the market favored growth and cyclical stocks. The sectors with the largest underperformance were Insurance, Services, Pulp & Paper, Land Transport, and Real Estate.

This resulted in a significant disparity between the technology-heavy Nikkei 225 index and the broader Topix index, which has a different weighting methodology. Style indices also showed a significant divergence, with the Growth index outperforming its Value peer by more than 150bps.

The outlook: Takaichi-san began her term on a positive note. Now, her ability to compromise with the opposition parties and implement her program, including a "proactive but responsible fiscal policy", is going to be key. The market seems to have already largely discounted the prospect.

The election of a female Prime Minister, in a country which ranks 118th of 146 in the World Economic Forum's Gender Gap Index, was a major accomplishment. While this may contribute to the momentum pushing corporate transformation forward in Japan, she has, above all, **enabled the fragmented political parties to cooperate and progress**.

In terms of diplomacy, **the Japan-US summit will have established a foundation for dialogue, which is important given Japan's limited mitigation options** such as retaliatory tariffs. Meanwhile, Tokyo demonstrated that it will protect its national interests, and refused to stop importing LNG from Russia. This is seen as crucial given the country's dependence and the ongoing unrest in the Middle East.

Now that the groundwork has been laid, the new Prime Minister will be under greater scrutiny to see if she can deliver on her promises. She has advocated for "proactive but responsible fiscal policy" while addressing rising prices, promoting growth investment and strengthening defense and diplomatic capabilities.

In addition, as investors remain excited about the new government and AI, we expect market volatility as quarterly earnings are released. **Although the impact of the US tariffs has been less severe than initially expected, major manufacturers, such as automakers, are still struggling.** Attention will also focus on whether AI- and defense-related companies gain momentum. **Meanwhile, weak demand in China has led to overproduction and declining prices**, not only on commodities, such as steel and chemicals, but also for some industrial products. **Japanese companies will face challenges expanding sales of high-value-added products in an increasingly competitive environment.**

On October 30, while on his way to meet Xi Jinping, Donald Trump ordered the Pentagon to resume nuclear weapon testing after a 33-year suspension. This message to other nuclear powers should be seen as a reminder that geopolitical tensions are nowhere close to being resolved.

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