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Bonne Année
Happy New Year
良いお年を
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The facts: The Bank of Japan made one more move towards policy normalization in December, as it estimated the economy was solid enough. Meanwhile, Prime Minister Takaichi finalized the budget plan for the upcoming year amidst deeper tensions with China.

The Bank of Japan waited until the last month of the year to decide, in a unanimous vote, on the second interest rate hike of 2025. It **raised rates by 25bps to 0.75%, the highest level seen in Japan in 30 years**. This contrasted with the Federal Reserve's stance, which moved at the same pace but in the other direction to 3.5%. These decisions were widely anticipated, and left the yen unchanged against the dollar in December. The exchange rate thus ended the year where it had started it. In between, though, the yen had strengthened about 10% in the first half of 2025, before depreciating again. More importantly, **longer-dated yields continued to climb with the 10- and 30-year rates respectively reaching a multi-decade high of 2.07% and an unprecedented 3.41% level**.

As a matter of fact, government data showed that core inflation had remained at 3% YoY in November. More importantly, **the central bank was increasingly seeing a positive momentum towards next year's spring labor negotiations**. Several unions signaled their intention to fight for an additional pay hike in 2026. The Japanese Trade Union Confederation (Rengo) set a target rate of 5% or more. Several federations representing workers of the railway and basic industries, and even the auto industry (which is the most affected by tariffs), were also looking for a pay hike of at least the same magnitude as last year. Additionally, information collected by the BoJ through its

contacts with business leaders confirmed that most of them seemed to consider it necessary to raise salaries at a pace similar to last year's, to retain staff and boost motivation amid persistent, severe labor shortage. In fact, the job market remained tight with the unemployment rate standing at 2.6%, and a ratio of 1.18 jobs per applicant at the end of November.

The Japanese economy however shrank in the September quarter. The country's GDP actually declined by 2.3% (worse than the preliminary estimate of 1.8%). Consumption held up rather well, but capital spending was weaker than expected and exports were hit by tariffs. Moreover, industrial production was facing semiconductor shortages, especially in the car industry. Nonetheless, according to the Tankan survey, **large corporations raised their profit forecasts for the current fiscal year from a 5% decline three months ago to flat in the December release. Capital spending remained strong** and was expected to grow 12.6%. In addition, from large to small companies and from Services to Manufacturing, sentiment did not show any deterioration. Moreover, export growth accelerated for the third consecutive month in November, led by a double-digit surge in shipments to Western Europe, and the first increase in exports to the USA since March, before the US President initiated tariffs.



In the meantime, **the new Prime Minister's cabinet approved a record JPY122.3trn (\$783bn) budget**, which it aims to submit to the Parliament for approval before the end of March. More details remained to be unveiled on the tax reform, with specific topics ranging from a potential expansion of the income tax exemption threshold, to a mortgage tax deduction and an increase in the NISA regular savings limit. In her desire to present a "responsible and proactive fiscal policy", Takaichi-san insisted that **revenue will exceed spending (excluding the debt servicing cost) for the first time in 28 years**. Last but not least, the defense budget will exceed JPY9trn for the first time ever.

In fact, **tensions with China did not abate** since Takaichi-san said she would not stand still in the event of a Chinese

invasion of Taiwan. During the month, a Chinese military aircraft targeted its radar at Japanese peers, and Beijing did not pick up the hotline, which was created in 2023 after an incident between the two countries. Additionally, China conducted drills in waters around Taiwan. Even if she remained open to a dialogue, Sanae Takaichi refused to take her comments back. The Prime Minister kept a strong popularity (between 70 to 80% depending on opinion polls) but **some clear impact on the domestic economy started to be noticed**. According to the Immigration Services Agency's control statistics, the number of visitors from China was down 19.5% between October and November. Tax-free sales at department stores started to weaken, and hotel reservations by Chinese travelers plunged 57% in late November, according to a booking platform.

The effects: The Topix index gained 1% in December, making 2025 another double-digit return year. Value categories continued to lead the way with Financials benefitting from the BOJ's normalization. On the contrary, China-related consumer stocks continued to suffer.

The Japanese market posted its ninth consecutive monthly gain in December, and finished 2025 with a 22.4% return. For the third year in a row, the Topix index produced a double-digit annual return in local currency, thus beating the S&P500 index. This return would however be down to 8.4% for a European investor, unless the position was hedged against the weakness of the yen.

The Value style index continued to lead its Growth peer by more than 4% in December (and had a 16% advance over the full year). This came from the strength of Financials. **Banks kept benefitting from the steepening of the yield curve** and gained nearly 5%. MUFG and Sumitomo Financial Group reached all-times highs. Japan Post Bank even surged 17% as is announced a share buy-back plan of up to JPY 30bn. **Insurance, which had lagged so far, did even better, as new cash will be invested in higher-yielding bonds**. On the contrary, Utilities, another typical Value sector, fell by about the same magnitude. The need for more power in a new AI era remains a positive, but electric utilities are

heavily indebted, and they will suffer from higher rates as they need to build new capacity. Even the Hokkaido Governor's green light to a restart of Unit 3 of Hokkaido Electric Power's Tomari nuclear power plant, did not prevent the stock from posting a 13% drop!

The AI topic however continued to influence the market, but in a more differentiated way. Robot manufacturers got the strongest attention this time as the International Robot Exhibition held in Tokyo at the beginning of December featured physical AI and humanoid robots. Fanuc entered a partnership with Nvidia to develop industrial robots, while Yaskawa announced a tie up with Softbank Group around physical AI. Both stocks gained between 17 and 20% in December. **Memory players were also among the top performers**. SK Hynix predicted the memory shortage would last through late 2027. Kioxia Holdings, a global leader in flash memories and SSDs, went up double digit, while game console manufacturers, such as Nintendo and Sony, which need to buy memory, were sold. **Categories**



involved in IT infrastructure, including optical cable and semiconductor equipment manufacturers, **had more mixed returns**. Concerns grew that Oracle and other players may be delaying their plans to build new datacenters.

Last but not least, tensions with Beijing continued to put pressure on stocks exposed to China. Consumer-related categories were particularly impacted by a decline in Chinese tourists' spending. **Retail, department stores and leisure categories went down by low- to high-single digit percentages in December**. Sanrio, which owns Hello Kitty and considers China as one of its strategic markets, fell by another 12% in December after already plummeting 20% in

the previous month. The toy and video game specialist Bandai Namco also fell another 9% this month, following an abrupt shut down of the "Bandai Namco Festival 2025" by the authorities in Shanghai in late November. For now, though, evidence was lacking that Chinese people had reduced their spending on Japanese anime goods. The Bailian ZX creative fun mall, a Shanghai-based specialty mall focused on anime and games, continued to see large numbers of Chinese people purchasing Japanese anime goods.

The outlook: We are cautiously optimistic that some of the structural themes that drove 2025 market's return will continue to prevail. Yet we see growing geopolitical tensions as a major risk.

2025 was another remarkable year. Japanese equities managed to overcome the huge drawdown around the "liberation day" on April 2, when equities fell nearly 20%. Admittedly, the backdrop was helpful as tariff rates were lowered, the yen remained weak and AI-related stocks had strong returns. However, many Japanese corporations also made efforts to raise prices, increase local production and streamline their supply chain. **Accelerating corporate reforms, the monetary policy shift and a new political leadership boosted confidence**. We expect many of these tailwinds to remain supportive in 2026, even if the bar looks high.

As a matter of fact, **the Topix index gained more than 80% in the last three years**. Valuations remain relatively attractive when compared to other countries, but they have definitely been stretched. According to Graphene Investments' calculations, **P/Es expanded by four points over the same period to reach 15.82x forward earnings at the end of December**.

As we expect global growth to slow down, wages to increase, the monetary policy to become more restrictive,

and the fiscal situation to be stretched, one might think that generating profit growth will be a challenge. **Japanese corporations however have a big asset in restructuring potential and the subsequent productivity gains**. Our investment universe is full of companies with too many segments, some of which are unprofitable or margin dilutive, or do not make strategic sense. With mounting pressure from the economic environment, the regulator and external investors, executives have no choice but to move away from historical inertia. In some cases, this could prove to be very simple. Kirin's head of investor relations recently explained to us that the company intended to offset an expected 7-8% wage growth with a reduction in overtime hours. Elsewhere, the sale of cross-shareholdings reduces the conflicts of interests, which may occur, for example on pricing, when a client is also a significant shareholder. Additionally, and despite the recent interest rates hike, the Bank of Japan remains accommodative. While the official rate is the highest seen in Japan in 30 years, **the real interest rate**, taking into account a 3% increase in consumer prices, **remains just above minus 2%, among the lowest in the world**. Anyhow, large Japanese



firms and consumers hold a lot of cash. If smaller companies were to be in trouble, the government would look to be supportive and provide tax credit and subsidies. Given her strong popularity, Takaichi-san might also decide to dissolve the Lower House with hopes of increasing the number of seats held by the LDP, to facilitate the implementation of her policy.

That said, 2026 is not looking riskless either. **The Prime Minister needs to work on a healthier fiscal situation, especially as the country's refinancing costs are climbing...** and Ueda-san is willing to go on with further monetary policy normalization. As a matter of fact, **any error of the central bank could have a severe impact on the currency.** The balance is fragile. A much weaker yen would lead to higher import prices which would hit consumers. On the contrary, a much stronger yen would weigh on exporters' profit growth. At least, in the short-term, companies have kept a fairly cautious USD/JPY rate assumption of 147 as a buffer for the rest of fiscal year 2025, according to the latest Tankan survey. Our biggest concern thus relates to the geopolitical situation. As we said last month, **the impact of current Chinese sanctions remains concentrated** on marine exports and Chinese tourists' spending. The former makes up less than 1% of total shipments and the latter less than 0.3% of total GDP in 2024, according to Japan Tourism Agency. Moreover, the 2026 budget seems to include spending on impact-mitigation measures. **We would however become a lot more concerned if China decided to ban its rare earth exports.** More generally, tensions are rising all over the world, a growing number of powerful country leaders behave unpredictably or let personal interest interfere with their mission. **No one can predict if open conflicts will emerge, but such risks never bode well for equity markets.**

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