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**The facts:** The news in Japan focused on Sanae Takaichi, who announced a snap election despite a tense, moving geopolitical environment. Macroeconomic indicators did not bring much clarity, but investors were eyeing companies' forecasts with the start of the third quarter earnings season at month-end.

There was nothing really striking in the January flow of macroeconomic releases from the Cabinet Office. The volatile machinery orders went down sharply between October and November, partly as a payback of the previous two months' strength. Exports posted a mid-single-digit year-over-year growth for the fourth consecutive month in December but auto shipments to the USA remained lackluster because of tariffs. For the 45th month in row, the national CPI rose faster than the Bank of Japan's 2% target. However, inflation cooled down from 2.9% in November to 2.1% in December, which was just a reflection of the government subsidies to rein energy charges. The strength in households' real spending in November was also explained by a favorable calendar with more long weekends than the year before. Overall, **the increase in consumer confidence was probably the most notable signal, in that it was the strongest in almost two years and confirmed a trend which has been lasting for about ten months.** Average winter bonuses at large companies topped ¥1 mln (\$6,430) for the first time on record, and were 8.6% higher than last year, according to the Japan Business Federation. Unions wage negotiations looked at least as aggressive as last year, and consumers were also counting on the new Prime Minister's promises to curb the cost of living.

As a matter of fact, Sanae Takaichi was the center of attention in January. In her New Year message, she pledged to "push through necessary reforms". As the month went by, rumors grew, and were later confirmed, that she would

dissolve the Lower House. Behind this move, she hoped to capitalize on her current popularity to increase the razor-thin majority of the ruling coalition and push bolder policies more easily. With the election date set for February 8th, senior LDP officials signaled the chance of a temporary tax cut on food to attract voters, as most opposition parties had called for it. At the end of the month, **media surveys were all predicting that the Prime Minister would succeed in securing a large majority**, despite most polls showing that her own popularity had lost a few points... but remained close to 70%. Ahead of this election, the **BoJ opted to keep its rates unchanged, but raised its forecasts for growth and inflation for fiscal year 2026.**

In the meantime, the geopolitical tensions with China, which had been sparked by Takaichi-san's comments on Taiwan, escalated a step further. **Beijing's Ministry of Commerce suspended its Japan-bound exports of rare earths intended for the production of dual-use goods** (i.e. goods that have both civilian and military applications, like drones and chips). International relations were also put under stress by Donald Trump's manoeuvres to use various, more or less convincing reasons to increase his control on countries with key natural resources, like Greenland and Venezuela. Meanwhile, the brutal crackdown against protests in Iran led the US administration to consider strikes against the Islamic regime. Given that Venezuela and Iran respectively own 17 and 11% of global proven oil reserves,



according to OPEC's 2025 statistical bulletin, these tensions made barrel prices very volatile.

The December quarter earnings season started in this tense context. Announcements were still in early stages at the end of the month, but about half of the releases so far exceeded

consensus forecasts, which by Japanese standards was fine. Financials came as the best category with a beat rate close to 70% on EPS, as Japan's yield curve steepened. At the other end were consumer-related categories, with only 35% of Consumer Staples exceeding consensus expectations, as the sector struggled with rising costs.

**The effects:** Following the same trend as 2025, the Topix index started the year on a strong footing. The prospects of a strengthened majority in the upcoming election and continuing optimism on AI led the Tokyo Stock Exchange 4.6% higher in January.

The Japanese equity market did not seem to be impacted in its entirety by Donald Trump's actions and comments regarding Venezuela and Greenland. In fact, the Topix index went up 7.5% in the first half of the month. The yen remained relatively weak, the Prime Minister repeated her calls for reforms and investors warmed to the view that the upcoming election would reinforce her power. **Even the new Chinese sanctions, which triggered a 1.5% pullback in two days, did not stop that uptrend.** The second half of the month showed more hesitations. **Investors started to raise concerns about the fiscal implications of a consumption tax cut.** Sovereign bonds were under pressure and Japanese rates increased further, with the 10-year rate reaching 2.38%, its highest level since 1999 and the 40-year rate a historic record at 4.21%. **These tensions calmed down after the Nikkei newspaper published two reassuring articles about Moody's and S&P's views.** In the meantime, the yen appreciated sharply (nearly 4% in three sessions), but stabilized quickly thereafter. Investors suspected an intervention instructed by the Ministry of Finance, which the BoJ data did not confirm. Others raised the possibility of a coordinated action with Washington. The US sovereign debt was also under pressure as European Union members reacted to Donald Trump's offensive against Greenland, and Japan's direct involvement to support its currency would have meant selling US government bonds, thus making things worse. Earnings, which started being published in the last few days of the month, created some added volatility at

the stock level, but the Topix index finished 4.6% higher in January.

**Financials were unsurprisingly the best category this month. In reality, banks did extremely well and rose 13% in January, but insurance lagged behind the index...** With the normalization of the monetary policy, the domestic banking business is finally seeing an increase in its net interest margin which, along with a supportive investment banking activity, has bolstered earnings. The insurance sector does not benefit from the same tailwinds and was expected to take a hit from the latest surge in rates due to its large bond holdings.

**Defense and resource-related categories were next.** Although geopolitics did not seem to weigh that much on the market, they did at the sector level. With the tensions in the backdrop, **Takaichi-san is expected to increase defense spending to 2% of GDP by the end of March, two years ahead of schedule.** The three main conglomerates engaged with the Ministry of Defense (namely Mitsubishi Heavy Industries, Kawasaki Heavy Industries and IHI) saw their stock prices rise between 18 and 30%. Given the export restrictions implemented by China, rare earths supply became a key topic. Companies involved in alternative sourcing and the deep-sea project in the Pacific Island of Minamitorishima (the first attempt by Japan to source rare earths domestically) were thus in favor. Toyo Engineering, which is involved in developing technology



required to extract rare earth muds, surged 82%! Lastly, oil explorers and refiners gained more than 10% as oil prices rose by about the same magnitude. **Conversely, categories relying on these commodities lagged the index.** Oil-consuming sectors, such as Transportation or Rubber Products, were either down or up only slightly. The car industry and some technology players lagged too, albeit to a lesser extent, as rare earths are needed in electric motors, high-precision sensors and various electronic components such as speakers, capacitors and display systems.

**The AI theme also remained a strong driver.** Like in December, memory providers gained the most whereas buyers like video game companies continued to suffer. **Kioxia Holdings more than doubled in value just in January.** This global leader in flash memories and SSDs extended its agreement with Sandisk to produce flash memory for another five years. Nintendo and Sony, on the other hand, respectively lost 5% and 14%. Semiconductor equipment manufacturers and optical fiber suppliers were also among the top performers. Advantest climbed 30% as it published

particularly strong results. The demand for testers used in the production of high-performance AI chips remained buoyant, although the manufacturer described its outlook as "unpredictable" due to factors such as geopolitical risks and sharp FX variations.

**The biggest laggards ended up being the consumption-related categories,** whose returns were between 1% for Foods and -2.5% for Retail Trade. **Domestic companies rose slightly in the wake of the VAT-cut expectations but the strength was short-lived.** Early earnings releases showed their difficulty in passing through their higher costs as consumers struggled with inflation. Moreover, **December data from department stores showed that tax-free sales had declined by 10 to 20%, mainly due to a decrease in visitors from China.** Takashimaya expects the weakness to last and sees its sales to foreign visitors falling by another 10% in its fiscal year ending in February 2027. Yet, its stock price surged 17% when it announced a tender offer to buy back all outstanding zero-coupon convertible bonds due in 2028.

**The outlook:** A victory of the ruling coalition in next month's snap election would make it easier for Takaichi-san to implement structural changes. It could also ease tensions with China, but Japan and its corporations must take actions to increase their resilience.

Prime Minister Sanae Takaichi called the snap election with the aim of securing a public mandate. To assess the success of her move, the key number is 233, which is the simple majority of seats in the 465-seat chamber. Takaichi-san is putting her job on the line and said she will resign as Prime Minister if the LDP-JIP coalition does not reach at least that threshold. Given the latest polls, there is a good chance that she will achieve that goal, yet **a two-thirds majority would be even better, as it would allow the Lower House to overrule opposition in the Upper House despite the coalition not holding a majority there.** With high expectations being set, the attention will turn to the details of the necessary reforms to address Japan's structural challenges, which we feel are still missing at this point. She

knows her program cannot be all about expansionary fiscal policies without reforms to enhance productivity. It would fuel inflation, pressure rates, and increase the debt servicing cost. **If she manages through these challenges, as Abe-san did before her, new flows from international investors, which remain heavily underweight, could boost the market.** A victory is also key for her to withstand China's pressure. The current situation is reminiscent of her mentor Shinzo Abe's return to power in 2012, amid high tensions with China. Abe-san kept winning elections and building a solid political base, which helped him be taken seriously when dealing with his Chinese counterpart.



In the short-term, Japan will have to rely on the ¥48.1b contingency fund, the government has decided in the FY25 budget, to support Japanese seafood producers, the stockpiling of active ingredients for antibiotics and the expansion of critical minerals supply. **Japan remains very dependent on China as far as rare earths are concerned. It is however taking action to reduce its reliance. Since 2010, it has cut its Chinese procurement from 90 to 70% of its needs with greater imports from Australia and Vietnam.** Despite the technical challenges, the Japan Agency for Marine Earth Science Technology has started to drill in the deep-sea area around Minamitorishima, which it estimated to contain the equivalent of several hundred years of global demand. Meanwhile, Japanese companies are also actively looking for a workaround amid supply shortages and increased geopolitical risks. In 2025, Honda and Nissan Motor were forced to cut production due to the suspension of shipments by Chinese-owned semiconductor manufacturer Nexperia. Japanese associations of car manufacturers and auto parts industries thus plan to establish an information-sharing system about the semiconductor industry, which should start in April. Approximately 20 domestic and international semiconductor manufacturers are expected to participate, none of them being Chinese. **Meanwhile, Toyota Motors is working with Toyota Tsusho to significantly reduce its rare earths consumption, JX Advanced Metals has developed a technology to recycle rare earths, and Nidec is developing motors that are made without rare earths.** Even if geopolitical risks remain, it is astonishing to see how adversity breeds innovation and changes.

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