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The facts: The escalation of the conflict in the Middle-East was the key event in March, leading to a historic spike in oil prices which, for Japan's energy-reliant economy, put the rather positive economic indicators on the back burner.

Several pieces of news in March kept confirming that Japan's economy had continued to head in the right direction. The Cabinet Office revised the country's GDP growth from 1.1 to 1.3% for the December quarter, thanks to stronger capex and private consumption. Retail sales were a little softer in February but confidence among consumers, factory workers and shopkeepers kept improving for the same period. National inflation receded modestly to 1.3% YoY in the same month, thanks to energy subsidies. At the same time, **the Japanese Trade Union Confederation, Rengo, confirmed that it had obtained a pay hike greater than 5% in the spring negotiations**, as many large companies fully met wage demands amid labor shortage.

This optimism was de facto challenged by the geopolitical context. US and Israeli strikes on Iran, which started at the end of February, escalated sharply in March. **Iran's retaliations damaged key facilities in neighboring countries and led to the closure of the Strait of Hormuz.** This shipping route is critical as it is used by about 20% of the world's oil consumption, according to the International Energy Agency (IEA). At the end of the month, strikes were continuing but, according to Donald Trump's promises, they were supposed to avoid civilian infrastructure as long as discussions were progressing. Unconfirmed rumors spread that Iran had asked for a ceasefire, but it was unclear if the conflict would end soon. In an effort to reduce the burden of oil price increases, the IEA agreed upon the largest oil reserves release ever, while Donald Trump ended Russian

and Cuban sanctions on oil. Prices for **the black gold, however, spiked 45% in March**, its biggest monthly surge in history!

Japan, which sourced more than 90% of its oil and about 10% of its gas needs from the Middle East in 2024, is particularly at risk. Mid-March, **Prime Minister Sanae Takaichi thus also started to release 20% of the country's oil reserves, which stood at around 250 days at the end of January. She rolled out subsidies for fuel products including a cap on gasoline prices.** She will also allow more use of coal-fired power plants in an effort to secure power supply to cope with the energy shock. The Prime Minister also met with Donald Trump. That meeting went relatively well, despite an awkward remark of the US President comparing the sudden strike on Iran with Pearl Harbor. Mr. Trump did not press Japan to intervene in the conflict, nor did he directly mention Japan's duty to raise its defense spending. Both also agreed to move to the second round of Japanese investments in the USA, which includes a cooperation on infrastructure development to increase US crude oil production, particularly in Alaska.

The Prime Minister's initiatives were all the more important as the Yen continued to weaken against the US dollar, making energy imports even costlier. The Bank of Japan kept its rates unchanged. It reaffirmed its view on the moderate recovery of the economy but added that the situation in the Middle East, as well as developments in crude oil prices, were additional risk factors.



As a matter of fact, **several Japanese companies already announced production cuts**. This was the case for petrochemical firms, which feared that the Middle East conflict would strain supply of naphta, a vital component for plastic manufacturing. Even the snack-maker Yamayoshi Seika suspended the production of several products due to difficulties securing fuels. The two main Japanese refiners Idemitsu Kosan and Cosmo Energy delayed their mid-term plans as they had limited inventories to draw from. Interestingly, though, **several others were more responsive than usual to raise prices and swiftly reflect swings in raw material costs**. This was the case for chemical companies

like Shin-Etsu and Toray, but Murata Manufacturing, GS Yuasa or Sony, to name a few in other sectors, also did it.

Behind this agitation, **overseas investors seemed to have also been increasingly active in Japan**. Among the most frequently reported news, Berkshire Hathaway entered into a capital and business alliance with Insurer Tokio Marine. Activist investor Elliott Management built a stake in Japanese shipping giant Mitsui OSK, while Bain Capital and KKR were apparently also showing interest in investing in the utility company Tokyo Electric Power.

The effects: Against this backdrop, the Topix Index plummeted nearly 11%, its worst month since the subprime crisis. Unsurprisingly, Energy stood out, whereas oil-consuming categories were sold off. Our strategy outperformed by 91bps thanks to its moderately defensive positioning.

The Topix index trended downward throughout the month and was particularly volatile. Nearly half of the daily trading sessions posted a return of a magnitude greater than 2% either way. The index attempted to rebound several times after Donald Trump announced that the conflict would be resolved "very soon" or postponed attacks for several days, claiming talks were progressing, but fell back the next day as strikes kept happening. **The decline accelerated once the yen fell past the psychologically important \$160 line, its weakest level since July 2024**. In the end, the Topix index lost 11.2% in March (or 10.3% after dividend), which was its worst month since October 2008.

All but two of the 33 Topix sectors went down. The exceptions were Marine Transportation and Mining. The former gained 10% as the Strait of Hormuz's closure implies higher freight rates and longer shipping routes. Mitsui OSK rose more than that as the news of Elliot's purchase also helped. Mining which, despite its naming, mainly includes oil companies, returned nearly twice as much. The Oil & Coal sector also held relatively well as refiners are expected to benefit from higher selling prices, but it lost about 4% as

output may be limited by input constraints. Wholesale Trade also limited its loss to 6%, as many of its members own energy assets abroad, which are likely to appreciate.

At the other end, **energy-intensive sectors such as Machinery, Rubber and Air Transportation lost 17 to 18%**. In appearance, the Electric Power & Gas sector did not lose more than 5% but most utilities were down more than 10%, as they remain highly exposed to LNG price swings. However, a few managed to gain more than 10%, like Renova and Erex, which own and operate renewable energy power plants, as well as Electric Power Development, which mainly produces coal fired and hydroelectric power.

More generally, **defensive sectors resisted better than cyclical ones**. Foods and Pharmaceutical were down only 5 to 6%. Information & Communication lost less than that, and the main telecommunication companies NTT and KDDI even finished up. On the contrary, Transportation Equipment, Construction and Electric Appliances went down more than 15%.



The case of financials was more peculiar. **Banks were hit strongly**, as a prolonged conflict would slow global economies, raise credit default and liquidity risk. Certain large US asset managers in private credit were unable to accept redemptions. Additionally, the war challenges the BoJ's normalization policy. **Insurance fared much better**, though, with the help of Tokyo Marine, whose share price went up 12% in the wake of the alliance with Berkshire Hathaway.

In this context, our strategy's moderately defensive positioning managed to outperform the Topix index by an estimated 91bps gross of fees. Our selection of relatively more defensive, more domestic companies exposed to Japanese structural trends helped us alleviate the most cyclical plays.

Our simulated portfolio's top three performers delivered strong results ranging from 16 to 23%. These included the

Our decisions: Our exposure remained relatively unchanged since the beginning of the year. With limited visibility, our trades reflected pure stock picking, discipline and valuation. We switched a chemical company for one that is more active in restructuring its portfolio, and increased our weight in a large bank for risk management purposes.

Only two of our selection's 44 stocks were replaced during the first quarter of 2026.

The first trade led us to sell a paint company for a more diversified firm. We had kept Kansai Paint, despite the sluggish paint demand for auto and increased competition in India, because of its growing efforts to raise margins overseas. The underlying reforms however are taking longer than expected to bear fruits and we saw the opportunity to switch to another more responsive, cheaper chemical company. Sumitomo Chemical's products range from agriculture (herbicides, pesticides,..) to pharmaceuticals, essentials and semiconductor-related chemicals. The conglomerate initiated structural reforms to enhance its profitability, such as cutting fixed costs, selling less profitable businesses and focusing on greener, more

main E&P player in Japan, Inpex, and the only utility with vertically integrated coal-fired plants, J-Power. The last one, Kakaku.com, is an operator of online services ranging from job search to restaurant and hotel booking, which was recently targeted by activist investor Oasis Management looking to push shareholder proposals to unlock more value. Additionally, our worst three holdings (a tire manufacturer, a semiconductor company and a bearing manufacturer) underperformed by a moderate magnitude.

Lastly, several of our holdings announced they were taking immediate steps to reduce the burden of higher input costs. Toray introduced a surcharge system for certain resins and carbon fibers to address the skyrocketing costs of crude oil and naphtha. Meanwhile, starting in April, GS Yuasa revised the prices of its industrial supply systems and lead acid batteries delivered in Japan.

innovative materials that carry higher margins. In the short-term, with a leaner structure, the company should fully benefit from the upcoming launch of three blockbusters in crop protection and the strong demand for photoresist and semiconductor materials, for which it recently added manufacturing facilities in Taiwan and the USA.

We also sold Mitsubishi Corp, a trading company whose stock price had climbed sharply to a point where our quantitative screening triggered a profit-taking signal. In exchange, we reinforced our holding in Mitsubishi UFJ Financial Group. The weight of the financial sector increased in the index since the Bank of Japan started to raise rates. Our portfolio, whose target weights are fixed, was no longer overweight on banks and we thought this was inappropriate with the arrival of Takaichi-san as a Prime Minister, who is



looking to boost growth. We chose to increase the weight in MUFG as it also benefits from a large M&A pipeline, its exposure to Morgan Stanley and has a sound balance sheet with a short-duration domestic bond portfolio, in case rates were to shoot up on debt concerns.

Both decisions were taken before the Middle-East conflict burst. Sumitomo Chemical's sales in the Middle East is less than 5%, and it had just reduced its stake (from 27.5 to 15%) in the less profitable integrated refining and petrochemical complex Petro Rabigh in Saudi Arabia. This did not change our underweight stance on Chemicals, which is even more logical now that input costs are up. As for MUFG, we remain confident about our long-term overweight position. Shorter-term, the bank does have credit exposure on the

Middle East, but the risk appears limited as the bulk of financing is for government-related projects.

Japan's commodity dependence is a theme that is well represented in our portfolio, not only with the top performers of this month, but also via companies that focus on energy diversification, energy efficiency and energy infrastructure development. All in all, we believe that our portfolio offers a good balance of relatively defensive and domestic plays with cheaper cyclical ones to go through this period. As a matter of fact, as of the end of March, **our Value strategy showed a PE of 13.7x, or an attractive two-point discount against the Topix index, yet it manages to match the same 10% long-term growth.**

The outlook: Even in the case of a quick resolution, we think time will be needed for energy markets and supply chains to return to normal. Investors have started to discount it but, as long as the conflict is not over, we can't know if this is enough. As the Japanese market corrects, we believe investors should selectively position themselves for the long-term.

We will refrain from trying to guess how long this conflict will last, as no one actually knows that. What we know, though, is that even if the war was to end tomorrow, prolonged disruptions are likely to remain for some time. The IEA indicated on March 23, that more than 40 energy assets across nine countries in the Middle East had been "severely or very severely" impaired. As damages involve oil fields, refineries and pipelines, the restoration of output is likely to be delayed even after hostilities subside. The director of the IEA compared the scale of the damages to multiple past shocks combined including shocks of 1972 and 2022. QatarEnergy's CEO even stated that it could take up to five years to recover the 17% LNG capacity of Qatar that was wiped out! Oil demand is highly inelastic in the short run because most end uses have few immediate substitutes. The conflict effects many sectors including petrochemicals, fertilizers or helium, disrupts entire supply chains and raises freight costs. The longer the war lasts, the more dramatic it becomes as it will cause demand destruction. In fact, **four**

of the five oil shocks since the 1970s led to a global recession, but countries now have larger reserves and the global economy is less oil intensive.

Japan and its Asian trading partners are particularly at risk. As a matter of fact, according to the METI, Japan's manufacturing still relies on oil for roughly 30% of its energy mix, of which more than 90% comes from the Middle East. The newly appointed Prime Minister is taking this critical situation very seriously. She is counting on the country's large reserves, which during the 1979 oil shock helped mitigate inflation. Their release however is temporary and cannot be a suitable solution in the event of a sustained shortage. Subsidies will alleviate the burden, but may also eat up on the government's budget for growth investments, which already raised concerns over the country's indebtedness. In the meantime, **Takaichi-san smartly pursues diplomacy to diversify Japan's geographic supply of resources** but the results will take time to unfold. Additionally, the Bank of Japan is caught in a stranglehold.



The cost-push pressure intensified by an excessive yen depreciation justifies hiking rates and the recent labor negotiation validates it as well, but a global recession would support the opposite.

With a market decline greater than 10%, though, some effect on earnings has already been discounted. We thus cannot rule out a short-term rally, in the event of a quick reopening of the Strait of Hormuz. The Japanese market had been a little overheated for some time, and was due for a healthy correction that could be welcomed by investors who look to invest for the long-term. **Under a new leadership, and despite the dire short-term situation, we strongly believe that the Japanese equity market is increasingly gathering the conditions to convince overseas investors to reverse their long-term underweight position. The growing number of activists is already showing the path.**

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