Japanese Equities

Investment comment

June 30, 2026

Document intended mainly for professional investors

The facts: Donald Trump achieved a fragile ceasefire with Iran just in time for the G7 meeting, triggering a large relief in oil prices. Yet, the Bank of Japan decided to raise rates as Japan's energy-reliant economy appeared resilient enough. This however did not prevent the yen from continuing to weaken.

Geopolitical news remained at the center of investors' interest in June, and the agreement reached between Tehran and Washington was positively received as it meant that traffic in the Strait of Hormuz would finally resume. However, little detail was provided. Iran kept claiming that it retained control of the corridor. Both parties blamed each other for not respecting their part of the deal, and attacks on commercial vessels continued. As a consequence, although traffic had officially resumed, **the number of ships able to sail through was nowhere near pre-conflict levels, with some sources citing that it reached 30% at best. Nevertheless, oil prices went down by more than 20% in June**, to around $70 per barrel, a price not seen since the conflict burst.

According to official data through to May, Japan's economy, which is extremely reliant on the Middle East for oil imports, remained resilient. The main impact was the acceleration of producer prices, which rose at a 6.3% annual pace. With consumer prices capped below the 2% official target thanks to government subsidies, the economy managed to resist relatively well. The March quarter's final real GDP, which included the first month of the war, showed that the economy had grown at an annualized rate of 1.8%, just below the initial 2.1% estimate, as capex were revised lower. Consumption remained solid. Retail sales went up 1.9% between April and May. This was the third consecutive gain. Production increased 0.5% in the same period, marking the second consecutive month of growth. Lastly, exports and imports showed double-digit annual growth, even if a large part was driven by prices. All in all, **the most notable change was a small positive inflection in sentiment,** illustrated by the Consumer Confidence and Economy Watchers surveys.

Against this backdrop, **the Bank of Japan hiked its reference rate by 25bps to 1% and it dropped its mention of "significantly low real interest rates".** Even the last minute hospitalization of Governor Ueda did not change this widely expected move. Asada-san, who is the first member appointed by Takaichi-san, however voted against this decision, emphasizing downside risks to production and employment. Ayano Sato, another advocate of a loose monetary policy, was also appointed as a new board member by the current administration at the end of the month and will participate in future meetings from July onwards.

Neither this rate hike, nor previous FX interventions prevented the yen from declining further. **The Japanese currency closed above 160 to a dollar, which was its lowest level in 40 years!** The newly appointed Fed Chairman, Kevin Warsh, did not change the Fed fund rates in June but his speech sounded more hawkish than expected, given that Donald Trump's appointee was expected to support the president's push for a loose monetary policy… Finance Minister Katayama warned several times that she was ready to respond appropriately to the yen weakness, and she held

a video conference with the US Treasury Secretary Scott Bessent on the topic.

As for the Prime Minister, she kept applying her plans. The Japanese cabinet approved the FY2026 supplementary budget, authorizing an additional ¥3.1T in spending, of which 2.5T was allocated to the contingency fund for the Middle East situation. Meanwhile, **the government announced a detailed plan for public-private investment across the 17 strategic fields, ranging from physical AI to aerospace & defense to energy security**, to name a few. Approximately ¥370T in combined public and private investment were expected to be spent through FY2040… As for the promise of a tax cut on food and beverages, things were looking more complex, but a cut from 8 to 1% was still being considered for implementation in April 2027.

The effects: The Topix index gained 0.95% in June. Oil- and rate- sensitive categories moved the most, but AI once again led the index, albeit in a more volatile matter. In this context, our value-style portfolio lagged slightly.

The geopolitical situation and interest rates have been key drivers for Japanese equities in June. The Topix index had several rough sessions throughout the month, when strong US economic data (such as job creations or higher-than-expected inflation) or Kevin Warsh's speech suggested that the Federal Reserve could raise rates. However, the reopening of the Strait of Hormuz and the subsequent decline in oil prices, which are key for Japan's economy, offset these concerns, and the Topix index returned 1.1% after dividends in June.

Along these lines, **categories benefiting from the conflict in Iran** (mainly oil and trading companies which have energy assets) **had the worst returns, close to -10%.** Conversely, oil-consuming sectors did much better, but they did not all outperform the Topix index. Air Transportation gained 1.4%, but Rubber Products and Electric Power & Gas had low-single-digit negative variations. Chemicals were the worst, as the shortage of naphtha remained an issue. **Banks benefited from higher rates and steepening yield curve**, and returned 6.7%. Domestic banks are raising their deposit rates, but the benchmark for lending rates is rising even faster. On the other hand, Real Estate underperformed slightly. Lastly, **the weak yen did not provide the usual tailwind to exporters** like auto manufacturers, which were suffering from sales to China. In particular, Toyota's sales to China plunged for the fourth consecutive month in May, with -32% YoY.

In fact, the main performance driver remained AI. The Nikkei 225 index, which is a price-weighted reference and whose weight in IT nears 60%, went up 5.63% in June! Its top two holdings, semi-conductor equipment manufacturers Advantest and Tokyo Electron, went up 23 and 47% respectively. Not far behind, memory supplier Kioxia gained another 36% and reached a market capitalization greater than Toyota Motor's! US player Micron Technologies released strong third-quarter results and an upbeat forecast, as it secured 16 strategic customer agreements. Other semiconductor manufacturers also followed suit with double-digits returns.

These moves however were not linear, and despite their strong performance, many of these names experienced large swings. Concerns over a US rate hike as well as news such as Broadcom's guidance, which was perceived as underwhelming, or the postponement of Open AI's IPO until 2027 triggered some nervousness. Softbank Group lost 20% in June because of its stake in the AI company. Each time this happened, a rotation into domestic and defensive categories as well as laggards occurred.

In this context, our portfolio underperformed by 61 bp gross of fees. **Our Value bias did not help. As a matter of fact,**

249bps separate the performance of the two style indices. Our portfolio enjoyed the run of a few AI-related names like Advantest and capacitor manufacturer Murata, which were among our best performers. Panasonic also returned about 20%, as it confirmed its confidence in the sales objectives it had announced during its investor day for back-up battery units and AI-related electronic materials. Amid better consumption trends, we also enjoyed a nice rebound from some of our domestic plays, which had lagged year-to-date, like sweets producer Kotobuki Spirit, auto dealer Nextage, and online apparel retailer ZoZo (which recently bought back 5% of its shares). Those winners however did not suffice to offset our overweights in Transportation Equipment and Pharmaceuticals, which kept underperforming despite the continuing yen weakness. Throughout the month, though, our portfolio witnessed much lower volatility than the index.

Our decisions: Given the persistent lack of visibility, we were not necessarily willing to make changes in the portfolio, aside from specific stock considerations. With this in mind, we sold a paper manufacturer and reinvested the proceeds in an IT services company.

Our quantitative screening model triggered a sell signal on Oji Holdings. This paper manufacturer faces large cost increases due to rising tensions in the Middle East and the weak yen. It aims to pass these through to customers but the speed remains too slow. We expected that its vertical integration would be an advantage, but pulp prices were still low and are expected to remain so given the current supply environment. Additionally, the company's restructuring efforts failed to yield significant results. We did not find the current valuation attractive enough to keep the stock, all the more as we felt estimates were not conservative enough in the current context.

We subsequently opted to buy TISI which is one of Japan's biggest IT services companies. It is well known for its credit and branded debit core systems, which settle more than 50% of transactions in Japan. This extremely sticky system has enabled it to penetrate a large set of sectors (as diverse as finance, manufacturing, retail, telecom, government and utilities) and develop other services to drive the need for digital transformation at lagging Japanese corporates. The development of AI is boosting client spending and is driving demand for infrastructure upgrades, which we believe TISI should benefit from. The stock has severely de-rated along with software and consulting businesses as investors feared AI disruption risks. We believe this creates an opportunity. TISI differentiates itself as a system integrator and a mission-critical operator, which makes it more resilient than traditional consulting business. It also operates mainly in Japan, a country where a lot needs to be done for digitalization and in-house expertise is extremely limited. Moreover, TISI is improving its corporate governance by accelerating the sale of cross shareholdings, raising its payout ratio and simplifying its structure by merging with Intec, a long-term subsidiary, which should drive synergies.

Following this decision, our portfolio's characteristics remained relatively unchanged vs last month, apart from a slight widening of our value advantage against our benchmark (with a PE now 2.63 points cheaper than market average).

The outlook: We believe that the path towards achieving a durable peace in the Middle East will be erratic. The Prime Minister's efforts to increase Japan's resilience are positive, as long as she maintains fiscal discipline. We thus expect the market to become increasingly nervous in the second half of the year.

We were surprised by the way the market treated the temporary ceasefire. The 20% decline in oil prices suggests that investors considered it as a permanent deal. Yet, as both sides keep breaking their part of the deal, we would not be astonished if the situation changes quickly. Even so, **as shipping company Mitsui OSK's CEO said, ship owners will not resume traffic unless the deal is "material"**. Moreover, we don't know how much of the strait is mine-free. Energy reserves need to be refilled for next winter. To make things worse, other large oil producers like Russia face refinery shortages after several Ukrainian strikes hit infrastructures.

Even if it is a long-term project, we praise Takaichi-san for her efforts to protect her country and build greater resilience against energy dependence, which her plan for public-private investment tackles. Physical AI will also be positioned as a flagship business. A wide range of applications are envisioned, including factory automation, unmanned transportation and infrastructure inspection. Entrusting on-site processes in sectors facing serious labor shortages (such as manufacturing, logistics, and construction) with AI and robots, will fundamentally improve productivity. **The Prime Minister advocates "responsible and proactive fiscal policy". Yet, it is unclear how much of the amounts will be privately funded.**

Moreover, by tightening (or some would say normalizing) its monetary policy, the Bank of Japan made the cost of debt more expensive. The government's latest nomination to the central bank's board is an illustration of this concern. With two new members (out of nine) who favor reflation, it will be interesting to see if it changes the dynamics. Moreover, **the monetary policy is increasingly pressured by a weak yen** and it looks like FX interventions may curb further depreciation. Last but not least, **a new chairman of the Fed also adds to the uncertainty.**

Calendar coincidence, Kevin Warsh took the rein during the same month Alan Greenspan passed away. The Fed's former chairman had made comments on several occasions, back in 1996, about investor's "irrational exuberance", which initially shocked the market. No one can predict a bubble, and the one he was referring to did not burst until 2001. We however cannot help pointing out that some stock reactions are a little excessive. For instance, we noticed two chip materials companies whose stock surged after they announced large capacity investments that will come on line in... 2030! **The past few weeks reminded everyone that nervousness begins to set in. We intend to remain disciplined and avoid chasing the crowd.**

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