Japanese Equities
Investment comment

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Document intended mainly for professional investors

The facts: Geopolitics, fiscal concerns and AI remained at the forefront of the news in Japan in July. While general sentiment remained relatively solid, inflationary trends accelerated. The start of the quarterly earnings season was encouraging for AI-related companies, but others experienced cost pressures.

As expected, the fragile interim agreement between the US and Iran to halt the war and reopen the Strait of Hormuz was not only short-lived, but the situation escalated and even Saudi Arabian forces, which had not been directly involved until now, took part in joint operations with the US military. With attacks targeting pro-Iranian organizations in Iraq, the conflict is continuing to spread throughout the region.

On the domestic side, the government finalized its “Basic Policy on Economic and Fiscal Management and Reform 2026”, also known as the “Honebuto policy”, which will involve investing ¥370T over 14 years. **The term “Honebuto” literally means “big-boned”, signifying that the policy will lay the foundations for future grow**th. While this measure is in line with Prime Minister Takaichi’s vision that Japan needs a long-term investment strategy to secure its growth and national security, it also accelerated concerns over the country’ s fiscal health and lifted JGB yields further.

Despite the government’s efforts to ease these concerns, the yen traded around a new record-low of about ¥163 to the dollar. Finally, **at the end of the month, the Ministry of Finance decided to carry out an intervention with the help of the USA**. Meanwhile, the Bank of Japan elected to maintain its policy rate at 1.0%. Some investors were concerned that the BoJ might implement a rate hike alongside currency intervention, as it did in July 2024, leading to a sharp market decline. Although a possible rate hike by the Federal Reserve added to market anxieties, these have now been allayed. Japan’s central bank will assess the impact of the June rate hike, as well as that of the 7.1-magnitude earthquake which struck the Kumamoto Prefecture (now a hub for semiconductor production) just two days before the policy meeting. **Governor Kazuo Ueda continues to signal the bank’s intention to raise rates further to curb inflation**. Incidentally, one of the policy board members proposed a 25-basis points hike, in line with this view.

As regards AI, while concerns about the sustainability of investments continued to mount, a three-day visit by Nvidia’s CEO Jensen Huang mid-month made the headlines in Japan. He met with around 30 semiconductor-related companies, as well as Japanese government officials who are keen to enforce the country’s sovereign AI strategy and reduce its dependence on foreign cloud infrastructure. **Upon his departure, Mr. Huang had secured deals across Japan’s entire tech ecosystem, including a national AI factory, partnerships with leaders in robotics and industrial automation, and agreements with semiconductor material providers** to power Nvidia’s next-generation chips. While he reiterated his close ties with Japan, which date back 30 years in arrear when video game company Sega’s investment helped keep a near-bankrupt Nvidia afloat, this visit followed his trips to Taiwan and South Korea. It appears to represent a foothold in the

company's Asian expansion strategy, in response to the deteriorating relationship between Washington and Beijing. Subsequently, news from China added to the negative sentiment: memory producer Changxin Memory Technology (CXMT) announced Asia's largest IPO ever and a report said the country had developed its own DUV chip-making technology to compete with existing leaders.

In the middle of all this news, sentiment about the economy remained rather resilient. The Cabinet Office's Consumer Confidence index kept improving albeit at a low level of just below 35. The BoJ's quarterly Tankan survey released at the beginning of July came in stronger than expected. **Both current and outlook business sentiment indices improved at large manufacturers, with the current index reaching its highest level since 2018**. The more frequent survey carried out by Reuters in July was unchanged from the previous month after rising over the previous two months on the back of solid semiconductor demand. On the other hand, sentiment fell in services according to both surveys, as the conflict in the Middle East, the weak yen, and rising interest rates pushed up costs. As a matter of fact, the Corporate Goods Price index was up 7.1% year-over-year in June, accelerating further after 4.9% in April and 6.3% in May.

Business sentiment was well reflected in the quarterly earnings season which started at the end of the month. Many of the AI- and semiconductor-related companies announced very strong first fiscal quarter results and revised their guidance up. On the other hand, **those that were not able to pass-on the rising costs to selling prices suffered**.

The effects: The Topix index ended the month with a modest gain of 0.21%. There was a clear shift out of AI-related stocks and into defensive and lagging sectors. In this context, our more balanced selection outperformed by more than 3%.

Conflicting news about the potential reopening of the Strait of Hormuz had a daily impact on the market. Additionally, ongoing concerns about equities' steep rise in recent months and the sustainability of AI investment led to a theme rotation out of AI and semiconductor stocks and into more defensive, underperforming sectors.

Several pieces of news surrounding AI and server suppliers also contributed to this shift. These included the listing of SK Hynix on the Nasdaq and the subsequent announcement of lower-than-expected results, the expansion and listing of Chinese memory producers, and the news that **a Chinese state-owned company was proceeding with the production of deep ultraviolet (DUV) lithography equipment**. This intensified the selling pressure as many investors believe that the rapid growth in profits will not be sustainable given the emergence of competition.

Expectations that Japan will need to finance its spending by issuing debt continued to weigh on government bonds. Despite interventions occasionally breaking the trend for a short while, yields kept rising which resulted in the yen's depreciation. This contributed to the outperformance of some exporters by enabling them to offset rising costs, but it also further increased the burden on companies that depend on imported products. **The move was swiftly reversed following the currency intervention**, which boosted the yen by more than ¥5 to ¥155-157 to a dollar.

By the end of the month, the best-performing sector was Marine Transportation, supported by easing concerns about an adverse supply/demand balance despite the Middle East conflict requiring ships to travel farther and make fewer rotations. Financials in general, including Insurance, Securities, and Banks, also did well on the back of rising

interest rates. The mining sector outperformed too, as did previous laggards, such as Rubber and Iron & Steel. At the other end of the spectrum, AI-dependent categories, such as Non-Ferrous Metals, lost as much as 23%, as did Glass & Ceramics, and Electric Appliances which include semiconductor equipment and memory manufacturers.

The performance of style indices also showed a notable rotation from Growth into Value. **The Topix Value index outperformed its Growth peer by 3.6 percentage points** after substantially falling behind between April and June.

In the last few days of the month, strong quarterly earnings and outlooks released by AI-related companies, such as Alphabet and Microsoft in the US and Advantest and Tokyo Electron in Japan, restored some optimism around that technology. The Kumamoto Earthquake, however, raised concerns about industrial production in the region.

In this context, our stock selection outperformed its benchmark by over 3%. In the Technology sector, which includes Electric Appliances and Precision Instrument, we were obviously hit by AI's weakness, but this was offset by strong fundamentals evidenced by the earnings reports. **In Information & Communication, the market's re-assessment of so-called "AI-disrupted" companies contributed to our success**. Conversely, Nextage, a used-car dealer, faced profit-taking after reaching an all-time high based on strong results and guidance.

Our decisions: We modified our portfolio this month from a risk management perspective. We reduced our exposure to Toyota Motor whose weight in the index has declined, and used the proceeds to reinforce a semiconductor tester provider, in order to reduce our significant underexposure to AI-related stocks.

Given the rising uncertainty, we are not particularly inclined to change our current selection. However, our risk management discipline required us to adjust our overweight position in Toyota Motor, which had come to exceed the preset limit. **Our risk management rules oblige us keep our stocks' fixed target weights within +/- 3% from their index weight.** The carmaker, which had the largest weight in the index until May, had to be reduced after its recent underperformance. The whole sector has suffered from an adverse operating environment characterized by cost inflation and waning demand due to the situation in the Middle East. Toyota is no exception, but we are confident that our sole car manufacturer holding has a strong hand with its diversified technology strategy. We also like the company's efforts to improve capital allocation by progressively unwinding its cross shareholdings under the new CEO (formerly its CFO). While Toyota Motor's market cap reclaimed its top spot, it was surpassed mid-month by two AI-related stocks Softbank Group, which has stake in OpenAI, and Kioxia, a memory chip manufacturer.

Although neither of these stocks exceeded 3% in the index, which would have forced us to buy them, their growing weight influenced our decision to reinforce our position in Advantest to reduce our significant underexposure to this dominant market theme. **We had long been reluctant to do so, because it's a sector where Japan lacks pure players, and we often felt that, just to get a tiny exposure to AI, investors were buying companies with a much larger business in completely different specialties**. This is what boosted printer manufacturer Seiko Epson, toilet maker Toto and food producer Ajinomoto. They respectively also have highly specialized involvements in crystal oscillators (used in servers), ceramic electrostatic chucks (instrumental in semiconductor production) and build-up films (used in high-density wiring substrates for chiplet production).

The outlook: Given that the current low-visibility environment is likely to persist, Japan will continue to face its challenges. Although strong earnings announcements have provided some relief so far, we expect a mixed reaction to the stronger yen and the rest of releases may cause volatility in the market.

As we have been saying since her election, we praise Takaichi-san's efforts to protect the country and ensure its long-term growth. Although recent polls have shown notable declines in her popularity, **her support rate is showing higher confidence than the average ratings of her predecessors at a similar stage of their tenures**. While the Cabinet's decision to go ahead with the cut in food consumption tax from 8% to 1% will barely let her keep the promise she made to voters, the impact on the real economy may be limited.

With sustained wage growth and relatively resilient consumer confidence, a virtuous cycle seems to be in place for the time being. However, the situation is largely supported by a fraction of Japanese companies, which are currently benefiting from the weak yen, brisk semiconductor-related demand, and to a certain extent, fair consumer confidence supported by the wealth effect provided by rising equity and property markets. But **all of this remains very fragile unless the government and the central bank make the right decisions**. We remain cautious about the Japanese economy while we wait for the government to clarify how it intends to finance its growth plans, and for the central bank to achieve normalization without hurting the economy.

One solution proposed by the government is for the Government Pension Investment Fund (GPIF), which manages nearly ¥300T for the general retirement system, to purchase government bonds. While the government could influence changes at the GPIF, this would take some time, as the fund would require valid reasons to see benefits in an increase of its allocation to domestic bonds. Former Prime Minister Shinzo Abe led a change in the fund's allocation in 2014, increasing equity investment as a part of his policy to end deflation. It took him nearly two years after taking office to influence the GPIF.

Following the significant correction, it will be interesting to see whether the modestly restored optimism surrounding AI stocks is sustained. In the meantime, we expect the rest of the quarterly earnings season, unfolding in August, to show us a clearer picture of how companies are doing. Although challenges persist for Japanese corporations, we will continue to select holdings with exceptional products and services and disciplined management, who have the ability to weather these headwinds.

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