



Document intended mainly for professional investors

The facts: Japan was no exception to the global wave of rising rates which developed in September, torn between inflation, fiscal pressure and the strength in AI demand, despite increasing safety concerns. Amid acute geopolitical tensions, politics remained center stage, and central banks, including the Bank of Japan, took action.

Sovereign rates have been trending upwards globally for several months, but the pace accelerated in September. US yields, for instance, hit a two-decade high. Even Japan, which had enjoyed low rates for so long, saw them spike. **The ten-year JGB yield broke the 3% threshold for the first time since 1996!** Several reasons were raised for this move, including inflationary pressures linked to wars, strong AI demand and fiscal concerns.

After seven months of tensions in the Middle East, political discussions between the USA and Iran still failed to find a solution. Worse, the Houthis threatened other alternative export routes through the Strait of Bab-el-Mandeb. Additionally, the critical East-West Saudi Arabia pipeline, which according to the International Energy Agency, helps distribute about 4% of the global oil supply, was temporarily shut down after a drone attack. By month-end, though, the flow was said to have been partially restored, and certain sources also said that the traffic in the Strait of Hormuz was back to 60-80% of pre-war levels. Negotiations appeared to have intensified during last week's United Nations General Assembly meeting in New York, but so far, no agreement had led to officially reopening the traffic. Oil prices receded slightly from their mid-month peak of \$109/barrel for Brent but remained up 14% in September.

Imported inflation thus continued to weigh on the Japanese economy. Oil imports rose 59% in value in August, leading to a 7.6% rise in producer prices. Although consumer prices

were kept artificially low by government subsidies on energy, a pass-through appeared to be gaining momentum. As a matter of fact, **when excluding food and energy, the CPI accelerated sequentially and increased 0.5% in August. Moreover, government subsidies expired at the end of September.** Consumer sentiment remained low by historical standards, but interestingly, the confidence index has been improving over the four months leading to August. **Real wages have been rising for the last seven months, with July showing the biggest year-over-year growth (although only +2.4%) in five years with the help of bonuses.** Yet real household spending kept declining in the same period.

While energy prices cloud the global economic outlook, Japan (like other exporting countries such as South Korea and Taiwan) saw manufacturing activity continue to expand on solid demand for chips and AI-related goods. This occurred despite a growing number of US tech leaders warning on safety and calling for regulation. Japan's Purchasing Managers Index, published by S&P Global, stood at 54.1 in September. This was a slight ease from August, yet overseas demand remained strong, with new export orders rising for the ninth straight month due to robust demand in Asia and improved sales to the USA. **As cost pressures remained elevated, firms continued to raise selling prices at one of the steepest rates since late 2022,** the same survey showed. Industrial production, however, declined for a second straight month, losing 1.7%



sequentially. However, this appears to have been affected by temporary production suspensions due to an earthquake, heavy rainfalls and scheduled plant maintenance. Updated projections suggested that manufacturers expect a rebound over the next two months.

Meanwhile, **Takaichi-san** reshuffled her cabinet without changing the key figures, and **confirmed her “growth” strategy, which include a food consumption tax cut. She was also reportedly considering an increase in defense spending from the current 2% of GDP to 3.5% in the medium term**, and she managed to progress on the earlier \$550B investment promises in the USA, ahead of her meeting with Donald Trump, which added to fiscal concerns.

All things considered, central banks looked increasingly likely to take action. As a matter of fact, the Federal Reserve raised rates by 25 basis points in a unanimous vote. **The**

Bank of Japan followed suit, despite two dissenting votes coming from Toichiro Asada and Ayano Sato, both of whom are Takaichi-san’s appointees. It **raised rates from 1 to 1.25%, the highest level since 1995. Unlike its American counterpart, the Governor’s speech lacked hawkish signals.** Kazuo Ueda made vague comments on the speed and degree of future rate hikes. The yen, which initially strengthened in September, gave back its gains afterwards to finish the month relatively unchanged.

Meanwhile, the long-awaited meeting between Donald Trump and Xi Jinping turned out to be more symbolic than fruitful, as the US president extended the trade truce by a mere two months. Takaichi-san, who met with the US leader on the sidelines of the United National General Assembly and had been keen to insist on the bilateral alliance, was happy to share that Donald Trump had called her after his meeting with Xi Jinping to confirm their cooperation for peace and stability in the region.

The effects: With just a small decline, the Topix index resisted relatively well to rising rates, and did not prevent AI-related categories from progressing. Our strategy lagged the index as a few of our holdings weighed, but kept its large outperformance for the year.

The Topix index was range-bound in September, with only 3% separating the lowest and the highest closes. It however ended down (by 1.15%) for the first time in six months, but by just a small 0.3% once adjusted for dividend distribution. With rising rates, it was expected Value categories to outperform Growth ones, which they did albeit by a small margin.

AI-related categories were very volatile throughout the month. Not only tightening financing conditions were weighing, but there was also DeepSeek launching a new model requiring much less memory and alerts triggered by US tech leaders about major safety issues that could endanger humanity! Yet, a large rebound occurred after Governor Kazuo Ueda made a speech that was less hawkish than feared. Moreover, Meta launched Muse, an AI agent

capable of actually run tasks like sorting emails, cancelling subscriptions, shopping and negotiating bills for its users. As a consequence, **two of the only three categories that finished up in September were Technology and Communication.** Specifically, semiconductor equipment and chip manufacturers as well as electronic components rebounded sharply, finishing up 3 to 5%, whereas Softbank Group, which owns a large stake in OpenAI and Arm, went up 24%. **The other top category was Financials.** As has been the case for several months, banks and, to a lesser extent, insurance continued to benefit from rising rates.

At the bottom of the range was Real Estate, which on the contrary, suffered from the expected increase in mortgage payments. Mizuho and two other major banks announced they will raise their mortgage rates in October.



Consumption-related categories were also down mid-single digit. These include Retail Trade, Foods and Services, many of which were also affected by potential disruptions by Muse. Recruit Holdings, for some reason, was one of them. Car manufacturers were not spared either with supply issues, the weather disrupting production, and increased Chinese competition adding to concerns.

However, **Mining which includes oil producers, was the worst performing sector of the TSE**, and ended down 7.5% in September. Despite oil prices going up, investors were probably eyeing a resolution of the Middle East conflict. However, many of the recent winners from the tense geopolitical context, namely Marine Transportation and Wholesale Trade, continued to outperform slightly. Mitsui O.S.K. Lines said it expected the shipping disruptions in the Strait of Hormuz to continue into 2027. Trading companies benefited from Berkshire Hathaway's CEO, Greg Abel, saying his company intended to hold its investments in the top five Japanese trading houses for many decades.

Our decisions: We are confident with our current selection, but we sold one stock whose upside was coming to an end after several months of bids between two buyers. We opted replace it by a materials company which benefits from inflation in a tense geopolitical context.

Our model did not signal any sell message for any of our holdings this month. Yet, we sold Kakaku.com, a conglomerate which owns websites ranging from restaurant reservation services and travel booking to job search. The company has been the target of a takeover battle between Swedish buyout firm EQT and a LY/Bain Capital consortium. The fight has been lasting for many months already and has driven Kakaku's stock price 79% higher since rumors started mid-April. The latest proposed price came barely 3% above the previous offer, suggesting that the bidding war was coming to an end. We thus decided to sell the stock, which seems to have limited upside left.

Our portfolio lagged the Topix index by about 109 bps. This does not seem illogical given the advance we have accumulated year-to-date, which still exceeds 500 bps. Moreover, September's return was concentrated. Only about 20% of the c. 1,600 members of the Topix index actually outperformed the price index. This compares to more than 50% of our stock selection beating it, but our losers weighed more than our winners did. Our worst two stocks, a car dealer and a sweet producer, declined by more than 10% without any specific reasons. Two others were down 10%. Chugai announced that its partner Roche had discontinued the development of an obesity treatment, while Sumitomo Forestry suffered from its exposure to US detached houses amid higher rates. Last but not least, some of our holdings in Services also lost 7-8% in Muse's disruption spiral. We think most of these reactions are overstated.

We switched to JX Advanced Materials. Formerly part of ENEOS, JX was spun-off in March 2025. Its activities span the entire metals value chain from mineral resources and smelting/refining to advanced materials and recycling. It benefits from its global green hybrid smelting process which uses little fuel and it owns stakes in commodity assets like copper mines and sands projects to extract rare earth, which protects it from inflationary pressures and potential supply constraints in a geopolitically tense context. In the longer-term, the company is shifting its basic mining activities towards high-value semiconductor and ICT materials with broad AI exposure (materials for memory, optical transceivers in data center, and rolled copper foils for servers) in which it already holds very strong positions.



As a matter of fact, it is the world's leader with 65% market share in sputtering targets, the source material from which a very thin metal film is deposited on a wafer. It also owns a 40% share in InP substrates, a material used to generate, detect, and transmit light and high-frequency signals in optical communication in data centers. The company must invest to respond to the surging demand, which caused the stock to decline 35% from its May high. We felt this was an opportunity given the visibility in demand and the

corresponding pricing power. Moreover, the purity requirements of this high-precision industry offer the company strong barriers to entry.

At the end the month, and following this switch, the fundamentals of our portfolio improved a little and remained consistent with our Value style. It traded at 14.16x (against 15.82x for the Topix index) with a long-term growth at 10.86% (against 10.19% for the benchmark).

The outlook: We hope the government will soon bring back confidence on how it intends to combine its growth plan with fiscal discipline. For now, we prefer to keep a prudent outlook given the geopolitical context and its implications for Japan's economy.

As we discussed last month, even at 1.25%, the current monetary policy remains accommodative and the government has some easy fixes at hand to prevent longer rates from rising dramatically. Yet, we look for a long-term answer from the government to bring back confidence in a precise, coherent, and realistic growth plan, with fiscal discipline. **Prime Minister Takaichi** knows this. It is actually what she will be focusing on, according to the draft policy speech revealed at month end. We are keen to have more details about it, as it remains to be seen how she **plans to fund the consumption tax cut without relying on special government bond**. She kept her promise to her voters, but the outcome of the food VAT reduction is expected to be mixed. A survey by Teikoku Databank suggested that **less than 20% of polled companies expect the reduction to stimulate the Japanese economy. Moreover, given that it only starts applying in April 2027, it will not offset the upcoming end of electricity subsidies.**

As for AI, we did not change our mind about its development. We already mentioned that the adoption of new technologies is never linear, and that its spread would face headwinds such as social, security and environmental considerations. We still believe that it will be positive for the long term. **While the recent headlines and the increasing number of cyberattacks add short-term volatility to the**

markets, we doubt it will put an immediate stop to the AI capex cycle, simply because the USA cannot afford losing against China. Several Japanese companies should thus continue to benefit.

With the next earnings season starting next month, we will however be particularly keen to track margins, how companies manage to tackle rising costs (including materials, wages, investments and financing) and see how demand reacts to it. Several sectors have accelerated the pass-through, but they may find it difficult to fight against international competition. Japanese chemical manufacturers, for instance, have been forced to raise prices due to soaring prices paid for naphtha, 80% of which was coming from the Middle East. Yet, their Chinese peers access naphtha at a 10 to 20% cheaper rate. **While the traffic seems to improve in the Strait of Hormuz, we do not find any reason yet to believe that this will be durable.**

To finish on a more positive note, **the TSE is launching the next phase of its multi-year reform, which aims to reduce the number of members in the Topix index.** With historically loose criteria, the index had accumulated approximately 2,200 constituent stocks when the new market segmentation began in April 2022. In fact, there was too little incentive for companies to improve or even maintain their corporate value. After the first phase of the



reform, the constituents list was narrowed to approximately 1,700. Starting in October, there will be a transition period, and the index is expected to go down to approximately 1,000 members by the time the review is completed in July 2028. From October 2028 onwards, constituent stocks will be replaced once a year according to the new criteria. While this feels slow, **the new system will eventually create a greater sense of tension among listed companies to raise their standards.**

Important information: *The views expressed herein are for information purposes only. They should not be interpreted as a recommendation to adopt or modify an investment stance, or purchase or sell a financial instrument. They reflect Graphene Investments' analysis as of the specific date stated at the top of this document, based on information that was available at that time. Such information, and the resulting opinions and assumptions, are subject to change without notice. Graphene Investments does not guarantee their completeness and accuracy.*

Any reference to market, financial instrument or strategy returns is for information purposes only. Past performance should not be considered as an indication of future performance. Given that Graphene Investments doesn't yet manage any fund or account that can be considered representative, any reference to investment performance refers to the gross return of the Japan Essential Value strategy, as estimated by Graphene Investments on the basis of the virtual portfolio, denominated in yen without any currency hedging, managed by the investment team in conditions that reflect the strategy's investment process. Calculation details are available upon request to Graphene Investments. The return actually generated by the same strategy in each investment vehicle where it is implemented may differ, depending on the characteristics of that vehicle as well as implementation conditions.

Before making any investment decision, investors should carry out their own analysis, based on up-to-date information, to form a personal opinion about the suitability and risk of that investment.

This document may not be reproduced, in whole or in part, without the prior, written consent of Graphene Investments.



AMF license #GP-16000022
75 Bd. Haussmann 75008 Paris (France)
T: +33.1.70.82.44.50
F: +33.1.70.82.44.49
E: contact@graphene-investments.com
W: www.graphene-investments.com