

Japanese Equities
Investment comment

October 31, 2026

Document intended mainly for professional investors

The facts: October saw the emergence of several new AI-related concerns. The government was busy reassuring the market about the country's fiscal sustainability while the Bank of Japan stayed put despite the deterioration in the Middle-East. The reporting season however got off to a relatively solid start.

The market started the month positively with expectations of rather strong earnings releases. Mid-month, however, investors turned their attention to concerns about the debt financing behind the substantial investment by AI-related companies in the U.S.A. This was triggered by the sharp decline of corporate bonds issued by the so-called neoclouds, such as CoreWeave, a loss-making, Nvidia-backed company. The company's co-founder told the Financial Times that they were seeking an investment-grade rating that would open the door to "unlimited" capital. On the same day, **research firm Gartner said that around 80% of neoclouds could be impaired if AI providers maintain their current investment pace.**

Another AI-related concern arose when two critical vulnerabilities were discovered in PHP, one of the world's most widely used programming languages. In Japan, an increasing number of companies, as well as a regulatory commission's website, reported unauthorized access or data breaches. **Enhanced cyberattacks**, one of AI's several risks highlighted by Anthropic in its IPO prospectus, **are already a real threat. Japan's tech giant GMO Internet Group suffered a major ransomware attack. This prompted the government to accelerate the implementation of its Active Cyber Defense Act** in order to proactively neutralize hostile behaviors.

The government was credited with containing the impact of higher energy prices in Japan. **September CPI data, however, showed core inflation accelerating a pitch to catch up with the Producer Price Index, which has risen substantially since the outbreak of the war.** Tensions and active strikes in the Middle East, stalled indirect US-Iran talks, and Houthi-led attacks on Saudi Arabia's infrastructure this month gave little hope on commodity imported inflation. Consequently, sentiment on the outlook, which kept improving until recently, also showed a slight sign of waning.

In this context, the BoJ decided to keep its policy interest rate at 1.25%, in order to assess the impact of the September hike. One of the nine board members voted against this decision. **The central bank also announced its long-awaited victory against deflation (not inflation!) and plans to accelerate the sale of its ETF holdings** from an annual ¥330B (at book value) to ¥860B, in preparation for exiting its accommodative monetary policy. According to the bank, it will empty its pocket in 43 years (instead of 112 years at the previous rate!), though this timeline will change as the market evolves.

October marked the first anniversary of Prime Minister time in office. Despite the economic and geopolitical headwinds, Takaichi-san maintained one of the highest popularity rates among G7 leaders by skillfully negotiating with Donald Trump to keep tariffs at a manageable level. Moreover, she developed a long-term investment plan, making sovereign



technologies a priority for the country. However, the plan's funding keeps investors cautious.

In fiscal year 2025, companies contributed ¥21.7T in corporate taxes, the highest in 36 years and a 21.4% increase year-on-year, to the total government tax revenue of ¥84.2T. **They look so far set to continue their contributions with relatively solid earnings.** According to LSEG, 28% of TSE companies reported their latest quarterly earnings so far, and 56% of them exceeded the consensus estimate. Many of AI- and semiconductor-related firms announced very strong results helped by higher utilization rates, price hikes, and a weaker yen. They also revised their full-year guidance upward. Conversely, those that are taking longer to pass rising costs through to prices, suffered.

The effects: The Topix index declined 3.49% in October. Investors rotated out of the AI theme and into domestic and defensive sectors. Meanwhile, our more balanced selection and our bottom-up approach put our strategy more than 200 basis points ahead of the benchmark.

The Topix index had a bumpy ride over the month. It started the period positively, before a sharp correction set in. It seems that institutional investors decided to take profits early in the new quarter. Banks and telecommunication companies, which had performed well in the previous quarter, were down. Investors soon became less risk-adverse, though, as the Federal Reserve's FOMC looked less likely to raise rates this month. Sentiment turned negative again at mid-month, when US CPI data for September came in higher than expected. Pessimism was exacerbated by worries about the sustainability of AI-related investments and their returns. Credit concerns surrounding CoreWeave and the sharp decline of South Korea's datacenter infrastructure provider on the day of its IPO only made things worse. Hopes raised by Anthropic's filing for IPO were short-lived and the market continued to correct as the first earnings announcements in the US dominated investors' attention. While many reported solid earnings, their substantial capital expenditure plans fueled investors discomfort.

Major Japanese stocks in the AI ecosystem fell in October, even though some of them posted solid results. Underperformers included Lasertec, the chip-inspection system maker, Tokyo Electron, a major semiconductor equipment manufacturer, Ibiden, a key supplier of high-end packaging substrates, and Kioxia Holdings, a Japanese star in flash memory chips for AI and data centers. Among those which announced results, the market's reaction was favorable for semiconductor-testing company Advantest, but negative for capacitor specialist Murata Manufacturing.

Victims of the cyberattacks in Japan obviously saw their stock price suffer, which even led to widening of spreads on GMO Internet Group's outstanding bonds. **Conversely, these events fueled a surge in cybersecurity-related companies,** such as BayCurrent and Shift. Together with the so-called "AI losers," they led the Services sector to become the top-performing category in October. Aside from the Mining and Marine Transportation groups, whose outperformance reflected the worsening situation in the Middle East, **Pharmaceuticals and Retail, supported by strong earnings announcements, offered shelter to investors rotating out of the AI theme.** Non-Ferrous Metals, Machinery, and Electric Appliances, which benefited from that technology's boom, naturally were weaker.

The BoJ's decision to accelerate the sale of its ETF holdings did not move the market, given the limited amounts it represents in the total traded volume. On a positive note, the central bank is expected to increase its surplus profits and payments to the national treasury as it realizes gains through selling. This also raised expectations that the proceeds will be used as non-tax revenue to finance tax cuts and economic measures. **As expectations settled on stable**



rates in Japan and the USA, banks experienced profit-taking from a year-to-date gain of over 36%.

As a result, contrary to September, the Topix 500 Growth index outperformed its Value equivalent by 130 basis points, despite the underperformance of AI-related stocks. This was supported mainly by the strength of the Services sector and the softness of Financials. Our selection outperformed its benchmark by over 200 basis points despite our Value bias as our bottom-up choices, such as Advantest, and our more defensive stocks in Services and Communications, including cybersecurity-related, contributed.

Our decisions: We kept our portfolio unchanged in October after last month's reinforcement in basic materials, in reaction to long-lasting geopolitical tensions. This made sense as we did not alter our relatively defensive scenario.

Neither our quantitative screening nor our risk-related large cap exposure limits triggered a Sell signal, and we kept our picks unchanged in October.

Our portfolio thus retained similar characteristics, with a twelve-months forward price/earnings ratio of 13.6x and long-term growth of 11.1%. While our selection's valuation profile was enhanced by the combination of lower prices and a resilient growth, the market's weakness reduced the benchmark's valuation twice as much, from 15.8x to 14.6x forward earnings.

The outlook: After the US mid-term election, the market attention will return to the remaining earnings announcements. On the domestic side, the government will focus on passing the bill on the consumption-tax cut before the end of the year, while tackling the increasing headwinds that are coming on its way.

The market's short-term focus will inevitably be on the US mid-term elections. The implications of the outcome for the financial markets are difficult to predict. However, **if the Democrats win full control of Congress, as current polls suggest, investors may discount the possibility of constraints on the pace of AI development. Even if we disregard the election results, we are not convinced that things will improve.** Beyond that, the rest of the results and their implications on the outlook will prevail.

At the end of the month, the Diet began a tug of war over the food tax cut bill, a long-cherished goal of Japan's Prime Minister. The government would prefer to garner as much support as possible from the opposition parties during the Lower House session before the bill goes to the Upper House, where the government barely has a majority. Opposition parties, who had vocally called for this tax reduction during their own election campaigns, are requesting that the leading party should identify the sources of funding, thus making the process difficult. This is reminiscent of a phrase that Takaichi-san often uses when answering questions in the Diet: "I ask you to think about ways to make it happen rather than focus on reasons why something can't be done." Time will tell if the message was received.



Although investors' concerns about Japan's fiscal soundness temporarily faded, they will not go away. In order to maintain the "responsible investments", the government is considering all possibilities, including cutting ineffective subsidies identified by the Japanese equivalent of the US DOGE, led by Finance Minister Katayama. Another option to fund the consumption tax cut is the surplus of the Foreign Exchange Fund Special Account, but this one depends on market conditions. A proposal to increase corporate taxes to finance the increased defense spending has also emerged. This is in addition to a special defense corporate tax which adds a 4% surcharge on corporate taxes starting this fiscal year.

Regarding the technical aspects of the market, we discussed the next phase of the TSE reform in our last Monthly Investment Comment. Starting at the end of October, the allocation ratio of approximately 600 of the 1,600 constituent stocks in the Topix index will gradually be reduced, until it goes down to zero by July 2028. This will contribute to give this former "all-share" index a slight tilt towards larger capitalizations. Since nearly two-thirds of the BoJ's ETF holdings are said to be linked to the Topix index, concerns were raised, suggesting that the central bank would end up holding more in large companies, to the detriment of smaller ones. A rough calculation makes us believe that the effect would be completely negligible, but some people believe that it played a role in the BoJ's decision to accelerate its ETF sales.

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