Special Report

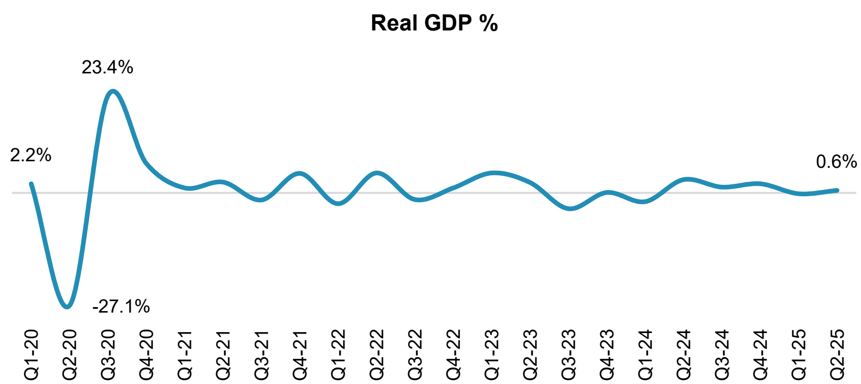
Japan Economy: Gradual Recovery Amid Global Headwinds

July 2025

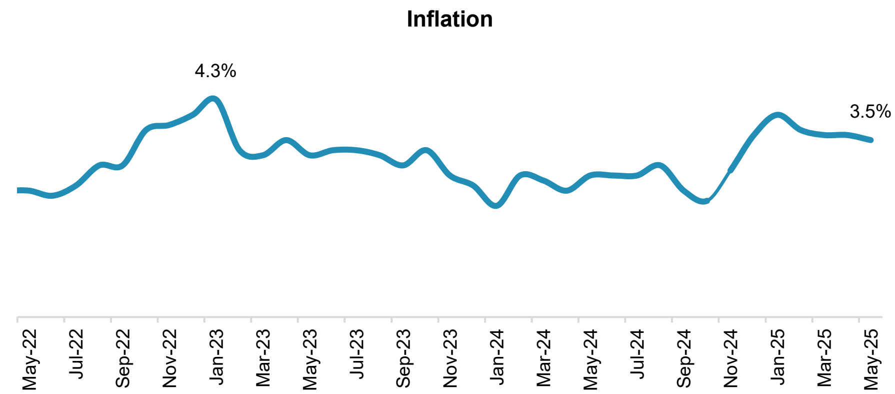
CONTENTS

Economic recovery with moderating inflation, tightening labour market and diverging manufacturing PMI

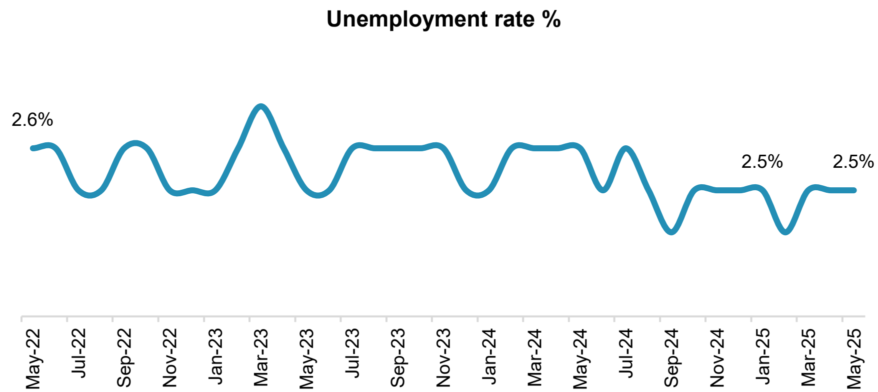
Japan’s economy rebounded in Q2 2025 with a 0.6% GDP growth after a Q1 contraction, driven by strong domestic demand.



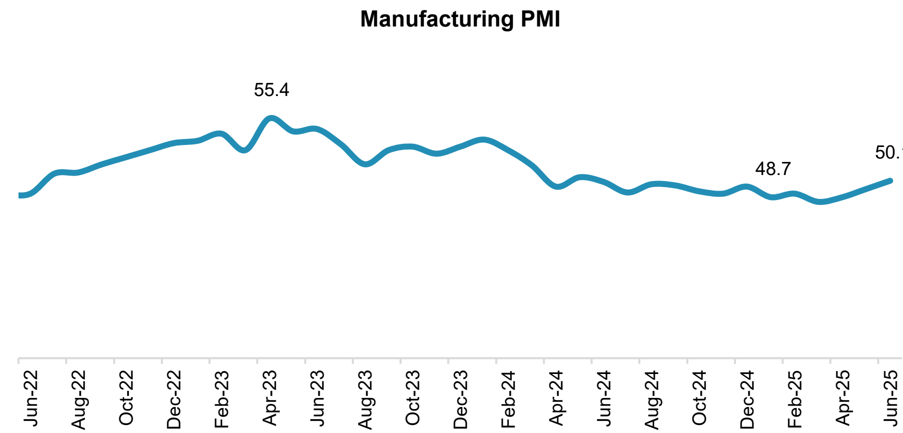
Headline inflation eased to 3.5% in May, reflecting the gradual price moderation but still above the central bank’s target.



Unemployment held steady at 2.5%, indicating a strong and stable labour market.



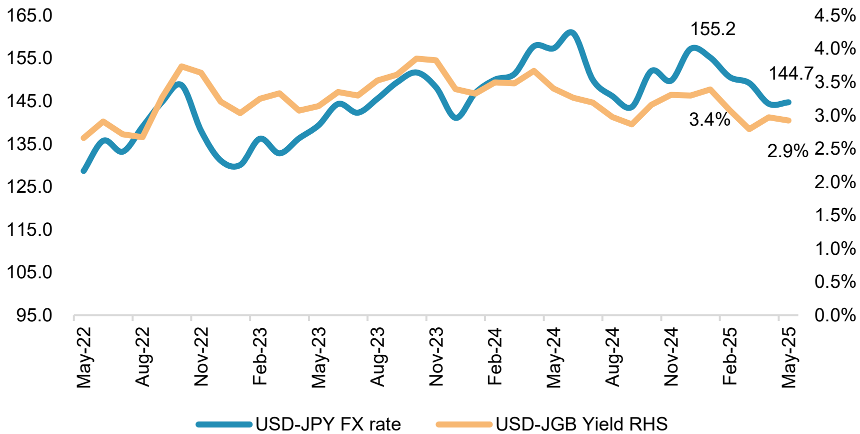
The manufacturing sector returned to growth in June (PMI at 50.1) after a year of contraction, signalling improved business sentiment.

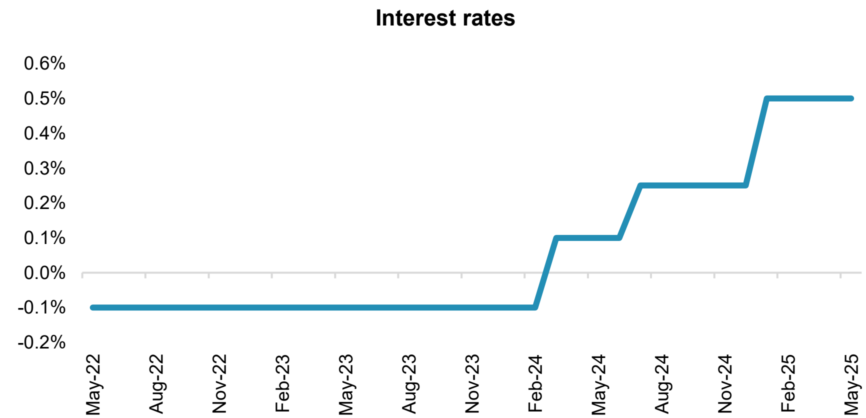


Source: *Government of Japan, Ycharts, Aranca Research*

Currency & Monetary Policy: Yen strengthens amid policy shifts, but external risks loom

In Q2 2025, the yen strengthened modestly as the BoJ's rate hikes and rising bond yields drove unwinding of carry trades. While robust inflation and wage growth support further tightening, external risks like U.S. tariffs and China's slowdown cloud the outlook.



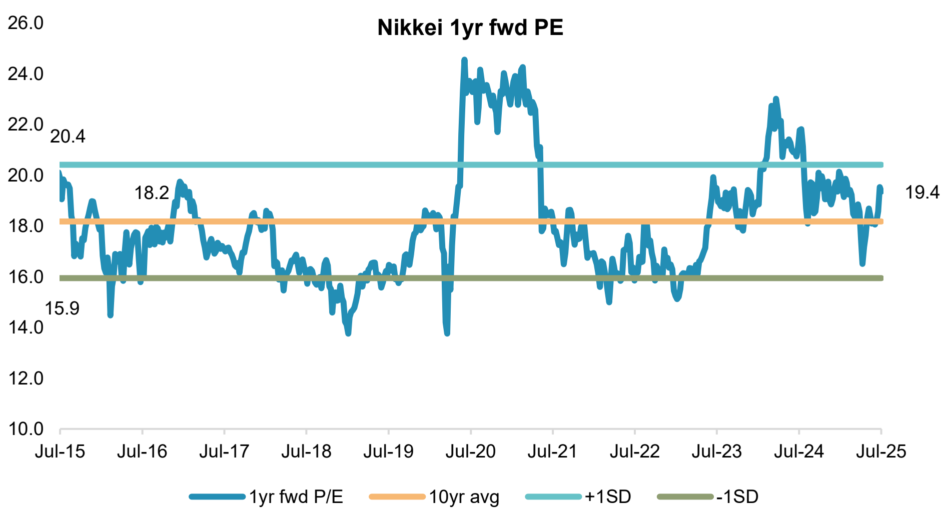


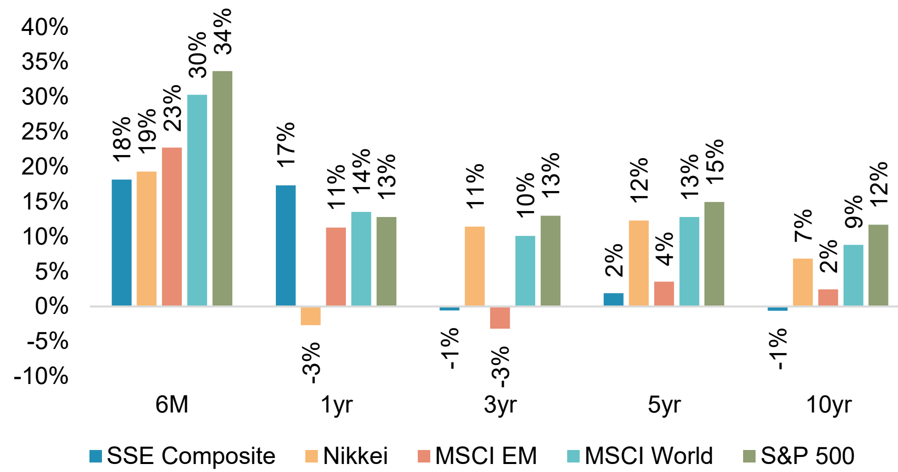
- In Q2 2025, the yen strengthened modestly, with USD/JPY at 143.73 by July 2—up 0.17% over the month and 11.05% over the year—driven by unwinding of carry trades amid the Bank of Japan's rate hikes and rising 10-year JGB yields (1.43%). However, risks from potential U.S. tariffs and a slowing Chinese economy may weigh on Japan's export outlook and yen trajectory.
- The BoJ maintained its policy rate at 0.50% in June 2025, pausing after a few hikes since 2023, reflecting caution amid global uncertainties. Inflation remained robust, with core CPI at 3.6% in May, and wage growth from the 2025 Shunto negotiations (4.74% hikes by large firms) supported expectations of sustained inflation above the 2% target. Rising bond yields signalled market expectation of tighter policy, although BoJ emphasised a data-dependent approach. While domestic indicators supported potential future rate hikes, external risks like U.S. trade policies and weak global demand could challenge Japan's monetary and economic outlook.

Source: *YCharts, Aranca Research*

Tariffs, Yen, and Governance: Drivers of Japan's equity market volatility

On a YTD basis, Japan's equity index was hit the most compared to global indices, thereby moderating its rich valuations to a 6.5% discount to its 10yr average



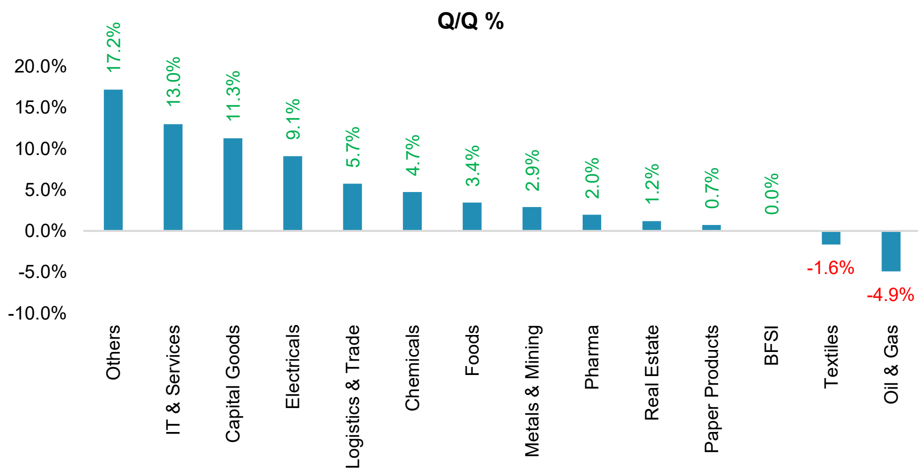


- In Q2 2025, Japan's equity markets faced significant volatility amid global trade tensions and domestic shifts. The Nikkei 225 fell over 20% from its December 2024 peak, entering a bear market after U.S. President Donald Trump announced tariffs on Asia-Pacific imports, targeting key Japanese sectors like autos and semiconductors. This triggered circuit breakers on April 7—the first since March 2020—as the Nikkei and TOPIX fell 8%. A sharp rebound followed on April 8, with the Nikkei gaining ~6% on hopes of tariff negotiations.
- Structural reforms continued to support resilience. Corporate governance improvements boosted share buybacks and reduced cross-shareholdings, while domestic consumption strengthened due to wage hikes and inflation above 2%, aiding financials and real estate.
- Despite early turmoil, the outlook remained cautiously optimistic. The TSE's push for P/B ratios above 1x made small- and mid-cap stocks more attractive. Corporate earnings stayed strong, with TOPIX companies set to post a fourth straight year of record profits by March 2025, supported by a weak yen and solid domestic demand. However, risks persisted, including U.S. trade policy uncertainty and slowing earnings momentum.

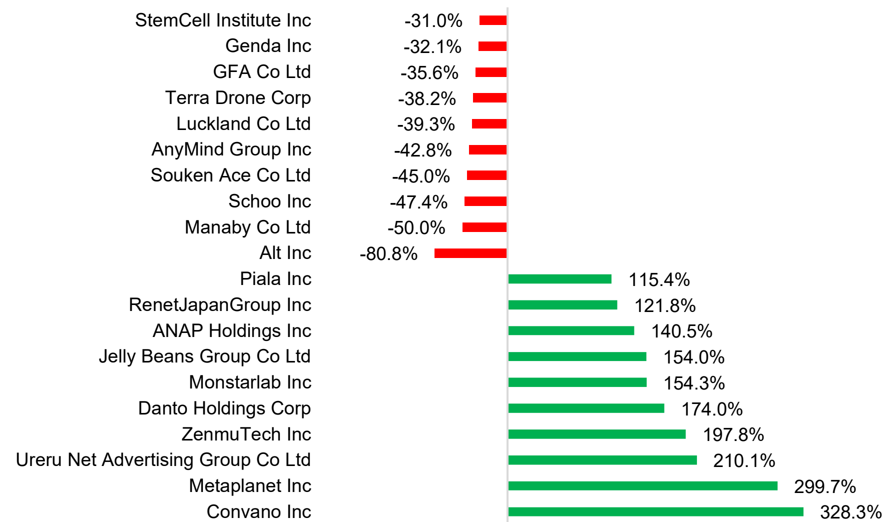
Source: *Bloomberg, Aranca Research*

Equity: Sectoral Performance

Two out of 14 sectors declined Q/Q in Q2-25 with the sharpest drawdowns in Oil & Gas; IT & Services witnessed the highest returns



Propensity of the top gainers was significantly higher than the top losers over the last three months



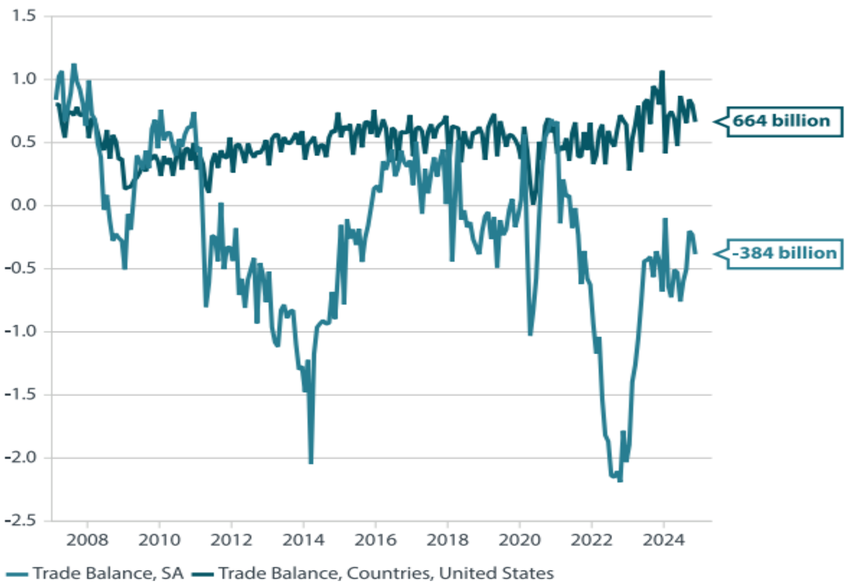
- Six months to 2025, the index exhibited mixed performance amid geopolitical uncertainties. By June end, the JPX index was down 24.1% Q/Q. Of the 14 sectors, 12 showcased positive performance. On the losing side of June's Q/Q leaderboard was Oil & Gas, which fell 4.9% Q/Q, followed by Textiles (down 1.6% Q/Q).

- For the last three months, Convano Inc remained at the top within Japan's equities universe with a 328.3% gain, followed by Metaplanet Inc (up 299.7%). However, Alt Inc and Manaby Co Ltd dropped the most, with 80.8% and 50.0% drawdowns, respectively.

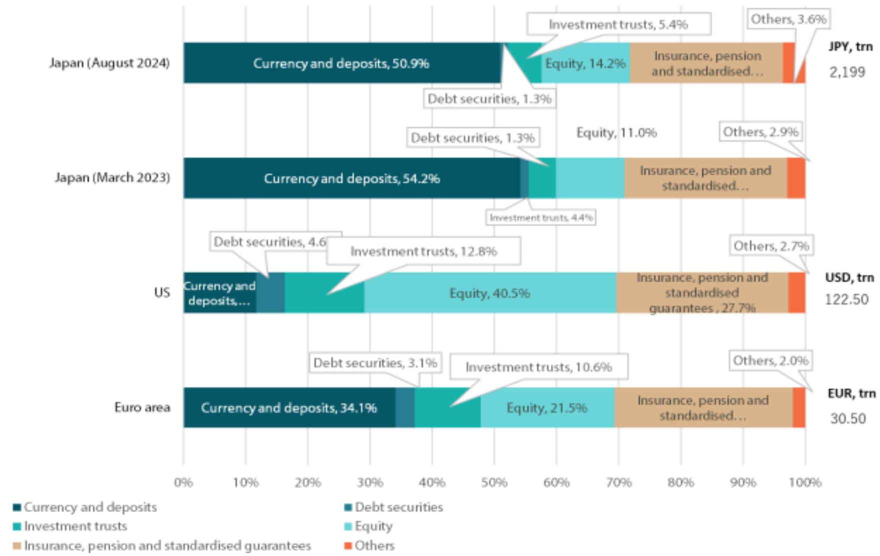
Source: *JPX, Koyfin, Aranca Research*

Japan at crossroads: Responding to US tariff pressure

Japan's foreign trade



A shift in Japanese household savings has been taking place



- US imposed a 25% tariff on Japan, effective August. Japan, which has swung between trade surpluses and deficits since 2011, risks tipping into more frequent deficits if its substantial bilateral surplus with the US is disrupted. Japan has options to protect itself against both direct and indirect impact, consisting mostly of policy options. We have outlined 6 options below;

1) **Nuclear Restarts:** Restarting reactors cuts fuel imports and boosts energy self-sufficiency, helping offset trade and currency risks
2) **BOJ Policy Normalisation:** Gradual rate hikes depend on real wage growth and the rising domestic demand to support a stable recovery.
3) **Savings to Investments:** Shift from savings to investments reduces foreign dominance and cushions market volatility.
4) **Reallocating Yen Gains:** Investors may lock in weak-yen gains by shifting from foreign bonds to domestic equities, aiding reflation.
5) **Governance Reforms:** Improved disclosures, payouts, and reforms are increasing the appeal of equity and attracting local investment.
6) **Consumption Revival:** Sustained real income growth and moderate inflation are key to boosting domestic consumption and growth.

Source: *Nikko AM, Aranca Research*

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