Special Report

Japan’s Policy Shift: Growth Outlook and Asset Class Impact

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Executive Summary

01 Japan's Economy: Steady Growth Amid Inflation and Trade Challenges

- Japan's economy is recovering, but faces persistent inflation and tariff risks, which have pressured GDP growth.
- The Bank of Japan (BoJ) has held its policy rate at 0.50% (the highest since 2008) to balance growth risks and inflation, with markets pricing in gradual tightening, until late 2026.
- Economic growth projections are modest (0.6% for FY25), sensitive to both domestic demand and tariff changes.

02 Japanese equities continue to remain undervalued despite sharp returns

- Japanese equities are undervalued as compared to global peers, with a forward P/E of 16.8x vs. the S&P 500's 24.1x, and the lowest price-to-book ratios for banks among major markets.
- Capex intensity dropped to 2.2% in FY24, the lowest since 2018, but is expected to rebound in late 2026 with recovering demand.

03 Japan's Bond Market: Rising Yields and the Shift Toward Domestic Opportunities

- The BoJ's first rate hike in over a decade pushed speculators to shift positions, driving bond yields higher.
- The BoJ will keep cutting bond purchases through 2027, while yields remained steady supported by steady demand for domestic bonds and inflation above target.

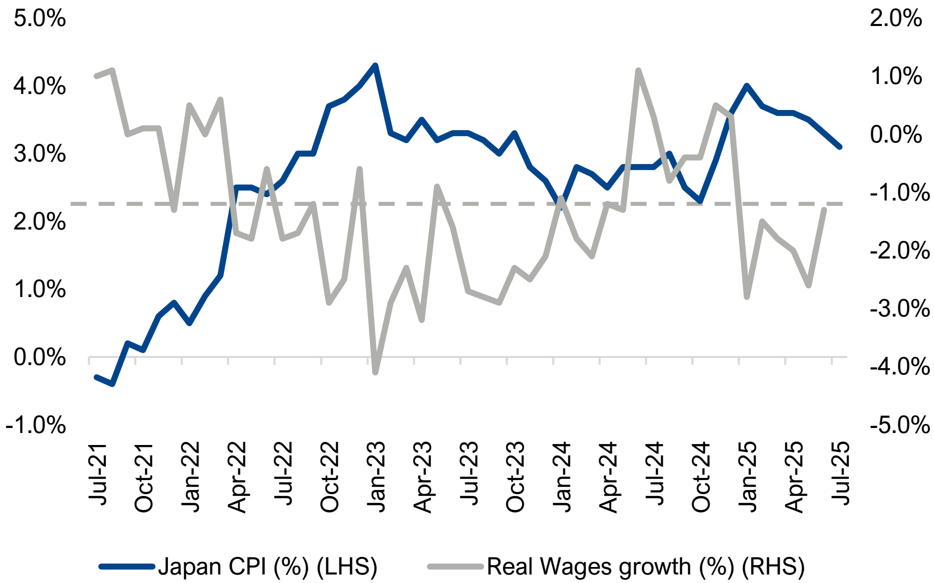
04 Japanese Yen: The Currency Rebound Driven by Policy Shifts and Speculative Positioning

- BoJ's rate hike prompted a shift by speculators from short to net long Yen positions, reflecting expectations of further Yen strength.

Japan: Macroeconomic trend

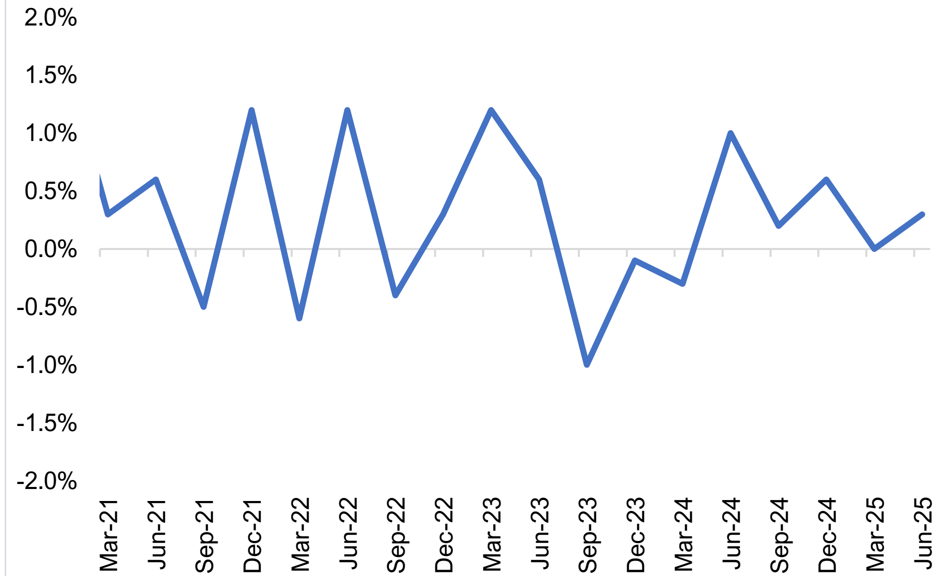
Rise in inflation and tariff uncertainty has pressured real GDP growth

Japanese CPI and Real Wages Growth



- **CPI Above Target:** Inflation rose to 3.1% in July 2025, exceeding the BoJ's 2% goal, driven by tariffs, wage gains, and higher fuel and commodity costs.
- **Wages to Accelerate:** Real wage growth stayed below 2% in June 2025 but is projected to reach ~5% next year, likely adding inflationary pressure further supporting the BoJ's hawkish stance.

Japan's Real GDP Growth Rate QoQ



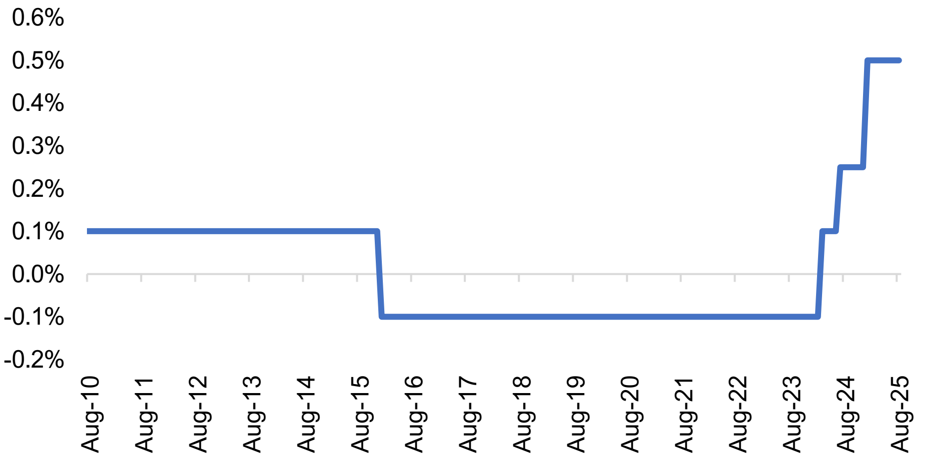
- **Better than Expected Growth:** Japan's GDP grew 0.3% in Q2 2025, supported by front-loaded exports and automakers cutting prices to sustain output.
- **Tariff Uncertainty Persist:** Economists warn growth remains vulnerable, with the impact of a 15% US export tariff likely to show up in upcoming data.

Source: *Bloomberg, MHLW-Japan*

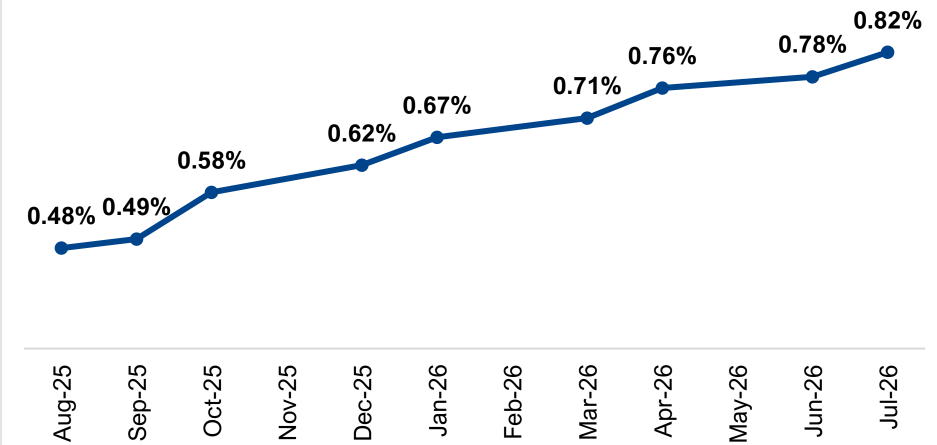
Understanding Bank of Japan's Monetary Policy

Markets anticipate further rate hikes; however, tariff-led uncertainty remains high

BoJ: Interest Rates



Implied overnight rate through swaps



BoJ: April 2025 vs. July Forecast of Key Economic Indicators

Year*	Real GDP	CPI	Core CPI
Fiscal 2025	0.6%	2.7%	2.8%
April 2025 Forecast	0.5%	2.2%	2.3%
Fiscal 2026	0.7%	1.8%	1.9%
April 2025 Forecast	0.7%	1.7%	1.8%
Fiscal 2027	1.0%	2.0%	2.0%
April 2025 Forecast	1.0%	1.9%	2.0%

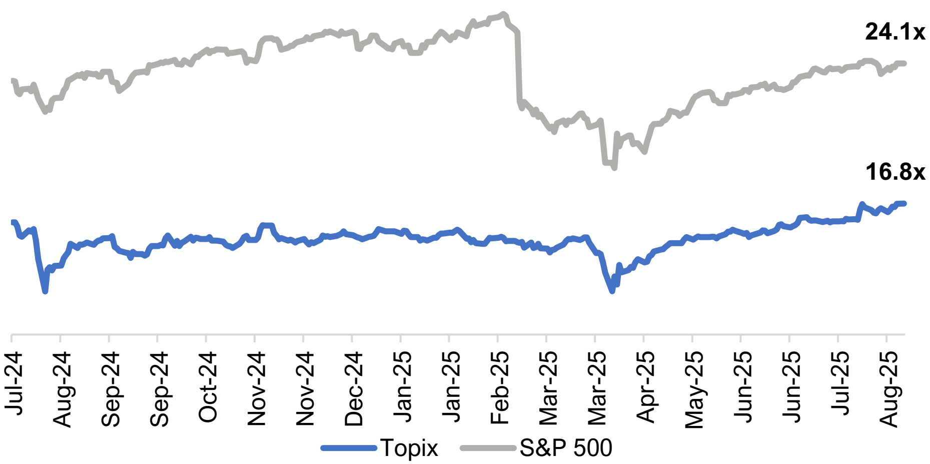
- **Rate Held at 0.50%:** The BoJ kept its policy rate unchanged, the highest since 2008, reflecting caution amid tariff risks to the export-led economy.
- **Futures Signal Gradual Hikes:** OIS futures point to rates rising to ~0.62% by Dec 2025 and ~0.82% by Jul 2026.
- **Upgraded Forecasts:** FY25 core inflation raised to 2.7% (vs. 2.2%) and GDP growth to 0.6% (vs. 0.5%).
- **Bias Toward Gradual Tightening:** Most hikes are priced into JGB yields; a sharper move would need an upside inflation surprise, possibly from stronger tariff effects

Source: *Bloomberg, Aranca Research, Bank of Japan, *Note: In Japan, fiscal year extends from Apr 1 to Mar 31. Accordingly, FY25 corresponds to Apr 1, 2025–Mar 31, 2026.*

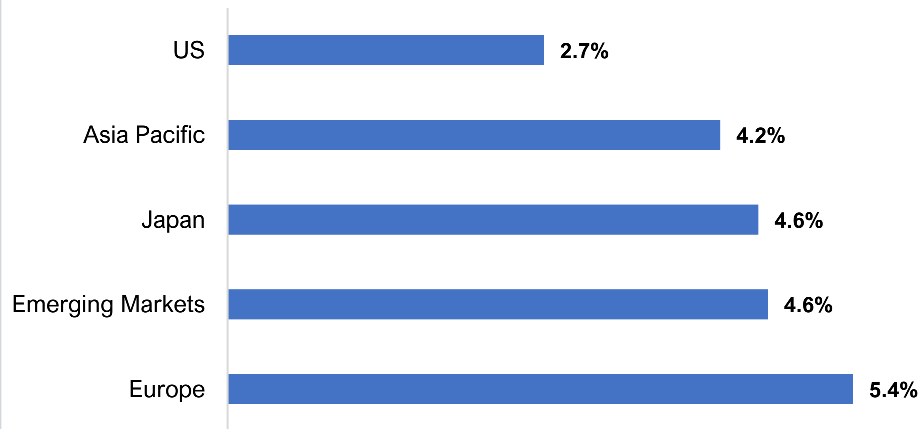
Comparing Japanese and Global Equity Markets

Japanese equities remain undervalued relative to global peers

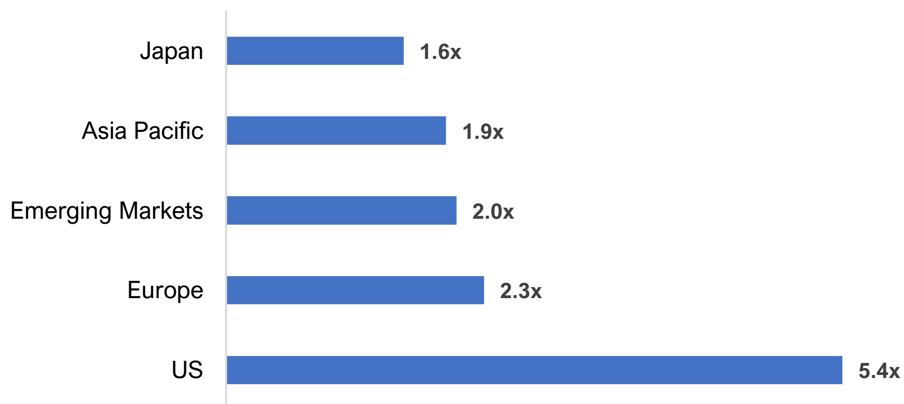
S&P 500 and Topix Forward PE



Free Cash Flow Yield*



Price to Book Ratio*



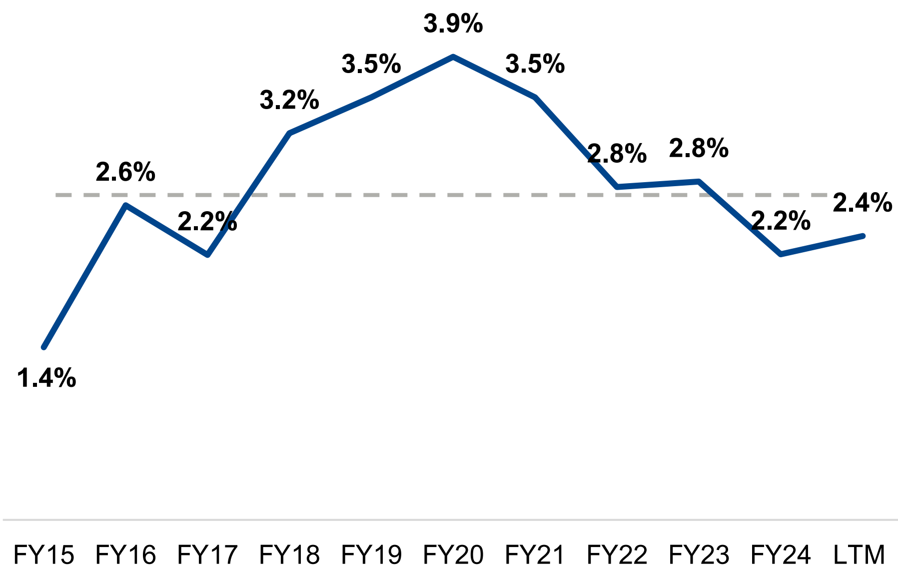
- **Relative Undervaluation:** Japanese equities trade at a forward P/E well below the S&P 500.
- **Attractive Valuation Metrics:** Strong free cash flow yields and among the lowest global P/B ratios highlight the discount.
- **Reform & Growth Catalysts:** Corporate reforms, share buybacks, and overseas expansion support potential re-rating.
- **Domestic Flows:** Rising rates are driving local investors toward equities, adding to upside momentum.

***Source:** Bloomberg, Aranca Research, * TTM Figures as of Aug 18, 2025*

Japan Inc: Investment Intensity and Profitability

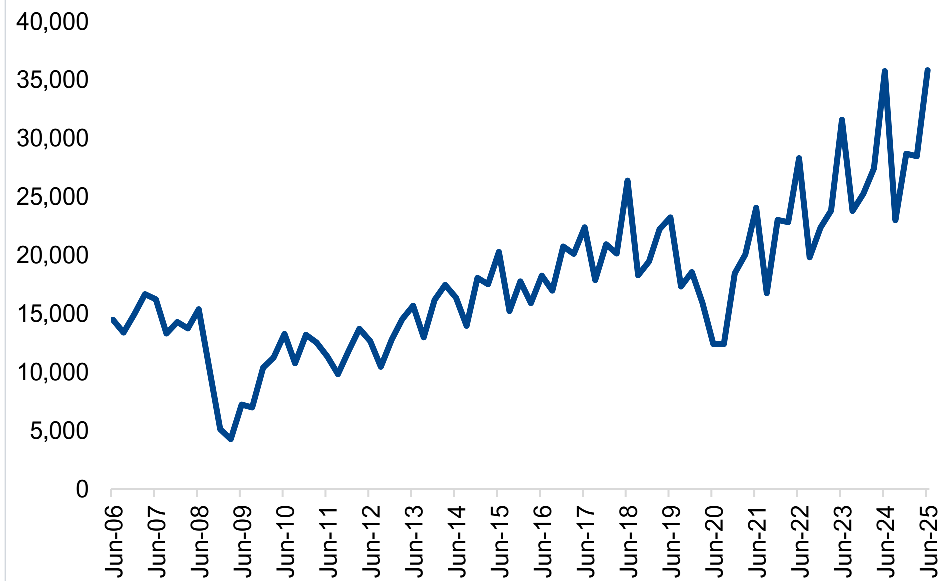
Capex intensity fell but is poised to rebound as corporate profits surge

Japan: Capex Intensity*



- **Capex Intensity at Lows:** Topix capex intensity dropped to 2.2% in FY24, the weakest since 2018, but could rebound in FY25 as higher rates spur domestic demand and capacity expansion.
- **Firms Signal Recovery:** The BoJ Tankan survey shows large firms planning an 11.5% YoY capex increase by March 2026, with smaller firms also raising investment, reflecting optimism for recovery.

Japan: Corporate Quarterly Profit (Yen Billions)



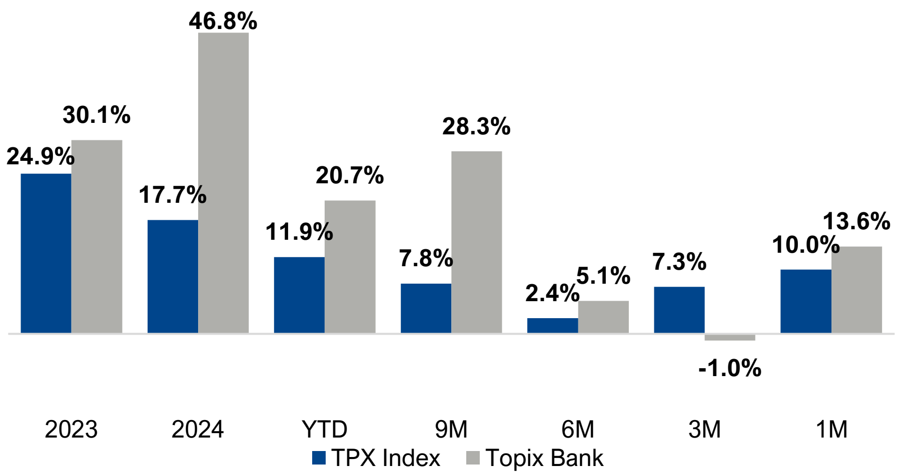
- **Short-Term Bottom Line Pressure:** Rising interest rates and a stronger Yen are expected to weigh on exporters' earnings.
- **Medium-Term Resilience:** Profitability has witnessed recovery as growth momentum, tourism, and improved capital efficiency (ROE 9% in 2024 vs. 3% in 2010) support adaptation to the new environment.

Source: *Bloomberg, Aranca Research, * Note: In Japan, fiscal year extends from Apr 1 to Mar 31. Accordingly, FY25 corresponds to Apr 1, 2025–Mar 31, 2026.*

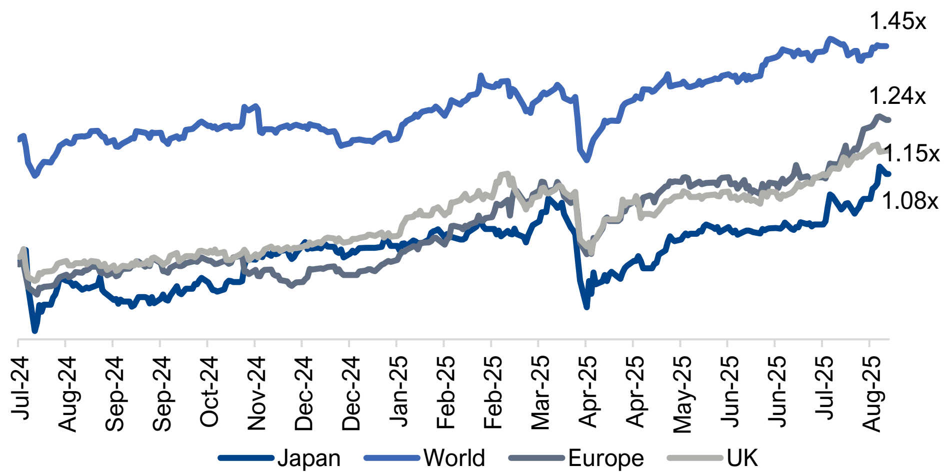
Comparing Valuations: Japanese Banks vs. Global Peers

Japanese banks outperform equities yet trade at lower valuations than global peers

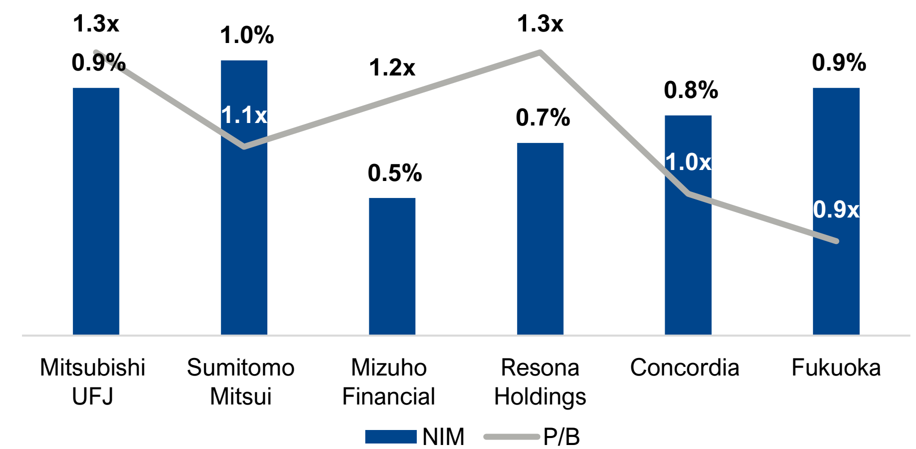
Japan: Topix Bank vs. Topix Returns



Japanese Banks vs. Worldwide Banks: P/B ratio



Major Japanese Banks NIM and Price to Book*



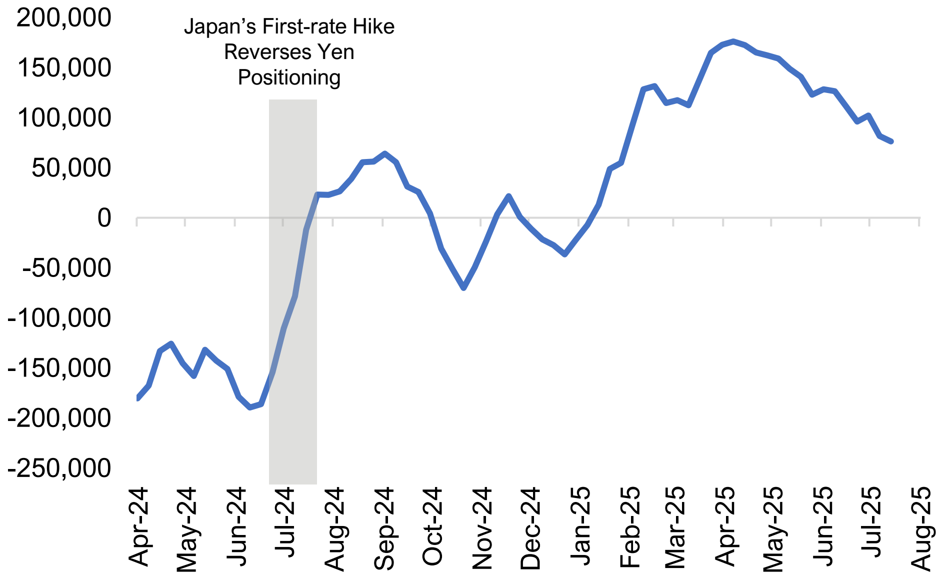
- **Outperformance with Strong Fundamentals:** Japanese banks have led Topix peers in 2025, supported by rising rates, wider margins, record profits, and strategic progress.
- **Global Valuation Gap:** Despite robust earnings at MUFG, SMFG, and Mizuho, the sector continues to trade at a discount to international peers.
- **Persistent Market Disconnect:** The lower P/B ratio underscores how strong fundamentals are not yet fully reflected in valuations.

Source: *Bloomberg, Capital IQ, Aranca Research, * TTM Figures as of Aug 18, 2025*

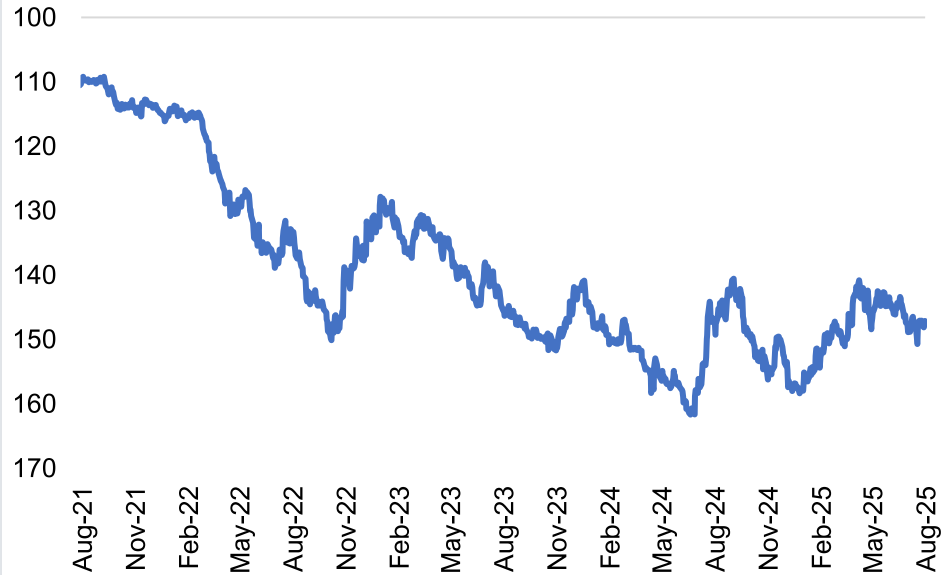
Monetary Policy Impact on Japanese Yen

Unwinding of the Japanese Carry Trade continues, aiding USD/JPY Prices

Speculative Positions in Japanese Yen Futures*



USD/JPY Inverted



- **Speculators Turn Net Long:** After the BoJ's 15bps rate hike on July 31, 2024, investors shifted from ~190,000 short contracts (USD 15.6 bn) on July 2 to net long positions in JPY futures.
- **Outlook for Yen Strength:** Rising rates and tariff impacts could fuel further long positioning, supporting medium-term JPY strength.

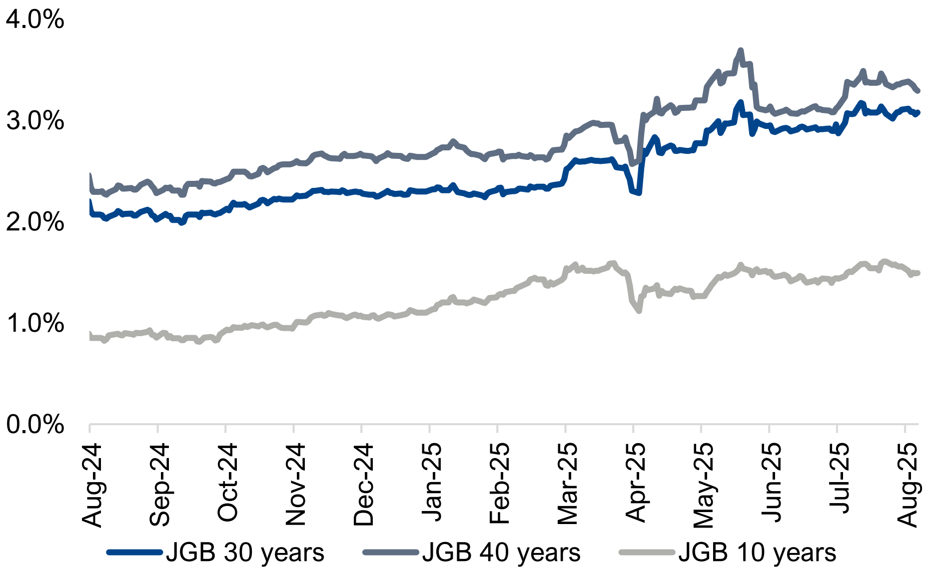
- **BoJ Tightening Stabilizes Yen:** The JPY stabilized after weakening to 161/USD in July 2024, as BoJ rate hikes helped curb further depreciation. While this limits export competitiveness, may support domestic equities.
- Greater currency stability may also boost investor confidence and sustain growth amid global risks.

***Source:** Bloomberg, Aranca Research, * Combined number of Long and Short Positions in Japanese Yen Futures (CME)*

Japan's Yield Climb: BoJ's Slow Exit Fuels Bond Market Shift

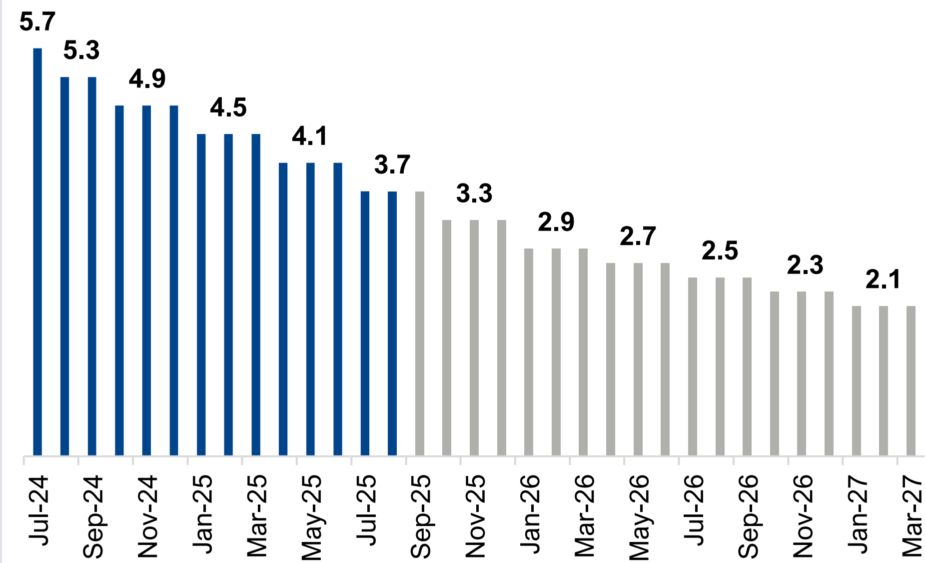
Upward momentum in Japanese yields set to persist amid slower bond purchases

Japanese Government Bond Yields (JGB)



- Japanese government bond yields across long maturities continue to rise on BoJ rate hikes, with further tightening expected.
- Higher yields are drawing investors to domestic bonds, reinforcing a tighter monetary environment and supporting local markets.

Announced Amount of monthly JBG Purchases (Yen trillion)



- The BoJ will cut JGB purchases from about JPY 3.7 trillion per month in mid-2025 to roughly JPY 2.1 trillion by early 2027. Reductions will be phased quarterly, with a policy review in April 2027. The tapering is expected to support further yield increases.

Source: *Bloomberg, Aranca Research*

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