



Market Watch

Japan's election implications

Summary

Event: Japan's ruling coalition failed to secure a majority in the upper house election – the 47 seats won was shy of the 50 seats required to maintain control. This marked the first time since 1955 that the Liberal Democratic Party or its coalition lost its majority in both legislative bodies. The narrow margin of defeat was widely expected and Prime Minister Ishiba intends to stay on, at least for now.

Market reaction: Global and Japan markets have taken the results in their stride, given the narrow loss for the coalition. USD/JPY pulled back from a three-month high around 149 towards 147.5, while the 30-year Japan government bond yield inched higher towards 3.1%. The Nikkei225 index rose as much as 1.2% before paring gains.

Investment strategy: The election defeat is mildly bearish for Japan's government bonds and the JPY, and neutral for Japan equities. The ruling coalition will have to work with opposition parties to pass legislation and stay in power. This will entail agreeing to opposition demands for sales tax cuts, which would further raise the government deficit and delay BoJ rate hikes. A trade deal with the US would partly offset some of the uncertainty caused by the election.

We maintain Japan equities as a core holding within a diversified allocation, while we are Overweight Asia ex-Japan equities, given attractive valuation. In bonds, we favour Emerging Market local currency debt, which should benefit from rate cuts and a weaker USD.

Macro implications of the election results

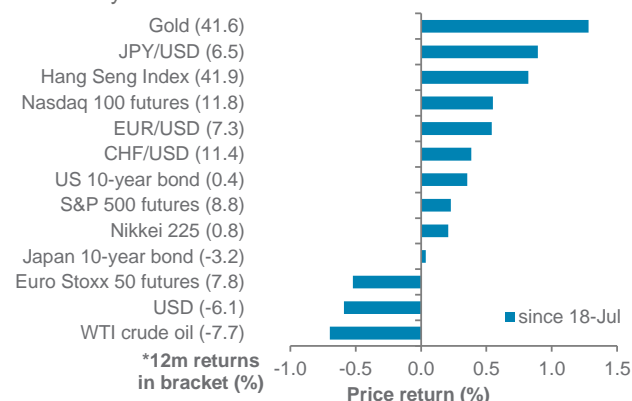
Political and policy uncertainty. While a new coalition is yet to be confirmed, diluted power of the existing ruling parties will likely impede decision-making. For instance, the proposed JPY 3.5tr cash handouts face hurdles, while potential partners will demand sales tax cuts.

Narrow path to 1 August US trade deadline. PM Ishiba's decision to stay on sustains the prospects for a trade deal with the US by 1 August. US Treasury Secretary Bessent expects a "mutually beneficial" US-Japan trade deal. That said, agreement on politically sensitive topics, such as automobiles and rice exports, is expected to be increasingly challenging given the politically weakened ruling coalition. While the odds are in favour of a trade deal, Japan faces a 25% tariff on all exports to the US if a deal is not reached by 1 August.

BoJ rate hike delayed. Expansionary fiscal policies by the ruling coalition is likely to delay BoJ rate hikes. Japan's exports contracted 0.5% y/y in June and the outlook remains uncertain until the government reaches a trade agreement with the US. Rate hikes may resume later this year as wages and price pressures remain elevated. Money markets are pricing only a 15bps hike by end-2025.

USD/JPY pulled back from a three-month high around 149

18-22 July and 12-month asset class returns; as of 9:30am SGT on 22-July-2025



Source: Bloomberg, Standard Chartered

Japan's 30-year government bond yield inched higher towards 3.1%, approaching the German 30-year bond yield

Japan, US and German 30-year government bond yield



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Bonds

Our View: Long term Japan government bond yields to stay elevated. We believe investors can find better risk/reward in Emerging Market local currency bonds and UK Gilts.

Rationale: Japan's election results suggest that the ruling coalition, comprising the Liberal Democratic Party (LDP) and Komeito, has avoided the worst-case scenario of a significant loss of majority, leading to a change in government. Prime Minister Ishida has vowed to remain in office. We believe that the weakening of the LDP-led government could lead to a more expansionary fiscal policy for Japan. The Ministry of Finance (MoF) has previously signalled efforts to stabilize the bond market by reducing the issuance of long bonds, which may help ease upward pressure on long-term bond yields.

Thus, while we expect the 30-year Japanese government bond yield to remain elevated near term, we see a low chance of it surpassing 3.2%, a level that was achieved prior to the election when the market had expected a more severe loss for the LDP. That said, investors will closely watch coalition negotiations, fiscal policy developments and MoF actions to gauge the trajectory of yields in the coming months.

Equities

Our View: Japan equities remain as a core holding. Within Asia, we prefer rotating into regions with attractive valuations and greater domestic stimulus support, such as China and Korea.

Rationale: While early market moves on Tuesday (at the time of writing) suggest that investors have largely priced the defeat of the ruling coalition, political instability and uncertainty around the trade negotiation with the US in the coming weeks will likely result in heightened market volatility. Overall, Japan remains a core holding within our global equity allocation. On the positive side, the parliament's emphasis on policy stimulus will likely support corporate earnings. The government's NISA program is also likely to improve shareholder returns. Technology stocks in Japan are riding on the global AI-wave. However, Japan equities face headwinds such as muted Q1'25 earnings and policy uncertainty. Consensus earnings growth projections for MSCI Japan are 2.3% for 2025 and 9.5% for 2026 – both below the 5-year historical average. Therefore, we would add selectively to Japan's technology sector on pullbacks, while reallocating into Asia ex-Japan equities, where we are Overweight. In particular, we favour markets with attractive valuations and greater fiscal support and political stability, such as South Korea and China.

FX

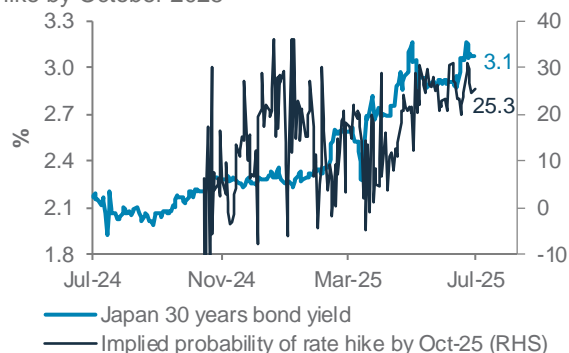
Our view: Expect rangebound USD/JPY with a bullish bias in the near-term, with a test of resistance at 151.

Rationale: USD/JPY fell 1% on Monday from a three-month high around 149 as the election loss for the ruling party was not as bad as feared. USD/JPY had rallied heading into the election. However, the uptrend is likely to resume, with the pair likely to test resistance at 151 in the near term as the markets price for a 40-year Japan government debt sale and a dovish BoJ meeting.

Meanwhile, Japan's trade deal with the US remains uncertain following Prime Minister Ishiba's election setback. The BOJ is likely to hold rates this month given political and trade uncertainty. BoJ Governor Ueda may find it challenging to provide any timeline for when rate hikes will resume.

Japan long bond yield to stay elevated while market implied probability of a rate hike remains low

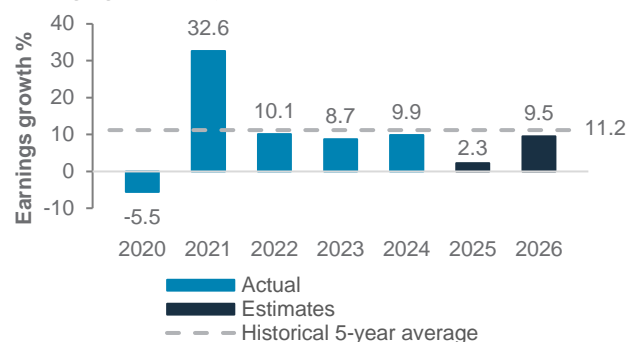
Japan 30-year bond yield and market implied probability of rate hike by October 2025



Source: Bloomberg, Standard Chartered

Japan's earnings growth projections for both 2025 and 2026 are below the 5-year historical average

Earnings growth projections for MSCI Japan index



Source: FactSet, Standard Chartered

USD/JPY uptrend is likely to resume, with next resistance at 151

USD/JPY and technical levels



Source: Bloomberg, Standard Chartered

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