



Market Watch

Takaichi spurs Japan stimulus bets

Summary

Event: Stimulus proponent Sanae Takaichi won a surprise victory to lead Japan's ruling Liberal Democratic Party, setting her on course to become Japan's first ever woman Prime Minister. Takaichi defeated frontrunner, Agriculture Minister Shinjiro Koizumi, lifting expectations of more fiscal spending and a less hawkish monetary policy.

Market reaction: Japan's Nikkei 225 index surged 4.8% to an all-time high on Monday, while the JPY fell 1.9% to a 2-month low vs. the USD and an all-time low vs. the EUR. Japan's long-term bond yields surged on concerns about more government spending and higher inflation. Money markets pared back expectations of a BoJ rate hike in October to 20% from around 60% on Friday (day before Takaichi's election).

Investment strategy: Takaichi's pro-stimulus stance is modestly positive for local equities in the near term, but international investors need to consider the offsetting impact of a weak JPY on overall returns. We see limited scope for large-scale fiscal stimulus, given the risk of stoking inflation. As such, we continue to see US and Asia ex-Japan equity markets outperforming other regions. We expect limited downside for JPY as Takaichi's win only delays a BoJ rate hike.

Macro implications of Takaichi's victory

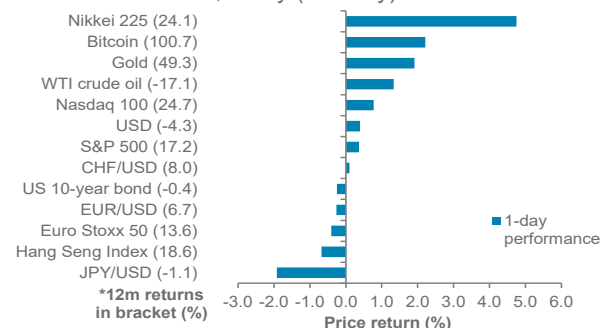
Proponent of Abenomics. Takaichi is a protégé of former Prime Minister Shinzo Abe (2012-2020), whose so-called 'Abenomics' policies, consisting of fiscal and monetary stimulus and structural reforms, helped lift Japan's economy from decades of deflation, revived its stock market and significantly weakened the JPY.

Limitations of returning to Abenomics. The current economic backdrop is significantly different from the period when Abenomics was successfully implemented: a) Japan has moved out of deflation, with core inflation (ex-fresh food and energy) running above the BoJ's 2% target since late-2022, offsetting the impact of wage growth and hurting household budgets; b) Japan's long-term bond yields have surged since the pandemic. A sizable fiscal stimulus in this environment would risk a bond sell-off; and c) the US administration is likely to be less tolerant of further JPY weakness.

What to expect? We expect Takaichi to be more fiscally responsible than markets expect. Policy priorities include: a) uniting the party, which recently lost its majority in both houses of parliament; b) accommodating veteran finance ministers into the cabinet, signalling fiscal prudence (broad sales tax cut unlikely); c) targeted stimulus for low-income households; d) support for national priorities, such as semiconductors, defence, nuclear power and infrastructure sectors; and d) letting the BOJ gradually raise policy rates to counter inflation.

Japan's equities surged and JPY weakened after the surprise election of Takaichi

Asset class returns, 1-day (Monday) and over 12 months



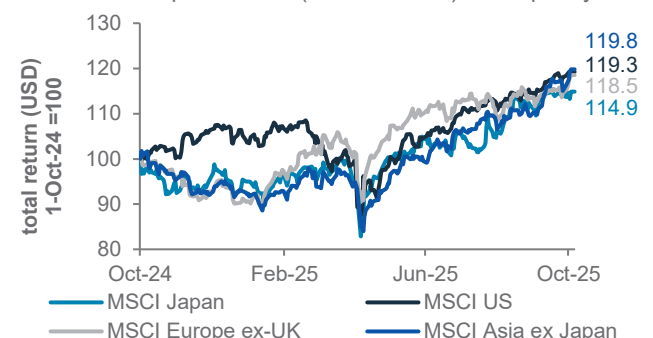
Japan's inflation and wage growth are running above the BoJ's 2% target, limiting scope for major fiscal stimulus

Japan labour cash earnings, inflation (ex-energy, fresh food)



Japan's equities have underperformed other major markets over the past year, despite a record-setting rally

Relative performance of MSCI Japan, US, Europe ex-UK and Asia ex-Japan indices (in USD terms) in the past year



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Equities

Our View: We expect Japan equities to perform in-line with global equities, in USD terms. We prefer US and Asia ex-Japan equities.

Rationale: Takaichi is a champion of Abenomics. Investors may draw parallels with the period when Abenomics first took hold, i.e., from Nov-12 to Aug-15, when the TOPIX index rallied +119% (from 760 to 1,665) and the JPY weakened 36% (USD/JPY from 79.48 to 124).

However, Japan was suffering from stagnation during that period and inflation was persistently low. That justified an aggressive easing of monetary policy. The current environment is the opposite – economic growth has been picking up and inflation is already above the BoJ's target. Japan is the only major Developed Market where its central bank is likely to tighten monetary policy. Therefore, while Takaichi's win is a positive for equities, we are not likely to see a repeat of the 'Abenomics' stock market performance. We expect equity markets in the US, driven by AI-driven earnings growth, and Asia ex-Japan, driven by weaker USD and attractive valuations, to outperform.

Bonds

Our view: Add 10-year Japan government bonds if yield rises over 1.7%.

Rationale: Takaichi's pro-stimulus policies have led to a steepening of the Japanese bond yield curve (with long-term yields rising more than short-term ones). Market concerns over a delayed BoJ rate hike coincide with expectations of increased Japanese government bond (JGB) issuance to cover deficits.

Following the election, the 10-year JGB yield climbed to 1.68-1.69%, returning to levels reached during the 2008 global financial crisis. Meanwhile, the 30-year yield surged to a record 3.3% before settling at around 3.29%. The BoJ's yield curve control could limit excessive increases in the 10-year yield; we see near-term resistance around 1.7%. For longer maturities e.g. 30-year bond, the government may reduce supply to mitigate the impact, while the BoJ could intervene if the yield overshoots the 3.3% psychological threshold.

FX

Our view: Limited short-term USD/JPY upside, with strong resistance near 151–152; likely pullback towards 145 on rate differentials.

Rationale: Following Takaichi's victory, USD/JPY initially pushed higher above 150 as markets interpreted her policy stance as supportive of continued monetary accommodation. However, Japan's inflation risk is likely to eventually align with a gradual shift by the BoJ toward higher rates, especially if wage pressures persist. Thus, the JPY's weakness is likely to be short-lived, especially given that the currency remains close to 40% undervalued vs. the USD and EUR, based on Purchasing Power Parity. We expect a subsequent rebound as investors take profit on speculative short-JPY positions.

Meanwhile, USD downside risks from the ongoing US government shutdown and softening US labour market data are likely to sustain Fed rate cut expectations. This backdrop should weigh on the dollar broadly and cap further gains in USD/JPY. Overall, a broader USD pullback is expected to dominate and limit JPY appreciation, bringing the pair back toward our 3-month target of 145.

Japan's equities have benefitted from JPY weakness caused by Abenomics policies since 2012

TOPIX index and USD/JPY



Source: Bloomberg, Standard Chartered

Japan's 10-year government bond yield faces near-term resistance around 1.7%; BoJ's yield curve control policy should limit further gains

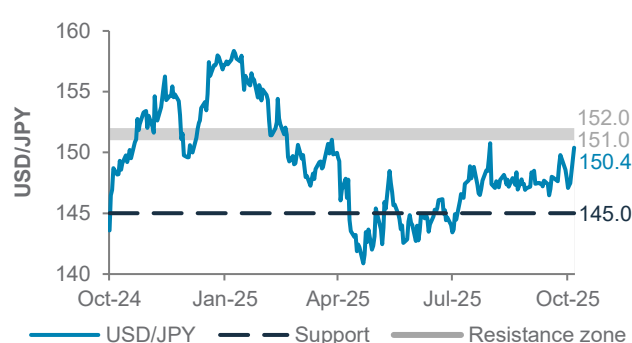
Japan government bond 10-year yield



Source: Bloomberg, Standard Chartered

USD/JPY faces strong resistance around 151-152; we expect it to pullback towards 145 amid narrowing rate differentials between Japan and the US

USD/JPY and technical levels



Source: Bloomberg, Standard Chartered

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