Outlook 2025

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Key points

- **Return of inflation in Japan is driving margin expansion, corporate restructuring and capital efficiency.**
- **Recovery in pricing power and normalisation of monetary policy is creating investment opportunities.**
- **Companies lifting their valuations through deployment of excess cash and unwinding of cross shareholdings.**

What is your outlook for Japan?

A transition to mild inflation and the normalisation of monetary policy in Japan is positive for both the domestic economy and the stock market. Actions that have accelerated under the return of inflation - such as regaining the ability pass on higher prices to customers and consumers, restructuring uncompetitive business portfolios, and addressing excessively strong balance sheets and rethinking capital allocation between retention, capital expenditure and shareholder returns – will continue to evolve.

Looking forward, we do not expect the incoming US administration to derail the positive direction of travel in Japan. The country's return to inflation is likely further solidified if Trump can re-accelerate the US economy, while the domestic political push for wage growth, pressure for corporate governance improvements and turnaround in corporates' cash hoarding versus better capital allocation is unlikely to change as a result of the US administration's policies.

Further down the road, Japan will likely need to arrive at a deal with the US administration, which could lead to promises such as an increase in defence expenditure. Heavy industry names that are benefiting from more favourable contract terms represent potential investment opportunities.

Meanwhile, the proposed tariffs taken at face value (including those potentially levied onto countries like Mexico or Canada) would equally hurt Japanese companies selling into the US as much as their US competitors. As such, we expect the relative cost increase for major Japanese automakers will be comparable to US counterparts given their NAFTA production ratios, and thus the relative competitive positioning is unlikely to change.

How are you looking to position your portfolio against this backdrop?

We have a positive view on sectors that benefit from strengthening domestic demand and a recovery in pricing power, normalising monetary policy and the accelerated unwinding of strategic shareholdings. We also hold positions in domestic utilities that are increasing shareholder returns, and automotive-related companies that are focused on lifting their valuations through the increased deployment of cash and the unwinding of cross shareholdings. At the same time, a sustainable reacceleration in China's economy could throw up new investment opportunities in factory automation (FA) and consumer-related segments of the market.

With the outlook for sustained inflation gaining ground in Japan and the Bank of Japan set to continue its path of gradual monetary policy tightening, we maintain an overweight position in rate-sensitive financials, primarily through banks and insurers. Key active holdings include mega banks and non-life insurance companies.

We also continue to favour the construction sector through positions in general contractors, subcontractors, and building materials. The domestic capex environment remains robust, while a return of pricing power will continue to drive margin expansion independent of global macro developments. General contractors that are leading their peers in terms of profitability, capital efficiency and shareholder returns are among our top picks in the sector.

More broadly, Japanese companies are increasing investment in labour-saving technology and digital transformation to enhance productivity, a trend that we are positioning to capture through holdings in IT services firms.

On the other hand, we have an underweight position in the semiconductor space, as we are increasingly cautious on the semiconductor cycle into fiscal 2025 (especially DRAM, NAND and semi-equipment) regardless of potential tariff impacts. Given there remains the potential for the global manufacturing cycle to recover alongside China's potential to reaccelerate, however, we continue to look into ideas within the FA space, focusing on companies with stronger business models and earnings recovery visibility.