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Elections and earnings could impact JPY asset markets

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Japan equities recently rebounded and JGB yields have stabilized, but there might be more turbulence in the coming weeks. The government should survive the Upper House elections, but there is also a real risk of a destabilizing change in policy positions. Beyond that, the 2Q25 corporate earnings season might provide reason for a stock selection pivot. We also continue to see medium-term JPY appreciation and continue to favor selling USDJPY on rallies, and selling the USDJPY upside risks for yield pickup.

Japan equities—the TOPIX specifically—rose a robust 3.3% over the last week of June, breaking convincingly above the 2,800 level for the first time in 11 months. The climb petered out slightly in the first three days of July, with the index falling 0.8%. Given the TOPIX's typically high correlation with the S&P 500—which rose 1.2% over those three days—should investors try to position for more upside in the TOPIX?

We would advise more caution, not least because of the upcoming 9 July deadline for the reconsideration of reciprocal tariffs. Two potential impediments lie in the way of a sustained recovery for Japan's equities: the pricing in of tariff damages in upcoming 2Q25 corporate earnings guidance; and the 20 July Upper House election, which holds an outside chance of a risk outcome that could have negative policy and market impacts. The lingering trade tensions with the US also pose an additional source of potential risk.

Following the ruling Liberal Democratic Party's (LDP) losses in the Tokyo Metropolitan Assembly election, the Upper House election has become potentially more consequential. Although we think the ruling coalition (LDP plus Komeito) has only a 50% chance of winning an outright majority, it can still remain in government if it manages a decent-enough showing to convince the Constitutional Democratic Party (CDP) to form an alliance of sorts. The risk outcome (20% chance we

think) would be a poor-enough showing as to precipitate a fall of Prime Minister Shigeru Ishiba's government. The various outcomes could impact equities and JGB yields, either directly or indirectly.

JGB yields likely to remain stable. After a somewhat turbulent rise through April and May, 10-year and 30-year Japanese government bonds (JGB) yields seem to have settled down. The most recent auctions of both tenors yielded reasonable bid-cover ratios of around 3.5 times, although yields in the secondary market did tick up slightly in response. Our base case remains for yields on both tenors to remain fairly flat over the next 12 months (around 1.3% for the 10Y), especially if the Ishiba government survives and continues to pursue a primary surplus by fiscal year 2026 (2QCY26-1QCY27). If the Ishiba government is replaced by an opposition party favoring large-scale consumption tax cuts and lower social security contributions, there is a meaningful risk of bond yields shifting higher, with a meaningful risk of a JGB downgrade.

Corporate guidance might provide a pivot for stock selection. For now, we remain Neutral on Japan equities overall as the 2Q25 earnings season that starts in late July could lead to downside in the TOPIX over the next three months. For cyclical stocks, especially exporters, we expect downward revisions of full-year guidance. If there is a broad downward revision of full-year guidance though, we believe this could mark the end of negative catalysts. Since April, stocks of companies more insulated against tariffs (in the defense, gaming, power and data centers, IT services segments) have outperformed. We however, believe that undervalued (oversold), high-quality cyclical stocks offer attractive medium-term returns, and we recently added these to our preferred equity market segment. These include automobile, machinery, and health-care stocks.

USDJPY medium-term downtrend intact, sell on rallies. We continue to expect the pair to decline to 136 over the coming 12 months (on de-dollarization and a narrowing US interest rate premium), and favor selling the USDJPY on rallies, as well as selling upside risk for yield pickup. Tensions surrounding the 9 July tariff deadline could see the broad USD bounce temporarily, but we expect this to be unsustainable. The JPY also has some catch-up potential. It is also worth noting that the USDJPY's fall has fallen short of that of the broad USD: since its mid-January peak, the USD index has fallen 12% compared to the USDJPY's 8.7%. For JPY-based investors, we believe AUD long exposure should provide positive total returns versus the JPY over the next 12 months. We also see value in selling the upside potential in the JPY versus the AUD for yield pickup.

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