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Earlier BoJ hikes likely, but some uncertainty remains

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The recent positive outcomes to the Upper House election and trade talks with the US should be sufficient to let the BoJ bring forward its rate hikes. Nevertheless, we think markets might be a bit too aggressive about the timing for the first hike that is being priced in. We think a first hike in December 2025 is most likely, with a second in June 2026. This is likely to see higher 10-year JGB yields, along with higher corporate earnings, although we remain Neutral on Japan equities for now. With the uncertainty surrounding PM Ishiba's tenor potentially producing volatility, we see value in selling USDJPY upside above 149 for a one-month horizon.

The relatively benign outcomes to both the Upper House election and the trade negotiation with the US have removed a meaningful amount of uncertainty in the months to come. First, the likely emergence of a fiscally conservative alliance in the Upper House should preclude the risk of fiscal slippage. Additionally, the surprisingly good trade deal with the US will likely lift Japan's growth trajectory. This is likely to enable the Bank of Japan (BoJ) to move its rate hike schedule forward. Indeed, the futures market is now ascribing over 55% chance of at least a 25bps hike by October 2025 and a 70% chance of the same by December 2025.

We would, however, urge a little caution as we are not entirely out of the woods just yet. For starters, it might take a bit of time for the new government's fiscal direction to be concretized in legislation. Second, even if the trade deal leads to a smaller eventual tariff hike, it would still be a hike. This is likely to lower corporate profits, which could in turn crimp capital spending and wage increases, and consequently hurt consumption. This negative impact looks set to only bottom out in 1Q26, leaving both 3Q25 and 4Q25 with negative growth. This should leave 2025 GDP growth at just +0.5% while 2026 should see a sharp acceleration to over +1.0%. We thus believe that the BoJ will likely hold off till December 2025 to hike 25bps, with a repeat in June 2026.

Higher JGB yields over the medium term. Japan Government Bonds (JGB) are likely to be the most directly impacted asset class. Although we expect that the easing of fiscal concerns should still see 10-year yields decline from currently elevated levels of around 1.6%, the downside room is probably more limited now, and we expect 10-year yields to level off around 1.5% through 2025, before gradually rising to 1.7% through 2026. Meanwhile, stabilization in the fiscal outlook should keep the 20-year and 30-year yields below 3% for the rest of 2025.

Trade deal a positive for Japan equities. The lower tariff rates, especially for automakers, should not only lead to better GDP growth, but also stronger EPS growth of +2% to +3% through 2026. Including the impact of the recent JPY depreciation, we see sufficient reason to raise our earnings growth forecasts for FY25 and FY26 to +2% and +5% (from -1% and +4%), respectively. We remain Neutral on broad Japan equities though, pending an assessment of how comprehensively the tariff damage gets incorporated into forward guidance in the 2Q25 earnings reports. For now, we prefer high-quality cyclical laggards in automakers, machinery, and health care for their better medium-term return prospects. Additionally, banks should be a key beneficiary from early rate hikes, in our view.

Medium term USDJPY downside intact. Notwithstanding the likelihood of earlier BoJ rate hikes, we maintain the trajectory of our expected USDJPY downside: 140 by December 2025 and 136 by June 2026. We see this decline as being mainly driven by broad de-dollarization and impending US Federal Reserve rate cuts. Nonetheless, the tenuousness of PM Ishiba's hold on his position, and the jockeying to replace him, could well generate more USDJPY volatility near term. We thus see value in selling USDJPY upside above 149 on a one-month time frame.

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