

GM Sector Coverage: Japan/S. Korea

NUS INVESTMENT SOCIETY
Global Macro

Updated: May 2025

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GM Japan/S. Korea | May
2024
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JAPAN

Japan is a highly developed island nation in East Asia and the world's third-largest economy by nominal GDP. It operates as a constitutional monarchy with a market-based economic system, and the Japanese Yen (JPY) serves as its official currency.

The Bank of Japan (BOJ) is the central authority responsible for monetary policy, employing a range of unconventional tools—including negative interest rates and quantitative easing—to target inflation and stimulate economic activity in a long battle against deflation.

Japan's economy is driven by a strong manufacturing and export sector, with key industries including automobiles, electronics, and robotics. Its primary trading partners are the United States, China, and South Korea, making external trade a vital component of its economic landscape.

Domestically, Japan faces significant demographic challenges, most notably an aging population and a declining birthrate, which have profound implications for fiscal policy and long-term economic sustainability.

Key Snapshot - Q4 2024

Nominal GDP (USD)	\$4.39 Tn
Q3 YoY GDP Growth	0.3%
CPI YoY	2.3%
PPI YoY	-3.2%
Trade Balance (USD)	+\$9.55 Bn
Exchange Rate (USD/JPY)	151.52
Stock Index	Nikkei 225
Currency	JPY

Source: Reuters, Trading Economics, World Bank – correct as of Q3 2024.

Outlook for 2025

Globalism to Nationalism?

We expect 2025 to accelerate the ongoing shift from globalism to nationalism—a transition driven not solely by Donald Trump’s return but by longer-term structural issues that have beset the global order since the post-Cold War era. Widening inequality and hegemonic destabilization have rendered globalism increasingly unsustainable, creating fertile ground for nationalist policies and economic self-interest to take precedence.

Notably, there is a marked divergence between a strong US and weak China in the non-manufacturing sector, which makes up more than half of the global economy. One reason for this, is a clear difference in the wealth effect. More pronounced differences in growth or contraction trends of working populations are also a factor. Interestingly enough, the manufacturing sector paints the opposite picture: solid China and weak US (as well as other major economies outside of China). This is the result of China increasing its supply capacity with massive industrial subsidies to shore up a structure that snatches demand from other countries. In turn, this makes it more likely that the new Trump administration will greatly increase tariffs on China, which is expected to magnify these imbalances. Beyond these measures, stricter restrictions on illegal immigration and proposed federal spending cuts by DOGE add layers of complexity that conventional forecasts have yet to fully capture. Such policies could significantly impact labour market dynamics and capital flows, introducing uncertainties that may shift economic trajectories in unpredictable ways.

One obvious swing factor from China’s perspective is the policies presented at the NPC in March. Chinese economic policy over the past few years has revolved around strengthening supply capacity amid a lack of demand. We think this resembles Japan’s mistake following the collapse of its bubble economy, specifically that it failed to realize that structural reforms were needed to break out of the recession.

Quantitative Decoupling of the Japanese economy

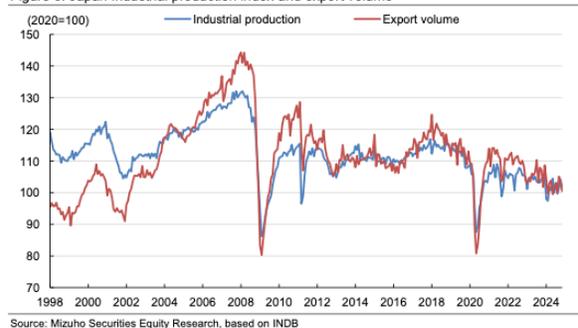
What is likely to happen to the Japanese economy in this situation? To put it bluntly, the reality is that there is hardly any effect in volume terms (on a real basis). It simply does not matter whether overseas demand rises or falls for an economy like Japan that

faces supply constraints because it can only supply a certain amount of volume.

Both Japanese export volumes and the Industrial Production Index have been on a steady decline since their 2007 peak, as Japan quantitatively decoupled from the world economy due to supply constraints. Although demand shocks in 2008 and 2020 accelerated these falls, the persistent downward trend—especially since 2018—signals that factors beyond global economic cycles are at play. Chief among these are labour shortages, which have, over time, rendered Japan’s export and production trajectories relatively inelastic to external demand.

Domestic Demand, Terms of Trade, and Structural Challenges

Figure 5. Japan Industrial production index and export volume



In a supply-constrained environment, the future course of the Japanese economy will be driven primarily by domestic demand. However, boosting domestic demand presents formidable challenges in a country facing a declining population and deteriorating terms of trade. Even as yen depreciation and global inflation push up import prices, Japan’s structural weakness—where falling supply outpaces any potential demand recovery—exacerbates the issue. Without a compensatory rise in export prices or moderation in imported resource costs, any policy-induced boost to domestic demand risks deepening the trade deficit and further depreciating the yen, thereby inflicting additional harm on the economy. Structural revitalization would likely require long-term measures, such as improving energy self-sufficiency through nuclear power or reforming labour market and demographic challenges—efforts that are unlikely to yield immediate results.

BOJ’s Dilemma

Against this backdrop, the Bank of Japan (BoJ) finds itself in a precarious position. Inflation is becoming structurally entrenched even as growth remains low.

This is a situation in which raising interest rates to defend the currency may be justified, but it is not clear to what extent a rate hike would be able to curb yen depreciation.

The BoJ therefore continues to hesitate, and recent monetary policy meetings have reflected this ambivalence. While a July 2024 meeting hinted at a rate hike coupled with quantitative tightening as a form of currency defence, the subsequent December meeting's dovish tone revealed a reluctance to pursue aggressive monetary tightening.

Three hypotheses have been proposed: trauma from past market shocks, heightened uncertainties following recent US elections, and growing concerns over the BoJ's own financial condition. The latter, in particular, underscores the risk that continued rate hikes, given the bank's large current deposit liabilities, could impair its balance sheet and, if publicized, undermine its credibility.

In other words, continuing to raise interest rates while holding huge current deposits (a liability for the BoJ) will worsen the bank's bottom line. This in itself is not a problem for monetary policy execution, but the BoJ wants to avoid the risk of needless turmoil in the outside world, for example in the financial markets and politics. The orthodox way to avoid this problem would be to reduce the size of the current deposits by accelerating quantitative tightening. In fact, the BoJ plans to readjust its quantitative tightening policy in June 2025. However, given the scale of the current deposits it holds, it will take a decade or so for the BoJ to reduce its liabilities and improve its bottom line using this policy.

Although the BoJ has planned adjustments to its quantitative tightening policy, the magnitude of its liabilities suggests that any meaningful improvement in its financial condition is a long-term proposition. Alternative strategies, such as enhanced market communication, halting rate hikes, or even profit-taking measures, present their own set of trade-offs, leaving the BoJ with a difficult decision on whether to take the high road or the low road.

Figure 6. Main schedule for 2025

	US	Japan	China	Europe/Others	Central banks
Jan	15 Jan: Congress of the 118th House of Representatives (23 Jan) 16 Jan: President inauguration (20 Jan) 17 Jan: State of the Union address 18 Jan: Inauguration of the President 19 Jan: Inauguration of the President 20 Jan: Inauguration of the President 21 Jan: Inauguration of the President 22 Jan: Inauguration of the President 23 Jan: Inauguration of the President 24 Jan: Inauguration of the President 25 Jan: Inauguration of the President 26 Jan: Inauguration of the President 27 Jan: Inauguration of the President 28 Jan: Inauguration of the President 29 Jan: Inauguration of the President 30 Jan: Inauguration of the President 31 Jan: Inauguration of the President	1 Jan: New Year's Day 2 Jan: New Year's Day 3 Jan: New Year's Day 4 Jan: New Year's Day 5 Jan: New Year's Day 6 Jan: New Year's Day 7 Jan: New Year's Day 8 Jan: New Year's Day 9 Jan: New Year's Day 10 Jan: New Year's Day 11 Jan: New Year's Day 12 Jan: New Year's Day 13 Jan: New Year's Day 14 Jan: New Year's Day 15 Jan: New Year's Day 16 Jan: New Year's Day 17 Jan: New Year's Day 18 Jan: New Year's Day 19 Jan: New Year's Day 20 Jan: New Year's Day 21 Jan: New Year's Day 22 Jan: New Year's Day 23 Jan: New Year's Day 24 Jan: New Year's Day 25 Jan: New Year's Day 26 Jan: New Year's Day 27 Jan: New Year's Day 28 Jan: New Year's Day 29 Jan: New Year's Day 30 Jan: New Year's Day 31 Jan: New Year's Day	1 Jan: New Year's Day 2 Jan: New Year's Day 3 Jan: New Year's Day 4 Jan: New Year's Day 5 Jan: New Year's Day 6 Jan: New Year's Day 7 Jan: New Year's Day 8 Jan: New Year's Day 9 Jan: New Year's Day 10 Jan: New Year's Day 11 Jan: New Year's Day 12 Jan: New Year's Day 13 Jan: New Year's Day 14 Jan: New Year's Day 15 Jan: New Year's Day 16 Jan: New Year's Day 17 Jan: New Year's Day 18 Jan: New Year's Day 19 Jan: New Year's Day 20 Jan: New Year's Day 21 Jan: New Year's Day 22 Jan: New Year's Day 23 Jan: New Year's Day 24 Jan: New Year's Day 25 Jan: New Year's Day 26 Jan: New Year's Day 27 Jan: New Year's Day 28 Jan: New Year's Day 29 Jan: New Year's Day 30 Jan: New Year's Day 31 Jan: New Year's Day	1 Jan: New Year's Day 2 Jan: New Year's Day 3 Jan: New Year's Day 4 Jan: New Year's Day 5 Jan: New Year's Day 6 Jan: New Year's Day 7 Jan: New Year's Day 8 Jan: New Year's Day 9 Jan: New Year's Day 10 Jan: New Year's Day 11 Jan: New Year's Day 12 Jan: New Year's Day 13 Jan: New Year's Day 14 Jan: New Year's Day 15 Jan: New Year's Day 16 Jan: New Year's Day 17 Jan: New Year's Day 18 Jan: New Year's Day 19 Jan: New Year's Day 20 Jan: New Year's Day 21 Jan: New Year's Day 22 Jan: New Year's Day 23 Jan: New Year's Day 24 Jan: New Year's Day 25 Jan: New Year's Day 26 Jan: New Year's Day 27 Jan: New Year's Day 28 Jan: New Year's Day 29 Jan: New Year's Day 30 Jan: New Year's Day 31 Jan: New Year's Day	1 Jan: New Year's Day 2 Jan: New Year's Day 3 Jan: New Year's Day 4 Jan: New Year's Day 5 Jan: New Year's Day 6 Jan: New Year's Day 7 Jan: New Year's Day 8 Jan: New Year's Day 9 Jan: New Year's Day 10 Jan: New Year's Day 11 Jan: New Year's Day 12 Jan: New Year's Day 13 Jan: New Year's Day 14 Jan: New Year's Day 15 Jan: New Year's Day 16 Jan: New Year's Day 17 Jan: New Year's Day 18 Jan: New Year's Day 19 Jan: New Year's Day 20 Jan: New Year's Day 21 Jan: New Year's Day 22 Jan: New Year's Day 23 Jan: New Year's Day 24 Jan: New Year's Day 25 Jan: New Year's Day 26 Jan: New Year's Day 27 Jan: New Year's Day 28 Jan: New Year's Day 29 Jan: New Year's Day 30 Jan: New Year's Day 31 Jan: New Year's Day

Source: Mizuho Securities Equity Research based on various materials

BoJ Jan 2025's Rate Hike & Policy Stance

Market was expecting rate hike to 0.5%, but statement and outlook report hawkish

The Bank of Japan (BoJ) raised its policy interest rate to 0.5% following the policy board meeting on 23–24 January 2025. This change itself, though, was not much of a surprise as it was consistent with the already widely priced in expectations by financial markets. Nonetheless, the details of the policy statement and the Outlook report on growth and inflation suggest that the bank has taken a more aggressive stance than implied by the rate hike alone. The statement exudes confidence in reaching the 2% inflation target, citing steadily rising wages—driven by improving corporate profits and an intensifying labor shortage—and a gradual upward trend in underlying CPI inflation. In parallel, policymakers express concern over yen weakness, forecasting that the year-on-year CPI (excluding fresh food) will remain in the 2.5%–3.0% range for fiscal 2024 before settling at around 2.5% in fiscal 2025, partly due to higher import prices amid recent yen depreciation. The Outlook report hints at the BoJ's inclination to tighten monetary policy. It has revised its inflation forecasts upward—anticipating core CPI increases of

2.7% in FY24, 2.4% in FY25, and 2.0% in FY26, while the core-core CPI projections follow a similar upward revision. Real GDP growth expectations remain largely unchanged at modest levels. Notably, the report reflects the bank's growing confidence that its inflation target will be met, even as it acknowledges risks of an inflation overshoot driven by currency depreciation. In contrast to earlier dovish comments—such as those by Deputy Governor Shinichi Uchida following the turbulent financial market reaction in July 2024—the current tone aligns with the recent stabilization of global financial and capital markets, suggesting a readiness to adjust monetary policy more proactively.

Economic Data

Overview

Japan's economic landscape in Q4 2024 remains characterized by subdued growth and evolving price dynamics. Nominal GDP is estimated at approximately USD 4.39 trillion, marking a marginal year-on-year expansion of around 0.4%. While export strength continues to underpin the external sector, domestic demand and demographic headwinds persist as structural challenges.

Inflation & Price Dynamics

The Consumer Price Index (CPI) has climbed to 2.3%, suggesting that the long battle against deflation may be gradually yielding to a more normalized inflation environment. In contrast, the Producer Price Index (PPI) has registered -3.2%, indicative of easing input costs in the industrial sector. This divergence points to a scenario where downstream price pressures are starting to materialize—albeit cautiously—while upstream cost factors remain weak.

External Sector & Trade Balance

Exports remain a critical driver for Japan. With a robust trade surplus of approximately USD 9.55 billion, sectors such as high-tech components, automotive, and machinery continue to perform strongly. The current exchange rate of roughly 151.52 yen per USD lends competitiveness to Japanese exports, even as global uncertainties persist.

Financial Markets & Monetary Policy

The equity markets, as reflected in the Nikkei 225 index, have shown resilience despite the mixed economic signals. The Bank of Japan (BoJ) maintains an accommodative stance, with near-zero policy rates

and ongoing quantitative easing supporting credit flows. This policy approach aims to balance the modest pick-up in inflation with the need to stimulate domestic consumption, while also addressing the long-term challenges posed by an aging population and modest wage growth.

Labor Market & Domestic Consumption

Japan's labor market remains tight, with historically low unemployment bolstering consumer confidence. However, wage growth continues to be muted and is expected to gradually align with productivity trends. The constrained domestic consumption, underpinned by demographic challenges, continues to be a headwind for sustained GDP expansion.

Despite the robust external sector, Japan faces significant long-term challenges. The demographic decline, characterized by a shrinking and aging workforce, along with stagnant productivity growth, weighs on potential GDP expansion. Structural reforms aimed at boosting domestic consumption and enhancing labour productivity remain critical to unlocking future growth.

Japan in Q4 2024 stands at a critical juncture. With modest GDP growth and an emerging, albeit uneven, inflation recovery, the economy is navigating between its legacy of deflation and a cautious return to price stability. The BoJ's supportive monetary policies, robust export performance, and resilient financial markets provide a buffer against domestic weaknesses. However, persistent structural challenges—especially demographic pressures and muted domestic demand—underscore the need for continued reform and vigilant monitoring of both global and local risk factors.

Monetary Policy: Navigating the BOJ's Policy Shift

Overview

In early 2025, the Bank of Japan (BOJ) has undertaken a significant shift in its monetary policy stance, transitioning from a prolonged period of ultra-loose monetary measures to a more normalized approach. This change is driven by sustained inflationary pressures, robust economic growth, and a strategic response to both domestic and international economic dynamics.

Policy Framework & Recent Decisions

In March 2024, the BOJ ended its negative interest rate policy, raising the short-term policy rate from -0.1% to a range of 0–0.1%. This marked the first rate

hike in 17 years, signalling a departure from its previous accommodative stance. Subsequently, in July 2024, the BOJ increased the policy rate further to 0.25%, and in January 2025, it reached 0.5%. These adjustments reflect the BOJ's commitment to achieving its 2% inflation target sustainably, as inflation has consistently remained around this level. Governor Kazuo Ueda has indicated that additional rate hikes may be considered if economic conditions continue to support such moves.

Economic Indicators Influencing Policy

Japan's economy has demonstrated resilience, with GDP growing at an annualized rate of 2.8% in Q4 2024, driven by strong exports and moderate domestic consumption. Inflation has stabilized around the BOJ's 2% target, with consumer prices excluding volatile food items rising by an average of 2.5% over the past year. Wage growth has also shown positive trends, supporting increased consumer spending and contributing to the BOJ's decision to adjust its policy stance.

Market Implications & Financial Conditions

The BOJ's policy adjustments have led to notable movements in financial markets. Japanese government bond yields have risen to multi-year highs, reflecting expectations of further rate hikes. The yen has appreciated against major currencies, influenced by strong economic data and the prospect of continued monetary tightening. Equity markets have remained relatively stable, with the Nikkei 225 index showing resilience amid the policy shift.

Risks & Outlook

While the BOJ's policy normalization reflects confidence in Japan's economic trajectory, several risks persist. Global economic uncertainties, including trade tensions and geopolitical developments, could impact export demand. Domestically, the aging population and potential shifts in consumption patterns pose challenges to sustained growth. The BOJ has indicated that future policy adjustments will be data-dependent, with a focus on achieving stable inflation and supporting economic expansion.

Boj Tankan: current conditions DI remains high

In the December 2024 Boj Tankan survey, the current business conditions DI for large manufacturers improved to 14ppt—up 1ppt from September—

surpassing the Bloomberg consensus of 13ppt. In contrast, the DI for large non-manufacturers declined to 33ppt (down 1ppt), aligning with consensus expectations.

Among manufacturers, the uplift is largely attributed to yen softness and stable resource prices, with marked improvements seen in sectors such as petroleum & coal, general-purpose machinery, production machinery, and pulp & paper. Forex assumptions for FY24 were revised to ¥146.88/\$ (up from ¥145.15/\$) and ¥159.03/€ (up from ¥157.07/€), reflecting a slightly stronger yen versus the dollar while remaining broadly in line versus the euro.

For non-manufacturers, the deterioration is particularly evident in the retail and accommodations, eating & drinking sectors, where tough comps—including delayed autumn/winter product launches and the waning momentum of post-pandemic recovery—have weighed on sentiment. Future business conditions DI forecasts indicate a modest decline for manufacturers to 13ppt (down 1ppt) and a sharper fall for non-manufacturers to 28ppt (down 5ppt), suggesting an anticipated deterioration in conditions. Sales forecasts were revised upwards slightly across both sectors, albeit more muted than historical trends, while planned FY24 capex is now expected to rise by 11.3% YoY overall—with manufacturers revising their outlook to a 16.0% increase (down 2.4ppt) and non-manufacturers to an 8.7% increase (up 2.5ppt).

Outlook:

Caution over incoming Trump administration for mfg; concern over rising costs on yen weakness for non-mfg

Policy and Trade Uncertainty

There is a prevailing sense of caution as companies brace for the incoming Trump administration, with many business leaders wary of the potential for sweeping new policy measures. The anticipation of higher tariffs and trade frictions looms large, particularly for large manufacturers. This uncertainty is reflected in the forecast revisions for several key sub-sectors, where general-purpose machinery, production machinery, and business-oriented machinery have all recorded significant expected deteriorations. The market appears to be factoring in the likelihood of policy shifts that may include aggressive tariff hikes and related measures, potentially exacerbating trade tensions. In this

environment, companies are revising their outlooks downward, even as they grapple with the dual challenges of external policy risk and an unpredictable international trading landscape.

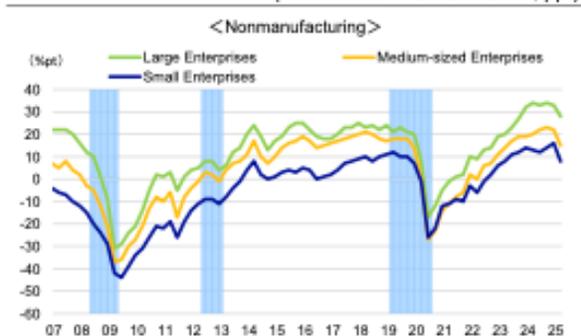
Business Conditions Outlook

Figure 2. Manufacturing: Business condition DI ("Favorable" - "Unfavorable", ppt)



Note: Mar 2025 shows outlook in the Dec 2024 report. Source: Mizuho Securities Equity Research, based on BoJ Tankan

Figure 3. Non-manufacturing: Business condition DI ("Favorable" - "Unfavorable", ppt)

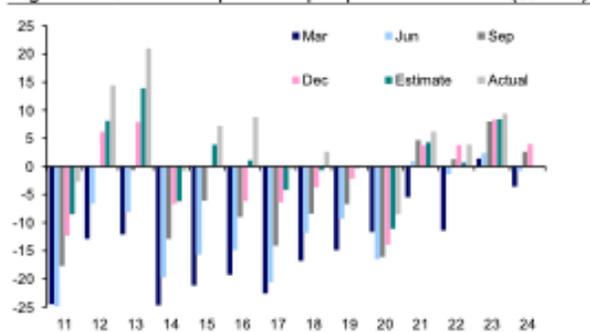


Note: Mar 2025 shows outlook in the Dec 2024 report. Source: Mizuho Securities Equity Research, based on BoJ Tankan

The forecast for future business conditions is marked by a distinct divergence between manufacturing and non-manufacturing sectors. For large manufacturers, the future business conditions Diffusion Index (DI) is projected at 13ppt, a slight decline relative to December's current DI. This modest drop, however, belies more pronounced weaknesses in specific segments such as general-purpose machinery and nonferrous metals, where declines of up to 8ppt and 6ppt, respectively, have been observed. These figures appear to be premised on expectations of heightened trade friction and tariff increases. On the other hand, large non-manufacturers are projecting a considerably steeper decline, with their future conditions DI falling to 28ppt—down 5ppt versus the December survey. It is essential to interpret these figures with the usual caution inherent in Tankan

data, as conservative outlooks often tend to overshoot subsequent actual performance. The conservative bias observed in non-manufacturing forecasts suggests that while the projected declines are steep, the actual downturn might be less severe than these headline numbers indicate.

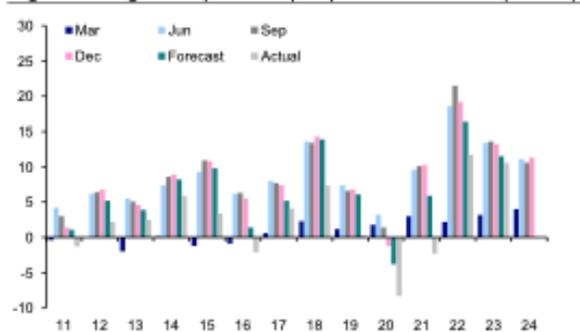
Figure 10. Small enterprises' capex plans (% YoY)



Notes: Small enterprises, all industries. Including Land purchasing expenses, excluding software and R&D investment. Data for the December 2021 survey, and December 2023 survey are based on the new survey target companies. Source: Mizuho Securities Equity Research, based on BoJ Tankan

Cost Pressures and Currency Concerns

Figure 9. Large enterprises' capex plans (% YoY)



Notes: Large enterprises, all industries. Including Land purchasing expenses, excluding software and R&D investment. Data for the December 2021 survey, and December 2023 survey are based on the new survey target companies. Source: Mizuho Securities Equity Research, based on BoJ Tankan

Cost pressures remain a central concern, exacerbated by the reemergence of yen depreciation. This resurgence in yen weakness is anticipated to drive up costs across various sectors, with infrastructure and other non-manufacturing segments being particularly sensitive to these fluctuations. The spectre of rising costs is evident in the outlook for non-manufacturers, where an increase in input expenses could offset potential revenue gains. For manufacturing companies, however, the dynamics are somewhat more nuanced. Despite an expectation that output prices will continue to fall (with a future

DI of +24ppt), the even sharper decline in input prices (projected to a future DI of approximately +37ppt) may enable these companies to maintain, or even improve, their profit margins. This differential between the pace of input and output price declines is critical, suggesting that while manufacturers face headwinds from global cost pressures, there exists a silver lining in the form of potentially improved margins.

Supply/Demand and Price Dynamics

Figure 4. Large enterprises' supply and demand conditions DIs ("Excess demand" - "Excess supply", ppt)



Note: Mar 2025 shows outlook in the Dec 2024 report.
Source: Mizuho Securities Equity Research, based on BoJ Tankan

The latest survey results provide a multifaceted view of supply/demand imbalances and price trends. Domestically, the manufacturing sector exhibits an easing of the supply/demand imbalance, with the current DI for domestic conditions falling to -10ppt. However, the picture is mixed: basic materials are experiencing a tightening of supply/demand conditions (reflected in a more negative DI), whereas processing industries are showing signs of slight relief with a less pronounced imbalance. In the overseas arena, the current DI for manufacturing stands at -12ppt, indicating that supply/demand conditions have eased compared to previous readings. Looking ahead, output prices for manufacturing are forecast to decline further, as evidenced by the future DI of +24ppt, while input prices are projected to fall more sharply. In contrast, non-manufacturers anticipate an upturn in output prices (with a future DI rising to +31ppt), a divergence that underscores the distinct pricing pressures faced by the two sectors. These dynamics illustrate a complex interplay between declining prices, easing supply/demand conditions, and the relative shifts in input costs, which together influence overall margins and sectoral profitability.

Forecast Revisions and Investment Trends

Recent revisions in both sales and earnings forecasts paint a picture of modest optimism in the face of persistent challenges. For FY24, large enterprises across both manufacturing and non-manufacturing sectors have slightly revised their sales forecasts upward—manufacturing is now expected to grow by 2.7% year-on-year, while non-manufacturing forecasts have been lifted to 3.2% YoY. However, this cautious optimism is tempered by the revised RP (earnings) forecasts, which continue to signal a decline; manufacturing is forecast to experience a 5.2% drop, with non-manufacturing sectors faring somewhat better but still facing a 2.8% decline. Capital expenditure (capex) plans, meanwhile, remain robust. Overall capex for large enterprises is projected to grow by 11.3% YoY, underscoring a strong commitment to investment despite the uncertain outlook. Notably, non-manufacturers are showing a particularly aggressive catch-up trend in their capex plans, with a forecasted growth rate of 8.7%, suggesting that these companies are eager to redress previous investment shortfalls and position themselves for future growth.

Labor Market and Capacity Constraints

Figure 13. Manufacturing: Production capacity DIs ("Excess" - "In short", ppt)



Note: Mar 2025 shows outlook in the Dec 2024 report.
Source: Mizuho Securities Equity Research, based on BoJ Tankan

Capacity constraints and labour shortages continue to be significant issues across industries. Despite some easing in production capacity—reflected by current DIs that suggest only modest tightness—there is an ongoing sense of a capacity shortage that is likely to intensify over time. This is compounded by a persistent labour shortage that is now affecting both manufacturing and non-manufacturing sectors, although the latter appear to be more acutely impacted. Large enterprises remain relatively buoyant, with forecasts indicating modest growth in new graduate hiring for FY24 and FY25. In contrast, smaller enterprises and SMEs are revising their hiring plans downward, a trend that could exacerbate capacity constraints and inhibit future growth. The

dual challenge of a tightening labour market and the need to expand production capacity is a key concern for industry observers, suggesting that companies may face significant hurdles in meeting demand if the current trends persist.

State of Funding Markets in Japan

In Brief

- Alternative funding avenues in Japan have expanded, with private equity and venture capital investments reaching record highs in 2024.
- The Tokyo Stock Exchange's market capitalization surpassed ¥1 quadrillion for the first time in July 2024, reflecting robust equity market performance.
- The Bank of Japan's recent monetary policy adjustments, including rate hikes, have influenced funding conditions, with expectations of further tightening in 2025.

2024 Japan Equity Market Performance

Japan's equity markets experienced a transformative year in 2024. The Nikkei 225 index reached an all-time high of 42,438 in July, surpassing its previous peak from 1989. This surge was driven by strong corporate earnings, improved corporate governance, and increased domestic investment. Notably, the rally was predominantly fuelled by domestic factors, including significant share buybacks and heightened retail investor participation, rather than foreign investment. By the end of 2024, the Nikkei had risen over 21%, positioning it as a standout performer among global indices.

The robust performance of Japanese equities has attracted attention from global investors. For instance, the iShares MSCI Japan ETF (EWJ) is currently trading at \$69.37, reflecting positive sentiment towards Japan's market.

Alternative Funding Landscape

The alternative funding landscape in Japan has seen significant growth. Private equity and venture capital-backed investments reached \$17.90 billion in 2024, marking a 40.8% increase from the previous year. This surge indicates a growing appetite for alternative investments, driven by Japan's well-developed economy and a burgeoning M&A environment. The presence of numerous family-run businesses seeking succession solutions has further fueled private equity activities.

Additionally, the Japanese government has introduced initiatives to bolster its position as a global financial hub. In June 2024, plans were announced to establish "Special Zones for Financial and Asset Management Businesses" in Tokyo, Osaka, and Fukuoka. These zones aim to attract foreign investment and enhance the country's alternative funding ecosystem.

Monetary Policy and Funding Conditions

Figure 3: Bank of Japan Policy Rate Changes (2024-2025)

The Bank of Japan (BOJ) has shifted its monetary policy stance in response to sustained inflationary pressures and robust economic growth. In March 2024, the BOJ ended its negative interest rate policy, raising the short-term policy rate from -0.1% to a range of 0–0.1%. Subsequent hikes in July 2024 and January 2025 brought the policy rate to 0.5%. These adjustments reflect the BOJ's commitment to achieving its 2% inflation target sustainably. Market analysts anticipate further rate increases, with projections suggesting a rise to 0.75% by July 2025 and 1.0% by January 2026.

These monetary policy changes have influenced funding conditions. Rising interest rates may lead to higher borrowing costs, potentially impacting corporate financing strategies. However, the robust performance of equity markets and the expanding alternative funding landscape provide diversified avenues for capital raising.

Sources: Bank of Japan, Reuters, AP News, S&P Global, Janus Henderson Investors, U.S. Department of State

2025 Japan Equity Market Outlook

Japan's equity markets are poised for a dynamic and transformative year in 2025, driven by a confluence of robust economic growth, strategic monetary policy adjustments, and significant corporate governance reforms. The Nikkei 225 index concluded 2024 with a remarkable 19% gain, closing at 39,894.54, and is projected to potentially surpass the 45,000 threshold by the end of 2025.

Monetary Policy and Economic Indicators

The Bank of Japan (BoJ) is anticipated to continue its trajectory towards monetary policy normalization in response to sustained inflationary pressures. In

January 2025, the BoJ raised its policy rate by 25 basis points to 0.5%, the highest level since 2008, aiming to achieve its 2% inflation target. Economists project further rate hikes in the latter half of 2025, with expectations of the policy rate reaching 0.75% by July and potentially 1.0% by January 2026. The monetary tightening reflects the BoJ's commitment to addressing persistent inflation, which is projected to average 2.7% in fiscal year 2024 and 2.4% in fiscal year 2025.

Japan's economy has demonstrated resilience, expanding for the third consecutive quarter with an annualized growth rate of 2.8% between October and December 2024, surpassing analyst expectations. This growth is underpinned by strong exports and moderate private consumption, with capital investment also contributing positively. The International Monetary Fund (IMF) projects Japan's growth to accelerate to 1.1% in 2025, driven by private consumption as wages are expected to outpace inflation, enhancing household purchasing power.

Corporate Governance and Shareholder Activism

Japan is undergoing a significant transformation in corporate governance, marked by an increase in shareholder activism. The adoption of the United Nations' Sustainable Development Goals (SDGs) has been widespread among Japanese corporations, reflecting a commitment to societal duties alongside shareholder interests.

However, market consolidation efforts have faced resistance, exemplified by the abandoned merger discussions between Honda and Nissan, highlighting the complexities in aligning corporate practices with global standards of capital allocation.

Private Equity and Venture Capital Landscape

The private equity (PE) and venture capital (VC) sectors in Japan are experiencing robust growth. In 2024, PE and VC-backed investments reached \$17.90 billion, reflecting a 40.8% year-over-year increase. Notable transactions, such as the acquisition battle for Fuji Soft between Bain Capital and KKR, underscore the escalating interest of global investment firms in Japanese assets. This surge in investment activity is indicative of a broader trend of international investors recognizing the potential within Japan's evolving market landscape.

Geopolitical Considerations

The re-election of President Donald Trump introduces a layer of complexity to Japan's economic outlook. Potential shifts in U.S. trade policy and geopolitical tensions necessitate vigilant monitoring, as they could influence Japan's export dynamics and broader economic stability. Despite these challenges, some analysts posit that Japan could navigate these uncertainties more adeptly than other developed markets, potentially benefiting from deteriorating U.S.-China relations that may redirect investment towards Japan.

Sector Highlights

- **Technology and Innovation:** Japan's emphasis on technological advancement, particularly in artificial intelligence and cybersecurity, is attracting substantial investments. The prospective acquisition of cybersecurity firm Trend Micro by leading PE firms exemplifies this trend, highlighting the strategic importance of bolstering cybersecurity capabilities in an increasingly digital economy.
- **Consumer Goods and Retail:** The anticipated uptick in domestic consumption, driven by wage growth and improved consumer confidence, is poised to benefit the consumer goods and retail sectors. As households experience increased purchasing power, demand for a diverse array of consumer products is expected to rise, stimulating growth within this sector.
- **Automotive Industry:** While traditional automotive manufacturers face challenges, investments in electric vehicles (EVs) and autonomous driving technologies present new avenues for growth. Japan's automotive industry is actively transitioning towards sustainable and innovative solutions, aligning with global trends towards decarbonization and smart mobility.

Policies

After three decades of near-zero inflation, there are signs that Japan's economy can sustainably converge to a new equilibrium. Inflation has surpassed the Bank of Japan's 2-percent target for over two years and a tight labour market is delivering the strongest wage growth since the 1990s. But Japan continues to face challenges from its aging population and high public debt. Policy priorities are to re-anchor inflation expectations, rebuild fiscal buffers, and advance labour market reforms to support potential growth.

Recent Developments, Outlook, And Risks

The economy contracted in the first half of 2024 due to temporary supply disruptions but gained momentum in the rest of the year. Domestic demand, private consumption in particular, has strengthened, while net external demand has been sluggish. Both headline and core inflation (excluding fresh food and energy) remain above the BoJ's 2-percent headline inflation target. Goods inflation has been boosted by energy and food prices, while services price growth is relatively weaker and below 2 percent. Inflation expectations are becoming increasingly aligned with the inflation target, though some measures remain below that target. The yen-dollar exchange rate has experienced sizable swings, largely driven by shifts in interest rate differentials (which reflect broader macroeconomic developments), but also amplified by the build-up and subsequent unwinding of yen carry-trade positions. The pass-through to inflation is estimated to have been relatively mild so far. Wages are growing at their highest rate since the 1990s amid labour shortages and strong inflation, but they have remained lacklustre in real terms.

Growth is expected to accelerate in 2025, with private consumption strengthening further, as above-inflation wage growth will boost households' disposable income. Private investment is also expected to remain strong, supported by high corporate profits and accommodative financial conditions. The output gap is estimated to be closed, and growth is expected to converge to its potential of 0.5 percent in the medium term. Headline and core inflation are expected to converge to the BoJ's 2-percent headline inflation target in late 2025, helped by a moderation in commodity prices for oil and food. The current account surplus is expected to moderate in 2025 as the income balance narrows, with the trade balance remaining in deficit. The external position is assessed as broadly in line with the level implied by medium-term fundamentals and desirable policies.

Risks to growth are tilted to the downside. On the external side, these include a slowdown in the global economy, deepening geoeconomic fragmentation and increasing trade restrictions, and more volatile food and energy prices. On the domestic side, the main downside risk is weak consumption if real wages do not pick up. Another domestic risk to the outlook is a possible decline in confidence in fiscal sustainability that leads to a tightening of financial conditions in the context of high public debt and gross financing needs. If downside risks materialize, it could result in Japan reverting to an effective-lower-bound constrained

environment given the still-low level of the policy rate.

Risks to inflation are broadly balanced. On the downside, inflation expectations may stall below the headline inflation target following Japan's prolonged experience with low inflation. Upside risks stem from rising food and energy prices, and from stronger-than-expected wages in the upcoming spring wage negotiations. Higher barriers to trade and cost pressures in major trading partners could spill over to Japan but the impact on domestic prices would be ambiguous given lower economic activity.

Economic Policies

Fiscal Policy

The estimated fiscal deficit in 2024 is smaller than expected --- Tax revenues have been boosted by high corporate profits, and expenditures to support the economic recovery (such as transfers to households and SMEs) have been partly phased out. The fiscal deficit is projected to increase slightly in 2025, with additional spending planned for defence, children-related measures, and industrial policies (IP). There is a significant risk that the deficit will widen further, given the political demands on the minority government. This should be avoided as fiscal space remains limited: any expansionary measure should be offset by higher revenues or expenditure savings elsewhere in the budget.

Public debt, as a share of GDP, is expected to decline in the near term, as nominal GDP growth is projected to exceed the effective interest rate on public debt. Public debt will remain high, however, and is estimated to start rising by 2030, driven by a higher interest bill and expenditure pressures related to spending on health and long-term care for an aging population. A clear consolidation plan is needed even in the near term to fully offset these pressures, ensure debt sustainability, and increase fiscal space needed to respond to shocks (including from natural disasters). This will require elaborating concrete and credible expenditure and revenue measures in the context of a robust medium-term fiscal framework:

- The composition of public spending should be more growth-friendly, including by eliminating poorly targeted subsidies, notably energy subsidies, while preserving expenditure on high-quality public investment. Enhancing the targeting and efficiency of social security spending is critical to containing rising costs while preserving quality.

- On the revenue side, options include strengthening financial income taxation for high-income earners, lowering exemptions and broadening the taxable valuation base under the property tax, streamlining income tax deductions, and unifying and eventually increasing the consumption tax rate. The PIT reform to the income deduction limit that is currently under consideration would need to be financed by additional revenues or savings elsewhere in the budget.
- The repeated use, and incomplete execution of supplementary budgets undermines efficient resource allocation, budget transparency, and fiscal discipline. The use of supplementary budgets should be limited to responding to large, unexpected shocks that overwhelm automatic stabilizers, which would also avoid providing unwarranted stimulus in normal times. All medium-term spending commitments—including on IP and green transformation—should be incorporated into the regular budget process.

As interest rates rise, the cost of servicing the large public debt is expected to double by 2030, putting a premium on a robust debt management strategy. In the face of rising gross financing needs and a shrinking BoJ balance sheet, government bond issuance will need to rely on additional demand from foreign investors and domestic institutions.

Monetary and Exchange Rate Policies

The current accommodative monetary policy stance is appropriate and will ensure inflation expectations rise sustainably to the 2-percent inflation target. Accommodation should continue to be withdrawn gradually if the baseline forecast bears out, under which we expect the policy rate would reach a neutral level by end-2027. High domestic and external uncertainty underscore the need for the BoJ to maintain its data-dependent and flexible approach and clear communications to anchor market expectations.

The BOJ's ongoing reduction in the size of its balance sheet has been clearly communicated, is appropriately modest in pace, and is proceeding smoothly. The BoJ should stand ready to modify the pace of its purchases should disorderly bond market conditions arise or if financial conditions become inconsistent with the desired monetary policy stance.

Japan's large stock of outstanding government debt and sizable net international investment position provide an important transmission channel for monetary policy to spill over into asset prices abroad. Clear communication and gradualism can limit adverse asset price reactions and outward spillovers. The authorities' continued commitment to a flexible exchange rate regime is welcome. Exchange rate flexibility should continue to help absorb external shocks and support monetary policy's focus on price stability. At the same time, it will also help maintain an external position in line with fundamentals.

Financial Stability

Japan's financial system remains broadly resilient, supported by strong capital and liquidity buffers. Banks' revenues have generally increased as credit costs remain low, the rise in interest rates has been gradual, and the yen has depreciated. Major banks continue to manage interest rate risks proactively through portfolio rebalancing and diversifying their funding sources. Financial intermediation remains stable supported by continued demand for loans from both corporate and household sectors. The insurance sector is well-capitalized and profitable, despite challenges from market volatility and demographic shifts.

However, despite the resilience, systemic risk has risen slightly since the 2024 Article IV consultation, reflecting a combination of rising macroeconomic uncertainty, risk of faster than expected interest rates increases or unrealized losses, and rising bankruptcies among SMEs. Rising global macroeconomic uncertainty could impact Japanese banks' investments. While gradually rising interest rates have helped bank profitability, faster-than-expected increases in interest rates or sudden changes in global financial conditions could amplify financial market volatility and interact with three persisting vulnerabilities identified in the 2024 FSAP: large securities held under mark-to-market accounting, significant foreign currency exposures—particularly through US dollar funding instruments—and signs of overheating in some areas of real estate.

A faster-than-expected tightening of financial conditions could also disrupt the JGB market, amplifying interest rate risks for banks with larger exposures. Less-capitalized domestic banks are more vulnerable to rate hikes, facing heightened risks from unrealized losses and higher funding costs. Corporate defaults among smaller SMEs have been increasing,

albeit from a low base, and could pose risks for regional banks with high SME loan exposure.

Strengthening systemic risk monitoring and the macroprudential policy framework is needed to better mitigate risks in the financial system. Ongoing efforts to expand data collection, enhance analytical capacity, and improve coordination between the FSA and BOJ are welcome. To further enhance systemic risk analysis, closing remaining data gaps and advancing analytical tools for a more comprehensive assessment of systemic vulnerabilities, including those related to foreign currency exposure, remain key priorities. Assigning a formal mandate to the Council for Cooperation on Financial Stability would reinforce the institutional framework, while expanding the macroprudential policy toolkit with targeted borrower-based measures would help mitigate vulnerabilities in the real estate sector.

Further strengthening financial sector oversight is essential to bolster stability and resilience against emerging risks and vulnerabilities. While progress has been made in expanding staffing resources in certain areas, additional allocations are needed to reinforce financial supervision. The authorities should continue to enhance risk-based supervision to respond flexibly to an evolving banking system. Strengthening the Early Warning System with more forward-looking indicators, especially for credit and liquidity risks, and establishing minimum liquidity requirements for domestic banks would enhance stability. Supervisors should also have the authority to adjust bank capital ratios above minimum requirements based on individual risk profiles and financial conditions.

The authorities should remain prepared to address market strains as they arise. The liquidity and functioning of the JGB market have improved since April but experienced temporary deterioration in early August amid a spike in market volatility. Rising foreign market volatility could impact domestic liquidity conditions, potentially triggering spillover effects. To mitigate these risks the central bank should closely monitor liquidity conditions and funding rates in money markets, while paying particular attention to the uneven distribution of liquidity among banks as well as the growth in repo transactions driven by demand from financial dealers and foreign investors. The scope of institutions eligible to receive emergency liquidity assistance could be expanded to nonbank financial institutions, prioritizing central counterparties. Recovery and Resolution Planning should be gradually expanded to

all banks that could be systemic at failure, requiring more banks to maintain a minimum amount of loss-absorbing capacity tailored to their resolvability needs.

Structural Policies

Japan's total factor productivity growth has been slowing for a decade and has fallen further behind the United States. A steady decline in allocative efficiency since the early 2000s has been a drag on productivity, and likely reflects an increase in market frictions. In addition, Japan's ultra-low interest rates may have allowed low-productivity firms to survive longer than they otherwise would have, delaying necessary economic restructuring. Reforms aimed at improving labour mobility across firms would help improve Japan's allocative efficiency and boost productivity.

Japan's labour market is expected to witness a significant transformation driven by population aging and advances in artificial intelligence (AI). Japan is aging rapidly—a trend that is expected to continue over coming decades—and has been at the forefront in labour-saving automation to alleviate labour shortages. Policies can play a crucial role in mitigating the impact of aging on labour supply and facilitating mobility needed to benefit from AI adoption:

- Thanks to government efforts, Japan's seniors already have a relatively high labour force participation rate compared to other OECD countries. But policy frictions such as an income threshold that triggers a loss of pension benefits may be inducing seniors to work fewer hours than they otherwise would.
- Japan has made significant progress in increasing female labour force participation during the last decade. Further supporting women's ability to fully participate in the labour force will require continuing to expand childcare resources and facilitate fathers' contribution to home/childcare, and further encouraging the use of flexible working arrangements.
- Training programs are crucial to enhance the complementarity of AI with the labour force and improve the productivity of senior workers.
- Improving mobility and reducing barriers to job switching are essential to address labour shortages due to aging and the potential job displacement impact of AI. Subsidized training programs that are targeted to in-demand

occupations could help reskill and upskill the labour force and facilitate occupational mobility.

While AI may help to address some of Japan's labour shortages, and since upskilling/reskilling the labour force takes time, attracting foreign workers could help alleviate labour shortages. Government programs have led to a tripling of the number of foreign workers in Japan during the past decade. However, foreigners continue to play a much smaller role in the Japanese labour force than they do in other OECD economies.

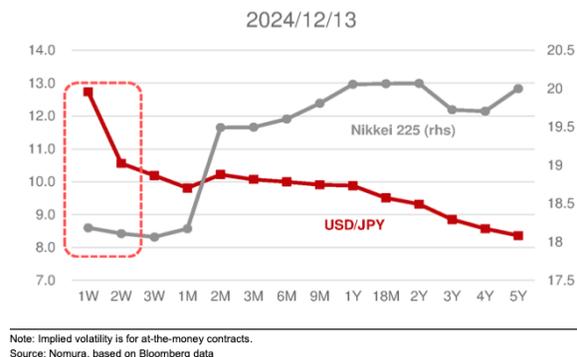
Similar to other G20 economies, Japan has increased its adoption of industrial policies. Japan's industrial policies aim to advance several objectives, including economic security, resilience, inclusive growth, and green and digital transformation (the latter including support for the semiconductor industry). Under this umbrella, multi-year envelopes of 20 trillion and 10 trillion yen have been identified for green transformation and the semiconductor/AI industries, respectively. Given Japan's limited fiscal space and the unclear growth impact of past IP, industrial policy schemes should be subjected to a comprehensive cost-benefit analysis. Going forward, IP should be narrowly targeted to specific objectives when externalities or market failures exist, to minimize distortions. It should avoid favouring domestic products over imports or creating incentives that lead to a fragmentation of the global system for trade and investment, in line with Japan's commitment to multilateral economic cooperation.

Japan remains committed to green transformation, and further progress on policies would enable reaching its targets. Notable ongoing efforts—such as the issuance of climate transition bonds to finance government green investment, and the implementation of carbon credits trading—are in line with international practices and previous staff advice. Nevertheless, without further policy changes, Japan is likely to fall short of its targets. To help meet its green commitments while boosting growth, a combination of policies is needed. Options include the removal of energy subsidies, the expansion of carbon pricing, feebates and tradable performance standards. Carbon pricing would need to be accompanied by targeted cash transfers to protect the vulnerable from adverse distributional effects.

Hedging against a BOJ surprise

Central bank actions can change market dynamics in an instant, and the Bank of Japan (BOJ) is no exception.

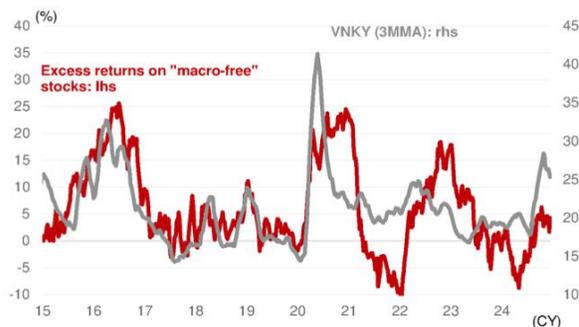
With the upcoming BOJ monetary policy meeting, market participants remain alert to the possibility that the governor's post-meeting press conference might reveal unexpected commentary. Although short-term investors have recently exhibited relative calm—with the Nikkei 225 regaining the symbolic 40,000 level and CTAs maintaining near-neutral positions—an unforeseen change in tone or policy guidance could catalyse sharp market movements.



1. "Macro-Free" Stocks

The stocks that we dub "macro-free" are those that are relatively unaffected by exchange rates, interest rates, and other macro variables, and we take no account of company-specific fundamentals (whether good or bad) in identifying them. Investors who wish to take fundamentals into account too should take a good look at investor positioning in a given stock before making a decision. Upsurges in volatility tend to invite reversals, and fundamentals-based trend-following strategies tend to underperform in those circumstances, depending on the degree of crowding.

Fig. 4: VNKY and "macro-free" Japanese equities
"Macro-free" stocks tend to outperform when volatility is rising



Note: For TOPIX 500 constituents, we estimated trailing 12-month excess return on each based on key macroeconomic variables (USD/JPY and real 10yr UST yield), then selected those in bottom 20% in terms of coefficient of determination, which we call "macro-free" stocks (rebalanced at end of each year). Excess return calculated as relative performance vs TOPIX 500 on 12-month trailing basis.
Source: Nomura, based on Bloomberg data

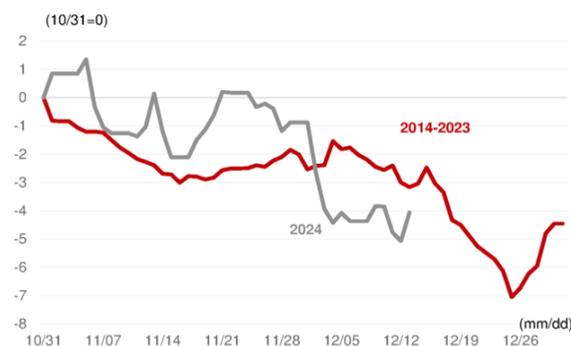
Instead of reacting primarily to shifts in the broader economic backdrop, these stocks tend to be driven by

company-specific developments or other idiosyncratic factors. Their independence from macro drivers makes them particularly attractive when volatility spikes, a common occurrence following unexpected central bank communications.

For that reason, we would like to entertain the idea of whittling down the list of “macro-free” stocks to those companies that are forecast to report falling profits in the current fiscal year but rising profits in the next fiscal year.

Fig. 6: Excess return on stocks with a deeply negative year-to-date return and high individual investor ownership

Clear underperformance again this year as individuals sell positions to harvest tax losses



Note: Shows excess returns on stocks with year-to-date return of -10% or worse and individual investor ownership of at least 70% at end-October. Universe is TOPIX.
Source: Nomura, based on Bloomberg data

If we back-test this strategy, we find that the stocks thus selected typically touch bottom after the release of Q2 results, and then go through a subsequent rebound that lasts through the release of Q3 results. This year as well, it looks as though these stocks found a floor after the release of Q2 results, and if the usual pattern holds from here, these stocks may still have plenty more to gain—which is to say that these trades may not be all that crowded yet, thus offering more favourable risk-reward dynamics. Strategic Rationale and Historical Patterns

Despite the seeming lack of concern over what the BOJ might decide at this week’s meeting, we think that a surprise in the content of the press conference could send stocks sharply higher or lower. Importantly, we think macro hedge funds in particular are primed to react to any surprises, as their current exposure is almost negligible. In Japanese equity markets, there is a strong tendency for a sharp move in the stock market to cause volatility to jump, regardless of whether the move in the cash equity market is upward or downward. We think “macro-free” stocks could function as an effective refuge, as they tend to outperform the market when volatility spikes

2. Tax-Loss Harvesting

In screening for relatively reliable short pick candidates that would be less affected by a market reversal in the event of a surprise from the BOJ, we would like to focus once again on tax-loss harvesting by individual investors

Just as in a typical year, stocks with deeply negative year-to-date returns through the end of October and high individual investor ownership ratios have plainly underperformed this year. History suggests that they are likely to continue performing poorly through Christmas or thereabouts. The likely weakness here looks as though it could be an adequate hedge against any surprise from the BOJ. Tax-loss harvesting also has important implications for the coming year. Individual investors selling off unprofitable equity holdings in November and December for the sake of lessening their tax burdens tend to put their money back into the market in Jan-Mar of the next year, and when they do this, they tend to favour high-dividend stocks. The more selling there is for tax-loss harvesting purposes at the end of the year, the better high-dividend stocks tend to outperform in the first quarter of the following year. We imagine that dividend-seeking individual investors trying to get a jump on other investors who buy up stocks late in the fiscal year in order to claim the dividends may also play a part in this phenomenon.

Recent Developments

JGB Structural Steepening

A fresh wave of volatility is gripping Japanese fixed income markets as 30-year Japanese Government Bond (JGB) yields surge past 3%, breaching historic levels while Japan’s 20-year bond auction has recorded the weakest demand since 2012. Japan’s Consumer Price Index (CPI) for April shows a month-on-month increase of 0.1%, lower than the expected 0.2%, while year-on-year inflation remains steady at 3.6%. Core inflation has risen to 3.5%, marking the highest level in over two years. Most analysts surveyed by RTRS believe the Bank of Japan will raise interest rates to at least 0.75% this year. Japan’s economic indicators for May also show a mixed picture. The Manufacturing PMI rose to 49, up from 48.7, indicating slight improvement in the sector. However, the Services PMI declined to 50.8, down from 52.4, suggesting a slowdown in service activities. The Composite PMI also fell to 49.8 from the previous 51.2, reflecting a contraction in overall economic performance..

Japan's ballooning debt situation has long been a simmering concern, but the tremors in JGBs are spilling over into global markets. With a debt-to-GDP ratio of 234%, the highest among developed economies, the fiscal strain is drawing renewed scrutiny. Comments from Prime Minister Shigeru Ishiba have catalysed global focus, even as Japan's debt metrics have quietly deteriorated over the past decade. Weak demand for long-dated JGBs, combined with structural concerns, has sent long-end yields sharply higher.

USDJPY

Traditionally, USDJPY has been more sensitive to short-term rate differentials than long-end yield dynamics. However, if this bond selloff persists and fiscal concerns deepen, we could see short-term appreciation in the yen as capital reconsiders Japan risk.

"Funky" Global Dynamics

While the last move to higher U.S. yields was accompanied by a weaker dollar (DXY dropped about 2%), yields across the globe went higher.

- Japanese bond yields have surged, with the 10 year yield jumping from 1.25% to 1.56% this month. That move didn't prevent them from having a "failed" auction.
- Dutch pension rules have changed, limiting their purchases of ultra long bonds, which weighed heavily on markets.
- While I highlighted Japan, most sovereign debt has been hit in the past week.

Hence while it is "easy" to point to the "lost narrative" this goes beyond anything specific to the U.S. It is "almost" like some major international asset manager, on record stating they are worried about global debt, is selling bonds, globally.

When we examine what foreign buyers (thinking far more about pension funds and insurance companies than central banks) may shy away from in the U.S.: Treasuries are the easiest to be underweight.

With yields higher across the globe, it is easier to just buy your own domestic sovereign debt, than buying U.S. debt and hedging the FX risk. Of all the assets the U.S. sells to the world, treasuries are the least "differentiated", which may weigh on them.

Bottom Line

The only thing stopping us from "pounding the table" to buy treasuries, is the pressure globally on yields, and the fact that 5% on 30's was such a "buying

trigger" for the past month, might leave many overly exposed in a world where the markets seem to be good at finding, and punishing those types of positions. Also, to the extent basis trades were "reloaded", likely means new "stops" are lurking out there, higher than where they were in April, but possibly reachable?

Nibble on yields here, but we would want to see stability globally before ploughing into U.S. treasuries (which is the opposite of how we've been trained to behave with the U.S. market generally leading the world, rather than the other way around).

Trade Recommendation

30y and 40y JGB yields have surged to multi-year highs, driven by weakest 20y auction demand since 2012 and shifted insurer demand/duration gaps.

We think that Supply-demand imbalance at the long end is becoming structural, not a one-off. Return of gradual BOJ tightening should eventually cap long yields, but near term risk favors further curve steepening.

1. Summary

Rates: Play structural long-end repricing via 2s-30s JGB steepener

Equities: Overweight Japan Post Bank; tactical long Mizuho vs MUFG; selective insurers/regionals

- **Timeframe:** Near-term (1–3 months) on steepener, 3–6 months on equity valuation catch-up.

2. Rates Trade: JGB 2s-30s Steepener

Position:

- **Long** JGB 30y futures (or receive fixed/ pay JPY-Libor in 30y)
- **Short** JGB 2y futures (or pay fixed/ receive JPY-Libor in 2y)

Rationale:

- **Long-end repricing:** life insurers reducing duration; auction demand drying up.
- **BOJ pivot path:** eventual hiking cycle likely to lift front rates, but long end to remain under upward pressure from supply dynamics.

Entry Spread: 2s-30s spread around **+210 bp**

Target: +250 bp (reflecting further long-end steepening)

Stop: +185 bp (cuts if yield shift reverses)

Horizon: 1–3 months

3. Equity Trade: Rate-Sensitive Financials

Ticker	Thesis	Entry Zone	Target	Stop
Japan Post Bank (7182 T)	Highest net-income Δ from LT yield moves	¥ 1 450–1 500	¥ 1 600	¥ 1 200
Mizuho Financial (8411 T)	Breakout on results + valuation catch-up to MUFG	¥ 3 850–3 950	¥ 2 300 ¹	¥ 1 800

Ticker	Thesis	Entry Zone	Target	Stop
MUFG (8306 T)	Relative hedge vs Mizuho; less LT yield exposure	¥ 1 900–1 950	¥ 700	¥ 820
Insurance Basket (e.g. TL Nissay)	Back-end rate exposure to widen OAS vs. corporates, benefiting from curve steepening	Market levels	+5%	-3%

1. Japan Post Bank (7182 T)

- **Catalyst:** Highest positive net income delta from long-term yield moves (per GIR Kuroda)
- **Drivers:** Further steepening; fee income tailwinds; ROE re-rating

2. Mizuho Financial (8411 T)

- **Catalyst:** Strong Q1 briefing; valuation gap vs MUFG; breakout technicals
- **Structure:** Long Mizuho vs short MUFG to isolate valuation catch-up

3. Insurers & Regionals

- **Focus:** Life insurers (Orix, Nippon Life) for balance sheet carry benefits; regional banks for funding curves
- **Structure:** Long CDS spreads vs financials; long bank equity basket

4. Key Risks & Mitigants

Risk: BOJ delays any hiking path → front rates remain anchored, flattening curve

- **Mitigation:** Tighten stops on steepener; shift to curve-flattener if BOJ signals persist

Risk: Global risk-off → long bonds rally, flattening JGB curve

- **Mitigation:** Hedge duration via OIS or US Treasury futures

Risk: Equity reversal on regional financial distress (unlikely given Japanese fiscal backstop)

- **Mitigation:** Use protective puts or collar structures

SOUTH KOREA

South Korea has transformed itself into one of the world's most dynamic and export-driven economies. Once a low-income nation, it now boasts a sophisticated industrial base, led by cutting-edge sectors such as semiconductors, automotive, shipbuilding, and consumer electronics. This rapid evolution has been fueled by heavy investments in research and development, a well-educated workforce, and a culture of innovation that continuously adapts to global technological trends.

The economy is notably export-oriented, with strong global value chain integration that supports its position as a major supplier of high-tech components and finished goods. Its major trading partners include China, the United States, Japan, and the European Union, which together help sustain robust export performance. The Bank of Korea plays a crucial role in maintaining monetary stability and supporting economic growth, with policy measures designed to keep inflation close to a 2% target despite occasional external shocks.

Domestically, South Korea's vibrant financial markets are epitomized by the KOSPI index, reflecting investor confidence and economic dynamism. Despite challenges such as an aging population and evolving labor market dynamics, South Korea continues to adapt through innovative public policies and corporate strategies. Its proactive approach to technology, digital transformation, and increased productivity has helped cushion the economy against global uncertainties, ensuring steady growth and a resilient trade surplus.

Key Snapshot - Q3 2024:

Nominal GDP (USD):	\$1.8 Tn
Q3 YoY GDP Growth:	1.2%
CPI YoY:	3.1%
PPI YoY:	-1.0%
Trade Balance (USD):	+\$15 Bn
Exchange Rate (USD/KRW):	1,300
Stock Index:	KOSPI
Currency:	KRW

Source: Reuters, Trading Economics, World Bank – correct as of Q4 2024.

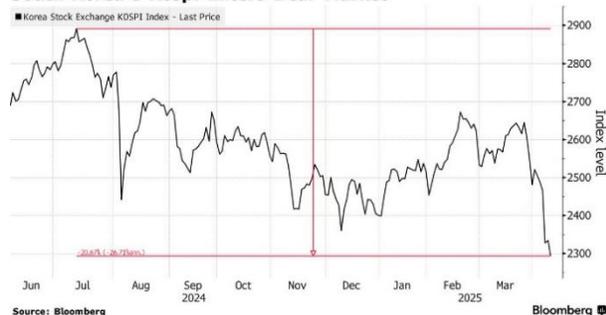
Outlook for 2025

Order restored amid trade headwinds

Entering 2025, South Korea navigated one of its most political chapters in recent history. With political stability regained, South Korea must now regain investor confidence, both domestically and foreign by re-establishing a stable haven for investors, which is now made worse with external uncertainty.

Over the past 6 months, South Korea's economy has faced intense pressure from external shocks and domestic volatility. The KOSPI index officially entered bear market territory amid trade tensions with the United States. As part of President Trump's Liberation Day Tariffs, a 25% tariff was imposed on South Korean imports on 2nd April 2025. US Tariff against Korea turned out harsher than expected, giving US room to negotiate.

South Korea's Kospi Enters Bear Market



However, in a surprising reversal on April 9, Trump announced a 90-day pause on these country-specific reciprocal tariffs, reducing them to a baseline 10% for most nations, including South Korea. This pause was intended to provide a window for bilateral trade negotiations. South Korean officials, including Trade Minister Cheong In-kyo, viewed this development as a positive opportunity for dialogue, though they emphasized the need for swift consultations to minimize potential impacts on the export-reliant economy.

Economic Policies

Monetary Policy: Dovish Shift

In response to rising recession risks, the Bank of Korea has adopted a markedly more accommodative policy stance. Having maintained a policy rate of 3.5% through most of 2024, the central bank has now cut

the 7-day repo rate to 2.75%, marking the third reduction in just four months. This brings borrowing costs to their lowest level since September 2022. The move reflects not only risks of decelerating domestic growth but also a alignment with global central banks that have begun a global rate cutting cycle to prioritize economic support amid trade uncertainty.

In March, South Korea's consumer price index (CPI) rose to 2.1% year-on-year, surpassing the market consensus of 1.9%. This uptick was primarily driven by increased prices in processed foods and dining out, as companies passed on higher input costs to

Consumer Price Index: YoY: Monthly: South Korea



consumers. Additionally, one-off hikes in university tuition and kindergarten fees contributed to the inflationary pressure. Despite these mixed trends, the overall inflationary environment has complicated the Bank of Korea's (BoK) monetary policy decisions.

<https://insights-ceicdata-com.libproxy1.nus.edu.sg/Chart-pack-Global-Dynamics-and-Impact-on-South-Korea>

movements in the CRB Spot Index, a broad measure of global commodity prices, closely correlate with year-on-year changes in South Korea's Consumer Price Index (CPI). This reflects the country's high dependence on imported raw materials, which makes domestic inflation highly sensitive to external cost shocks. However, in the current environment, easing

Commodity prices have a strong effect on South Korean Inflation



global crude oil prices could help temper inflationary pressures.

However, given the demand side shock from US tariffs, a rate cut could be expected from the BoK in the coming months to bolster consumer spending and investments

Fiscal Policy

Against the backdrop of aggressive U.S. tariffs and decelerating global demand, the South Korean government has unveiled emergency fiscal measures to safeguard its export-dependent economy. A ₩3 trillion (USD 2 billion) stimulus package was recently announced to support the automobile industry, which has borne the brunt of trade disruptions. Finance Minister Choi Sang-mok noted that the tariff regime would deliver a “huge blow” to the country’s industrial base, stressing the urgency of policy support.

This fiscal intervention complements ongoing efforts to stabilize consumer prices and manage the public debt trajectory, which remains relatively modest compared to regional peers. While broader fiscal expansion remains constrained by the country’s conservative budgeting philosophy, targeted spending in strategic sectors such as AI, chips, and batteries continues as part of Korea’s long-term competitiveness agenda.

Recent Developments

Domestic Instability: Fall of President Yoon

South Korea's democracy has demonstrated remarkable resilience in the face of recent challenges. The removal of President Yoon Suk Yeol in March ended months of institutional paralysis triggered by his controversial attempt to impose martial law in late 2024. Yoon’s deployment of troops to the National Assembly suppressing media freedoms, was met with widespread public protests and swift legislative action, culminating in his removal from office.

This episode underscores the maturity of South Korea's democratic framework as the Constitutional

Court upheld the impeachment in a unanimous decision, citing serious violations of the Constitution and a breach of public trust. Yoon's ousting ended months of institutional paralysis and set the stage for a snap presidential election scheduled for June 3, 2025.

With a caretaker government now in place and presidential elections upcoming in June 3, political risk premium previously priced in has begun to recede.

Tariff Headwinds

Recent developments point to a cautiously optimistic turn in South Korea’s trade outlook. After weeks of heightened trade tensions, U.S. President Donald Trump announced a 90-day pause on the newly imposed 25% tariffs affecting Korean exports such as autos, steel, and aluminium. This pause was interpreted by South Korean officials as a diplomatic opening. Trade envoy Cheong In-Kyo swiftly engaged in negotiations with U.S. Trade Representative Jamieson Greer in Washington, aiming to reduce tariff rates and minimize the economic fallout. Nonetheless, a 10% base tariff remains in place alongside a 25% duty on cars, auto parts, steel and aluminium products, all of which are among South Korea’s key exports.

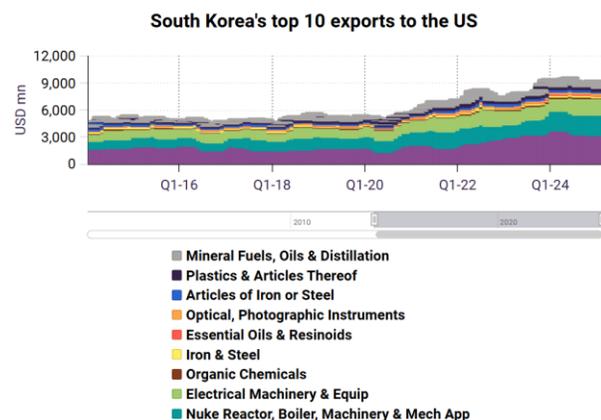
In a positive development, former President Trump held a call with South Korean interim leader Han Duck-Soo in April to discuss potential cooperation in shipbuilding and energy. Trump described the conversation as a “great call,” signalling a warmer tone as South Korea intensifies efforts to negotiate tariff relief with Washington.

Trade divergence

Bilateral trade dynamics between its two largest trade partners US and China have diverged in recent years. South Korea maintains a consistent surplus with the United States while its trade balances with China has become increasingly negative. This shift reflects weakening Chinese demand and growing supply chain reshuffling since 2022 amid global geopolitical tensions.



Exports to the US have been increasing in high-value sectors particularly in petrochemical chemicals, nuclear and electrical machinery. These structural shifts underscore the importance of preserving trade ties with the U.S., especially as South Korea engages in ongoing negotiations to mitigate the impact of tariffs. Strengthening these export channels could serve as a buffer against the softening trade momentum with China and help anchor external balances amid broader global uncertainty.



Household Debt Crisis

South Korea continues to face a persistent and intensifying household debt problem, prompting regulatory action and policy debate.

In Q4 2024, South Korea's household debt hit a record 1,927.3 trillion won (\$1.34 trillion). Facing one of the highest household debt-to-GDP ratio of 91.7%, second only to Canada at 106% with global average being 60.3%. The main drivers were surging home-backed loans, especially in affluent districts of Seoul, fueled by rising property prices.

In Q1 2025, the trend of household loan growth has stabilized. However, April 2025 marked a destabilization as outstanding household loans increased by 5.3 trillion won.

Starting July 2025, the Financial Services Commission (FSC) plans to apply the third phase of the Stressed DSR rules, which are designed to limit household debt by capping the proportion of income that can be used to service debt. Under this phase, a stress interest rate of 1.5 percentage points will be added to actual loan rates when calculating a borrower's DSR, effectively reducing the maximum loan amount available.

Notably, the FSC intends to implement these rules with slight variations across different regions. In the Seoul Metropolitan Area, a full 1.5% stress rate will be applied to reflect headline concerns over higher debt levels and overheating housing markets.

Whereas for the Non-Metropolitan Areas, a lower stress rate is being considered to account for the different economic conditions. This is to avoid exacerbating the unsold housing inventory issues facing Non-Metropolitan Areas

Moving forward, Bank of Korea has since noted that housing mortgage loans may temporarily increase in May and June, it is expected to stabilize in the second half of 2025 due to reassignment of land transaction approval areas and DSR regulation implementation.

Short Selling Resumes

Short selling of over 2700 stocks resumed on 31 Mar 2025, signalling the end of the ban of short selling

imposed in Nov 2023 following a series of breaches that involved some global investment banks.

In Korea, retail investors account for more than 50% of the market trading volume. According to analysts from Goldman Sachs, they foresee higher trading activities from foreign investors as they make up 70% of the short-selling activities.

However, despite South Korea officially resuming short selling, the Korea Exchange (KRX) has effectively imposed restrictions on derivatives market makers. This prevents them from engaging in short selling, contradicting the regulatory easing.

As market makers rely on short selling for hedging purposes, many market-making functions are paralyzed due to the restrictions. Bid-ask spreads will also widen due to the inability to properly hedge futures. KRX has stated that it may lift these internal restrictions once short selling volumes normalize. Transaction volumes have already dropped by 47% since the resumption—from ₩4.76 trillion to ₩2.52 trillion over a five-day span. Despite the legal reinstatement of short selling, functional restrictions on market makers could raise concerns about regulatory inconsistency and lead to distorted market liquidity.

Trade Recommendation

Trade Idea: Short USD/KRW

We recommend initiating a **short USD/KRW position**, based on the macroeconomic and structural drivers that are expected to strengthen the Korean Won we discussed earlier.

Political conditions in South Korea have improved in recent months, following efforts to reduce partisan gridlock and promote economic recovery. This stability has enhanced investor confidence, improved market sentiment, and reduced perceived country risk, creating a favourable backdrop for KRW appreciation.

The lifting of the short-selling ban in Mar 2025 signals a normalization of market conditions and reflects confidence in regulatory integrity. This general trend in deregulation is expected to increase participation from foreign institutional investors, which could translate into higher capital inflows and stronger demand for the KRW.

Trump's "Liberation Day" has shaken global confidence in the USD's safe-haven role, reigniting the de-dollarization narrative and triggering ripple effects across USD-denominated assets, thereby challenging the dollar's longstanding status as the world's undisputed reserve currency.

The proposed Mar-a-Lago Accord, suggesting the weakening of the USD to boost U.S. exports, has become a key driver of the dollar's recent devaluation. In May 2025, we saw TWD surge more than 9% against the USD. Similar themes have played out in Asia with offshore Yuan strengthening and HKD under pressure as HKMA steps in to defend the peg. Part of the underlying reason for the surge is the speculation that the Taiwan government would allow the TWD to strengthen as part of trade talks with US. Our view is that we can expect similar currency strengthening in non-retaliating countries as future trade deals unfold, with the U.S. dollar likely to weaken against allied currencies. This, combined with growing domestic uncertainty in the U.S., could reduce demand for the dollar and contributing to the

strengthening of its trade partners' currencies.



USD/KRW is currently trading within a well-defined descending channel since April, with price action recently rejecting the upper bound of resistance. The pair is below its 50-day SMA, indicating bearish momentum intact. Risk-reward favours shorts on rallies towards 1,370 with stops above 1,395 and medium-term targets around 1,320.

Entry: 1,364

Take Profit (TP): 1,320

Stop Loss (SL): 1,395

Risk-Reward Ratio (RRR): 1.50

Time Horizon: 3–6 months

Key Risks & Mitigants

Risk: If tariff negotiations with the U.S. collapse, the BoK may accelerate policy easing to cushion recession risks.

- **Mitigation:** Hedge exposure via short KRW cross-pairs (e.g., safe-haven KRW/JPY), to hedge against Korea-specific risks.