Letter from SuMi TRUST AM – Japan Outlook for the First Half of 2025

Written by Hiroyuki Ueno and Katsutoshi Inadome

Executive Summary

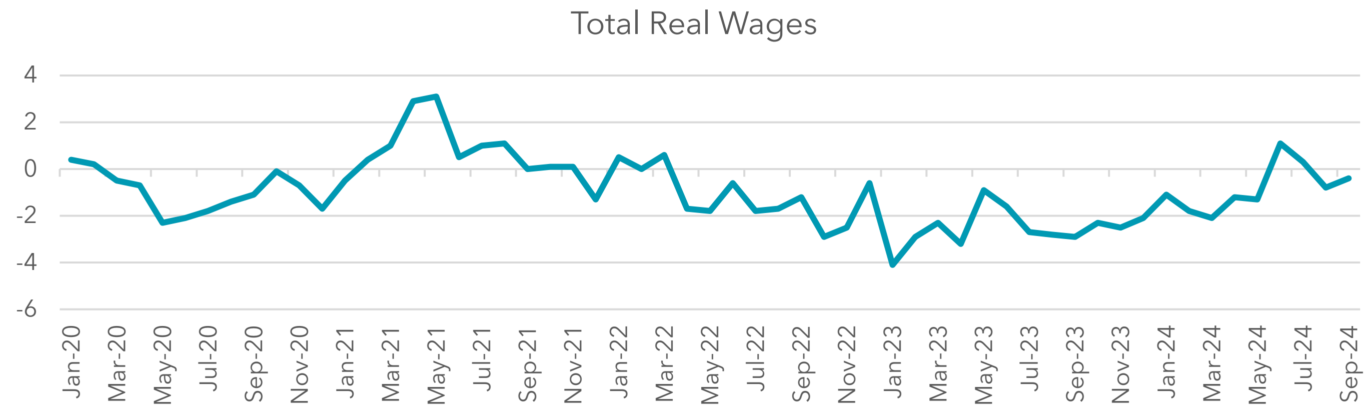
1. Japanese economy: we expect the economy to gradually improve, supported by greater personal consumption as wages rise and government economic policies help increase household disposable income.
2. Monetary policy: we forecast a rate hike by the Bank of Japan (BoJ) at the end of 2024 or the start of 2025. We are keeping a close eye on the rate of cuts by the US Federal Reserve (FRB).
3. Equity market: as more tourists visit Japan and domestic real wage levels rise, we expect that the Service sector will be the main beneficiary with a sustainable improvement in corporate earnings.

I. Japanese Economic Outlook

There is limited room for 2024's real GDP growth rate to increase substantially as the economy continues to feel the impact of certain car manufacturers admitting to incorrect testing data in the summer. Personal consumption remained steady, supported in June by the first significant rise in real wages for 27 months and boosted by income tax cuts. Demand for both digitalisation and for technological developments to ameliorate the tight labour market buoyed capital investment. Meanwhile, the economy was negatively affected by the general reduction in automobile-related investments and expenditures related to automotive assembly plants after certain car manufacturers halted shipments.

For the first half of 2025, despite concerns that policy decisions by the incoming US administration may weaken or otherwise negatively impact the global economy, we forecast that the Japanese economy will recover at a modest pace. We expect it will be supported by capital investment levels and increasing personal consumption on the back of rising wages and an improving employment environment. Market participants are likely to be focused on developments surrounding wages and the price of goods as Japan escapes deflation. In terms of capital expenditure, we believe that companies will maintain current levels as they tackle various challenges in the mid- to long-term. These investments will include productivity improvements, data center-related initiatives, restructuring of corporate supply chains, and measures to lessen the burden of ongoing structural labour shortages.

For personal consumption, we expect an upwards trend as tourist arrivals to Japan continue to rise and real wages increase. Labour unions have stated their intention to negotiate for employee wage increases exceeding 5% at the 2025 annual spring wage negotiations, and we expect they will achieve an improvement in base pay of approximately 3% against the backdrop of steady corporate earnings, labour shortages, and greater employment mobility. Meanwhile, the Japanese government released its 2025 economic package on November 22nd. The package included a plan to raise the annual earnings threshold for income tax from the current 1.03 million yen, as well as to provide a 30,000 yen subsidy to low income households exempt from resident tax. Accordingly, this increase in disposable income will support consumption levels.



Source: SuMi TRUST AM (based on data from Bloomberg)

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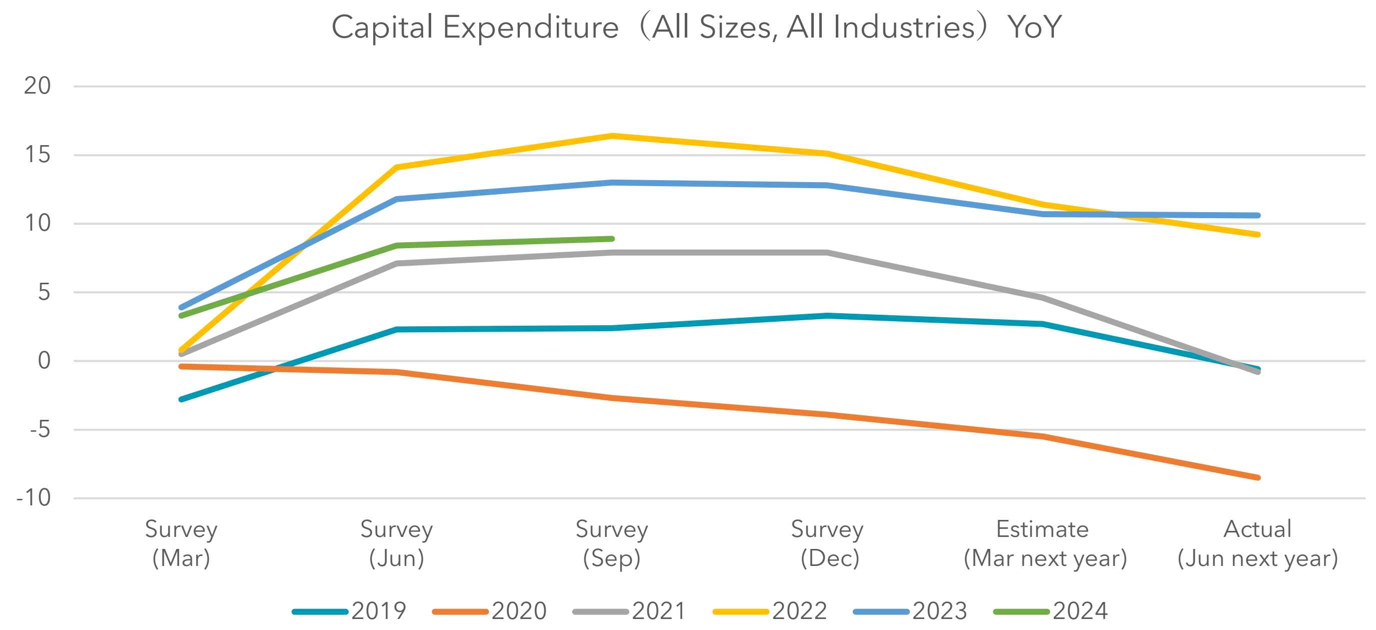


Source: SuMi TRUST AM (based on data from Bank of Japan)

II. Monetary Policy Outlook

We anticipate that the BOJ will increase interest rates in December or January, and market participants will be able to evaluate the impact in the first half of 2025. In addition, with labour unions intending to push for a more than 5% increase in wages, payroll expenses should subsequently be passed through to the prices of goods and services.

The timing of BOJ communications with the market will be important in ascertaining whether a rate hike will come in December or January. Should rising wages and the price of goods maintain a 'virtuous cycle' in line with the BOJ's target then we may see a further rate hike in June 2025. Further, should the foreign exchange rate approach 160 yen to the dollar, we expect that the Japanese government and the BOJ will consider currency intervention measures or additional rate hikes. Our forecast for Japan 10-Year Government Bond yields as of the end of June 2025 is between 0.75-1.50%.

Currently, market participants are paying close attention to the pace of the US Federal Reserve's interest rate cuts. While the US economy is showing signs of resilience, there are waning expectations for interest rate cuts due to concerns that Trump's economic policies may again cause inflation to accelerate. We expect some clarity about the pace of interest rates after Trump's inauguration towards the end of January 2025, when he confirms which policies he will actively pursue. Our forecast for ten year US government bond yields as of the end of June 2025 is a range of 3.25%-4.25%.

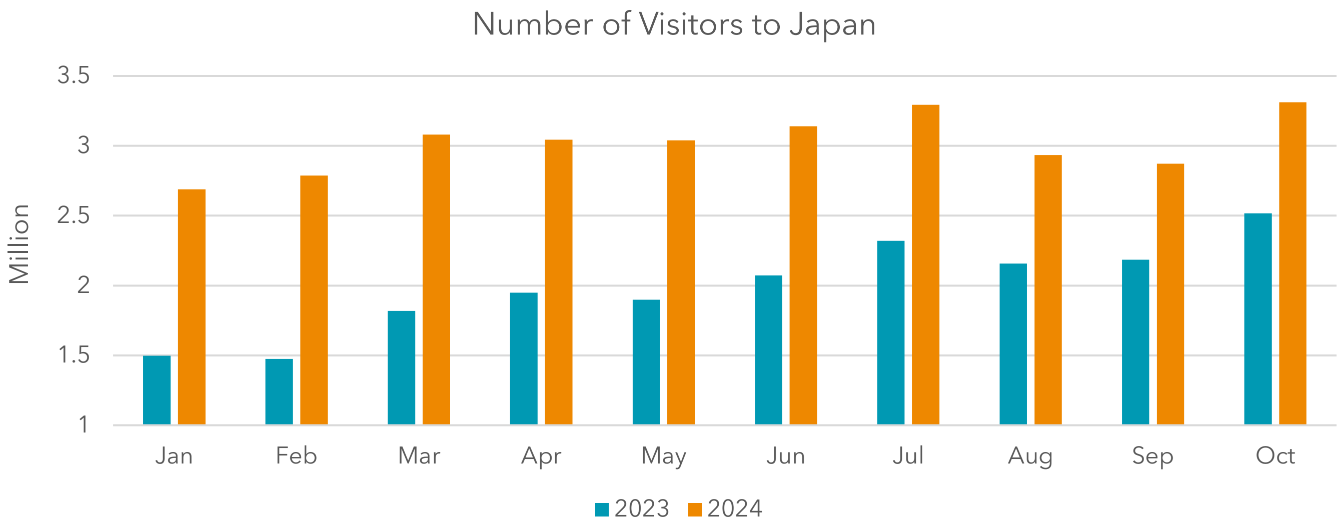
III. FX Outlook

In the first half of 2025, the Japanese yen will likely move in response to developments in Japanese and US monetary policy. While the BOJ's plans will take into account the economy, prices, and the general finance environment, we expect that they will continue to raise rates as planned since real interest rates are currently at a low level. The US Fed decided to cut interest rates for the first time in four and a half years at the Federal Open Market Committee meeting in September 2024. The market is continuing to pay close attention to the pace of any further rate cuts. Meanwhile, there are some market participants who expect the pace of Fed rate cuts to slow due to inflationary concerns stoked by Trumpian economic policy and the US economy stabilising. We expect these factors to be reflected in the FX rate, and we are forecasting the JPY to sit in a range of 140-160/USD as of the end of June 2025.

IV. Japanese Equity Market Outlook

The Japanese equity market should be able to maintain its current robust performance, buoyed by expectations for a soft landing for the US economy, improving corporate earnings in the service sector, and a positive outlook for shareholder return programs by Japanese companies.

We expect to see a recovery in service sector earnings on the back of increasing numbers of overseas tourists visiting Japan as well as a boost in personal consumption thanks to rising real wages and an improvement in the labour environment. In October, there were a record number of tourists arriving in Japan at more than 30 million. Figures released by the Japan Tourism Agency show that overseas tourist travel expenditure by category for the July-September quarter in 2024 was 1.95 trillion yen (approx. 13 billion USD), up 41.1% year-over-year. Per capita travel expenditure was also up 6.7% year-over-year at 223,195 yen (approximately 1,500 USD).



Source: SuMi TRUST AM (based on data from the Japan National Tourism Organisation)

The new NISA (Nippon Individual Savings Account) system is also doing extremely well. According to figures released by the Japan Securities Dealers Association, individual investors using NISA were focused on the growth stocks of domestic companies and this helped support the Japanese equity market in 2024. Figures released by the same organisation for the year as of October 2024 revealed the number of new NISA accounts and user trends for ten asset managers (five major, five internet-based). In summary, average account openings per month were 1.7 times higher in the period from January to October 2024 compared to the same period from last year. Growth investments made via a NISA account were 4.2 times higher, reaching a total of 8 trillion yen (approximately 53 billion dollars). Analysis of the NISA accounts showed that in October 2024 the ten most-purchased stocks in the growth space were all domestic companies, and half of them were either in the Information and Communications or the Transportation Sector. In addition, the data showed that NISA account holders favoured stocks with high dividends, shareholder returns, or those that had stable management. Overall, the inflow from NISA accounts was a boost for the domestic equity market in 2024.

Investment Type	Number of Stocks
Domestic Stock	10
Foreign Stock	0

Industry	Number of Stocks per Industry
- Information & Communication - Banks - Pharmaceutical	3 stocks
- Transportation Equipment	2 stocks
- Land Transportation - Services - Foods - Precision Instruments - Machinery	1 stock

Dividend Yield	Number of stocks for each Dividend Yield range
6.00%~6.99%	1
4.00%~4.99%	2
3.00%~3.99%	2
2.00%~2.99%	1
~2.00%	4

Source: SuMi TRUST AM (based on data from the Japan Securities Dealers Association (JSDA))

Starting in December 2024, the iDeCo personal pension account contribution limit will be raised from 12,000 to 20,000 JPY. There are expectations that the combination of the new NISA system with defined benefit pension plans, including those for public servants, will offer more substantial tax savings for individuals through income tax deductions, which will likely increase buying demand even further. We expect this and the developments noted above to spur the Nikkei average to the 43,000 JPY level by the end of June 2025.

iDeCo personal pension account contribution limit 12,000 JPY	27,500 JPY
Defined Contribution Plan contribution amount	
Contribution amount from other plans including Defined Benefit Plan (Evaluated uniformly at 27,500 JPY)	27,500 JPY

iDeCo personal pension account contribution limit 20,000 JPY	55,000 JPY
Defined Contribution Plan contribution amount	
Contribution amount from other plans including Defined Benefit Plan (Evaluated individually)	

Source: SuMi TRUST AM (based on data from the Ministry of Health, Labour and Welfare)

V. Risk Factors

Risk factors include rapid fluctuations in the USD-JPY exchange rate and the potential that the incoming US administration will increase tariffs, the slowing Chinese economy, and geopolitical tension due to the ongoing conflict between Russia and Ukraine.

US president-elect Donald Trump has expressed his desire to place a blanket tariff of 10 to 20% across all imports as part of his economic policy. He has indicated he will raise taxes on Chinese goods specifically, and Japan also being a target of large tariffs would be a significant blow to Japanese companies who rely on exports. The market is also cautious about any sudden fluctuations in the USD-JPY exchange rate which may be caused by the announcement of the BOJ's next rate hike and the pace of US Fed's interest rate cuts. The key to whether this will have a large impact will be whether Japanese companies can maintain steady corporate earnings should the yen drop below the assumed exchange rate of 145 yen to the USD that many companies have used in their forecasts.

The risk of a slowdown in the Chinese economy causing a drop in demand will continue to be on our radar for the first half of 2025. In China, there continues to be weakness in real estate development investment and fixed assets despite the government launching a 10 trillion yuan economic package to support regional government purses. Real improvement is unlikely until efforts are made to address deep-rooted problems such as anxiety about household finances, a languishing real estate market, and the structural lack of supply and demand.

Finally, the military conflict between Russia and Ukraine is still ongoing. Tensions increased once again in November with the arrival of North Korean ground troops to support Russia and Ukraine using weapons supplied by the United States. This conflict continues to fuel high prices for oil and other resources, and continues to aggravate energy prices, which we expect will weigh on Japanese corporate earnings in the near future.

VI. About the Writers

Hiroyuki Ueno, Chief Strategist

Hiroyuki joined SuMi TRUST AM in 2002 and has been Chief Strategist since October 2017.

Through over 20 years of experience working in the investment industry, he is well-versed in the investment management business and has a strong network in the industry as well as among financial authorities.

Hiroyuki's primary focus is macroeconomy and financial market analysis. His insights based on his own analysis combined with information gathered from his broad network are widely acclaimed.

Hiroyuki is a Certified Member Analyst of the Securities Analysts Association of Japan (CMA).

Katsutoshi Inadome, Senior Strategist

Katsutoshi joined SuMi TRUST AM in February 2023, his primary focuses are market analysis and research, with a particular focus on interest rates, currencies, and fixed income markets.

Katsutoshi has about 18 years' experience in the financial industry. Before joining SuMi TRUST AM, he was a bond strategist at Mitsubishi UFJ Morgan Stanley Securities, where he was responsible for developing fixed income portfolio management strategies.