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ECONOMIC RESEARCH – JUNE 2025

INVESTMENT INSIGHT JAPAN

- ✓ Leading indicators still mixed
- ✓ Consumption resilient but still cautious
- ✓ Inflation weakens slightly but remains high
- ✓ BoJ unlikely to touch rates in 2025

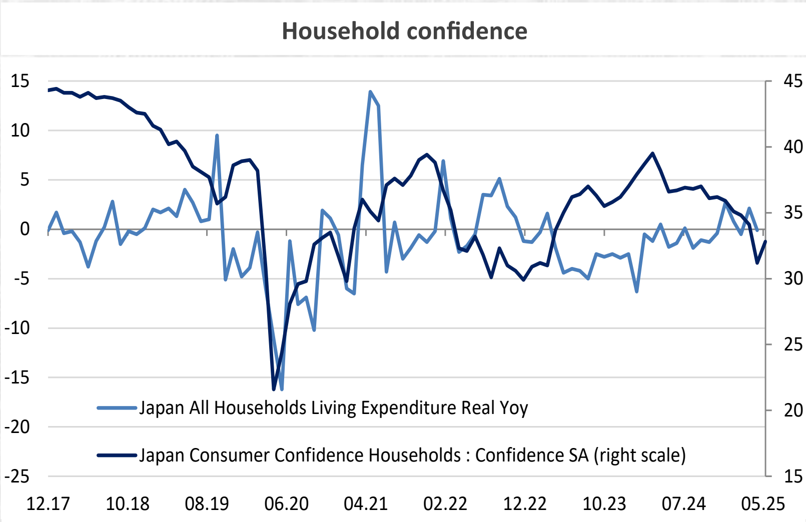
REDUCED OUTLOOK FOR JAPANESE ASSETS

Leading indicators suggest moderated growth

Leading indicators for the Japanese economy in Q2 2025 present a mixed and uneven picture, suggesting a moderate and uneven growth trajectory. The services sector is showing signs of resilience but with a notable slowdown in its expansion, while the manufacturing sector remains in contraction for the eleventh consecutive month. The composite PMI for May 2025 fell slightly to 50.2, indicating a moderation in overall private sector growth, with new orders continuing to show weakness due to the impact of US tariffs.

Fragile consumption and consumer caution

Household spending experienced an unexpected and pronounced decline of -1.8% month-on-month in April, highlighting the continued weakness of consumer demand. This significant drop, which was steeper than anticipated, underscores the fragility of consumption. Despite a slight rebound in the consumer confidence index in May, it remains at historically low levels, far below its long-term average. This persistent lack of confidence is a direct result of high inflation, which is eroding household purchasing power as nominal wages fail to keep pace with rising prices. The sustainability of any economic recovery hinges on a more robust and self-sustaining domestic demand, which is not yet in place, leaving the economy susceptible to further shocks.



Sources : Bloomberg, BBGI Group

Inflation remains above target

Inflation in Japan continues to hover above the Bank of Japan's (BoJ) 2% target, driven by persistent price pressures. The Tokyo CPI, a key leading indicator, showed core inflation accelerating to 3.6% in May, exceeding market expectations. While the BoJ has slightly lowered its inflation forecast for the fiscal year, it acknowledges the difficulty of achieving stable, sustainable inflation with external uncertainties like tariffs and internal challenges.

The bank of Japan's policy dilemma

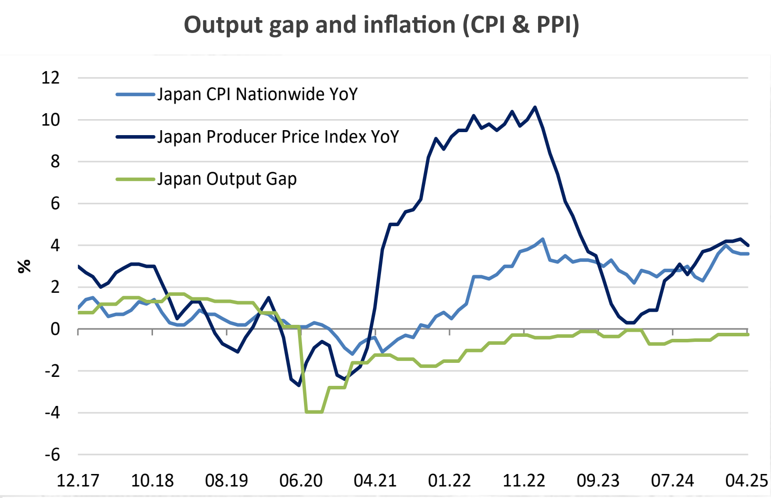
The BoJ faces a delicate transition, balancing two competing priorities: achieving sustainable inflation and supporting a fragile economic recovery. Despite core CPI remaining above the 2% target, the bank has lowered both its inflation and GDP growth forecasts. This has made a rate hike less likely in 2025, potentially pushing the next adjustment to early 2026. The BoJ must choose between an ultra-accommodative policy to stimulate growth or an adjustment to counter inflation, which risks an economic slowdown.

Revised economic forecasts reflect uncertainty

The BoJ has revised its core inflation forecast down to 2.2% (from 2.4%) and its GDP growth forecast to +0.5% (from +1.1%) for fiscal year 2025. These significant revisions reflect the bank's acknowledgement of increasing risks, particularly from global trade tensions and the fragility of domestic demand. The BoJ now expects inflation to move closer to its 2% target only toward the end of its forecast period, relying on a future easing of import and food prices to help this trajectory.

A cautious and vulnerable outlook

The Japanese economy's path to recovery remains cautious and highly vulnerable. While some leading indicators show tentative signs of improvement, the overall picture is one of persistent challenges, including weak consumer demand and a struggling manufacturing sector. The sustainability of this recovery depends on a fundamental and sustained improvement in household purchasing power and a more stable global economic environment. With external factors like trade tensions and domestic structural issues, a strong, self-sustaining recovery is not a foregone conclusion. The central bank's cautious stance and the delayed prospect of a rate hike underscore the delicate transition phase the economy is in, as it seeks to consolidate inflation without jeopardizing fragile growth momentum.



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