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ECONOMIC RESEARCH – NOVEMBER 2025

INVESTMENT INSIGHT JAPAN

- ✓ **Exports stall, GDP falls by -0.4% in Q3**
- ✓ **Possible GDP recovery in Q4, but on a knife edge**

STAGFLATION RESHUFFLES THE DECKS FOR JAPANESE ASSETS

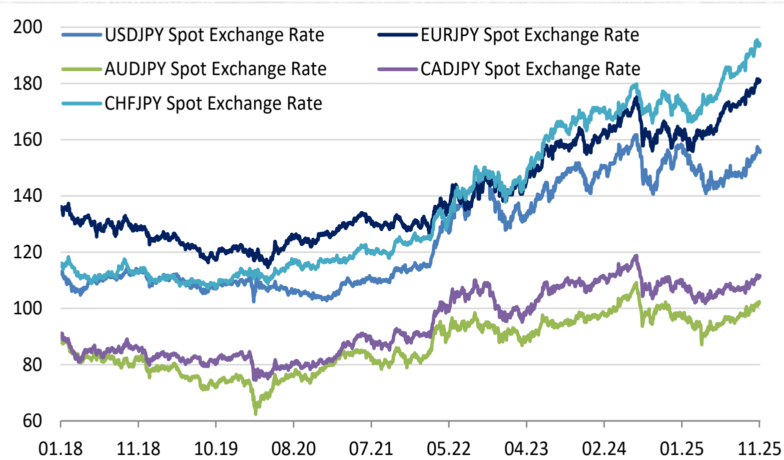
JGB market stress the inflationary decoupling

The Japanese Government Bond (JGB) market is currently undergoing a severe stress test. Yields have decoupled from negative Q3 growth fundamentals, reacting almost entirely to the shock October 3.0% inflation print. The 10-year yield has surged to a new baseline of 1.8%, indicating investors now demand a significantly higher risk premium to compensate for monetary erosion. The market is aggressively pricing in a Bank of Japan (BoJ) response to persistent core inflation.

Bond outlook asymmetrical risk and capital erosion

Our yield forecasts have been revised upwards, as the previous target range for early 2026 has already been breached. We now anticipate the 10-year JGB yield could test the 2.0% threshold in Q1 2026 if the exchange rate fails to stabilize. In this environment, the asset class offers a highly unfavorable risk/reward profile. The current coupon is insufficient to offset the capital loss caused by rising yields, guaranteeing negative total performance. For foreign investors, the spread against US Treasuries or German Bunds remains too narrow to justify exposure to a market caught between recessionary forces and rising prices.

Yen exchange rate against major currencies



Sources : Bloomberg, BBGI Group

Yen dynamics the trap of negative real yields

The Japanese Yen (JPY) remains trapped in a toxic valuation environment, squeezed between a faltering real economy and rampant inflation. Despite the BoJ's move to positive rates (0.50%), the real yield remains deeply negative at approximately -2.5%, severely penalizing cash holdings in Yen. Institutional investors continue to favor the carry trade, selling Yen for USD or EUR to capture positive real returns abroad. The Q3 GDP contraction has reinforced market sentiment that the BoJ lacks the maneuvering room to hike rates fast enough to close this gap, triggering renewed structural selling pressure.

Currency outlook trade deficits and policy thresholds

Beyond interest rate differentials, the Yen is weighed down by a chronic trade deficit and declining exports, forcing a continuous selling of the domestic currency for settlement purposes. We assess that depreciation factors will remain dominant until the BoJ can raise key rates above the 1% threshold. A reversal in the Yen's fortune is unlikely without an aggressive rate cutting cycle from the US Federal Reserve to narrow the differential automatically. Until this macroeconomic pivot occurs, the currency will remain under sustained pressure.

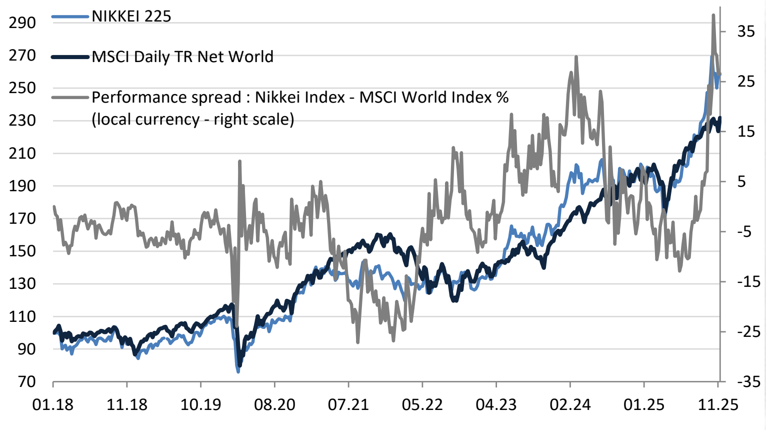
Equity market paradigm the "Bad Yen" shift

The Nikkei has moved past its "goldilocks" inflection point. The historical correlation where a weak Yen automatically boosted the index has fractured; we are now witnessing "cost-push" dynamics where currency weakness increases import costs for the broader economy rather than just boosting exporter margins. With real wages negative and consumption sluggish, companies relying on domestic demand have lost their catalyst and lack pricing power—price hikes are now resulting in lower volume rather than higher margins. The market is repricing for stagflation, leading to a compression of the PE ratio to 22x.

Strategic allocation selectivity and governance alpha

While the Nikkei appears superficially attractive relative to the S&P 500, the discount reflects deteriorating growth prospects. We forecast a lower trading range of 45,000–50,000 points and advise a shift in strategy. Investors should underweight cyclical and purely domestic stocks that are vulnerable to input cost inflation. Instead, allocation should focus on sectors capable of passing on inflation—specifically Banks and Insurance (benefiting from higher long-term yields)—and global exporters with technological moats (Semiconductors, Robotics). Additionally, the structural theme of governance reform (share buybacks, ROE improvement) remains a critical source of alpha in a volatile market.

Nikkei and MSCI World indices



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