Sumitomo Mitsui DS Asset Management

Back in the mix in ‘26

Opportunities and risks for Takaichi’s Japan

Japan Outlook - January 2026

For Professional, Institutional, and Accredited Investors Only

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1. Executive summary

Economic recovery set to strengthen

- The economic recovery already underway is likely to deepen and broaden over 2026.
- The three key drivers of this will be Prime Minister Sanae Takaichi's reform agenda, further monetary normalization, and easing trade tensions.
- With the near-term recession risk from US trade policy having receded, we expect Japan's exporters to be facing a significantly better environment in 2026 than they have this past year.

Strong tailwinds for Japan's equity market

- We expect Japanese equities to maintain their upward momentum into 2026.
- Despite the market having set new all-time highs in 2025, the arrival of a clear-cut political catalyst puts Japan in an almost unique position among the developed economies.
- Building on the previous successes of her mentor and former Prime Minister, Shinzo Abe, Takaichi has been unambiguous about her commitment to the project of national economic renewal and substantial fiscal stimulus measures have already been unveiled.

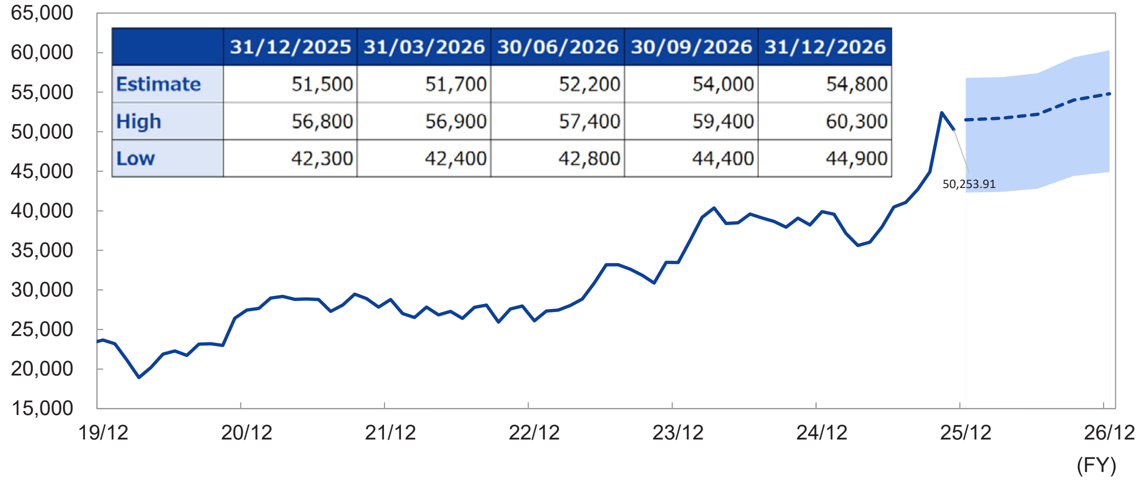
Key risks for the year ahead

- A non-trivial upside risk exists that Takaichi's policy momentum attracts substantial foreign inflows and leads to the market overheating.
- On the other side, a key downside risk we see is that sharp yen gains could occur and stymie the exporting companies that often drive broad market gains.
- Lastly, the radicalism of the Takaichi's policy agenda brings with it an elevated level of risk of governmental policy failure.

SMDAM's core thesis for Japan in 2026

In 2026 the Japanese market re-rates to a higher valuation multiple driven by the multiple catalysts outlined in this report, most centrally the reform agenda of the new Prime Minister. This will result in a narrowing but not full closing of the valuation gap with the US and other developed markets and will see the Japanese market achieving new all-time highs. Whilst downside risks around trade tensions, the inflationary path, and heightened risk of policy failure may create some short-term volatility, on balance we see significantly more upside potential and opportunities than risks for 2026.

Figure 1: Nikkei 225 Forecast



	31/12/2025	31/03/2026	30/06/2026	30/09/2026	31/12/2026
Estimate	51,500	51,700	52,200	54,000	54,800
High	56,800	56,900	57,400	59,400	60,300
Low	42,300	42,400	42,800	44,400	44,900

Data is from December 2019 to December 2026. Data after November 2025 is our forecast.
Note: The forecasts are as of November 19th 2025. (Source) Bloomberg, SMDAM

2. Back to the future – the traditional case for Japan

"The test of success is not what you do when you are on top.
Success is how high you bounce when you hit the bottom."

— George S. Patton Jr.

The words of US General Patton, who commanded Allied forces in Europe in WWII, are peculiarly appropriate to the Japanese equity market. Having bounced now so substantially off the lows the market reached in the aftermath of the crisis of the late 1980s, the open question today is a much more positive one: how high can the market go?

Just over one year ago, the Nikkei 225 index of leading Japanese companies achieved something simultaneously remarkable and yet also inevitable. The index, which had previously peaked in December 1989, surpassed this level to reach a new all-time high. The inevitability with hindsight comes from the fact that the index had in fact been making steady progress since 2014, and the return of Japan's equity market was always likely to be a matter of 'when' rather than 'if'.

As a specialist provider of investment strategies by which global investors can access this unique national market, SMDAM have the privilege of analysing this transformation and translating it into opportunities for allocators outside Japan.

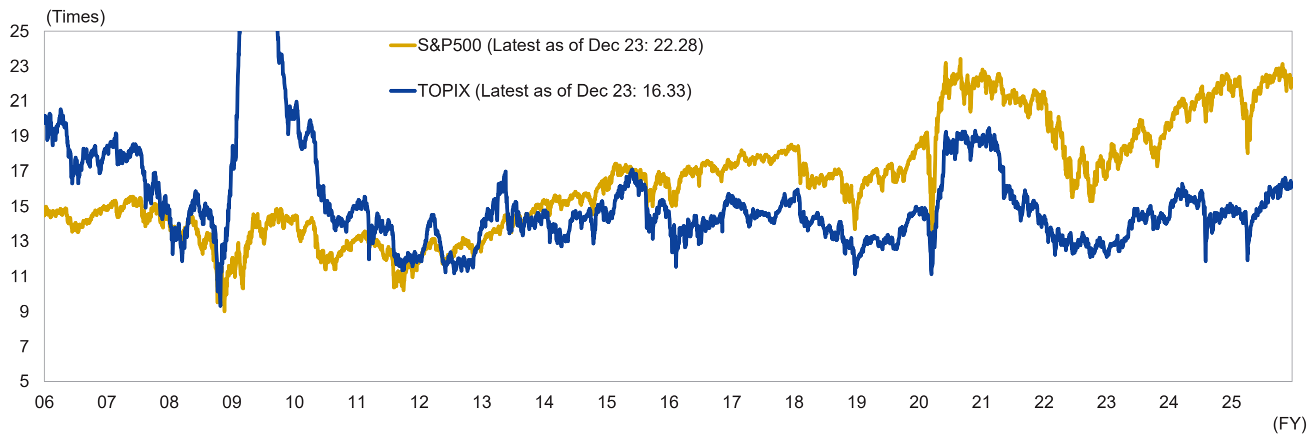
In this whitepaper we summarise our views of why the Japanese market is poised for success in 2026, and beyond.

There has been a case for investing in Japan which took shape in the so-called 'lost decades' of low growth after the bubble of the late 1980s deflated. This case may be known already to readers, but the confluence of this traditional case in favour of Japan with the line-up of multiple catalysts that could spark a re-energised dynamism in 2026 is unique.

Japanese equities are under-valued relative to other developed markets

As shown in the chart below, the Japanese market has spent the past decades trading on relatively low valuations. Low valuations in themselves may not be interesting, but low valuation plus a meaningful catalyst are. This value gap is especially true in relation to the US market, but the same comparative disadvantage appears in relation to UK and European markets as well.

Figure 2: S&P 500 and TOPIX 12-Month Forward P/E Ratio



Note: Data as of 31 Oct 2025
Source: SMDAM and Bloomberg

The two key causes of this trend can be summarised as below:

1. Too much cash on balance sheets

As an understandable but suboptimal response to the crisis of the early 1990s, Japanese corporates have displayed a long-term preference for hoarding cash on their balance sheets to provide a buffer against downturns. This tendency has always been viewed negatively by investors who much prefer to see excess cash being put to work, either via increased capital investment or simply being returned to shareholders via dividends or buybacks. As will be returned to below, there is growing evidence that this characteristic and the drag on valuations it created has been significantly eroded.

2. No focus on shareholder value

With corporate priorities tending to favour keeping all stakeholders happy at the cost of business performance, investors have grown tired of seeing undervalued Japanese companies stubbornly remain undervalued over time. Today, there is a widespread consensus that Japan suffered greatly from the lack of emphasis on shareholder value to serve as a 'north star' towards which corporate decision-making could set its course. As above, this has changed dramatically.

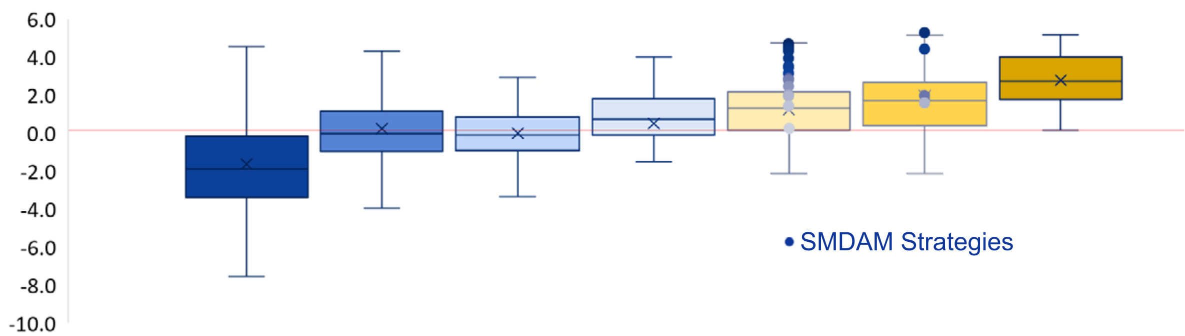
Under-researched

With a total listed universe of nearly 4,000 companies, Japan's public equity markets abound with opportunities.

However, a logical consequence of this is that both buy- and sell-side coverage remains patchy. This means that numerous attractive opportunities exist where active management can uncover specific stocks well in advance of the wider market registering the positive case. This gives active managers in Japan a structural advantage over their peers in other developed markets who must fish in a relatively smaller pond and therefore find it much harder to beat the market consensus.

As the graphic below shows, average excess returns for managers in the Japanese market have been considerably better than those of managers focused on the US or European markets. This feature of the market means that with overall performance in Japan set to continue to improve in 2026, active stock pickers will benefit from a further tailwind.

Figure 3: Average Excess Return Comparison (2015/7–2025/6)



	U.S. All Cap (258)	U.S. Small (485)	Europe All Cap (88)	Europe Small (29)	Japan All Cap (164)	Japan Small (45)	SMDAM Japan (20)
Excess Return (Universe Median)	-1.89%	-0.03%	-0.10%	0.74%	1.30%	1.69%	2.71%
% of Products with a Positive Excess Return	22.10%	49.30%	47.70%	72.40%	77.40%	84.40%	100.00%

Source: eVestment, data for the period from July 2015 to June 2025
Universe: eVestment Universe (MSCI relevant benchmark for all comparison)

3. This time is different (really!)

" More money has been lost because of four words than at the point of a gun. Those words are 'This time is different.' "

— Carmen M. Reinhart and Kenneth Rogoff,
This Time Is Different: Eight Centuries of Financial Folly

The case for the Japanese market and its latent value outlined above is not new. What is new is the convergence of multiple catalysts for this value to be unlocked. Whilst we are cautious about the risks that temper the opportunities, on balance we see conditions in Japan today as uniquely positive for supporting strong equity market returns in 2026. The arrival of the new Prime Minister, Sanae Takaichi is clearly the most material change to affect the market and its outlook, but crucially this development is additive to several other positive developments in recent years. The combination of the below factors could make 2026 an extremely strong year for the Japanese market, even in the context of 2025's success.

The Japanese cabinet has already approved the first economic stimulus package, valued at approximately 21.3 trillion yen, and more – much more – is expected to follow. Other welcomed policy initiatives are focused on moderating the rate of price increases, and launching a program of national renewal centred on upgrading infrastructure, channelling investment into strategic technologies, and rebuilding defence capabilities. A key risk of this agenda is that inflation spikes, but our current modelling projects inflation to hold steady at circa 2% in 2026. If this delicate balancing act between spending and inflation can be accomplished then monetary and fiscal policy will both have room to support growth and rising earnings for Japanese corporates.

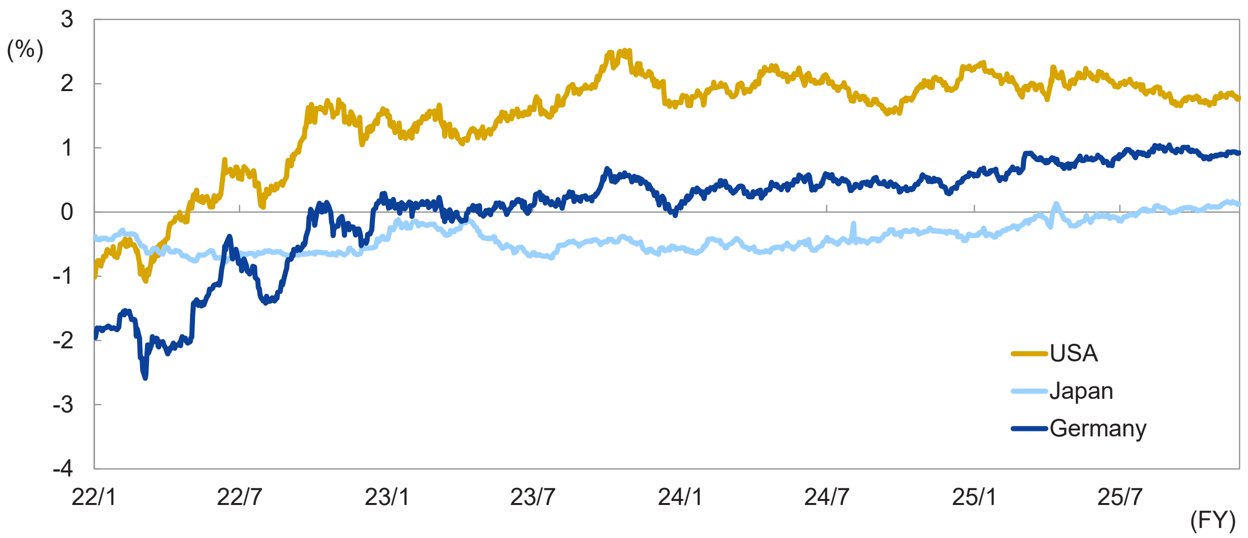
Japanese equities are under-valued relative to other developed markets

Under Shinzo Abe the Japanese economy made undoubted progress. The election of his protégé, Sanae Takaichi has therefore come with very high expectations. Whilst this might suggest she and her team will find it difficult to live up to their billing, so far this has emphatically not been the case. The policy reforms announced so far amount to a fundamental reorientation of the fiscal stance of the Japanese government – our forecast is that her agenda represents the ultimate catalyst for the Japanese market to go on to hit new all-time highs in 2026.

Importantly, Takaichi and her cabinet are starting the new year with very high approval ratings, with various polls putting her and her team on over 70% approval ratings. This means she has the legitimacy and popular support to get her agenda moving quickly.

As the chart below highlights, despite the rise in yields recently, real 10-year government bond yields in Japan are still noticeably below those of other Western governments, and in fact have only just remerged into positive territory. As such, our view is that Japan's fiscal situation is stable enough to provide room for fiscal stimulus without endangering debt sustainability.

Figure 4: Comparison of 10 Year Real Government Bond Yield



Note: Data is from 3rd January 2022 to 28th November 2025.
Source: Bloomberg

This extreme willingness to put the fiscal firepower of the state to work reinvigorating the economy makes Takaichi's regime stand out from her predecessors and means this time really is different to past muted revivals of the Japanese market. At SMDAM, we see her arrival on the Japanese political scene as the latest piece of the puzzle to fall into place – the image that's now fully revealed is one of an economy with tremendous residual strengths and all the latent potential of a coiled spring.

Monetary normalisation

Importantly, unlike her predecessors who may have wanted to commence pro-active fiscal policy but were unable to do so due to the absence of suitable conditions, Takaichi has entered office with a supremely supportive backdrop.

The conjunction of these three indicators symbolises the ideal macroeconomic environment for Japan to continue to grow in 2026, and when achieved would signify the normalisation process has been essentially completed.

This context has created the pre-conditions for rational decision-making at the microeconomic level by consumers and firms which will drive the Japanese economy moving forwards in 2026.

SMDAM's economists see the Japanese economy as now firmly rooted on a path towards what we term as '1, 2, 3 normalisation', by which we mean 3% wage increases taking place in parallel with 2% price inflation and 1% productivity growth. The conjunction of these three indicators symbolises the ideal macroeconomic environment for Japan to continue to grow in 2026, and when achieved would signify the normalisation process has been essentially completed.

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Return of inflation

Connected to the above, inflation has returned to the Japanese economy which has now seen over 36 consecutive months of price rises. The rekindling of some moderate upwards price pressure is a welcome development for several reasons:

1. During the deflationary decades, consumers responded to falling prices by withholding or postponing purchases. This progressively sucked demand out of the market, leaving Japanese companies without the headwinds provided by domestic consumer demand their foreign competitors could harness.

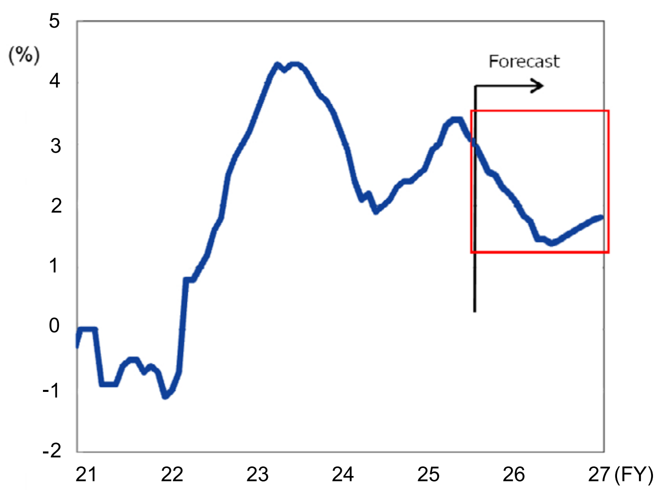
2. Secondly, the lack of inflation meant the time-value of money created perverse incentives. With prices gently falling, the purchasing power of a single unit of currency effectively rose over time, therefore creating a powerful incentive to save rather than spend, again choking off the demand businesses need to see before they will invest.

The relative improvement in Japanese CPI over the past few years is shown in the chart below – our expectation is that it will settle in early 2026 at the 2% level.

Crucially, although the depreciation of the yen caused by comparatively low rates has meant import prices have risen, the major cause of the uptick in inflation appears to have been rising wages.

This is positive for the macroeconomic outlook as it means the long-awaited virtuous cycle of higher wages feeding into higher prices driving corporate earnings growth, which in turn means employers can accommodate higher wage demands from staff, is beginning to become anchored in firms and consumers' expectations about the future.

Figure 5: BOJ's Core CPI Forecast (YoY, %)

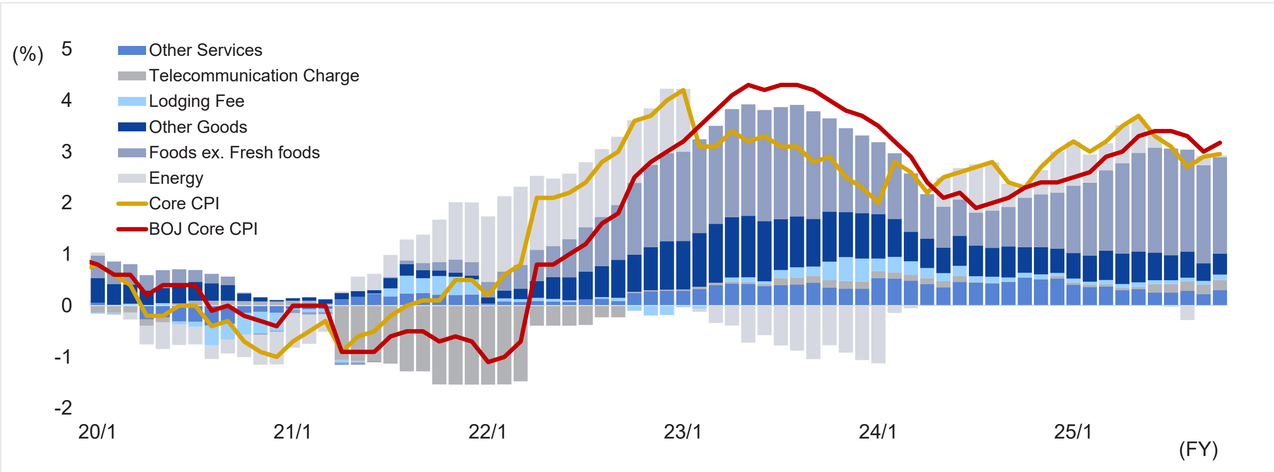


Note: Data is from January 2021 to March 2027. BOJ's Core CPI is excluding fresh foods & energy. Data from April 2025 is forecasts.
Source: Bank of Japan

However, we should also acknowledge that Japan's inflation rate over recent years has been disproportionately driven by food costs which are largely imported. As such, if trade disruptions persist then inflation could settle at a higher rate. However, as we discuss in the final section, currently we are optimistic about the prospects of Japan's trading situation avoiding further deterioration.

If our thesis is correct, the return of inflation means investors can expect Japan to follow a 'normal' pattern of development again, and crucially one which is highly supportive of rising equity valuations in 2026 and beyond.

Figure 6: Breakdown of Core CPI (YOY, %)



Note: Data is from January 2020 to October 2025. The Core CPI excludes the fresh foods. Special factors, such as the effects of free education and abolishing the provisional gasoline tax, are considered.
Source: MIAC, SMDAM,

Governance reforms

Having begun over a decade ago, these reforms are by now in one sense old news, and investors might be wary about accepting the validity of the claim that they are now moving the needle. However, the gradual but consistent accumulation of momentum for the reform agenda has today created a genuinely dynamic context in which Japanese companies are not only open to the prospect of change but are actively pursuing it. This is yet another way in which all the groundwork for the success of Takaichi's regime is already in place.

The key measures of the corporate governance reform agenda are as follows:

1. Listing and delisting trends

This is to ensure that only viable enterprises which act as responsible stewards of capital are admitted to the Tokyo Stock Exchange (TSE). Whilst the comparatively high number of listed entities is a boon to active managers, the stricter listing requirements are aimed at reducing the number of particularly small-cap stocks that list simply due to the prestige still associated with being a public company in Japan. In fact, as the chart below shows, delists are set to rise markedly as companies who have failed to create shareholder value leave the market.

Figure 7: New Listings and Delistings in Japan

Note: Data is from 3rd January 2022 to 28th November 2025.

Source: Bloomberg

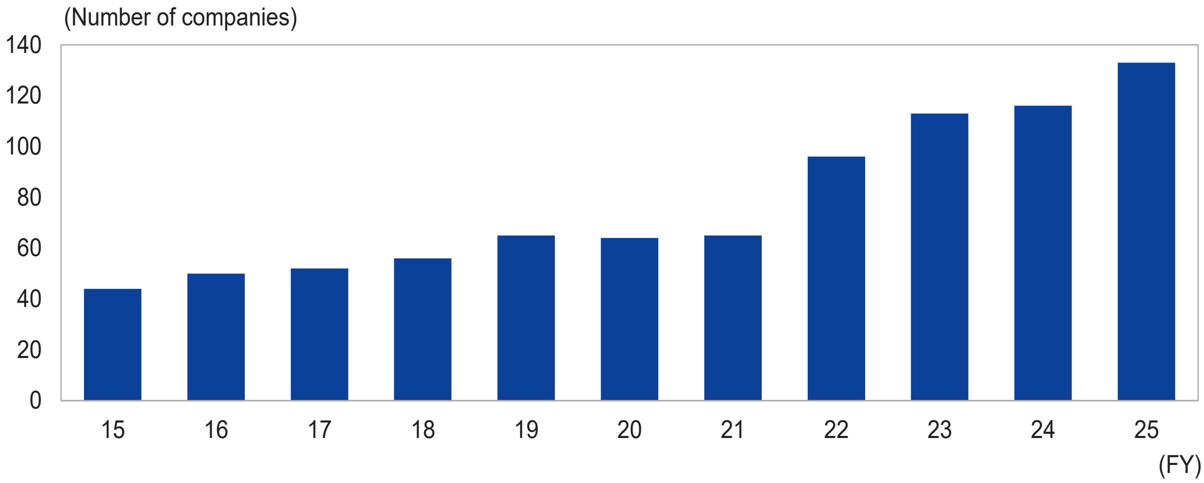
2. Expanded disclosure requirements

The TSE is further requiring all companies to publish their plans to improve capital efficiency. This allows investors to gain a much higher degree of transparency over what investment plans a company has, allowing greater discretion over where to place their capital. Whilst the headline emphasis has consistently been placed on raising P/B ratios over 1, in fact the focus is much broader and geared towards incentivising overall improvements in capital efficiency.

3. Changing attitudes to shareholder activism

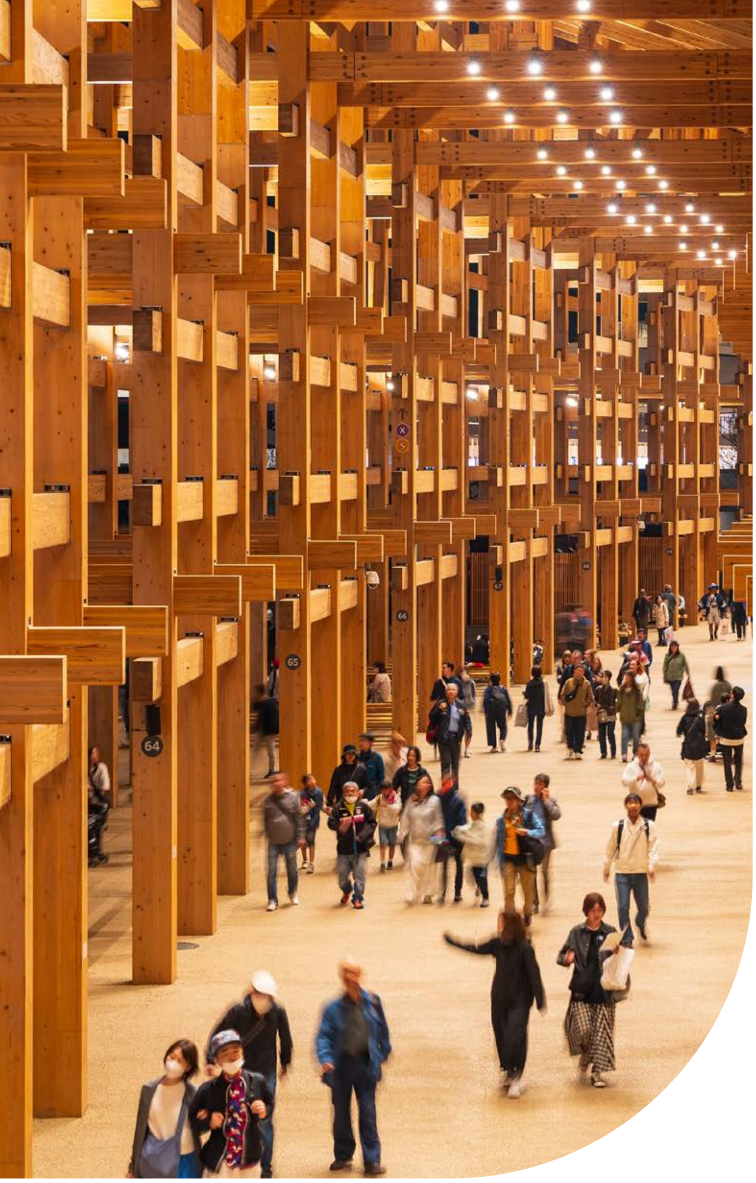
Related to the two measures above, the traditional disapproval towards activist shareholders has noticeably changed in the past few years. This has sparked a chain reaction in Japan whereby all shareholders have come to expect their voice to be heard by management, with overall positive results in terms of how accountable managers are. As the chart below shows, both the presence of activist funds and the quantity of proposals they are putting forward have risen dramatically in the past few years.

Figure 8: Number of Shareholders Proposals



Note: Data as of 31 Oct 2025

Source: SMDAM and Japan Institute of Business Law



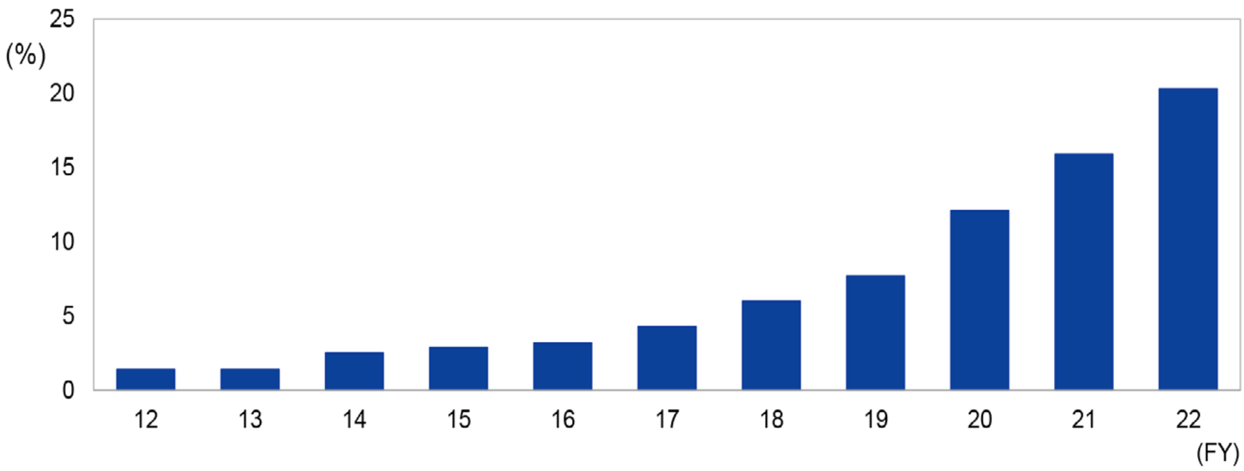
4. Utilise excess cash

Whilst many stakeholders can be agnostic with regards to precisely what cash is deployed to do, there is a widespread consensus that the cash needs to be put to work in some manner. This could be through share buybacks, raising dividends, capital investment, and perhaps even simply higher wages feeding into the general narrative of the virtuous cycle of rekindling inflation.

5. Independent directors and boardroom diversity

Long established as the norm in other developed markets, another key plank of the reform agenda is the rise in independent directors on boards. Now enshrined in Japan's Corporate Governance Code, this stipulates that companies listed on the Prime Market should appoint at least one-third of their directors as independent directors, while companies listed on other market segments should appoint at least two independent directors. The impetus this gives for company management to act as responsible stewards of shareholder capital was initially resisted but has become increasingly accepted as the years have gone by.

Figure 9: Percentage of Companies with a Majority of Independent Outside Directors



Note: Data as of 31 Oct 2025
Source: SMDAM and JPX

4. 12 charts for the next 12 months

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair.”

— Charles Dickens, A Tale of Two Cities

The celebrated opening lines from A Tale of Two Cities, Charles Dickens’ classic novel set in the aftermath of the French Revolution, come to mind when reflecting on global markets in 2025.

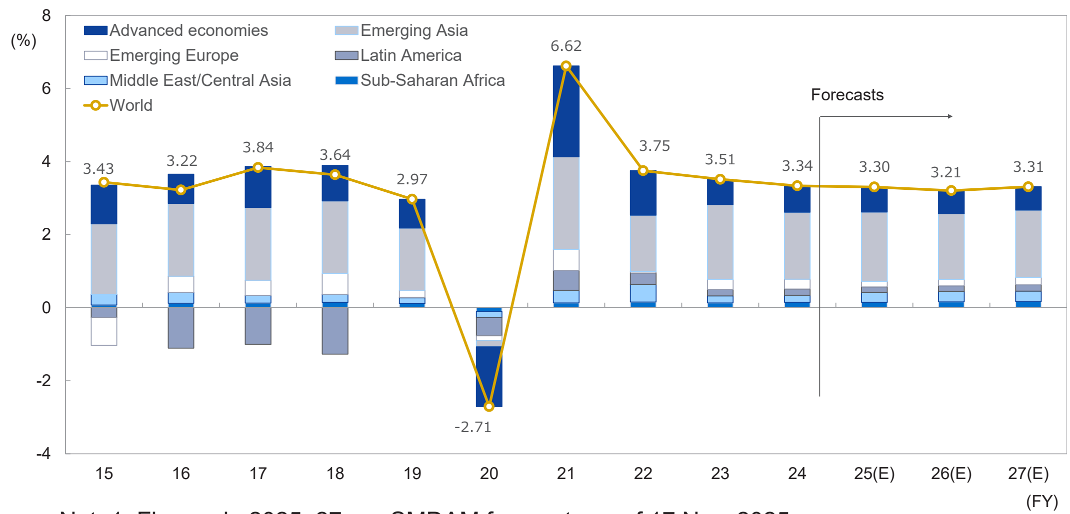
2025 saw a starkly contrasting mix of optimism and pessimism which will set the tone for 2026. The key emblem of optimism is AI and its incredible potential to drive growth and productivity over the coming decades. The continued presence of heightened geopolitical tensions, war, trade fragmentation, and ‘higher for longer’ inflation were the main sources of pessimism. Reading through from 2025 to 2026, this contradictory admixture of positive and negative trends will likely persist.

Here we end our outlook by summarising some of the key themes we expect to influence Japan in the coming 12 months.

Chart 1: Despite the noise, global growth is expected to continue

As the chart (Figure 10) below shows, SMDAM’s economists are forecasting global growth to be resilient even in the face of further potential disruptions akin to the past year. The persistence of slow and steady (if unremarkable) global growth creates a favourable environment for relatively open economies such as Japan, and reduces the risk that a global recession would represent.

Figure 10: World GDP Growth

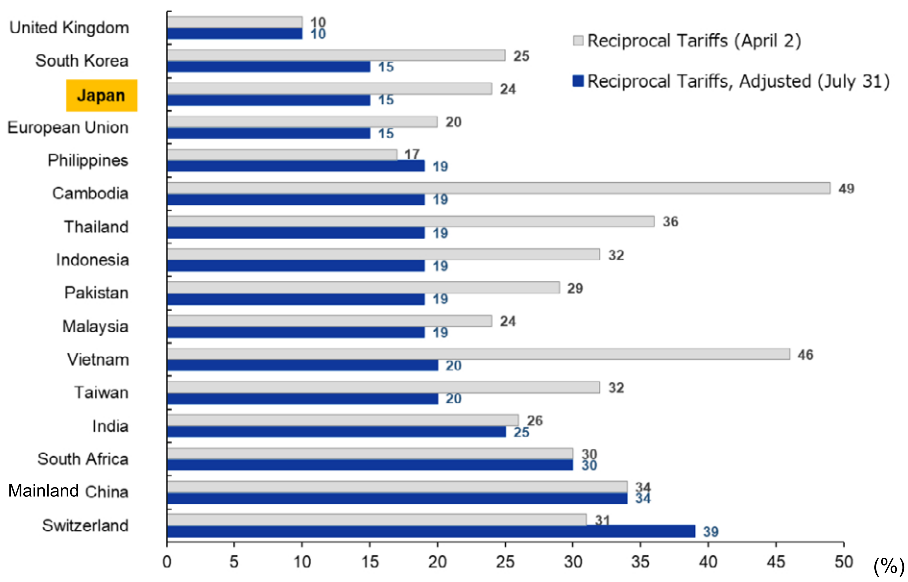


Note1: Figures in 2025–27 are SMDAM forecasts as of 17 Nov. 2025.
Note2: Regional classification is based on IMF.
Note3: World GDP growth is sum of regional contribution.
Source: IMF, Bloomberg, SMDAM estimates

Charts 2, 3 and 4: Japan’s exporters can live with the current level of trade disruption

As the chart (Figure 11) of comparative tariff rates below underlines, Japan’s treatment was not as bad as that of some US partners. Whilst this might sound like a relatively minor ‘win’ to be celebrating, the fact remains Japan’s highly resilient and often competitively insulated manufacturing companies can operate in this environment.

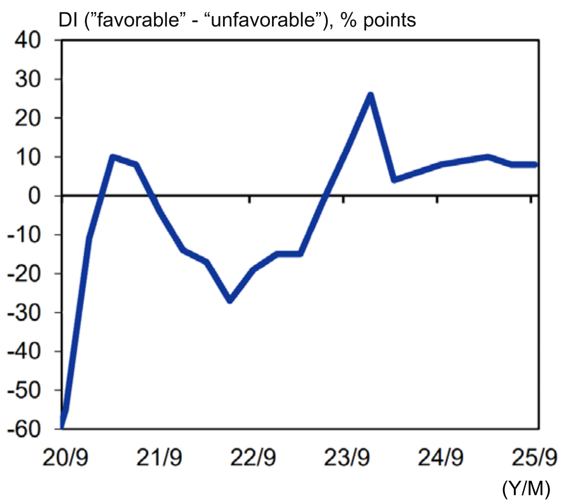
Figure 11: Reciprocal Tariff Rates for Major Countries & Regions



Note 1: The 34% tariff on imports from China has been temporarily suspended. A reduced tariff rate of 10% will remain in effect until November 10. Note 2: Under an Executive Order issued on September 4, reciprocal tariff rates on Japanese imports have been revised as follows: For goods with Most-Favored-Nation (MFN) rates above 15%, the reciprocal tariff is set at 0%. For goods with MFN rates below 15%, the reciprocal tariff is calculated as 15% minus the applicable MFN rate.
Note 3: Reciprocal tariff rates on European Union (EU) imports follow the same structure as those applied to Japanese imports, as outlined in Note 2. Note 4: Trans-shipped goods from third countries will be subject to a higher tariff rate of 40%.
Source: The White House; compiled by DIR. Data as at December 31, 2025.

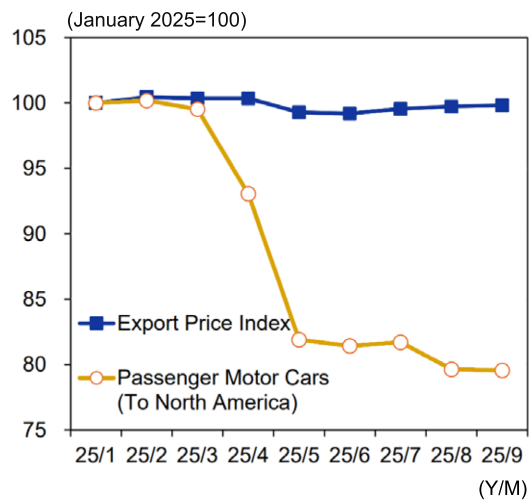
This thesis is supported by the evidence below showing that sentiment has remained net optimistic among Japan’s car manufacturers (Figure 12). As the second chart (Figure 13) on the right shows, interestingly they appear to have opted to react by lowering export prices rather than cutting volumes, suggesting a highly adaptive and pragmatic approach to the altered trading environment.

Figure 12: BOJ Tankan Survey Business Condition Diffusion Index (Motor Vehicles, All Enterprises)



Source: Bank of Japan, Compiled by DIR

Figure 13: Export Price to North America



Note: Based on contract currency. Indexed with January 2025 set as 100.
Source: Bank of Japan; Compiled by DIR.

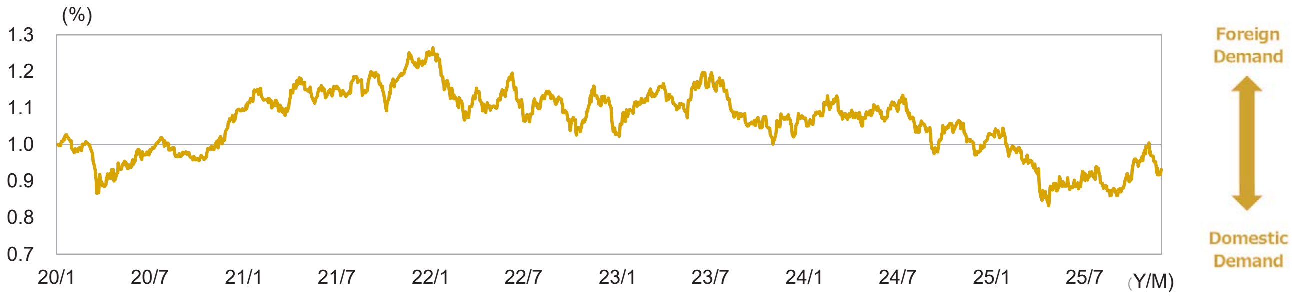
Chart 5: Japan is a value market, and that's ok!

Japan is and likely will remain a value market, or a blend market at most. Despite the 2020/2021 sojourn into growth territory shown in the chart below (Figure 14), the value factor has tended to outperform growth here, and we expect this to carry on into 2026. The fact that such a unique conglomeration of catalysts in the plural have now emerged gives us faith that the Japanese equity market will continue to perform in 2026, primarily by unlocking the currently unrecognized value available across the market cap spectrum (Figure 15).

Figure 14: Japanese Stocks: Value / Growth (Daily)

Note: Data as of 31 Oct 2025. Foreign/Domestic Demand represents Nikkei Global Exposure 50 vs Domestic.
Source: SMDAM and Bloomberg

Figure 15: Japanese Stocks: Foreign Demand / Domestic Demand (Daily)



Note: Data as of 31 Oct 2025. Value/Growth represents Russell Nomura Total Market Value Index vs Growth with Dividend.
Source: SMDAM and Bloomberg

Chart 6: Japan is increasingly less correlated to the US market

With many global investors concerned about the concentration risk represented by the major US indices today, it is highly noteworthy that correlation between US and Japanese stocks has been falling (Figure 16). Our view is that this is driven by the fact that Japan's economic cycle is 12-18 months behind the US. In Japan, the primary driver of equity market movements is the ongoing domestic demand recovery, and this stands in stark contrast to the US market's late-cycle dynamics.

Charts 7 and 8: Japanese corporates are becoming more like their US counterparts: Part 1

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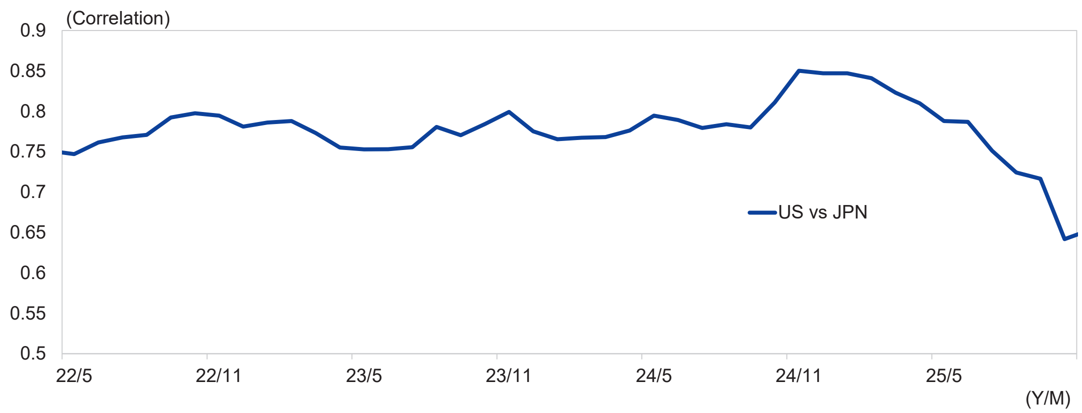
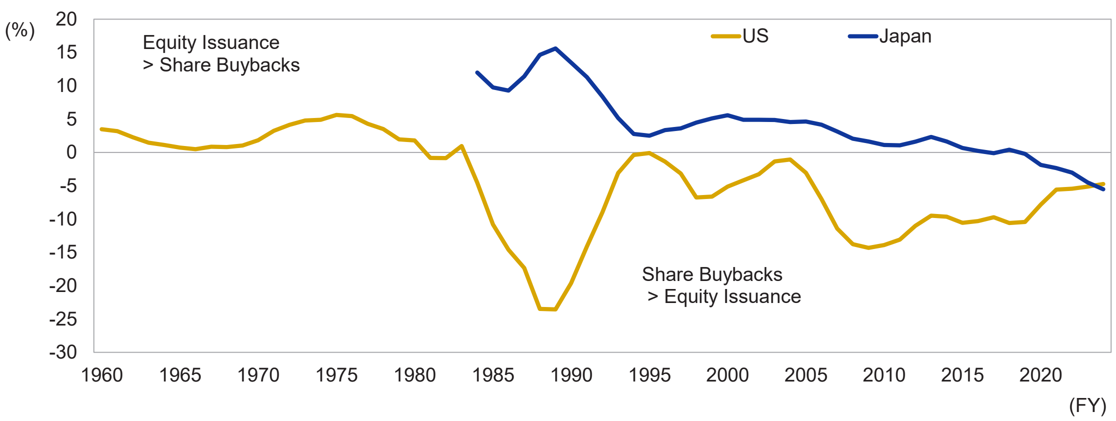
Figure 16: Rolling 3-year Correlation of MSCI Japan Vs MSCI USA (USD)



Source: Bloomberg, SMDAM as at 29 August 2025

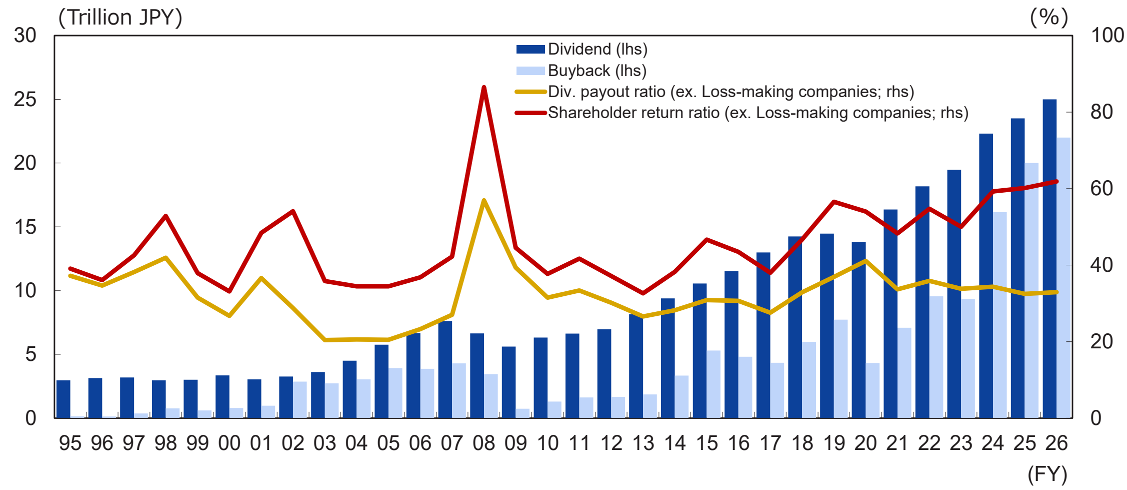
Figure 17: Net Equity Issuance in Japan and the US



Note: Data as of 31 Oct 2025. Net Equity Issuance / Market Cap (5Y MA)
Source: SMDAM, BoJ and FRB

As with any complicated issue, a case by case approach is probably best, but we can certainly point to the chart above and argue that increased buybacks in Japan are net accretive for investors. With new equity issuance falling and buybacks rising, earnings per share are increased and the risk of shareholders being diluted is reduced. As the chart (Figure 18) below shows, 2025 is on track to be a record-breaking year for buybacks and dividends as methods of returning cash to shareholders, and this follows on from an equally outstanding 2024 in this regard.

Figure 18: Shareholder Return Ratio, Div. Payout Ratio, Dividend Payment, & Share Buyback



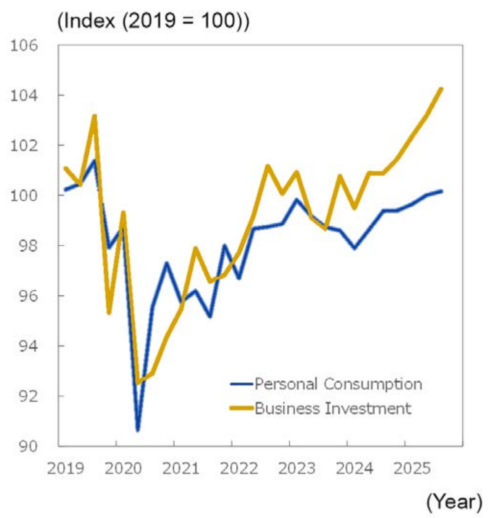
Note: Data is from FY1995 to FY2026. FY2025, FY2026 are forecasts by Daiwa Securities.
Source: Toyo Keizai, Quick, INDB, Daiwa Securities, SMDAM

The steady progress made in the Japanese market over the past decade is well demonstrated by the chart above, and our view is that rising share buybacks and dividends are set to continue into 2026.

Chart 9: Japanese corporates are becoming more like their US counterparts: Part 2

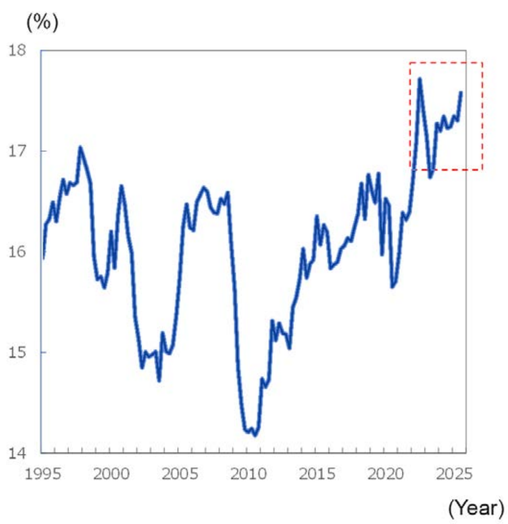
The persistent CAPEX gap between US and Japanese listed companies is showing noticeable signs of narrowing. The trend shown in the charts (Figure 19-A and 19-B) below suggests Japan is moving into an upswing phase of the capital investment cycle, with the potential result of enhanced medium- and long-term growth as a result. Crucially, this upswing is already underway precisely at the right time to capitalise on the more favourable environment engendered by Takaichi’s other reforms.

Figure 19-A: CAPEX is showing a strong recovery



Source: Cabinet Office, SMDAM.
Note. Data is from 1Q 2019 to 3Q 2025

Figure 19-B: CAPEX / Nominal GDP



Source: Cabinet Office, SMDAM.
Note. Data is from 1Q 2019 to 3Q 2025

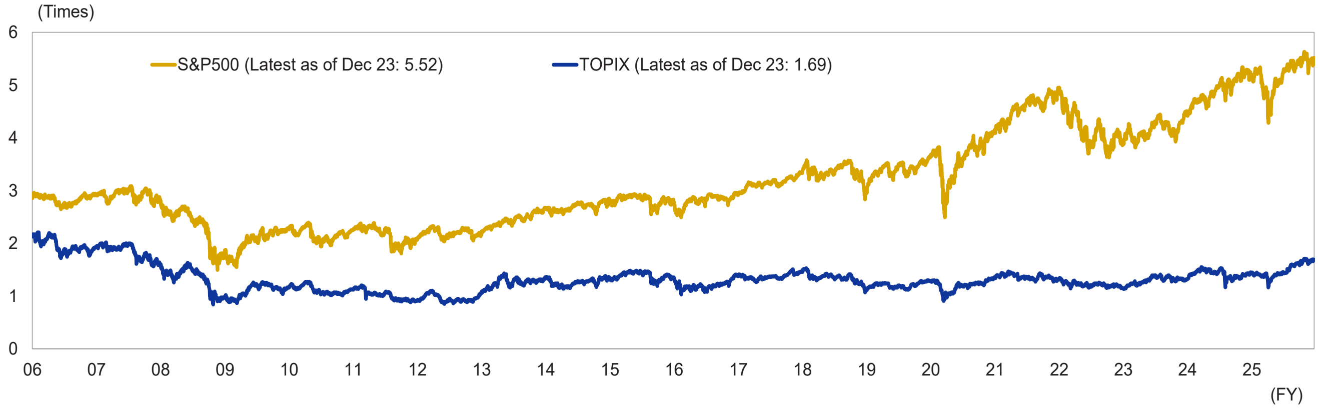
Charts 10 and 11: The Japanese market is still cheap

Despite the strong performance of the last few years, the ability of Japanese corporates to keep growing their earnings means the market is still relatively cheap. The Japanese market p/e ratio relative to the US has already been shown above, but here we see the same pattern is even more pronounced in terms of the p/b metric. As the chart (Figure 20) shows, valuations in the Japanese market are still heavily in investors favour – dramatically so when compared to the US. As can never be stated enough, buying a market on the kind of p/e valuations the US market has now reached (circa 22-23 times earnings) statistically speaking promises very poor returns over the next 10 year period (Figure 21).

Chart 12: Inappropriately low valuations are always corrected somehow

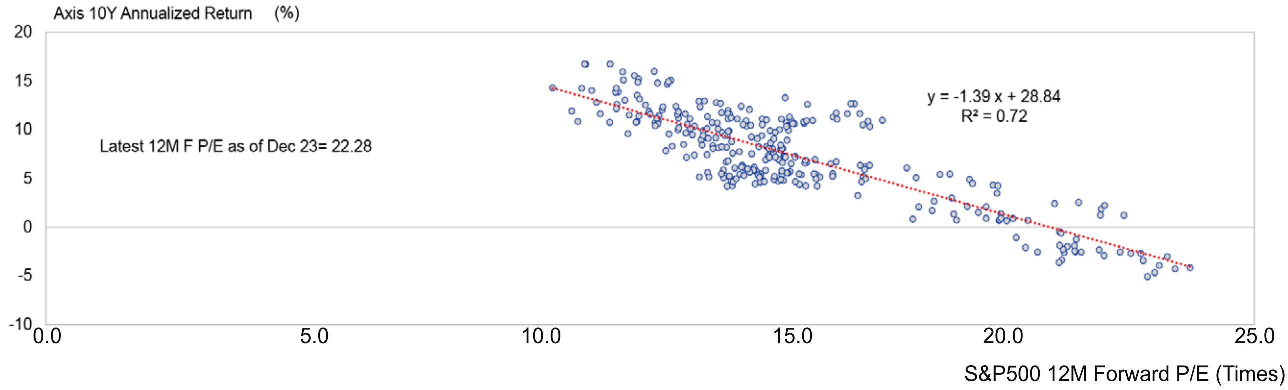
The number of takeover bids received for companies listed on the TSE has risen exponentially over the past few years (Figure 22). Whilst this is in itself not something to be celebrated, it does underline that other actors, principally private equity and strategic corporates, see value and expect corporate performance to continue to improve.

Figure 20: S&P 500 and TOPIX Historical P/B Ratio



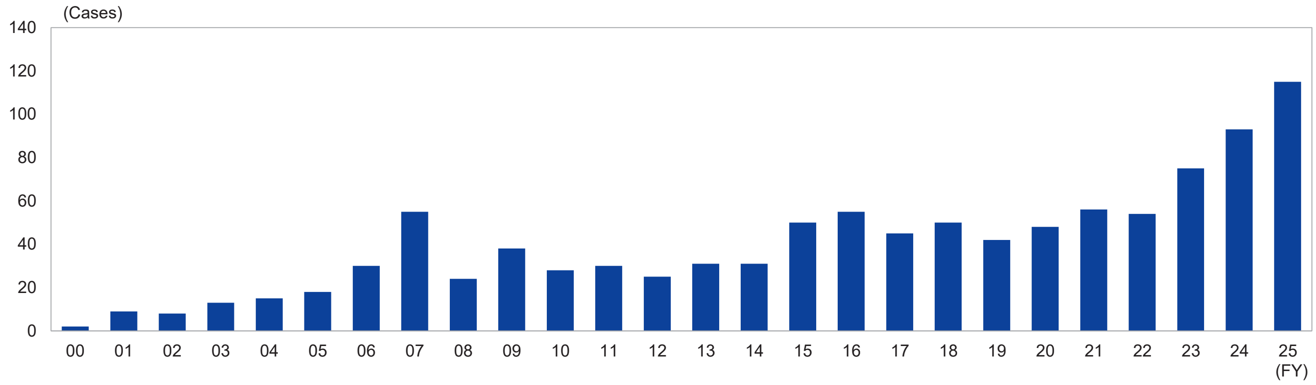
Note: S&P 500 and TOPIX Historical P/B Ratio
Source: SMDAM and Bloomberg, as at December 23, 2025

Figure 21: Rolling 3-year Correlation of MSCI Japan Vs MSCI USA (USD)



Note: Data as of 31 Oct 2025. Net Equity Issuance / Market Cap (5Y MA)
Source: SMDAM, BoJ and FRB

Figure 22: Number of TOBs (Cumulative Total from January to October Each Year)



Note: Data as of 31 Oct 2025. Universe: TSE Companies Listed
Source: SMDAM and Bloomberg

Sumitomo Mitsui DS Asset Management

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