Special Report

Japan Economy: Gradual Recovery Amid Global Headwinds

April 2025

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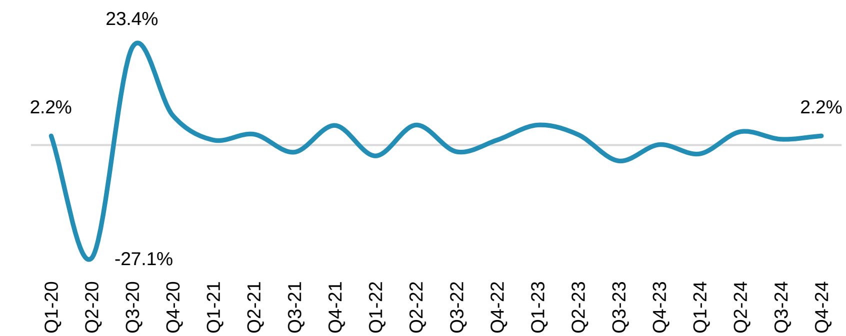
Commencement of economic recovery with moderating inflation, tightening labor market and diverging manufacturing PMI

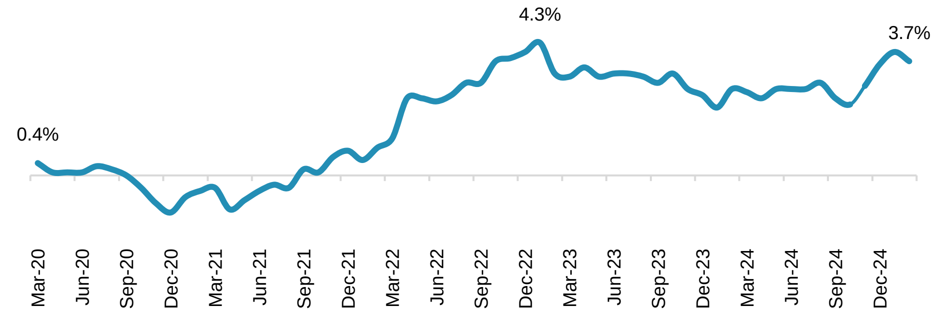
Q4 2024 is the third consecutive quarter wherein Japan reported a positive real GDP Q/Q growth on an annualized basis

Real GDP %



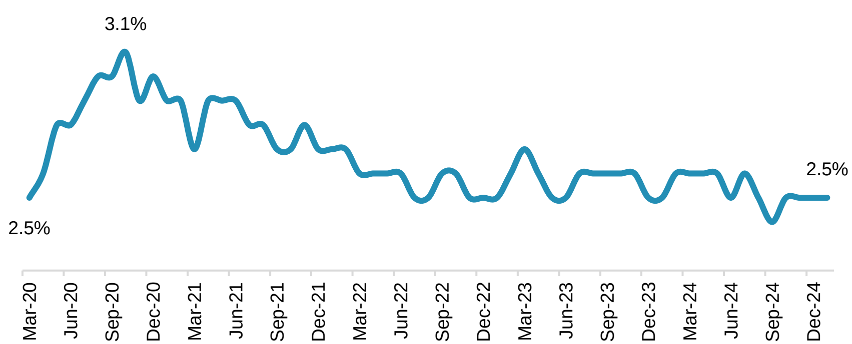
Japan's inflation climbed to a two-year high in January, thereby encouraging rate hike calls from Bank of Japan's members

Inflation



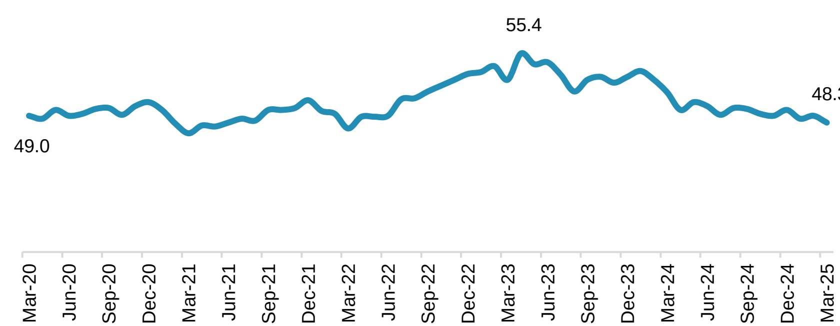
Japan's unemployment rate steadied at 2.5% for the fourth consecutive month in January, reflecting structural labor shortages.

Unemployment rate %



Japan's manufacturing activity remained below the threshold for nine consecutive months, reaching its lowest level in March since June 2021.

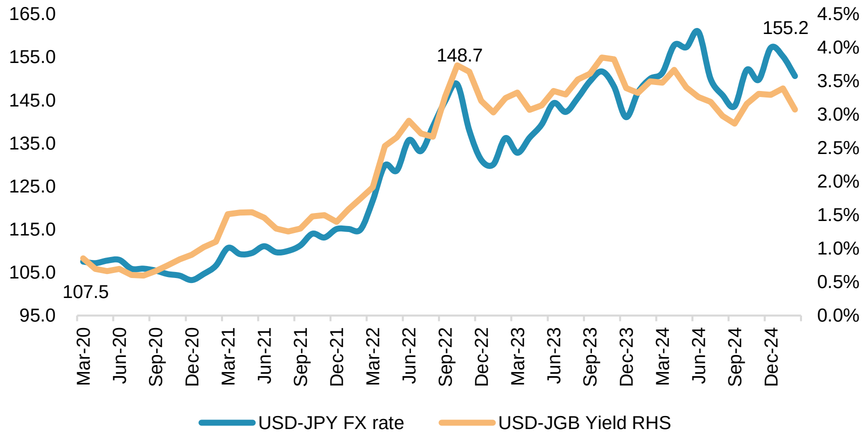
Manufacturing PMI



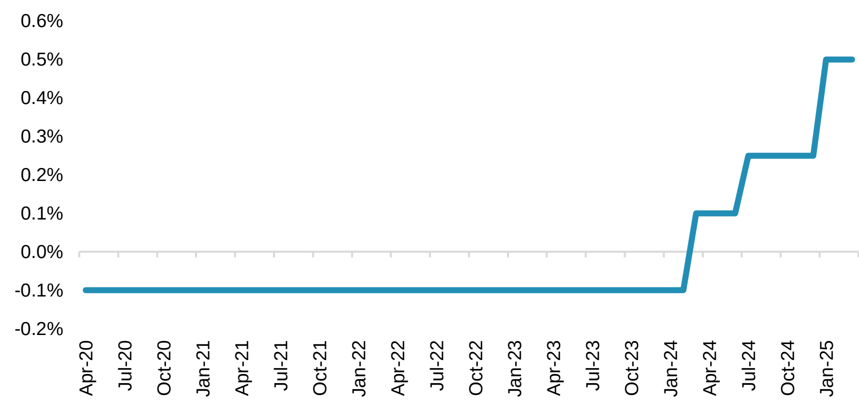
Source: *Government of Japan, Ycharts, Aranca Research*

Currency & Monetary Policy: Stabilization of yen with a gradual monetary tightening pathway

Successive rate hikes and rising expectations of further tightening helped the currency appreciate in the first two months of 2025, while Japan ended its negative interest rate era by hiking short-term interest rates for the third time since March 2024



Interest rates

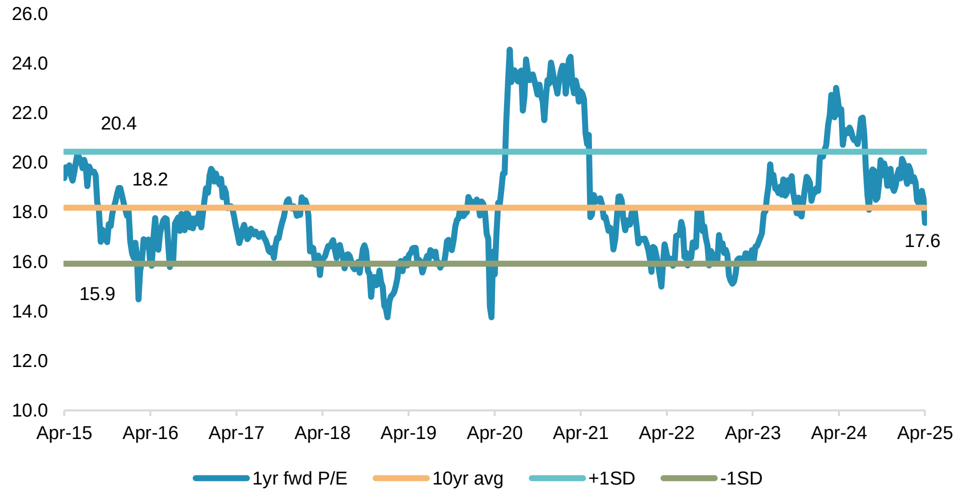


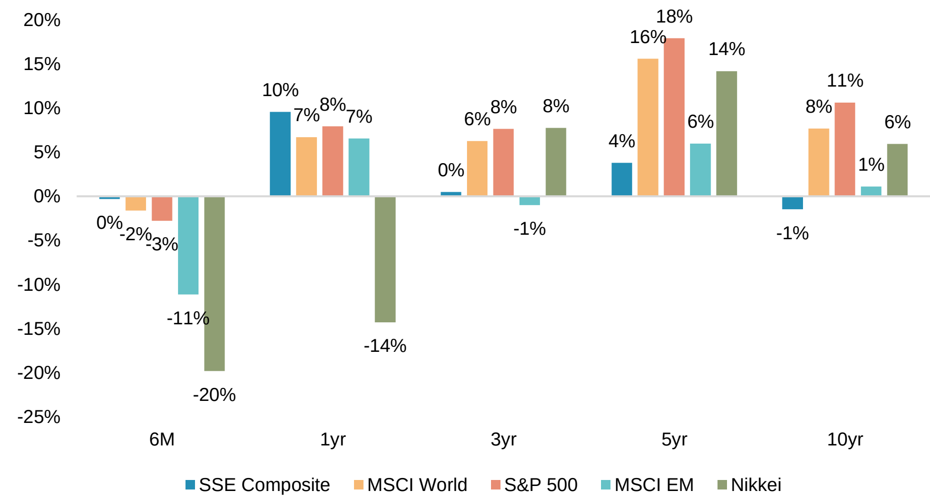
- The yen endured one of its weakest years in decades in 2024, with USD/JPY reaching a peak of 161.9 in July due to wide US-Japan rate differentials and the BoJ's initially dovish stance. However, successive BoJ rate hikes and rising expectations of further tightening helped the yen appreciate to around 150.6 by February 2025. Despite this modest recovery, yen's volatility remains elevated as the currency remains sensitive to US protectionist policies, BoJ rate decisions, and fluctuating global risk sentiment. Markets now expect the yen to remain rangebound at 145–155 in the near term, with further appreciation dependent on the BoJ's willingness to hike rates beyond 0.5% later in 2025.
- Japan's BoJ continued normalizing its monetary policy in early 2025, lifting its short-term rate by 25bps to 0.5% in January, which was the highest level in 17 years. This marked the third rate hike since March 2024, signaling the end of Japan's negative interest rate era. Hawkish voices within the BoJ are advocating for further hikes to 1% by late 2025 to manage current inflation risks. The BoJ's inflation forecast stands at 2.7% for FY 2024 and 2.4% for FY 2025, suggesting a gradual path to its 2% inflation target by FY 2026. The BoJ's bias toward further tightening will have implications for interest-sensitive sectors and yen-denominated assets throughout 2025.

Source: *YCharts, Aranca Research*

Equity: Navigating through external volatilities

Japan's equity index was hit the most compared to global indices, thereby moderating its rich valuations to a 3.4% discount to its 10yr average



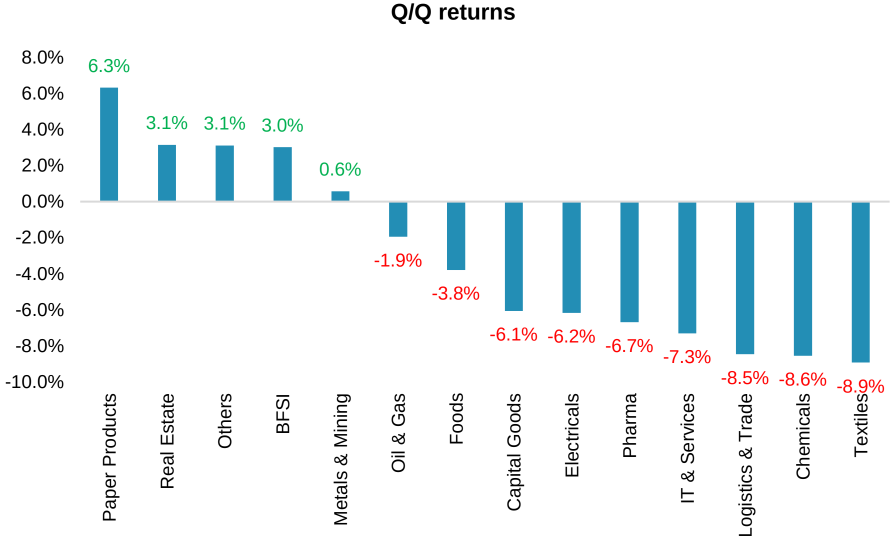


Over the last six months and one year, the Nikkei Index reported the highest fall among other indices, with 20% and 14% respective drawdowns. This was due to: i) US tariff threats, ii) tech sector slump, iii) recession fears, and iv) potential yen carry trade unwind. This drawdown has moderated Nikkei's valuations, which now trades at 17.6x 1yr forward P/E, implying a 3.4% discount to its 10yr average. In January 2025, Nikkei declined following Trump's inauguration due to renewed tariff risks. However, it rebounded by month-end, supported by domestic demand and gains in semiconductor stocks. February saw increased volatility as trade tensions intensified, prompting a rotation into domestic sectors and financials, which benefited from rising interest rate expectations. By March, the Nikkei stabilized as solid fundamentals—wage growth, governance reforms, and BoJ policy support — underpinned investor confidence, although external risks restricted gains.

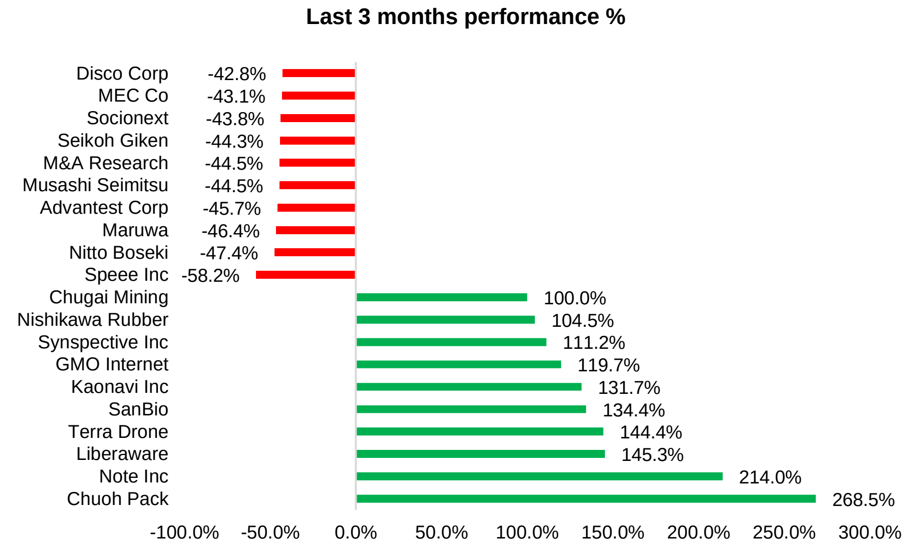
Source: *Bloomberg, Aranca Research*

Equity: Sectoral Performance

Nine out of 14 sectors declined Q/Q in Q1-25 with sharpest drawdowns in Textiles; Paper Products witnessed the highest returns



Propensity of the top gainers was significantly higher than the that of the top losers over the last three months

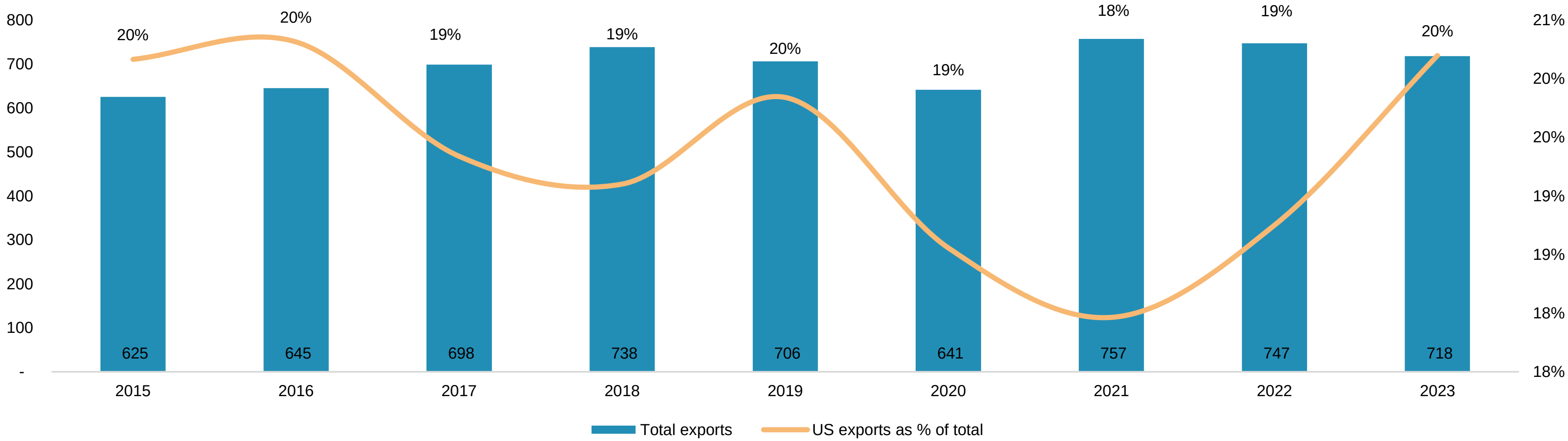


- Entering 2025, the index exhibited mixed performance amid geopolitical uncertainties. By March end, the JPX index was down 5.0% Q/Q. Out of the 14 sectors, five showcased positive performance. On the losing side of March's Q/Q leaderboard was Textiles, which fell 8.9% Q/Q, followed by Chemicals (down 8.6% Q/Q).
- For the last three months, Chuoh Pack remained at the top within Japan's equities universe with a 268.5% gain; followed by Note Inc (up 214.0%). However, Speee Inc and Nitto Boseki dropped the most, with 58.2% and 47.4% drawdowns, respectively.

Source: *JPX, Koyfin, Aranca Research*

Will Japan's economy witness fisherman's benefit under Trump 2.0 administration?

Japan needs to reduce dependency on the USA, which accounts for 20% of its total exports; Japan may benefit by capturing substitute demand through fisherman's benefit with tariff impositions by the US



- The US administration's 10% tariff on China and potential 25% tariffs on Mexico and Canada could negatively impact Japan's economy by slowing global trade. In addition to imposing a blanket 10% tariff on each country, 24% tariff is levied on Japan. However, as affected countries lose price competitiveness, Japan may benefit by capturing substitute demand —a phenomenon known as "Fisherman's Benefit".
- Under Trump 2.0 administration, broader tariff measures could further strain Japan's economy, targeting nearly all products and extending beyond China. However, Japan's exports, particularly in comparison to those of Korea and Germany, remain competitive. If tariffs are imposed on a wide range of products and countries, Japan's relative export advantage may partially offset the negative impact.

Source: *Trendeconomy, Trading Economics, Aranca Research*

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