Sumitomo Mitsui DS Asset Management

Is discretion still the better part of valour?

Japan Market Insights - August 2025

Japan Equity Research Team
SMD-AM

We are one of the largest investment management companies in Japan, offering discretionary investment management, investment trusts and advisory services to a range of institutional investors, pension funds, government agencies and retail investors worldwide.

Highlights:

- Despite the failure to negotiate away all US tariffs, the market welcomed the US-Japan trade agreement and the reduction in uncertainty.
- Expectations remain high that Prime Minister Ishiba could resign in August, and that this would foreshadow the introduction of a more expansionary fiscal policy.
- Long-term interest rates rose, potentially signaling increased risk appetite, and the weakening yen provided a boost to Japan's exporters.
- Automobile stocks led the initial rally, with the Nikkei recovering to over 41,000 yen at the close on July 23. The index has since retreated slightly but remains in positive territory year-to-date.
- Going forward, with a trade deal in place with the US and no further hikes expected from the Bank of Japan until 2026, potential changes to fiscal policy will be the central variable impacting Japan's macroeconomic outlook.

Playing the long game

When the European Union (EU) concluded that the best way to respond to President Trump's threatened tariffs was by negotiating to get US tariffs as low as possible, but without raising their own retaliatory tariffs in response, two main schools of thought emerged. Simplifying a little, these opinions were as follows:

1. Given the likely outcome of reduced exports from Europe to the US, a mercantilist view circulated that this represented a 'surrender' by Europe . Under this zero-sum view, a threat to impose tariffs from one side should be met with an equal or greater threat from the other side. Failing to do so under this worldview could only be interpreted as a 'defeat' for the side with the lower tariffs.

2. Meanwhile, a pragmatist could argue that this decision represents a calculated choice by the Europeans about when to fight and when to prioritise de-escalation. From this perspective, the choice not to impose retaliatory tariffs by the EU could be seen as a practical choice aimed at avoiding further escalation and reducing tensions.

Assaying the US-Japan trade deal, the Japanese seem to have come to a similar conclusion to the Europeans as to how best to respond to President Trump's tariffs. Both US partners ultimately settled on an approach whereby they negotiated to get the US tariffs as low as possible, but stopped short of engaging in direct "beggar thy neighbor" retaliatory measures themselves.

To paraphrase Shakespeare's Henry IV: Part 1, where Falstaff famously justifies his decision to run away from a battle by declaring that "discretion is the better part of valor", both Japan and Europe seem to concur with Falstaff.

Sometimes knowing when to stage a tactical retreat is just as important as knowing when to enter a full-scale confrontation, and a damaging and mutually-destructive trade war between the US and their European and Japanese allies has been avoided, for now at least.

Tariff negotiations are a process, not a destination

Since President Trump has returned to office and made it clear that his pre-election talk of tariffs was in earnest, we have learnt that US trade negotiations are iterative – they are seldom definitive. With various trade partners, the US has been willing to enter into multiple rounds of negotiation, with deadlines being announced and often extended, progress made, and settlements announced, often with headline-grabbing numbers attached.

However, the resulting agreements often appear to be flexible and to build in substantial room for further rounds of clarification or adjustment. For this reason, our view is that it is essential to view such developments as part of an ongoing journey, rather than as an arrival at a fixed and final destination.

What was agreed between Japan and the US?

Following the US-Japan tariff agreement and the speculation that Prime Minister Ishiba will be resigning in August, Japanese stock prices rose, as did long-term interest rates, and the yen weakened.

On July 23, around 8 a.m. Japan time, U.S. President Donald Trump announced on social media that an agreement had been reached in tariff negotiations with Japan. He revealed that Japan would invest $550 billion in the United States, open its market for automobiles and agricultural products, and that reciprocal tariffs with Japan would be set at 15%. It was also reported that the tariff on automobiles, a key focus of the negotiations, was set at 15%, although tariffs on steel and aluminum products would remain at 50%. The market reaction to this announcement was broadly supportive given the widespread expectation that the tariff negotiations would be protracted and difficult to conclude.

The fact that agreement was reached relatively quickly and included a reduction in automobile tariffs in particular came as a positive surprise. On the day of the announcement, the Nikkei swiftly began trading higher and the yield on newly issued 10-year government bonds rose as investors potentially switched allocations at the margin out of fixed income and into equities. Whilst the dollar-yen exchange rate initially showed a lack of clear direction, as will be explained below this subsequently crystallised into a slight weakening of the yen.

Subsequently, reports that Prime Minister Shigeru Ishiba would resign by August added further fuel to the fire driving stock prices higher, and the earlier observed pattern whereby rising stock prices paired with rising yields on 10-year issuance consolidated further. From this point onwards, the direction of travel in terms of the yen-dollar rate became clearer, with yen depreciation becoming the dominant motif in the foreign exchange market.

No alarms and no surprises

Meanwhile, Japan's domestic politics has provided some much-needed clarity. The results of the House of Councilors election were largely in line within consensus expectations, and the absence of surprises here put more emphasis onto the favorable results of the trade negotiations. This effectively amplified the reaction to both the tariffs resolution and Prime Minister Ishiba's expected departure. As we have observed time and again in the multiple rounds of US trade negotiations, the removal of uncertainty tends to be received highly positively by markets – even if the resulting situation is that tariffs are higher than they had been previously. The strategic importance of Japan's automobile sector and the fact that this major source of exports received a rate of 'only' 15% was therefore interpreted favorably as an avoidance of the worst-case scenario.

This translated into a strong tailwind for Japanese stocks in general, and the index remains up on a year-to-date basis.

However, we need to be clear that our view remains that tariffs are ultimately negative for the growth picture. According to SMDAM's Japanese Equity research platform, which bases its estimates on current market conditions and historical trends, the recent tariff agreement is projected to reduce Japan's GDP growth rate by 0.41%. Previously, our models had forecast a reduction of 0.62%, and this mitigation of the downward impact is the primary cause of the increased confidence seen since. As such, when you expect something to be negative, but then you subsequently change your view about precisely how negative something will be, this is in a sense good news.

However, the overall impact of the tariffs is forecast to be negative, and so other variables become more significant. Attention will now turn to the possibility of further rate hikes from the Bank of Japan's, although these are not expected before April 2026 at the earliest.

After PM Ishiba – alternatives from within the LDP

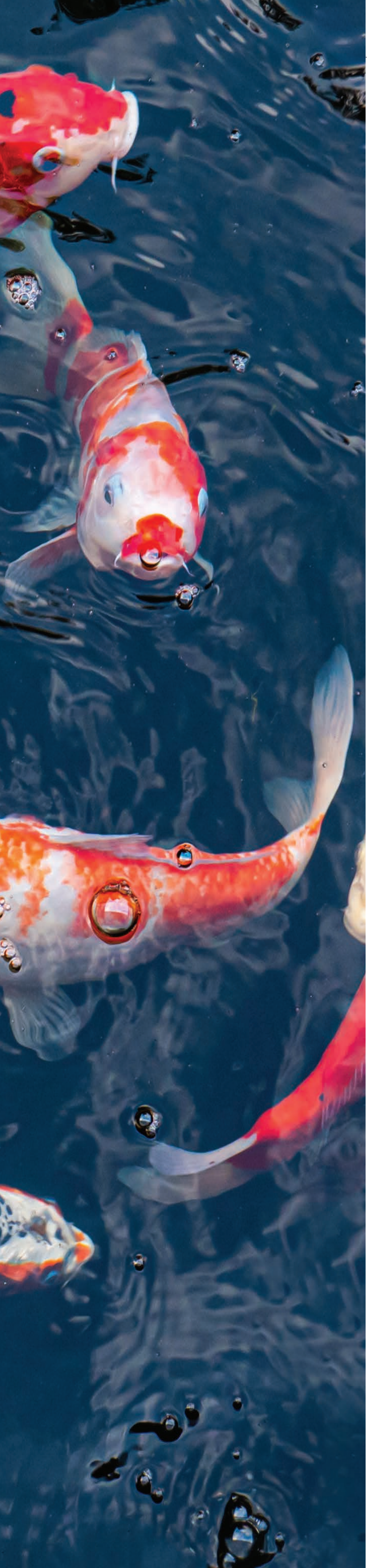
Although Prime Minister Ishiba has repeatedly denied it, reports of his imminent resignation continue to spread. This has fueled speculation about the potential direction of fiscal policy if he were to depart, with the working assumption being a more active and expansionary fiscal stance would be likely. This expected development was received cautiously by bond and foreign exchange markets which moved to price in a potential fiscal deterioration. Simultaneously, in the stock market there was renewed optimism about the prospect of incoming economic stimulus. Our current view here at SMDAM, based on our analysis of current political and economic conditions, if Prime Minister Ishiba were to resign and a Liberal Democratic Party (LDP) presidential election were held, the most probable candidates from the mainstream of the party are Yoshimasa Hayashi, Katsunobu Kato, and Shinjiro Koizumi, while Sanae Takaichi, Takayuki Kobayashi, and Toshimitsu Motegi are seen as strong candidates from the fringes. Depending on Prime Minister Ishiba's intentions and the precise timing of his departure, the presidential election could be held in either August or September, with an updated fiscal program launching under the new president from October onwards. The table below outlines our view on how this sequence of events could unfold.

YY	MM	DD	Main political schedule
2025	7	31	Liberal Democratic Party members' gathering
2025	8	1	Extraordinary Diet session (Election of President and Vice-President of the House of Councillors)
2025	8	15	Anniversary of the end of the war
2025	8–9 (TBA)		Possible LDP presidential election if Prime Minister Ishiba resigns
2025	9	30	Expiration of the term of Liberal Democratic Party executives
2025	10 (TBA)		Extraordinary Diet session (deliberation of the FY2025 supplementary budget bill)
2025	12	—	Cabinet approval of the initial budget bill and tax reform outline for FY2026
2026	1	—	Ordinary Diet session
2026	3	—	Enactment of the initial budget and tax reform-related laws for FY2026

Source: Prepared by SMD-AM based on various reports. - TBA: To be announced

Finding the signal in the noise

It is notable that despite the tumultuous developments – both domestic and international – outlined above, the Nikkei is positive over both a year-to-date and a one-year timeframe. Looking ahead, given the early agreement in the US-Japan tariff negotiations and the better-than-expected outcome, it will be important to closely monitor the ruling party's governance and policy direction. Given the expectation that rate hikes will not occur until April 2026 at the earliest, there is now an outsised focus on which domestic policy levers the current and subsequent PM will pull, and when.



The table below summarises these issues and highlights the most pressing concerns.

Main points of interest in the ruling party's governance and policy direction
Will Prime Minister Ishiba continue or resign?
If Prime Minister Ishiba continues, stable parliamentary management will be difficult with a minority ruling party. If he cooperates with opposition parties, will it be outside cabinet cooperation or expanded coalition? Additionally, how will the handling of opposition party pledges, such as the reduction of consumption tax, be addressed?
If Prime Minister Ishiba resigns, who will be elected as the president in the Liberal Democratic Party presidential election? Additionally, who will be chosen as the prime minister in the prime minister nomination election?
If the ruling party's candidate is selected in the prime minister nomination election, how will they cooperate with the opposition parties? Will it be outside cabinet cooperation or an expanded coalition? Additionally, how will the handling of opposition party pledges, such as the reduction of consumption tax, be addressed?
If an opposition party candidate is selected, it will result in a change of government. How will the various opposition parties' pledges be consolidated and implemented as policies?

Source: Prepared by SMD-AM based on various reports.

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