WEEKLY ANALYSIS

THE RISE OF THE YEN THREATENS THE NIKKEI

Growth has stabilized at a moderate pace. Consumers remain hesitant. Persistent but limited inflationary risks. BoJ stays on course. Steepening of the yield curve. Likely appreciation of the yen. Consolidation of the Nikkei.

Key Points

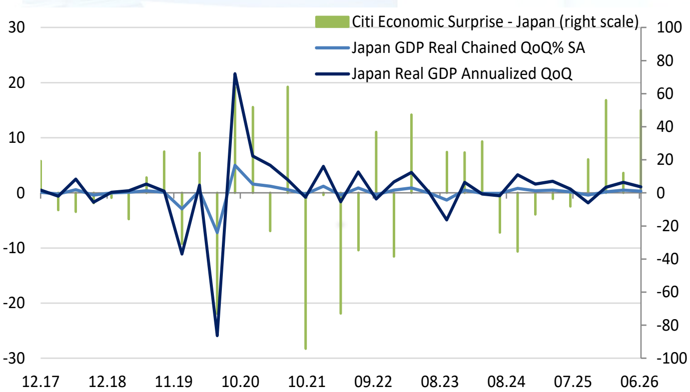
- GDP momentum slows in Q2
- Q3: Balancing domestic recovery and external risks
- Shift in leading indicators
- Household confidence stabilizing
- Inflation between buffers and input pressures
- The BoJ's dilemma and trade-offs in the face of the currency shock
- Sharp steepening of the yield curve
- Conditions finally in place for a yen appreciation
- Mixed outlook for Japanese stocks

GDP momentum slows in Q2

In Q2 2026, the Japanese economy continued its path of structural adjustment amid moderate growth. While the transition from Q1 to Q2 confirmed continued GDP expansion, the drivers of Japanese growth showed a notable slowdown, due to the combined effect of a decline in domestic demand and a sharp drop in gross fixed investment. Preliminary data show real GDP growth of +0.3% (+1.2% nominal, seasonally adjusted) and +1.1% on an annualized basis. This result follows growth of +0.5% (+1.8% on an annualized basis) in Q1 2026, but it highlights a loss of momentum in the recovery. This moderation, which fell short of consensus expectations of +0.5%, is attributable to a reversal in private sector components. First, household consumption declined again, posting an unexpected slight drop of -0.02% compared with an expected increase of +0.4%. This decline breaks the momentum of a tentative recovery observed in the previous quarter, following a long period of stagnation in consumption. Despite the substantial wage increases granted during the Shunto, the impact on actual spending is lagging, particularly in the automotive sector.

The psychological impact of budget cuts and persistently high energy costs have encouraged precautionary saving, dampening demand for volatile goods. Consumer confidence is struggling to gain sustained momentum, while inflation excluding fresh food stood at +1.8%, keeping real wages under pressure and prompting greater selectivity in overall purchasing patterns. Conversely, business investment (Capex) declined more sharply, as evidenced by a 1.2% drop in gross fixed capital formation, in stark contrast to the accumulation trend seen at the beginning of the year. Capital expenditures are being weighed down by the Bank of Japan's gradual normalization of interest rates and persistently high input costs. This contraction reflects heightened strategic caution. Faced with volatility in the foreign exchange market and global logistics disruptions, major contractors have postponed their modernization programs. As for the contribution from foreign trade (+0.5%), it acted as a buffer through a positive net contribution, with export volumes holding steady year-over-year thanks to strong global demand for electronic components and AI equipment. This sectoral recovery demonstrates the ability of export-oriented conglomerates to adapt in the face of protectionism. The public sector posted a negative contribution (-0.8%), due to current expenditures constrained by fiscal consolidation. After a lackluster second quarter, the outlook for the current third quarter is not very optimistic. A modest and moderate recovery is expected, driven primarily by an improvement in household consumption and a rebound in business investment, which will reinforce the ongoing momentum in exports.

Japanese Economic Performance (GDP) in Yen



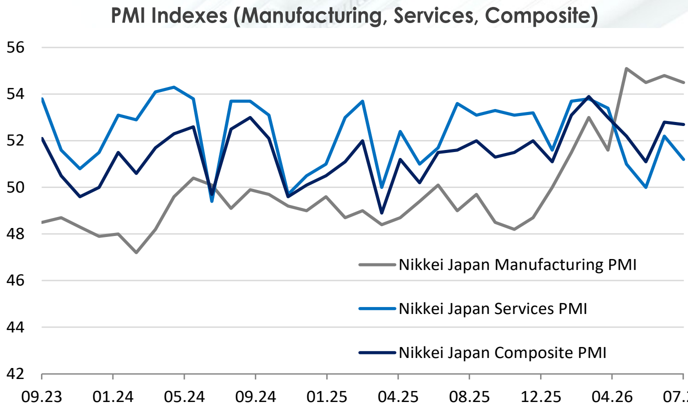
Sources: Bloomberg, BBGI Group SA

Q3 stabilised between internal recovery and external risks

The lingering effects of geopolitical instability and volatility in input prices continue to shape Japan's economic trajectory in Q3. Japan, which remains sensitive to global markets, is beginning to absorb the effects of technology-driven demand. For Q3 2026, the key challenge lies in whether consumer spending can take the lead. The gradual stabilization of service prices is reassuring households, but the macroeconomic picture remains tempered by caution in fixed investment. Gains in purchasing power, now evident in the service sector, are providing a welcome boost to household spending. We anticipate, however, a moderation in manufacturing activity over the quarter, constrained by adjustments to export inventories. Continued investment in digitization and automation by companies to address the labor shortage should nevertheless support the capital expenditure (Capex) component, preventing a sharp decline in GDP, which is likely to come in at around +0.2% on a quarterly basis. On the monetary front, the BoJ's dilemma remains very much in evidence. Faced with a yen undergoing erratic adjustments and fluctuating below 155 JPY/USD due to residual interest rate differentials, the BoJ is continuing to raise rates gradually. It seeks to anchor inflation expectations over the long term without stifling the credit recovery or dampening private demand. The fragile balance seen in the middle of the year is giving way to a cautious economic policy. The Japanese government is adjusting its targeted energy support measures, limiting the direct impact on household budgets while keeping debt under control. At the same time, the sustained momentum in semiconductor shipments to Asia is providing a key growth driver for major corporations, cushioning the slowdown in overall demand. The outlook for Q3, however, remains dependent on external economic balances. If international demand weakens further, the slowdown in foreign industrial orders will weigh on operating margins, hampering the recovery in capital formation in Q4. Japan's economic trajectory thus hinges on a decisive race between the consolidation of self-sustaining domestic demand and the resilience of regional export channels. We estimate that growth should stabilize at +0.3% in Q3 under these specific conditions.

Positive change in leading indicators

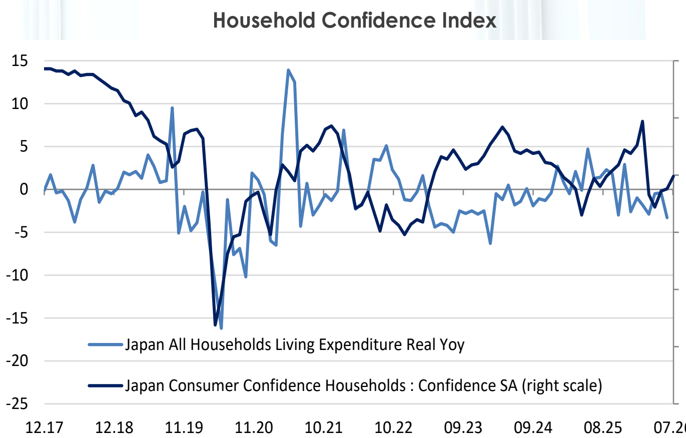
The Composite Leading Indicator, after peaking at a multi-year high of around 116.5 in the middle of the year, signals a technical recovery in domestic fundamentals. On the private sector side (Tankan Survey), sentiment among major manufacturing groups and the services sector remains high, driven by global demand for electronic components and AI, as well as the boom in international tourism. Activity in the service sector (Services PMI) is showing a notable recovery, supported by the appreciation of the Shunto and temporary government subsidies for energy that were in effect during the summer. Overall, signals from leading indicators suggest a moderate acceleration in GDP, ranging from +0.2% to +0.4% on a quarterly basis (+0.8% to +1.2% annualized), confirming that the economy has emerged from the slowdown seen in late spring. In Q4, the end of summer energy subsidies and the expected adjustment to key interest rates by the Bank of Japan (BoJ) could reignite slight pressure on borrowing costs, moderating the growth of capital expenditures (Capex). However, the export outlook, which remains exposed to the risks of a slowdown in the U.S. and European markets, should nonetheless benefit from the Asian technology cycle, which will continue to act as a buffer. Growth is expected to converge toward its potential cruising speed (around +0.2% quarterly), supported mainly by real wages that have turned more firmly positive.



Sources: Bloomberg, BBGI Group SA

Household confidence is stabilizing

While Q2 2026 raised fears of a collapse in consumption due to energy shocks, Q3 marked a pause in the decline in consumer confidence. The detrimental impact of imported inflation was temporarily mitigated by the implementation of summer subsidies. In July, consumer confidence began a moderate recovery (34.9), moving away from May's low (33.6). Supported by the full implementation of the Shunto wage increases and this price shield, real purchasing power returned slightly to positive territory. With this respite on electricity bills, spending patterns in the services sector are becoming more flexible. Japanese households, however, are maintaining high precautionary savings, limiting shifts toward durable goods and tempering the outlook for domestic demand for the end of the year.



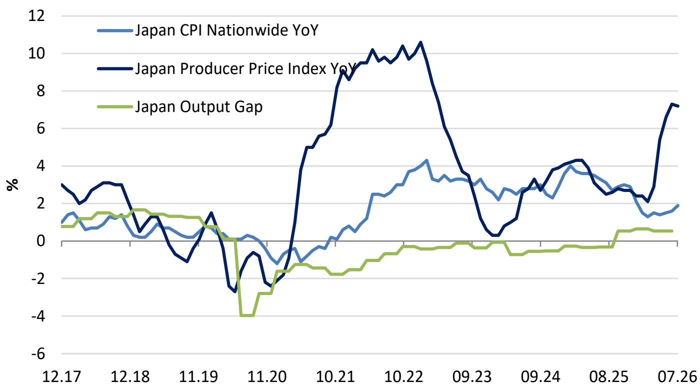
Sources: Bloomberg, BBGI Group SA

Inflation: between shields and input pressures

While the imported inflation shock in Q2 threatened to permanently entrench rising prices in Japan, Q3 offers a partial but precarious respite on the consumer price front. The acceleration in the CPI is temporarily contained by the reinstatement of government subsidies on electricity and gas bills. However, in July, core inflation rebounded slightly year-over-year and stabilized at +1.8%. With domestic energy prices stabilizing, companies are adjusting their selling prices more selectively. However, pressure on production costs remains intense. Unlike the energy component, which has been alleviated by the government, industrial inputs are now the dominant factor.

Over the summer, manufacturing companies, overwhelmed by the delayed pass-through of raw material and freight costs, continued to pass on their costs, leading to trade-offs in final demand. Core inflation (excluding fresh food) is thus settling near the Bank of Japan's target. It is no longer just subsidies that are driving the trend, but rather persistent production costs. This resilience in core inflation is fueling market expectations that inflation will remain close to +2% per year in Q3 and Q4. These expectations are increasing pressure on the BoJ to implement gradual monetary tightening in order to stabilize the exchange rate. Service price indices (PPI) also exceeded forecasts for July, surging by +3.6% (estimated +3.2%). The joint and exceptional intervention orchestrated in late July/early August 2026 by the Japanese Ministry of Finance, the U.S. Treasury, and the Fed (the first coordinated action in decades) helped halt the yen's slide against the dollar (which was then nearing 164 JPY/USD). The Import Price Index (IPI) is expected to show a sharp monthly deceleration in August, putting an end to the automatic spiral effect on industrial supply costs.

« Output gap » and Inflation (CPI & PPI)



Sources: Bloomberg, BBGI Group SA

The BoJ's dilemma and arbitrage in the face of the currency shock

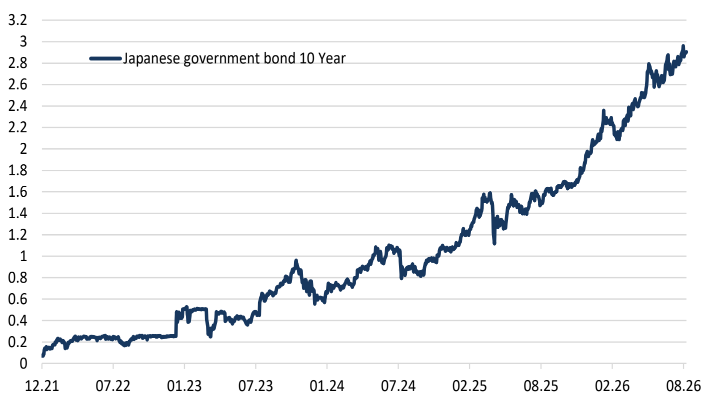
The respite provided by the joint intervention in August has now given way to a challenge of an entirely different magnitude for the Bank of Japan. The bank can no longer hide behind caution as the yen has once again approached the critical threshold of 160 JPY/USD as soon as speculative pressure returned, while the delayed pass-through of global input costs threatens to erode the Shunto's purchasing power gains. The monetary policy path, caught between the need to preserve the domestic economic recovery and the obligation to stem the currency's depreciation, is no longer a matter of debate but has become an emergency. The authorities' strategy has reached a decisive turning point with the direct support of U.S. authorities.

Purely verbal or isolated action is definitively a thing of the past. The Fed's joint support, which temporarily calmed the foreign exchange market by halting the surge in input prices, offers policymakers a tactical reprieve. With core inflation remaining near +2% and persistent pressure on producer prices, the status quo advocated by Governor Ueda is becoming difficult to maintain. The BoJ knows that selling dollars does not guarantee a lasting effect without a realignment of policy rates in light of the international yield spread. We believe an aggressive decision is likely at the BoJ's upcoming meetings. The key question is no longer whether to intervene in the foreign exchange market, but rather the magnitude of the next policy rate hike. We believe it should be 0.50%, in two 0.25% increments, in September and October, coupled with a reduction in the pace of government bond (JGB) purchases. The goal is to anchor expectations of rate hikes while limiting imported inflation. In this context, a series of closely spaced rate hikes will prove effective in transforming the temporary lull in the yen into a lasting stabilization of the national currency.

A sharp steepening of the yield curve

The trend in the Japanese government bond (JGB) yield curve reflects a structural adjustment in market expectations regarding the Bank of Japan's monetary policy. In August 2026, yield dynamics resulted in a marked steepening at the long end of the curve, pushing the 10-year yield above 2.9%. The emergence of inflationary pressures in Q2 and the depreciation of the yen accelerated this trend. The BoJ, forced to act to protect the national currency while managing the end of the summer rate shield, began the planned reduction of its monthly debt purchases. This gradual withdrawal of the major public buyer has unleashed volatility in the bond market. The trajectory of short-term rates is now influenced by the prospect of a 50-basis-point hike in policy rates to 1.5% by year-end. The impact of the joint defense of the yen with U.S. authorities has temporarily calmed extreme risk premiums, but institutional investors are demanding higher yields to absorb government debt. The long-term segment is under dual pressure from resilient core inflation and uncertainty regarding fiscal sustainability amid support for households. Local banks and insurers are reallocating their portfolios, shifting away from medium-term maturities to wait for more lucrative entry levels. We believe the yield curve will maintain this upward bias in Q4. Balance sheet normalization, combined with increases in policy rates, is creating an environment of less negative real yields, essential for curbing capital flight. At the same time, rising long-term financing costs are beginning to feed through to credit costs, marking the definitive end of the era of "free capital." We anticipate that the 10-year yield will stabilize around 3% to 3.5% by the end of 2026.

Ten-year government bond yield

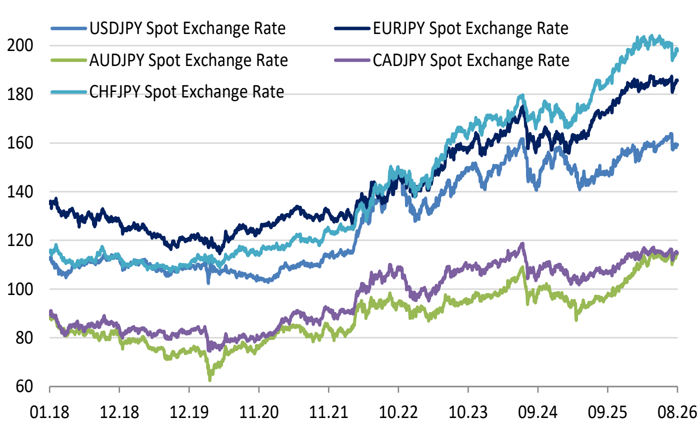


Sources: Bloomberg, BBGI Group SA

Conditions finally in place for a rise in the yen

During Q3 2026, the yen's movement around 155 JPY/USD no longer reflects solely the impact of import costs or doubts about economic activity. It now signals the beginning of a fundamental rebalancing of global financial flows. While the real interest rate differential has long been unfavorable to Japan, a decisive turning point is taking place in the capital outflow. Japanese institutional investors (pension funds, insurers) are beginning to reallocate their portfolios toward domestic bond assets, drawn by rising sovereign yields. This gradual repatriation of capital is complementing the joint action of the BoJ and the Fed in the foreign exchange market. The latest reports from the GPIF and monthly flow data from the MoF show that, with short-term rates now projected to reach 1.5% and 10-year yields expected to cross the 3.5% threshold, the yield spread with U.S. or European bonds would narrow sufficiently to support the yen. These financial giants are finally finding attractive returns in Japan without being exposed to currency risk, thereby reducing their structural sales of yen to purchase dollar-denominated assets. At the same time, the initial enthusiasm among individual investors for foreign investments via savings accounts (NISA) is beginning to level off due to currency conversion costs and volatility in global markets. Scheduled monthly flows from households into global indices such as the "All-Country" are slowing, limiting systematic arbitrage in favor of the dollar or the euro. Market conditions thus finally appear to be in place to halt the downward spiral of the yen. The combination of bilateral interventions and significant monetary tightening is laying the groundwork for a sustained strengthening of the Japanese currency.

Evolution of the yen against major currencies

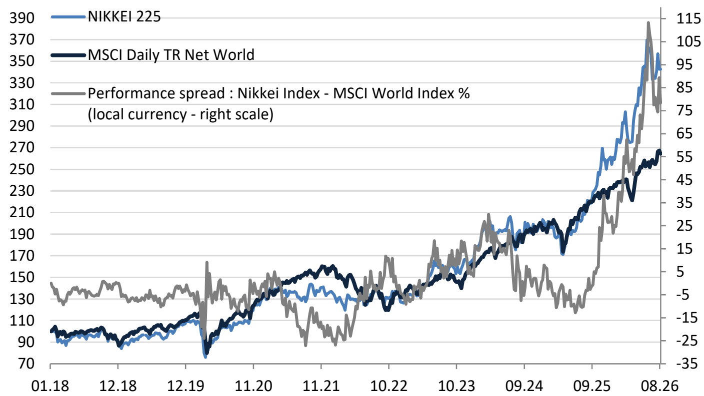


Sources: Bloomberg, BBGI Group SA

Mixed outlook for Japanese stocks

After reaching new highs, Japanese stock markets are now approaching the end of 2026 with a stance of tactical caution. The Nikkei index, after peaking at over 75,000 points during the period of massive yen depreciation, has entered a consolidation phase since late June, during which it has stabilized at levels 10% to 15% lower. Coordinated action by authorities in the foreign exchange market and the prospect of more aggressive monetary tightening by the Bank of Japan are increasing the likelihood of a yen appreciation. A sustained strengthening of the yen would automatically erode the profits repatriated by major export conglomerates (automotive and technology), leading to downward revisions in earnings guidance. This traditional driver of performance, which has been the main engine behind the Nikkei 225 and Topix indices, risks losing its momentum in the short term. At the same time, tensions in the yield curve are beginning to spill over into the real economy. Rising sovereign yields and borrowing costs are weighing on corporate gross fixed capital formation and dampening plans for capacity expansion. On the domestic demand side, margins for SMEs and companies focused on the domestic market remain under pressure. The pass-through of operating costs and rising financial expenses are limiting their ability to pass on the full extent of inflation without hurting sales volumes. Faced with these complex trade-offs, caution prevails, leading to greater selectivity at the expense of large cyclical sectors of the market. Given the now-mixed outlook for Japanese stocks, we recommend underweighting relative to benchmark indices.

Nikkei and MSCI World Index



Sources: Bloomberg, BBGI Group SA

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