

Japan Event Flash

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**Mitsubishi UFJ Trust and Banking
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Japan's First Female Prime Minister Takes Office - Hopes Pinned on "Sanaenomics"

Japan's prime ministerial nomination election was held on October 21st, and as widely anticipated, Sanae Takaichi emerged victorious. This outcome was in line with market expectations and came as no surprise (Polymarket odds on October 20 were 97.9% for Ms. Takaichi, Exhibit 1). This result means that Takaichi becomes Japan's first female prime minister.

After her victory in the LDP presidential election on October 4th, there was some uncertainty about the domestic political outlook. This was following the withdrawal of the Komeito party, a long-time coalition partner, on October 10th. Speculation briefly arose that Yuichiro Tamaki of the Democratic Party for the People, representing the opposition coalition, might become Prime Minister. However, the LDP formed a new coalition government with the Japan Innovation Party, paving the way for LDP President Takaichi to assume the Prime Minister's office. Prime Minister Takaichi delivered her policy address to the Diet on October 24th. The extraordinary Diet session is scheduled to last 58 days, ending on December 17th.

By forming a coalition with the Japan Innovation Party, the LDP now holds a total of 231 seats in the Lower House, approaching the majority threshold of 233 seats (Exhibit 2). In the Upper House, the coalition also holds 120 seats, approaching the majority threshold of 125 seats. While the new coalition government remains a minority ruling party, the ability to implement policies with the cooperation of minority opposition parties (such as Sanseito) suggests a slight improvement in the stability of government operations.

Going forward, attention will likely focus not only on economic measures (Sanaenomics) such as countering rapid inflation and the content and scale of the FY2025 supplementary budget, but also on whether the cabinet decision on economic measures and the passage of the supplementary budget proceeds smoothly. The economic measures are likely to include the abolition of the provisional gasoline tax rate, advocated by both the LDP and the Japan Innovation Party. Although the system framework will take time, the introduction of income tax cuts with cash benefits (a mechanism providing tax cuts for higher-income individuals and cash benefits for lower-income individuals) will likely be decided.

The Japan Innovation Party's proposal of a 0% consumption tax on food items (a two-year time-limited measure) is also seen as a possible inclusion. In addition, other policies demanded by the Japan Innovation Party are likely to be accepted, such as a 10% reduction in the number of Diet members, a cut in social insurance premiums, expansion of free education, and the realization of the secondary capital concept (a growth strategy to correct Tokyo's overconcentration and promote economic growth in areas like Osaka).

During the LDP presidential election, Ms. Takaichi pledged to build a backup system for the capital's crisis management functions as part of national resilience plans. This suggests Osaka will be selected as Tokyo's alternative. Furthermore, regarding energy policy, since both the LDP and the Japan Innovation Party advocate promoting nuclear power generation, efforts will likely focus on improving energy self-sufficiency through the early

restart of nuclear power plants. Strengthening economic security sectors (AI, semiconductors, cybersecurity, etc.) will also be pursued.

Regarding diplomacy, given the importance of Japan-U.S.-South Korea cooperation on security, Japan will have little room to create friction in its foreign policy, and concerns about hawkish diplomacy are likely to be restrained. At the Japan-U.S. summit scheduled for October 28, President Trump may seek agreements on specific investment projects and amounts for U.S.-bound investments and could also demand further increases in defense spending. Prime Minister Takaichi's response will be closely watched.

Considering that the Japan Innovation Party, a coalition partner, prioritizes fiscal soundness while aiming to balance growth strategies with social security reforms, and that the Aso faction, mindful of fiscal discipline, forms the core of the Takaichi Cabinet, it is expected that appropriate consideration will be given to medium-term fiscal discipline. However, in the short term, expansionary fiscal policy is likely to be pursued to reflect many of the Japan Innovation Party's policies.

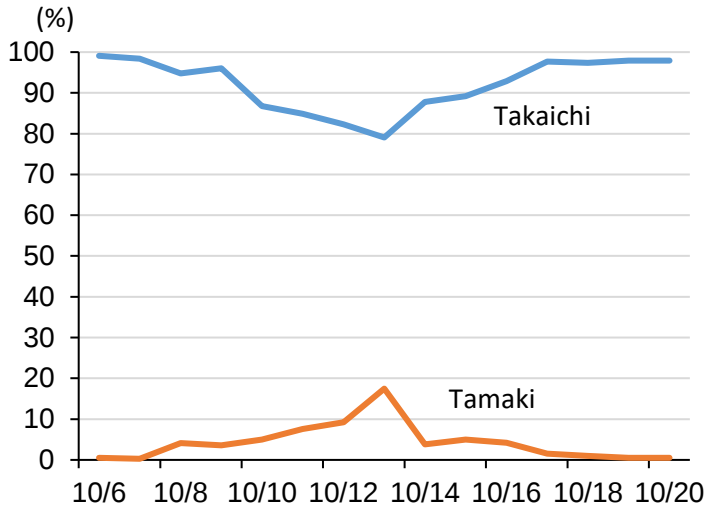
Regarding monetary policy, the Bank of Japan is likely to maintain its stance on raising interest rates. This is because, given the current priority on countering high inflation, accelerating yen depreciation due to the BoJ halting rate hikes would lead to further price increases - an undesirable outcome. In addition, the United States is seeking a correction in the weak yen through BoJ rate hikes. On October 6, Mr. Honda, Prime Minister Takaichi's economic advisor, stated, "It depends on the macroeconomic environment, but in the current environment, raising rates by 0.25% would not be a problem." The coalition partner, the Japan Innovation Party, is likely to respect the Bank of Japan's independence on monetary policy while accepting rate hikes. The Bank of Japan is expected to raise its policy rate from 0.5% to 0.75% in January next year, after carefully assessing global economic trends and the impact of tariff policies on Japanese corporate profits and wage/price-setting behavior. However, given Ms. Takaichi's past explicit opposition to BOJ rate hikes, she is unlikely to push for aggressive tightening. The terminal rate is now highly probable to cap at 1%.

Under Prime Minister Takaichi, the Japanese stock market is likely to push for further highs, driven by expectations of expansionary fiscal policy and monetary policy that is slightly more dovish than previously anticipated. Amid receding uncertainty surrounding domestic politics, the Nikkei 225 is likely to settle at elevated levels above 50,000. Support for Japanese equities is likely to come from solid corporate earnings, increased shareholder returns driven by improved corporate governance, the continued undervaluation of Japanese stocks relative to US equities, and robust buying from foreign investors fueled by expectations for "Sanaenomics."

Regarding long-term interest rates, concerns over fiscal expansion (a factor pushing rates up) and a somewhat dovish monetary policy stance (a factor pushing rates down) are likely to offset each other. Therefore, we anticipate rates will remain range-bound around current levels (1.665% as of October 20). For USD/JPY, the yen weakening driven by "Sanaenomics" and the dollar weakening due to U.S. rate cuts are expected to counterbalance each other, leading to a range-bound market centered around 150 yen.

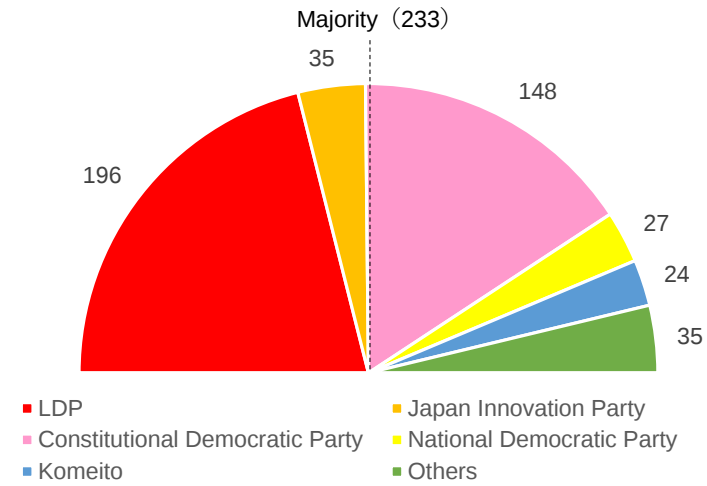
For Japanese stock picks, consumer-related stocks look promising as household support measures are expected to expand to counter high prices. Other areas to watch include defense-related stocks, nuclear power-related stocks, AI/semiconductor/cybersecurity-related stocks, and stocks with high exchange rate sensitivity that stand to benefit significantly from a weaker yen. Stocks related to the "Osaka as a Secondary Capital" initiative are also expected to gain attention, as the realization of this plan is anticipated to revitalize Osaka.

Exhibit 1: Probability of Victory in the Prime Ministerial Nomination Election (Polymarket)



Source: Bloomberg, MUFG: Trust Bank

Exhibit 2: Number of Seats in the Lower House



Source: Nikkei, MUFG: Trust Bank

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