

# Japan: Reassessing Perceptions

## Executive Summary

- Concerns including debt, deflation, and demographics have long led many global investors to overlook the Japanese stock market, resulting in below-benchmark allocations in active portfolios.
- The end of deflation, corporate governance reforms, and greater emphasis on shareholder returns have significantly altered the outlook for Japanese equities. However, bearish investor perspectives remain commonplace. We believe these perspectives need updating.
- Looking ahead, economic normalization, progress from existing reforms, upcoming changes to the Corporate Governance Code,<sup>1</sup> and the scope for Japanese companies to use their balance sheets more efficiently could be future tailwinds for the Japanese market and economy.



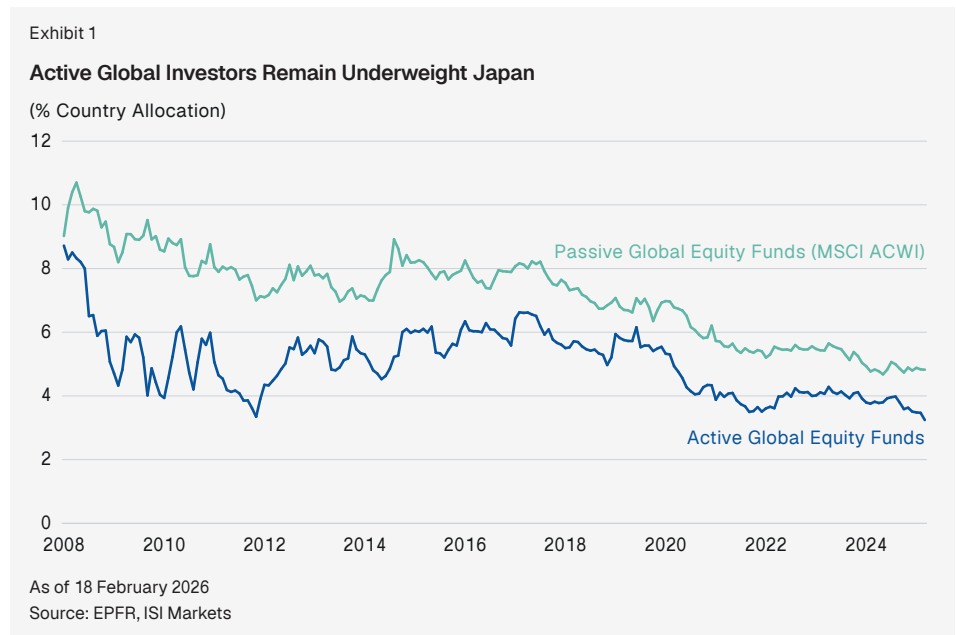
**The gloom over the prospects for the world's fourth-largest economy is overdone.**

**Misunderstood Japan**

Few large countries are as misunderstood as Japan. Even after a record influx of foreign tourists in recent years that has given many a better sense of everyday Japan,<sup>2</sup> Western perceptions of Japanese culture and society can be superficial and outdated.

We argue the Japanese stock market and economy are also often subject to shallow or outmoded perspectives. This can lead to excessive pessimism and cause global investors to avoid the world's second-largest developed equity market.

For many, Japanese equities and the country's economy still evoke a series of gloomy associations: An outsized public debt pile, dire demographics, stagnant consumer demand, and a moribund stock market. These long-standing bearish views are reflected in portfolio positioning: Active global investors remain structurally underweight Japanese equities relative to a neutral passive weight (Exhibit 1).



We argue the downbeat investor sentiment towards Japan, as well as the recent negative narrative about the country's fiscal position, is misplaced. It overlooks several important shifts long underway in Japan's economy, corporate sector, and policy environment, or key changes poised to take effect. Taken together, we believe these developments challenge long-held assumptions—we explore how in more detail below. They point toward a more constructive outlook for Japan's stock market, while suggesting the gloom over the prospects for the world's fourth-largest economy is overdone.

## No Ticking Fiscal Time Bomb

Japan's public indebtedness is perhaps second only to its demographics on the list of investor concerns about the country. With the highest gross debt-to-GDP ratio in the G7 group of leading economies (Exhibit 2)—projected by the International Monetary Fund (IMF) to hit approximately 227% in 2026—Japan's public finances have long attracted scrutiny. And they have returned to the spotlight in recent months after high-profile fiscal policy announcements by recently elected Prime Minister Sanae Takaichi.

Like her political mentor, Shinzō Abe, whose second premiership (2012–2020) spawned the Abenomics program of economic reforms, Takaichi favors increased government spending to reflate the Japanese economy and boost its long-term potential.

Shortly after becoming leader in October 2025, she announced a ¥21 trillion (US\$137bn) package of measures designed to stimulate the economy and address widespread cost-of-living frustrations among the Japanese population, an issue that proved politically damaging for her two predecessors as prime minister.

The drum-playing premier hit another fiscal beat in January 2026. After calling a snap general election in a bid to strengthen her ruling coalition's mandate, Takaichi unveiled a post-election plan to suspend the 8% consumption tax on food and beverages for two years, a move expected to cost approximately ¥5 trillion (US\$32bn). A sharp rise in long-dated Japanese government bond (JGB) yields followed this announcement, with the 30-year bond and 40-year bond both hitting all-time highs (Exhibit 3).

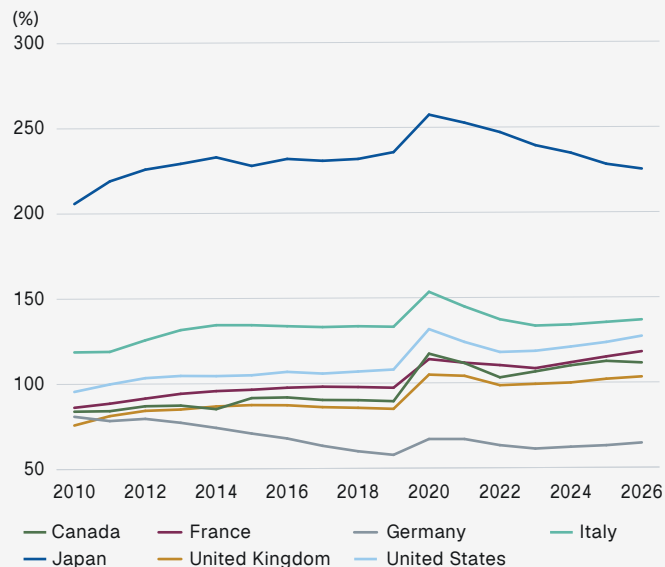
Takaichi's electoral gamble paid off spectacularly with a landslide victory for her Liberal Democratic Party (LDP) in early February.<sup>3</sup> However, even armed with a strong mandate, the mooted suspension of consumption tax on food and drink may not necessarily be implemented. Some of her colleagues in the LDP viewed the measure as election posturing meant to counter the opposition's proposal for a permanent tax cut.

Setting aside whether the policy will see the light of day, the surge in long-dated bond yields in January was widely read as growing investor nervousness over the fiscal discipline of Takaichi's government and concern that Japan's ability to service its debt pile was approaching a tipping point, potentially with wider consequences for global financial markets.

We believe this interpretation may be faulty. We argue the supply-demand structure of long-dated debt was a major reason behind these yield increases. Because 30- and 40-year JGBs are relatively illiquid, modest selling can easily move their price. More broadly, we believe the rise in long-term yields is a consequence of interest rate normalization as Japan sheds its deflationary past.

Exhibit 2

### General Government Gross Debt as % of GDP for the G7 Economies

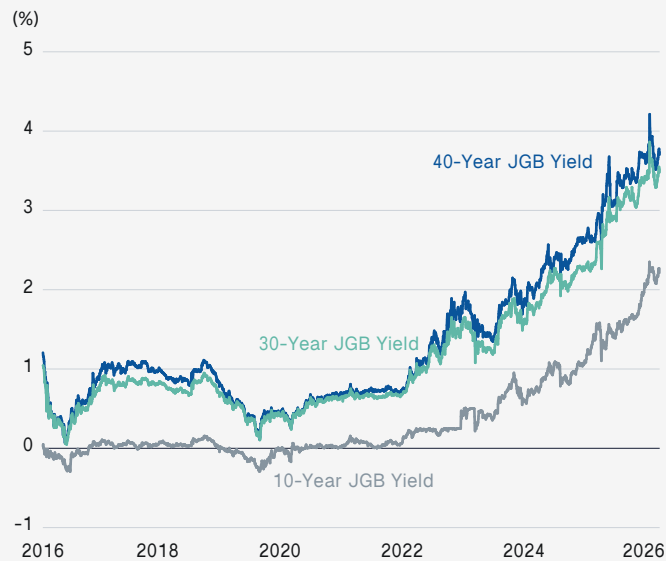


As of 16 February 2026

Source: International Monetary Fund

Exhibit 3

### Rising Japanese Government Bond Yields



As of 19 March 2026

Source: Bloomberg

## Japan's debt dynamics have quietly improved.

We also observe that Takaichi and Finance Minister Satsuki Katayama, a former bureaucrat from the fiscally conservative Ministry of Finance, have reiterated their intention to pursue growth policies grounded in fiscal sustainability. This should reassure bond and currency markets—and here it is worth noting that JGB yields moved lower following the election result. As for worries about the loss of tax revenue from the mooted tax suspension, we believe these are misplaced. Tax revenues should continue to increase as inflation returns to the country.

The gloomy debt-focused narrative also misses three other essential points.

First, Japan's debt dynamics have quietly improved. Both gross and net debt-to-GDP—the latter is a far more meaningful measure of Japan's fiscal well-being, given the country's substantial publicly held assets—have fallen since 2020 (Exhibit 4) as nominal growth has strengthened, inflation has returned, and tax receipts have risen. This has enabled Japan's fiscal position to stabilize despite continued public spending commitments.

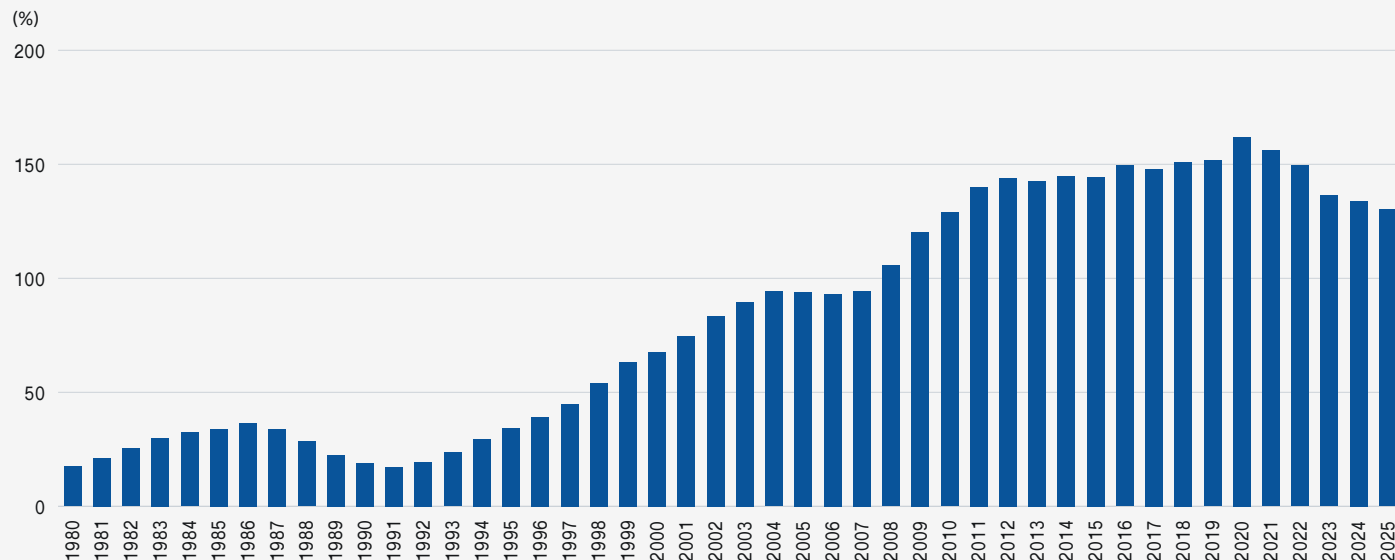
Second, Japan's long-duration debt profile and dominant domestic investor base—approximately 88% of JGBs are held domestically (including 50% held by the Bank of Japan (BoJ) and 6.5% held by the Government Pension Investment Fund)—further reduce the vulnerability often implied by international comparisons.

Third, speculation from some quarters (including from *The Economist*<sup>4</sup>) about potential capital flight runs counter to the direction of likely future investment flows. For more than a decade, Japan's zero interest rate environment pushed domestic investors abroad in search of yield. With the BoJ now normalizing policy and rate differentials narrowing, this period is ending. In this environment, the direction of flows is more likely to reverse, with both global and Japanese investors allocating more capital to Japanese financial assets.

Japan is not on the cusp of a fiscal rupture, in our view. Instead, the fundamental foundations underpinning the country's long-term economic stability are arguably improving, not deteriorating.

Exhibit 4

### Japan's Public Net Debt Has Been Falling since 2020



As of 31 October 2025

Source: Haver Analytics, International Monetary Fund

## Underleveraged Balance Sheets: Scope for Growth

Another common misconception is that Japan is overly dependent on government stimulus to generate growth. The reality is the Japanese economy is recovering well without the central government needing to prime the pump. An annualized growth rate of 1.3% in Q4 2025 slightly exceeded market expectations and points to steady, if unspectacular, economic momentum.

As for sources of stimulus, we believe the best option for potential growth comes from the corporate sector. In our view, Japanese balance sheets are materially underleveraged: net debt-to-EBITDA has fallen steadily over the past two-and-a-half decades, from 5.8x in 2000 to -1.3x at the end of 2025, meaning Japanese firms now have more cash and other liquid assets than debt on their balance sheets (Exhibit 5).

Conservatively managed balance sheets were an understandably risk-averse reaction to the corporate trauma inflicted by the bursting of Japan's massive stock market and real estate bubbles in 1990. But those days are behind us. Many Japanese firms have substantial capacity to take on prudent levels of leverage.

This corporate dry powder is becoming increasingly relevant as a new inflationary environment becomes embedded. Holding excess cash is no longer a rational decision. Wage growth, capex opportunities, and shareholder expectations for returns have risen. A new revision to the Corporate Governance Code expected later this year will explicitly address excess cash on balance sheets and encourage more efficient capital deployment. Companies that fail to articulate clear uses for their cash will face mounting pressure to invest in growth, raise employee compensation, or return capital to shareholders.

These reforms are not new, but they are entering a new phase. Earlier iterations focused on board independence and disclosure. The coming revision, however, turns toward capital efficiency, a shift with far greater implications for earnings quality, return on equity, and long-term market performance.

Japan is still in the early innings of this transition. For investors, we believe this represents a multi-year structural tailwind. And it is one that should be reinforced by generational change in Japanese management teams. As corporate managers unmarked by the years of post-bubble stagnation increasingly take the helm at Japanese firms, risk-averse attitudes and highly conservative balance sheet stewardship should fade away.

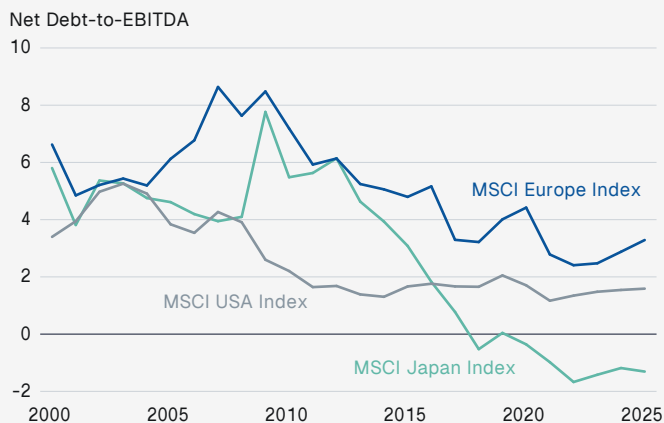
## The Silver Lining of Japan's Demographics

Japan's shrinking population is routinely cited as a fundamental drag on growth. The country's adverse population trends and aging society—Japan's median age of 50 is the world's third-highest<sup>5</sup>—are well documented, but the implications of the demographic story are more nuanced. A declining workforce strengthens labor's bargaining power—already visible in Japan's tight labor market (Exhibit 6). Because consumption makes up roughly 60% of GDP, wage-led growth can be a powerful stabilizer. Rather than depressing demand, Japan's demographic structure could help catalyze a shift from excessive savings toward higher household consumption. Labor tightness has already led to strong real wage gains and should support further growth over the medium to long term.

We believe Japan is also better positioned than most developed economies to navigate labor shortages. The country is already a significant player in automation and robotics, giving it a head start in adapting to an AI-enabled economy. A smaller workforce carries fewer social risks than elsewhere because the threat of displacement is minimal; the issue is labor scarcity, not redundancy. Combined with Japan's high trust and socially cohesive environment, technological adoption may enhance economic resilience rather than destabilize it. Indeed, Japan's AI Basic Plan, approved by Takaichi's cabinet in December 2025, is partly focused on developing AI to address labor supply shortfalls.<sup>6</sup>

Exhibit 5

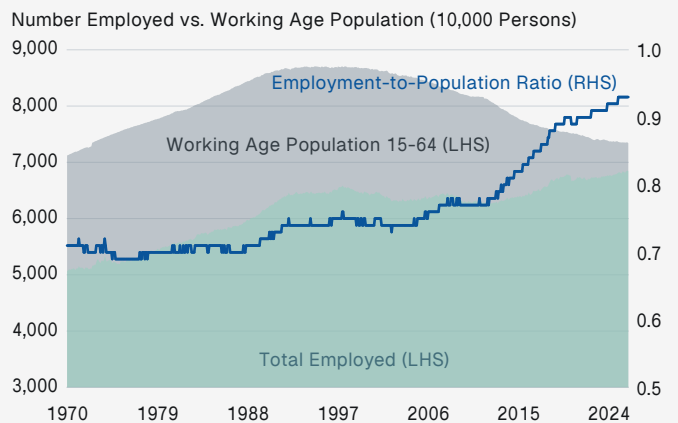
### Japanese Balance Sheets—From Leveraged to Net Cash



As of 31 December 2025  
Source: Bloomberg, MSCI

Exhibit 6

### Approaching Full Employment



As of 31 December 2025  
Source: Haver Analytics, Ministry of Internal Affairs and Communications

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### A Potential Currency Kicker

For many global investors, the decision to allocate to Japan can be tied to the outlook for the currency. To this end, a potential recovery in the yen from levels currently approaching the multi-decade low seen in June 2024 may give another reason to revisit the Japanese market.

We believe real interest rate differentials have driven yen weakness. However, with the BoJ on a path towards rate normalization, we believe the yen may find support ahead—here it is worth noting that IMF purchasing power parity measures (calculated in October 2025) suggested fair value for the yen then stood at ¥94/\$, far from the current ¥159 level.<sup>7</sup>

Currency appreciation in reaction to higher interest rates would enhance foreign currency returns from Japanese equities and revalidate the attractiveness of Japan's domestic assets. A stronger yen would also dispense economic benefits by helping to moderate inflation. For households, currency strength boosts purchasing power; for companies reliant on imported inputs, it dampens cost pressures. Japanese exporters, meanwhile, would remain competitive even with a materially stronger currency, having spent decades improving efficiency and diversifying production footprints.

### A Quicker Drumbeat

At the time of writing in mid-March, US-Israeli military attacks on Iran have been met with retaliation against America's regional allies and Iran's effective closure of the Strait of Hormuz. This has caused turbulence in global energy markets, sending the Brent crude oil price to over US\$100 per barrel. In turn, this has led to volatility in stock markets, including within the Japanese market, where the sell-off has been material but not yet major: the TOPIX Index is still up 5.9% year to date in yen, total return terms.<sup>8</sup>

The situation in the Persian Gulf is clearly fluid. However, given Japan's extensive oil reserves, we anticipate only modest impacts on the oil-importing Japanese economy should the conflict prove to be short term in nature. However, we acknowledge a prolonged war could pose significant inflationary risks.

Putting aside immediate global geopolitical tensions and energy market gyrations, like most major developed economies, Japan faces significant structural challenges. Nonetheless, we believe the consensus investor narrative towards the Japan stock market and economy needs refreshing. Fiscal conditions have slowly improved, corporate reforms show signs of acceleration, adverse demographics can have underappreciated benefits, and currency dynamics may yet shift in favorable ways.

February's decisive general election result has reduced uncertainty around policy direction in a country that has experienced frequent leadership changes. However, we continue to believe that Japan's equity market outlook is not dependent on election outcomes or political narratives. Instead, in our opinion, the key structural drivers of returns remain earnings growth and improvements in capital efficiency, supported by broader economic normalization.

Japan is changing; its economy and stock market are arguably moving to a quicker drumbeat. We believe global investors may find it timely to re-evaluate this change.

# Important Information

## Notes

1. Source: [Financial Services Agency](#). As of 26 February 2026.
2. Source: The Japan Times, '[Foreign visitors to Japan topped 40 million in 2025](#).' As of 20 January 2026.
3. Source: CNBC, '[Yen near 160, a record Nikkei 225, higher yields: What experts expect after Sanae Takaichi's landslide victory](#).' As of 9 February 2026.
4. Source: The Economist, '[Japan's big-spending Takaichinomics is ten years out of date](#).' As of 27 November 2025.
5. Source: [www.statista.com](#), '[Median age of the population in the top 20 countries 2025](#).' As of 27 January 2026.
6. Source: Cabinet Office, Government of Japan, '[Artificial Intelligence Basic Plan](#).' As of 23 December 2025.
7. Source: IMF, '[World Economic Outlook \(October 2025\) - Implied PPP conversion rate](#),' As of 31 October 2025.
8. Source: Bloomberg. Data as of 19 March 2026

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