

Japan: Stay neutral with upcoming elections

28 January 2026

Overview

- **Equity rally stalled:** Japan's early-2026 equity rally is fading as fiscal concerns over Takaichi's aggressive fiscal plans triggered record JGB yield spikes.
- **Snap elections priced in:** Markets now question her majority prospects on the 8 Feb election, raising political uncertainty and ability to push through her plans.
- **Currency reversal:** Fiscal-monetary tensions and potential yen strength create near-term headwinds for equities, especially after strong early-year gains.
- **Market impact:** Foreign inflows remain crucial; any yen-driven reversal could pressure equities. Big pullbacks offer chances to buy themes we favour: policy beneficiaries (i.e., defence, infrastructure, energy security), governance-reform domestic plays, banks, and AI-linked sectors.

Executive Summary

Japan's early-2026 equity rally has stalled as fiscal concerns surrounding Prime Minister Takaichi's agenda intensify. Markets are expecting her to secure a majority in the 8 February snap election, but investors are now questioning both her mandate and the sustainability of her proposed JPY5tn food tax suspension. Long-dated JGB yields have surged to record highs, signalling discomfort with expanding deficits. The resulting fiscal-monetary tension, coupled with potential yen strength, poses near-term headwinds for equities. A weaker mandate would amplify political uncertainty, and with foreign flows still pivotal, any yen-driven reversal could pressure returns.

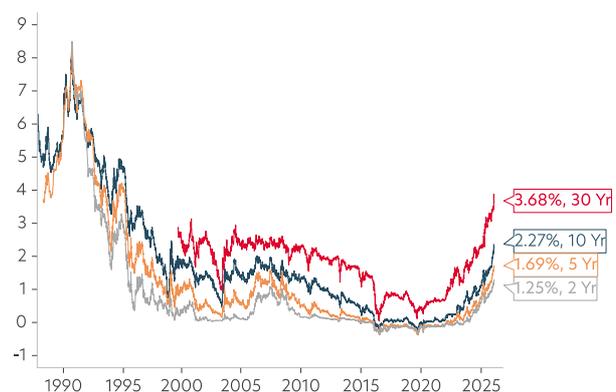
Upcoming snap elections on 8 February

Japan's equity markets entered 2026 with strong momentum, delivering roughly 8% local-currency gains before sentiment deteriorated sharply as fiscal stress concerns began to dominate investor focus. Markets had initially priced in a relatively smooth political trajectory—specifically, expectations that Prime Minister Sanae Takaichi would secure a renewed majority in the 8 February snap election, enabling her to push ahead with her policy agenda. However, recent market behaviour suggests investors are now questioning both the durability of that mandate and the fiscal sustainability of her proposals.

Investors are rethinking her bold plans

The snap election itself caught markets at a delicate moment. Takaichi's decision to dissolve the Lower House early was framed as an effort to secure a stronger political mandate amid high approval ratings, which have hovered in the 60–70% range in recent polls. Yet the market reaction has been anything but confident. Her flagship proposal—a two-year suspension of the 8% consumption tax on food, costing an estimated JPY5tn annually—has amplified concerns over Japan's already stretched fiscal position. Yields on long-dated Japanese Government Bonds (JGBs) surged to record levels, with the 30-year yield hitting 3.68% (**Fig. 1**). Investors effectively delivered their verdict: Japan is now testing the limits of what is fiscally tolerable.

Figure 1: Japan bond yields spike



Source: Bloomberg, UOB Private Bank

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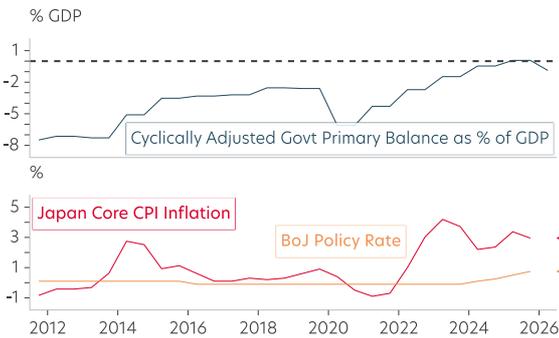
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Against the backdrop of an anticipated increase in bond supply to fund Japan's fiscal expansion, market concerns are justified on signs of a "Liz Truss Moment". Moreover, unlike previous cycles, the BoJ has shown limited willingness to cap long-end yields, allowing markets to price fiscal risk directly amid BoJ's ongoing quantitative tightening (QT).

Having said that, Japan is not in the same situation as the UK during the Liz Truss episode. Japan is a large creditor nation with massive domestic savings and a relatively small budget deficit (**Fig. 2**).

What the JGB market stress reveals is a growing conflict between Japan's monetary and fiscal policies. Prime Minister Takaichi is pushing for fiscal expansion at a time when the BoJ is tightening monetary policy. The JGB selloff is essentially the market enforcing fiscal discipline.

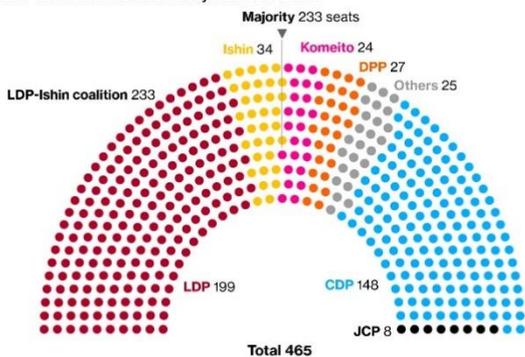
Figure 2: Japan is different from the UK



Source: Bloomberg, UOB Private Bank

Figure 3: LDP has to win big to get majority seats

Seats Representation in Japan's House of Representatives
LDP-Ishin coalition currently has 233 seats



Source: Bloomberg, UOB Private Bank

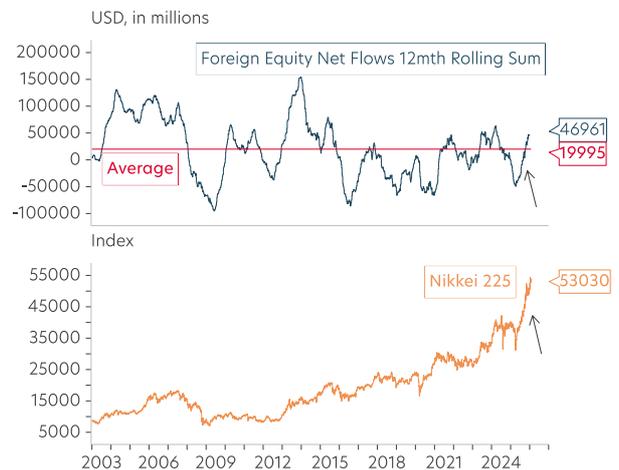
Japanese equities may falter until JPY stabilises

The market implications are noteworthy. Japan's longstanding pattern of negative correlation between the yen and equities—yen weakness boosting exporter earnings and equity valuations—may now be at an inflection point. If fiscal exuberance gives way to consolidation and JGB yields ease from their extremes, a period of yen stabilisation or appreciation is plausible. Such a shift, combined with a softer fiscal impulse, would represent a near term headwind for Japanese equities, particularly after the strong run up earlier in the year.

Downside risks rise meaningfully if Takaichi fails to secure a majority. The equity market's resilience has been built on the assumption of policy continuity and decisive governance; a fractured mandate would instead inject political uncertainty into an already fragile macro-fiscal backdrop.

Finally, foreigners remain a key driver of Japanese equity performance (**Fig. 4**). Flow reversal due to a strengthening JPY would temper returns.

Figure 4: Foreigner flows vs Nikkei performance



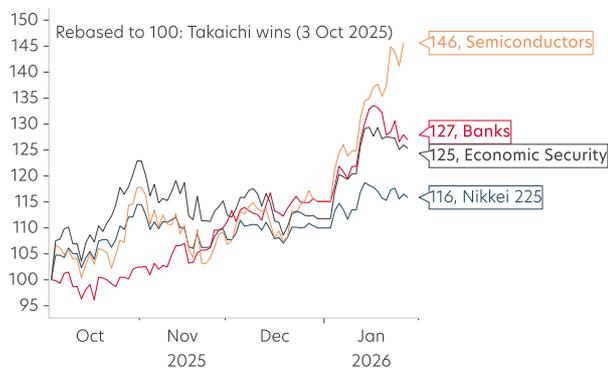
Source: Bloomberg, UOB Private Bank

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Figure 5: Performance since Takaichi's election



Source: Bloomberg, UOB Private Bank

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Investment takeaways

In FX, we see the JPY appreciating, especially against the USD. Some currency volatility can be expected around Japan's election headlines, but dips in JPY should be viewed as opportunities to build long exposure.

In rates, investors should maintain front- to belly-curve exposure where BoJ creditability anchors yields. We are cautious on long-dated JPY corporate bonds amid JGB supply and fiscal uncertainty.

In equities, a stronger JPY is typically a headwind for exporters but supportive of domestic consumption and financials. We remain constructive on the policy beneficiaries under the Takaichi administration (i.e., defence, infrastructure and energy security), domestic themes linked to governance reforms, banks as well as AI beneficiaries (**Fig. 5**).

In summary, Japan is no longer an outlier of financial repression. Politics has re-introduced fiscal risk, markets are enforcing discipline amid a growing fiscal-monetary dichotomy, and the BoJ is normalising policy. The result is higher market volatility – but also a credible setup for JPY appreciation.

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