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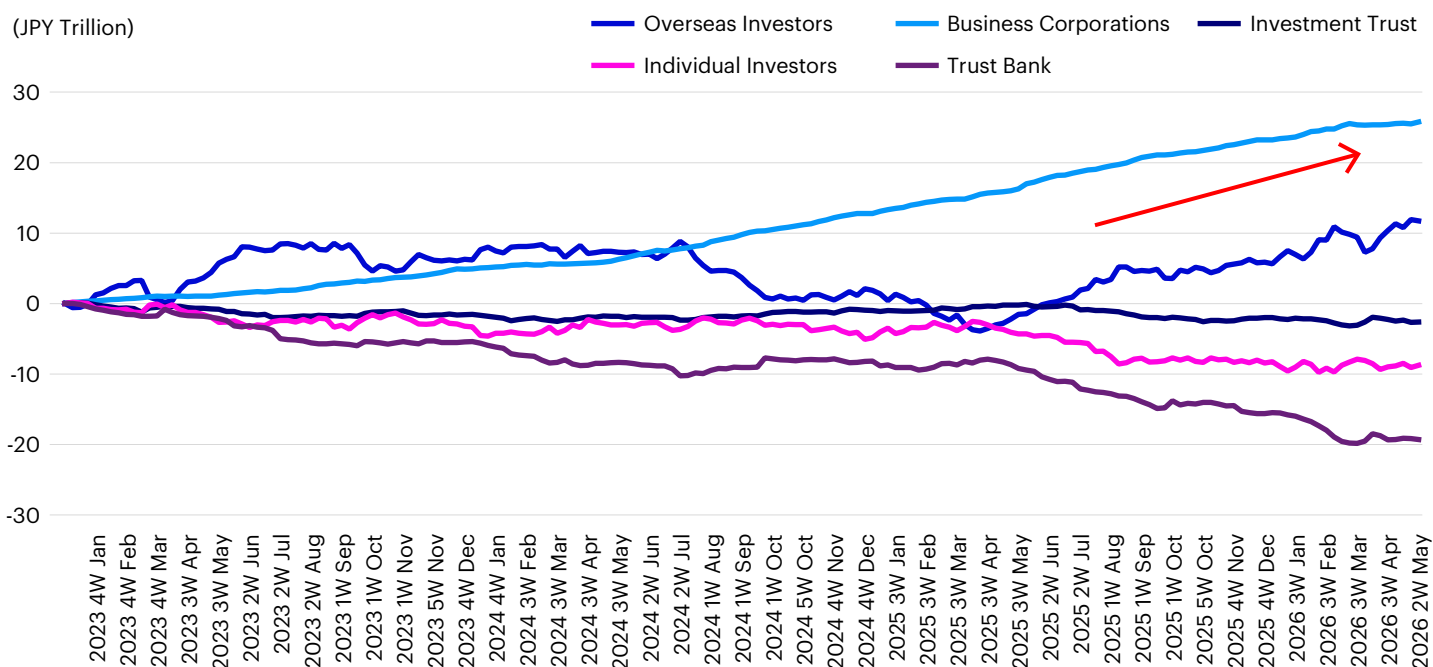
Key takeaways

- Japanese equities have continued to rise in 1H, outperforming the major developed markets amid optimism around Prime Minister Sanae Takaichi’s pro-growth agenda following her landslide victory.
- Real wage growth is materialising amid strong pay rises in “Shunto” spring wage negotiations for three years and moderating inflation, underpinning healthy economic growth.
- While AI and semiconductor euphoria has stayed, 2026 has also seen a rerating among stocks that fell out of favor despite healthy fundamentals or strong growth prospects on the ground.

Japanese equities have extended a historic rally

Japanese equities have extended their historic rally so far this year, broadly outperforming major developed markets. Foreign investors have continued buying Japanese equities amid excitement surrounding Japan’s political developments. At the beginning of the year, Prime Minister (PM) Sanae Takaichi called a snap election for the Lower House against the backdrop of a high approval rating and won a landslide victory, which has strengthened her political foundation and sparked high expectations for her pro-growth policy implementation. Although we experienced significant volatility due to heightened geopolitical conflict in the Middle East, the correction was short-lived, and overseas investors remain major buyers of Japanese equities year-to-date (Figure 1).

Figure 1: Japan equities trades by investor category



Source: Tokyo Stock Exchange. Data as of 15 May 2026. Note: Both futures and cash equities trades are included.

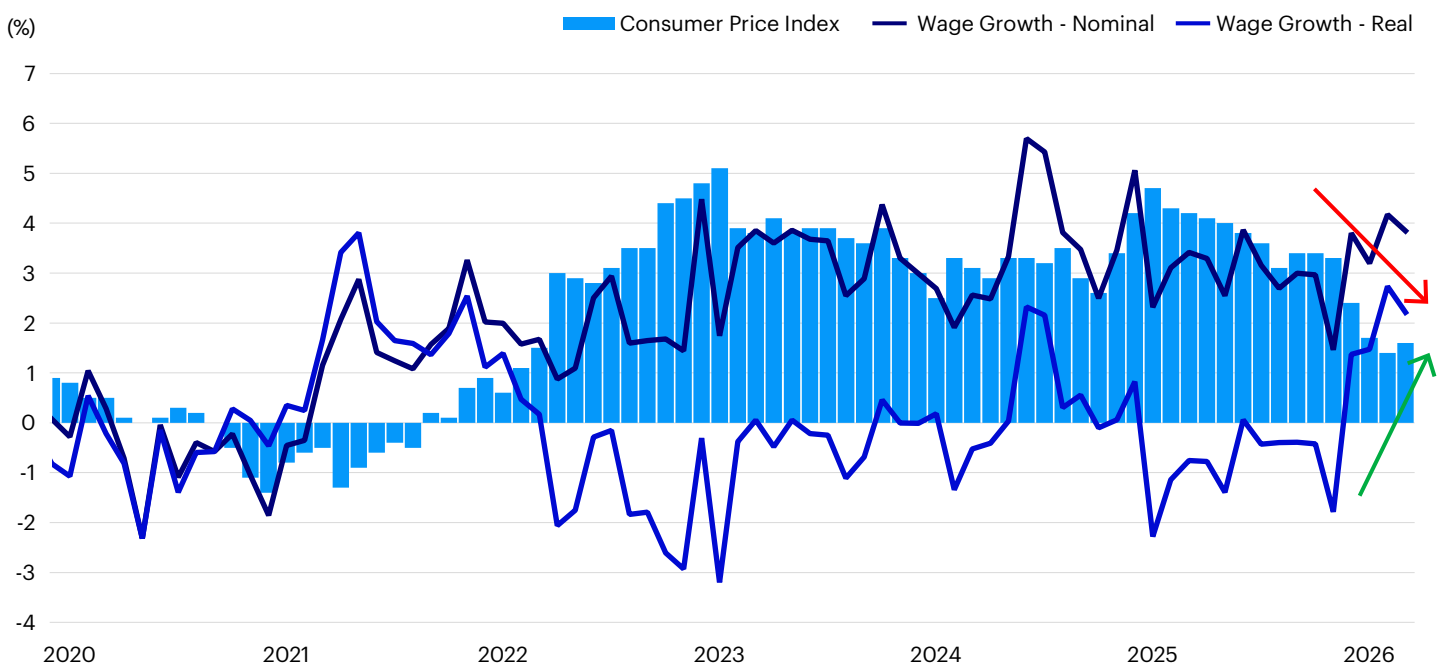
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Macro tailwind for 2026 - real wage growth - is beginning to materialize

While we still believe the market has already priced in most of the best-case scenarios of PM Takaichi's accommodative fiscal and monetary policies to boost domestic demand, "real" wage growth is beginning to materialize, as we discussed in our investment outlook published last year. The influential "Shunto" spring wage negotiation has yielded significant pay rises for the past three consecutive years as expected. At the same time, moderating rice prices, which pushed Japan's inflation to the highest level among developed economies at one point, combined with government winter energy subsidies, part of PM Takaichi's anti-inflation measures, have curtailed inflationary pressure. Subsequently, real wage growth has returned to positive territory in recent months (Figure 2).

Figure 2: Consumer Price Index (CPI) and wage growth



Source: Created by Invesco based on data from CEIC, Bloomberg and Ministry of Health, Labour and Welfare. Data as of March 2026.

Ahead of real wage growth, household consumption has been modestly but steadily increasing throughout 2025 as well as in the first quarter of 2026. These readings point towards wage increase expectations finally taking root in Japan, and real wage growth increasing households' purchasing power from now on. We believe a virtuous wage-price cycle reviving domestic demand is on track and healthy economic growth could underpin stock market performance going forward.

Risk scenario: Delay in Middle East peace talks

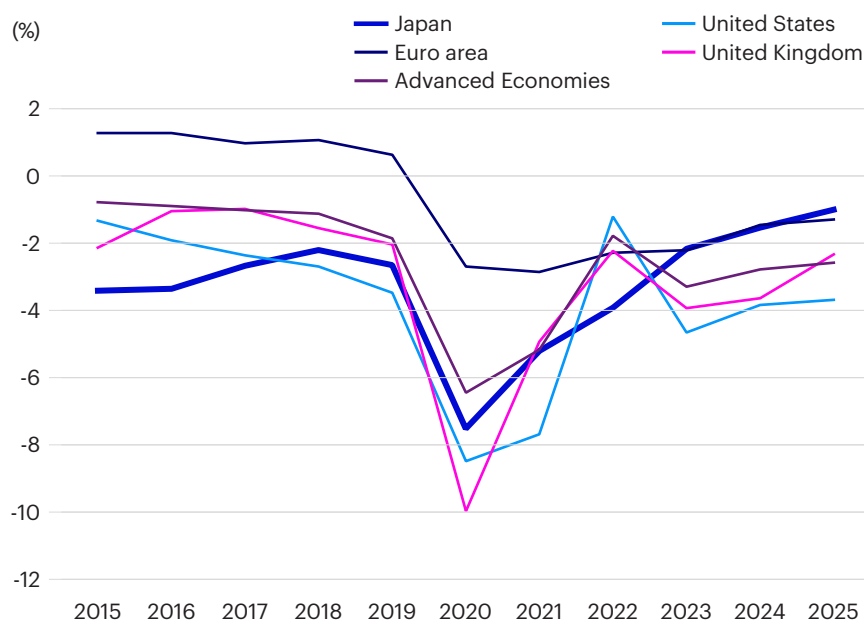
At the same time, the war in the Middle East, from where Japan has historically imported more than 90% of its crude oil¹, poses the biggest risk to our scenario. Japan's economy has yet to face material energy shortages thanks to large oil reserves that meet roughly 200 days of demand as of May 2026.² The government has also started offering subsidies to keep petrol prices low for consumers since March. More recently, PM Takaichi unveiled a JPY 3 trillion (approximately USD 19 billion) supplementary budget to fund another electricity and gas subsidy during the summer peak season and extend gasoline subsidies. While Japan's primary balance has improved significantly and remained contained compared to major advanced economies, thanks to tax revenue growth amid returning inflation and growing nominal GDP (Figure 3), providing government subsidies in the long run is unsustainable.

1. Source: Agency for Natural Resources and Energy, Ministry of Economy, Trade and Industry (METI). Data as of March 2026.

2. Source: Agency for Natural Resources and Energy, Ministry of Economy, Trade and Industry (METI). Data as of May 2026.

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Figure 3: Primary balance comparison among advanced economies (% of potential GDP)



Source: IMF Financial Monitor (April 2026).

Consequently, mounting concerns about Japan’s fiscal health have put selling pressure on the Japanese yen and government bonds. In contrast, its equity market has shrugged this aside, so far. That said, if the Middle East conflict is prolonged and energy prices remain elevated, fiscal concerns may spill over into the equity market, and eventual energy price hikes will act as a drag on private consumption, as well as corporate earnings.

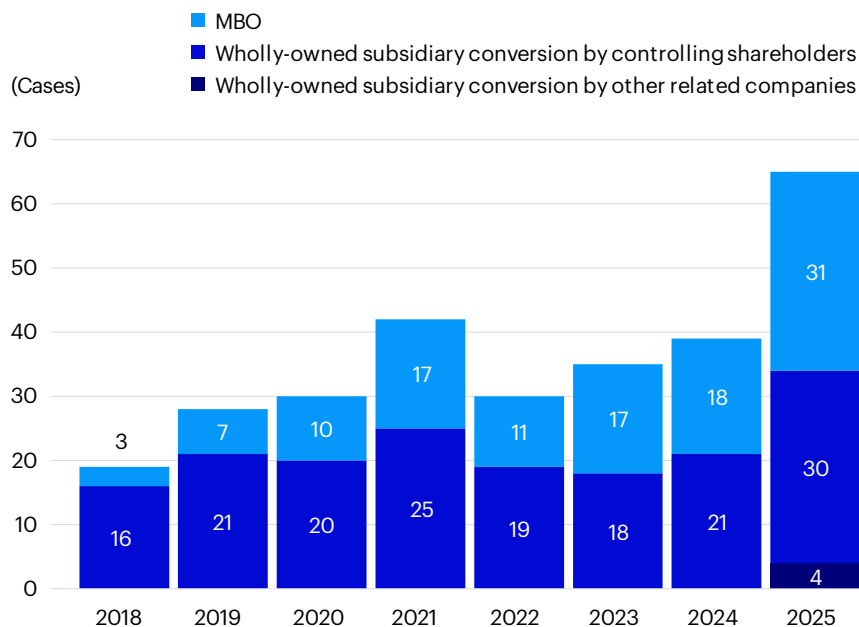
Active investment implications: Rotation to laggards and broadening buying interest

Over the last several years, top-down and theme-driven factors have dominated the Japanese equity market, triggering very narrow rallies in specific segments. This year, while AI and semiconductor euphoria has stayed like elsewhere, driving the Nikkei 225 index, which is highly exposed to those names, above JPY 60,000 for the first time in April this year just after surpassing JPY 50,000 last year, we have also observed catch-ups among stocks that fell out of favor despite healthy fundamentals or strong growth prospects during market rallies on the ground.

For instance, three years on from the Tokyo Stock Exchange’s (TSE) gearing up its market restructuring efforts to promote capital efficiency and stock price rises, we have witnessed a rise in corporate actions and the resulting rerating among laggards. One such trend is an increase in management buyouts (MBOs) and subsidiary conversions as these companies relinquish market listings amid growing pressure from investors by paying a price premium (Figure 4). As part of its restructuring efforts, the TSE has also upgraded transparency and accountability requirements for MBOs and subsidiary conversions to protect minority shareholders, and there have been cases in which activist intervention have lifted takeover prices. Such progress in corporate governance is expected to unlock value among overlooked names.

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Figure 4: Management Buyouts (MBOs) and wholly owned subsidiary conversions



Source: Tokyo Stock Exchange. Note: Aggregated using MBOs and similar transactions disclosed between 2018 and 2025.

It is also noteworthy that this year has seen the outperformance of the Tokyo Stock Exchange (TSE) Growth Market 250 index (+22.5% year-to-date³), which comprises start-ups and high-growth companies and had suffered from a significant decline in investor interest over the last several years, against the TOPIX index (+14.9% year-to-date⁴), which represents the overall market. Investors are broadening their buying interests into niche but cutting-edge small companies capitalizing on growing markets, such as energy security, aerospace, and defense, staging a comeback for the TSE Growth Market 250 index.

Accordingly, we reiterate our view that market leadership will broaden with investors' focus shifting to individual companies' fundamentals and growth prospects, rewarding bottom-up stock picking over top-down themes.

3. Source: Bloomberg. Data as of 27 May 2026.

4. Source: Bloomberg. Data as of 27 May 2026.

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Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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