Asset Management One Co., Ltd.

Japan Outlook 2025

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Contents

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Asset Management One

Creating a sustainable future through the power of investment

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Japan Economic Outlook for 2025

Economic and Price Outlook for 2025

The economy is expected to continue recovering in 2025, driven by domestic demand such as consumer spending and capital investment. This recovery is supported by the prospect of real wages turning positive and a strong appetite for efficiency and labor-saving investments against a backdrop of labor shortages. The driving forces of the Japanese economy include (i) Personal Consumption: This will be supported by higher wages and increased incomes from tax cuts, (ii) Domestic Capital Investment: This reflects investments in digital transformation, efficiency, and labor-saving initiatives in response to labor shortages, as well as continued on-shoring due to a weak yen and geopolitical risks, and (iii) Inbound Consumption: Increased spending by foreign tourists is also expected to contribute. On the other hand, risk factors include (i) Stagnant consumption due to persistently high prices, (ii) Downturn in overseas economies such as those of the US and China, and (iii) Higher import tariffs resulting from the Trump administration's policies.

The Bank of Japan (BoJ) raised its policy rate (the unsecured call rate) from around 0-0.1% to around 0.25% at the Monetary Policy Meeting in July 2024. With regard to JGB purchases, it was decided to reduce the purchase amount from the monthly figure of around 6 trillion yen to around 3 trillion yen per month in the January-March quarter in 2026 (a reduction of around 400 billion yen each quarter).

Given that immediately after the July rate hike, the USD/JPY rate strengthened rapidly and Japanese stocks plummeted, the BoJ clarified its stance not to raise interest rates while the market is unstable. At the same time, however, the BoJ essentially maintains its stance of continuing to raise policy rates if the economy and prices are on track. The next rate hike is expected to take place by January 2025, with an equal chance of occurring in either December 2024 or January 2025.

Forecast Summary

Calendar Year	Actual 2022	Actual 2023	AMO's Estimate 2024	AMO's Forecast 2025
Real GDP (YoY, %)	1.2	1.7	-0.2	1.7
Core CPI (YoY, %)	2.3	3.1	2.6	2.2
BOJ Policy Rate(%)	-0.10	-0.10	0.25	1.00
JGB 10-Year Yield (%)	0.42	0.61	1.00	1.20
USD/JPY	131	141	150	143
TOPIX EPS	145	171	185	200
YoY, %	7.0	18.0	8.2	8.1
TOPIX	1892	2366	2800	3000
YoY, %	-5.1	25.1	18.3	7.1

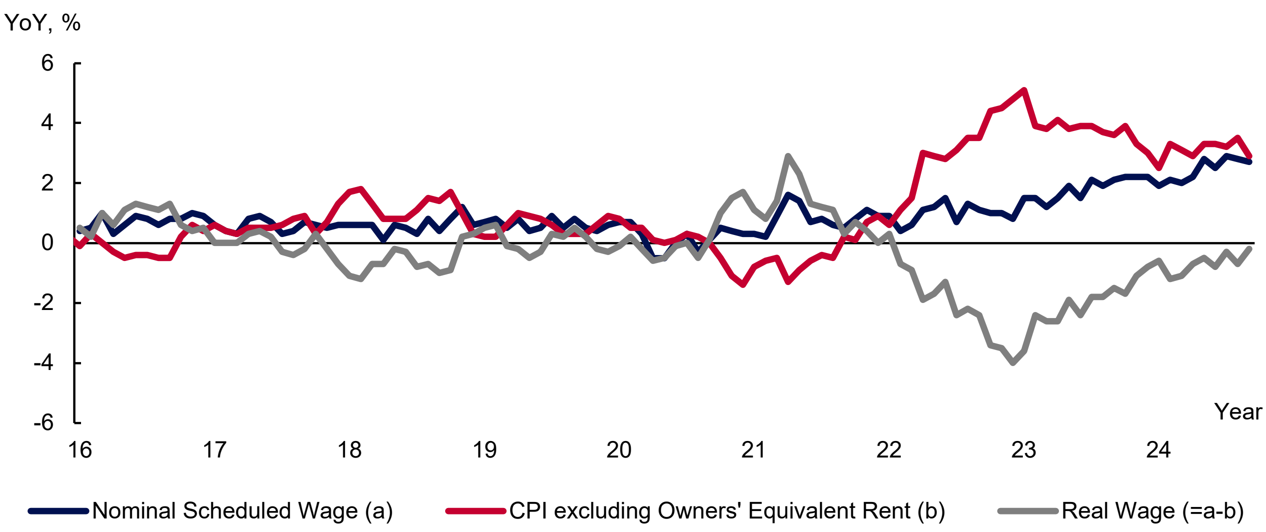
Source: Bloomberg, Factset, Asset Management One Co., Ltd.
Note: The data doesn't suggest or guarantee any future economic situations, market outlook, other trends related to investment environments, etc.

We anticipate that the BoJ will raise the policy rate to 1%, which is considered the neutral rate, by the end of 2025. If the Trump administration's policies lead the Federal Reserve (Fed) to pause rate cuts in 2025, the BoJ will find it relatively easier to proceed with rate hikes. The significant market fluctuations in August 2024 were likely due to the BoJ's decision to hike rates at a time when expectations for Fed rate cuts had significantly strengthened.

Consumer prices (excluding fresh food, core) are expected to maintain growth of around 2%. Goods prices will fluctuate depending on international commodity markets, exchange rates, and the government's energy subsidy policies, but the underlying trend of prices, which has been steady around 0%, is expected to reach an increase rate in the high 1% range as the rise in service prices expands due to wage increases.

Japanese Trade Union Confederation (RENGO) has demanded wage increases of more than 5% in the upcoming spring labor negotiations of 2025, and has indicated a policy of demanding wage increases of more than 6%, particularly for labor unions in small and medium-sized enterprises (SMEs). We expect that the trend of wage increases and consumer price rises will continue in 2025 as well.

Real Wage Growth



Source: Japan Ministry of Health, Labor and Welfare, Asset Management One Co., Ltd.
Note: Monthly data from January 2016 to September 2024

Will wage increases, which hold the key to maintaining a 2% consumer price increase, continue beyond 2026 ?

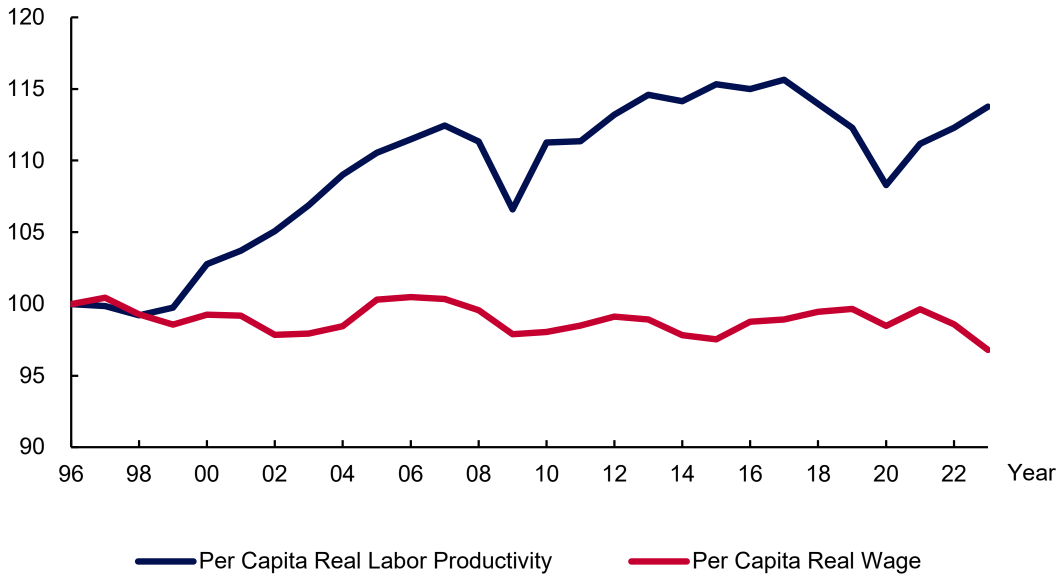
In the medium to long term, it will be crucial whether wage increases are accompanied by productivity growth rather than relying on cost-push pressures due to supply constraints (manpower shortages). Otherwise, it will squeeze corporate profits.

Looking at the economy as a whole, wages in Japan have been restrained compared to labor productivity growth. However, the situation varies significantly depending on the industry and company size. When examining the labor share by company size, it is considerably higher in SMEs compared to large companies, suggesting that rising labor costs have a greater impact on profits. If SMEs operate in a B2B context, it may be possible to pass on costs to large companies. On the other hand, in B2C contexts such as the food and beverage and personal services industries, such cost pass-through may be more challenging.

Generally, the relationship between wage growth rates and labor productivity is influenced by regulations and employment practices in the labor market. In Japan, workers have historically accepted lower wage increases in exchange for higher job security (often referred as "lifetime employment"). In contrast, in countries like the US, where job security is lower, wage increases have more closely reflected productivity growth.

In Japan, manpower shortages are becoming more severe due to demographic trends, and this situation is unlikely to be resolved in the short term. While job-based employment is already becoming more prevalent, we expect that wage increases reflecting labor productivity growth will become more established as societal norms evolve.

Real Labor Productivity and Real Wage



Source: Japan Ministry of Health, Labor and Welfare,
Japan Cabinet Office, Asset Management One Co., Ltd.
Note: 1. Annual data from CY1996 to CY2023
2. CY1996=100

Japan Monetary and Fiscal Policy Outlook

Monetary Policy

The BoJ is expected to continue raising interest rates as a basic policy amid prospects for a virtuous cycle of income and growth. The next rate hike is anticipated by January 2025, with the unsecured call rate likely to be raised to 0.50%. By the end of 2025, the BoJ is expected to raise the policy rate to 1.0%, which is considered the lower limit of the neutral rate.

Admittedly, there is a significant hurdle in raising the interest rate above 0.50%, which has been recognized as an "insurmountable barrier" since the Bank of Japan Law came into force in 1998, granting the BoJ autonomy over its monetary policy. On the political side, the Democratic Party For the People (DPFP) and other parties that emphasize income redistribution policies, may pressure to delay the rate hike due to concerns about the impact on mortgage rates and other factors.

Additionally, if the Fed does not signal a pause and proceeds to cut interest rates, financial markets may adjust excessively, as they did in August 2024, due to the differing directions of monetary policy between the US and Japan.

The BoJ will need to provide a more detailed explanation of the neutral interest rate level and the impact of a rate hike on the macroeconomy and other factors than it currently does. Under Governor Ueda, decisions to lift negative interest rates or raise interest rates are often communicated through newspaper reports in the late evening immediately before a meeting. This approach tends to surprise the market. While this can be a positive surprise in the case of monetary easing, in the current situation, the BoJ is expected to change its stance to allow the market to factor in the decision more in advance through newsletters like the Fed, rather than immediately before the meeting, in order to avoid excessive market volatility.

Fiscal Policy

Following the results of the lower house election, the ruling party has become a minority government and has been forced to incorporate the policies of the opposition parties, especially the DPFP. The supplementary budget for Fiscal Year (FY) 2024 (ending March 2025) is expected to be around 13 trillion yen in terms of expenditure. The contents include (i) benefits for low-income earners, (ii) extension of gasoline, electricity, and gas subsidies, (iii) subsidies for the semiconductor industry (i.e., Rapidus Corporation), and (iv) local subsidies, all of which are extensions of previous policies and are expected to have a limited additional buoyancy effect on the economy.

In the tax reform for FY 2025 (ending March 2026), the DPFP has proposed raising the threshold of the “1.03 million yen barrier” to “1.78 million yen.” If fully realized, this change could result in a tax revenue decrease of approximately 7.6 trillion yen, which is expected to correspond with an increase in personal income, according to government estimates. The DPFP supports this increase based on the fact that the nationwide weighted average minimum wage has risen from 611 yen in 1995 to 1,055 yen in 2024, representing a 1.73-fold increase. During the same period, the consumer price inflation rate has increased the 1.03 million yen tax threshold to approximately 1.13 million yen when applying a 1.1-fold increase. The anticipated 7.6 trillion yen reduction in tax revenue is roughly equivalent to a 3% decrease in consumption tax, indicating a significant fiscal impact. We expect the actual effects to fall somewhere between these estimates. The implementation of the tax reform is scheduled for April 2025, but it is expected to be applied retroactively from January. Assuming a marginal propensity to consume (MPC) of 30%, we project that personal consumption could increase by approximately 0.3 percentage points, while real GDP may rise by about 0.2 percentage points.

Key Points Regarding Future Policy Trends

Based on statements and political stances prior to the Japanese presidential election, it has been pointed out that Prime Minister Ishiba may promote policies such as increased fiscal spending for regional revitalization, corporate tax hikes, and strengthened taxation on financial income. However, due to his weak foundation within the Liberal Democratic Party (LDP) and the loss of a majority for the ruling coalition in the House of Representatives elections in October, the scope for Ishiba to assert his uniqueness has significantly diminished. Furthermore, in the domestic stock market and asset management industry, there has been a suggestion of continuity in policies favorable to the market, such as those promoted by the former Prime Minister Kishida's administration under the concept of becoming an "asset management nation." As a result, concerns about Ishiba's unique policies have somewhat eased. In the context of a minority ruling party government, there is an increasing necessity to incorporate policy proposals from the DPFP, such as raising the income threshold of 1.03 million yen (expanding the basic income tax deduction) and gasoline tax reductions, leading to a greater emphasis on income redistribution policies.

Despite relatively strong economic conditions, low unemployment rates, and a generally rising stock market, the low approval ratings for the government have become a common issue among developed countries. The rising prices have made life difficult, leaving many without discretionary funds to invest in risk assets, preventing them from benefiting from the stock market gains. This voting behavior among those affected is believed to have influenced the election results in the US and Europe in 2024. The same trend was observed in Japan, where the policy stance of the DPFP to "increase take-home pay" has gained support among the public.

Due to Ishiba's weak support within the party, there were calls in the market for Takaichi, who advocates for the continuation of Abenomics, to compete against Ishiba in a runoff in the LDP presidential election. However, it is believed that policies lacking consideration for income redistribution will not gain public support in the current situation. Therefore, it is not expected that there will be a strengthening of anti-Ishiba forces within the party or a split within the LDP.

In the tax reform for FY 2025, it is highly likely that the DPFP's proposal to raise the annual income threshold of the "1.03 million yen barrier" will be included. A gasoline tax reduction is also expected to be considered. While fiscal policy may become expansionary and boost domestic economic conditions, the issue of how to secure funding becomes critical if it results in permanent tax cuts. Raising the threshold is anticipated to encourage labor supply, and if labor supply increases, there is a possibility that consumption tax revenue will rise through increased income. However, it has been pointed out that Japan's labor participation rates for women and the elderly, which were once considered low on an international scale, have already risen significantly, suggesting that the effect may be limited.

Note: The term "1.03 million yen barrier" refers to a concept in Japan in the context of taxes. This barrier indicates that if an annual income exceeds 1.03 million yen, the individual will lose certain tax benefits, such as the spouse deduction or dependent exemption. Specifically, if a spouse earns 1.03 million yen or less, they can take advantage of the spouse deduction, resulting in reduced tax liabilities. However, if their income exceeds 1.03 million yen, these deductions will no longer apply, leading to an increased tax burden. As a result, many part-time workers, such as housewives or spouses, typically adjust their working hours to avoid exceeding the 1.03 million yen threshold. Due to this system, many people are mindful of the "1.03 million yen barrier" when considering their income while working.

Additionally, it is necessary to consider the thresholds of 1.06 million yen and 1.3 million yen, which could lead to a reverse phenomenon where social insurance burdens arise, resulting in decreased take-home pay.

Since social insurance premiums are shared by companies, any increase in these premiums is expected to particularly heighten the cost burden for SMEs. On the other hand, this will also affect the amount of pension that workers will receive in the future. The traditional system, which assumes a household structure where the husband works and the wife is a full-time homemaker (and does not divorce), is increasingly seen as outdated. There is a growing consensus that everyone should bear the burden of social insurance premiums.

Note: The thresholds of 1.06 million yen and 1.3 million yen pertain to social insurance premiums. If part-time workers and others earn more than 1.06 million yen or 1.3 million yen annually, they will be removed from their spouse's dependency, resulting in the burden of social insurance premiums and a reduction in their take-home pay. The 1.06 million yen threshold applies to those working in companies with 51 or more employees. When an annual income exceeds 1.06 million yen and weekly working hours exceed 20 hours, the worker is removed from their spouse's dependency and must pay employees' pension and health insurance premiums. The 1.3 million yen threshold applies to those working in companies with 50 or fewer employees. If the annual income exceeds 1.3 million yen, the worker is removed from their spouse's dependency and must pay national pension and national health insurance premiums.

Japan Market Outlook

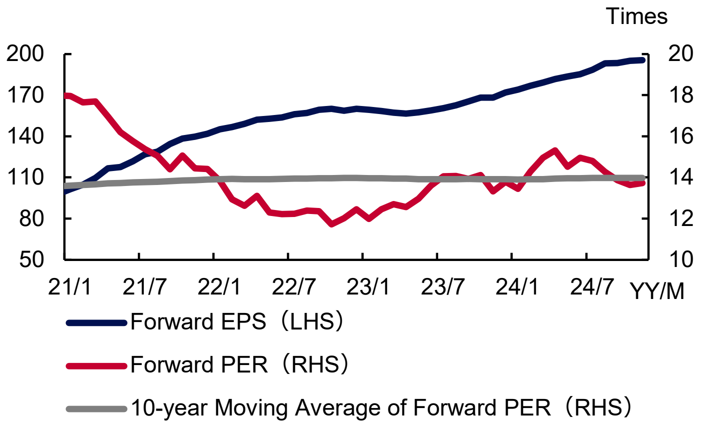
Japanese equity, interest rate and currency exchange rate outlook for 2025

Japanese equities

Notwithstanding the BoJ's tightening stance, we expect profit growth to continue against the backdrop of domestic economic recovery, leading to a sustained upward trend in Japanese stocks. We think factors to support Japanese stocks include (i) The transition from a deflationary economy to a growth economy, (ii) Progress in management reforms focused on capital costs and stock prices, (iii) The increasing strategic importance of Japan to the US. under the Trump administration from a security perspective, and (iv) Market revitalization through the government's policy of becoming a "nation of asset management."

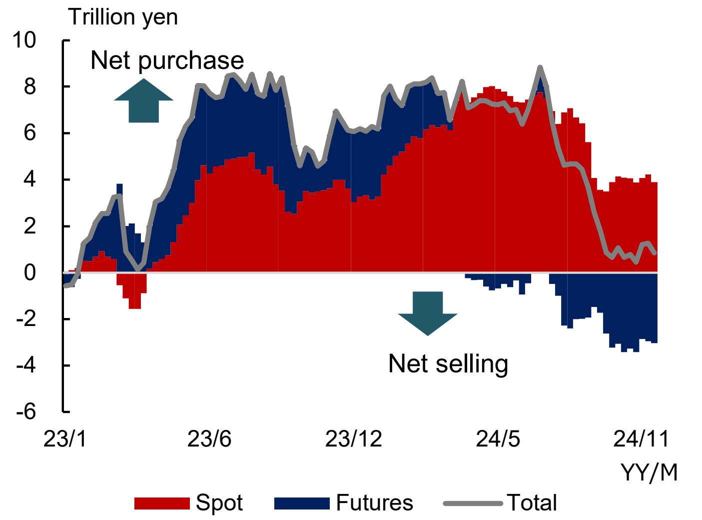
Japanese equities rose substantially in 2024, most of the gains occurred by end of July, when the BoJ decided to raise interest rates, leading to August sharp correction. The yen strengthened temporarily after the BoJ's rate hike and the Fed started cutting rates, which increased USD/JPY volatility, while domestic corporate earnings for the July-September quarter were somewhat lackluster, especially for automobiles, due to foreign exchange losses, and volatility in Japanese equities remained higher than before the BoJ's July hike, which have led to a holding back of Japanese stock purchases, particularly from foreign investors. However, corporate earnings are projected to continue expanding in 2025, with an expected inflation rate of 2%. The BoJ is anticipated to cautiously adopt interest rate hikes, and the rise in domestic long-term interest rates is expected to be managed. As a result, a significant valuation adjustment of the TOPIX, similar to what occurred in August 2024, is not anticipated. We expect the TOPIX index to reach 3000 by the end of 2025.

TOPIX Forward EPS and PER



Source: LSEG Data & Analytics, Asset Management Co., Ltd.
Note: 1. Monthly data from January 2021 to November 2024
2. Forward PER indicates price to earnings ratio based on 12 month forward earnings
3. Stock price = Forward EPS × Forward PER

Japanese Equity Purchases by Foreigners

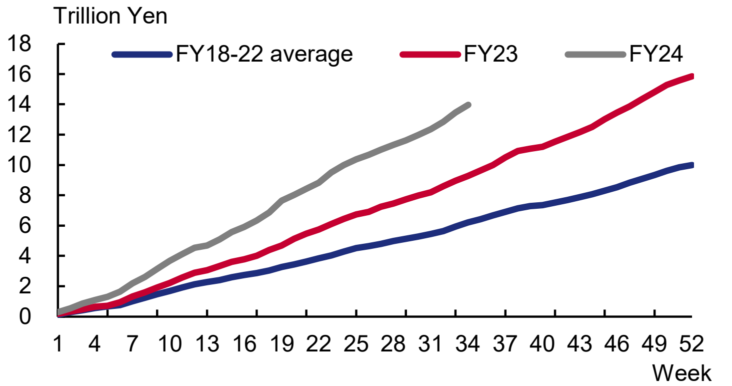


Source: Bloomberg, Asset Management One Co., Ltd.
Note: 1. Weekly data from the week of 4-6 January 2023 to the week of 6- 22 November 2024
2. The cumulative net purchase amount of Japanese equities, total of two markets, excluding Nikkei 225 micro futures

The trend of companies enhancing capital efficiency is gaining traction, particularly with a rise in share buybacks in 2024, which has sustained share prices. In 2025, we anticipate a similar increase in share buybacks. While more companies are expected to pursue privatization through management buyouts (MBOs) due to the higher costs of being listed, those wishing to remain public will continue to face the need for management reforms. This dynamic is expected to contribute to the revitalization of the market.

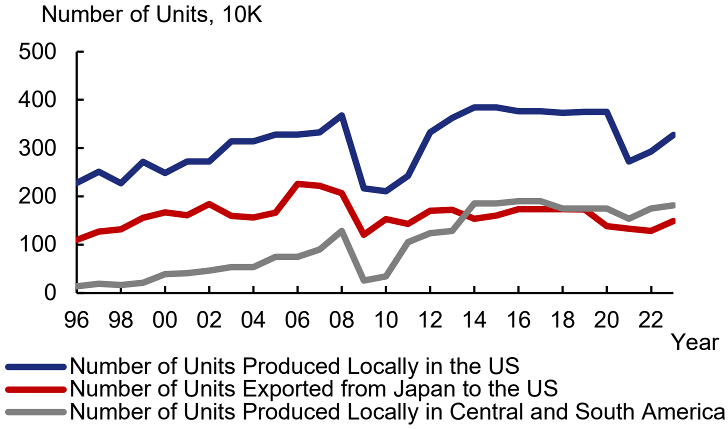
There are concerns that geopolitical risks will increase in 2025 as Trump's second administration begins. Although Trump has suggested raising import tariffs not only against China but also uniformly across the world, we think that it is used as a bargaining tool in bilateral negotiations and it is not likely that import tariffs will actually be raised on all items. Japan's share of US imports has also not been high in recent years, at less than 5%. From the perspective of China, Japan's strategic position is seen as increasing in importance, which makes Japan a relatively low-risk country. However, the impact of tariff hikes on automobiles, which are the top export item to the US and are often bypassed through Mexico and other countries, will be a concern.

Japanese Equity Purchases by Corporates



Source: LSEG Data & Analytics, Asset Management One Co., Ltd.
Note: Weekly data from FY2018 and FY2024

Japanese Automobiles Units Breakdown



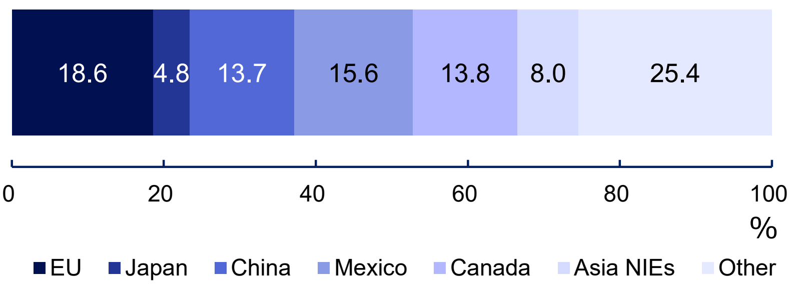
Source: Japan Automotive Manufacturers Association, Asset Management One Co., Ltd.
Note: Annual data from CY1996 to CY2023

Japan’s Top 10 Exports to US

CY2023	Trillion Yen	Share(%)
Total	20.3	100.0
Automobiles	5.8	28.8
Engines and Turbines	1.1	5.3
Automobile parts	1.1	5.3
Construction and Mining Machinery	0.9	4.7
Scientific Optical Equipment	0.5	2.6
Semiconductor Production Equipment	0.5	2.4
Pharmaceuticals	0.4	2.2
Heavy Electrical Machinery	0.4	2.0
Electric Measuring Instruments	0.4	1.9
Centrifugal Machinery	0.3	1.7

Source: Ministry of Finance Japan, Asset Management One Co., Ltd.

US Imports by Country



Source: US BEA, JETRO, Asset Management One Co., Ltd.
Note: CY2023

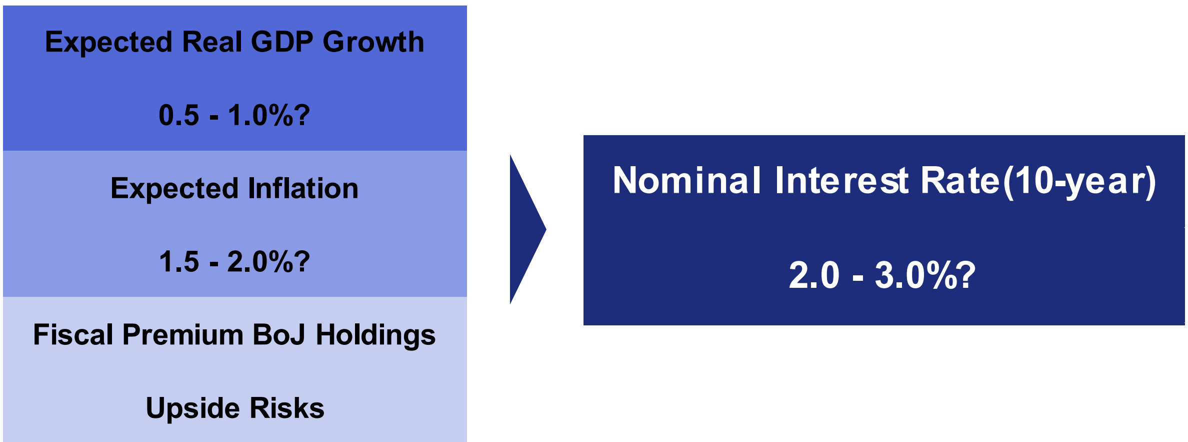
Japanese long-term interest rates

We expect Japanese long-term interest rates to trend moderately upwards following the entrenchment of inflation and the BoJ’s interest rate hikes. Given that 2% inflation is entrenched in the Japanese economy in the medium to long term and Japan's potential growth rate is around 0-1%, it is theoretically possible for the long-term interest rates to rise to around 2-3%. However, the BoJ's holdings remain large and, even taking into account the impact of QT (Quantitative Tightening), the stock effect is expected to restrain the rise in long-term interest rates for the time being. We also do not expect US long-term interest rates to rise further, and developments in overseas interest rates are likely to act as a factor restraining the rise in domestic long-term interest rates. We expect real long-term interest rates to remain in negative territory and not significantly affect the domestic economy.

USD/JPY rates

The Fed is likely to suspend interest rate cuts by the end of 2025 and take a wait-and-see approach, and even if the BoJ raises interest rates, the USD/JPY rate is expected to appreciate only moderately to a level above 145 yen. There remains the possibility of a renewed expansion of carry trades by short-term foreign investors. However, if the BoJ's tightening stance is halted and the Japanese government reaches a milestone level such as 155 or 160 yen, and there are signs of a build-up of yen selling positions by short-term foreign investors, the government will not hesitate to intervene in the market.

Theoretical JGB 10-year Yield



Movement Towards Overcoming Deflation – Follow up

In 2024, the Japanese economy is steadily progressing towards a complete escape from deflation, with a price increase rate exceeding 2% for three consecutive years and a significant wage increase rate in the spring labor negotiations for two consecutive years. Regular salaries are also rising, leading to nearly positive real wages. Consumers appear to be viewing the revitalization of economic activity through price increases positively. In 2025, it will mark the fourth year of rising prices and the third year of increased wage growth. To enhance the sustainability of the cycle of wage increases and increased consumption, it is important to support not only the improvement of companies' ability to pass on costs but also to consider increasing the "labor equipment rate (capital equipment per person)" and to further promote investments in efficiency and labor-saving measures.

Movement Towards Overcoming Deflation

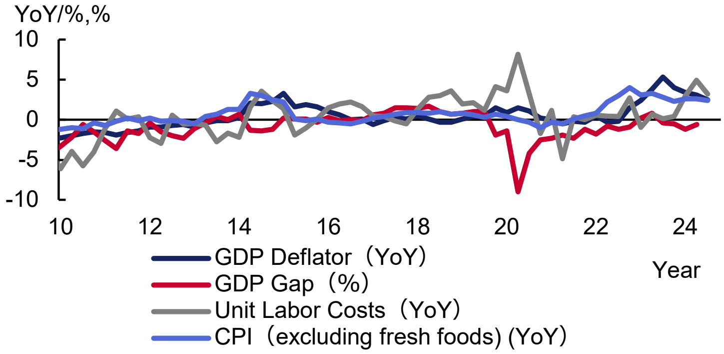
In 2024, the Japanese economy continued to see a core consumer price index (core CPI, which excludes fresh food) increase of over 2% year-on-year, and nominal GDP exceeded 600 trillion yen. The BoJ, perceiving a situation where the 2% price stability target could be sustainably achieved, lifted the negative interest rate in March 2024 and raised the policy interest rate to 0.25% in July, marking the beginning of the normalization of monetary policy.

Regarding the exit from deflation, three of the four indicators emphasized and closely watched by the government, excluding the supply-demand gap, have turned positive. The core CPI has remained above 2% year-on-year since April 2022. The GDP deflator has also been above 2% year-on-year. The unit labor cost (nominal employee compensation / real GDP) has increased, driven by rising employee compensation amid employment growth and wage increases.

Furthermore, real GDP growth rates increased for two consecutive quarters in the April-June and July-September quarters of 2024, and the supply-demand gap is expected to turn positive soon.

The trigger for the positive cycle of prices and wages was the rise in prices due to soaring international commodity markets, the depreciation of the yen, and wage increases driven by labor shortages. However, the effects of policies supporting companies' proactive pricing and wage increase behaviors are also considered significant. The former Prime Minister Kishida's administration promoted a "virtuous cycle of growth and distribution," raising wages in public sectors such as healthcare, nursing care, childcare, and public procurement, while also increasing the prices of public services. Additionally, efforts have been made to expand wage increase tax systems, raise the minimum wage, and create an environment for appropriate price pass-through for SMEs that often rely on subcontracting. For FY2024, the minimum wage guideline was set at an average of 1,055 yen per hour nationwide, marking the largest increase of 50 yen. The minimum wage influences the wage decisions of non-regular employees, such as part-timers, and affects the pricing strategies of SMEs.

4 Economic Indicators to Assess If Japan is Overcoming Deflation



Source: Japan Cabinet Office, Ministry of Internal Affairs and Communications, Asset Management One Co., Ltd.

Note : 1. GDP Gap: quarterly data from Q1 2010 to Q2 2024, others: quarterly data from Q1 2010 to Q3 2024

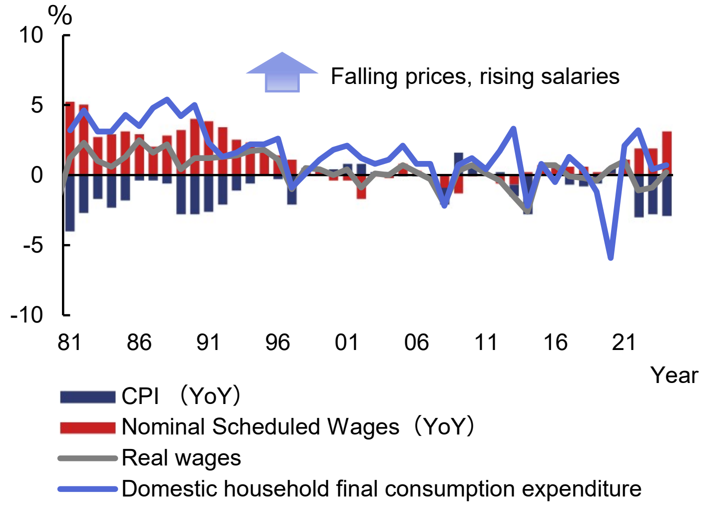
2. Unit labor costs = Nominal employee Wage/real GDP (numbers in 2014 and 2019 were affected by the increase in consumption tax rate)

Real wages are expected to enter positive territory in 2024

The wage increase during the spring labor negotiations in 2024, according to RENGO's calculations, reached 5.1%, the highest increase since 1991. As a result, regular salaries are approaching +3% compared to previous year's level, indicating that real wages are almost positive.

When examining the trend of real wages since 1981, there have been periods of positive growth. In the 1980s and early 1990s, wages grew at a rate higher than the rate of price growth, leading to positive wage growth. Subsequent positive periods were mainly driven by falling prices. However, these positive periods were relatively short-lived. For the first time since the 1990s, positive real wage growth will be achieved by wages growing at a rate higher than the rate of price growth. The impact of the same increase in real purchasing power can vary depending on whether prices are rising or falling. If consumers recognize the end of deflation and anticipate continued price increases, the behavior of waiting for prices to fall and postponing consumption may no longer be rational.

Real Wages and Real Personal Consumption



Source: Ministry of Internal Affairs and Communications,
Japan Ministry of Health, Labor and Welfare,
Japan Cabinet Office,
Asset Management One Co., Ltd.

Note: 1. Annual data from FY1981 to FY2024
2. Figures for FY2024 are those as of September or July-September 2024
3. Nominal Scheduled Wages data indicates those of industries covered with 30 or more employees
4. CPI excludes fresh foods and inversely indicated

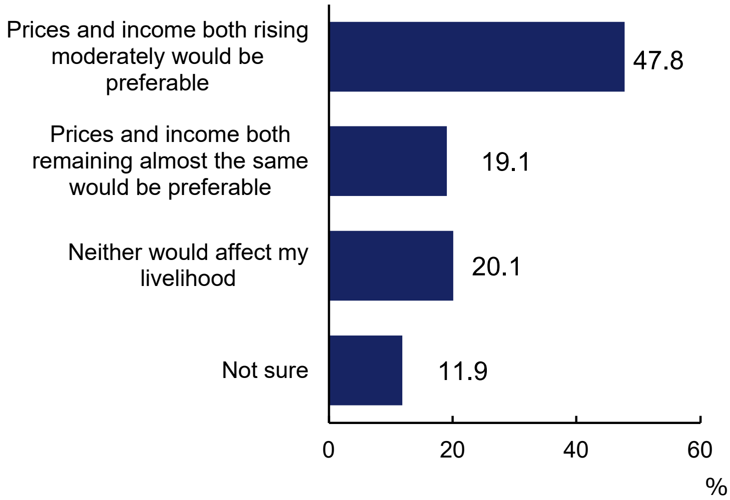
Changes in consumer sentiment

In 2024, with three consecutive years of price increases and two consecutive years of significant wage increases, there has been a shift in consumer perception towards price increases. According to the BoJ's survey on consumer attitudes, approximately half of the respondents indicated a preference for a situation where both prices and income rise moderately, as opposed to a scenario where both remain relatively unchanged. The primary reasons cited for this preference were that it would facilitate income growth and better management of household finances, as well as stimulate economic activity. It is evident that consumers do not necessarily desire strict control of immediat price hikes or cost-of-living, but rather view the stimulation of economic activity through price increases in a positive light.

Service prices are also set to rise

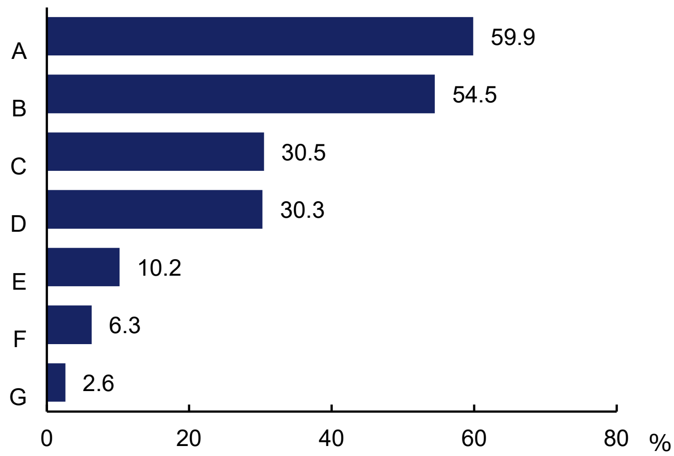
In assessing the spillover from wages to prices, the increase in service prices—particularly those with a relatively high proportion of labor costs—is crucial for sustaining the cycle of rising prices and wages. The Consumer Price Index (CPI) for services, excluding imputed rents for owner-occupied housing, has been fluctuating around a year-on-year increase of approximately 2%. The BoJ has published an analysis in its "Economic and Price Outlook" report, stating that an increase in the minimum wage will significantly elevate service prices. In light of the former Prime Minister Kishida's objective to raise the national average minimum wage to 1,500 yen per hour by the middle of the 2030s, both the ruling and opposition parties have proposed policies aimed at expediting this timeline in the recent House of Representatives election. The BoJ anticipates that if minimum wage increases persist, prices—especially for services—are likely to rise.

View on Prices and Livelihood



Source: BoJ, Asset Management One Co., Ltd.
Note: Survey Period from 8 August to 3 September 2024

Why Do You Prefer Prices and Income Both Rising Moderately?



A: My income would likely increase, making it easier to manage the household budget
B: It would boost economic activity
C: I could expect a better future and thus be positive about, for example, consumption and home purchases rather than saving
D: A smaller price differential between Japan and abroad would stabilize foreign exchange rates
E: It would be easier to repay my existing loans
F: It would make room for interest rates to decline in times of economic downturn
G: Other

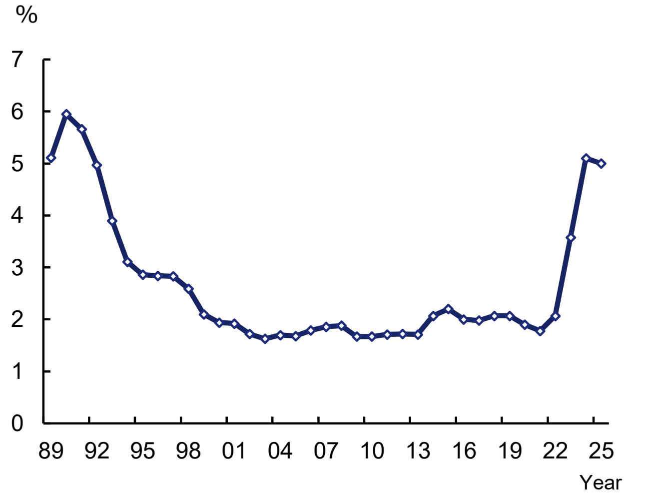
Source: BoJ, Asset Management One Co., Ltd.
Note: Survey Period from 8 August to 3 September 2024

Wage increases will continue

To solidify the trend of wage increases, the RENGO has decided to set their wage increase demand for 2025 to "at least 5%", the same as in 2024. Additionally, for labor unions in SMEs, they will seek a demand of "at least 6%" to address wage disparity.

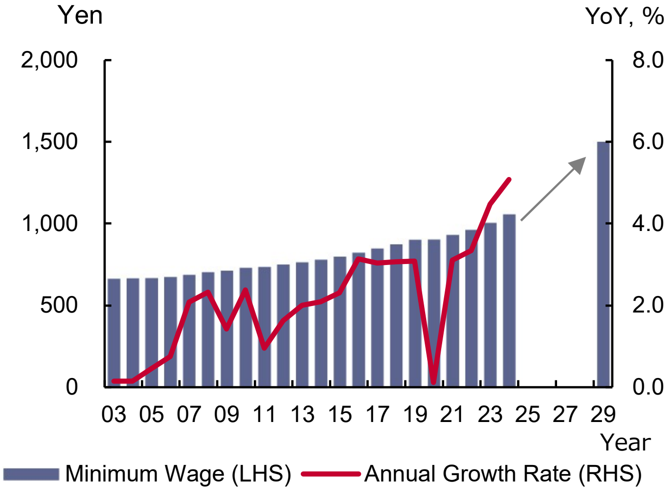
According to "Survey on Actual Conditions of Wage Increases" conducted by the Ministry of Health, Labor and Welfare's in 2024, when examining the factors considered most important in determining wage revisions, apart from "company performance" which holds the largest percentage, there is a noticeable increase in the importance of "securing and retaining labor (securing new workers)" and "maintaining employment (preventing the outflow of existing workers)" due to the recent labor shortage. By company size, larger enterprises tend to prioritize hiring new workers, while smaller enterprises focus on maintaining existing employment. In order to sustain a decent standard of living amidst rising prices and secure a labor force under labor shortages, there is a high likelihood of achieving substantial wage increases in 2025.

Percentage of Wage Increases in Spring Labor Negotiations



Source: The Japanese Trade Union Confederation (RENGO), Asset Management One Co., Ltd.
Note: 1. Survey period from 1989 to 2024
2. RENGO's demand policy for 2025

Minimum Wages



Source: Japan Ministry of Health, Labor and Welfare, Asset Management One Co., Ltd.
Note : 1. From FY2003 to FY2024
2. 1,500 yen for FY2029 based on PM Ishiba's statement

Percentage of Firms by Size of Firm by the Most Important Factors in Deciding to Revise Wages

%

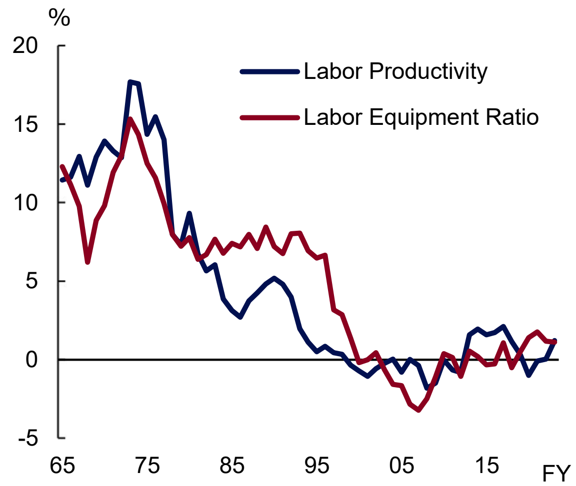
	Corporate Performance	Securing and Retaining Labor	Maintaining Employment	Price Trends	Market Trends
Total	35.2	14.3	12.8	7.8	7.6
Over 5,000 ppl.	35.4	19.8	6.4	8.0	12.2
1,000 - 4,999	29.5	20.2	12.1	10.3	10.9
300 - 999	32.2	20.6	7.8	10.8	9.2
100 - 299	36.8	11.5	14.8	6.5	6.7

Source: Japan Ministry of Health, Labor and Welfare, Asset Management One Co., Ltd.
Note: 1. Survey period from 20 July to 10 August 2024
2. The survey covers the year 2024
3. Excerpts of the top five factors

Labor productivity gains will be required

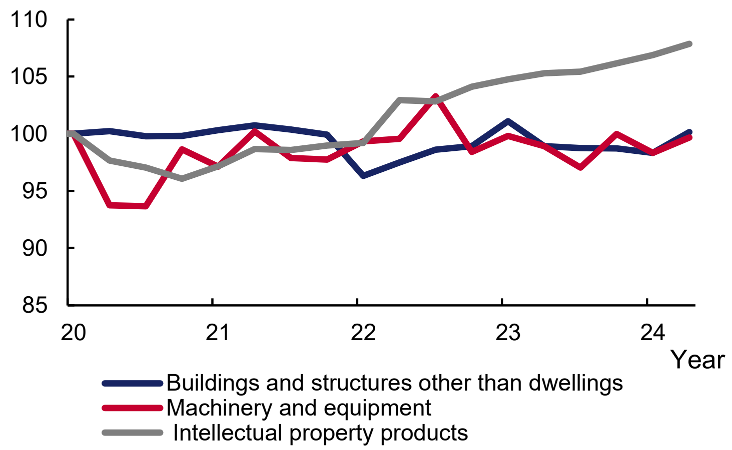
In order to achieve the minimum wage of 1,500 yen mentioned by Prime Minister Ishiba in the 2020s, it would require an annual wage increase exceeding 7%. To cope with such significant wage increases, it is essential for companies to not only improve their ability to pass on costs through price adjustments but also enhance labor productivity through investments in labor-saving measures to address the decline in the labor work force. Real capital investment has been increasing since around the middle of 2020. In particular, intellectual property products (such as research and development, mineral exploration and evaluation, computer software and databases, original works of entertainment, literature, and art) continue to recover, indicating a strong willingness among companies to invest in IT and other areas. In 2025, we will enter the fourth year of price increases and the third year of increasing wage growth. Considering the perspective of improving the "labor equipment ratio" (capital equipment per person), support for further efficiency and labor-saving investments is considered important.

Labor Productivity and Labor Equipment Ratio



Source: Ministry of Finance Japan,
Asset Management One Co., Ltd.
Note: 1. Annual data from FY1965 to FY2023
2. 5-year moving average of annual data
3. All sizes, all industries
(excluding finance and insurance)
4. Labor productivity is Value-added per employee

Gross Capital Formation Classified by Type



Source: Japan Cabinet Office, Asset Management One Co., Ltd.
Note: 1. Quarterly data from Q1 2020 to Q2 2024
2. 2020 Q1 = 100

Immediate Political and Policy Focus

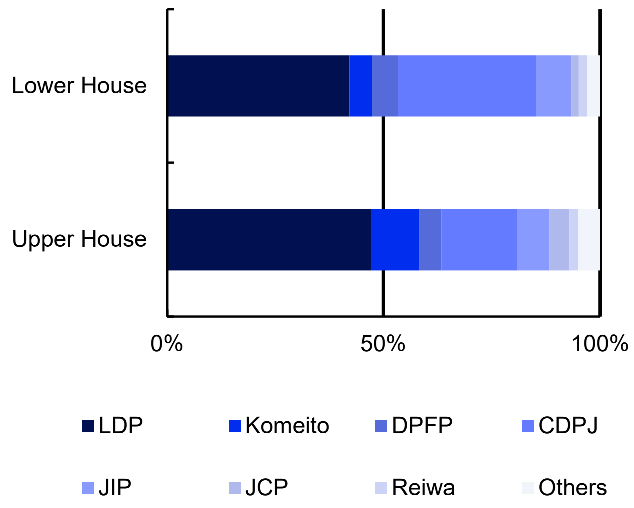
The "development of an environment for wage increases for SMEs" is in a very important phase in an effort to completely break out of deflation, and the inclusion of "improving productivity of SMEs" in the economic stimulus measures is commendable. Tax reform is expected to lead to an increase in household income. It is expected to boost personal consumption and bring an inflow of funds into the financial market through the Nippon Individual Savings Account (NISA), a tax exemption scheme for small investments, and other programs. There are no major differences between the ruling and opposition parties in their recognition of the issues facing Japan, and we believe that the discussion of issues that both parties have tended to turn a blind eye to in the course of their cooperation will provide an opportunity to promote fundamental reforms from a medium- to long-term perspective.

Ruling minority government

In the October 2024 lower house election, the ruling parties of the LDP and the Komeito fell short of a majority, and the second Ishiba administration was formed as a ruling minority that cannot pass a budget or bills without the approval of the opposition parties. In the future, it will be necessary to incorporate the policies of the opposition parties in order to win their approval. In particular, the Democratic Party for the People (DPFP), which has quadrupled its seats in the Diet, has shown no intention of joining either the coalition government or the opposition coalition in the immediate future, and is strengthening its bargaining power by negotiating on a policy-by-policy basis. Attention has focused on the possibility of instability in policy management due to a ruling minority and the ease with which the fiscal scale can be expanded by incorporating the policies of the opposition parties. In addition, if the parties take a long time to coordinate their policies, there is a concern that this may lead to stagnation of economic activities through deterioration of consumer and business sentiment.

On the other hand, with the pace of decline in the working-age population expected to accelerate around the beginning of the 2030s, the next few years represent the last chance to transform the structure of our economy and society toward a sustainable one. The ruling and opposition parties have been dragging each other down in a confrontational structure so far in the past, but we now believe that the development of a cooperative relationship that transcends the boundaries of the ruling and opposition parties could provide an opportunity to work on reforms from a medium- to long-term perspective.

Seats in the Lower House and the Upper House by political parties



Source: LDP, Komeito, DPFP, JIP, JCP, Reiwa, Asset Management One Co., Ltd.

Economic measures

The government has decided on an economic stimulus package entitled "Comprehensive Economic Measures for National Security and Sustainable Growth - Increasing Current and Future Wages and Incomes for All Generations" and aims to pass a supplementary budget to accompany it by the end of FY2024. 13.93 trillion yen will be disbursed for economic measures. The economic measures consist of three pillars: (i) Economic growth to increase wages and income, (ii) Measures to address high prices, and (iii) Measures to ensure security and safety. For households, benefits will be provided to support low-income and child-rearing households affected by high prices. In addition, subsidies to reduce electricity and city gas prices will be resumed only from January to March 2025, and gasoline subsidies will continue, albeit on a reduced scale.

In order to completely break out of deflation, trends among SMEs will be key to the establishment of wage increases and price transfers that exceed price increases. As for policy support that SMEs expect in order to cope with the minimum wage increase, according to the questionnaire, "expansion of tax benefits (income expansion taxation, etc.) when wages are increased" and "request for expansion of subsidies for capital investment and other initiatives to improve corporate productivity (profitability)" were cited. In light of this situation, the inclusion of "raising the minimum taxable amount in the 2025 tax reform" and "improving the productivity of SMEs" is commendable.

Comprehensive Economic Measures

Three Pillars

Pillar 1: Increase Wages and Income for All Generations, Now and in the Future
Encourage Growth of the Japanese Economy and Regional Economies
- Improvement of wage-raising environments
- Productivity improvement of SMEs (raising the floor)
- Regional Revitalization 2.0 (wage and income increase nationwide)
- Strengthening growth (future wages and income increase)
Pillar 2: Pave the Way for a Transition to a Growth-Oriented Economy that Leaves No One Behind
Overcoming Price Increases
- Support for low-income earners affected by price increases
- Promotion of price increase measures tailored to regional realities
- Support for industries affected by price increases
- Strengthening resilience against energy cost increases
Pillar 3: Establish a Foundation for a Transition to a Growth-Oriented Economy
Ensuring National Security and Safety
- Recovery and reconstruction from natural disasters (including responses to energy issues and island areas)
- Strengthening national defense, disaster prevention, and reduction
- Responses to changes in external and security environments
- Crime prevention measures in urban areas, countermeasures against dark part-time jobs
- Support for children and child-rearing, promotion of women's and elderly's active participation, etc.

Source: Japan Cabinet Office, Asset Management One Co., Ltd.

Government Wage Increase Support Measures

Promotion of Price Pass-Through and Fair Transactions
- Strengthening the enforcement of the Subcontract Act, considering legal revisions - Conducting fact-finding surveys on the compliance status of labor cost guidelines and implementing improvement measures by the end of 2024
Business Improvement Subsidies
- Providing support of up to 6 million yen to SMEs that make business improvements and equipment investments (*close to the minimum wage) *When the business location's minimum wage is within 50 yen of the regional minimum wage
Wage Increase Promotion Tax System
- Tax deduction of up to 45% of the increased amount of wages and other payment amounts
Energy Saving and Digitalization Investments
- Raising the subsidy rate to two-thirds for SMEs (*close to the minimum wage) that introduce IT tools *When the business location's minimum wage is within 50 yen of the regional minimum wage and more than 30% of employees have been employed for over 3 months
Preparation of Human Resources and Management Foundations
- Supporting re-skilling - Promoting and spreading job-type personnel policies - Matching management personnel with local companies - Strengthening consultation systems - Supporting M&A to enhance earning power

Source: Japan Cabinet Office, Asset Management One Co., Ltd.

Tax Reform for FY2025

Tax reform is in the spotlight for FY2025. In previous years, the tax reforms have been compiled by the ruling party's Tax Reform Commission of the LDP and the Komeito, but in FY2025, it is necessary to incorporate the so-called “1.03 million yen barrier” that the DPFP has pledged as a centerpiece of its policy. The Cabinet Office estimates that raising the minimum taxable amount to 1.78 million yen, as advocated by the DPFP, would result in a 7.6 trillion yen decrease in tax revenue. In addition to financial resources, discussions need to take into account various barriers such as income tax and other taxes and social insurance coverage requirements, because as income increases, people will be subject to requirements for pension and other social insurance coverage and will have to bear the burden of insurance premiums. Therefore, the future of tax reform is uncertain at this time. In any case, the increase in the taxable minimum is expected to boost consumer spending through higher incomes. Assuming that income growth of about half of the 7.6 trillion yen will be realized, a marginal propensity to consume of about 30% would boost personal consumption by 0.3% and real GDP by about 0.2%.

The economic measures also included “Realization of a ‘Leading Asset Management Center’ and ‘Asset Management Oriented Nation’ - Toward Future Wage and Income Growth. The increase in household incomes could lead to an inflow of funds into the financial markets through the NISA.

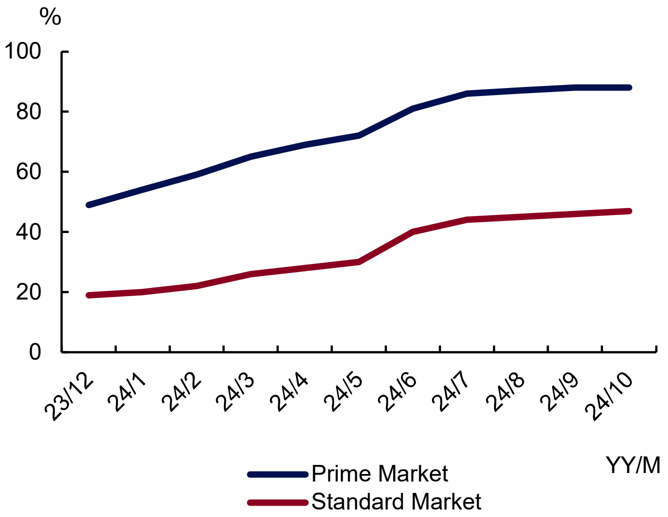
Topic: Movement Toward Improving Corporate Capital Efficiency Deepens

The Tokyo Stock Exchange (TSE) is strongly urging listed companies to make more in-depth reform plans to improve ROE, rather than temporary measures such as share buybacks.
Stricter guidelines for the exercise of voting rights by institutional investors and an unwinding of cross-shareholdings are expected to further increase the cost of maintaining a company's listing and the need for ongoing management reforms is expected to increase.
Almost two years have passed since the TSE requested all listed companies on the Prime and Standard markets to achieve cost of capital and stock price conscious management at the end of March 2023.

Progress in disclosure of measures in response to TSE request

The TSE revealed that as of the end of September 2024, the stock prices of companies in the Prime market that have disclosed measures in response to their request (1,310 companies), companies under consideration (124 companies), and companies not yet disclosing measures (197 companies) had increased by +27.89%, +14.03%, and +13.99%, respectively, since the end of March 2023. In addition, the TSE published case studies in late November 2024 and companies that were featured as good practices (43 companies) had increased by +49.95% over the same period.

Percentage of Companies that Disclosed Measures in Response to TSE Requests



Source: JPX, Asset Management One Co., Ltd.
Note : Percentage of companies that disclosed measures, including those under consideration, based on the number of companies, at the end of each month

Stock Price Trends of Companies Responding to TSE Requests

		No. of companies	Stock Prices
Prime Market			
	Included in Case Studies	43	49.95%
	Disclosed	1,310	27.89%
	Under consideration	124	14.03%
	Not disclosed	197	13.99%
Standard Market			
	Included in Case Studies	13	81.52%
	Disclosed	510	21.09%
	Under consideration	211	16.48%
	Not disclosed	842	9.89%

Source: JPX, Asset Management One Co., Ltd.
Note: 1. Stock Prices indicate share price return from 31 March 2023 to 30 September 2024
2. "Included in Case Studies" indicates companies that are featured as good practices in the document published by the TSE on November 21, 2024

TSE is seeking not only temporary measures such as share buybacks and dividend increases, but also more in-depth measures.

The casebook on disclosure of measures to respond to the requests was published, and while both good and bad examples were presented in the casebook, the points presented in the bad examples are in a form that makes it easy to grasp what the TSE is asking for. The disclosure was divided into three categories according to the level of disclosure. Level 1 is an insufficient analysis of the current situation and consideration of measures, Level 2 is that analysis of the current situation and measures are not up to investors' standards, and Level 3 is further improvements are required after receiving a certain level of recognition from investors and ten examples were presented for each.

For example, in Level 1, it is reiterated that this does not mean that a response is not necessary if the ROE is above the cost of equity and the P/B ratio is above 1x. In Level 2, the TSE harshly pointed out that companies that have increased their dividend payout ratios and announced share buybacks in order to improve ROE seem to be taking short-term, one-time measures to improve their stock prices, then pointed out the need for companies to fully consider what kind of balance sheet they are aiming for in the medium to long term, and how companies will allocate cash on hand for investment for future growth and shareholder returns. For those firms that indicated only a policy of selling cross-shareholdings, the TSE similarly recognized the importance of disclosing capital allocation policies. At Level 3, the TSE suggests companies with stagnant profitability and there is no prospect for improvement, should consider drastic measures, including downsizing or withdrawing from unprofitable businesses, and should at least indicate their policy or approach on the issue.

The content of the casebook is intended to make companies aware of where they stand if they have not developed or implemented appropriate measures, or if they have implemented them but have not done so adequately. Many of the good case studies were objective and well-designed analyses of the current situation that conveyed to the reader how the company plans to improve ROE in the future. Examples were given of companies that provided specific measures to facilitate dialogue with investors and disclosed what kind of dialogue they are already engaged in.

Examples of Gaps Between Investor Expectations and Current Status

Level 1 : Situations where current analysis and initiatives are not sufficiently conducted
(1) Current analysis and evaluation are superficial.
Lacking deeper insights; merely re-presenting past medium-term management plans, etc.
(2) Simple initiatives are just listed and not well-thought.
Lacking concrete perspectives that are unique and not commonly found elsewhere, etc.
(3) Refusing to engage in dialogue with investors without a reasonable justification
When investors request individual meetings, declined without a satisfactory reason
Level 2 : Situations where current analysis and initiatives are not evaluated from an investor's perspective
(1) Current analysis lacks an investor's perspective.
Lacking addressing fundamental issues behind low PER, etc.
(2) B/S and capital allocation strategies are not sufficiently considered.
No clear explanation of how to allocate resources between growth investments and shareholder returns, etc.
(3) Target settings lack an investor's perspective.
Set ROE targets that are lower than capital costs, etc.
(4) Insufficient dynamic analysis and countermeasures for issues.
When the current plan is not progressing as expected, no dynamic analysis or countermeasures are explained, etc.
Level 3 : Situations where certain evaluations are given by investors, but further improvement is required
(1) Fundamental analysis and measures for unprofitable businesses or non-core businesses are not conducted.
No fundamental analysis or measures for businesses that are shrinking, non-profitable, or non-core, etc.
(2) Business-related KPIs and remuneration are not aligned with medium-term corporate value enhancement.
KPIs and remuneration are not aligned with medium-term corporate value enhancement; expected to strengthen the link with TSR and other indicators valued by investors, etc.
(3) Insufficient disclosure of the status of dialogue with investors
Contents of dialogues are disclosed but just common ones, etc.

Source: JPX, Asset Management One Co., Ltd.

TOPIX revision enters enforcement phase

In 2025, further expansion and deepening of measures to respond to TSE requests is expected. The exclusion from the "TOPIX" index of stocks with a tradable share market capitalization of less than 10 billion yen, which has been proceeding in stages since October 2022, will reach its final stage at the end of January, reducing the number of index constituent stocks from the initial 2,200 to approximately 1,700. This figure is expected to further decrease to 1,200 by October 2026, when the constituent stocks will be replaced again. The regular rebalancing of constituents is scheduled to take place in October of each year after 2028. In order to maintain its status as an index component, the situation will strongly require constant management reform.

Review of TOPIX (Reduction in Number of Listed Stocks)

Phase 1
October 2022 to January 2025
Gradually reduce and ultimately exclude stocks with a market capitalization of less than JPY10 billion.
2,200 stocks → 1,700 stocks
Phase 2
October 2026
First regular replacement. Stocks will be selected based on liquidity (including "standard" and "growth").
1,700 stocks → 1,200 stocks
From October 2028 onwards
Regular replacement will be conducted every October.
1,200 stocks

Source: JPX, Asset Management One Co., Ltd.

Companies are facing higher costs to maintain listing, and corporate actions are expanding and speeding up.

The TSE's requests and the corporate governance reforms that have been pursued so far have increased the cost for companies to remain listed.

Voting guidelines by institutional investors, such as domestic asset managers, have also become stricter, with a policy of voting against the reappointment of representative directors for companies with low profitability and market valuation. The cross-shareholding leading to lower capital efficiency and less effective voting rights, which can be said to be unique to Japan, has also come under scrutiny, and the voting guidelines also incorporated items related to shareholdings, such as opposition to the election or reappointment of representative directors if certain criteria are exceeded. Some companies changed the purpose of holding stocks from cross-shareholdings to pure investments. In response to this trend, the Financial Services Agency is expected to change the Cabinet Office Ordinance on Disclosure of Corporate Information to require disclosure of the reason for the change to pure investment and future divestiture policy, which is expected to take effect in February 2025.

In companies that have already reduced their cross-shareholdings, there is a noticeable increase in opposition rate to the reappointment of directors, and new governance practices are beginning to take effect. In addition, foreign activists are increasingly active in targeting companies with large cross-shareholdings. In addition to responding to the TSE's request, various changes are taking place in the market as a whole, and the pressure on management to make management reforms with an awareness of the cost of capital and stock price has substantially increased considerably.

Although an increasing number of companies are opting for Management Buyout (MBOs), the TSE is not negative about such management decisions. Even though more and more companies are making management decisions to go private because they believe that the cost of maintaining a listing is too high, the TSE respect their decisions and are committed to emphasizing quality rather than the number of listed companies. It is highly likely that these trends will continue in the future, and more attention will be paid to corporate actions by companies, leading to market revitalization.

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