

From policy caution to market euphoria: what's fuelling Japan's record equity rally

Drivers of rally go beyond "Takaichi Trade", BOJ policy expectations

By Naoki Kamiyama, Chief Strategist

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The "Takaichi Trade" and BOJ's cautious stance

Policy expectations, BOJ stance seen as secondary drivers; growth expectations for AI, semiconductors key

As the Nikkei Stock Average surged well past the 50,000 threshold to a fresh record high in late October, it would be tempting to attribute the equity rally to policy expectations and the Bank of Japan (BOJ)'s seeming caution towards hiking interest rates. However, we believe that central bank caution and yen weakness—which became more pronounced on the assumption that Prime Minister Sanae Takaichi's administration would favour low interest rates—are secondary drivers. Rather, the rally is likely to be largely powered by growth expectations for AI and semiconductors. While defence-related stocks (on expectations of higher defence spending under the Takaichi administration) and real estate names (which benefit from low rates) have also contributed, their impact appears limited for now.

For much of the past year, the markets have interpreted the fact that the policy rate has been kept below the inflation rate as the BOJ being cautious towards hiking rates further, and this has reinforced the yen's weakness. The concept of the so-called "Takaichi Trade" emerged about a year ago during the ruling party's leadership race. Takaichi, who was then a candidate in the leadership race, was seen to have favoured low interest rates. Under this assumption, investors positioned for prolonged yen weakness when it became likely that Takaichi would become prime minister this year.

However, today's economic backdrop is markedly different from a year ago. Persistently low rates would now risk fuelling inflation via higher import costs. This change in economic conditions explains why some Cabinet economic advisors openly support a gradual rate increase. A December rate hike by the BOJ is therefore a possibility, and if the Takaichi administration tolerates or tacitly approves of it, the yen-weakness premium embedded in the "Takaichi Trade" could lose its shine.

In the short term: rate hikes and market adjustment risks

The 30 October BOJ meeting resulted in two dissenting votes from policy members who favoured hiking rates instead of standing pat (the number of dissenters in the nine-person board was unchanged from the previous meeting). Governor Kazuo Ueda reiterated his language from the previous meeting, saying there were no preset ideas on timing, and this lowered market expectations for a December move. With the markets leaning towards the BOJ retaining the status quo in December, an actual hike could trigger short-term volatility. In the short term, policy tightening could pressure growth stocks and sectors sensitive to interest rates.

Equity uptrend could endure in the medium to long term

Unless the BOJ aims to push policy rates far above inflation to cool the economy, even if the central bank were to hike rates, Japan's equity uptrend could endure in the medium to long term, supported by strong corporate earnings, government growth initiatives, and sustained optimism for semiconductors and AI. Companies improving capital efficiency and governance could remain resilient, providing structural support to the equity market.

Nikkei's break above 50,000: a signal to global investors that Japanese equities are an "unignorable asset"

A powerful signal to global investors

Another factor with a potentially longer-term equity market impact is the powerful signal the Nikkei rising above 50,000 sends to global investors. It cements Japanese equities as an "unignorable global asset". The recent market surge, driven by a relatively small set of semiconductor and AI-related stocks, mirrors the concentration seen in the S&P 500's "Magnificent Seven". While such a concentration inherently carries some risks, it also highlights Japan's ability to keep pace with global growth trends. Although South Korea and Taiwan dominate chip production, Japan's indispensable role in semiconductor equipment and materials is now widely recognised.

Takaichi's high approval ratings reduce political risk, for now

The Takaichi administration was initially associated with political risk as her Liberal Democratic Party (LDP) had to scramble to create a new coalition after long-time ally Komeito abruptly parted ways with the LDP. However, Takaichi's high approval ratings signal policy momentum, reducing political risk for investors. There are strong expectations for Takaichi to implement inflation-control measures boosting consumption, defence spending and fiscal expansion. All these measures could provide a significant lift to corporate earnings.

That said, given Takaichi and Finance Minister Katayama's emphasis on "responsible fiscal expansion", the markets may be disappointed by the scale of stimulus and deficit bond issuance. This could trigger a temporary equity market pullback, while long-term yields—elevated by fiscal concerns—may ease slightly.

Policy expectations alone won't account for long-term equity gains

In the longer term, expectations for "Sanaenomics"—responsible but proactive fiscal policy, the strengthening of defence capabilities per Tokyo's commitments to Washington, and investments in energy security and disaster resilience—support long-term growth prospects in sectors like defence, infrastructure and energy. However, few firms are purely defence focused, so policy alone will not be able to account for Japan's long-term equity gains. Semiconductor-related stocks, which have driven much of the recent rally, depend more on global demand and sustained revenue/profit growth than domestic policy. While these sectors are in alignment with growth strategies, the market's trajectory will hinge on the staying power of strong expectations for AI agents and physical AI.

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