Japan's compelling case—an updated view

Global Equity Pulse

The investment case for Japanese equities remains attractive in 2026, as economic normalization and sustained inflation continue to provide growth tailwinds. A broadening of corporate reforms is also underway, driving structural enhancements of shareholder returns.

At Templeton Global Investments (TGI), recent company meetings and visits reaffirmed our confidence in Japanese equities by giving us further evidence of corporate Japan's commitment to growth execution and capital allocation discipline, all to the potential benefit of investors.

Growing better in a normalizing economy

During the January 2026 TGI investment conference in Tokyo, our portfolio managers and researchers conducted multiple meetings with Japanese companies. The takeaways from these exchanges have strengthened our conviction in Japan's potential for multiyear return on equity (ROE) improvements.

We note that, after three decades of deflation, the normalization of Japan's domestic economy is now firmly entrenched. Companies we spoke to are no longer preoccupied with managing anemic growth in a deflationary environment. With core consumer price inflation consistently above the Bank of Japan's (BoJ) 2% target since April 2022, and union leaders again seeking at least a 5% wage increase in 2026, we think Japan has entered a virtuous cycle of higher wages, increased consumption and ramped-up capital expenditure (capex).

For corporates, the aggregate effect is a healthier environment that's conducive to boosting growth and profitability. In our latest meetings, several high-conviction companies in the industrials and consumer sectors highlighted strategies or intentions to increase prices and improve operating margins amid the inflationary tailwinds. These are key drivers to revenue growth, stronger earnings power and subsequently, higher ROE, in our view.

The regime shift of economic normalization is also evidenced by an increasing appetite for research and development (R&D) investments, as well as mergers and acquisitions (M&A). An active push to boost productivity and digital capabilities—also motivated by Japan's persistent labor shortage—is driving up corporate capex, with the Bank of Japan's Tankan survey forecasting a 9.5% capex expansion for fiscal year 2025 (ending March 2026), up from 6.9% a year ago.[1] Meanwhile, companies are exploring more M&A to drive growth and consolidate market share both at home and abroad. As a result, the number of domestic M&A deals climbed from 136 in 2023 to 176 in 2025. Deal value also jumped, from just US$8 billion in 2023 to US$39 billion in 2024 and US$38 billion in 2025 (see Exhibit 1).

Exhibit 1: Japan's Rising M&A Trend

	2023	2024	2025
Deal number	136	149	176
Deal value (US$ billions)	8	39	38

Source: "Japan 2026: Top 10 Themes." Jefferies. As of January 14, 2026.

Generating higher ROE amid corporate reforms

Importantly, companies are balancing their pursuit of growth with capital allocation discipline, as corporate reforms accelerate and broaden across corporate Japan.

In our recent company meetings, we took note of a strong awareness of the need to optimize balance sheet efficiency, upgrade business portfolios and prioritize investments with higher return on invested capital (ROIC). Concurrently, productivity and labor practice improvements are also high on the agenda.

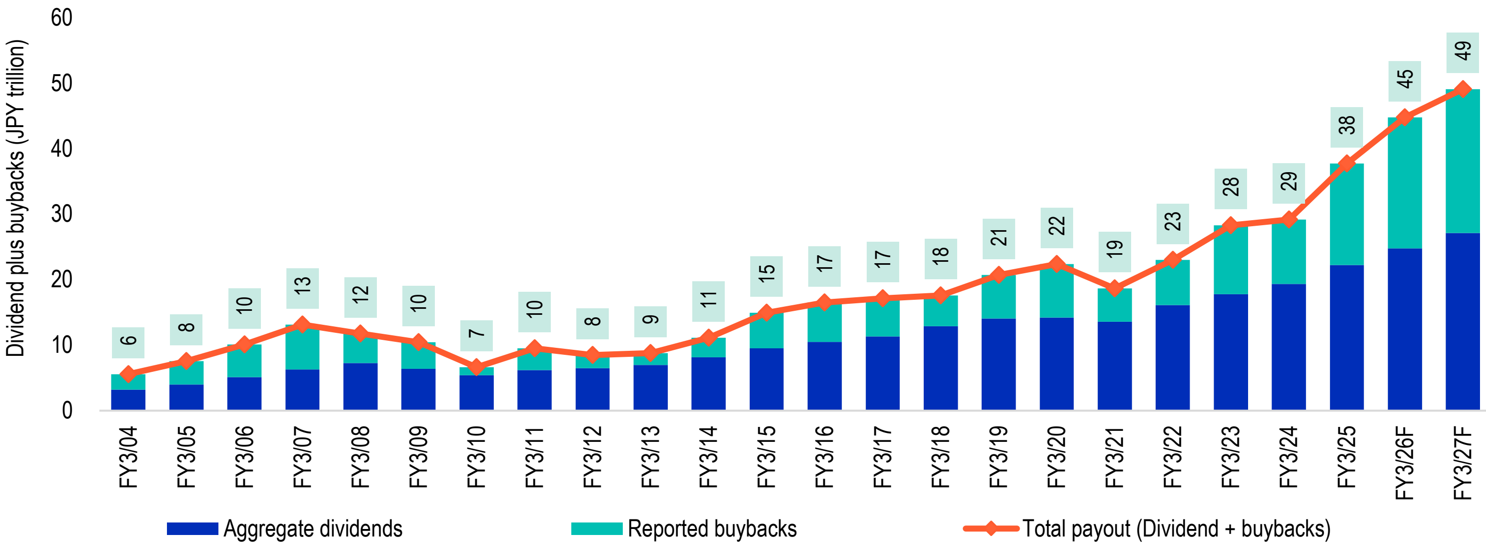
We believe these initiatives again position Japanese companies for stronger revenue growth and better profitability over the long term, directly contributing to enhanced shareholder returns via higher ROE. This has consistently been part of the core rationale in our investment thesis for Japan over the past three years.

For instance, in our recent meetings, one of our high-conviction companies—an automotive giant—revealed its plan to step up share buybacks. With the ability to also sustain profit margin improvements through its best-in-class franchise, the company is looking to achieve a previously unannounced ROE target of 20% by the early 2030s.

This is aligned with the broader trend of rising dividends and share buybacks among Japanese companies, as they increasingly opt to deploy excess cash for shareholder returns instead of letting it sit on balance sheets and dilute ROE. Data indicates a steady, multiyear growth in the combined value of dividends and buybacks, which reached ¥38 trillion for the fiscal year ended March 2025, with ¥45 trillion and ¥49 trillion projected for the subsequent fiscal years (see Exhibit 2).

Exhibit 2: Dividend and Buyback Growth Continues Unabated

TOPIX - Aggregate dividend and buybacks trend since 2003



Source: "Japan 2026: Top 10 Themes." Jefferies. As of January 14, 2026. The Tokyo Price Index (TOPIX) is a capitalization-weighted index tracking the performance of large firms listed in the first section of the Tokyo Stock Exchange. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized.

Another key aspect of corporate reforms in Japan is the restructuring of portfolios. This entails divesting non-core assets and unwinding cross-shareholdings, which then allows companies to return capital to shareholders while sharpening their strategic focus on businesses with higher growth and better margins.

Overall, we remain confident of Japan's investment case. As economic normalization and corporate reforms continue, Japanese stocks may offer structural earnings and ROE improvements while currently still trading at a discount relative to developed market equities, based on MSCI indexes in US dollar terms.

To position our portfolios for these regime shifts in Japan, we adopt a bottom-up investment approach with a preference for domestic-facing businesses that we believe are committed to and capable of enhancing their earnings power and ROE. Meanwhile, we stay highly selective on foreign income earners, limiting our exposure to those serving structurally growing end markets such as semiconductors and defense. Ideally, these companies are also market share winners and are undertaking corporate reforms.

Investment outlook

In the United States, the nomination of Kevin Warsh as the next Federal Reserve (Fed) chair should cause little concern in the market, given his rich experience. Focusing on fundamentals and valuations, we believe cyclicals and consumer discretionary stocks are likely to benefit most from tailwinds such as the expectation of unusually strong tax refunds and improved liquidity conditions. In Asia Pacific (APAC), earnings growth acceleration underpins a constructive regional outlook. Taiwan and South Korea are expected to lead in growth, benefiting from robust artificial intelligence (AI) infrastructure capex and strength in memory chip pricing. South Korea's corporate reform potential also looks compelling. Solid earnings growth and attractive dividend yields are similarly expected in Europe, supported by moderate economic expansion and resilient corporate margins. Utilities and industrial companies stand to benefit from investments in energy infrastructure, electrification, defense and reshoring initiatives.

North America

On January 30, US President Trump nominated Kevin Warsh to succeed Jerome Powell as chair of the Board of Governors of the Federal Reserve. After being confirmed by the US Senate, Warsh would become chair when Powell's term ends in May. In our view, financial markets should welcome Warsh's appointment. Warsh has experience, having served as a governor of the Federal Reserve Board from 2006-2011. He was present for all major decisions during the global financial crisis and therefore understands well both the everyday and crisis-management tools and role of the Fed.

For investors in the United States, the focus should now shift back to where it belongs—market fundamentals and valuations. Strong corporate earnings across sectors and regions will continue to buttress a broadening of equity returns, in our view. Solid growth, underpinned by capital expenditures, will likely contribute to a steepening of yield curves. Improving returns in global equity and fixed income markets should attract investment, contributing to modest dollar weakness.

In our global portfolios, we continue to underweight the US market, a decision based solely on bottom-up stock selection. We believe cyclicals and consumer discretionary stocks are likely to benefit most from tailwinds such as the likelihood of unusually strong tax refunds and improved liquidity conditions. Technology remains more of a wildcard; while macro conditions should provide support, potential headwinds could cap upside.

If artificial intelligence (AI) truly proves to be a transformational technology, the economic and labor implications could be significant, and potentially disruptive, over the next couple of years. McKinsey estimates that up to 25% of jobs could be fully automated by 2030, a shift that would represent one of the largest structural changes in modern labor markets. Massive productivity gains will drive adoption, but the transition will not be frictionless. Job displacement could accelerate, retraining and job creation will lag automation, and early signs may emerge in 2026 as inference costs fall and companies aggressively pursue efficiency.

Being on the right side of these trends will be key to relative performance. It will be important to watch developments closely and react swiftly if the situation warrants a change in portfolio positioning.

APAC

The APAC market had a mixed showing in January, enduring renewed concerns of geopolitical uncertainties and US tariff threats. We nonetheless maintain our constructive view on the regional outlook. APAC companies have navigated the worst of global trade headwinds and, barring surprise macroeconomic shocks, should see faster growth in 2026. Supportive monetary or fiscal policies across a range of key APAC markets—such as India, Japan and potentially China—may provide a conducive backdrop as well.

In this environment, the Asia-Pacific ex Japan region is estimated to see earnings growth of around 23% in 2026, doubling from 2025's 11%.[2] Taiwan and South Korea are expected to lead the growth, as their technology supply chains further benefit from robust AI infrastructure capex and strength in memory chip pricing. This is in line with our high conviction on the AI theme, and we aim to maintain our exposure to regional semiconductor majors, supplemented by high-quality "pick-and-shovel" companies that enable chip production and server infrastructure buildout, among others.

We are also interested in capturing the ROE, estimated to be in the high teens, emerging in South Korea, where strong earnings growth is set to underpin attractive valuations, despite the rally of 2025. A top-down policy push to narrow the so-called "Korean discount" has led to accelerating corporate reforms and a gradual increase in shareholder value. But we note the dispersion of performance and returns beneath this theme and will thus approach the market selectively.

Europe

In many important respects, we emerge in 2026 with a manifestly different Europe than in recent years, one molded by years of financial turmoil, Brexit, energy crises, war in Ukraine and now, difficult trading relations with the United States. We believe this new Europe has the potential to undo more than a decade of global equity market underperformance, with 2025 beginning to reveal early signs of that shift. The debate triggered by former European Bank Central Bank President Mario Draghi's report on European competitiveness highlighted a growing recognition that structural reform, capital investment and improved policy coordination are no longer optional. That acknowledgement, alongside a more pragmatic fiscal stance in Germany and a clearer commitment to collective defense spending, points to a region with a more durable growth outlook than investors have been accustomed to.

Furthermore, Europe appears well placed to benefit from a gradual rebalancing of global capital flows. Lower inflation risk, a more predictable monetary policy backdrop and improving fiscal support provide a constructive setting for European equities as diversification away from the United States continues.

From an earnings perspective, consensus expectations imply solid growth in 2026, supported by moderate economic expansion and resilient corporate margins. Dividend yields remain attractive and should provide an additional buffer in a more uncertain global environment. Even assuming stable valuation multiples, anticipated returns compare favorably with other developed markets, while Europe currently continues to trade at a meaningful discount to its global peers.

At a sector level, opportunities are most evident where capital expenditure rather than consumer demand is the primary driver of growth. Utilities and industrial companies stand to benefit from investment in energy infrastructure, electrification, defense and reshoring initiatives, while maintaining relatively defensive business models. In contrast, areas with elevated political exposure or that have already experienced extended pricing cycles warrant greater selectivity.

Market review: January 2026

Global equity markets advanced in January, though returns were uneven across regions as geopolitical developments, sector rotation and policy-related uncertainty shaped investor positioning. The MSCI World Index rose on the back of strong gains in Europe and continued resilience in parts of Asia, while US equities lagged. Risk appetite was robust early in the month. However, momentum moderated later in January as markets contended with heightened geopolitical tensions, growing scrutiny of US monetary policy independence and the early stages of fourth-quarter earnings season.

Sector dispersion was a defining feature of the month. Defense, industrials and selected technology segments outperformed, reflecting elevated geopolitical risk and continued investment in strategic and security-related themes, while consumer-oriented sectors and parts of global growth underperformed. Commodities and precious metals benefited intermittently from geopolitical uncertainty and concerns around resource security, contributing to strength in materials-heavy markets.

ENDNOTES

1. Source: "Tankan December 2025 Survey," Bank of Japan. As of December 15, 2025. Based on software, R&D and fixed investment excluding land purchases.
2. Source: "Asia-Pacific Weekly Kickstart." Goldman Sachs. As of January 24, 2026.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. There can be no assurance that a multi-factor stock selection process will enhance performance. Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods. The investment style may become out of favor, which may have a negative impact on performance.

Active management does not ensure gains or protect against market declines.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. Investments in companies in a **specific country or region** may experience greater volatility than those that are more broadly diversified geographically. The government's participation in the economy is still high and, therefore, **investments in China** will be subject to larger regulatory risk levels compared to many other countries. There are special risks associated with investments in **China, Hong Kong and Taiwan**, including less liquidity, expropriation, confiscatory taxation, international trade tensions, nationalization, and exchange control regulations and rapid inflation, all of which can negatively impact the fund. Investments in Taiwan could be adversely affected by its political and economic relationship with China.

Investments in fast-growing industries like the **technology sector** (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement.

Large-capitalization stocks may fall out of favor with investors based on market and economic conditions.

Diversification does not guarantee a profit or protect against a loss.

Dividends may fluctuate and are not guaranteed, and a company may reduce or eliminate its dividend at any time.

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