

# MARKET SIGHT LINES



## Policy Execution and Reform Support Japan Equities

By **Michael O'Keeffe, CFA**  
*Stifel's Chief Investment Officer*



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We've been positive on Japan with the anticipation of improving growth, rising capex, and corporate governance reforms. Some investors have anchored their case for Japan equities on how a weaker yen can help exporters and support stocks. We're seeing a shift. Following Prime Minister Sanae Takaichi's recent decisive election victory and a clearer mandate for fiscal expansion, investors are beginning to focus less on currency support and more on the potential for durable domestic earnings growth. Near-term volatility, yen strength, and headline sensitivity remain part of the landscape, but improved earnings are becoming more domestically focused and reform driven. In this Sight|Lines, we discuss the improving investment environment in Japan and how that reinforces our positive views looking forward.

### **THE TAKEAWAY: JAPAN IS SHOWING EARNINGS POWER POTENTIAL**

Improving growth, rising capital investment, and continued corporate governance reforms are strengthening Japan's earnings backdrop and supporting a more durable, domestically driven investment case. In summary:

- We remain positive on Japan as new leadership and reforms set up for earnings growth.
- The recently announced U.S.-Japan bilateral investment fund reflects policy coordination and strategic alignment, lessening trade frictions that often worry investors.
- The familiar "weak yen supports exporters" framework is being replaced by a more durable Japan-led earnings narrative.
- With rates now modestly positive and policymakers more tolerant of sustained inflation, we see improving earnings for domestic-facing companies like financials.
- Rising capex and corporate governance reforms remain drivers of shareholder value.
- Leadership inside the market will evolve, with domestic-facing companies better positioned than those that are export heavy.
- While we acknowledge policy execution risks, we remain constructive on Japan given improving growth, rising capex, and improved corporate governance, with the U.S.-Japan agreement strengthening the case further.

## IN-DEPTH: POLICY EXECUTION, NORMALIZING RATES, AND REFORM ARE SHIFTING JAPAN'S EARNINGS MIX AND MARKET LEADERSHIP

Improving growth, rising capex, and corporate governance reforms are positive for Japan. Going deeper:

- Prime Minister Takaichi's election victory provides a clear mandate for fiscal expansion and policy execution:
  - Takaichi's Liberal Democratic Party secured a two-thirds supermajority in the 465-seat lower house on February 8, giving Takaichi the biggest election mandate of any Japanese leader since World War II.
  - Since the election, the yen has strengthened and Japanese stocks have outperformed the U.S. and Europe.
- The \$550 billion U.S.-Japan bilateral agreement reflects deepening strategic alignment and reduced trade friction:
  - President Trump announced on February 17 that the trade deal has "officially and financially" taken effect, with Japan moving forward with its first set of investments.
  - Initial projects total about \$36 billion and include a \$33 billion natural gas power plant in Ohio (which would be the largest in the U.S.), a crude oil export facility in Texas, and a critical minerals facility in Georgia.
- Policy uncertainty has eased, with investors now focused on fiscal follow-through and domestic measures:
  - Takaichi has reiterated her commitment to sustainable fiscal policy and announced plans to fundamentally overhaul the government budget over approximately two years.
  - Japan's GDP grew just 0.2% on an annualized basis in Q4 2025, weaker than the median economist forecast, underscoring the case for Takaichi's proactive spending policies.
- With Japan's policy rate now at 0.75% and policymakers more tolerant of inflation, the earnings backdrop for domestic-facing financials is improving:
  - The TOPIX Banks Index has surged 22% year to date, significantly outpacing the broader market and reflecting investor confidence in the sector's earnings trajectory under a normalizing rate environment.
  - Since the Bank of Japan began raising rates in July 2024, this index has earned a 90% total return, underscoring how the shift away from negative rates has improved the sector's outlook.
- Rising capex and corporate governance reforms continue to drive shareholder value across various sectors.
  - In 2023, the Tokyo Stock Exchange publicly pressured companies trading below 1x price-to-book to improve capital efficiency, raise return on equity, and outline credible plans to enhance shareholder value.
  - Across industries there's been a surge in buybacks, an increase in dividends, more divestiture of non-core assets, and management having a greater focus on profitability.
- Market leadership is shifting toward domestic-facing companies, while export-heavy firms face margin pressure from tariffs and currency headwinds.
  - Japanese automakers have faced significant headwinds, reporting profit declines and weaker sales.
  - As discussed above, Japanese financial stocks have shown resilience given rate normalization.

### WHAT WE THINK

We have been constructive on Japan given policy reform, rate normalization, and increasing capital expenditures. The Takaichi victory and the bilateral U.S.-Japan investment agreement strengthens the case for Japan, as they reflect a clearer path for policy, a deepening strategic relationship with the U.S., and reduced trade friction between the two countries. While we're mindful of policy execution risks, we remain positive on Japan going forward.

**Michael P. O'Keeffe, CFA** 

*Chief Investment Officer*

[michael.okeeffe@stifel.com](mailto:michael.okeeffe@stifel.com)

[StifelInsights.com](https://www.stifel.com)

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. Volatility is measured by calculating the standard deviation of the annualized returns over a given period of time. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. TOPIX-Banks Index is a capitalization-weighted index of all the banks listed on the First Section of the Tokyo Stock Exchange and is one of the 33 industry sectors of the TOPIX Index (TPX). The index was developed with a base value of 1000 as of January 6, 1992. The parent index is TPX. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The S&P 500 30-Day Realized Dispersion Index measures the historical dispersion of the S&P 500 (TR) over using the 30-day returns and adjusted closing weights of each constituent in the S&P 500, along with the 30-day return of the S&P 500 itself. S&P Select Industry Indices are designed to measure the performance of narrow GICS sub-industries. The S&P Software & Services Select Industry Index comprises stocks in the S&P Total Market Index that are classified in the GICS Application Software, Interactive Home Entertainment, IT Consulting & Other Services and Systems Software sub-industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

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