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Global Macro Research
04 February 2026

7:22 minute read

#Japan / #Politics / #Asset Prices

Japan: A pivotal snap election

Prime Minister Sanae Takaichi hopes to win a stronger mandate in the lower house election on 8 February 2026. We outline three scenarios, with policy and market implications.

Key Takeaways

- Japanese assets are proving highly sensitive to fiscal headlines and play a key role in broader global financial markets, making the upcoming general election particularly important.
- We outline three scenarios with policy and market implications: 1) decisive victory for the LDP or ruling coalition; 2) narrow victory for the LDP/Ishin coalition; 3) LDP loses majority and Takaichi resigns.
- Our base case is a decisive victory for the ruling coalition. The latest surveys signal a strong win for Takaichi's administration, with a single party majority potentially in reach.
- A decisive win for Takaichi could be the best outcome for markets over the medium term, as strategic investments and tax reform bolster equities.
- And despite our more dovish Bank of Japan expectations relative to market pricing, we think the yen may gain support from a gradual increase in real rates as inflation is set to slow more than is currently appreciated.
- Finally, while Japanese government bond markets are at the sharp end of global long-end pressures, bond market volatility could gradually subside after the election. Despite expectations of excessive fiscal expansion, market dynamics appear to be acting as a constraint for Takaichi.

Targeting a stronger mandate

After gaining popularity for her economic measures addressing the cost-of-living crisis, Sanae Takaichi aims to win a stronger mandate, in the election on 8 February 2026, moving beyond a one-vote majority in the lower house to regain control of committees and budget processes.

The election will influence Japan's fiscal direction, the trajectory of Japanese assets and broader market sentiment.

Since Takaichi secured victory in the LDP party leadership race last October, Japanese assets have experienced remarkable volatility. The so-called "Takaichi trade" stems from expectations that the new government would pursue growth via fiscal expansion while widening the deficit.

Yet, the supplementary budget and the FY2026 budget turned out to be less expansionary than many had anticipated, briefly easing investor concerns.

Takaichi's initial economic package kept the 2026 deficit under control

The economic plan of Takaichi's administration prioritized strategic investment (in AI, next gen technologies, supply chain resilience) and cost-of-living support for households over tax incentives aimed at boosting wages.

Additional spending in the FY25 supplementary budget rose to ¥17.7trillion, exceeding the ¥13.9trillion in 2024. The fiscal deficit impact was offset via tax reform in the FY26 budget plan.

Government spending is set to rise only marginally through 2026 and mainly due to cautious projections for debt servicing rather than higher general expenditures. The assumed interest rate increased from 2% in FY25 to 3% in FY26 – a conservative estimate despite recent market trends.

Indeed, Japan's debt-to-GDP ratio has steadily improved since the pandemic, thanks to faster nominal GDP growth and higher tax revenues.

Takaichi's plan does not disrupt this trend, but permanent tax cuts, like those proposed by opposition parties, could reverse progress and raise the ratio.

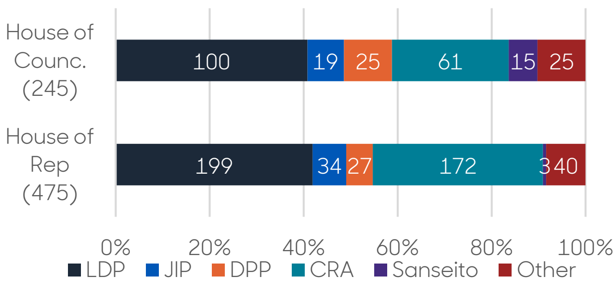
Market dynamics appear to be acting as a constraint for Takaichi to ensure fiscal prudence. However, opposition parties seem less concerned by market pressure. And a change of government or grand coalition that spooks the bond market could ultimately derail debt dynamics if yields move sharply higher.

A revamped opposition could push tax cuts back on the agenda

Recently the election outlook has been complicated by the formation of a new opposition bloc, the Centrist Reform Alliance (CRA), a merger between the Constitutional Democratic Party of Japan (CDP) – the second largest party – and Komeito – the ruling Liberal Democratic Party (LDP)'s former coalition party. The ruling coalition controls 233 parliamentary seats, whereas the newly established CRA holds 172.

Previously, the LDP and Komeito ran elections with seat coordination, agreeing not to run against each other in specific districts. Reassigning Komeito's support to the CDP placed some of these LDP seats at risk.

Figure 1: The new opposition bloc increases competition



Source: House of Representatives, (Lower House), House of Councillors (Upper House), Aberdeen, February 2026

The CRA entered the election campaign promising a permanent VAT cut on food.

The LDP have consistently pushed against consumption tax cuts. This is in contrast to most opposition parties which, for many years now, have called for a complete abolition of consumption tax.

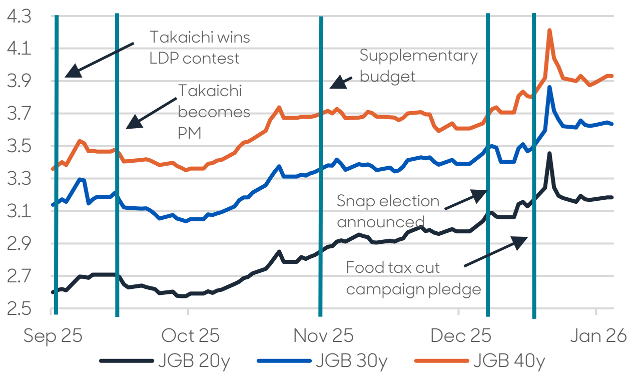
Currently the consumption tax rate for food is 8% and 10% for other items. The revenue from food tax amounts to ¥5 trillion a year – 6% of total general account tax revenue and 0.8% of GDP.

Although Takaichi had originally preferred a refundable tax credit, she introduced a two-year temporary food tax cut to counter the new opposition party while managing debt levels.

Raising the consumption tax again after a cut is always politically challenging and there is limited backing for the policy within the LDP, especially among the more powerful factions that originally backed Takaichi in the leadership contest.

Financing plans are vague and, with long-term yields highly sensitive to the plan (Figure 2), it is still unclear if the food tax abolition will happen. Even if implemented, the tax cut may be far smaller.

Figure 2: Japanese government bonds (JGBs) highly sensitive to fiscal policy



Source: Bloomberg, Aberdeen, February 2026

Election scenarios and market implications

Recent lower house election surveys by local media indicate the LDP/Ishin coalition is likely to win over 300 seats, exceeding the "absolute stable majority", with the LDP possibly securing a simple majority (more than 233 seats) on its own.

Although we should be wary of relying too heavily on pre-election surveys, it seems the ruling coalition party currently enjoys strong momentum, while the main opposition group, CRA, has not been able to build traction.

In the event of a surprise result on Sunday, the immediate aftermath of the election will likely trigger broad market volatility. However, the medium-term outlook should prove a better assessment of the fiscal plans of the ruling party or coalition.

Scenario 1: A decisive victory – an LDP landslide, single party majority/LDP-Ishin majority

- While Takaichi has the reputation of favouring very expansionary fiscal policy and would be less constrained following an LDP landslide, her tone since becoming PM and the details of the economic package all signal a conservative approach that is wary of debt dynamics and disorderly rise in bond markets.
- Furthermore powerful factions, such as that led by Taro Aso, are fiscally conservative, respecting MoF processes, fiscal rules and restoring the primary balance over time.
- The Aso faction backed Takaichi in the LDP leadership contest and has been opposed to any form of consumption tax cut. The policy will most likely be shelved completely, postponed, or implemented in a much smaller scale.
- Tensions with China will likely remain in this scenario. The risk of extended periods of export controls and travel restrictions could disrupt the growth outlook.

Scenario 2: A narrow victory – LDP gains seats but falls short of a majority

- A narrow victory for the LDP would limit Takaichi's ability to make budget decisions. Compromises and coordination with opposition parties could lead to periodic fiscal concessions that increase the deficit, and slow or reverse the debt/GDP decline.
- A reduction in food tax appears more probable under these circumstances. Introducing this policy temporarily, for two years, could reassure investors somewhat; however, reversing it might prove difficult, particularly if Takaichi continues to head a minority government at that time.

Scenario 3: Regime change: ruling party loses seats

- Takaichi has pledged to step down in this scenario, which will trigger immense political uncertainty. The LDP would need to hold a leadership contest.
- Coalition talks could lead to a range of outcomes, from status quo of LDP/Ishin to a grand collation expanding to more parties that are less concerned over debt dynamics.
- At the time of writing, consensus is for Takaichi to remain in power. So, this outcome would trigger the greatest market turmoil.

Long-dated JGBs remain highly sensitive to fiscal signals

Under scenario 1, a decisive victory, an initial knee jerk market reaction is still possible given the perception Takaichi will have free reign to raise government expenditure, even though she has been pivoting to a more conservative approach recently.

Once there is clarity over the consumption tax cut, whether it is postponed or abandoned, and swift passing of the existing FY26 budget before the fiscal year ends in March, we think yields will stabilise and the curve could bull flatten. Takaichi needs to be very explicit in her intention to be fiscally responsible during speeches.

Short-dated JGBs are more heavily influenced by the monetary policy outlook. We continue to expect short-dated bonds to be anchored if the BoJ proceeds to hike at a gradual pace. Indeed, with the removal of corporate tax incentives for wage hikes phased over the next two years, it may take longer for core services inflation and underlying inflation measures to meet 2% year-on-year growth.

Scenario 2, narrow victory, represents greater fiscal risks, as the PM's electoral gamble to increase her mandate will be deemed to have failed. Takaichi's political standing would be weakened raising fears of looser fiscal policy to accommodate opposition parties. Yield volatility is likely to remain elevated as bond vigilantes continue to react swiftly to fiscal signals.

Scenario 3, regime change, may lead to an extended period of bond market volatility following the election result. Yields would be influenced by the LDP leadership succession after Takaichi's resignation, changes in the ruling coalition, and debt-to-GDP outlook factors that will take weeks to settle. If the Japanese bond sell-off turns disorderly, there are several tools available to authorities to stem a crisis. A UK LDI-style forced bond selling cycle can be mitigated very quickly.

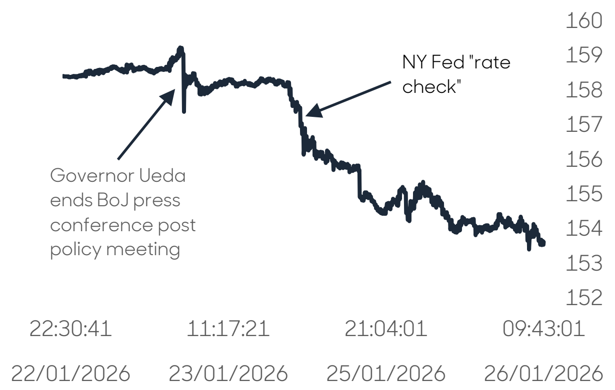
Multiple drivers behind the yen

USDJPY has been hovering close to the psychological threshold of 160 in recent weeks.

Authorities may be wary of the potential market impact of the upcoming election and the spillovers to global markets as evidenced by coordinated "rate checks" by the BoJ and New York Fed (Figure 3).

It is likely that the MoF will stand ready to intervene in the event of a knee jerk reaction to the election result.

Figure 3: The "rate check" rattled FX markets but actual intervention still necessary to cap USDJPY



Source: Haver, Aberdeen, February 2026

In scenario 1 – the yen is likely to depreciate initially in line with the "Takaichi trade". But medium-term the view that stable fiscal policy will continue should help trigger a more sustained rally in the yen toward 140-150 range.

In scenario 2, a smaller victory, and concerns over the policy outlook suggest a more modest rally in the yen. The longer any coalition formation takes, the greater the FX volatility. While in **scenario 3**, more frequent MoF intervention may be needed until the political uncertainty clears.

USDJPY weakness is partly a function of negative real interest rates in Japan. However, inflation is expected to decelerate over the coming months as food prices decline, pushing real rates higher and supporting the yen regardless of the political outcome.

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The equity market outlook looks the least vulnerable to the political outcome. Despite the potential for near term volatility, over the medium term structural support for Japanese corporates remains strong.

Japanese firms hold an integral position within the global value chains and are well placed to take advantage of the next leg of the AI theme.

Corporate governance reform continues to make good progress, raising transparency, reducing cross shareholdings and increasing shareholder value by placing pressure on firms to improve return on equity, raise dividend payouts and explain low valuations. Further regulatory changes are expected to push firms to reduce large cash holdings in favour of reinvesting in businesses.

Japan is exiting the "deflation mindset" that plagued the economy for thirty years and firms weathered the worst of US tariff headwinds last year.

A key risk to watch is China's stricter export controls on Japan following Takaichi's remarks about Taiwan. These restrictions, especially on rare earths, could cause longer lead times and procurement issues if they persist.

Nonetheless, Japan has recently boosted its mineral stockpiles, recycling, and supply diversification. China restrictions do not cover non-military use rare earths so the impact should remain limited.

Takaichi could prove positive for growth and markets

A decisive win for Takaichi could be the best outcome for markets over the medium term. Strategic investments should boost growth and favour equities.

A conservative fiscal approach and recent tax reform should maintain the downward trajectory in debt/GDP and gradually reassure bond investors over the fiscal outlook.

The yen is expected to gain support from a gradual increase in real rates as food inflation readjusts.

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AA-060226-203918-64