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Japan: continuity despite an election setback

Japan's ruling coalition lost its majority in the upper house, weakening PM Shigeru Ishiba's leadership. The outcome threatens the domestic policy agenda, complicates the trade talks with the US, and could trigger near-term bouts of market turmoil. But the longer-term outlook for Japanese assets looks stable.

Key Takeaways

- Japan's ruling coalition lost its majority – securing 122 seats out of the 125 needed – in the upper house elections on Sunday.
- But the margin of the loss is not as significant as signalled in the polls. PM Ishiba will remain as leader, and the coalition will continue as before.
- However, this is a setback for the PM as the coalition must now negotiate with opposition parties on a range of domestic and trade policies.
- Near-term political uncertainty may weigh on markets. Bond yields have proved sensitive to deficit concerns and the current political backdrop has greater fiscal easing risks.
- However, authorities have policy tools in place to calm bond markets. The structural backdrop continues to favour equities longer term.

Nonetheless it is a setback for Prime Minister Shigeru Ishiba, who has pledged to remain in office and provide continuity.

In the press conference following the result, he emphasized the LDP was still the largest party, and that it was his responsibility to lead amid US trade talks, regional security tensions, and persistent inflation.

Across the opposition, fringe parties gained support. Frustration over inflation had been at the centre of the election campaign.

The Democratic Party for the People (DPP) saw large gains, increasing seats from nine to 22. The small nationalist Sanseito party increased seats from just two to 15. The party has three seats in the lower house and stands ready to join any coalition.

With no majority in either the upper or lower house (Figure 1 and 2), the election result threatens the domestic policy agenda. The ruling coalition will need to form partnerships with opposition parties on a bill-by-bill basis.

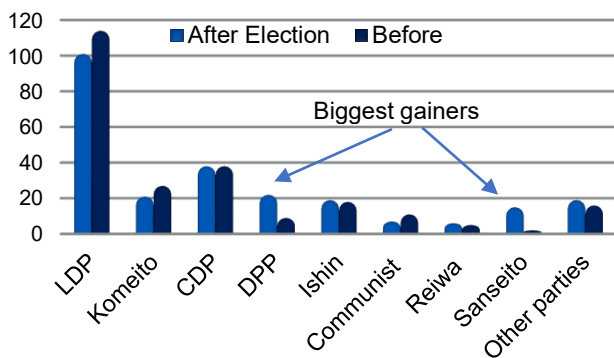
Political continuity but fringe parties gain momentum

Japan's ruling Liberal Democratic Party (LDP) and its coalition partner Komeito lost their upper house majority in Sunday's election, securing a total of 122 seats, just short of the 125 needed to retain control (Figure1).

The result is not as bad as investors had expected considering the weak polls. The ruling minority coalition will continue. Risks of new coalition negotiations or snap general election following no-confidence vote have declined materially.

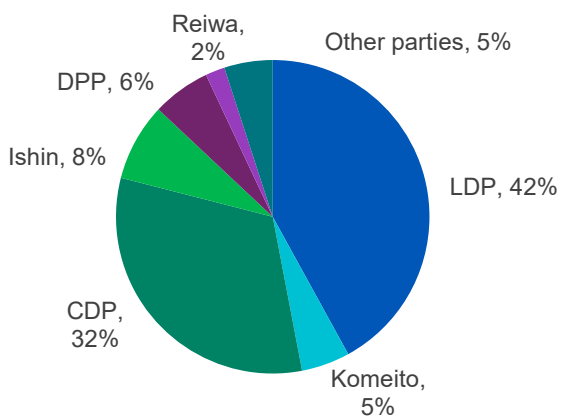


Figure 1: Upper house composition



Source: The House of Representatives, Aberdeen, July 2025

Figure 2: Lower house composition



Source: Aberdeen, July 2025

Fiscal gridlock

The fringe parties campaigned for consumption tax cuts, increased spending across social security, childcare, and education.

The LDP had plans for a supplementary budget to help companies navigate tariffs and help households with the cost-of-living crisis.

There are likely to be some policy compromises that incorporate opposition party demands. The LDP has proposed cash subsidies for households, abolition of gasoline tax and extra childcare spending.

But, the LDP has consistently pushed back on consumption tax cuts, which have been an important source of government revenue. Once implemented, tax cuts are politically very hard to unwind.

Ishiba is keen to avoid policies that may further undermine the fiscal situation and risk long-term interest rates rising further.

Tariff deadline looming

The US had signalled 1 August as a "hard deadline" for tariff implementation even though talks may continue afterwards.

The main sticking points continue to revolve around agricultural market access and food safety, autos sector trade imbalance, FX transparency and digital trade.

Trade negotiations slowed through the election campaign. Yet, US Treasury Secretary Scott Bessent met PM Ishiba in Tokyo on 18 July, just two days before the election.

Bessent posted on social media that "a good deal is more important than a rushed deal". This provides some scope for progress.

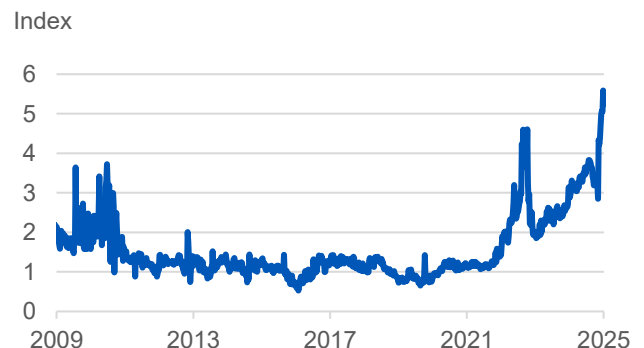
However, with the deadline nearing, and the LDP's weakened domestic political position, there are risks that ratification of any deal will be complicated. Concessions may not receive the necessary votes.

Market volatility near term, but longer-term policy tools are at hand

While the worst of the election risks have been ruled out, fiscal policy is likely to have an expansionary bias despite deficit concerns.

High debt-to-GDP ratio and few natural buyers have left Japan vulnerable to bond market gyrations. Supply and demand imbalances in the long end of the Japanese government bond market have drastically reduced liquidity (Figure 3) and heightened sensitivity to deficit concerns.

Figure 3: Bond market liquidity measures show the heightened level of sensitivity in Japan



Source: Bloomberg, Aberdeen, July 2025. Note: Liquidity index tracks average yield deviations from fair value. Higher readings signal poor liquidity.

However, authorities have multiple tools to tackle extreme scenarios.

Should bond market volatility spike following tense policy negotiations, the Bank of Japan (BoJ) could resume long-dated JGB purchases, signal temporary yield caps, or offer explicit forward guidance to calm bond markets.

Special funding facilities could be made available to help investors avoid fire sales.

The Ministry of Finance is already shifting toward shorter-term issuance to tackle supply and demand imbalances, while the Financial Services Agency (FSA) could delay full implementation of the new solvency framework, buying time for the markets to adjust.



For equity investors the near-term focus will undoubtedly be on tariff negotiations. However, longer-term structural trends will dominate.

Japan is well positioned to benefit from the AI and digitisation megatrend. While near-term supply chain dynamics remain uncertain, Japanese firms have been focusing on automation, quality control and manufacturing needs that arise with localisation and reshoring.

Japan has invested heavily in clean energy solutions and innovation.

Looking beyond the near-term geopolitical noise, Japanese assets look well positioned for the longer term.

BoJ carefully timing the next move

Domestic political uncertainty adds further complexity to the BoJ's policy decision. Despite inflation being a key focus of the election campaign, the central bank has been more cautious over the outlook for underlying inflation.

Despite headline inflation still hovering above target, the BoJ is yet to be convinced that domestically generated inflation will sustainably reach target-consistent rates.

In the upcoming July policy meeting, we expect revised forecasts for growth and inflation, and for the central bank to reiterate risks to its outlook.

Tariff uncertainties were discussed during the last meeting, while corporate profits, winter bonuses and next year's "Shunto" spring wage negotiations were also flagged as risks.

The BoJ will want to see the broad contours of a trade framework with the US in order to gain confidence in its own forecasts. A clearer indication of fiscal easing and the impact on JGB yields will also be required before further monetary tightening is possible.

We maintain our view that the BoJ will wait at least until January 2026 to next hike interest rates, to 75bps. But given the governor's dovish comments and the fragile political backdrop, any rate hike could be delayed even further.

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