

## Japan Macro Watch

# Rockier road ahead for the LDP: Macroeconomic and market implications

Select Subject

## Komeito exits coalition after 26 years

On 10 October, Komeito announced its intention to leave its coalition with the Liberal Democratic Party (LDP), which has been in place for the 26 years since 1999. This deprives the LDP of Komeito's 24 Lower House seats (5% of the total) and 21 Upper House seats (8%) and means the LDP will need to try and run the government with only its own 196 Lower House seats (42%) and 100 Upper House seats (40%, Exhibit 1).

The focus thus far has been on which opposition party the minority LDP-Komeito coalition would partner with to secure a majority. Komeito's exit means that the LDP now needs the support of at least two parties to pass legislation, unless it forms a grand coalition with the Constitutional Democratic Party (CDP; Exhibit 2). The various possible combinations (at least on paper) creates far greater uncertainty about the running of the government and its policies.

## Watch runoff to prime ministerial election

The immediate focus is the election to choose a new prime minister (PM). Although they are struggling to unite, the three major opposition parties (CDP, Japan Innovation Party (JIP), and Democratic Party for the People (DPFP)) together hold more seats than the LDP. We therefore need to monitor the debate on who individual parties (including Komeito) intend to support in the runoff-round vote. The prime ministerial election was initially scheduled for 15 October, but discussions between the LDP and Komeito over their coalition had already promoted consideration of a delay to the 20<sup>th</sup> or 21<sup>st</sup>. The ballot could now be postponed even further following Komeito's decision to withdraw.

## Further complicates fiscal policy debate

Even if Sanae Takaichi becomes prime minister, passing legislation will now require the support of two or more other parties, further complicating future discussions on fiscal policy. At this point, the only broad consensus is on quickly scrapping the provisional gasoline tax and kicking off the debate on refundable tax credits.

We do not expect any major pushback from opposition parties on local government grants or infrastructure investment, etc., which represent the continuation of existing policy, so discussions on the FY25 supplementary budget could proceed relatively smoothly (see [Takaichi's fiscal policy: Options and key focus ahead 09 October](#)).

## Other opposition parties also key to tax reform debate

The more important focus is the debate on FY26 tax reforms, which is difficult to forecast at this point. Other opposition parties' demands will likely be key in gauging the viability of the income tax cuts advocated by the DPFP and reductions in social insurance premiums proposed by the JIP. (continued overleaf)

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We think it is entirely possible that the various parties could change their stances depending on where policy discussions look to be heading, and developments therefore bear close watching. However, the overall need to incorporate more opposition parties' demands will likely exacerbate the skew toward expansionary fiscal policy.

**Exhibit 1: Number of seats in the Diet (by party)**

The LDP holds about 40% of the seats in both houses

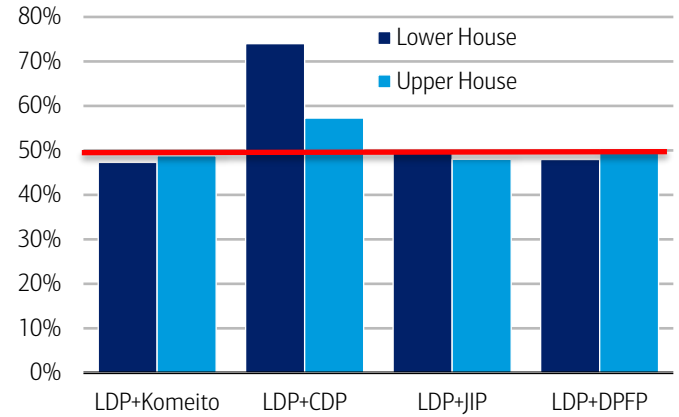
	Lower House		Upper House	
	# of seats	Share	# of seats	Share
LDP	196	42%	100	40%
Komeito	24	5%	21	8%
Ruling coalition	220	47%	121	49%
CDP	148	32%	42	17%
JIP	35	8%	19	8%
DPFP	27	6%	25	10%
Reiwa	9	2%	6	2%
Communist	8	2%	7	3%
Sanseito	3	1%	15	6%
Others	15	3%	13	5%
Total	465	100%	248	100%

Source: BofA Global Research

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**Exhibit 2: Seat share under the potential LDP's two-party coalition**

LDP now needs the support of at least two parties to pass legislation, except a grand coalition with CDP



Source: BofA Global Research

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**Snap election risk remains**

If the LDP fails to secure opposition parties' votes to elect a new PM or their support for upcoming fiscal policy discussions, it is not impossible that the LDP could call a snap Lower House election as it did last October. While relatively little time has passed since the October 2024 Lower House and July Upper House elections, both of which resulted in the loss of the ruling coalition's combined majority, we still think the LDP could opt to call a general election in a bid to revive its fortunes.

Calling an election in the next few months would severely delay the debate on the FY25 supplementary budget, FY26 initial budget, and tax reforms, and the implementation of several policies the market was expecting would also move back.

**BoJ to wait for uncertainty to subside**

Within the various opposition parties (including Komeito), only DPFP leader Yuichiro Tamaki has made any explicit demands about Bank of Japan (BoJ) monetary policy<sup>1</sup>. The other parties have mostly indicated that they respect the BoJ's independence, and we therefore see changes in the political landscape as unlikely to prevent its rate-hiking path.

However, we see the BoJ as unlikely to hike at the next monetary policy meeting (MPM) on 30 October given the sudden increase in uncertainty about the prime ministerial election and broader political landscape. We think the central bank will find it difficult to raise interest rates given the lack of visibility on the LDP government's viability and the outlook for policymaking.

However, recent yen weakness and rising inflation expectations are also ratcheting up pressure on the BoJ to hike. Its decision on whether to raise rates in the December or later MPMs will likely depend heavily on domestic political conditions over the next few months, and we therefore expect it to wait for uncertainty about domestic politics to

<sup>1</sup>In November 2024, he stated that "the BoJ will eventually need to normalize its monetary policy," but added that "it should not rush to raise rates over the next six months." Furthermore, as recently as April this year, he expressed a negative view on additional BoJ rate hikes in response to the US tariff policy.



subside (see [Tug-of-war between rising inflation expectations and political uncertainty 10 October](#)).

- Takayasu Kudo, Japan economist

## FX/rates: Uncertainty to remain high

The news of Komeito's withdrawal from the coalition prompted buying of JGB futures and JPY in overseas markets on Friday, but the rise for both was more muted than the decline in Nikkei 225 futures. We think expectations for a renewed escalation of the US-China trade conflict were also a major factor behind the yen's rally and the decline in yields.

Two opposing market views have formed about the impact of Komeito's coalition exit on FX and rates. The first is that the unwinding of the Takaichi trade will result in a stronger JPY and twist-flattening of the JGB curve. The second is that increased political uncertainty will result in continued yen weakness and twist-steepening. Considering the implications for politics and fiscal/monetary policy, we believe the latter appears more persuasive.

A supplementary budget will likely take longer to pass, but we doubt that Komeito's exit will lead to greater fiscal discipline. If the LDP remains in power, it will be with Takaichi as PM; in the event of a new government centering on current opposition parties, DPFP leader Yuichiro Tamaki appears to be a leading candidate for PM. Tamaki and Takaichi share a belief in accommodative fiscal and monetary policy. The need for any future government to incorporate the demands of multiple parties will also tend to swell the budget.

The spike in political uncertainty makes the BoJ even less likely to hike in October, given the potential criticism it would face for any unforeseen consequences from a unilateral decision to raise interest rates.

We expect the bias of yen weakness and curve steepening to continue.

- Shusuke Yamada, FX/rates strategist

## Equity: Valuation pullback versus rising procyclical fiscal policy expectations

The TOPIX P/E rose to 15.8x through 9 October, rapidly approaching the top of its core range (12-16x), suggesting that expectations have run ahead of reality ([see Japan Equity Strategy, 10 October](#)). We think valuations will unavoidably correct in response to the sudden spike in uncertainty about the political outlook.

However, it is also far from certain that this will prompt a sustained market collapse. Future risks--none of which we would rule out at this point--include (1) a snap Lower House election in the near future, (2) a coalition government of current opposition parties, and (3) a loss of policymaking momentum.

At the same time, we think the stock market will also focus on the following scenario. (A) Lower House member of parliament (MPs)' term runs through October 2028, and Takaichi may not see any immediate pressure to call a Lower House general election; (B) at least at this point, opposition parties show no signs of banding together (though this could change), which could allow the LDP to govern on its own; (C) the LDP may have a greater incentive to form a coalition with another party such as the Democratic Party for the People (DPFP). There are doubtless considerable obstacles to a new coalition, but the growing need to incorporate more opposition parties' demands in policy discussions could increase the bias toward procyclical fiscal policy.

Given the uncertainty surrounding all of the above, we will need to monitor how the situation unfolds. However, we think stock market expectations for fiscal expansion in



line with part (C) of our scenario could increase depending on news flow after valuations have corrected to some extent. An increase in fiscal spending would be generally positive for stocks, depending on its magnitude. We also continue to expect EPS to recover and ROE to rise through 2026 (see above report).

- Masashi Akutsu, Equity strategist



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