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Morning Briefing

Stagflation In Japan

Check out the accompanying [chart collection](#).

Executive Summary: Japan's GDP is contracting as its inflation mounts, but newly installed Prime Minister Sanae Takaichi isn't up to the stagflation challenge, William reports. Her massive stimulus package risks stoking inflation, as do US tariffs and a weak yen. That's unnerving investors, and the Bond Vigilantes are circling. ... Also making investors nervous: Takaichi has pledged Japan's allegiance to Taiwan, triggering China's President Xi Jinping and jeopardizing Japan's relationship with its second biggest trading partner. Xi has retaliated with trade and tourism bans that aren't helping the cause of stimulating Japan's economic growth.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay [here](#).

On Friday, Day 31 of the Takaichi era, Japan's first female leader unveiled a [21.3 trillion yen](#) (\$134 billion) stimulus package that smacks more of fear than confidence. This latest blast from Tokyo's fiscal bazooka came four days after news that GDP contracted [1.8% y/y](#) in the July-September period, the first negative reading in six quarters ([Fig. 1](#)).

The real problem, though, is the widening gap between sliding GDP and rising inflation, i.e., growing stagflation. Richard Katz, author of the [Japan Economy Watch](#) newsletter, calculates that "consumer prices today have risen 12% since 2021. At the same time, GDP is barely higher than it was in 2018." In October, core CPI inflation (less fresh food) posted its biggest increase since July, jumping [3% y/y](#) and confirming that stagflation is becoming more ingrained ([Fig. 2](#)).

Let's look at why stagflation could be difficult for Japan to beat:

(1) *Importing inflation as GDP contracts.* On one hand, US tariffs and a weak yen have Japan at risk of importing even more inflation than it already is doing. On the other, a slowing economy in China, Japan's second-biggest customer, dashes hopes of hastening Japan's economic growth via a lower exchange rate. It hardly helps that Takaichi is trading barbs with Chinese leader Xi Jinping over Taiwan.

Team Takaichi doesn't look up to the task of keeping inflation from racing even further ahead of both GDP and wages. For one thing, neither Takaichi nor Finance Minister Satsuki Katayama has barely even uttered "stagflation" even though it's the elephant in the economic room.

(2) *Stimulus now risks stoking inflation.* Rolling out a splashy stimulus package now to boost consumer spending is to misunderstand how inflation works. Ditto for Takaichi's cajoling Japanese companies to share profits with workers. Seeking bigger wage gains makes eminent sense politically. But without a sudden surge in productivity, a wage surge in an economy with a [2.6% unemployment rate](#) and a shrinking population is a recipe for an inflationary disaster ([Fig. 3](#)).

Another problem is that, so far, Takaichinomics is a repeat of the policies championed by mentor Shinzo Abe during his 2012-20 premiership. To be sure, the Abenomics priorities of cutting bureaucracy, modernizing labor markets, rekindling innovation, empowering women, and restoring Tokyo's place at the center of Asia finance are worthy goals. But Abe's Liberal Democratic Party (LDP) couldn't get any of them done over the last 12-plus years; how can Takaichi expect to in 12 months?

(3) *Revolving door politics.* This one-year window is important because that's roughly how long Japanese leaders get nowadays to make their mark—before Tokyo's political revolving door spins out a new one. Since 2006, [eight of the last 10](#) governments have come and gone in 12 months. That's all that Takaichi's immediate predecessor [Shigeru Ishiba](#) got.

So far, Takaichi has done little to convince Tokyo officialdom that her reign will stretch into a second year. Since October 21, Takaichi has doubled down on the same-old-same-old policy playbook: generous deficit spending, a weak yen, prodding the Bank of Japan to keep rates low, and lobbying Japan Inc. to fatten paychecks ([Fig. 4](#)).

(4) *Is Japan really back?* For all Takaichi's bold "Japan is back" talk, evidence that it's more than just talk is in short supply. She must walk the walk on supply-side upgrades to increase competitiveness. That's includes extricating Japan from the [bottom third](#) of OECD countries in worker efficiency.

Tokyo's to-do list on the productivity front includes: making the labor market more meritocratic, incentivizing innovation, supporting startups, deregulating and fostering a culture of risk-taking. Each of these disruptions would experience strong pushback from government bureaucrats and a corporate system that too often prizes seniority over talent. It

follows that 12 months isn't much time for a Japanese leader to shake things up.

(5) *Productivity deficit*. Here, an early Takaichi scandal is quite instructive. On a Friday in early November, Takaichi held what the Japanese media calls the “[3 a.m. study session](#)” with her staff—bad optics for a leader who campaigned on “work-life balance” in a nation plagued by a culture of overwork.

Takaichi's explanation for the controversy hardly helped: Her staff had to rush to her office because her home fax machine was on the fritz. That high-tech Japan remains so wedded to [pre-Internet technology](#)—including paper documents and ink stamps—is among the reasons productivity is stuck in first gear.

(6) *Stock wipeout*. Nor does it help that Takaichi's moves so far are unnerving investors from all sides. Last week, a sliding yen and rising Japanese government bond (JGB) yields shook stocks. The selloff wiped about \$127 billion off the value of Tokyo-listed stocks ([Fig. 5](#)).

Some of the selling reflects a loss of enthusiasm for Takaichi's economic strategy. In late August, [20-year Japanese government bond \(JGB\) yields](#) spiked to the highest levels since 1999 on the mere specter of fiscal expansion ([Fig. 6](#)). That was a month after the LDP lost majorities in both houses of parliament in the July 27 election. Markets now worry that the price for cobbling together a coalition government is a tax cut that would exacerbate Tokyo's debt burden.

(7) *Liz Truss moment?* Last week, Takaichi's aggressive stimulus package gave investors 134 billion reasons to worry about what comes next. For starters, she is widely expected to reduce the country's 10% consumption tax at a time when Japan's debt-to-GDP ratio is historically elevated ([Fig. 7](#)).

“The Takaichi government continues to face anxiety about a [Liz] [Truss shock-like scenario](#),” notes Tobias Harris at Japan Foresight.

(8) *Bond Vigilantes circle*. For years now, short sellers have been circling JGBs, sensing that financial Armageddon was imminent. Bets on a JGB crash are one of the most obvious “widow maker” trades anywhere. [Trump's tariffs](#), though, have injected extreme uncertainty into global debt markets and refocused investors' attention on how increased fiscal laxity could collide with Tokyo's precarious finances.

Japan's demographic trajectory is a case in point. The developed economy with the biggest

debt burden also has the fastest-aging population. In 2024, Japan's population shrank by 0.75%, the largest decline since records began in 1968, as the birthrate stagnated, too. This disconnect explains why then-Prime Minister Ishiba, in May, called Japan's fiscal situation worse than that of Greece and why the Bond Vigilantes are circling ([Fig. 8](#)).

Japanese Economy II: Costly War of Words With Beijing. Now, Takaichi's tiff with China over Taiwan is thickening the plot. Her stimulus announcement came two weeks to the day after she triggered Xi's Communist Party by saying China's attempting to take Taiwan by force would be a "survival-threatening situation" for Tokyo.

Takaichi's November 8 comments at a parliamentary meeting enraged China. So did her suggestion that Japan might stand with the US if Washington moved to break up a Chinese blockade on the island, which Beijing regards as a renegade province. Team Xi quickly took the dispute to the United Nations, accusing Takaichi of a "grave violation of international law" by threatening "an armed intervention" into cross-Straits dynamics.

Here's more:

(1) *Geopolitical repercussions.* The fallout is growing even faster for a \$125 billion trade relationship, Japan's second biggest after the US. Team Xi acted fast to ban seafood and slow the flow of mainland tourists to Japan. China has been the largest supplier of the tens of millions of inbound visitors filling hotels, airline, and bullet train seats, eateries, shopping galleries, and amusement parks.

China's ban on state-owned enterprise employees visiting Japan and dissuading mainlanders from buying Japanese goods has economists scaling back GDP forecasts. And investors worry that tensions won't soon subside. On Monday, China slammed Tokyo's plan to deploy missiles to southern Japanese island of Yonaguni, which is near Taiwan, as a ploy to "create regional tension and provoke military confrontation."

(2) *Heated rhetoric.* The last time Japan-China relations unraveled this quickly was in 2012, after Tokyo nationalized the contested islands called "Senkaku" in Japan and "Diaoyu" in China.

Two years earlier, in pre-Xi-era 2010, China halted exports of rare earth minerals to Japan for about seven weeks after coast guard ships collided near those disputed islands. Since then, Tokyo's efforts to decouple its supply chains to avoid China's export-restriction gambits have become something of a case study for industrialized nations—including the

US, which has faced its own Chinese curbs.

(3) *Unwelcome drag*. This latest tit-for-tat had Takaichi and Chinese Premier Li Qiang keeping their distance from one another at last weekend's G-20 summit in Johannesburg. In more normal times, it would've been an ideal opportunity for Japan and China to strengthen trade ties.

Stefan Angrick at Moody's Analytics says the spat is "hardly catastrophic, but an unwelcome drag for an economy already struggling to find traction." Clearly, he notes, "a sharp drop in Chinese travel to Japan would sting."

By Angrick's numbers, a halving of Chinese tourist arrivals would lower Japan's GDP by 0.2ppt in short order. Given that GDP entered Q4 in the red, Takaichi's economic team has little room for error. Nomura Research estimates the boycott could cost Japan more than \$14 billion annually. Japan's total exports of goods and services already tell 4.5% y/y in Q3.

(4) *Weak yen risks*. The weak yen also could worsen Japan's relations with both China and the US. The "Trump of it all" can't be ignored.

Of course, the Trump White House is watching the yen's slide back toward the 160 level, too (Fig. 9). Nothing might get Trump and Treasury Secretary Scott Bessent to turn on Japan faster than the perception that it's manipulating the yen.

Trump and Bessent want a weak dollar. A weak yen wouldn't help that cause. It could offer Beijing political cover to devalue the yuan, the rationale being: If Tokyo can beggar-thy-neighbor, why can't China?

This year, Xi has conspicuously kept the yuan-to-dollar exchange rate steady to firmer. One reason: to reduce the risk that property developers default on offshore debt. Another: to build trust in the yuan as a reserve currency. But no policy shift might tame China's deflation faster than a weaker yuan, so devaluation must beckon even though it might come at a cost of higher US tariffs on China.

A race to the bottom on currencies could upend Asia's 2026 in unpredictable ways. This includes the "yen-carry trade" going awry. Twenty-six years of holding rates at zero turned Japan into the globe's top creditor nation. For decades, investment funds borrowed cheaply in yen to bet on higher-yielding assets around the globe. So sharp yen moves tend to slam financial markets virtually everywhere. This could increase debt market volatility at any

moment.

(5) *The BOJ's dilemma*. As Tokyo's debt burden grows, the Bond Vigilantes are getting more active in Tokyo. Interest payments, meanwhile, are hogging an ever-larger share of tax revenues. That's limiting the BOJ's latitude to get rates away from zero once and for all. A quarter century after dropping rates to zero, the BOJ has only managed to raise rates to 0.5%.

This, despite widespread agreement that ultralow borrowing costs backfired. They took the pressure off the government to raise Japan's competitive game. Rather than revive Japan's animal spirits, free money deadened the need for corporate chieftains to restructure, innovate, and swing for the fences. Or to increase productivity.

Now the BOJ finds itself in an impossible situation as stagflation deepens. "Here's the dilemma," Katz says. "The posture necessary to reduce inflation—putting the brakes on growth via higher interest rates—worsens the stagnation."

Conversely, Katz adds, "treating stagnancy via fiscal and monetary gas pedals exacerbates inflation. Takaichi prioritizes growth while downplaying the threat of inflation." In such an environment, Katz concludes, "higher corporate profits and stock prices don't make Japanese voters feel *they're* back."

Calendars

US: Tues: Retail Sales 0.4%; Business Inventories 0.1%; PPI 0.3%*m/m*, 2.7%*y/y*; ADP Employment; Consumer Confidence 93.4; Richmond Fed Manufacturing Index -2; Pending Home Sales. **Wed:** Initial Claims 225,000; Durable Goods Orders 0.3%. (Source: FX Street)

Global: Tues: Germany GDP 0.0%*q/q*, 0.3%*y/y*; France Consumer Confidence; Cipollone. **Wed:** ECB Financial Stability Report; Japan Leading Index 1.0%; Lagarde; Mauderer. (Source: FX Street)

Strategy Indicators

S&P 500/400/600 Forward Earnings ([link](#)): During the November 21 week, forward

earnings rose simultaneously for the LargeCap and SmallCap indexes for the 25th time in 27 weeks. LargeCap's forward earnings rose for a 27th straight week, its longest winning streak since it did so for 38 weeks through the September 13, 2024 week. MidCap's recovery has slow-walked at times, rising in 22 of the 27 weeks since it bottomed during the May 16 week. SmallCap's has risen in 25 of the 26 weeks since it bottomed during the May 23 week. LargeCap's forward earnings rose 0.3% w/w to its 25th straight weekly record high. MidCap's has recorded just nine record highs this year and dropped 0.1% w/w from its third straight high a week earlier. SmallCap's jumped 0.5% w/w to a 36-month high and improved to 6.0% below its June 2022 record. Forward earnings had bottomed in early 2023 for these three indexes following 2022's year of cost-cutting. Since then, LargeCap's forward earnings has soared 35.3% from its 54-week low during the week of February 1, 2023; MidCap's has slowly gained 11.2% from its 55-week low during the week of March 10, 2023; and SmallCap's has rebounded 10.1% from a very recent 42-month low during the May 23 week. These three indexes' forward earnings downtrends from mid-2022 to early 2023 and again during Trump's Tariff Turmoil were relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (9.7%, 12.0%, 13.7%), MidCap (0.4, 1.4, 15.9), and SmallCap (-10.2, 6.1, 16.3).

S&P 500/400/600 Valuation ([link](#)): Valuations were lower for these three indices for a second straight week during the November 21 week, but more so again for LargeCap. LargeCap's forward P/E dropped 0.5pt w/w to 21.6 and is now down 1.2pts from a 25-year high of 22.8 during the October 31 week. It's still 4.6pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.1pt w/w to a 22-week low of 15.6, and is now 0.8pt below its 32-week high of 16.4 during the September 5 week. It's also 1.5pts below its 40-month high of 17.1 during the November 29 week and 3.4pts above the 12-month low of 12.2 in October 2023. That compares to a record high of 22.9 in June 2020 when forward earnings was depressed and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.3pt w/w to a 26-week low of 14.6, and is down 1.2pts from a nine-month high of 15.8 during the October 24 week. It's 1.7pts above its 17-month low of 12.9 during the April 4 week and 4.0pts above its 14-year low of 10.6 in September 2022, but remains 1.5pts below its 41-month high of 17.1 during the November 29, 2024 week. That compares to a record high of 26.7 in early June 2020 when forward earnings was depressed and a record low of 10.2 in November 2009 during the Great Financial Crisis. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E was steady at a 29% discount to

LargeCap's P/E, up from a 26-year low 30% discount during the October 31 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E fell 1ppt w/w to a 34% discount to LargeCap's P/E, matching its 24-year-low 34% discount during the July 5, 2024 week. That compares to a 23% discount during the November 29, 2025 week, which was its best reading since the March 2, 2023 week. SmallCap's P/E weakened to an 18-month-low 7% discount to MidCap's, but remains above its 20-year-low 10% discount in late 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

Global Economic Indicators

Germany Ifo Business Climate Index ([link](#)): "Companies have little faith that a recovery is coming anytime soon," notes Ifo president Clemens Fuest. "After the ups and downs of the past three months, there can no longer be any talk of an upward trend in the Ifo index." The Ifo business climate index unexpectedly dropped in November to 88.1, below the 88.5 consensus estimate and down from 88.4 in October. However, it wasn't that far from August's 15-month high of 88.8. It was at 84.7 at the end of 2024. The current conditions component rose from 85.3 in October to 85.6 this month, remaining in a relative flat trend in recent months. The expectations component remains near recent highs, slipping to 90.6 this month from 91.6 last month—which was the highest since February 2022. By sector, the service sector continued to improve, with services providers once again assessing the current situation as somewhat more positive; however, expectations deteriorated slightly during the month. Meanwhile, the manufacturing index fell, with expectations taking a significant hit while current conditions improved slightly. The business climate in the trade sector also took a hit, with both the expectations and the current situation components deteriorating. The report notes that "retailers, in particular, were disappointed at the start of the Christmas season." The construction index was also on the weak side, as a drop in expectations overshadowed a clear uptrend in the current situation."

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