

# Relief without Resolution

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The second quarter opened with considerable disruption. April 2nd, dubbed 'Liberation Day,' marked a historic escalation in US tariffs and the most significant shift in US trade policy in a century. Equity markets fell more than 10% in the first week of April as fears of a renewed trade war unsettled markets.

Sentiment rebounded swiftly, however, as Trump softened some proposals. US equities recovered initial losses and outperformed international developed markets by 6% in local currency terms. Investors appeared to become sanguine about the perceived reordering of trade policy, particularly as the economic impact, at least in the near term, proved limited.

That said, the rebound masks deeper risks. While markets welcomed the policy shift, tariffs remain elevated and could weigh on long-term growth. Geopolitical tensions and a politicised trade environment suggest volatility is unlikely to subside. More importantly, governments globally are grappling with rising debt, higher financing costs, and difficult trade-offs between near-term fiscal pressures and long-term sustainability. These dynamics are reshaping investment landscapes. In the sections that follow, we explore how these pressures are playing out in the US and Japan, and why scenario analysis and valuation discipline are critical in navigating the increasingly unstable environment ahead.

## Rising Rates, Rising Concerns

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After more than a decade of ultra-low rates, interest costs are rising across advanced economies. In the US, higher long-term rates persist due to inflation and rising debt issuance. Recent tariff announcements have pushed 30-year US yields above 5%, levels last seen during the Global Financial Crisis.

With Trump's proposed "Big Beautiful Bill" forecasted to add at least \$3.3 trillion to US debt by 2034, and 2024 marking the first time debt interest payments exceeded national defence spending, the weakening fiscal position has not gone unnoticed. Moody's downgraded the US credit score from Aaa to Aa1, citing chronic budget deficits and rising debt service cost.

For decades, low servicing costs allowed policymakers to increase spending and absorb shocks with minimal strain. That flexibility is eroding. Tighter budgets offer less room to respond to future crises, and investors are increasingly questioning the long-term sustainability of US fiscal policy.

Despite these risks, US equity markets remain near record highs, supported by strong earnings and AI enthusiasm. But the disconnect between fiscal fragility and buoyant markets suggests growing complacency. As pressures intensify, investors may need to re-think long held assumptions about US macroeconomic resilience and their regional exposures accordingly.

## Parallel Pressures in Japan

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Japan is also confronting rising bond yields, with long-dated government bonds reaching 25-year highs amid rising inflation expectations, limited demand for long bonds, and reduced support from the Bank of Japan.

Although Japan holds the highest debt-to-GDP ratio among developed economies, its largely domestically held debt has historically limited external pressure. But fiscal cracks are emerging, particularly from health and social care costs for its aging population. The IMF forecasts interest expenses, already 10% of government spending, could double by 2030.

These risks are not confined to Japan. As the world’s second-largest sovereign bond market, instability in JGBs can ripple globally. In August 2024, rising yields triggered Japanese repatriation from the US, a yen surge, and a global sell-off. If yields rise further, renewed demand for JGBs could pressure US Treasuries, adding to bond market volatility.

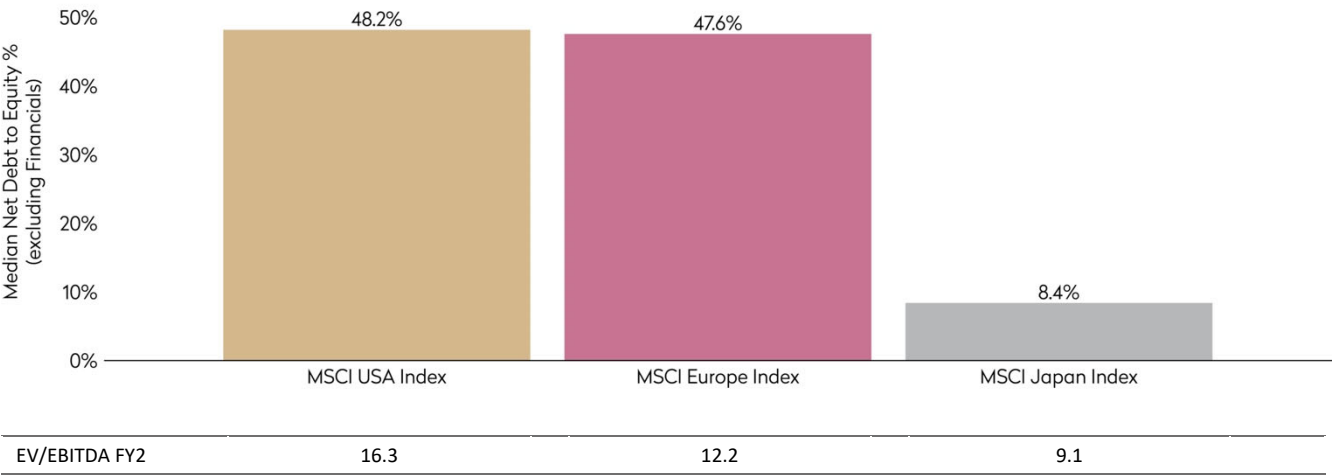
### Opportunities in Japanese equities

Against the backdrop of sovereign strain, Japan’s corporate sector presents a different story. Japanese companies are generally conservatively run, with strong balance sheets and attractive valuations; traits that offer resilience and upside potential for long-term investors.

We don’t assume that Japanese corporates will unlock all their balance sheet value, but their financial strength shifts the range of outcomes in our favour. In a worst-case scenario, a well-capitalized business typically fares far better than a leveraged one. In a best-case, shareholders may benefit from the return of excess capital, particularly in a market where corporate governance is improving and capital allocation is increasingly under scrutiny.

These dynamics support our constructive view on Japan. Despite similar macro debt concerns to the US, Japan offers better starting valuations and more resilient corporate fundamentals. For bottom-up investors like Mondrian, it remains a fertile ground for identifying mispriced stocks in a less efficient market.

### Strong Japanese Balance Sheets Support Skew of Outcomes



Data as at March 31, 2025  
Source: Jefferies, FactSet, MSCI

### Conclusions

Markets have staged an impressive rebound since April, but the underlying macro picture is far from resolved. In the US, ballooning deficits, higher servicing costs, and politicised trade policy are long-term risks. Japan faces its own fiscal challenges, but its corporate sector stands out as resilient, attractively valued, and improving in quality.

As fiscal flexibility narrows and geopolitical uncertainty persists, the range of outcomes across regions is widening. This demands selectivity, valuation discipline, and a willingness to look beyond dominant narratives. As investors seek resilience and value in a more uncertain world, combining valuation discipline with thoughtful scenario analysis remain as relevant as ever. In this shifting macro landscape, Japan stands out as a compelling destination for risk-conscious, long-term investors.

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