RATHBONES

Investment Report

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Made in Japan, needed by the world

6 November 2026

The country has much to offer, in the age of AI.

Japan's image is often futuristic: visitors encounter talking toilets, conveyor-belt sushi and vending machines selling almost everything.

Beyond such curiosities lies an important investment story. Japan's shrinking workforce has forced its companies to use technology to solve problems that many developed economies are only now starting to confront: too few workers and the need to produce more with less.

Close to three in ten people are aged 65-plus, and the population has fallen for 14 straight years. That is a drag on domestic economic growth. But at the same time, it has also created an unusually demanding home market for automation, precision manufacturing, and energy efficiency. In the age of AI, that experience is becoming more valuable, not less.

The mindset behind such expertise is monozukuri: 'the making of things'. This means attention to craftsmanship, process, and every link in the supply chain. It helps explain why Japanese companies remain important in two fields less high-profile than the finished produces we know and use: components, and products and expertise essential to the production stage of finished manufactured goods.

Quick take:

- Japan is interesting to investors because it's a world leader in robots and other tech that help solve the problem of shrinking workforces.
- Its companies include less obvious beneficiaries of the AI boom.
- Business conditions are at a 35-year high.

Robots: doing the jobs no one is left to do

Japan is one of the world's largest industrial robotics markets. The next opportunity is not simply to install more robots, but to make them useful in less predictable settings. For example, Fanuc is combining its motion-control expertise

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with Nvidia's simulation and physical-AI technology, including tests of 'imitation learning', in which robots learn movements and visual information from skilled workers. Physical AI broadens what robots can do; Japan already controls important parts of the machinery that will turn that advance into practical use.

The opportunity extends beyond the robot. Factory automation relies on pneumatic systems, which use compressed air to power production lines. Leaks, excess pressure, and idle machinery waste energy. SMC's air-management systems monitor flow, pressure, and temperature, then reduce supply during standby periods. SMC estimates that its systems can reduce air consumption by up to 62%. Fanuc and SMC capture two sides of the same structural need for improved efficiency: more flexible automation and lower running costs.

There are some threats. Notably, Chinese competitors have made some growth in their own domestic industrial-robot market in 2024, so Japan cannot rely on reputation alone. But Japanese companies often enjoy a durable advantage in continuous improvement, service, and system integration.

AI's less obvious beneficiaries

AI offers another example of Japan's importance further down the supply chain. More powerful chips require increasingly complex manufacturing. Tokyo Electron's 3D-integration technology facilitates the precise combination of logic and memory. That improves bandwidth: the volume of data a chip can process. It reduces latency: the time a chip takes to process data. It also lowers power consumption. Japan may not build the world's leading consumer AI model, but companies such as Tokyo Electron help make the chips on which those models depend.

The AI opportunity is largely cyclical. Semiconductor capital spending can be lumpy and expectations are high. That doesn't weaken the long-term opportunities in this sector, but it changes what investors should look for. The key is to separate businesses benefiting from the rising complexity of chip manufacturing from those relying mainly on the next upswing in spending. This is where Japan comes into play, since it has companies grappling with this complexity.

Efficiency is green

Japanese companies also have much to offer the world in climate technology. Japan isn't a pioneer in wind turbines or electric vehicles. But there are other ways of greening the world's energy supply. For example, Japanese companies have expertise in the use of hydrogen and ammonia as low-carbon sources of electricity.

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And corporate Japan has technologies that help enable a greener global economy to operate. For example, Hitachi Energy is a global leader in smart grid technology. Without such systems, power grids would crash when sudden changes in wind power threaten to upset the essential balance between power in and power out.Nidec makes premium-efficiency IE3 motors, which help reduce the power consumed by factories. Motors are central to factory pumps, ventilation, and compressors, which must all be made more energy-efficient.

Rewiring the boardroom

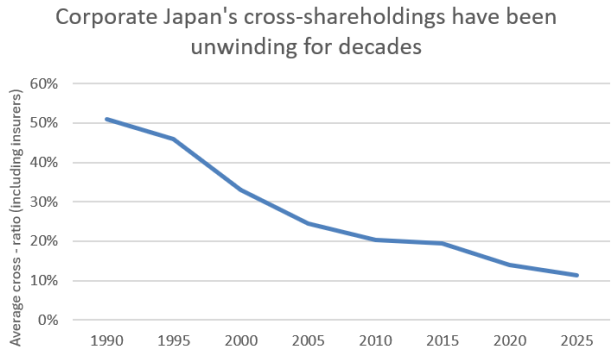
These technologies are more valuable to companies, allowing businesses to make the most of them when management allocates capital well – towards promising opportunities and away from low-returning divisions.

Governance reform encourages this – the Tokyo Stock Exchange has pushed companies to improve returns.

Meanwhile, cross-shareholdings, where different companies hold stakes in each other, creating a base of undemanding shareholders, continue to be unwound. (See chart on cross-shareholdings.)

Better boards, clearer return targets, and greater pressure on low-return assets can change how companies invest and return cash. The chart on Japanese shareholder returns shows them rising to ¥44trn in Fiscal Year 2025. But the next phase of Japanese shareholder capitalism should be judged less by the number of buyback announcements and more by whether companies can lift future returns on capital.

The stronger opportunity may sit with companies that reinvest released capital at higher returns, while also improving returns of cash to shareholders. Meanwhile, in a world of increasing debt, Japan's low-debt balance sheets stand as a welcome anomaly.



Source: Nomura Institute of Capital Markets Research, compiled by JPX.



Source: JPX, Ichiyoshi Securities, SBI Okasan Securities, Bloomberg

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Japan: risks and relevance

We've already discussed the risks from China and the cyclical nature of the robotic and semiconductor industries. These will test companies with weaker business offerings. When considering which companies can create a moat to defend against opposition, investors must look for companies that offer precision manufacturing, intellectual property, tailor-made solutions for clients' factories, and manufacturing know-how.

Ironically, Japan's increasingly ancient population has forced its companies to become good at the modern technologies of today's brave new world. That's why Japan is so interesting to investors.

A top-down macroeconomic view

Japan is too big for investors and economists to ignore. It's the world's fourth-largest consumer market and the third-largest carmaker, behind China and the US.

Economic policies such as the ending of negative interest rates, and planned state investments in strategic sectors, are helping the economy evolve. So too are the corporate reforms we've already mentioned. A combination of structural supply-side factors – elements raising the cost of supplying good and services, such as higher costs for food, materials, and labour – is driving inflation higher. This, in turn, is boosting nominal GDP growth (economic growth without stripping out inflation).

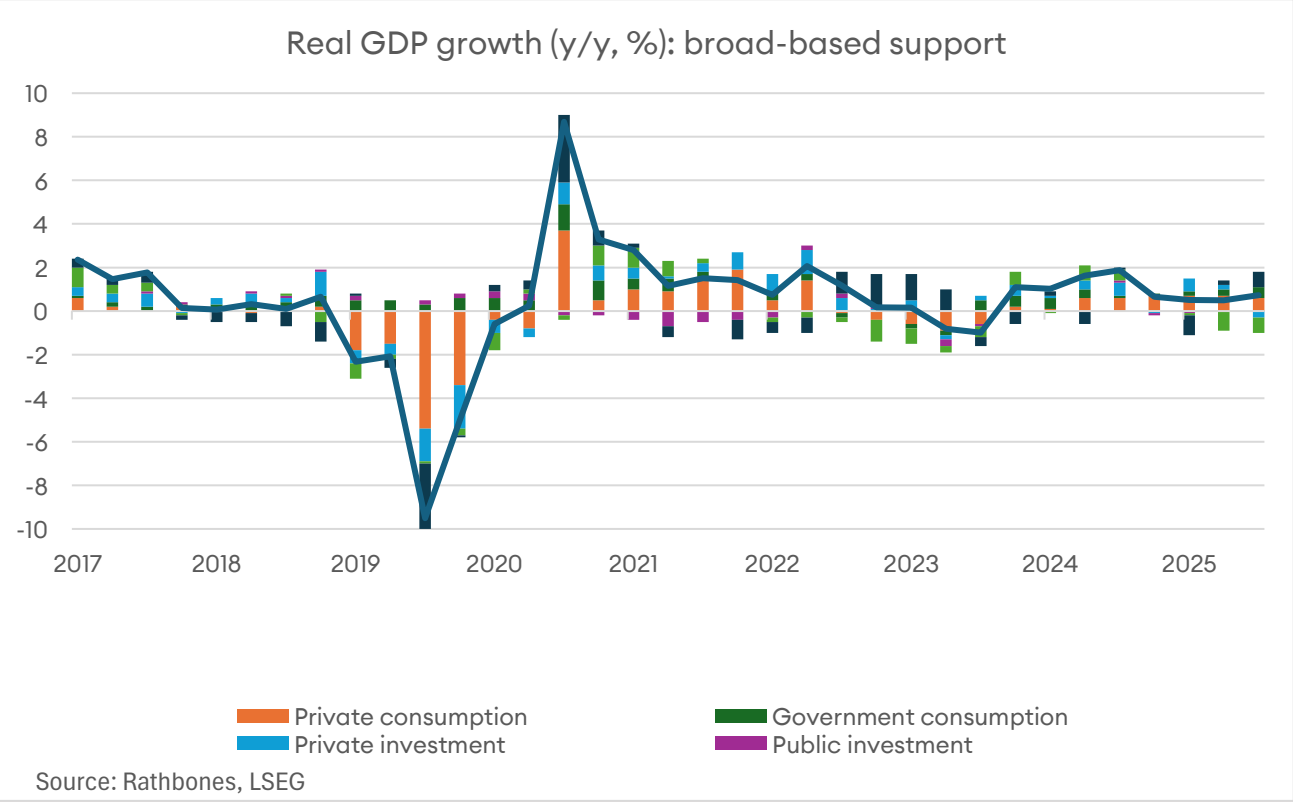
Most of Japan's inflation is home-grown. Wages have been rising, because a tighter labour market is giving workers more bargaining power. This has made it politically and socially acceptable for companies to raise prices because workers are more able to afford this. Yen weakness is also raising import prices.

But it's worth putting these inflationary factors in context. Japan's economy has been resilient to the energy price shocks generated by the Iran and Ukraine Wars. It owes this to swift government responses, including a cap on petrol prices. Both headline and core consumer price inflation are sitting below the Bank of Japan's target inflation rate of 2%.

However, there's a risk of higher inflation. This is partly because subsidies that capped energy prices, initially creating deflationary pressure, are no longer doing this: the reduction in inflation was a one-off that came in when they were introduced. It's partly also that higher wages could increase the cost of services – a much more labour-intensive sector than manufacturing. With a relatively strong economy and inflationary pressures mounting both domestically and externally, the Bank of Japan increased its policy rate for a second time in 2026 at its September meeting, to 1.25%. The market now expects further – and faster – rate hikes to suppress inflation.

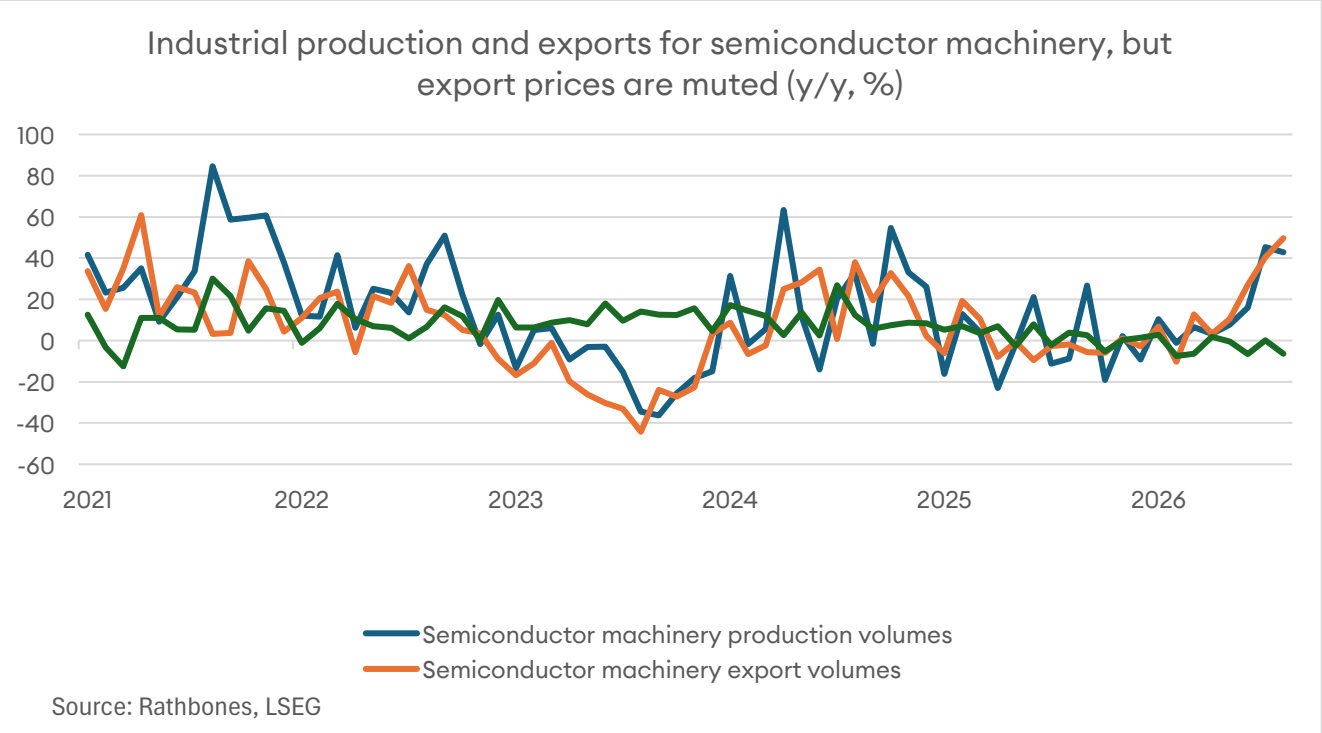
Looking more at the overall health of the economy, both the domestic and the export sectors have supported growth.

Households and businesses have been shielded from the energy price increase by the petrol price cap. The recently approved VAT cut to food and drink prices from 8% to 1%, due in April, will further buttress consumption and remove some of the supply-side inflationary pressures.



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But Japan's domestic economy has seen no parallel to the US AI boom, which boosted capital spending. Instead, the country has seen a surge in semiconductor machinery production that matches a surge in export volumes.

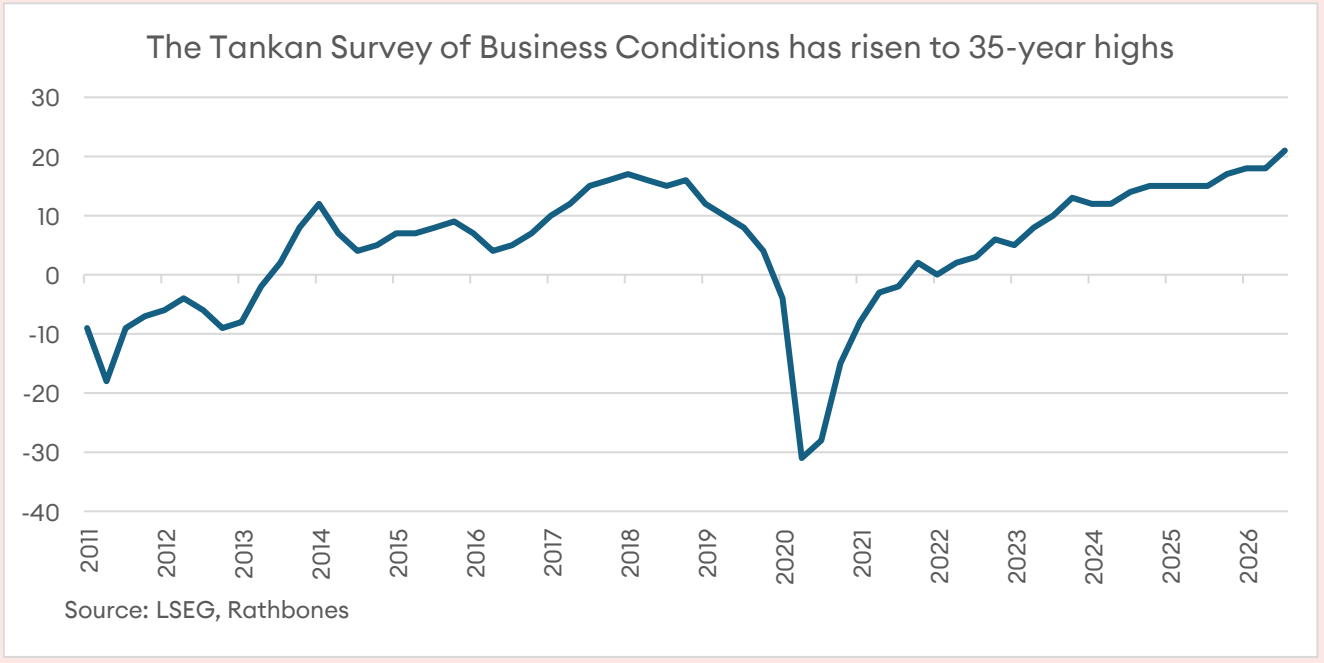


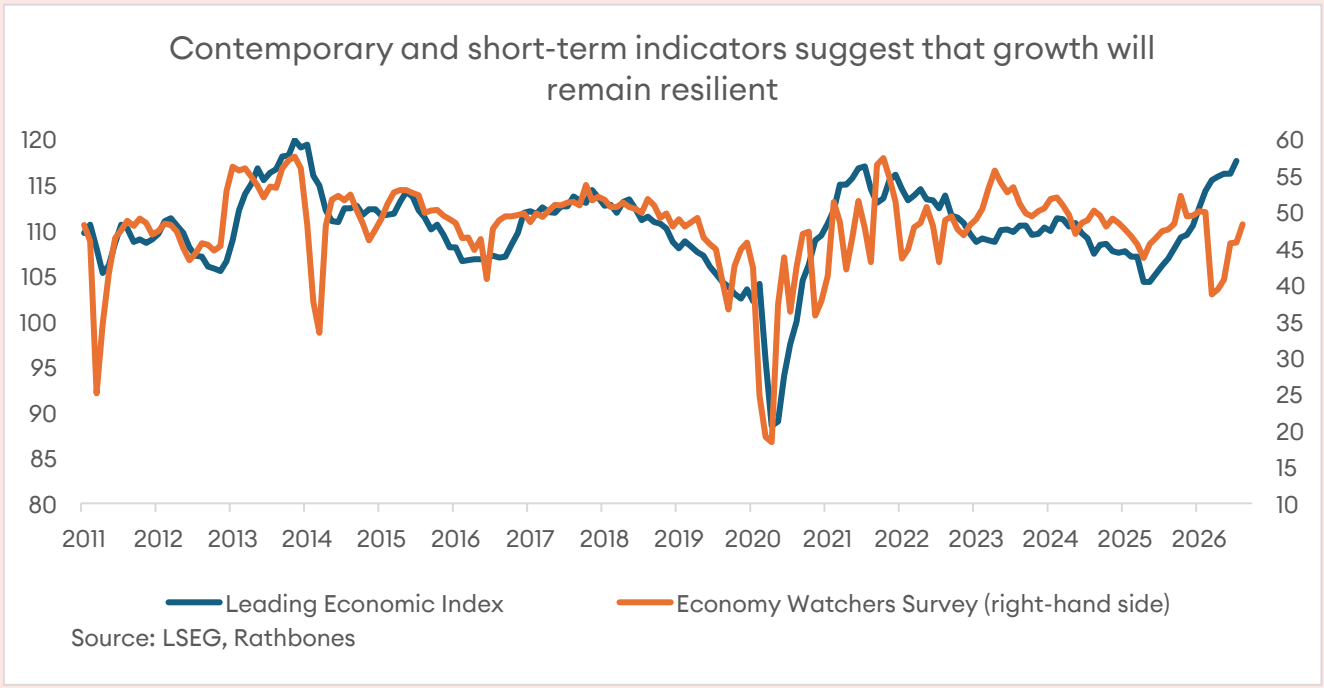
The healthy economic conditions are reflected in surveys of economic sentiment. The quarterly Tankan survey of business conditions recently rose to a 35-year high, bolstered by manufacturing and non-manufacturing alike. As does the Cabinet Office's Economy Watchers Survey, which has been recovering from the fall in the index in March 2026, following the start of the US-Iran war, as the economy demonstrates its resilience to the global oil shock. And the Cabinet Office's Leading Economic Indicator index continues to show an improved outlook that will continue to support growth in the short-term. Premier Sanae Takaichi's expansionary fiscal policy – both spending increases and tax cuts – continues to support the domestic outlook.

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