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A WORD ON THE JAPANESE EQUITY MARKET

GROWTH, INFLATION, WAGE PRESSURES - AN UNPRECEDENTED COMBINATION FOR JAPAN

Jean-François Chambon, a Japan equity manager at Ofi Invest Asset Management, updates us on Japan's growth trends and economic environment, and their impact on the equities market.

How has the Japanese economy been faring in recent months?

Since the start of 2023, the Japanese economy has been surprisingly strong. GDP rose by an annualised 2.7% in the first quarter, which is suite robust for a country whose growth is structurally below 1% and that only surpasses this level occasionally and with support of additional demand from major clients, i.e., foreign countries. One exception to the solid figures achieved since the start of 2023 – exports, which dragged down growth in the first quarter. Only since the month of April have we seen an upturn in exports, thanks to a recovery in car sales.

What is driving Japanese growth?

The engines of the Japanese economy are now mainly domestic, i.e., household consumption and business investment. Consumption is being driven higher mostly by the spending of surplus savings accumulated during Covid, as households were unable to consume during the lockdowns.

Then there's tourism, which until 2020 was a developing sector in Japan, with 32 million tourist arrivals annually and projections of 40 million or even 60 million ultimately. Since early 2023, tourism has rebounded at last, as health restrictions have been lifted. Japan has already received 7 million foreign visitors so far this year, and the trend is accelerating.

As for business investment, the recovery has been driven by strong order backlogs, but, most of all, by the fact that these orders can finally be produced now that supply-chain disruptions have been resolved in Asia, to which Japanese companies were especially vulnerable.

What about inflation in Japan?

In addition to strong growth, Japan has also surprised by managing to create a high-inflation regime in a country that had long been stuck in deflation[1]. Core inflation[2] – i.e., ex energy and fresh goods – is now almost 4%. This is also the first time that prices have risen in all sectors. This increase has come late to Japan, which is hit directly by imported inflation given that it possesses almost no raw materials.

We believe that inflation is now close to peaking, due to this lag. This is likely to lead the Bank of Japan (BoJ) and its new governor, Kazuo Ueda (who has taken up the same line as his predecessor), to take on a wait-and-see attitude in the short term in adjusting monetary policy. The BoJ indeed is still convinced inflation will return naturally to an annual rate of about 2%, and that's why it has stood out from its peers in recent months with highly accommodative monetary policy despite the current surge in inflation.

To find out whether the BoJ's forecasts are well-founded, pay close attention to wage trends in the coming months. No price-wage spiral appears to have begun in earnest, and that would be a key factor for the BoJ, as it would be based on psychological factors that are hard to grasp at this stage.

Recall that Japanese households have not experienced price rises in several decades. The trend began to reverse itself in the mid-2010s, driven by Prime Minister Shinzo Abe's massive stimulus programme, but Japanese households did not realise this, as companies managed to

(1) Deflation is the opposite of inflation. It is characterised by a long-lasting and self-sustaining decline in the general level of prices.
(2) Core inflation is inflation minus certain extremely volatile items such as agricultural and energy commodities.

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hide the very slight inflation through various tactics, such as shrinking quantities in order to maintain prices. This is no longer possible. With inflation hitting all sectors at the same time, companies are no longer able to mask price hikes and – most importantly – they at last have the opportunity to raise their prices without fears of losing market share. So, there is lots of pressure from employees for raises.

Negotiations with trade-unions for 2023 produced an across-the-board 3.6% increase in wages. This is not enough to trigger a wage-price spiral, but the Bank of Japan is paying especially close attention to the 2024 negotiations round, which could be tougher.

How should investors view this new economic momentum?

Three factors are worth watching in this macroeconomic context.

First of all, the functioning of the bond market has been seriously disrupted since the end of last year. The Bank of Japan now holds more than half of long-dated bonds.

The second factor is how households view inflation - very negatively, as it turns out, due to the decline in real wages. How will this affect their consumption? Will they switch to older, cheaper products?

Third, the exchange rate, which is closely tied to real interest rates, at least in recent years. The dollar posted strong gains in 2022 with the Fed's aggressive tightening of monetary policy. The dollar has reached high levels, too high for the comfort of the authorities.

This is no doubt the other reason that the Bank of Japan could tighten its monetary policy more gradually in the medium term, beginning with asset purchase programmes and then a change in the deposit rate, which is still in negative territory today.

What do you think of the Japanese equity market?

The market is up by almost 90% from its Covid lows, a very robust performance. Its P/E[3] is now about 14, its historical average, which looks rather attractive when looking at how expensive other equity markets are. But equities nonetheless remain at a 33-year high, which is making us highly selective in our choice of sectors.

So far this year, the sectors most exposed to global demand have performed the best, while financials have been hit hard by banking crises in Europe and the US.

In the medium term, Japan looks best placed to benefit from the Chinese recovery and from development in Southeast Asia, including a major local positioning in robotics industries and a current predominant presence in sectors such as automotive.

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(3) P/E: Price/Earnings ratio, a market research indicator.

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