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Japanaissance? Japan’s inflation revival and structural transformation

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In Focus: “Japanaissance”? Japan’s inflation revival and structural transformation

The Japanese asset bubble popped more than three decades ago, beginning a prolonged period of depressed growth and sluggish asset performance. But in February this year, Japanese equities finally climbed to new all-time highs and are now up more than 20% year-to-date. A raft of structural reforms beginning nearly a decade ago, together with a series of post-pandemic changes, are starting to pay off, helping to make Japan into an attractive investment destination once again.

With inflation and wage growth seeing a revival, many investors are now speculating that Japan has broken out of its long-term stagnation and should feature more prominently in investor portfolios. Indeed, in March, the Bank of Japan tightened policy for the first time in 17 years and released its policy of Yield Curve Control (YCC). In the corporate sector, firms are beginning to implement reforms, including more share buybacks and greater dividends.

We anticipate Japan will see returns considerably higher than recent history and may see a structural revival. With 45% of TOPIX stocks having no analyst coverage (versus just 3% of the US Russell 3000 Index), we also believe there is ample room for active management. Valuations also remain attractive, sitting well below other major developed markets and well below historical averages. With growth poised to be higher and asset returns improving, we ask: Are we about to witness a “Japanaissance” in Japanese growth and asset performance?

– Invesco, Global Market Strategy Office

Data as at 7 June 2024 unless otherwise specified. Sources: Bloomberg and Invesco, as of 7 June 2024.

In Focus

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2 The Bank of Japan finally tightened policy at its March meeting, and policymakers suggest more tightening is to come

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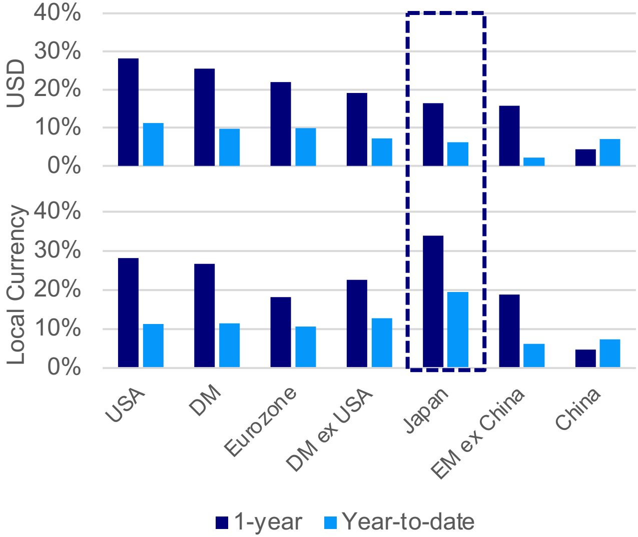
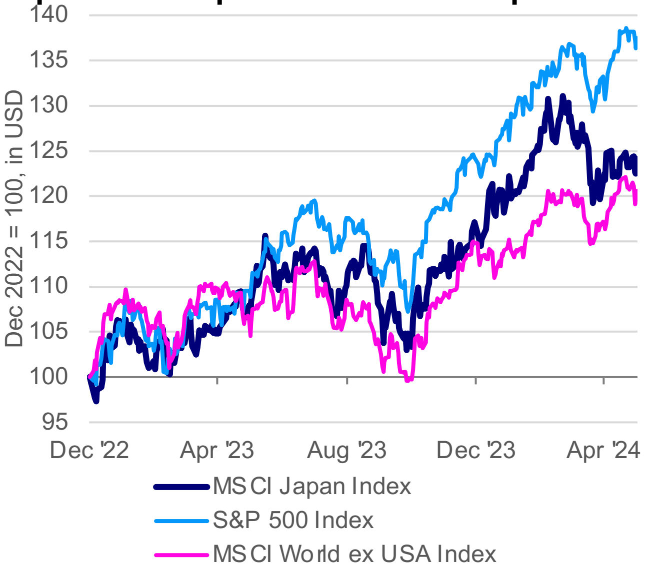
1 After 34 years, Japanese equities are trading above previous all-time highs

Major equity market performance, %



Japan has outperformed ex-US equities



- In February this year, Japan's Nikkei 225 registered its first all-time-high since the Japanese real estate bubble 34 years ago. In local currency terms, the index is up 33.9% year-over-year (16.4% in USD).
- However, in USD terms, performance has been sapped by dollar strengthening in the face of recent upside US inflation surprises.
- As in the right-side chart, Japanese assets have also outperformed their ex-US developed market counterparts in Q4 last year and Q1 this year. This begs the questions—what's changed in Japan, and how sustainable is this?

Sources: Invesco and Bloomberg. Left: Indices are as follows: US = S&P 500 Index, DM = MSCI World, EM ex. China = MSCI Emerging Markets excluding China, Japan = MSCI Japan, Eurozone = MSCI European Monetary Union, DM ex. US = MSCI World ex US, China = MSCI China. Right: Daily data indexed from 29 December 2022 = 100. All data as at 31 May 2024.

2 The Bank of Japan finally tightened policy at its March meeting, and policymakers suggest more tightening is to come

Bank of Japan policy changes announced on 19 March

Previous Policy

Short-term policy rate

Interest rate on banks' deposits at BOJ = –0.1%

Yield Curve Control / long-term policy rate

Long-term policy rate (10-year JGB yield)
= around 0%, with upper bound of 1%
as a "reference"

Non-JGB asset purchases

Purchase equity ETFs and J-REITs as necessary with upper limits

Forward guidance

BoJ will not hesitate to take additional easing measures if necessary

New Policy

Short-term policy rate

Uncollateralized overnight call rate = 0.0 to 0.1%
※Interest rate on banks' deposits at BOJ = +0.1%

Yield Curve Control / long-term policy rate

Long-term rates are no longer controlled (Fixed-rate purchase operations of JGBs are conducted in case of a rapid rise in long-term interest rates)

Non-JGB asset purchases

New purchases are no longer conducted

Forward guidance

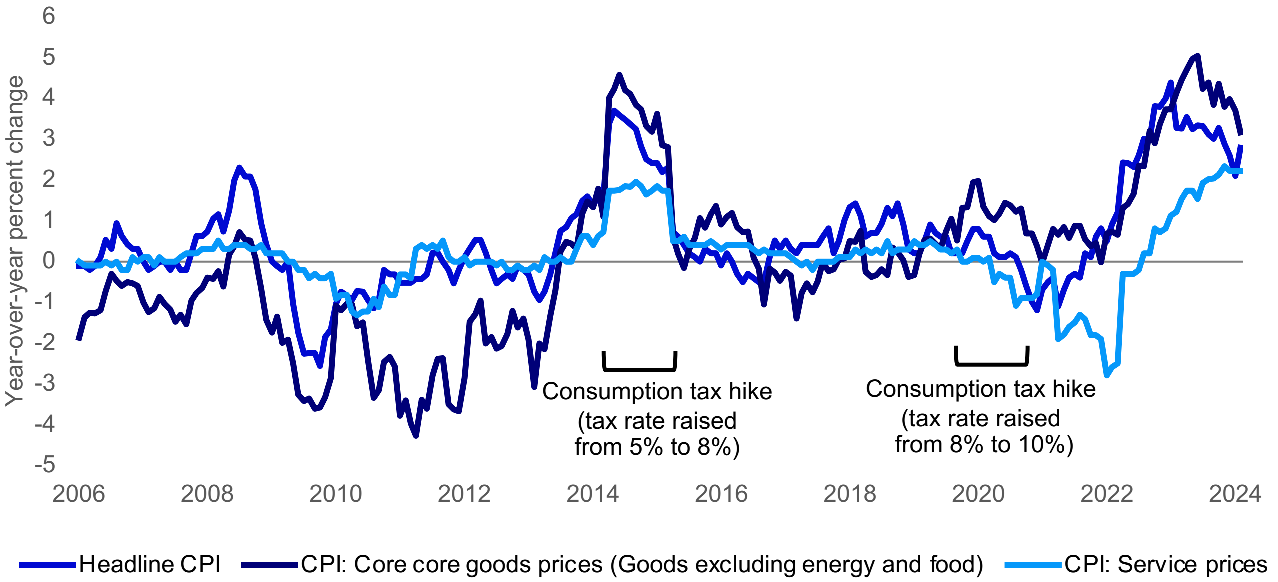
Abolished

Source: Invesco from the Bank of Japan. As at the BOJ meetings on 22 March 2024 and 7 May 2024. JGBs = Japanese government bonds.

- Among the most significant recent changes from Japan came in March this year, when the Bank of Japan (BOJ) tightened monetary policy for the first time since February 2007. At this time, the BOJ abolished negative interest rate policy, YCC policy, and its policy of forward guidance.
- This has stoked the view that Japan has finally made a transition from a deflationary economy to an inflationary economy. Meanwhile, investment has been picking up (see point #5).
- With yields rising, some market participants anticipate renewed domestic appetite for JGBs and other Japanese assets.
- The BOJ also suggested further policy tightening in its policy meeting on 25-26 April as it showed its will to raise policy rate if the economy and inflation proceed as it expects in its outlook report. We now expect the BOJ to make one or two additional policy rate hikes by end-2024.

3 Why tighten? Japanese inflation is back!

Japan's inflation, consumer price index (CPI)

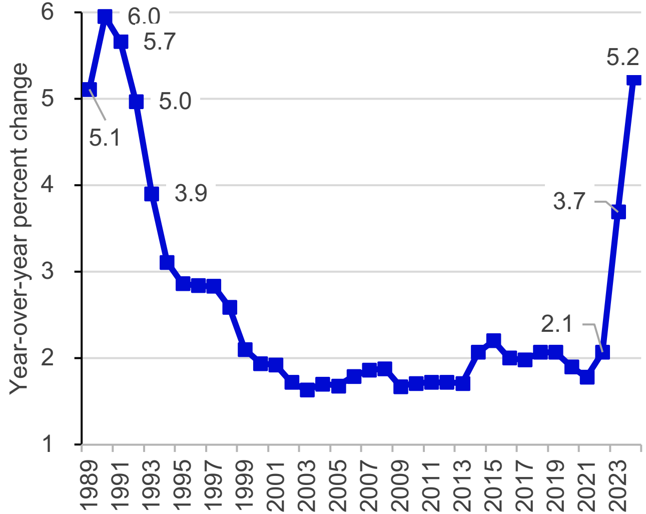


- After a decades-long struggle with trying to prevent deflation, Japanese inflation has finally moved higher and is expected to be sustained near 2% year-over-year, which triggered the March rate hike by the Bank of Japan.
- Importantly, services inflation finally picked up to near 2% level in recent months, which reflects a significant change in corporations' price-setting behavior. We anticipate that services inflation is likely to stay around 2% level, supported by wage hikes.
- Although goods inflation has decelerated in recent months, the recent depreciation of yen and a rise in oil prices should keep it at a relatively high level in the coming months, in our view.

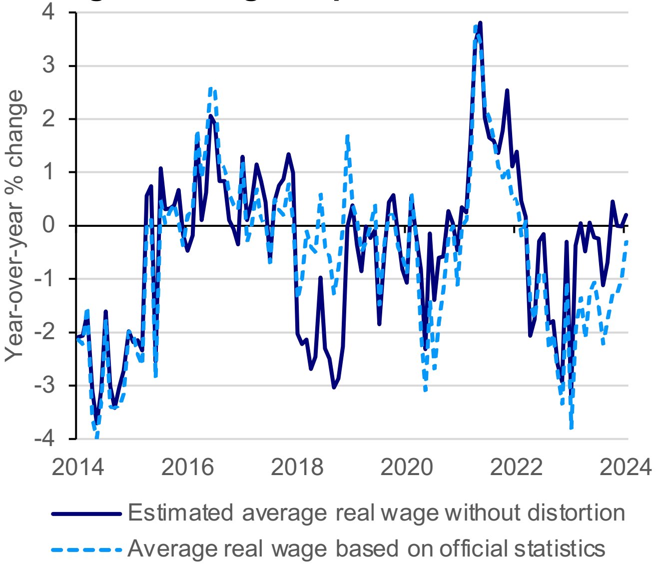
Source: Invesco from CEIC. Monthly data as at 8 April 2024.

4 Wages have been on a tear, supporting the inflation outlook

Average pay raise agreed through "shunto" negotiations



Average real wage, Japan

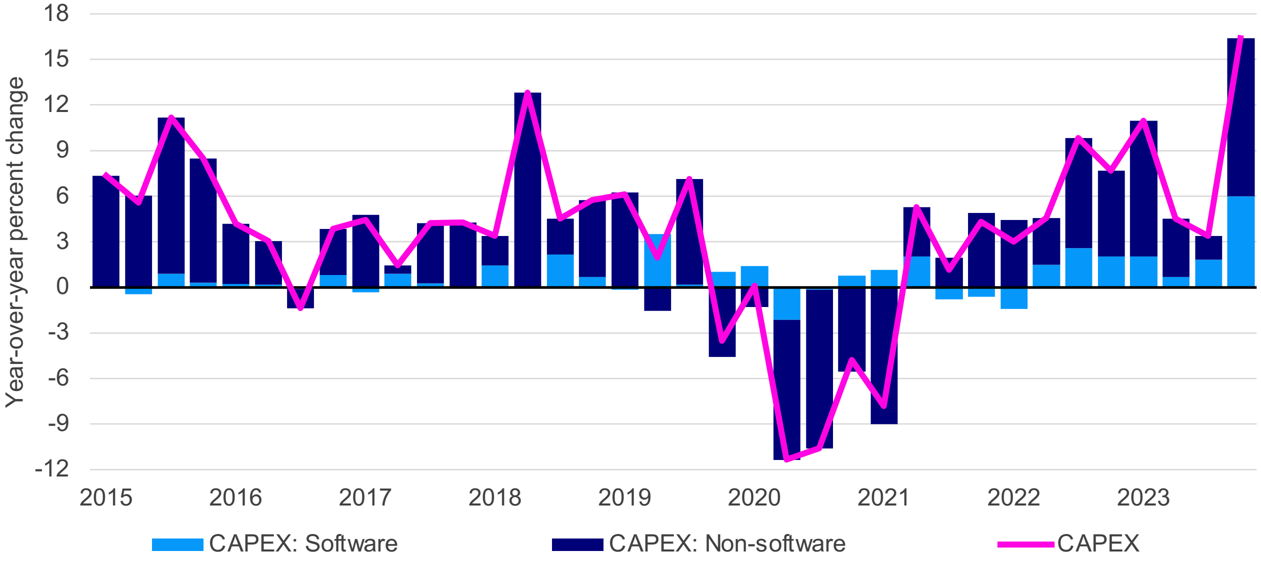


- Adding fuel to the inflation view are the results of Japan's annual spring wage negotiations ("shunto"), which yielded surprisingly high wage increases and paved the way for the BOJ's March tightening move.
- The shunto results indicated an overall pay raise of 5.2% YoY, indicating the highest pay raise since 1991. The base pay scale raise was surprisingly high at 3.6% (for those firms' results under which pay scale raise is clearly calculated). These results should substantially raise the possibility that Japan enters a virtuous cycle between wages and prices, leading to sustained, 2% inflation.

Left: Note that 2024 figures are based on third round of data release by Rengo. Source: Invesco from Rengo. Annual data as at 30 April 2024. Right: Estimated by Invesco using data from Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare and CEIC. Monthly data as at 30 April 2024.

5 Capex has also start picking up, suggesting a future rise in productivity

Japan's corporate capital expenditures

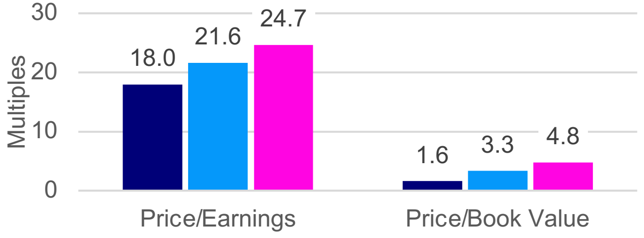


Source: Invesco from CEIC. Quarterly data as at 8 March 2024.

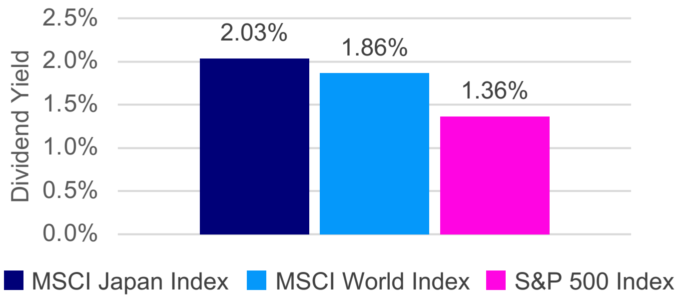
- Japan's corporate capital expenditures (capex) have also showed a sizable increase, which should encourage the BoJ to continue tightening policy at the margins.
- New data on corporate capex revealed that Japanese firms' capex increased by 16.4% YoY in Q4 2023, having significantly accelerated from 3.4% in Q3 2023.
- The results of the most recent BOJ's Tankan survey suggested a considerable rise in capex in FY2024. Strong CAPEX is likely to encourage the BOJ to implement further monetary tightening.
- Capital deepening (as captured by capital expenditures) typically boost worker productivity, which may help sustain future real wage growth.

6 Japanese asset valuations remain attractive

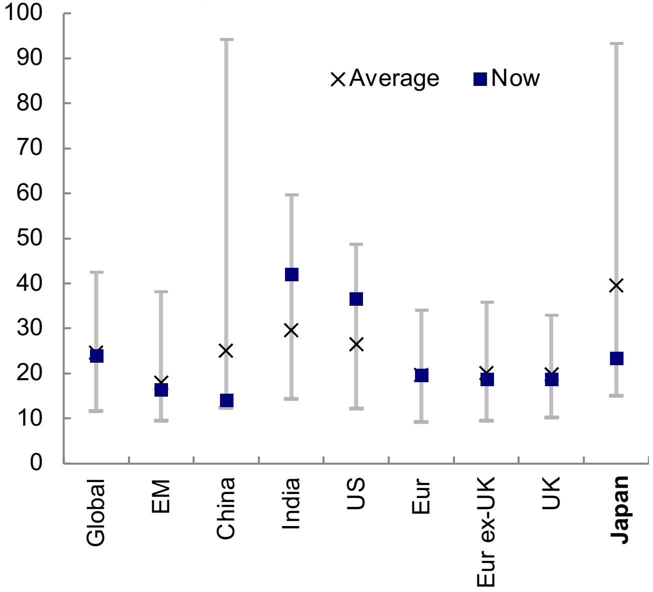
Valuation comparison



Dividend yield comparison



Historical ranges for CAPEs

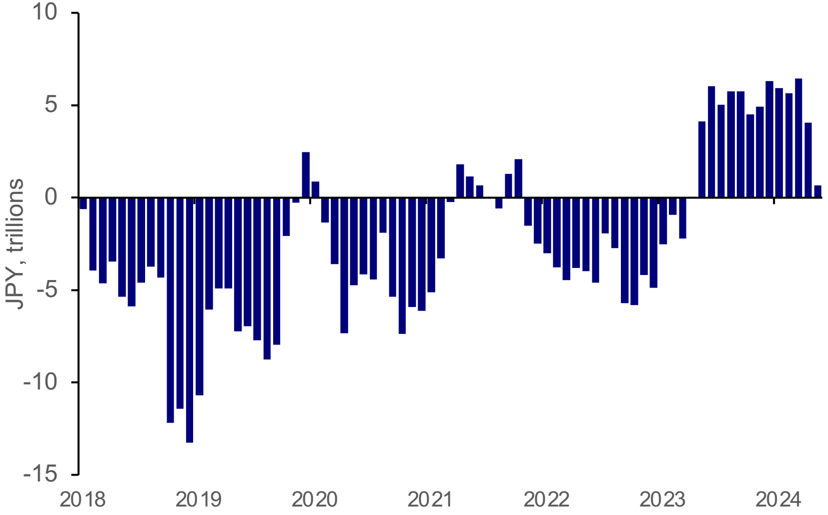


- While Japanese equities have experienced a strong rally in the past year, their valuations are still attractive relative to other major indices. In addition, the dividend yield on Japanese equities is higher than that of other major indices.
- A powerful catalyst for Japanese equities to climb higher could be the new NISA (Nippon Individual Savings Account), a tax-exempt investment savings plan introduced in January. Cash deposits comprise a whopping 52.5% of households' financial assets in Japan, 12.5% in the U.S. and 35.5% in the eurozone. The NISA could be the catalyst to move some Japanese household cash to equities.
- The Bank of Japan's policy normalization has been a boost to confidence, sending a strong message that the Japanese economy no longer needs such a high level of support because it is in better condition and is expected to continue to improve.

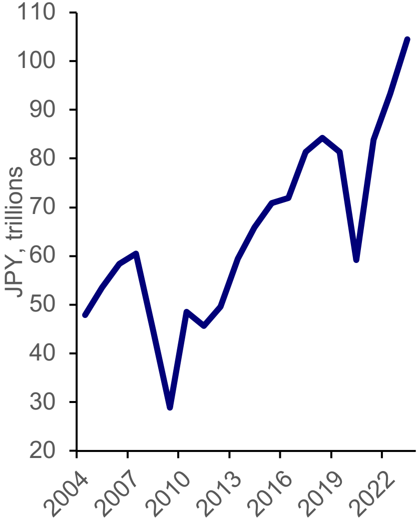
Left: Sources: MSCI and Bloomberg, as of 31 May 2024.
Right: Note: CAPE = Cyclically Adjusted Price/Earnings and uses a 10-year moving average of earnings. Based on daily data from 3 January 1983 (except for China from 1 April 2004, India from 31 December 1999, and EM from 3 January 2005), using Datastream indices. As of 30 April 2024. Sources: LSEG Datastream and Invesco Global Market Strategy Office.

7 Foreign investors are buying Japanese assets again

Non-residents' purchase of Japan equities
(12-month moving sum, trillions JPY)



Japanese companies' current profits (trillions JPY)

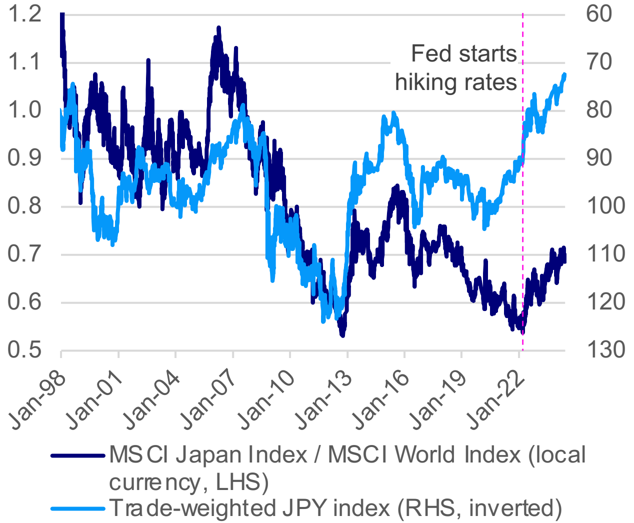


- Foreign investors have become more interested in buying Japanese equities as Japanese companies have become more profitable in recent quarters. In fact, Japanese companies have benefited not only from the weaker yen but also from the adoption of more aggressive price-setting behavior as Japan appears to be leaving behind its deflationary environment.
- Market participants generally expect a further robust increase in Japanese companies' profits as they can now envisage sustained, domestic demand-led economic growth in the medium term.
- Foreign investors are expected to have increase their exposure to Japanese equities once Japan's domestic demand growth path becomes more solid with higher wages and private consumption.

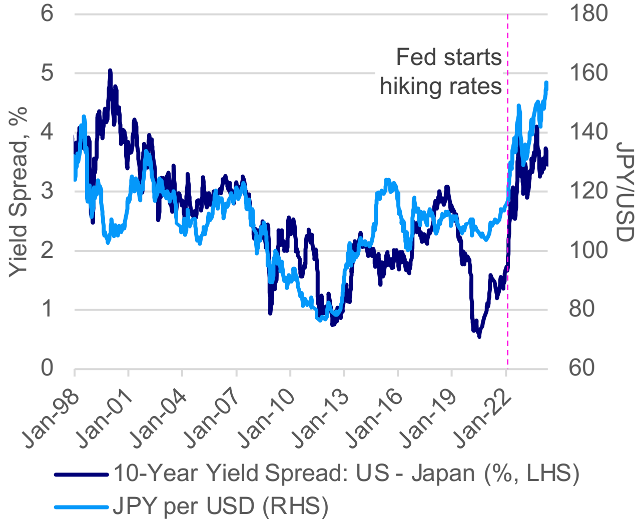
Left: Both spot and futures transactions are included. Source: Tokyo Stock Exchange and Nomura. Monthly Data as at 10 June 2024.
Right: Source: Japan's Ministry of Finance, based on annual data as at 10 June 2024.

8 Beware Japanese stocks if the yen recovers

Japanese stocks have been supported by the weak yen



Yen value has been driven in large part by rates differentials



- Japanese stocks tend to outperform when the yen weakens (which boosts the yen value of overseas earnings). And, indeed, the Japanese currency has been weakening for several years.
- The yen has performed poorly over the course of the Fed's rate hiking cycle, which has helped support Japanese equity performance as foreign earnings grew in value and exports became cheaper.
- Recent tightening moves by the BOJ suggest that the yen may see some support against the dollar, but we expect the path of the US Federal Reserve will be the more important driving force in yen direction.

Based on monthly data from January 1998 to February 2024. Trade-weighted JPY index is the real effective exchange rate (REER) from the Bank for International Settlements. Sources: Bank for International Settlements, Bloomberg, MSCI, and Invesco Global Market Strategy Office

The Path Ahead:

1

Policy remains accommodative

In contrast with many major Western developed markets, Bank of Japan policy remains in an accommodative stance despite recent tightening steps. This should be supportive of growth.

2

Japan must sustain structural reform

Expectations are high for a structural shift in Japanese growth. Near-term, we expect a cyclical pick-up in growth, including above-potential growth through the remainder of this year. To sustain equity momentum, Japan must continue to deliver strong results and further reform progress.

3

Valuations remain attractive

Compared to major markets, Japanese equity CAPEs are well below historical averages and dividend yields look attractive. This remains true despite the recent rally in Japanese equities.

4

Dollar-yen rates differential to dominate

Despite yen intervention by Japan’s Ministry of Finance, Federal Reserve rate policy is likely to dominate the path of the yen. A turnaround in the yen may impact Japanese equities due to their large foreign earnings exposure.

Source: Invesco. For illustrative purposes only.

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All data as at 7 June 2024 unless otherwise stated. All data is USD, unless otherwise stated.

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