Outlook on

Japan

APR 2024

Summary

- The Bank of Japan exited negative interest rate policy at its March meeting, a historic move symbolizing the end of deflation in Japan.
- Following stronger-than-expected wage gains at spring labor negotiations, this was a first step in policy normalization; we expect one or two more rate hikes by year end.
- As Japan leaves deflation behind, we have started to see changes in corporate and household behavior that demonstrate greater willingness to invest and take risk.
- We remain very positive on Japanese equities over the medium and long term thanks to corporate governance improvement and the shift from deflation to inflation.

The Bank of Japan (BoJ) finally exited negative interest rate policy at its March meeting. After eight years, it was a historic move, and coming on the heels of stronger-than-expected wage increases at this spring's labor negotiations, it was also a signal that decades of deflation in Japan have officially come to an end.

The central bank eliminated its yield curve control framework and announced that its short-term interest rate will be the primary policy tool. It is now targeting a short-term policy rate of 0% to 0.1%. In addition, the BoJ announced the termination of its exchange-traded fund (ETF) and Japanese real estate investment trust (J-REIT) purchase program and the tapering of commercial paper and corporate bond purchases over the next year. However, it will continue to buy Japanese Government Bonds (JGBs) at a rate of approximately ¥6 trillion every month and reaffirmed its commitment to avoid a rapid increase in long-term interest rates through unlimited buying of JGBs if needed.

In sum, the message remained dovish. With core inflation (which excludes fresh food and energy prices) running at 3.2% recently, the BoJ was essentially ensuring that the economy would continue to see negative real interest rates for the foreseeable future. The termination of the ETF and J-REIT purchase program did not come as a surprise; meaningful purchases have not been seen in a long time, and there are no plans to unwind current holdings.

Wages Are Climbing

The shift in policy had been well telegraphed by the BoJ prior to its meeting as early results from this year's spring labor negotiations (Shunto) were significantly higher than expectations. Last year's base wage increase of 2.1% was double that of most economists' projections, and this year's expectation was for only a modest increase compared to last year's. But early negotiations have pointed to a base wage increase of 3%–4%. These levels clearly support the view that the economy is starting to see endogenous inflation growth and justified the decision by the BoJ.

We view this as a first step in policy normalization and expect another rate hike, and potentially two, before year end. In many ways, the symbolism of the policy shift—Japan finally exiting its deflationary spiral—is more meaningful than its economic impact.

Signs of Leaving Deflation Behind

The behavior of households and corporations in Japan has been the direct result of a deflationary mindset, and we have long believed that as this mindset changes, we are likely to observe changes in consumption, investment, and savings patterns. These, in turn, will have significant ramifications for the equity market and the broader economy over the longer term, in our view.

We have already witnessed many of these changes in companies' behavior recently. In December last year, for example, Nippon Steel announced the acquisition of US Steel. In January, we saw Sekisui House acquire MDC Holdings, a large US homebuilder. In February, Renesas Electronics announced the takeover of Altium, an Australian-American electronic design automation software firm. These are multibillion-dollar all-cash transactions financed by debt, showing that these Japanese firms are thinking strategically about how to grow their businesses and that they are willing to take on risk. We would also note the significant acceleration in capital expenditures by listed firms in 2023 compared with 2022. We expect capex spending to grow this year as well.

The investment behavior in the household sector is also evolving. Following changes to Japan's Nippon Investment Savings Account (NISA) program in January that raised the maximum investment amount to ¥3.6 million from ¥1.2 million and made the tax deferral period permanent (from five years), January inflows into NISA approximately tripled compared with 2023 levels, based on a tabulation of five large internet brokers in Japan. These are early anecdotal examples, but we are heartened by them, nonetheless.

Looking Ahead

As we look forward to the new Japanese fiscal year starting in April, we remain very positive on the medium- and longer-term outlook for Japanese equities as two key themes continue to play out: corporate governance improvement that is driving better capital efficiency and higher shareholder returns; and the shift from deflation to inflation.

Since the start of 2024, Japanese equities have performed well in local currency terms and even in US dollar terms despite the depreciation of the yen, and yet, forward price-to-earnings valuations are still around the ten-year average. While certain pockets of the market appear to be ahead of fundamentals, aggregate valuations in Japan remain compelling to us.

With Japan's stock markets reaching new highs lately, an equity market pullback due to a short-term momentum reversion is possible. However, in our view, that would be an excellent opportunity for investors to re-evaluate their portfolio weightings to Japanese equities, considering the extremely positive structural changes underway.