Japan's Market: Cautious optimism on a virtuous cycle between inflation and wage increase

Japan Outlook - Hisashi Shiraki, SMDAM Chief Global Strategist

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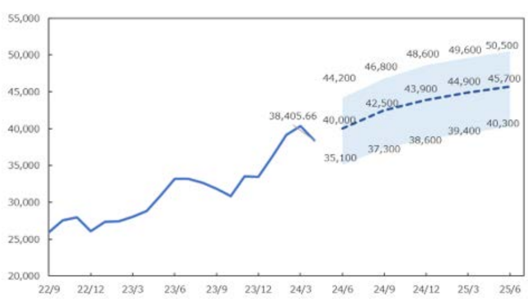
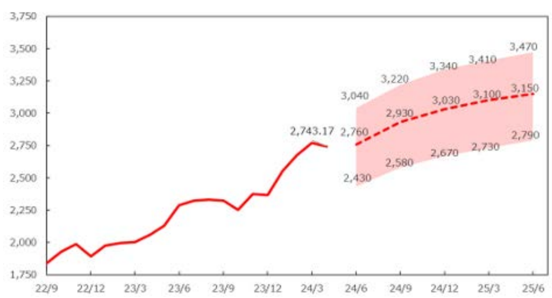
Japan Market Outlook

- We believe corporate earnings will continue to drive the Japanese stock market higher. The solid increase in nominal GDP and the accelerating business cycle of manufacturers could boost EPS in the current year and beyond.
- We maintain our price target in 2024 for the Nikkei 225 at 43,900, and that for TOPIX at 3,030.
- The equity market could be boosted by a virtuous cycle of wage increases and inflation, along with expectations for further fiscal expansion by the new “Post-Kishida” cabinet after the leadership election of the ruling Liberal Democratic Party (LDP) in September.
- In the short term, the market could face increased volatility due to speculation over Japan's monetary policy and foreign exchange rates.

Nikkei 225 Forecast



TOPIX Forecast



Source: Bloomberg, forecast by SMDAM. Data after April 2024 is our forecast.

Upside and downside risks

There is growing optimism about the virtuous cycle between mild inflation and wage increases in Japan, as well as the Bank of Japan's continued adherence to its accommodative monetary policy.

Downside risks include an excessive and rapid appreciation of the yen, hasty tightening of the monetary policy by the BOJ, and political turmoil triggered by divisions in the LDP as a result of the "slush fund scandal".

Economy standing still and inflation slowing

Though real GDP in the fourth quarter of 2023 was revised upward to show the first positive growth in 2 quarters, the first quarter of 2024 is expected to be negatively affected by the reduction in automobile production, a repercussion of the falsified safety certification test scandal and the Noto Peninsula earthquake. Business and consumer confidence, however, are generally firm and the economy is not in a major slump.

The nationwide core CPI rose 2.8% YOY in February, up from 2.0% in the previous month, primarily because the impact of subsidies on electricity and gas bills has reduced. However, in March, the core CPI for the Tokyo metropolitan area was up 2.4% from a year earlier, down slightly from 2.5% a month earlier. The decline in cost-push pressure from import prices, continues to push inflation down.

Government expected to continue their accommodative fiscal policy

In November 2023, Prime Minister Kishida's Cabinet approved a set of comprehensive economic measures to overcome deflation. The budget, which amounts to 20.9 trillion yen on a national and local basis, included measures to counter high prices, support for growth sectors, and national infrastructure resilience.

Flat rate tax cuts are expected to take effect in June 2024. In fiscal policy we should pay close attention to the risk of further expansion aimed at raising the approval ratings of the Cabinet and the ruling Liberal Democratic Party, which have declined significantly as a result of the so-called "slush fund scandal".

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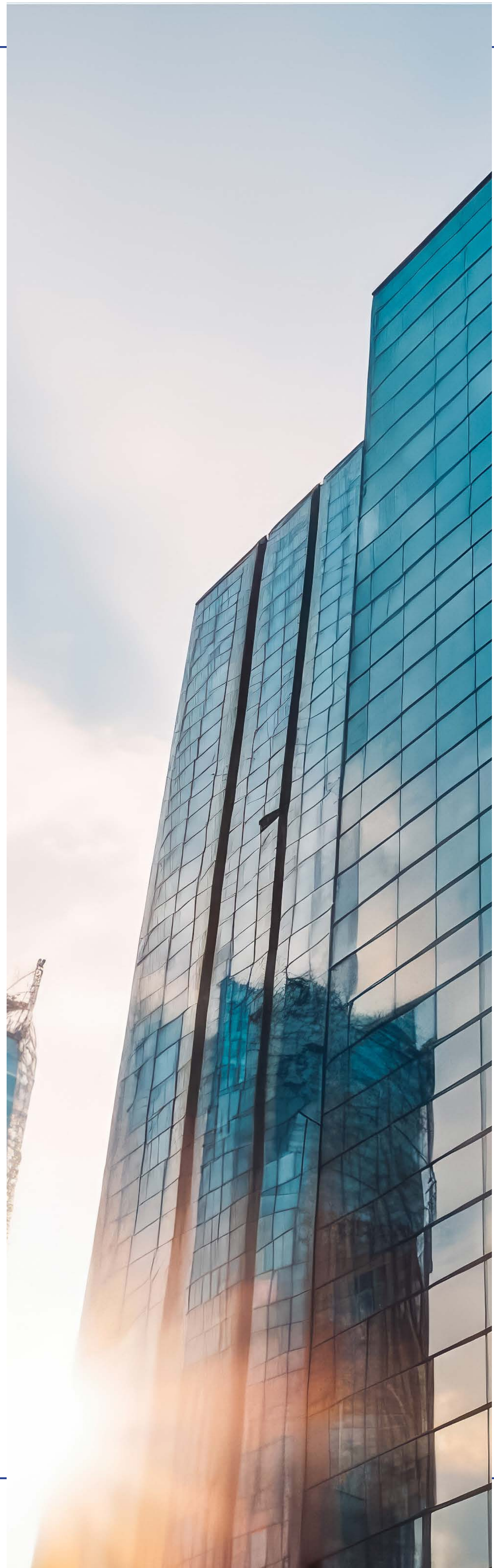
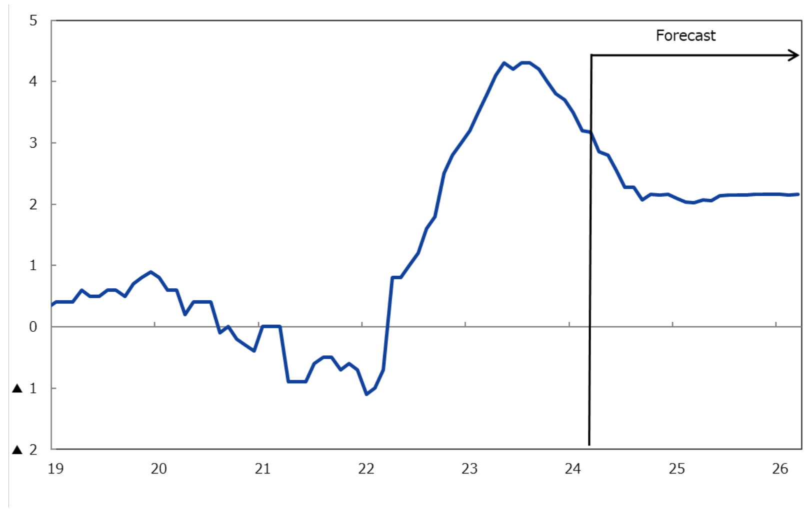


The Macroeconomic Outlook

We have maintained our real GDP growth forecast for FY 2023 at +1.3% and that for FY 2025 at +0.7%, and we have lowered our estimate for FY 2024 to +0.5% from +0.7%.

The main reason for the downward revision in FY 2024 was a reduction in consumer spending due to rising prices. It is highly likely that the economy contracted in the first quarter of 2024 due to temporary factors such as a reduction in automobile production, related to the certification test scandal, the Noto Peninsula earthquake, and a reaction to the decline in royalties and receipts from intellectual property rights.

Forecast of GDP and Core CPI



Note: BOJ's Core CPI is excluding fresh foods (except alcohol) & energy. Data from January 2005 to March 2024. Source: MIAC, Bloomberg & SMDAM

However, we expect a gradual recovery to follow this temporary lull in the economy, avoiding any major setbacks, supported by rising wages, economic measures (including fixed tax cuts and benefits), and the resilience of overseas economies. While we have maintained our core CPI forecast for FY 2023 at +2.8%, we have raised that for FY 2024 to +2.8% from +2.4%, and that for FY 2025 to +2.1% from +2.0%. The upward revisions in FY 2024 and FY 2025 were mainly due to higher renewable energy levies, the end of subsidies for electricity and gas bills, and changes in exchange rates and crude oil price assumptions.

Increase in the renewable energy levy and end of subsidies on electricity and gas bills will lift core CPI around 3% after May 2024. After which we expect core CPI to slow down in response to the abatement of push factors and the reduction of cost push pressure originating from import prices.

However, the core CPI is expected to remain stable at around 2% from the second half of 2025, supported by the rise in service prices following the improvement in wages.

Expected raises in interest rates in line with upward revision of inflation and BOJ statements

Our monetary policy forecasts have shifted, as we expect the Bank of Japan will raise interest rates by 0.25% in October 2024, and then again in April 2025, and October 2025 to lift the policy rate to 0.75%. The key reasons for our changes in monetary policy forecast include an upward revision of inflation and communications from the Bank of Japan.

Due to the former, the core CPI is expected to exceed 2% YOY going forward, which would justify further tightening by the central bank. As for the latter, BOJ governor Ueda expressed confidence that the results of the Union's spring wage negotiations will be reflected in prices in the summer and autumn, suggesting that he might decide to raise interest rates.

Previously, the BOJ had been expected to take time to assess the spread from wages to prices, but we have changed our view. The risk for this scenario is the acceleration of rate hikes due to the weakening yen.

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