Japan's Market: Awaiting Change in Spring

Japan Outlook - Hisashi Shiraki, SMDAM Chief Global Strategist

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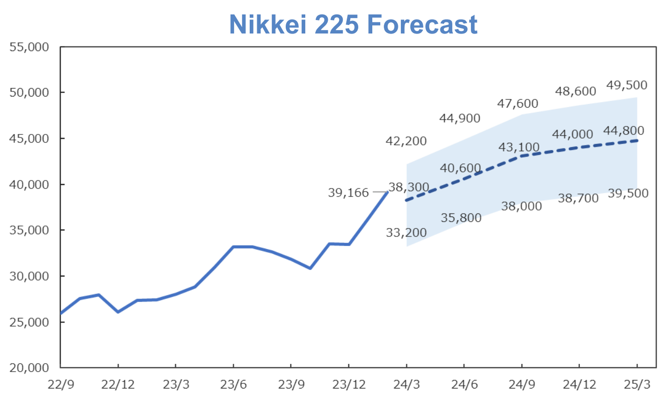
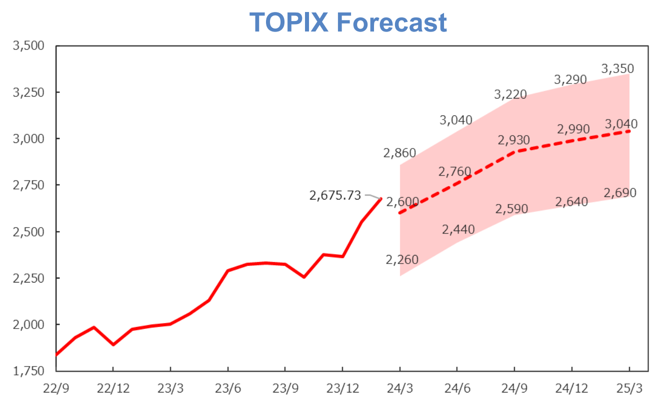
Outlook on the Japanese equity market

- We are bullish on the Japanese stock market due to the solid increase in nominal GDP, strong corporate earnings, and accelerating business cycle of manufacturers.
- We have raised our 2024 target for the Nikkei 225 from 41,800 to 44,000 due to the recent strength in large cap growth names, including semiconductors and exporters.
- Further fiscal expansion, caused by rising tax revenue and the declining popularity of the ruling Liberal Democratic Party (LDP) and its cabinet due to allegations over slush funds, could provide another boost to the equity market.
- A pivot by the Bank of Japan (BOJ), which is expected in April, could be a tricky factor for the market in the near future after decades of an ultra-low interest rate environment in Japan.





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

There is growing optimism about the virtuous cycle between mild inflation and wage increases in Japan, as well as the Bank of Japan's steady continuation of its accommodative monetary policy. Conversely, we will be closely watching for an excessive and rapid appreciation of the yen and any negative impact on corporate earnings, hasty and impatient monetary tightening 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

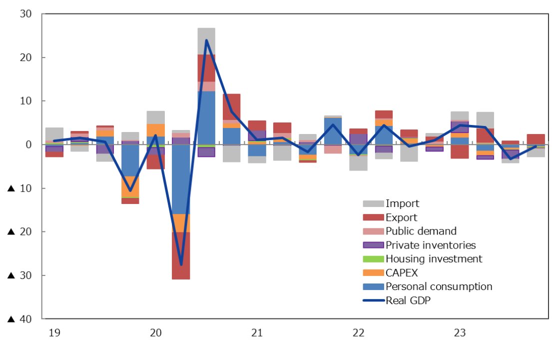
Real GDP fell in the fourth quarter of 2023, marking the second consecutive quarter of negative growth. Domestic demand is sluggish, with declines in consumer spending and capital investment. As for the start of 2024, although there are negative factors, such as the suspension of automobile production due to inspection irregularities by some manufacturers and the Noto Peninsula earthquake, business sentiment remains firm and the economy will avoid a serious slowdown.

Japan's Core CPI rose by 2.3% in December 2023 from a year earlier, and the pace of inflation slowed by 2.5% from November 2023. The Tokyo Metropolitan area CPI rose by 1.6% in January, down from 2.1% a month earlier. Inflation has been slowing, mainly in goods prices, and import prices, which cause cost-push pressure, are declining, pushing inflation down.

The macroeconomic outlook

We have lowered our FY 2023 real GDP growth forecast from +1.3% to +1.6%, that for FY 2024 to +0.6% from +1.1%, and that for FY 2025 to +0.7% from +0.8%. The downward revision to the growth forecast was mainly due to the aforementioned suspension of automobile production due to inspection irregularities, as well as a slowdown of economic growth in the second half of FY 2023. The downward revision in FY 2024 was due to the impact of the economic slowdown toward the end of the previous fiscal year and the impact of the rate hike in FY 2025. The economy is expected to return to a moderate recovery led by domestic demand thanks to slowing inflation, rising wages and the government's economic stimulus. On the other hand, we believe that exports will remain firm despite slowing growth in the wake of a future slowdown in the US economy.

Real GDP growth rate (YOY, %)



Note: Data is from Q1 2019 to Q4 2023. Source: Cabinet office, SMDAM

While we have maintained our core CPI forecast for FY 2023 at +2.8%, we have raised that for FY 2024 to +2.2% from +2.0%, and that for FY 2025 to +1.9% from +1.7%, respectively. The upward revisions to FY 2024 and FY 2025 were mainly due to an increase in the salary base and an increase in the assumption of US dollar-yen rate. It is highly likely that the national core CPI will increase once the downward effect of subsidies on electricity and gas bills are eliminated in February 2024, but after that, the national core CPI is likely to follow a deceleration trend and fall below 2% at the beginning of 2025 due to the reduction of cost-push pressure starting from import prices. However, the national core CPI is expected to remain stable, not significantly down from 2%, as the rise in service prices due to the improvement in wages.

We expect the government to continue their accommodative fiscal policy. In November 2023, Prime Minister Kishida's Cabinet approved "comprehensive economic measures to completely overcome deflation." The measure, which amounts to 20.9 trillion yen on a national and local basis, includes 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. Regarding the "Noto Peninsula earthquake", the cabinet decided to double the reserve fund for FY 2024 to 1 trillion yen. In fiscal policy we should pay close attention to the risk of fiscal expansion, aimed at improving the approval ratings of the Cabinet and the Liberal Democratic Party, which have declined significantly as a result of the party ticket and "slush fund scandal".

We expect the end of ultra-easy monetary policy in April 2024, including exiting negative rates and elimination of the YCC (yield curve control). The Bank of Japan is expected to revise its economic outlook report in April, in the wake of the results of the unions' spring wage talks, which will be released mid-March, and judge the probability of achieving the price stability target. The BOJ is expected to raise its policy rate to somewhere in the range of 0 to 0.1% from -0.1% in April 2024. After that, we expect the BOJ will raise its policy rate by 0.25% in April 2025 and October 2025, respectively.

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