Japan's Market: Optimistic projections with economic expansion expected in late 2024

Japan Outlook - Hisashi Shiraki, SMDAM Chief Global Strategist

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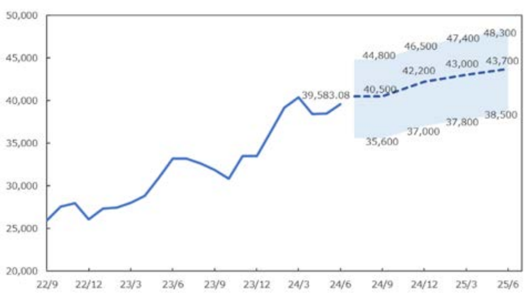
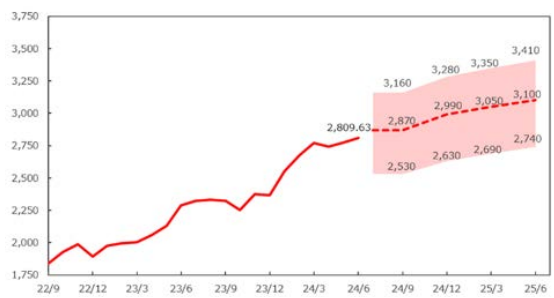
Japan Market Outlook

- We maintain our bullish perspective on the Japanese equity market. Our view is that steady earnings growth and rebound of consumer spending will lift the equity market in the second half of 2024 and beyond.
- In the short term, the market could face increasing volatility owing to speculation over monetary policy.
- We have slightly lowered our FY 2024 price target for the Nikkei 225 to 43,000 and that for TOPIX to 3,050 due to the slowing business cycle of the global economy.
- As a result of the strong wage increase from the spring wage negotiations, which was the highest in 33 years, we expect Japanese consumer spending, which accounts for more than half of the economy to receive a boost.

Nikkei 225 Forecast



TOPIX Forecast



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

Upside and downside risks

The upside risk scenario is unchanged as optimism persists about the virtuous cycle between mild inflation and wage increases in Japan, and the Bank of Japan is set to continue adhering to its accommodative monetary policy. Additionally, we are seeing further improvements in corporate governance and shareholders' value.

Downside risks include the tightening of fiscal policy to achieve a surplus of primary balance, 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 ruling Liberal Democratic Party caused by the "Slush Fund Scandal".

Economy rebounds after negative growth and rising inflation

In the first quarter of 2024, the economy contracted for the first time in two quarters. This was due in part to a decrease in automobiles production caused by the illegal certification test scandal, the Noto Peninsula earthquake, and a reactionary decline in royalties and receipts for intellectual property rights. On the other hand, although consumer sentiment, such as "Economy Watchers Survey" and "Consumer Sentiment Index", has been adversely affected by rising inflation, private consumption, CAPEX, and exports have been recovering.

The nationwide core CPI rose +2.2% YOY in April, slowing down from +2.6% a month earlier. The Tokyo core CPI rose +1.9% YOY in May, re-accelerating from +1.6% last month. Inflation is accelerating again as electricity prices rise on the back of higher renewable energy levies.

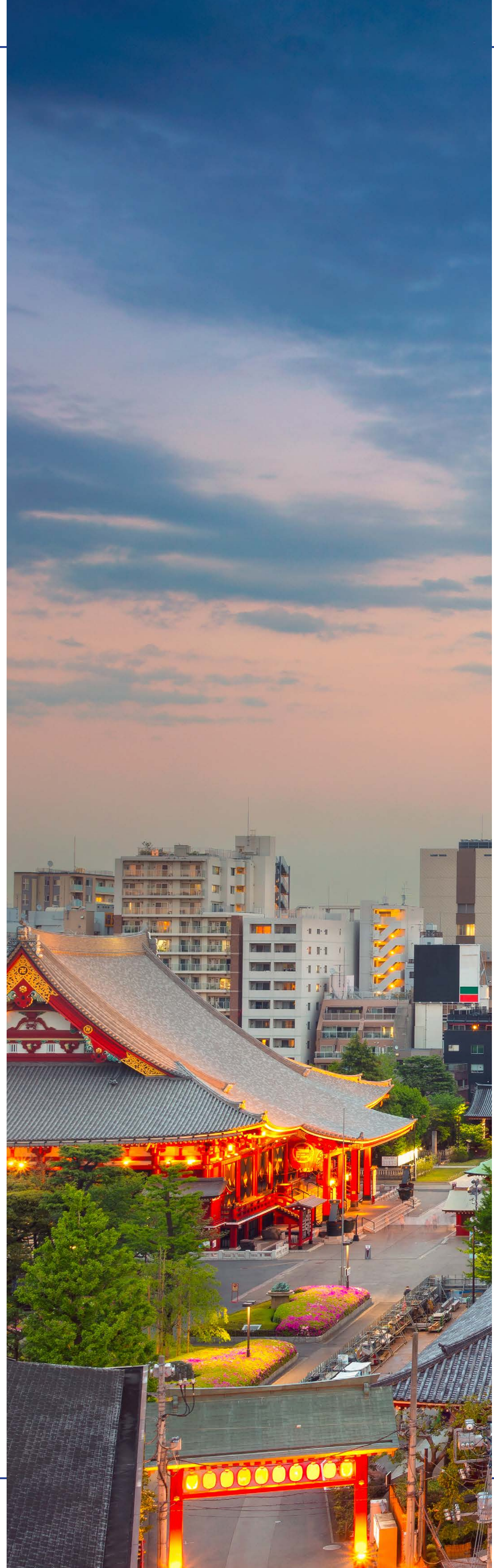
Economy expected to recover and resume growth trend

We have maintained our real GDP growth forecast for FY 2024 at +0.4% and that for FY 2025 at +0.7%. The Japanese economy is expected to return to a moderate growth path from Q2 2024.

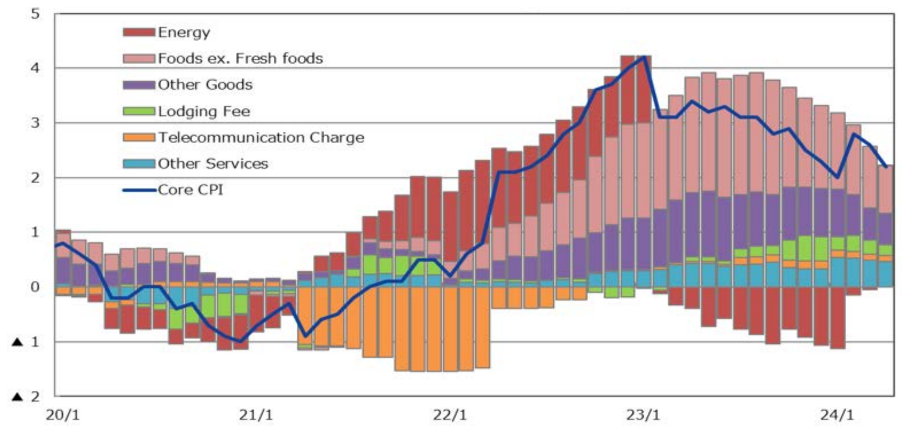
The economy is expected to recover gradually and avoid recession as temporary downward pressure, caused by factors such as a reduction in automobile production, a major earthquake, and a reactionary decline in royalties on intellectual property rights, is expected to ease. In addition, wage increases, fiscal stimulus, such as tax cuts and benefits, and the resilience of overseas economies could lift the economy going forward.

After that, the core CPI is likely to slow down against the background of a decline in the cost push pressure starting from import prices and a stabilising of energy prices. However, from the second half of 2025, the core CPI is expected to remain stable at around +2% YOY, supported by the rise in service prices associated with wage increases.

While we have lowered our core CPI forecast for FY 2024 to +2.5% from +2.6%, we have maintained that for FY 2025 at +2.0%. The increase in the



Breakdown of CPI (YOY, %)



Note: Data is from January 2020 to April 2024. Source: MIAC, SMDAM

renewable energy levy and the end of subsidies for electricity and gas are the main factors to lift the nationwide core CPI to the middle of 2% again in the short term. Thereafter, the core CPI is likely to decelerate again due to the waning of cost-push pressures from import prices and the receding energy factor. However, the core CPI is expected to remain stable at around +2% YOY from around H2 of CY 2025, supported by the rise in service prices accompanying wage hikes.

No change expected in government's 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 "slush fund scandal".

Steady interest rates rise in line with expected inflation

We expect the Bank of Japan will raise its policy rate to 0.25% in October 2024, and then to 0.5% in April 2025, and to 0.75% in October 2025. The Bank of Japan is expected to raise interest rates in the summer and autumn in line with the projected impact of this year's spring wage negotiations on inflation. The BOJ is then expected to raise interest rates once every six months while monitoring the impact of the rate hike on the economy. The risk of a front-loaded rate hike will depend on developments in the foreign exchange market and key inflation figures.

We also need to be vigilant about the risk of rising inflation expectations shown in the Bank of Japan's Tankan Survey, Short-Term Economic Survey of Enterprises in Japan, and in the report of corporate prices for the central bank's "Branch Managers' Meeting".

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