



Shift to secular growth could be a “real deal” moment for Japan equities

Labour shortages, wage increases putting the market on a different trajectory

By Naoki Kamiyama, Chief Strategist
27 September 2023

Introduction: could it be different this time?

In June, the Nikkei Stock Average rose above 33,000 for the first time since 1990, when Japan’s equity market was at its “bubble” era zenith; as of this writing the index has remained steady near that threshold. Over the past 30 years, excitement over Japanese equities was often followed by disappointment, and many foreign investors have overlooked the country as a result. However, there is a growing sense that the market strength might be different this time, and that the current bull phase may have legs. We describe how Japan’s shift from cyclical to secular growth involving higher wages could be a “real deal” moment for the country and its equity market.

Past disappointments in Japan equities

Before we assess what could be different this time, it may be worth noting the characteristics that caused past disappointments. Prior to the current phase, Japanese equities tended to track economic cycles. Put another way, the market lacked secular changes and was saddled by deflationary sentiment; this made it difficult for equities to go on a sustained rise, and gains tended to be followed by equal, or even greater, losses. The introduction of “Abenomics” late in 2012 altered the trend somewhat but it never really gave the market the impetus investors hoped for.

The turnaround: post-pandemic labour shortages grip Japan

Capex revival amid export boon boosts demand for workers

The turnaround began during the COVID-19 pandemic, when strong exports, mainly to the US, led to manufacturing capacity shifting from a surplus to a deficit. Manufacturers subsequently sought to boost capex and hire more workers, triggering a labour shortage. The shortage was exacerbated as the economy fully reopened after the pandemic, with the return of travel, tourism and leisure activities prompting a scramble for workers in the service industry. Amid this post-pandemic recovery, the Nikkei advanced and built a foothold at the 30,000 mark.

The current labour shortage and boost in capex are Japan’s first since the Global Financial Crisis and have marked a shift from cyclical to secular, structural growth. Japan was previously saddled with a labour surplus, partly because of a corporate culture which emphasised work force retention. The oversupply of workers discouraged companies from raising wages and investing in new capex. However, for the first time in recent memory firms are experiencing a labour shortage and are in a position to raise wages and invest in new capex, underlining the break from the previous cycle (Chart 1).

Chart 1: Japan’s real exports (January 2007-July 2023)



Source: Bank of Japan data compiled by Nikko AM

Structural shift in Japan sets it apart from other countries

In addition to hiring new workers, another way for firms to deal with labour shortages is to adopt cutting-edge and state-of-the-art technologies such as robots and automation. By encouraging new capex, labour shortages become an incentive for firms to improve overall productivity and encourage a broad structural shift. The change from cyclical to secular growth in Japan sets it apart from its developed market peers such as the US, which is experiencing neither a profound structural shift nor a big change in productivity.

When the Japanese economy was stagnant, labour was not the only factor in surplus—so were goods that firms acquire through capex. Japan was caught in a classic downward spiral as surplus labour meant firms had little incentive to boost productivity through new capex as that would have further reduced employment for an already excessive workforce. Machinery often sat idle as a result, and the need for new capex was limited, while demand for money was also low.

Rising wages key to sustained equity market gains

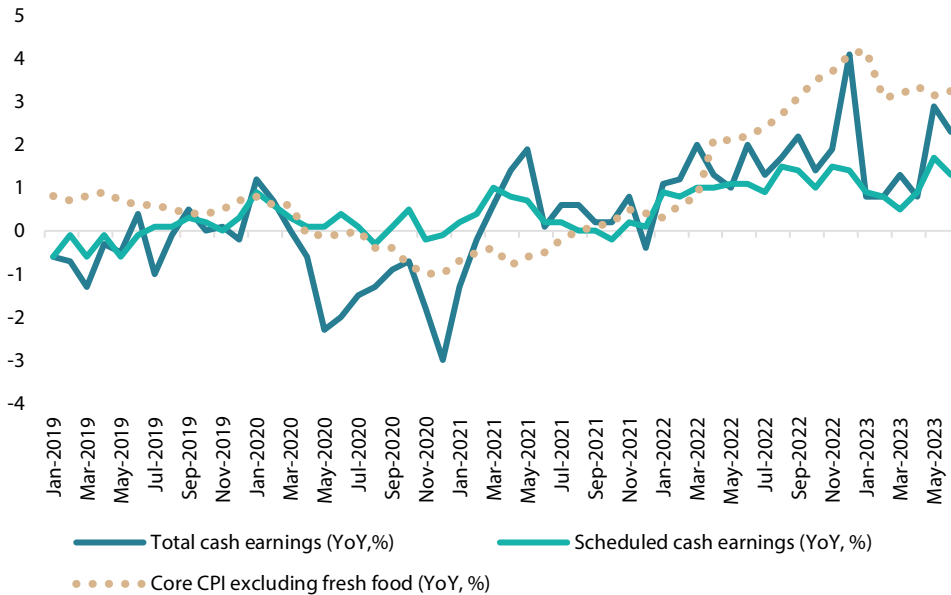
Nikkei reaches 33,000 helped by rise in wages

With the previous surpluses in labour, goods and credit now turning into shortages, wages look set to continue rising and sustaining inflationary pressure for the long-term, especially with no end in sight to the worker shortages currently gripping Japan. The post-pandemic labour shortage coupled with the rise in wages are seen as the factors that helped the Nikkei climb from the 30,000 range to 33,000.

Labour shortages and the corresponding rise in wages are expected to continue even if external demand tapers off, assuming that the US heads towards a soft landing instead of a full-blown recession and the recovery in Japan’s post-pandemic domestic demand continues. Inflation in Japan is not yet on a steady trajectory, and the country may not achieve this until the pace of the rise in wages (currently at around 2%) outpaces that of

consumer prices (Japan’s core CPI excluding fresh food was up 3.1% year-on-year in July). Only then would domestic consumption pick up in earnest, reinforcing the structural change underway and creating a cycle in which goods, labour and money are constantly in short supply (Chart 2).

Chart 2: Japan’s wage and consumer price trends (January 2019 – June 2023)



Source: Ministry of Health, Labour and Welfare and Statistics Bureau of Japan data compiled by Nikko AM

Equities to watch upcoming wage-related indicators for further impetus

Looking ahead, indicators such as winter bonus payment amounts and the annual “shunto” pay negotiations between unions and employers next spring (this year’s shunto resulted in the highest overall pay rise in 30 years) may provide give the market a broad idea about the sustainability of wage hikes. And if these indicators are bullish, they could become the impetus for the Nikkei to rise further above 33,000.

Coincidentally, judging from what BOJ Governor Kazuo Ueda told the Yomiuri Shimbun in an interview early in September, he appears to be keeping a close eye on trends in prices and wages, particularly on that of the target percentage pay increase component known as “base-up” that the unions negotiate with employers. Winter bonuses themselves will not directly impact the base-up component. But they will provide us with hints about how confident firms are regarding their profitability and sales and in turn about the trajectory of wage hikes that BOJ’s Ueda is focusing on.

Summary

The current rise in Japanese equities could have legs, setting it apart from other phases in the previous 30 years which often led to disappointment. Japan’s shift from cyclical to secular growth, highlighted by labour shortages fuelling a rise in wages, is a development that is setting the equity market on a fundamentally different trajectory. We expect wage developments, as a factor affecting both consumption and inflation trends, to help determine further gains for Japan equities.

Important information: This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

Luxembourg and Germany: This document is communicated by Nikko Asset Management Luxembourg S.A., which is authorised and regulated in the Grand Duchy of Luxembourg by the Commission de Surveillance du Secteur Financier (the CSSF) as a management company authorised under Chapter 15 of the Law of 17 December 2010 (No S00000717) and as an alternative investment fund manager according to the Law of 12 July 2013 (No. A00002630).

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or

have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.