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

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

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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.

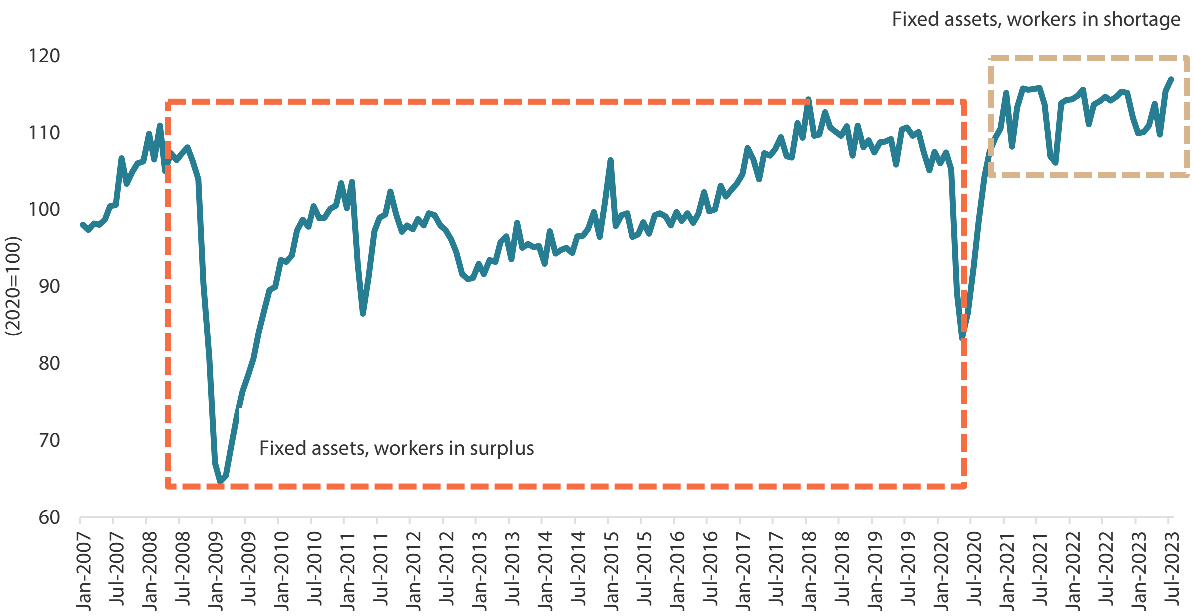
The turnaround: post-pandemic labour shortages grip Japan

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 re-opened 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.

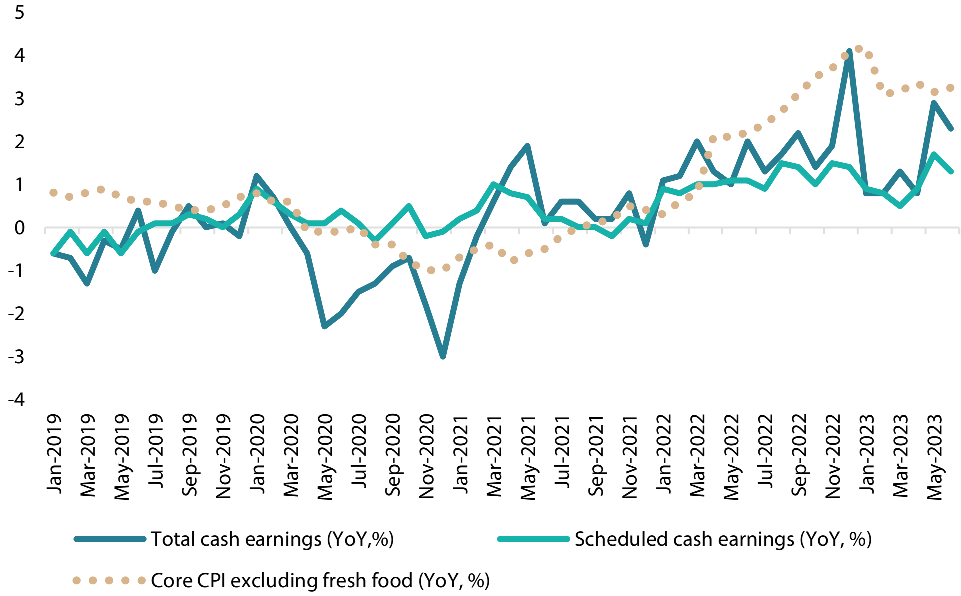
Rising wages key to sustained equity market gains

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 piece 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 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.

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