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# Japan: False Dawn or Land of the Rising Sun?

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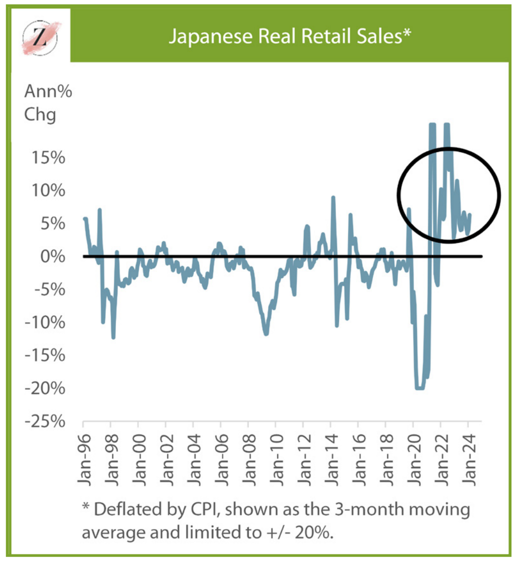
"Fall down seven times, get up eight" is a Japanese saying of resilience and perseverance. It also succinctly describes the pattern of the Japanese economy over the last 35 years. The Japanese real estate and equity bubble burst in December 1989, and since then the domestic economy has fluctuated between deflation and reflation with 45% of monthly inflation readings indicating falling prices. This situation is unique to Japan, which has been one of the weakest economies among the G7 countries over this timeframe. Japan has repeatedly experienced "false dawns" over the last 35 years where its economy appeared to be escaping the cycle, only to have economic recoveries fizzle out.

## IS THIS TIME DIFFERENT?

Only time will tell if the current economic upswing in Japan will endure, but there are signs that perhaps this time is indeed different, and the current episode of Japanese economic strength will continue. For one thing, Japan is experiencing a rare, prolonged period of positive inflation. In most countries, an extended period of elevated inflation is a cause for concern, but in Japan's case it's a welcome development and suggests its economy is escaping the decades-long bout with deflation. In fact, the Bank of Japan (BoJ) is confident about the outlook for prices to the extent that it lifted the policy rate from the eight-year experiment with negative interest rates. Exiting deflation is an extremely important economic development because it breaks the self-fulfilling cycle where consumers delay purchases, which in turn forces prices lower creating more deflation. If consumers believe prices will rise in the future, they won't delay consumption, which creates a healthy, dynamic economy. **Chart 1** shows the volume of retail sales in Japan. Clearly, the country is in the most prolonged period of positive consumption since the mid-1990s.

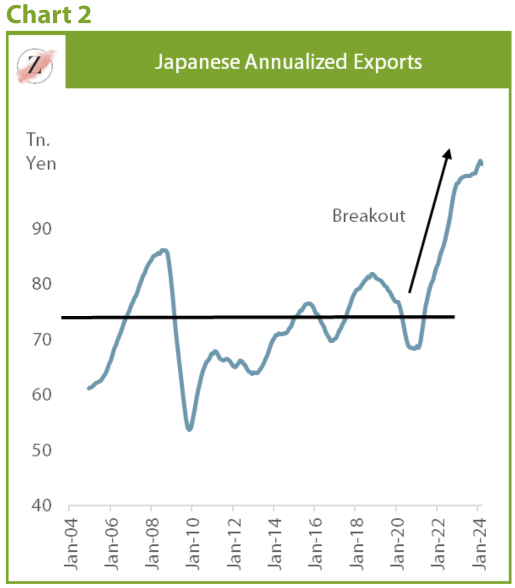
**Chart 1**




* Deflated by CPI, shown as the 3-month moving average and limited to +/- 20%.

Along with healthy inflation, annual wage gains in Japan have also broken out from the typical 1.75% to 2%, which has persisted for decades. Rengo, Japan's largest federation of unions, announced earlier this year that its members have secured deals averaging wage gains of 5.3% and many of its affiliated groups have announced similar wage inflation. This is a very healthy development for an aging population whose economy needs a boost in domestic consumption to maintain healthy GDP growth.

**Chart 2**




Meanwhile, Japan is also benefitting from global trade developments, resulting in widespread redrawing of supply chains. Beginning with the Trump administration imposing import tariffs on goods to protect domestic industries and workers, nations are rethinking the source of imported goods. This global reset was supercharged with the onset of the COVID-19 pandemic, as shortages of everything from semiconductors to commodities clarified the need to find alternative suppliers. Japan has clearly benefited from this global trend, which is reflected in surging exports in **Chart 2**. More recently, President Biden announced plans to triple import tariffs on several Chinese products, indicating the global trend to rearrange supply chains is likely to continue. Japan is well-positioned to continue benefiting from this trend.

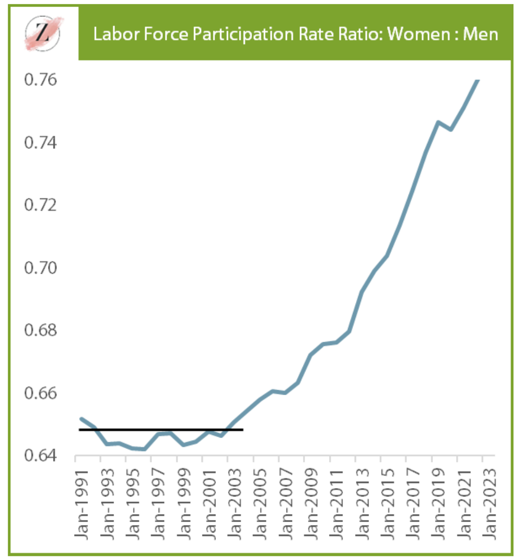
## REMOVING IMPEDIMENTS TO GROWTH

Some of the groundwork to foster a dynamic and robust Japanese economy was laid decades ago as leaders recognized the need for economic reforms to reverse some of Japan's long-term structural problems. Japanese authorities long ago recognized the economic headwinds facing them: poor demographic trends with an aging and shrinking population. The International Monetary Fund (IMF) estimates Japan's potential labor force peaked in the early 1990s and has repeatedly identified the need to bolster the labor force. Essentially, there are fewer Japanese workers paying taxes and supporting social security programs, resulting in weak consumption. In response, Japanese authorities have implemented various **measures aimed at increasing the labor force.**

Japan has historically been a particularly closed society with very little **immigration**. While this reality is a cultural phenomenon, it is also very much a problem for an economy in need of workers. In response, measures to increase immigration have been introduced, such as a point-based system to attract skilled labor, re-categorizing workers to allow for lower skilled immigrants, streamlining visa renewal procedures, and relaxing family member accompaniment rules. As a result, net immigration has turned positive in recent years but remains extremely low, especially when compared to other developed nations. There is certainly room for improvement in terms of Japanese immigration and it will be a slow process due to the cultural rigidities, but progress is being made.

Another growth strategy which is having more success is sometimes referred to as **"womenomics."** This includes measures to attract more women out of their traditional role of housekeeper and bring them into the workforce. A range of policies have been implemented over the years including expanding childcare, eliminating tax deductions for dependent spouses, and limiting working hours for men in order to have women fill the gap in the workplace. These measures are having some success, as indicated by steadily climbing participation rates (the percent of working-age population either working or looking for work) for Japanese women relative to men **(Chart 3)**.

**Chart 3**

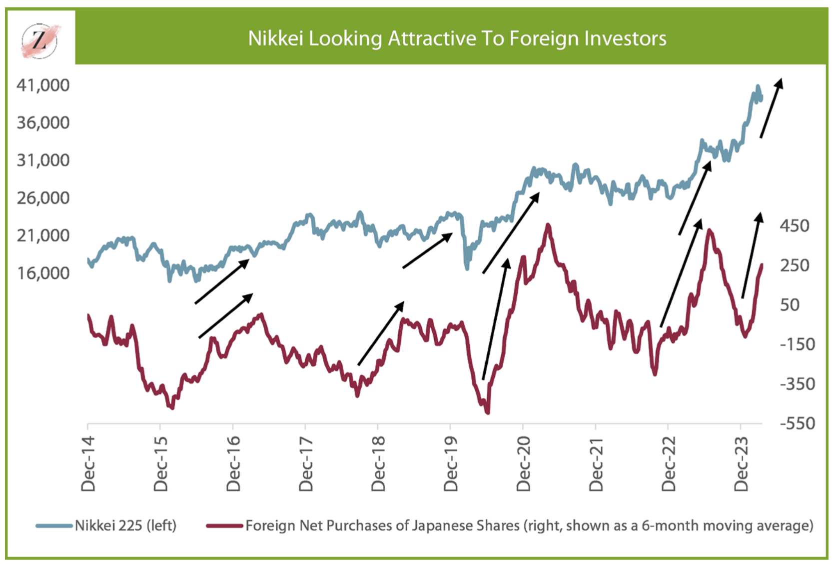



## MARKETS TAKING NOTICE

The Japanese equity benchmark index, the Nikkei 225 rallied to an all-time high earlier this year and is up 130% since the pandemic low four years ago. Part of the explanation for strength in Japan's equity market has to do with previously mentioned reforms contributing to economic strength. Additionally, a very weak yen due to relative monetary policy is also part of the explanation, as is the "not China" trade as investors shun Chinese assets to gain Asian exposure elsewhere. However, corporate reforms aimed precisely at delivering shareholder value are little discussed but major contributors to Nikkei strength. To this end, the Tokyo Stock Exchange has started publishing a monthly list of registered companies who voluntarily disclose information indicating they are using capital efficiently in efforts to bolster their stock price.

Another element of Japan's corporate reforms has to do with their historic practice of cross-shareholdings, where companies own each other's shares to protect from hostile takeovers and to form corporate alliances. The practice has long been criticized as an inefficient use of capital, but according to the Tokyo Stock Exchange, there has been a noticeable reduction in these holdings as "Japan Inc." strives to unload unproductive assets. In 2023, the liquidation of cross-shareholding rose 45% from its five-year average. All that to say, investors have taken note of Japan's efforts to deliver shareholder value, which is reflected in foreigners increasing holdings of Japanese shares **(Chart 4)**.

**Chart 4**




## RISKS

Although there are numerous positive trends working in favor of Japanese equities, some risks do remain.

**1) Geopolitics & Oil:** Japan is particularly vulnerable to oil and natural gas prices because they have no natural reserves, so all oil and natural gas consumed in Japan must be imported. Since 60% of Japan's energy consumption is derived from crude oil and natural gas, and with tensions continuing to rise in the Middle East, Japanese corporations and households will likely face a higher energy bill, which will be a blow to their finances.

**2) Rising Rates:** Earlier this year, the BoJ abandoned its negative rate policy and increased interest rates to +0.10%. While that rate of interest remains tiny, it's nonetheless rising and a sharp contrast to the direction of policy rates globally. Diverging policy rates pose a risk to the Japanese economy and stock market.

**3) Markets Reflect Improved Prospects:** The Nikkei 225 more than doubled since the pandemic low. The benchmark index is in overbought territory so near-term weakness would not be a surprise. Also, while equites in Japan were relatively cheap one year ago, that valuation advantage has been wiped out and shares are now trading at roughly the same valuations as the rest of the All Country World Index.

**BOTTOM LINE:** Japan is experiencing an upswing in economic activity and appears to have escaped from decades of deflation. Economic reforms along with corporate reforms focusing on shareholders' returns will continue to benefit the economy and equity market. Global investors have taken note and piled into Japanese shares. Having a friendly Asian ally for global investors to explore as an investment option is likely to be a long-term theme. Although conditions are frothy in Japan, we continue to look for high quality, reasonably priced Japanese investments that will benefit from Japan's macroeconomic recovery.