Macro Economics

Overall Strategy | **Neutral**

Rising Wages, Higher Prices: Japan's road to recovery amid growth and inflation risks

Bottomline

A neutral stance is warranted for Japan as growth risks continue to trend downward due to rising living costs and subdued sentiment. Moreover, wage growth and domestic demand still require further development. Nevertheless, short-term factors will likely support investor sentiment, including ongoing corporate restructuring initiatives.

GDP to recover in 2H24 but may not be broad-based yet

The economy performed better than expected in 2Q24 as it expanded by 0.7% on a quarter-on-quarter seasonally-adjusted basis (SA QoQ), fueled by a rebound in domestic demand. However, year-on-year (YoY) growth still declined by 1.0%, indicating a lack of broad-based development. Moving forward, household consumption is expected to improve further, supported by higher wages that will enhance household income *(Figure 1)*. Despite this, the overall growth outlook remains subdued due to rising living costs and a potential global economic slowdown that could affect Japan's net exports.

Inflation to be pushed higher by rising wage growth

Headline inflation inched higher to 2.8% YoY in August, above the 2% target of the Bank of Japan (BOJ). Looking ahead, an upward bounce may occur in 4Q24 as inflation risks lean to the upside, driven by broadening wage growth momentum that can improve domestic demand and push services prices higher. Moreover, another upside risk is the phaseout of government measures aimed at reducing overall inflation.

Potential hike in 4Q24 as the BOJ gradually eases rates

The BOJ kept rates steady at 0.25% in September as the central bank continues to evaluate its second rate hike since 2007. The decision aligned with the Bank's outlook of the economy exhibiting weakness despite a moderate recovery. After the decision, markets are anticipating another rate hike in 4Q24, increasing the policy rate by 10bps before the year ends. This may be warranted if inflation exceeds expectations and strong wage growth continues to boost consumption in the coming months. BOJ officials emphasized the importance of gradually continuing to raise interest rates.

Another significant yen rally not likely

The yen returned to ~140 per dollar levels, which further strengthened after an unexpected BOJ rate hike and rising U.S. recession fears *(Figure 2)*. This prompted traders to unwind their yen carry trades, as the currency is a popular option for carry funding due to its low borrowing costs. Moving forward, the yen's appreciation may continue due to potential actions from the BOJ and anticipated Fed rate cuts. Nevertheless, most net short positions in yen contracts have been unwound, hence another strong rally is unlikely.

Table 1: Bloomberg Japan Economic Forecasts

Metric	2023	Latest	2024F	2025F
GDP (YoY)	1.7%	-1.0% *1H24*	0.0%	1.2%
Inflation (YoY)	3.3%	2.7% *8M24*	2.5%	2.0%
Policy Rate	-0.1%	0.25%	0.30%	0.70%
USDJPY	141.04	143.61	143.00	136.00

Figure 1: Japan Wage Growth vs. Private Demand

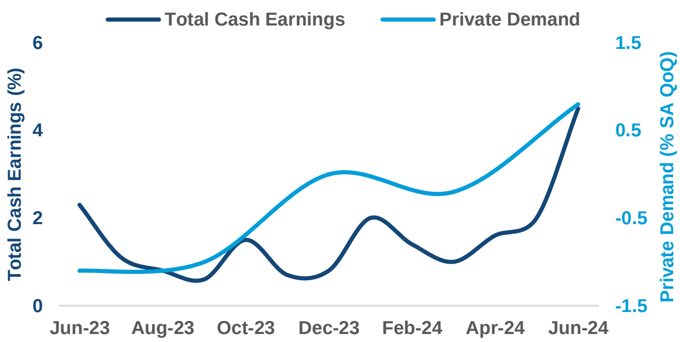
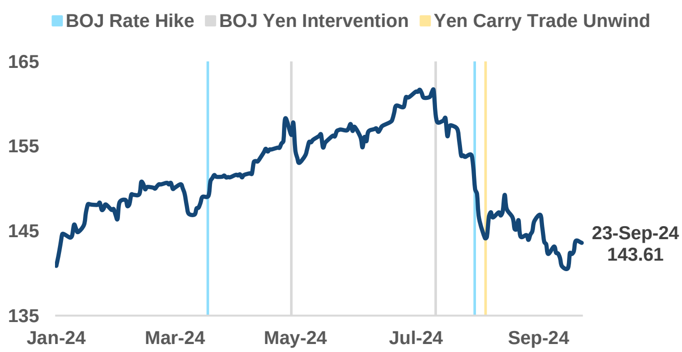


Figure 2: USDJPY



Sources: Bloomberg; Bank of Japan; Ministry of Health, Labour, and Welfare of Japan

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