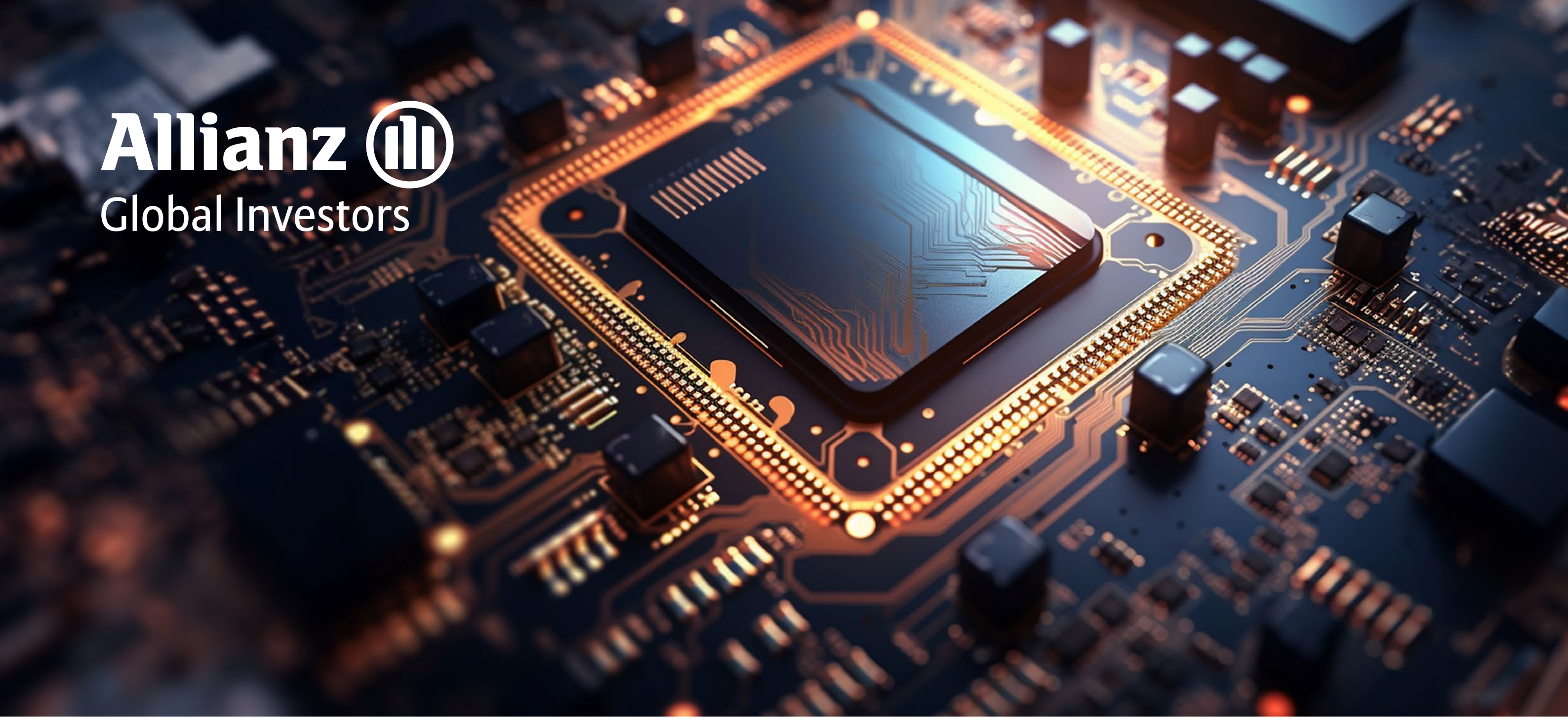


AUGUST 2024

# Japan – what's changed?

**In early August, the biggest one day drop in the Nikkei 225 since 1987 saw recent gains wiped out, with the index dropping over 12 percent – though a good deal of this has now been recovered. This dip came several months after the index broke the 40,000-point level for the first time, driven in part by the artificial intelligence boom driving up Japanese tech stocks. However, several indicators at the start of the summer led global markets – and Japanese equities in particular – to react strongly, leading to this historic dip.**

## An overreaction?

The recent investor flight from Japan can be attributed to three main factors: concerns regarding a recession in the US, driven in part by weakening labour market figures; the rate hike from the Bank of Japan (BoJ); and the potential implications of this for yen carry trades. However, taking a closer look at each of these issues, we see that investor concerns are likely excessive.

First, regarding the course of the US economy, fears surrounding recession have now largely abated and there is a general consensus that a soft-landing scenario is the most likely outcome. Indeed, inflation cooled in July, second quarter GDP outlooks are positive, and the job market seems to have reached a better balance. The expectation is now that the Fed will be able to tame inflation without plunging the world's biggest economy into recession.

Second, despite the recent hike, the BoJ remains friendly towards markets and the economy, and the rate rise should not be seen as a pivot to a more hawkish position. Indeed, the bank has since indicated that it will take a more cautious approach to rate hikes, with analysts suggesting that only a further 25bps is likely this year, rather than the previously forecasted 50bps.

Third, the BoJ's softening position on future rate hikes has removed some of the immediate market angst regarding the future of yen carry trades. And as carry trade positions accumulated, this overly depreciated

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the yen, resulting in unfavourable sentiment around domestic household consumption. A more moderate yen is good for both Japanese exporters and private consumption.

## Outlook for remainder of 2024 positive

Looking forward to the rest of 2024, the outlook for the Japanese economy is positive. Recent issues in the automotive production sector are being resolved, potentially providing a much-needed boost to industrial production, while projected capital expenditure remains high – especially with respect to digitalization and labour saving – moving from high single to double digit growth.

Furthermore, one effect of the yen going from excessively weak to mildly strong will be to lower cost push inflation. This, in combination with wage hikes of around 5 percent expected in the second half of the year, is set to raise real household income and lift private consumption.

As mentioned, the BoJ seems to have taken market reactions to its recent moves on board and is signaling a more cautious approach to rate rise going forward. Indeed, previous consensus that the next rate rise – from 25 to 50bps – would come in October has now been overtaken by the view that this will come early next year.

Despite this positive outlook, several potential risks should be considered. The Japanese political situation is currently in an unexpected state of flux, and it is yet to be seen if policy changes will have any impact on the outlook for the economy. Furthermore, the commercial real estate sector should be closely monitored for any potential problems emerging, while the possibility of contagion from China – where severe structural problems are currently being worked through – should not be completely dismissed.

## Investor concerns

For equity investors, recent developments in Japan should not mean rapid and significant change. Diversified positions should be maintained to tame potential volatility, while names that benefit from a stronger yen could be added to a balanced portfolio. Likewise, taking profits on exporters – that have benefited from currency weakness – should also be a consideration.

Overall, investors should remain sanguine in the face of rapid short-term developments in Japanese equities. Much of August's loses have already been recovered, and our outlook for the Japanese economy remains positive.

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