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CIO Viewpoint

Japan's new leadership targets fuller rebound, higher growth

Investment Solutions

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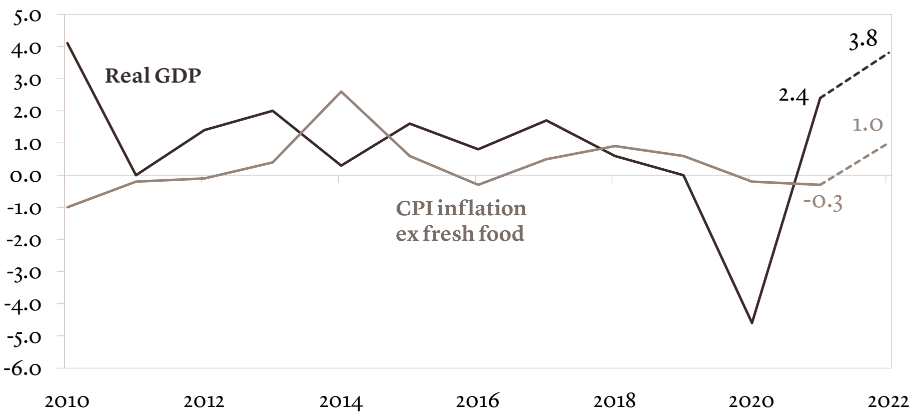
Japan's economic recovery is on a path of its own. With less pronounced supply shortages and little sign of rapidly rising consumer prices, the Bank of Japan (BoJ) is under no pressure to hike interest rates, even as other central banks have begun to signal policy tightening. On the fiscal front, new Prime Minister Kishida Fumio will likely pursue additional pandemic support, even as other governments scale back spending.

So why is Japan on such a different monetary and fiscal trajectory from the rest of the world? Much of it has to do with the country's relatively muted growth in 2021. Japan will lag all of its G7 peers in real gross domestic product (GDP) growth this year, according to both official and Bloomberg consensus forecasts. In our view, the Japanese economy should expand by 2.4% in 2021, even factoring in the expected strong rebound in Q4 amidst re-opening. This comparatively muted figure reflects the impact of three damaging Covid-19 waves, and related mobility restrictions that have weighed on the country's economic rebound.

As we look ahead to the next 12 months, Japan seems poised for a fuller rebound. Its epidemic curve has flattened sharply and its vaccine programmes have overtaken most peers, with 71% of the population now fully vaccinated. We expect GDP to expand by 3.8% in 2022, above both the Bank of Japan's (BoJ's) 3% projection and consensus forecasts (see chart 1). This is because we see Japanese consumer demand recovering more briskly when many of the world's logistical bottlenecks begin to ease.

1. Bouncing back, with low inflation

GDP growth and average monthly consumer price index figures



Sources: Official statistics, Bloomberg, Lombard Odier forecasts

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Key takeaways

- Japan's economic rebound is lagging other developed nations. We see scope for GDP to accelerate to 3.8% in 2022, above consensus forecasts
- New Prime Minister Kishida Fumio's LDP party has retained a comfortable majority and plans more fiscal spending
- With no sign of inflation, accommodative monetary policy should continue
- We see potential for Japanese assets to appreciate, helped by JPY weakness against the USD and the fiscal boost.

Yet even with this sharp recovery, we note that Japan's inflation in the next 12 months is unlikely to repeat the significant temporary spikes that Europe and the US have seen this year. As its peers wrestle with whether inflation will prove persistent or transitory amidst port congestions, a global energy crunch, and passenger vehicle shortages, a lack of inflationary pressures will give the Bank of Japan more space to continue supporting the economy.

Liberal Democrat victory translates into a fiscal boost

With no sign of inflation, the new Prime Minister, Kishida Fumio, who became the president of the ruling Liberal Democratic Party (LDP) on 29 September, has plans to spend more. He now has a clear mandate to pursue that plan. The LDP was able to minimise its seat losses and retain a comfortable working majority with their coalition partner Komei in the lower house in the general election on 31 October (see chart 2). This came despite the significant unity between centre-left opposition parties ahead of the election, and the widespread forecast of a significant narrowing of the LDP's majority.

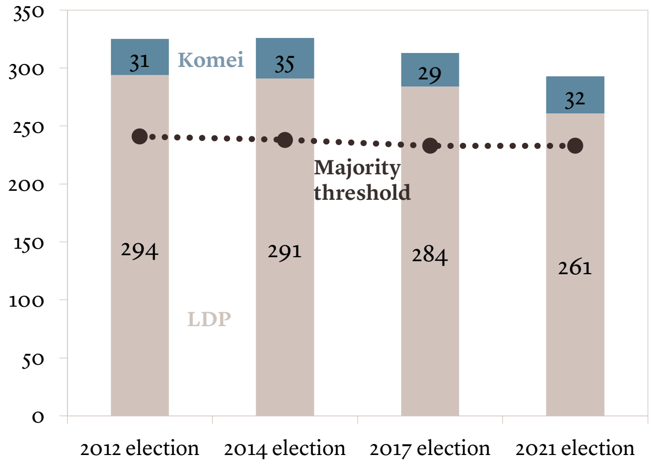
Having defied his sceptics, Mr. Kishida is quickly capitalising on this moment of political strength to focus on a new supplementary budget to support the country's economic rebound. He is calling for further stimulus spending in the form of a package worth "several tens of trillion yen." The main items in the new extra budget – to be deficit-financed – will likely include tax breaks for companies raising wages, a pay boost for nurses and care-giving sectors, and the re-introduction of subsidies for domestic tourism, branded as a "Go To" campaign. We expect the extra budget to be passed rather swiftly in the afterglow of the solid victory on Sunday.

Before the lower house election, Mr. Kishida also pledged to strike a different path from Abenomics, by promoting the slogan "new capitalism" and a new fight against inequality. We suspect, however, that this rhetoric will not signal a meaningful departure from the key Abenomics programmes. This is due to the simple fact that Mr. Kishida will continue to depend heavily on large pro-business factions within the LDP to keep his job. One sign of that party dependence came earlier this month when Mr. Kishida tempered expectations that his government would introduce a tax on capital gains and dividends. In response to this suggestion, the Tokyo Price Index, or TOPIX, fell 4.5%. Mr. Kishida's response was swift: "If there has been a "misunderstanding," he said, "growth is the key to distribution... growth is first and foremost in importance."

Given the unique interdependence between PM Kishida and the LDP's main factions, we firmly expect the main pillars of Abenomics to be maintained for much of PM Kishida's term. Granted, some personnel changes in the LDP leadership following the election could create scope for PM Kishida to leave his own stamp on the new government's agenda. Yet we feel that significant reversals on tax, regulatory, and monetary policies are highly unlikely, due to the strong consensus in favour of defending former PM Shinzo Abe's accomplishments.

2. A comfortable majority

Seats won by LDP and coalition partner Komei since Abe's second term



Sources: News reports, Lombard Odier

Supportive monetary policy

We also believe that the status-quo of supportive monetary policy will be maintained in coming years. Mr. Kishida's election victory has increased the likelihood that he will remain in power long enough to appoint the new governor of the BoJ when its current governor, Haruhiko Kuroda, retires in April 2023. Since Mr. Kuroda's policy innovations are widely supported by the LDP elite, we expect his successor to continue his commitment to the BoJ's inflation target and accommodative policy stance.

Indeed, the bank has kept interest rates close to zero for more than two decades and first implemented negative rates in January 2016. Last week it cut its inflation forecast from 0.6% to 0% for the year ending March 2022 and hinted that the country might not hit its 2% inflation target before Governor Kuroda's 10-year term runs out in 2023. If the BoJ is correct in this forecast, then the rationale for any hawkish turn remains extremely weak, especially since higher yields would add an unnecessary financial burden on both the government and the bank itself.

As a result, we believe Japan's monetary and fiscal policy divergence from the rest of the world will be a key theme in the months and years ahead. The US Federal Reserve could announce cuts to its asset purchase programmes this week. The European Central Bank has already announced it plans to wind down its pandemic emergency purchase programme (PEPP) at the end of March. In emerging markets, many policymakers have already hiked rates, and some may even be close to their peak in the cycle. While the Bank of Japan can tweak its lending support and asset purchases next year, we believe the new measures will not have a meaningful impact on the markets' long-term expectations.

The yield on Japan's 10-year sovereign bond fell to 0.09% after last week's BoJ's meeting, a two-week low. The benchmark's yield reached a year-to-date low of nearly zero in August. This highlights the markets' reasonable expectation of continued monetary policy support from the BOJ, perhaps even beyond Kuroda's term.

Investing in Japan's potential

In view of continued support on both the fiscal and monetary fronts, a weaker yen, and wider demand for value stocks, we see some potential for Japanese assets to appreciate going forward.

Japanese stocks underperformed global equities for much of 2021, reflecting the country's slow start to vaccinating its population and the economy's exposure to a slowing Chinese economy. While the latter still presents a risk, we note that additional fiscal stimulus from Mr Kishida's government would benefit growth, while the yen's weakness continues to support exports. We increased our exposure to Japanese equities within multi-asset portfolios in early September, bringing our allocation in line with our strategic asset allocation. This reflects our expectation of an additional fiscal boost, further underpinning the economic rebound.

On the currency front, we expect the yen to marginally weaken in the months ahead, to trade around 115 to 117 against the US dollar through the end of this year. The yen is already trading close to a four-year low against the US dollar, and is arguably undervalued from a long-term perspective. Yet we believe shorter-term pressures should dominate for now, in particular, low domestic yields compared with rising foreign returns, and the global economic recovery, which favours more cyclical currencies. Meanwhile, high energy prices act as a drag given the country's net energy imports. While the yen has historically offered investors portfolio diversification by appreciating during periods of market uncertainty, we are less confident of its appeal now.

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