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CIO Viewpoint

Japan is poised for a timely wage boost in 2023

Investment Solutions

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Japan is set to get a boost to its economic momentum. The country re-opened its borders to foreign visitors in October and may now see wage growth spur domestic demand. Both factors improve the outlook for the country's growth in 2023, shifting the equity allocation opportunities to small and medium-sized enterprises.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

In common with many advanced economies, Japan is experiencing record inflation. Consumer prices, excluding fresh food, have risen faster than at any time since 1982, excluding periods of consumption tax hikes. Prices rose 3.7% in October from a year ago, with average inflation over the whole of 2022 expected to hit 2.5%. Compared with the US or the eurozone, Japanese inflation remains relatively modest. Still, for an economy that has struggled with decades of ultra-low inflation, this represents a radical economic shift.

Businesses have benefitted significantly from this reflation, contributing to resilient domestic demand despite deteriorating conditions outside the country. Higher pricing power and the cheap yen have boosted corporate profit margins to multi-decade highs, and some of this will translate into continued solid demand for workers and capacity expansion (see chart 1). Non-manufacturing businesses are receiving a boost from Japan's belated re-opening to tourism last month: foreign arrivals reached nearly half a million in October, compared with just 22,000 in the same month last year. The government's steady expansion in green infrastructure investments and military spending will also help corporate sector sentiment. We therefore expect gross domestic product (GDP) to expand by 1.6% in 2023.

Since businesses are in a relatively solid position, the key to Japan's domestic demand in 2023 will be the strength of private consumption. That will be driven by the prospects for real wages. While limited income gains plus energy and food price spikes have squeezed consumers in 2022, some relief is on the way. The country's pensioners, whose benefits are indexed to inflation with a one-year lag, will see a modest rise in benefits in 2023.

Recognising the political risk of eroding consumers' purchasing power, the government has introduced a range of support measures for electricity, gas, and petrol consumption as part of a cost-of-living package approved on 28 October. As part of these efforts to contain inflation, Japan is also working to reduce its foreign

Key takeaways

- Japan's economy is set to grow in 2023 thanks to re-opened borders and an expected improvement in domestic demand
- With record inflation, wages are a key economic variable. Politically, there is a consensus around higher salaries with government incentives
- The BoJ's historically loose monetary policy may be about to change when the current governor's ten-year term ends in March 2023
- We have shifted our Japanese equity allocation to small and mid-caps, which stand to benefit from improving domestic growth.

energy imports. After winding down nuclear power in the wake of 2011's tsunami, in 2019 Japan supplied only 12% of its energy needs from domestic sources. It now has ten operating nuclear reactors, with another 15 either approved or applying to restart.

Wage watching

Japan's economic growth will depend on domestic demand, which in turn depends on wage growth for working households. Over a decade of 'Abenomics,' workers' earnings growth disappointed, in part due to Japanese firms' conservative long-term growth outlook. 2022's inflation and rebound in the service sector is now having an impact, with rising total wages (regular wages plus overtime and bonuses, see chart 2).

Prime Minister Kishida Fumio's "new capitalism" agenda has adopted more aggressive tax incentives for firms to raise wages and train workers, linked higher pay to public procurement incentives, and boosted public sector salaries for caregivers, childcare, and nurses. A hike in average minimum wages affects around one-sixth of the total workforce.

With this emerging political consensus for higher wages, Japan's largest federation of trade unions recently said it will ask for a 3% rise in base pay in the annual February/ March round of wage negotiations, known as 'shunto.' This is unusual, as the union usually demands only 2% or less. Such an increase would put wage growth in line with Bank of Japan (BoJ) Governor Kuroda Haruhiko's stated target to contain inflation. Investors should not rule out the possibility of solid wage growth in 2023.

Hawks ahead

In contrast with government efforts to limit inflation, the BoJ has kept monetary policy loose. Interest rates are unchanged from their short-term target of -0.1% since January 2016, with a 0.25% cap on 10-year Japanese government bond (JGB) yields, a policy known as yield curve control.

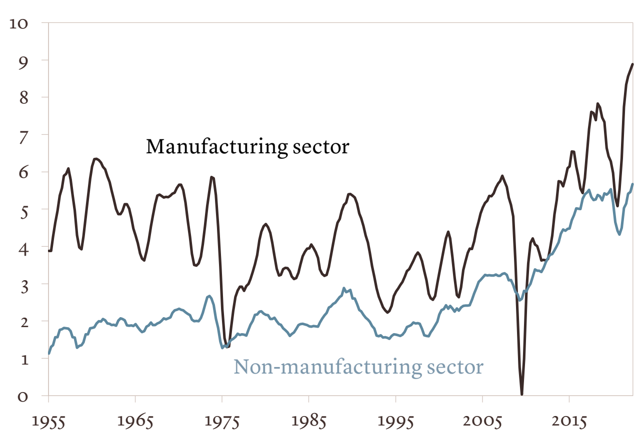
That may be about to change. Mr Kuroda is due to step down in March 2023 after a ten-year term. His replacement, appointed by the prime minister, may take a first step away from the policies introduced by Mr Kuroda in 2013 to boost inflation. It is also possible that Mr Kuroda outlines such a pivot before leaving office. For now, the Governor has continued to insist that inflation will decline once energy prices fade, and that the central bank is comfortable with letting inflation overshoot its 2% target in the short term as long as wage growth reaches around 3%.

Two potential successors are mooted to Mr Kuroda: Amamiya Masayoshi, the BoJ's current deputy governor, and his predecessor, Nakaso Hiroshi. Both are considered to hold orthodox monetary policy views, with Mr Nakaso being more clearly hawkish than Mr Amamiya.

In the meantime, Mr Kishida's government plans to tackle a more uncertain geopolitical environment with higher spending on the country's military, even as his cabinet's approval ratings with the public reach a record low of 37%. That decline is linked to his handling of connections between members of his ruling Liberal Democrat Party (LDP) and the Unification Church that emerged in the wake of former PM Abe Shinzo's assassination on 8 July. Almost half of the LDP's members are believed to

1. Japan's corporate profit margins at all-time high

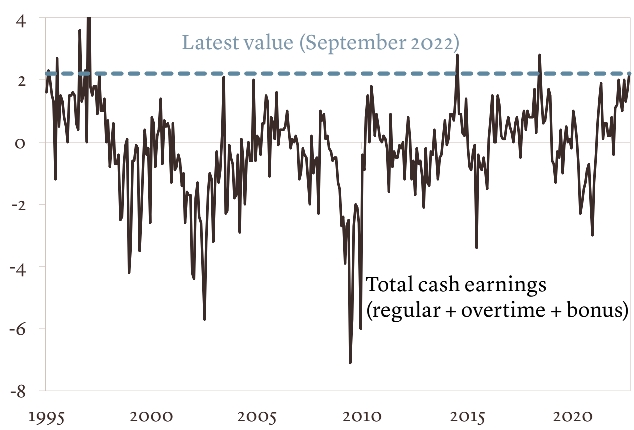
Current profits as % of sales (Ministry of Finance data)



Source: Japanese Ministry of Finance, CEIC, Lombard Odier

2. Positive momentum in Japanese wage growth

Total cash earnings growth, % YoY



Source: Bloomberg, Lombard Odier

be linked to, or have attended events by the church, whose followers are also known as ‘Moonies.’ While Mr Kishida’s management of the issues is criticised in Japan, he is also politically distanced from the LDP faction most closely linked to the church, and there is no obvious candidate to challenge him. This means the likelihood of a snap general election is rather low, but cannot be excluded. It is more probable that Mr Kishida determines the BoJ’s upcoming leadership, and remains in power until the next general election, due before the end of October 2025.

Domestic demand to support SME stocks

We remain neutral on the Japanese yen and expect the dollar-yen to trade in a range of 137-145 over the first quarter of 2023. Once the US Federal Reserve pauses its interest rate hikes later in the year, the BoJ turns more restrictive, the government continues to defend the yen and the country cuts its energy imports, we see a decline in the dollar-yen exchange rate, which should trade at 128 by the end of 2023.

We have recently shifted our Japanese equity allocation from large capitalisation stocks to small and mid-caps. These, we believe, stand to benefit from their greater exposure to the domestic economy and enjoy a more defensive sector mix as well as government policy support. In addition, small and mid-cap names are trading at attractive relative valuations. Japan’s domestic demand offers better visibility in 2023, and these stocks should be the logical beneficiaries.

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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Lombard Odier Asset Management (Europe) Limited
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID
Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).

MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
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Bank Lombard Odier & Co Ltd · Abu Dhabi Global Market Branch
Al Maryah Island · Abu Dhabi Global Market Square · Al Khatem Tower · 8th floor · P.O. Box 764646 · Abu Dhabi · UAE · abudhabi@lombardodier.com
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Avenida 9 de Julho No. 3624, Torre DGN 360, 6° andar · Jardim Paulista · CEP 01406-000 · São Paulo · Brasil
sao.paulo.office@lombardodier.com
Supervised by the Comissão de Valores Mobiliários of Brazil.

DUBAI
Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

ISRAEL
Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
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JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Superintendencia de Bancos de Panamá.
Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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ASIA - PACIFIC

HONG KONG
Lombard Odier (Hong Kong) Limited
1601 Three Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
A licensed entity regulated and supervised by the Securities and Futures Commission in Hong Kong.

SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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