Daiwa Securities

Daiwa's View

Real purchasing power decline brings sense of relief for super-long-term investments

- Japan's economy improves in nominal terms, worsens in real terms
- Income outflows due to high resource prices reduce Japan's real purchasing power
- Downward pressure on economic growth provides sense of relief for super-long-term bond investments

FICC Research Dept

Ryoma Kawahara
81-3-5555-8777
ryoma.kawahara@daiwa.co.jp

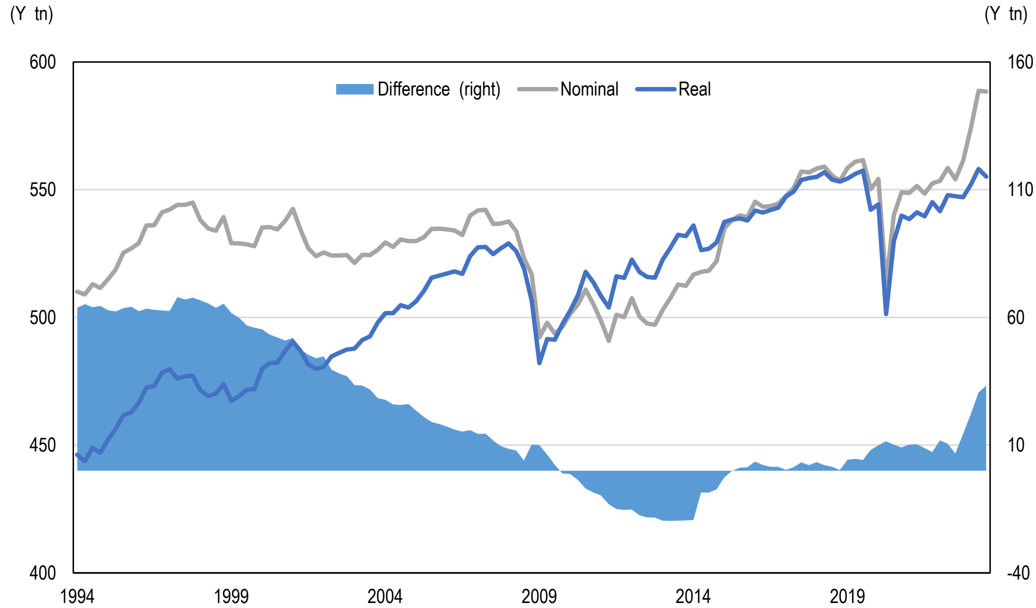
Eiichiro Tani
81-3-5555-8780
eiichiro.tani@daiwa.co.jp

Daiwa Securities Co. Ltd

◆ Summary

Japan's Jul-Sep 2023 GDP, released on 15 November, shrank an annualized 2.1% from the previous quarter. This first contraction in three quarters has raised some concerns about Japan's economic outlook at a time when the BOJ is hoping to realize a virtuous cycle of higher wages leading to higher prices. Japan's worsening terms of trade have brought about "stagflation" (high prices + economic stagnation). If import prices remain high as expectations for a US soft landing increase, Japan's economy will remain under downward pressure due to spending restraints resulting from a decline in its "real purchasing power." Headwinds for realizing demand-pull inflation will limit any rise in super-long-term forward bond yields. These developments will probably provide a sense of relief for super-long-term investing.

Chart 1: GDP Trends

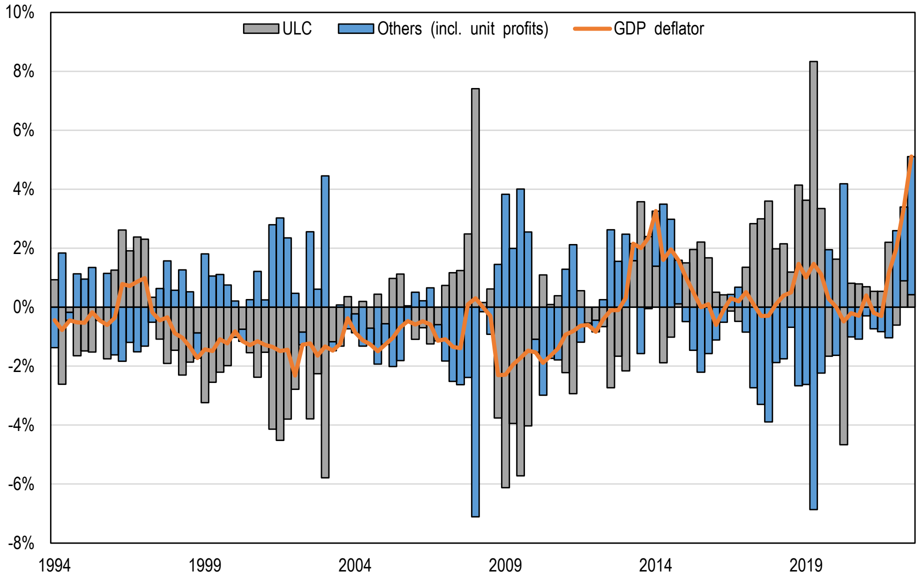


Source: Cabinet Office; compiled by Daiwa.

Our review of GDP trends confirms a substantial increase in nominal terms (Chart 1). This is consistent with the fact that corporate earnings in value terms are at all-time highs. This is also the reason for the rise in nominal wages on the back of high corporate earnings.

Here, we want to confirm where the difference between nominal and real GDP (inflation component) is coming from. The GDP deflator shows that much of the current inflation comes from sources other than unit labor cost (ULC). We think that the majority of this factor is unit profit, or in other words, due to the ability of companies to pass on higher costs to their prices. Previously, Japanese companies were unable to pass on higher costs to their prices, especially during the coronavirus outbreak when unit profits declined sharply. The recent unit profit rise can be viewed as a good sign in the sense that it suggests progress is now being made passing on higher costs to prices. The other factor is ULC, or in other words, the passing on of wage hikes to prices. In the past there was a continued inverse relationship between ULC and the other factors. However, recently this relationship has finally shifted to a positive correlation, indicating that a virtuous cycle of higher wages leading to higher prices has been realized (Chart 2).

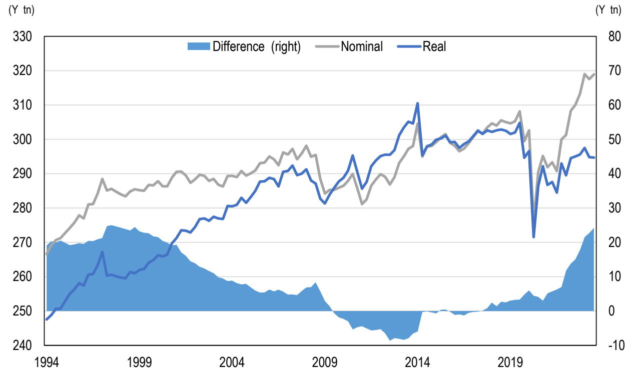
Chart 2: GDP Deflator Trends and Contribution Analysis



Source: Cabinet Office; compiled by Daiwa.

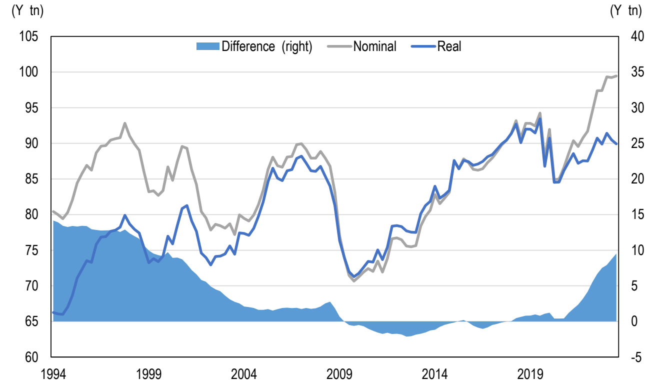
However, amid these signs of positive structural changes, GDP results this time were poor. So, we want to again review the GDP breakdown. First, consumption in real terms still has not recovered to the pre-pandemic levels. Real consumption has been declining since the recent peak in the Jan-Mar 2023 quarter. Next, we looked at capex, which has also been declining similar to real consumption (BOJ's Tankan survey indicates that capex is expected to increase, but the survey responses are in nominal terms). Inflation is pushing lower both real consumption and capex. Meanwhile, households and businesses are losing purchasing power. Under such circumstances, we can describe the Japanese economy as being in a state of stagflation (charts 3 and 4).

Chart 3: Private Consumption Trends



Source: Cabinet Office; compiled by Daiwa.

Chart 4: Capex Trends

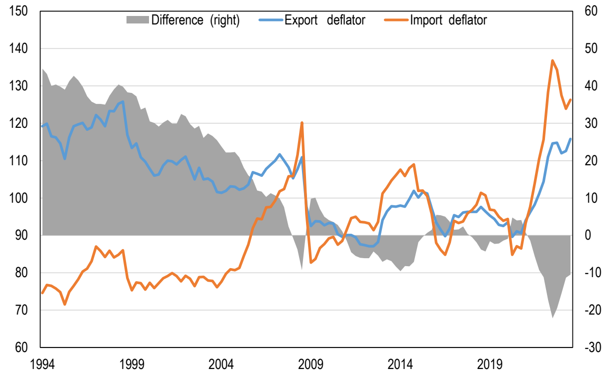


Source: Cabinet Office; compiled by Daiwa.

This decline in purchasing power is due to worsening terms of trade. The rise in preexisting import inflation, mainly due to high resource prices, has led to the current state for household and corporate real purchasing power. Looking at the import deflator and the export deflator trends, the import deflator has risen substantially, while the export deflator has risen only modestly compared to imports. In other words, even though the prices of goods and services purchased abroad have increased and higher costs are being paid, the prices of Japanese goods and services sold abroad have grown only modestly and have not boosted sales. Japan is probably experiencing a situation of "buying at high prices, selling at low prices" (Chart 5).

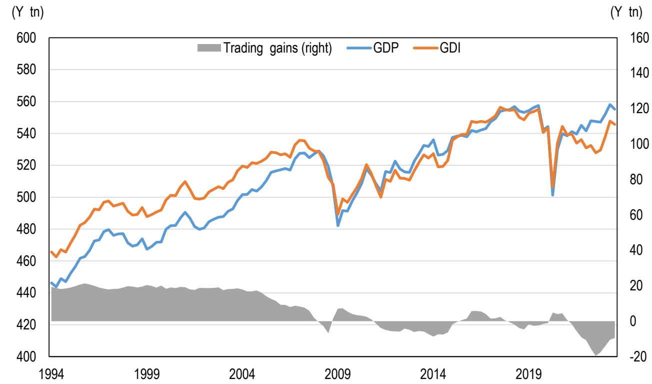
This impact can be observed numerically in real GDI (gross domestic income) and trading gains. Real GDI is calculated as "real GDP + trading gains." A review of the real GDP and real GDI trends show that real GDP has recovered to its pre-pandemic level due to economic normalization, while real GDI has not due to worsening terms of trade. The high resource prices since the coronavirus outbreak have caused income to flow out of Japan (Chart 6).

Chart 5: Import Deflator, Export Deflator Trends



Source: Cabinet Office; compiled by Daiwa.

Chart 6: GDP, GDI and Trading Gains Trends



Source: Cabinet Office; compiled by Daiwa.

Under these circumstances, the outlook for the Japanese economy appears grim. The BOJ's most recent *Outlook Report* concludes that the impact of high resource prices is expected to continue in FY24. This may be due to the anticipated soft landing for the US economy as well as geopolitical risks, despite the impact in the absence of measures from the Japanese government to mitigate the sharp rise in electricity and gas prices.

If a US economy soft landing and heightened geopolitical risks are realized, the import deflator will remain at a high level for some time, mainly due to high resource prices. Under such circumstances, it will be difficult for terms of trade to improve significantly and we would expect real GDP to remain depressed due to declining purchasing power.

This would act as a constraint on both demand-pull inflation and the realization of a sustainable and stable 2% price target until 2025, limiting nominal potential growth and super-long-term forward yield increases. As such, in terms of the contrast with the nominal potential growth rate, these developments will probably provide a sense of relief for super-long-term investing.

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