

## Strategy

### Japan: An Equity Investor's Guide to Inflation

22 September 2022

#### Key Takeaway

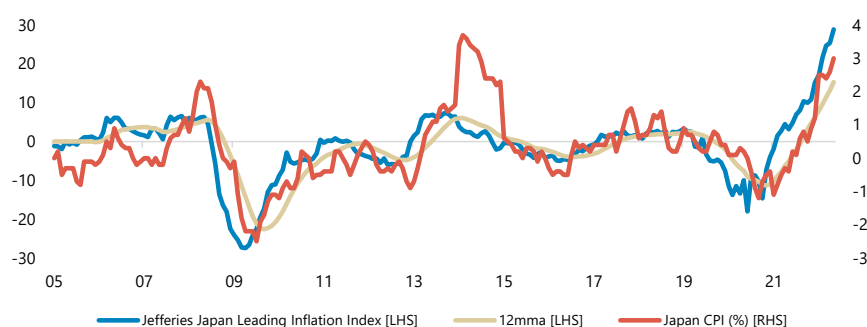
We were early on our non-consensus Japan inflation call but the August CPI and core CPIs are understating the inflation pressures. Jefferies Checklist on Inflation is soaring (see inside) – Small Cap firm output prices are at a record high. The market is again mistaking transitory for secular. We highlight five non-consensus narratives and an inflation-busting basket. Think the Unthinkable!

A deeper look under the August CPI should reveal that Japan has the same secular inflation pressures as Europe, the UK, and the US – service prices (2.1% y-y). Aside from a few months of decline in the midst of the pandemic, service prices have enjoyed one of their longest periods of sustained price rises in economic history. Services account for 75% of Japanese GDP. The acceleration in the imported food and energy bill has masked the sea-change in service prices. Moreover, the green shoots of service price inflation were occurring well before BoJ's Kuroda became active in YCC this year. As we argued in [Japan: When a Butterfly Flaps its Wings in Tokyo](#) in early May.....

*'Japan's decision to reopen its borders to tourism will tighten labor markets much more quickly than investors are discounting. Alongside upward pressures from US yields, increasing domestic inflation, and higher imported costs, the BoJ will be forced into a quicker change in its YCC policy... As the momentum in the labor markets accelerates, the authorities will find themselves defending the YYC target much more aggressively but without the data points in their favor'*

The best way to proceed is by carefully examining the consensus narrative. Firstly, glancing at our Japan inflation lead indicator and our inflation checklist, both are pointing upwards. The former excludes imported costs and reported inflation gauges such as CPI.

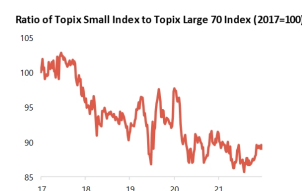
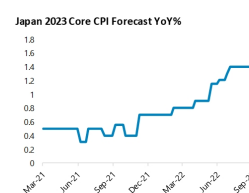
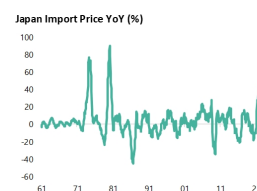
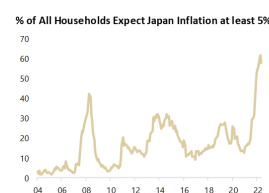
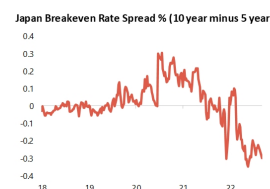
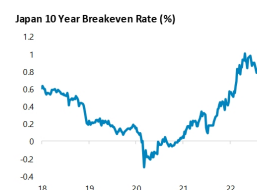
#### Jefferies Japan Leading Inflation Index with 12mma and Japan CPI (%)



Source: Bloomberg, Jefferies

**Secondly**, market based measure of inflation and financial surveys are showing modest rises. The breakeven curve is deeply inverted (see charts opposite).

(Continued Overleaf)



Source: Bloomberg, Jefferies

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^Prior trading day closing price unless otherwise noted.

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**Thirdly, Household (see chart on front page RHS) and corporate surveys are exhibiting heightened inflation pressures.** There were visible changes in output prices surveyed by the Tankan. Indeed, many were close to or above the inflationary 1970-80s (see overleaf). While the BoJ output gap is still below trend, this is a very lagging indicator. **The narrative that Japanese companies can't raise prices is completely false observing the Tankan data and producer prices.**

**Fourth,** not only have land values stopped deflating but expectations of land price rises have risen considerably (see exhibit 8).

**Fifth,** Japan's labor participation rate is already very high (75%, source: OECD vs 62% in the US) while the job-to-applicant ratio (1.29) is rising in line with an improving economy. **But, the New Jobs to applicant ratio is already at 2.4 – consistent with wage inflation in the US. What Gives?** Our analysis shows that foreign workers have been, at the margin, the balancing item (see exhibit 9) and offsetting the shrinking workforce.

**However, the labor markets must be close to a tipping point looking at the near record surge in part-time earnings (see exhibit 10).** Labour's share of income has stagnated. In *Solving Japan's Wage Stagnation Syndrome* (Richard Katz, Jan. 22) the author argued that *'During 1996-2019, productivity, i.e., GDP per work-hour, grew 30 percent in 16 rich countries. However, real hourly compensation (wages plus benefits) grew only 19 percent. While Japan's productivity growth more or less matched the others, labor income grew a negligible 3 percent, creating the biggest gap between productivity and wages among OECD countries'*. The fact that non-regular workers' (40% of the workforce presently vs 15% of the labor force in the 1980s) pay is now growing must be a decent signal for future wage growth. Ultimately, this has been the biggest source of salary changes as we have witnessed in the US and Europe in the past year – truck drivers, construction workers, etc. have seen much faster wage growth than in the past two decades. **Will the inflation narrative change if YCC is removed? No.** Indeed, exactly the opposite. The yen would tend to appreciate lowering input costs and imported inflation. In turn, this ought to boost real incomes and therefore put further pressure on the services sector.

**How to beat inflation?** Ultimately, banks through a steeper yield curve. Insurance companies through higher longer-term rates. Beneficiaries of recruitment and hiring as well as productivity. Sticking close to the service sector ought to be a major portfolio tilt.

Exhibit 1 - A Checklist for Japanese Inflation

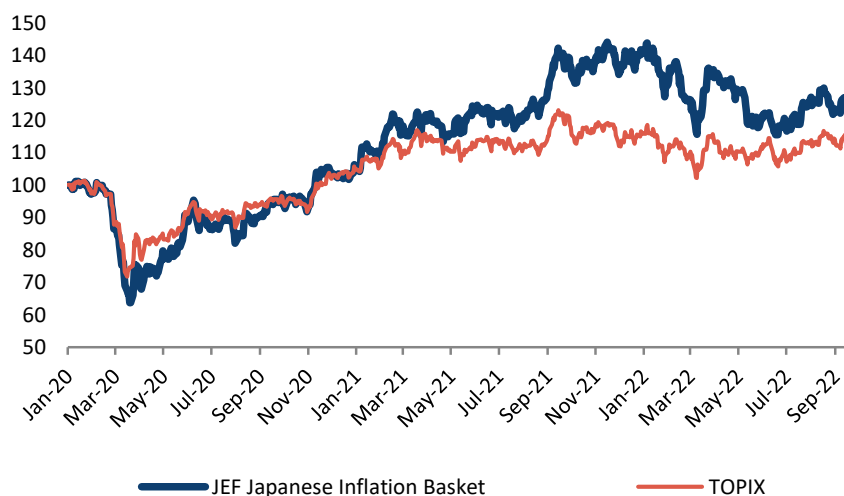
|  |  |
|--|--|
| <b>Market based inflation expectations</b> |  |
| 10 year breakevens                         |  |
| 10 year minus 5 year breakevens            |  |
| <b>Import costs</b>                        |  |
| Import prices % y-y                        |  |
| <b>Measured CPI</b>                        |  |
| Headline CPI % y-y                         |  |
| Core CPI % y-y                             |  |
| <b>Surveyed Expectations</b>               |  |
| Consensus estimates 2023                   |  |
| Household survey                           |  |
| Tankan survey Large                        |  |
| Tankan survey Small                        |  |
| <b>Employment conditions and Wages</b>     |  |
| Job-to-applicant ratio                     |  |
| Part-time wages                            |  |
| Labor force participation rate             |  |
| Contractual wages                          |  |
| <b>Land price expectations</b>             |  |
| Domestic survey                            |  |
| <b>Spare Capacity</b>                      |  |
| Japan Output Gap (2 Quarter Lag)           |  |

## Key

|  |                           |
|--|---------------------------|
|  | Significantly Below Trend |
|  | Below trend               |
|  | Above Trend               |
|  | Significantly Above Trend |

Source: Jefferies

Exhibit 2 - JEF Japanese Inflation Basket



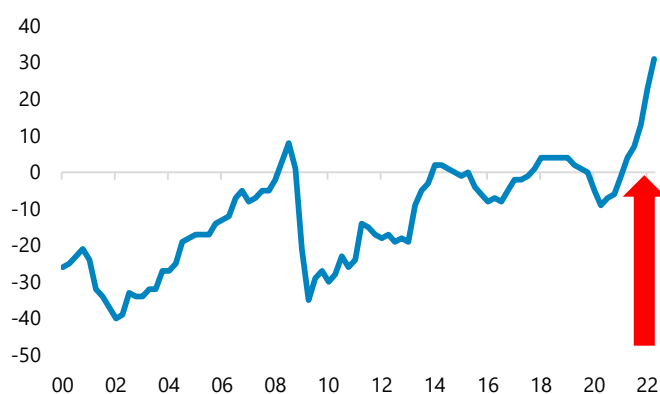
Source: FactSet, Jefferies

Exhibit 3 - JEF Japan Inflation Basket

| Ticker                    | Company Name     | PE (x, 12M) | PB (x, 12M) | DY (% 12M) | ROE (% 12M) | FY1 EPS Growth (%) | 3M Return (%) | 6M Return (%) | JEF Research Rating |
|---------------------------|------------------|-------------|-------------|------------|-------------|--------------------|---------------|---------------|---------------------|
| 8316 JP                   | SMFG             | 7.7         | 0.5         | 5.2        | 6.2         | 5.9                | 7.0           | 6.6           | BUY                 |
| 8308 JP                   | RESONA HOLDINGS  | 8.2         | 0.5         | 4.0        | 6.3         | 25.5               | 6.5           | 3.2           | NC                  |
| 8795 JP                   | T&D HOLDING INC  | 16.2        | 0.6         | 4.1        | 3.2         | 542.4              | (6.6)         | (6.2)         | BUY                 |
| 6098 JP                   | RECRUIT HOLDINGS | 22.2        | 3.9         | 0.6        | 19.7        | 7.2                | 10.1          | (18.8)        | BUY                 |
| 6861 JP                   | KEYENCE CORP     | 33.9        | 4.7         | 0.5        | 14.7        | 11.0               | 6.6           | (8.3)         | BUY                 |
| 9613 JP                   | NTT DATA CORP    | 17.7        | 1.8         | 1.2        | 10.0        | 6.2                | 1.6           | (16.3)        | BUY                 |
| 6954 JP                   | FANUC CORP       | 23.1        | 2.6         | 2.6        | 11.5        | 9.6                | 4.0           | 4.3           | BUY                 |
| Average in Local Currency |                  | 17.6        | 2.0         | 2.9        | 10.0        | 118.4              | 4.7           | (4.7)         |                     |

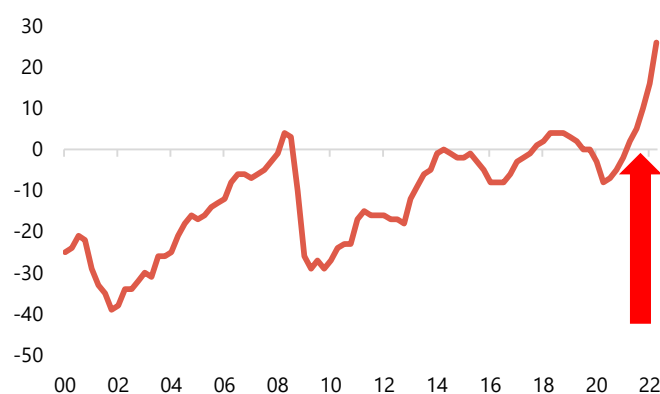
Source: Bloomberg, Jefferies

Exhibit 4 - Japan Tankan Change in Output Prices Forecast (%)



Source: Bloomberg, Jefferies

Exhibit 5 - Japan Tankan Change in Output Prices (%)



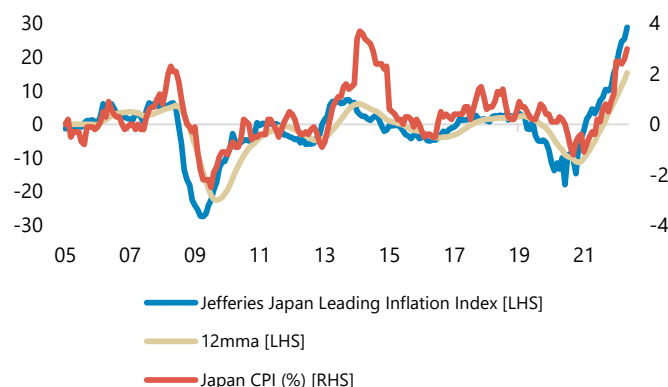
Source: Bloomberg, Jefferies

**Exhibit 6 - Jefferies Japan Leading Inflation Index**



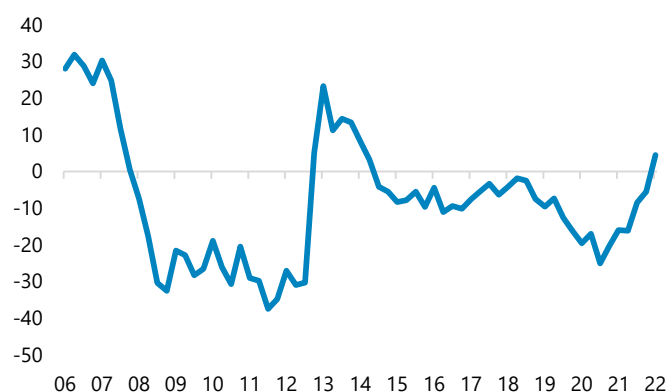
Source: Bloomberg, Jefferies

**Exhibit 7 - Jefferies Japan Leading Inflation Index with 12mma and Japan CPI (%)**



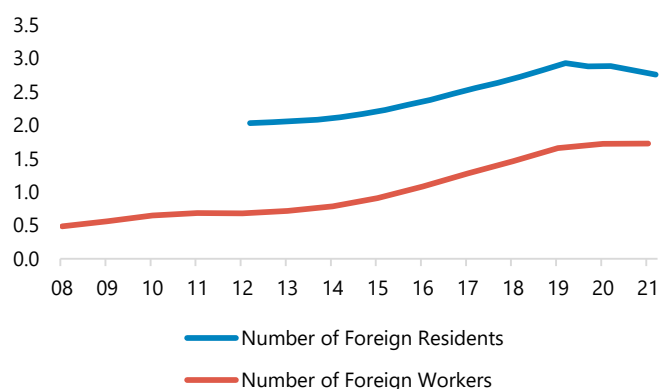
Source: Bloomberg, Jefferies

**Exhibit 8 - Japan Expectations for Land Prices (Diffusion Index)**



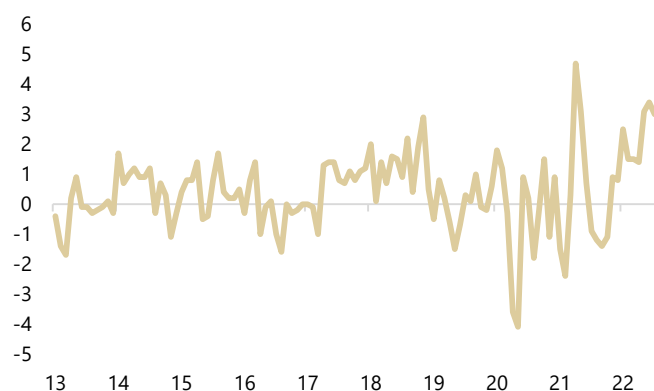
Source: Bloomberg, Jefferies

**Exhibit 9 - Number of Foreign Residents and Workers in Japan (mn)**



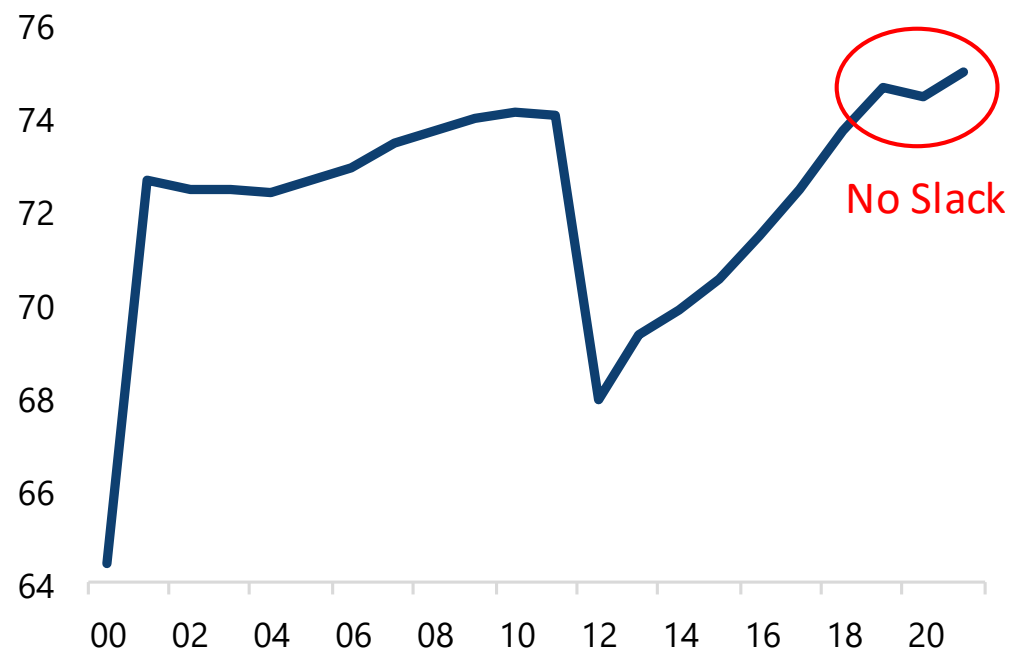
Source: CEIC, Jefferies

**Exhibit 10 - Part-time wages y-y%**



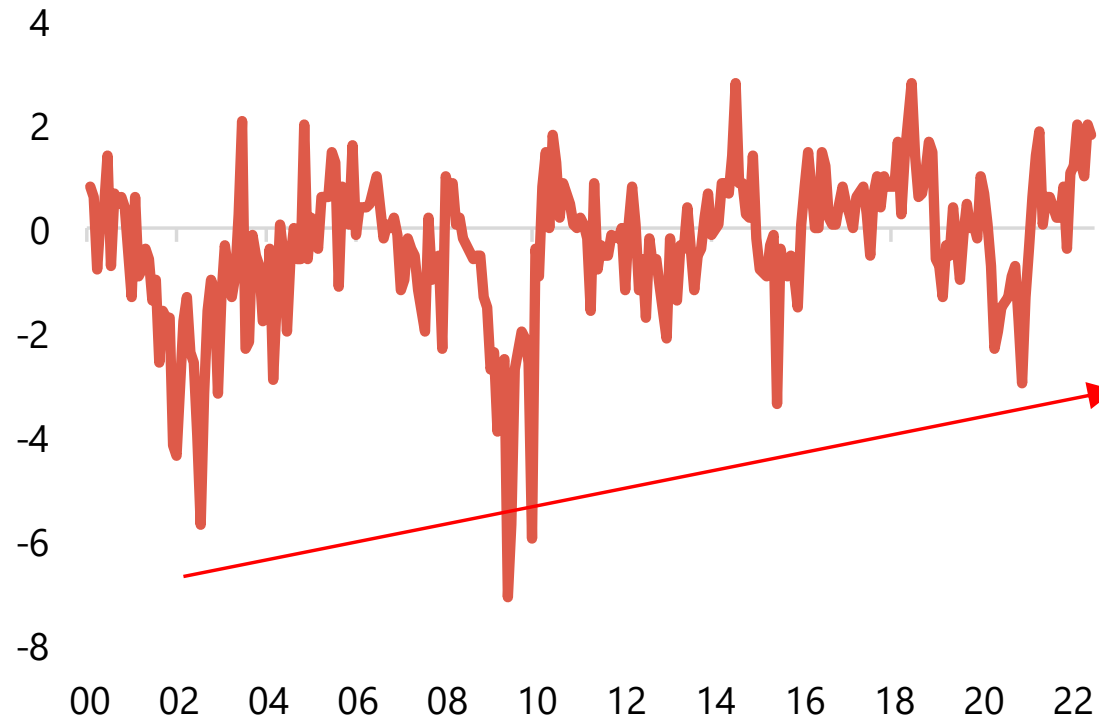
Source: Bloomberg, Jefferies

## Japan Labor force participation rate ages 15-64 (%)



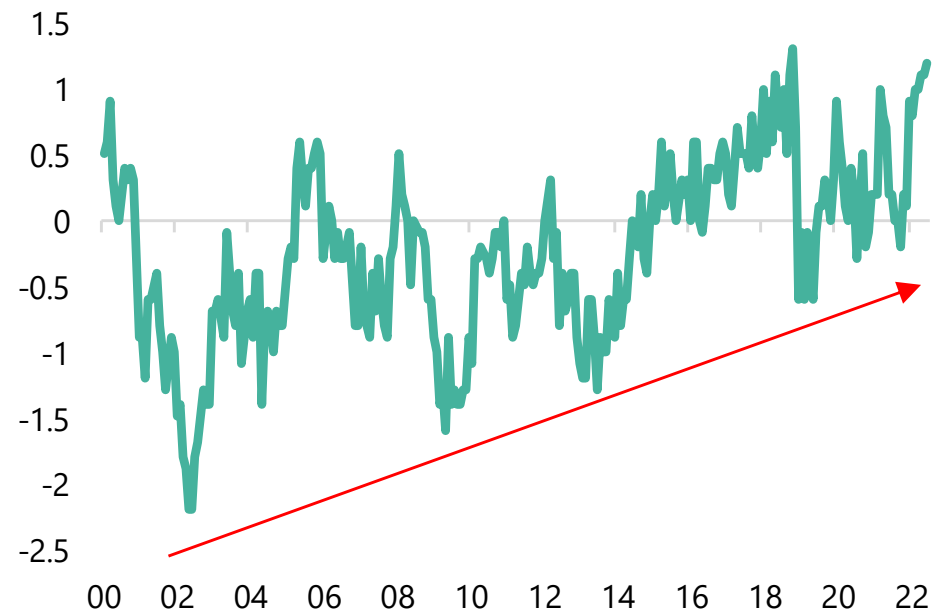
Source: Bloomberg, Jefferies

## Japan Labour Statistics Avg Monthly Cash Earnings YoY (%)



Source: Bloomberg, Jefferies

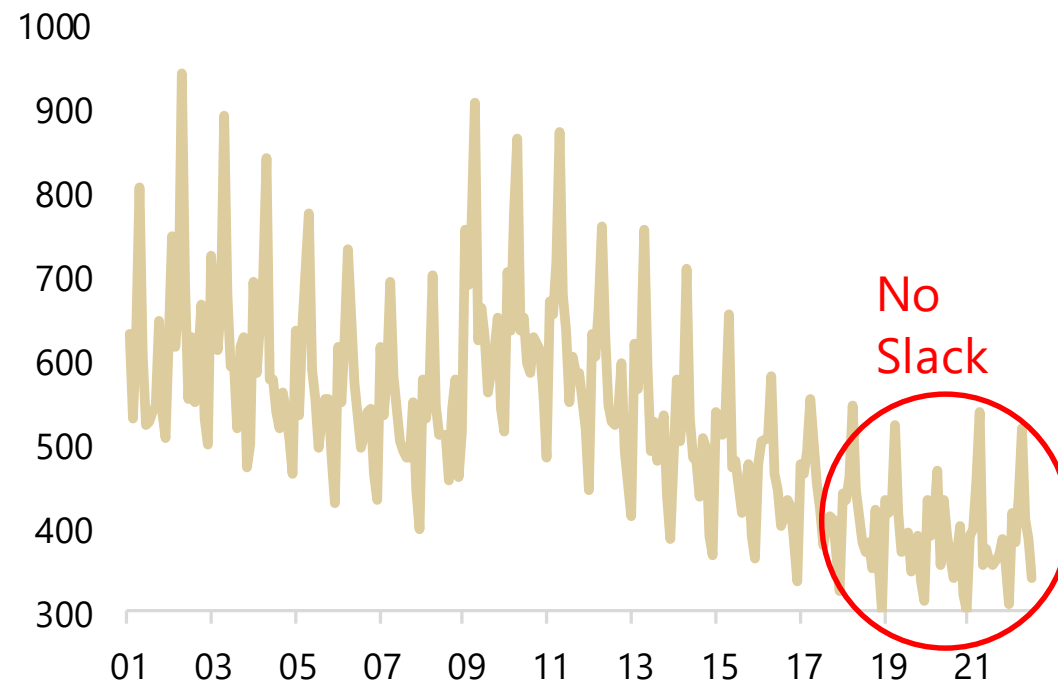
## Japan Labour Statistics Avg Monthly Cash Earnings Scheduled YoY (%)



Source: Bloomberg, Jefferies

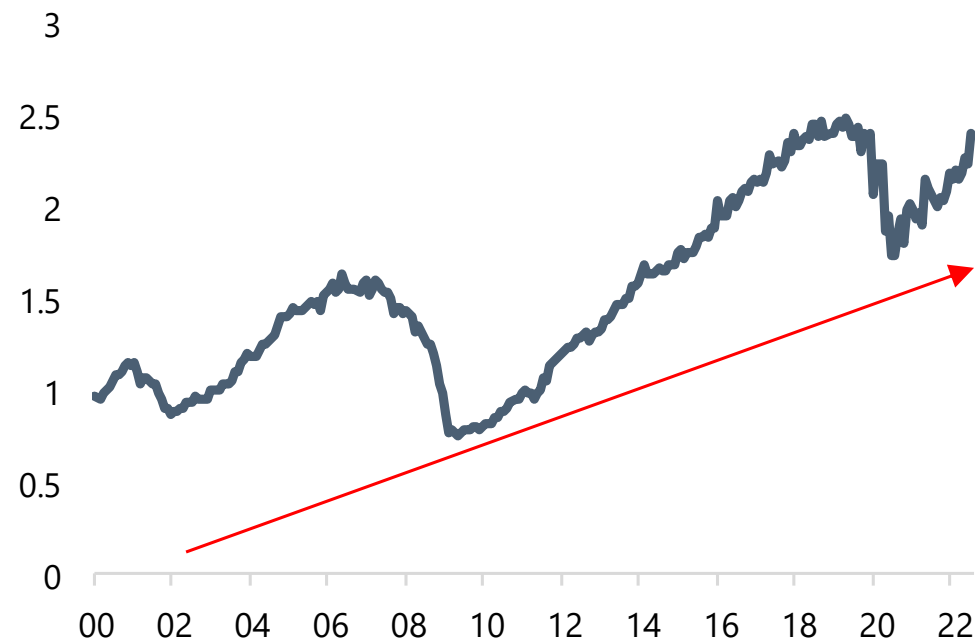


## Japan New Job Applicants NSA (Units/Persons)



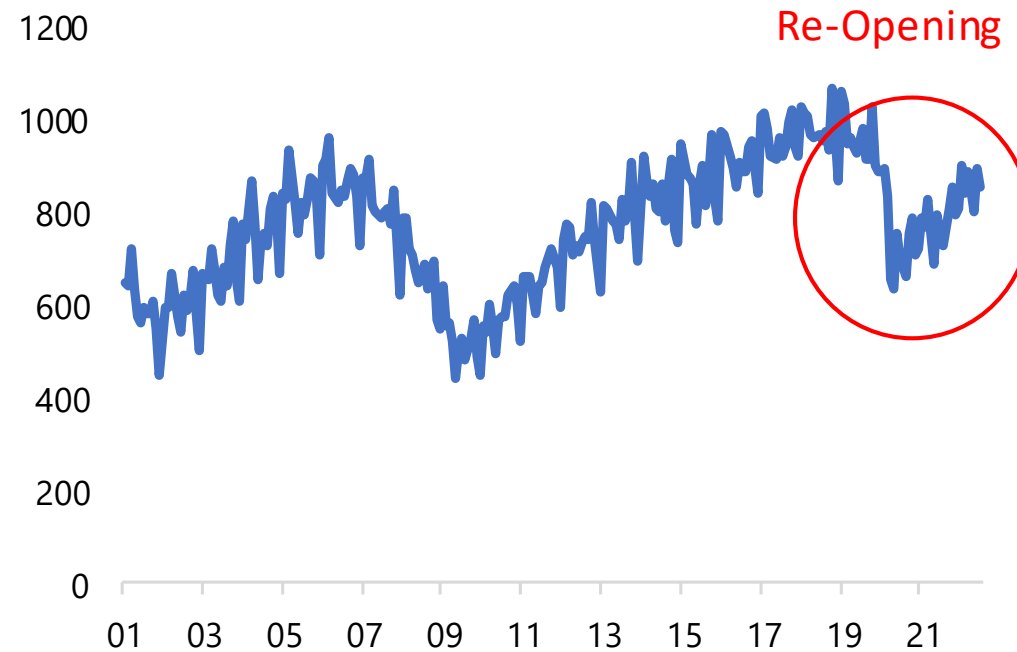
Source: Bloomberg, Jefferies

## Japan New Jobs to Applicants Ratio SA (%)



Source: Bloomberg, Jefferies

## Japan New Job Offers NSA (Units/Persons)



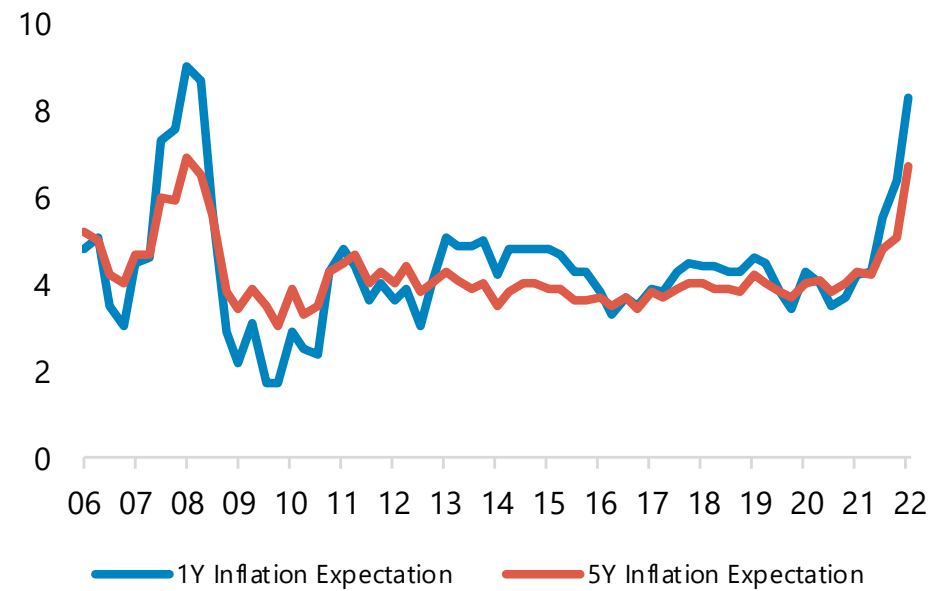
Source: Bloomberg, Jefferies

## Japan Services Producer Price YoY (%)



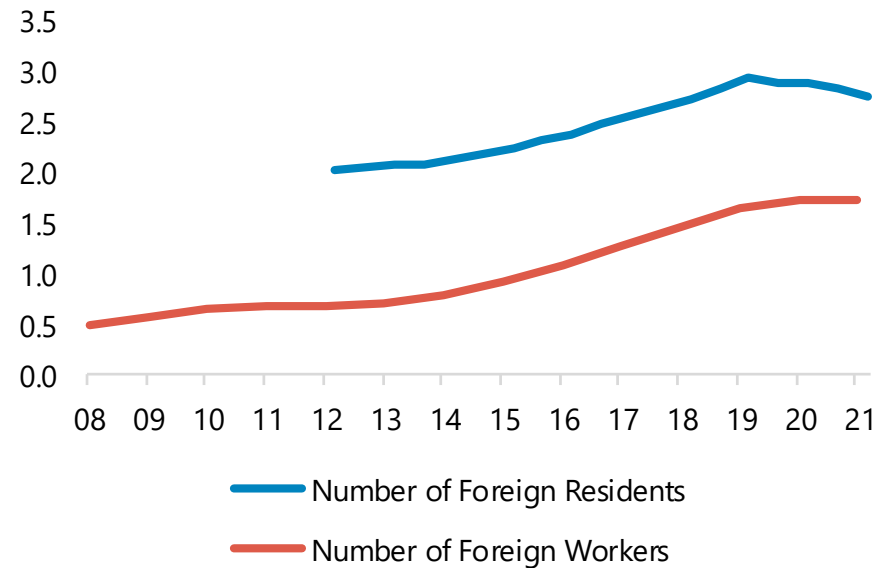
Source: Bloomberg, Jefferies

## Forward Inflation Expectations 1Y and 5Y Hence (%)



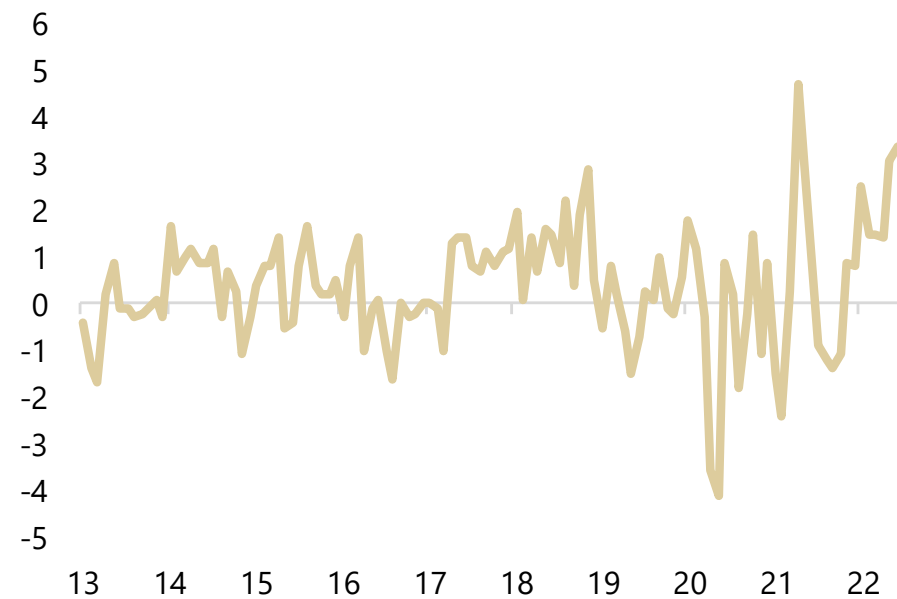
Source: Bloomberg, Jefferies

## Number of Foreign Residents and Workers in Japan (mn)

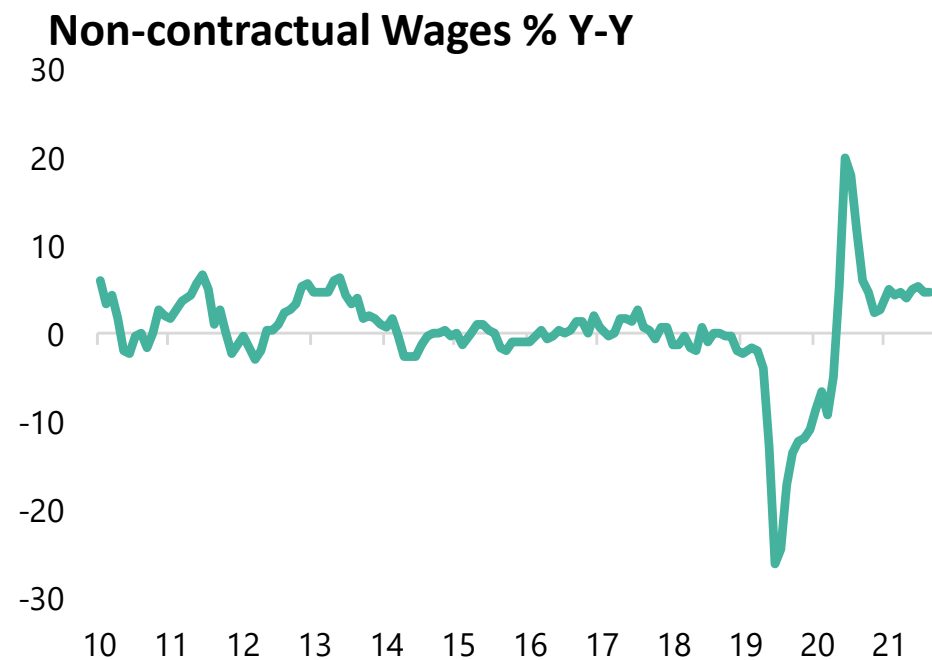


Source: CEIC, Jefferies

## Japan Labour Statistics Part-time Total Monthly Cash Earnings YoY (%)



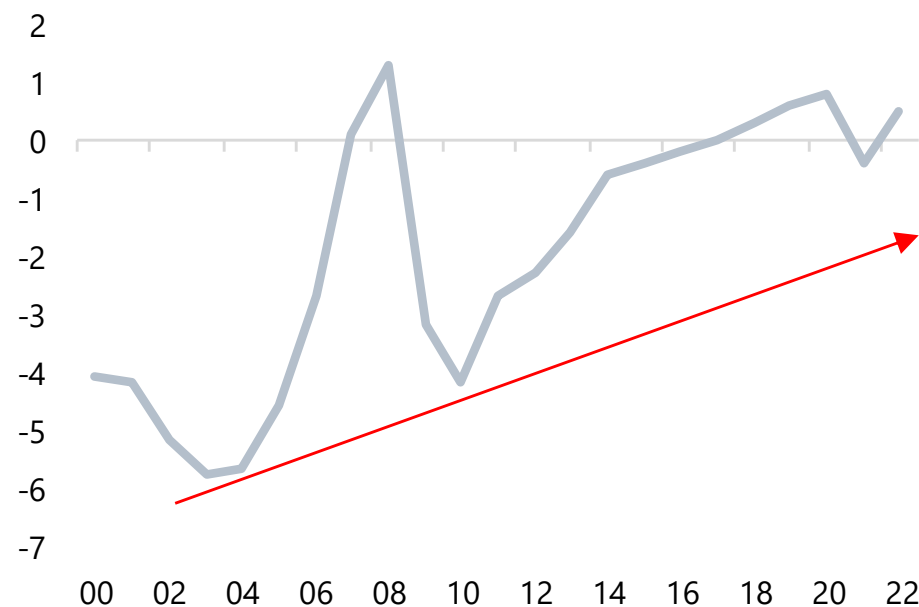
Source: Bloomberg, Jefferies



Source: Bloomberg, Jefferies

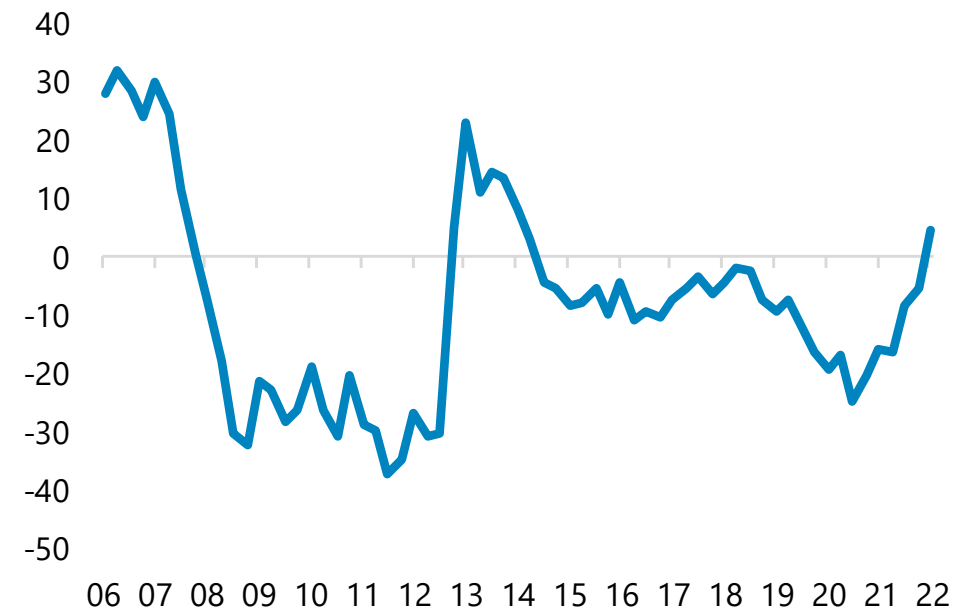


## Japan Land Prices Nationwide Residential Property Prices YoY%



Source: Bloomberg, Jefferies

## Japan Expectations for Land Prices (Diffusion Index)

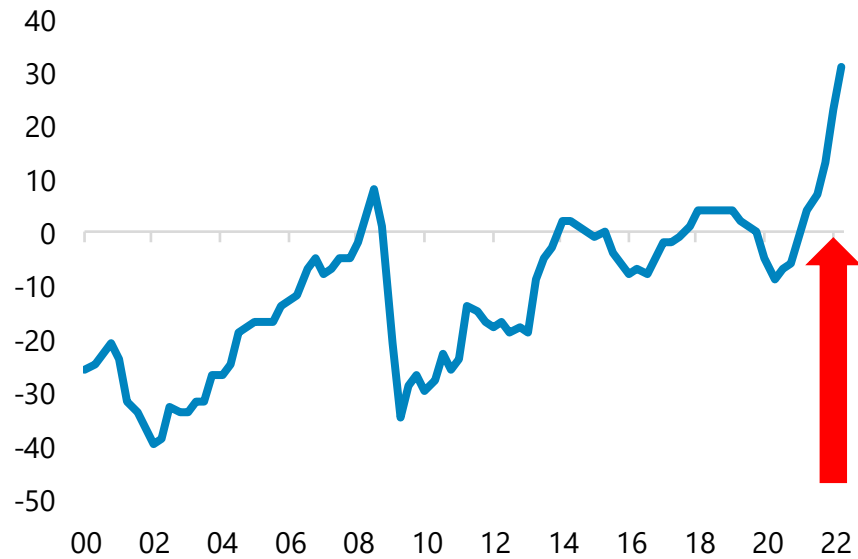


Source: Bloomberg, Jefferies

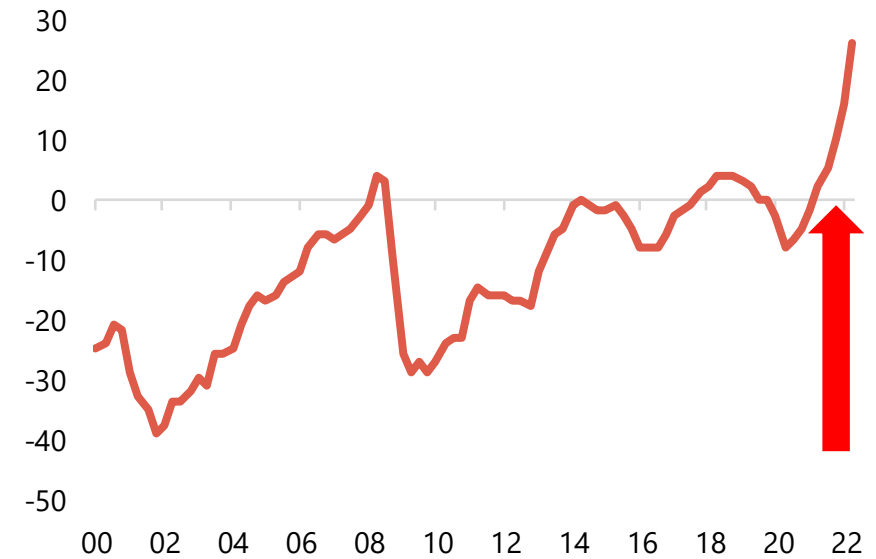
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## EQUITY RESEARCH

Japan Tankan Change in Output Prices Forecast (%)



Japan Tankan Change in Output Prices (%)



Source: Bloomberg, Jefferies

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|                         | Count | Percent | Count                | Percent | Count                     | Percent |
| BUY                     | 1951  | 61.80%  | 97                   | 4.97%   | 22                        | 1.13%   |
| HOLD                    | 1062  | 33.64%  | 13                   | 1.22%   | 1                         | 0.09%   |
| UNDERPERFORM            | 144   | 4.56%   | 1                    | 0.69%   | 0                         | 0.00%   |

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