SALT INSIGHT

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Wages, inflation, and monetary policy in Japan

The impending September Monetary Policy Meeting of the Bank of Japan (BoJ) last week had markets braced for a further tweak to policy settings. In the end the statement was at the dovish end of expectations. However, in the press conference, Governor Kazuo Ueda declined to push back on market speculation, following his prior comments, that further normalisation of policy may not be too far away.

"Tweaks" to YCC

At the recent European Central Bank (ECB) Monetary Policy Forum in Sintra, Portugal, Ueda emphasised the importance of wages as a key determinant in gauging the outlook for inflation.

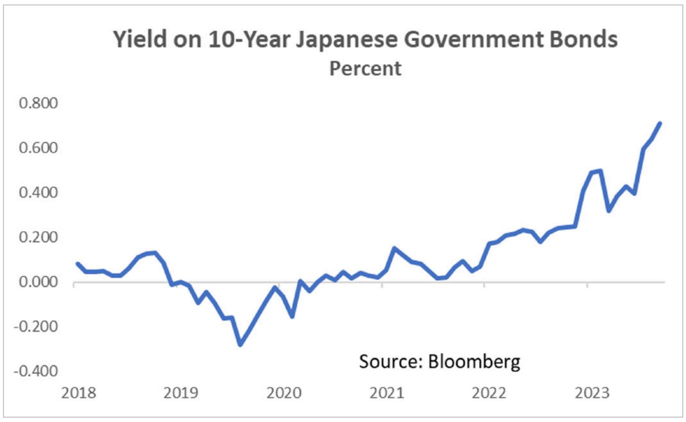
At that point, three months ago, he believed there was "still some distance to go" in achieving sufficiently robust wage growth to be comfortable about achieving 2% inflation on a sustainable basis.

Those comments came between two "tweaks" to the BoJ's Yield Curve Control (YCC) policy. The first, under the leadership of Ueda's predecessor Haruhiko Kuroda in December last year, saw the BoJ widen the trading band for 10-year Japanese Government bonds (JGB's) to +/-50 basis points around a yield of 0%.

The BoJ explained that it decided to adjust its YCC policy settings to improve "market functioning" and to rectify "yield curve distortions" while still maintaining accommodative financial conditions.

Then in late July this year, under Ueda's leadership, the BoJ decided to allow "greater flexibility" in its YCC policy, after it had fought to keep long-term yields below 0.5%, by shifting the emphasis of the 0.5% level to "references" rather than "rigid limits". The BoJ said it would offer to buy 10-year Japanese government bonds at 1.0% in fixed-rate operations, signalling that it would now tolerate a rise in the 10-year yield to as much as 1.0%.

While 10-year yields spiked higher after recent hawkish comments by Ueda in the media, at levels currently around 0.75% they are yet to test the 1.0% level, and the pressure to make any further changes to YCC, at least for market functionality reasons, has diminished.



The cumulative effect of these successive tweaks, whatever the internal BoJ rationale, has been to fuel speculation in the market that the BoJ was none-too-subtly backing away from YCC as market conditions allowed for a normalisation of monetary conditions in Japan, and that changes to the BoJ's Negative Interest Rate Policy (NIRP) could also be nigh.

A brief history of deflation in Japan

To understand Japan inflation dynamics and the thinking of the BoJ, it's helpful to put recent developments into context.

In our recent Structural Themes paper, we challenge the conventional wisdom that an ageing population is deflationary. The deflation argument runs that an ageing population leads to reduced consumer spending and a potential surplus of labour, putting downward pressure on prices and wages.

We argue that as a population in any given country ages, the proportion of people working declines relative to the proportion that is not working. That means the dependency ratio rises as the non-working proportion of the population becomes dependent on a declining working proportion.

The argument then becomes about productivity. In the absence of significant productivity gains, labour shortages will eventuate and put upward pressure on wages and inflation. This is why we argue that productivity gains from AI are something to celebrate rather than fear, especially if we aim to maintain current living standards, let alone improve them.

Japan has long been held up as the poster child for the argument that ageing populations are inherently deflationary.

However, it has also coincided with two other phenomena. The first of these is the role of China as the factory to the world, producing ever more goods at ever cheaper prices. China's strategy is now different as it focusses on building "common prosperity" and "self-reliance", suggesting to us that China will no longer be such a force for global disinflation as it has in the past.

The second, and we would argue more important factor, is that Japan's deflation has coincided with a period of extraordinarily weak wage growth which is primarily a result of its unique wage-setting behaviour, which has been influenced by cultural and economic factors.

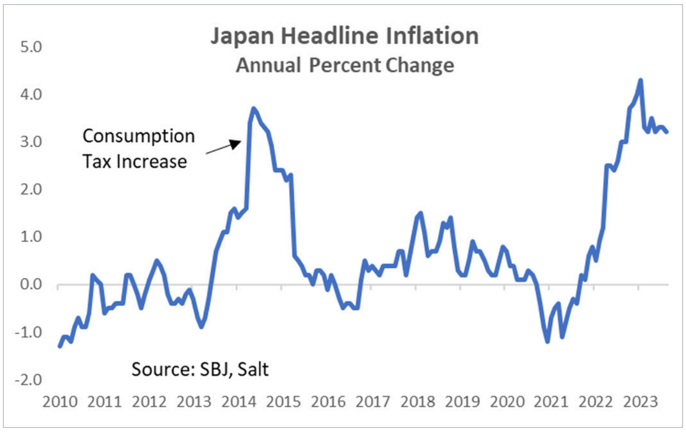
Japanese companies have been cautious about raising wages significantly due to a culture of job security and lifetime employment. Employees are often rewarded with job security over higher wages, which leads to a lack of upward pressure on salaries. This, in turn, limits consumers' purchasing power, as they have less disposable income to spend. When consumers spend less, demand for goods and services decreases, causing prices to fall or remain stagnant – a classic deflationary scenario.

Moreover, the wage-setting behaviour of Japanese corporations is influenced by the deflationary expectations that have become deeply ingrained in the national psyche. Companies are hesitant to raise wages when they anticipate that prices will continue to fall. This wage-price spiral (which is an atypical sideways-to-downwards spiral) perpetuates deflation, as lower wages lead to lower demand, which, in turn, results in lower prices.

Recent inflation and wage trends encouraging

Recent inflation and wage data has been encouraging, at least for a country with a central bank that has long struggled to generate sustainably higher inflation.

Headline inflation peaked at 4.3% in January and has since moderated to just over 3%. While some moderation was expected, recent data has come in on the upside relative to BoJ expectations and the Central Bank has revised its own forecasts up recently.

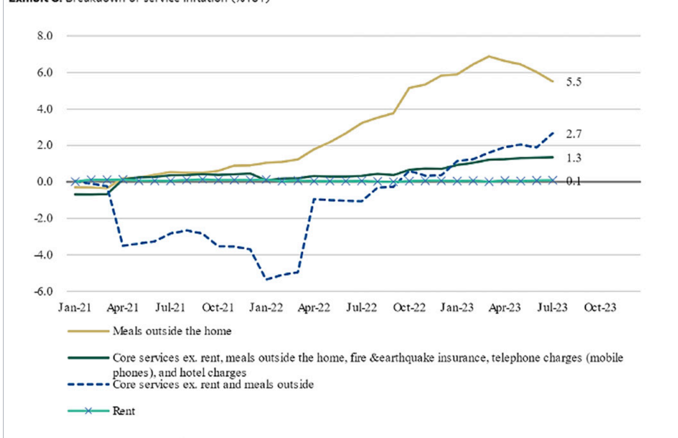


BoJ Deputy Governor outlines two possible reasons for the recent higher inflation:

1. the effects of cost-push factors are lasting longer than expected, and
2. firms' wage- and price-setting behaviour is changing somewhat earlier than anticipated.

The BoJ and Ueda himself has stressed the importance of services inflation to the monetary policy outlook. That's for much the same reason we have tended to focus on services inflation everywhere in the Developed Markets recently – the biggest input into services prices is wages. Here too, recent trends have looked less reassuring, as core services inflation has picked up, despite stable rent growth.

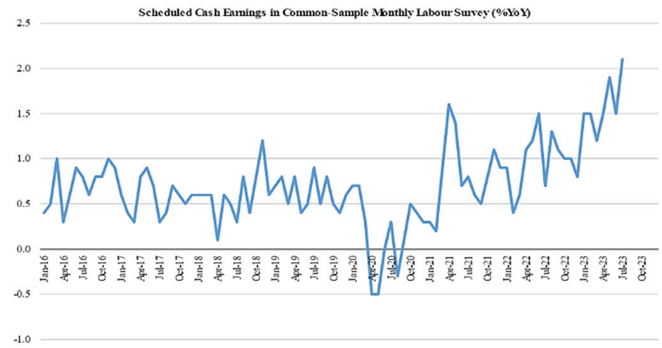
Exhibit 8: Breakdown of service inflation (%YoY)



Source: MIC, Morgan Stanley Research

To look at wage data itself, nominal wage growth hit a recent high of 2.9% in May but has since slowed to 1.3%. However, a closer look at the data reveals that on a "common sample" basis, the series we think the BoJ will pay closer attention to, wage growth is trending higher. The 2.1% recorded for the year to July is the first time this series has surpassed 2%, though this survey only goes back to 2016.

Exhibit 1: Scheduled cash earnings on common-sample basis surpassed 2% for the first time since the data release began in 2016:Monthly Labour Survey (%YoY, common sample basis)



Source: MHLW, Morgan Stanley Research

Furthermore, the latest shunto, or "Spring wage offensive" showed wage gains of around 3.5%, a large increase compared to offensives in recent years. The shunto is held every year in Japan in Spring and plays a key role in shaping wage increases for workers.

Negotiations typically take place between February and April, so the next shunto in early 2024 will be critically important in shaping the wage outlook. While it is still a few months away, Governor Ueda's recent comments in the media that they may have enough information about how that is shaping up by the end of the year have not escaped market attention.

BoJ Policy Outlook

Developments in the labour market, particularly wages, are critical in determining the BoJ's next steps. The market consensus was that the BoJ would likely exit YCC and shift from NIRP to ZIRP (Zero Interest Rtae Policy) sometime in 2024. Those expectations are now being brought forward to early in 2024 and may move to even sooner than that, depending on the data.

The cautionary note is that the BoJ will only move when they are confident of a likely sustained move in wages and inflation. We estimate the BoJ will be looking for sustained wage growth of 3% before it would be confident about sustained 2% inflation. And given Japan's history, structurally stronger wage growth requires as much a cultural shift as an economic one.

Implications for investors

Expectations of "less loose" BoJ policy settings will continue to weigh on bond markets. Indeed, a tightening in Japanese monetary policy has the potential to reverberate throughout the interconnected global bond market, influencing yields, exchange rates, and investor sentiment on a global scale.

To a large extent, the Bank of Japan is now the "last suspect standing" in the decade-long supply of ultra-cheap or "free" money to the global capital markets. Theories abound that gains in the values of a wide range of securities have been sustained by a plethora of carry trades, which originate in borrowings from Japan's financial institutions, and which find their destinations in many global assets offering either higher yields or tempting scope for capital gains. However, carry-trading funds are fickle due to the losses that may be sustained by the carry trader should a sharp contrary move develop in either interest rates or exchange rates.

So, prudent investors should be aware that some more speculative assets, as well as some "old favourite" carry trade destination assets like US Treasury Bills, will become more vulnerable to reversals, if and when the BoJ allows domestic financial conditions to tighten.

While this is not imminent, that day is coming nearer. In the absence of another such large-scale supplier of cheap-to-borrow, easily convertible liquidity coming to market (which seems unlikely) investments around the world will increasingly need to stack up in terms of fundamentals such as their profitability and quality.

Active, non-indexed bond funds less exposed

Given that Japan is one of the most indebted sovereign bond issuers in the world, it follows that Japanese Government bonds are highly represented in international bond indices that are often used as benchmarks for global fixed income fund construction. A typical index-based or passive global bond fund will therefore hold around 12% of its assets in Japanese Government bond securities. Japan is the second-largest weighting behind the USA in these indices and sits just above the weighting to China (also a problematic bond issuer for risk-conscious investors to be exposed to).

We believe index-tracking bond funds can force investors to hold vulnerable securities which have high exposure to the most indebted governments. In launching our own Salt Sustainable Global Fixed Interest Opportunities Fund we asked the simple question: "is there really a case to finance governments which manipulate bond yields to finance unsustainable national debt levels?" Our answer is that there are many much better fixed income securities available, which a quality-focussed active investor can identify. Low historical volatility in certain sovereign bonds can be deceptive, as it can reflect a market pricing mechanism over which an issuing government may have too much leverage – not least, by compelling domestic institutions to hold its debt securities as is true in both Japan and China.

The lesson learned in 2022 is that "bonds can bite," and investors should not treat the asset class as an assured diversifier in their portfolios. Active screening is crucial to making international bonds a worthwhile destination for capital, as the asset class has long been sub-optimal when held in a passive form, without a rigorous screening process focussed on finding genuine debt security opportunities.