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Featured G

Japan: Building Macro Tension

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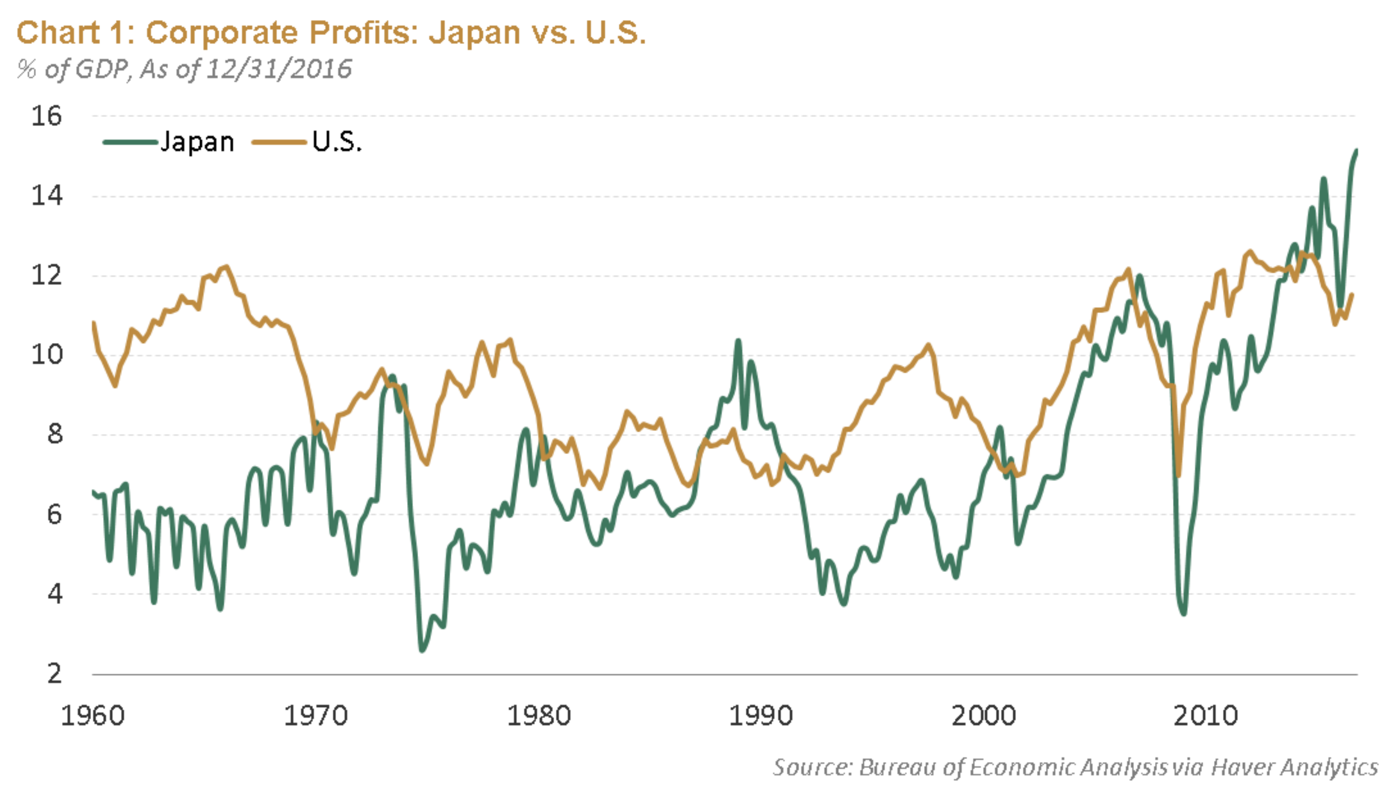
With modest economic growth over the past two decades and virtually no inflation, Japan hasn't exactly been the most interesting macro opportunity in financial markets. However, this may be set to change. Prime Minister Abe's policies are clearly having a positive impact on the corporate sector, and may soon support the household sector as well.

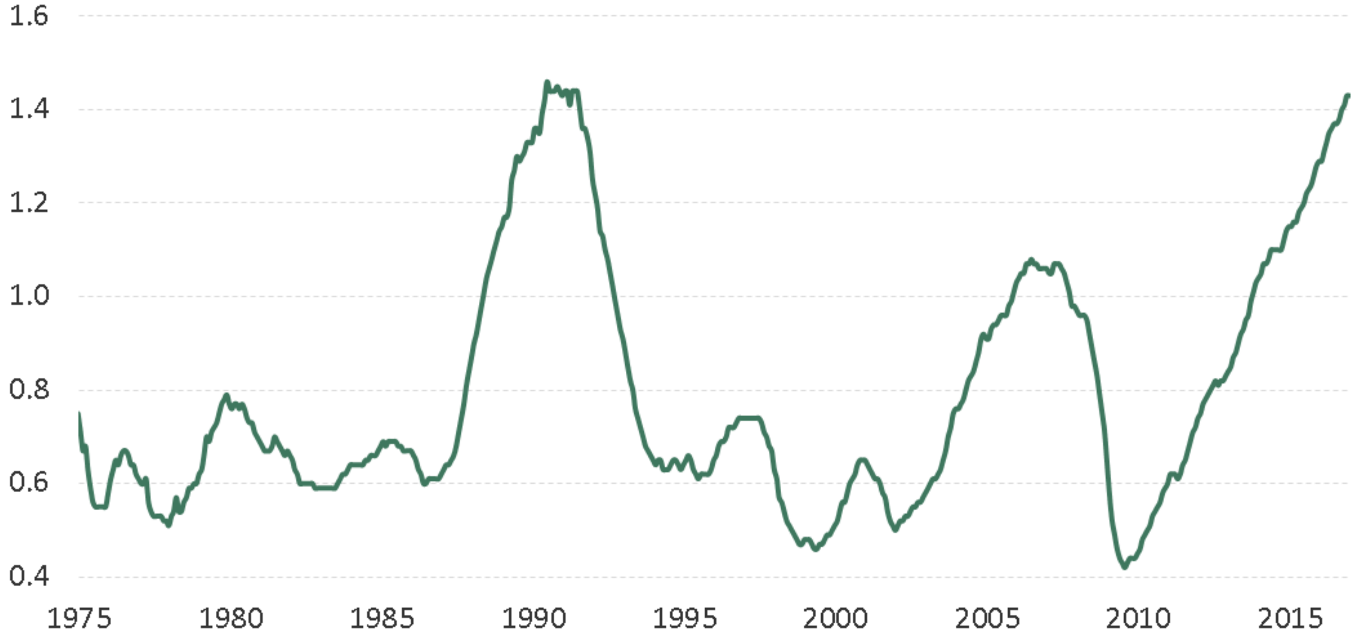
For much of the past fifty years, Japanese corporations have generally been less profitable than their U.S. counterparts. Given the more socialist corporate environment in Japan, companies have historically been slower to close excess capacity and reduce excess employment to improve profitability. But this environment now seems to have changed. In Japan, corporate profits, as a share of gross domestic product (GDP), are now well above the same measure in the U.S. The weakness of the yen partly explains this improvement, but there is more to the story. It's worth noting, for example, that the most recent surge higher in Japanese profits occurred in the 3Q16, when the Japanese yen exchange rate versus the U.S. dollar was near 100, its strongest level in several years.



This strength in Japanese profitability is translating into stronger hiring demand. In Chart 2 below, the job offer-to-applicant ratio has risen sharply higher—back near the levels last seen during the late 80s when the Japanese economy was booming. Now, overall growth is not nearly as strong as it was back then, but this nevertheless suggests that something different is brewing in the land of the rising sun.

Chart 2: Japan: Job Offers-to-Applicants Ratio

As of 1/15/2017



Source: Thomson Datastream

In particular, this combination of strong profit growth and robust labor demand suggests wages are set to rise meaningfully in Japan. Wages have definitely risen in this cycle and are now growing near their highest levels in twenty years. However, the labor demand story referenced above suggests wages may be set to rise much further.

Chart 3: Japan: Hourly Wage Growth

Annual % Change, As of 12/31/2016

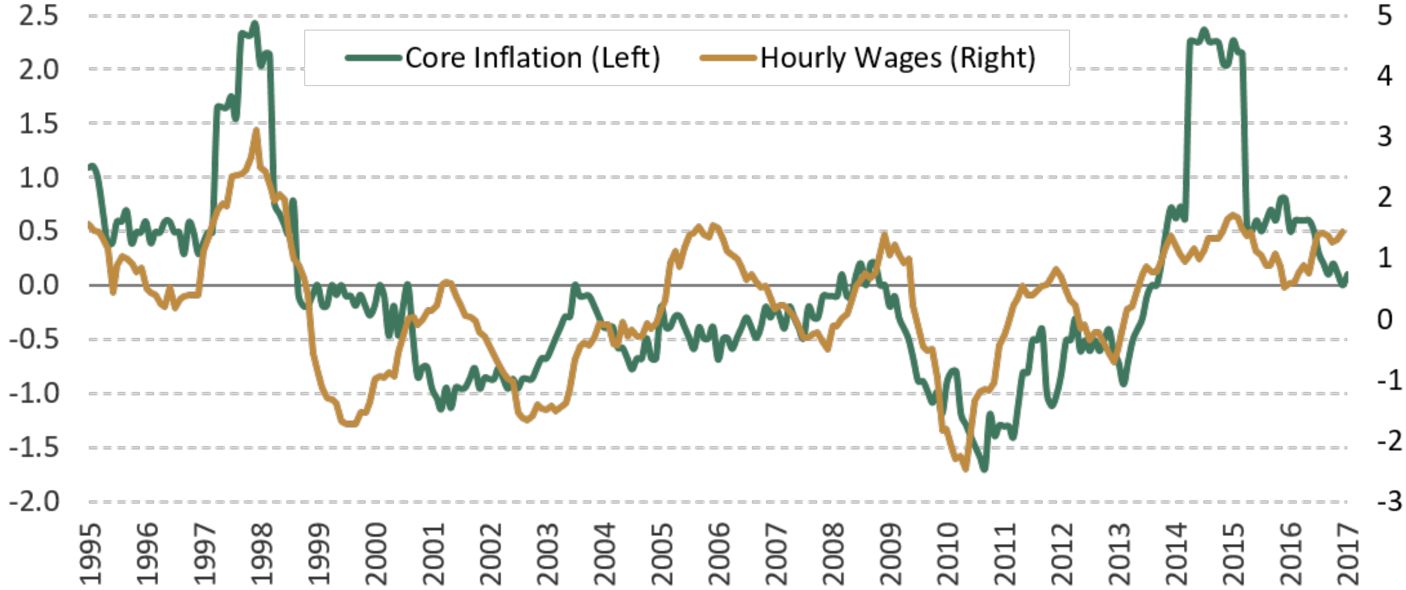
Source: Bloomberg (© 2017, Bloomberg Finance LP)

These changes within the labor market have important implications for bond markets and policymakers. For now, the Bank of Japan (BoJ) continues to aggressively pursue quantitative easing. Despite the improvement in growth and inflation, the central bank is committed to keeping 10-year Japanese Government Bond (JGB) yields near 0% because it wants inflation to rise sustainably towards 2%. Since inflation has averaged close to 0% over the past twenty years, changing inflation expectations sustainably has not been easy. The central bank continues to feel that it needs to pursue easy monetary policy longer than usual to generate this shift higher in inflation expectations.

However, since Japan is a fairly closed economy, wage growth and inflation are strongly correlated. If wage growth accelerates further from current levels, then inflation is also likely to move higher towards the BoJ's target. In that context, JGBs remain very unattractive. At best, investors are likely to earn the 0% yield on the 10-year bonds that the BoJ is targeting. However, longer maturity bonds in Japan seem set to experience material capital losses. Japanese 30-year yields currently offer a yield of 0.87% as of March 2—even if inflation is closer to 1.0% versus the BoJ's stated 2.0% target, there is considerable scope for 30-year JGB yields to rise in Japan. Given these prospects for the JGB yield curve, I'd say avoid Japanese bonds!

Chart 4: Japan: Core Inflation vs. Wages

As of 1/15/2017



Source: Bloomberg (© 2017, Bloomberg Finance LP) (Hourly Wages), *Thomson Datastream (Core Inflation)*

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