For professional investors only

The facts: Even though consumption appeared a bit stronger in June, several other indicators pointed towards more fragility in Japan's economy. The Bank of Japan however said, it would soon announce a plan to taper and possibly hike rates. Overall, the yen remained desperately weak this month.

Consumer spending seemed stronger than in April. According to the Ministry of Internal Affairs & Communication, real household spending was up year-over-year in April for the first time since early 2023, and monthly retail sales had their second consecutive such increase in May. Auto sales recovered from the halt of shipments at Daihatsu Motors, while department stores' sales were strong during the Golden Week. The number of foreign visitors increased 60% from last year and stood above the 2019 pre-pandemic level. **Sales at food and beverage retailers however fell for the third straight month, showing consumers were paying attention to their spending.** In fact, real wages have been declining for more than two years. Encouragingly, though, the pace of decline narrowed to -0.7% YoY in April as recently negotiated salary hikes are slowly translating into wages and inflation is decelerating.

On and off subsidies, provided by the government to alleviate energy bills, distorted the national CPI. However, excluding food and energy, consumer prices have been decelerating for nearly six months now, to 1.7% YoY in May. This contrasted with production prices, which accelerated to their fastest pace in ten months to 2.4%.

In fact, **several indicators reflected companies' growing concerns about cost increases.** The outlook component of the May Economy Watchers Survey (which polls factory workers, shopkeepers and other service providers close to the economy) was the weakest since December 2022. Respondents pointed out rising input costs owing to labor shortage, rising electricity prices and the weak yen. The preliminary reading of the June PMI in Services plummeted with service providers complaining about the same issues. Last but not least, the credit research firm Tokyo Shoko Research found that the number of bankruptcies had exceeded 1000 for the first time since July 2013, at the end of the funding support measures introduced during the global financial crisis. **Many companies were still struggling to raise prices to protect their margins.** Coincidently, the tightness of the job market, measured by the number of jobs per applicant, came down to a 2-year low at 1.24 in May.

The Bank of Japan was thus navigating carefully in this environment. It announced it would soon present a plan to reduce its bond buying operations but did not initiate it immediately. Opinions on rate hikes were diverse, but as the month went by, the possibility of a move in July was apparently coming back on the table. Meanwhile, the Federal Reserve remained on hold despite softer-than-expected data. The European Central Bank decided to cut its rates by 25 bps in June, but stayed cautious in its fight against inflation. After a small attempt to strengthen at the beginning of the month, the yen finished a little softer. It ended at a 38-year low of 160.9 against the dollar and its 172.4 rate against the euro was a record since the creation of the European currency.

It appeared difficult to contain selling pressures on the Japanese currency, which was particularly painful in a resource-dependent country. **The government thus decided to extend once again energy subsidies from August to October, a high-energy consumption period.** It was also considering new subsidies for people living on pensions and low income. Yet, **the popularity of the Kishida cabinet kept declining and reached a new low of 16.4%** in the latest Jiji survey in June. The Lower House voted down a no-confidence motion, but several candidates (such as Digital Minister Taro Kono, former Defense Minister Shigeru Ishiba or former Environment Minister Shinjiro Koizumi) appeared ready to run for Presidency of the Liberal Democratic Party in September.

Political shakeups were happening in several other countries as well, adding more uncertainties throughout the world. In the USA, the debate between the main two contenders for the Presidential election left people with the sad choice between a Republican convicted of felony and a Democrat with increasingly serious mental absences. Meanwhile the polarization in the latest European elections reflected people's discontent against their political leaders. Both the US and European were increasingly willing to protect their markets against Chinese competitors, by adding tariffs on EVs or specific chips. Last but not least, the geopolitical situation remained unstable. Vladimir Putin was looking for allies in North Korea and Vietnam, while the conflict in the Middle East threatened to spread to Lebanon.

The effects: The Topix index managed to gain another 1.3% in June. Given their increased volatility, the weaker currency and the stronger rates did not play as large tailwinds this month. Bottom up considerations had a bigger role along with the increase of activist moves.

The Topix index experienced some profit taking in the first half of the month, when the yen strengthened slightly on the back of softer-than-expected data in the US. This however did not last very long, and even some hawkish statements from the Bank of Japan did not reverse the weakening trend, which has now been continuing for some time. All in all, June added a small +1.34%, which was sufficient for the Topix index to end the month at its record high, a few points ahead of the last high reached in mid-March.

The overall weakening of the yen did not seem to support the traditional beneficiaries. Some exporters outperformed, but their reaction had more to do with other specific reasons. Machinery gained more than 3% thanks to the large contribution of Mitsubishi Heavy Industries (up 26%). The conglomerate announced that it did not expect any more costs related to issues on a Pratt & Whitney aircraft engine. The firm was also said to be in discussion for missile production with the US. Electric Appliances advanced in the same proportion in the wake of the continuing excitement around AI. Apple's suppliers benefited from the company's partnership with OpenAI to integrate ChatGPT into its smartphone. As the new version of the iPhone will need higher energy efficiency, Murata Manufacturing, which makes multilayer ceramic capacitors, saw its stock gain 12% in June. TDK's gained twice as much as it also announced the successful development of a new material for its solid-state batteries. **Transportation Equipment and Marine Transportation, which traditionally benefit from a weak yen too, were down 3 to 5%.** Admittedly, the former category, which mainly includes automakers, was harmed by scandals around vehicle certification issues, but the latter should have benefitted from the rise in container freight, which was getting back close to post-Covid levels.

For their parts, **higher JGB rates continued to drive financials about 3% higher, and Real Estate and Construction slightly lower albeit to a smaller extent than last month, given their volatility in June.** Regional banks did not do better than large ones, with the exception of Aozora

Bank whose stock price gained 10% as Daiwa securities raised its stake to 24%. Japan's largest bank MUFJ even gained 4% despite being handed a "business improvement order" by the FSA for sharing client data. On the contrary, Real Estate and Construction went down very slightly. Higher rates were seen to possibly reverse the nascent upturn in office building rents. Utilities, which had bucked the trend against higher rates thanks to the resumption of nuclear plants, underwent large profit taking in June. As a matter of fact, the Sankei newspaper reported that the restart of Tokyo Electric Power Company's reactor would be delayed.

Last but not least, **investor activism gained momentum again in June, ahead of the traditional busy season of annual general meetings.** This supported several stock prices. It was the case for Softbank Group Corp, in which Elliott Management rebuilt a stake at the beginning of the month and was calling for a $15bn share buyback. The stock's 15% return and large capitalization helped Information & Communication achieve a mid-single-digit return. Strong stock reactions also occured at smaller companies like underwear manufacturer Wacoal Holdings and semiconductor manufacturer Sanken Electric when 3D Investments Partners and Effissimo Capital Management respectively applied for the right to increase their stakes.

The outlook: We continue to believe that the BoJ does not have a lot of room for action, as Japan's situation remains fragile. We expect stock returns to be increasingly volatile but companies with real corporate vision in the implementation of their reforms to stand out over time.

We do not think that the latest rebound in consumption is convincing enough to call it the start of a durable trend for now. It was supported by one-time factors, such as the catch-up from earlier production delays, and tourists spending, which is only about 1% of Japan's GDP. In fact, several companies stressed Japanese consumers' sensitiveness to prices. Even in the low price-point industry of fast food, a survey from IT media revealed that consumers would move away from McDonalds' Teriyaki burger in favor of the local competitor's (MOS Burger's) if it were to raise its price by only … Y30. It remains to be seen if this type of behavior changes when salary negotiations are fully reflected in real wages. For now, though, the weakening sentiment leads us to remain cautious.

We thus fear that the BoJ does not have a lot of flexibility, and may act more on the increasing pressure triggered by the unbearable costs of the weak yen than the actual strength of the economy. Up until a certain point, the weak yen supported some imported inflation, but also boosted exporters' profits by allowing companies to raise wages while passing on price hikes. At the current exchange rate, though, wage increases are not sufficient and even exporters are increasingly worried about the impact on their overseas investments. In the end, the government still needs to keep extending subsidies and provide other forms of help, like tax cuts, for lower income people and smaller enterprises, which has caused increased criticism against the government in place.

The Japanese equity market performed very well in 2023 and the first quarter of 2024, but returns have been more range-bound in the last three months. Not only valuations have come up to 15x forward earnings, but the outlook is uncertain. **The transition towards achieving a healthy inflation cycle is not that easy for Japan. Moreover, overseas demand is not looking very bright either, especially given the elevated geopolitical risks** amid political instability at several key trading partners. We thus expect short-term returns to be more volatile.

We still believe that many Japanese corporations have a lot of room to improve, provided that they do so with a long-term vision. Both the Tokyo Stock Exchange and activists are putting pressure. Kabuto Cho launched a campaign this year to encourage companies to come up with plans that are conscious of cost of capital and stock prices. According to KPMG Azsa, 70% of companies in the Prime section of the TSE disclosed a policy to reduce cross-shareholdings in their corporate governance reports from fiscal year 2024 according to KPMG Azsa. Coincidently, according to Sumitomo Mitsui Trust Bank, Japanese companies received a record number of proposed resolutions from institutional investors ahead of this year's annual general meeting season. Share buyback surged. The Nikkei reported that the repurchase authorization set for the January-May period increased 60% year-on-year to a record high of about 9 trillion yen, bringing it close to the one-year record of about 9.6 trillion yen set in 2023. We would however refrain from any excitement around hopes that buy backs funded by the sale of cross shareholdings will suffice to offset profits decline or other forms of selling pressure. The trend only provides short-term relief. We'd rather favor corporations that are able to take advantage of it to free up from decades of conflict of interests, enjoy full restructuring and regain pricing power.

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