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Pyrspectives

Q1 2024

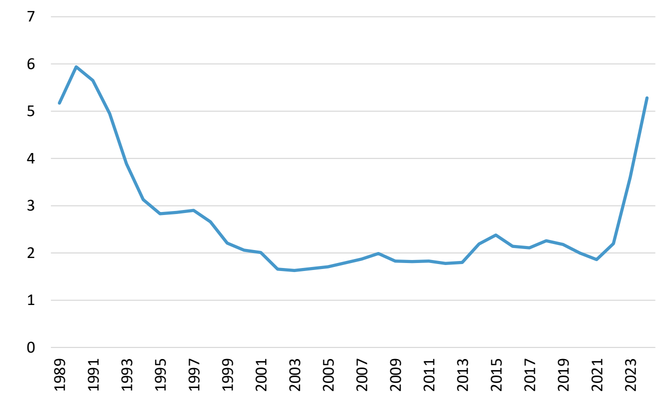
We have liftoff at the BOJ!

Ok... maybe it's not that exciting. Markets hit the snooze button in response to the first Bank of Japan (BoJ) rate hike since 2007. Policy rates have gone from -0.1% to a guided range between 0 and +0.1%. Yield curve control has also been abandoned although the purchase of Japanese Government Bonds (JGBs) will continue at a similar pace (currently 6 trillion yen per month) and can be scaled up to cap yields when needed. Whilst the headline changes have been miniscule, it's the rumblings in the real economy that deserve a deeper look. To quote the BoJ as they describe what prompted the policy changes:

'the Policy Board assessed the virtuous cycle between wages and prices, and judged it came in sight that the price stability target of 2% would be achieved in a sustainable and stable manner'.

You've probably never read the words virtuous cycle in the context of one describing dynamics in the Japanese economy. The consensus view on Japan has for a while been that a rapidly ageing population condemns it to a deflationary secular stagnation world trapped under the weight of its enormous debt burden. We partly agree on the growth side. Barring a productivity miracle, growing their way out of the debt trap seems farfetched. Real GDP growth is once again reverting to its ~1% trend experienced over the last 40 years. Nominal GDP however is growing at its fastest clip in 30 years (6.7% and 5.4% in Q3 and Q4 2023). Contrary to what most believe, we've argued in previous notes of the inflationary impact of ageing demographics which have exacerbated labour shortages around the world and contributed to rising nominal wages.

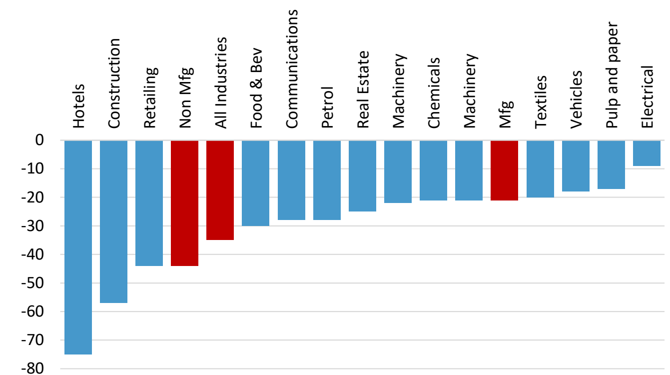
Japan – annual wage hikes for large companies (%)



Source: Ministry of Health, Labour and Welfare, Japan

Japan – employment conditions index

(% of firms saying they had "excess" workers minus those saying they had "insufficient" workers)



Source: Ministry of Health, Labour and Welfare, Bank of Japan

The latest spring wage negotiations confirm this phenomenon is finally taking root in Japan. The Japanese Trade Union Confederation, which represents large corporations, achieved an average 5.28% wage hike this year for its members, the highest since 1991. This comes off the back of chronic labour shortages across every industry (see charts above). Some of the major companies and their expected wage hikes this year include the likes of Nippon Steel (+14.2%), Suzuki Motor (10%), Aeon Retail (6.39%) and Honda Motors (5.6%). Large corporations certainly have the ability to pay higher wages. Profits since 2000 have tripled whilst

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employee compensation has flatlined. The challenge is securing higher pay for employees in small and medium sized enterprises which make up 70% of total employment. Wage talks for SME's conclude at the end of March.

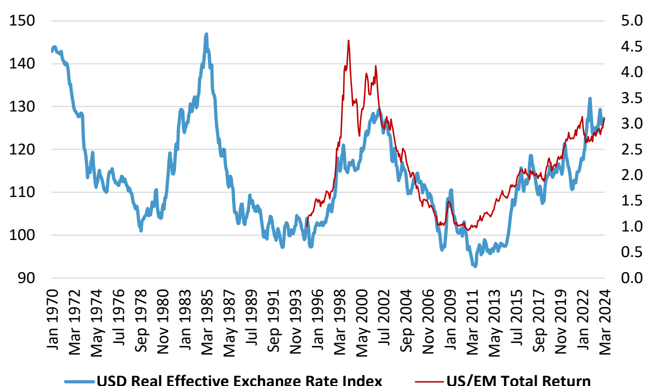
Should the virtuous cycle truly take hold, the BoJ may only just be getting started. What does this all portend for financial markets? The higher nominal environment has already shown it's not a terrible set up for Japanese equities at least in local currency terms. The big fear across global bond markets is the so-called repatriation of Japanese capital. Over the last two decades, to escape near zero yields at home, Japanese investors have sought higher returns abroad. In the process Japan has accumulated the largest net international investment position in the world, now slightly above $3 trillion. They are the largest foreign holders of US Treasuries and hold a decent chunk of sovereign debt across Europe and Australia as well. With 10- and 30-Year JGB's at 0.75% and 1.75% the yield pickup is still very much on offer across the rest of the world. We therefore don't expect any significant repatriation in the immediate future. But the BoJ has only just got the ball rolling. At the very least a stable rather than growing international investment position out of Japan will add another pillar to our new higher for longer world.

As it relates to FX, the recent BoJ hikes remind us of the period surrounding the GFC. Just as today, the BoJ lagged the US in their hiking cycle and raised rates twice after the peak in Fed funds had already been reached in June 2006. The yen however continued to depreciate until June 2007, a couple months before the Fed would begin cutting. The subsequent Fed cuts would drive the Yen to appreciate by 30% against the dollar from June 2007 to November 2009. Once again, today it's the Fed not the BoJ that will drive moves in the Yen.

The Dollar Cycle

The existence of cycles has been a perplexing empirical observation recorded throughout financial history. Ray Dalio famously examined 48 'big debt cycles' where he emphasized the role of credit in creating cyclical movements in incomes and output. Others have built upon Keynes' 'animal spirits' and adopted a more behavioural explanation for the existence of business cycles. One of the more important cycles we observe which ties together almost every financial variable of note is the dollar cycle. A real effective exchange rate index of the dollar shows that since breaking off the Gold Standard in 1971, the dollar has moved in long ~20-year cycles, with the latest data suggesting it's at an historic high against most other FX pairs.

The dollar has moved in long cycles



Source: Refinitiv Datastream

The link between USD strength/weakness and US equity out/underperformance has also been striking. The chart above compares Emerging Market equity performance vs the US as far back as our data allows which is 1995. Comparing the rest of the world vs the US would yield similar results. The late 90's was a devastating period for EM's starting with the Mexican Peso Crisis in 1994 followed by a string of East Asian crises in 1997. Much like today, US exceptionalism was at full force by the turn of the century. We now know that was the start of the 'Golden Age' for EM as the dotcom bubble burst and China's accession to the WTO kicked off a commodity supercycle which lasted until the GFC.

Since then, more than a decade of one-way traffic into US dollar assets has left us perched at the top of the dollar cycle with equity valuations nearing the levels reached back in 2000. It's no secret we believe better value to be found elsewhere. Certainly, when it comes to the value of the dollar in the short term, the Fed appears to have capitulated in the face of stubbornly high inflation whilst the government continues to spend like there's no tomorrow. In most countries that's a recipe for currency weakness and it's a reality the US can't run away from for too long. We must of course mention the immediate beneficiary to this debasement is Gold which hit an all-time high of $2,200 this month.

No change in Indonesia?

In mid-February, Prabowo Subianto, the current Defence Minister and former general, won the 5th presidential election in Indonesia. His family have been involved in politics since independence with his grandfather being a key figure in Indonesia's independence movement.

Prabowo, 72 years old, is seen as a controversial candidate following his discharge from the military in 1998 after being accused of ordering the kidnapping of more than 24 pro-democracy activists in Jakarta. He is also accused by human rights groups of being involved in the killing of civilians as a young officer in the 1980s in East Timor, which was fighting Indonesian occupation. He was also banned from entering the US for two decades.

Having previously lost the prior two Presidential elections to Joko Widodo on a strongman persona, Prabowo has rebranded himself as a cuddly grandfather to appeal to Indonesia's young demographic.

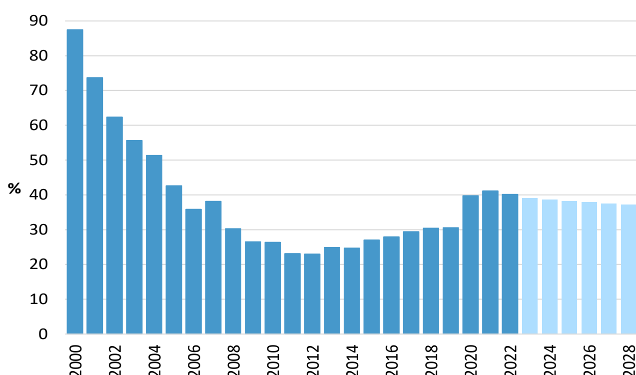
Prabowo now has the backing of Widodo, which is key given the current president's 80% approval rating, the highest approval rating for any leader a major democracy. Joko Widodo's popularity is even more impressive considering he has been in power for a decade. His vice-presidential nominee, Gibran (37), is President Widodo's son, who was allowed on the presidential ticket after a ruling last year to amend the age limit (40) by the constitutional court, which was led by Widodo's brother-in-law. The presence of Gibran has given new hope for young Indonesians. Others view it as an attempt for Widodo to retain control.

Prabowo canvassed on continuing with many of Widodo's policies which should provide stability. President Widodo spent heavily on infrastructure to connect the archipelago of 17,500 islands and implemented reforms to make the country more attractive to foreign direct investment. He was also very successful at taking advantage of Indonesia's vast supply of nickel, a key mineral used in electric vehicle batteries, by enforcing processing of the raw material domestically rather than allowing the export of the ore.

The key question is whether the incoming president will continue with the new capital city in Kalimantan, a key project of President Jokowi, which some others see as a waste of public money.

Prabowo is fortunate to inherit a sound fiscal position, with inflation within target and growth steady around 5%. He will need to continue the pro-business reforms that have increased the attractiveness of Indonesia for investment especially at a time when companies look to diversify their manufacturing footprint away from China. Importantly, the new President will need to maintain cordial relations with both the US and China which President Widodo has been very successful at.

Indonesia gross government debt to GDP (%)



Source: Refinitiv / Datastream

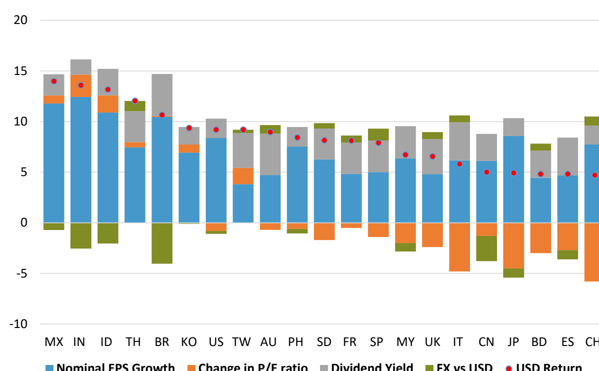
All of Prabowo's policies point to increased fiscal spending however there is a cap on the fiscal deficit at 3% which could limit what he can achieve. The fiscal deficit limit was relaxed during COVID, which could be increased again to meet his policy goals as there was no exodus of foreign capital. Given many governments across the world expanded fiscal spending to stimulate growth during COVID, Indonesia's fiscal position was not seen as an outlier. Loosening fiscal deficit limits could put foreign capital at risk of leaving.

Equity Returns since 2001

One feat of investment research we look forward to each year is the Global Investment Returns Yearbook by Dimson, Marsh and Staunton. Released last month for the first time under UBS (previously published by Credit Suisse), it is to our knowledge the most comprehensive review of global equity returns and a must-read for anyone interested in the long-term drivers of overall investment returns. When analysing the sources of equity returns over the very long run (since 1900) the contribution from dividends always sticks out. In the US, dividends make up 4.1% of the total 6.5% real return per annum from 1900 to 2024. In other words, had you invested $1 in US equities at the start of 1900 and reinvested all of your dividend income, your initial investment would have grown by 2443 times in real terms by 2024. Ex-dividends, your real return is only 18.2 times. The other less surprising finding is that countries with higher earnings growth do tend to have the strongest overall equity returns over longer periods.

For individuals, the 124-year time horizon can be hard to relate to. That's why we've constructed our own decomposition of equity returns from January 2001 to December 2023. The chart below uses Datastream Total Market Indices for each market to assess the drivers of total returns in nominal USD terms.

Equity returns decomposition (Jan 2001 to Dec 2023)



Source: Refinitiv / Datastream

It's an interesting period to cover given that you average out the superior performance of EMs from 2001 to 2010 with their mediocre performance from 2011 to today. Overall, had you invested a dollar into each country on Jan 1st 2001, by the end of 2023 Mexico, India, Indonesia and Thailand would have given you the highest returns. The US produced an annual return of 9.1% the highest among developed economies, whilst China has been the worst performing market driven by de-rating immediately after 2001 but also in the last two years.

The importance of dividends across this period is significantly less, ranging from 40% of total return in Australia to 8% in India. But the importance of earnings per share growth has stood out, ranging from 77% of total return in Mexico to 39% in Spain. The highest returning countries have for the most part also exhibited the strongest earnings growth.

Final Word

Since the rate of inflation in the US bottomed in June 2023, the evidence has been pulling and pushing us either side of the inflation debate. Indeed, the data reflected that push and pull with inflation being stuck around 3-3.5% for eight months now. The March meeting however may well have tilted the signs towards higher inflation in the coming months with the Fed bowing to market expectations and reaffirming their stance for 3 rate cuts this year. This came in spite of the evidence for higher inflation piling up slowly over the course of the last few months. Firstly, the reversal in energy prices which contributed a significant chunk of the disinflation last year has now reversed and contributed to monthly inflation in February. Secondly, there are signs of the global manufacturing cycle bottoming which should lower the level of goods deflation. Meanwhile, services inflation has remained sticky. Chair Powell himself raised his forecasts for growth and inflation this year.

Finally, we offer our regular reminder of perhaps the most critical and underappreciated variable currently impacting the real economy and financial markets. The soaring fiscal deficit in the US which added another $298 billion in the month of February, a 14% increase over last year's number, including a 50% increase in net interest payments on government debt.

Pyrford International
31 March 2024

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