

Japanese reflation risks

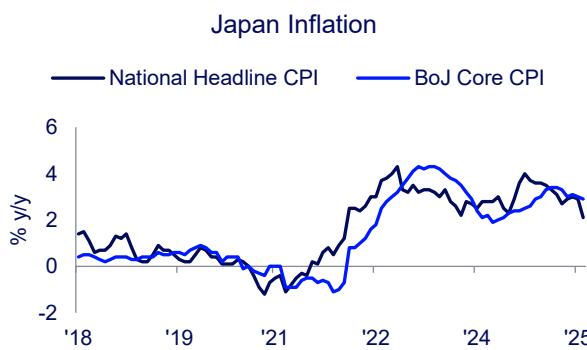
EXECUTIVE SUMMARY

- Japan's shift from chronic disinflation to a reflationary environment marks a defining macro inflection point. Imported cost shocks, post covid, and yen depreciation initiated the inflation cycle in the economy. The inflationary impulse is now led by durable domestic forces – namely historically tight labor markets and sustained wage gains. The Bank of Japan's (BoJ) gradual normalization has lifted short term rates, while long term yields have risen more sharply as markets reassess Japan's new inflation regime.
- State Street's PriceStats signals were early in detecting an inflationary rise in Japan. Currently, these signals indicate online goods price inflation decelerating and running below its long run seasonal trend, indicating that cost push inflation is fading despite a weak yen. This cooling of high frequency prices suggests that future inflation momentum will depend increasingly on wage driven services, not necessarily FX pass through. At the same time, State Street positioning metrics show that international asset managers remain neutral in the yen and carry trades, reducing near term risk of a disorderly unwind should Japanese yields rise or the currency rebound more forcefully. While higher Japanese inflation, rates, and yields would have far reaching global consequences, risk of Japanese investors reversing their net purchases seems largely hypothetical for now.
- Over the next 12–18 months, BoJ policy decisions, wage dynamics, and fiscal signals – alongside real time inflation indicators will be essential in gauging whether Japan's reflation stabilizes or accelerates into a disruptive global market event.

JAPANESE REFLATION RISKS

The adage 'Nothing is so inflationary as a whiff of deflation' has not been apropos for Japan as it has been constrained by falling prices for decades. Strikingly, inflation has now returned to Japan. However, the combination of negative real rates, a deeply undervalued currency, added to the promise of further fiscal stimulus, implies that Japanese reflation also comes with risks. The Bank of Japan (BoJ) has already shifted to higher short-term rates and reduced quantitative easing, but longer-term yields have risen much more dramatically. In this note, we apply our data insights on inflation and investor behavior to assess near-term inflation risks, what this means for the JPY and carry trades as well as allocations both into and out of Japanese assets.

Exhibit 1. Japan's Escape from Deflation



Source: Bloomberg

FROM DEFLATION TO INFLATION

Japan's inflation journey over the last five years has been an epic story. After decades of low inflation or outright deflation, Japan has managed to revive inflation through a variety of structural and cyclical forces. As shown in Exhibit 1, inflation began with imported and supply side inflation. COVID era goods disruptions and, later, commodity and energy shocks lifted global input costs, while yen depreciation amplified import prices and firms' pass-through behavior shifted.

In its post exit policy reset, the BoJ noted that earlier import cost pass through had waned, but services prices continued to rise moderately, supported in part by wage increases. Another factor supporting a continued inflationary dynamic is the change in import price pass through and the impact of FX on inflation. The BoJ's latest Outlook for Economic Activity and Prices notes that exchange rate changes now tend to affect consumer prices more than in the past. This reflects not only higher import penetration but also stronger "secondary spillover effects" tied to more active wage and price setting.

Thus, what broke the deflationary trap was the combination of (i) a large and persistent imported cost shocks and (ii) corporate and labor market conditions that finally made pass through socially and politically feasible. These conditions were underpinned by tighter labor supply – driven by demographic shifts and participation limits – and a multiyear shift toward meaningful base pay increases. The BoJ communication also shifted: it moved from emphasizing transitory cost push forces toward

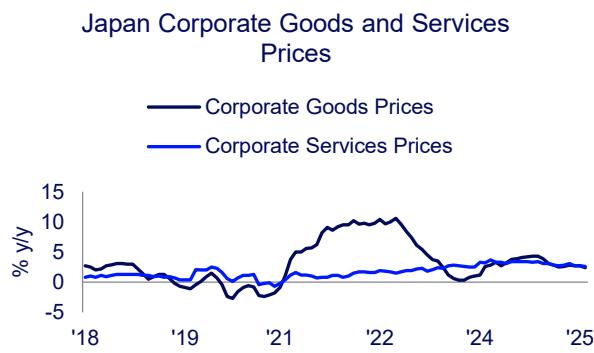
explicitly conditioning further normalization on durable wage price dynamics.

WHAT THE DATA SAYS

The latest inflation data points to this shifting dynamic. While the cost push force is not gone, it is less one directional than in 2022-23. As shown in Exhibit 2, corporate goods prices have been on a downtrend since their 2023 peak, despite a brief re acceleration in 2024, while corporate services prices have been on a consistent and gradual uptrend.

Headline inflation has also been distorted by energy subsidies, which flipped fuel and utilities prices from 3.0% y/y in November to -1.3% y/y in December. With BoJ core CPI firm at 2.9% y/y and services prices gradually rising, the overall picture points to decelerating headline momentum but with a firmer trend in underlying domestic pressures.

Exhibit 2. Japan Corporate Goods and Services Prices

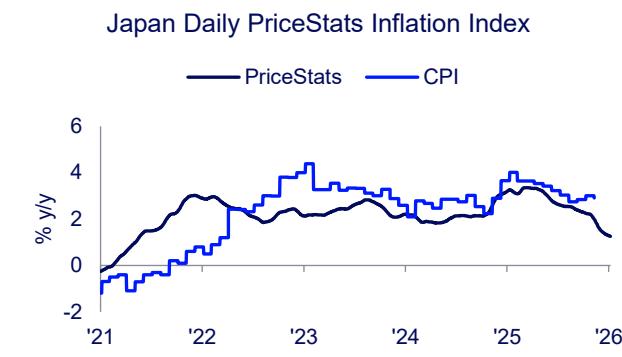


Source: Bloomberg

AN ALTERNATIVE INFLATION VIEW

These trends are reinforced by our timely State Street's PriceStats readings. They were very early in detecting Japan's inflation rise over the past three years—but now show Japanese online prices decelerating and tracking below their long run seasonal trend, as seen in Exhibit 3. This indicates that goods price momentum has cooled despite yen depreciation. While exchange pass- through into inflation can take some time, we interpret this softer trend in online inflation as evidence that any new inflation will depend less on the exchange rate and more on wage led services pricing.

Exhibit 3. Japan Daily PriceStats Inflation Index (% y/y)



Source: State Street Markets

More importantly the softer trend also mitigates concerns of a potential inflation overshoot and the knock-on impact that would have on longer-dated yields and the yen. This is especially prescient as we wait for potentially more expansive fiscal policy ahead after the Japanese election.

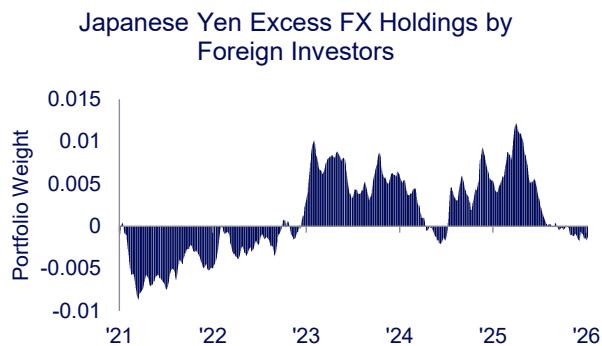
As outlandish as it would have seemed just a few years ago, with real rates still comfortably in negative territory, the yen weak and the planned fiscal stimulus under the new political leadership, the risk of too high an inflation rate in Japan is no longer a matter of obscure tail risk!

OVERSHOOTING RISKS

The concern is that much higher Japanese inflation, rates and yields would have far reaching consequences across global markets. This comes from two potential sources.

First, and most immediately, as the perennial low yielding economy non-Japanese borrowers have amassed significant exposures in recent years. Higher Japanese yields and/or a rapid reversal in yen weakness could produce a destabilizing unwind in these carry trades. However, for now neither the yen nor Japanese rates are at levels that challenge this. State Street's metrics in Exhibit 4 show that international asset managers are neutrally positioned in the currency and indeed the carry strategy as a whole; partially mitigating the near-term risk of more destabilizing FX moves.

Exhibit 4. Japanese Yen Excess FX Holdings by Foreign Investors



CONCLUSION: CARRY ON OR INTERVENE?

Viewed through State Street PriceStats we have been believers of a more durable shift in the Japanese inflation trend for a number of years. The onus is now shifting to an increasingly domestic and wage supported inflation trend. Allied to still accommodative policy settings, the risks of more destabilizing levels of yields are becoming a reality. As we've discussed where Japanese yields, and the yen, finally settle will be a vitally important factor for global markets.

State Street's own metrics on inflation and investor positioning suggest short-term risks are modest. The annual inflation rate is falling again, suggesting little impact from recent yen weakness. While modest yen and carry trade holdings by asset managers reduce the risks of a more violent carry trade unwind for now.

Nevertheless, the shape of fiscal policy after February's election, alongside the inflation trend and response of Japanese policy makers more generally, are all volatility points. The yen and arguably long-term JGB yields are increasingly beginning to reflect fiscal expectations and have moved far from fundamentals; State Street PriceStats PPP metrics suggest the yen is 40% undervalued, while recent moves in yields appear to have occurred on alarmingly low volumes. Most of the time financial markets self-correct such divergences, but on rare occasions they require more direct actions from policy makers. These short-term risks will continue till Japanese bond and currency markets remain highly volatile and detached from value.

Looking farther ahead, it will be important to monitor whether (1) 2026 Shunto base pay outcomes and spillovers remain high enough to support services inflation and (2) inflation expectations remain anchored even if real wages do not improve on the household side. For investors, these dynamics will be central to the BoJ's normalization path. Higher short-term rates can now, it appears, come with a more modest risk of much higher long-term yields. They have already moved. Only at that point we will get, arguably, the most important tests of all. Will foreign borrowers still want to fund in JPY with Japanese rates at neutral levels and will Japanese investors wish to hold so many foreign sovereign bonds with higher (and stable) yields at home? Either way Japan looks set to be one of the most important markets to track in the next 12-18 months.

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