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Feature Articles

This month's focus: Inflation and Investment (2)

Factor Analysis of the Japanese Stock Market during Inflation

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The purpose of this paper is to focus on alpha, not beta, and to explore what strategies are effective during inflationary periods. I examined the various indicators of factor investment that had been effective during the recent deflationary period and analyzed whether they remain equally effective during inflationary periods or they have changed. Inflation beta showed significant predictive power for stock returns during inflationary periods, but there were scattered representative factors, such as value, that did not have a clear relationship with inflation. Contrary to intuition, cash and debt-based financial indicators showed no decrease in preference or avoidance even during inflationary periods. Three out of the four intangible asset-related indicators examined showed a reduction in alpha during the inflationary period. This can be attributed to the shift from disinflation to inflation, where real assets were reevaluated, and the overvaluation of intangible assets was revised. The only indicator that did not show this trend was the alpha of labor costs, a proxy indicator for human capital. One reason for this may be related to the recent human capital boom. The combination of inflation and labor shortages may, in fact, be causing "investment in people" to be highly valued and influencing the stock market's selection of stocks.

Thoughts on Foreign Investment under a Post-deflationary Environment

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Some in Japan argue that an inflationary environment will encourage Japanese investors to invest more overseas, causing the JPY to weaken further. However, the causal relationships and correlations among different variables in financial economics are normally very complex. We should keep in mind that growth in overseas investment over the past ten years and the accompanying yen depreciation have been stimulating inflation.

In this article, I perform a comprehensive examination of the likely future behavior of various types of investors and conclude that overseas investment by Japanese institutional investors, companies, and the government, which have thus far produced JPY depreciation, is likely to be scaled back in the foreseeable future if Japan shifts to a more inflationary environment and JPY interest rates increase further.

In my view, the recent move by individual investors in Japan to increase investment in risk assets, such as Japanese equities and overseas investments, has been partly driven by the introduction of the new NISA scheme. While the financial assets of Japanese households exceed ¥2,000 trillion, with more than half allocated to "safe assets" such as deposits, some in Japan now expect an avalanche of this capital into risk assets given that inflation has started with a weak JPY and higher stock prices.

I fundamentally disagree with the view that such a dramatic change is likely in the foreseeable future. Instead, I argue that understanding developments in the financial assets of Japanese households from a comprehensive perspective is important.

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In fact, portfolio selection by Japanese households has changed little over the past ten years and remains strongly biased toward "safe assets." The weighting of equities has risen somewhat over the last decade, while there has also been steady growth in investment trusts (and accompanying investment in overseas assets). I think this gradual trend is likely to continue, partly because of the new NISA system.
Even so, the most marked change has been a shift within deposits from time deposits to liquid deposits. If JPY interest rates rise in an inflationary environment, the most likely change initially would be a reversal in this via a shift back to time deposits from liquid deposits.
Dramatic growth in risk asset investment will not happen solely because of a shift to mild inflation. Rather, I suggest that in the initial stages of the current post-deflationary economic environment, the JPY is more likely to appreciate than to depreciate.

Inflation and Real Estate Investment

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The global inflation trend has sparked increased interest in the inflation-hedging effect of real estate investments. This paper examines whether real estate investment can serve as a hedge against inflation risk. First, we review the importance of real estate investment for four investment types, the theoretical background of real estate as an inflation hedge, and the existing literature. Using Japanese REIT data, we estimate inflation betas against inflation shocks for total, core, and energy CPI. The results suggest that both the TSE REIT index and individual REITs have limited hedging abilities against unexpected inflation. In particular, longer holding periods significantly increase their ability to hedge the inflation risk.

Use of Commodities in Resource Inflation Risk Management

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The risk of globally polarizing events, such as the Lehman collapse/global financial crisis, US-China conflict, coronavirus pandemic, and Ukraine crisis, have materialized, and inflationary pressures are increasing due to the inflow of excess liquidity. This paper discusses how commodities should be used by market participants and companies in response to heightened inflationary risks.

Articles

The Stable Risk-Return Relationship in TOPIX

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Under the intertemporal CAPM framework, when a strong correlation exists between market volatility and the hedging term, the estimated risk-return relationship of the market portfolio cannot be interpreted as indicative of aggregate risk aversion. To address this issue, a method is proposed using a constrained Markov switching model that reflects the properties of the hedge term. The risk-return relationship of TOPIX estimated using this method demonstrated a statistically significant positive value, with insufficient evidence of its time-variability.

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Articles

An Empirical Analysis of the Voluntary Disclosure of Corporate Misconduct Investigation Findings and Stock Market Reaction: Implications for Corporate Governance

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The negative cumulative abnormal stock return from corporate misconduct is likely to be larger when the results of investigation of the misconduct are disclosed than otherwise. This implies that companies that have committed misconduct tend to voluntarily disclose the investigation findings in proportion to the magnitude of the negative stock market reaction. Additionally, companies with a certain type of institutional design that disclose their investigation results are likely to suffer from a further negative cumulative abnormal return.