Same Consumption Downgrade, Divergent Paths Ahead for China and Japan


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— Recent evidence suggests that the consumption downgrade trend, which has impacted China for several years, is also occurring in Japan.
— Consumption downgrade might be more accurately described as consumption polarization in both China and Japan. Demand for high-end luxury brands and low-end everyday items remains robust, while affordable luxury goods face challenges.
— The root cause of consumption downgrade in China is the negative wealth effect resulting from falling property prices and weak stock market performance, which has a more structural impact. In Japan, it is driven by negative real wage growth and a weakening yen, leading to reduced purchasing power. However, this situation is expected to improve in the next 12 months

Consumption has been a crucial driver for the economies of both Japan and China, but it has fallen short of expectations in both countries recently. In China, the latest retail sales data disappointed the market, reflecting the broader economic slowdown. Investors have also grown increasingly concerned about weakness in the luxury sector, which they see as a harbinger of a more pronounced slowdown in China's retail landscape. On the other hand, Japan has grappled with its own consumption challenges. Despite a strong stock market and rising asset prices, private consumption has lagged due to stagnant wage growth and high inflation. In May, Japan's household spending fell by 1.8% year over year (yoy), defying predictions of a 0.2% increase. This persistent weakness in household spending suggests that the phenomenon of "consumption downgrade" – a trend that has impacted China for some time – now appears to be taking hold in Japan as well.

It is worth noting that consumption downgrades in China and Japan are not reflected in the consumption structure of households at a macro level. Economists often define basic consumption as the minimum necessary spending needed to survive, which includes housing, food costs, expenditure on clothing, and transportation. In contrast, hedonic consumption refers to expenditure that provides pleasure from the consumption experience, including healthcare, education, entertainment, and other service expenses. In both China and Japan, the consumption structures of households and individuals have barely changed over the last 10 years. In fact, the proportion of hedonic expenditure has even slightly increased in China, signaling that Chinese citizens have been spending even more on fulfilling their non-basic needs.

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Chart 1: China Per Capita Consumption Structure: 2014 - 2023

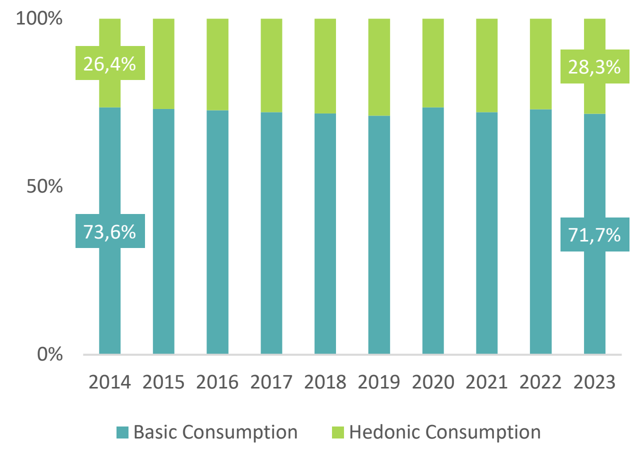
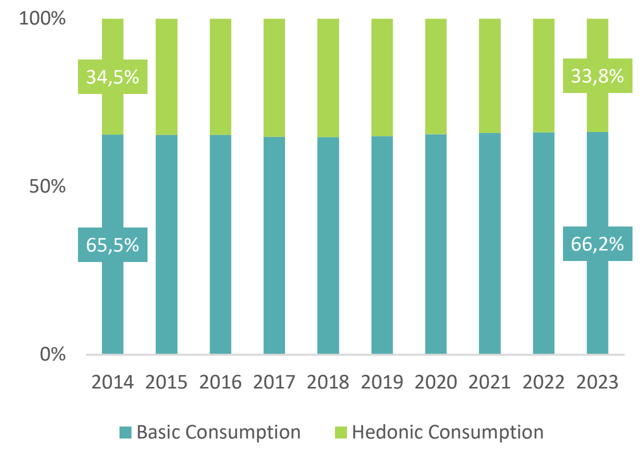


Chart 2: Japan Consumption Structure for Household with 2+ People: 2014 - 2023



Source: National Bureau of Statistics, as of June 30, 2024. **Basic Consumption** includes expenditure on food, tobacco and liquor, clothing and footwear, housing, household equipment and transport and communication. **Hedonic consumption** includes expenditure on education, culture and recreation, health care and medical services and miscellaneous goods and services.

Source: Statistics Bureau of Japan, as of June 30, 2024. Basic Consumption includes expenditure on food, housing, fuel, light and water charges, clothing and footwear, transportation, and communication. Hedonic consumption includes expenditure on medical care, education, culture and recreation and other consumptions.

Consumption downgrades in China and Japan share some similarities. They both reflect the way that people have reduced their consumption of mid-priced goods and shifted their spending towards goods and services that offer better value for money. Taking the fashion industry as an example, there is a consistent trend in China and Japan where the sales revenue of mid-priced brands is declining, while low-priced brands have experienced significant growth post-COVID. It is also important to note that high-end luxury brands have continued to achieve strong sales growth in both China and Japan. Therefore, the polarization of consumption habits is actually happening in both countries.

Chart 3: Revenue from China and Japan: 2019 – 2023 of a Japanese Discount Clothing Brand

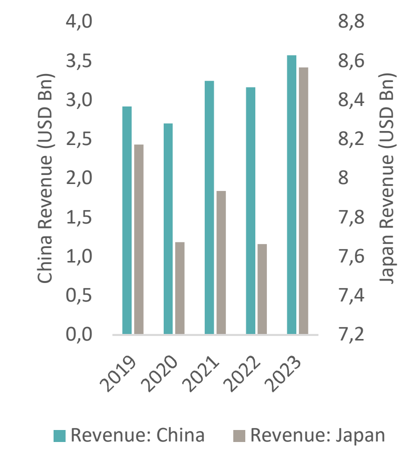
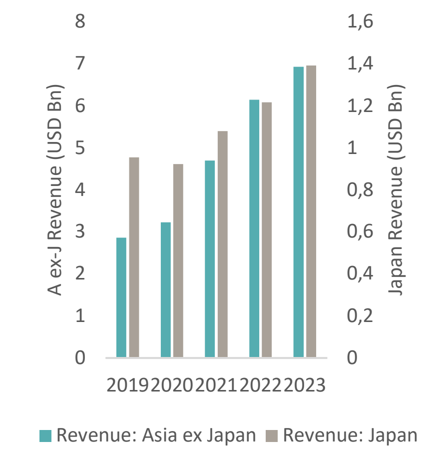


Chart 4: Revenue from Greater China and Japan 2019 – 2023 of a US-based Affordable Luxury Fashion Brand

Chart 5: Revenue from Asia ex-Japan and Japan: 2019 – 2023 of a French Luxury Design Brand



Source: Financial statements of Fast Retailing, Tapestry, Inc and Hermes, as of June 30, 2024.

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While the symptoms of the consumption downgrade trend are strikingly similar in both China and Japan, the underlying root causes driving this phenomenon differ between the two countries. As a result, the future trajectory of consumption patterns emerging from this downgrade is also likely to diverge.

In China, the consumption downgrade is largely driven by falling home prices due to the PRC's measures to curb property prices since 2019, magnified by disappointing stock market performance. These factors are believed to have a pervasive effect in China, where 70% of household assets are tied up in property. In other words, the phenomenon is caused by the negative wealth effect, which is more structural since the slump in property prices is anticipated to persist as the government's support measures disappoint. The Third Plenum, which recently concluded in Beijing, indicated plans to reform the consumption tax. This reform aims to allow local governments to receive a larger share of the tax revenue, fueling market speculations that a consumption tax on luxury goods may be introduced. Such a move could further reduce the onshore consumption of luxury items in China.

Chart 6: China House Price Change over the Last 6 Years

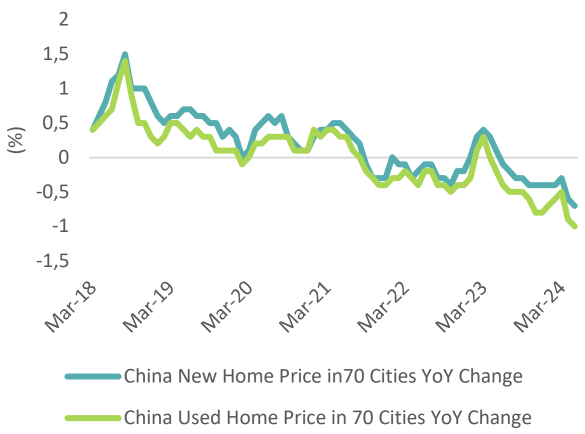

Chart 7: CSI 300 Index Price Development over the Last 6 Years

Source: WIND, as of June 30, 2024.

On the contrary, the recent consumption downturn in Japan was due to stagnant wage growth amidst rising inflation, fueled by a weakening yen that has made the price of imports more costly. Hence, the cause of Japan's consumption downgrade is a fall in purchasing power, which, however, is expected to change in the next 12 months with the gap between US and Japan interest rates narrowing down. Although consumption remains weak, the strong wage growth resulting from the spring wage negotiation is expected to be reflected in the wage data from H2 2024. While the Consumer Price Index (CPI) in May has rebounded slightly to 2.8% year-over-year from 2.5% in April, it is on a downward trajectory. The uncertainty lies in whether the Japanese yen (JPY) would continue to weaken against the US dollar (USD).

As a result, the investment implications for investors who want to take advantage of consumption polarization are also different. In China, where consumption downgrade is expected to persist, low-cost consumer staples providers who offer good value for money and proactively expand overseas to look for additional growth drivers are poised to grow further. Spiritual and cultural consumptions such as gaming and video might also benefit since consumers could obtain fulfillment via spiritual consumption instead of material consumption. In Japan, it might be worth considering buying into affordable luxury goods providers that are expected to benefit from a rebound of demand for mid-priced goods and services as a result of an expected increase in real wage.

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