30 September 2017

Tactical dissolution in Japan, 180-degree turn for Shinzo Abe

GDP up +2.5% yoy. Positive contribution of exports and consumption. Improvement in earnings growth outlook. Nikkei relatively attractive.

Key points

- GDP growth in Japan accelerates to +2.5% yoy
- Export boom continues (+18.1%)
- Trade balance grows to 113 billion yen
- The North Korean crisis fails to affect private consumption, up +0.6%
- Wave of positive economic indicators in September
- Tactical dissolution of the lower house
- Snap election likely favourable to the LDP
- Status quo at the BOJ and yen stable in the 110-120 range
- Avoid bonds in spite of persistently low inflation
- Japanese equities remain relatively attractive

GDP growth accelerates in Japan

The latest revision of Q2 growth figures (+2.5% yoy) continues to sustain expectations of a sharper economic upswing in 2017 and could lead annual growth results to beat beginning-of-the-year forecasts.

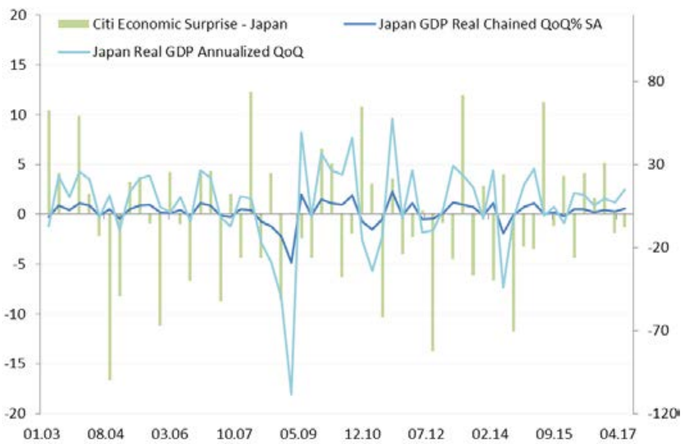
GDP growth is thus strengthening further after having already advanced +1.7% and +2.2% over the past two quarters.

Japan is currently posting its sixth consecutive quarter of GDP growth, its longest expansion phase in 10 years. The Japanese economy has been given a boost by the continued recovery in exports and is now benefitting from increasing momentum in domestic demand.

These results were nevertheless somewhat disappointing given the consensus growth forecast of +2.9%. However, these developments bolster our positive projections regarding Q2 economic growth in Japan. We expect the Japanese economy to continue to improve and potentially post growth in excess of +2.5% for FY2017.

Nominal GDP was revised down from +4.6% to 3% yoy and +1.4% for the quarter, but overall the figures published indicate that economic growth is accelerating, thanks to private spending (+1%) and exports (+0.5%) in particular.

GDP (quarterly and annualized)



Sources: Bloomberg, BBGI Group SA

In August, exports registered their highest growth rate since 2013, surging +18.1% (annualized). We expected export growth to continue gaining momentum, which indeed it seems to have done in Q3. Even if the yen has risen slightly against the dollar (+3.6%) year-to-date, it has nonetheless depreciated -11.5% yoy.

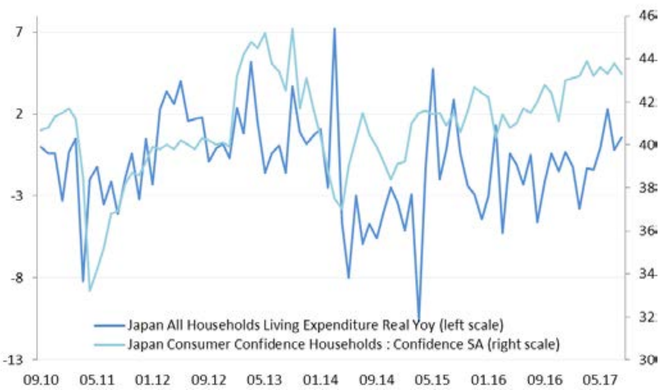
The export boom continues

The Japanese economy is indeed experiencing its highest rate of export growth since November 2013. The country's economic recovery will benefit from a more favourable economic climate globally and from the traditional growth factors of the Japanese economy, very oriented toward international trade during the second half of the year. Shipments of cars, car parts and semiconductor manufacturing equipment were the main drivers of export growth, in particular to the US (+21.8%). With regard to imports, the pace of growth was more measured (+15.2%), though slightly above expectations. Japan's trade balance thus expanded, posting a surplus of 113.6 billion yen. The improvement in Japan's foreign trade is an encouraging sign in terms of future GDP growth. Japan's current account balance also improved, growing from 1.5 to 2.03 trillion yen in June.

The North Korean crisis is not affecting the upward trend in private consumption

Although indicators are not showing a clear trend, consumer spending seems to be perking up. Nevertheless, Japanese consumers are staying cautious overall. This lack of enthusiasm likely stems in large part from limited growth in incomes and wages. Private consumption will thus remain only a weak driver of GDP growth, pending sharper increases in household incomes.

Household expenditures/consumer confidence



Sources: Bloomberg, BBGI Group SA

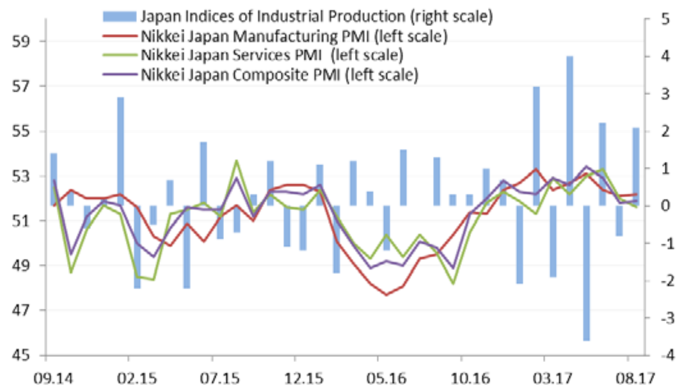
The political uncertainty generated by the North Korean crisis has not had any major impact on (growing) vehicle sales or on supermarket retail sales, up +0.6%.

Overall, real household expenditures have jumped up +0.6% yoy, in concert with disposable income, up +1.6% yoy. Private consumption, which still accounts for close to 60% of Japan's GDP, is thus on the path to recovery, although uncertainty lingers given an economic context and climate that remain tentative in spite of the further decrease in the unemployment rate to 2.8%. Household consumer confidence remains high (43.3), and the unemployment rate may well be approaching full employment levels. Accordingly, the jobs-to-applicants ratio has also reached its highest level in 30 years at 1.52. The BOJ's outlook on inflation growth has always been based on an increase in wages, boosted in particular by corporate earnings growth and thus by the partial redistribution of these earnings in the form of general wage hikes. In our view, these circumstances are more likely to occur in the second half of the year.

Wave of positive economic indicators

The third largest economy in the world is on a better footing, and leading indicators seem to be pointing further in this direction. The upturn in exports and external demand, bolstered in part by a more favourable global economic environment and rising investments in Asia, is now having a discernible impact on industrial production and on the sector's outlook. In August, industrial production grew +2.1%, or 5.4% annually, after slowing down in July (-0.8%).

PMI indices and industrial production



Sources: Bloomberg, BBGI Group SA

This impact is finally noticeable and surprisingly strong. Leading indicators are now suggesting that production will continue to increase in Q3, which will no doubt boost GDP figures for the same period. Inventories are down, indicating a forthcoming increase in production. The services PMI confirms this advance, progressing to 52.6, which is an encouraging result in the medium term given new orders have also risen to 52.5. The optimism of companies in the industrial sector in Japan has reached a 10-year high. Manufacturing confidence jumped 5 points in September. The trend is similar for companies in the services sector. These elements are moreover particularly timely from a political standpoint, as they strengthen the perception that the plan implemented by Prime Minister Shinzo Abe has been effective, just as he has launched his parliamentary election campaign.

In Q2, Japan posted its sixth consecutive quarter of GDP growth, which is its longest growth streak since 2005. The upturn in exports that had been expected in the wake of the yen's depreciation materialised, due in particular to the improvement in global economic conditions. The yen has strengthened slightly against the dollar ytd (+3.6%), but yoy it has depreciated -11.5%. The success of Abenomics is thus perceptible at the GDP level but has yet to have a real impact on inflation and purchasing power.

Tactical dissolution of the lower house

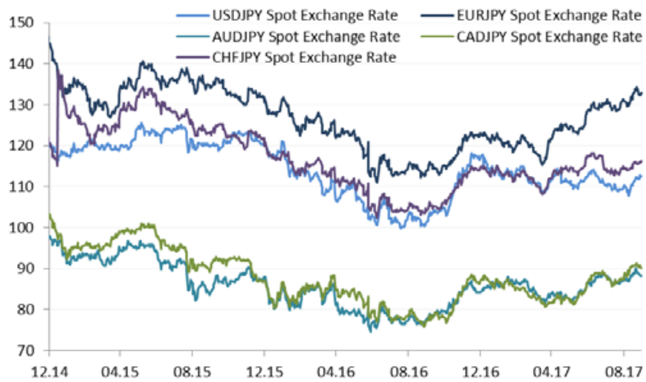
On Thursday, 28 September, the prime minister announced the dissolution of the lower house of parliament in accordance with Article 7 of the Constitution, thus triggering snap elections. Shinzo Abe's decision to call for early elections on 22 October is no doubt related to the relative improvement in the country's economy in the last several quarters. Five years after launching his ambitious recovery programme, it must be noted that, while results are in part satisfactory, certain promised reforms are progressing slowly. In deciding to dissolve the lower house of parliament one year before the end of his term, he is attempting to garner further support to fast-track his plans to increase public spending. It is true that the proposed 180-degree turn could win over the electorate, since the additional funds raised by the VAT increase from 8 to 10% would be allocated to the population and not to reducing public debt as initially planned.

The public debt, amounting to 240% of GDP, will thus not be reduced, since the additional funds will be earmarked for families, the elderly, and education. As the VAT increase is only scheduled to take place in 2019, an extra budget increase of 2 trillion yen will be implemented. Given this programme, it is not surprising that Shinzo Abe is impatient to hold early elections that will likely lead to another LDP victory. The Japanese leader's popularity had already risen following his firm handling of the Korean crisis; he is thus taking advantage of the opportunity to pull the rug out from under the feet of his rival, Ms Koike, who just announced the launch of the Party of Hope, thus leading to the implosion of the Democratic Party, until then one of the main opposition forces. Although it is not considering merging, the Democratic Party will leave its candidates free to join Ms Koike's party. This is not a new strategy for Mr Abe, who had already experimented with the technique in 2014 and who thus hopes to further strengthen his numbers in the lower house. With its ally Komeito, the LDP currently holds 322 out of 465 seats.

Status quo for the BOJ and a stable yen

The Bank of Japan maintained its economic outlook and kept monetary policy steady during its last meeting on 21 September 2017, as it continues to anticipate that economic improvements will lead to a rise in inflation toward its 2% target. There was some dissent, as one of the new board members stated that current policies were not sufficient to push inflation up. The short-term interest rate objective remains unchanged at -0.1%, as does the goal of steering 10-year rates close to 0%. The Japanese currency did not react significantly to this announcement or to the improvement in economic growth expectations of the past few weeks. We still believe that the improvement in fundamentals will not have any immediate impact on the yen, which will likely remain on the sidelines due to an entirely unfavourable interest rate environment.

Yen against USD, EUR, AUD, CAD, CHF



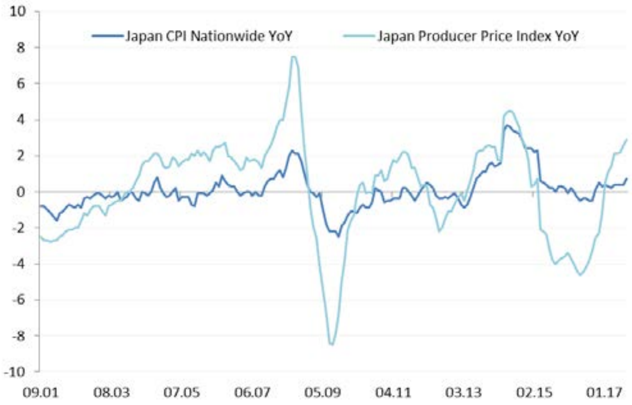
Sources: Bloomberg, BBGI Group SA

Government policy thus continues to seek to weaken the yen, as interest rate spreads and the prospect of further rate hikes in the US will likely weigh further on the Japanese currency in 2017. A weaker exchange rate was one of the key elements of the government's policy to boost inflation and exports. This policy remains current, and we continue to predict that the yen will return to a fluctuation range of 115 to 120 yen to the dollar over the next several months.

Avoid bonds even though inflation remains low

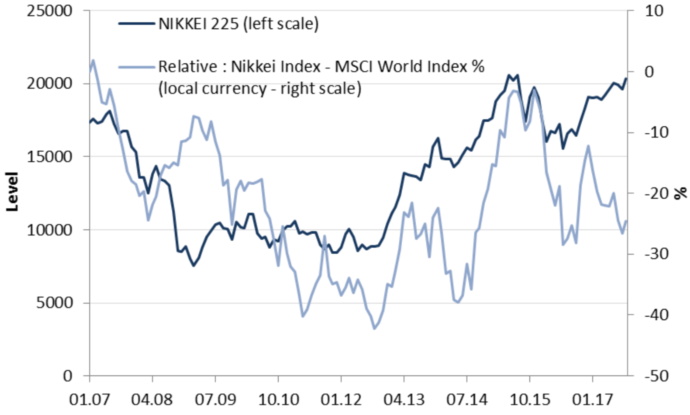
The incipient signs of an uptick in price indices have strengthened somewhat, with the national CPI index progressing +0.7% annually in August. However, inflation is still nowhere close to the BOJ's target. The best hope of a lasting increase in prices continues to be a further weakening of the yen. The change of circumstances with regard to inflation is still too recent and too imperceptible a phenomenon to have a significant impact on interest rates. At this time, the Japanese bond market is not a worthwhile prospect for foreign investors.

Inflation (CPI and PPI)



Sources: Bloomberg, BBGI Group SA

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

Japanese equities still relatively attractive

At the beginning of the year, we were predicting that an acceleration in the growth of Japanese corporate earnings was highly likely, due in particular to the improvement in global economic conditions and to the depreciation of the yen. Reported results have indeed exceeded expectations, and earnings forecasts for the next twelve months are thus being revised upward. Dividend distributions of listed companies could thus increase for the fifth consecutive year.

Several months ago, we had already noted that a weaker yen would likely be the determining factor in any forthcoming increase of the Nikkei, potentially pushing Japanese equities toward their highest levels since 2015. It turns out the Nikkei is now only 600 points (or +2.8%) away from its 21,000-point high. In spite of this progression, the performance of the Japanese market (+6.7%) has lagged slightly behind that of the US (+12.8%) and European (+9.3%) markets in 2017.

By international comparison, Japanese equities (15.8x 2018) are slightly less expensive than US equities (17.4x 2018) in PE terms. Balance sheets are solid overall, and changes implemented to improve corporate governance are noteworthy.

However, it must be emphasized that any future increase in the Nikkei depends at least in part on maintaining a weak exchange rate against the dollar. Currency risk must thus be factored in with regard to overall exposure to Japanese equities.

The market still provides some opportunity for positive surprises and for readjusting expectations over the next several quarters.

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