BearBull Global Investments Group

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Strong yen threatens GDP growth and the equities market

It is essential that the yen weaken. Consumption and leading indicators are wavering. Exports and corporate earnings are faltering. Going long the Nikkei is premature.

Key points

- The strong yen is threatening Japanese growth
- Risk of economic slowdown in Q1 2018
- The export cycle has already decelerated
- Corporate earnings growth is faltering
- Private consumption trends remain moderate
- Leading indicators are lacklustre
- The yen has temporarily regained its safe haven status
- The BOJ has no choice but to persist with its monetary policy to weaken the yen
- Finally some signs that inflation is gaining momentum
- Still too early to go long the Nikkei
- Underweight Japanese equities
- The yen must weaken

The strong yen is threatening Japanese growth

Japan's GDP growth ultimately turned out to be rather solid in 2017, although it closed the year on a weak note, with an annualised growth rate of +1.6% in Q4. Quarterly growth figures were relatively volatile, with Q3, for instance, coming in at +2.5%. The Japanese economy thus wrapped up the year on less positive footing, even though it extended its current growth phase by posting its eighth consecutive quarterly progression.

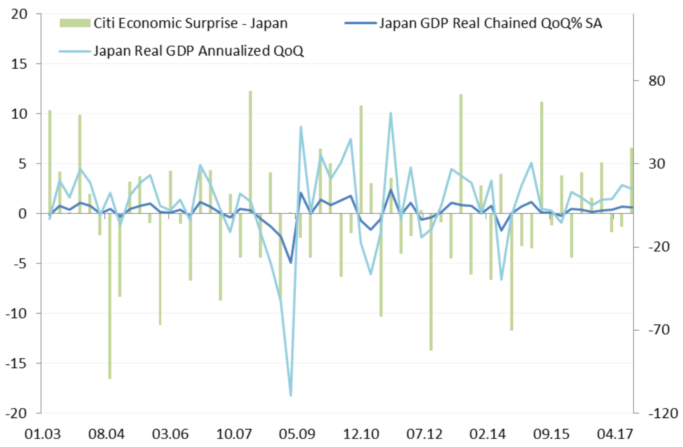
Japanese GDP growth has lost some of its momentum, while the international economic environment has simultaneously strengthened. Over the next several months, growth could slow further due to the yen's strength in the past few months.

Indeed, the Japanese economy will likely slow down in the first part of 2018 due in particular to the yen's +10% rise against the dollar.

The unexpected strength of the yen is clearly threatening exports and corporate earnings, which have been significant drivers of economic growth.

The Japanese economy has indeed been bolstered by an environment conducive to export growth and by an upswing in investment. However, export growth has already been flagging for several months, and even if in January it clocked in at +12.2%, this is still significantly below the +18% growth rate posted in August.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

The Japanese economy is thus likely to flounder in the absence of a weak currency at the very moment when domestic demand is in dire need of a confidence boost as well as genuine growth in wages and household disposable income. While corporate earnings growth should have led to wage increases, the growth rate actually dropped from +5.5% to only +0.9% between Q3 and Q4 2017. We are now far from the +26.6% growth rate posted in Q1, hence calling into question the outlook for an increase in consumption. The strengthening yen is thus a significant threat to the Japanese economy, which is in no state to withstand a lasting appreciation of its currency. The BOJ is no doubt aware of the significance of this factor, but it has no further means at its disposal to counter the negative impact of a strong currency other than those already implemented.

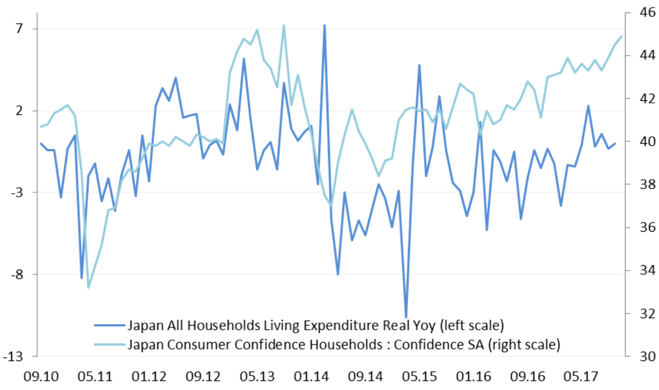
This situation is relatively concerning and calls into question the economic outlook for Japan over the next few quarters. If the yen does not depreciate in the near future, we expect economic growth in Japan to be more uncertain in 2018.

GDP growth will likely receive less support from external demand while at the same time suffering from slowing domestic demand. Any hope of an economic upswing in 2018 thus rests upon a reversal of the current exchange rate trend and a net depreciation of the yen.

Private consumption trends remain moderate

In this context, it is hardly surprising that Japanese consumers are staying cautious overall. Indeed, no solid trend is visible in terms of indicators pertaining to domestic consumption, although the latter is likely to pick up somewhat in conjunction with positive developments in the job market and in the economy. Limited income and wage growth remains a major cause of this lack of enthusiasm. Consumption will thus remain a weak driver of GDP growth pending a sharper increase in household income. Overall, real household expenditures have in fact progressed, with an encouraging growth rate of +2% yoy in January. However, annual household income stagnated (+0.2%) in nominal terms and decreased by -1.5% in real terms. On a quarterly basis, GDP's private consumption index was up +0.5%, which explains the relative stability of household confidence, which declined only slightly from 44.7 to 44.4, still close to the 10-year high reached in 2013. The job market context will likely help improve household sentiment, as the unemployment rate dropped further from 2.8% to 2.4% and may presently have reached the threshold of full employment. The jobs-to-applicants ratio has logically also reached its highest level in thirty years at 1.59, slightly higher than in the previous quarter.

Household spending/consumer confidence



Sources: Bloomberg, BBGI Group SA

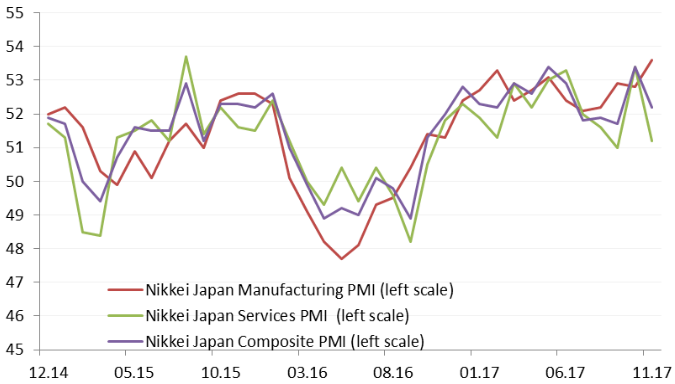
Consumption could thus remain a significant contributor to GDP growth, but it will remain structurally weak as long as the distribution of income derived from growth is not more balanced. Indeed, the improvement in corporate earnings has yet to result in the expected wage hikes.

The BOJ is still hoping this redistribution of earnings will occur in order to boost inflation and consumption. While it has not yet come to pass, we believe it is now more likely to do so. However, a depreciation of the yen remains an essential condition for that to happen.

Leading indicators remain lacklustre

Rising uncertainty linked to Q4 results will not be alleviated by leading indicators in the short run, as the latter remain relatively lacklustre. The Japanese economy is growing, but hesitancy remains, and the likely temporary strength of the yen is not reassuring. The upswing in exports and external demand, supported in part by a more favourable international business cycle and by growing investment in Asia, initially had a visible impact on industrial production and on the outlook for the sector, but leading indicators are not pointing to any further acceleration at the outset of 2018. In fact, industrial production exhibited extreme volatility in January (-6.6%), resulting in a sharp correction of the annual growth rate from +4.4% to only +2.7%. Rising inventories over the past several months were indicating a likely decrease of future business activity and industrial production, but the decrease has been more substantial than expected. The trend remains positive though it was significantly destabilized by the yen's rise. The global PMI dropped further from 52.8 to 52.2 in February, reaching 2017 lows. The services PMI held steady at 51.7, slightly below its January level, suggesting a deceleration in the growth of new contracts.

PMI indices



Sources: Bloomberg, BBGI Group SA

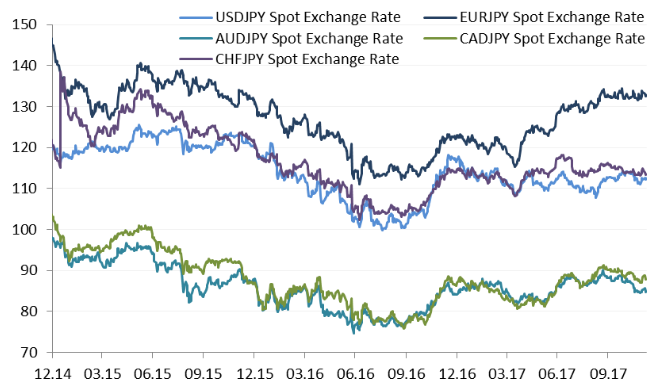
The manufacturing PMI slid from 54.8 to 54 in February as a result of the yen's appreciation, although the collapse in the new orders sub-index was rather more significant (from 57.4 to 54) and more worrying in terms of future growth, even if this indicator remains in an expansion zone for the eighteenth consecutive month.

The yen temporarily regains its safe haven status

The Bank of Japan still does not have much room to act in terms of reaching its 2% inflation target (January CPI was 1.4%). It has not changed its assessment of economic conditions and is maintaining its monetary policy of low rates and monetary injections. The Bank is still hoping that economic growth will be sufficient to drive inflation up toward its target. The short-term interest rate objective remains unchanged (-0.1%), as is the aim of steering 10-year rates toward 0%. Governor Kuroda is unlikely to change the Bank's policies, which will remain a significant factor in the eventual decline of the Japanese currency. We continue to believe that an improvement in fundamentals will not have an immediate impact on the yen, which will continue to be disregarded by investors due to an utterly unfavourable interest rate environment. The government's policy is thus still to weaken the yen, as interest rate spreads are likely to widen and penalise the currency. The on-going normalisation of US monetary policy along with expectations of further increases in long-term rates in the US will likely further weigh on the yen in 2018. A weaker exchange rate has been one of the key elements of the government's policy to boost inflation and exports. This policy remains relevant. A change in monetary policy is indeed unlikely in 2018, even if the BOJ has significantly reduced the pace of its asset purchases, to the point where its balance sheet contracted ever so slightly for the first time in December. We do not believe this event heralds a change in monetary policy, even if Governor Kuroda recently announced that he would normalise the Bank's policy if its inflation target were achieved.

The yen has benefitted from its safe haven status over the past several weeks, but the currency will likely weaken again and draw closer to the high end of the band within which it has fluctuated over the past twelve months (USD 110, CHF 110, EUR 135).

Yen to the USD, EUR, AUD, CAD, CHF

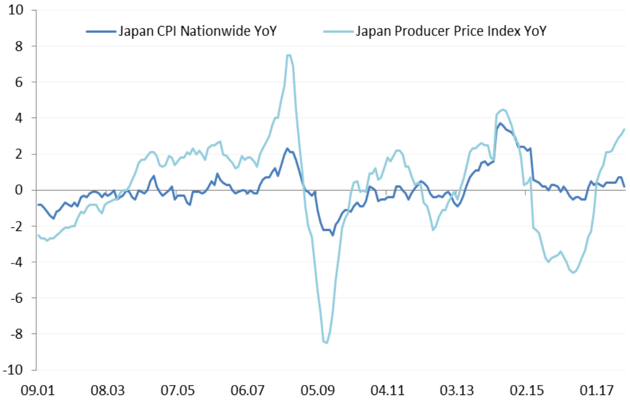


Sources: Bloomberg, BBGI Group SA

Finally some signs that inflation is gaining momentum

The upswing in price indices was petering out at year end but could pick up again at the beginning of the year, as signalled by the CPI's +1.4% increase in January and the February data for Tokyo, a more reliable indicator of the evolution of prices in the country overall. The best hope for a lasting rise in prices is for the yen to depreciate, although tightness in the job market may now finally have an effect on wages and prices. Indeed, the unemployment rate fell to 2.4% in January, significantly below expectations (2.8%). The BOJ could thus shortly see its expectations finally materialise, although we are still far short of the stated 2% target. A weaker yen remains a crucial factor in terms of boosting corporate earnings and wage growth. In this context, the Japanese bond market still fails to offer any interesting opportunities for foreign investors.

Inflation (CPI and PPI)



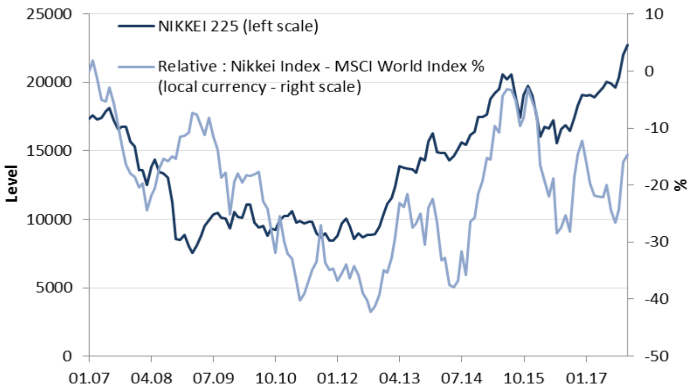
Sources: Bloomberg, BBGI Group SA

Still too early to go long the Nikkei

In December 2017 we recommended that investors take profits in the Japanese market as it reached the 23,000 mark. Since then, a fall-off in international stock markets likely contributed to investors' awareness that Japanese equities remain very dependent on the exchange rate. The Nikkei's -13% drop to 21,000 points was among the steepest of the developed markets. Several weeks ago we cautioned that it seemed unlikely that Japanese equities would continue to rise in 2018 if the monetary context did not become more unfavourable to the yen. The yen's +6% increase against the dollar, along with renewed uncertainties among investors at the beginning of the year, was thus a key factor in the weakness of Japanese shares. Today we believe that an uptick in the earnings growth of Japanese companies is still likely, due in particular to the upturn in the global business cycle; however such growth is ever more dependent on a depreciation of the yen. Results posted were indeed better than expected, leading to upward earnings revisions for 2018.

The most recent earnings season has thus led us to expect an increase in profits for the period ending on 31 March 2018, possibly higher than the 13-15% consensus forecast, in a possibly somewhat cautious forward guidance context. Listed companies' expected divided distributions could progress for the fifth consecutive year.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

In December, we recommended that investors take profits in the Japanese market as the Nikkei reached new highs. Japanese equities were then trading at 19x expected March 2018 earnings (17x 2019), which could still be considered reasonable, given the likelihood of positive surprises with regard to full year results. However, while their valuation was in fact similar to that of US shares, we cautioned that currency risk had to be taken into account. Even though the market was still offering opportunities for positive surprises and upward revisions over the next several quarters, the high valuations warranted profit-taking pending better opportunities.

Valuations fell by 10% and are now less excessive. However, Japanese shares are unlikely to be able to free themselves from a stock market climate still marked by uncertainty with regard to rising interest rates. Thus, pending better visibility and an adjustment in the exchange rate, it seems somewhat premature to reinvest in the Japanese market.

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