10 December 2018

Sharp slowdown in Japan: GDP drops by -0.6% in Q3

Sharpest contraction of GDP since 2014. Economic rally in Q4. Stabilisation of the yen. Leading indicators weighed down by uncertainty. Inflation reaches +1.4%. Nikkei on the upswing.

Key points

Unexpected growth shock in Q3; Japanese GDP dropped by -0.6%, or -2.5% yoy

Exports pick up in Q4

Trade balance turned negative

Imports jumped by +19.9%

Increase in wages not sufficient to boost consumption

Leading indicators weighed down by uncertainty

Yen weaker still in 2019

Inflation reached +1.4%

Outlook still mediocre for Japanese bonds

Nikkei and Japanese stocks on the upswing

Unexpected growth shock in Q3; Japanese GDP dropped by -0.6%, or -2.5% yoy

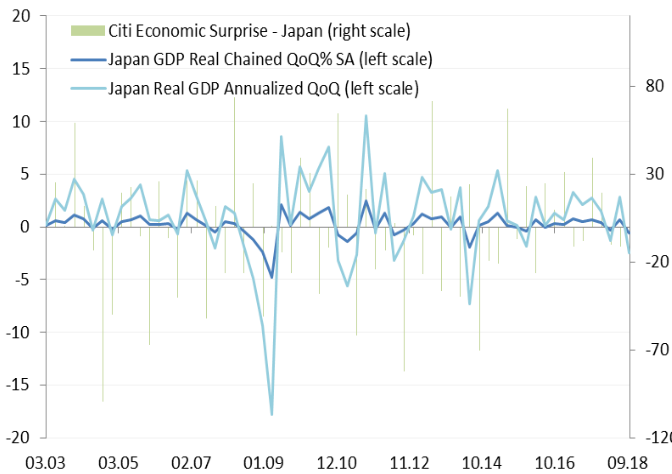
Given the significant instability of Japan's economic performance, several months ago already we questioned the sustainability of the country's remarkable growth rate of +0.7% in Q2 (+3% annualised), the fastest growth rate posted since 2016. We predicted that GDP growth was unlikely to maintain this pace, in particular in the context of intensifying risks of trade tensions and a decrease of economic activity in Asia. Nevertheless, the growth shock caused surprise when the revision of growth figures, first published in November, showed that GDP had contracted by -0.6%, i.e. more than expected. In fact, it was the sharpest contraction since 2014.

Unfortunately, these results confirmed the instability of Japan's economic performance over the past quarters.

Q3 results thus almost completely wiped out the exceptional performance generated in Q2, leaving little opportunity for the situation to reverse significantly for 2018 in Q4.

The Japanese economy thus contracted more sharply, essentially due to a steep drop in corporate spending. Natural disasters that hit Japan also played a role in this phenomenon and can in fact explain the contraction, which was the strongest of the decade.

GDP (quarterly and annual)



Sources: Bloomberg, BearBull

The impact of natural disasters on GDP was indeed significant. However, with regard to corporate capital expenditure (-2.8%), it should be noted that the contraction followed a particularly solid quarter (+3.1%). Nevertheless, this element somewhat calls into question the positive perception of an improvement in business confidence, even though leading indicators are still not very optimistic. Exports, a key component of Japanese GDP, were also affected by these extraordinary events. The -1.3% contraction in September thus diverged from the positive monthly results posted since December 2016. The +8.9% jump in October hinted at a welcome rally in Q4 for this segment. Private consumption was also weaker, declining by -0.2%. However, it was mostly the slump in non-residential private investment expenditure (-2.8%) that weighed on the revised figures.

Q4 results will likely not paint such an indecisive picture of the Japanese economy as did performance in Q3. The risks of a trade war continue to constitute the main threat to Japanese growth, in particular given that the yen is likely to continue to stabilise over the next few months. Indeed, the monetary factor remains one of the key elements with regard to generating more positive growth.

Exports pick up in Q4

September was a particularly difficult month for the Japanese economy, which was impacted by several natural disasters with significant direct and indirect effects on several sectors. Japanese exports, which had been negatively impacted (-1.3%) in September by typhoons and earthquakes, rebounded very significantly in October (+8.2% yoy).

These results are especially important given the dependence of the Japanese economy on the export sector; Japanese growth is indeed particularly influenced by the health of the country's export sector. The upswing in the latter thus suggests a more positive last quarter in terms of GDP growth. The semi-conductor, electronic component, and vehicle sectors contributed to this upswing, thus boosting confidence in the on-going improvement in these sectors.

Trade balance turned negative

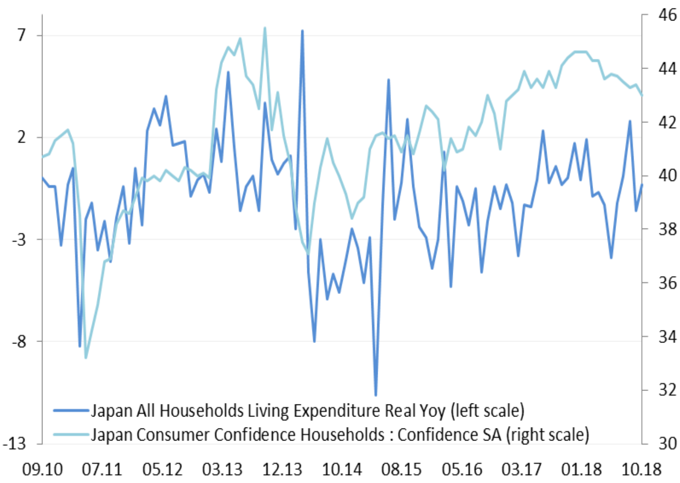
Foreign trade results indicated a further deterioration of Japan's trade balance. While it was positive in 2016 and 2017, it turned negative in the past several months, posting a -302 billion yen deficit in October, after having achieved a surplus of +453 billion yen in April 2018. The +19.9% increase in imports, the largest increase since 2014, accounts for how a substantial surplus turned into a significant deficit. Energy costs were the most crucial factor, with a +33.7% increase in crude and LNG prices.

By region, Japan still has a surplus of 550 billion yen with the US, partially compensated by a deficit of over 400 billion yen with China and a negative balance of approximately 70 billion with Europe.

Increase in wages not sufficient to boost consumption

Wages increased by +1.5% yoy in October, which in real terms (-0.1%) is still insufficient to boost consumption. The +2.8% increase in August was short-lived. The -0.3% decrease in October followed on the heels of a -1.6% decrease in household spending in September. Japanese consumers thus remain particularly cautious, in spite of a still very low unemployment rate (2.4%), wage growth, and an increase in corporate earnings. Consumer confidence has been steadily decreasing since the beginning of the year (44.6) and still did not seem to stabilize in November (42.9). More will likely be needed for a clearer and more lasting trend to take hold.

Household spending / consumer confidence



Sources: Bloomberg, BearBull

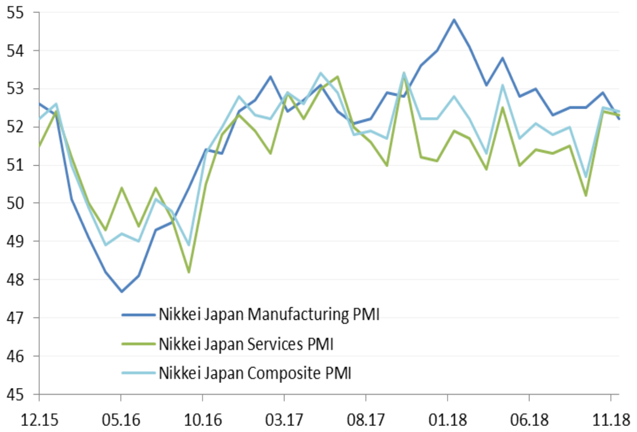
However, overall retail sales increased by a promising +1.2% in October, or +5.8% yoy. Vehicle sales dropped slightly in November but were still up +8.3% yoy. Nevertheless, more substantial improvement in the job market and more significant transmission of corporate earnings growth into wage increases are needed to boost household confidence and consumption levels in Japan.

Leading indicators weighed down by uncertainty

Uncertainty continues to weigh on leading indicators as 2018 comes to a close. Business leaders sentiment is still not significantly improving in Japan, as in most countries. The wrestling match initiated by the US president remains the key factor of uncertainty in Japan as well, in spite of the truce negotiated on 30 November.

The stabilisation of the yen after a correction of approximately -10%, although favourable to large Japanese export companies, does not seem sufficient to allay the concerns of purchasing managers, who still prefer to remain cautious given the persisting risks of a major trade war. The Japanese economy, which was booming in Q2, suddenly and unexpectedly contracted (-2.5% yoy), thus confirming the hesitancy seen in surveys. The PMI indices have been stabilising for several months but are still not showing clear signs of an upturn following the steady decline seen in the first half of the year.

PMI indices



Sources: Bloomberg, BearBull

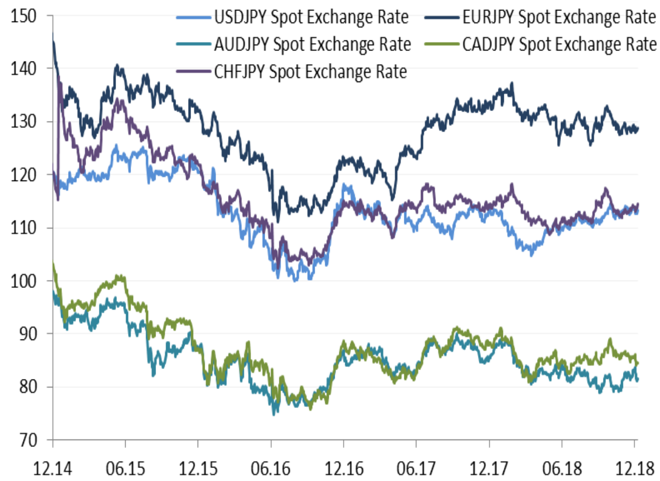
In November, the manufacturing PMI improved slightly (52.2) over October (51.8); even so, it did not point to any upturn in the industrial sector over the next few months. When industrial production came in at +2.9% for October it was thus a positive surprise, possibly offering clearer signs of an upturn in activity following a gloomy Q3. The composite index remained at 52.4, still close to its 2017 lows, bolstered by the more positive trend in the services PMI, which posted a heartening increase in October and stabilised at 52.3 in November.

Yen weaker still in 2019

We are not changing our outlook for the yen, which remains bearish for 2019. We had been mentioning for several quarters already that a weak yen is a necessary condition for growth to pick up in Japan. A weak yen would breathe some life into the Japanese economy and enable it to resume a more sustained pace of growth. We also predicted that a 10% depreciation of the Japanese currency against the dollar, which would bring the exchange rate from around 105 in March to 115 in Q2, would be sufficient to contribute to an upturn.
In our March analysis, we noted that the strength of the yen was in part tied to its safe haven status in an uncertain context and predicted that the exchange rate would likely fall back to 110-115 when financial market volatility decreased. Monetary policy still aims to weaken the yen, but available means remain limited.

We continue to expect that investors will shun the yen given a totally unfavourable interest rate environment and rate spreads that are likely to continue to penalise the Japanese currency. The implementation of monetary policy normalisation as well as the prospect of further increases in long-term rates in the US are thus likely to weigh more heavily on the yen in 2019. After reaching our 115 target, the yen will likely stabilise before weakening once again.

Yen against USD, EUR, AUD, CAD, CHF



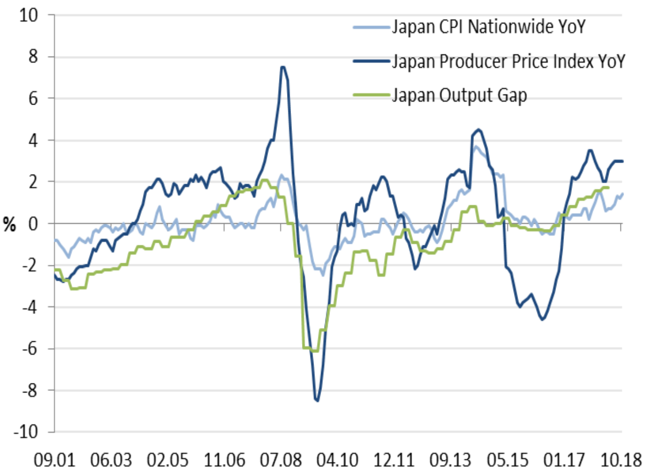
Sources: Bloomberg, BearBull

Outlook still mediocre for Japanese bonds

Q2 saw a welcome increase in price indices. Indeed, they slackened only over the period in which the yen was appreciating. Inflation (CPI) rose above 1%, establishing itself at 1.4% in October. An upswing in prices was conditioned upon on a depreciation of the yen, but inflation is still far from the BOJ's target (2%), and production prices are not displaying sufficient momentum to establish a more robust trend overall.

However, the current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors.

Output gap and inflation (CPI and PPI)



Sources: Bloomberg, BearBull

Nikkei and Japanese stocks on the upswing

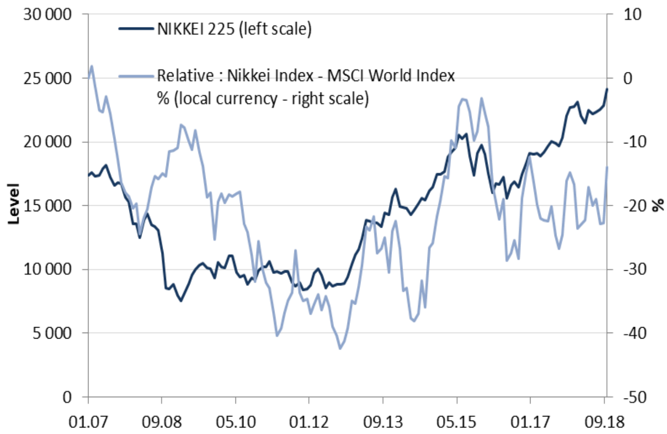
Japanese firms will likely benefit from a favourable global macroeconomic context in 2019, in spite of the current fears of an economic slowdown and a depreciation of the yen. The Bank of Japan's Tankan survey actually indicated a decrease in the confidence of large manufacturing firms, although average exchange rate forecasts for the end of the year (107.4 yen to the dollar) were well below current levels (113 yen). This gap, if it should persist as we believe it will, should lead to upward revisions in Japanese corporate earnings.

The earnings growth of +17.9% yoy announced at the end of June dropped to a mere +2.2% at the end of September. An acceleration of Japanese corporate earnings growth is thus possible in a context of sustained global economic growth, if the risks of a trade war do not intensify. The drop in share prices and the decline in equity valuations to 15x earnings provide an attractive repositioning opportunity.

Today, Japanese blue chips are valuing revenues and profits using an exchange rate estimate of approximately 107 yen for the current fiscal year. As we mentioned, the yen is currently trading at close to 115 against the US dollar.

We expect the exchange rate to stabilise between 110 and 120 yen for the end of the year and for 2019, which should ultimately significantly bolster corporate results at the end of the Japanese fiscal year.

Nikkei and MSCI World indices



Sources: Bloomberg, BearBull

Further depreciation of the yen will thus likely sustain a further upswing of the Nikkei, provided that the investment climate also improves and that the risks that are currently weighing on the global growth outlook recede.

BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae