Economic Research

WEEKLY ANALYSIS

Alain Freymond
Partner & CIO

18 March 2019

Positive surprise with Japanese GDP up +0.5% in Q4

Economic upturn in Q4. Necessary depreciation of the yen. Trade balance back in surplus. Leading indicators under pressure. BOJ remains cautious. Rising Nikkei.

Key points

- Positive surprise with uptick in Japanese GDP in Q4 (+0.5% and +1.9% annualised)
- Trade surplus back on the rise (339 billion)
- Increase in wages not sufficient to boost consumption
- Leading indicators under pressure from manufacturing sector
- BOJ revises expectations for recovery
- Necessary depreciation of the yen
- Avoid Japanese bonds
- Nikkei scarcely benefits from rise in confidence
- Corporate earnings fall yoy (-7%)
- Investors' expectations are low, could be positively surprised in 2019
- Likely return of foreign investors and inflows into the Nikkei

Positive surprise with uptick in GDP in Q4

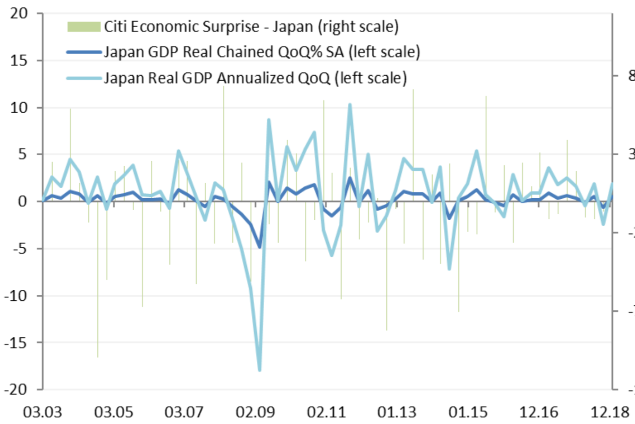
Japan's quarterly economic results were rather variable throughout 2018. The upward revision of Q4 GDP growth to +0.5% (+1.9% annualised) offset the shock of the previous quarter's -0.6% contraction, the economy's worst performance since 2014. The Japanese economy thus expanded faster than expected over a quarter that was rather challenging for most economies globally and for the Eurozone in particular.

Thanks to this sharp upswing in economic activity, Japan was able to avoid entering a technical recession after a challenging third quarter.

These results exceeded forecasters expectations but remain fragile given that the global economic context has remained uncertain thus far in 2019.

2018 thus closed on a positive note, underscoring, however, the volatility and instability of the economy, which alternated, each quarter, between expansion and contraction.

GDP (quarterly and annual)



Sources: Bloomberg, BearBull

The impact of natural disasters on GDP were significant in Q3, causing a drop in firms' capital expenditure (-2.8%) and industrial production. In contrast, private consumption increased by +0.6% in Q4, while capital spending jumped by +2.7%. The latter figure seems to indicate that the upward trend in capex is structural, which should be confirmed by continued investments in 2019, unless foreign demand falls once again. Japan is feeling the effects of the labour shortages resulting from its ageing population.

Exports, an essential driver of GDP growth for Japan, fell once again in Q4 due to a decrease in foreign demand. The continuing uncertainty tied to the trade dispute between the US and China is weighing on confidence and affecting the Japanese economy. This uncertainty continues to be the main threat to GDP growth, particularly given the yen is expected to continue to depreciate over the next few months. Indeed, the currency factor remains one of the key elements necessary for more positive GDP growth.

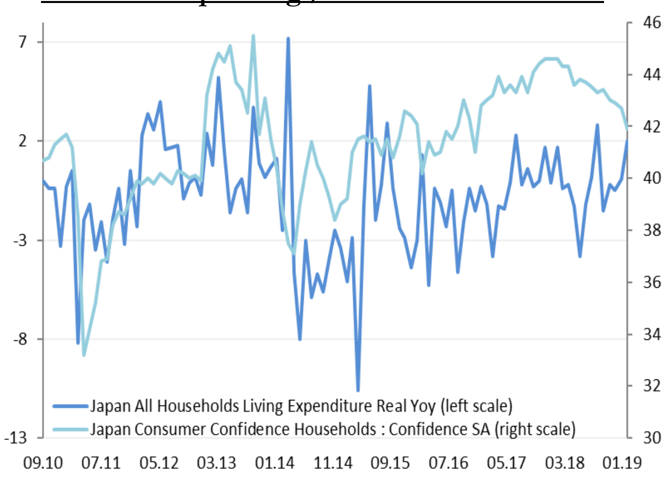
Trade surplus back on the rise (339 billion)

The trade balance returned into positive territory in February with a surplus of 339 billion yen (116 billion seasonally adjusted) and will contribute positively to GDP growth. These results notwithstanding, Japanese exports continued to decline, dropping by -1.2% following a decrease in Asian demand, which represents close to 50% of Japanese exports. Fortunately, exports to the US and Europe delivered a more solid performance. Ultimately, exports fell by only -1.2% yoy, mainly due to a decrease in exports of vehicles and semi-conductors (-14% to South Korea). Japanese exports to China grew +5.5% yoy in February, following a -17.4% correction in January. The -6.7% fall in imports in February contributed significantly to the positive outcome in foreign trade, concealing the continuing weakness of the export sector.

Increase in wages not sufficient to boost consumption

Wage negotiations currently underway in Japan seem less promising than last year's, although the Japanese prime minister is putting pressure on large corporations to raise salaries and contribute to fighting deflation. However, the global economic context and the fall in exports are not favourable to wage hikes at present. Large corporations will likely prefer more flexible solutions such as paying out bonuses rather than increasing their fixed costs. Wages are thus unlikely to increase by more than +2% in 2019, or slightly less than average wage growth in 2018. In this context, Japanese consumers remain especially cautious, in spite of still very low unemployment (2.4%). Consumer confidence has been declining steadily for over a year (44.6) and did not seem to stabilise in February (41.5). More will likely be required for a more marked and lasting trend to take hold.

Household spending / Consumer confidence



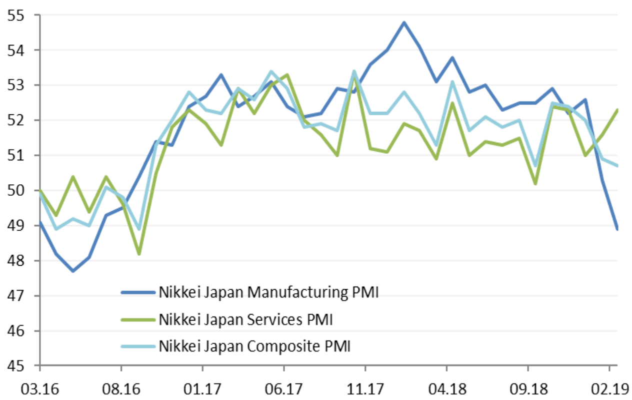
Sources: Bloomberg, BearBull

While household spending did increase by +2% yoy in January, clearer improvement in the job market and a broader translation of corporate earnings growth into wage increases are required to boost household confidence and spending in Japan.

Leading indicators under pressure from the manufacturing sector

Uncertainty continues to weigh on leading indicators, which slid back further in February. Sentiment among Japanese business leaders is still not improving and remains impacted by the absence of a solution to the Sino-American crisis, which continues to affect the Japanese economy. The stabilisation of the yen following a -10% correction, though favourable to large export-sector companies, was followed by a swift +5% appreciation. The upswing to 112 yen to the dollar over the past few weeks is welcome but does not appear to be sufficient to allay the concerns of purchasing managers, who prefer to remain cautious. For now the latter are ignoring political signals suggesting a trade agreement, which should offer better visibility on the economic front, is forthcoming. The composite PMI index continues to fluctuate and shows no clear signs of recovery. In this sense it is broadly impacted by the manufacturing PMI index, which has contracted sharply since the beginning of the year, falling from 52.5 to 49.0, which is worrisome, as it suggests a sharp slump in industrial activity at the beginning of 2019.

PMI indices



Sources: Bloomberg, BearBull

The -3.7% contraction in industrial activity in January is the sharpest in a year and confirms purchasing managers' scepticism. Government forecasts of a +5% upswing in February are likely too optimistic. The auto sector in particular is struggling. The composite index is holding steady thanks to a sharp upturn in confidence as indicated by the upward trend in the services PMI, which increased from 51 to 52.3.

The BOJ revises expectations for recovery

The Japanese central bank has left its monetary policy unchanged but is concerned with respect to global demand and its implications regarding the likelihood that exports and industrial production will bolster GDP growth in Q1 2019. The BOJ has thus revised its GDP growth forecast downwards. Governor Haruhiko Kuroda expressed concern with regard to the country's economy given the current context, but he does not seem to be considering further measures to support the economy. He likely deems the slowdown in external demand to be temporary, as essentially due to the lack of solution to the trade crisis.

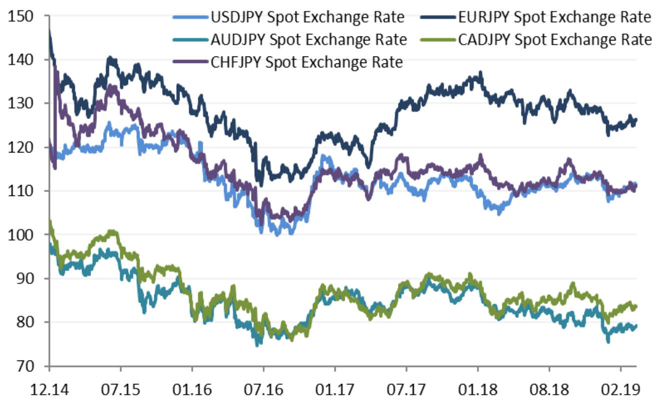
Domestic demand continues to grow, which is a positive factor sufficient to maintain the status quo with regard to monetary policy. The central bank's baseline scenario remains relatively stable, anticipating moderate GDP growth in 2019. Measures to shore up the economy implemented by Beijing should have a more significant impact in H2 on global demand and on Japanese exports.

The BOJ is also facing a complicated situation on the inflation front. Its 2% target remains a priority, but the current context is likely to further delay any significant increase in price indices in Japan. Recall that the domestic CPI index clocked in at barely +0.2% in January. Finance Minister Taro Aso noted that he did not think meeting the 2% target was so critical, but the BOJ remains convinced that maintaining this objective is key and that its strategy with respect to discontinuing the ultra-accommodative monetary policy it has implemented over the past several years must be clearly communicated.

Necessary depreciation of the yen

We have not changed our outlook for the yen, which remains bearish for 2019. For several quarters already we have been noting that the yen's weakness is a key condition to boosting economic growth and inflation in Japan. A weak yen would breathe some life into the Japanese economy and enable it to resume a more sustained pace of growth. Monetary policy still aims to weaken the yen, but means available to the BOJ 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.

Yen against USD, EUR, AUD, CAD, CHF



Sources: Bloomberg, BearBull

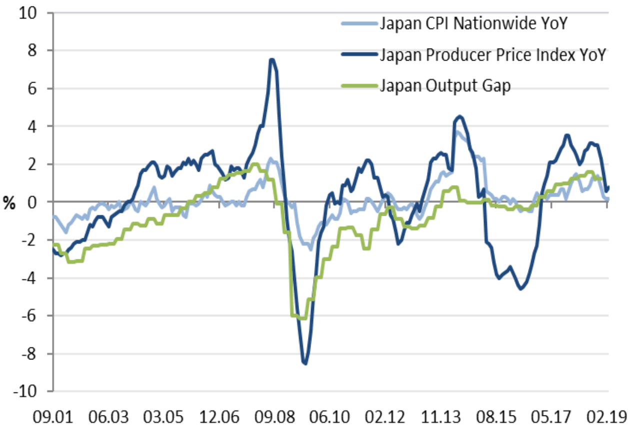
The implementation of monetary policy normalisation in the US, even at a slower pace, along with a moderate growth outlook for long-term rates globally will thus likely weigh more heavily on the yen in 2019.

The yen's exchange rate turned out to be particularly variable between the end of last year and the beginning of 2019, appreciating by +5% over a few weeks and then falling by close to -4% over Q1 2019. We expect the yen to rise back up to 115 against the US dollar and then to stabilise above this rate.

Avoid Japanese bonds

Economic conditions prevented inflation (CPI) from maintaining a faster pace. Indeed, inflation fell swiftly from +1.4% in October 2018 to only +0.2% in January 2019. An upswing in prices was conditioned upon on a depreciation of the yen, but inflation is still far from the BOJ's target (2%). Production prices followed the same downward trend, falling from +3% to +0.8%. The current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors in terms of yields, while the risk of capital losses is high over the long term.

Output gap and inflation (CPI and PPI)



Sources: Bloomberg, BearBull

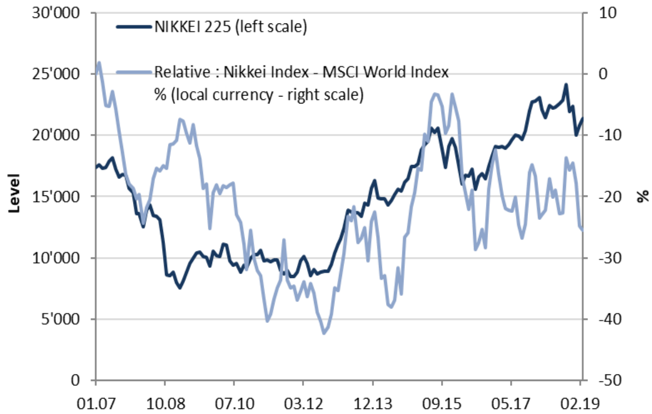
Nikkei scarcely benefits from rise in confidence

Japanese corporate earnings ended up falling -7% yoy in Q4 2018, which was a brutal shock compared to the positive results posted in June (+17.9%). The volatility of Japan's economic performance and the fall in exports had a significant impact on corporate earnings in H2. An economic upturn is now necessary for Japanese corporate earnings growth to resume, but this seems unlikely without an upswing in the global business cycle.

Yet Japanese firms invested significantly in physical capital, with capital expenditure growing by +5.7% yoy, likely in reaction more to the structurally low unemployment rate than to a positive economic outlook for the immediate future. The poor performance of Japanese firms could, however, be followed by a significant rally once an agreement is reached by China and the US with regard to their trade dispute. Chinese and Asian demand is then expected to recover and boost profit growth in 2019 and 2020.

The worst may already be over for Japanese corporates, which could once again benefit from a change in international investors' risk perception, whose investments in Japanese securities have been broadly negative over the past several months. Investors' earnings expectations for 2019 are low, leaving room for adjustment that might boost a continuation of the increases in share prices seen since the beginning of the year. The Japanese stock market is benefiting only modestly at this stage from the improvement in the market climate, progressing by only +7.8% in yen, one of the poorest performances among developed markets in Q1 2019.

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 improves and that the risks that are currently weighing on the global growth outlook recede. The outlook is positive for 2019, but we are maintaining a relatively neutral strategy with regard to Japanese equities.

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