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Private and public spending boost Japanese GDP

GDP up +0.3% in Q2. Consumption still robust. Exports plunge. BOJ could decide to sit tight. Earnings of listed firms down.

Key points

- Japanese GDP maintains positive momentum in Q2 with +0.3% growth
- Consumption, up +0.6%, bolsters growth
- Falling exports (-10.2% in August), in particular to Asia, hurt Japanese economy
- Trade deficit shrinks to -136 billion
- Manufacturing still under pressure
- Leading indicators stabilising?
- In spite of lower unemployment rate, consumers increasingly worried
- BOJ likely to remain patient
- BOJ unable to weaken the yen
- Avoid Japanese bonds
- Earnings of Nikkei-listed corporates down -12%

Japanese GDP maintains positive momentum in Q2

Japanese GDP posted satisfactory growth of +0.3% at the end of June, just a little under the previous quarter's results (+0.5%). Although the yoy performance of the Japanese economy is by no means exceptional, it did turn in a respectable +1.3%.

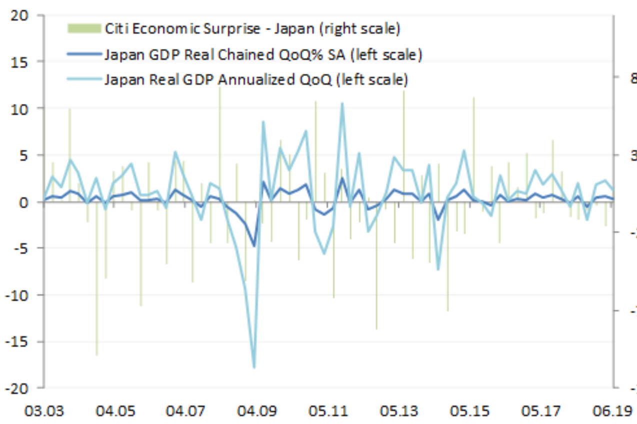
This confirms the trend reversal that occurred in Q4 (+0.5%) following a -0.6% contraction in the previous quarter, in spite of a very uncertain global context. Household consumption (+0.6%) contributed significantly due to a rather sharp increase in spending compared to the previous quarter.

Investment overall was disappointing and had a negative impact on growth. While investment in equipment increased in some more domestically-oriented sectors, it decreased in the manufacturing sector, more sensitive to the escalation of trade tensions, in the wake of falling exports.

Japan thus remains very committed to coming to a trade agreement with the US to avoid further pressure on its export capacity, for instance via US import duties on Japanese goods, which would likely further weaken the already struggling Japanese auto industry. As for consumption, it will likely remain robust in Q3, before it starts feeling the effects of new taxes taking effect in October.

Public spending, up +1.2%, was solid, as was public investment (+1.8%), such that government spending contributed +0.3% to GDP growth and was thus another essential factor in the resilience of Japan's GDP in Q2.

GDP (quarterly and annual)



Sources: Bloomberg, BearBull

The fragility of the Japanese economy, and its dependence on the export sector in particular, is clearly reflected in these results. Public spending for the most part offset the export sector's poor performance. The -12% drop in Japanese corporate earnings yoy – the steepest contraction since 2011 – is an indication of worsening economic conditions. While the overall performance of the Japanese economy thus seems satisfactory, in the absence of a trade agreement in the near future and given a very likely slowdown of consumption following the planned introduction of taxes in October, the fragility of the Japanese economy could become evident and disappoint at the end of the year.

Falling exports to Asia hurt Japanese economy

Historically, Japan ran a trade surplus over the past decade and a deficit between 2011 and 2015. The country's trade balance was once again negative in August (-136 billion) following a deficit in July (-249 billion) and a surplus in June (587 billion). The downturn in global demand continues to have a negative impact on Japanese exports. The further drop in exports in August (-8.2% yoy) was again more significant than the fall in June (-6.6%). In July, the decrease was concentrated in Asia, where demand plunged -8.3% yoy, while exports to Europe (+2.2%) and the US (+8.2%) were actually doing significantly better. The drop in imports in August was relatively more significant (-12%), contributing to the decrease in the trade deficit between July and August. The uncertainty, which persists to this day, regarding the issue of trade relations between the US and China continues to weigh on confidence and affect the Japanese economy, which is hardly on solid ground with regard to its own tariff issues with the US, in spite of seemingly constructive talks. The situation is unlikely to change in Q3; we expect the trade deficit to persist, still penalised by the same factors but likely to a lesser degree, before improving at the end of the year. On the currency front, in August the yen benefited from its safe-haven status in times of rising uncertainty in financial markets. However, along with an upturn in foreign demand, the currency factor remains a crucial element in any future improvement in GDP. The nominal interest rate spread, largely working against the yen, is in fact being offset by trends in real interest rates, which are currently preventing the yen from depreciating and thus boosting exports.

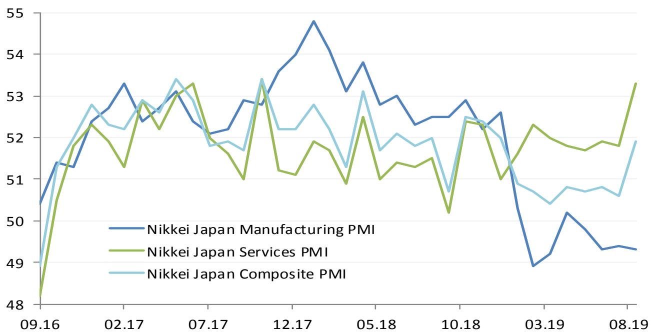
Manufacturing still under pressure

Japan's manufacturing sector thus remains influenced primarily by the external factors mentioned above, and there are few signs offering any hope of a trend reversal in the near future. The small uptick in industrial output in July (+1.3%) was unexpected and stands in contrast with the decline posted in June (-3.3%), while inventory levels also decreased by -0.3%. Machine orders fell somewhat less than anticipated, while orders in the manufacturing sector in particular were surprisingly more robust (+5.4% in July) than those in other sectors, which posted steep declines (-15.6%). The volatility of monthly data unfortunately does not help to discern more reliable trends, such as that seen in the machine tools segment, where orders continued to fall, posting their steepest yoy contraction since 2009 in August (-37.1%). The manufacturing sector is thus still being battered, although manufacturing PMIs, which have been stabilising since March, may be signalling an improvement by the end of the year.

Leading indicators stabilising?

Uncertainty is still weighing on leading indicators, with the manufacturing PMI stabilising slightly under its growth threshold in August (49.3). During the past six months of relative stability, however, economic figures have been showing a deterioration of the situation in the manufacturing industry. For more positive signs, one has to look at the services sector, which paints a very different and significantly more positive picture. The services PMI, which came in at 53.3 in August, thus reached its highest level since October 2017, pushing the composite PMI (51.9) above its growth threshold (50).

PMI indices



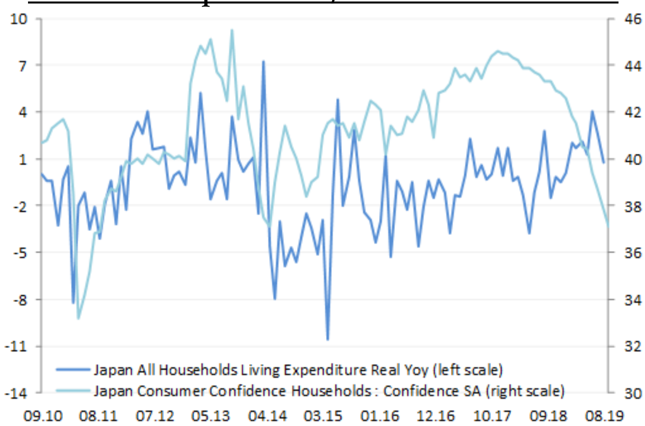
Sources: Bloomberg, BearBull

In spite of indications that the US and Japan have agreed on the terms of a preliminary agreement on trade and tariffs addressing the issue of Japan's trade surplus, uncertainty persists among industrial purchasing managers, who are concerned about the fall in exports to Asia. With regard to services, the latest surveys seem to indicate that business leaders are not worried about the increase in taxes from 8% to 10% that will take effect in October, thus significantly contributing to the improvement in overall sentiment. In August, the composite PMI finally showed more tangible signs of a forthcoming economic upturn.

In spite of a lower unemployment rate, consumers increasingly worried

The job market remains very tight, in spite of the difficulties faced by the manufacturing sector over the past few quarters. The unemployment rate continued to fall over the quarter, reaching a record low of 2.2%. The small unexpected decrease in the jobs-to-applications ratio (from 1.61 to 1.59) in August likely reflects firms' adjustment process, whereby in the short term they are orienting somewhat more toward part-time jobs. Household expenditure increased slightly in July (+0.8% yoy), but real wages continued to decline over the same period (-0.3%). The central bank continues to hope that the job market's particular situation will boost wages, consumption, and inflation, but these effects are still struggling to materialise. It is thus not surprising given this context that Japanese consumers remain extremely cautious, as shown by the confidence index, which posted its worst result (37.1) in August since January 2015.

Household expenditure / consumer confidence



Sources: Bloomberg, BearBull

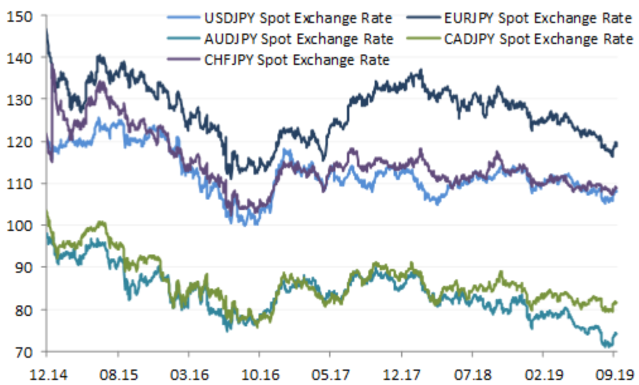
BOJ likely to remain patient

The Bank of Japan will likely keep its monetary policy unchanged during its next meeting in September. However, it will not be an easy decision to make given the current context in which two leading central banks (the Fed and the ECB) are once again cutting rates. During the BOJ's most recent meeting in July, Governor Kuroda also brought up the idea of a precautionary rate cut, clearly noting that he would not hesitate to lower rates once again if price indices stalled. The monetary policy committee takes deflationary risks seriously, but the proponents of patience still seem to be winning out. While the US Fed certainly yielded to the pressure of scaremongers who for 12 months had been harping on about an impending recession even in the absence of genuine warning signs, the BOJ is probably wondering if the appreciation of the yen and the struggling manufacturing sector are sufficient reasons to justify a rate cut in September or if sitting tight for a few weeks will leave enough time for a more positive outlook to take shape. Kuroda could look at the stabilisation of manufacturing leading indicators over the past several months already as a positive sign and anticipate that the Japanese economy overall will likely benefit from the improvement in global conditions that will undoubtedly materialise following the rate cuts in the US and Europe. The BOJ continues to face a complicated situation in terms of inflation, which once again slipped back to 0.5% in July, well below the 2% target. Indeed, the BOJ is under a lot of pressure to act, in particular in terms of weakening the yen, but we do not believe that a rate cut would be the appropriate trigger in that regard.

BOJ unable to weaken yen

Negative nominal interest rates (-0.1%) in yen remain unattractive overall by global comparison, and more specifically compared with US dollar rates still close to 2%. This nominal rate differential could seem favourable to the dollar, but due to lower inflation (0.5%) in Japan and steeper declines in rates in the US, real dollar yields have fallen faster than real yen yields, which have remained more stable. This real yield differential is thus likely one of the main factors explaining movements in the yen/US dollar exchange rate over the past few months, and this differential is thus currently not a negative factor for the yen. The BOJ would obviously prefer real yen yields to be lower, but in that regard the only factor likely to have an impact would be an upswing in price indices, as a large cut in policy rates does not seem to be a serious option. Thus the BOJ's only choice is to opt for patience, waiting for external factors such as an upturn in inflation or in long-term rates in the US to take shape, changing valuation parameters such that the yen may depreciate. We are not changing our outlook for the yen, which remains fundamentally bearish for 2019. A weak yen remains a necessary condition in terms of boosting economic activity and inflation in Japan. The stability of the yen against the US dollar (-1.3%) since the beginning of the year will likely be followed by a decline of the yen.

Yen against USD, EUR, AUD, CAD, CHF

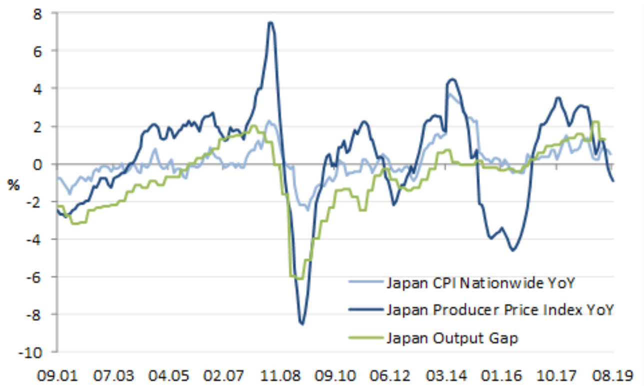


Sources: Bloomberg, BearBull

Avoid Japanese bonds

Long-term rates in yen followed international trends, slipping from +0.15% in October 2018 to close to -0.3% in August. Prices indices are moving away from the BOJ's inflation target, with the CPI down to 0.5% and the PPI to -0.9%. The current context is not favourable to the bond market, which still fails to offer attractive prospects to foreign investors in terms of yields, while the risk of incurring capital and FX losses over the long run is significant.

Output gap and inflation (CPI and PPI)



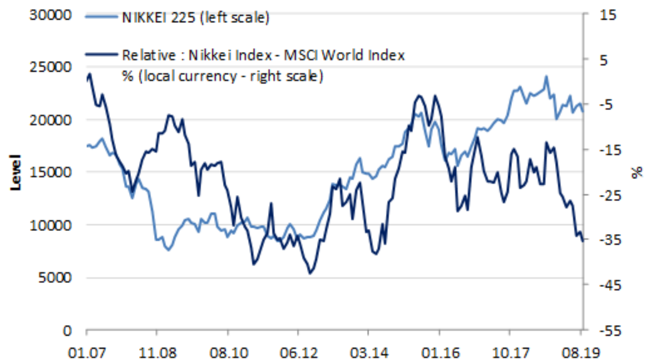
Sources: Bloomberg, BearBull

Earnings of Nikkei-listed corporates down -12%

Economic activity and the results of Japanese firms have been strongly affected by the feud with South Korea and the trade tensions between China and the US. The fall in exports is obviously having an impact on the results of listed companies, whose earnings dropped by -12% yoy. Japanese companies exporting products assembled in China to the US have no other choice but to relocate and transfer production elsewhere, to Southeast Asia in particular. These changes in their production lines have consequences in the short term in terms of costs and earnings. The Nikkei thus remains strongly impacted by Japan's specific economic situation within the overall context of the trade war between China and the US.

The consequences of this uncertainty are genuine, but the worst may already be over for Japanese firms, which could once again benefit from a change in risk perceptions, as investors' 2019 earnings expectations are low and could thus be exceeded.

Nikkei and MSCI World indices



Sources: Bloomberg, BearBull

A weaker yen, lower trade tensions, and an improved economic outlook driven by the latest decreases in long and short rates in the US would be favourable to an upswing of the Nikkei. With this in mind, we maintain a rather neutral strategy on Japanese equities.

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