



18 March 2020

## Covid-19 tips Japan into recession before Olympic Games

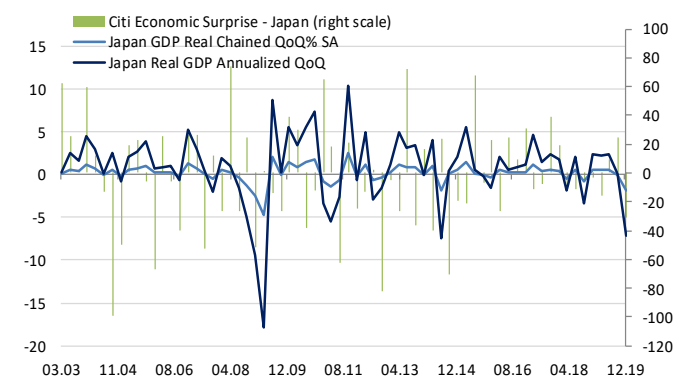
**GDP drop in Q4 2019. Likely recession in the current quarter. Exceptional new economic support measures. Prospects are now positive for the Nikkei.**

### Key points

- Japan's GDP collapsed before the coronavirus crisis
- Japan will almost certainly enter into recession in Q1 2020
- More government economic support measures to come
- Loss of relevance of leading indicators
- Japan's trade balance in record surplus in February
- Households logically remaining cautious
- BOJ strengthens asset purchase programme in the face of Covid-19 risk
- Decline of yen to continue in 2020
- Repositioning opportunity on the Nikkei

**Government expenditure grew by only +0.7%, while capital goods expenditure dropped by -4.6%. Japan's economy was thus already in an extremely weak situation when it was hit by the health crisis in China at the start of the year.**

### GDP (quarterly and annual)



Sources: Bloomberg, BearBull

### Japan's GDP collapsed before the coronavirus crisis

Japan's real GDP in Q4 2019 had already dropped by -1.8% after very weak growth (+0.1%) in Q3. Annualised real growth stood at -7.1% even before the outbreak of the coronavirus crisis, which also affected the country at the start of 2020. Japan increased its consumption tax from 8% to 10% in October, the first rise in five years, impacting the consumption component of GDP, which dropped by -2.8%. In addition to the fragile and uninspiring economic context at the start of the year, Japan was severely affected by the subsequent coronavirus crisis. Public investment and investment expenditure slowed, partially mitigated by relatively robust private consumption.

### Japan will almost certainly enter into recession in Q1 2020

The massive contraction of activity in China in Q1, which may well see China's GDP collapse to +1% yoy, has been affecting Japan for several weeks. China is Japan's largest trade partner, and Chinese tourists also make up the largest contingent of foreign travellers to the country. China's stalled economy and the travel ban will have a heavy impact on Japan's economy in Q1 2020.

The exponential development of Covid-19 cases also curbed international tourism before more severe government measures put a complete stop to population flows in March. In this difficult context for GDP in this first quarter, recession in Japan is more than likely now after a negative Q4 2019.

Even if the Covid-19 epidemic has a limited impact on Japanese growth, the country is unlikely to be able to avoid a recession in the next few months. A technical recession in Q1 is almost certain, and chances that growth for the year as a whole will be positive now seems more remote. The third largest economy in the world may thus well post its biggest economic contraction in more than five years, and risks of a recession for the year as a whole are estimated at 75%.

The effects of Covid-19 on China's major economic partners still need to be assessed, but the pressure remains significant for the moment, as the rising yen, in high demand as a safe-haven currency during the ongoing financial crisis, will continue to have a negative impact on the competitiveness of Japanese exports, which were already hit by declining international demand. The expected economic slowdown in Europe and the US in the recent context of partial or total confinement measures taken by the various countries will also have a tangible impact on demand for Japanese products and trade with Japan.

Japanese exports are thus unlikely to recover quickly in Q2 in this negative international environment. Consumption, which held up rather well during that period, will certainly be affected by Prime Minister Abe's decision to temporarily close schools and restrict social activities in the country and by the various confinement measures that have already been taken. The recent drop in oil prices will be a positive factor for Japan's economy, which is very dependent on oil imports, but it is unlikely to have a significant impact on household consumption and investment. The lower oil prices will thus not shore up Japanese growth, even if they help the trade balance.

### More government economic support measures to come

Shinzo Abe's government had already announced measures to try and stimulate the economy at the end of 2019. Those were going to amount to a little over 13 trillion yen, i.e. approximately 2% of Japan's GDP. These measures mainly concerned infrastructure projects. Considering the gravity of the effects induced by the coronavirus crisis, the government has announced new support measures of up to 1.6 trillion yen.

This is an emergency programme destined to support small and medium-sized companies that would face difficulties if their revenues fell to help them cope with liquidity needs in the short term by granting them payment facilities and loans.

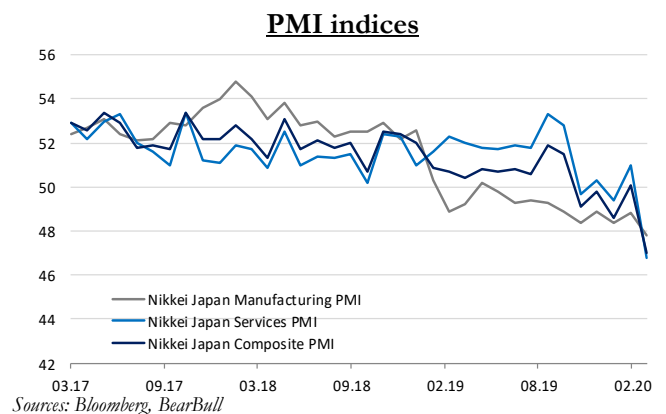
Nevertheless, we believe that new budget and tax measures are likely to be added to those already announced in order to counteract the already visible effects on industrial production and GDP.

### Industrial production could collapse in Q1

The latest figures published for industrial production in January (+1%) raised hopes of a slight uptick in output after a difficult last quarter in 2019. These initial positive results seemed to indicate that Japan's economy might be looking up at the start of the year, which would have helped it avoid a recession in Q1. This perspective was completely shattered by the emergence of the coronavirus crisis, which also hit Japan. Industrial production might collapse in Q1 and only pick up again slowly in Q2, once international demand gradually improves.

### Loss of relevance of leading indicators

There are not many more reasons to be optimistic when looking at the leading indicators for February (47.8) in the manufacturing sector, which in this context are logically continuing on the downward trend they began in February 2018. The situation has deteriorated very quickly in the services sector with the Nikkei/Markit Japan Services PMI Business Activity index dropping from 51 (January) to 47 (February).



Leading indicators are thus logically dropping further still below the growth threshold of 50. It is actually relatively surprising that confidence indicators in March are not showing greater concern from purchasing managers, even though the immediate effects of the Covid-19 crisis are clearly known and the long-term impact also seems quite predictable. In the current context and given the absence of visibility with regards to how the pandemic will evolve, the PMI leading indicators have clearly lost, for the moment, any predictive relevance.

## Japan's trade balance in record surplus in February

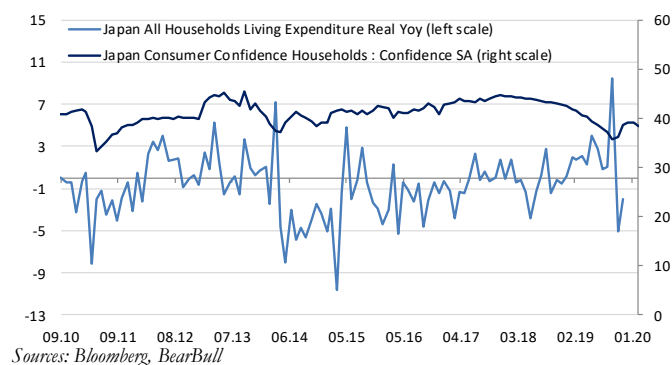
Japan's trade balance has soared following the -14% drop in its imports overall and the approximately -50% drop in Japanese imports from China. Indeed, Japan's foreign trade exceeded 1,100 billion yen in February, thus recording its highest surplus in the last ten years, also thanks to a drop in exports of only -1%, clearly below economists' expectations of -4.2%. The drop in imports of products from China will have a negative impact on Japan's industrial production in all areas, especially the automotive and electronic sectors. The drop in industrial production expected in the next few months will thus continue to weigh on the capability and probability of a recovery in Japanese exports, whose decline has now lasted fifteen months and which will suffer the negative effects in the next few months of the likely drop in demand in Europe and the US and the loss of competitiveness caused by the rising yen.

## Households logically remain cautious

Consumer confidence showed renewed weakness in February and is likely to drop significantly still in March. The health situation seems relatively under control in Japan, which has only recorded 1,400 cases and 25 deaths to this day. In China, the epidemic is practically contained at this time, while in South Korea developments with regard to the disease are also considered favourable, as the number of new cases has dropped below 100.

Consumer confidence might thus improve quickly with the positive developments regarding the epidemic in Asia and support a recovery in consumption after a -10.7% drop in retail sales yoy in February. The VAT increase in Q4 2019 had already significantly disrupted consumer behaviour at the end of the year, and the coronavirus crisis has also caused short-term changes in consumption patterns. We expect a recovery in private and public consumption in Japan in Q2.

### Expenditure & consumer confidence

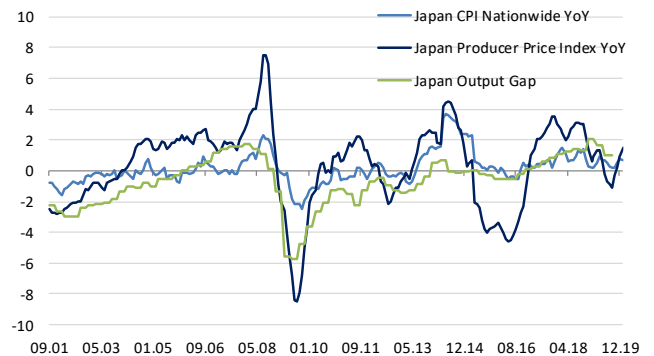


## BOJ reinforces asset purchase programme in the face of Covid-19 risk

The central bank of Japan has decided to act as well to try and calm the panic that also affected Japan's financial markets by announcing the doubling of its purchases of Japanese equity index-linked ETFs, bringing to 13 trillion yen, i.e. 112 billion dollars, per year the amount dedicated to these interventions. This is the first measure the BOJ announced with regards to strengthening its support for Japan's economy after the outbreak of the coronavirus crisis.

The BOJ has also announced it would increase the scope of its corporate debt buyback by 2 trillion yen until September and that it would increase its provision of collateralised loans by 8 trillion yen. The central bank acted with the aim of ensuring sufficient liquidity to maintain the stability of financial markets and avoid further deterioration of confidence, which has already been undermined by the health crisis.

### Output gap & inflation (CPI & PPI)



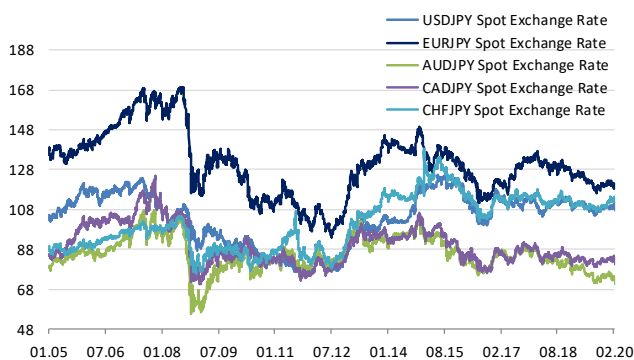
Key rates remain unchanged but the BOJ has made clear that it will provide all the required liquidity to banks through its asset repurchase programme. The BOJ thus has not acted on its key rates despite the Fed's decision to lower its own key rates by 150 basis points to zero. We believe the BOJ, whose goal remains to weaken the yen, is under significant pressure to once again cut rates.

## Decline of yen to continue in 2020

In the last few weeks, the short-term interest rate differentials between US dollar and yen rates have drastically tightened. Following the rate cuts, first by 0.5% then a further 1%, hastily implemented by the US Fed, US key rates now stand at zero, very close to the nominal yield of -0.1% currently in effect in Japan. The nominal rate differential, which was still very favourable to the dollar just a few days ago, has thus evaporated.

Nevertheless, due to a lower inflation rate (+0.7%) in Japan and a higher rate in the US (+2.3%), real yields have been less negative in yen than in dollars recently. Changes in the nominal yield differential first drove the yen up by close to +10% against the dollar between 21 February and 9 March, before being followed by a recovery of the greenback during the subsequent stock market crash. The exchange rate is ultimately relatively unchanged since the start of the year at close to 108 yen to the dollar. Japan's economy now more than ever needs to regain some competitiveness, which is essential to the recovery of its exports, undermined by the health crisis. The BOJ is likely to relaunch its weak-yen policy in 2020.

### Yen against USD, EUR, AUD, CAD, CHF



Sources: Bloomberg, BearBull

We have not changed our outlook for the yen, which basically remains bearish in 2020. The weakness of the yen remains an essential condition for the recovery of activity in Japan and the rebound of inflation. The stability of Japan's currency since the start of the year against the US dollar is likely to be followed by a further decline.

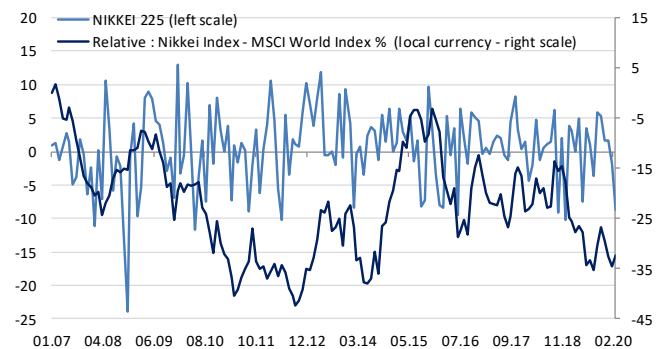
### **Repositioning opportunity on the Nikkei**

Sales (-6.4%) and profits (-4.6%) of Japanese companies dropped at the end of 2019 and are unlikely to improve in early 2020. The latest Reuters Corporate Survey of 500 major firms on the situation of Japanese companies now suggests that close to 50% of them are affected by the coronavirus crisis, seeing falls in revenues and profits.

Two thirds expect a growing impact in the next few months as the pandemic starts to impact other international economies. Half of the firms surveyed confirmed a severe impact on their production chains. Japan's economy, still heavily export-based, needs the yen to weaken, but more importantly, it needs a recovery in global trade, which will depend on the rebound in activity in China at first, and then on the end of the pandemic.

While economic activity seems to be recovering gradually in China after two months of crisis, there is a possibility that the European and North American economies may come through their own health crises in better condition. In this context and following the share price correction of more than -30%, which takes these risks into account, we now believe that Japanese equities offer interesting repositioning opportunities.

### Nikkei & MSCI World indices



Sources: Bloomberg, BearBull

BearBull Global Investments Group (Ltd) is regulated by the Dubai Financial Services Authority (DFSA) and offers the following services to UAE and International clients:

- Multi-Family Office
- Institutional Wealth Advisory
- Private Wealth Advisory
- Real Estate Investment Advisory
- Corporate Finance Advisory
- Financing Solutions

**Disclaimer:** This document and any attachments thereto are confidential and intended solely for the use of the addressee(s) and should not be transmitted to any person(s) other than the original addressee(s) without the prior written consent of BearBull Group. This document and any attachments thereto are provided for information purposes only and are not an offer or solicitation for any purchase, sale or subscription. BearBull Group shall not be liable for any decision taken based on the information disclosed herein and no advice, including any relating to financial services, is given herein by BearBull Group. This document and any attachments thereto are based on public information. Under no circumstances can this report be used or considered as a commitment by its authors. BearBull Group makes every effort to use reliable, comprehensive information and BearBull Group makes no representation that it is totally accurate or complete. In addition, the views, opinions and all other information provided herein are subject to change without notice. Prices and margins are indicative only and are subject to change at any time without notice depending on inter alia market conditions. Past performances and simulations are not representative of any future results. The opinion, views and forecasts expressed in this document and any attachments thereto reflect the personal views of the author(s) except for any specific mention, and do not reflect the views of any other person or that of BearBull Group. We do recommend that you seek professional advice before making any investments decision.

COPYRIGHT © BearBull Group Ltd (DIFC), 2019.  
All Rights Reserved

**BearBull Group**  
Gate Village 3, Level 1  
Dubai International Financial Centre  
P.O. Box. 127676, Dubai  
United Arab Emirates  
**T** +971 4 4019160  
**F** +971 4 4019992  
**M** [info@bearbull.ae](mailto:info@bearbull.ae)

[www.bearbull.ae](http://www.bearbull.ae)