Economic Research

WEEKLY ANALYSIS

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Nikkei benefits from even better expectations for 2021

Sharper contraction of GDP (-7.9%) and corporate profits (-46%) in Q2. GDP expected to recover in Q3. Profit growth of +21% in 2021. Excessive valuation of the Nikkei.

Key points

- The change in prime minister will have no influence on Japan's economic policy
- Japan's GDP contracted more sharply than expected in Q2 2020
- The Japanese economy is already benefiting significantly from China's recovery
- The BoJ is not expected to change its current policy in the coming weeks
- Return of trade surplus for Japan
- Dead calm interest rate markets and inflation
- Japan's economy still in desperate need of a weaker yen
- Japanese corporate profits fell by -46%

The change in prime minister will have no influence on Japan's economic policy

The appointment of a new prime minister in Japan following the resignation of Shinzo Abe for health reasons is not expected to have a significant impact on the Japanese government's economic policy.

Mr. Yoshihide Suga, 71, a loyal follower of Shinzo Abe, was elected as the new prime minister by parliament and is likely to ensure the continuity of his predecessor's policies. Indeed, he faithfully served and advised Shinzo Abe for many years and therefore knows the workings of the Japanese bureaucracy inside and out.

While the composition of the government has undergone some changes, the son of former LDP Prime Minister Koizumi (Environment) is joined by Shinzo Abe's brother, who joins Defence, while Motegi (Foreign Affairs) and Aso (Finance) remain in place.

The key issues for Japan remain the same, and the priorities of the new prime minister will be foremost to manage the health crisis, climb out of the economic recession and deal with the issue of the Olympic Games postponed to the summer of 2021.

The ultra-accommodative monetary policy will undoubtedly be maintained, as will the massive fiscal stimulus plans, which are essential for economic recovery.

BoJ Governor Kuroda is likely to remain at the head of the central bank until the end of his term in 2023. The BoJ is the main lever to counter the effects of the pandemic and support economic recovery through its ultra-accommodative monetary policy, which will remain unchanged following the replacement of Shinzo Abe by Mr. Suga.

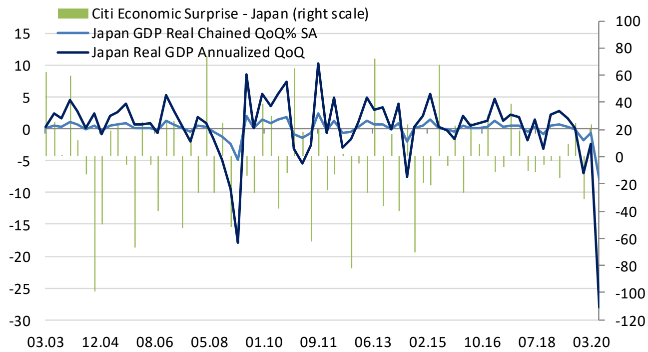
Japan's GDP contracted more sharply than expected in Q2 2020

The Japanese government announced a greater than expected fall in GDP in Q2 2020, with a decline of -7.9% after revision of the initial estimate, for an annualised contraction of -28.1%. This is now the third successive quarterly decline in GDP in Japan, which is sinking deeper into recession. Investment spending (-4.7%) was revised downwards, while inventories of unsold merchandise and consumer goods rose by 0.3%, potentially reducing the prospects for a recovery in output in Q3. Exports of goods and services fell by a further -18.5% over the period, while imports remained relatively stable (-0.5%). The collapse in Japan's GDP is the largest recorded since 1955.

Consumption also fell and does not seem to be showing clear signs of recovery in Q3, as indicated in particular by the further -8.3% decline in household expenditure and -7.9% fall in private consumption, with negative contributions from the travel and food components. In this context, domestic demand contracted overall by -4.9%.

Household consumption remains particularly fragile since the increase in the VAT in October 2019. It is still very much affected by restrictions and changes in consumption practices linked to the health crisis and is struggling to regain momentum. On the public expenditure side, the Japanese government has announced its commitment to support spending and consumption, but the contribution to GDP remains insufficient for the moment. Japan therefore suffered a significant GDP contraction of -10.3% over the last three quarters. Fortunately for Japan's economy, Q3 2020 is looking brighter.

GDP (quarterly and annual)



Sources: BearBull Global Investments Group Limited

Japan's economy is already benefitting significantly from China's recovery

The economic recovery already under way in China in Q2 (+11.5%), which seems to have continued at a sustained pace during the summer, will certainly be a major support factor for Japanese growth in Q3. The Japanese export sector is indeed likely to quickly benefit from the return of China's external demand, which is likely to have a positive impact on Japan's GDP in Q3.

Japanese exports to China grew by 8.2% in July and 5.1% in August. A rapid resumption of exports to China but also to the United States is clearly a positive sign for the current quarter. Industrial production, up 8.7% in July, also recorded its strongest ever monthly growth rate since the statistic was first published in 1978.

The Japanese economy is likely to ultimately contract by only -5.7% over the whole year thanks to the ongoing recovery in Q3, with GDP expected to grow by +15.4% (SAAR), then by +5% (SAAR) in Q4. It should then continue to recover at the slower pace of +2.5% in 2021 and +1.7% in 2022.

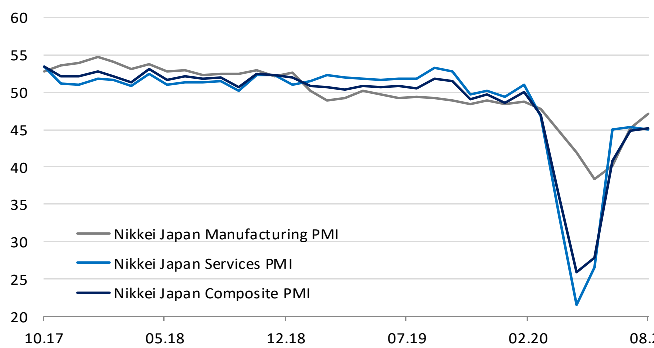
Leading indicators point to a timid recovery in H2

The historical plunge to 38.4 in the manufacturing PMI index and to 21.5 in the services PMI index in May, well below the growth threshold of 50, was consistent with the economic collapse observed in Q2.

However, the strengthening of these indicators since June now confirms the trend observed during the summer of an upturn in economic activity and industrial production in particular. The manufacturing PMI index is steadily strengthening, without yet reaching the growth threshold of 50, but shows clear positive momentum.

On the services side, uncertainty remains after a sharp initial recovery, which had led to a rebound to 45 in June, and which has not been followed since by the hoped-for revival of optimism.

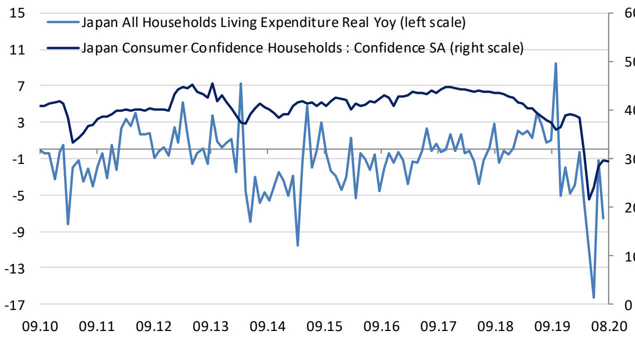
PMI indices



Sources: BearBull Global Investments Group Limited

Consumer confidence has not shown any real change in sentiment either in recent months and is still well below the levels of recent years despite a slight improvement early in the summer.

Consumer expenditure and confidence



Sources: BearBull Global Investments Group Limited

The leading indicators for construction are still gloomy as well, so economic growth in Q3 will likely depend mostly on the current recovery in industrial production and exports, as it is not expected to be strongly supported by domestic demand.

Return of trade surplus for Japan

Japanese exports are benefiting from the recovery in China and are likely to benefit in the coming months from a revival of international demand. The deepest point of the crisis seems to have been reached in May, and the situation for the Japanese export sector has improved since then.

On the imports side, a weak domestic economy and low energy prices explain the relative stability of imports, which are still down -20.8% year-on-year, while exports are now posting better results, with a fall of -14.8% over the same period. The trade surplus thus increased from 11.6 billion yen already in July to reach 248.3 billion yen in August.

The BoJ is not expected to change its current policy in the coming weeks

The Bank of Japan now seems a little less pessimistic in its assessment of the economic situation in Japan. At its last meeting in September it kept its key rates unchanged at 0.1% as expected. It also confirmed the continuation of its "unlimited" asset purchase policy, thus underlining that its very aggressive monetary policy strategy was not in question. The new prime minister elected by parliament on Wednesday also confirmed that he considered Mr. Kuroda's monetary policy to be entirely appropriate to deal with the current issues and challenges facing Japan's economy.

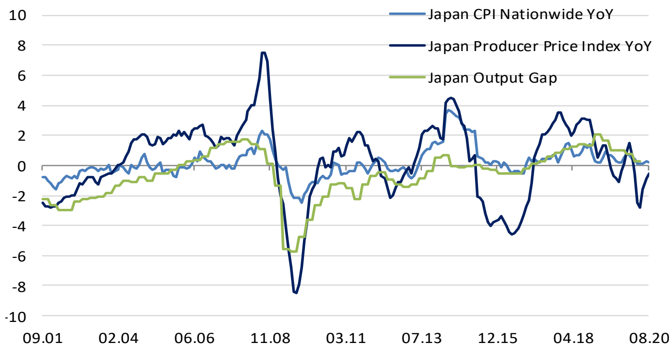
The BoJ emphasised that its perception of current and developing trends in Japan's economy had improved, noting that an improvement in the international situation would clearly have a positive impact on production and exports. It also noted the gradual improvement in domestic consumption but remained cautious regarding the short-term outlook. The bank will thus likely keep its key rates close to zero until at least 2023.

Dead calm interest rate markets and inflation

Inflation in Japan declined again in August with the consumer price index rising by only 0.4% year-on-year. Weak domestic demand contributed to the lack of pressure on prices, while the relative appreciation of the yen against the dollar since the beginning of the year significantly lowered import costs.

There is therefore still no inflation in sight in Japan, and interest rates may remain stable and close to zero across the entire yield curve. The Japanese government's ten-year yield is thus still at 0.015%, practically unchanged since the beginning of the year.

Output gap & Inflation (CPI & PPI)



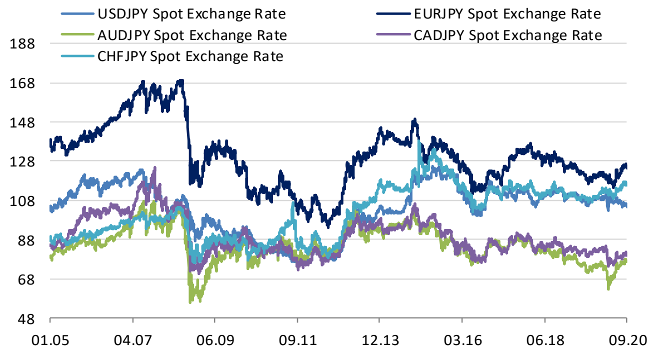
Sources: BearBull Global Investments Group Limited

Japan's economy still in desperate need of a weaker yen

The weakening of the yen, which had been underway since September 2019, was called into question when the health crisis erupted, after depreciating by around -7.5%. The volatility of the yen/USD exchange rate of more or less 10% over just a few weeks unfortunately gave way to a new appreciation of the Japanese currency of about +6.5%.Despite the gradual reduction in health, economic and financial uncertainties in recent months, the yen is still perceived as a safe haven.

The disappearance of the yield differential between dollar and yen rates has certainly contributed to this trend. However, Japan's economy still needs a weaker yen to increase the competitiveness of its export sector, which is still very heavily affected by the fall in world demand.

Yen against USD, EUR, AUD, CAD, CHF



Sources: BearBull Global Investments Group Limited

We are not changing our outlook for the yen, which remains fundamentally bearish for 2020. A weak yen remains an indispensable condition for the revival of activity in Japan and the resumption of inflation. The stability of the Japanese currency against the US dollar since the beginning of the year should be followed by a further depreciation.

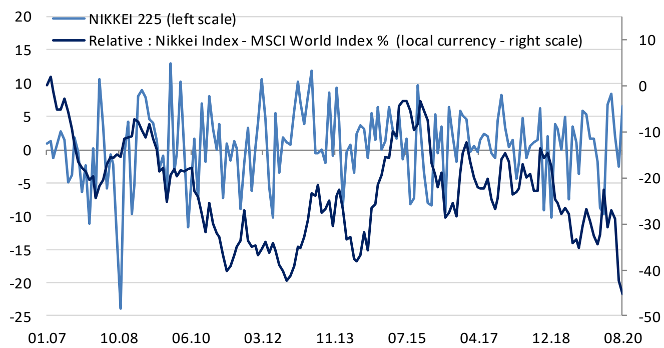
Japanese corporate profits fell by -46%

According to the Ministry of Finance, Japanese companies posted a fall in profits of around -46% and a drop in sales of -17.7% over a year. The domestic sectors most directly affected by the health restrictions posted even greater declines (-53.7%), but it was sectors such as the automobile (-76.1%) and transport sectors that were most affected. The current forecast of +26.4% earnings growth for 2021 for the Nikkei brings the valuation for next year of the main Japanese stocks in the index to 18.2x 2021 earnings.

At the end of March, we recommended repositioning into Japanese equities, whose stock prices had largely taken into account the various risks linked to the Covid-19 crisis following a price correction of over -30%. In our opinion, the rebound of the Nikkei index from 16,500 to 23,000 points already quite clearly reflects the change in outlook for 2020 and 2021.

Earnings expectations for 2020 and 2021 are now respectively at 1,010 (1,132 at the beginning of the year) and 1,227 per share. The Nikkei index has thus practically erased the entire decline that began at the end of February and is once again richly valued in our opinion. It therefore seems appropriate to us today to reduce equity risk and take profits on Japanese stocks once again.

Nikkei & MSCI World indices



Sources: BearBull Global Investments Group Limited

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