20 November 2020

Nikkei benefits from better than expected corporate results

Stronger GDP recovery (+5.2%) in Q3. Overall contraction of -5.3% in 2020. Expansionary monetary policy until 2023. Corporate earnings 30% higher than expected. Nikkei at highest level since 1991.

Key points

- Third Covid-19 wave hits Japan, threatening economic momentum
- Economic recovery turns out to be stronger than expected in Q3
- Leading indicators continue to waver
- Clear recovery in industrial production and capacity utilisation
- Japan once again in deflation
- Weak yen remains essential
- Ultra-accommodative monetary policy
- Nikkei boosted by surprising results
- Corporate results 30% higher than analysts' expectations

Third wave of Covid-19 hits Japan, threatening economic momentum

The second wave of the Covid-19 epidemic, which hit Japan during the summer, seemed to be under control in September, while in Europe it was barely re-emerging. But Japan is now once again in turmoil with a strong resurgence in the number of new cases.

The government's "Go To Travel" promotion campaign is often cited as a factor in the resurgence of the pandemic.

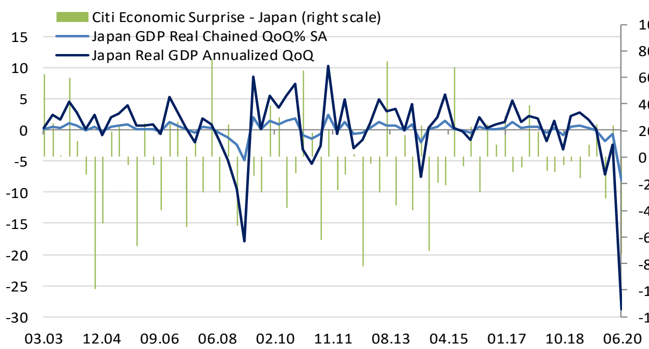
Japan is thus once again on "maximum alert" after a new record of more than 2,000 positive Covid-19 cases per day. Nevertheless, Japanese Prime Minister Yoshidhide Suga has still not announced any new restrictive measures in the face of the upsurge in cases and is essentially counting on the civic-mindedness of the Japanese population to adopt social distancing measures and masks more systematically and with greater vigilance.

In international comparison, Japan's situation is no more serious than in many other industrialised countries, but tests are not yet being carried out on a very large scale, which may underestimate the current magnitude of this third wave.

Economic recovery turns out to be stronger than expected in Q3

Japan's economy contracted for three consecutive quarters, plunging the country into recession, before a healthy and stronger than expected rebound in activity in Q3 2020.

GDP (quarterly and annual)



Sources: Bloomberg, BearBull Global Investments Group Limited

Japan's economy is finally coming out of recession thanks to a +5.2% upswing in GDP over three months, although it has not yet erased the nearly -8.2% fall in GDP in Q2. The recovery is encouraging given the state of Japan's economy pre-Covid, marked by a slowdown already at the end of 2019 caused by an increase in the VAT.

The economists' consensus, which predicted a 4.4% increase in growth, was therefore too cautious, since Japan's economy performed significantly better than their forecasts. Several components of GDP made positive contributions during the quarter under review, which was, however, largely shored up by public spending.

The rebound of +21.4% (SAAR) is still far from compensating for the -28.8% fall in Q2, with relatively disappointing private consumption and investment and greater support from government spending. Private consumption grew by +4.7%, significantly less than anticipated (+5.2%), which represents less than 50% of the fall in the previous quarter (-8.1%). Private consumption has thus shown a modest and somewhat disappointing recovery.

Household spending remains particularly weak since the increase in the VAT in October 2019 and is still very much affected by the restrictions and changes in consumption linked to the health crisis.

Private consumption is struggling to regain momentum despite a sharp decline in pandemic-related risks during the summer. Investment spending continued to decline, as seen already in Q2 (-4.5%), with a further fall of -3.4%, which was greater than expected (-2.9%). Japanese companies seem a little more confident about the future, but this is still not enough to trigger new investment spending.

On the public spending side, the Japanese government had announced its commitment to boost spending and consumption, which resulted in a +2.2% increase in government spending, reversing the -0.4% decline seen in the previous quarter.

Public investment also grew by +0.4%, marking a slowdown from the previous increase in spending of +1.2%. The combination of these two factors contributed +0.5% to GDP.

Exports of goods and services also clearly supported the +5.2% increase in GDP thanks to the joint effect (+2.9%) of an increase in exports (+1.1%) and a decrease in imports (+1.8%).

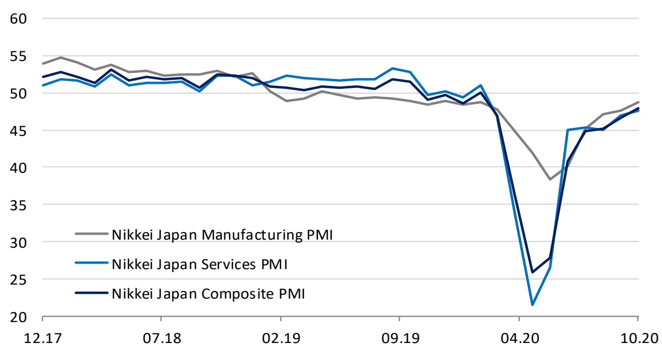
Thus, GDP expanded once again in the third quarter of 2020, but it is still clearly and unsurprisingly far below its pre-Covid levels. The recovery in consumption is still hesitant, which weakens the positive trend in GDP, still too dependent on public spending and exports.

The last quarter should again prove to be weaker given a domestic context once again affected by a third wave of Covid-19, which may negatively affect still fragile household consumption, and by the effects of the lockdown instituted in various industrialised countries, also buyers of Japanese exports. The fourth quarter will therefore probably be weaker than previously expected (+5.1%), although GDP should still increase by +3.8% (SAAR). Over the year 2020 as a whole, Japan's GDP is thus likely to contract by -5.3%.

Leading indicators continue to waver

Despite the recovery in Q3 and the positive foreign trade figures, uncertainty still dominates among purchasing managers. The strengthening of the PMI indices since June ran out of steam in November, and they still are not pointing to an acceleration in the trend. The PMI indices for manufacturing (48.3) and services (46.6) are declining and have yet to climb above the growth threshold of 50.

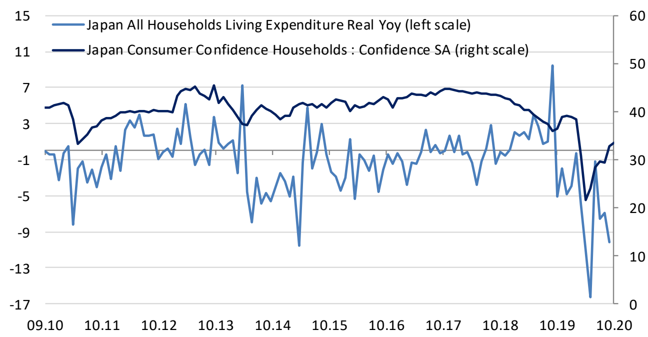
PMI indices



Sources: Bloomberg, BearBull Global Investments Group Limited

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

Consumer expenditure and confidence



Sources: Bloomberg, BearBull Global Investments Group Limited

However, the leading indicators for retailers improved significantly in October and exceeded the growth threshold for the first time since January 2018. Overall, further positive GDP growth in the coming months will likely depend essentially on the continuation of the positive trend in exports.

Clear recovery in industrial production and capacity utilisation

Japan's industrial production jumped by 20% in Q3, the strongest three-month increase since 1973. Chinese demand, as mentioned previously, continued its strong recovery, contributing very positively to this result.

Exports to China, as well as to the US, gave a strong boost to Japanese manufacturers, which augurs well for the future growth of Japanese exports and GDP. The capacity utilisation rate in the manufacturing sector rose by a further 6.4% in September to reach 90% after having reached a floor of 70% in Q2. Although it is not the highest operating ratio in recent years, at least it already evidences the very clear increase in activity of Japan's production lines.

The country's central bank will also be reassured by this development, which continued in October and November, de facto partly reducing the need for new stimuli.

Japan's trade balance back in surplus

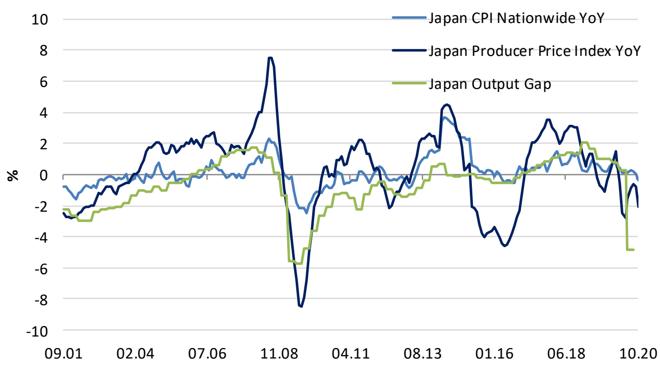
Japanese exports are benefiting from the solid economic recovery in China and improving international and especially American demand. Japanese exports thus recorded a fifth consecutive month of growth in October, despite a decrease in European demand, and are now virtually unchanged yoy compared to October 2019, after plunging by -28.4% yoy in March. October export figures are essential for Q4 GDP, which remains very dependent on Japan's foreign trade results. It is quite likely that a slowdown will occur again due to the resurgence of Covid-19 cases and the ensuing health measures taken by some of Japan's economic partner countries.

In this context, Japan's industrial recovery should continue at a somewhat slower pace. Moreover, Japan and other Asian countries including China signed a free trade agreement in November which, according to the Japanese authorities, is likely to support the economic recovery underway. Japan's trade surplus expanded further in October to reach 872 billion yen, its highest level since April 2020.

Japan once again in deflation

The consumer price index collapsed in October (-0.7%), posting its biggest drop in nine years, driven by falling energy prices and government offers to lower the cost of travel and hotel accommodation. Inflation is moving away from the BOJ's target. The Bank says it is not worried about this in the short term, although it no longer expects an upturn before next summer. Interest rates are likely to remain stable and close to zero across the entire yield curve. In this context, the BOJ will have to maintain its extreme economic stimulus policy without letting up.

Output gap & inflation (CPI & PPI)

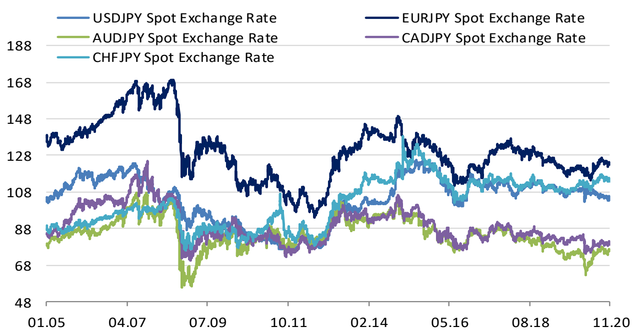


Sources: Bloomberg, BearBull Global Investments Group Limited

Weak yen remains essential

Despite the gradual reduction of uncertainties in terms of health, economic and financial conditions, the yen is still perceived as a safe haven. The disappearance of the yield differential between the dollar and the yen has certainly contributed to the appreciation of the yen, but Japan's economy still needs a weaker yen to hope to emerge from the current deflation. The recent strength of the Japanese currency against the US dollar is likely to be followed by some depreciation.

Yen against USD, EUR, AUD, CAD, CHF



Sources: Bloomberg, BearBull Global Investments Group Limited

Ultra-accommodative monetary policy

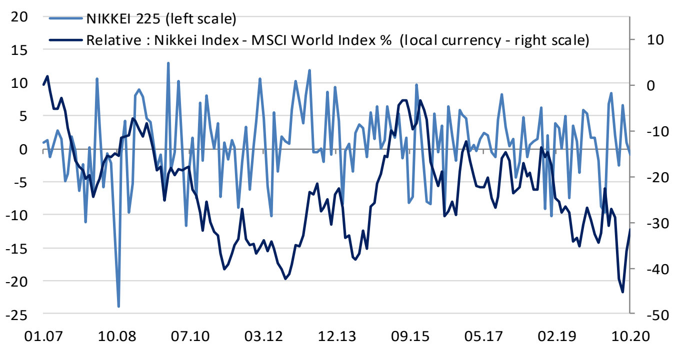
The Bank of Japan is likely reassured by the resumption of international economic trade and by Japan's foreign trade results. It does not seem ready to modify its monetary policy in the current context and therefore has left its key rates unchanged at -0.1%. The BOJ has nevertheless revised its growth forecast downwards for 2020 from -4.7% to -5.5%. It will continue its policy of "unlimited" asset purchases, stressing that Japanese economic activity is likely to follow an improving trend even if the pace of growth is likely to remain moderate.

The policy of keeping key rates close to zero will therefore be maintained in Japan at least until 2023.

Nikkei boosted by surprising results

Japanese equities were hit hard in March by massive sales by investors worried about the impact of the pandemic on Japanese exports. At the end of March, we recommended resuming positions in Japanese equities, as stock prices had largely taken into account the various risks associated with the health crisis following the more than -30% correction in prices. The results of the last quarter have since beaten analysts' estimates by the widest margin (more than 30%) observed over the last three years. These results undoubtedly confirm that the low point in the cycle has been reached and that the outlook for the next fiscal year starting on 31 March 2021 could be very favourable. The Nikkei index is now trading above 25,000 points for the first time since 1991, a rise which has however certainly not greatly benefited foreign investors who have been largely absent from this market in recent months. However, upward earnings revisions will have a positive impact on international demand for Japanese securities in the coming months. Despite these positive future developments, in the short term, we believe that a loss of momentum seems likely.

Nikkei & MSCI World indices



Sources: Bloomberg, BearBull Global Investments Group Limited

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