BearBull Global Investments Group

Economic Research

WEEKLY ANALYSIS

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Japan well positioned to benefit from the recovery in world trade in 2021

Recovery will only get under way in Q2. High potential for recovery of Japanese exports. Consumption may strengthen significantly. Weakness of the yen is the only option. Upward revision of corporate profits.

Key points

- Double-digit growth in Q4 points to positive momentum for 2021
- Increase in consumption and exports
- Better outlook for Q2
- Leading indicators still uncertain
- Consumer confidence is improving
- Japan's economic surplus hits USD 6 bn
- Japan can't seem to get rid of deflation
- The BOJ needs a new strategy
- Japanese long-term rates following the general trend
- Weak yen remains the only option
- Japanese equities to benefit from earnings revision cycle

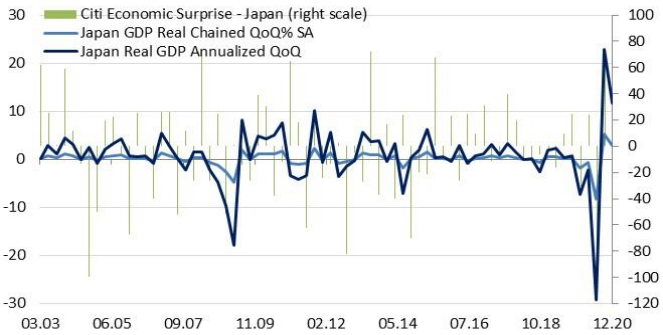
Double-digit growth in Q4 points to positive momentum for 2021

Japan's GDP grew by +2.8% in Q4, significantly less than in the previous quarter (+5.3%), as we expected. This result is nonetheless exceptional, as it represents an annualized increase in GDP of +11.7%. The last quarter was indeed expected to be weaker given the domestic context once again affected by a third wave of Covid-19, which was logically expected to have a negative impact on still-fragile household consumption. Japanese exports were also expected to decline due to the effects of the lockdowns implemented in various industrialised countries, customers of Japanese exporters. Q4 was therefore logically expected to be weaker than previously expected (+5.1%), but it ultimately turned out even slightly lower than our estimates of +3.8% GDP growth (SAAR). Over 2020 as a whole, Japan's GDP contracted by -4.8%, a rather positive result in international comparison.

An annualised quarterly growth rate of +11.7% seems rather promising in terms of an economic recovery in Japan at the beginning of 2021. The potential for economic recovery is therefore encouraging in the long term, even if hopes for a recovery in Q1 2021 must be put into perspective due to the government's declaration of a state of emergency in January to once again fight against the risks of a return of the pandemic.

At the time of writing, the situation is unchanged, particularly in the city of Tokyo and its surroundings. Hopes for recovery have since been postponed to Q2, while the vaccine distribution process is now in place.

Performance of the Japanese economy (GDP) in yen



Sources: Bloomberg, BearBull

Increase in private consumption and exports

The main supporting factors were again both domestic and exogenous. Household consumption and export growth fuelled and supported the economic recovery in Q4. Corporate investment also recovered (+4.5%) after six months of decline. Consumer spending (+2.2%) nevertheless remains below trend given the health restrictions. However, households retain the capacity to resume consumption once the crisis is under control, undoubtedly a clear positive sign for Q2 2021. On the export side, Chinese demand was accompanied by recovery in the US, which together drove Japanese exports up by +10.5% in Q4. This acceleration compared with the +7.5% rise in Q3 is also a very favourable sign in terms of recovery in 2021. Government spending (+2.0%) weakened compared to the previous quarter but remains an important supporting factor.

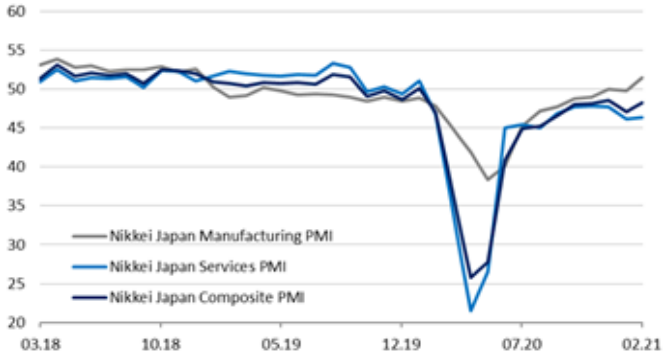
Better outlook in Q2

Japan's economy is expected to weaken again in Q1 due to the state of emergency and new health measures taken by the government. Household spending fell by -6.1% in January year-on-year, and the consumer confidence index fell from 31.8 to 29.6. The rebound in this indicator in February to 33.8 suggests that a recovery may be possible as early as the end of the quarter. The unemployment rate improved slightly in January and is now below 3% thanks to the creation of around 110,000 new jobs. Vehicle sales, which have grown significantly, namely by more than +6% in recent months, slowed by -2.2% in February. Retail sales in department stores are still not taking off despite a small increase of +0.5% in January. While consumption still seemed to be affected by the health measures at the beginning of the quarter, industrial production recorded satisfactory growth of +11.4% in January in the products and capital goods sector. The manufacturing and mining sector grew by +4.2% as well, also pointing to a likely strengthening of the upward trend for the first time in three months. The production of memory chips and semiconductor and battery equipment surged in response to the shortage in recent months, which also weighed on the automotive sector. Exports to China recorded one of their strongest increases (+15.1%). These elements reinforce our conviction that the economic recovery is, for the time being, driven primarily by exports and external demand. However, it will also need to rely on consumption in order to strengthen in Q2. Indeed, it is unlikely that we will see a recovery in consumption as early as March, as the government will maintain its health measures to ensure that its commitment to maintain the Olympic Games can be met. Industrial production is expected to grow again in February and contract in March. Meanwhile, orders for machine tools recorded their strongest rise (+36.7%) since 2018, emphasising the strength of Asian and international demand, which will be favourable to this sector once the global recovery is further along.

Composite leading indicators still uncertain

PMI indices in Japan were up slightly in February. However, it is primarily the industrial segment that has strengthened above the growth threshold of 50, while the services PMI remains uncertain. The manufacturing sector saw its PMI rise from 50.6 to 51.4 in February, recording its strongest increase since December 2018. The services PMI remains below the 50 threshold despite a small increase from 45.8 to 46.3 in February, highlighting that demand remains fragile, while the effects of the pandemic remain significant. The composite PMI indicator is also still below 50 despite a small increase from 47.6 to 48.2.

PMI indicators (manufacturing, services, composite)



Sources: Bloomberg, BearBull

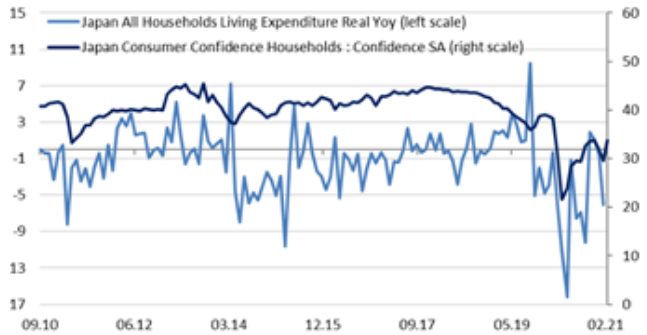
A certain sense of optimism can however be envisaged upon analysing the segments of the indicator that help predict future market trends.

Consumer confidence improving with the prospect of an end to health restrictions

Nevertheless, consumer confidence is at its highest level since Q1 2020 thanks to a clear increase in February from 30 to 33.8. The prospect of the health restrictions coming to an end soon is beginning to boost consumer morale, although household spending does not yet reflect this improvement. The -6.1% drop in

consumer spending in January was thus much larger than the consensus forecast. We must thus remain patient, as a noticeable and lasting recovery in this segment is only likely to take place from Q2 onwards.

Household confidence



Sources: Bloomberg, BearBull

Japan's economic surplus reaches 6 billion (USD)

Japan's economy continues on trend, with a positive current account balance once again in January. Despite a -2.3% decline compared to the previous year, Japan still recorded its 67th monthly surplus. The trade balance, however, is in sharp decline and shows a deficit of 1.2 billion dollars. Exports grew by +2.7% year-on-year to USD 51.67 billion, while imports fell by -10.9% to USD 53.51 billion. The situation is also negative for the services balance, with a loss of 4.4 billion dollars. It is thanks to a balance of payments, income (USD 12.9 billion) and transfers of USD 1.9 billion that Japan's current account remains positive.

Japan can't seem to get rid of deflation

Deflation has returned in Japan, and Japan's hesitant economic momentum presently seems unable to counter it. However, February's figures are proving to be slightly better than expected, with core inflation in Tokyo falling by -0.3% in February over one year, a little less than the -0.5% drop observed in January.

Output gap and inflation (CPI, PPI)

Sources: Bloomberg, BearBull

The CPI index also dropped by -0.3% in February. The rise in energy prices and the fall of the yen against the dollar in recent weeks together will likely push price indices into positive territory in March. Producer prices fell again by -0.6% in January after several months of slight increases. Year-on-year producer prices are down -0.5%. These events are not expected to influence the BOJ's monetary policy.

BOJ needs a new strategy

The BOJ still seems helpless in the face of an inflation situation that does not seem to be improving. The central bank is staying the course and maintaining an inflation target of 2% but is unable to implement a credible policy to support this target. Rates are negative, and a further drop seems unlikely and, above all, unwanted by the banking sector, which is already in difficulty because of the low rates. The Bank of Japan will likely remain inactive, reassured by the resumption of international economic exchanges and by the results of Japanese foreign trade. It does not seem ready to modify its monetary policy in the current context and will therefore leave its key rates unchanged at -0.1%. The BOJ has nevertheless revised its growth forecast for 2021 downwards, with growth now forecast to come in at +3.9%.

The BOJ will probably continue its policy of "unlimited" share purchases, stressing that the trend in Japanese economic activity is likely to continue to improve even if the pace of growth is expected to remain moderate. The policy of keeping key rates close to zero will therefore be maintained in Japan at least until 2023.

Japanese long-term rates are following the general trend without conviction

Meanwhile, Japanese 10-year long-term rates have also been affected by the upward trend in US Treasury rates and the overall adjustment observed in most bond markets. Even though the inflationary outlook is radically different in the US and Japan, Japanese 10-year government bond yields "tightened" in the first two months of the year. While the trend in long-term rates was similar, the amplitude of change was logically much more modest. Indeed, long-term rates only increased by 15 basis points, a small but sufficient movement to reach a new high point for the last four years. Ten-year bond yields thus temporarily hit 0.18% at the end of February and are currently stabilising at around 0.15%.

Weak yen remains the only option for Japan

Despite the gradual reduction in uncertainties in terms of health, economic and financial conditions, the yen was still perceived as a safe haven at the end of 2020. The disappearance of the yield differential between the dollar and the yen has certainly contributed to the appreciation of the yen, but the Japanese economy still needs a weaker yen to hope to emerge from the current deflation.

The strength of Japan's currency against the US dollar during the pandemic phase has finally been called into question in recent weeks, as we had been suggesting for the past few months, with the prospect of a global economic recovery in 2021. The yen thus depreciated by -6.3% at the beginning of the year against the dollar, whose exchange rate rose from 102.7 to 109.2 in a few weeks and returned to its level of the end of December 2019.

Evolution of the yen against the main currencies

Sources: Bloomberg, BearBull

The BOJ's monetary policy, although particularly expansive, has nevertheless not grown the money supply at the same rate as the Fed or the ECB's policies. The BOJ might consider a new policy aimed at weakening the yen more markedly through a faster expansion of the monetary base from now on. The reduction in leverage by Japanese companies in recent years, which led to a decrease in leverage from 290% to 220% between 1995 and 2020, had curbed the BOJ's expansionary policy. The aim now would be to allow higher overall growth of the Japanese money supply, sufficient in international comparison to enable the Japanese currency to depreciate.

Japanese equities to benefit from earnings revision cycle

Japanese GDP growth is already particularly export-driven, with an acceleration in 2021 expected to be largely favourable to exporters, who will benefit from the global cyclical recovery driven by Asia and more broadly by the convergence of regional economic cycles. Profits of Japanese companies in cyclical sectors are expected to rebound sharply and benefit from this convergence as well as a return of demand for capital goods in particular. The Nikkei index is now trading above 28,000 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 could reach +30% and have a positive impact in the coming months on the international demand for Japanese shares. Despite these favourable developments for 2021, in the short term, we believe that a loss of momentum seems likely due to the already high valuation levels of Japanese stocks, about 20% higher than that of European equities for comparison.

Nikkei and MSCI World indices

Sources: Bloomberg, BearBull

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