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The Nikkei hit 23,000, time to take profits

The Japanese economy still has momentum. Exports are still the main driver of growth. Consumer spending remains tentative. The Nikkei may already be reflecting earnings growth.

Key points

- GDP rose a further +0.6% in Q4 (+2.5% yoy)
- Longest economic expansion phase in Japan since the mid-90s
- Exports continue to drive growth, rising +14.1% yoy
- GDP cannot expand in the absence of a recovery of domestic demand
- Revenue redistribution is too unequal
- Private consumption will hopefully pick up in 2018
- Several leading indicators are faltering
- The yen will likely continue to weaken
- Inflation is still not taking off
- No current opportunities in bonds
- Take profits on the Nikkei

Longest economic expansion phase in Japan since the mid-90s

After particularly solid results in Q2 (+2.5% yoy), Q3 GDP growth seemed somewhat less inspiring at first glance. GDP appeared to have progressed a further +0.3% (+1.4% yoy), marking its seventh consecutive quarter of growth in one of its most significant expansion phases in the past ten years, although this latest advance actually pointed to a slight slump in the country's economic performance before today's revision.

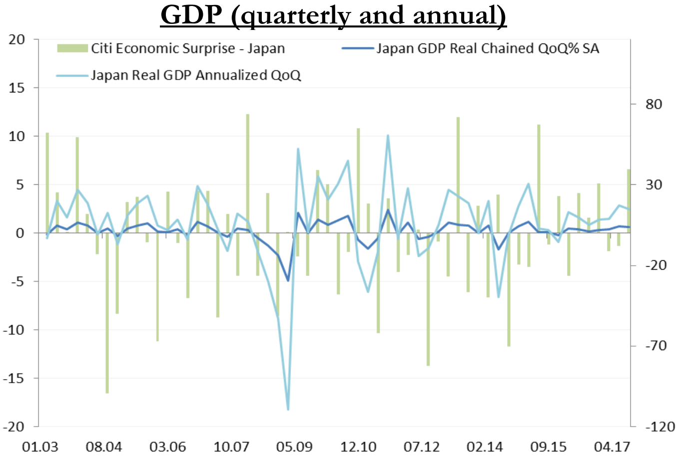
The revised figures show much higher growth, with GDP ultimately rising +0.6% over three months, or +2.5% yoy, as in Q2.

These results thus do not call into question expectations of a sharper recovery in 2017 that could push annual growth beyond what had been expected at the beginning of the year.

Japan's GDP, which seemed to have lost some of its momentum, even though the international economic context had rather improved and the yen had weakened, finally held up fairly well, with a growth rate exceeding its potential.

In fact, the Japanese economy continued to be bolstered by a sustained upswing in exports, already observed in the previous quarters, and by an upturn in investment. Growth thus turned out to be more solid than upon first analysis. Exports increased +1.5% over the quarter, i.e., 14.1% yoy.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

GDP cannot expand in the absence of a stronger recovery of domestic demand

The contribution of domestic demand to the Japanese economy is still insufficient, and indeed domestic demand has struggled to take off. GDP growth was impacted by a -2.5% decrease in public spending following a +5.8% increase in the previous quarter. Private demand, represented by household spending, also stalled, remaining stable at 0% after rising +0.7% in Q2. Aside from inventory, private consumption actually declined by -0.5%, likely due to persistently slow wage growth and adverse weather conditions. These developments are in fact relatively disappointing and liable to call into question H2 forecasts. We were expecting more positive economic developments for the Japanese economy in H2, as we were anticipating an upswing in consumption – which could still materialise.

GDP growth cannot be supported exclusively by domestic demand. Exports should continue to perform well, but doubts remain with regard to domestic demand and its ability to pull its weight with regard to overall growth in 2018, especially over the long run.

However, we are anticipating growth to nevertheless be once again somewhat more balanced with respect to the three factors mentioned above.

Revenue redistribution is too unequal

Private and public consumption is likely to pick up and support further positive contributions by the industrial and export sector bolstered by a weak yen and a more robust global demand. However, caution is warranted with regard to the persistent issue in Japan of unequal revenue redistribution. The current economic upturn is of course welcome, but it still has not generated the expected impact on the job market and on rebalancing income distribution. Corporate profitability is high, but its benefits are not trickling down to employees as the BOJ had been hoping.

Growth is structurally weak due to households' inability to increase their consumption levels.

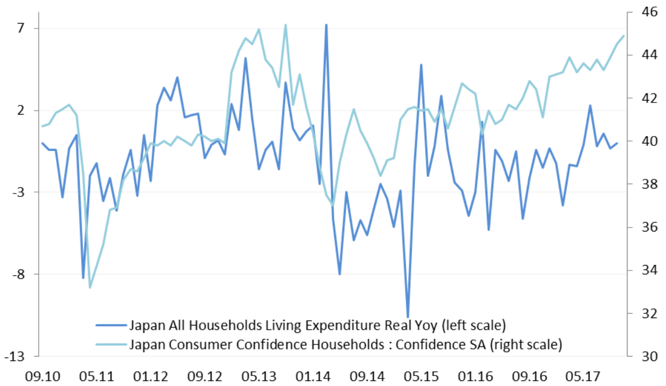
This persistent weakness cannot be directly stimulated by Abenomics. In the absence of a fairer distribution of revenues, for instance via an increase in wages, the BOJ's monetary policy will remain expansionary, interest rates will remain near zero, and public debt will likely increase further.

In this context, we temper our optimism regarding Japanese GDP growth, even though it is still likely to progress by +2.5% in 2018.

Private consumption will hopefully pick up in 2018

Japanese consumers remain cautious overall. Indicators are not really revealing any solid trend, although consumption should gain some momentum in conjunction with positive developments in the job market and the economy. The slow progression of incomes and wages remains a significant cause of consumers' lack of enthusiasm. Consumption will thus remain only a weak driver of GDP growth, pending a clearer progression of household income.

Household spending / Consumer confidence



Sources: Bloomberg, BBGI Group SA

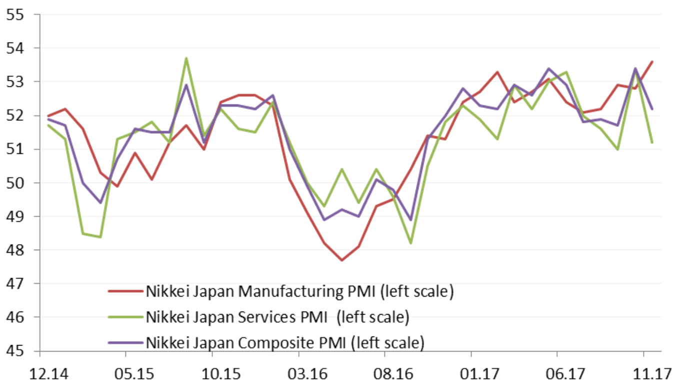
Overall, the growth in real household expenditures is disappointing; after a sharp upswing of +0.6% in August, spending stagnated in October. The good surprise is the positive change in household confidence, which increased sharply over three months from 43.3 to 44.9, and which is thus nearing the ten-year high it reached in 2013. The job market situation is likely contributing to the improvement in household sentiment, as the unemployment rate seems to have reached a floor (2.8%) and perhaps even a level indicating full employment. The job offers to applicant ratio is at its highest level in the last thirty years at 1.55, a slight increase over the previous quarter.

Consumption is structurally weak due to unequal redistribution of revenue. Corporate earnings were excellent in 2017, but this significant improvement had limited effects on workers' incomes. Wages increased by only +0.5%, which is completely insufficient to stimulate domestic demand. However, it is this redistribution of revenues that the BOJ was counting on to revive inflation and consumption. While these conditions are not yet in place, we believe they are presently more likely to materialise.

Several leading indicators are faltering

Q3 figures are thus rather positive, the world's third largest economy is doing better, and leading indicators also seem to point toward further improvement in this situation, despite a few temporary hesitations. The upswing in exports and external demand, bolstered in part by a more favourable global economic cycle and by the growth of investment in Asia, is now having a visible effect on industrial production and on the outlook for the sector, although this outlook does not seem to be fully supported by leading indicators as far as an acceleration in Q4 and at the beginning of 2018 is concerned.

PMI indices



Sources: Bloomberg, BBGI Group SA

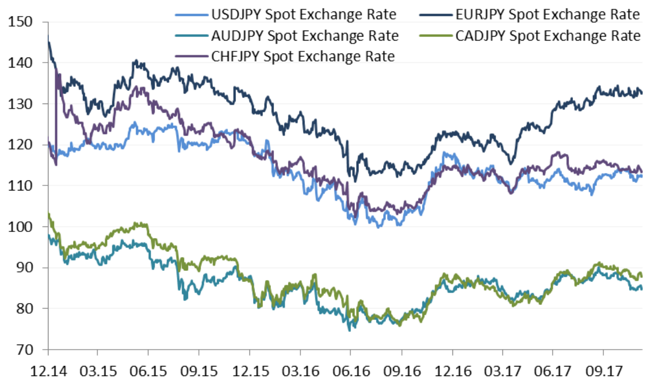
In October, industrial production progressed by +0.5%, or +5.9% yoy. Leading indicators were already suggesting that the economic upswing would continue in Q3 in Japan, as indeed it did. However, in the past several months, these indicators have seemed to be flagging. The rise in inventories in the past few months points to a reduction of future economic activity and industrial production. The manufacturing PMI for November reached 53.6, which is slightly higher than in February, but the combined index (52.2) is feeling the impact of the correction in the services PMI, which contracted from 53.4 to 51.2.

The yen will likely continue to weaken

The Bank of Japan still does not have much room to act in terms of reaching its 2% inflation target. It has not changed its assessment of economic conditions and is maintaining its monetary policy unchanged, i.e., low interest rates and monetary injections. The Bank is still hoping that economic growth in Japan will be sufficient to drive inflation up toward the desired target. The short-term interest rate target is also unchanged (-0.1%), as is the aim of steering 10-year rates toward 0%. The correlation observed with movements in long-term rates will necessitate a slight definitional change in objectives, whereby the BOJ will likely set the lower limit of its target range at 0%.

Governor Kuroda is unlikely to change the Bank's policies, which will remain a significant factor in the future decline of the Japanese currency. We continue to believe that the improvement in fundamentals will not have an immediate impact on the yen, which will continue to be disregarded by investors due to an utterly unfavourable interest rate environment.

Yen against the USD, EUR, AUD, CAD, and CHF



Sources: Bloomberg, BBGI Group SA

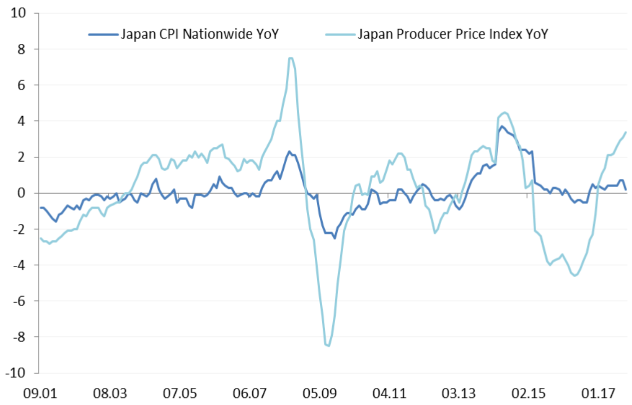
The government's policy is thus still to weaken the yen, as interest rate spreads are likely to widen and penalise the currency. The on-going normalisation of US monetary policy along with expectations of further increases in long-term rates in the US will likely further weigh on the yen in 2018. A weaker exchange rate has been one of the key elements of the government's policy to boost inflation and exports. This policy remains relevant.

The yen will likely revert to fluctuating within a range of 115 to 120 against the dollar over the next few quarters.

Inflation is not taking off, and bonds are not providing any opportunities

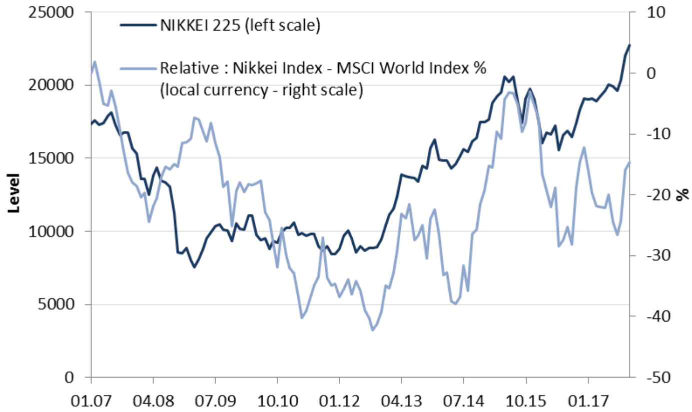
The upswing in price indices is already losing momentum, with the domestic CPI index dropping from +0.7% to +0.2% in October. Inflation has thus once again moved away from reaching the BOJ's target. Any hope of a long-term increase in prices still most likely depends on a further decline of the yen. The change in circumstances with regard to inflation is still too recent and too restricted in amplitude to have a significant impact on interest rates. The slowdown in growth and a diminished outlook for 2018 will certainly not contribute to an improvement in price index forecasts. The Japanese bond market still fails to offer any interesting opportunities for foreign investors.

Inflation (CPI and PPI)



Sources: Bloomberg, BBGI Group SA

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

Take profits on the Nikkei

At the beginning of the year, we believed that an acceleration in the growth of corporate earnings in Japan was highly likely, due in particular to the upturn in the global economy and to a weaker yen. Results were indeed better than expected, and earnings forecasts for the next 12 months are consequently being revised upward. The latest earnings season thus leads us to anticipate that earnings will continue to grow in 1Q18 and will likely exceed the 13-15% consensus forecast stemming from a forward guidance context that is likely somewhat cautious. The distributed dividends of listed companies could increase for the fifth consecutive year. Several months ago, we mentioned that a decline in the yen would likely be the key factor in the Nikkei's next growth phase, potentially pushing Japanese share prices toward highs previously reached in 2015. This is now the case, as the Nikkei has exceeded its previous high of 21,000 by +8.5%. Following this extraordinary increase (+12%) since our last forecast in September, the Nikkei's YTD progression has reached +21.4% in local currency, namely, slightly higher than the results achieved by the S&P500 (+20.4%).

By international comparison, Japanese equities are now trading at 19x expected 1Q18 earnings (17x 2019 earnings), which is not unreasonable given the likelihood of positive surprises over the FY. Their valuation is in fact similar to that of US shares. Overall, balance sheets are solid, and the changes resulting from better governance are significant. However, it should be noted that the future progress of the Nikkei remains at least partly dependent on maintaining a weak exchange rate against the dollar. Currency risk should thus be taken into account in any exposure to Japanese equities. The market still offers opportunities for positive surprises and for adjusting expectations over the next few quarters.

However, given market valuations are rather high, we consider it an appropriate time to take profits pending more attractive opportunities.

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