8 June 2018

GDP growth in Japan declines in Q1 for the first time since 2015

Risks of a technical recession in Q2. Depreciation of the yen still insufficient. Lacklustre leading indicators. Positive output gap. Nikkei rise depends on the yen factor.

Key points

- Previously mentioned risks of an economic slowdown materialised in Q1 (-0.2%)
- Growth declines by -0.6% yoy
- Long sequence of quarterly increases in GDP comes to an end in Japan
- The economy should be able to avoid a technical recession in Q2
- Persistently weak household spending
- Historically low unemployment rate (2.5%)
- Leading indicators remain lacklustre
- The yen weakens further against the dollar
- Positive output gap (+1.5%) will boost inflation growth
- Record earnings in 2018 for Nikkei stocks (+35%)
- Any future increase in the Nikkei will depend on the yen

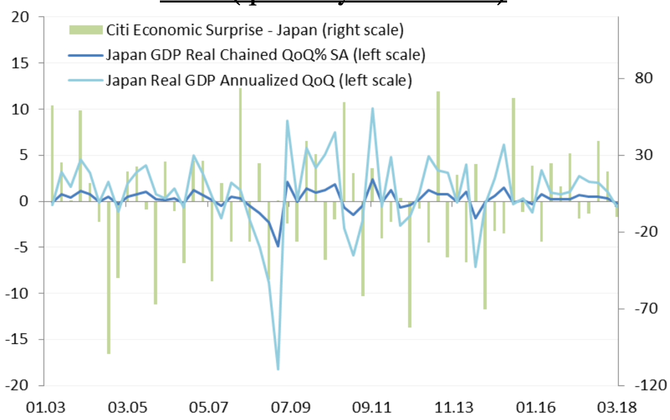
The previously mentioned risks of an economic slowdown materialised in Q1

As we predicted, the Japanese economy contracted in Q1, due in particular to a +10% increase of the yen against the dollar, as GDP shrunk by -0.2% over three months. Real GDP thus declined by -0.6% yoy, its worst performance since Q4 2015. The unexpected strength of the yen between December 2017 and March 2018 clearly curbed the growth of exports and corporate earnings, which had been significant drivers of the economic upturn. However, the fall-off in consumer spending is the main factor that weighed on GDP growth at the beginning of 2018.

Growth thus finally stalled after eight consecutive quarters on the rise, interrupting one of the longest sequences of stable GDP growth in Japan.

Growth had already slowed during the past several quarters, leading to expectations that it would turn negative at the beginning of 2018. In analyses earlier this year, we thus pointed to an increase in the risks that the Japanese economy would underperform, in particular due to currency effects. However, the latter were not the only determining factor. Indeed, in spite of the +10% appreciation of the yen, exports, for instance, remained relatively solid, contributing +0.6% to GDP. Another positive factor was the +0.3% increase in corporate capital spending. However, these two elements were not sufficient to counter weak consumer spending, which decreased slightly by -0.1%.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

The Japanese economy had been bolstered by an environment favourable to export growth in 2017 and by renewed capital spending, but the appreciation of the yen clearly penalised this economic upswing and is likely to further weigh on GDP growth in Q2.

The economy should be able to avoid a technical recession in Q2

Export growth in Q1 slowed sharply (+7.8%) yoy in March, dropping by over half compared with growth posted in August 2017 (+18%). Unfortunately, it appears that the Japanese economy is lacking the support of a weak currency at the same time as domestic demand more than ever requires confidence and genuine growth of wages and household disposable income.

Corporate earnings growth was supposed to lead to wage increases, but it has already fallen significantly from +5.5% to +0.9% between Q3 and Q4 2017, barely clearing +0.2% at the end of March, far from the +26.6% growth rate posted in Q1 2017. This context warrants concern with regard to the outlook for consumption, as inflation dropped from 1.1% in March to 0.6% in April.

The yen's rise was fortunately interrupted in March, giving way to weakness and a welcome respite for the Japanese economy. The threat is thus receding in Q2, but at 109.5 yen to the dollar, the yen remains relatively strong compared to its value as of 31 December 2017. The BoJ is no doubt aware of the significance of this factor but has no other means at its disposal to counter the negative impact of a strong currency than those already implemented.

This situation thus remains concerning and continues to weigh on the economic outlook for Japan over the next few quarters.

Absent a steeper depreciation of the yen in Q2, we expect continuing uncertainty with regard to the Japanese economy in 2018.

GDP growth could suffer from a decline in both external and domestic demand. Hopes for recovery in 2018 thus rest upon a more lasting trend reversal with regard to the exchange rate, with a steeper depreciation of the yen.

Even if there is now a real risk that the strength of the yen will once again drag the Japanese economy into a surprise technical recession, we believe that disaster will be averted in Q2.

Persistently weak household spending

After rising a promising +1.9% in January, household spending fell back in the following three months by -0.9%, -0.7% and -1.3% on an annual basis. Japanese consumers thus remain particularly cautious in spite of a persistently low unemployment rate. Indeed, income growth is not benefiting from the historically low unemployment rate, as the +2% upswing in wages in March was unfortunately followed by a growth rate of barely +0.9% in April.

Will the unemployment rate (2.5%) have to drop below 2% for wage growth to rise above +2.5% and have an observable impact on inflation?

Indeed, the job market has improved, as indicated by the jobs-to-applicant ratio, which is at a 30-year high (1.59). However, the diminished progression of incomes and wages remains a key factor in consumers' lack of enthusiasm.

As long as household net incomes do not increase significantly, it is highly likely that private consumption will not contribute to GDP growth to the extent hoped for.

Household spending/consumer confidence

Sources: Bloomberg, BBGI Group SA

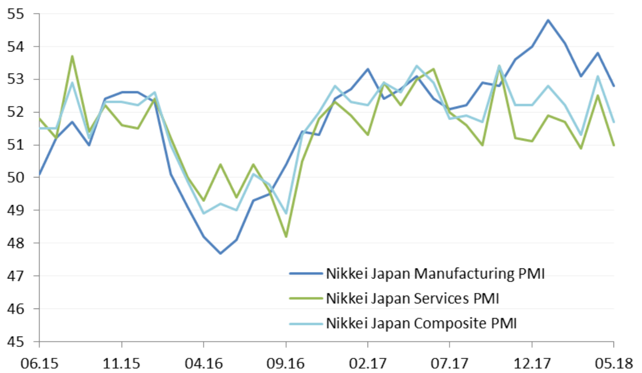
As for the BoJ, it continues to hope that corporate earnings will be more effectively distributed, leading in particular to the wage increases required to boost private demand growth and inflation. A weaker yen remains a necessary condition to achieve this objective.

Leading indicators remain lacklustre

Rising uncertainty linked to Q4 figures will not immediately be mitigated by leading indicators, which remain relatively lacklustre. The Japanese economy is still growing, but hesitancy remains, and the temporary strength of the yen in Q1 is not reassuring. The upswing in exports and external demand, supported in part by a more favourable international business cycle and by growing investment in Asia, initially had a visible effect on industrial production and on the outlook for the sector, but leading indicators are not pointing to any further acceleration at the outset of 2018.

Industrial production progressed by only +0.3% in April, coming in below expectations and disappointing observers. Its growth of +2.5% on an annual basis was also disappointing and substantially lower than the highs of 2017 (+6%). Rising inventories over the past several months indicated a likely decrease of future business activity and industrial production, but this decrease has been more substantial than expected. The trend remains positive though it was significantly destabilised by the yen's rise. PMI indices were down overall, with the composite index sliding to 51.7, reaching 2017 lows. The services PMI also fell to 51.0, slightly below its January level, suggesting a deceleration in the growth of new contracts.

PMI indices



Sources: Bloomberg, BBGI Group SA

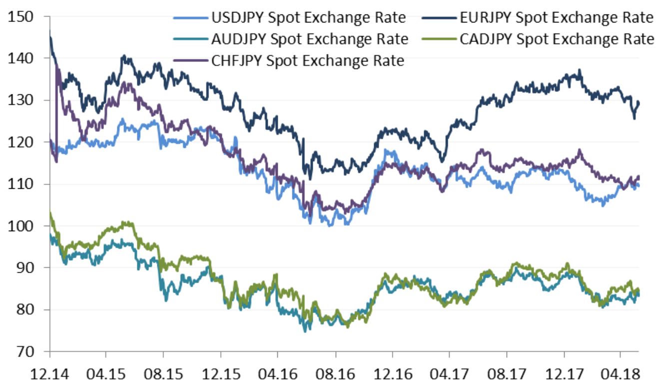
The manufacturing PMI for May stabilised at 52.8, and overall, leading indicators with regard to the business cycle are suggesting the economy will continue to slow down.

The yen finally weakens further against the dollar

The recent weakness of the yen will likely give a boost to the Japanese economy, but the currency's depreciation of around 5% against the dollar, from 105 to 110, is likely not enough to provide the contribution required. In our March analysis, we noted that the strength of the yen resulted in part from its safe haven status in an uncertain context and predicted that the exchange rate would likely return to a 110-115 range once financial market volatility diminished. The aim of monetary policy is still to weaken the yen, but available means remain limited. We continue to think that the yen will in all likelihood be disregarded by investors, given a totally unfavourable interest rate environment and interest rate spreads that should continue to penalise the Japanese 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, even if some believe the yen remains undervalued.

Having temporarily benefitted from its safe haven status, the yen will likely weaken again in Q2 and reach a level of 115 against the dollar.

Yen to the USD, EUR, AUD, CAD, CHF

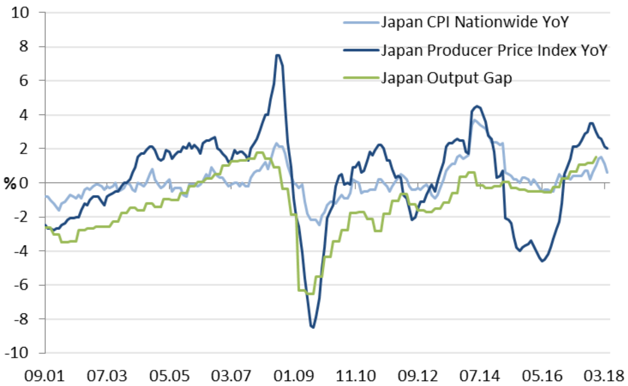


Sources: Bloomberg, BBGI Group SA

Positive output gap (+1.5%) will boost inflation growth

Price indices did not confirm the expected upswing in the past several months. The slowdown at the end of last year persisted in the last few months after the CPI rose by +1.5% in February. Indeed, inflation was once again sluggish, rising by only +0.6% in April. The best hope for a lasting rise in prices is likely still for the yen to depreciate, unless a tighter job market finally has an impact on wages and prices. It is clear that the BoJ's 2% target is still far from being achieved, but the bank remains optimistic, highlighting in particular that the increase of the output gap to +1.5% in Q4 2017 suggests that GDP growth was above potential. If this is confirmed, it would indicate that inflation could finally rise more sharply in Japan. In this context, the Japanese bond market still fails to offer any interesting opportunities for foreign investors.

Output gap and inflation (CPI and PPI)



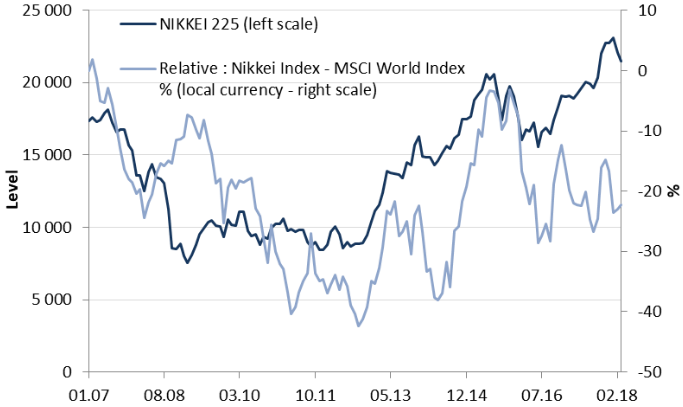
Sources: Bloomberg, BBGI Group SA

Record earnings for Nikkei stocks

The correction of approximately 15% in the price and valuation of Japanese equities in Q1 offered repositioning opportunities for long-term investors. At 17x earnings and given the likelihood of positive surprises, valuation levels were comparatively close to that of US shares, but the currency risk remained an important factor to consider. In spite of the correction of the Nikkei index from 24,000 to 20,500, we noted that, unless the yen undergoes a lasting depreciation, the likelihood of an upswing remains highly uncertain.

The 10% rise of the yen against the dollar was a determining factor in the poor performance of Japanese shares. The recent fall of the currency from 105 to 111 yen to the dollar is fortunately providing some support for a rise of the Nikkei. Today, we believe that an acceleration in corporate earnings growth in Japan is still possible in the context of a stronger global economy, provided the risks of a trade war diminish and the yen depreciates and remains weak.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

Japanese stocks ended the fiscal year on a record performance at end-March 2018 for the second time in a row. The auto sector and semi-conductors topped the list of Nikkei shares, which posted an average increase of +35% or over 260 billion dollars, substantially surpassing the previous year's +18% increase. Stock dividends to be distributed could progress for the fifth consecutive year. However, earnings growth for the current fiscal year is expected to decline slightly by -2% due to the yen factor, rising commodities prices, and the introduction of tariffs by the US. Leading Nikkei companies are forecasting an exchange rate at 106 for the current fiscal year, which is significantly more conservative than the current rate of 110 and below our own forecast of a decrease to 115. Continued depreciation of the yen should thus support further increases in the Nikkei towards 24,000 over the next few months if the international stock market climate remains constructive.

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