26 September 2018

The Japanese economy rallies, GDP jumps up +3% in Q2

Highest rate of GDP growth since 2016. Expected depreciation of the yen is the determining factor. Leading indicators still uncertain. Rising inflation. Nikkei achieves 24,000 target.

Key points

- Unexpected and welcome surge in Japanese GDP (+0.7%) after a weak Q1 (-0.2%)
- Highest annualised rate of GDP growth since 2016 (+3%)
- Pace of growth to remain sustained in Q2
- Bilateral negotiations to avoid the worst
- Corporate earnings on the rise
- Tentative increase in household spending, consumption is struggling to take off
- Uncertainty holds leading indicators in check, PMIs are stagnating
- Yen weaker still in 2019
- Inflation (1.3%) is benefitting from the yen's weakness
- The Nikkei soars to new heights

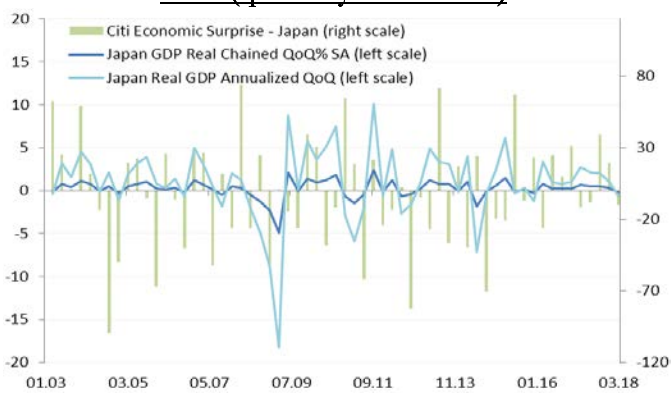
Unexpected and welcome surge in Japanese GDP after a weak Q1

We had forecast a slump in Japan's economic performance in Q1, which was confirmed with the announcement of a -0.2% decline in real GDP over the quarter, due in particular to a challenging monetary context marked by a 10% appreciation of the yen against the dollar. We had also noted that monetary factors would remain important with regard to GDP growth in Q2 and for the rest of the year. We mentioned, in particular, the need for a further depreciation of the yen against the dollar toward the 110-115 zone, which would help the Japanese economy avoid a technical recession and resume a reasonable pace of growth in the second half of 2018.

The yen thus weakened appreciably in Q2 and then more significantly, reaching 115 yen to the dollar at the end of September, close to the high end of our forecast range of 110 to 115.

Japan's economic performance was thus variable over the first half of 2018. One can thus legitimately wonder whether this latest growth spurt, which far exceeded expectations, will prove lasting or whether it is just a flash in the pan. The +0.7% growth rate in Q2, or +3% annualised, is the highest since the beginning of 2016. Few forecasters are thus likely to bet on a continuation of this elevated pace of growth for the entire year, especially since trade tensions between China and the US are intensifying and Japan is not immune to a possible decrease in economic activity in China and Asia.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

We mentioned that the depreciation of the Japanese currency is likely to be the key factor in a potential upturn in the economy and the stock market. However, the monetary factor is certainly not the only element explaining the more positive developments in GDP figures recently. Investment spending contributed favourably, progressing by +3.1%, a much higher rate than in Q1. This new trend is encouraging, as it also shows a positive evolution in industry confidence, despite leading indicators that are still not very optimistic. Over the quarter, the substantial rise in consumption may be the most interesting development in terms of the dynamics observed in Q2. Indeed, after having slowed down in Q1 (-0.1%), the contribution of private consumption, up +0.7%, was particularly noteworthy. Thus, as consumption represents 60% of Japan's GDP, a lasting improvement in trends in this segment would have a significant impact on GDP growth in H2.

We believe it is likely that these positive trends in domestic demand will persist in H2.

The yen's appreciation substantially dampened Japanese export growth in Q1. The latter plunged from +9.4% yoy at the end of December to only +2.1% at the end of March. However, exports were up +6.7% (annualised) at the end of June – a significant upswing and another positive trend arising in the context of the yen's depreciation mentioned above and which we believe is likely to persist in H2.

The pace of growth should remain sustained in Q2

Trade tensions certainly remain one of the main sources of uncertainty in terms of evaluating the macroeconomic outlook for the remainder of the year and for 2019. The Japanese economy is of course not immune to these tensions' potential side-effects, which would undoubtedly impact the country if the crisis were to deepen. Moreover, the US president could very well want to seize upon Japan's trade surplus, which would create renewed uncertainty regarding the Japanese export sector. That said, with three months to go until the end of the year, it seems that the key parameters with regard to Japanese exports and foreign trade will remain favourable. The correction of the yen has strengthened the competitiveness of Japanese products and services, as indicated by the increase in overall exports (+6.6% in August) both to Asia (50% of exports) and to the US. However, the trade balance has deteriorated, in spite of the progression in semi-conductor, vehicle and ship sales, due to the steeper rise in imports (+15.4%), which essentially resulted from the increase in energy prices. The trade balance thus posted a deficit of 4 billion dollars for the second consecutive month. These developments should diminish the risk of the US president stepping up the pressure, especially since Japan's imports from the US rose by +21.5% yoy.

Bilateral negotiations to avoid the worst

The Japanese economy can thus, for now, once again count on a slightly weaker yen to the dollar. It may also be able to count on the negotiation process finally undertaken with the current US administration, which looks like it has a good chance of leading to an acceptable compromise for Japanese industry. Prime Minister Shinzo Abe has indeed agreed to start talks with the Trump administration with regard to initiating new bilateral negotiations with the US. Even if the US does not seem inclined to grant significant concessions, the news still had an immediate positive impact on share prices in the auto sector, targeted by the US, which the latter faults for producing only 50% of vehicles produced on American soil.

Corporate earnings on the rise

Japanese corporates will likely benefit from the favourable macroeconomic context as well as from the depreciation of the yen. However, the Bank of Japan's latest Tankan survey actually indicated a decrease in the confidence of large manufacturing firms, although average exchange rate forecasts for the end of the year (107.4 yen) were well below current levels (114 yen). This gap, if it should persist as we believe it will, should lead to upward revisions in Japanese corporate earnings. The government is still hoping that corporate earnings growth will be transmitted to consumers via gradual increases in wages. It is thus likely to rejoice at the yoy earnings growth of +17.9% posted at the end of June after a particularly anaemic, and worrisome, first quarter (+0.2%).

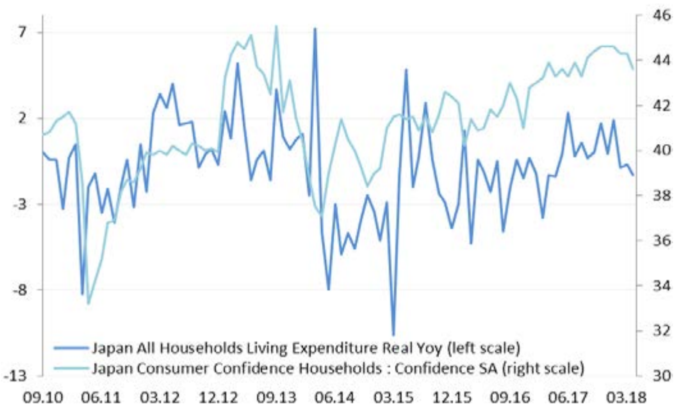
Consumption will benefit from this positive factor, likely in the second half of the year. Household spending is expected to rise thanks to increases in wages. GDP growth will thus likely continue to benefit from rising domestic demand and from new momentum in consumption. The depreciation of the yen will likely boost the upswing in the Japanese economy at the end of the year.

Tentative increase in household spending

Growth in household spending was of course weak (+0.1%) in July, but it did have the merit of interrupting a series of five consecutive decreases in consumption. Japanese consumers thus remain particularly cautious, even though the unemployment rate continues to be very low (2.4%). However, retail sales did rise by +0.9% in August. Wages are growing slightly more rapidly, as indicated by the June figures, which show a monthly increase of +3.3%, the highest in the past ten years. Even faster growth will likely be required, however, for a more marked and lasting trend to take hold.

However, the job market situation is continuously improving, and the positive trends in corporate earnings will likely lead to a sharper increase in wages, which is still a prerequisite for any improvement in consumer confidence.

Household spending/ consumer confidence

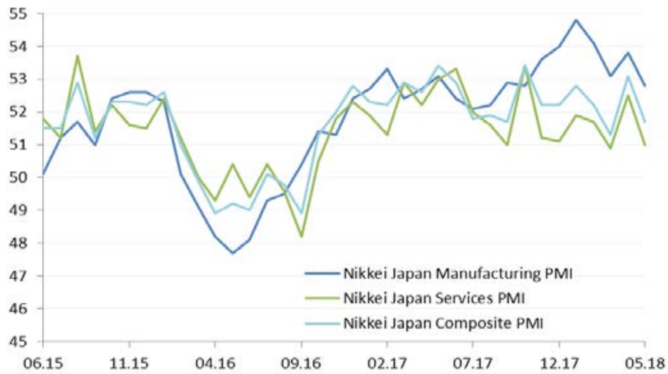


Sources: Bloomberg, BBGI Group SA

Uncertainty holds leading indicators in check

The weakness of the yen, although favourable to the large Japanese export firms, does not appear to be sufficient to allay the concerns of purchasing managers, who still prefer to remain cautious given that the risks of a trade war continue to rise. Although the Japanese economy is once again booming, doubts continues to be pervasive in surveys, likely pending signals that the trade tensions are abating. In spite of the upturn in industrial production in July and August after a negative Q2 (on an annual basis), the 2.2% growth rate remains weak. PMI indices are thus still not showing any signs of recovering after declining steadily over the past six months and in spite of the improvement in the state of the Japanese economy. Indeed, the composite index remains at 52, still close to its 2017 lows. The services PMI does only marginally better, progressing from 51 to 51.5. The manufacturing PMI improved slightly from July (52.3) to August (52.5), which does not indicate, however, an upturn in the industrial sector in the next few months.

PMI indices

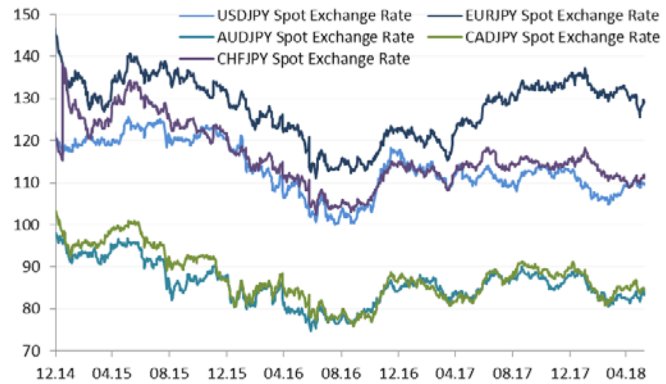


Sources: Bloomberg, BBGI Group SA

Yen weaker still in 2019

For several quarters we had been arguing that a weak yen was an essential prerequisite for any upturn in economic activity in Japan. A weak yen would provide a shot in the arm to the Japanese economy, enabling a more sustained pace of growth. We estimated that a 10% depreciation against the dollar, whereby the exchange rate would increase from around 105 in March to 115 in Q2, would be sufficient to contribute to an upturn. In our March analysis, we noted that the strength of the yen was in part linked to its status as a safe haven in an uncertain context and predicted an increase of the exchange rate back to 110-115 once financial market volatility decreased. Monetary policy still aims at weakening the yen, but available means remain limited. We continue to believe that investors will abandon the yen due to an utterly unfavourable interest rate environment and to rate spreads that will continue to penalise the Japanese currency. The implementation of monetary policy normalisation and the likelihood of further increases in long-term rates in the US will likely weigh more heavily on the value of the yen in 2018 and 2019. After reaching our objective of 115, the yen will likely stabilise before continuing to depreciate in 2019.

Yen against USD, EUR, AUD, CAD, CHF

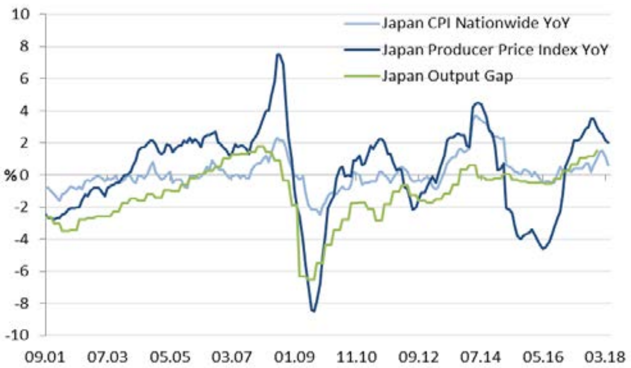


Sources: Bloomberg, BBGI Group SA

Inflation is benefitting from the yen's weakness

A welcome upturn in price indices occurred in Q2. The pause in price increases lasted only as long as the yen was strengthening. Inflation (CPI) passed the 1% bar again, clocking in at 1.3% in August. A weaker yen was the prerequisite for an upswing in prices, but we are still a ways from the BOJ's target (2%), and production prices are not exhibiting sufficient momentum to allow for hopes of a more robust overall trend. However, the current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors.

Output gap and inflation (CPI and PPI)

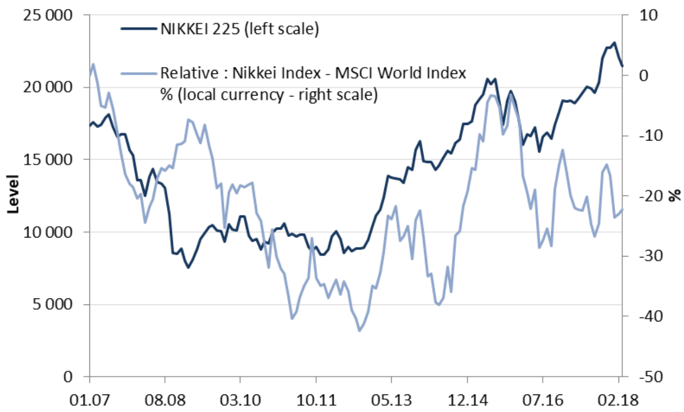


Sources: Bloomberg, BBGI Group SA

The Nikkei soars to new heights

Several months ago, following the correction in Japanese share prices in Q1, we noted that an acceleration in the pace of Japanese corporate earnings growth was possible in the context of a strengthening global business cycle, if the risks of a trade war did not intensify and especially if the yen underwent further, lasting depreciation.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

The 15% drop in share prices along with equity valuations of 17x earnings were already offering attractive repositioning opportunities. For the current fiscal, Japanese blue chips are valuing revenues and profits using an exchange rate estimate of approximately 107 yen. As we have seen, the yen is now trading at close to 115 yen to the US dollar. We anticipate a stabilisation of the exchange rate by the end of the year at between 110 and 120 yen, which would thus ultimately significantly boost year-end corporate results. The current decline of the yen is thus no stranger to the improvement in investor sentiment and to investor interest in Japanese shares.

The continued depreciation of the yen will thus likely boost the Nikkei beyond our 24,000 target, which has already been achieved, as long as the investment climate remains positive.

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