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Japanese GDP resilient despite trade showdown

GDP growth stabilises at +2% yoy. Cautious consumers. Manufacturing under pressure. BOJ may cut rates to -0.3%. Nikkei impacted by trade tensions.

Key points

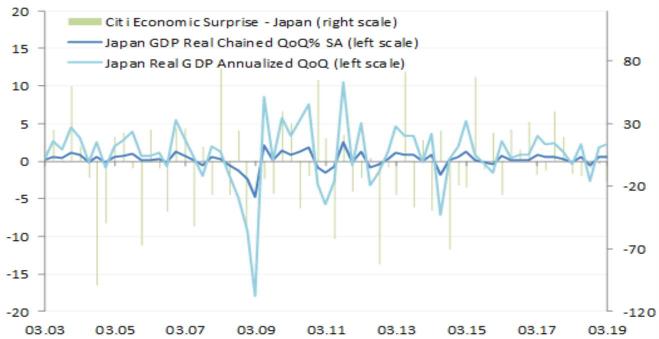
- More positive surprises in Q1 with +0.5% GDP growth
- Japanese growth stabilises at +2% yoy, surprising forecasters
- Less impressive performance than it might seem
- Consumers remain worried
- Leading indicators still weighed down by the manufacturing sector
- Economic upswing in May
- Further decline in trade balance
- BOJ to maintain its expansionary policy
- Weaker yen remains necessary
- Avoid Japanese bonds
- Nikkei impacted by trade war

More positive surprises in Q1 with +0.5% GDP growth

Q1 GDP growth of +0.5% in Q1 exceeded economists' forecasts and confirms the trend reversal that occurred in Q4 (+0.5%) following the -0.6% contraction in the previous quarter. Japan's quarterly economic performance, which was unstable all through 2018, thus seems to be stabilising at an annualised pace of +2%. Economic growth thus turned out to be more significant than expected for the second consecutive quarter, in spite of a challenging environment for the Japanese export sector. Japanese economic momentum is thus in synch with that of other industrialised nations, which have been posting better results than expected since the beginning of the year.

The trade conflict between the US and China did not have any further impact on confidence in Q1, but the recent escalation of tensions and rising uncertainty could exert some effects going forward.

<u>**GDP (quarterly and annual)**</u>



Sources: Bloomberg, BBGI Group SA

These overall results are a welcome surprise given the negative forecasts of most economists, who were anticipating economic stagnation or even a -0.2% contraction in Japan.

Less impressive performance than it might seem

These results thus ward off the immediate threat of recession; however, they unfortunately do not make a solid case for a lasting return of growth in Japan, due to persisting structural weaknesses. Indeed, export levels remain very low, investment in equipment has stalled, and consumption continues to be impacted by less than optimistic household sentiment. In terms of household consumption, sentiment remains bleak, and the sector's contribution was thus slightly negative (-0.1%) in Q1 following a slight rise in momentum at the end of 2018. GDP was bolstered by public spending, up +6.2%, but the private sector hung back, as shown by the -1.2% decrease in capital investment. Equipment expenditure increased by +0.3%. significantly less than the previous increase of +2.7%.

Nevertheless, we believe that, structurally, capex is trending upwards. Japan is feeling the effects of a labour shortage tied to population ageing and must compensate by continuing to invest.

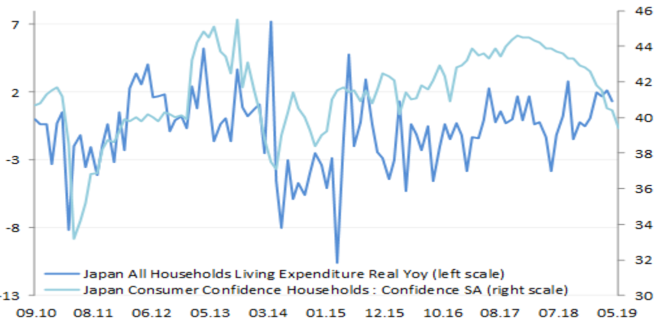
As imports fell more sharply (-4.6%) than exports (-2.4%), the net contribution to GDP was in fact favourable (+0.4%), amounting to most of the growth observed. The current account balance for April points to favourable conditions thanks to a higher-than-expected 1.7 trillion yen surplus. The persistent uncertainty with regard to trade relations between the US and China is weighing on confidence and affecting the Japanese economy as well.

This uncertainty remains the foremost threat to GDP growth in Japan, in particular given that the yen will likely depreciate in the coming months. Indeed, the monetary factor is still key in terms of generating positive GDP growth. The Japanese economy should nevertheless remain on the upswing in 2019 and exceed the current forecast for full-year growth of +0.7%. Growth in Q2 may slow somewhat before picking up in the second half of the year, in particular once the support measures implemented by the Chinese government start to have a positive impact on the Japanese economy.

Consumers remain worried

The job market remains particularly tight, as unemployment fell further to 2.4% in April. The central bank is still hoping that the job market's special circumstances will result in wage increases and boost consumption and inflation, but these developments are failing to materialise. Japanese household spending increased slightly in April yoy (-1.3%), but real wages continued to decrease over the same period.

Household spending / consumer confidence



Sources: Bloomberg, BBGI Group SA

Japanese consumers thus remain especially cautious. Indeed, consumer confidence has been steadily decreasing over the past eighteen months, reaching its lowest level since 2015. More will likely be necessary in order for a stronger and more lasting trend to take hold.

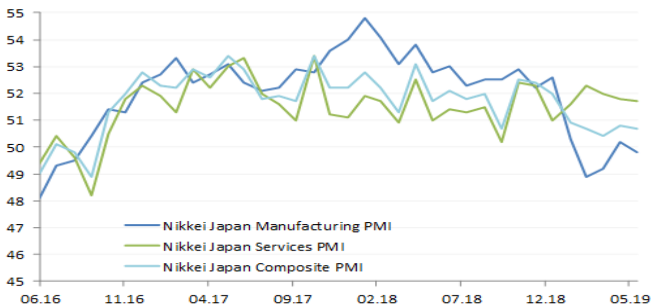
Leading indicators still weighed down by the manufacturing sector

Uncertainty continues to weigh on leading indicators, which nevertheless improved somewhat since the end of Q1. Japanese business sentiment did not really improve in May, while rising tensions between the US and China raised concerns once again among Japanese business leaders. The uncertainty affecting Japan's two largest trade partners is no doubt having an impact on purchasing managers' morale.

Weak economic conditions in Asia have also affected Japanese exports, heightening producers' concerns. In this context, the manufacturing PMI, which had bounced back from its February low (48.9), rose above its theoretical growth threshold only briefly in April (50.2) before sliding back again in May (49.8). Japan, which is also in Washington's crosshairs because of its trade surplus, thus saw its new orders indicator contract again for the sixth month in a row.

The composite PMI index also remains hesitant and is still not showing clear signs of an upturn. Existing trends are persisting, with the manufacturing PMI stabilising slightly under 50 and the services PMI fluctuating around the 52 level.

PMI indices



Sources: Bloomberg, BBGI Group SA

Economic upswing in May

Industrial output progressed by +0.6% in April, at a faster pace than expected. However, this upswing only offset the equivalent contraction in March. Industrial output has thus been stable since February. Nevertheless, retail sales rebounded by +4.8% in May, after an already significant +2.5% increase in April. The sector is looking up after a sharp downturn in March. Machinery orders were also higher than expected in April. The +5.2% increase can be considered an indication that capex is continuing to grow in spite of the trade tensions.

Further decline in the trade balance

Japanese exports fell another -2.4% yoy in April, thus confirming the existing trend for the fifth consecutive month. The impact of the trade war and the slowdown of the global technological cycle continued to weigh on the Japanese economy. Exports to China contracted more sharply (-6.3%), with a -41% drop in semiconductor equipment exports. The situation is radically different with regard to the US, whose imports of Japanese goods rose by +9.6% over the period. Japan's trade surplus with the US thus increased by +18% yoy, which will no doubt strengthen the US president's resolve to pursue his goal of rebalancing trade between the two countries. This situation will likely curb Japanese investment expenditure in the short term. Overall, the trade balance decreased to 60.4 billion yen, well below expectations, mainly due to the significant increase in imports in April (+6.4%). Donald Trump's decision to suspend the introduction of 25% tariffs on vehicles imported from Japan is a temporary positive factor.

The BOJ to maintain its expansionary policy

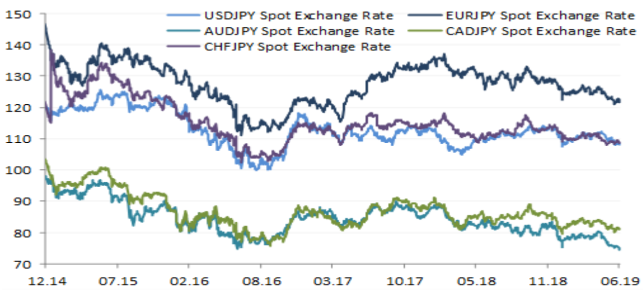
The Bank of Japan will likely keep its monetary policy unchanged at its next meeting on 20 June. The country's economic conditions can be considered positive in light of various indicators such as the unemployment rate, GDP growth, and the upswing in industrial output. In fact, however, conditions remain precarious given that domestic demand is weak and foreign demand is still affected by the threat of a trade war. Nevertheless, the Bank's governor does not seem concerned, in particular with regard to foreign demand. He expects the global economy to bounce back during the second half of 2019 in spite of current trade tensions. With regard to monetary policy, while there will likely be no change in June, it seems more and more likely that rates will be cut in September from the current -0.1% to -0.3% to maintain pressure on the yen. The BOJ is still facing a complex situation on the inflation front, which nevertheless has improved somewhat over the past few months. After plunging from 1.4% to 0.2%, the CPI climbed back up to 0.9% at the end of April. Inflation thus accelerated slightly, although it is still far from the BOJ's 2% target, which remains a priority, while the current context is likely to hamper the hoped-for increase in price indices in Japan. The governor of the central bank had in fact expressed his views on the matter, mentioning how challenging it is for central banks to manage inflation in a globalised environment characterised by technological innovation.

It thus seems necessary to introduce more flexibility with regard to determining the BOJ's inflation targets, particularly in terms of maintaining, or restoring, the institution's credibility.

Weaker yen remains necessary

Our outlook for the yen remains unchanged and bearish for 2019. We had been mentioning for several quarters already that a weak yen is a necessary condition for growth and inflation to pick up in Japan. Higher inflation would breathe some life into the Japanese economy and enable it to resume a more sustained pace of growth. Monetary policy still aims to weaken the yen, but means available to the central bank remain limited. We continue to expect that investors will shun the yen given a totally unfavourable interest rate environment and rate spreads that are likely to continue to penalise the Japanese currency. The interest rate spread temporarily narrowed over the past few weeks, but it will likely widen again, favouring a depreciation of the yen against the dollar. We thus expect the relative stability of the Japanese currency between 108 and 112 yen to the dollar since the beginning of the year to be temporary. The yen will likely depreciate, reaching 115 against the US dollar before stabilising above this level.

Yen against USD, EUR, AUD, CAD, CHF

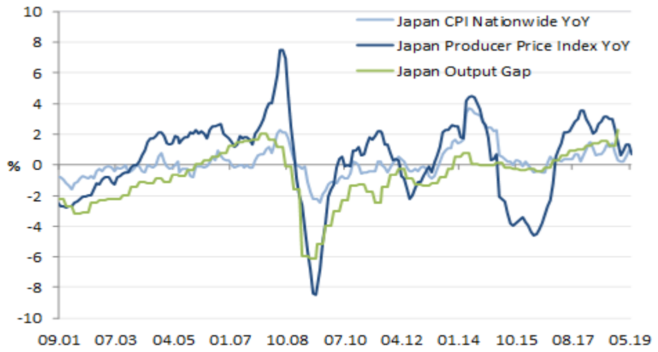


Sources: Bloomberg, BBGI Group SA

Avoid Japanese bonds

Inflation does not currently represent a significant threat with regard to the Japanese bond market, in spite of an increase of the CPI to 0.9%. Production prices decreased by -0.1% in May (+0.7% yoy), while imported inflation fell by -1.4% yoy. An upswing in prices was conditioned upon a depreciation of the yen, but inflation is still far from the BOJ's target (2%). In keeping with global trends, 10-year government yields are once again negative (-0.13%). The current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors in terms of yields, while the risk of incurring capital losses over the long run is significant.

Output gap and inflation (CPI and PPI)

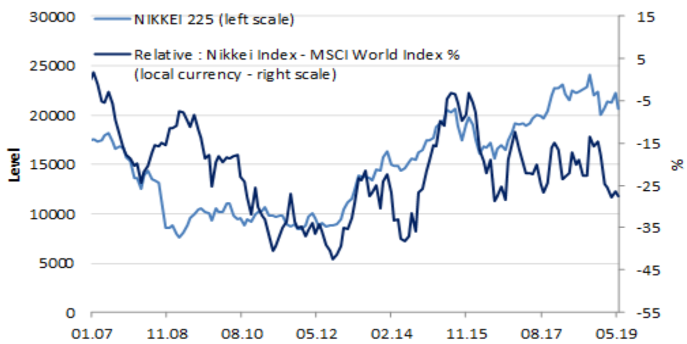


Sources: Bloomberg, BBGI Group SA

Nikkei impacted by trade war

The Nikkei remains affected for now by Japan's specific economic circumstances in the overall context of the trade war between China and the US. While the consequences of this uncertainty are real, the risks are likely overestimated. Japanese market fundamentals have in fact improved. Margins in particular are higher, and valuations are reasonable. The worst may already be over for Japanese businesses, which could once again benefit from a shift in risk perceptions, as investors' earnings expectations for 2019 are low and can be exceeded.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

Further depreciation of the yen will likely drive another upswing of the Nikkei, provided as well that the investment climate turns more positive and the risks currently weighing on the global growth outlook subside. The outlook is positive for 2019, but we maintain a relatively neutral strategy with regard to Japanese equities.

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