Economic Research

WEEKLY ANALYSIS

Alain Freymond – Partner - CIO

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Sharp economic slowdown in Japan in Q3

Anaemic GDP growth of +0.1% in Q3. Consumption slows. Exports contract. BOJ in holding pattern pending a government stimulus plan.

Key points

- GDP growth in Japan ground to a halt in Q3 (+0.1%)
- Exports fell further, but the trade balance is once again showing a surplus
- Industrial output dipped again at year-end after showing some signs of improving
- Leading indicators still lacklustre
- Consumption slows in spite of improving household confidence
- BOJ's flexibility is much reduced
- Yen will continue to weaken in 2020
- Earnings of Nikkei companies fell for the third quarter in a row
- Neutral positioning with regards to Japanese equities

GDP growth in Japan ground to a halt in Q3 (+0.1%)

GDP growth slowed sharply in Japan in Q3 due to a further drop in exports. The quarterly growth rate of +0.1% is well below the growth rate in Q2 (+0.3%), which was already lower than growth in Q1 (+0.5%). Economic growth yoy has fallen to +0.2%, a sharp decline compared to yoy growth of +1.3% (revised to +1.8%) at the end of June.

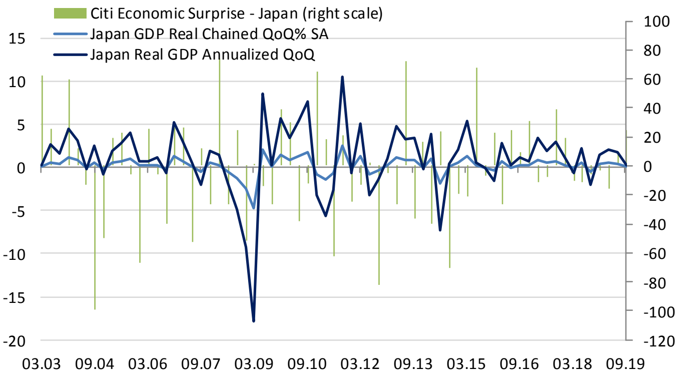
The Japanese economy is increasingly impacted by its falling exports and by the trade tensions that continue to put pressure on global demand for manufactured products.

These results are well below the consensus forecast, which had predicted yoy growth of +0.9%.

The Japanese economy was also affected by tensions with South Korea and by weather events including Typhoon Hagibis, factors that will likely no longer be present in Q4.

Capital expenditure continued to rise (+0.9%), while public spending (+0.8%) slowed compared to the previous quarter. Private consumption, capital expenditure, construction, and public spending contributed positively, while falling inventories and the contraction in net exports, and in particular service exports, as Korean tourists shunned Japan, contributed negatively.

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



Sources: Bloomberg, BBGI Group SA

Consumption held up fairly well over the quarter, rising by +0.4% just before the introduction of new taxes at the beginning of the fourth quarter, just a little below the +0.6% increase expected.

However, there is still the risk that private demand will slow following this introduction, impacting economic growth in Q4.

By historical comparison, excess consumption demand in Q3, immediately preceding the introduction of the tax, was well below that seen in 2014, which had then led to a very sharp slowdown in economic activity in the following months.

To mitigate the potential impact of the tax on growth, Prime Minister Shinzo Abe will likely announce a fiscal package aimed at stimulating the economy. The scope of these stimulus measures will be a determining factor for the Japanese economy over the next few months. A range of figures have been cited for this economic stimulus programme going from 3 to 6 trillion yen (28 to 55 billion dollars).

Parliamentarians in Japan's upper house approved the trade agreement with Washington on 4 December. The agreement would ideally take effect as soon as 1 January 2020. The agreement covers imports and exports of agricultural products as well as e-commerce and other online activities. This development reduces the level of uncertainty that was weighing on relations between Japan and the US until now.

Exports fell further, but the trade balance is once again showing a surplus

Japanese exports fell further in November, actually posting their sharpest drop (-9.2%) in three years. The open crisis with South Korea had a significant impact on the economy due to the boycott of Japanese goods as well as the collapse of Korean tourism to Japan. This factor is likely temporary, but it contributed to exports' 11th consecutive drop, highlighting the sector's struggles in the uncertain trade environment prevailing in the past several quarters.

Exports to the US (-11.4%) as well as to China (-10.3%) also declined significantly. The auto and steel sectors were particularly impacted by weaker foreign demand. In spite of the announcements suggesting that China and the US are about to reach an agreement, uncertainty persists, putting a damper on orders. The fall in exports will no doubt be taken into account by the Japanese government as it draws up its stimulus plan, which is unlikely to reach the higher end of the expected range, however. These developments imply that, in the short term, the Japanese economy is somewhat more dependent on consumption than previously.

Historically, Japan has run a trade surplus over the past decade, notwithstanding a deficit between 2011 and 2015. Although the trade balance was negative for several months, it turned positive once again in October with a surplus of 17.3 billion yen stemming from the -14.8% fall in imports. The situation is unlikely to change significantly in Q4, and we expect the trade balance to remain close to equilibrium. An economic upturn is unlikely to materialise in 2020 without a more significant contribution from the export sector. We thus have slightly more favourable expectations for Japanese exports in Q1, which could grow more rapidly than imports. As Japanese exports were impacted by flagging global demand and a slowdown in the manufacturing sector, any significant trend reversal will require conditions in these areas to improve as well as at least relative weakness of the yen. The nominal interest rate spread, which typically penalises the yen, has in fact be countered by trends in real interest rates, which for now are impeding any depreciation of the yen likely to boost exports.

Industrial output dipped again at year-end after showing some signs of improving

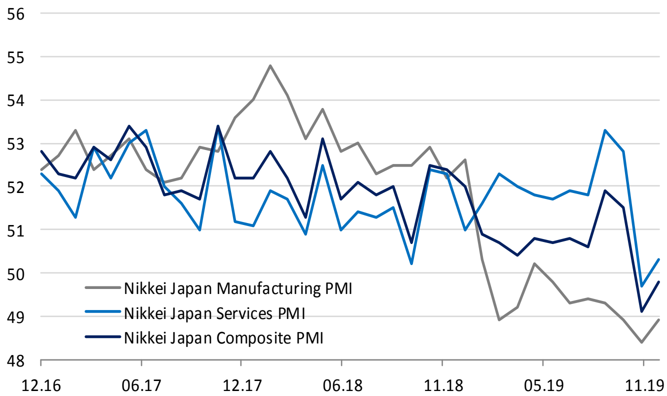
The Japanese manufacturing sector continues to be broadly influenced by the external factors mentioned above, and there are few signs that the trend will reverse any time soon. The small upswings in industrial output in July (+1.3%) and September (+1.7%) were erased by the -4.2% fall in November, among the steepest in the past five years. These results seem especially worrisome at this stage in the cycle, even though external factors were exacerbated by the tax increase and the super typhoon, two non-recurring temporary factors that depressed industrial output.

Leading indicators still lacklustre

Leading indicators for the manufacturing sector in November (48.9) have not provided further reasons to be optimistic, although they did tick back up from their October lows (48.6). Uncertainty continues to prevail with regards to leading indicators, which nevertheless stabilised just under their growth threshold. Since February, the manufacturing PMI has been oscillating around 49, indicating that conditions remain challenging for industry.

The latest figures published for November show that the services PMI rose back over the 50 mark after plunging abruptly in October, such that the global PMI (49.8) is now flirting with its growth threshold (50), albeit without great conviction.

PMI indices

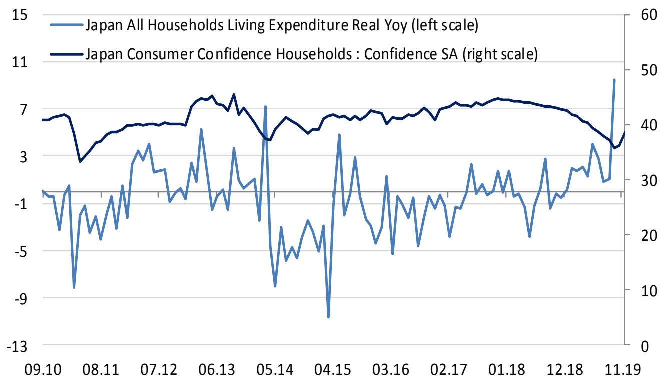


Sources: Bloomberg, BBGI Group SA

Consumption slows in spite of improving household confidence

Consumer confidence improved significantly for the second month in a row in November after declining for 20 long months. The increase is substantial and constitutes a positive factor indicating that the VAT increase will not necessarily penalise private consumption. The challenges in the manufacturing sector have had only a very limited impact so far on the unemployment rate, which nevertheless jumped from 2.2% to 2.4% in October.

Household expenditure / consumer confidence



Sources: Bloomberg, BBGI Group SA

The job market remains tight, but the job-openings-to-applicant ratio (1.57) will likely decline further due to decreased demand in the manufacturing sector.

Given the more challenging environment, businesses are turning somewhat more to part-time positions in the short term. While real household consumption slackened from +0.6% to +0.4% in Q3, more recent statistics indicate a significant drop in household spending in October.

Auto sales plummeted by -26.4% yoy in October before bouncing back somewhat in November (-14.6%). Department store sales benefited from an increase in demand (+20.7%) prior to the introduction of new taxes but fell sharply in October (-19%). The central bank continues to hope that the job market's particular situation will boost wages, consumption, and inflation, but these effects are still struggling to materialise.

BOJ's flexibility is much reduced

The Bank of Japan kept its monetary policy unchanged at its meeting on 31 October and is unlikely to announce any major change at its last meeting of the year on 19 December.

The governor of the central bank recently pointed out that the BOJ's ultra-accommodative monetary policy was aimed at boosting inflation and not at financing government spending, commenting just as the government is preparing to announce additional economic stimulus measures to counter the threat of an economic slowdown.

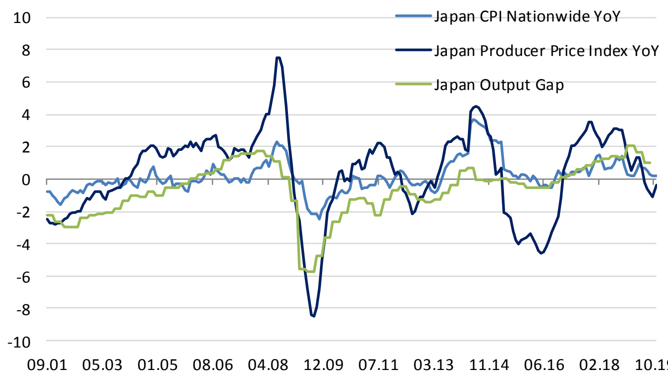
The warning is unlikely to have a significant effect on politicians, who will likely not hesitate to take measures that could further increase government debt and the debt ratio, which is already among the highest across industrialised nations.

Governor Kuroda will likely not hesitate to cut rates again should price indices lose momentum.

The monetary policy committee takes deflationary risks seriously, but patience still seems to be winning out.

The latest CPI figures show that inflation has stabilised at 0.2%, which can be considered as relatively far from the BOJ's target.

Output gap and inflation (CPI and PPI)



Sources: Bloomberg, BBGI Group SA

The BOJ is probably wondering if the appreciation of the yen and the struggling manufacturing sector are sufficient reasons to justify a rate cut in December or if sitting tight for a few weeks will leave enough time for a more positive outlook to finally take shape.

Kuroda could look at the stabilisation of manufacturing leading indicators over the past several months already as a positive sign and anticipate that the Japanese economy overall will likely benefit from the improvement in global conditions that will undoubtedly materialise following the rate cuts in the US and Europe.

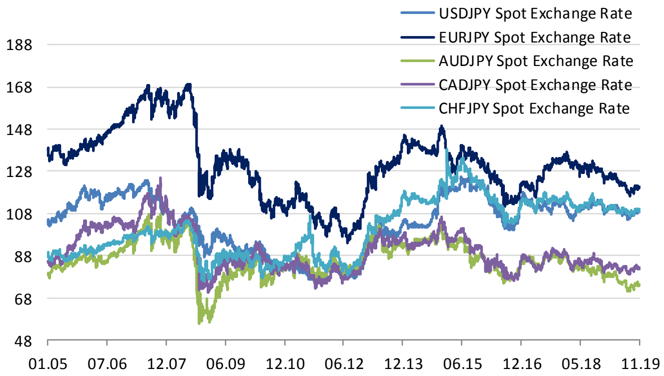
Indeed, the BOJ is under a lot of pressure to act, in particular in terms of weakening the yen, but we do not believe that a rate cut would be the appropriate trigger in that regard.

Yen will continue to weaken in 2020

Negative nominal interest rates (-0.1%) in yen remain unattractive overall by global comparison, and more specifically compared with US dollar rates still close to 1.5%. This nominal rate differential could seem favourable to the dollar, but due to lower inflation (+0.2%) in Japan combined with higher inflation (+1.8%) in the US, real yields are in fact similar (-0.3%).

This real yield differential is thus likely one of the main factors explaining movements in the yen/US dollar exchange rate over the past few months. The BOJ would obviously prefer real yen yields to be lower, but in that regard the only factor likely to have an impact would be an upswing in price indices, as a large cut in policy rates does not seem to be a serious option.

Yen against USD, EUR, AUD, CAD, CHF



Sources: Bloomberg, BBGI Group SA

Thus, the BOJ's only choice is to opt for patience, waiting for external factors such as an upturn in inflation or in long-term rates in the US to take shape, changing valuation parameters such that the yen may depreciate. We are not changing our outlook for the yen, which remains fundamentally bearish for 2020.

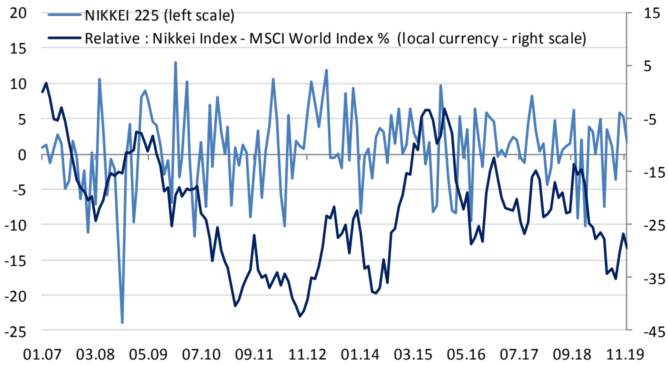
A weak yen remains a necessary condition in terms of boosting economic activity and inflation in Japan. The stability of the yen against the US dollar since the beginning of the year will likely be followed by a decline of the yen.

Earnings of Nikkei companies fell for the third quarter in a row

Economic activity and the results of Japanese firms remain strongly affected by the feud with South Korea and the trade tensions between China and the US.

The fall in exports is obviously having an impact on the results of listed companies, whose earnings dropped by -5.3% yoy, while sales fell for the first time in three years (-2.6%).

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

A weaker yen, lower trade tensions, and an improved economic outlook bolstered by the latest decreases in long and short rates in the US would be favourable to an upswing of the Nikkei. With this in mind, we maintain a neutral strategy on Japanese equities.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva – Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch