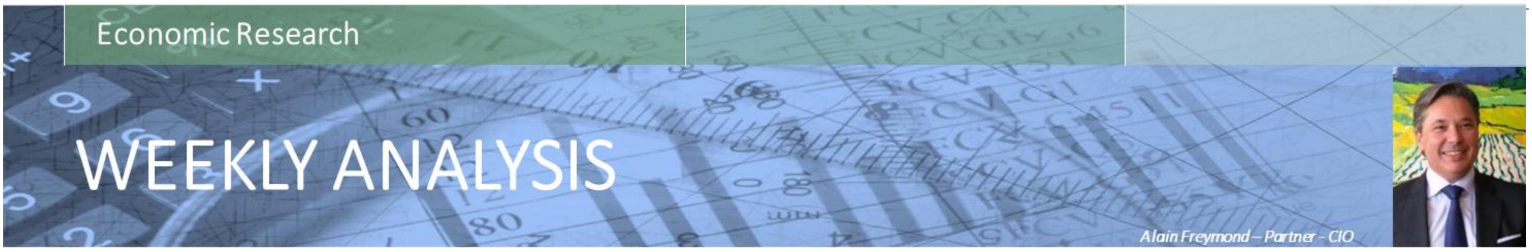


11 June 2020

USD 2 trillion to pull Japan's economy out of recession

Slide into recession in Q1. -20% contraction expected in Q2. Record budget for growth. Economic pick-up in Q3. Drop in corporate earnings. Excessive valuation of the Nikkei.

Key points

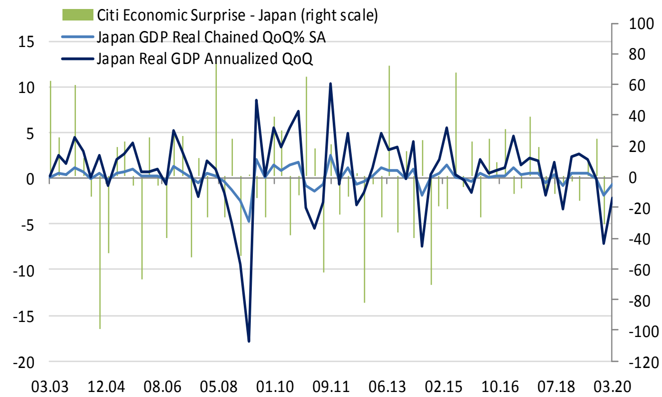
- Japan's GDP resisted well to Covid-19 in Q1
- Recession is likely to take a turn for the worse in Q2
- Record budget approved to support Japan's economy
- Expected rebound of leading indicators
- Record -21.9% collapse in exports
- Likely pick-up in private consumption and public spending in Q3
- BOJ unlikely to change policy
- Depreciation of yen to continue in 2020
- Decline of -32% in corporate profits in Q1
- Beware the excessive valuations of Japanese equities

Japan's GDP resisted well to Covid-19 in Q1 2020

The Japanese government has revised its estimates for Q1 GDP growth, which may have dropped a little less than initially expected, namely by only -0.6% instead of -0.9%, or by -2.2% on an annual basis, significantly better than the estimated -3.4% annualised contraction. The revision does not really affect data relating to household consumption (-0.8%) or exports (-6%), and mainly concerns non-residential corporate investments, which are actually estimated to have increased by +1.9% over the period instead of the previously calculated decrease (-0.5%).

This positive revision must be put into perspective because of the very likely imprecision of certain statistics that are difficult to collect in these times of Covid-19. Japan thus already slipped into recession in 2020 following economic contractions in the last two quarters, as GDP had already declined by-1.8% in Q4 2019.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

However, recession is likely to take a turn for the worse in Q2 2020

Japan has been largely spared by the Covid-19 pandemic, with some 17,250 cases and 919 deaths. The health crisis remained relatively limited initially in Japan, justifying the absence of strict confinement measures, although the population complied to a fairly large extent with the government's calls to reduce social interactions and population movements as much as possible. Household consumption thus logically slowed down at the end of the quarter, while exports collapsed due to the drop in international demand. Japanese companies reacted quite quickly by cutting back on investments. Nevertheless, the government had to declare a state of emergency in April-May due to a resurgence of Covid-19 cases, driving household consumption down by -11.1% in April. **GDP is likely to slide into recession with a drop in excess of -20% in Q2 and a decline of approximately -4% over the whole of 2020.**

Record budget approved to support Japan's economy

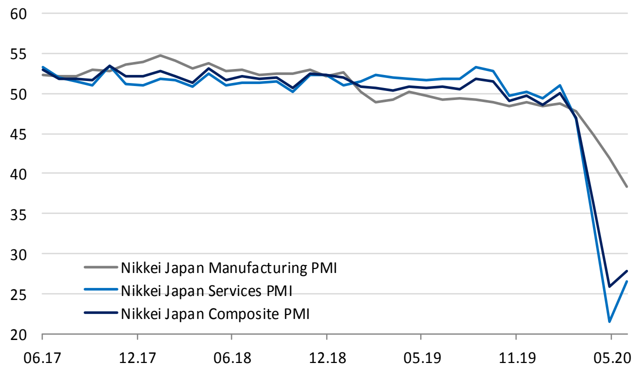
Shinzo Abe's government had already announced measures to try and stimulate the economy at the end of 2019, which were followed at the start of the year by further measures aiming to support small- and medium-sized enterprises. In June, Japan's MPs adopted a new record budget to support the economy. Indeed, the lower house of the Japanese parliament signed a record new extraordinary budget of approximately USD 300 billion in order to finance a second economic support plan. A third or so of this budget will be allocated to financing a government fund to provide zero interest rate loans to struggling small- and medium-sized enterprises, in addition to the Bank of Japan's new lending mechanisms. The rest will serve to finance various measures, including helping businesses to pay their rent and their partially unemployed employees, subsidise municipalities in crisis, bolster the healthcare system and medical research, and offer bonuses to healthcare workers, cash-strapped students and single-parent families.

This budget, which lies at the heart of a massive second economic support plan, weighs in at close to USD 1 trillion. Altogether, state support to the countries' businesses and households is likely to reach USD 2 trillion, essentially in the form of loans.

Expected rebound of leading indicators

The historic plunge of the manufacturing PMI index to 38.4 and of the services PMI index to 21.5 in May, far below the growth threshold of 50, is consistent with the ongoing economic collapse in Q2. The accelerating decline in industrial production from -3.7% in March to -9.1% over the month of April is also coherent in this context. The outlook for industrial production in May (-4%) is still negative, but growth is likely to turn positive in June (+4%). We expect a likely recovery in leading indicators in June. In the current context, the visibility of economic prospects remains particularly low, but the gradual recovery in activity in June, after two months of confinement in most countries, will have a positive impact on Japan's economy and its exports.

PMI indices



Sources: Bloomberg, BBGI Group SA

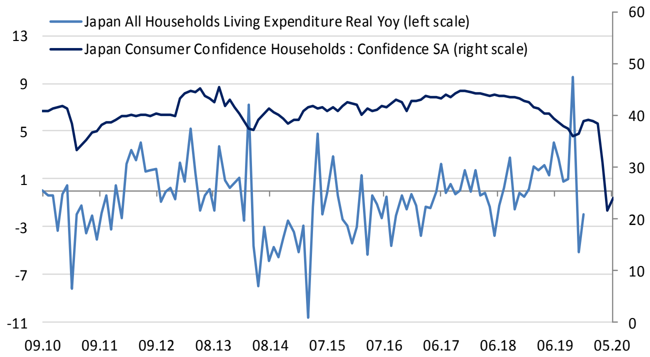
Record -21.9% drop in exports

Japan's foreign trade balance deteriorated further in April due to a record drop in exports estimated at -21.9% (-11.7% in March) and a decline in imports of -7.2% over the same period. The trade deficit (seasonally adjusted) is now close to three times as large as in March. Japan's trade balance has deteriorated with the large majority of the country's trade partners. Existing trade deficits have increased, such as the deficit with China, which has doubled to reach 552 billion yen. In terms of trade surpluses, the positive balance with the US has decreased by two thirds in one month to 181 billion yen.

Likely pick-up in private consumption and public spending in Q3

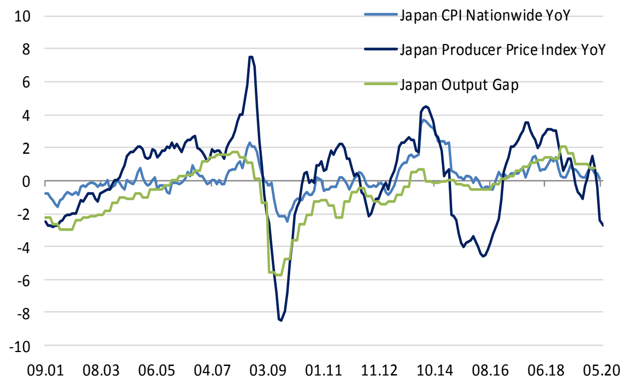
Department store sales were further hit by the health crisis, falling by -76.1% in April in a logically more pronounced trend than that observed in supermarkets, where sales dropped by -4.5%. Despite the sharp collapse in consumer confidence in April, the rebound observed in May also hints at a more favourable third quarter. Public spending is also likely to add a positive contribution in the coming months with the implementation of various government measures.

Consumer spending and confidence



Sources: Bloomberg, BBGI Group SA

Output gap & inflation (CPI & PPI)



Sources: Bloomberg, BBGI Group SA

BOJ unlikely to change current policy for the next few weeks

The Bank of Japan decided to act to try and quell the wave of panic that also affected Japan's financial markets in March by announcing it would double its purchases of Japanese equity index ETFs, increasing the sum earmarked for these purchases to JPY 13 trillion, i.e. USD 112 billion per year. After this first measure, the BOJ also announced it would increase its corporate debt purchases by JPY 2 trillion until September as well as collateralised loans by JPY 8 trillion.

In the last few months, the BOJ has purchased government bonds without limit, extended its ETF purchase programme to include REITs, and launched a lending programme for a total value of USD 700 billion.

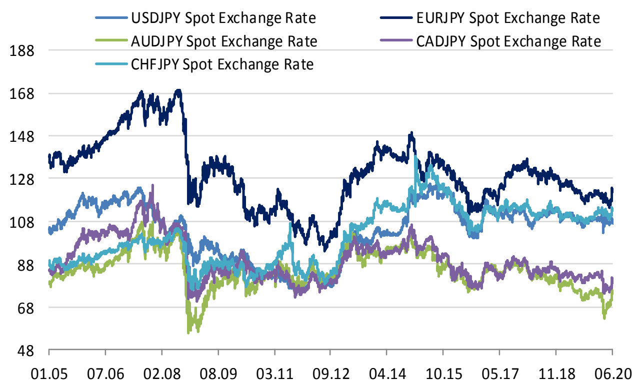
During this period, improved sentiment and rising equity markets drove long-term interest rates slightly upwards, pushing them to their highest level since April 2019. The BOJ is unlikely to consider this progression as liable to hinder its objectives. The Bank's action has helped stabilise financial markets and avoid additional deterioration in confidence, already undermined by the health crisis.

Key rates will likely remain unchanged in June, and the BOJ has pledged to provide all required liquidity to banks and the economy through its asset purchase programme.

Depreciation of yen to continue in 2020

The volatility of the JPY/USD exchange rate rebounded sharply during the financial crisis in March. First, the yen benefitted from a 'safe-haven' effect, appreciating by almost +10% against the dollar from 112 to 102 yen before returning to its previous equilibrium level at the end of the month. Since the start of the year, the yen has ultimately remained relatively stable at around 107 yen to the dollar. During the Covid-19 crisis, the yield spread between dollar and yen short-term rates narrowed dramatically. The nominal rate spread favourable to the dollar at the start of the year has thus disappeared, thereby reducing the positive impact of this factor on the outlook for a weaker yen. Nevertheless, Japan's economy still needs a weaker yen to increase the competitiveness of its exports sector, hampered by the global health crisis.

Yen against USD, EUR, AUD, CAD, CHF



Sources: Bloomberg, BBGI Group SA

We have not changed our outlook for the yen, which remains fundamentally bearish for 2020. A weak yen remains an essential condition for Japan's activity to pick up and inflation to recover. The stability of Japan's currency since the start of the year against the US dollar is likely to be followed by a decline in the near future.

Massive -32% drop in Japanese corporate profits in Q1

According to the Ministry of Finance, during Q1 2020, earnings before tax of companies in the Topix index fell by -32% compared to the same quarter in 2019. Earnings per share plunged by -89%, which is by far one of the most dramatic earnings contractions in Asia and in the world. Japanese corporations have thus posted a 4th consecutive quarterly drop in profits. GDP could collapse by -20% in Q2, which would be a record not seen since 1955 and would bode extremely ill for the evolution of Japan's corporate profits.

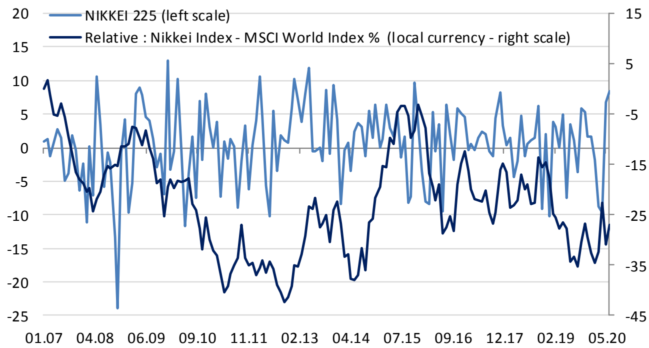
Japanese corporate earnings are likely to drop further still in Q2 before rebounding in H2 2020.

Beware the now excessive valuations of Japan's equities

At the end of March, we recommended taking positions in Japanese equities whose share prices had largely factored in the above-mentioned various risks relating to the Covid-19 crisis for the second quarter. Following the correction of more than -30% in stocks that took into account these risks, we then believed that Japanese equities offered interesting repositioning opportunities. Now, after two months of stock market recovery, risks once again seem higher.

In terms of valuation, Nikkei stocks are traded at more than 23x expected earnings for the next 12 months and 17x expected 2021 earnings, for a dividend yield of 1.9%. Expected earnings per share in 12 months for Nikkei stocks now stand at 1,000. They still stood at 1,132 per share at the start of the year. The rise in PE ratios is partly due to the contraction of approximately -13% in earnings expectations for the next 12 months. However, the +40% performance of the Nikkei index since its lows in March, one of the strongest among stock market indices worldwide, seems essentially driven by hopes of a recovery in H2 as well as the central bank's liquidity pledge.

Nikkei & MSCI World indices



Sources : Bloomberg, BBGI Group SA

The Nikkei index has thus practically erased the drop that began in late February and has once again reached high valuation levels, to our minds. Hence, we now believe the time is right to reduce equity risks and once again take profits on Japanese equities.

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