# WEEKLY ANALYSIS

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## MODERATE OUTLOOK FOR THE NIKKEI

Growth at a standstill in Q4. Mixed leading indicators. Slight improvement in consumer confidence. Trade deficit narrowed. Inflation down. Expansionary monetary policy. Moderate outlook for the Nikkei.

### Key points

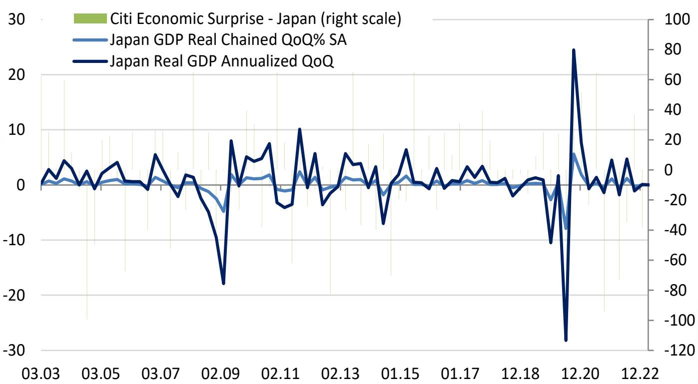
- Japan's economy stalled in Q4 (0%)
- Barely positive outlook for Q1 2023
- GDP growth up +1% in 2023
- Leading indicators still moderately optimistic
- Weak improvement in consumer confidence
- Trade deficit decreases by -50% but persists
- Japanese inflation finally seems to be easing
- BoJ also faces post-SVB adjustments
- Yen yields still unattractive
- Interest rate differentials still unfavorable for the yen
- Mixed outlook for Japanese equities

### Japan's economy stalled in Q4 (0%)

We were expecting a still sluggish Q4 for the Japanese economy, potentially not supported by external or domestic demand. The seasonally adjusted Japanese GDP result was released and finally came in at 0% in Q4, leaving only a minimal +0.1% year-on-year increase. However, this is slightly better than the contraction of -0.8% recorded in the previous quarter, but the weakness of Q4 underscores the continuing fragility of the economic situation in Japan after a Q2 increase of +3.5% annualized, which may have been more encouraging for the second half of the year. This result is also far below the expectations of the Japanese authorities. From the point of view of the Japanese central bank, this lack of performance will further support the need to strengthen economic support measures and maintain an accommodating monetary policy. The effects of Covid and the fall of the yen have not been without effect on the economy of the Rising Sun, which in Q4 has not yet been able to count on the Chinese recovery that is expected in the coming quarters thanks to the decision to end anti-Covid restrictive measures. The private consumption was weak and grew by a small growth of +0.3% over the quarter, while capital goods spending and investment declined by -0.5%. Japanese companies do not yet seem to be convinced of the possible improvement in the business climate and have thus adjusted their expectations more cautiously by limiting their investments.

The Japanese economy will still face further difficulties due to the low probability of aggregate demand during the winter. Domestic consumption will again prove to be a decisive factor in trying to offset the risks of a sharper downturn in international demand. Consumption was still weak in Q4, due in part to rising prices, but this weak momentum still came as a negative surprise to observers who were expecting better results supported by the fiscal stimulus provided by the Central Bank of Japan (BoJ).

**Performance of the Japanese economy (GDP) in yen**




*Sources: Bloomberg, BBGI Group SA*

### Barely positive outlook for Q1 2023

The Japanese economy thus just avoided a technical recession by recording an annualized increase of +0.1% in Q4, confirming the expected weakness of the economy. The outlook for Q1 is hardly better, with GDP still expected to suffer from insufficient household consumption despite the ongoing fiscal stimulus, as was already the case in the previous quarter.

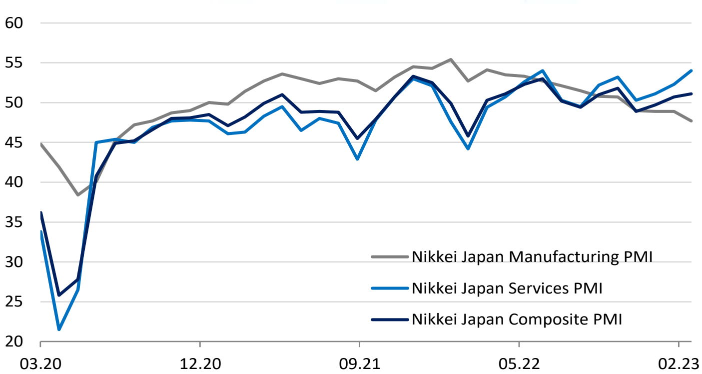
Consumer spending by foreign travelers in Japan could support domestic consumption without significantly influencing its overall level. Japan's recovery is expected to take hold very gradually, as the decline in consumer purchasing power, following the steady decline in disposable income, is expected to stabilize only very gradually. The reopening of China seems to be the main factor on which the Japanese economy can count for a boost in exports, but it is still difficult to determine when the first effects will be visible, as Japanese exports to China have actually declined over the past two months. With global demand expected to remain weak in Q1, the near-term economic outlook for Japan is again bleak, but likely to rise by 1% for the year as a whole.

## Leading indicators still moderately optimistic

The Jibun Bank of Japan PMI leading indicators released in early March improved slightly. The composite indicator (51.1) recorded its third consecutive increase and moved back above the growth threshold (50). The rebound in the services index (54) was the main factor behind the improvement, while the manufacturing segment still struggled (47.7). The PMI indices confirm the continuation of the trend observed in the Japanese leading indicator, which declined again in January from 96.9 to 96.5, while the coincident business cycle indicator also slipped from 99.1 to 96.1.

The collapse of industrial production (-5.3%) in January follows a brief stabilization in December. However, the capacity utilization rate fell by -5.5% to 89.6% and is evidence of the ongoing weakness. While the fall in machine tool orders shows no sign of abating, according to the latest figures for February, down -10.7% year-on-year. However, Japanese companies are now expecting a recovery in machine orders in the first quarter of +4.3% that could erase the decline of the last three months (-5%). The manufacturing sector is expected to grow by +13.6% following a decline of -14% in the previous quarter, mainly supported by the recovery of demand in the aerospace sector and machinery production. They also expect a favorable impact from the reopening of China. Some hope therefore still seems to be allowed, even if uncertainty still dominates in this extremely important sector for Japanese exports.

**PMI indicators (Manufacturing, services, composite)**

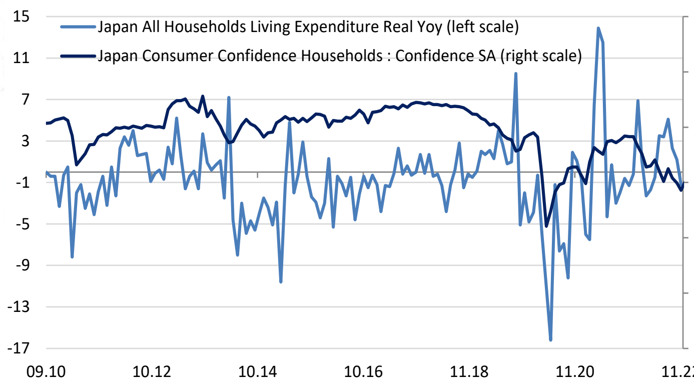



*Sources: Bloomberg, BBGI Group SA*

## Weak improvement in consumer confidence

Japanese consumer confidence remains low and still far below the level observed a few quarters ago, but it has nonetheless improved over the past three months and is gradually rising again. The confidence indicator rose from 28.6 to 31.1, highlighting a slight improvement in households' perception of risk. Despite a stable ratio of job offers per applicant of 1.35 and an unemployment rate still falling in recent months from 2.6% to 2.4%, disposable income only increased by +0.8% over one year and real income contracted by -4.1% after taking inflation into account, which corresponds to its biggest drop since 2014. Overall, the labor market remains under pressure, suggesting that a gradual transmission to wage levels is possible. Retail sales, on the other hand, have recovered and are up by +1.9%, bringing the year-on-year increase to 6.3%. The recent drop in inflation from +4.4% in January to +3.4% (Tokyo) in February year-on-year probably supported the recovery in retail sales and confidence.

**Household confidence**



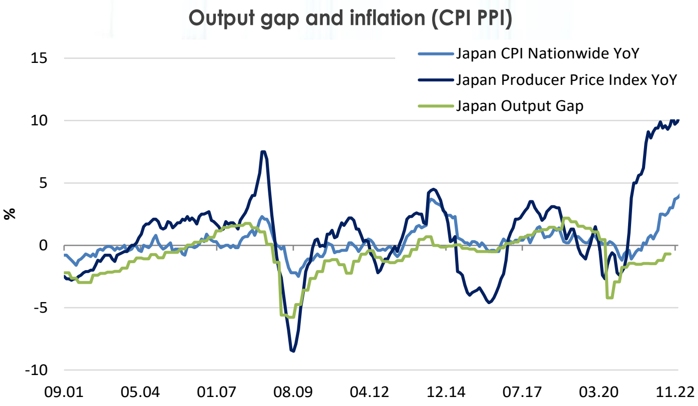

*Sources: Bloomberg, BBGI Group SA*

## Trade deficit decreases by –50% but persists

Japan's adjusted trade balance recorded its third consecutive month of relative improvement in February. After falling to a record 2'299 billion yen deficit in October 2022, the trade deficit halved to 1'190 billion yen, surprising most experts. This encouraging result for Japan was achieved mainly by a decrease in imports and a recovery in exports. Imports increased by +8.3% year-on-year, significantly less than the +50% increase recorded previously, thanks in particular to a decrease in the cost of energy imports. On the export side, the +6.5% increase was supported by a recovery in vehicle exports. The Chinese recovery is beginning to have an effect on the dynamics of Japanese exports and could gradually support GDP growth. Furthermore, the expected signs of economic slowdown in Europe and the United States do not seem to be negatively affecting Japanese exports to these two regions for the time being. Indeed, they are up by +18.6% and +14.9% respectively, while shipments to China decreased in March compared to the previous month. Overall, Japan's foreign trade still recorded its nineteenth consecutive month of deficit in a climate still characterized by insufficient international demand to strengthen its exports and by energy prices in yen which weigh on the level of imports.

## Japanese inflation finally seems to be easing

The favorable evolution of the exchange rate since its peak of 150 yen against the U.S. dollar in October has certainly contributed significantly to the net improvement in Japan's inflation measures in recent months. The drop from 150 to about 130 yen has reduced the level of imported inflation reversing the previous trend that had supported inflation growth in 2022. Japanese inflation had been effectively contained for a long time before the sharp depreciation of the yen from 115 to 150 yen per U.S. dollar reinforced a trend already initiated by rising commodity prices. The Consumer Price Index (CPI Tokyo) had jumped from +0.8% to +3.9% in twelve months, it has now fallen from +4.4% in January 2023 to +3.4% in February. At the national level, the same type of decline is expected in a year-on-year comparison, which would lower the price increase at the end of February from +4.3% to +3.3%. Government subsidies have also largely contributed to this positive development, which would certainly not have been significant otherwise. In parallel to this evolution of the CPI indices, producer prices have recorded an already significantly better trend since October, with a net deceleration of the monthly data and even a price contraction in February of -0.4%. In year-on-year comparison, producer prices had peaked at +10.5% in December 2022, thanks to the recent more positive momentum, the year-on-year increase was then able to slip to +8.2% in February 2023, which is still high, but should gradually decline further. The transmission of the rise in import prices and producer prices to the consumer price indexes should continue to develop positive effects in the coming months. The energy and raw materials factor will certainly remain a determining factor in the evolution of inflation over the next few months, although it will probably make a smaller contribution than in recent months. The stabilization of oil and gas prices will in fact reduce the impact of these prices on imported prices. In addition to the improvement of this trend, the recent recovery of the exchange rate, which fortunately appreciated by almost +15% against the dollar in a few weeks, should also have several positive effects on the result of foreign trade and inflation.




*Sources: Bloomberg, BBGI Group SA*

Japanese inflation thus seems to have already reached a growth peak from which the recent trend should strengthen and allow the BoJ to maintain a monetary policy that is still very broadly expansionary, particularly since the evolution of risks following the SVB's bankruptcy.

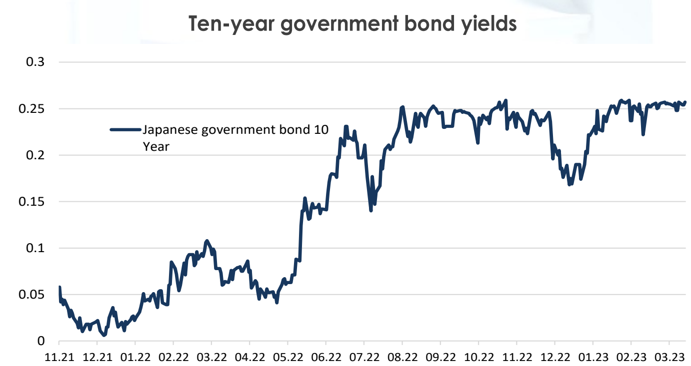
## BoJ also faces post-SVB adjustments

Until December 2022, the BoJ implemented a monetary policy in clear opposition to that of other central banks pursuing restrictive policies to fight inflation. While maintaining its inflation target of +2%, it had pursued a strategy of controlling the yield curve, despite the rise in prices, by adopting a policy that is still considered the most flexible of the central banks, despite a decided increase from 0.25% to 0.5% in its key rates in December. The policy of supporting the Japanese economy with low rates, by controlling rates across the yield curve, has led it to act by further increasing its purchases of government debt. The BoJ now holds 52% of the debt issued by the Japanese government.

The crisis of confidence caused by the SVB bankruptcy has not been without effect on the Japanese bond market and on investor sentiment in Japan. The Japanese Finance Minister also had to remind that Japanese financial institutions had enough liquidity and capital and that the financial system was stable and not threatened by this event. He also stressed that he was following the situation very closely with the BoJ and other financial authorities. Thus, a common front has also been established in Japan to deal with possible difficulties that could still affect Japanese banking institutions. The Japanese banking sector also suffered sharp price declines, perhaps more related to the risks concerning Credit Suisse than those concerning the US regional banks. These events had serious repercussions in Japan, also on the average level of interest rates, which underwent an immediate downward adjustment of around 0.25% to return to their equilibrium levels prior to the December rate hike. We believe that Japanese monetary policy will not undergo a radical change in this context, especially if inflation is reduced.

## Yen yields still unattractive

The rise in yen yields from 0.25% to 0.5% between December 2022 and February 2023 was not a significant change to consider a yen bond investment. The recent drop in yields to 0.25% in the above context does not change our assessment of the situation. The low yen yields and the prospect of a flight to quality that could support the yen are not sufficient to create the conditions to positively consider an exposure to Japanese bonds.



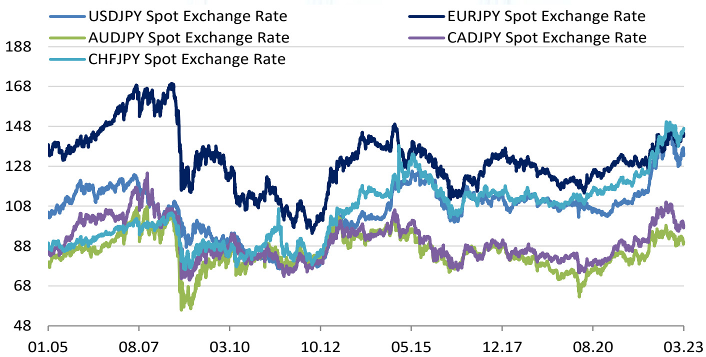

*Sources: Bloomberg, BBGI Group SA*

Holding bond positions in yen is indeed still not attractive compared to the returns offered in other currencies. Japanese bonds therefore do not offer any attractive prospects in the current context of more attractive international alternatives.

### Interest rate differentials still unfavorable for the yen

The BoJ's monetary policy is expected to remain relatively stable over the next few months, with the estimated policy rates for both June and September still at 0.14%, suggesting extremely limited potential BoJ activity. In the short term, however, the yen could still benefit a bit from the expected dovish change in the Fed on the one hand and the Japanese wage negotiations that resulted in a wage increase on the other hand, which could open the door to rate hikes by the BoJ later this year. For the time being, the yen is benefiting from the uncertainty related to the SVB bankruptcy and is resuming a positive trend. However, the appreciation of the yen seems to us to be already significant and already takes into account the recent change in trend on dollar rates. Dollar yields have indeed declined in recent days, by nearly 50 bps on long maturities, but the decline is more than 120 bps on two-year Treasury yields. These relative yields are therefore down sharply compared to those in yen, but they remain high enough to support an equilibrium exchange rate close to 130 yen in our view. We believe that the yield differential will be the main factor determining the level of the exchange rate and in the absence of an unlikely more restrictive policy from the BoJ, our outlook favors a stabilization of the yen against the US dollar in the range of 127-130 yen per dollar in the near future.

Evolution of the yen against the main currencies




*Sources: Bloomberg, BBGI Group SA*

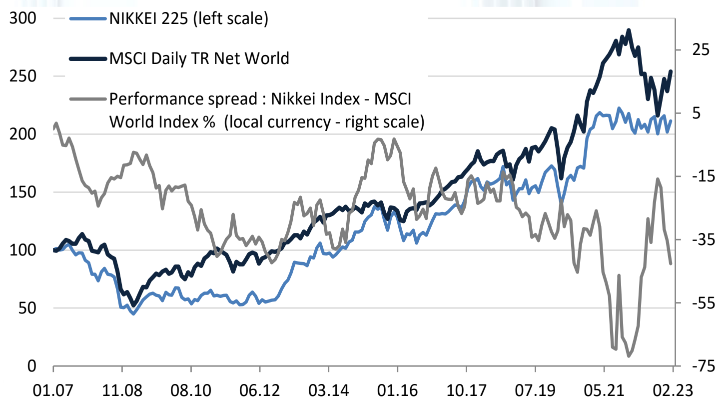
### Mixed outlook for Japanese equities

The Japanese banking sector recorded its worst weekly performance since April 2020 in the wake of the Silicon Valley Bank bankruptcy in the US. The -18% correction in the banking sector in five days is a testament to the panic caused also in Japan by the failure of a US bank. Overall, the Topix composite index erased almost all of its gains for the year, falling by almost -8%.

The gradual improvement in the international stock market climate had also benefited the Japanese indices, which were approaching their 2021 highs before this event. The absence of pressure on Japanese interest rates has certainly proved to be a key factor in the exceptional resilience of Japanese stocks, even though the profit outlook for companies was still negatively affected by the decline in international demand and still sluggish domestic consumption.

In relative terms, the Nikkei is no longer as attractive today with a valuation of 16x 2023 earnings, compared to a PE of just 12x for European stocks. However, it remains cheaper than the S&P500 (PE of 17x). The decline in the relative risk premium for Japanese stocks in the stabilizing yen environment now limits the attractiveness of Japanese equities in an internationally diversified strategy. In this environment, despite the still relatively positive outlook, we suggest an underweight allocation to Japanese stocks.

Nikkei and MSCI World Indices




*Sources: Bloomberg, BBGI Group SA*



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