WEEKLY ANALYSIS

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NIKKEI AT ITS HIGHEST IN 33 YEARS

0.7% acceleration in Japanese GDP. Household confidence remains hesitant. Trade deficit down 66%. Inflation falls to +3.2%. Expansive monetary policy. Nikkei at 33-year high.

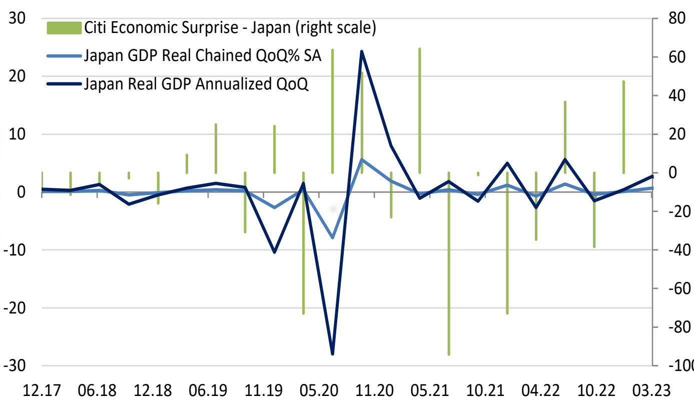
Key points

- Japanese economy recovers strongly in Q1, growing more strongly than expected (+0.7%)
- Slower growth in Q2
- Slightly more encouraging leading indicators
- Slight improvement in consumer confidence
- Trade deficit decreases by -66%
- Japanese inflation confirms its downward trend
- BoJ monetary policy to remain highly expansive
- Yen yields still unattractive
- Yen yield spreads still unfavorable
- Nikkei at 33-year high

Japanese economy recovers strongly in Q1, growing more strongly than expected (+0.7%)

The stagnation of Japanese GDP in Q4 2022 had enabled the Japanese economy to avoid a technical recession, despite starting the year with a rather hesitant and uninspiring outlook. Economists' forecasts called for a very moderate recovery at the start of the year, but this was largely outweighed by a much stronger than expected economic recovery. The seasonally-adjusted Japanese GDP result after a first revision showed quarterly growth of +0.7% for an annualized GDP increase of +2.7%, well above the expected +1% increase for the year as a whole. The strengthening of completed investments by businesses suggested that business sentiment remained resilient despite concerns about a slowdown in the global economy. Conversely, rising inventories supported growth, but perhaps suggest that demand is not keeping pace with production, a potential source of concern for the future. Consumer spending unfortunately turned out to be a little weaker than initially estimated. This stronger-than-expected growth is accompanied by a +0.4% rise in inventories, which are close to their highest levels in more than three decades. The world's third-largest economy is thus catching up with the already more positive trend in the US and Chinese economies, following the government's decision to end its health restrictions. This GDP result significantly reduces fears that a slowdown in the global economy will weigh more heavily on household and business sentiment in Japan. That said, Japan's real GDP remains below pre-pandemic levels. Private consumption and business spending are still below their previous levels. Private consumption advanced by only +0.5%, while capital expenditure rose by +1.4%. Despite the surprising momentum of the 1st quarter, GDP growth is likely to weaken over the following months, without calling into question the forecast of +1% growth for the year as a whole.

Japanese economic performance (GDP) in yen



Sources: Bloomberg, BBGI Group SA

Slower growth in Q2

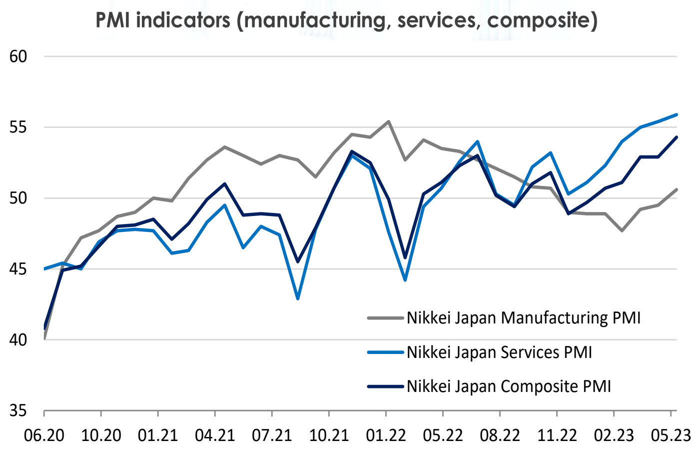
Growth is likely to continue at a reduced pace in Q2, due in particular to the expected weakness in consumption and wages. The increase in inventories suggests that companies are replenishing their stocks as supplies of spare parts increase, particularly in the automotive sector and especially for electronic chips. Household consumption could, however, contribute to the resilience of economic growth in Q2, particularly in view of the expected further decline in inflation.

Consumer spending by foreign travellers in Japan could provide support for domestic consumption, but without significantly influencing the overall level of consumption. Japan's recovery is likely to continue very gradually, as the decline in consumer purchasing power following the steady decline in disposable income is likely to stabilize only very gradually. The reopening of China seems to be the main factor on which the Japanese economy can count to boost its exports, against a backdrop of declining external demand, particularly in Europe. China's recovery still looks modest compared with expectations at the start of the year, but the Chinese authorities are in the process of implementing new stimulus measures to strengthen the current momentum. With global demand still expected to be weak in Q2, the short-term economic outlook for Japan is also more uncertain, but is likely to rise by +1% for the year as a whole.

Slightly more encouraging leading indicators

The Jibun Bank of Japan manufacturing PMI leading indicators published for May advanced further since the end of March to 50.8, and now point to a probable improvement in the situation in industry. The composite indicator also rose to 54.3, now well above the growth threshold, thanks in particular to the good progression of the services index, which suggests a continuation and reinforcement of the current strength. The PMI indices confirm the continuation of the trend observed for the Japanese leading indicator, which has been recovering since the start of the year and now stands at 97.6, while the coincident business cycle indicator rebounds sharply from 96.1 to 99.4.

Industrial production slipped slightly recently by -0.4% after two months of growth, underlining the risk of its positive influence on GDP growth waning in Q2. The capacity utilization rate also advanced to 93.8, logically accompanying the previous rebound in industrial production. As for machinery orders, the trend remains gloomy and shows no signs of abating: the latest figures published for May show a year-on-year decline of -22% year-on-year.

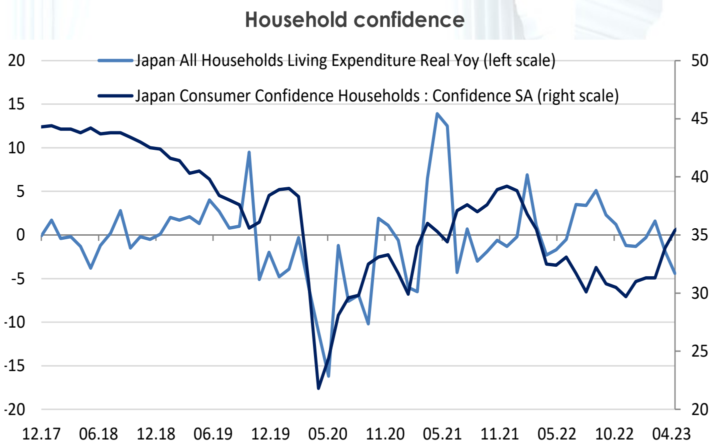


Sources: Bloomberg, BBGI Group SA

Japanese companies, who had been expecting a recovery in machinery orders that could erase the previous decline, will now shift their expectations and hopes of a revival to the next economic upturn expected in China in the coming months. Hopes therefore still seem to be justified, even if uncertainty still prevails in this sector, which is extremely important for Japanese exports.

Slight improvement in consumer confidence

Japanese consumer confidence is gradually improving, even if it is still well below the level observed a few quarters ago. However, it has already recorded six months of consecutive increases, taking it from 297.6 to 361.1. These developments underline an increasingly perceptible improvement in the situation of households and their appreciation of risk. Despite a stable job vacancy/applicant ratio of 1.32 and a still very low unemployment rate stabilizing at 2.6%, disposable income is now up by just +1% year-on-year and real income is contracting by -3% after inflation is taken into account, corresponding to one of the steepest falls since 2014. Overall, the labor market remains under pressure, although this suggests that a gradual transmission to wage levels is possible. However, retail sales, which are recovering overall, slipped in May by -1.2%, reducing the year-on-year increase to +5%. The recent fall in inflation to +3.2% in May (Tokyo) year-on-year should reinforce the positive trend in retail sales and confidence.



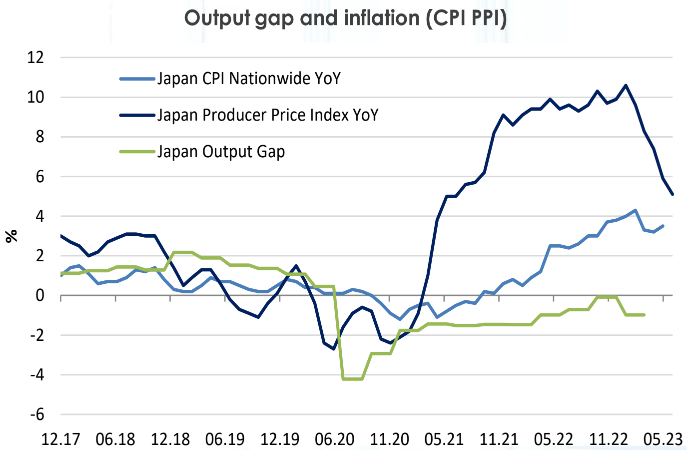
Sources: Bloomberg, BBGI Group SA

Trade deficit decreases by –66%

Japan's adjusted trade balance recorded its seventh consecutive month of relative improvement in May. After plummeting to a record 2,299 billion yen deficit in October 2022, the trade deficit has shrunk by around two-thirds to 777 billion yen, surprising most experts. The main reason for this contraction in the current deficit is the reduction in imports. Imports fell by -9.9% year-on-year, in stark contrast to the +50% rise in 2022 due to higher energy prices. The fall in crude oil prices is having a favourable impact on energy import costs, which can therefore slip by almost -10% year-on-year. On the export side, year-on-year growth continued to decline in May, coming in at just +0.6%. For the time being, the very marked deceleration in exports reflects the impact of the slowdown in external demand, notably from Europe (up +16.6%) and the United States (+9.4%). However, the -3.4% fall in Chinese demand, which was expected to pick up in the second quarter, is taking longer to materialize, and is making a greater contribution to the weakness of Japan's overall exports, which are therefore unable to help boost Japanese GDP growth for the time being.

Japanese inflation confirms its downward trend

Japanese inflation had long been contained before the yen's sharp depreciation from 115 to 150 yen/USD reinforced an upward trend initiated by rising commodity prices. The reversal of the trend in both exchange rates and commodity prices has contributed to an improvement in inflation over the past few months. The consumer price index (CPI Tokyo) jumped from +0.8% to +3.9% in one year, peaking in January 2023 at +4.4%. The decline since then continued with a further drop to +3.2% in May. At national level, the same type of movement is expected, lowering the price increase to +3.2% at the end of May. In parallel with this trend in CPI indexes, producer prices have shown an already significantly improved trend since October, with a clear deceleration in monthly data and a further price contraction in May (-0.7%). Producer prices had peaked at +10.5% in December 2022, but thanks to the recent positive momentum, the year-on-year increase slipped to +5.1% in May. The transmission of rising import and producer prices to consumer price indices should further develop positive effects over the coming months, and bring inflation a little closer to the BoJ's target. The energy and raw materials factor will certainly remain a determining factor in inflation trends, making a positive contribution. The stabilization of oil and gas prices will reduce their impact on import and producer prices. A further weakening of the yen by around -5% during the current quarter, linked to uncertain growth prospects, will not help to improve this trend for imported prices. Overall, we believe that the various domestic and external factors should favor a further decline in Japan's various inflation measures towards the Japanese central bank's target. The Bank will be able to draw on these developments to maintain a policy of supporting economic growth by controlling the yield curve.



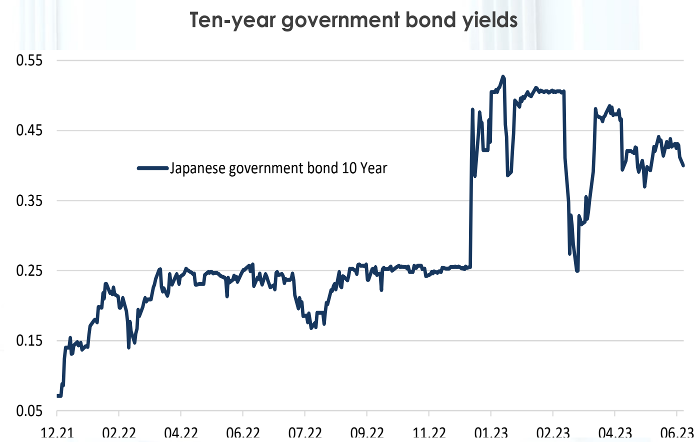
Sources: Bloomberg, BBGI Group SA

BoJ monetary policy to remain highly expansive

The recent evolution of price indices in Japan now offers the institution the opportunity to avoid having to question its accommodating monetary policy. The deceleration in price rises could soon show growth of less than +3%, which would then no longer be so far from its target of +2%. The BoJ had struggled to emerge from the previous deflationary phase, and will certainly not be prepared to risk a return to that situation by tightening policy too soon. Premature tightening would have damaging consequences that would be harder to counter than a subsequent acceleration in prices. The BoJ has made it clear that the risk is in trying to control inflation too aggressively, and will therefore maintain its policy of controlling the yield curve by keeping the fluctuation band fixed at 0% plus or minus 0.5% for ten-year government rates. Governor Kazuo Ueda is therefore unlikely to change his policy in July, regardless of the monthly trend in inflation, which he also fears will eventually slip even below +2% if monetary policy ceases to be expansionary. Japan's monetary policy is therefore still logically the most flexible of the major central banks' policies, and we expect it to remain so for a relatively long time yet. We believe that this policy is reasonable in the context of weak aggregate demand in Japan, which could effectively push inflation down to +1.7% by the end of 2023. We believe that Japanese monetary policy will not undergo any radical change in this context, particularly if inflation falls, which will undoubtedly penalize the exchange rate for some time to come.

Yen yields still unattractive

The Bank of Japan now holds over half of Japan's government bonds, and has just confirmed that it will maintain this policy in view of the country's particularly anemic economic dynamic. An extremely long period of reduced growth, very low inflation and wage stagnation had led the monetary authorities to adopt a policy of zero interest rates and yield curve control, which is now reaching its limits. The yield curve is rising, but remains contained between 0% and 0.5% for up to ten years. The BoJ has increased its balance sheet as a percentage of GDP to an extreme level of 125%, already twice as high as the ECB (60%) and the Fed (35%). The current policy will have to be adjusted in due course by a rise in interest rates, which will constitute an increasingly negative environment for the yen bond market.



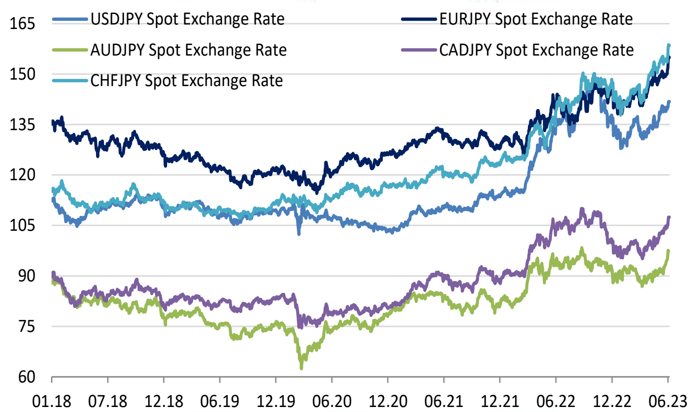
Sources: Bloomberg, BBGI Group SA

Against this backdrop, holding yen-denominated bond positions remains unattractive when compared with the yields offered in other currencies. Japanese bonds therefore offer no attractive prospect in the face of even a remote risk of rising rates and uncompetitive yields in the current context of more attractive international alternatives.

Interest rate differentials still unfavorable to the yen

The BoJ's monetary policy is likely to remain relatively stable over the coming months in the context described above. The estimated key rates for both September (0.14%) and December (0.15%) remain unchanged, demonstrating the absence of any anticipated change in policy in the second half of the year. In the short term, the yen seems increasingly affected by the interest-rate differential, which remains unfavorable to the Japanese currency against all the major currencies. In March, the yen benefited only very temporarily from the uncertainty linked to the SVB bankruptcy, and has since suffered further depreciation. A few months ago, we mentioned that this appreciation of the yen already seemed to us to be significant, and also took into account the stabilization or even decline in dollar yields. Yield spreads on various maturities, although down on previous spreads, seem to us sufficiently high to sustain Japanese investors' interest in holding dollars. 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 BoJ policy, our outlook still favours yen weakness against the US dollar.

Yen performance against major currencies

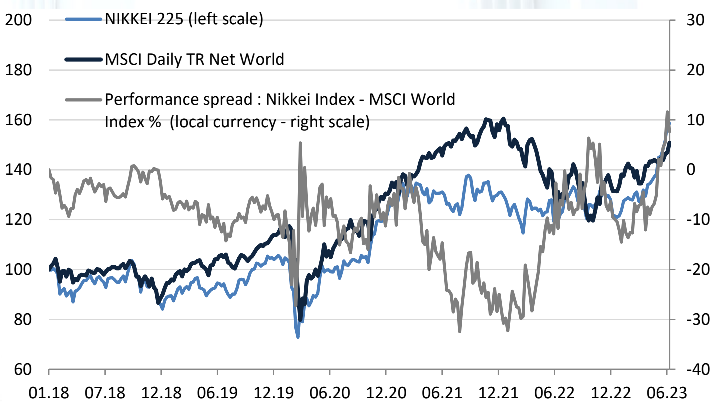


Sources: Bloomberg, BBGI Group SA

Nikkei at 33-year high

The Japanese economy regained some momentum, while inflation slipped and justified a status quo on monetary policy in the 1st half, surprising analysts and reviving more positive expectations for Japanese equities in the medium term. After several years of sluggish growth, expectations for Japanese corporate earnings improved. As a result, the Japanese market has outperformed its local competitors since the start of the year, setting new 33-year highs. Corporate profits are proving robust, and are also rekindling the interest of foreign investors attracted by the prospect of profit growth and shareholder-friendly reforms after a long, more uncertain period of business development. The post-Covid in Japan and China, as well as a degree of normalization underway in production/supply chains, boosted earnings growth for listed companies at the start of the year. The absence of pressure on Japanese interest rates has certainly proved a key factor in the exceptional resilience of Japanese stocks. Weak external demand may still represent a source of uncertainty for corporate earnings, which will nonetheless benefit from the probable return of international investors who are now more inclined to reconsider the weighting of Japanese stocks in their diversified allocations. In the short term, however, the acceleration in performance in recent weeks is likely to be followed by some understandable profit-taking, weighing somewhat on the immediate performance of Japanese indices. After the Nikkei's recent rise, a stabilization now seems likely in this context. We recommend an underweight exposure to Japanese equities.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

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