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Weekly Analysis

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ATTRACTIVE PROFITS FOR NIKKEI STOCKS

Surprising export-led GDP growth. Inflation still in decline. Reduced trade deficit. Expansive monetary policy. Yen's decline falters. Attractive profits for Nikkei companies.

Key points

- Japanese economy surprises with +1.2% growth in Q2 and positive outlook once again
- Positive trend for the 2nd half
- Leading indicators still very uncertain
- Fall in real household income
- External account deficit narrowing
- Inflation continues its downward trend
- End of negative key rates for the BoJ?
- Yen yields still unattractive
- Interest rate differentials still unfavorable to the yen
- Satisfactory growth in listed company profits

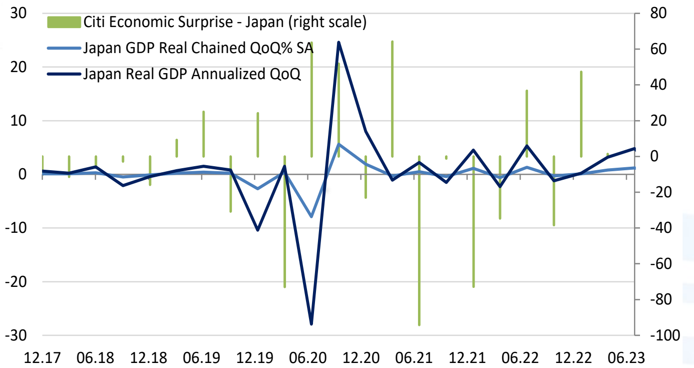
Japanese economy surprises with +1.2% growth in Q2 and a positive outlook once again

After a clear rebound in economic activity in Japan in Q1 (+0.7%), which followed a stagnation in Japanese GDP in Q4 2022, Q2 confirms the resumption of growth in Japan and removes the spectre of a recession often evoked at the start of the year by the majority of economists. They were expecting at best a very moderate recovery at the start of the year, and clearly appear to have been overly pessimistic in the light of 1st half results that were well above expectations. The seasonally-adjusted Japanese GDP result for Q2, after an initial revision, showed quarterly growth of +1.2% for an annualized GDP increase of +4.8%. This rate of growth is already well above the consensus forecast of +1% for the year as a whole. The export sector (+1.8%) played a major role in driving GDP growth over the period, while private consumption (-0.6%) posted a sharp decline. Business spending also made a negative contribution (-1%), as did the inventories component, which had an impact of -0.2%.

The GDP revision suggests slightly weaker growth than initially estimated, due in particular to still cautious household behavior and weaker consumption. Wage growth proved insufficient to sustain domestic demand, with real income growth reduced by -2.5%. We also note that the bulk of GDP growth was attributable to a marked recovery in exports, indicating a relatively high level of dependence on trends in international demand.

The world's third-largest economy thus continued to surprise with its resilience in Q2, at a time when the international context seems to be clearly pointing towards a slowdown in activity in the USA, Europe and China. The surprising momentum of Q1 thus continued into Q2. Our forecast of +1% growth for the year as a whole is thus bolstered by a buoyant first half, which could nevertheless weaken in the second half of the year should global demand prove weaker.

Performance of the Japanese economic (GDP) in yen



Source: Bloomberg, BBGI Group SA

Positive trend for the 2nd half

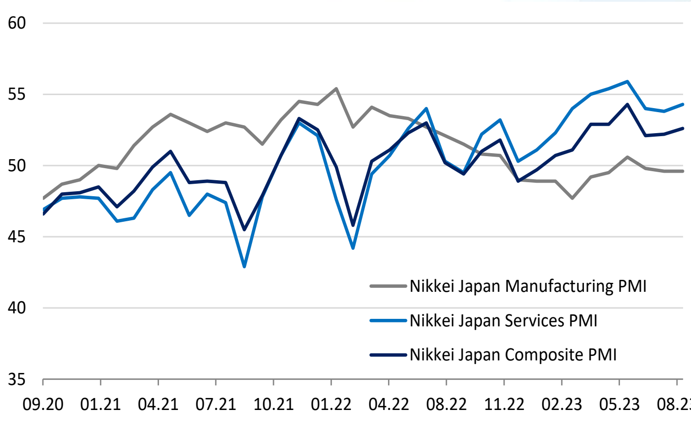
The Japanese economy is now back above its pre-pandemic level, but private consumption is still lower than it was at that time, and even weaker in real terms than its 2014 level, underlining the fragility of an export-led recovery.

Weak domestic demand clearly remains a source of concern. It should be able to strengthen to sustain the positive economic trend currently visible in Japan. But in the current context, the decline in consumer purchasing power, following the steady decline in disposable income and ongoing inflation, is likely to stabilize only very gradually. The same applies to Japanese companies, which are still reluctant to make new investments. Consumer spending by foreign travellers in Japan could provide support for domestic consumption, though without significantly influencing the overall level. China's economic recovery appears to be the main factor underpinning a positive trend in its exports, against a backdrop of likely weakening external demand 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 packages aimed at boosting activity. Global demand remains weak, but the risks of recession have clearly diminished in Europe, while soft-landing in the USA remains the most likely scenario. The short-term economic outlook for Japan is therefore uncertain, but Japanese GDP is set to grow again in the second half of the year and by more than +1% over 2023 as a whole.

Leading indicators still very uncertain

The Jibun Bank of Japan manufacturing PMI leading indicators published for August remain stable after a slight dip in July. The manufacturing index fell back just below 50 to 49.6, suggesting a slowdown in industrial activity. The composite indicator (52.6) also dipped, but remains in the growth zone, supported by a stabilization at 54.3 in the services index. Activity in the service sector appears to be clearly on the up, pointing to a continuation of the current positive momentum. Overall, the PMI indices confirm the economic recovery underway, while pointing to potential weakness in the industrial sector. The leading indicator of the economic cycle also remains highly uncertain, however, stabilizing at 107.6, while the coincident indicator remains close to its highest level since 2019 at 114.5. Industrial production was down -2% over the last month, affected by a decline in electronics and machinery, while the automotive sector performed more favorably.

PMI indicators (manufacturing, services, composite)



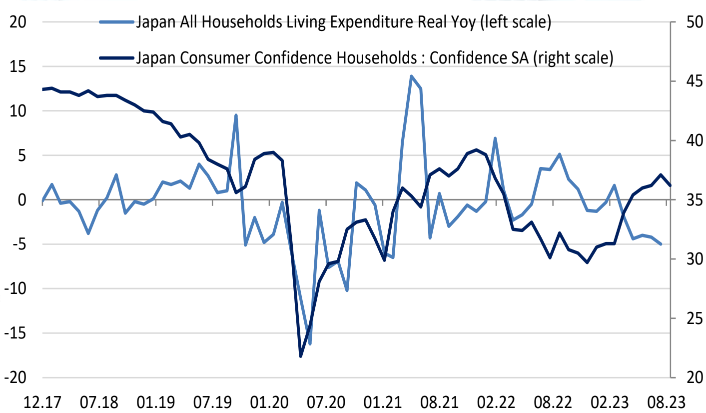
Source: Bloomberg, BBGI Group SA

The Japanese economy is feeling the effects of the global slowdown not only on its declining industrial output, but also on the evolution of its foreign trade. The year-on-year drop in exports in July is also a clear sign of weakness not seen in the last two years since February 2021. The decline in chip exports is notable, while exports to China contracted by -13.4% year-on-year.

Fall in real household income

Japanese consumer confidence improved in the 1st half of the year, but has since stagnated at the same level. After six months of consecutive increases, which took it from 29.7.6 to 37.16, the trend for this confidence indicator is losing momentum. Despite a stable job vacancy/applicant ratio of 1.29, the unemployment rate rose from 2.5% to 2.7%, probably still low enough not to be a worrying factor for households. However, real household income fell by -2.5% year-on-year at the end of June, which explains the continued relative caution in consumption. Overall, Japanese corporate earnings were up fairly sharply by +11.6% year-on-year at the end of June, which nevertheless suggests that a gradual transmission to wage levels is possible in the context of a still relatively tight labor market. However, retail sales, which are recovering overall, slipped in May by -1.2%, reducing the year-on-year rise 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.

Household confidence



Sources: Bloomberg, BBGI Group SA

Foreign trade deficit recovers

Japan's adjusted trade balance had improved strongly up to July, showing a marked recovery from its massive 2,299 billion yen deficit in October 2022. The trade deficit narrowed by 75% to 557 billion yen in August, surprising most experts. The main reason for this contraction in the current deficit is the sharp drop in imports. Imports fell by -13.5% year-on-year, in stark contrast to the +50% rise in 2022 due to higher energy prices. On the export side, the year-on-year trend was now slightly negative in August (-0.3%). Exports continue to show a very mixed picture between different regions. Exports to the USA rose by a further +13.5% year-on-year, while those to Europe advanced by almost as much (+12.5%).

The fall in overall exports is thus essentially due to the weakness of the Chinese economy, which reduced its Japanese imports by -13.5% over the same period. The sharp deceleration in exports therefore essentially reflects the downturn in Chinese activity and demand that has been in retreat for more than eight consecutive months. The automotive sector has recovered, benefiting from solid US demand, up +34%, and from European imports, which are also up significantly.

Inflation continues its downward trend

Japanese inflation had long been a source of concern for the central bank, which feared the deflationary risks posed by a persistently negative domestic CPI index in 2020 and 2021. The orchestrated fall in the yen from mid-2021, which depreciated from 115 to 150 yen/USD in just over a year, contributed to the rise in Japanese inflation, already triggered by the upward trend in commodity prices. The consumer price index (CPI Tokyo) had jumped from +0.8% to +3.9% in one year, peaking in January 2023 at +4.4%. The decline since then has been partly supported by the fall in crude oil prices in 2023. The Tokyo price index is now just +2.9%. Excluding food, the index is even slightly lower (+2.8%), which should reinforce the BoJ's conviction that inflation is falling into line and that accommodative monetary policy can be maintained. The Tokyo indices are a leading indicator for prices nationwide, and the BoJ is therefore hoping that the current trend will continue and spread to the whole country. At national level, the CPI index declined similarly from +4.3% to +3.3% in August. In parallel with this trend in CPI indices, producer prices (PPI) have been trending significantly upwards since October 2022, with a clear deceleration in monthly data. Producer prices had peaked at +10.5% in December 2022, but thanks to the recent positive momentum, the year-on-year increase slipped in August to just +3.3%. 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. 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 BoJ will be able to draw on these developments to maintain a policy of supporting economic growth by controlling the yield curve.

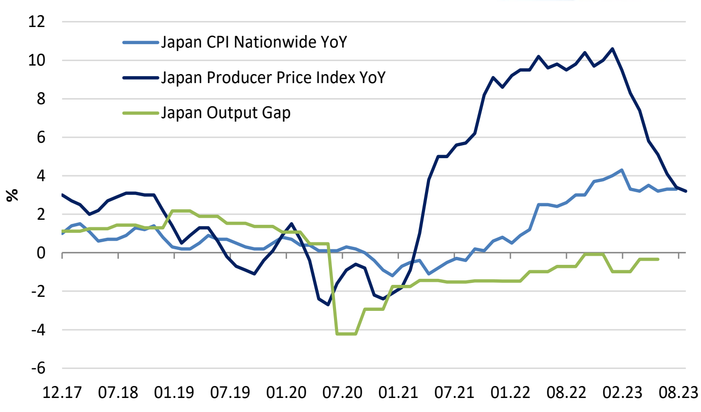
End of negative key interest rates for the BoJ?

The recent evolution of price indices in Japan now offers the BoJ 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 adjusting the fluctuation band with a new maximum of 1% for ten-year government rates. The BoJ governor is therefore unlikely to change his policy in the short term, 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 in our view should remain so for a relatively long time to come. We believe that this policy is reasonable in the context of weak domestic 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. Consequently, expectations of an early end to negative rates (-0.1%) seem excessive to us, as a change to a more restrictive monetary policy is still premature in the present context of inflation approaching the BoJ's target.

Yen-denominated yields still unattractive

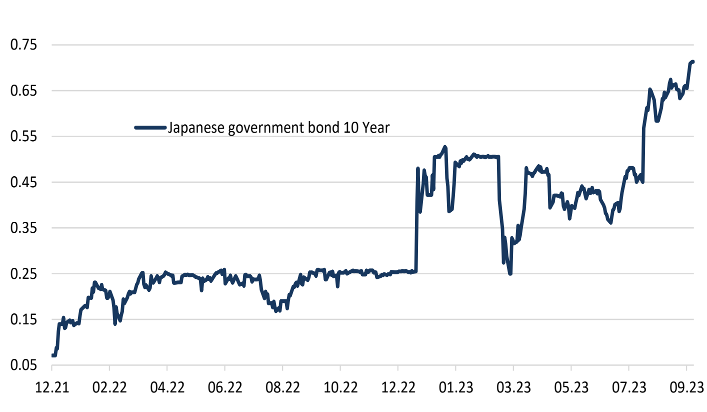
The Bank of Japan now holds over half of Japan's government bonds, and has just confirmed that it will maintain this policy in view of the country's particularly anemic economic dynamic. An extremely long period of reduced growth, very low inflation and wage stagnation had led the monetary authorities 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 1% for up to ten years.

Output gap and inflation (CPI PPI)



Sources: Bloomberg, BBGI Group SA

Ten-year government bond yields



Sources: Bloomberg, BBGI Group SA

The current policy will necessarily 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. 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

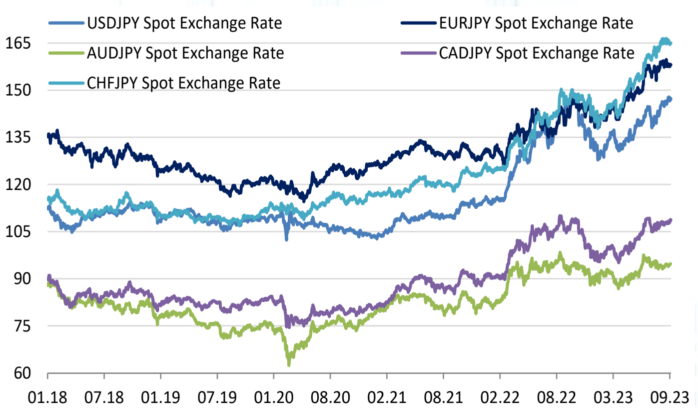
The BoJ's monetary policy is likely to remain relatively stable over the next few months in the context described above. The estimated key rates for both December (-0.02%) and January 2024 (-0.02%) are still slightly negative, demonstrating the absence of any anticipated change in policy for the end of the year. In the short term, the yen seems to be increasingly affected by the interest-rate differential, which remains unfavourable to the Japanese currency against all the major currencies, but particularly against the dollar. A few months ago, we already mentioned that any appreciation of the yen would certainly be temporary in a medium-term trend of lasting depreciation. Yield spreads on various maturities seem to us sufficiently high to sustain the interest of Japanese investors 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 up to 150 yen to the dollar.

Satisfactory growth in profits for listed companies

The Japanese economy surprised economists with greater momentum in Q1, and still looks set to maintain growth in Q3 and Q4. Japanese corporate profits rose by +11.6% in Q2, a trend which should continue in the second half if external demand holds up and exports to China can resume. After several years of reduced growth, expectations for Japanese corporate earnings are now +8% for 2024. The Japanese market has thus outperformed other developed markets, gaining +25% in local currency since the start of the year, and in recent weeks has set new 33-year highs. Corporate profits appear to be solid, and are also rekindling the interest of foreign investors attracted by the prospect of earnings growth and shareholder-friendly reforms after a long, more uncertain period of business development.

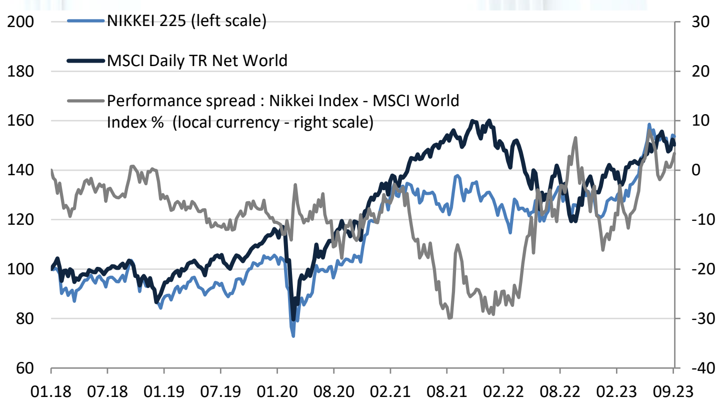
The absence of pressure on Japanese interest rates remains a notable factor in the exceptional resilience of Japanese stocks. Japanese stocks will benefit from the probable return of international investors, who are now more inclined to reconsider the weighting of Japanese stocks in their diversified allocations following a decline in the yen. With the Nikkei expected to stabilize at around 33,000 points, we believe that the conditions are now ripe for a new uptrend. We now recommend reinvestment and repositioning in Japan's leading stocks.

Evolution of the yen against the main currencies



Sources: Bloomberg, BBGI Group SA

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

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