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Weekly Analysis

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THE PERSPECTIVES ARE DETERIORATING FOR THE NIKKEI

Possible recession in the 4th quarter. Rebound in inflation linked to the fall in the currency. Contraction in real household income. Monetary policy still expansionary. Yen's decline falters. Less positive conditions for the Nikkei.

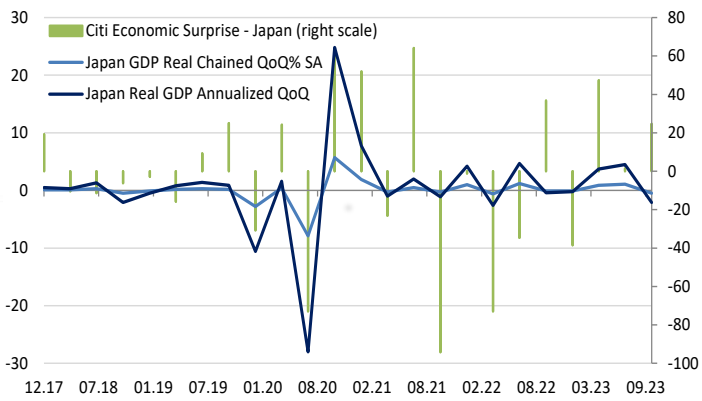
Key points

- A much more dramatic 3rd quarter than expected
- Possible recession at the end of the year in Japan
- Significant deterioration in leading indicators
- Persistent contraction in real household income
- Further decline in foreign trade
- Temporary rebound in inflation?
- BOJ monetary policy still accommodative
- Yen yields still unattractive
- Interest rate differentials still unfavourable to the yen
- Satisfactory growth in listed company profits

A much more dramatic 3rd quarter than expected

A few months ago, we wrote that the astonishing growth in Japanese GDP in the 2nd quarter was unlikely to continue into the middle of the year. The particularly uncertain leading indicators for the 3rd quarter suggested that a slowdown in consumption and exports could have a very significant impact on Japan's economic performance during the summer. After a seasonally adjusted Japanese GDP result for Q2, showing quarterly growth of +1.1% for a revised annualised increase in GDP of annualised GDP growth of +4.5%, the figure published for Q3 came as a partially expected shock. Indeed, the -2.1% fall in annualised quarterly GDP completely reverses the start of the previous positive trend by being much more negative than the moderate fall of -0.4% expected by the consensus. Over the quarter, almost all components made a negative contribution. Private consumption was barely stable over the quarter, while business investment fell by -0.6%, following a -1% decline in the previous quarter. As for net exports, the negative impact of -0.1% was partly due to higher imports over the period. Inventories also contracted slightly, suggesting a certain return to normal after the rebuilding of stocks following the problems encountered by supply chains during the pandemic. The actual contribution from inventories is estimated at -0.6% The world's third largest economy eventually succumbed to the Japan's main trading partners. While the international context seems to be clearly pointing towards a slowdown in activity in the United States, Europe and China, Japan's trade balance is being affected by weak exports and a sharp rise in imports. Our forecast of +1% for the year as a whole has therefore been lowered to +0.9%, both because of this more negative than expected 3rd quarter, and because of the lowering of our outlook for the final quarter of 2023, when global demand will be weaker.

Performance of the Japanese economic (GDP) in yen



Sources: Bloomberg, BBGI Group SA

Possible recession at the end of the year in Japan

With just a few months to go before the end of the year, Japanese GDP remains more dependent than ever on international demand, while domestic consumption is still struggling to revive. The economy is weakened by sluggish household consumption and exports that are totally dependent on the international trends. It will be difficult for the land of the rising sun to end the year with an acceleration in economic momentum. In the absence of a revival in external demand, Japan's economic situation will therefore require further support.

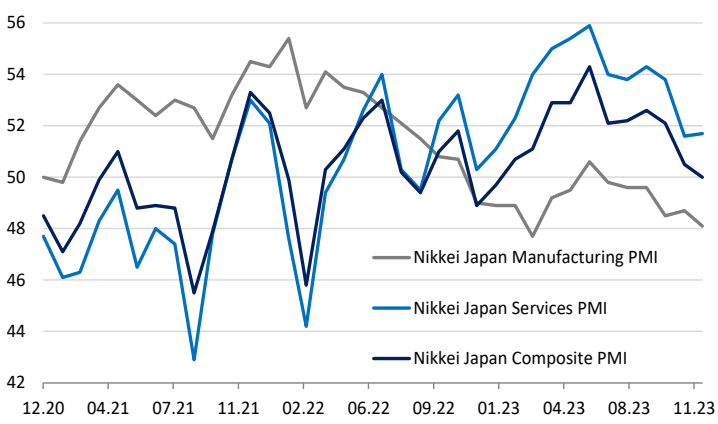
In the current context, the fall in consumer purchasing power, following the steady decline in disposable income and ongoing inflation, can only be stabilised very gradually. The same applies to Japanese companies, which are still reluctant to make new investments. Growing consumer spending by foreign travellers to Japan will provide only modest support and will not significantly influence the overall level of consumer spending. Japan would be badly in need of an economic revival from China, which could counter the weakening seen in other major partners, but the Chinese economy is also proving incapable of strengthening significantly for the time being.

With global demand weakening, the short-term economic outlook for Japan remains highly uncertain. Against this backdrop, which in Q4 will continue to be marked by a gloomy outlook for both domestic consumption and foreign demand, Japanese exports are likely to weaken, along with domestic consumption and business investment. Q4 GDP could be negative again.

Significant deterioration in leading indicators

The Jibun Bank of Japan manufacturing PMI leading indicators published for November did not improve. The manufacturing index continues to fall below 50 and now stands at 48.1, suggesting a continuation of the ongoing slump in industrial activity. The composite indicator has also accelerated its downward trend and is now just on the razor's edge at 50, clearly showing a deterioration in the situation. The services indicator seems to be holding up well, with a reading of 51.7 in November, which is still well below its May high of 55.9. Activity in the services sector ended up following the negative trend, but still looked slightly better. Overall, the PMI indices have been on a downward trend for several months, pointing to potential weakness in the industrial sector and a slowdown in services. Activity measured by the Ministry of the Economy and Trade in the tertiary sector has also weakened according to the latest published figures, as has industrial production, which has fallen by -4.4% year-on-year.

PMI indicators (manufacturing, services, composite)



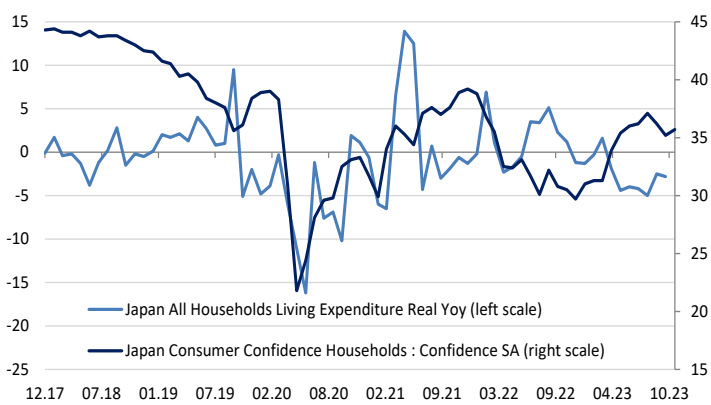
Sources: Bloomberg, BBGI Group SA

The Japanese economy is feeling the effects of the global slowdown not only on its declining industrial output, but also on the trend in its foreign trade. The value of exports rose by just +1.6% year-on-year, down sharply from the +4.3% recorded in September. Since the growth peak of almost +30% in September 2022, Japanese exports have been virtually stagnant for twelve months. This trend in Japanese exports is particularly worrying, and represents a major risk for developments over the coming months. Without a clear upturn in exports in Q4, the Japanese economy will be unable to avoid a further contraction in GDP, plunging the country into a technical recession. Hopes seem slim, and are linked to an expected improvement in Chinese activity and demand for Japanese products.

Persistent contraction in real household income

Japanese Household spending fell by -2.8% year-on-year, and appears to be stabilising thanks to a small rise of +0.3% month-on-month. Wage growth does seem to be picking up a little, but it remains very weak (+1.2% year-on-year) and still well below inflation. Real wages are therefore still falling for the eighteenth consecutive month. This is unlikely to be enough to revive Japanese consumer confidence, which improved in the first half of the year but has since stagnated at the same level. After six months of consecutive rises, which took it from 29.7.6 to 37.16, the trend has already run out of steam (35.7), despite a stable job vacancy/applicant ratio of 1.29 and a still very low unemployment rate (2.6%). Caution is therefore still the order of the day when it comes to consumer spending. However, with Japanese corporate earnings probably up by around 14% year-on-year at the end of September, it is not out of the question that a gradual pass-through to wage levels may be possible in the context of a still relatively tight labour market, and that this could lead to an improvement in sentiment. The absence of a real fall in inflation is still weighing on consumer sentiment. The fall in the yen will also contribute to a recovery in price indices and a slump in confidence. The recent fall in inflation to +3.2% in May (Tokyo) over a year could, however, temporarily reinforce the positive trend in retail sales and slightly improve household confidence.

Household confidence



Sources: Bloomberg, BBGI Group SA

Foreign trade deficit recovers

Japan's adjusted trade balance suffered a further decline after virtually uninterrupted growth since October 2022. The trade deficit rose from 434 billion yen to 462 billion yen in one month, despite a 12.5% year-on-year fall in imports. The trade balance deteriorated in October with its four main trading partners, the United States, China, Saudi Arabia and Australia. The fall in the

surplus with the first of these, and the rise in the deficits with the other three, contributed to the increase in the overall deficit.

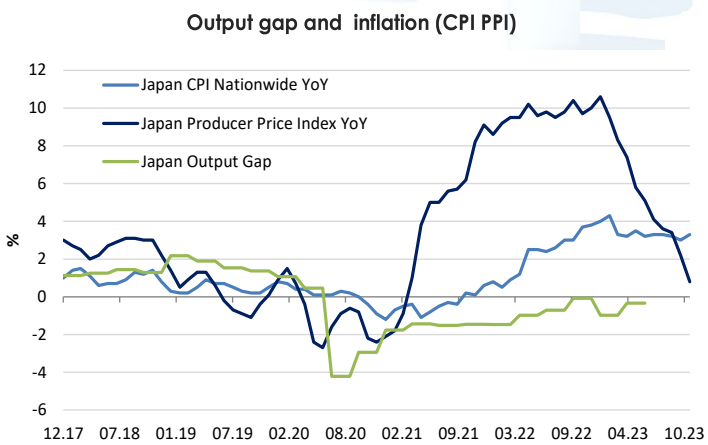
The very sharp slowdown in exports therefore essentially reflects the slowdown in activity in China and demand that has been in decline for several consecutive quarters. The automotive sector has recovered, with a rise in exports to the United States, while the fall in chip exports suggests a drop in demand for electronic products. On the import side, the reduction is clearly due to lower energy prices.

Temporary rebound in inflation?

The deflationary fears of 2020 and 2021 are no longer the order of the day in Japan, where inflation rose sharply in 2022, exceeding the threshold of +4%/year. The fall in the yen orchestrated from mid-2021 onwards, which depreciated from 115 to 150 yen/USD in just over a year, made a major contribution to the return of inflation in Japan, which had already been triggered by the uptrend in commodity prices. 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 has been partly sustained by the fall in crude oil prices in 2023. The price index (national CPI) has now rebounded from its recent low of 3% to +3.3%. While the index excluding food has stabilised at +2.9%, the index excluding food and energy is still up by +4%.

In parallel with these developments in the CPI indices, producer prices (PPI) are following a more favourable trend, with a further decline of -0.4% in prices in October and a year-on-year increase reduced to +0.8%, after having reached +10.6% in December 2022. This is a rather encouraging result for the CPI indices over the coming months, which should gradually benefit from this factor influencing the propensity of companies to increase their selling prices in order to maintain their margins.

The transmission of the rise in import prices and producer prices to the consumer price indices should therefore continue to 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 favour a further decline in Japan's various inflation measures towards the Japanese central bank's target, if the exchange rate stabilises.



Sources: Bloomberg, BBGI Group SA

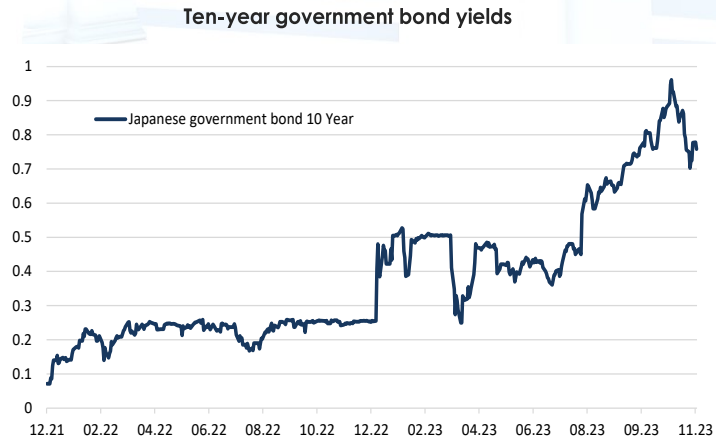
The BoJ will be able to draw on these developments to maintain a policy of supporting economic growth by controlling the yield curve.

BOJ monetary policy remains accommodative

The Recent developments in Japanese price indices now offer the BoJ the opportunity to avoid having to question its accommodative 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 difficulty emerging from the previous deflationary phase and will certainly not be prepared to risk a return to that situation by tightening its policy too soon. A premature rate hike 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, so it will 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.Japanese monetary policy is therefore still logically the most flexible of the policies pursued by the main central banks, 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 changes in this context, particularly if inflation falls, which will certainly penalise the exchange rate for some time to come. Consequently, we feel that expectations of an early end to negative rates (-0.1%) are excessive, as a change to a more restrictive monetary policy is still premature in the current context of inflation approaching the BoJ's target, while Japan's monetary base has accelerated sharply since the contraction seen in July (-1.3%) and the 9% year-on-year rise seen in October.

Yen-denominated yields still unattractive

The Bank of Japan now holds more than half of Japan's government bonds, and has just confirmed that it will maintain this policy in the face of a particularly sluggish economy.



Sources: Bloomberg, BBGI Group SA

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 control of the yield curve, which is now reaching its limits. The yield curve is rising, but remains contained between 0% and 1% for up to ten years. The current policy will have to be adjusted in due course by a rise in interest rates, which will create an increasingly negative environment for the yen bond market. Against this backdrop, holding yen-denominated bond positions is still not attractive 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 environment offering more attractive international alternatives.

Interest rate differentials still unfavorable to the yen

The BoJ's monetary policy should remain relatively stable over the next few months in the context described above. The key rates estimated for December (0%), March and June 2024 (0%) show that there are no expectations of a change in policy over the next few quarters. 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 said that any appreciation of the yen would certainly be temporary in a medium-term trend of sustained depreciation. Yield spreads on various maturities seem to us to be sufficiently high to sustain the interest of Japanese investors in holding dollars.

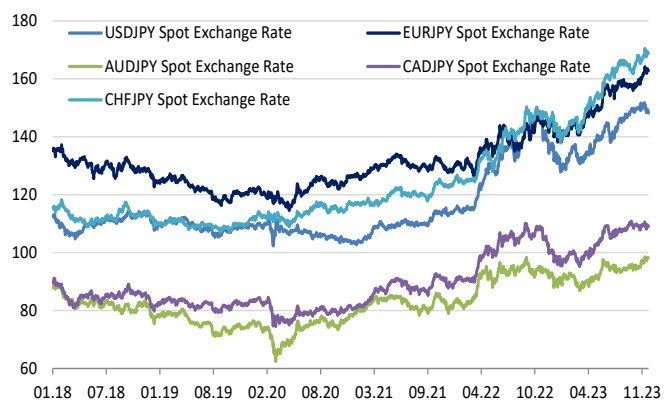
We believe that the yield differential will be the main factor determining the level of the exchange rate, and in the absence of a more restrictive policy from the BoJ, which is unlikely, our outlook still favours a weak yen against the US dollar of up to 150 yen to the dollar.

Satisfactory growth in profits for listed companies

Japanese corporate profits are likely to have risen by 14% in Q3 and, according to the current consensus, should rise by a further 11.4% in 2024. On the basis of these results and expectations, the Japanese market rose sharply in yen terms until June, after which it stabilised. It thus outperformed the other developed markets in local currencies, gaining 28%, of which almost 20% was wiped out by the fall in the yen.

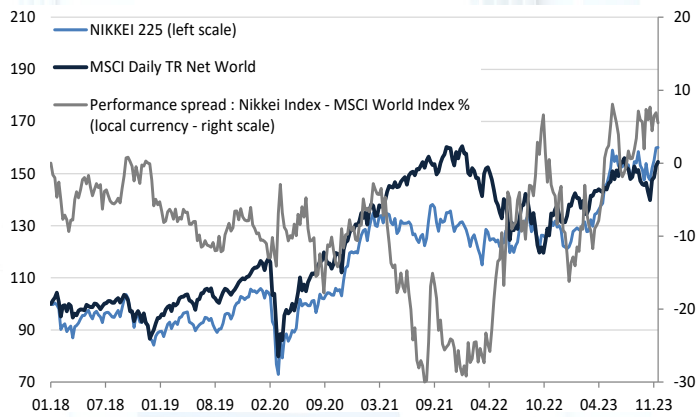
Corporate profits appear to be solid, and are also reviving the interest of foreign investors attracted by the prospect of profit growth and shareholder-friendly reforms after a long, more uncertain period of business development. The absence of any risk of interest rate rises is also a significant factor in the exceptional resilience of Japanese equities, whereas the international context has tended to be marked by upward trends in financing costs. However, following the Nikkei's recent rebound to around 34,000, the conditions for a new phase of growth now seem less favourable. We now recommend a more cautious, underweight exposure to Japanese equities.

Evolution of the yen against the main currencies



Sources: Bloomberg, BBGI Group SA

Nikkei and MSCI World indices



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