

# WEEKLY ANALYSIS

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## NIKKEI TACKLES ITS ALL-TIME 1989 RECORD

Japan is in recession. Another difficult start to 2024. Inflation finally falls. No solution for the Japanese currency. Monetary policy will remain accommodative. The Nikkei attacks the all-time record set in 1989.

### Key points



- Q4 GDP confirms our forecast of a moderate recession in Japan at the end of 2023
- Outlook for Q1 2024 remains weak
- Further decline in leading indicators
- Contraction in real household income
- Inflation falls sharply despite yen weakness
- BoJ monetary policy still accommodative
- Yen bond market unattractive
- No solution for the Japanese currency?
- Nikkei approaches all-time high of 40,000

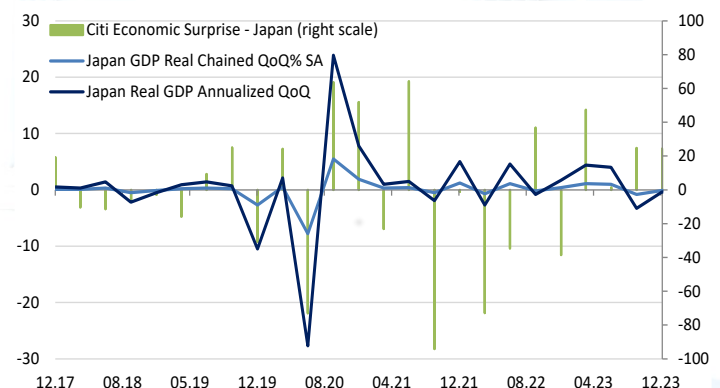
### Q4 GDP confirms our forecast of a moderate recession in Japan at the end of 2023

Our forecast of negative year-end GDP growth in Japan appears to have materialized, given the preliminary figures published for the final quarter of 2023. We were expecting the negative trend of the previous quarter to continue, due in particular to persistently weak international demand and sluggish domestic consumption. The published figure of -0.1% for Q4 and -0.4% annualized is not in itself dramatic, but it keeps Japan in a phase of economic decline after a particularly negative 3rd quarter (-3.3%). The consensus of forecasters was once again taken aback by this result, which fell well short of expectations for growth of +1.1%, while only one economist out of thirty-four had also predicted a possible recession.

Private consumption was disappointing, weighing on the performance of the Japanese economy with a non-annualized decline of -0.2%, even though the previous quarter had been revised downwards by -0.3%. Capital goods investment also stalled, slipping by -0.1%

following a -0.6% revision for the previous quarter. The slight +0.2% rise in exports does not seem to be a source of satisfaction, due to a positive one-off effect linked to better service exports, in connection with exceptional royalties over the quarter. The effective contribution of inventories appears to have been null over the period. Japan thus recorded its second consecutive quarter of negative growth at the end of the year, plunging the economy into a technical recession. Japan's under-performance in recent quarters has also had a damaging impact on its position among the world's economies, since the fall in Japanese GDP has relegated it to fourth place, supplanted by the German economy, which has now overtaken Japan's and moved up to 3rd place.

Japanese economic performance (GDP) in yen



Sources: Bloomberg, BBGI Group SA

### Outlook for Q1 2024 remains weak

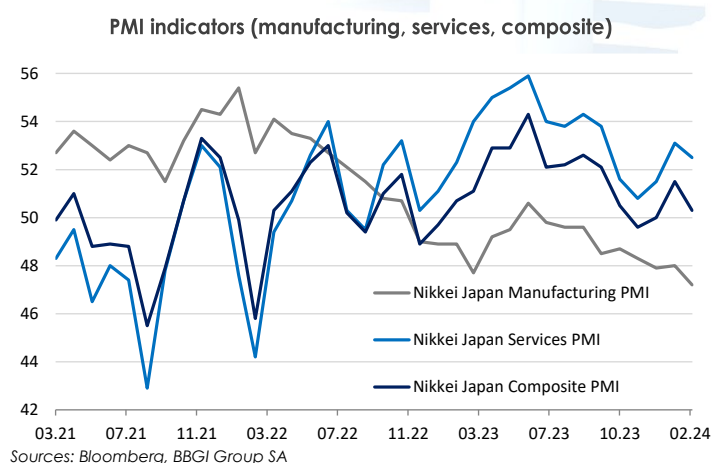
Japan's GDP remains more dependent than ever on international demand, while domestic consumption is still struggling to recover. The economy is undermined by sluggish household consumption and exports that are totally dependent on international trends. Household consumption continues to be negatively affected by inflation, which is still resilient and unlikely to fall rapidly in the specific Japanese context, where the yen is still devaluing strongly, and cannot be curbed by action on the part of the BoJ in the current recessionary climate.

The central bank cannot effectively combat imported inflation, while the yen continues to decline. The decline in consumer purchasing power, resulting from the steady decline in disposable income and ongoing inflation, can therefore only be stabilized very gradually. The same applies to the situation of 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 greatly benefit from an economic revival in China, which could counteract the weakening of its other major partners, which could finally materialize in 2024. The Chinese government's economic support measures could indeed show concrete signs of recovery, and subsequently develop the expected effect on Asian economies and the Japanese economy in particular.

Global demand is likely to remain subdued in the early part of the year, before strengthening thereafter and once again bolstering Japan's economic outlook. In the short term, however, the outlook remains highly uncertain. We do not foresee a strong potential recovery in international demand and domestic consumption at the start of 2024. Q1 growth is therefore likely to remain weak, but could still turn out to be very slightly positive.

### Further decline in leading indicators

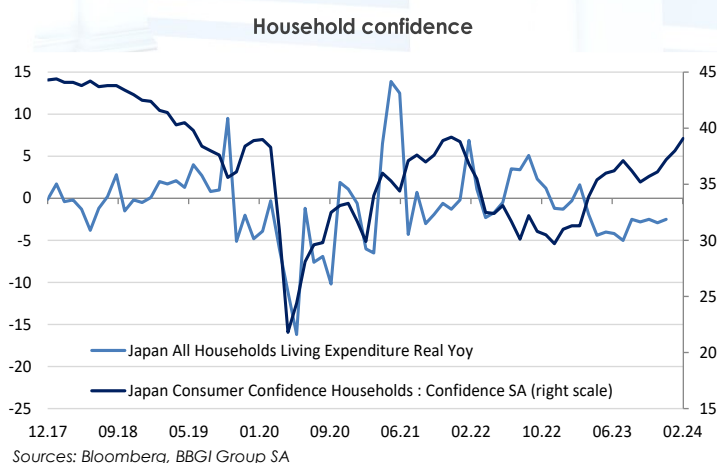
Jibun Bank of Japan's leading indicators logically show no signs of improvement in the still sluggish economic climate at the start of the year. The manufacturing PMI published for February, at 47.2, continues to fall below 50 and is now slightly below its previous level (48), suggesting a continuation of the ongoing slump in industrial activity. The composite indicator also remains on a downward trend, and is now just on the razor's edge at 50.3, clearly showing a worsening situation. The services indicator seems to be holding up well, with a reading of 52.5, 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 Economy and Trade in the tertiary sector also weakened, according to the latest published figures, while falling industrial production reduced its year-on-year decline slightly to -1%. The Japanese economy is feeling the effects of the global slowdown, not only on its declining industrial output, but also on orders for machine tools, which are still heavily affected by the international slowdown. Since the start of 2023, orders have fallen sharply, dropping by 14% year-on-year at the end of December. Despite significant economic growth in China, Chinese orders fell by -5.5% over the same period. Japan's January export figures of +11.9% year-on-year contrasted sharply with previous figures. The latter surprised observers and, thanks also to a further -9.6% contraction in imports, enabled a striking turnaround in the adjusted trade balance, which returned to a surplus of 235 billion yen after a negative balance of -412 billion in December.

### Contraction in real household income

Weak household spending contributed to the downturn at the end of the year. The year-on-year decline of -2.5% in December was part of a negative trend that had already been observed for several months, but which now seems to be showing signs of stabilization. Wage growth seems to be picking up a little, but remains very weak (+1% year-on-year) and still well below inflation. Real wages are therefore still falling, which is not enough to boost Japanese consumer confidence. That said, the confidence index is continuing the recovery phase it began at the end of 2022, and is now at its highest level since February 2022. The stable job supply per applicant ratio of 1.27 contrasts somewhat with the further decline in the still very low unemployment rate (2.4%) to its lowest level since 2019. As a result, consumer spending remains cautious. However, with Japanese corporate earnings likely to have risen by around +15% year-on-year at the end of December, it is not out of the question that a gradual transmission could be possible on wage levels in the context of a still relatively tight labor 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, and the yen's -7% depreciation at the start of the year will not ease the expected decline in prices.

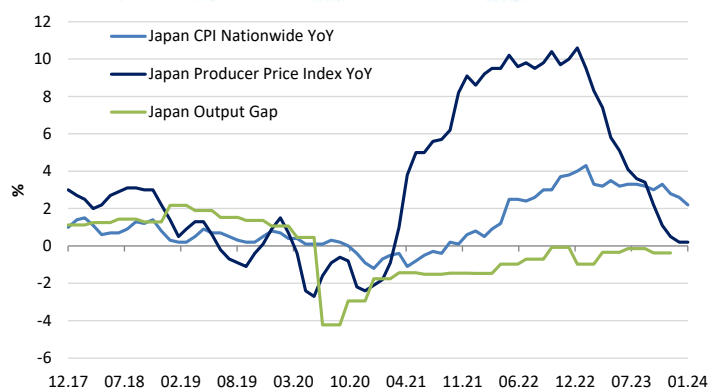


## Inflation falls sharply despite yen weakness

The latest inflation figures published for the month of January are finally particularly pleasing, as the fall in the CPI index for Tokyo over one year from +2.4% to just +1.6% between December and January comes as an excellent surprise to all observers and potentially to Japanese consumers. In this environment, the index excluding food and energy still showed a figure of +3.1%, but still declined from its previous level of +3.5%. The fall in the yen orchestrated since mid-2021, which has depreciated from 115 to 150 yen/USD in just over a year, has made a major contribution to the return of inflation in Japan, already triggered by the upward trend 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 supported by the fall in crude oil prices in 2023. In parallel with these developments in CPI indices, producer prices (PPI) followed a more favorable trend, with prices remaining stable in January, reducing the year-on-year increase to just +0.2%.

These are rather encouraging results for both the CPI and PPI indices over the coming months, which should gradually benefit from this factor influencing companies' propensity to raise their selling prices in order to maintain their margins. The transmission of higher import and producer prices to consumer price indices could also have positive effects over the next few months, further lowering CPI indices. Overall, we believe that the various domestic and external factors should favor a further decline in Japan's various inflation measures, unless the exchange rate sags again in the coming months.

« Output gap » and inflation (CPI PPI)



Sources: Bloomberg, BBGI Group SA

## BoJ monetary policy remains accommodative

The recent evolution of price indices in Japan now offers the BoJ the opportunity not to have to question its accommodating monetary policy. With the deceleration in price rises now below its target of +2%, the BoJ can look forward with a little more serenity to not raising its key rates. It should be remembered that the ECB had a hard time getting out of the previous deflationary phase, and we believe that it will certainly not be ready to risk a return to this situation by tightening its policy too soon. A premature rate hike would have damaging consequences that would be harder to counter than a subsequent rise in prices.

In fact, BoJ Governor Kazuo Ueda has indicated that he considers inflation to be on track to meet its targets, noting that a virtuous circle is in the process of being set in motion, which should even strengthen gradually. Governor Ueda's current analysis is therefore relatively optimistic, based on a forecast of gradual inflation accompanied by wage and employment growth.

A forthcoming end to the negative rate policy is now increasingly likely, and could even come in March or April. However, given the current state of the Japanese economy, which has fallen into recession, a potential normalization of monetary policy will not involve any significant rate movement or trend. The BoJ governor is therefore unlikely to change his policy in the short term, regardless of the monthly trend in inflation, which is once again slipping below +2%, reviving deflation risks.

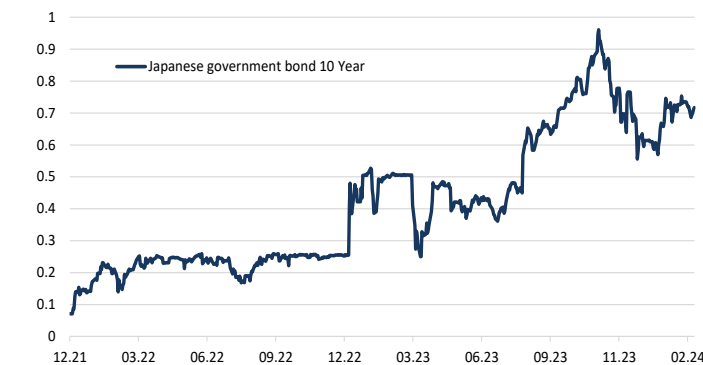
The adjustment or normalization of Japanese monetary policy will therefore be extremely gradual, to avoid any further slippage. Logically, it will still be the most flexible of the policies pursued by the main central banks, and we expect it to remain so for a relatively long time yet. We believe that this policy is reasonable in the context of weak domestic demand in Japan, which could effectively push inflation even lower than the January level of +1.6%.

We also believe that Japanese monetary policy will not undergo any radical change in this context, particularly if inflation eases, thus certainly penalizing the exchange rate for some time to come. Expectations of an early end to negative rates (-0.1%) may therefore be justified, but the change in monetary policy will remain very moderate.

## The yen bond market is not attractive

Ten-year Japanese government bond yields have not really reacted in recent weeks to the negative trend in Japanese GDP and the economy's entry into recession in Q4 2023. Nevertheless, ten-year yields, which had almost touched 1% in early November, have eased in recent months, slipping below 0.6% before stabilizing above 0.7% in February. Declining inflation has been the main factor underpinning this trend, which is likely to strengthen over the coming months. We believe that the current situation will not allow the Japanese Central Bank to significantly alter its policy.

Ten-year government bond yields



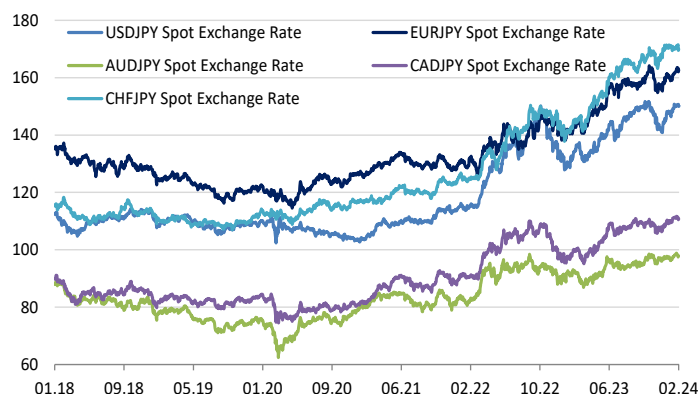
Sources: Bloomberg, BBGI Group SA

The policy of zero interest rates and yield curve control is certainly reaching its limits. The yield curve is rising slightly, but remains contained between 0% and 0.7% up to ten years. The prospects of capital gains for yen-denominated bond investments are highly uncertain and limited to an extremely short time horizon, which could see long rates return to yield levels of 0.5%. Beyond the short term, the likelihood of rates normalizing is high, which will create 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 prospects in the face of even a remote risk of rising rates and uncompetitive yields in the current environment offering more attractive international alternatives.

### No solution for the Japanese currency?

The yen's rebound against the dollar was short-lived during the fourth quarter of 2023. At the start of the year, positive inflation surprises and increasingly clear signs of an economic slowdown in progress, suggesting a recession, quickly weighed on the Japanese currency, which resumed its previous downward trend. The yen's further fall of -7% in the space of a few weeks may support Japanese exports, but for the time being it represents a new threat to imported inflation. 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.

Yen performance against major currencies



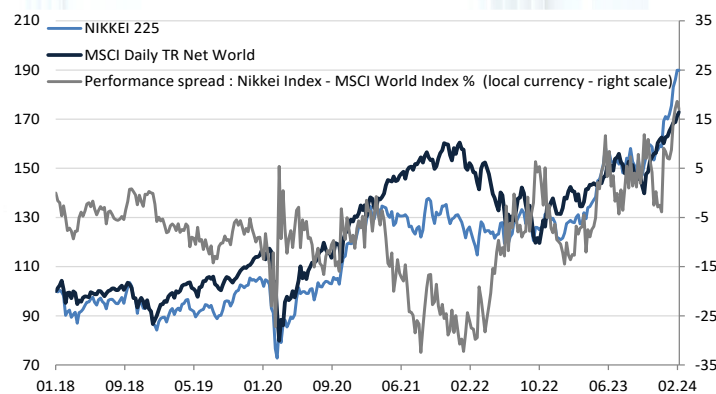
Sources: Bloomberg, BBGI Group SA

A few months ago, we said that any appreciation of the yen would certainly be short-lived, as yield spreads on various maturities would be high enough to keep Japanese investors interested 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 above 150 yen to the dollar.

### Nikkei approaches all-time high of 40,000

The Japanese market has soared in recent months on the back of rising profits for exporting companies, helped by the yen's massive fall. However, the rise has also been driven by an increase in technology stocks and companies linked to the production of semi-conductors, as well as sectors benefiting from the AI revolution. The index has risen by over +50% since its low point in January 2023, surpassing the all-time high reached in 1989 of 38,957. Corporate profits look solid, and are also rekindling the interest of foreign investors attracted by the prospect of earnings growth and shareholder-friendly reforms, after a long and more uncertain period of business development. The absence of the risk of rising interest rates is also a notable factor in the exceptional resilience of Japanese stocks, whereas the international context has tended to be marked by upward trends in financing costs. Now above its all-time high, the Nikkei can certainly still take advantage of the current craze to test the 40,000-point level before likely profit-taking

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

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