Weekly Analysis

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FRAGILE RECOVERY IN JAPANESE GROWTH

Return to GDP growth. Fragile positive momentum. Moderate consumer confidence. Inflation still too high. Sustainable rebound of the yen? Lower tensions for BoJ. No interest in bonds. Nikkei at 40,000?

Key points

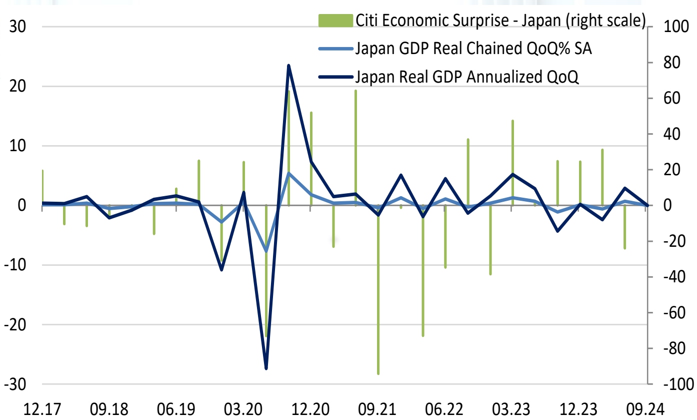
- Japanese growth resumes at a moderate pace
- Continued momentum towards the end of the year
- Leading indicators remain subdued
- Consumer momentum still fragile
- Can the yen's +15% rise reduce inflation?
- Pressure eases a little for the BoJ
- Bond market still unattractive
- Can the yen continue to rise?
- Nikkei back to 40,000 level

Japanese growth resumes at a moderate pace

After a Q1 contraction of -0.5%, which brought the year-on-year rate of decline to -1.8%, the Japanese economy seemed unlikely to recover in Q2, despite a further fall in the yen. Private consumption, which had been very disappointing at the start of the year, finally picked up and partly underpinned the economic recovery observed in Q2. Japanese real GDP surprised many observers with a quarterly increase of +0.7%, or +2.9% annualized, in stark contrast to the negative result recorded at the start of the year. Private consumption picked up again, rising by +0.9% this quarter, after four negative quarters. On the corporate side, investments have picked up, making a positive contribution to the overall result with an increase of +0.8%. The negative contribution of inventories (-0.1%) was not major, as was that of exports, which also contracted slightly (-0.1%). It is interesting to note this rise in spending by companies, who now seem a little more confident about increasing their production capacity. This trend in Japan may suggest a positive impact from a certain recovery in demand for semi-conductors and the automotive sector. As far as household consumption is concerned, we are probably finally witnessing the positive effects of the wage increases agreed during the wage negotiations at the start of 2024, which have gone some way to offsetting the unfortunately still excessive trend in consumer prices in Japan.

In nominal terms, Japan's GDP grew by +1.8% over the quarter, reaching for the first time the 600,000 billion yen (approx. $4,200 billion) threshold set by the Japanese political authorities ten years ago. It remains to be seen whether this change in consumer attitude will be sustainable, as households are facing significant inflation for the first time in Japan's modern history. A revival in external demand is also essential if the situation in the manufacturing sector is to improve and export momentum to pick up. This last point is currently being called into question by the slowdown in the Chinese and US economies.

Japanese economic performance (GDP) in yen



Sources: Bloomberg, BBGI Group SA

Continued momentum towards the end of the year

Japanese GDP remains more than ever over-dependent on international demand, which remained weak in August, slowing year-on-year export growth. Indeed, Japanese exports suffered another setback recently, recording a decline in growth from +10% at the end of July to just +5.6%.

The slowdown was most marked in the direction of the USA, where export levels even contracted (-0.7%) for the first time in three years, due to a drop in vehicle exports. On the positive side, demand for semiconductor production equipment and machinery rose sharply (+55%). The technology sector (+40%) also benefited from increased global demand for the development of artificial intelligence. The trend was also negative with Europe (-8.1%), while exports to China remained up by +5.2%.

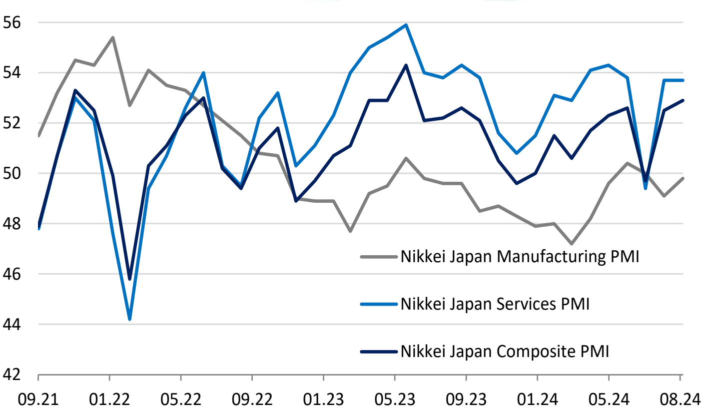
For households, the fall in consumer purchasing power, following the steady decline in disposable income and ongoing inflation, represented a brake on consumption at the start of the year, before wage negotiations which certainly supported a better dynamic in the spring. We remain relatively cautious regarding the continuation of the momentum observed in Q2 as the main factor supporting growth in H2. More than ever, Japan needs an upturn in global demand, and in particular an economic recovery in China. But the yen's recent rise from 160 to 140 yen to the dollar (+13%) will not help the situation of Japanese exporters.

We do not foresee a strong potential recovery in international demand and domestic consumption in the short term. Growth is therefore likely to remain weak in the second half of 2024.

Leading indicators remain subdued

The Jibun Bank of Japan leading indicators for manufacturing had temporarily returned to positive territory in May and June, before falling back below the growth threshold to 49.8 at the end of August. The services indicator, which had plunged below 50 in June, quickly recovered to stabilize at 53.7 over the past two months. The outlook for the composite indicator is therefore still positive, with a reading of 52.9 suggesting a continuation of the GDP recovery seen in Q2.

PMI indicators (manufacturing, services, composite)



Sources: Bloomberg, BBGI Group SA

On the industrial production front, July's data firmed up somewhat, also supporting the sentiment that manufacturing activity is strengthening. The month-on-month increase in industrial production (+3.1%) was also the strongest since May 2023. Capacity utilization also improved by +2.5% over the month.

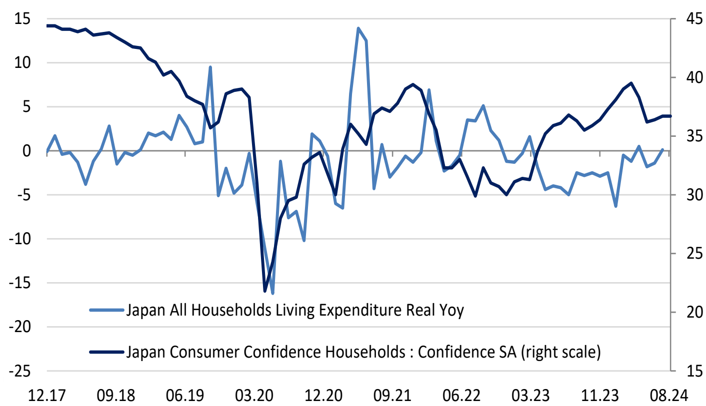
Machinery orders were down in July (-0.1%), but up +8.7% year-on-year. The recent trend is disappointing, and may also cast doubt on the continuation of business investment spending. However, the SRI Tokyo Eco Watchers indicator shows an overall improvement in all segments.

Consumer momentum still fragile

Weak household spending had weighed on GDP growth in Q1, before recovering in Q2. Household spending barely rose (+0.1%) in July, while retail sales recorded a small increase of +0.2%, for annual growth of around +2.6%. However, wage growth does appear to have jumped by +3.6% in July year-on-year, and is now clearly ahead of inflation (+2.8%). Household consumption could still be boosted by another factor that could influence consumer confidence. Indeed, government tax rebates can help improve household disposable income and support consumption.

That said, the confidence index, which could have already testified to this possibility, has instead barely stabilized over the past three months below its March high. Nor does it seem to be positively influenced by the still relatively robust job market. In our view, the absence of any real fall in inflation to below +2% is still weighing heavily on consumer sentiment.

Household confidence



Sources: Bloomberg, BBGI Group SA

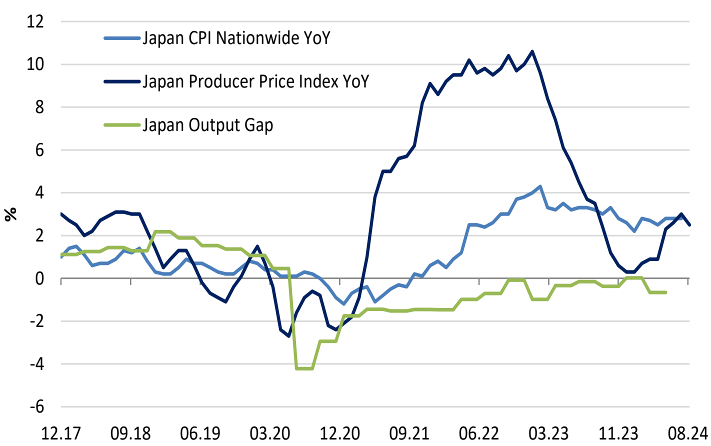
Can the yen's +15% rise reduce inflation

The yen's sharp depreciation between January and July was certainly not a positive factor for price trends in Japan. The +15% rise in import costs due exclusively to the yen's fall against the dollar was gradually passed on to producer and consumer prices. During this period, the producer price index recorded steady monthly rises, which were also transmitted to the CPI index. In August, the producer price index slipped by -0.2% for the first time in eight months. It is only since the strong reaction on the foreign exchange market following the BoJ's July rate hike, which effectively wiped out the entire devaluation of the Japanese currency in just one month, that producer price indices have begun to move into negative territory.

The yen's +14% appreciation has thus helped to curb producer prices, but is still having no effect on CPI, which is still up +2.8% according to the latest statistics.

Inflation in Japan has nevertheless fallen sharply from its peak of +4.3% in July 2023 to just +2% in July 2024 for the ex-food index, with the ex-food and energy index following a similar path (+1.9%). Japan's inflation outlook continues to be heavily influenced by exchange rate trends. If the appreciation of the yen seen in August and September continues over the coming months, we believe that the impact on imported prices should be particularly favorable to better inflation control.

« Output gap » and inflation (CPI PPI)



Sources: Bloomberg, BBGI Group SA

Pressure eases a little for the BoJ

The recent trend in Japanese price indices may indeed rekindle questions about a possible increase in BoJ key rates. The deceleration in price rises was temporarily below the +2% target, but is now back above this level. The BoJ had to react to counter the yen's collapse, which it has already done twice. After two extremely modest rate hikes in March and at the end of July, Japanese key rates remain the lowest in the world at just 0.25%. Despite these very low rate hikes, the Bank of Japan's latest intervention triggered a tsunami on the foreign exchange market with the massive reversal of “carry trade” positions by investors borrowing in yen to invest in other foreign assets, such as US equities.

When the Japanese monetary authorities raised their key rate by 0.1% in July, they probably didn't realize that this decision would have the now familiar consequences for the exchange rate. The yen's almost instantaneous appreciation of +14% at the beginning of August took observers by surprise, at a time when there seemed to be no end in sight to the yen's depreciation trend. Just prior to this, the yen had reached its lowest historical level since 1986, even though the central bank had purchased over $60 billion in an attempt to stem the fall in its currency. At the time, we suggested that this fall would prompt the BoJ to hike key rates at its next meeting on July 30-31, but the outcome of this decision now seems to have exceeded the institution's expectations.

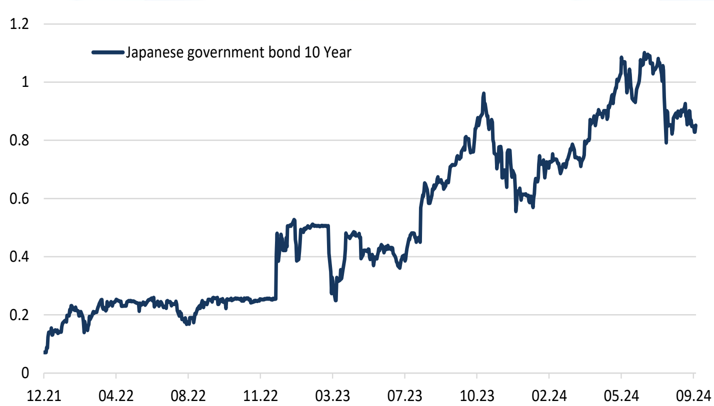
The adjustment of Japanese monetary policy should, however, remain extremely gradual over the coming months, so as not to weaken the recent upturn in the Japanese economy. The Fed's decision on September 18 to cut rates by 0.50% will certainly provide further justification for the yen's appreciation. The yen's appreciation alone should support a status quo decision at the BoJ meeting on September 20, which ended in a status quo and wait-and-see stance.

In our view, Japanese growth is still very fragile. As for inflation, the level is still too high for the time being, but could well be corrected thanks to the beneficial effects of the yen's recent rise on imported prices. In this context, we believe that the central bank can probably consider that the next few months will offer more reasons to be patient before any further hike. Against this backdrop, our economic outlook for Japan does not lead us to anticipate a further rate hike before the end of the year. Logically, the BoJ will remain the most accommodating central bank in the industrialized world. We consider this policy to be reasonable, given the weakness of domestic demand in Japan and the expectation of external stimulus.

Bond market still unattractive

Ten-year Japanese government bond yields have not really reacted in recent weeks to the change of trend in the economy and the rise in Q2 GDP. But the reaction to the latest 0.1% hike in key rates at the end of July and the reversal of carry trade positions has been significant, particularly on long-term bonds. The rise in the yen was accompanied by an almost instantaneous rise in bond prices. Ten-year yields dropped 30bp in two days before stabilizing at between 0.8% and 0.9%. Ten-year yields thus fell from 1.05% to 0.75%. Over the past six months, the correlation between yen-denominated long yields and the exchange rate has again been very high, confirming the close link already observed in 2023. Unsurprisingly, an appreciation from 161 to 140 yen to the dollar was accompanied by a fall in long rates over the same period. The Japanese yield curve is still one of the few curves in the industrialized world with a positive slope ranging from 0.1% to 0.8% (ten years). Beyond ten years, yields are significantly higher, rising to 2% at 30 years.

Ten-year government bond yields



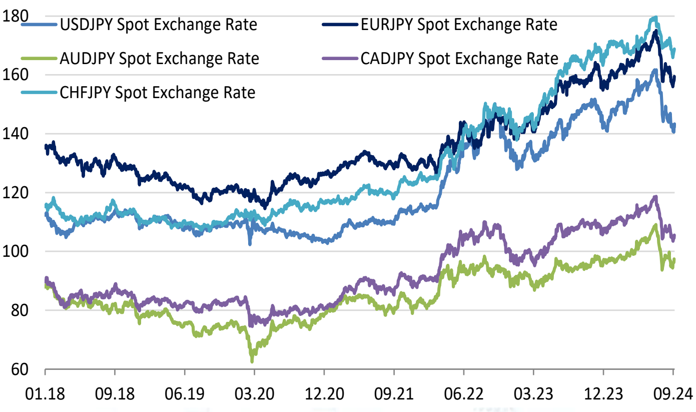
Sources: Bloomberg, BBGI Group SA

The slope of the yield curve has thus flattened slightly with the recent rise in short rates and fall in ten-year rates, but remains positive. The prospects of capital gains for yen-denominated bond investments are highly uncertain and limited to an extremely short time horizon, in the event of a downward revival in inflation which may not even have a lasting effect. Beyond the short term, the likelihood of rate normalization 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. With the exception of domestic investors, who we believe may still have an interest in yen-denominated fixed-income investments, Japanese bonds offer no attractive prospects for foreign investors in the face of a growing risk of interest-rate tension, and in a current environment that offers more attractive international alternatives.

Can the yen continue to rise?

The The yen's downward spiral seemed endless just a few weeks ago, when the Japanese currency hit its lowest level since 1986 in July.

Yen performance against major currencies



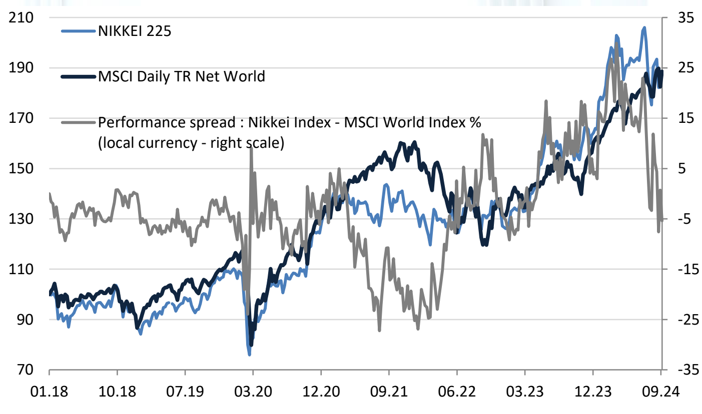
Sources: Bloomberg, BBGI Group SA

In a powerful downtrend, the yen's rebound phases against the dollar were only very short-lived and quickly followed by further bearish rallies, to the point where the "carry trade" seemed the perfect, risk-free strategy for many speculators. It's true that the yen was not supported by an adequate monetary policy and that the interest-rate differential remained very penalizing. In the end, all it took was a 0.1% rise for the trend to reverse, and for the unwinding of speculative positions to finally trigger a powerful reversal. For many months, we have been talking about the Japanese currency's decline, pointing out that it is now becoming an increasingly important concern for the BoJ. In our view, there is a growing likelihood of a clearer shift in BoJ's attitude towards defending the yen, through higher rates and a change in speculators' perceptions. At the time, we were announcing our forecast for a 12-month appreciation of the yen, a development that finally took place in just a few days. The question that remains today is whether the rebound will be sustainable. Our current forecasts are based on no further rate hikes, a limited decline in inflation and continued moderate economic growth over the next three months. These three factors do not provide support for yen appreciation. We expect a period of stabilization around 140-145 yen over the next few months.

Nikkei back to 40,000 level

Japanese equities did not escape the carry trade reversal, and were also hit by a 20% drop in three days at the beginning of August. With no real fundamental reason to justify such a shock, the Nikkei index's return below 32,000 points seemed to us an interesting repositioning opportunity. Today, the already significant rebound above 37,000 points has put the Nikkei back at a reasonable valuation level. Japanese stocks are now trading at 20x 2024 earnings, while profit expectations have now been revised upwards by almost +14%, i.e. growth similar to that seen in Q2 2024. A return of the Nikkei to 40,000 is likely.

Nikkei and MSCI World indices



Sources: Bloomberg, BBGI Group SA

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