10th June 2016

The BOJ will hold off after the surprise +1.9% increase in GDP

Surprise GDP growth. VAT increase pushed back. Greater negative interest rates essential. The appreciation of the yen is unsustainable. Bounce back in equities put back.

Key Points

- Surprise +0.5% growth in Japanese GDP in 1st quarter, +1.9% year on year
- VAT rise once again pushed back by 2-3 years
- Consumption remains somewhat anaemic
- Little hope of a sustained rebound in economic activity
- However, leading indicators more positive
- The BOJ forced to take action to revive growth
- Even lower negative interest rate policy
- Inflation target slipping away
- New reversal of the trade balance
- Share buybacks favoured by negative interest rates
- Rise on equity market pushed back again
- The 12% appreciation of the yen in 2016 has hit unsustainable levels

The surprise increase in Japanese GDP in the 1st quarter 2016 makes it less likely that the BOJ will intervene

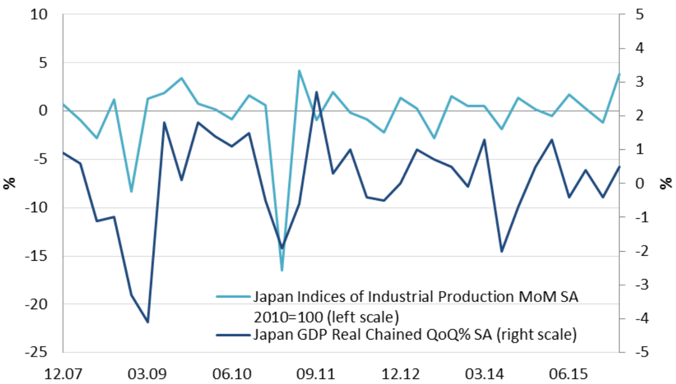
Japanese GDP gave observers a pleasant surprise in the 1st quarter, and its recent revision to +0.5% suggests a more robust than expected recovery of the Japanese economy. Equally, the +1.9% seasonally adjusted year on year growth rate seems impressive in international comparison, and in the rather weak global economic context of the 1st quarter. Published growth figures were considerably influenced by a drop in imports.

The BOJ (Bank of Japan) could decide that these figures are encouraging enough to justify maintaining its current policy until 28th-29th July, after the upper chamber elections on 10th July.

As such, it is certainly only a question of weeks before the Japanese central bank announces it will reinforce its negative interest rate policy (currently -0.1%) and asset purchases, particularly ETFs (Exchange Traded Funds) and bonds. The asset purchase policy injects 80 trillion yen per year into the economy (US $752 billion), and could be increased to 100 trillion yen.

GDP growth of +0.5% in 1st quarter has not entirely extinguished risks of Japanese activity falling back off again. Consumption and investment are still very weak.

GDP and Industrial Production (%)



Sources: Bloomberg, BBGI Group SA

Nonetheless, the Japanese parliament has approved a record budget for the 2016-2017 tax year, under pressure from earlier disappointing economic data. Members of parliament accepted an exceptional budget of nearly 100 trillion yen (nearly US $940 billion), as the Japanese economy contracted -1.1% in 4th quarter 2015. This record budget remains essential in sustaining the economy, especially consumption. However, the good 1st quarter results should not put into question the size of the fiscal and budgetary stimulus that Prime Minister Abe, whose optimism now seems to be somewhat justified, wants to apply.

Nevertheless, he likely remains too confident in hoping that inflation will once again hit 2% by the end of the year. The +12% rise in the yen against the US dollar since the start of the year has reduced inflationary pressures, but we do not believe that this can be explained by the surprise improvement to GDP in the first quarter. The US dollar fell three times as much against the yen as it did against any of the other currencies in the trade-weighted US dollar index. Ensuring the yen depreciates should be one of the BOJ's objectives. The central bank will perhaps take such action at its next meeting, by further dropping negative interest rates, for example.

Unsurprisingly, VAT rise pushed back again

Still struggling to keep up the support for the economy when public debt has already headed north of 200% of GDP, in the end Prime Minister Abe announced that the VAT rise would be postponed. Any rise would have improved public finances. The increase had already been put back in October 2015, and was still entirely inappropriate in the current context. It is likely that this VAT increase will be put off again. It is said that it will be off the cards for 2-3 years, and will only be implemented once the economy has truly achieved a lasting recovery.

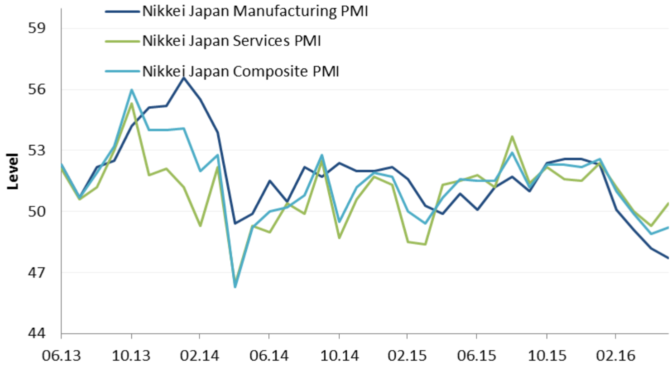
Consumption remains somewhat anaemic

The +12% increase in the yen since January and the drop in crude oil prices at the start of the year did not boost consumption. Household spending trailed off -0.4% again in April, after having fallen -5.3% in March. It seemed inevitable that the Prime Minister would push back the VAT rise again when consumer confidence refused to increase (40.9 in May). Retail sales in department stores also fell -3.8% year on year, confirming how weak spending is. The eagerly awaited wage rises did not reach everyone due to the decrease in company profits. Profits were not as high as hoped, even falling -9.3% year on year. The unemployment rate did remain very low (3.2%), but job market conditions do not look any prettier. Caution will therefore likely reign just as long as wages do not rise. Intention to hire remains very low; only 2% of companies have stated that they want to hire staff in 3rd quarter, -3% less than in March. The drop in company profits has caused uncertainty to linger as to how much they will help prop up consumption by increasing purchasing power, as the government so dearly hopes they will.

Little hope of a sustained rebound in activity

Leading services PMI and composite PMI indicators, however, do point to an improvement in the situation in the near future. The services PMI headed above 50 (50.4), which is a good sign, whilst the composite PMI (49.2) increased, but still remained below the growth threshold. Industrial production struggled to rise, actually slipping -3.5% in April. Leading indicators gave a glimpse of an improvement in economic performance, without making any great show of enthusiasm.

Composite – Manufacturing – Services PMI (SA)



Sources: Bloomberg, BBGI Group SA

Even lower negative interest rate policy

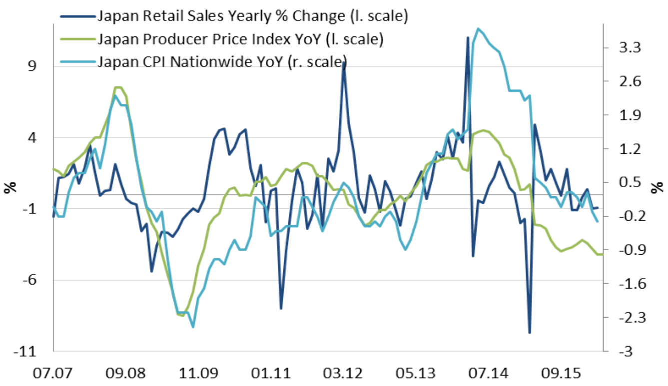
At its next meeting, the Bank of Japan will probably not change its monetary policy, and will leave its negative interest rates as they are.

Governor Hauruhiko Kuroda had indicated that the BOJ could in theory drop its key interest rate from -0.1% to -0.5%, but that this would take place at its next meeting in June. 1st quarter GDP figures should undoubtedly persuade him to postpone this drop until the July meeting. However, upward pressure on the yen suggests that interest rate spreads will need to be increased to make the yen a little less attractive, and to ensure it starts to fluctuate between 115 and 125 to the US dollar once again. The fact that key interest rates in the United States have not been increased is not unrelated to this situation, which we believe should be short-lived. Equally, a weakening of the exchange rate is always one of the key elements of any policy aiming to revive inflation.

The inflation target is slipping away

The latest inflation (Core CPI) figures for April show a -0.3% price drop year on year. The BOJ is therefore facing a delayed relapse in inflation and inflationary forecasts. The bounce back in crude oil prices over the past few weeks could finally play a positive role, but a rise in the yen should in part cancel out its effects. The new CPI measure excluding food and energy used by the BOJ increased +0.9%, but is still way off the +2% target.

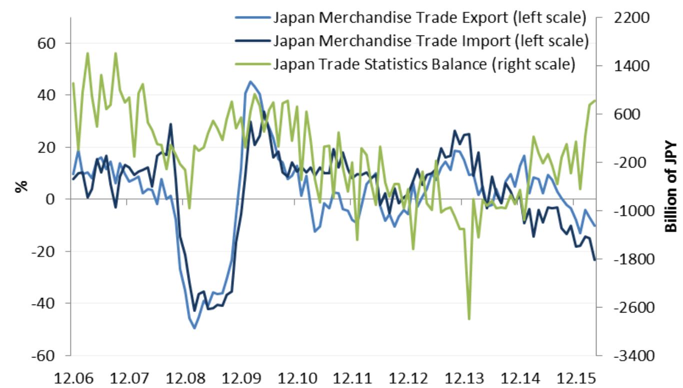
Inflation (CPI and PPI) and Retail Sales



Sources: Bloomberg, BBGI Group SA

Because this structural element only changes very little, even in the long-term, expansionary monetary policy cannot change the current situation. The coming months will remain difficult for the Japanese economy. Since Haruhiko Kuroda started QQE (qualitative-quantitative easing), the central bank has injected more than 200 trillion yen into the economy. A very high proportion of these injections has come back to the BOJ in the form of bank deposits, and has never made its way into the real economy. Introducing -0.1% negative interest rates on bank reserves held at the BOJ aimed to prod the banks into a change of attitude. Although this measure does not as of yet seem to be very effective, the BOJ should nevertheless view it as an important part of their current QQE programme, and consolidate it over the coming months by further dropping interest rates from -0.1% to -0.3%. The BOJ's negative interest rate policy is already unique in having a variable component that does not exist in others, particularly the European and Swiss models. In Switzerland, the required reserve in the central bank which is exempted from negative interest rates is set at a fixed sum. The system that the BOJ has implemented links it to the QQE programme. The amount increases when QQE increases the current account balance. As such, introducing negative interest rates very quickly affected the banking sector and listed assets.

Trade Balance Billions JPY



Sources: Bloomberg, BBGI Group SA

New reversal of the trade balance

The trade balance increased again in April to 823.5 billion yen, but according to the finance ministry's preliminary figures for May, the balance has once again plunged into the red under pressure from falling exports. This comes after just a few months of growth. The new deficit should stand at 574 billion yen (US $5.5 billion).

Share buybacks favoured by negative interest rates

As we have already mentioned, the negative interest rates are encouraging Japanese companies and banks to repurchase their shares. Japanese companies with liquidity available will be increasingly tempted to buy back their shares just as profit growth is treading water, after a positive 2015 (+15%) and a listless 2016. It is estimated that nearly US $650 billion has been accumulated in cash positions by listed companies (excluding banking and public services). The debt to equity ratio is at a historic low (around 40%). It will bounce back in a context of share buybacks. This is one of the only strategies which increases ROE (return on equity) in a zero economic growth context. The particularly attractive level of the price-to-book ratio is another factor that may persuade companies to purchase equities. It is believed that almost 50% of the assets on the Japanese stock market are trading below their book value.

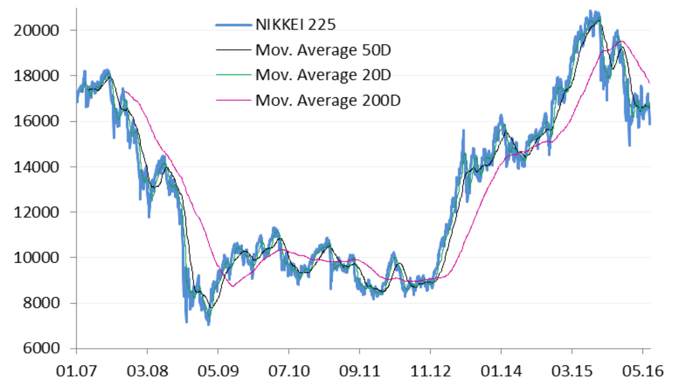
Rise on equity market pushed back again

The Japanese market under-performed in comparison to most developed markets in 2016, both in local currencies and in USD. It is still losing ground, on -16.68% in yen since the start of the year (-5.5% in USD), whilst international equities have just tipped into positive ground in USD. The Nikkei corrected to a greater degree, and the bounce back in prices still lacks any vim and vigour.

In terms of relative valuation, the price-to-book ratio is the best advertisement for Japanese equities. The Nikkei is trading at 1.27x book value, as compared to 2.47x for the S&P500, and 2.11x for the SMI; the valuation of European equities is similar (1.20x).

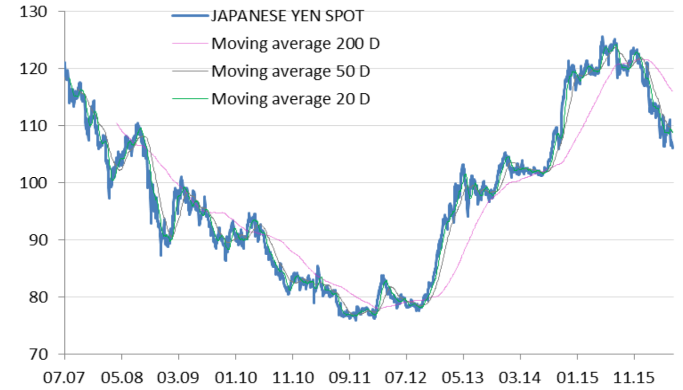
The equity market could of course react positively to a change in inflation and growth prospects. However, as we have seen, we do not expect any very positive surprises, and the rise in the yen could further dim any hope. Foreign investors are deserting the Japanese market in this rather un-encouraging climate. As such, flows of funds decreased in May.

Japanese equity market – Nikkei 225



Sources: Bloomberg, BBGI Group SA

USD/Yen Exchange Rate (2007-2016)



Sources: Bloomberg, BBGI Group SA

The yen has hit an unsustainable level

We do not believe the yen's rise to be sustainable for the Japanese economy. We would predict that a correction will take the yen back to fluctuating between 116 and 126 to the US dollar.

Domestically, the weakness of the yen should go hand in hand with a further drop in key interest rates, from -0.1% to -0.3%, as well as the announcement of a mixed recovery programme, based on complementary budgetary programmes, a more efficient tax system, and more intensive asset purchases.

The BOJ will step in to counter the yen's rise. The decision the Fed took on 15th June could influence the BOJ. Should interest rates remain unchanged in the United States, this would certainly spark BOJ action aiming to weaken the yen. Should this not happen, the Bank of Japan will likely hover in the background.

Conclusion

GDP provided a surprise, increasing +0.5% in 1st quarter, but a lack of results on inflation will force the monetary authorities and the government to react.

The BOJ will need to take action to halt the yen's appreciation and stabilise the currency.

This is a condition sine qua non for Japanese equities to rise in the near future.

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