
*September 11, 2015*

# Record Japanese corporate profits despite disappointing GDP

**Disappointing GDP in the 2nd quarter. Concerns regarding China seem overstated. The Yen should achieve greater stability. New investment opportunities on the equity markets.**

## Key Points

- Japanese GDP disappoints in the 2nd quarter
- Exports are not up to expectations despite a +4.6% rise in July
- Trade balance benefits from lower imports and energy costs
- Massive increase in current account surplus to ¥1,808 billion year-on-year
- A wave of mixed economic news in the summer
- Japanese economy should avoid another recession
- Monetary authorities remain confident but a new stimulus plan is needed
- Yen to stabilize between 120-125 against the USD
- Corporate profits at record highs
- Rise in Japanese stocks to 21,000 seems likely

## Disappointing GDP, but Japan should avoid sliding back into recession in the 3rd quarter

**Figures for the 1st quarter have allowed the land of the rising sun to see some light at the end of the tunnel with +1% rise in GDP and +3.9% year-on-year. The performance for the 2nd quarter triggered a wave of uncertainty, even after a positive revision of economic growth.**

**The revised figures of Japanese GDP reported a contraction of -1.2% after seasonal adjustment.**

**This result is slightly better than the initial estimate of -1.6% and median market forecast (-1.8%).**

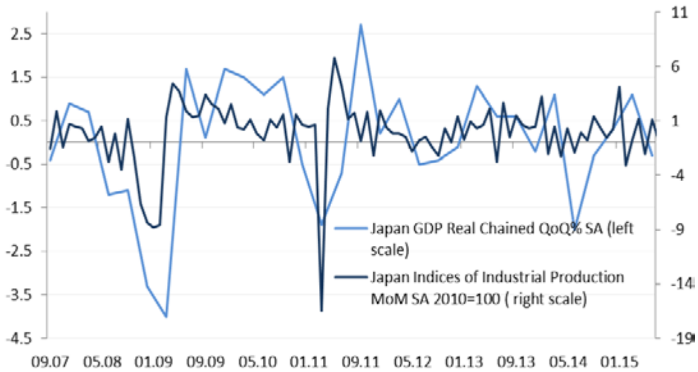
**This is not at all reassuring for investors as regards the ability of the Japanese economy to reach the 2% economic growth cycle, as established by monetary authorities.**

Essentially, the inclusion of new data on private investments and inventories helped improve the official figure. Consumption remained relatively low, declining to -0.7%, while foreign trade was slightly lower compared to the original figure. There was great disappointment in exports, which did not reach the expected growth, while imports were revised upwards.

**The second quarter was still not that of the expected trend reversal. We had pointed out a few months ago, that if patience was a virtue in Asia, we will still need more before we see Japanese GDP take-off.**

The latest figures for the 2nd quarter confirm this forecast and do not give much hope for a swift trend reversal in the 3rd quarter.

**GDP and Industrial Production %**

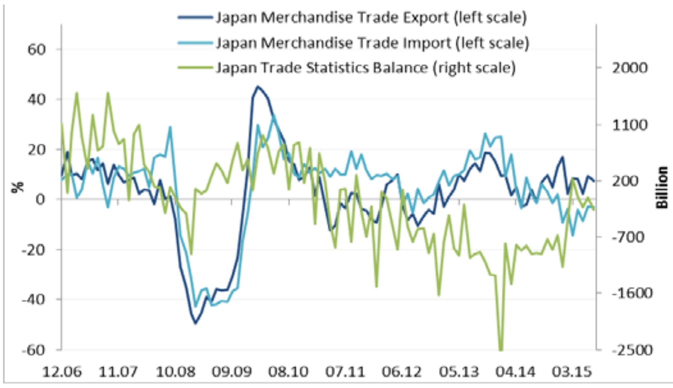



*Sources: Bloomberg, BBGI Group SA*

Especially since it seems that those factors which actually weighed on 2nd quarter results could still hold back the Japanese economy in the 3rd quarter .

**Hopes for a renewed economic vigor based on exports were partly disappointing in recent months due to mixed data on industrial production and exports of finished products, although exports of durable goods and capital goods were satisfactory.**

## Trade Balance Billion JPY




*Sources: Bloomberg, BBGI Group SA*

### Mixed economic news during the summer

**Merchandise exports grew by +4.6% in July, while imports dropped -6.5% reflecting the fall in crude oil prices.**

Japan's merchandise trade deficit was substantially reduced from ¥850bn to ¥108bn yen year-on-year. The securce component benefited from the Yen's depreciation which helped draw tourists in the country and thus brought the deficit from ¥450bn (July 2014) to ¥185 bn (July 2015). Therefore, Japan's balance of current accounts had a ¥1,808bn surplus in July, four times the surplus recorded in the same period of 2014, driven in particular by lower energy costs.

A few positive signs were also seen in terms of salaries, which confirm the encouraging signs which had been already observed in the household disposable income figures on a clear rising trend since summer 2014 .

**The increase in savings is holding back consumption, but this precautionary saving, in a situation of low unemployment (3.3%) does not seem to be sustainable in the long term.**

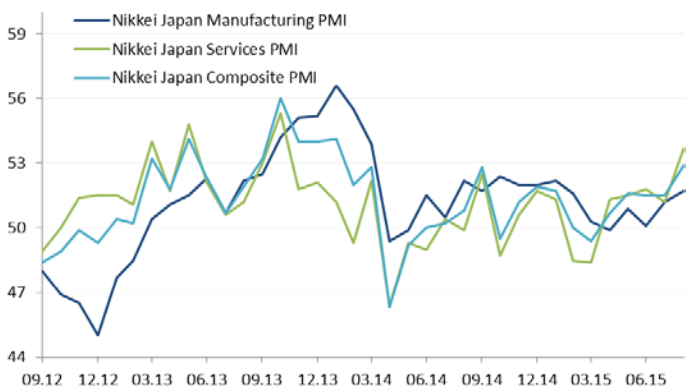
**We should probably assist to a revival of consumer spending in the coming months and recovery in economic activity.**

Among the most recent economic news, industrial production in July decreased by -0.6% and machinery orders (-3.6% in July) tumbled below estimates (+2.8% compared to +10.3% expected year-on-year). This figure is often considered as a leading indicator of corporate capital spending. The core machine order segment of the private sector is less volatile and suggests the CAPEX spending could still disappoint in the 3rd quarter.

However, capacity utilization rate for most segments remained high in July by historical standards. This supports the theory of a pick up of investments in the coming quarters. On the consumer side, the confidence index was slightly better in August (up 41.7 from 40.3) with the evolution of the unemployment rate at only 3.3 %. The job offers to applicant ratio was of 120%, the highest on record since 1992. Inflation remained muted (+0.1%) in July, while producer prices slipped -0.6%.

**On their side, leading economic indicators illustrated a positive picture in August. This was thanks to a rise of the composite PMI from 51.5 to 52.9 and a even sharper increase of the services sector from 51.2 to 53.7.**

## PMI Composite – Manufacturier-Services (SA)




*Sources: Bloomberg, BBGI Group SA*

### Will Japanese firms step in to save consumer spending?

**On the corporate side, profits reached their peak since the 1980s and have now exceed the ¥20 trillion threshold in the 2nd quarter. This figure is ¥3 trillions greater than the previous peak in 2007.**

That said, companies' investment spending remained lower than ¥10 trillion in the same period. We believe that companies' investments could increase over the next semester, contributing to growth. Equally, they could also boost workers by upping the average salary. This fits in with the Bank of Japan's (BOJ) vision; they hope that this trend will finally take place. We may have to wait for a drop in unemployment and tougher wage negotiations before this materializes.

### Japanese authorities remain confident

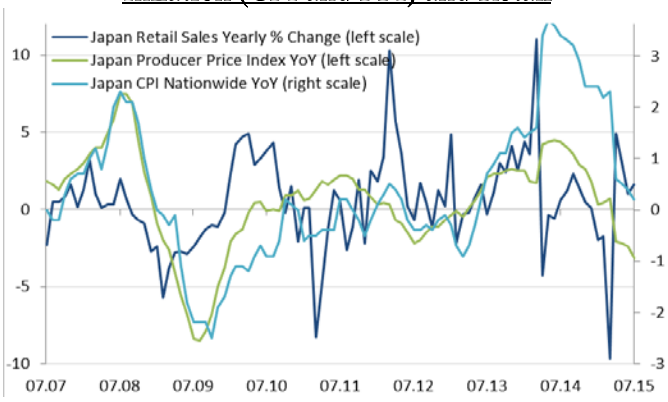
Nevertheless, Japanese authorities remain confident and have continued to hammer home their optimism. Two years after Abenomics was launched, however, growth has yet to take off.

The drop in the Yen has yet to produce the expected effects, and inflation remains close to zero, despite the target rate which stands unaltered at 2%, as well as massive liquidity injections. Notwithstanding, Haruhiko Kuroda, governor of the central bank, still hopes that business profits and very low unemployment rates will soon lead to an increase in salaries and household consumption. Abenomics is very much struggling to prove its effectiveness. Amongst the components that are missing, putting in place wide-sweeping structural reform is a slow process, although some progress has been noted, particularly in terms of governance. There has still been no significant step forward on the issue of the labor market.

## Inflation stays grounded and remains a monetary policy objective for the BOJ

The massive liquidity injections from 2013 onwards have barely lifted the Japanese economy out of deflation, and signs of inflation remain few and far between.

**Inflation (CPI and PPI) and Retail**




*Sources: Bloomberg, BBGI Group SA*

In reality, ¥80 trillion worth of liquidity injection by the BOJ has yet to boost inflation above zero (core inflation, excluding energy and food). In the latest consumer confidence survey in August, consumers expected +2.7% inflation over one year, a slight drop as compared to the previous quarter. These expectations may be rather high, but are lower than those collected in a BOJ survey in June, which showed that expectations were stable at +4.8%.

As regards companies, opinion seems to be somewhat more divided. There are now more companies forecasting a drop in selling prices than those expecting a rise. The latest forecasts by economists do not paint a more optimistic picture, showing a drop in forecasts since their 2014 peak, to only 0.5% over one year, and hardly 1% over two years. Moreover, with the drop in commodities, particularly oil, deflationary pressures are beginning to build again.

**The authorities' patience or rather their current feebleness could last another few months.**

**However, if no significant progress is made, the governor of the central bank will certainly announce fresh measures.**

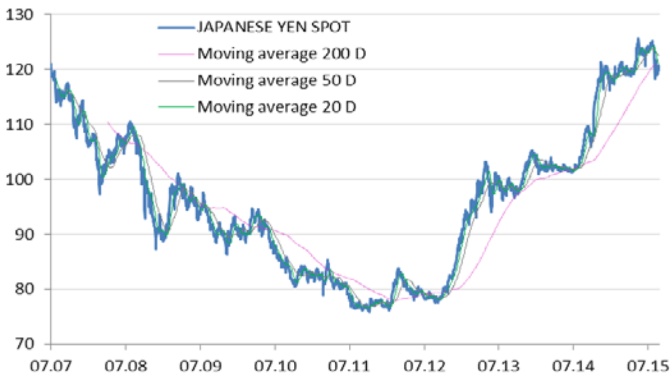
## New support program expected by the end of the year

In this context, we believe that there is little chance that statistics will start to tell a different story with regard to inflation over the coming weeks. The monetary authorities are certainly aware of this and may not want to wait any longer before they act. Following their next meeting at the end of October, they could quickly announce new support measures, ranging from expanding the asset buying scheme to fresh temporary reflationary measures.

## The Yen appreciates temporarily, but should stabilize at 120-125 against the U.S. dollar

As regards the Japanese Yen, it has stopped falling after two years of depreciation, having returned to the June 2007 exchange rate. Indeed, the Yen appreciated from 125 to 75 against the dollar during the crisis, until 2011. It then tumbled in the 1st quarter of 2012, and then again the 2nd quarter of 2013, following a radical change in monetary policy. Although to begin with the 2013 devaluation fueled hopes of growth for GDP and Japanese exporters, from then on the People's Bank of China's (PBOC) change of tack rather perturbed the situation.

**USD/Yen Exchange Rate (2007-2015)**




*Sources: Bloomberg, BBGI Group SA*

This is especially due to the fact that initially the PBOC's decision to devaluate the Yuan by 5%. This, coupled with the uncertainties that have resurfaced regarding China's growth, rather buoyed up the Yen and the Euro at the expense of the U.S. dollar.

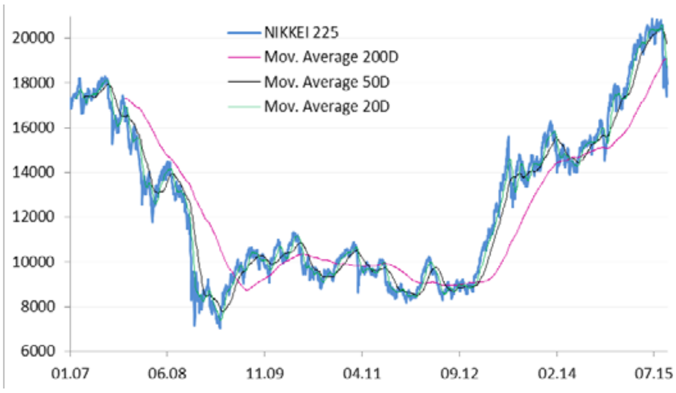
We do not believe that the slight increase in real interest rates in the Yen due to deflationary pressures will be sufficient to change the Yen's trend towards stabilization with a mid-value of 120 Yen over the coming months. Disappointing growth and inflation are likely to spark a reaction from the central bank, which should contribute to weakening the Yen once again.

## Japanese equities punished by fears over China: an opportunity to buy on the Nikkei

The approximately -15% drop in the Japanese market was no higher than that of European equity markets in August. In fact, investors' reactions in the face of further uncertainty regarding Chinese growth were similar, despite the growing importance of existing links between the two biggest Asian economies. China has become an essential partner for Japan, alongside the United States. These two countries each represent 18% of total Japanese exports.

However, it must be noted that exports to Asia represent more than 50% of total Japanese exports, demonstrating how important it is for Japan that the Asian economy has a clean bill of health, especially the Chinese economy. As such, it is not a coincidence that companies with close links to China dragged the equity market down. Nonetheless, we believe that fears that forecast Japanese companies will tumble are overstated. After a recent moment of weakness, the Japanese market is trading on 17x earnings for this year. It is boosted by an environment that is advantageous from many angles. First of all, the monetary conditions provided by the BOJ will remain very accomodative and will drive a drop in the Yen over the next few quarters. Following this, we expect considerable growth in Japanese companies' profits (+20%) in 2015. Moreover, the joint action of the BOJ, which should intensify its asset buying scheme, and public pension funds increasing their exposition to equities, will prop up demand.

**Japanese Equities Markets – Nikkei 225**




*Sources: Bloomberg, BBGI Group SA*

## Conclusion

**GDP is disappointing and the lack of results on inflation will spark a reaction from the monetary authorities.**

**Interesting fundamentals will be a boon for the equities market. We believe that the Nikkei could quickly recover to 21,000 points, a level it already reached earlier this year.**

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