Alain Freymond – Partner - CIO

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Positive surprise in Japan: GDP surges by +2.2% yoy

Falling yen boosts exports. GDP also benefits from global economic recovery. Stabilisation of the yen. Pick-up in consumption. Increase in profits. Nikkei undervalued.

Key points

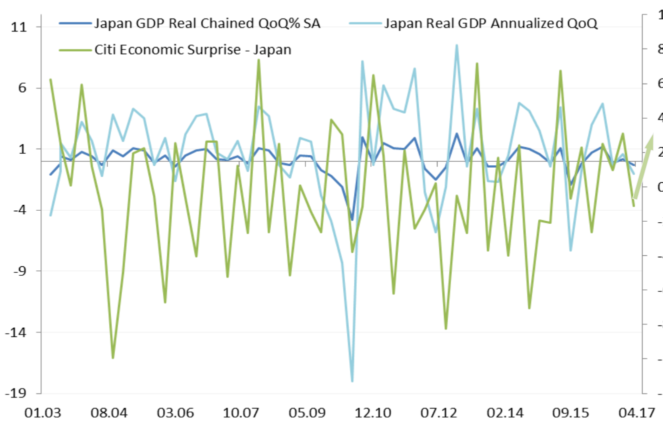
- Remarkable Q1 in Japan in terms of economic growth
- Fifth consecutive month of export growth
- Japan GDP rises 2.2% yoy in March and 0.5% over the quarter
- Positive contribution of exports and domestic demand
- Positive signs with regard to consumption
- Fluctuation of leading indicators
- Stabilisation of the yen/dollar between 115 and 120
- Return of inflation still barely perceptible
- Continue to avoid yen-denominated bonds
- Increase in profits and dividends
- Japanese equities undervalued by international standards

Remarkable Q1 in Japan in terms of economic growth

Revision of growth figures in Q1 (+0.5%) points to a sharper recovery in 2017 that could increase annual growth beyond original predictions. Japanese GDP rose +2.2% yoy, which corresponds to a substantial acceleration compared to Q4 performance of +1.7%. Japan's GDP posted a fifth consecutive quarterly increase, which constitutes its longest expansion phase in ten years. Japan's economy was also supported by the ongoing recovery of exports, and it has finally been boosted a little by stronger domestic demand. Despite these increasingly positive results, the general feeling remains hesitant, and economists remain cautious in their forecasts, anticipating average GDP growth of merely +1.3% in Japan in 2017. We expect a slightly stronger economic outcome for Japan's economy, which could slow down slightly after the results in Q1 before posting a performance close to +1.7% over the year.

The expected weakness of the yen against the dollar following the US elections has clearly had a positive impact on the competitiveness of Japan's exporters and boosted exports as we had anticipated. While the yen strengthened slightly in Q1, this will likely not change the overall trend. We now expect the exchange rate to stabilise between 110 and 120 yen to the dollar, which would likely be very favourable to Japan's economy. GDP growth in Q1 thus largely benefitted from the yen's weakness, resulting in the improved competitiveness of Japanese products. This had not been the case in the previous quarter, and it is therefore good news: Private consumption once again contributed positively in the last quarter by posting a growth rate of +0.4%.

GDP (quarterly and annual)



Sources: Bloomberg, BBGI Group SA

Thus, Japan's recovery was slightly less dependent on exports at the beginning of the year, contrasting for once with the usual characteristics of Japan's economy, very much oriented towards international trade. Beyond the relative weakness of the yen, the recovery of the global business cycle has also enabled external demand to support export growth. It does, however, raise the question of the sustainability of the observed pickup in household consumption expenditure, in particular given the marked absence of any increase in income and wages. Nevertheless, this relatively positive result should be appreciated, as it partly reverses the trend of the previous quarter, at least momentarily.

Positive signs with regard to consumption

Retail sales in supermarkets (+0.6%) and retail outlets (+0.7%) record their first yoy increases in April, after several months of renewed weakness, matching back up with the positive results achieved in the same period by the catering sector. Consumption remains fragile, especially in Tokyo, where sales declined (-0.8%) in April. Private consumption, which in Japan still represents some 60% of GDP, is thus moving towards recovery, but uncertainty remains in a persistently cautious economic climate and context, despite a further decrease in the unemployment rate to below 3%. The unemployment rate will likely remain close to its lowest level since 1994 and begin to exert pressure on wages in certain sectors. The ratio of job offers relative to demand is thus also at its highest level in the last 30 years.

Household expenditure /consumer confidence

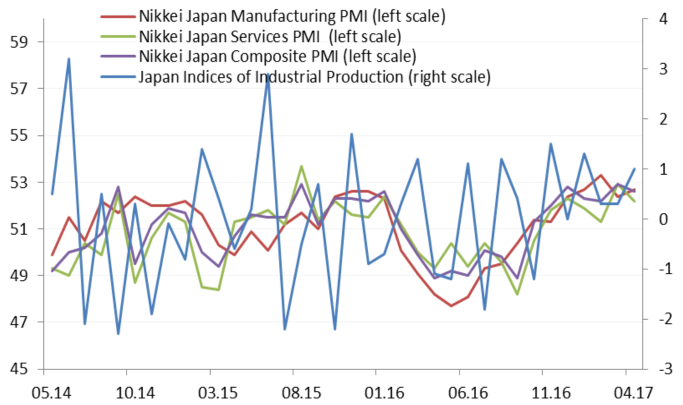
Sources: Bloomberg, BBGI Group SA

The BOJ's expectations of an upturn in inflation have always been motivated by an increase in wages, supported in particular by an increase in corporate profits and their partial redistribution in the form of across-the-board wage increases. Household confidence remains high (43.2), and the unemployment rate is declining steadily, now reaching 2.8%, i.e. a level close to full employment. The ratio of jobs available per job-seeker was of 1.48 in April, clearly indicating that tensions on the job market are about to intensify. Retail sales rose by +3.2% yoy, but wages and productivity are struggling to take off. Nevertheless, we believe that economic conditions are developing favourably to lead to a reasonable recovery of consumption in 2017.

Fluctuation of leading indicators

The pickup in exports and external demand, partly supported by a more favourable global business cycle and growing investments in Asia, will likely have a more noticeable impact on industrial production. However, the latter is not showing any signs of acceleration as of yet and, despite a 3.5% increase yoy in March, fell by -1.9% over the month. Machine orders also disappointed with a -0.7% decrease after excellent results in February (+5.6%). Leading indicators for the manufacturing sector weakened a little in May (52) after peaking at 53 in February. However, the composite PMI index remains at high levels, confirming forecasts of a moderate recovery of economic activity. This trend showing a future improvement in economic conditions is also confirmed by the business cycle indicator, which also returned to a positive value (105.5), the highest since November 2015.

PMI indices and industrial production

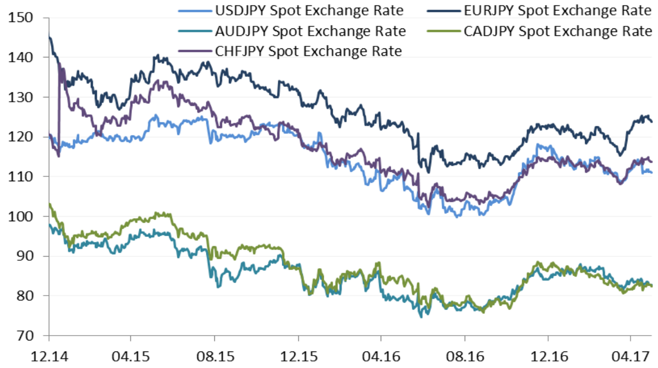


Sources: Bloomberg, BBGI Group SA

Stabilisation of the yen/usd between 115 and 120

The unexpected +2.2% yoy growth rate is indeed a positive surprise that has nevertheless not significantly affected expectations for 2017. However, it has had but little effect on the Japanese currency, which could have benefitted from it. While the increase from +1.4% to +2.2% between Q4 2016 and Q1 2017 is noticeable, for the moment doubts and uncertainty outweigh any optimism that could have benefitted the yen. We believe the improved fundamentals will not have any immediate impact on the yen, which will probably remain sidelined because of a thoroughly unfavourable interest rate environment. Government policy is still aiming at weakening the yen, while interest rate differentials and the perspective of new interest rate increases in the US will undoubtedly push the value of the yen further down in 2017. The change of paradigm in the US has clearly provided significant support for the devaluation of the yen, which is now seeking a new direction. The weakening of the exchange rate was one of the key elements in the government's policies to stimulate inflation and exports. This policy remains current, and we still believe that the yen will likely return to fluctuating between 115 and 120 yen to the dollar in the next few months.

Yen against USD, EUR, AUD, CAD, CHF



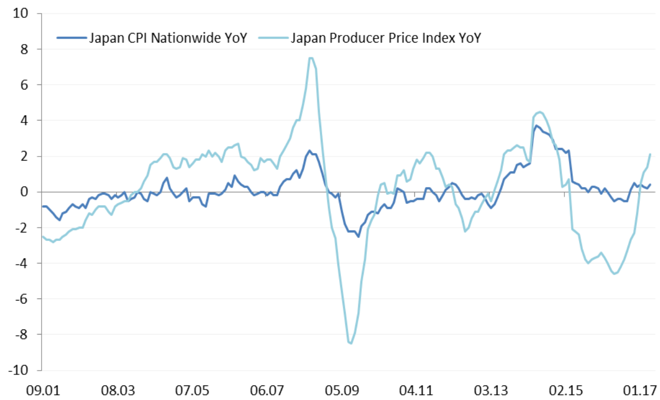
Sources: Bloomberg, BBGI Group SA

In our minds, an acceleration of economic growth seems essential for a sustained trend reversal with regard to the yen, which for the moment remains in a sustained period of weakness against the dollar.

Return of inflation still barely perceptible

Risks of deflation have decreased but have not been completely ruled out, despite several months of slight upturn in price indices. The first signs of an upturn in price indices, already observed in November 2016, have since strengthened, enabling the national CPI index to post an annual increase of +0.4% in April. Inflation has thus made a tentative comeback in the last few months, but it still lacks support to achieve the 2% goal set by the BOJ. A new acceleration in May could point to future progress in that direction, but wage increases and the continued weakening of the yen still look like essential conditions for any hope of a sustained price recovery.

Inflation (CPI and PPI)



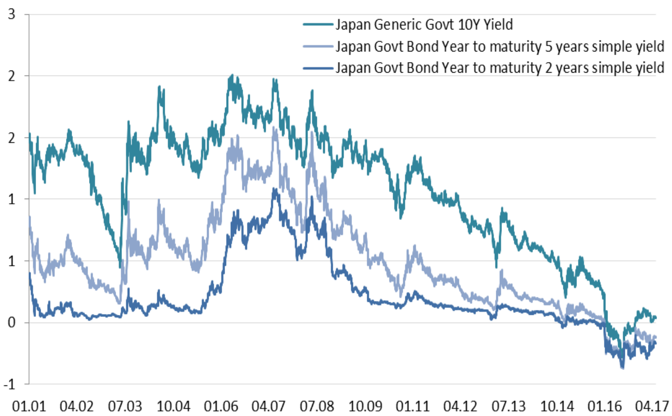
Sources: Bloomberg, BBGI Group SA

In terms of producer prices, the trend is clearer. After two years of deflation, PPI indices grew once again by +2.1% yoy in April due to the increase in commodity prices and the weakness of the yen in particular. Thus, the BOJ can clearly not yet rejoice, but its reflation attempts via a weakening of the yen finally have a chance of succeeding at the very moment it will benefit from the additional effects caused by a likely continued increase in crude prices.

Continue to avoid yen-denominated bonds

The change of circumstances on the inflation front is still too recent and too small-scale a phenomenon to have any significant impact on interest rates. If the increase in long-term government rates is indisputable since July 2016, the scale of the increase remains very limited.

Government bond yields



Sources: Bloomberg, BBGI Group SA

The rebound in long-term government rates in yen from -0.3%, corresponding to the record low reached right after Brexit, to +0.1% in December 2016 has been interrupted. Since the beginning of 2017, the Japanese government's ten-year rates are barely positive. For the moment, the Japanese bond market offers no interesting prospects for foreign investors. In the short term, we do not expect any changes in the strategy of the BOJ, which will likely maintain a monetary policy in the next few months characterised by a negative key rate of -0.1% and a flexible asset acquisition programme, to better manage bond yields and, in particular, to prevent a downtrend of long-term rates into negative territory (QQE with Yield Curve Control).

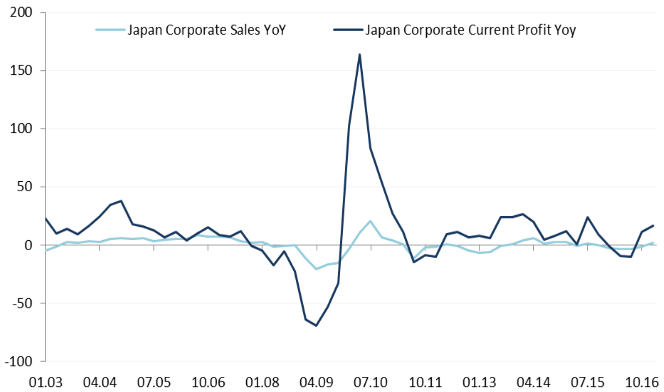
Japanese equities undervalued by international standards

2016 will have been a record year for corporate profits in Japan thanks to an increase in retained earnings of almost +20%. The dividends of listed companies that should be distributed could increase for the fifth consecutive year and exceed 22 billion dollars. At the beginning of the year, we believed an acceleration of corporate profit growth in Japan was likely, due in particular to the global business cycle's recovery and the weakening of the yen.

Japanese companies will most probably increase their pay-out ratio by about 4%, but they will nevertheless retain substantial funds to meet their investment needs. They anticipate earnings growth of about +5.5% in 2017. The yen's downtrend will certainly have been a decisive factor in the renewed interest of investors in the equity market. A few months ago, we had already mentioned that the yen's depreciation would undoubtedly be the most decisive factor in the next surge of the Nikkei index, potentially pushing Japanese equities to their highest levels since 2015. Thus, it is also worth considering that Japanese equities will still benefit from favourable prospects with regards to profit growth as well as high margins in 2017.

By international standards, Japanese shares seem considerably cheaper than US equities in terms of PE, but it is mainly the EV/EBITDA ratio that is particularly favourable to Japanese companies (7.4). This ratio is inferior to US equities' (12) for a lower average debt level, i.e. 30% of enterprise value, against about 40% for US and 50% for European equities.

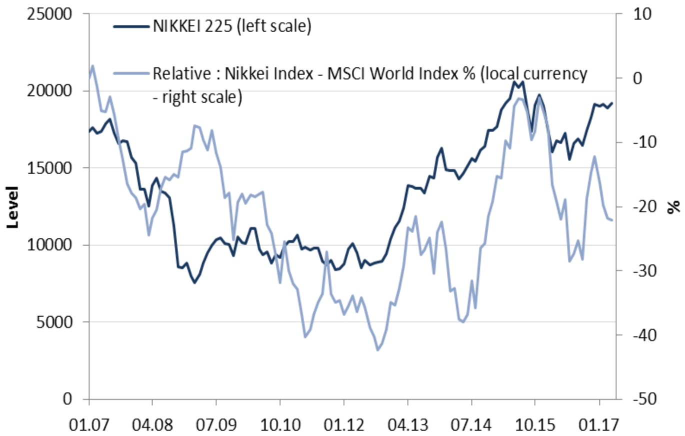
Corporate earnings and sales growth



Sources: Bloomberg, BBGI Group SA

The future growth of the Nikkei remains dependent on the continued weakening of the currency. Thus, currency risk must be considered within a global exposure to Japanese equities. At 15.8x 2017-2018 profits, the market provides opportunities for positive surprises and for a readjustment of expectations.

Nikkei and MSCI World Indices



Sources: Bloomberg, BBGI Group SA

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BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva – Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch