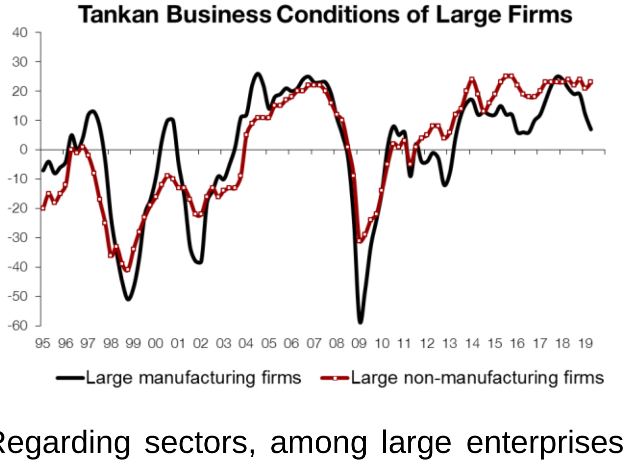
GENERALI INVESTMENTS

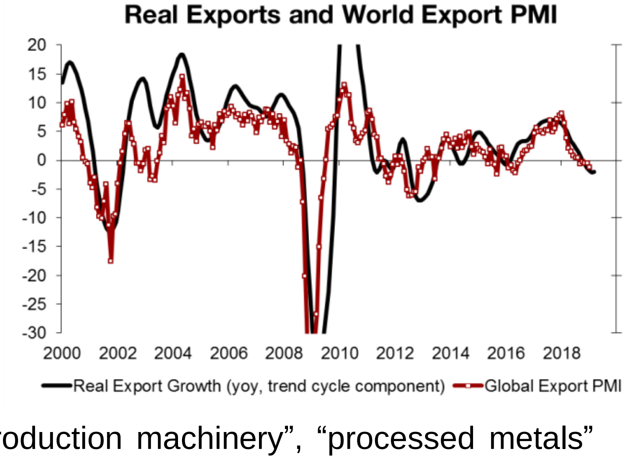
GIAM Macro & Market Research – Market Commentary

Japan: International headwinds contrast domestic resilience

- **Over the last days, two different business confidence surveys highlighted the rising dichotomy of foreign and domestic demand in the Japanese economy.**
- **The BoJ's Tankan report showed another drop of business confidence within the largely export oriented manufacturing sector while the mood among large domestic non-manufacturers even slightly increased.**
- **Japan's manufacturing PMI fell back again mainly driven by the export orders component. By contrast, the service PMI (released today) even edged up.**
- **The reports highlight our call that any key rate cut by the Bank of Japan (BoJ) will be dominated by international developments rather than domestic forces.**
- **Recently, some members of the policy board voiced their concerns about the international environment, hinting at a lengthening of the BoJ's forward guidance beyond spring 2020. However, regarding more substantial measures, the BoJ may want to await more information of the H2 2019 development. This argues for more BoJ action towards the end of the year.**

On July 1, the BoJ has published its Tankan report (details on July 2), which covers business confidence and investment tendencies on the basis of a large sample of 9970 manufacturing and non-manufacturing enterprises. The main upshot is that Japanese firms have increasingly come under pressure from international headwinds. The headline figure of the report – the business confidence of large manufacturers – deteriorated to a DI (diffusion index) level of 7 index points (ip), down from 12 ip in the quarter before. Compared to the latest peak in Q4 2017 at 25 ip (see left graph), the DI has already decreased significantly. The turning point coincides with the diminishing global export PMI and Japan's deteriorating real export growth, which weakened from a rate at about 7% yoy at the end of 2017 to now about -2% yoy.

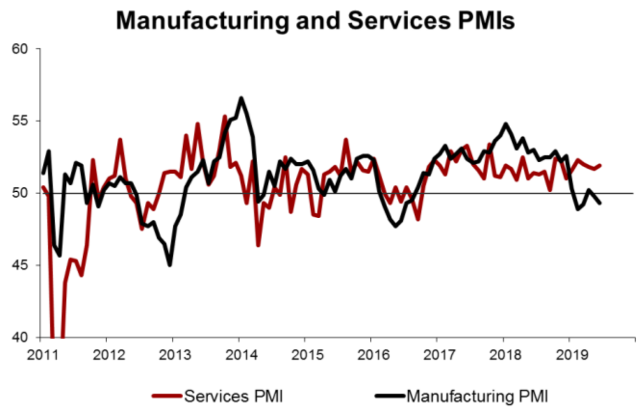




Regarding sectors, among large enterprises "production machinery", "processed metals" as well as "motor vehicles" were the most negative affected during the last quarter. Overall, "processing sectors" were much more hit than "basic materials", which is in line with the more general observation that the downturn in international trade affected those countries especially hard that strongly depend on manufacturing exports. Apart from large firms, the Tankan report also covers medium-sized and small manufacturing firms, which saw their confidence down by 2 ip resp. 7 ip, slightly fluctuating around the result from large enterprises. Moreover, the Tankan also asks for firms' expectations over the next three months. Here, large firms maintain their cautious view but also see - on average - no deterioration. However, the car sector remains pessimistic, given a possible threat of tariffs on car exports to the US by the Trump administration. By contrast, large firms in the electrical machinery sector expect their business to improve slightly, a view that is not shared by medium-sized and small enterprises of this sector.

The already existing dichotomy with the non-manufacturing sector has – on average - further widened over the last three months. Business conditions of large non-manufacturers improved from 21 ip to 23 ip, showing a very stable development since early 2017 (see graph) and only milder fluctuations since 2014. The DI for "services for individuals" remained unchanged on an elevated level (33 ip), while the drop in sentiment in the "communication sector" was due to a reduction in mobile phone charges. The strength in the service sector reflects the low unemployment rate (hovering around 2.4% since early 2018) and good job opportunities (the job offers to applicants ratio recently peaked at 1.65). However, the non-manufacturing sector looks somewhat less optimistic into the future as their outlook DI over the next three months diminishes by 6-7 ip across all firm sizes. This might already anticipate rising volatility implied by the planned sales tax hike from 8% to 10% on October 1, although private consumption of durable consumer goods should benefit over the next three months (before seeing a drop thereafter). Thus it looks a bit more plausible, that non-manufacturing sectors fear some spill-over effects from the deteriorating international environment.

In addition, the Tankan report also shows firms' investment intentions. All over, companies plan to increase investments (including R&D and software but excluding land purchases, which is the closest concept to GDP data) by 5.7% in FY2019. Given the strong seasonality regarding this question, it needs to be compared to the result one year ago, which was 9.1%. Thus, overall firms are slightly more cautious regarding their investment spending, but the slowing is more pronounced in the manufacturing sector (8.5% down from 11.1%) while non-manufacturers intend to step up their outlays somewhat.



This picture of an increasing dichotomy has also been confirmed by the recent PMIs. The manufacturing PMI fell back again close to its recent trough in February, showing the lowest level since mid-2016, when the country was hit by a severe earthquake. The downturn was especially driven by PMI new export orders. In contrast, the services PMI remained upbeat.

In sum, Japan's economy looks increasingly under pressure from the international environment, while the domestic oriented-service sector held up well. Manufacturing firms' business outlook is still not too pessimistic. Against this background, the BoJ voiced concern about the international outlook (hinting at a possible lengthening of the BoJ's forward guidance beyond spring 2020), but does not look forced into acting immediately. However, given our expectations regarding the Fed monetary policy easing (we expect a dovish tilt with two key rate cuts this year), a persistent strength of the JPY/USD, a continued cyclical slowing of growth in Japan's dominant trading partners the US and China (the recent trade truce was welcome news but a compromise is far from given), we see the BoJ progressively coming under pressure to move. Moreover, Tokyo core CPI inflation diminished to 0.9% yoy in June, after 1.1% yoy in May. Nationwide CPI, which is one month delayed, receded to 0.5% yoy while the core-core version ex food and energy diminished to 0.3%. Looking ahead, we expect inflation to soften again over the coming months (due to base effects, the persistent reduction of mobile phone charges, medical care, and the recent appreciation of the JPY/USD). However, from October on the sales tax hike will blur the development of the underlying inflation. Given this background (compare the recent Focal Point and Market Commentary), we see the BoJ slightly more likely than not to cut its short term policy rate but only late this year, as it may want to await more information of the H2 2019 international development.

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