

# JAPAN GDP—INTO THE SWEET SPOT

23 Aug 2017

The April-June GDP report suggests that the Japanese economy has entered into a sweet spot, with growth accelerating and broadening into all components of domestic demand. While the 4% annualised GDP growth rate marks peak slingshot acceleration, the details of the report fully verify our thesis that Japan has entered a self-sustaining domestic demand-led up-cycle. Looking ahead towards 2018/19, we maintain our call for 2-2.5% real GDP growth (and 3-3.5% nominal GDP growth). For policy makers, the margin for error on Yen strength is eroding quickly. Specifically, the Japan sweet spot is marked by the following factors.

## A positive wage and income dynamics

Workers compensation rose a strong 2.6% in April-June, pushing the absolute amount of workers compensation back up to levels last seen in 1998/1999. Unlike various monthly labour survey data, the compensation data of the GDP report combines number of people employed with earnings received. Simply put, it is the best data reflecting the “purchasing power of the Japanese people” (although it excludes self-employed and public employees). More importantly, the up-trend in workers’ pay is structural, not merely cyclical. Japan’s demographic dynamics forces a structural shift from part-time to full-time employment and steady upward pressure on wages and incomes. While for the past two decades, excess employment put downward pressure on wages and forced headwinds against consumption, Japan’s labour shortages are now becoming reliable tailwinds for domestic demand.

Interestingly, in April-June consumer spending surged even more so than workers compensation—spending rose ¥2.5 trillion, compensation rose ¥1.7 trillion; this marks the first drop in the savings rate in over three years. We doubt that this marks the start of a true reversal in Mr & Mrs Watanabe’s propensity to save, but it may suggest that household confidence in the sustainability of the employment up-cycle is starting to grow.

## Housing cycle still going strong

The structural improvement in employment quality—full-time employment has been accelerating steadily over the past 18 months, for the first time in basically twenty years—creates a strong foundation for rising household formation and, importantly, rising household sector leverage (because part-time employees have de-facto no access to credit). Here, the GDP report confirms continued strength in residential investment, up 6%, for the sixth consecutive positive growth quarter). Again, we stress that Japan’s housing up-cycle is not merely cyclical, but structural, a direct consequence of the demographic dynamics where household formation is now rising. At the same time, access to credit continues to ease as more and more banks enter the mortgage lending market, for example, regional banks becoming active in the major urban areas.

## Corporate “animal spirits” are back

Private CAPEX (business investment) surged 9.9% in April-June for the eighth consecutive growth quarter. While clearly a “tactical” surge in spending at the start of the new financial year, the structural forces demanding higher business investment are powerful: pressure is building to switch to more capital intensive business models, particularly in the services sector; IT investment has fallen behind global competitors, particularly in financial services; the car and car-parts industry is forced to re-invent its production facilities because of electrification and AI-fication; the re-start of nuclear power plants is re-starting the utility plants’ replacement cycle, etc.–this just to name a few of the CAPEX demand-drivers. Meanwhile, the combination of record-low interest rates and record-high corporate cash balances suggests no financial limits for added CAPEX. If at all, the general rise in the rate of return on invested capital suggests it increasingly pays to invest.

## Investor focus–has CAPEX peaked?

Clear-speak: in our view, Japan’s business investment cycle has further to run. From here, we think the visibility of the CAPEX cycle is poised to become the key leading indicator for our bullish Japan thesis in general, investor sentiment in particular.

Technically, it is tempting to call for an imminent CAPEX slowdown. CAPEX is now back up to 15.9% of GDP—about a full percentage point higher than its long-term average; any level higher than 16% of GDP has been extremely rare and, more importantly, has never been sustained for long (see Chart 1 below). Japan bears are poised to predict a downfall in CAPEX. In contrast, we do think that “this time is different,” with the structural drivers mentioned above poised to force a more sustained structural up-cycle in business investment. From here, machinery and construction orders, as well as corporate loans growth data will have to be scrutinised more carefully to determine whether the bulls or the bears are right.

## No room for policy complacency

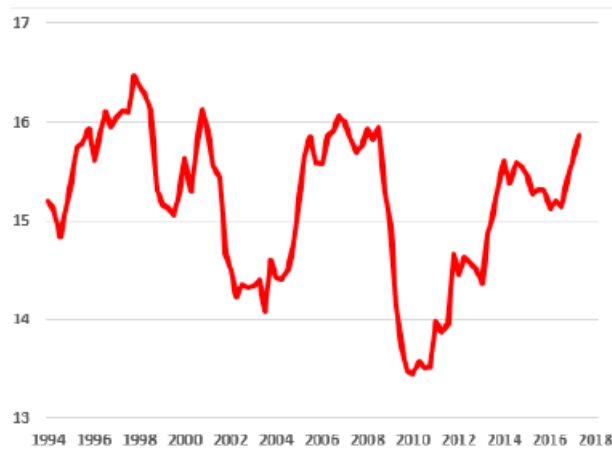
Against our up-beat view on private demand, we expect public policy makers in general, “Team Abe” in particular, to leave nothing to chance. There is little risk of policy complacency. Of the 4% GDP surge, about one-third was a public demand boost. From here, this will normalise. The public sector drag on growth should come to around 1% in the coming quarters.

An added concern is the fact that exports actually dropped—minus 1.9%, the first negative quarter in one year. This does raise possibly uncomfortable questions around Japan’s global competitiveness, particularly since the April-June quarter was one of general acceleration in global growth. More importantly, it raises the dangers unchecked Yen appreciation could bring. Compounding weak export volumes with Yen appreciation risks tipping a first negative quarter into another one for the start of a negative trend. In the latest earnings reports, many companies appear to be budgeting for ¥108-110/\$, so the margin for error is getting squeezed quickly, in my view. Should the rise in geo-political uncertainty continue to put upward pressure on the Yen, a counter response from Japanese policy makers may be warranted, in my view.

Here, we maintain the view [that the new Abe Cabinet](#) is likely to present added ease of fiscal policy, with a supplementary budget of around ¥5 trillion likely to be presented by October. For monetary policy, we expect no change from the BoJ—the sweet spot in

growth is anchored in steady productivity gains and, more importantly, inflation remains more of a theoretical conundrum rather than a real-world threat. However, the real-world outlook could quickly be forced towards rising deflation risks by unchecked Yen appreciation: every ¥10 of sustained Yen appreciation, cuts down Japan's headline CPI by as much as 40-60bp (latest nationwide CPI was +0.4%yy).

Chart 1: Japan private business investment-% share in GDP



Source: Bloomberg

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