JAPAN GDP—NOT BAD, BUT NO ROOM FOR COMPLACENCY

Jesper Koll – Senior Advisor
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The drop in Japan's third-quarter GDP does not mark the start of a recession, but it does underscore that neither the Bank of Japan (BOJ) nor fiscal policy has room to change. If anything, the GDP report confirms BOJ Governor Kuroda's recent assertion that the balance of risk to the macroeconomic outlook has become more asymmetrical, tilted toward the downside. All said, the GDP report strengthens our conviction that Japan will decouple further from the U.S. policy mix: The BOJ stays steadfast at zero-rate-yield cu rve control, and "Team Abe" is poised to ease fiscal policy with a pro-growth budget expected to be presented before year-end.

The details of the GDP report show an annualized contraction of 1.2% in real GDP. The weakness was broad-based, with the largest negative contribution from public investment (-0.4 ppt) and negative contributions from consumption, net exports, inventories (all -0.3 ppt) and private capex (-0.1 ppt). While a string of natural disasters during the late summer explains some of the downside volatility, some fundamental trends need careful watching:

- **Household savings continues to surge, with the household savings rate up by 1% of GDP since the end of last year.**

While workers' salaries continues to rise—up for seven consecutive quarters, the longest positive growth trend in more than 20 years—consumer spending continues to lag the rise in incomes. Specifically, since the end of last year, workers' salaries rose ¥6.4 trillion but consumer spending rose only ¥1.3. This relentless build-up of consumer precautionary balances poses a key policy challenge to Team Abe. To fix it would require fundamental reform in the social security and healthcare system, which is politically unpopular (and economically meaningless without significant cuts in entitlements—which is exactly why the savings rate is rising as consumers prepare for the worst).

- **Business investment is back up to 16.7% of GDP, the highest level in more than 30 years.**

The bullish case for Japan is dependent on a structural upshift and upgrade in the productive capital stock. The case is strong, supported by rapid technological change, low financing cost, deregulation and Japan's favorable competitive position (e.g., onshoring). Survey data is unanimous in suggesting that a strong domestic capex cycle is under way. However, from a macroeconomic perspective, the already extraordinarily high share of private investment spending in GDP does suggest that the limits to growth may start to come into sight. At the very least, the end of the pre-Olympic construction boom should start to put some downward pressure on capex as a growth driver from mid-

2019. Stay bullish capital deepening and productivity-enhancing capex, but expect more concerted efforts from policy initiatives to counter the coming downdraft in private sector construction orders. Here, public orders for reconstruction of the summer's disaster areas provide a welcome buffer.

- **Housing investment is up for the first time in five quarters.**

Good news on the residential construction front. Here, the BOJ's adoption of negative interest rates had triggered a surge in activity as mortgage rates fell to record lows in the spring of 2016. This mini-boom turned into a mini-bust by mid-2017, with housing activity contracting for five consecutive quarters. Now we see the first up quarter, which we hope confirms our fundamental view that residential housing is in a multiyear structural uptrend, driven by rising demand for private homes and condominiums from the new middle class rising in Japan. Household formation continues to rise, with marriage rates increasing and birth rates, slowly but surely, also on an upturn. The next couple of quarters should see continued positive housing investment to help verify our structurally positive view.

Unless otherwise noted, all data from Japan's Cabinet Office as of November 14, 2018.

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DEFINITIONS

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Macro : Focused on issues impacting the overall economic landscape as opposed to those only impacting individual companies.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Bullish : a position that benefits when asset prices rise.

Capex : Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations.