JAPAN GDP SIGNALS A HEALTHY ECONOMY

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Japan's gross domestic product (GDP) report from last week was stronger than expected, up 2.1% quarter over quarter and annualized, against expectations for a small decline. Details confirm the positive surprise was due to a strong boost from public demand, and weak private demand pulling down imports (which reduces the drag from trade on GDP). Genuine positive forces were the strong rise in residential housing, up 4.5%, and the fact that private sector inventories did not rise. The former is key to our thesis that, although consumer spending is still basically flat, household sector confidence and willingness to take risks are actually on the rise in Japan; the latter suggests the limited risk of an inventory overhang standing in the way of future production growth. In addition, the fact that private business investment declined by a mere 1.2% is still somewhat positive. After the 10.3% surge in the previous quarter, this suggests the structural upcycle in domestic capex is still intact.

Good Domestic, Bad Global

All said, the GDP report confirms a Japanese macro environment of relatively strong resilience: while the tradeable goods sector has been pulled into recession by the downturn in China and declining U.S. passenger car sales (sedans in particular), Japan's domestic service sector is actually decoupling in a positive direction. To wit: Industrial production is down approximately 4% from one year ago, but domestic tertiary sector activity is up approximately 1% from Q1 2018.

This "good domestic news, bad global news" is also reflected in corporate earnings (with the full-year results season for FY2018 ending March 31 just completed): manufacturing sector profits dropped 4.3% in FY2018, while profits rose 10.2% for non-manufacturers (excluding financials). Total profits for listed companies dropped 0.6%, pulled down by the more dominant weight of industrials.

From here, the key macro questions are: 1) When will the industrial downcycle bottom? and, more importantly, 2) Will the positive decoupling by domestic services continue (particularly in light of the consumption tax hike due October 1, 2019)? In my personal view, prospects for a continued uptrend in the domestic sectors are very good. The demand boost from the recent 10-day holiday at the start of the new Imperial Era is very much a positive factor, as well as the positive momentum in small and medium-sized companies' investment spending and capital stock upgrades.

Against this, the upturn in global fortunes is primarily dependent on Chinese cyclical developments in general, and a policy-induced upturn in capital goods demand in particular. Make no mistake: From a Japanese perspective, the biggest negative of the U.S.-China trade war is the fact that corporate leaders and entrepreneurs across Asia continue to postpone capital spending and capacity expansion plans. So, as long as

uncertainty over the new Asia/China trade regime remains, the primary reliable source of demand for capital goods comes from China policy stimulus. This will change only if, or when, a trustworthy new trade regime comes into sight. And when it does, Japan will be a significant beneficiary, given that as much as half of the machinery and equipment that goes into an Asian factory is made by a Japanese company.

More Fiscal Stimulus and a Double Election?

“Team Abe” deserves to be congratulated for the perfect tactical boost delivered against the cyclical downturn in the industrial sector (as confirmed in the GDP report). From here, policy makers remain extremely vigilant. I believe that any sign of further deterioration in the industrial sector or evidence of service sector activity momentum slowing is poised to bring an added fiscal boost. However, a pushback in the consumption tax hike is unlikely. Instead, added transfers to the push for Research & Development (R&D) and Information Technology (IT) investment support by households and public works is more likely, in my view.

Meanwhile, speculation about Prime Minister Abe calling a snap “double election” is rising (for the lower house, plus half of the relatively less important upper house, which is up for a fixed-term expiry election in July/August anyway). Here, the primary force is “Machiavellian”—the opposition parties are splintered and in disarray, troubled by increasingly bad finances, rising defections, and a growing inability to attack candidates. All said, before long, “Team Abe” will be poised to try to extend and solidify its grip on power. For markets, however, the primary force behind the election will not be economic policy, but brute, domestically powered politics.

In our view, the investment implications amid the macroeconomic and political environments are as follows: Stay long on Japan small caps to gear up for the positive domestic cycle, and prepare to raise tactical exposure to exporters and industrials as China cyclical momentum rises and gets compounded by an Asia capex boom after a new U.S.-China trade regime comes into sight.

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DEFINITIONS

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

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.

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

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.