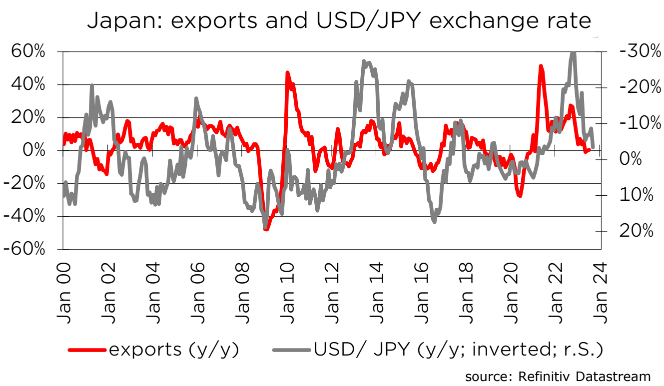
25 August 2023

Japan: eternal sunshine in the land of the rising sun?

Our otherwise bad-tempered media have been outdoing each other for months with expressions of respect and positive comments when it comes to Japan as a business location. "Nippon has awakened" or "the success story is back" is what it says in newspapers, and you rub your eyes in amazement. Wasn't there talk of a dying giant, a deflation-plagued and aging economy in the shadow of China? What is the paradigm shift and how sustainable are the latest developments in the land of the rising sun?

At first glance, the facts are actually surprisingly positive. Thanks to high exports the world's third-largest economy was able to increase its economic output in the second quarter of the current year much more than previously estimated. Based on preliminary estimates, real gross domestic product grew by 1.5 percent quarter-on-quarter between April and June, making it stronger than expected for the third time in a row. Analysts now expect growth of 1.8 percent in the current year, together with the USA, to be the strongest economic growth of all G7 countries - and far more than in the euro zone or in Europe. The export of motor vehicles, for example, rose again in the second quarter by 14 percent compared to the previous quarter. Due to the improvement in the provision of semiconductors and a significant stabilization of the supply chain, the accumulated orders could be processed faster than before. Net exports in particular contributed to the strong growth with the second highest contribution in the last 30 years. At the same time, the fall in prices for the raw materials imports, which are extremely important for Japan, led to a significant decline in nominal imports compared to the previous quarter. In addition to cheaper raw material prices, the noticeable reduction in imports of Covid vaccines also had an impact overall.



One of the overriding themes on the stock markets and in the macroeconomic future projections during the first half of 2023 were expectations regarding the progressive involvement of artificial intelligence (AI) in all areas of life. This is also of considerable importance for assessing the economic performance of the Japanese economy in general and the local stock exchange in particular. Many companies are active in the production of semiconductors and offer key technologies related to their production. In addition, the Japanese are much more open to new technologies than other economies and thus offer a favorable domestic market for testing and fine-tuning, but also for the export of products and services related to AI. Finally, due to its difficult demographic development, Japan is increasingly dependent on automation and the replacement of human labor - this is another reason for the immense government funding of research in this field.

In addition to exports, private consumption has also been more robust in the year to date than was expected in the projections at the beginning of the year. After all, demand from the population accounts for around 60 percent of

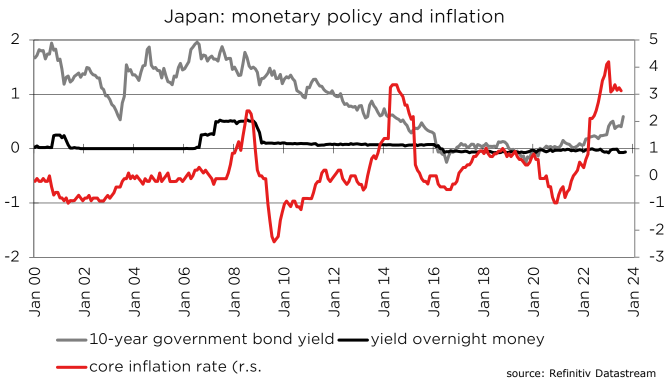
GDP. After the temporary end of the pandemic and the increased savings due to the lockdown, there were catch-up effects in the first half of the year, as in other industrialized countries. However, this effect is coming to an end, as the figures for the second quarter show. The reserves built up are decreasing and the wage increases are now being more than compensated for by the increased inflation, which has also happened in Japan. This is increasingly leaving its mark on the purchasing power of the Japanese population. Expenditure on travel and services, such as going to restaurants, is currently increasing – but in return, savings are already being made on the purchase of food and clothing.

The strong growth in tourism and, above all, the renaissance of Chinese group travel, which was interrupted by the pandemic, is having a stabilizing factor. At the beginning of the summer, the number of foreign tourists initially rose to 70 percent of the level reached before the pandemic. However, their spending has already touched the high of 2019 due to the ongoing devaluation of the Japanese currency.

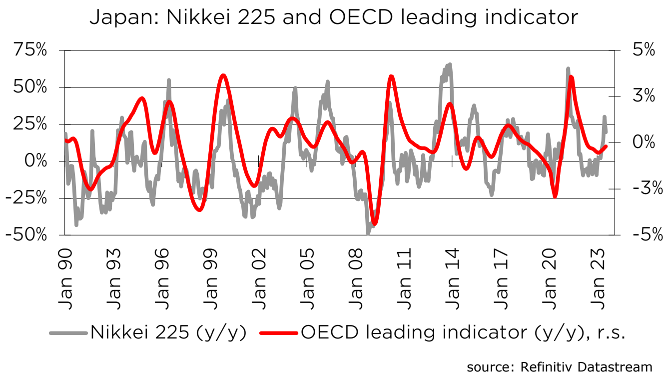
Despite all these factors, which should not be disregarded, we are assuming that consumer sentiment will tend to decline, that export increases will slow down and that the economy will weaken overall. This would also put an end to the ongoing speculation on the capital market that the Bank of Japan could tighten its monetary policy due to the unexpectedly strong growth and persistently high inflation. We consider this unlikely.

Speaking of the central bank - a few weeks ago the new governor of the Japanese central bank, Kazuo Ueda, "allowed" yields for 10-year government bonds of up to one percent for the first time, although the previously staunchly defended 0.5% line was officially extended. The time is clearly not far off when strict control of the yield curve and negative key interest rates no longer go with the macro data of growth and inflation. Slightly higher bond interest rates as in the other industrialized countries therefore also appear more plausible for Japan than before.

Japanese investors could then be inclined to bring their funds back home, which they had invested abroad for decades, and to invest them there without the hassle of currency fluctuations. It is not about small amounts. In the last ten years alone, Japanese institutional and private investors have invested around USD 3.5 trillion outside of Japan. Roughly ten percent of all Australian government bonds are held by Japanese entities, significant shares in the US and European bond markets, but the Brazilian market for fixed income products is also in Japanese hands to a significant extent. A withdrawal from these markets would have a significant impact on the global bond market. In addition, international investors are likely to be hit hard in their popular yen carry trades if interest rates rise and, conversely, the yen tends to strengthen. Borrowing in yen at low interest rates and investing in higher-yielding markets would quickly become less attractive. The stock markets would also be negatively affected, so that the effect would probably not be limited to bonds alone.



On the other hand, with higher interest rates, the state and the prefectures face significantly higher costs due to their immense new debt. Interest payments in Tokyo currently make up less than eight percent of the state budget. Measured against economic output, Japan is the undisputed leader among the industrialized countries with a debt of 225 percent. Nevertheless, the country continues to finance itself to more than a third through new debt. The new expenses flow primarily into military rearmament, a newly created climate fund and significantly increased child benefits. Higher credit burdens also have an impact on the mortgage market with little time lag, especially since more than 70 percent of mortgage loans in Japan are equipped with variable financing. It is by no means a foregone conclusion that interest rates will soon also rise in Japan and that this scenario will become a reality – but the danger of this has undoubtedly increased.



In addition to the dangers described for the stock market in Tokyo, there are also a number of reasons for dealing more intensively with this large and very broadly diversified market. About 50 percent of the stocks traded on Kabuto Cho are still trading below book value. In view of a favorable valuation compared to the company's own history and a comparatively low level of debt, there is further potential for price increases despite the performance already achieved. In this environment, the Japanese state is increasingly trying to reduce the obstacles to commitments by domestic and foreign investors by pushing for internationally comparable governance rules and trying to achieve higher payout ratios. In Germany, the population still holds almost 50 percent of their savings in liquid forms of investment. A fact that is painful in view of the unusual inflation, but which at the same time shows what potential there is when switching to higher-yielding investments. The government and the central bank have several goals in focus. On the one hand, one would like to make investing in stocks and bonds more palatable to the population and thus give companies more stability and security against takeovers. On the other hand, this also makes it easier to "inflate away" Japanese debt on the shoulders of private households.

So the fact remains: where there is light, there is always shadow, and the sun over Japan will not take a break as it runs from east to west. Investments in this market remain associated with both opportunities and risks.

We thank our colleague Dr. Frank Geilfuss for this post.

Market data

Stock marktes	As of 25.08.2023 09:30	Change versus 18.08.2023 -1 week	24.07.2023 -1 month	24.05.2023 -3 months	24.08.2022 -1 year	30.12.2022 YTD
Dow Jones	34099	-1,2%	-3,7%	4,0%	3,4%	2,9%
S&P 500	4391	0,5%	-3,6%	6,7%	6,0%	14,4%
Nasdaq	13464	1,3%	-4,2%	7,8%	8,3%	28,6%
DAX	15620	0,3%	-3,5%	-1,4%	18,2%	12,2%
MDAX	27033	-0,4%	-4,1%	1,0%	3,7%	7,6%
TecDAX	3084	0,8%	-4,6%	-3,4%	1,6%	5,6%
EuroStoxx 50	4231	0,4%	-3,5%	-0,8%	15,4%	11,5%
Stoxx 50	3924	1,0%	-1,8%	-1,5%	7,6%	7,4%
SMI (Swiss Market Index)	10969	1,2%	-1,9%	-3,6%	-0,4%	2,2%
Nikkei 225	31624	0,6%	-3,3%	3,1%	11,7%	21,2%
Brasilien BOVESPA	117026	1,4%	-3,6%	7,6%	3,7%	6,6%
Russland RTS	1046	-0,1%	2,2%	0,2%	-11,5%	7,8%
Indien BSE 30	64979	0,0%	-2,1%	5,2%	10,0%	6,8%
China CSI 300	3709	-2,0%	-2,5%	-3,9%	-9,1%	-4,2%
MSCI Welt	2906	0,3%	-4,3%	4,2%	6,2%	11,7%
MSCI Emerging Markets	982	1,9%	-3,1%	1,2%	-0,3%	2,7%
Bond markets						
Bund-Future	132,49	108	-123	-158	-1777	-44
Bobl-Future	115,80	43	-25	-141	-865	5
Schatz-Future	105,10	10	5	-33	-406	-33
3 Monats Euribor	3,83	17	42	68	333	194
3M Euribor Future, Dec 2023	3,86	-6	-6	7	168	26
3 Monats $ Libor	5,65	1	4	23	264	89
Fed Funds Future, Dec 2023	5,46	5	6	57	200	81
10 year US Treasuries	4,24	-1	37	50	113	41
10 year Bunds	2,53	-7	14	8	123	-3
10 year JGB	0,66	4	22	25	44	25
10 year Swiss Government	1,00	-5	8	-4	16	-61
US Treas 10Y Performance	575,79	0,1%	-2,7%	-3,2%	-5,5%	-0,7%
Bund 10Y Performance	538,83	0,9%	-0,7%	0,3%	-7,2%	2,6%
REX Performance Index	433,95	0,6%	-0,1%	-0,2%	-5,0%	0,3%
IBOXX AA, €	3,71	-9	10	2	124	11
IBOXX BBB, €	4,54	-7	7	-12	92	-16
ML US High Yield	8,66	-8	26	-21	62	-32
Convertible Bonds, Exane 25	6620	0,0%	0,0%	0,0%	-2,0%	0,0%
Commodities						
MG Base Metal Index	382,94	2,2%	-1,0%	2,6%	-3,8%	-8,4%
Crude oil Brent	83,94	-1,1%	1,5%	7,1%	-17,2%	-1,2%
Gold	1913,60	1,1%	-2,4%	-2,8%	9,1%	5,4%
Silver	24,20	6,4%	-1,0%	4,5%	26,5%	1,9%
Aluminium	2122,50	1,6%	-2,0%	-4,0%	-13,0%	-9,7%
Copper	8326,50	1,4%	-1,9%	6,0%	3,3%	-0,5%
Iron ore	107,82	1,6%	-4,2%	2,1%	2,2%	-3,1%
Freight rates Baltic Dry Index	1110	-10,3%	14,8%	-14,3%	-8,5%	-26,7%
Currencies						
EUR/ USD	1,0786	-0,7%	-2,8%	0,0%	8,6%	1,1%
EUR/ GBP	0,8570	0,3%	-0,9%	-1,5%	1,4%	-3,4%
EUR/ JPY	157,49	-0,4%	0,7%	5,5%	16,0%	12,0%
EUR/ CHF	0,9549	-0,2%	-0,5%	-1,9%	-0,3%	-3,0%
USD/ CNY	7,2885	0,0%	1,4%	3,2%	6,2%	5,6%
USD/ JPY	145,89	0,3%	3,1%	4,6%	6,4%	11,3%
USD/ GBP	0,79	1,2%	1,9%	-1,7%	-6,0%	-4,4%

Source: Refinitiv Datastream

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