M.M.WARBURG & CO
BANK

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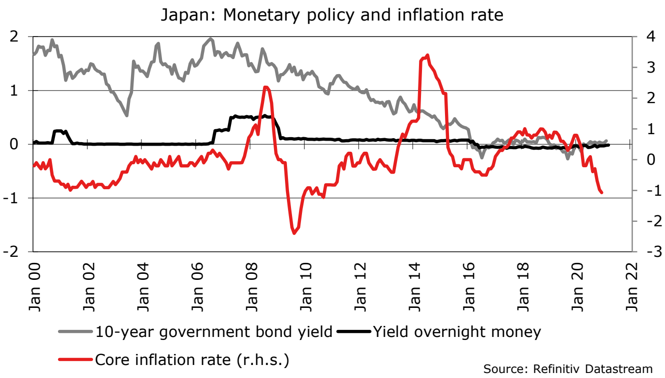
Crisis management – the Japanese way

For Japan's economy, the new year has begun the same way the last one ended. At 47.1 points, purchasing manager indexes signal another decline in economic activity compared with 48.5 points in December. Unlike in many other industrialized countries, this applies to both the manufacturing and services sectors. Hope-inspiring first signs of a robust recovery have recently been severely disrupted by the pandemic's second wave. Economists at the Bank of Japan have meanwhile revised their growth and inflation estimates further downward, though only minimally. For fiscal 2020, which traditionally ends on March 31, gross domestic product (GDP) is expected to contract by 5.6% year-on-year due to pandemic-related restrictions, and an inflation rate of -0.5% is likely to signal a slight decline of prices. Japan has thus by no means conquered its chronic affliction, deflation. Highly export-dependent Japan sold 11% less in goods and services on the world market last year and even reduced its imports by 14%.

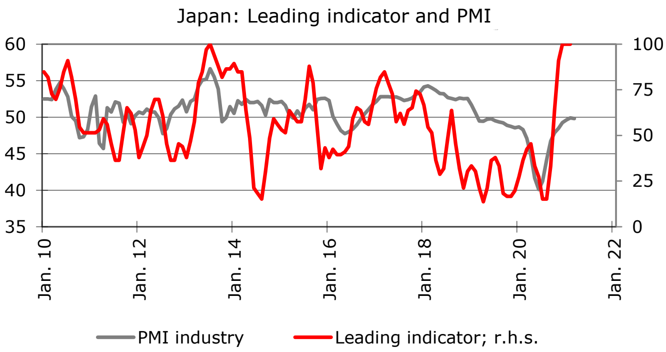
The Japanese central bank is probably not responsible for the economy's continuing frailty. Already two months before the official reassessment of its monetary policy, the central bank once again confirmed its extremely relaxed monetary stance, while negative interest rates on bank deposits and the target yield for 10-year government bonds remained unchanged after the Policy Board's January meeting. We should then also expect only "home remedies" in monetary policy and no change of course to issue from the important March meeting. The maximum limits on purchases of securities, raised because of the pandemic, have so far only been about 55% utilized (JPY 11 trillion vs. JPY 20 trillion), and commercial banks have only called up about JPY 53 trillion from a JPY 90 trillion pot of special credits. So, continuity and planning security are likely to come at least from this side.



Verbally and with coordinated measures, the government and central bank are seeking to explain the currently negative data as a covid-induced exception and showing optimism about this year and beyond. The economic growth rate expected for 2021 has just been raised from 3.6% to 3.9%, and the projection for 2022 from 1.6% to 1.8%. The core inflation rate for this year is forecast at 0.5%, and the central bank is optimistic about reaching its 2% target in 2023. Occasional local optimists even argue that the world economy is about to enter a Japanese decade. The main reason for this scenario is hope of rapid and extensive vaccination of the population and a series of further economic stimulus packages.

The central bank is worried in this connection about the yen's revaluation due to US economic policy still under the influence of course changes made by Donald

Trump. Janet Yellen, the new US Treasury secretary, has announced that the weak-dollar policy will end, but not much has changed in the brief period so far. Most recently, the exchange rate almost reached the psychologically important level of JPY 100 per dollar – a point at which Japanese exporters regularly become nervous and lower their earnings expectations. Negative currency effects are coming at an inopportune time now, since exports rose in December by just over 2%, their first increase in almost two years. Growth of exports to China alone amounted to about 10%.



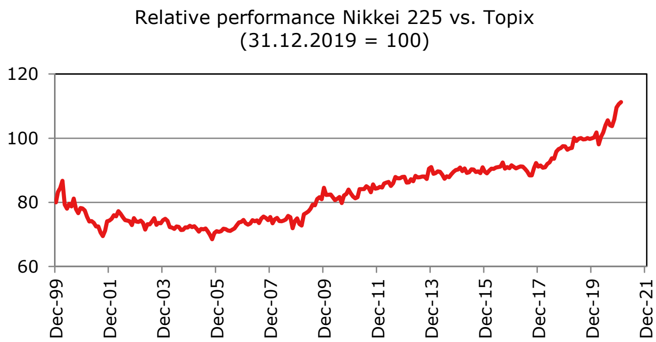
Source: Refinitiv Datastream

Japan's political scene could start to resemble Italy's due to the Liberal Democratic government's handling of the covid crisis. Having succeeded Shinzo Abe as prime minister only five months ago, Yoshihide Suga has been fighting for his political survival for weeks. About two-thirds of the population welcomed his inauguration last September, but his approval ratings have rapidly declined to just over 30%. His predecessor, for whom Japan's liberal economic policy garnered attention abroad as "Abenomics", never had such poor ratings in his eight-year tenure.

In the past, it has been customary in Tokyo for the prime minister to resign if popular support dropped below 30% and be content with a well-paid, inconspicuous position – not such a terrible prospect compared with what the country's ancient code of honor might have demanded. Since Suga will also have to step down as rotating head of the Liberal Democratic Party (LDP) in September, opponents are already sharpening their blades and considering every possible scenario for a double change of leadership. At least five potential successors for both offices have already adopted more or less offensive positions and expressed their ambitions. However, all known candidates have in common that they, as ministers or state secretaries, are partly responsible for the prime minister's perceived failure to master the crisis. In opinion polls, three-fourths of respondents have said they do not understand why the government has not fought the pandemic more aggressively. A state of emergency only exists in 11 of Japan's 47 provinces, and vaccination of the population is not scheduled to begin until the end of February. Badly affected households and small businesses may apply for direct cash infusions, and companies wanting to keep their staff on despite the crisis have been able to count on subsidies. However, what is lacking is a clear roadmap for dealing with the crisis for the overall economy and a vision for the future beyond it.

Without a word of explanation, the prime minister blocked the appointments of several independent experts to Japan's Scientific Council and acted like an authoritarian know-it-all in press conferences, where a humble man of the people would have been the better look. That has earned him the pejorative nickname "Sugalin" among journalists whom his behavior reminded of Stalin. Even though Suga has obviously begun in recent days to walk this back a little and now supports all popular demands, such as using the military to reinforce the public health effort, it might be too late for him. His party must already position itself now for elections in October, and that appears rather problematic with a crippled prime minister. Generally, this situation has weakened the leadership of this proud industrial national for months – not a good environment for the worst crisis of the past decades.

The pandemic also caused a steep setback on the Japanese stock market last spring. However, as the year proceeded, the Nikkei 225 index managed to reach its highest level in nearly 30 years with a price advance of over 16% (in JPY). Japan's technology sector also played a large role in this. Thanks in part to its large share of high-tech companies, the Nikkei 225 managed to do significantly better than the broad Topix index.



Source: Refinitiv Datastream

The main driver of this spring rally with no apparent connection to the real economy was, as in other industrialized countries, accommodative central bank monetary and fiscal policy. The central bank's balance sheet total grew by more than 20% as a result of numerous special pandemic assistance programs and continued purchasing of securities. Now, according to the International Monetary Fund, Japan is the country with the largest national debt worldwide at 266% of economic output. However, Japan's close interdependence with neighboring China and rapid economic recovery there is also partly responsible for the positive stock market trend. China's share of Japanese exports has more than tripled in the last 20 years. Furthermore, Japanese companies have taken considerable cost-cutting measures in recent years and made great progress in corporate governance. This already led to an unexpectedly positive correction of earnings expectations in the semi-annual reports of many companies.

Not least of all, the Japanese central bank helped the stock market more than make up its early spring losses by the end of the year by expanding the limit on index fund purchases. In view of the significantly higher stock prices at year's end, the central bank has rewarded itself and booked considerable gains. For the first time, the huge Japanese pension fund GPIF has been displaced as the largest owner of Japanese stock, with the central bank now occupying that position.

All these changes also attracted international investors back to Tokyo stock market in the course of the year. Foreigners hold about 30% of all Japanese stock. International investors account for more than two-thirds of daily trading volume and thus dominate the market. However, despite a return of these investors' interest in the second half of the year, the stock market in Kabuto-cho had to cope with outflows during the year of over USD 60 billion on behalf of foreign investors, thus confirming the trend since 2015.

So, what does all this mean for the future development of the Japanese economy and for its impact on stock prices? On the one hand, Japan is anything but the world economy's often-ridiculed "hopeless case." Its inevitable demise postulated repeatedly since the 1990s has been denied at least as often as its rebirth as a productivity miracle. Actually, Japan is probably now just a rich, old industrialized country with ingrained habits, cherished traditions, and growth that is simply modest. Europeans are quite familiar with the symptoms and this environment. The slow economic recovery is likely to continue in Japan just as it will in other "old" industrialized countries. Deflation will probably be tougher than elsewhere, as will sensitivity to changes on the currency front. There will also be excellently positioned companies and rewarding investment targets in the future. But it should be a good deal of time before the world economy sees a Japanese decade.

We would like to thank our colleague Dr. Frank Geilfuß for this contribution..

Market Data Overview

Stock marktes	As of 05.02.2021 13:27	Change versus 28.01.2021 -1 week	01.01.2021 -1 month	03.11.2020 -3 months	03.02.2020 -1 year	31.12.2020 YTD
Dow Jones	31056	1,5%	1,5%	13,0%	9,4%	1,5%
S&P 500	3872	2,2%	3,1%	14,9%	19,2%	3,1%
Nasdaq	13778	3,3%	6,9%	23,5%	48,6%	6,9%
DAX	14098	3,2%	2,8%	16,6%	8,1%	2,8%
MDAX	32459	3,2%	5,4%	22,2%	15,7%	5,4%
TecDAX	3524	3,3%	9,7%	22,1%	14,9%	9,7%
EuroStoxx 50	3666	3,1%	3,2%	18,3%	0,1%	3,2%
Stoxx 50	3178	0,8%	2,2%	12,6%	-5,7%	2,2%
SMI (Swiss Market Index)	10808	-0,4%	1,0%	8,0%	1,3%	1,0%
Nikkei 225	28779	2,1%	4,9%	23,5%	25,3%	4,9%
Brasilien BOVESPA	119261	0,3%	0,2%	24,3%	4,0%	0,2%
Russland RTS	1420	2,6%	2,4%	28,2%	-6,6%	2,4%
Indien BSE 30	50732	8,2%	6,0%	26,0%	27,2%	6,2%
China Shanghai Composite	3496	-0,3%	0,7%	6,9%	27,3%	0,7%
MSCI Welt (in €)	2758	2,6%	4,9%	13,6%	8,3%	4,9%
MSCI Emerging Markets (in €)	1388	3,6%	10,0%	20,9%	20,8%	10,0%
Bond markets						
Bund-Future	176,32	-145	-132	30	144	-132
Bobl-Future	134,87	-54	-31	-94	-4	-31
Schatz-Future	112,25	-11	-3	-21	17	-3
3 Monats Euribor	-0,54	2	4	1	-15	4
3M Euribor Future, Dec 2017	-0,56	2	0	-3	-11	0
3 Monats $ Libor	0,20	-1	-4	-3	-155	-4
Fed Funds Future, Dec 2017	0,08	0	0	0	-110	0
10 year US Treasuries	1,16	10	25	28	-36	25
10 year Bunds	-0,43	14	14	19	0	14
10 year JGB	0,06	4	4	2	12	4
10 year Swiss Government	-0,36	10	13	15	41	13
US Treas 10Y Performance	702,12	-0,7%	-1,9%	-2,0%	6,4%	-1,9%
Bund 10Y Performance	679,36	-0,7%	-0,8%	-1,3%	0,5%	-0,8%
REX Performance Index	497,28	-0,4%	-0,4%	-0,7%	-0,1%	-0,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,09	3	7	2	-2	7
IBOXX BBB, €	0,56	0	1	-24	-14	1
ML US High Yield	4,86	-1	-12	-107	-126	-12
Convertible Bonds, Exane 25	8391	0,1%	0,8%	7,0%	8,1%	0,8%
Commodities						
MG Base Metal Index	357,31	0,3%	0,7%	11,1%	28,7%	0,7%
Crude oil Brent	59,48	7,0%	14,6%	49,6%	8,4%	14,6%
Gold	1803,50	-2,8%	-5,0%	-5,3%	14,4%	-5,0%
Silver	26,95	2,8%	2,2%	11,3%	52,5%	2,2%
Aluminium	1973,25	-0,5%	0,0%	3,5%	18,8%	0,0%
Copper	7851,50	-0,4%	1,3%	15,3%	42,7%	1,3%
Iron ore	155,33	-7,9%	-0,3%	33,4%	98,3%	-0,3%
Freight rates Baltic Dry Index	1327	-9,7%	-2,9%	5,1%	184,8%	-2,9%
Currencies						
EUR/ USD	1,1987	-0,9%	-2,3%	2,4%	8,3%	-2,3%
EUR/ GBP	0,8753	-0,9%	-2,2%	-2,5%	3,0%	-2,2%
EUR/ JPY	126,65	0,4%	0,1%	3,3%	5,5%	0,1%
EUR/ CHF	1,0819	0,3%	0,2%	1,0%	1,4%	0,2%
USD/ CNY	6,4695	0,3%	-0,9%	-3,1%	-7,9%	-0,9%
USD/ JPY	105,03	0,8%	1,8%	0,5%	-3,4%	1,7%
USD/ GBP	0,73	0,2%	-0,2%	-4,5%	-5,0%	-0,2%

Source: Refinitiv Datastream

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