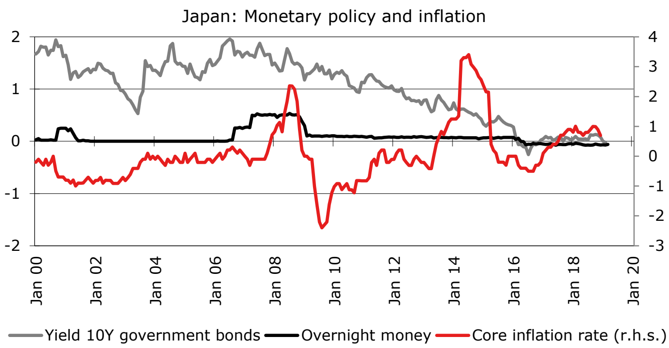
M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY 15. February 2019

Japan: New Holidays and Higher VAT Curb Growth

As expected, the Bank of Japan left interest rates unchanged and further lowered the inflation outlook at its first meeting in 2019. The target yield on 10-year bonds remained at zero percent as did the -0.1 percent interest on deposits. While the BoJ previously projected 1.4 percent inflation for the new fiscal year beginning on the first of April, the revised rate now stands at 0.9 percent. It may be debatable whether the 2% inflation ideal makes sense or not, Japan will be far from getting even close this year. In short, the Land of the Rising Sun will not become the Land of Tight Monetary Reins any time soon.



Japan's low inflation is surprising considering its labor market conditions. No matter how much the Japanese government and central bank wish for wage growth, it is not really coming along. To Prime Minister Shinzo Abe's great chagrin, the Japanese Business Federation (Keidanren) even demonstratively abstained from making recommendations for the spring round of collective bargaining. Last year, labour unions still demanded at least three percent higher wages to support the administration's efforts to raise inflation. However, declining raw material prices and a stronger yen up to the beginning of this year have also curbed imported inflation.

The BOJ's economic growth outlook of 1.3 percent for next fiscal year seems surprisingly optimistic notwithstanding unresolved trade conflicts, the economic slowdown in China, and the long-delayed VAT hike from 8 to 10 percent now finally scheduled for this fall. The IMF forecast for Japan's growth is somewhat more conservative at 1.1 percent. The uncertainty factor due to the multitude of unsolved problems already caused a roller coaster ride from quarter to quarter in 2018 and there will likely be more of the same this year. After Japan's GDP declined 0.6 percent in Q3 2018, the fourth quarter was back in the black with a plus of 0.4 percent.

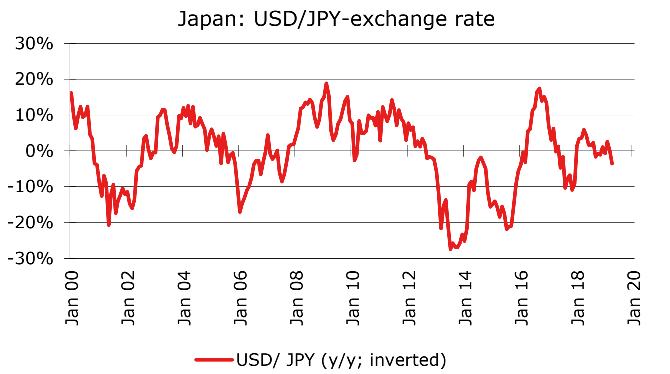
Notwithstanding various risks, the Japanese government still expects private consumption to increase by a hefty 2.7 percent. Even taking probable purchases in anticipation of the October VAT hike into account, this seems a bit ambitious to us considering the fact that private consumption plummeted after Japan's last VAT hike in April 2014. The planned tax relief on cars and mortgages will probably not suffice to fully counter the negative VAT effects.

In addition to global uncertainties and the VAT hike, other domestic problems will further hamper Japan's growth and stability in 2019. For one, according to the draft budget, government spending will rise by almost four percent in connection with higher military spending and the financing of free childcare. This puts the budget over the 100 trillion yen-mark (EUR 793 billion) for the first time. The Abe administration intends to finance a third of this budget extravaganza by issuing new government bonds. Although the higher tax revenue indeed brings down new borrowing for the seventh year running, the main budget deficit will not be caught up until 2025 according to the latest statistics. Japan originally planned to reach that milestone in 2020!

Moreover, Tenno Akihito will abdicate the throne after a 30 year reign on April 30th 2019, and pass the crown to his son Naruhito. In Japan, this entails several additional national holidays. The inthronation is scheduled for May 1st which falls into Golden Week and means that the time from April 27th to May 6th will be consecutive national holidays. The coronation ceremony will be held on October 22nd adding another one-off holiday. In 2020, February 23rd (Naruhito's birthday) will become a new regular national holiday and April 20th (ceremony for the new crown prince Akishino) will be a one-off holiday. To counter these extra holidays, December 23rd (birthday of former Tenno Akihito) will no longer be a national holiday.

And, if all of the above is not yet sufficient reason to take a cautious stance on the Japanese capital market at least for the time being, recently reports surfaced that Japanese labor market data may have been incorrect for many years running. The Department of Labor who collects this information has been using these data for calculating pension and unemployment benefits since 2004. However, it now transpired that national wage averages have been set far too low with negative consequences for lower income brackets. After this embarrassing news, the Japanese government feels compelled to verify other economic data. Even the BoJ is very disappointed as it uses these time series for calculating the output gap and thus deflation. About 40 of 56 regularly computed time series are now doubtful.

If the global economy is actually on the brink of a sustained downturn or smoldering crises flare up again, this could bode ill for investments in Japan. Japan remains the world's largest net lender and Japanese investors hold disproportionately large portfolio shares in foreign securities. In prior times of crisis, Japanese investors have reduced their foreign exposure and substantially brought their capital back home. This usually resulted in a strong yen and a weak Kabutocho. It is no done deal that this will come about any time soon. Considering the well-carved trench lines in ongoing global trade conflicts and generally southbound economic data, however, this scenario is becoming less far-fetched.



Forecasts for 2018 declared Japanese stocks promising investments, undervalued, and well suited for globalized portfolio. In view of the results of the previous year, the forecasts for 2019 have become more humble. Corporate earnings growth may turn out not as strong as anticipated given the factors sketched out above. Political stability, significantly improved corporate governance, increasing stock buy-backs, and latent undervaluation argue in favor of Japanese investments in the long term. The specific and possibly one-off burdens this year, however, make us cautious at the moment.

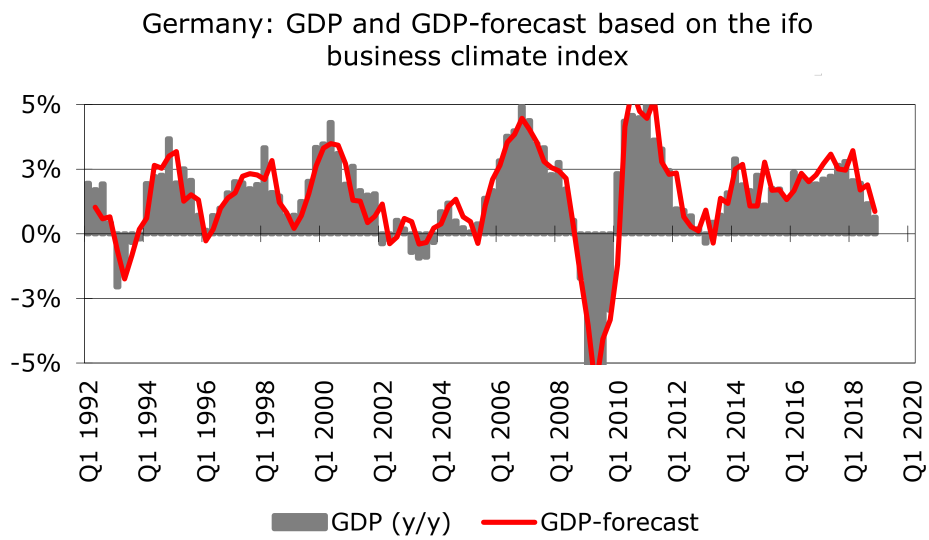
We want to thank our colleague Dr Frank Geilfuß from Berlin for his support in writing this article.

Weekly Outlook for February 18 to 22, 2019

	Sep	Oct	Nov	Dec	Jan	Feb	Release
DE: ZEW Economic Expectations	-10.6	-24.7	-24.1	-17.5	-15.0	-16.0	February 19
DE: ZEW Situation Assessment	76.0	70.1	58.2	45.3	27.6	25.0	February 19
DE: Producer Prices m/m	0.5%	0.3%	0.1%	-0.4%	0.1%		February 20
DE: Producer Prices y/y	3.2%	3.3%	3.3%	2.7%	2.3%		February 20
DE: Cinsumer prices, m/m - final	0.4%	0.2%	0.1%	0.1%	-0.8%		February 21
DE: Consumer prices, y/y- final	2.3%	2.5%	2.3%	1.7%	1.4%		February 21
DE: PMI manufacturing – flash	53.7	52.2	51.8	51.5	49.7	49.9	February 21
D: PMI manufacturing – flash	55,9	54,7	53,3	51,8	53,0	52,8	February 21
DE: Ifo Business Climate	103,9	102,8	102,2	101	99,1	99,3	February 22
DE: Ifo Business Expectations	101	99,7	98,7	97,3	94,2	94,4	February 22
DE: Ifo Situation Assessment	107	106	105,8	104,9	104,3	104,4	February 22
EU-19: ZEW Economic Expectations	-7,2	-19,4	-22,0	-21,0	-20,9	-22,0	February 19
EU-19: Consumer Confidence – flash	-6,2	-5,9	-6,6	-8,3	-7,9	-7,8	February 20
EU-19: PMI Manufacturing – flash	53,2	52,0	51,8	51,4	50,5	50,6	February 21
EU-19: PMI Services – flash	54,7	53,7	53,4	51,2	51,2	51,3	February 21
EU-19: Consumer prices, y/y - final	2,1%	2,2%	1,9%	1,6%	1,4%		February 22
EU-19: Core inflation, y/y - final	0,9%	1,1%	1,0%	1,0%	1,1%		February 22

MMWB estimated in red

Chart of the Week: Only Minor Dignity Damage



The German economy had a close encounter with recession in the fourth quarter of 2018 and ended the second half of the year with only minor damage to its dignity. Annualized real GDP increased 1.5 percent year on year. In light of the weak final quarter, a non-existent statistical overhang and the fact that key leading indicators like the Ifo Business Climate Index and the Purchasing Managers' Indices do not yet signal a trend reversal, it is safe to assume that the economic doldrums are going to continue for a while longer.
We therefore revise our growth forecast for 2019 from 1.1 percent down to 0.7 percent. As long as political uncertainties and the trade conflict between the US and China (and possibly soon also with the EU) persist and the Brexit remains unresolved, the negative factors have the greater weight in our forecast.

Market Data Overview

Stock marktes	As of 15.02.2019 11:44	Change versus 08.02.2019 -1 week	14.01.2019 -1 month	14.11.2018 -3 months	14.02.2018 -1 year	31.12.2018 YTD
Dow Jones	25439	1,3%	6,4%	1,4%	2,2%	9,1%
S&P 500	2746	1,4%	6,3%	1,6%	1,7%	9,5%
Nasdaq	7427	1,8%	7,5%	4,1%	4,0%	11,9%
DAX	11122	2,0%	2,5%	-2,5%	-9,9%	5,3%
MDAX	24112	3,9%	6,8%	0,3%	-5,2%	11,7%
TecDAX	2562	3,2%	3,4%	-1,1%	1,6%	4,5%
EuroStoxx 50	3195	1,9%	4,6%	-0,3%	-5,2%	6,5%
Stoxx 50	2971	1,9%	5,5%	0,9%	-1,4%	7,6%
SMI (Swiss Market Index)	9171	1,9%	4,7%	2,7%	3,1%	8,8%
Nikkei 225	20901	2,8%	2,7%	-4,3%	-1,2%	4,4%
Brasilien BOVESPA	98015	2,8%	3,7%	14,0%	17,3%	11,5%
Russland RTS	1170	-2,5%	2,0%	4,7%	-6,0%	9,8%
Indien BSE 30	35809	-2,0%	-0,1%	1,9%	4,8%	-0,7%
China Shanghai Composite	2682	2,5%	5,8%	1,9%	-16,2%	7,6%
MSCI Welt (in €)	2048	2,0%	6,9%	1,8%	6,5%	10,4%
MSCI Emerging Markets (in €)	1039	0,9%	6,4%	7,5%	-4,0%	9,3%
Bond markets						
Bund-Future	166,54	-21	197	640	856	300
Bobl-Future	133,10	-20	24	162	257	58
Schatz-Future	111,86	-6	-9	-9	-3	-8
3 Monats Euribor	-0,31	0	0	1	2	0
3M Euribor Future, Dec 2017	-0,25	0	-1	-9	-41	0
3 Monats $ Libor	2,68	-1	-10	5	83	-12
Fed Funds Future, Dec 2017	2,38	3	-3	-44	-2	0
10 year US Treasuries	2,65	2	-5	-47	-28	-4
10 year Bunds	0,11	2	-7	-30	-60	-14
10 year JGB	-0,02	1	-4	-13	-9	-2
10 year Swiss Government	-0,30	7	-7	-30	-42	-5
US Treas 10Y Performance	585,15	-0,2%	0,5%	5,6%	4,8%	0,8%
Bund 10Y Performance	639,28	-0,2%	1,3%	3,5%	8,0%	1,9%
REX Performance Index	489,80	-0,1%	0,0%	1,1%	3,0%	0,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,64	0	-25	-21	-17	-24
IBOXX BBB, €	1,73	-1	-34	-14	33	-33
ML US High Yield	6,96	-12	-39	-19	37	-106
JPM EMBI+, Index	829	0,0%	2,4%	6,3%	2,9%	4,8%
Convertible Bonds, Exane 25	7041	0,0%	1,3%	-1,9%	-2,8%	2,1%
Commodities						
CRB Spot Index	411,57	-0,4%	-0,2%	-0,6%	-6,7%	0,6%
MG Base Metal Index	305,74	-1,5%	4,4%	1,5%	-14,4%	3,8%
Crude oil Brent	64,65	4,5%	7,2%	-2,8%	2,3%	21,7%
Gold	1317,27	0,2%	2,1%	9,6%	-2,3%	2,8%
Silver	15,59	-1,3%	-0,3%	10,8%	-6,7%	0,5%
Aluminium	1820,75	-2,0%	1,2%	-5,5%	-16,3%	-2,3%
Copper	6137,25	-0,9%	4,6%	0,5%	-13,8%	3,2%
Iron ore	88,35	-4,1%	19,1%	18,1%	15,2%	27,7%
Freight rates Baltic Dry Index	628	4,5%	-45,2%	-37,8%	-42,6%	-50,6%
Currencies						
EUR/ USD	1,1277	-0,6%	-1,7%	-0,2%	-8,7%	-1,5%
EUR/ GBP	0,8794	0,5%	-1,0%	1,1%	-1,0%	-2,0%
EUR/ JPY	124,51	0,0%	0,5%	-3,2%	-6,0%	-1,1%
EUR/ CHF	1,1351	-0,1%	0,8%	-0,4%	-1,5%	0,7%
USD/ CNY	6,7662	0,4%	0,0%	-2,7%	6,6%	-1,6%
USD/ JPY	110,48	0,7%	2,1%	-2,8%	3,2%	0,8%
USD/ GBP	0,78	1,0%	0,7%	1,4%	8,9%	-0,6%

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