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Positive Outlook for the World Economy vs. Risk of Resource Prices Sustaining a “Bad” Increase

Where volatile excess liquidity goes will require close monitoring

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Economic Research Dept
Hiroshi Watanabe
Mitsumaru Kumagai

Summary

- Japan’s economy is foreseen to move from consolidation to a stable growth path in Jan-Mar 2011, after which exports are expected to drive a recovery in line with the recovery of the world economy. The view forward is positive since driving forces behind growth will support the world economy without interruption in 2011 and 2012.

- Both the economy and corporate profits are anticipated to move past their current lulls. While there is concern that profits will be squeezed by the surging cost of raw material imports ensuing from higher resource prices, it is not a major issue at the present moment. The current level of resource prices can be largely explained by real global demand. During similar periods in the past, recurring profit growth actually accelerated.

- This outlook would change, however, should resource prices increase for speculative reasons rather than in accordance with actual demand. A risk for 2011 is such a development coming to the fore at any moment. Depending on where the excess liquidity arising from global monetary easing is directed, resource prices may sustain a “bad” increase, and our current positive economic outlook may need to be revised.

Jan-Mar 2011 a Turning Point for Japan's Economy

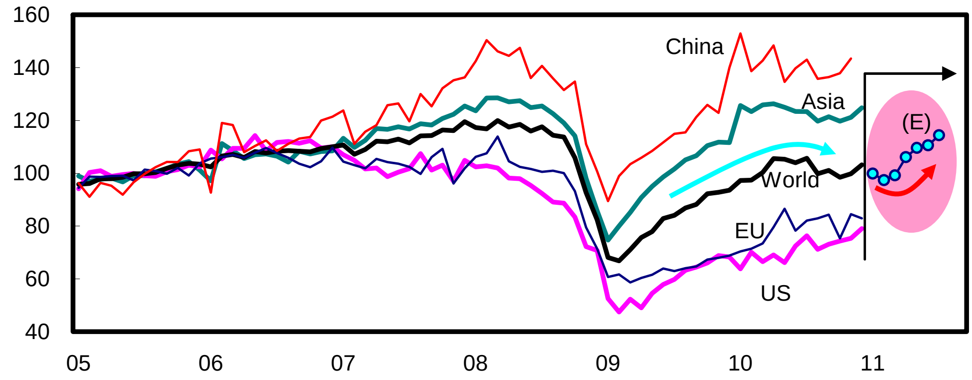
Exports will turn sharply upward starting in March

The consolidation of Japan's economy that has continued since mid-2010 is finally reaching a turning point. One step ahead of Japan, the world economy has moved from consolidation to recovery, and the appreciation of the yen initiated by investor flight from risk has also reversed. As a result, the drop in exports, the driving force of Japan's economy, is bottoming out.

As illustrated in Chart 1, the forecast for export volume estimated from the trends of the world economy and exchange rates suggests that exports will weaken to February and then recover at a relatively rapid clip starting in March*. In fact, the current trend of exports points to the possibility that this rebound will arrive somewhat earlier. Whatever the case, Japan's economy is foreseen to undergo an export-led recovery in 2011 and beyond in line with the recovery of the world economy.

Outlook for Export Volume (2005 = 100; SA) **Chart 1**

Export volume nearing a turning point



Source: Ministry of Finance, Organization for Economic Co-operation and Development (OECD); compiled by DIR.

Notes: 1) China: SA by DIR. Others: SA by Cabinet Office. Asia incl. China.

2) E: DIR estimate based on the following equation. Export volume = 2.68 + 20.22*CLI (-8) + 7.43*CLI (-9) - 0.17*REER (-10). Figures in parentheses: no. of preceding months. Export volume and REER (real effective exchange rate): y/y basis. CLI (OECD Composite Leading Indicator): m/m basis. Significance of parameters: 10%. Estimation period: Jan 1999-Dec 2010.

Forces Driving World Economy Will Continue without Interruption

The growth of the world economy will be supported by the US in 2011 and by China in 2012.

US economy will support growth in 2011

In the US, households are burdened with excess liabilities, and the adjustment of household balance sheets is a structural factor weighing on the economy. Employment and personal consumption, however, are tracing a cyclical recovery. Also, a major package of economic measures enacted in December 2010 (a fiscal burden totaling $857.8 billion between FY11 and FY20) will give the US economy a considerable boost in 2011. In a Blue Chip consensus forecast of 50 economists (Aspen Publishers) as of November 2010, the US economy was forecast to grow

*"Signal for Rebound of Exports", Hiroshi Watanabe, 3 December 2010.

2.5% in 2011. With the announcement of these economic measures, however, the 2011 forecast was revised upward to 3.1% in January 2011.

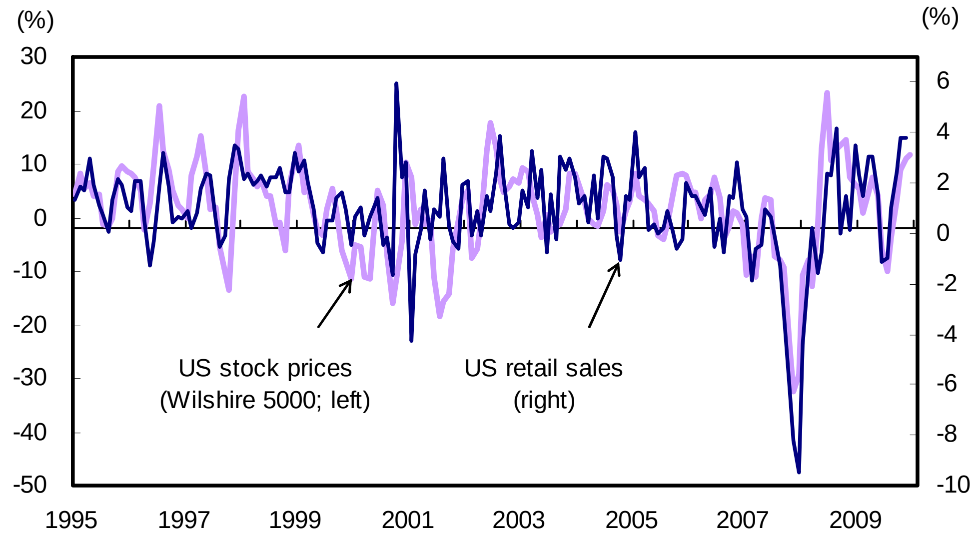
In addition to economic measures, a tailwind will be provided by higher share prices and cyclical recovery of the real economy

The new economic measures are a reflection of current circumstances. Incumbent presidents tend to suffer a major defeat in the mid-term elections, placing them in a position where they must accept policies of the opposition party. There is also a rule of thumb that additional economic measures tend to be announced in the run-up to facing voters in elections. The Obama administration, which lost badly in the mid-term elections of November 2010, has fully accepted the extension of the Bush-era tax cuts as insisted by the Republican Party and has established such additional measures as a 100% depreciation allowance for capex and reduction of the payroll tax rate.

Another rule of thumb can be cited. In view of economic measures like those mentioned above, share prices have a strong tendency to rise sharply in the third year of a presidential term. Since the start of the Kennedy administration in 1961, equities have increased around 20% in the third year of a presidential term whichever party (the Republicans or Democrats) was in power. The Dow Jones Industrial Average was around 11,000 in November 2010, and it would not be surprising if it exceeded 13,000 at end-November 2011.

Another factor to consider is how readily the wealth effect wields its influence in the US. As shown in Chart 2, stock price and personal consumption movements are closely related. This relationship has been sustained even as the adjustment of household balance sheets continues. In 2011, it is probable that a virtuous circle will take hold between stock prices and the economy and which will support the recovery of the US economy.

Virtuous Circle of Stock Prices and Economy in the US **Chart 2**



Source: Haver Analytics; compiled by DIR.
Note: Comparison to three months previous.

Given the economic measures and the wealth effect referred to above, the US economy is predicted to grow firmly in 2011. The following year, 2012, however, will see the Fed turn to exit strategies, and successive policy interest rate hikes are highly probable. Also, some of the economic measures focus on 2011, and a downward reaction may occur in 2012. Thus, momentum of the US economy is likely to weaken somewhat in 2012.

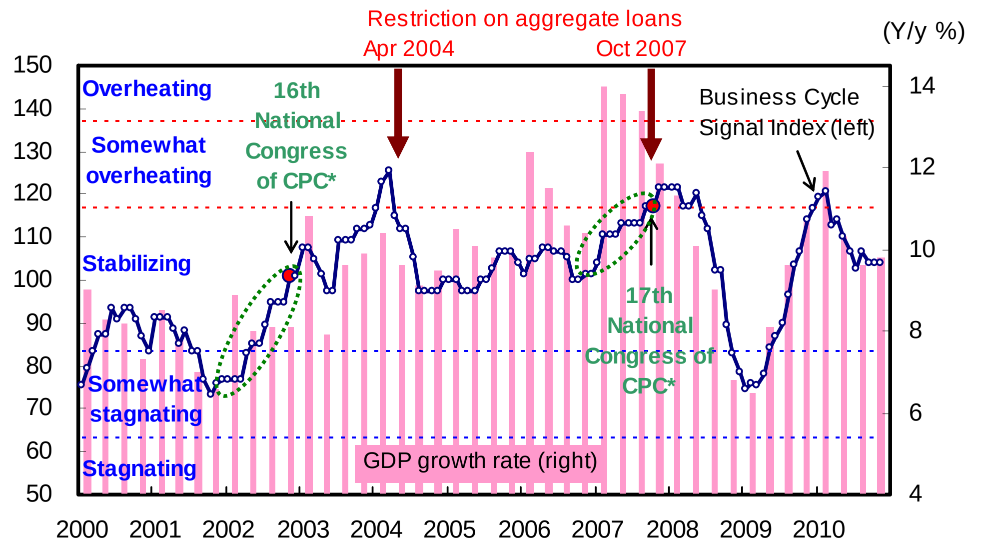
2011 a year of patience for China

China will then take over as the driving force of the world economy. For China, 2011 will be a year of patience. China has maintained a tight monetary policy since the start of 2010 with the view of achieving sustainable growth. Inflation, however, has remained high. China is therefore likely to adhere to such tightening policies as a higher reserve ratio, the restriction of real estate and speculative investments, and higher interest rates on bank loans while it considers what new measures to take.

One possibility is the acceptance of a higher yuan. China’s currency policy is not susceptible to external pressure, but it does tend to respond to imported inflation (for example, between 2005 and 2008, the revaluation of the yuan kept pace with the increase in import prices). Domestic factors, such as higher pork prices, account for most of the inflation occurring in China, but the impact of import prices, such as higher resource prices, is also significant. China could respond to this situation by revaluing the yuan. The creation of expectations for a higher yuan, however, may invite the inflow of capital and further stoke inflation. Thus, rather than allowing the yuan to appreciate gradually at an annual rate between 3% and 5%, the likelihood is high that China will permit a rapid appreciation of around 7% to 10%.

A matter of concern is whether the Chinese authorities will go so far as to place restrictions on the aggregate amount of loans. Such a move would have major repercussions for the economy. Chart 3 portrays an index of cyclical signals for China’s economy. Restrictions were previously placed on the aggregate amount of loans in April 2004 and October 2007, which were times when the economy entered the “somewhat overheating” zone. Currently, however, the economy has pulled back from the overheating zone, and there is little likelihood that the Chinese authorities will decide to restrict the aggregate amount of loans.

China's Economic Trend **Chart 3**



Source: Haver Analytics; compiled by DIR.
*Communist Party of China.

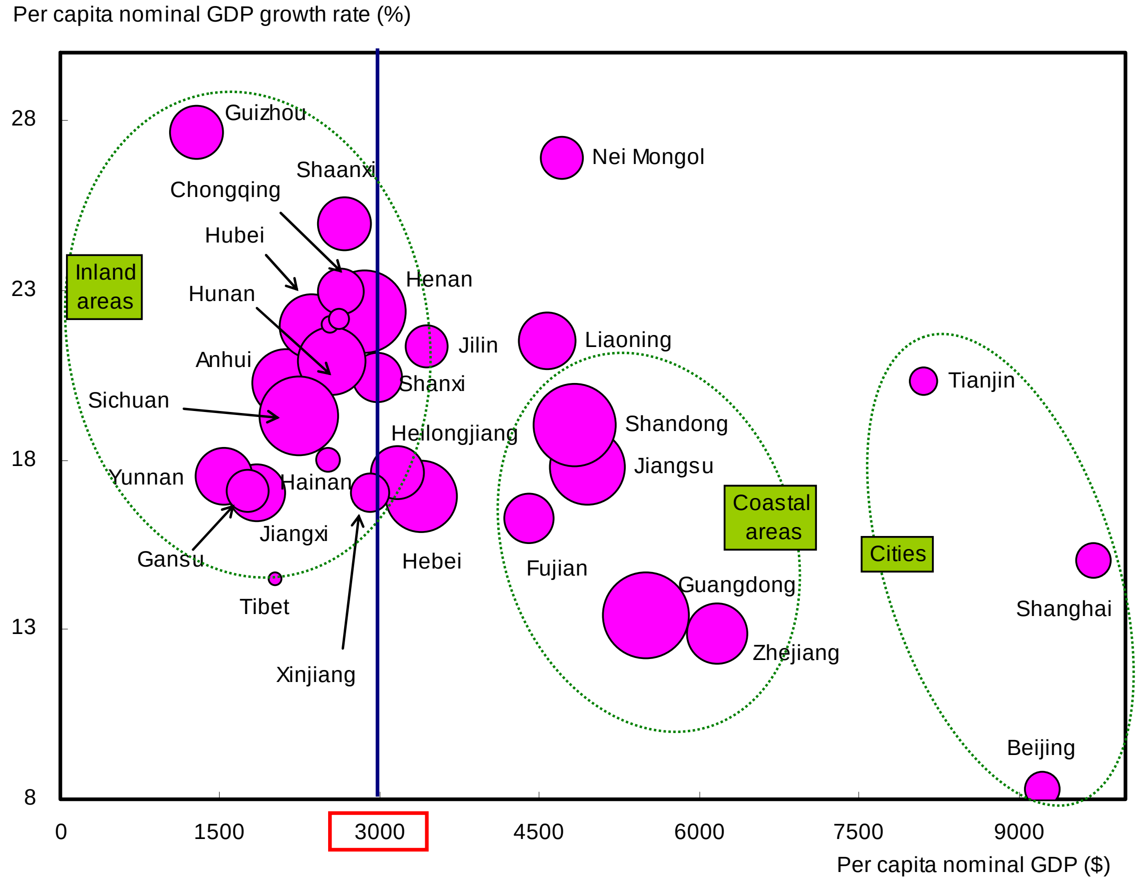
Personal consumption and capex will provide boost in 2012

China is expected to restrain the economy in 2011 and then step on the accelerator in 2012. Key is the arrival of a political season. In advance of the 18th National Congress of the Communist Party to be held in autumn 2012, regional leaders will seek to spur economic growth rates to advance their positions within the Communist Party. National Congresses were previously held in 2002 and 2007. It is evident from Chart 3 that the Chinese economy accelerated one year before these events.

Themes for 2012 are likely to be (1) correction of the income gap and stimulation of consumption, (2) capital investments in such strategic areas as alternative energy, materials, and biotechnology, and (3) infrastructure investments in mid-western areas. The income gap is turning into a social problem in China.

Chart 4 depicts per capita nominal GDP by province or city and shows that in broad terms there are three levels: around $9,000 in cities (those directly under the central government), $5,000 in coastal areas, and $3,000 in inland areas. As the income gap is reduced, such as by increasing the minimum wage, the consumption of household electrical appliances and automobiles can be expected to grow in inland areas where per capita GDP has reached $3,000, which is said to be the critical point for the spread of durable goods. Also, targeted investments are likely to be made in strategic fields in the industrial zones of coastal areas. As shown by the sizes of the circles in Chart 4, core population zones are dispersed, and infrastructure investments in railroads, roads, waterworks, and communications to connect urban areas remains a major theme. Japan's economy in particular is expected to benefit from such capital and infrastructure investment in China.

Per Capita Nominal GDP by Province/City (2008) **Chart 4**



Source: National Bureau of Statistics of China; compiled by DIR.
Note: Size of circles denotes population.

Corporate Profits Will Also Move Past a Lull

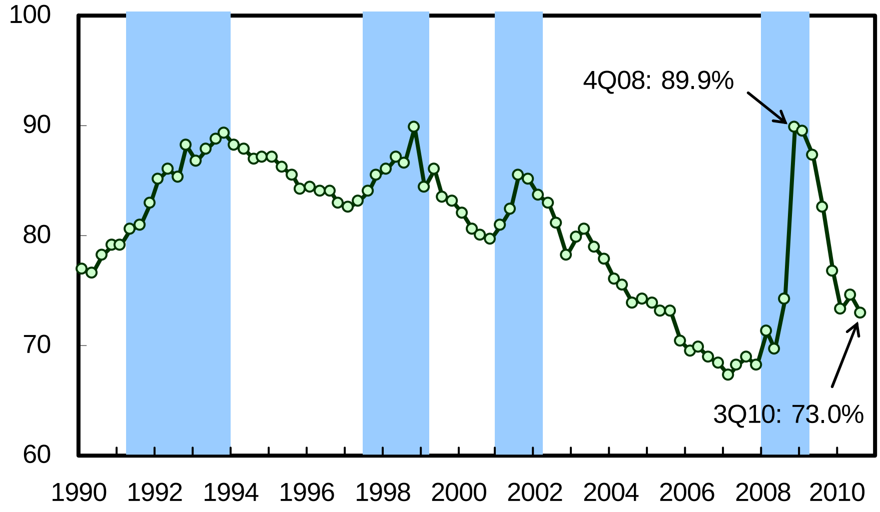
As noted above, driving forces behind growth will support the world economy without interruption in 2011 and 2012. The outlook for the world economy has brightened, and it has become possible to envision Japan's economy moving from consolidation to a stable growth path. The same can be said for profits.

Return to a lean profit structure

Corporate earnings, whether viewed in terms of sales or recurring profit, clearly hit a ceiling in 2010 and are expected to move out of their current lull from Apr-Jun 2011. Also, because the recovery of profits since 2009 has centered on cost reductions, the breakeven sales ratio has improved to its average in previous recoveries (Chart 5).

Consequently, cost reductions will not contribute to higher profits as easily as before. Companies, however, have achieved lean profit structures in the meantime. Should the revival of exports and production activity lead to higher sales, recurring profit can be expected to increase in a similar manner.

Breakeven Sales Ratio (Large-company & all-industry basis; %) **Chart 5**



Source: Ministry of Finance; compiled by DIR.
Note: Shaded areas denote economic downturns.

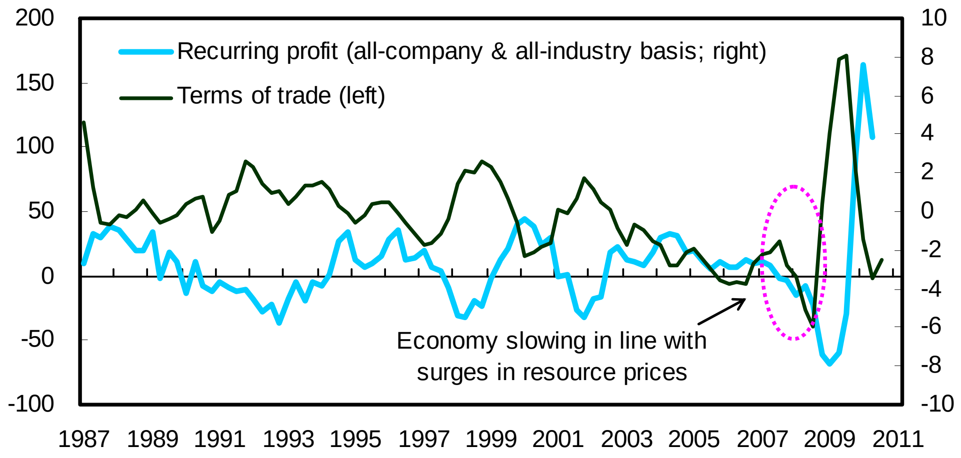
How Should Higher Resource Prices Be Understood?

The issue then becomes the recent rise in resource and commodity prices. The price of crude oil has surpassed $90 per barrel (WTI basis), and the prices of metals, raw materials, foods, and edible oils have all increased sharply. Corporate profits have the potential of being squeezed by a sharp rise in the cost of raw material imports.

Current increase in resource prices can be absorbed

The current increase in resource prices is, however, arising from the expansion of the world economy. Under such conditions, it should not become a major problem. As depicted in Chart 6, in previous periods when resource prices increased, the terms of trade (output prices / input prices) worsened, but profits grew at a faster pace. Even if companies were unable to fully pass on the increase in resource prices to selling prices, the growth of both export volume and domestic sales volume reduced marginal fixed costs enabling them to absorb the increase in raw material prices and other variable costs.

Terms of Trade and Profits (y/y %) Chart 6



Source: Bank of Japan, Ministry of Finance; compiled by DIR.
Note: Terms of trade = Output price / input price.

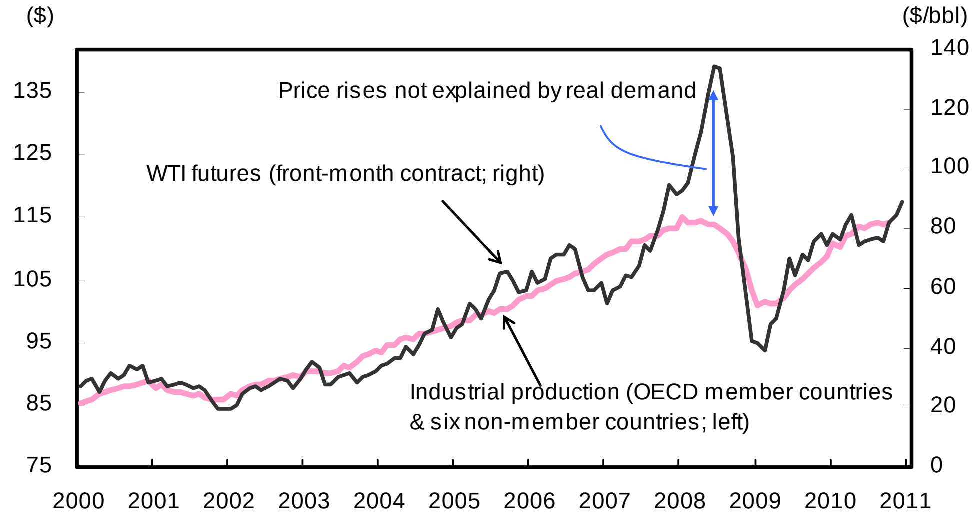
Speculative increase in resource prices a potential concern

A potential problem is indicated by the circled area in Chart 6, the situation that existed between 2H07 and 1H08. At that time, a "bad" increase in resource prices worsened the terms of trade, and recurring profit declined.

This "bad" increase in resource prices was an increase based on speculation rather than actual demand. As Chart 7 shows, such indicators of the real economy as world production normally move in tandem with crude oil prices. Hence, resource prices can be said to fluctuate in accordance with changes in real demand.

World Economy and Resource Prices Chart 7

Higher resource prices without real demand would impair world economy



Source: Organization for Economic Co-operation and Development (OECD), NYMEX; compiled by DIR.
Note: Six non-member countries: Brazil, Russia, India, China, Indonesia, South Africa.

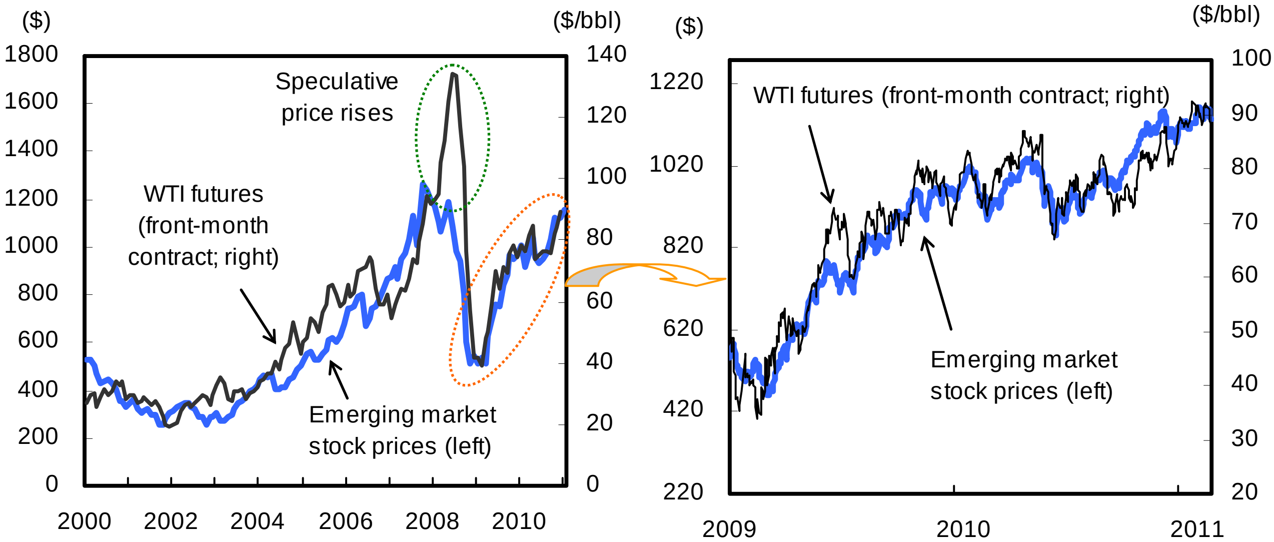
Between 2H07 and 1H08, however, crude oil prices diverged sharply above the real economy, a surge in resource prices that clearly cannot be explained by real demand. Looking back to that moment, business confidence began to worsen in the US around the time of the so-called BNP Paribas shock. US stocks and Treasuries were sold, and the funds that were shifted out of dollar assets were invested in commodities. The speculative increase in resource prices gave rise to stagflation in developed and emerging economies, which accelerated the worsening of world business confidence.

As shown in Chart 7, the recent increase in crude oil prices can be largely explained by the real economy. Hence, resource prices around their current level should not have a major adverse impact on corporate profits.

Resource prices, however, may diverge above their current level at any time, and they represent a real risk for corporate profits. Where the excess liquidity arising from global monetary easing might be directed is attracting interest. Currently, as illustrated in Chart 8, the correlation between stock prices in emerging economies and resource prices is very high. This can be understood as a reflection of excess liquidity flowing in a well-balanced manner into the equity markets of emerging economies and commodity markets.

Emerging Market Stock Prices and Crude Prices **Chart 8**

Excess liquidity flowing to emerging markets and commodity markets in a balanced way



Source: NYMEX, Haver Analytics; compiled by DIR.
Note: Emerging market stock prices: MSCI Emerging Market Index.

Where excess liquidity goes will require close monitoring

How long can such diversified investments continue? Among emerging economies, such countries as Brazil, which has experienced a sharp rise in its currency, as well as Chile and Columbia, have imposed capital controls to curb the inflow of speculative funds. Also, to restrain the appreciation of their currencies, many countries have intervened in currency markets to buy some time. Such intervention, however, will increase domestic money supply and risk promoting inflation. Responding to this situation by raising policy interest rates will only accelerate the inflow of capital and the appreciation of the home currency. The question therefore becomes the extent to which emerging economies can withstand the appreciation of their currencies.

Should they be unable to do so and move to impose capital controls simultaneously, funds losing an investment destination will flow into commodity markets, and prices may surge in a manner that cannot be explained by real demand. Should this happen as it did between 2H07 and 1H08, corporate profits and the economy might experience major blows not only in Japan but also at the global level.

We think the world economy looks promising for the next two years and a relatively high growth rate should be achieved. However, depending on where volatile excess liquidity goes, this outlook may need to be revised.