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Japan's Economy: Monthly Review

Will The Great Rotation Continue?

Attention on three merkmal: (1) outlook for world economy, (2) price of copper, (3) US currency strategy

Economic Intelligence Team
Mitsumaru Kumagai
Satoshi Osanai
Keisuke Okamoto
Shunsuke Kobayashi
Kazuma Maeda
Makoto Tanaka

Summary

- **Economic outlook revised:** In light of the 2nd preliminary Oct-Dec 2016 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +1.4% in comparison with the previous year for FY16 (+1.3% in the previous forecast), +1.4% in comparison with the previous year for FY17 (+1.3% in the previous forecast), and +1.1% in comparison with the previous year for FY18 (+1.1% in the previous forecast). Japan's economy is expected to shift into a path of balanced growth in the future due to the following factors: (1) a comeback for exports, (2) progress in inventory adjustment, and (3) a recovery in domestic demand supported by a steady undertone in consumption and capex. (For details see *Japan's Economic Outlook No. 192 Update (Summary)*, March 9, 2017, by Mitsumaru Kumagai.)

- **Will The Great Rotation continue?:** Currently, global money flows are shifting from bonds to stocks. This is known as The Great Rotation. This is due to the long-term interest rate hikes which the FRB began in December of 2015. Another reason that stock prices have been on the way up is that the global economy has recently been continuing its recovery. The general understanding of economists is that The Great Rotation ends when the economy declines and the stock market enters an adjustment phase. In our considerations regarding whether or not The Great Rotation will continue, we examine three major judgment criteria (merkmal). These are (1) Whether the growth rate of the global economy will be revised upwards, (2) Whether the price of copper is expected to rise, and (3) Whether the US currency authorities adopt a weak dollar policy.

- **Risk factors facing Japan's economy:** Risk factors for the Japanese economy are: (1) The policies of President Donald Trump, (2) The downward swing of China's economy, (3) Tumult in the economies of emerging nations in response to the US exit strategy, (4) Risk-off behavior of investors due to geopolitical risk and country risk, and (5) Negotiations regarding the UK's withdrawal from the EU (Brexit), and deleveraging at EU financial institutions.

1. Japan's Main Economic Scenario

Japan's economy moves toward balanced growth

In light of the 2nd preliminary Oct-Dec 2016 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +1.4% in comparison with the previous year for FY16 (+1.3% in the previous forecast), +1.4% in comparison with the previous year for FY17 (+1.3% in the previous forecast), and +1.1% in comparison with the previous year for FY18 (+1.1% in the previous forecast). Japan's economy is expected to shift into a path of balanced growth in the future due to the following factors: (1) a comeback for exports, (2) progress in inventory adjustment, and (3) a recovery in domestic demand supported by a steady undertone in consumption and capex. (For details see *Japan's Economic Outlook No. 192 Update (Summary)*, March 9, 2017, by Mitsumaru Kumagai.)

Real GDP growth rate revised upwards in comparison to 1st preliminary report, but falls below market consensus

The real GDP growth rate for Oct-Dec 2016 (2nd preliminary est) was revised upwards to +1.2% q/q annualized (+0.3% q/q) in comparison to the 1st preliminary report (+1.0% q/q annualized and +0.2% q/q), while at the same time falling below market consensus (+1.6% q/q annualized and +0.4% q/q).

Though revised figures did not reach the level of market consensus, the main cause is considered to be advances achieved in inventory adjustment, and hence should not be cause for excessive pessimism. With an upward revision centering on capex, the most important development of note is the Japanese economy's gradual shift to more balanced growth, driven by both domestic and overseas demand rather than by overseas demand alone. Our main scenario for Japan's economy is reconfirmed by these results, which show the economy to be heading for a comeback after having been in a temporary lull.

Moderate recovery expected for Japan's economy, but risk of possible downturn remains

We expect Japan's economy to continue in a moderate expansion phase. However, caution is required even as overseas demand continues its gradual expansion. If the world economy becomes more uncertain in the future, this could cause domestic demand to stagnate, and to become a negative factor bringing downward pressure on Japan's overall economy. A further risk is the expectation that the FRB will increase interest rates, causing a slowdown in the US economy or capital outflow from the emerging nations. Meanwhile, the future of the world economy becomes increasingly uncertain with US President Donald Trump moving the country more toward protectionism, declaring a withdrawal of the US from the TPP agreement, and calling for renegotiation of NAFTA with a possible future withdrawal. These are all risk factors which could bring negative pressure on Japan's economic growth, which is driven by overseas demand.

Personal consumption is expected to continue in a moderate expansion phase. The supply of labor remains tight, and this should provide underlying support for personal consumption through growth in employee compensation. However, the one worrisome point is that the CPI has been on the rise since last fall due to rising prices of fresh foods. Meanwhile, the government is encouraging corporations to increase base salary rates during the annual spring labor offensive this year. However, many corporations, which are becoming worried about future business performance, are taking the stance that they will raise annual salaries but not monthly wages. Keeping in mind the influence of prices, if real wages begin to stagnate, households will likely tighten the purse strings.

Meanwhile, housing investment is expected to gradually slow down. Interest on housing loans remains low, and therefore should provide continued underlying support. However, housing starts, which had rapidly expanded with the expectation that there would be a rush to purchase homes before the additional increase in consumption tax originally planned for April 2017, are expected to decrease in the future, especially for condominiums in urban areas, and housing investment is also expected to begin declining after that point. Housing starts now appear to be close to peaking out, hence housing investment, which is recorded on the basis of construction work-in-progress, stands a good chance of following in the wake of housing starts and weakening as well.

Capex is expected to see gradual growth. The supply of labor continues to be tight, and this should provide underlying support for investment in labor-saving and rationalization due to the continuing labor shortage in the non-manufacturing industries. Meanwhile, research & development expenses, which were to be recorded after the Jul-Sep period 2nd preliminary report, should also be a factor pushing up capex spending. However, it is important to be aware that although corporate earnings remain at a high level, this is due merely to the decline in input cost and not growth in volume. A more substantial increase in capex spending would be dependent on an increase in operating rate, backed by expansion of overseas demand.

Public investment is expected to move toward a comeback as we approach the fiscal year-end. The government’s second supplementary budget, which includes economic policy measures, should gradually provide more upward pressure for public investment.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone, centering on consumer goods. Looking at exports of goods by region, consumer goods are expected to maintain a strong undertone in the US, EU, and Asia backed by improvements in employment environment, the effects of monetary easing, and favorable personal consumption in all regions. However, with US President Donald Trump moving the country more toward protectionism, declaring a withdrawal of the US from the TPP agreement, and calling for renegotiation of NAFTA with a possible future withdrawal, caution is required. If the US becomes extremely protectionist in its trade policy, it could cause world trade to stagnate. We expect this to remain as a mid to long-term risk factor. If trade friction with the US comes to the surface, Japan’s export industries, especially the automobile industry, would likely take a serious hit.

Risk factors facing Japan’s economy

Risk factors for the Japanese economy are: (1) The policies of President Donald Trump, (2) The downward swing of China’s economy, (3) Tumult in the economies of emerging nations in response to the US exit strategy, (4) Risk-off behavior of investors due to geopolitical risk and country risk, and (5) Negotiations regarding the UK’s withdrawal from the EU (Brexit), and deleveraging at EU financial institutions.

2. Will *The Great Rotation* Continue?

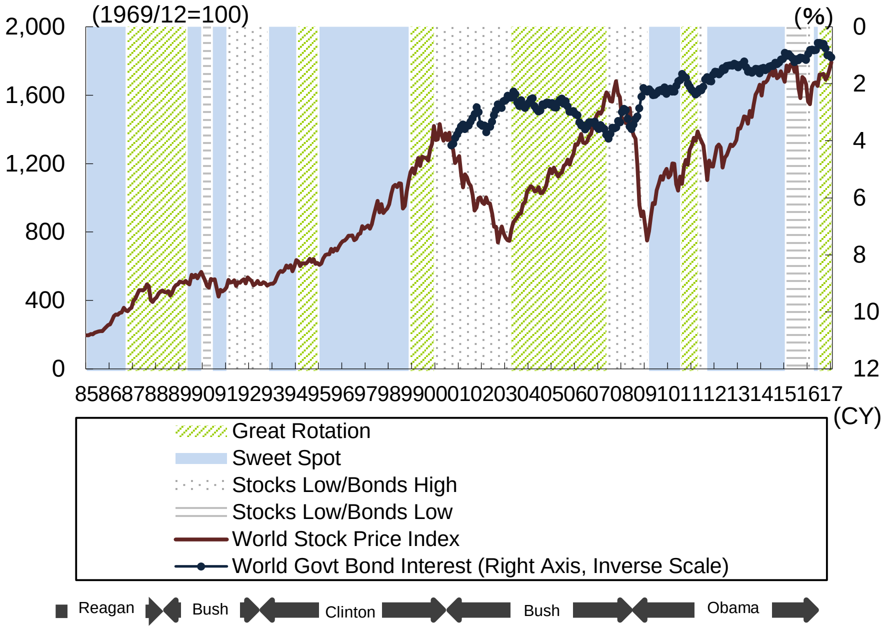
2.1 The shift of money-flow from bonds to stocks

Currently, global money flows are shifting from bonds to stocks. This is known as *The Great Rotation*. The MSCI World Index hit bottom in February 2016, but then since then has continued to soar. Even after Donald Trump was elected to the US presidency in November of 2016, overturning all assumptions, the world stock market continued to react positively. Meanwhile, government bond interest rates around the world have continued to climb. In this chapter we examine cycles in the global stock and bond markets. In our considerations regarding whether or not *The Great Rotation* will continue, we examine three major judgment criteria (merkmal). These are (1) Whether the growth rate of the global economy will be revised upwards, (2) Whether the price of copper is expected to rise, and (3) Whether the US currency authorities adopt a weak dollar policy.

The Great Rotation begins with raising interest rates and ends when economy declines

Chart 1 shows variations over time in the world stock index and government bond interest rates, and illustrates different periods of market behavior based on the following four patterns: World Index rising or falling; world government bond interest rates rising or falling. Periods shown in blue are when both stock and bond prices are at a high (known as *the sweet spot*), and periods in green are those where bond prices are low but stock prices are high (*The Great Rotation*). Meanwhile, periods with a white background and dots are those where stocks are at a low and bonds are at a high, and the white background with horizontal lines is where both stocks and bonds are at a low.

Variations Over Time in World Stock Index and Government Bond Interest Rates **Chart 1**



Source: Bloomberg, MSCI/Haver Analytics; compiled by DIR.
Notes: 1) The MSCI World Index is used for the world stock price index. All rights including copyright and intellectual property rights associated with the MSCI World Index are attributable to MSCI Inc.
2) For world government bond interest rates, we use the WGBI Average for years up to August 2000, and after that we use the Bloomberg Barclays Indices low yield.

The following cycles can generally be observed in the stock and bond markets.

First, when there is a downturn in the economy the stock market declines and interest rates decline as well, due to the weakening of demand for capital, and government policy such as monetary easing ((1) Stocks low / bonds high).

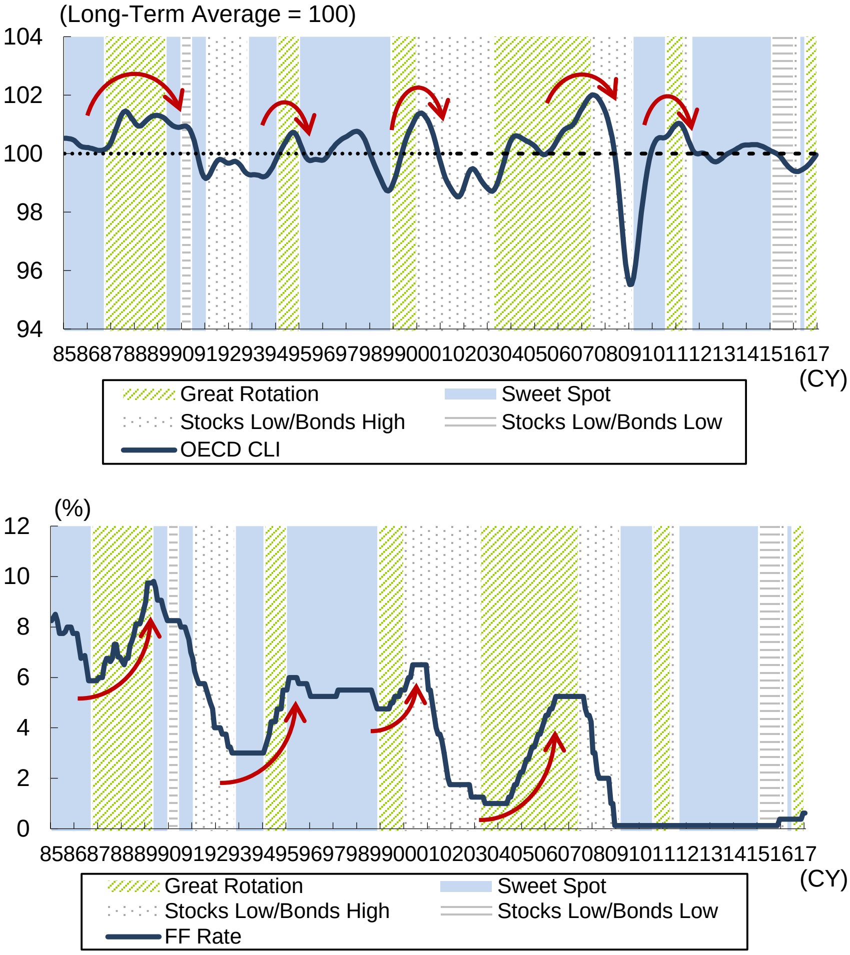
Next, we gain supply liquidity due to economic stimulus policy and monetary easing, and this brings upward pressure on the stock market. Here we arrive at (2) Stocks high / bonds high (known as *the sweet spot*). *The sweet spot* is when the economy is expanding and prices are relatively stable. It occurs during periods when the policy interest rate is also fairly stable. During a period such as this when the market is in the sweet spot, central banks will most often raise the policy interest rate since the economy can become overheated, causing inflation pressure to rise. This causes the bond market to decline, and when this happens the sweet spot period reaches its end.

Stage (3) *The Great Rotation* (stocks high / bonds low) often occurs after *the sweet spot*. Here the long-term interest rate continues to rise due to the central bank's having raised the interest rate. In cases where the global economy continues to expand, stock prices also remain high. Then, when a downturn in the economy occurs stock market performance also declines, bringing us to step (4) Stocks low / bonds low. This step can also be skipped and the cycle can return to its beginning at step (1) Stocks low / bonds high.

Chart 2 shows changes over time in the OECD Composite Leading Indicator (CLI), which indicates the world economic trend, and the Federal Funds Rate (FF interest rate). Areas in the chart shaded blue denote sweet spots, while green represents *The Great Rotation*. During these periods, the OECD CLI is most often over 100, meaning an economic growth period. On the other hand, during *the sweet spot* (blue), the FF rate tends to mark time. In contrast, when in the green (*The Great Rotation*), the interest rate is up. Then, when the economy enters a downward phase, *The Great Rotation* ends.

Looking at trends in recent years, we see that between the latter part of 2011 and throughout 2015, Japan, the US, and the EU all maintained, and in many cases strengthened, monetary easing policies, which led to interest rates continually declining. Meanwhile, large amounts in supply liquidity found its way into the stock market, leading to stock price highs. But the economy experienced ups and downs and had not yet entered a recovery phase, so the market cycle did not shift from *the sweet spot* to *The Great Rotation*, and the bond market fluctuated while stock prices remained high. Finally, the world economy headed upwards, and the FRB began raising interest rates in December of 2015. This triggered a shift in capital from bonds to stocks.

OECD Composite Leading Indicator (CLI) and FF Rate **Chart 2**



Source: Haver Analytics; compiled by DIR.
Note: The OECD CLI is composed of OECD data plus data from six major non-member states (Brazil, China, India, Indonesia, Russia, and South Africa). It is also amplitude adjusted.

2.2 Three major judgment criteria (merkmal) which predict whether or not *The Great Rotation* will continue

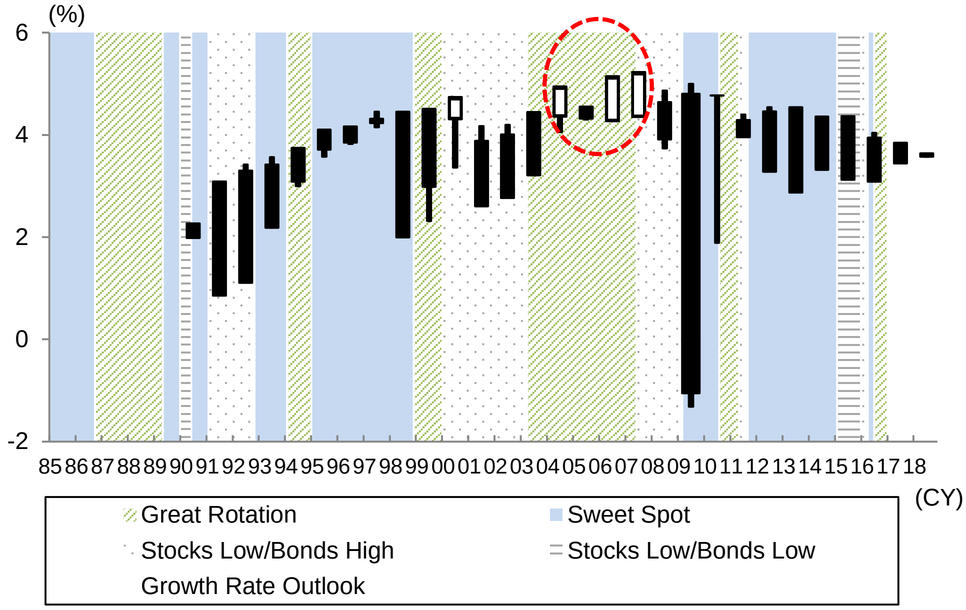
In this section we look at three indices in order to predict whether or not *The Great Rotation* will continue.

Merkmal (1): Is an upward revision of the global economy's growth rate in store?

Our first merkmal is change in the IMF World Economic Outlook, which forecasts the growth rate of the world economy. Chart 3 illustrates growth rate prediction values over the past two years up to October of the current year in the form of a candlestick chart, using data since 1990, which is the earliest data available. The IMF's outlook for growth rate has been revised downwards in most years, but between 2003 and 2007, which was a fairly long period for *The Great Rotation* phenomenon to last, there were also many years when the outlook was revised upwards. Moreover, when downward revisions occur they tend to be minor.

Naturally, since we can assume that the stock market immediately factors in the expected value of the economic growth rate, when the economy is more favorable than expected, stock prices go up. However, looking at the chart we see that during the years 2017 and 2018, the outlook for growth rate has been revised downwards. When the economic outlook worsens, this can of course have a negative effect on the stock market. Therefore, in order to predict whether or not the most recent occurrence of *The Great Rotation* will continue for the long-term, we need to pay attention to any revisions which may be made to the IMF outlook in the future. Whether the outlook is revised upwards or downwards, as well as the extent of the revision, are all important factors.

Variations Over Time in the IMF Outlook for Growth Rate in the World Economy **Chart 3**



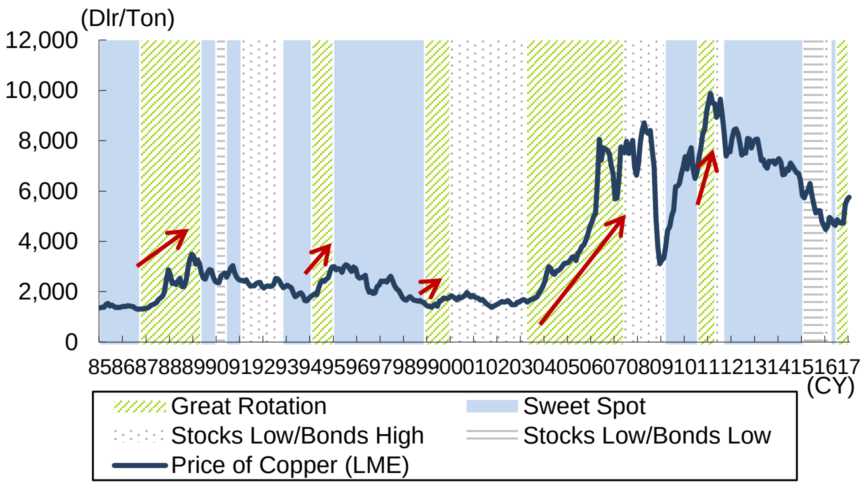
Source: IMF; compiled by DIR.
Note: Prediction values announced six times (in April and October) over the past two years up to October of the current year are shown, with candlestick chart bars denoting initial value (2 years previous), closing (October announcement), low, and high. Prediction values for the years 2017 and 2018 were announced in 2016.

Merkmal (2): Will the price of copper rise?

Our second merkmal is the question of the price of copper. Taking a look at Chart 4, we see that the price of copper clearly appears to rise during periods of *The Great Rotation*.

Copper is used to fabricate electrical wire and copper pipe, as well as electrical cable. It also has a broad use in manufacturing parts in various kinds of machinery and equipment, including automobiles, industrial equipment, and household electronics. The price of copper tends to rise when global production is on the rise. The largest consumer of copper in the world is China, hence copper is one of the economic indicators which tell us how that country's economy is doing. In addition, there are also many infrastructure related uses of copper, so when we consider the major infrastructure investment promised by US President Donald Trump, copper will take on an even larger significance as an indicator of the realization rate of these projects.

Variations Over Time in the Price of Copper (LME) **Chart 4**



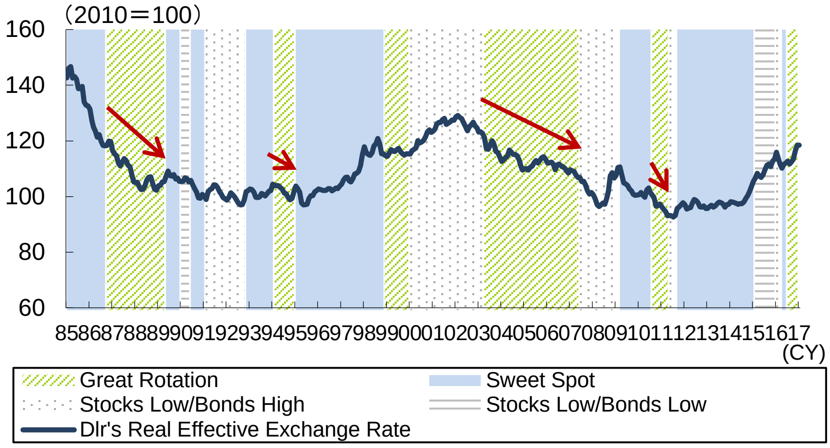
Source: IMF; compiled by DIR.

Merkmal (3): Will US currency authorities adopt a weak dollar policy?

Finally, for our last merkmal we consider the dollar exchange rate. During period of *The Great Rotation* the dollar tends to be on the weak side (Chart 5).

Here the US currency strategy comes into play. Certain conditions would have to be fulfilled in order for the US to adopt a weak dollar policy. These are as follows: inflation fears would be limited and the stock market would be stable. Hence, to look at it from the opposite side, for the US currency authority to adopt a weak dollar policy, they would have to be extremely pessimistic about the direction of the world economy. According to this logic, we can infer that the US might adopt a weak dollar policy during a period when *The Great Rotation* phase could easily continue.

Variations in Dollar's Real Effective Exchange Rate **Chart 5**



Source: Haver Analytics; compiled by DIR.

As for getting a view of future prospects, the FRB has hinted that it will raise interest rates a number of times in 2017. Hence, it is difficult to imagine a reversal of the current trend toward a higher long-term interest rate (which would bring on a low for the bond market). Meanwhile, we are closely monitoring the above three merkmal for signs of whether or not we can predict a continuation of stock price highs.

Economic Indicators and Interest Rates

Chart 6

Indicator	2016	2017				2018	FY15	FY16	FY17	FY18
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual	DIR estimates					Actual	DIR estimates		
Real GDP										
Q/q %, annualized	1.2	2.8	1.2	0.9	1.3	0.9				
Y/y %	1.6	1.9	1.6	1.5	1.5	1.1	1.3	1.4	1.4	1.1
Current account balance SAAR (Y tril)	20.9	20.2	19.1	19.1	19.7	20.0	18.0	20.3	19.6	20.8
Unemployment rate (%)	3.1	3.0	3.0	3.0	3.0	3.0	3.3	3.1	3.0	3.0
CPI (excl. fresh foods; 2015 prices; y/y %)	-0.3	0.3	0.6	1.0	1.0	0.8	-0.0	-0.2	0.9	0.7
10-year JGB yield (period average; %)	0.00	0.08	0.09	0.09	0.09	0.09	0.26	-0.04	0.09	0.10

Source: Compiled by DIR.

Note: Estimates taken from DIR's *Japan's Economic Outlook No.192 Update (Summary)*.