Daily Note

JAPAN – RECESSION RISK

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- **Japan's export-dependent expansion under threat as the world economy slows**
- **Souring business sentiment points to softer private demand**
- **Fiscal policy to pick up the slack as scope for external adjustment is limited**

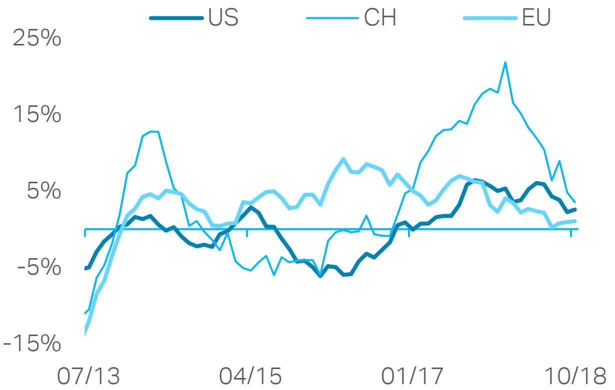
Could slowing world trade tip export-sensitive Japan into recession in the foreseeable future? Admittedly, this sounds more alarming than it really is: with trend GDP growth of just about ½%, any period of subpar growth is likely to include negative quarters, i.e. the bar for a slide into recession is relatively low. But, to us, this now looks like a plausible scenario,

The world economy has stayed on the back foot this year against a backdrop of cooling Chinese activity and tight dollar liquidity that has put the shackles on EM growth. With the exception of the US, industrial production has worsened. Soft export orders are keeping the pressure on the manufacturing sector, dragging PMIs down to levels last seen in 2016. Looking ahead, significant downside risks suggest global conditions are likely to get worse before they get better. While the US continues to outperform, buoyed by favourable fiscal measures, it looks like growth is set to dip next year, reverting closer to trend. Real US exports fell in Q3 and business investment is losing steam. We also view Beijing's reluctance to engage in major fiscal or monetary stimulus as enforcing further yuan/dollar depreciation throughout 2019, weighing on US growth, exporting deflation and spreading the pain from the bilateral trade war.

Japan lies at the epicentre of these frictions. While the negative third-quarter GDP reading was to some extent the result of one-off factors (natural disasters), it may also be a harbinger of more challenging times ahead. Y/Y growth in machine tool orders turned negative in October for the first time in two years – driven by falling foreign demand – confirming the lack of impetus in industrial activity. Exports rebounded last month following a 1.8% quarterly decline in Q3. But with shipments to China slowing after an exceptionally solid 2017, a sustainable recovery looks

Deflating Chinese demand

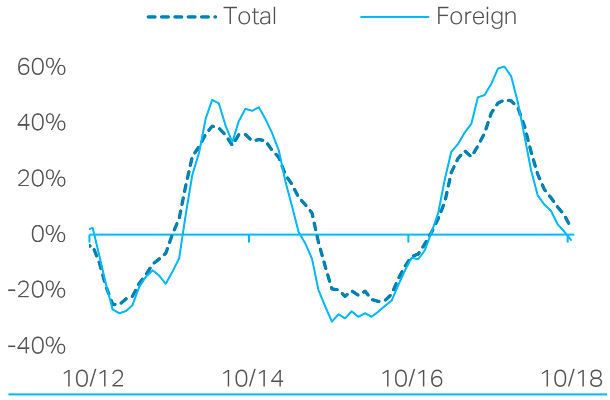
Japanese real exports, Y/Y (6m MA)



Source: Datastream, TS Lombard

Manufacturing downswing

Machine tool orders, Y/Y (3m MA)



Source: Datastream, TS Lombard

tenuous. Business confidence is flagging, with the expectations and employment indices in the latest Eco Watchers survey pointing down. The risk is that, as global trade suffers and the slowdown reaches US shores, sentiment deteriorates further, causing firms to rein in spending.

Strong private non-residential investment has been instrumental in Japan's recovery over the last couple of years. Capex and employment follow profits, and wages follow employment. In the early days of Abenomics, business earnings were lifted by a combination of yen depreciation and falling interest rates. The global synchronised expansion took the baton in 2016, boosting sales. Job creation gathered pace in 2017, tightening the labour market and paving the way for faster pay growth in 2018. Higher wages have propped up household incomes but expenditure continues to lag. Workers' propensity to consume has tumbled in 2018 due to a combination of structural and cyclical factors (see here for our take on this). Japanese households are opting to save more instead of spending the extra income, effectively acting like corporates – business saving remains at around a quarter of GDP, wholly excessive for an economy with such low potential growth.

Consumer confidence has soured of late, in tandem with slowing growth in employment and wages following a robust H1. If soft external demand causes businesses to retrench, then households could turn even more defensive and the virtuous cycle from income to spending – however imperfect it may be – will snap. In short, the path to rebalancing away from export-reliant growth to domestic demand is inherently unstable, as it continues to depend on a benign external environment.

A large and persistent private sector financial surplus can be offset only by deficits elsewhere, i.e. the government and/or foreigners (the current account). The problem is that, unlike in 2012/13, 'initial conditions' suggest limited scope for the external sector to shoulder the burden. Slowing global demand will keep the trade balance under pressure, though the recent drop in oil prices should offset some of the pain. It is also hard to see how the exchange rate can act as a powerful release valve this time round. First, with the BoJ signalling it has reached the end of the road on monetary easing even as inflation disappoints, the room for Governor Kuroda to engineer large-scale yen depreciation is limited. Second, in real trade-weighted terms the yen is already around 20% weaker than it was in Q4 2012 (and 45% down against the dollar). With the yuan's 30% weight in the basket roughly double that of the dollar, the downside looks limited even if yuan depreciation were to put the yen under pressure. Therefore, the current account surplus – which is hovering near multi-decade highs – is also unlikely to get a further boost from favourable moves in the primary income balance.

This leaves the government to pick up the slack. Shinzo Abe will have little choice other than to double down as the macro outlook sours in 2019. We expect fiscal policy to be loosened, perhaps considerably, relative to what is pencilled in by the Cabinet Office: in FY2019, the fiscal deficit could end up closer to 4.5% of GDP, where it has been for the last couple of years, than the latest official projection of 3.6%. Fiscal stimulus will help pull the economy along. But it could ultimately also expose the fatal flaw of Abenomics, i.e. deploying aggressive monetary easing to address domestic financial imbalances – ultimately a recipe for increasing Japan's external surplus instead of achieving a durable boost in private demand.

Finally, it is notable that dislocations in the FX forwards market (i.e. a wide cross-currency basis) – a corollary of strong hedging demand from Japanese investors in their reach for foreign yield – have led to a surge in overseas holdings of Japanese government paper despite depressed/negative yields. Non-resident investors own around 12% of total outstanding debt (and around 65% of short-term debt), not much less than the domestic banking sector's 15% share, facilitating the BoJ's passive taper. In a scenario where sustained fiscal deterioration takes Japan closer to the financial rocks, these flows could reverse, forcing the BoJ to ramp up QE just when it was starting taking baby steps towards normalisation.