JAPAN: ECONOMIC OUTLOOK

MAY 2017

Key points:

- The Japanese economy regained its footing over 2016. GDP grew in each quarter of the year, the first time this has occurred since 2005. Indicators to date for 2017 are reasonably solid with fiscal policy and monetary policy likely to be supportive, and an improving global economy a positive for exporters. We expect growth in 2017 to be modestly above trend.
- Conditions are favourable for business investment with corporate profitability in good shape, and capacity shortages will also act as a spur. Consumer caution remains an issue. Japan's labour market remains very tight with the unemployment rate at a low of 2.8%, but wages growth remains subdued.
- Despite the recent improvement, taking a medium term view, Japan remains a slow growth economy. This reflects its declining population and, like many other countries, a decline in productivity growth post the GFC.
- Monetary policy is expected to remain at its current, very loose, settings for an extended time, even with the Bank of Japan struggling to meet its inflation target. The medium term outlook for fiscal policy is more clouded.
- Japan recorded a merchandise trade surplus in 2016, the first since 2010. This helped raise the current account balance to JPY20.3tn. Besides the current account, Japan's high level of FX reserves and net foreign asset position reveal a very strong external sector, which helps cement the Japanese Yen as a safe haven currency in times of geopolitical and financial stress.
- Uncertainty over the Trump administration are still around, in particular, US trade policy remains a downside risk although it appears contained for now.

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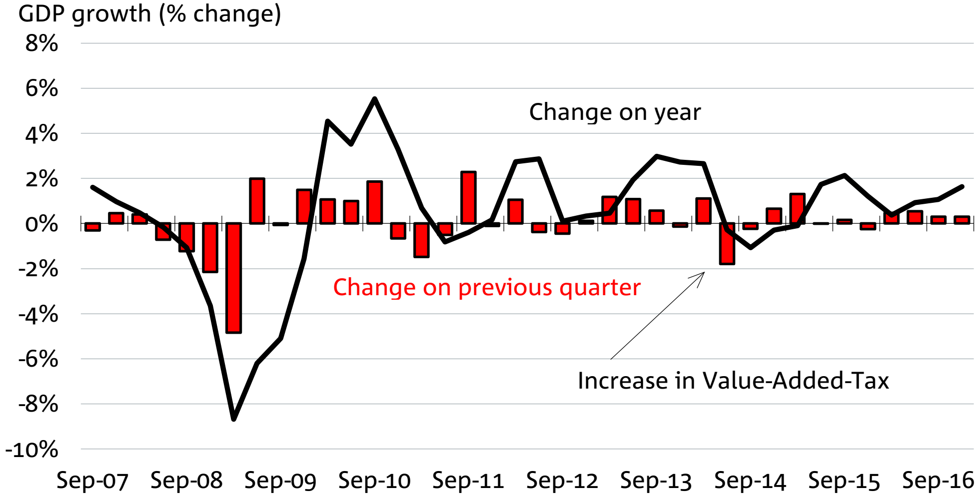
NAB Group Economics

ECONOMY REGAINED ITS FOOTING OVER 2016

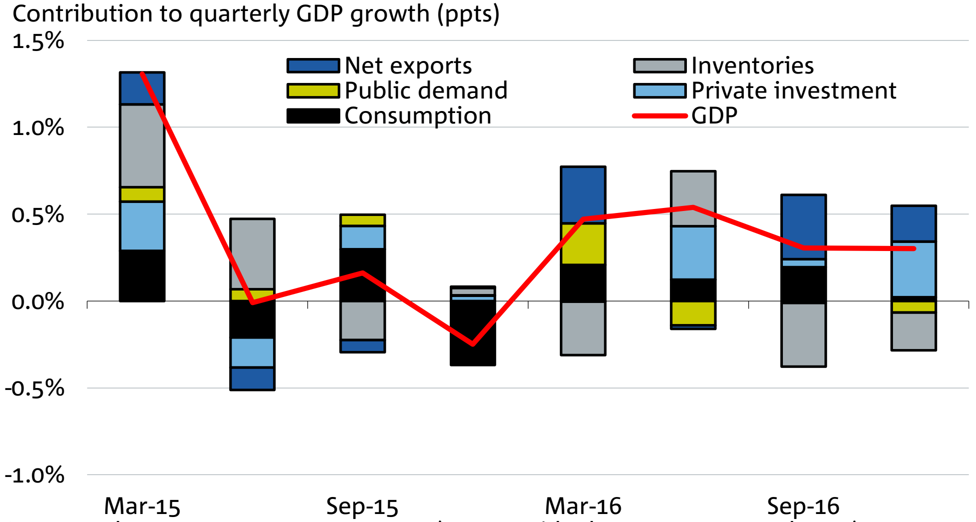
GDP grew in each quarter in 2016… the first year this has occurred in since 2005

GDP growth moved onto a more solid footing in 2016…



Sources: Thomson Reuters Datastream.

…with noteworthy support from investment and net exports



Sources: Thomson Reuters Datastream (note: residual component not shown)

- Japanese GDP grew by 1.6% between the December 2015 and December 2016 quarters. This followed a three quarter period (June to December quarters in 2015) over which GDP fell.

- With low trend rates of growth and normal statistical volatility negative GDP growth in Japan is not uncommon. However, in 2016 GDP grew in each quarter. The last time there were four quarters of GDP growth in a calendar year was over 10 years ago, in 2005.

- The details of GDP growth were also generally favourable. Business investment strengthened while net exports made a strong contribution. Business investment grew by 3.2% over the year, its strongest annual growth rate since activity was brought forward ahead of the April 2014 VAT increase. Net exports made a 0.9% contribution to growth over the course of the year reflecting both a strengthening in real export growth as well as a fall in real imports. Private consumption was solid, recording growth of 0.9% over the course of the year. In contrast, public demand only increased marginally.

- The improvement in GDP was despite a negative contribution from stocks. Over time, stocks make little contribution to growth, but the correction to stocks, particularly at the end of 2016, suggests some near term upside risk to GDP growth if stock re-building were to occur.

- Partial indicators point to a continuation of GDP growth for the first quarter of 2017. The Cabinet Office's private consumption index to February is tracking 1.0% above its December quarter average, while industrial production (manufacturing & mining) is up 0.1% and exports 3.0%. Slightly offsetting this otherwise positive picture, the tertiary sector activity index (which measures the services sector) is down slightly based on data to February. Business survey indicators are generally at solid levels, and have shown improvement over the last six to nine months. Overall, these measures indicate a solid start to the year and, reflecting this, the average analyst forecast, as surveyed by Bloomberg, is for GDP growth of 1.4% (annualised rate) in the March quarter.

- With fiscal policy and monetary policy likely to be supportive, and support coming from an improving global economy, we expect growth in 2017 to be modestly above trend.

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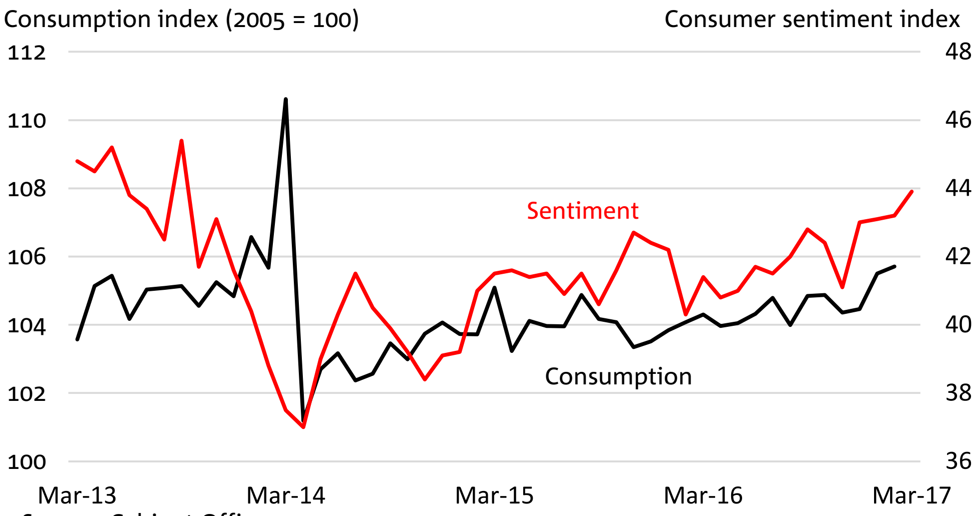
EXTERNAL DEMAND AN IMPORTANT DRIVER

Export recovery from mid-2016 but consumption also starting to recover from post April VAT slump

Export volumes started to strengthen from mid-2016

Source: Thomson Reuters Datastream. * Measured by real effective exchange rate; a lower number indicates improved competitiveness

Consumption starting to recover from post VAT hit



Source: Cabinet Office

- Over the course of 2016, GDP grew more quickly than Japanese domestic final demand. This reflected a noticeable strengthening in real export growth starting around the middle of the 2016, which accelerated late in the year and into 2017. Somewhat surprisingly, the start of this improvement occurred in a period where the Yen was appreciating leading to a decline in Japan's external competitiveness, although this had only partially eroded gains in competitiveness made since 2012.

- However, since August 2016, and particularly following the US elections in November 2016, the Yen has depreciated. Combined with an improving global economy, this should provide some future impetus to Japan's external sector.

- The main component of domestic demand is household consumption, which is equal to over 55% of GDP.

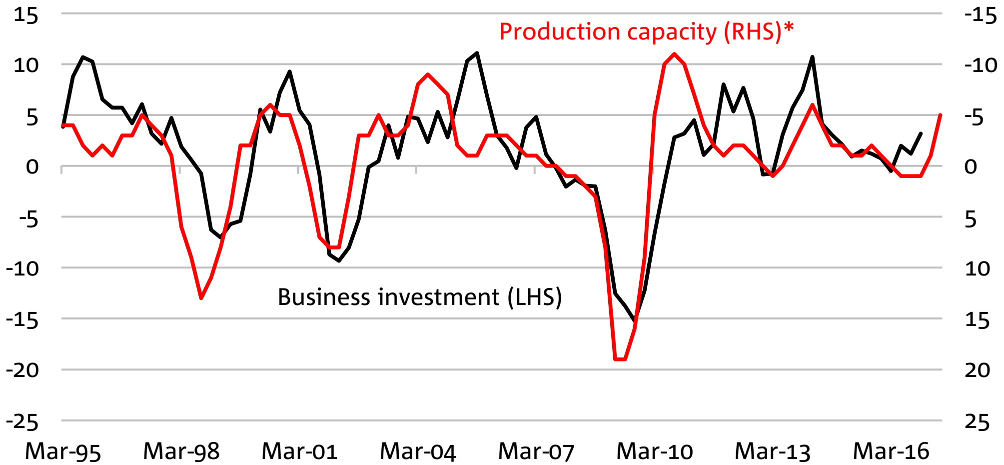
- Real household consumption took a long lasting hit following the April 2014 VAT increase; only now, three years later, is the Cabinet Office's consumption index now looking like it has risen back above pre-VAT levels (excluding the surge in early 2014 as households brought forward spending ahead of the tax increase). Of course, the VAT itself caused a reduction in households real incomes so this is not a total surprise. The decline in population over time is also a headwind to consumption growth in Japan. However, real compensation of employees – aided by the decline in oil prices and employment gains – has been rising well above actual consumption suggesting a degree of caution amongst Japanese consumers.

- Nevertheless, there does appear to be a gradual upward trend in overall consumption, which started towards the end of 2015. This has been mirrored in measures of consumer sentiment which have also shown improvement. Consumer sentiment is around the top of the range it has been since the GFC, but still remains clearly below pre-GFC levels. CPI inflation has already come off its 2016 lows and is expected to rise further, which will affect household spending power over 2017 and will likely prove to be a headwind to consumption.

CONDITIONS FAVOURABLE FOR BUSINESS INVESTMENT

Business investment growth accelerated modestly in 2016 and conditions are conducive to further gains in 2017

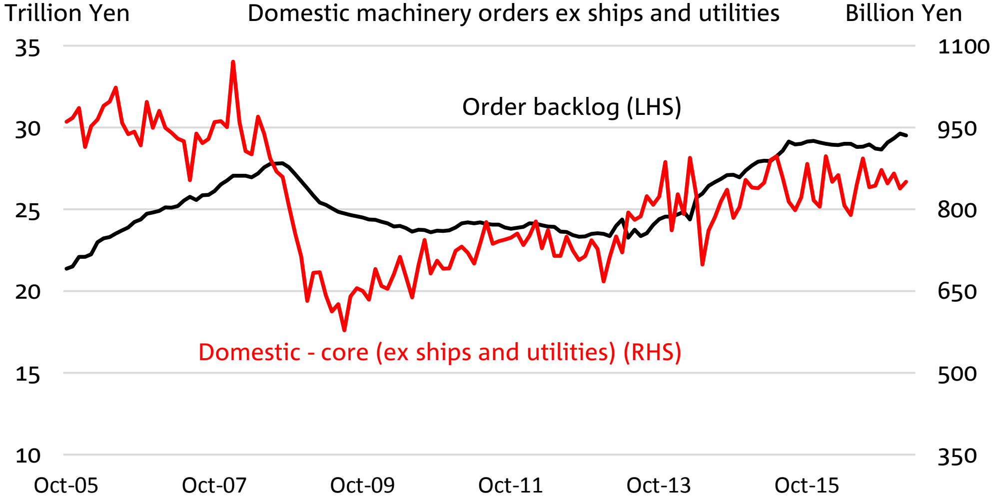
Production capacity constraints should spur further investment



Source: BoJ quarterly Tankan, Cabinet Office, NAB. * survey forecast forJune qtr 2017

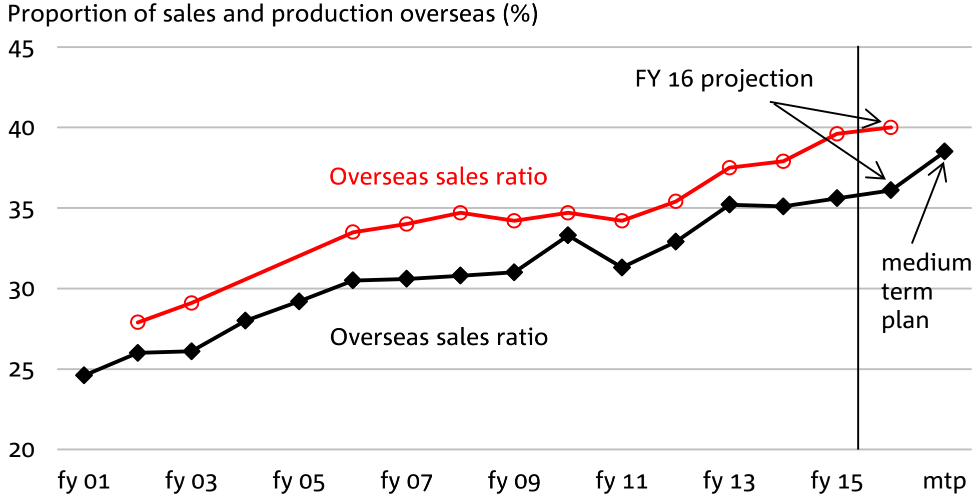
- Business fixed investment accelerated over 2016, although not to particularly high levels. Nevertheless, the annual growth rate in investment, of 3.2% yoy, in December quarter 2016 was the strongest it has been since June quarter 2014.
- Moreover, conditions are currently favourable for further investment. Responses to the quarterly Tankan survey suggest that production capacity is currently, on net, "insufficient" and historically this has been a good indicator of capex trends. The Tankan survey capex indicator also points to some moderate improvement in business investment in 2017.
- High levels of corporate profits are also consistent with solid investment, although the trend to shift production offshore, in line with the increasing importance of overseas markets for sales, will likely remain a headwind.
- While there has been no clear upturn in core (ex ships and utilities) domestic machinery orders, the investment pipeline (measured by the order backlog) has picked up.

Not yet evident in new orders, but investment pipeline is strong



Source: Cabinet Office

Shift to overseas production will hold back domestic investment



Source: Japan Bank for International Cooperation

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CORPORATE PROFITS - SOLID

Broad-based increase in corporate profitability; Toshiba a glaring exception

- Improved profitability, combined with their solid cash holdings should provide a favourable backdrop for firms to improve capital spending.
- A lower exchange rate was a factor driving the upturn in profitability during 2016. The increase in profitability was most pronounced in the December quarter, with a 16.9% yoy increase. There were a number of other drivers including: streamlining operations, lower input costs, as well as firms raising prices. Further, the low interest rate environment has lowered borrowing costs.
- ANA holdings, the parent of All Nippon Airways, recorded a 6% improvement in operating profits to JPY145bn for the year ended March 2017 due to strong demand from business travellers.
- Japan's large international shipping companies have reported an upbeat profit outlook due to restructuring operations (including selling unprofitable ships), and anticipated higher freight rates.
- Bankruptcies have generally declined since the Abenomics program commenced in 2013. Overall (listed and others) bankruptcies fell in Japan in calendar year 2016, according to Tokyo Shoko research. This decline was visible both in terms of the number of firms (4.6% fall relative to 2015), as well as value (5% decline).
- Despite this, there still remain some challenges in corporate Japan. The most glaring example is the case of electronics conglomerate, Toshiba Corporation. It suffered a USD4.81bn loss for the April-December 2016 period. The losses largely originated from its United States-based Westinghouse Electric unit.
- While there are plans afoot to spin off the company, the Japanese government is keen for the chip making business to remain in Japanese hands to safeguard Japan's industrial expertise.

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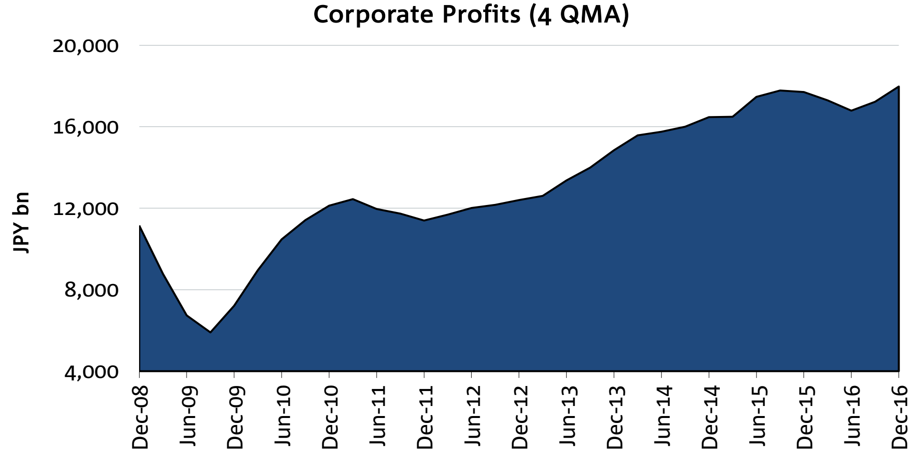
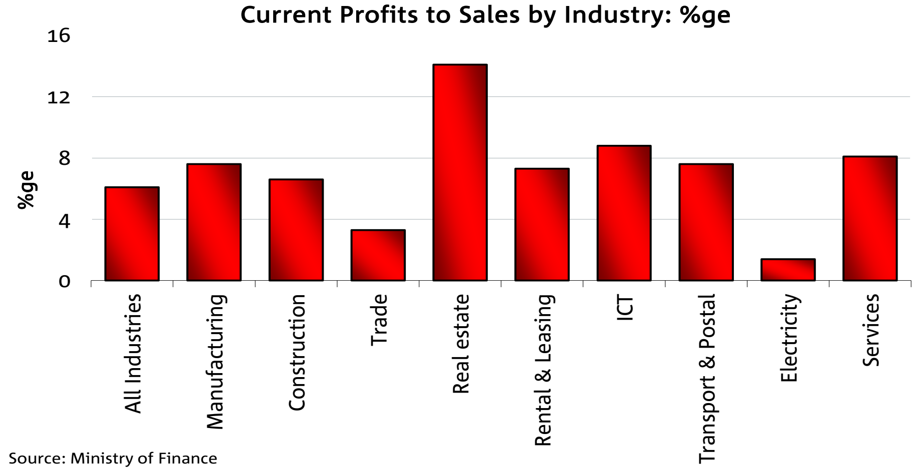
Corporate profitability: Continues to expand



Source: Ministry of Finance

Profitability: Broad-based across sectors



Source: Ministry of Finance

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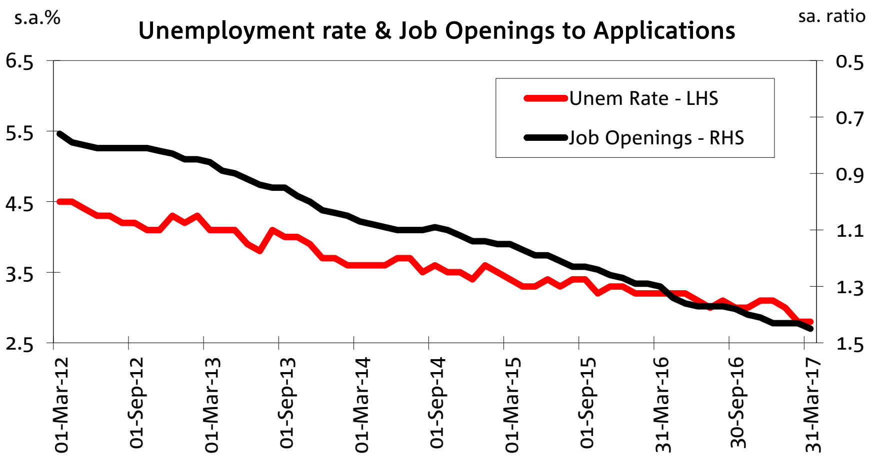
LABOUR MARKET

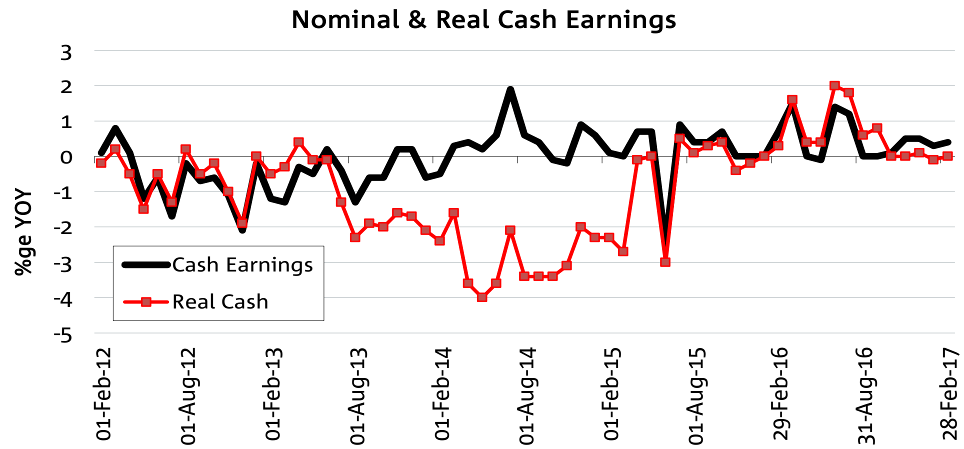
Labour market very tight with record low unemployment; yet to see meaningful upturn in wages

Low unemployment & difficulty filling jobs



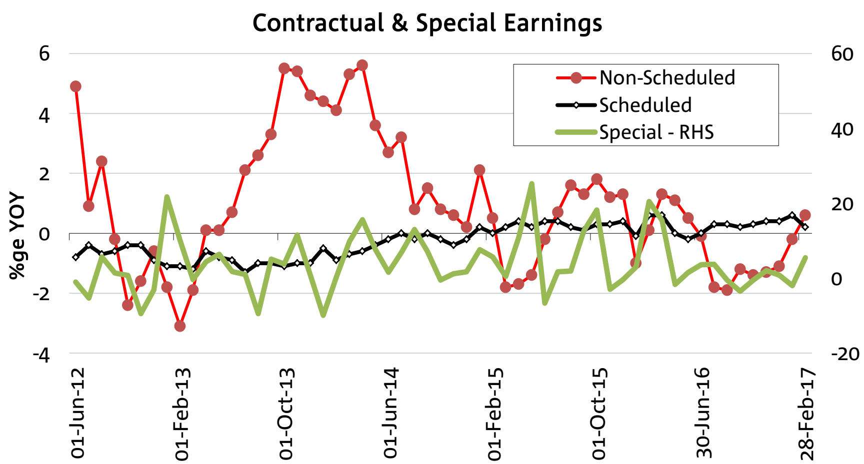
Source: Bloomberg/BOJ

Steady increase in nominal earnings



Source: MHLW

Scheduled earnings growth moderate, but stable



Source: MHLW

- Labour market conditions remain very tight in Japan, with the unemployment rate at a low of 2.8%. Securing workers is also proving problematic, with the ratio of job openings to applications at a record high of 1.45. According to think tank, Teikoku Databank, a shortage of labour was the second-biggest constraint on profitability, after consumer demand.
- Anecdotally, Yamato Transport, Japan's largest home delivery operator, is to quit providing same day deliveries for Amazon's Japan unit due to staff shortages.
- Despite the tightness of the labour market, cash earnings per employee have only risen modestly. Nominal cash earnings rose by 0.4% over the year to February, 2017, while they were flat in real terms due to a slight uptick in inflationary pressures over the past couple of months.
- By industry, cash earnings grew the strongest in finance (4.6% yoy to February 2017), while they were the weakest in the hospitality sector (-3%).
- In terms of the cash earnings, scheduled pay – which includes base pay, and is the largest component of monthly wages – expanded by 0.2% yoy to February, 2017, and has recorded positive growth since October, 2016. Non scheduled (including overtime) accelerated by 0.6% yoy in February, due to a rise in working hours focussed in the manufacturing and healthcare sectors. Special (including bonus payments) earnings grew by 5.5%.
- For its part, the Japanese government is drafting guidelines to limit overtime to an average of 60 hours/ month during a calendar year. It is also aiming to raise participation by providing improved access to childcare services, a strategy it has pursued with apparent success in recent years.

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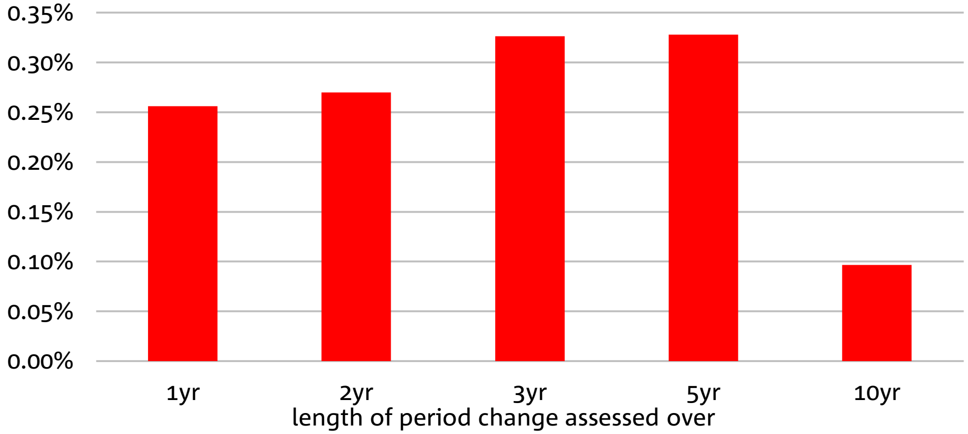
JAPAN REMAINS A LOW GROWTH ECONOMY

Trend growth higher than previously thought but declining population & productivity slowdown still point to a slow growth economy

Past GDP growth revised higher...suggesting stronger trend

Change in average GDP growth due to methodology changes* (annual, ppts)

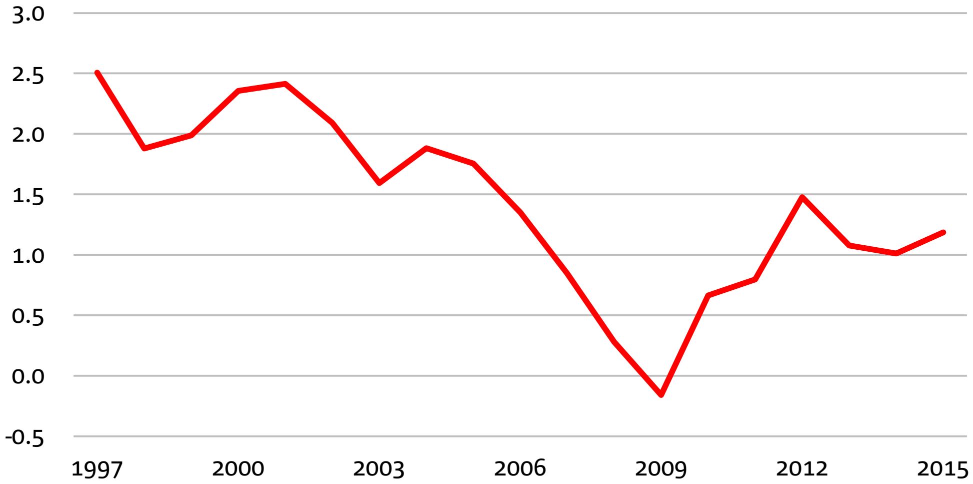


Source: Thomson Reuters Datastream (Cabinet Office), NAB. * Refers to implementation of 2008SNA in the second preliminary estimate of 2016 Q3 GDP

- Changes made by the Cabinet Office last year suggest that the economy has been on a faster growth track than previously thought, particularly over the last five years.
- Partly as a result of this, the Bank of Japan has raised its estimate of potential Japanese annual growth from 0 to 0.5% up to 0.5-1.0%.
- However, even with this higher estimate of Japan's growth potential, it remains, by international standards, a slow growth economy. One factor behind this – its declining population and aging society – is well known.
- Another factor is that Japan, like many other economies, has experienced a decline in productivity growth since the GFC.
- An economy can grow faster than its 'potential' rate while it has spare resources (e.g. unemployment is high or manufacturing plants are idle. However, while we expect Japan to continue to grow at an above trend rate in 2017, the scope for this to continue for much longer is limited. This can be seen by survey measures of capacity which point to significant labour shortages – consistent with the very low unemployment rate - and insufficient production capacity.

Productivity growth has moved lower post GFC

GDP per hour worked, annual % change (3 year moving average)

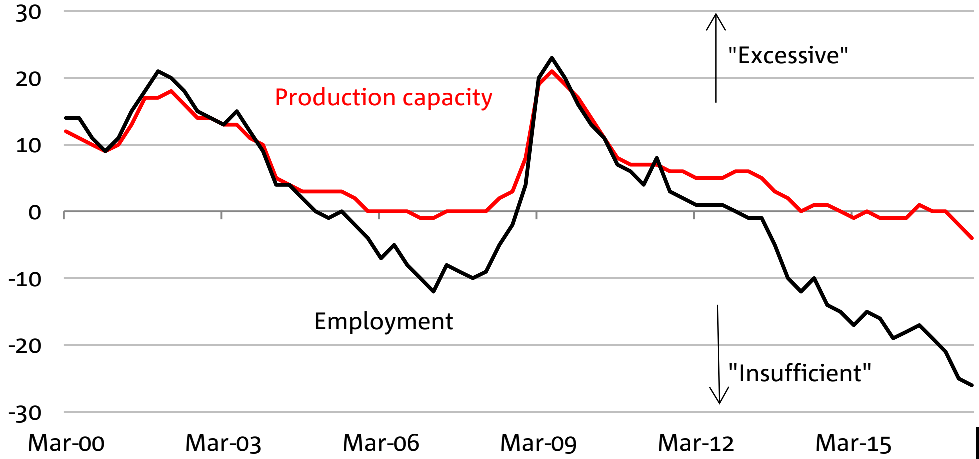


Source: OECD, NAB

Source: NPCI

Capacity constraints a limit on growth

Capacity measures - all enterprises (net balance %)



Source: BoJ quarterly Tankan; Survey forecast for June qtr 2017

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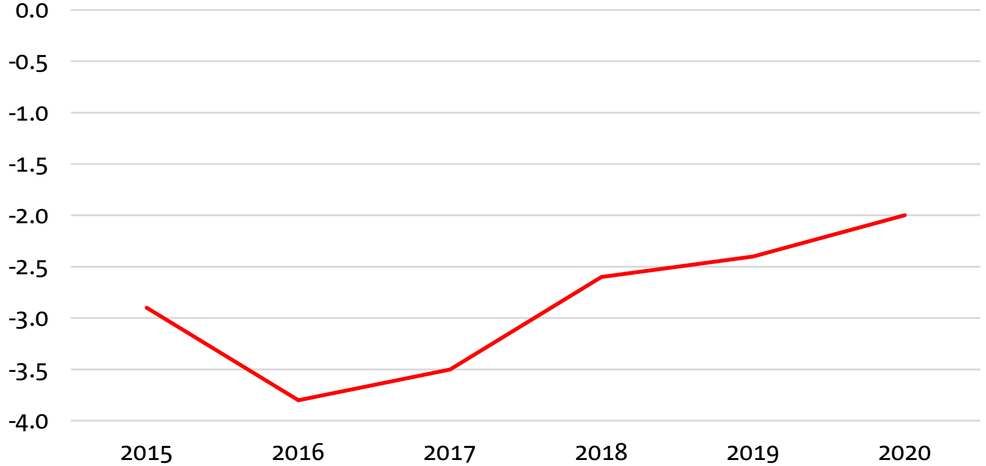
FISCAL POLICY PROVIDING A SHORT TERM BOOST

Fiscal policy turned stimulative in f.y. 2016 …full impact yet to be felt; longer term fiscal outlook clouded but likely to be more restrictive

Fiscal policy turned stimulative in f.y. 2016

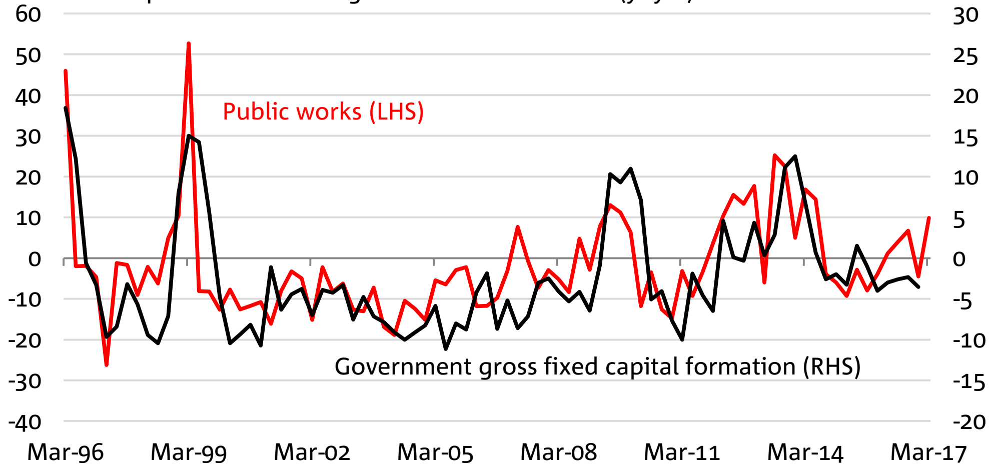
Central and local government primary balance, financial year (% GDP)



Source: Cabinet Office (baseline scenario)

Now showing up in orders but still to be felt in activity measures

Contracted public works and government investment (yoy%)



Source: Cabinet Office, East Japan Surety Company

- Fiscal policy turned supportive for the economy in the fiscal year just passed (the Japanese fiscal year runs from April to March). Following declines in the central and local government deficit (as a % of GDP) between fiscal year (f.y.) 2012 to 2015, the deficit increased in f.y. 2016 by 0.9% of GDP. With the stimulus for the whole year mainly coming from the second supplementary budget - only passed in October 2016 - and with the third supplementary budget only passed at the end of January 2017, the impact of the loosening in fiscal policy is yet to be fully felt.

- This can be seen in measures of contracted public works. Annual growth in this measure has been trending up, particularly in the first quarter of 2017. However, measured public investment – available only to end 2016 – has been declining.

- While fiscal policy may be expected to be a positive near term influence, over the medium to longer term the picture is clouded. Projections by the Ministry of Finance suggest that starting in f.y. 2017 the deficit will resume its downward trajectory as the Government tries to make progress towards its fiscal targets in order to address concerns over Japan's large public debt. In contrast the Bank of Japan expects public investment to rise in f.y. 2017 and then remain at a high level in f.y. 2018 due to Olympic games spending.

- The Government has a stated target of eliminating the primary budget deficit by 2020. However, the Ministry of Finance's projection's showing that the government is not on track to meet this goal, even with optimistic economic assumptions.

- This suggests that the Government will either have to delay or weaken its targets or look for revenue increases or spending cuts. There is speculation that the Government will take the first option. Indeed, over its lifetime the Abe government has shown a willingness so far to implement additional spending as required (in the form of supplementary budgets) and defer fiscal repair measures such as the long-muted second round increase in the VAT (now scheduled for October 2019, after having originally been scheduled for October 2015). Moreover, there is a debate going on within Japan about the role of fiscal policy in the current environment of negative interest rates and a central bank struggling to raise inflation to its target level, which may persuade the government to take a less restrictive stance.

- Overall, we think that the most likely result is for a slow, uneven, reduction in the budget deficit over time.

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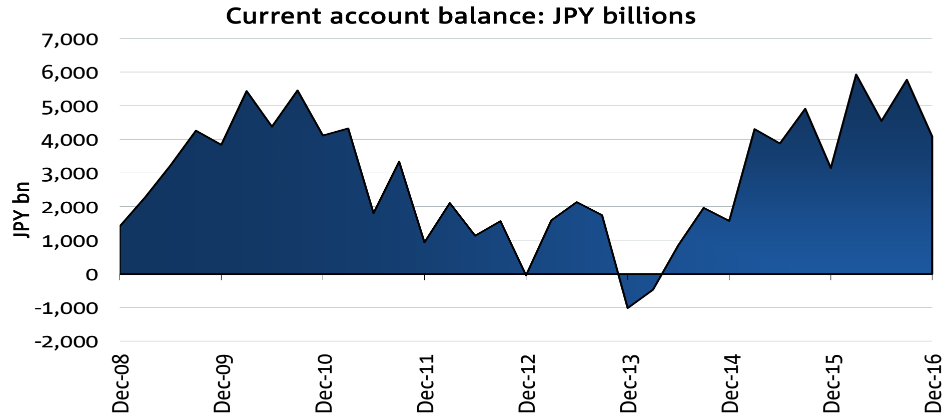
CURRENT ACCOUNT

Merchandise trade turns in a positive contribution for the first time since 2010

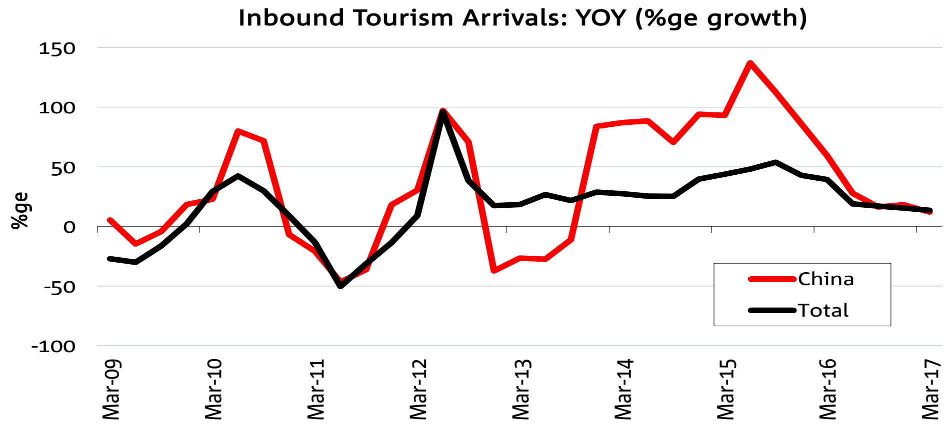
- Japan posted a JPY20.3tn current account surplus in 2016, a 25.3% yoy increase. Primary income – reflecting Japan's strong investments overseas - was the main contributor. However, the most interesting aspect was the JPY55.2bn surplus in the merchandise trade balance. This is the first merchandise trade surplus since 2010, and reflects, in part, automobile shipments to the United States and China, and electronic exports to Asia. Lower oil prices helped to contain the merchandise imports bill.
- There were 24 million international visitor arrivals in Japan in 2016: a 21.8% yoy increase.
- Japan continues to benefit from its reputation as a desirable tourist destination. The hosting of the 2020 Olympic Games in Tokyo has added to the allure of the country among overseas visitors.
- China continues to be an important source of international visitors. However, the growth rate in Chinese visitor arrivals is now in line with the overall rate.
- According to the Japanese National Tourism Organisation, there has been a significant increase in visitor arrivals from South East Asia, particularly Indonesia, Vietnam and Philippines.
- The growth in tourism numbers is expected to have positive spillovers for the economy, including the retail sector.
- Tourist spending has shifted from designer bags and watches to items such as cosmetics. It also planned to introduce the Alipay – the Chinese mobile-payment service – to improve accessibility for Chinese tourists.
- A risk is that trade might be impacted due to uncertainties about the policies of the Trump Administration, particularly for Japanese automobile exports.
- There is currently a bilateral dialogue underway between Japan and the United States, under the auspices of Taro Aso, Japan's Finance Minister and Steven Mnuchin, United States Treasury Secretary, which should address potential trade frictions between the countries.

Current account surplus increased 25% in 2016



Source:EconData DX

Inbound tourism: Solid growth; China in line with overall

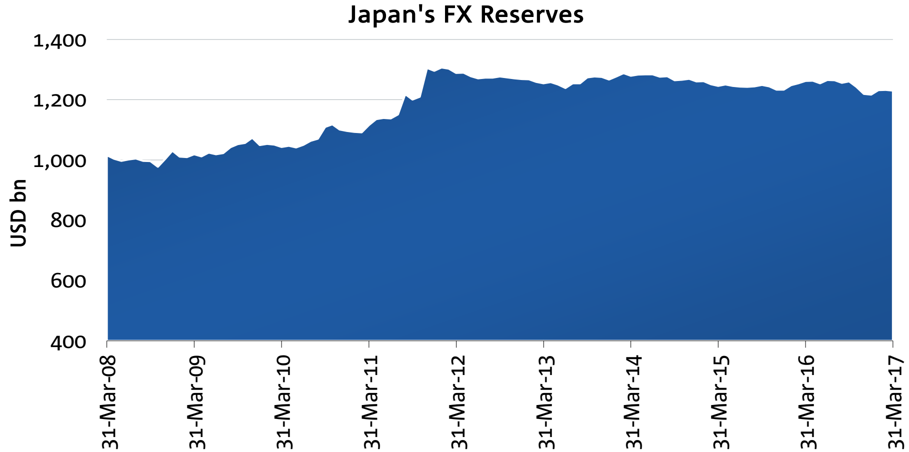


Source:EconData

VERY STRONG EXTERNAL FUNDAMENTALS

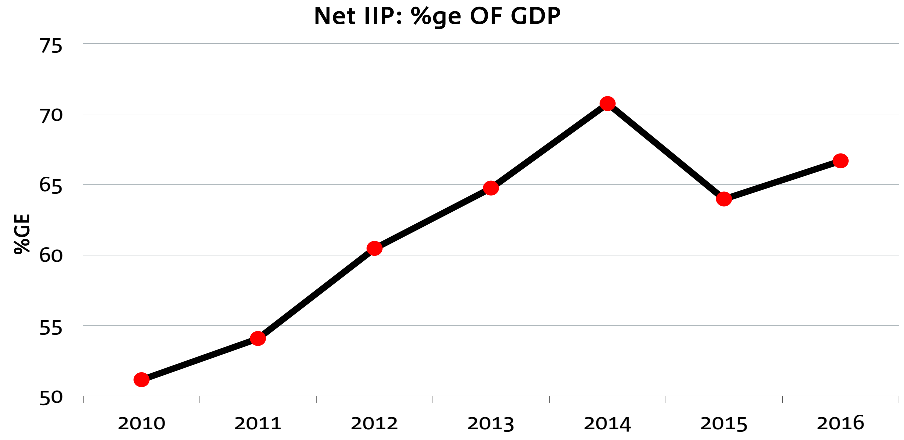
Japan's external strength is a factor why the JPY is viewed as a 'safe haven' currency

FX Reserves: Second highest after China



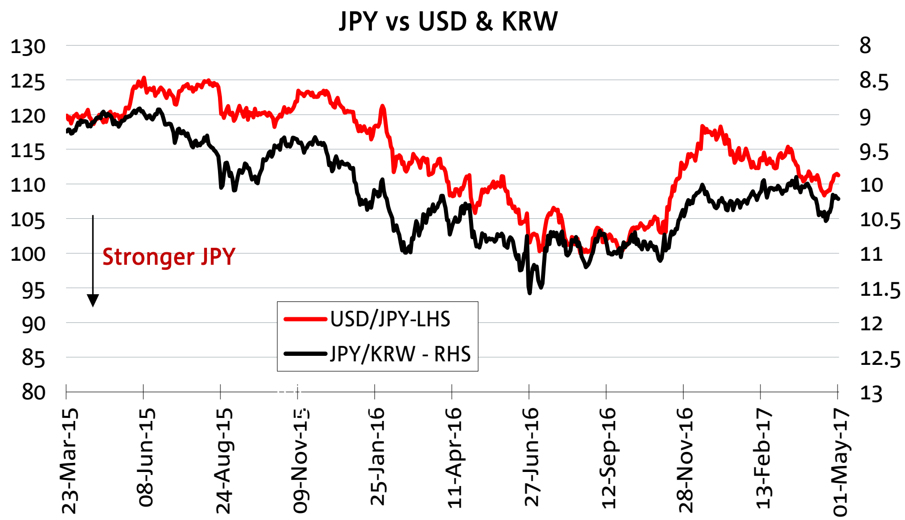
Source:Bloomberg

Japan has significant overseas assets



Source: Ministry of Finance

JPY – Eased somewhat since mid-late 2016



Source:Bloomberg

- FX reserves as at the end of March 2017 were USD1.23 trillion – the second highest in the world after China.
- Japan has significant overseas assets, and is a major purchaser of overseas businesses. Its Net International investment position (IIP), or net foreign assets, amounted to 67% of GDP. It picked up in 2016, after easing somewhat in 2015.
- Given unfavourable demographics and relatively cheap borrowing costs at home, a number of Japanese companies have been investing overseas to augment their returns.
- One of the biggest deals was Soft Bank's USD30.1bn purchase of British chip maker, ARM holdings. According to the *Nihon Keizai Shimbun* publication, this was the largest overseas acquisition by a Japanese business.
- Foreign acquisitions were prevalent across a number of sectors, including food retailing, heavy equipment manufacturing and pharmaceuticals.
- The election of President Trump in November led to a depreciation in the JPY against the USD, as investor bet on the reflation trade, in anticipation of President Trump's infrastructure spending program. Some of that enthusiasm has now waned. The JPY is currently around 111 to the USD. NAB FX strategy is forecasting the JPY to ease to 114 by June 2017 and 118 by December 2017, due to a widening differential in real yields between US and Japan on account of expected tightening by the US Federal Reserve.
- The Japanese Yen is regarded as a safe-haven currency by financial markets, and appreciates in times of financial and geopolitical stress. This safe have status stems largely from Japan's extremely strong external position.

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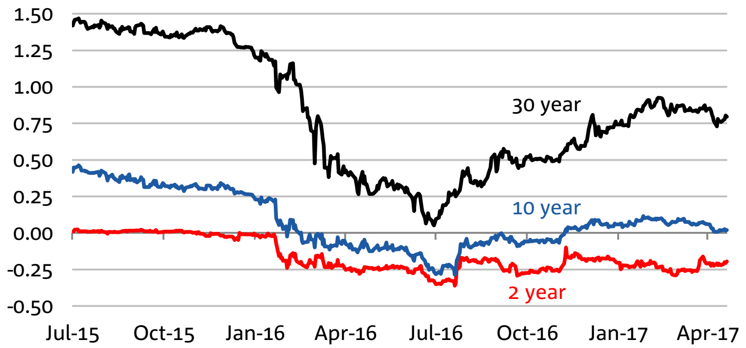
LOOSE MONETARY POLICY BUT INFLATION STUBBORNLY LOW

BoJ expected to remain on hold for an extended time

BoJ targeting 10yr bonds of around zero

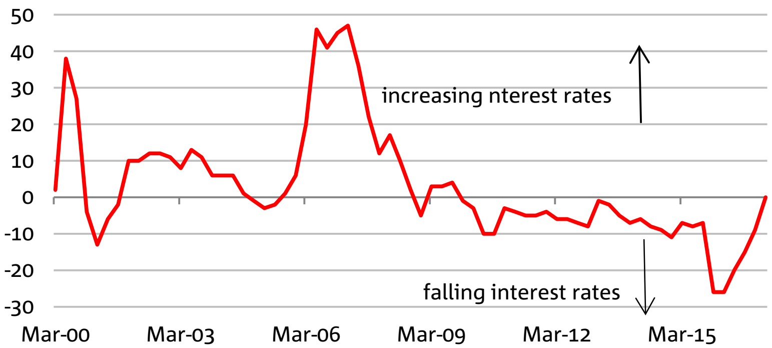
Japanese Government bond yields (%)



Source: Bloomberg; data to 27 April 2017

Businesses have seen a fall in loan rates

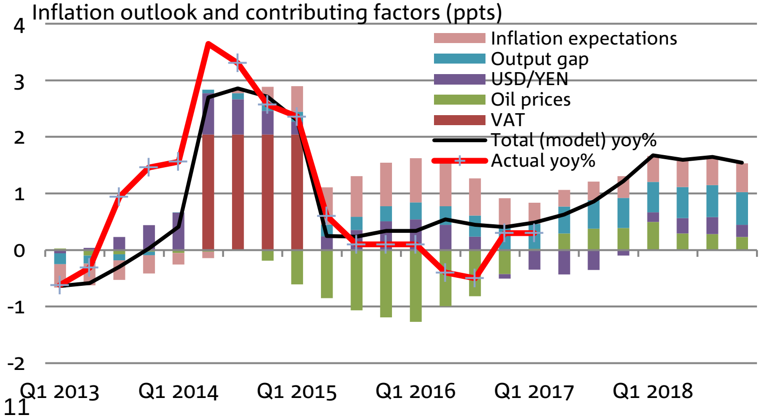
Change in interest rate on loans - all enterprises (net balance %)



Source: BoJ quarterly Tankan.

Inflation to rise, but fall short of BoJ target

Inflation outlook and contributing factors (ppts)



- The Bank of Japan (BoJ) is currently running a very loose monetary policy as it attempts to get Japan's inflation rate up to 2% on a sustainable basis.

- For several years the BoJ has pursued QE (large scale asset purchases, principally Japanese Government bonds or JGBs) but in January 2016 they introduced a negative rate for a portion of banks' deposits at the BoJ, and in September 2016 they introduced "yield curve control". Under the latter policy, the BoJ purchases sufficient 10-year JGBs so that the their yield remains around zero. The BoJ also introduced an "inflation overshooting commitment" in which they commit to asset purchases until inflation stays *above* the 2 % target in a "stable manner". The aim of this commitment is to underscore the credibility of the BoJ's inflation target and an assessment that a period of above target inflation may be needed to entrench higher inflation expectations.

- The BoJ has been successful to-date in keeping yields at around zero, even as global yields rose sharply following the US Presidential election, although longer term yields rose more noticeably. The resulting widening of the US/Japan 10-year government bond yield spread contributed to an associated depreciation of the Yen – effectively a loosening in financial conditions. As other central banks tighten (US) or scale back expectations of future loosening (ECB) then by fixing the yield (at least up to 10 years) Japan may get additional stimulus in the future through the exchange rate channel without the BoJ having to do any further work.

- Apart from the exchange rate channel, businesses are also seeing lower rates on loans. This has been the case for a while but the proportion of businesses reporting declining loan rates picked up sharply following the introduction of negative deposit rates.

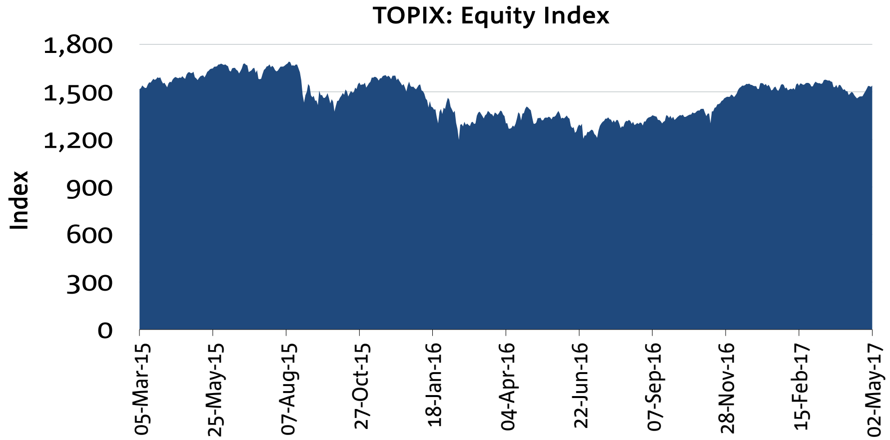
- Even with the current very loose monetary policy in place, the BoJ has struggled to make much progress in reaching its 2% inflation goal. Headline CPI inflation in February was 0.2% yoy, while ex fresh food and energy it stood at -0.1% yoy. The low rate reflects past oil price falls and Yen appreciation. However, with both of these headwinds fading and turning into tailwinds inflation is expected to strengthen from current levels. The tight labour market and indications of insufficient production capacity should also add to price pressures over time. Nevertheless, our inflation model suggests that, under current policy settings, the BoJ will struggle to meet its 2% inflation target.

- The BoJ has a more optimistic view, expecting CPI inflation to reach around 2% in fiscal 2018. However, it acknowledges that "the momentum toward achieving the price stability target…is not yet sufficiently firm." There is concern by some BoJ members that the current bond purchase program will at some point negatively impact on the functioning of the Japanese government bond market; while not the majority view it may add to BoJ caution and mean that further policy action won't be pre-emptive and will wait until it is clear that it is falling short of its targets before undertaking further action. As a result, for now the BoJ seems content to maintain existing policy settings for an extended time.

FINANCIAL MARKETS

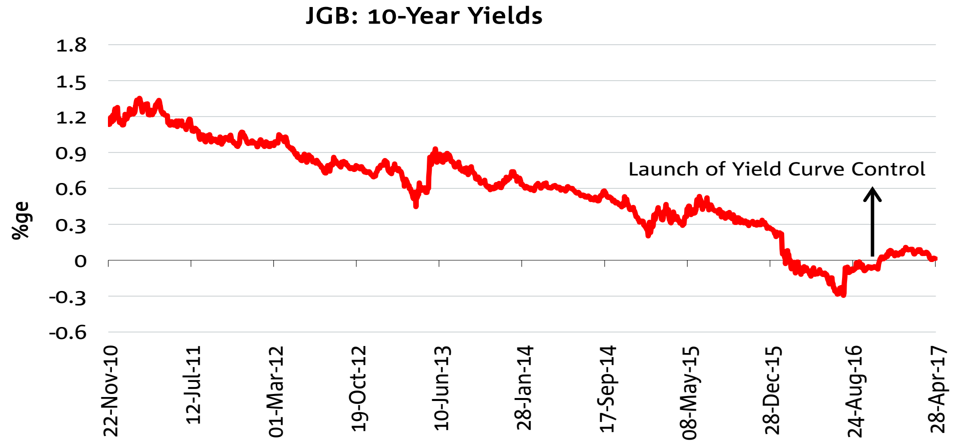
Equities edge up slightly in 2017; bond market largely determined by BOJ operations

Equities: Slight improvement in 2017



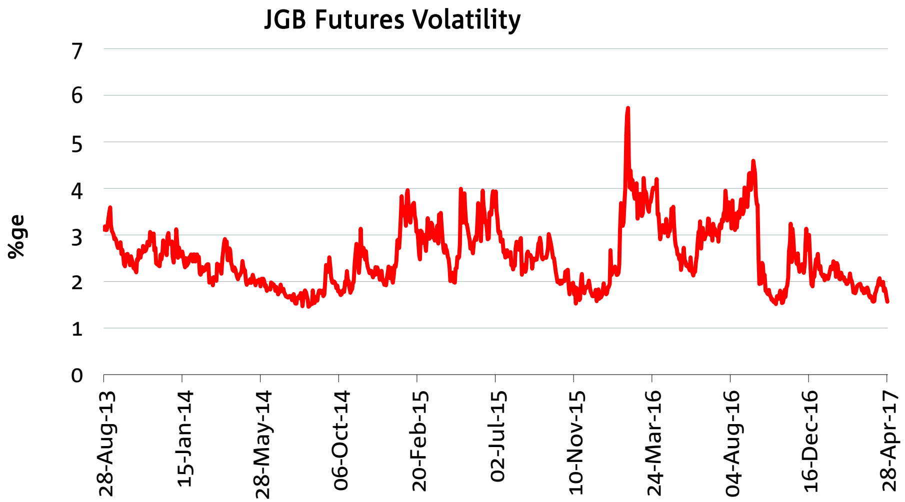
Source: Bloomberg

BOJ' Yield Curve Control maintains 10-year yields around 0%



Source: Bloomberg

JGB Volatility low due to BOJ purchases



Source:Bloomberg

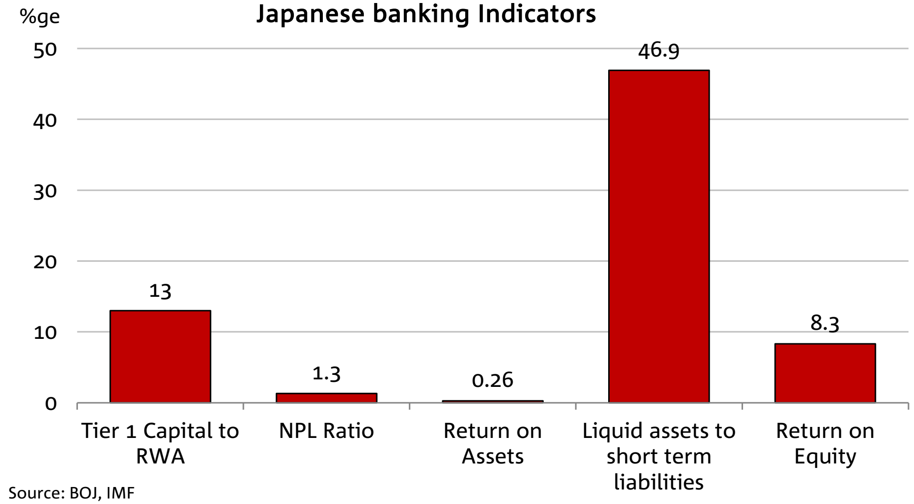
- Japan's benchmark Topix index has increased by 2.1% since the beginning of 2017.
- Japanese equities have been negatively impacted by equity sales from foreigners. Concerns that the Trump's administration infrastructure program may not go ahead, and the modest medium term outlook Japan's domestic demand have been important considerations for overseas investors.
- However, it has not all been one-sided. Overseas investors have shown interest in well managed companies, with favourable governance and/or growth opportunities. The most recent data released by the Tokyo Stock Exchange revealed that foreigners purchased a net JPY102.7bn of Japanese equities during the week commencing April, 17th.
- Benchmark JGBs have been hovering around 0%, influenced by the BOJ's yield curve control policy. Further, the BOJ's purchases have kept JGB volatility low.
- The low volatility belies a somewhat impaired JGB market. The BOJ holds around 40% of outstanding JGBs. BOJ operations have, at times, led to a scarcity of bonds, leaving financial institutions increasingly reliant on the BOJ's securities lending facility. The BOJ charges an annualised rate of 0.5% for providing this service.
- Japanese megabanks have substantially reduced their holdings of JGBs, and major life insurers too plan on curtailing their JGB holdings.

National Australia Bank

BANKING SECTOR

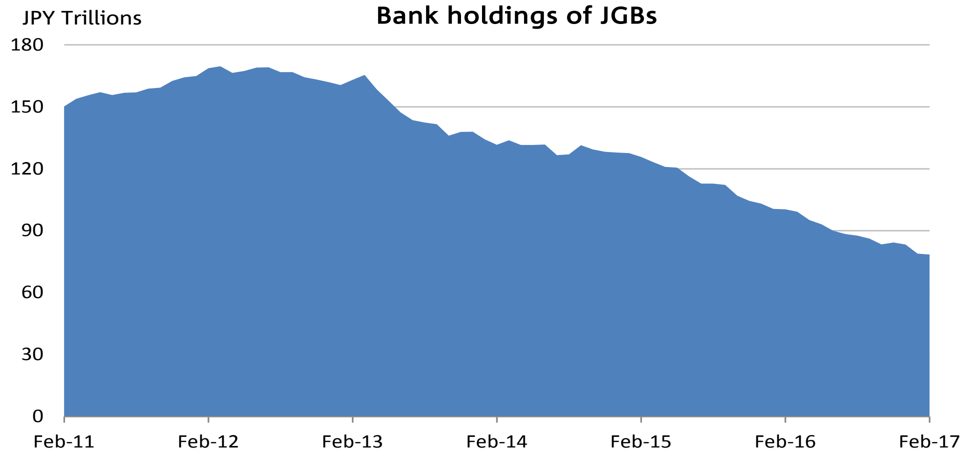
Broadly stable; the upsurge in real estate lending and elevated US dollar funding premiums pose challenges

Adequate capitalisation & low NPL's



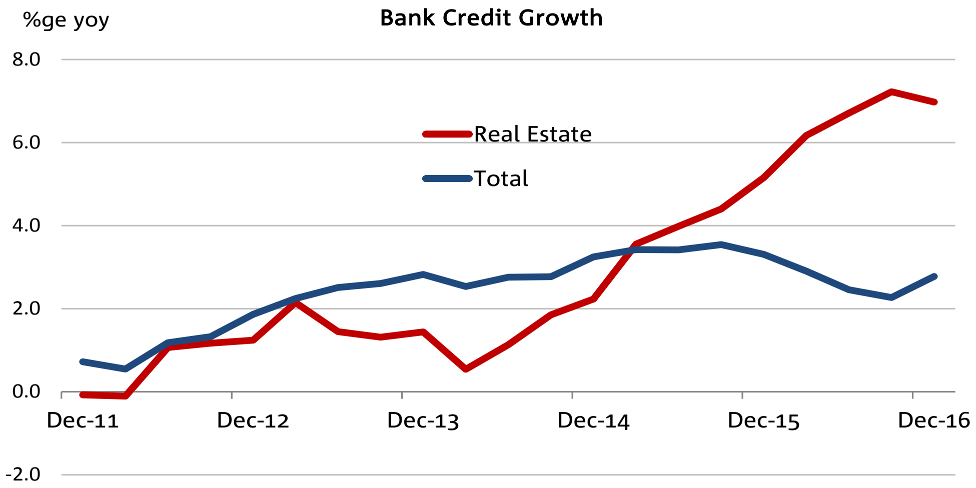
Source: BOJ, IMF

Banks' JGB holdings fall due to BOJ purchases



Source: BOJ

Lending to real estate significantly outpacing system



Source: BOJ

- The Japanese banking system is stable, with the Tier 1 capital ratio at 13%, and Non performing loans at a modest 1.3% of outstanding loans.
- Japanese banks have halved their exposure to JGB's since the BOJ commenced Quantitative easing in April, 2013.
- According to ratings agency Fitch, the megabanks' domestic franchises ensure sufficient JPY retail funding. However, overseas funding could be more challenging as it tends to be wholesale in nature: customer deposits, commercial paper, repos, debt and currency swaps. This external funding pressure could increase with expected rises in US interest rates.
- System credit expanded by 2.8% yoy to December 2016 among domestically licensed Japanese banks. However, lending to the real estate sector grew by 7% yoy. Outstanding loans to the real estate sector totalled JPY70.35tn, 15% of total lending.
- The current low interest rate environment has increased the allure of lending to real estate investment trusts. Further, individuals too are looking at real estate investments too boost returns.
- In its latest Financial Stability Review, the BoJ indicated that financial institutions with significant real estate exposure could suffer adverse effects in the event of a negative shock to sector. The BoJ recommend banks improve their risk management frameworks.

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