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BOJ TANKAN— POSITIVE DECOUPLING

Jesper Koll, Senior Advisor, WisdomTree

The latest Bank of Japan (BOJ) Tankan survey[1] of Japanese business conditions points to an increasingly positive gap in Japan's macroeconomic conditions. While manufacturers have been pulled into a slowdown-induced global recession, the domestic small and medium-sized non-manufacturing sector continues to expand. In other words, domestic demand appears to be decoupling positively from the global cycle.

The diffusion index (DI)[2] for large manufacturers dropped by a worse-than-expected 7 points, but it rose by 1 point for small non-manufacturers (against market expectations for a 2-point decrease). Even for large non-manufacturers, the 4-point decline in the DI is almost entirely due to the wholesale and transport sectors, which are highly geared into the industrial cycle. Meanwhile, the pure domestic sectors help out relatively well.

For policy makers, this is good news but leaves no room for complacency. Clearly, the positive dynamics in the domestic service sector will be challenged by the hike in the consumption tax, due October 1. To counter, the government just passed a fiscal package of ¥2 trillion designed to offset the loss of purchasing power (making education free, offering cash bonuses for home purchases and providing a 5% rebate for cashless consumer purchases). In our view, these measures will significantly offset the negative demand impact from the tax hike on the non-tradable-goods sector. However, we should expect more calls for added fiscal stimulus ahead of the tax hike. If the downturn in industrial and tradable goods fails to stabilize, some politicians may even propose postponing the tax hike altogether (which I do not expect Team Abe will do). As a result, the next two or three months are key.

Personally, I do expect signs of an industrial upturn in the coming quarters. China holds the key, with the combination of policy stimulus and a positive conclusion of the U.S.–China trade talks poised to trigger a positive inflection in the global and Japanese industrial cycles. In my view, the market is positioned for a change in performance leadership, with exporters expected to lead Japanese performance in the coming quarters.

[1] Tankan: Short-Term Economic Survey of Enterprises in Japan issued by the Bank of Japan.

[2] Diffusion index: Used in technical analysis, a diffusion index measures the number of stocks that have advanced in price or are showing positive momentum. It is useful for determining the underlying strength of the stock market overall, as a large number of stocks advancing shows a strong market, while few(er) stocks advancing shows a weaker market.

Back in Japan, the Tankan result in planned business investment is adding fuel to cyclical optimism. For the new 2019 fiscal year, companies are budgeting an increase of 1.2%. While this is lower than the exceptionally bullish 2.3% flagged at this time last year, it follows after a realized 10.4% surge in the 2018 capex[3]. So, yes, we are past peak momentum in the capex cycle, but the overall expansion continues.

But what about the BOJ? We maintain our call that Japan in 2019–2020 is focused on fiscal and regulatory policy, with the BOJ sidelined into inactivity. Two external factors could change this: either an earlier-than-expected rate cut from the Federal Reserve, a China currency devaluation—or perhaps both. Either way, fears of a BOJ exit from the current policy framework have now become fully asymmetric, tilted toward added ease. Personally, I expect no action until well after the 2020 Tokyo Olympics.

[3] Capex: Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations..