BOJ TANKAN: LOWERING THE BAR

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The latest Bank of Japan (BOJ) Tankan survey confirms five fundamental trends in corporate Japan:

1. Forecasts for profits and sales have been cut again, which, in our view, confirms that corporate managers have become extremely proactive to manage expectations. Specifically, large companies—which are basically the ones listed on stock exchanges—are now forecasting a 6.1% fall in current profits in fiscal year 2018 (after a 17.3% rise in fiscal 2017). The principal driver is a sharp deterioration in sales growth, now expected to rise a mere 1.9% in fiscal 2018 (after a 5.8% rise the previous year). In our view, this is extremely conservative, and positive surprises on top-line sales growth are likely to force positive upward revisions to earnings in coming quarters. After all, neither domestic nor global growth is decelerating that dramatically. Note: for every 1% that sales come in above budgeted baselines, profits should get boosted by approximately 8%.

2. Corporate budgets for foreign exchange rate assumptions underscore the drive to caution. Large industrial companies are now budgeting for an average ¥107.3 against the U.S. dollar for fiscal 2018, which is more conservative than the ¥109.7 expected three months ago. Again, every ¥1 of yen weakness relative to the baseline generates windfall profits of as much as 1%.

3. Business investment is tuning into a key demand driver. Capex plans were revised up sharply. All industries are now budgeting for a 7.9% increase in business investment in fiscal 2018, up from a .7% drop indicated in the previous survey three months ago. Importantly, Japan's newfound investment drive is led by investment in productive capital, software and R&D, rather than land purchases. In fact, land purchases are budgeted to drop 30.6% in fiscal 2018 (after a 3.3% drop the previous year). This bodes well for future productivity growth, as well as top-line sales growth for capital goods suppliers.

4. Overall business conditions appear more or less stable, but two sectors report a deterioration that deserves attention: among industrials, car companies reported a sharp deterioration—the headline direct investment (DI) dropped from +22 to +15, a clear early warning of the potential negative impact of U.S.-led protectionism against Japanese carmakers. More worryingly, the retail DI plunged from +11 to 0. The fact that the DI for Service for Individuals surged from 27 to 37 suggests that consumer spending is still accelerating smartly, but this continued rebound in individual spending is bypassing the traditional retail outlets. While this makes it difficult to assess the true strength of consumer spending, the probability of more intense M&A and consolidation in Japan's consumer services industry is growing.

5. Finally, price and inflation data suggests no change in the current Japan equilibrium: there appears to be no significant inflationary pressures. If at all, the newfound corporate investment spending push combined with new retail channel disruption suggests that the purchasing power of the Japanese people is likely to rise further from here.

All said, we maintain our view that corporate profits are ready for a positive upward revision cycle in the coming six months. Our forecasts expect profits to rise by about 12% in fiscal 2018. The Tankan confirms very conservative corporate benchmarks that raise the confidence in our positive forecast expectations.

All data sourced from the Bank of Japan's June 2018 Tankan survey, released on July 2, 2018.

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DEFINITIONS

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

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.

Inflation : Characterized by rising price levels.