

Japan Data Suggests Easing Bias—and a Political Update

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The latest Tankan report of Japanese corporate conditions makes a good case for the Bank of Japan (BOJ) to reassert the need for continued easing bias in the upcoming April 26th-27th BOJ policy board meetings. There is no “smoking gun” on inflation, but the business cycle has rolled over: this Tankan shows the first drop in overall conditions in two years.

The Tankan report also suggests positive structural change, with corporate investment in both research and development and information technology expected to accelerate, while land purchases are cut sharply, depressing the overall capital expenditure (capex) outlook. Corporate Japan is focused less on asset purchases and more on productivity enhancers.

Finally, the profit outlook strikes me as overly conservative, with positive surprises on sales growth likely to deliver a new earnings revision up cycle in coming quarters.

- **Overall Conditions:** Although overall business conditions remain at a high positive level, they dropped for the first time in two years, indicating a loss of positive momentum.
- **Equity Investors' Focus:** The most positive aspect of the Tankan is the very conservative profit outlook. After a 7.1% rise in current prices in fiscal year 2017, companies forecast a drop of 1.5% for fiscal 2018.

The principal reason is a very conservative top-line sales outlook: after a 3.1% rise in sales in fiscal 2017, companies are budgeting for merely 1% sales growth in fiscal 2018. Given that sales are highly correlated to global GDP growth, this strikes me as an overly conservative baseline that should leave room for positive revisions upward in coming quarters.

However, in contrast to what I see as overly pessimistic sales forecasts, the foreign exchange assumption is still biased toward yen depreciation. After budgeting for \$110.7 for fiscal 2017, \$109.7 is assumed for fiscal 2018.

All said, the Tankan suggests a good probability of a new positive earnings revision up cycle from here, primarily because of better-than-budgeted top-line sales growth. For equity investors, this is the key takeaway from the report, in my view.

- **Quality of Capex Improving:** The domestic business investment cycle has probably peaked, but the composition of capex plans is actually improving, away from land purchases and toward higher software/IT investment. This suggests structural change and rising probability of positive productivity growth ahead.

The data shows that overall business investment is budgeted to go from +4% in fiscal year 2017 to -0.7% in fiscal 2018. This is because land purchases are set to plunge 31.4% in fiscal 2018 (they fell 11.3% in fiscal 2017).

Excluding land purchases, capex is budgeted to rise 2% in fiscal 2018 (was +4.2% in fiscal 2017). Here, IT and software investment is set to rise 8.1% in fiscal 2018, up from +3.7% in fiscal 2017; R&D investment is budgeted to rise 1.5% in fiscal 2018, after +1.3% in fiscal 2017.

While this spells more negative news for the commercial real estate market, it does raise the probability of positive structural change—productivity and competitiveness should start to rise. Capital deepening is getting real.

Also, here's a quick update on Japan's politics:

The probability of Prime Minister Shinzo Abe staying in power has significantly increased after parliamentary testimony by the senior Ministry of Finance (MOF) official. There was no smoking gun, no traceable evidence implicating PM Abe and/or his wife to a real estate scandal. Abe was given the green light, and it was confirmed he will go to the U.S. and meet President Trump on April 18.

From here, the opposition parties may insist on setting up a parliamentary investigation, but the issue has now become very diluted, with broad cultural practices of politician-technocrat relations on the table. Unless new evidence comes forward, Abe is safe, in my view.

I do expect that the current head of the MOF, Taro Aso, may eventually resign and that Abe will offer the top MOF spot to Fumio Kishida, who is the second in command in Aso's faction. Aso would stay on as deputy prime minister.

For policy, there is no de facto implication. Kishida is, like Aso, a simple follower of technocrat guidance, with no strong or independent views.

The key trigger points going forward are all likely to raise credibility that, yes, the BOJ will not change policy and maintain the zero-rate cap for the foreseeable future, regardless of Federal Reserve moves.

The weak Tankan survey discussed above can be attributed to yen strength, the housing downturn, weak U.S. car sales and trade-war fears for a cyclical drop-off.

After the Tankan, we get the first BOJ board meeting with the new deputy governors on April 26th-27th. Given the new board, I expect the number of board members voting for added easing to rise from one to two (out of nine board members). In the board's economic outlook, a pushback in the central forecast for when the 2% inflation target will be met is also likely (currently, the middle or end of 2019, to be pushed back to 2020).

Bottom line, political volatility is past its peak and evidence for “zero rates for longer” is likely to put the yen on a weaker footing and the Nikkei on a stronger one, in my view.

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