Japanese Economy Update

September 2015

MACRO REPORT

Monica Defend
Head of Global Asset Allocation Research

Alessia Berardi
Senior Economist

Also contributing
Riccardo Soggiu
Senior Economist, Central Banks

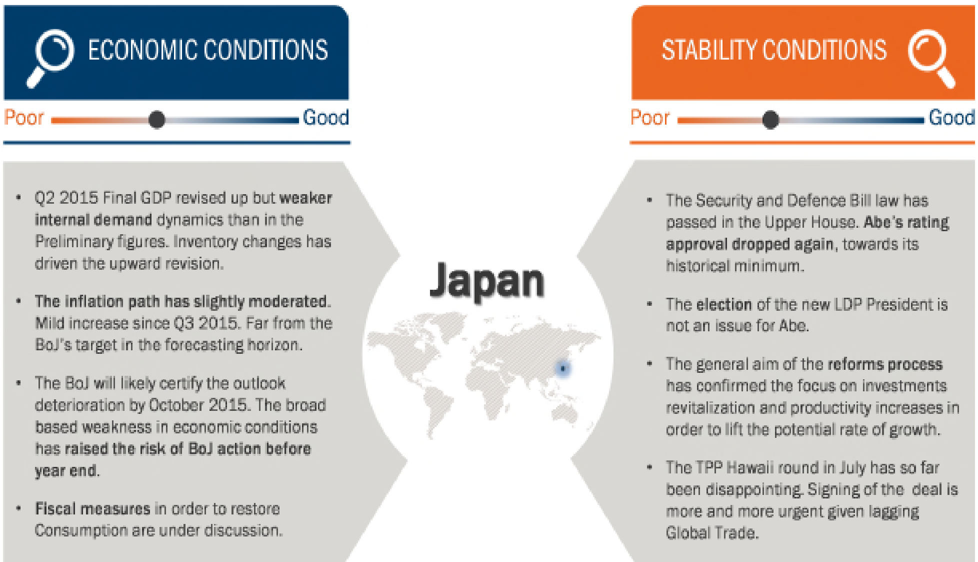
Key Insights

→ **Abenomics:** On the 20th of September, the defense and security legislative package (known as the "reinterpretation" of Article 9 of the Constitution) passed in the Upper House, without forcing it through via the 60 days rule. In the wake of that decision, Abe's approval rating dropped again, to 40%, near his historical lows.

→ **Economic Outlook:** On top of a negative contribution from external demand, domestic economic conditions (internal demand) appeared to weaken further between the Preliminary and the Final GDP releases. For that reason, we lowered our GDP forecasts along the forecasting horizon: 0.7% YoY from 0.9% YoY in CY 2015, 1.6% YoY from 1.8% YoY in CY 2016 and 0.9% YoY in CY 2017.

→ **Monetary Policy:** A proper and official certification of the deterioration in the economic outlook (both in terms of growth and inflation) will arrive at the end of October, with the Outlook update. Our main case for most of the year has been that the BoJ would not intervene in 2015, based on a look at the medium-term inflation dynamics rather than a short-term perspective. However, the worse-than-expected economic conditions that have been in place this year (as was the case in 2014), have raised some doubts with regard to that. Today, we no longer rule out the possibility that the Bank of Japan will intervene again, after the 31st of October.

Macro Pulse



Source: Pioneer Investments. Data as of September 21, 2015.

PIONEER Investments®

Economic Conditions

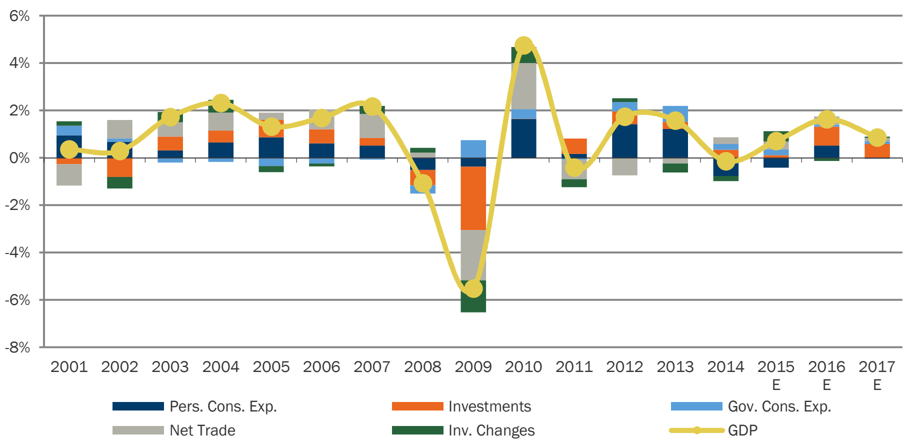
Growth & Economic Trend

In September, the Japanese Cabinet Office released the Final figure for Japan's Q2 2015 GDP at -1.2% QoQ ann., an upward revision from the -1.8% previously reported.
The negative surprise in Q2 2015 data was the poor Household Consumption performance at -2.7% QoQ ann., unchanged in the revision. Capex (Capital Expenditure) growth was revised down to -3.6% from a flat rate of growth registered in the preliminary figures. Net exports contribution remained sharply negative at -1.5%.

A modest GDP recovery is expected in 2015/2016.

On top of a negative contribution from external demand, domestic economic conditions appeared to weaken further between the Preliminary and Final releases. **For that reason, we lowered our GDP forecasts in the forecasting horizon: 0.7% YoY from 0.9% YoY in CY 2015, 1.6% YoY from 1.8% YoY in CY 2016 and 0.9% YoY in CY 2017.**

Figure 1. Japan GDP Contributions

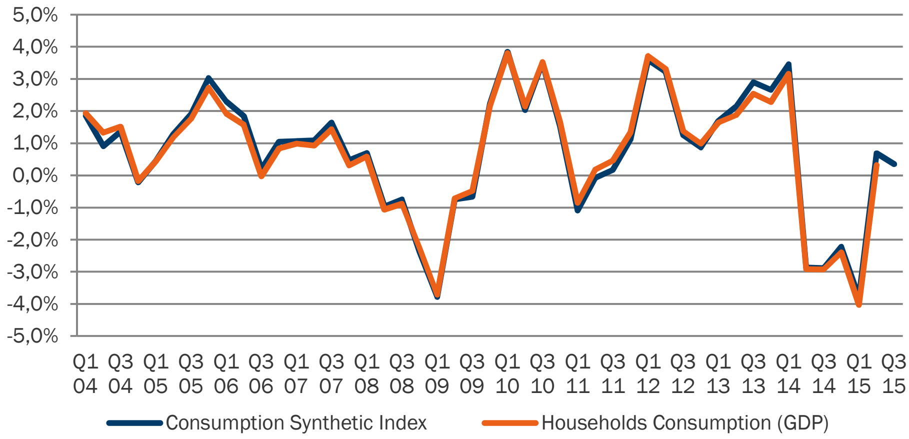


Source: Japan Cabinet Office, Datastream, Pioneer Investments, as of Q2 2015

*On the **Consumption side,** the outlook is mildly constructive.*

As mentioned above, such weakness on the Consumption side was quite surprising considering the domestic fundamentals behind Household Demand. The wage dynamics have been improving, albeit to a lesser degree than indicated by the Government's propaganda. The labor market conditions have remained tight, with the unemployment rate at 3.3%. Based on that, we expect that the degree of weakness registered in Q2 will prove temporary; however, we forecast only a mild recovery in Consumption going forward.
In July, Total Cash Earnings rose by 0.6% YoY after a sharp decline of 2.5% in June. The June fall was mainly related to a delay of bonus payments to July from June for most corporations. The pick-up reported in July was weaker than expected.

Figure 2. Japan Private Consumptions



Source: Japan Cabinet Office, Datastream, Pioneer Investments, as of September 21, 2015.

We expect that the trend of Core Inflation will remain mildly positive, moving towards 1.0% by the end of 2015.

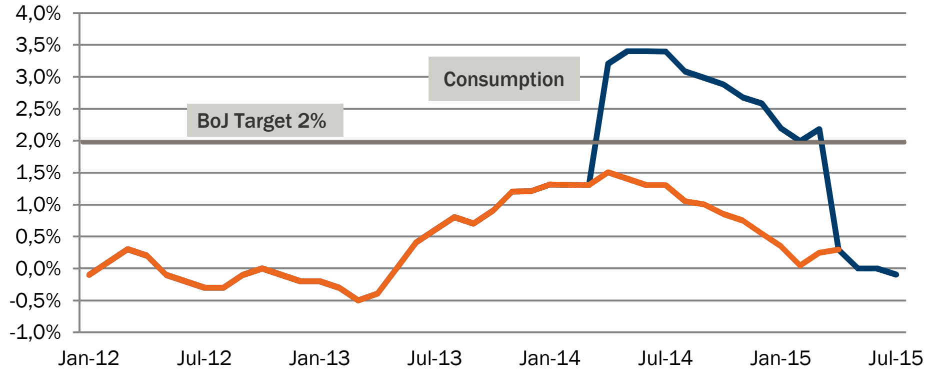
On the Investment side, the recent revision showed a negative performance in Q2, **worse than the flat growth previously reported**. On top of that, **the higher frequency data available for Q3 has continued to temper cautious optimism over an economic recovery based on a sort of Capex revival**. The Final figure of IP in July decreased by 0.8% MoM and was flat YoY, while Machinery Orders in August fell by 16.5% YoY thanks to the negative performance of the external component(-31.2% YoY after the -17.6% number reported in July) and to some weakness registered in the domestic component.

Related to a deterioration of domestic demand in the Final release of the GDP data, Imports have been revised down as well, at -10.1% QoQ ann., sharpening further the negative performance previously reported. Exports have remained strongly negative at -16.6% QoQ. **Even though global demand remains stagnant, failing to support growth from the external side, the Net exports contribution to growth in CY 2015 is still positive** (0.3% out of 0.7% of GDP YoY) due to the concomitant weak performance of imports.

With the Consumption Tax hike impact fading, Japan sort of came back to reality on the inflation side. In July, Core Consumer Prices (the BoJ's target) decreased by -0.1% YoY.

Back to deflation? Our answer is no. Going forward, **we expect that the trend of Core Inflation will remain mildly positive,** moving towards 1.0% by the end of the current calendar year and the beginning of the next one. That moderately positive outcome is fruit of an improving economic growth outlook from the recent weakness, a mild increase in oil prices and a stable or marginally depreciating yen. **However, according to our forecasts, the next peak of inflation will be in the first half of 2016 at about 1.5% YoY, meaning that inflation will remain below the BoJ target throughout the forecasting horizon**. Only when the next step of the Consumption Tax hike is implemented in April 2017, is the inflation rate expected to go higher than 2.0%. Among the inflation components, it's worth noting that **Food has been persistently increasing since the beginning of the year,** posing some threat to real disposable income, suggesting that it is one of the possible sources of the current weakness in household spending.

Figure 3. Japan Core Inflation



Source: Japan Cabinet Office, Datastream, Pioneer Investments, as of July 30, 2015.

Economic Policies

We no longer rule out the possibility that the BoJ will intervene again, after the 31st of October.

Monetary Policy

In its latest meeting, the BOJ started a minor reassessment of its economic outlook, showing a weaker tone with regard to Household Consumption and External demand support. A proper and official certification of the deterioration in the economic outlook (both in terms of growth and inflation) will arrive at the end of October, with the Outlook update.
Last October, after a continuous denial of the economic conditions, the BoJ intervened, further increasing its QQE.
Our main case for most of the year has been that the BoJ would not intervene in 2015, based on medium-longer term inflation dynamics rather than on a short-term perspective. However, another year of worse-than-expected economic conditions has raised some doubts with regard to that view. Today, we no longer rule out the possibility that the BoJ will intervene again, after the 31st of October.

Fiscal Policy

The next hike of the Consumption Tax, from 8% to 10%, is planned by April 2017. In the very near term, the Cabinet has to officially approve the hike in order to put in place all the IT adjustments required to proceed. Considering the disruptive impact on the economy that resulted from the latest tax hike, the Cabinet is also discussing a 2% reduction of tax on essentials, meaning the current 8% tax rate will remain in place on those items.
The Japan Post privatization moved forward recently. The path to privatization has been partially revised from that previously presented and blocked because of vested interests. The purpose is quite opportunistic and specific. According to Minister of Finance, the revenues raised (about JPY4tr) will go to fund the Great East Japan Earthquake and Tsunami Disaster Recovery Funds.

Stability Conditions

Politics

The defense and security legislative package (known as the "reinterpretation" of Article 9 of the Constitution) was just passed in the Upper House, without resorting to the 60 days rule. In the wake of that decision, Abe's approval rating dropped again, to 40%, near his historical lows. This subject is quite sensitive and public opinion was negative with respect to the lack of detail provided as to the motivations behind the change.

2015 Triggers and Risks

Triggers

- A further BoJ intervention could weaken further the JPY, supporting Japanese exports in a weak global trade environment.
- A more incisive implementation of the economic measures by the Cabinet could boost the competitiveness of the Japanese system, helping productivity and the potential GDP growth rate in coming years.

Risks

- A weak attitude in terms of growth strategies without any effort in terms of fiscal consolidation could move the country toward default.
- A higher nominal growth driven more by inflation than growth could lead to a lift off of interest rates.
- Higher-than-expected interest rates could offset the efforts put in place by the BoJ and the Cabinet to revive the economy, pushing the country's debt toward default.

Macroeconomic Forecast

Japan	2012	2013	2014	2015E	2016E	2017E	2014				2015E				2016E				2017E			
Macroeconomic Forecasts							Q1	Q2	Q3	Q4	Q1	Q2	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E
GDP & Components							% QoQ Annualized				% QoQ Annualized				% QoQ Annualized				% QoQ Annualized			
GDP	1.8	1.6	-0.1	0.7	1.6	0.9	4.5	-7.6	-1.1	1.3	4.5	-1.2	1.1	1.5	1.7	2.7	2.1	1.5	4.3	-5.8	1.5	0.5
Personal Consumption Expenditures	2.4	2.1	-1.3	-0.7	0.9	-0.1	8.5	-18.5	1.3	1.3	1.5	-2.7	2.2	0.9	1.1	0.9	1.1	0.8	5.5	-10.4	2.2	0.5
Government Consumption Expenditures	*1.7*	*2.9*	*1.0*	*1.0*	*0.4*	*0.5*	*-1.2*	*0.6*	*2.4*	*1.0*	*0.0*	*3.0*	*-0.4*	*-0.4*	*0.4*	*0.4*	*0.8*	*0.8*	*0.4*	*0.4*	*0.4*	*0.4*
Residential Investments	3.2	8.7	-4.5	-2.0	4.7	3.9	8.4	-36.9	-22.9	-2.4	7.0	8.0	8.5	0.7	2.5	5.2	9.1	5.3	4.5	2.2	0.3	-2.3
Non- Residential Investments	3.8	0.6	3.7	1.3	5.0	3.4	20.9	-15.9	-0.9	0.5	11.0	-3.6	0.6	6.6	6.0	7.5	6.8	2.9	3.9	0.9	2.1	2.1
Total Internal Demand (YoY%)																						
Total Consumption + Fixed Investments+Inventories	**2.6**	**1.9**	**-0.1**	**0.2**	**1.1**	**0.7**	**3.3**	**-0.4**	**-1.6**	**-1.8**	**-2.1**	**0.7**	**1.0**	**1.1**	**0.2**	**0.9**	**1.6**	**1.8**	**2.5**	**0.3**	**0.2**	**0.0**
Final Internal Demand (YoY%)																						
Total Consumption + Fixed Investments	**2.4**	**2.3**	**-0.2**	**-0.1**	**1.5**	**0.7**	**4.0**	**-1.3**	**-1.7**	**-1.7**	**-2.9**	**0.7**	**0.9**	**1.0**	**0.8**	**1.6**	**1.7**	**1.7**	**2.3**	**0.3**	**0.2**	**-**
Exports	-0.0	1.3	8.4	2.1	6.3	2.0	24.6	2.3	7.3	11.6	6.7	-16.6	3.6	4.3	15.6	9.7	2.9	3.9	3.2	-1.6	-0.6	-1.2
Imports	5.4	3.1	7.5	0.0	4.8	1.5	25.6	-14.5	3.7	3.4	7.3	-10.1	2.2	-2.5	14.6	8.3	4.1	2.4	1.7	-2.0	-0.1	-0.7
GDP Contributions																						
Net trade	**-0.7**	**-0.2**	**0.3**	**0.3**	**0.3**	**0.1**																
Inventories changes	**0.2**	**-0.4**	**-0.2**	**0.4**	**-0.1**	**0.1**																
Economic Trend							% YoY				% YoY				% YoY				% YoY			
Industrial Production	0.3	-0.5	2.2	-0.3	3.9	1.5	7.7	2.8	-0.4	-1.4	-2.1	-0.5	0.9	0.6	1.3	4.1	5.0	5.1	3.0	2.0	0.9	0.1
Corporate Profits	8.7	20.2	11.0	11.3	21.6	2.2	20.2	4.5	7.6	11.6	0.4	23.8	10.1	10.8	31.6	9.6	30.8	14.6	4.5	3.7	-0.4	0.8
Employees' Compensations	0.9	0.6	-1.2	0.3	0.9	0.8	-0.6	-2.1	-1.1	-1.0	-0.4	0.7	0.5	0.5	0.4	1.1	1.1	1.2	1.0	0.7	0.7	0.8
Corporate Goods Prices Index	-0.9	1.3	3.2	-1.4	1.7	2.0	2.0	4.3	4.0	2.4	0.4	-2.2	-2.8	-1.2	1.2	1.4	2.1	2.2	2.1	2.0	2.0	2.0
Consumer Prices Index	-0.1	0.4	2.6	0.6	0.9	1.8	1.3	3.4	3.2	2.7	2.1	0.1	-0.1	0.3	0.9	0.9	1.0	0.9	0.8	2.1	2.1	2.1
Unemployment Rate	4.3	4.0	3.6	3.4	3.2	3.2	3.6	3.6	3.6	3.5	3.5	3.3	3.3	3.3	3.3	3.3	3.2	3.2	3.2	3.2	3.2	3.2
M2+CD	2.5	3.6	3.4	3.7	3.0	3.2	3.9	3.2	3.0	3.5	3.5	3.9	4.1	3.5	3.3	2.6	2.9	3.1	3.2	3.2	3.2	3.2

Update as of September 21, 2015; for time series with higher frequency (monthly or daily) than quarterly, we consider the quarterly average; in grey AAR elaborations; in Italic exogenous variables; GDP components on quarterly frequency are %Q/Q annualized rates; all other figures, if not otherwise specified, are %Y/Y.

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