Investment Research
The Big Picture
2 December 2019
Section Japan

Japan

Sheltered for now – bumpy road ahead

- Demand has been remarkably resilient in Japan despite the weaker global economy. Another record fiscal budget and the Olympics should keep the economy growing in 2020. In 2021, the economy will have to find support abroad to keep growing. We expect GDP growth to decline from 1.0% in 2019 to 0.5% in 2020 and 2021.

- The VAT hike poses an immediate risk to domestic demand. A supplementary fiscal budget for the reconstruction from typhoon Hagibis should take the edge off, though.

- Looking a little further ahead, escalation of the global trade war is the key risk for Japan, as it hits the economy in two ways: on declining demand for Japanese goods and a deterioration of competitiveness on the back of yen appreciation.

- We expect further easing of economic policy will come from the fiscal side, whereas the Bank of Japan will keep its policy largely unchanged through 2020 and 2021 and stick to fine-tuning.

Bjørn Tangaa Sillemann
Analyst
+45 45 12 82 29
bjsi@danskebank.dk

www.danskeresearch.com
Important disclosures and certifications are contained from page 5 of this report.

Danske Bank

Solid economy despite weaker global demand

The economy has been robust during 2019 despite several headwinds. Domestic demand has been the primary growth driver on the back of decent household consumption and investments and an accommodative fiscal stance. Under difficult circumstances, exports have weakened and were down around JPY100bn y/y in September with US, China, ASEAN and also the smaller trading partner South Korea, where exports have been weak since the bilateral trade spat began earlier this year. The strong yen has been a key reason for this.

As of 1 October, Japan entered troubled, although not uncharted, territory, when VAT was raised from 8-10%. The last time VAT was hiked the economy went straight into recession. This time the government has taken several measures to mitigate the shock to private demand. Among other things, it has excluded groceries from the tax hike and for a limited time, cashless transactions to small and medium retailers are subject to a 2% refund. The general expectation of the Bank of Japan (BoJ) and the government has been that the impact would be far less severe this time. However, we saw a big spike in September retail sales followed by a huge plunge in October, indicating that people are reacting quite strongly to the VAT hike. The October typhoon Hagibis probably also benefitted by keeping people at home, though.

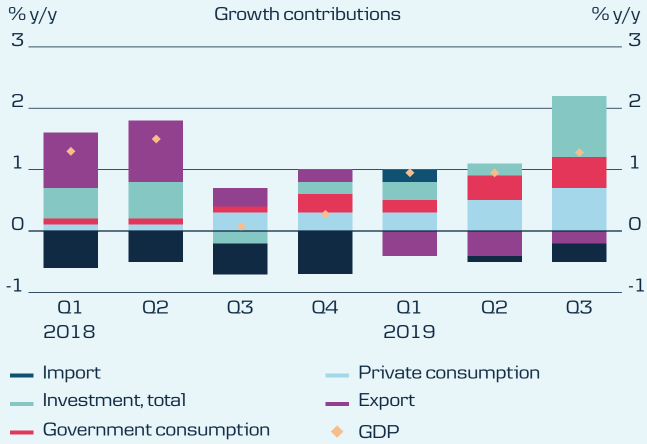
Olympics and public spending will support growth

Despite stagnating wages, the increasingly tight labour market has boosted total wage income. We expect a significant correction in consumption in Q4 due to the VAT hike and, looking ahead, we see scope for a limited pick-up in consumption. Consumers are cautious and once the impact of the VAT hike has settled, we expect private consumption to grow slowly. Massive public debt forces households to save.

2020 will be the year for the Tokyo Olympics and it will likely have a significant economic impact. According to a BoJ research paper (*Economic Impact of the Tokyo 2020 Olympic Games*) GDP has been affected already since the nomination of Tokyo back in 2013. To begin with, it was primarily investment, but tourism has also benefitted from the Olympics, even years before the actual games. Whatever the reason, tourism in Japan has exploded since the nomination in 2013, with the number of arrivals at 31.2 million in 2018 compared with 10.4 million in 2013. However, recently Japan has seen a large fall in the number of tourists, primarily driven by a decline in the number of South Korean visitors in the wake of the intensified trade spat between the two countries, see box.

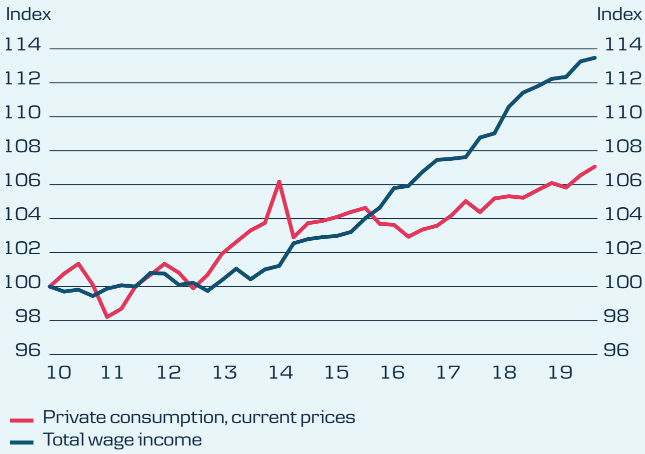
In 2020, the impact of the Olympics is going to peak, as 920,000 spectators are expected (by the organizers) to visit Tokyo per day and the BoJ expects the total contribution to GDP of the Olympics to add approximately JPY8trn to GDP in 2020, equivalent to 1.5% of GDP (just 0.2%-points more than in 2019, though). Investment in particular is going to wane as the Olympic boost disappears, but also because businesses assess that their production capacity has increased during 2019. That said, an increasing labour shortage will support the incentive to invest.

Solid private demand support growth



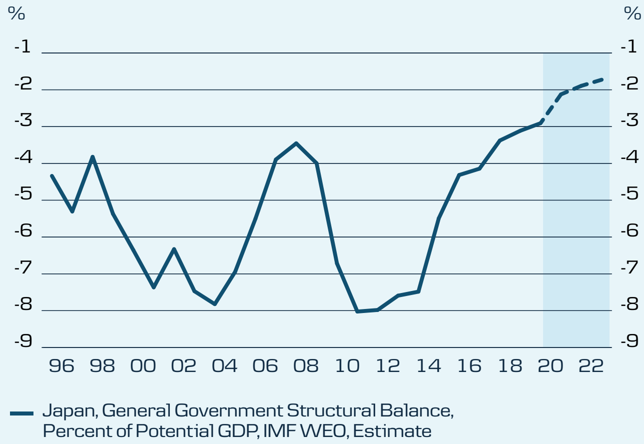
Source: Japanese Cabinet Office, Macrobond Financial

Front-loading ahead of VAT-hike - consumers remain cautious



Source: Japanese Cabinet Office, Macrobond Financial

Abe is still running large deficit to support growth



Source: IMF WEO, Macrobond Financial

The government is very much aware of the challenges ahead. Weak global demand, low inflation, fears of economic slump following the Olympics and the risks for private domestic demand from the VAT hike all push for another record fiscal budget for the fiscal year 2020. A JPY105trn budget is also in the pipeline and, following the October typhoon Hagibis, a supplementary budget including spending on reconstruction after the extensive destruction in eastern Japan is also on the way.

Bank of Japan buying time

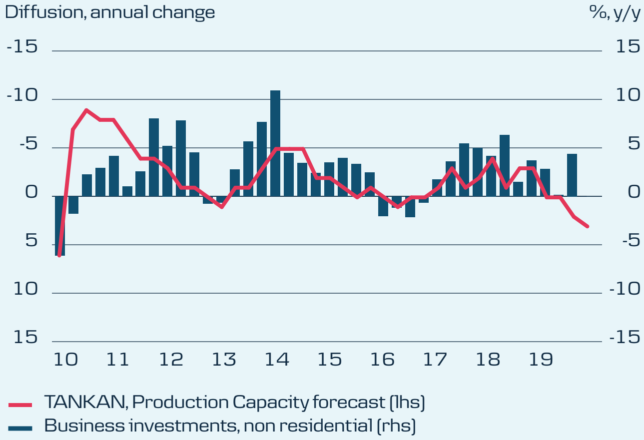
The BoJ's action plan depends heavily on where the global economy is heading. As long as foreign demand holds up, the risk of a recession does not escalate and yen strengthening is not going off the charts, then the BoJ will prefer to remain on hold. That said, the yen is not far from a seven-year high – a strong yen weighs heavily on the inflation outlook.

At the October policy meeting the BoJ changed its forward guidance and pledged to keep rates at "…present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost", a vague promise. It will be very much be at the BoJ's discretion to decide, when it is no longer necessary to pay close attention to the inflation outlook. That said, Governor Kuroda made a big deal out of assuring the markets of the willingness to act at the following press conference. In October, CPI inflation, excluding fresh food, stood at just 0.4% and one could argue the momentum towards reaching the price stability target has already been lost and doing more of the same and expecting a different result is naive. That is currently the official opinion of one member on the board and it will probably take a further turn for the worse to get more on board with that view. Kuroda has been touring with the message that a mix of fiscal and monetary stimulus is the best way to boost the economy, which indicates the BoJ is in the business of fine-tuning its policy stance at best, not inventing new tools. Finance Minister Taro Aso has iterated this by saying that "it's natural that monetary and fiscal policy should work as one to pull Japan out of deflation completely."

We have seen fine-tuning from the BoJ recently. One of the key areas of focus has been the shape of the yield curve. Kuroda has mentioned several times, that long yields have declined too much and in October, the BoJ cut its purchase of all Japanese government bonds (JGBs) with a maturity above three years. The BoJ seems generally concerned about the implications for regional banks and pension funds, and what we can count on the BoJ to do is to fine-tune its JGB purchases to ensure a positive sloping yield curve. Kuroda has also called for more government issuance in the super-long segment in order to secure this. On 50-year JGBs, Aso has said it is "a topic of consideration". Currently the maximum length of borrowing is 40 years.

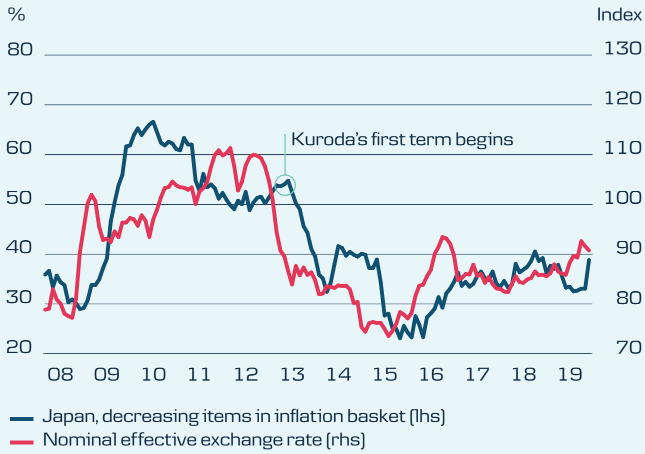
We expect inflation to remain far below target and the BoJ to keep its quantitative and qualitative easing with yield curve control unchanged throughout the forecast horizon.

More production capacity set to weigh on investments



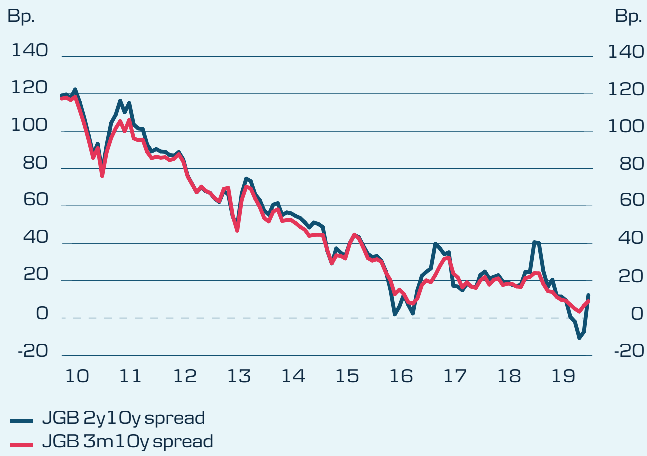
Source: Bank of Japan, Japanese Cabinet Office, Macrobond Financial

Deflation battle not won yet



Source: Bank of Japan, Macrobond Financial

BoJ has reacted to declining slope on yield curve



Source: Macrobond Financial

Macro forecasts - Japan

% y/y	2017	2018	2019	2020	2021
GDP	1.9	0.8	1.0	0.5	0.5
Private Consumption	1.1	0.3	0.4	-0.3	0.8
Private Fixed Investments	3.7	2.3	1.7	0.1	0.0
- Residential investment	2.2	-5.9	2.9	0.9	1.3
- Non-residential	3.9	3.9	1.5	0.0	-1.0
Public Investments	0.8	-3.4	1.7	1.4	0.0
Public Consumption	0.3	0.8	2.2	1.9	0.4
Exports	6.8	3.4	-1.8	1.7	2.1
Imports	3.4	3.3	-0.5	0.8	1.2
Unemployment rate (%)	2.8	2.4	2.4	2.4	2.4
CPI. excl. fresh food (y/y)	0.5	0.9	0.7	0.7	0.9
- Excluding consumption tax hike	0.5	0.9	0.5	0.6	0.9
BoJ rate on deposit facility*	-0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.0	0.0	0.0	0.0	0.0

*Note: *end-year*
Source: Danske Bank. Macrobond Financial

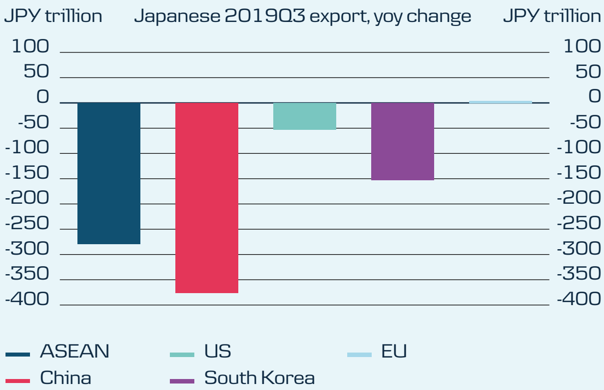
Asian trade dispute weighs on exporters

Japan-South Korean relations is at a low point and the prospects for a turnaround are hard to find. This weighs increasingly heavy on Japanese exporters as a string of boycuts of Japanese products have gained traction. South Korean imports of beverages have plummeted by 87% in August-October compared to the same period last year. Exports to South Korea have declined relatively more than any of Japan's other big trading partners. Slowing Chinese demand is still the biggest drag on Japanese exporters, but there are prospects for a rebound once the global economy and China regain momentum. The same cannot be said of South Korean demand.

According to polls, the dislike between Japanese and South Koreans has grown. There seems to be public support for a hawkish political stance from both sides of the dispute and the situation is deadlocked with the two countries off each other's list of preferred trading partners making it more cumbersome to trade. South Korea has even decided to invest USD857 million to break its dependence on Japanese tech materials.

The trade spat originates in the Japanese colonization of the Korean peninsula up until the end of WWII. In 1965, "The Treaty on Basic Relations" between the two countries was signed and Japan payed war reparations. In 2018 South Korea's Supreme Court ruled that the 1965 pact was only designed to settle financial issues between the two countries, and that the rights of individuals to seek compensation was not terminated. Based on that, Japanese firms have been ordered to pay damages for the "mental suffering" of former wartime forced labourers. South Korea is Japan's third largest export market. With no solution to this conflict in sight, Japan has only become more dependent on a pickup in the global economy.

Asian demand has declined the most



Source: Japanese Ministry of Finance, Danske Bank, Macrobond Financial

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Bjørn Tangaa Sillemann (Analyst).

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Biannually.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 29 November 2019, 11:00 AM CET

Report first disseminated: 2 December 2019, 6:00 AM CET

Global Danske Research

Global Head of FI&C and DCM Research
Thomas Harr
thhar@danskebank.com
+45 45 13 67 31

Chief Analyst
Arne Lohmann Rasmussen
+ 45 45 12 85 32
arr@danskebank.com

International Macro and Emerging Markets

Chief Analyst & Head of
Jakob Ekholdt Christensen
+45 45 12 85 30
jakc@danskebank.com

Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Allan von Mehren
+45 45 12 80 55
alvo@danskebank.com

Bjørn Tangaa Sillemann
+ 45 45 12 82 29
bjsi@danskebank.com

Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.com

Piet P.H. Christiansen
+45 45 13 20 21
phai@danskebank.com

Fixed Income Research

Chief Analyst & Head of
Jan Weber Østergaard
+45 45 13 07 89
jast@danskebank.com

Daniel Brødsgaard
+45 45 12 80 83
dbr@danskebank.com

Jens Peter Sørensen
+45 45 12 85 17
jenssr@danskebank.com

Foreign Exchange

Chief Analyst & Head of
Christin Kyrme Tuxen
+45 45 13 78 67
tux@danskebank.com

Jens Nærvig Pedersen
+45 45 12 80 61
jenpe@danskebank.com

Kristoffer Kjær Lomholt
+45 45 12 85 29
klom@danskebank.com

Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.com

DCM Research

Chief Analyst & Head of
Jakob Magnussen
+45 45 12 85 03
jakja@danskebank.com

Bendik Engebretsen
+47 85 40 69 14
bee@danskebank.com

Brian Børsting
+45 45 12 85 19
brbr@danskebank.com

Christopher Hellesnes
+46 8 568 80547
cahe@danskebank.com

David Andrén
+46 8 568 80602
davia@danskebank.com

Henrik Renè Andresen
+45 45 13 33 27
hena@danskebank.com

Louis Landeman
+46 8 568 80524
llan@danskebank.se

Mark Thybo Naur
+45 23 21 29 37
mnau@danskebank.com

Natasja Cordes
+45 45 14 38 54
naco@danskebank.com

Niklas Ripa
+45 45 12 80 47
niri@danskebank.com

Nicolai Pertou Ringkøbing
+45 45 12 80 56
nrin@danskebank.com

Sverre Holbek
+45 45 14 88 82
holb@danskebank.com

Sweden

Chief Analyst & Head of
Michael Boström
+46 8 568 805 87
mbos@danskebank.com

Carl Milton
+46 8 568 805 98
carmi@danskebank.com

Filip Andersson
+46 8 568 805 64
fian@danskebank.com

Jesper Petersen
+46 8 568 805 85
jesppe@danskebank.com

Michael Grahn
+46 8 568 807 00
mika@danskebank.com

Stefan Mellin
+46 8 568 805 92
mell@danskebank.com

Therese Persson
+46 8 568 805 58
therese.persson@danskebank.se

Denmark

Chief Economist & Head of
Las Olsen
+45 45 12 85 36
laso@danskebank.com

Bjørn Tangaa Sillemann
+45 45 12 82 29
bjsi@danskebank.com

Louise Aggerstrøm Hansen
+45 45 12 85 31
louhan@danskebank.com

Norway

Chief Economist & Head of
Frank Jullum
+47 85 40 65 40
fju@danskebank.com

Finland

Head of Research Finland
Valtteri Ahti
+358 10 546 7329
vah@danskebank.com

Chief Economist
Pasi Petteri Kuoppamäki
+358 10 546 7715
paku@danskebank.com

Jukka Samuli Appelqvist
+358 44 263 1051
app@danskebank.com