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Man in Tights: Abenomics Needs Another Arrow!

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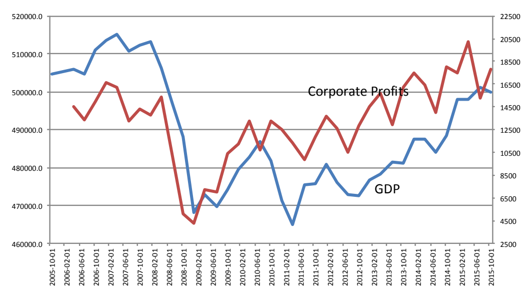
What happened to Abenomics

The Japanese economy is headed for another bout of recession. It is the third largest national economy in the world and, when it dips back into recession next year, it will drag an already too slowly growing global economy treacherously close to the brink of global recession.

It was just three years ago that the new Prime Minister, Shinzō Abe, announced a stunning set of aggressive economic policies that were designed to improve Japan's moribund economy, and for a while they did. The initial market reactions to his plans were quite enthusiastic: stocks rallied strongly, JGB prices increased, and the Yen depreciated, thus substantially improving the prospects for international trade and boosting corporate profits.

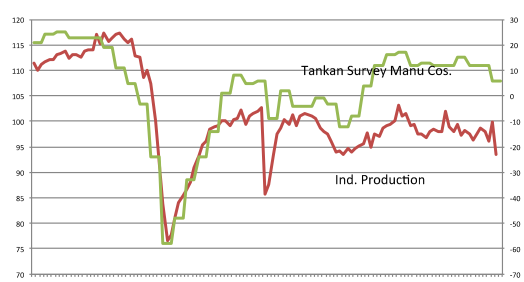
GDP and Profits Have Begun to Level Off (in Yen)



The economy has stopped growing

The economy improved significantly and so did corporate profitability, as seen in the first chart. However, progress on economic growth and corporate profitability seems to have stalled recently.

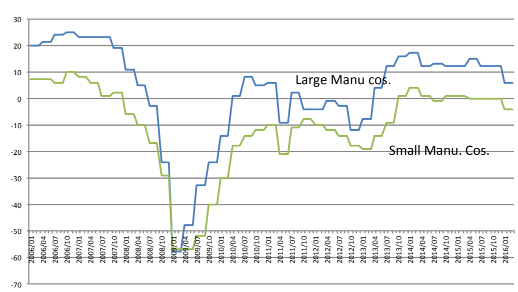
Industrial Production Turned Negative



Other economic indicators are equally grim

For example, industrial production has been in decline for over 18 months and the Tankan survey of large and small manufacturing companies has reflected a deepening sense of gloom for a similar period. According to the Tankan survey small manufacturers have been gloomier for quite a while than large manufacturers. They were unable to benefit from the depreciation of the Yen as the large international manufacturing companies were able to where the depreciating Yen helped them increase their international businesses.

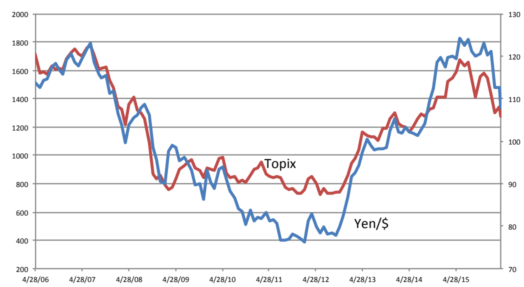
Tankan Manufacturing Surveys Falling



The markets have readjusted dramatically

As vividly seen in the next chart, market participants have thrown in towel on Abenomics this year. The Yen inexplicably stopped depreciating and has been sharply rising, by about 13% in the past several months, thus offsetting much of the trade gains that the depreciated Yen provided. As is typically the case, the change in direction of the Yen also caused an immediate decline in Japanese stock prices. Investors were quick to seize upon the inverse relationship between corporate profits and the value of the Yen. Japanese stock prices have depreciated 24% in the past 12 months. Moreover, financial market consensus estimates' for Japanese corporate profits in 2016 are headed for the biggest reduction since Abenomics began. Thus, the outlook for a stock price recovery in Japan is presently bleak.

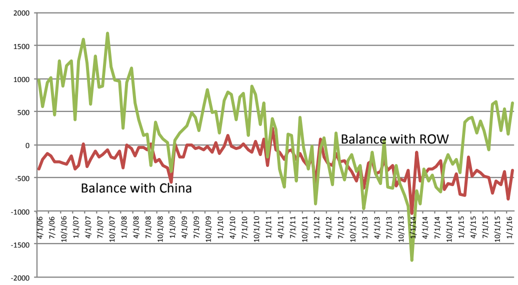
A Stronger Yen; A Weaker Stock Market



External trade, too, will shrink with an appreciating Yen

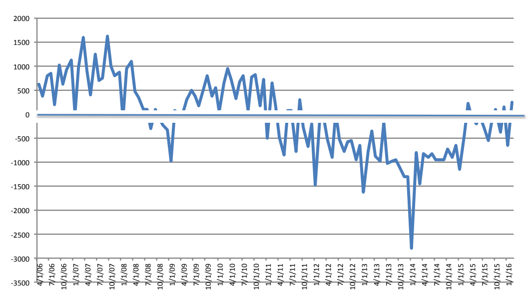
One of the reasons often offered to explain the slump in Japanese economic growth during the years of Abenomics was China. As China's economic growth diminished, the Japanese trade position with China turned into an ever-expanding deficit. However, coincidentally, because of the weaker Yen, the trade surplus with the rest of the world became significantly greater and even offset the rise in the trade deficit with China.

Trade Balance with Rest Of World Growing as China Declines



Looking forward China's economic growth rate is highly unlikely to accelerate; consequently, there will be no relief from a decreasing trade deficit with China. However, the appreciated yen will cause trade with the rest of the world to diminish.

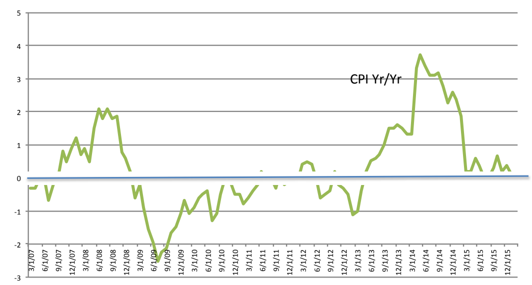
Japan's Net Trade Position



Inflation did not survive

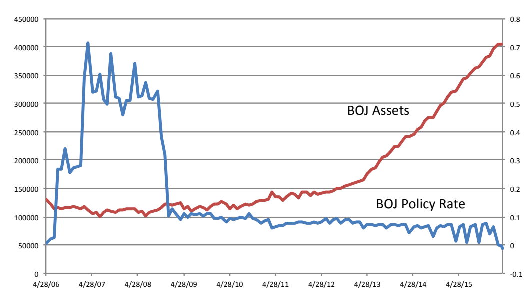
One of the original goals of Abenomics was to end deflation and to recreate price inflation. To that end PM Abe directed the Bank of Japan to inflate its balance sheet and drive interest rates to zero. They did, and it did briefly produce some inflation. However, it has not persisted. The latest CPI data reveals that inflation has slipped back into deflation territory.

Back to Deflation



The Bank of Japan increased its balance sheet 2.5 times over the past 4 years, initially by purchasing Japanese government bonds (JGBs). The BOJ now owns 299 Trillion Yen of JGBS, or 34.5% of the entire market. This is a very formidable amount once they decide to end QE and later reverse their accumulation policy if inflation materializes, as the BOJ has promised.

Extremely Easy Monetary Policy



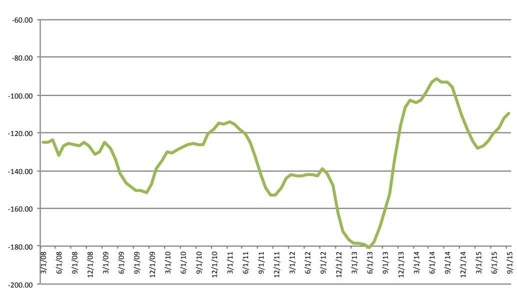
To slow the accumulation of JGBs and their dominance of this market, the BOJ has recently expanded their purchases to include corporate securities. As disappointment set in this year over the precipitous drop in inflation, the BOJ also decided to lower its official borrowing rate to below zero. Their dramatic policyaccommodation, however, has apparently not been enough to raise consumer prices on a consistent basis.

The second arrow of the Abenomics policy was fiscal austerity

One of the most controversial components of the original Abenomics plan was to improve the fiscal position of the federal government in small part by controlling spending and in major part by raising the consumption tax. They did raise the consumption tax in April 2014, and predictably it caused an immediate decline in GDP!

As expected, these restrictive fiscal measures did reduce the annual fiscal deficit from a very bloated $180 trillion yen in 2013, to a more moderate $110 trillion yen in 2015. Unfortunately, while Abenomics did keep its fiscal promise, it also undermined the support given to the economy by accommodative monetary policy.

Japan's Annual Budget Deficit is Declining

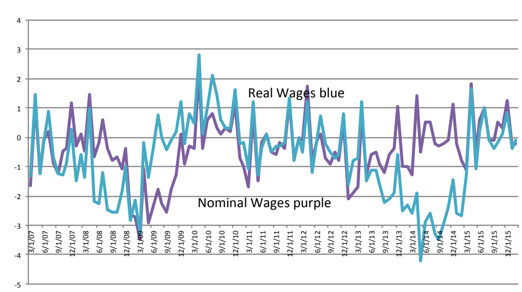


The distressing news for the economy is that the second round of consumption tax increases is scheduled for April 2017. The presently stagnant economy will not be able to survive another consumption tax increase. Unless policy is changed, the outlook for the Japanese economy in 2017 is a deep recession.

Another source of frustration for the Abeconomy

While extremely low interest rates should stimulate borrowing and make investment more attractive, improving investment wasn't the primary focus of Abenomics. Instead, it was to encourage consumers to spend more. However, the initial surge in consumer spending following Abenomics announcement in 2013 fizzled in 2014, when consumption taxes were raised. Consumption spending has declined further in 2015 and in 2016. Two obstacles have stood, and continue to remain, in the way of increased consumption growth: no real wages growth and low savings.

Real Wages Below Zero (Yr./Yr.)



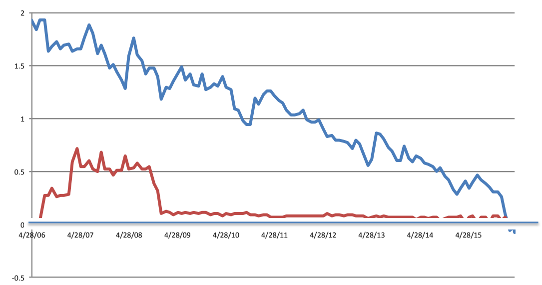
Apart from a very brief period in 2015, real wages have been negative for the past three and one half years. It is impossible to encourage more growth in consumption without positive growth in real wages.

Faster economic growth and labor force shortages would help to raise real wages, as would a jump in inflation expectations. However, neither condition prevailed long enough to cause a persistent increase in real wages. The expectation for low inflation among the Japanese population is quite entrenched, and neither corporate managers nor workers believe that any substantial rise in nominal wages is necessary.

Savings is likely to rise

One thing that abominably low interest rates have achieved is to lower the household savings rate. Households' savings as a percentage of disposable income fell to a low of 0.6% from 2.7% in 2011; it is one of the lowest savings rates among OECD countries. Savers have very few options: yields on the entire JGB curve are now negative causing savers to withdraw funds from deposits. Moreover, households that switched to equity investments, as most insurance and pension fund managers did, lost 24% of their asset value this year. Consequently, households may have to reconsider their planned savings in order to make up for adverse financial market results. Thus, it is likely that households will have to raise their savings and decrease their desired spending from income received to restore an acceptable level of savings.

Japan's Negative Term Structure of Interest Rates



The third arrow of the Abenomics Plan

The third arrow of Abenomics: structural reform of Japanese markets, labor policies, and regulations have not been fully implemented, therefore it is premature to evaluate whether this third arrow will be a success. Moreover, structural reforms usually have long horizons before benefits can be ascertained.

Nevertheless, if the structural reforms that have been taken are actually working, they should have raised the expectation of future economic growth in Japan, and therefore they should have encouraged Japanese companies to increase their investment. Typically when corporate profits rise, businesses increase their investments. This happened in the last profits boom of 2003 - 2006. However, this time around, in spite of record corporate profits over most of the Abenomics era, capital investment increased only moderately.

Conclusion: Another arrow is necessary

The economy is presently rolling downhill from slow growth into negative growth this year and next. Inflation just turned to deflation. Another consumption tax increase is scheduled for 2017. The term structure of interest rates is already negative, leaving precious little room for the BOJ to keep delivering accommodative monetary policy.

What is needed?

First, a renewed commitment to deliver a formidable fiscal stimulus package, while maintaining accommodative monetary policy, is needed. Second, remove short-term impediments to growth and forego reliance on long-term structural initiatives such as the TPP trade agreement that may produce benefits only in the long-run. Third, and an obvious recommendation, is to suspend or at least delay the intended consumption tax until other policies produce more economic growth.

By stimulating faster economic growth, Japan's negative output gap would shrink and this would eventually raise inflation both in consumer prices and in wages.

It has been almost three years since the advent of Abenomics, and the results are rather dismal. PM Abe and his administration need to act forcefully to stop the erosion in public confidence in his economic policies. Global financial investors have already lost confidence in Abenomics, and need to be won back by another arrow. Any lack of political power or determination to legislate change will stimulate additional global investor disillusionment, and push Japan and the rest of the global economy closer to the brink.

For more information, please contact
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	KEY INDICATORS TABLE (AS OF 31 MARCH 2016)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2059.74	6.78%	6.78%	1.77%	1.77%	3MO LIBOR	0.63	132.17
FTSE	6174.90	1.82%	5.34%	-5.01%	-7.89%	10YR UST	1.77	-8.03
NIKKEI	16758.67	5.29%	5.69%	-11.17%	-5.29%	10YR BUND	0.15	-15.45
HANG SENG	20776.70	9.19%	9.47%	-13.65%	-13.68%	10YR SPG	1.44	18.60
STI	2840.90	6.64%	11.35%	-14.81%	-13.14%	10YR SGS	1.84	-19.18
EUR	1.14	4.66%		6.05%		US ISM	51.80	-1.00
YEN	112.57	-0.11%		-6.29%		EU PMI	51.60	-1.10
CMCI	964.92	4.66%		-12.99%		JP TANKAN	7.00	0.00
Oil	38.34	13.60%		-19.45%		CHINA IP	5.90	5.40

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency