JAPAN UPDATE

Gus Faucher
Chief Economist

Stuart Hoffman
Senior Economic Advisor

William Adams
Senior Economist

Kurt Rankin
Economist

Mekael Teshome
Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

WEAKER GROWTH IN 2019-20 FROM TRADE UNCERTAINTY AND VAT TAX HEADWINDS; QUANTITATIVE EASING TO INTENSIFY

Growth momentum weakened in the first half of 2019

Japanese growth weakened in the first half of 2019 as trade policy uncertainty and China's slowdown weighed on manufacturing. Japanese manufacturers are more integrated into global supply chains than their US counterparts, more focused on electronics production, and more reliant on end-markets in emerging Asia; all of these have weakened markedly since late 2018, and Japanese manufacturing has followed suit. Machine tool orders fell 46.0 percent from their peak in March 2018 to June 2019, and the benchmark Jibun manufacturing PMI dipped below 50, indicating a contraction of the industry, for five of the first seven months of 2019. The manufacturing slump is not causing an outright recession: The Jibun services PMI held in expansionary territory throughout the first half of 2019. But fixed investment and exports account for 40 percent of Japan's GDP, versus just 30 percent in the US, so manufacturing headwinds are a larger drag on Japanese hiring and real GDP growth than in the US. Japanese growth will weaken further in October when the government raises the value-added tax (essentially a sales tax) from eight to 10 percent. The prior value-added tax hike, from five to eight percent in April 2014, caused a moderate recession, with real GDP falling 1.9 percent in a single quarter; it took four quarters for output to regain its pre-downturn level, and labor market conditions stagnated for half a year. The one-two punch of an industrial slowdown early in 2019 and a broad-based tax hike late in the year makes a Japanese recession likely in the next 12 months.

The Bank of Japan will intensify monetary stimulus

The Bank of Japan will intensify monetary stimulus in the second half of 2019 to limit downside risks to growth. Japanese monetary policy has made good headway in ending deflation in recent years: Aggressive stimulus fueled the tightest labor market since the early 1990s, bringing wage growth and core inflation back into positive territory (See Chart 1). But with a weakening manufacturing sector wages fell in early 2019, and a cooler economy will weaken Japanese inflation expectations later in the year. Progress toward the central bank's target of 2.0 percent inflation will stall for several quarters.

CHART 1: MULTI-DECADE HIGH FOR EARNINGS GROWTH IN 2018, TREND INFLATION POSITIVE FOR ALMOST SIX YEARS

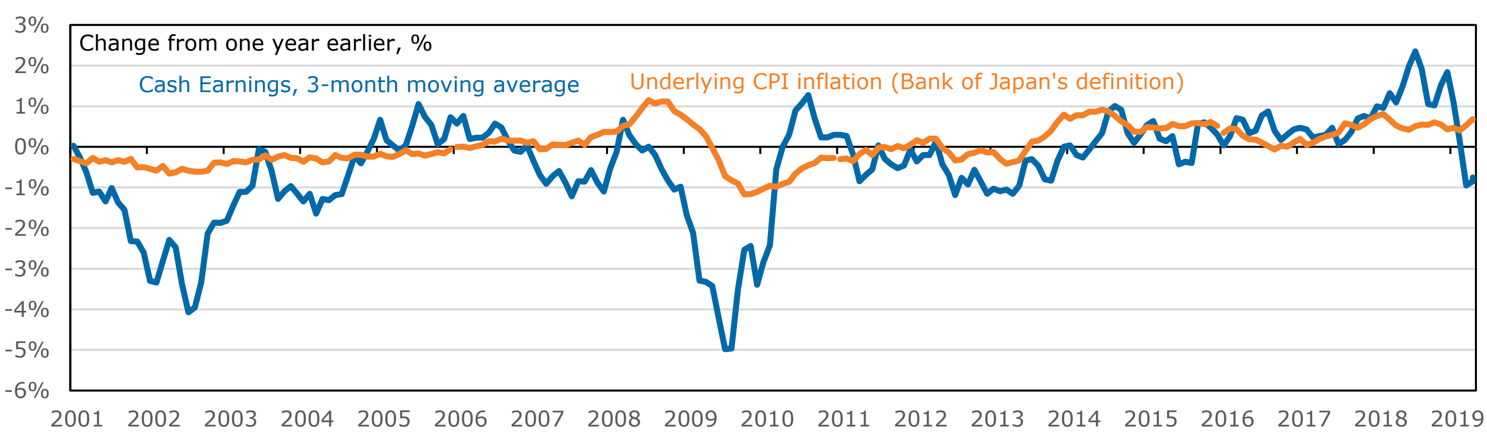

Chart sources: Ministry of Health, Labour and Welfare, Bank of Japan, CEIC
Note: underlying inflation is BoJ's trimmed mean CPI index

QE purchases likely to increase; change in long-term interest rate less likely

The BoJ's policymakers have been priming financial markets since April to expect more stimulus if growth falters or the yen appreciates and lowers the outlook for inflation. Their monetary stance is using three instruments in parallel to stimulate the economy (See Chart 2). First, since January 2016 they have set their policy interest rate at negative 0.1 percent. Second, since July 2016 they have purchased ¥6 trillion yen of exchange-traded funds annually, equivalent to 1 percent of the Tokyo Stock Exchange's market capitalization per year. The BoJ is also buying real estate investment trusts, but on a much smaller scale than ETFs and with a proportionately smaller impact on the real economy. Third, since July 2018 they have conducted open-ended bond purchases to keep the 10-year government bond yield in a target range of -0.2 to 0.2 percent. Government bonds purchases have slowed since 2016; fewer purchases are necessary to hold yields steady since the BoJ owns over 40 percent of government debt outstanding.

The BoJ will probably intensify stimulus in September 2019 by increasing ETF purchases to ¥10 trillion annually, lowering the short-term policy rate to -0.2 percent, and possibly lowering the upper limit of the 10-year government bond yield target to 0.1 percent from 0.2 percent. The BoJ's ownership of publicly-traded stocks, equal to 5 percent of market capitalization at the end of the second quarter of 2019, will rise considerably before quantitative easing ends. After appreciating seven percent from October 2018 to July 2019, the yen will probably hold its stronger level and average ¥108 per US dollar through mid-2020 as growth weakens; the yen is a "safe haven" currency, appreciating on bad economic news, because Japanese investors tend to sell foreign assets and buy yen assets when risk appetite wanes. The yen will then depreciate to ¥110 per dollar by year-end 2020 and ¥114 per dollar by year-end 2021 as monetary stimulus fuels economic recovery. Since the Bank of Japan launched its aggressive quantitative easing program in 2013, the unemployment rate has reached the lowest in nearly three decades, and wage growth and inflation made a sustained move back to positive territory. The BoJ will need to maintain a high-pressure economy for several more years to raise inflation to 2 percent. But notwithstanding extremely low interest rates, Japan's economy is now closer to the "old normal" conditions that prevailed before the stock market and real estate bubbles burst in the 1990s.

Japan's economy is stronger than generally appreciated; sovereign credit rating upgrade likely in 2020

Japan's economy is now more dynamic than generally appreciated: While real GDP is up only 7.3 percent since the 2012 launch of Abenomics, productivity per hour worked has kept pace with the US, with Japan's slower headline growth due entirely to demographics. The October tax hike will temporarily slow growth, but will permanently shrink the fiscal deficit. In 2020, when Japan's fiscal data demonstrate that public finances have improved, credit rating agencies are likely to upgrade the country's sovereign credit rating.

CHART 2: THE BANK OF JAPAN IS BUYING FEWER GOVERNMENT BONDS, BUT ETF BUYING WILL CONTINUE ON TREND

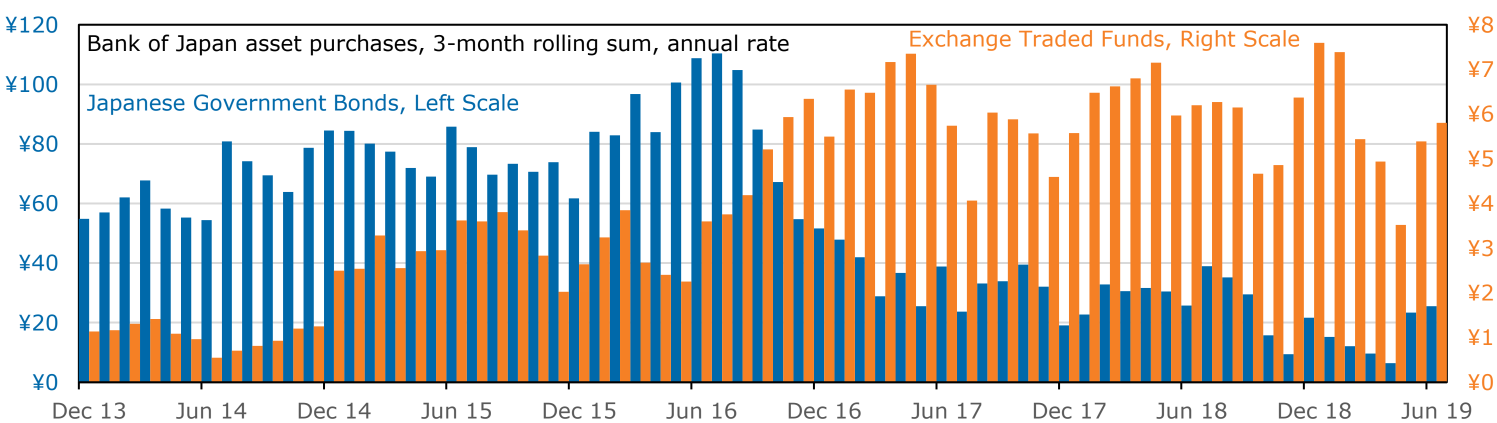

Chart sources: Bank of Japan, CEIC

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