Japan

The Japan Economy: A Mystifying Recovery

Summary:

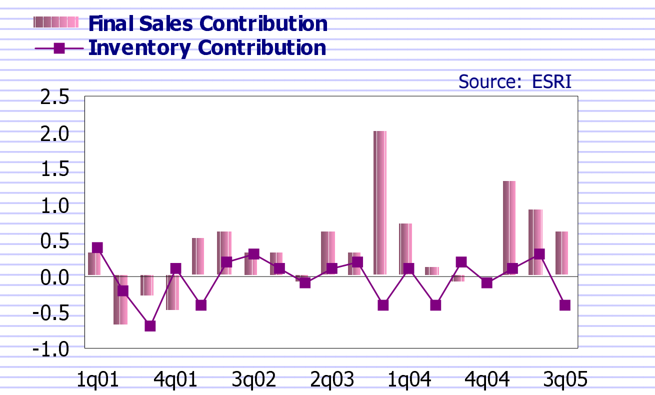
- *The Japanese economy continues to recover of late, with uneven support from consumer and investment spending; however, some risk factors such as the burgeoning fiscal debt position, the normalization of monetary policy and the global outlook continue to hover.*

- *Although the equity market in Japan has recovered noticeably in recent months, unless incoming economic data continue to strengthen meaningfully, the sentiment-induced and foreign-led run-up in the Nikkei 225 index could gradually level-off in 2006, against the backdrop of increased volatility.*

- *The USD/JPY should be biased to the downside in early 2006 in anticipation of some form of flexibility in the RMB regime. But other countervailing forces could limit the downside potential of the USD/JPY, unless the downward drift in the currency pair is backed by Japanese domestic repatriation flows.*

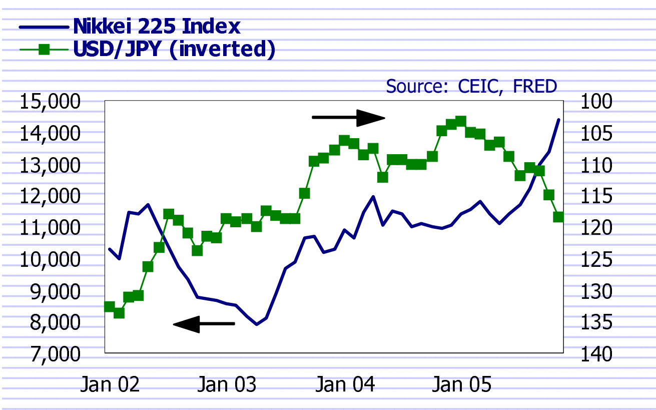
Recent data shows that the Japanese economy grew by over 5.0% at an annual rate on average in the first-half of 2005, and has moderated to about 1.0% in 3q05, primarily because of the larger than expected subtraction from the change in inventories. The negative 0.4% contribution from inventories could be viewed as a positive development for growth in the subsequent quarter as firms rebuild inventories in-line with the rise in actual and expected final demand; on average, the historical evidence shows that inventories could contribute as much as +0.3% to real GDP growth in the subsequent quarter. To be sure, other economic indicators in Japan (i.e., labor market, wages and salaries, manufacturing activity, etc) have also recovered at a reasonable, albeit still choppy, clip of late. As a result, real GDP growth is forecasted to expand by about 2.5% in 2005, roughly in-line with the 2004 growth rate, but more-or-less double the 10-year average growth pace since 1995.

Japan Real GDP Growth:
Contributions from Final Sales & Inventories



In our judgment, although incoming economic data to-date do somewhat reinforce the recent rise in the Nikkei 225 index, other sentiment-related factors do appear to have contributed meaningfully to the magnitude and velocity of the increase of late (although the recent bounce in the Nikkei 225 index since May 2005 of nearly 40% is somewhat in-line with the historical average, it is certainly on track to deliver a better percentage performance than the 2003 and end of 1987 through mid 1988 run-ups). Some of these sentiment-induced factors are more-or-less related to the passing of the privatization bills, successful structural reforms in the corporate sector and positive BOJ rhetoric on monetary policy normalization (i.e., from targeting the current account balance to interest rate targeting). To be sure, foreign investor demand—though currency hedged to a goodly extent—has continued to support the Nikkei importantly even as domestic investors turn to foreign assets. As a result, the Nikkei 225 index—which has been up over 30% compared to December 2004—is currently above the psychologically important level of 15,000, while the USD/JPY has continued to rise.

The Divergence between the Nikkei and USD/JPY



Nonetheless, should incoming economic data fail to reinforce or sustain the positive sentiment shifts of late, the equity market in Japan could gradually level-off in 2006; however, prior to leveling-off, financial market volatility could indeed rise sharply. Some of the potential risk factors for Japan in the coming year are as follows: 1) Japanese fiscal situation; 2) BOJ monetary policy transition; 3) External growth backdrop—in particular, the US economic outlook.

Potential Risk Factors

The present fiscal situation in Japan—with a debt to GDP ratio of nearly 160%—remains precarious. Unequivocally, the government needs to monitor its expenditure and revenue dynamics going forward in order to ensure that the fiscal situation does not unravel and threaten the on-going Japanese economic recovery to-date. As a result, the prior boost from tax benefits (corporate tax cuts could expire in Mar 2006 and the personal tax cuts are also expected to come to an end during the next fiscal year) is expected to subside in the coming months and going into the new fiscal year.

In addition, the eventual "normalization" of monetary policy in Japan—a transition towards a market-based approach of targeting the policy rate—also needs to proceed in an efficient and effective manner to ensure that market sentiment does not become uncertain and result in greater financial market volatility. Interestingly, even as BOJ members continue to provide signals to financial market participants to-date that an end to the current policy of targeting the current account balance is vaguely near, other government officials, including PM Koizumi, have indicated on numerous occasions that it is too early to "end" the current stance of "ultra-easy" monetary policy. Although the on-going debates on when the core CPI would eventually emerge from the 0% threshold is one of the necessary conditions for the BOJ to satisfy before curtailing the degree of accommodation, the exact assumptions embedded in the BOJ's underlying inflation condition are still fairly vague (i.e., 1) How many months do they require the core CPI to be above 0%?; 2) Light of the upside statistical bias in the CPI, how much does core inflation have to increase?). Nevertheless, if the disagreements on the monetary policy transition process remain unabated or intensify among the different Japanese officials, the whole changeover process could become more intricate and challenging. In fact, the foregoing situation could prospectively unravel, and progressively become unconstructive for financial markets and the real economy.

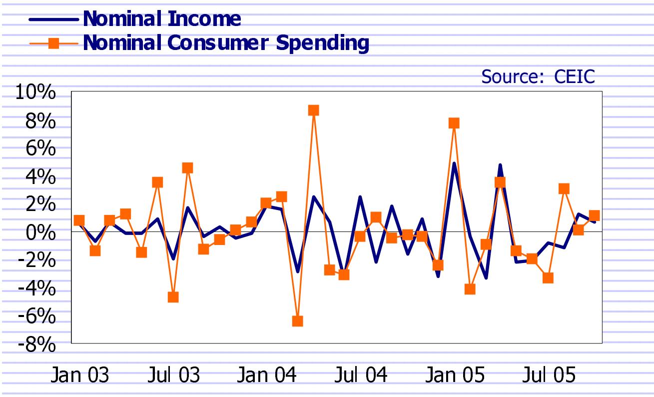
To be sure, a deliberate attempt to tighten fiscal policy, especially combined with a very gradual degree of monetary tightening, would overtime dampen economic activity, albeit to varying degrees. The extent of the moderation, however, will more-or-less be contingent on the expectations of private sector participants and the existing state of aggregate economic activity. Therefore, policymakers in Japan would need to monitor the economic and financial conditions very closely in order to gauge the spillover effects of the twin policy tightening measures in 2006 onwards.

Aside from the aforementioned domestic risk factors, the prospect of sub-par growth in the US, as the economy heads into 2006, could also dampen Japanese economic growth (in view of the pro-cyclical nature and the positive correlation between Japanese growth and global economic growth) if domestic-led growth (essentially from consumer spending and capital expenditures) in Japan fails to pick-up, and provide the necessary offset, as the external contribution from net exports dwindles. Indeed, recent evidence do suggest that China has gradually emerged as an important trading partner for Japan; however, in the event of a US-led global slowdown, the Chinese economy would also be affected to a large extent as they continue to rely on the external backdrop for growth support next year.

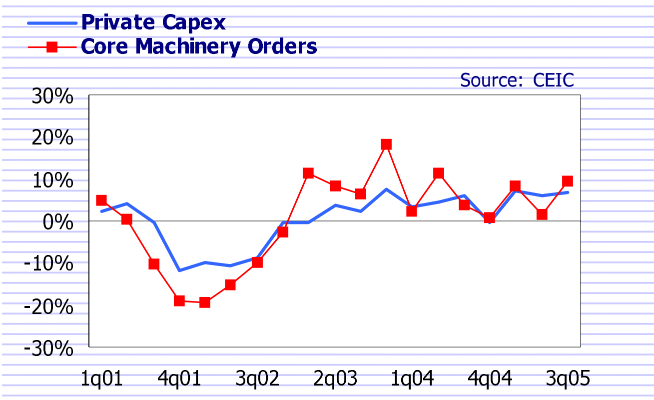
Current Economic Backdrop in Japan: A Selective Snapshot

Recent evidence on the economy shows that both capex and consumer spending have continued to recover, albeit the rate of recovery is still somewhat uneven. The retail sales data fell by 0.3% m/m in October following a 0.8% contraction in the prior month; however, household spending rose by 1.2% m/m in October, up from 0.1% in September. A slight rise in the propensity to consume coupled with the continued growth in income over the last 2 months should be more than sufficient to maintain a positive growth pace in consumer spending in the near-term.

Supportive Income Growth Should Support Spending



Private Capex Should Still Support GDP Growth

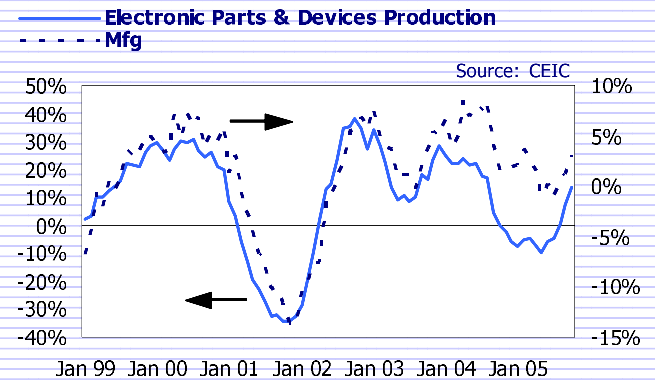


To-date, although the growth pace in corporate profits appears to have moderated from the outsized gains in 2004, it remains healthy by historical standards. However, it is still unclear if the growth trajectory would ease further going into 2006 as fiscal and monetary policies begin to tighten, and possibly impart some dampening degree on consumer spending. To be sure, the current cycle of corporate profit growth, which stretched for 12 consecutive quarters from 3q02 to 2q05, has been the longest string of profit growth of over 9% (compared to a year ago) in the last 20 years (3q05 growth came-in at 6.6%).

On the labor market front, the job-offers-to-applicants ratio rose to 98 in October 2005 (highest since October 1992). Similarly, the unemployment rate ticked up slightly in October to 4.5%, primarily as a result of an influx of job seekers. Moreover, while real disposable income and the various measures of earnings have indeed improved lately, the degree of improvements has still been reasonably varied.

The trend pace of growth in manufacturing output appears to have bottomed-out in July 2005, and has continued to expand over the last 3 months; production rose by 3% in October—the highest since February 2005.

Industrial Production



All in all, while the Japanese economic recovery appears to have gained some positive momentum of late, some risk factors continue to hover in the background as the economy heads into 2006.

The USD/JPY: A Dangling Mystery

The USD/JPY has risen by about 14% since the beginning of this year, and indeed the JPY has comparatively depreciated the most against the greenback compared to the other six major currencies (which include the EUR, GBP, CHF, AUD, NZD and CAD). To be sure, as we have indicated in our prior publications, the 5-year volatility of the USD/JPY is indeed relatively large—at least 800 pips. Naturally, foreign investors of the Japanese equity market would prefer to hedge their investments from sharp exchange rate fluctuations. As a result, despite the hefty upward push in the major Japanese equity indexes of late, the USD/JPY has continued to drift upwards.

Another oft-mentioned factor that appears to have contributed to the strength of the USD/JPY is the extent of the domestic outflows—presumably unhedged—into foreign investment trust funds. According to the Investment Trusts Association, publicly held foreign currency denominated assets in Japan have increased by over JPY 8 trillion since the beginning of the year through October 2005, more than 3x the average growth pace since 2002. The October 2005 figure stood at about JPY 49.3 trillion—the highest since 2000. In fact, it is plausible that either when the Nikkei 225 index declines and/or foreign financial markets seize-up, the JPY could indeed strengthen temporarily against the greenback as a result of repatriation flows.

Against the backdrop of the preceding factors, another reinforcing USD/JPY driver is the increasing popularity of the carry trades, in light of the widening yield differentials with Japan, as speculation pertaining to any RMB-related move gradually dwindles. In fact, the current market consensus (including us) holds the view that potential changes in the RMB regime would probably be more measured than the initial forecast (UOB continues to expect the USD/RMB to ease gradually to 7.7800 by the end of 2006). Needless to say, any surprise announcement by the Chinese authorities to introduce greater flexibility in its FX regime would indeed provoke a downward push in the USD/JPY.

After taking the foregoing factors into account, we expect the USD/JPY to drift lower through the end of the first-half of 2006 to around 113.00, before recovering slightly to 114.50 in 3q06 and drifting down again to 112.80 by the end of next year. Nevertheless, the inherent tendency for the USD/JPY to exhibit pronounced swings--with a standard deviation of about 800 pips--obviously complicates the task of forecasting an exact level for the currency pair; however, the directional projection for the USD/JPY through the first-half of 2006 should be biased to the downside in view of the aforementioned assumptions.

%	2003	2004	2005F	2006F
Real GDP	1.8	2.3	2.4	2.2
CPI	-0.3	0	-0.1	0.2
Unemployment Rate	5.2	4.7	4.4	4.4
Current account	3.1	3.6	3.4	3.3
Fiscal balance	-7.8	-7.2	-6.8	-6.4