Japan Economic Diffusion Index Still Negative

- Our reports over the past few months have been negative on Japan’s economic growth, as weaker economic readings have dominated positive ones, and also because our contacts at Japanese companies in Tokyo and Osaka told us their cautious outlook on global growth. On top of a weak economy, the combination of a VAT hike and limited policy options is a serious problem.

- The 2Q GDP report was strong, but on net, economic data last week continued to suggest the economy is weakening, and we expect the weakening trend to continue.

- But we’re also presenting four data points in this report to illustrate that while the economy is weakening, it’s not in free fall.
SUMMARY

Japan Economic Diffusion Index Still Negative

Every week for almost 30 years, our economic team has categorized virtually every economic data release that comes out around the world as either a sign of strength or weakness, covering 41 countries.

For example, last week, Japan’s GDP was a sign of strength, while the leading index was a sign of weakness. Most often it’s straightforward, but occasionally judgment is required.

Over the past seven months, Japan’s economic data were on the weaker side, which has put our Economic Diffusion Index for Japan in negative territory for most of 2019.
Japan Economic Diffusion Index Still Negative  Contd

To be sure, we’re not dismissing the strength of the GDP report. And there were some encouraging positives such stronger capex and compensation (see below). But the point here is that the weight of evidence still suggests Japan’s economy is weak and weakening. And 2Q real GDP has some pull-forward.

Weakest Economy Going Into VAT Hike

It’s particularly worrisome that our Economic Diffusion Index suggests that the economy is weakening ahead of a VAT hike in Oct. This weakness in the EDI reflects these weaker data, reported just in the past two weeks:

- IP
- Machine tool orders
- Small business profits survey
- Consumer confidence
- Job openings
- Leading index
- Economy Watchers.
Weakest Economy Going Into VAT Hike  
Contd
The widely-followed leading index plunged -1.7% m/m in June to a new low. This is the weakest reading for the LEI with a VAT hike just 4 months out. Going into previous VAT hikes in 1989, 1997, and 2014, the LEI had been increasing.
Weakest Economy Going Into VAT Hike  Contd

The Economy Watchers survey, which covers 2,000 companies that directly service consumers, paints the same picture. The survey was started in 2000, so there’s only one VAT hike episode in the history of the series. But going into the previous VAT hike in 2014, the Economy Watchers was trending higher and at an elevated 55.7. This time, the survey is clearly declining and is just 41.2.
Weakest Economy Going Into VAT Hike  Contd

On top of all this, it’s troubling that this time, there’s less room for stimulus to offset the negative impact from the VAT hike. Going into previous VAT hikes in 1989 and 1997, the govt debt-to-GDP ratio was “just 50% and 65% and BoJ’s policy rate was 2.5% and 0.5%, which left room for stimulus. Now the debt-to-GDP ratio is 200%, making it difficult to implement significant fiscal stimulus, and BoJ’s policy rate is already -0.10%.

Japan Economy Not in Free Fall

Our reports over the past few months have been negative, as economic data have been dominated by weaker readings. And based on EVRISI’s weekly company surveys for the US, China and Europe, which remain in weakening trends, and also based on what we heard from Japanese companies in Tokyo and Osaka in June, we expect Japan to continue to report weaker data.

However, we’re presenting these data over the next few pages to illustrate that while the economy is weakening, it’s also not in free fall.
First and most importantly, Japan’s labor market is the strongest in the past 30 years. Employment increased +0.9% y/y and was in record territory, helped by the record-high labor force participation rate. The unemployment rate is just 2.3%.
Japan Economy Not in Free Fall  Contd

Second, fitting with this strength in employment, the most encouraging part of the GDP report was that nominal compensation increased +1.7% y/y to a new high.

Inflation is still zero, so real compensation is up +1.7% y/y, which is stronger than the previous VAT hike episode, in which real compensation was up just +0.2%.
Japan Economy Not in Free Fall  Contd

Third, also fitting with strength in the labor market, office vacancy rates in major cities have declined to just 2.0% on average, which is in record-low territory. Consequently, office rents have also accelerated to almost a record +4.5% y/y.

![Office Rents Y/Y %](chart.png)
Japan Economy Not in Free Fall  Contd

And lastly, the number of tourists coming into Japan continues to surge to record highs. Over the past six years, the number of tourists has skyrocketed, increasing more than four-fold from 8.0m to 33.9m at an annual rate. Looking ahead, the tourism sector will be helped by two major events over the next twelve months: the 2019 Rugby World Cup and 2020 Tokyo Olympics.

The VAT is set to be hiked from 8% to 10% in Oct. In previous VAT hike episodes (1989, 1997, and 2014), during the two months leading up to the hike, the Nikkei traded within a narrow range. Then shortly after the hike, the Nikkei made its low, rallying +9% on average over the next four months.

Each episode shows quite different patterns, impacted by major eco / mkt events after the hike, eg, the 1990 Japan Bubble burst, the 1997 Asian Financial Crisis, and 2014 BoJ easing (please see next page). But one common denominator is that in each of these episodes, the Nikkei made its low shortly after the VAT hike. If the Nikkei tracks this simple framework, the Nikkei is likely to make its low in early Oct.
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