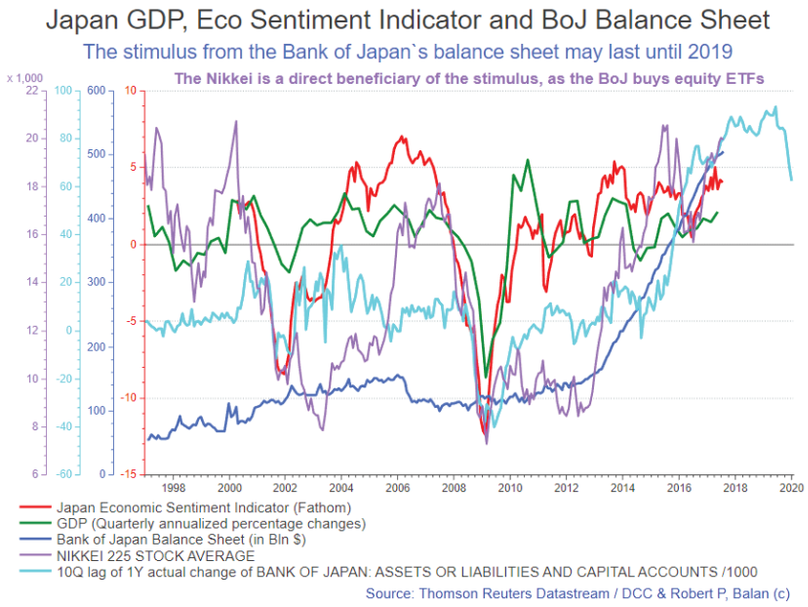
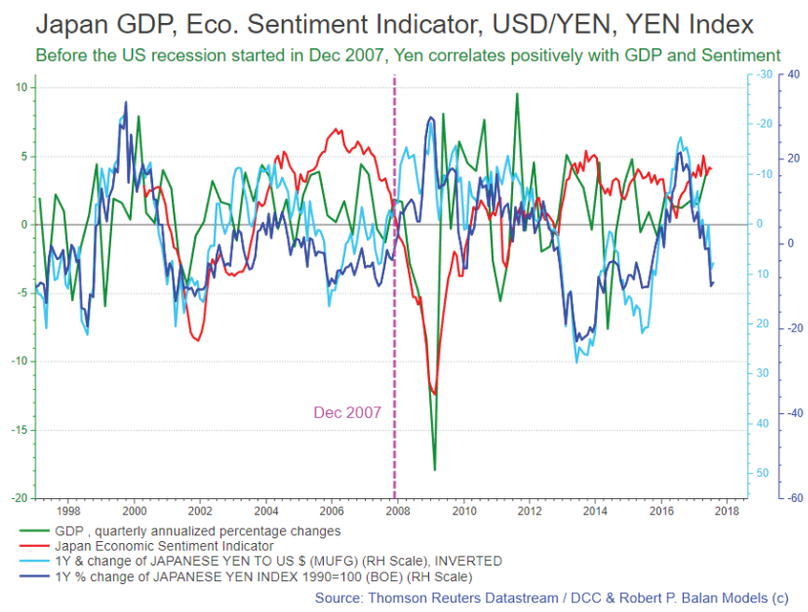
15 / From the Fall, the stage is set for a weaker Japanese Yen and stronger Nikkei – the harbingers of Reflation Wave II

Japan's fastest expansion in more than two years — as revealed in forecast-beating GDP figures last week — didn't come as a complete surprise to us and our readers. **We have always maintained that the impact of the Bank of Japan's huge balance sheet (nominally second only to the Federal Reserve's, but larger in terms of % to GDP – 94% vs 23% for the Federal Reserve), which filters into the real economy after a long lag (almost 10 quarters), will eventually show up in the hard data – and it is now in the process of doing so *(see 1st graph on this page)*. The stimulus also directly benefits the domestic stock markets as the BoJ also buys equity ETFs to bolster its balance sheet.** The latest BoJ foray an extraordinary $2 billion buying spree of Japanese equity ETFs over the course of last week. **Improvement in growth prospects due to the stimulus should ironically weaken the Yen, which itself, has positive implications for the Nikkei Index as well.**

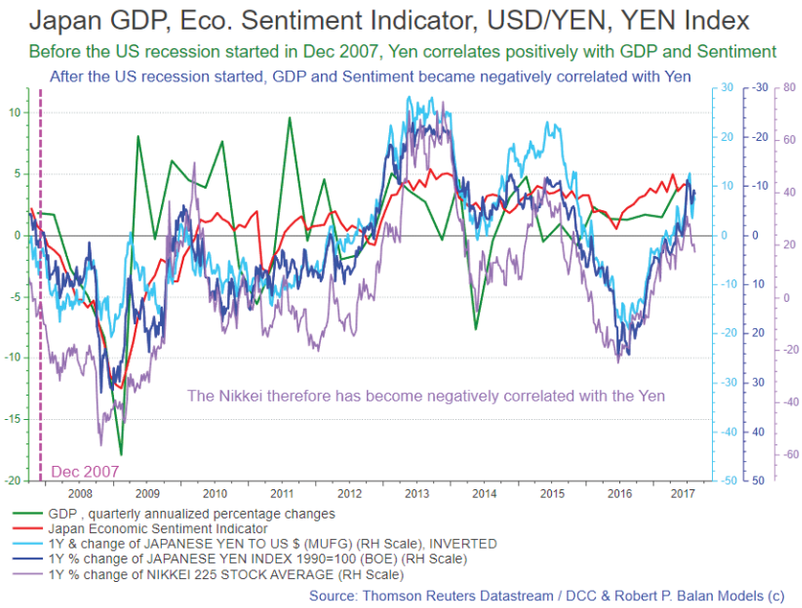


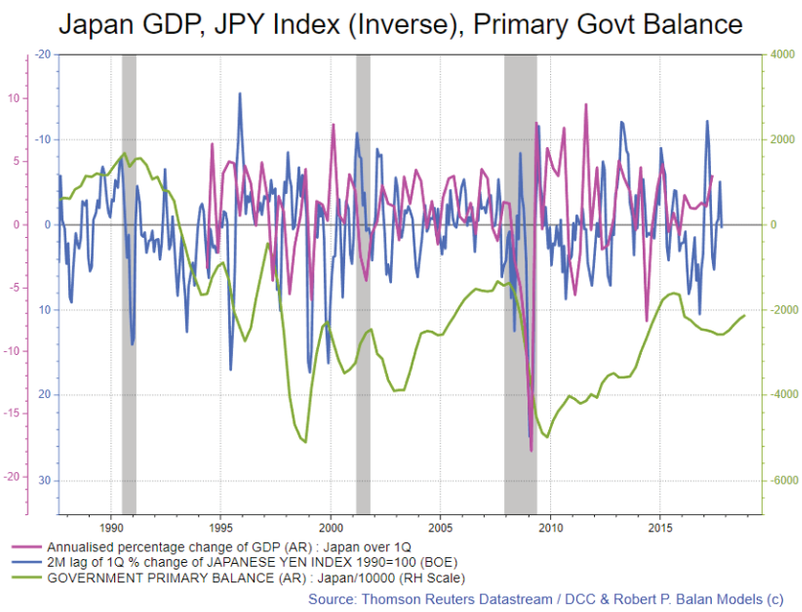


On 14 August, the Cabinet Office announced that Japan's economy grew by an annualised 4.0 percent in Q2 2017, exceeding the consensus estimate of 2.5 percent. **A Japanese Economic Sentiment Indicator (ESI) juxtaposed with GDP points to an upswing in economic activity that was yet to be reflected in the growth hard data *(see 1st graph on this page)*. But eventually it will be.** Japan's Cabinet Office takes up to seven weeks after the quarter-end to publish its preliminary GDP estimate -- it the last of the 'Big Four' to do so. But some caveat: Cabinet Office also makes the largest revisions to that initial estimate, so it may be a few months later before we will know the full scale of the ongoing uptick in growth.

The forthcoming improvements, as pointed to by the ESI, appear to have been driven by improving corporate sentiment, related both to a weakening yen and **increasing demand from China.** Japan's export growth to China has picked up sharply since the world's second-largest economy began a significant fiscal expansion at the beginning of 2016 (see the base metals story in this issue for more details). **A weakening of the Yen in Q4 2016 and Q1 2017, something that the BoJ has been desiring for a long time, was motivated by market expectations of policy divergence and a global more 'risk on' environment.** It also appeared to have contributed to improving business sentiment, and eventually into the real economy. Last week's provisional GDP estimate suggests that both business investment and household consumption drove growth in the second quarter, with net trade exerting a small drag as export volumes fell by 1.9 percent – this is at odds with survey-based data, which continue to point to rising optimism among firms, particularly manufacturers. That optimism does appear to have fed through to investment, which rose 11.7 percent on the quarter, contributing 2.6 percentage points to quarterly, annualized GDP growth ***(see 2nd graph above)***.

We have to scrutinize some of those correlations in detail, as there has been a change in the relationship of the domestic currency versus domestic growth and activity. **Prior to the US recession which started in December 2007, the relationships between growth/activity and the Yen was positive. After the onset of the US 2007 recession, the correlations turned negative *(see 1st graph on this page)*.** This information should be internalized, as it impacts the way investors look at the domestic equity markets. **The Nikkei, the main Japanese Index, has now a very strong negative correlation versus the Yen – Yen strength hammers Japanese equity prices, and vice versa. The other implications are enormous – stronger growth and activity will now lead to a weaker yen.** This is essentially a looped dynamical process – a stronger yen, on the other hand, leads to a weaker economy and slower activity ***(see 1st graph on this page)***. **The administration of Prime Minister Shinzo Abe has therefore put a lot of effort in trying to generate a weaker currency – their success record is spotty, however. It is proving to be difficult to weaken the Yen.**





The reason why global (and domestic investors) like the Yen so much is because Japan is one of the very few countries which can still boast of a current account surplus, although today, the current account surplus has nearly vanished after several years of decline. The composition of that surplus has been changing -- household and government savings have been waning since 1990, but Japan`s corporate sector's net savings compensated by climbing even higher. T**he Japanese population holds an astonishing ¥1,654 trillion of financial assets, or 341% of GDP. Highly liquid currency and deposits account for 52.6% of the total.** Households can effectively dis-save (spend) for decades by liquidating their financial assets in order to maintain their lifestyles. **That surplus has diminished, but it is still relatively large compared to other developed economies – that had served as a magnet for the Yen.** Nonetheless, the message is clear – the country`s bleak demographics profile could set it on an irreversible course towards a lasting deficit at some time in the future. Japan's dependency ratio, which is projected to decline until mid-century, can itself alone explain the majority of the secular decline in the gross national savings rate. That has removed some cachet off the Yen, but **the rate of weakening is not satisfactorily quick enough for the Abe administration, which is looking for further ways to accelerate the weakness of the local currency.**

The government has been forced to run chronically large budget deficits since the mid-1990s in an attempt to soak up the excess savings from the private sector. But with gross debt amounting to 245% of GDP today, and heeding the alarm expressed by global inventors, the current government has made long-term fiscal consolidation one of the cornerstone policies of "Abenomics". That, ironically, has provided another way to cut down the Yen strength, and at the same time, provide a high profile public relations effort – the government's targets a primary balance surplus by fiscal 2020. **The last time Japan had a primary government balance was Q1 1993. And most attempts to go back**

to balance had been stymied by a series of economic setbacks. Attaining primary balance, after all, requires a growing economy. It is a condition where the government can pay for its annual policy-related expenses out of its basic income such as tax revenue without incurring new debts. Japan will face a paradox as it attempts to rein in social spending. Difficult reforms required to reduce the cyclically-adjusted budget deficit may have the unintended consequence of further depressing private sector savings. The net effect on Japan's structural current account from any improvement in government balances could therefore be neutral, and will have achieved not much. And, for one thing, a lot of irony abounds as well. **It is ironic that a debt-free situation is required to weaken the currency, which redounds to economic growth, and a robust domestic stock market *(see 2nd graph on previous page)***.

In the final analysis, the fate of the Yen (and thereby of the Nikkei Index) may lie at the doorsteps of the Federal Reserve in Washington D.C. **The Nikkei is strongly linked to a weaker yen, and the domestic currency itself, is tied up with US long term interest rates – falling US rates strengthen the Yen which will therefore undercut the Japanese stock market *(see graph on this page).* Our outlook is for US bond yields to rise from a Q3 trough (see the article in the June 2017 Capital Observer). That could give the US Dollar a significant bounce after a multi-month of declines, and should therefore weaken the Yen and lift the Nikkei in a broad, intermarket reflation process which could persist into H1 2018.**