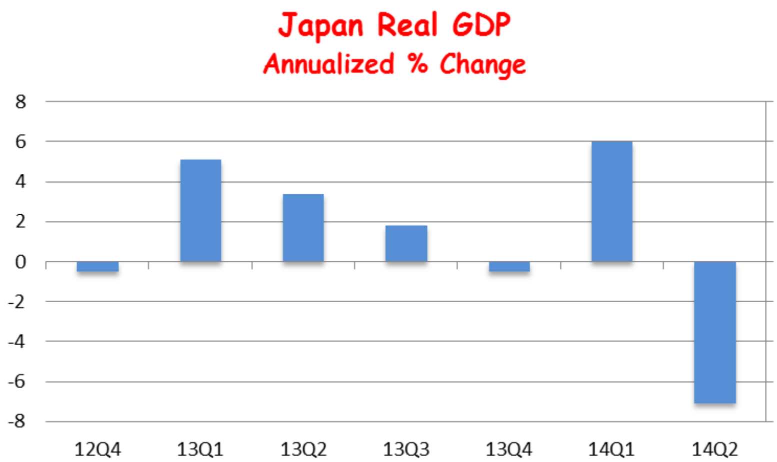
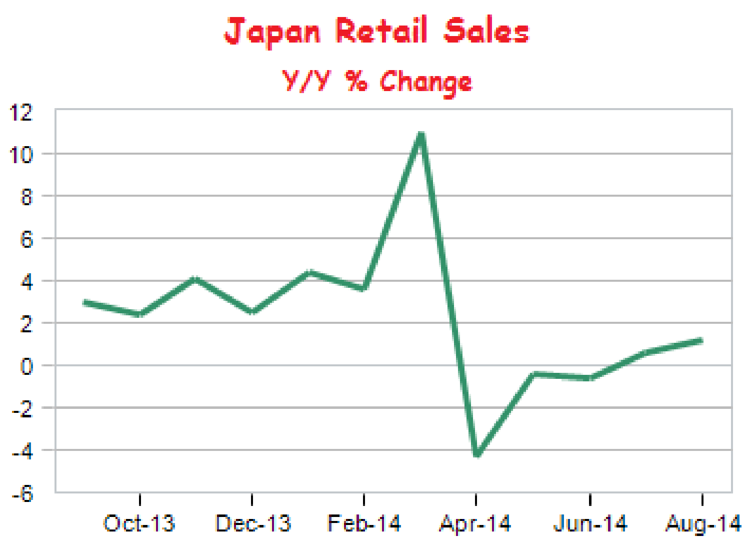
Japan's Economic Outlook



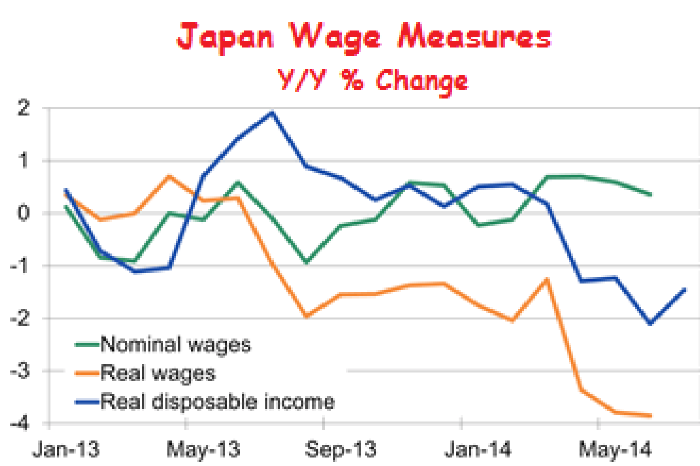
Sources: Economic and Social Research Institute, Moody's Analytics

The Japanese economy is stalling. After years of struggling with persistent deflation and a strong currency, the economy's prospects improved when Prime Minister Shinzo Abe introduced the Abenomics plan, which includes massive fiscal and monetary stimulus into Japan's economy. However, the economy's recent performance has raised concerns that Abenomics may be faltering.



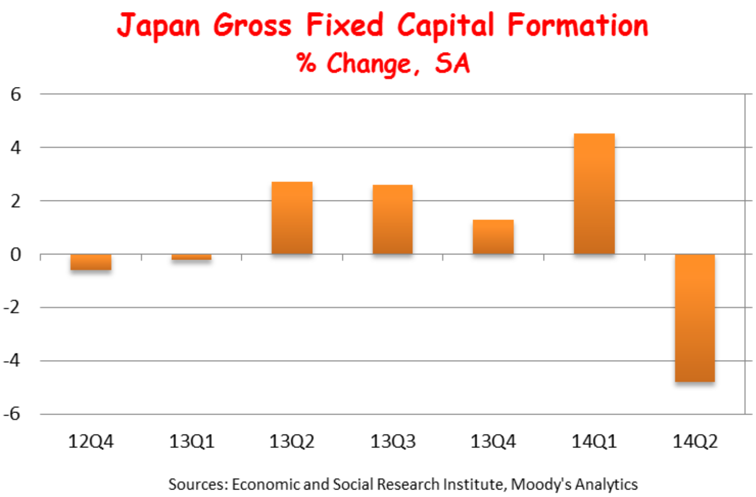
Sources: Ministry of Economy, Trade and Industry, Moody's Analytics

In April, the government increased the sales tax rate from 5% to 8% to improve the economy's fiscal position. This caused households and businesses to front-load purchases in the first quarter of the year to beat the tax hike, resulting in a spike in GDP growth. Following the uptick, GDP growth fell sharply in the second quarter. Although a second quarter slowdown was expected, the economy performed worse than anticipated and has not rebounded as hoped. Data indicates that growth has slowed to a snail's pace after the second quarter contraction. Overall, economic growth this year is expected to be weak with GDP expanding by around 1%.



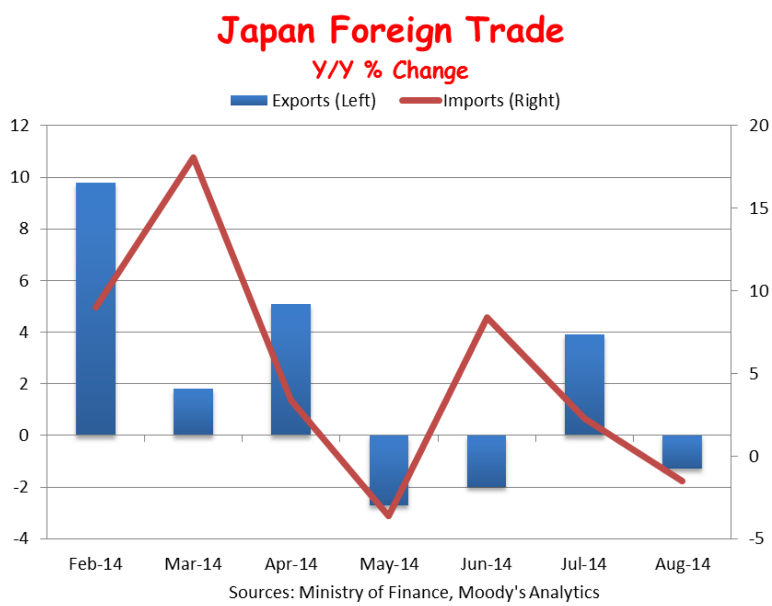
Sources: Ministry of Health, Labour and Welfare, Statistics Japan, Moody's Analytics

One of the biggest signs that Abenomics is faltering is the weakness in Japan's consumer sector. While consumer spending has declined sharply due to the tax hike, higher inflation and the weaker yen are also weighing on demand. One of the main goals of Abenomics is sustained real wage growth, as it is believed that this will drive a healthy cycle of higher spending and inflation. However, a recent spike in inflation due to the tax hike has lowered real wages, reducing spending and confidence levels among Japanese consumers. Firms have responded by decreasing production and employment, which means workers now have even less bargaining power for higher wages. Conditions in the household sector are therefore expected to remain weak in the near term.



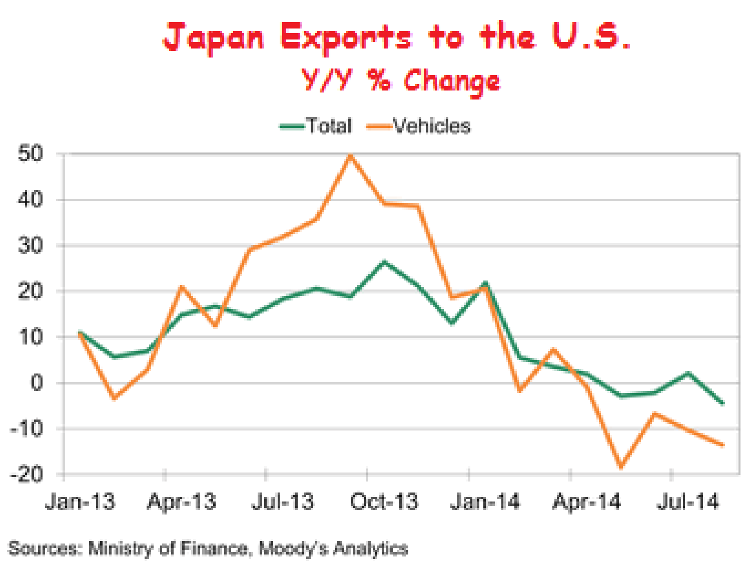
Another sign that Abenomics is slipping is the weakness in the corporate sector. A lot of the weakness in the household sector was expected, as Abenomics aims to lift the corporate sector at the expense of the household sector by eventually reducing corporate taxes. The hope is that Japanese firms will drive the economy's recovery by increasing wages and investment.

Unfortunately, however, the corporate sector is also showing weakness, with business investment plummeting and confidence levels down. Since household spending is unlikely to rebound significantly in the near term, business investment and spending are expected to remain weak as well.

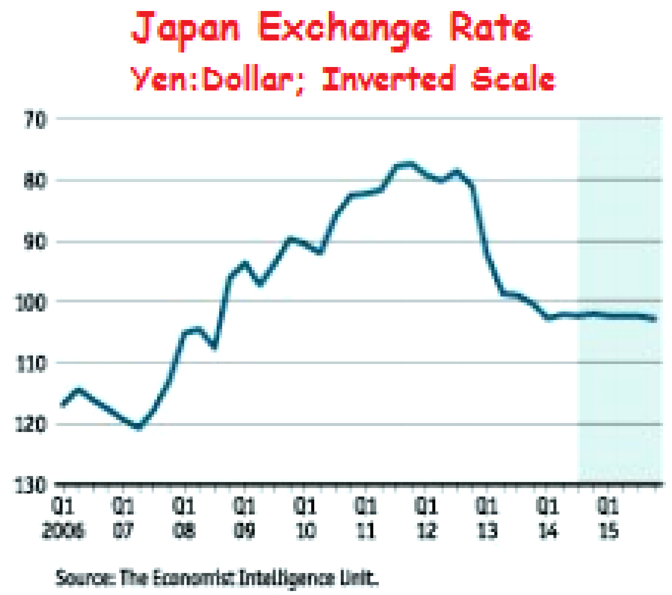


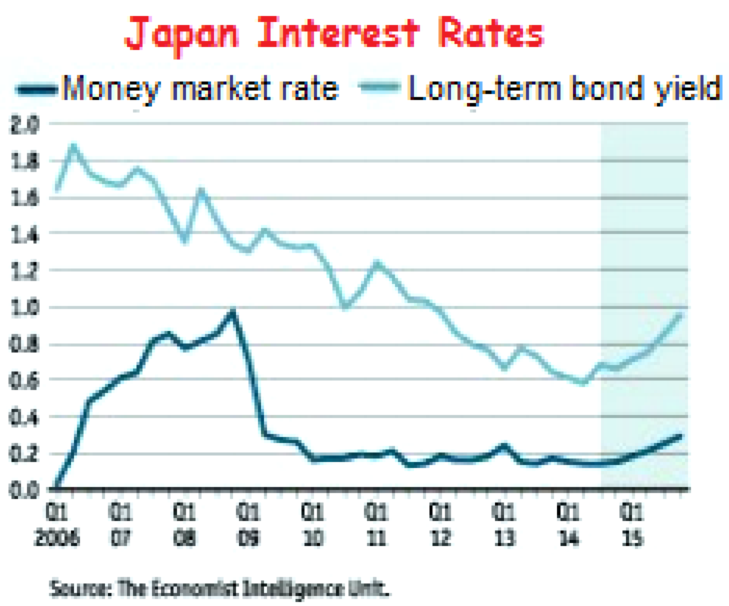
Japan's import growth has declined significantly as a result of reduced domestic demand following the April 1st tax hike. This trend is expected to continue in the coming months as the economy adjusts to the higher tax rate.

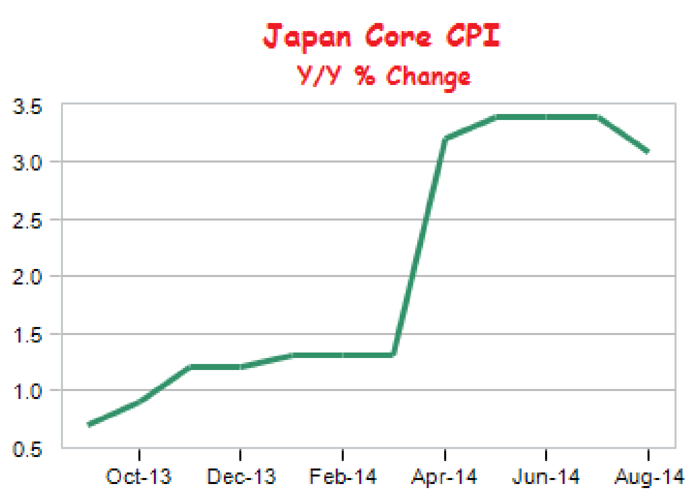
Japan's exports growth has also been disappointing, despite the weaker yen. Exports to the U.S. in particular have declined, as auto shipments are falling sharply. While car sales in the U.S. have increased since the beginning of the year, most of these sales have been for U.S. brand vehicles, such as G.M. and Chrysler.



It is expected that exports will grow at a faster rate in the coming months, as improving economic conditions in the U.S. and the weaker yen help boost external demand. The strong demand for new cars in the U.S. should also translate into more vehicle exports for Japan in the coming months. However, since a lot of Japan's manufacturing takes place outside of the country, the benefits of the weakened yen on Japan's exports will remain limited.







Sources: Statistics Bureau & Statistics Center - Ministry of Public Management, Home Affairs, Posts and Telecommunications, Moody's Analytics

After years of struggling with a strong yen, government efforts to weaken the country's currency have been successful. The Bank of Japan has held an expansionary monetary policy by increasing the monetary base at an annual rate of ¥60 trillion to ¥70 trillion.

The increase in the money supply has reduced interest rates in Japan and, therefore, the return on investment in Japanese assets. As a result, foreign and domestic investment in Japanese assets has decreased. This has reduced the demand for yen to purchase Japanese assets, causing the value of the yen to drop. As a result, the Japanese yen has significantly weakened against the dollar. The exchange rate is expected to remain stable in the near term.

The significant deprecation of the yen has helped push up consumer prices in Japan by increasing imported inflation, leading the economy out of its previous deflationary trap. The April tax hike also caused a spike in inflation, pushing Japan's core inflation rate above the central bank's 2% target rate.

The Bank of Japan has made it clear that it will be maintaining its expansionary monetary policy for the time being and is hoping that the core inflation rate will return to its target rate by the end of the fiscal year in March 2015. Over the near term, however, prices are expected to remain relatively flat since suppressed consumer demand makes it difficult for firms to increase prices.

Overall, Japan's economy is struggling to regain its momentum following the April tax hike. Consumer spending has plummeted and businesses have responded by decreasing production and employment. After years of struggling with persistent deflation and a strong currency, the inflation rate has picked up and the yen has weakened. While this is great news, higher inflation and the weaker yen are weighing on consumer spending. Exports growth is also demonstrating a lackluster recovery, despite the weaker yen. The economy is expected to pick up and grow at a barely-positive rate through the rest of the year. Conditions should improve once the economy adjusts to the higher tax and inflation rates.