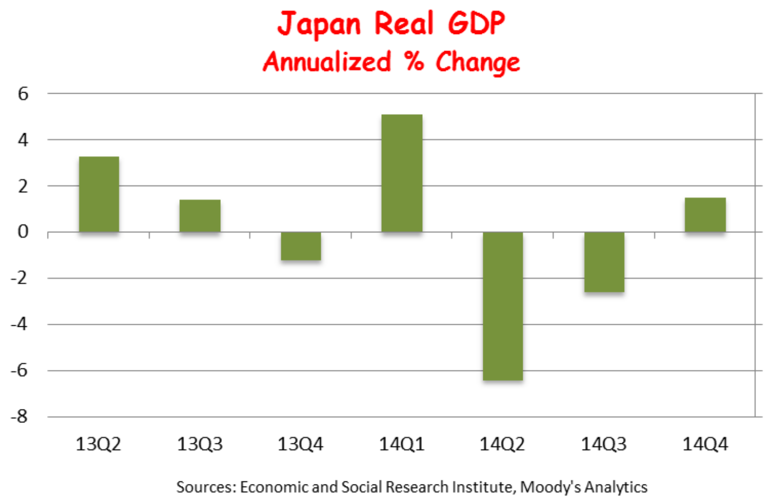
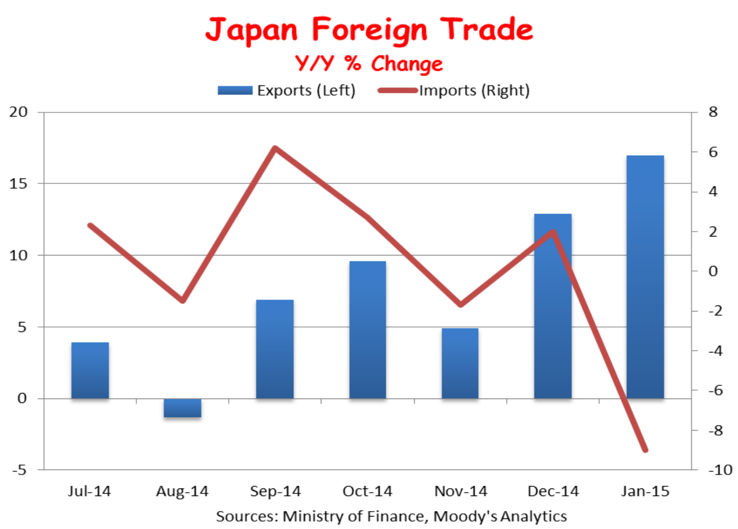
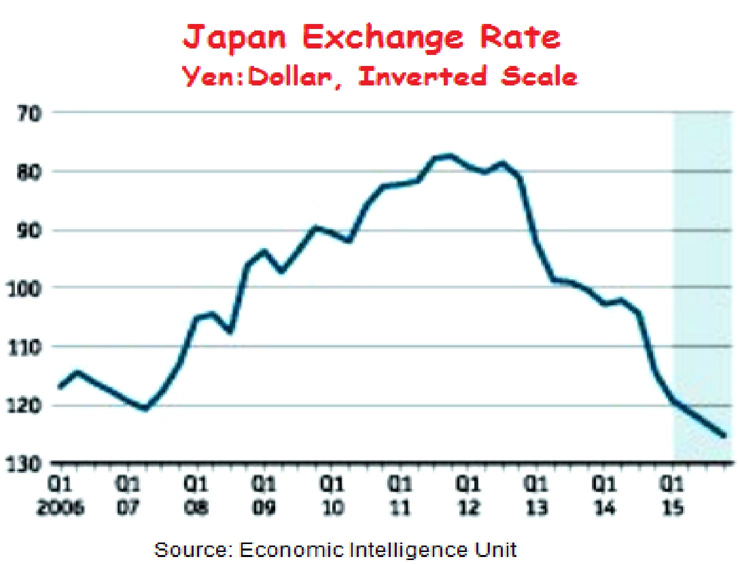
Japan's Economic Outlook



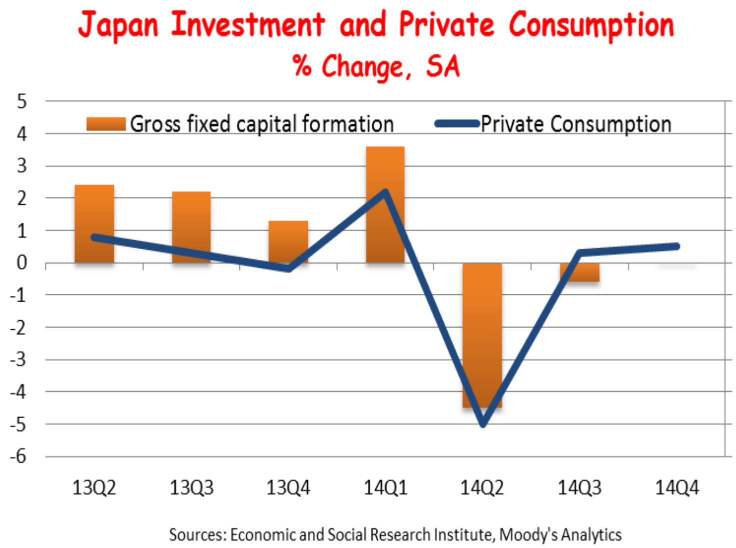
The Japanese economy has made its way out of recession. Growth took a major dip after last year's sales tax hike, when private spending plummeted in the second quarter. Although the economy demonstrated a slight recovery at the end of the year, it is still very weak. Year-over-year GDP growth was flat in 2014, down from 1.6% in 2013, and only avoided negative territory because of the spike in activity at the beginning of the year when consumers and businesses front-loaded purchases to beat the tax hike. Given the fragile state of Japan's economy, the government has postponed any further tax increases until April 2017.



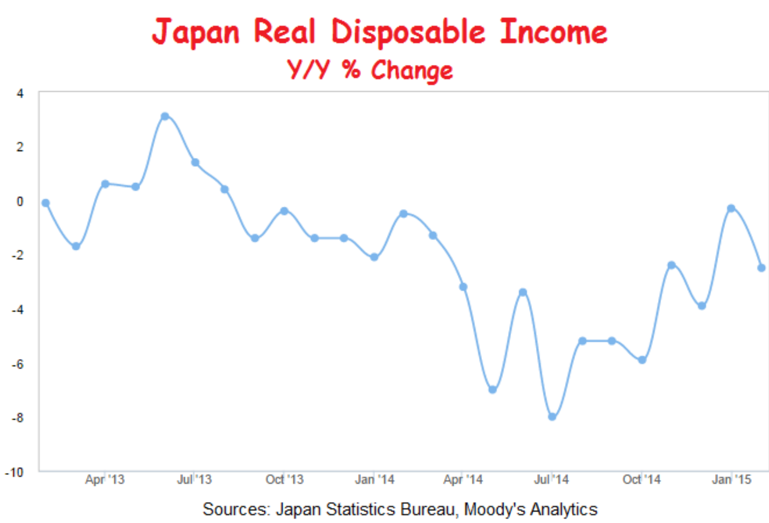
Robust exports growth is the main driver of Japan's recent growth. The Bank of Japan's massive monetary stimulus program, which involves increasing the monetary base at an annual rate of ¥80 trillion, has resulted in a significant depreciation of the Japanese yen. The weaker yen, coupled with improving economic conditions in the U.S., has resulted in an increase in exports. The yen is expected to weaken further against the dollar in the coming months as the Federal Reserve pulls the reins on its quantitative easing program. This, along with a strong U.S. outlook, is expected to keep exports growth strong this year.



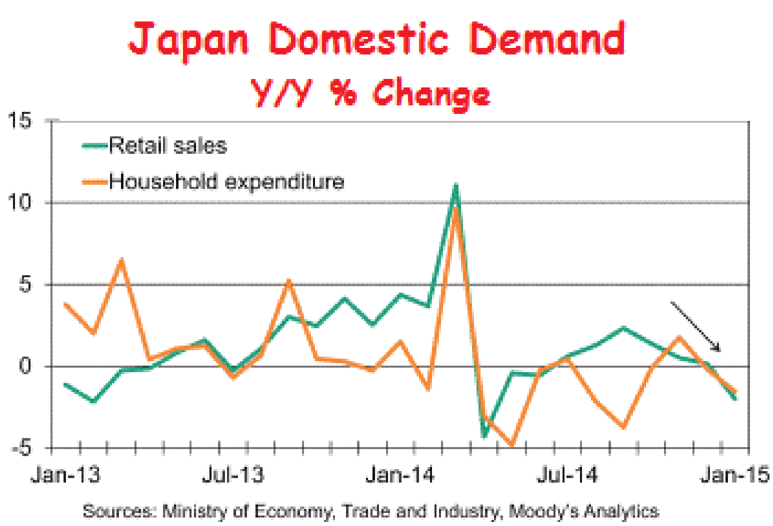
Japan's imports growth, on the other hand, has fallen to negative territory. Although some of the decline in imports is due to falling oil prices and the weakened yen, reduced domestic demand is also at play. The combination of rising exports and falling imports has caused net exports to increase, which is the main reason the economy has managed to climb out of recession. Given the lackluster domestic economy, Japan will likely continue to be led by external demand in the near term.



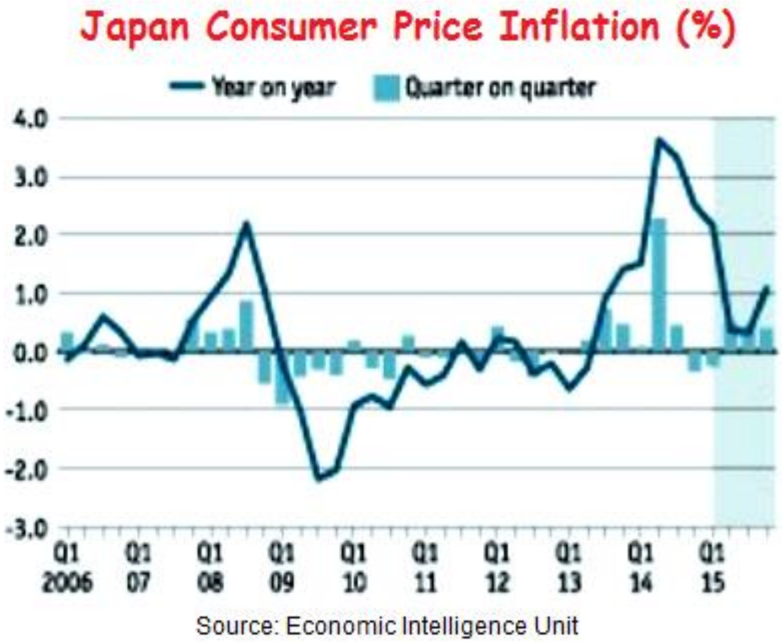
Prime Minister Shinzo Abe, who was re-elected in December, has made boosting the corporate sector a primary focus in lifting the economy and moving it to a higher growth trajectory. Abenomics involves a massive amount of monetary stimulus to weaken the yen and lift profits of export-oriented firms. The hope is that this will result in a virtuous cycle of higher wages, investment and spending. Unfortunately, however, despite the fact that the yen has weakened significantly and Japanese firms are experiencing record profits, investment growth remains flat and real wages are falling. Firms are signaling that they are not confident with Abenomics.

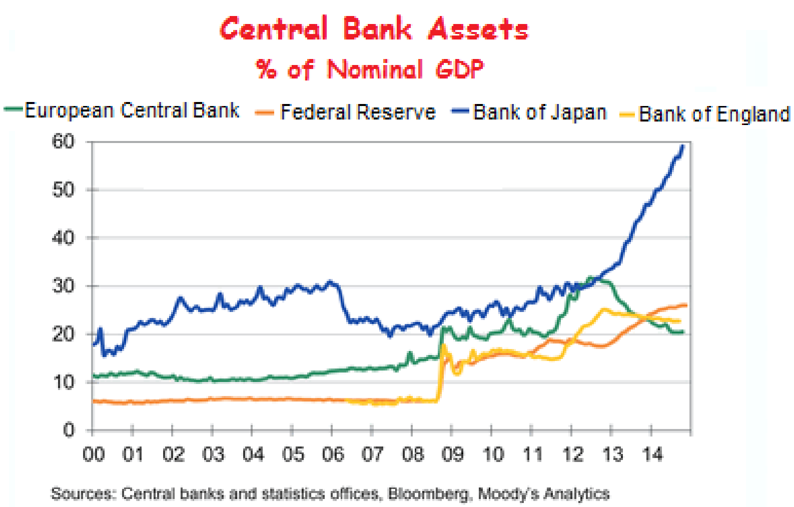


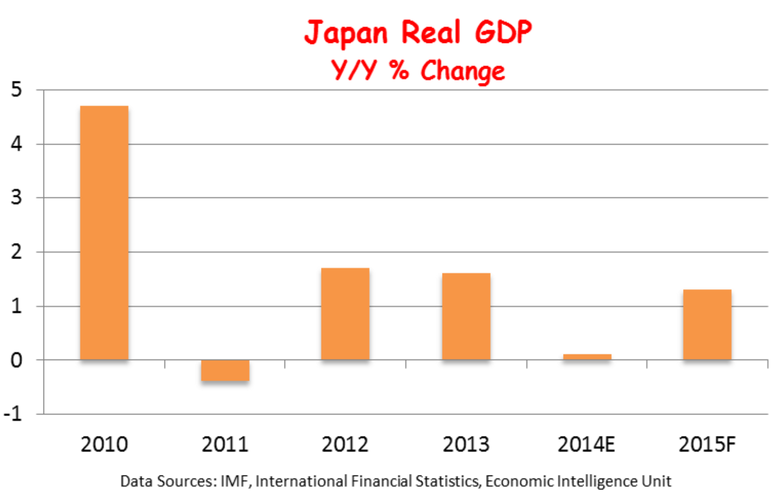
Not surprisingly, falling real wages have weighed heavily on the consumer sector, with household spending growth returning to negative territory at the beginning of the year. There is hope that the ongoing annual spring wage negotiations will result in higher real wages. Unfortunately, however, there is no guarantee that an increase in wages will result in higher spending by consumers, as any wage gains may be used to replenish lost savings.



Given the downbeat domestic economy, Prime Minister Abe is increasing his stimulus efforts by cutting corporate taxes. Beginning in April, the corporate tax rate will be cut by 3.29% over the course of two years. The tax cut, combined with falling oil prices and lower interest rates, is expected to boost investment and wages this year. Consumer spending will likely follow suit and begin to recover by next year.







The weakness in Japan's domestic economy, along with falling oil prices, has resulted in a significant decline in inflation. This is concerning because Japan has historically struggled with deflation and only exited its previous deflationary trap after the Bank of Japan's massive monetary easing program weakened the yen and resulted in an increase in imported inflation. Last year's tax hike also caused a spike in prices.

Prices will likely continue to trend downward until the domestic economy strengthens. The Bank of Japan has made it clear that it will be maintaining its expansionary monetary policy for the time being and is willing to take drastic measures to ensure the economy does not fall back into a deflationary trap. Therefore, the central bank will likely boost its monetary stimulus efforts further if the inflation rate does not increase by the end of the year.

Unfortunately, the central bank's massive monetary easing has created concern of a financial crisis. Asset purchases have skyrocketed and reached almost two-thirds of Japan's GDP. The worry is that, if investors suddenly reduce their bond holdings and bond yields increase, the government may not be able to pay its debt. Given that Japan's government debt has reached around 240% of GDP, this situation would be an enormous detriment to the economy and likely result in a financial crisis.

Overall, we see that the Japanese economy is struggling to regain its momentum following last year's tax hike. While the economy has exited recession, it is still very weak and struggling with stalling domestic demand. Economic growth is expected rise to a little over 1% this year, driven mostly by external demand.