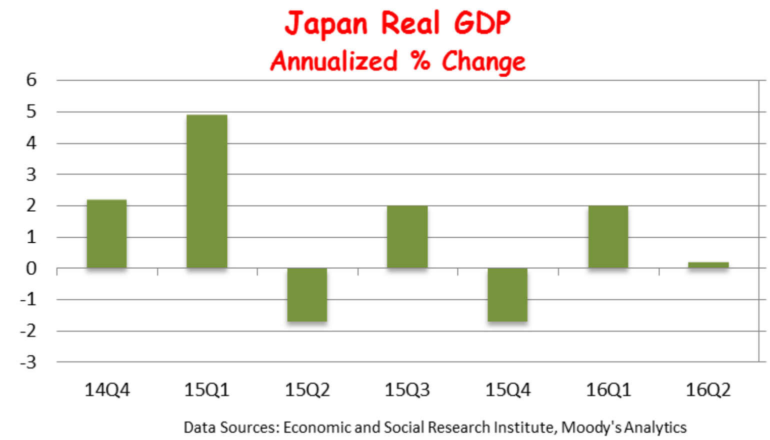
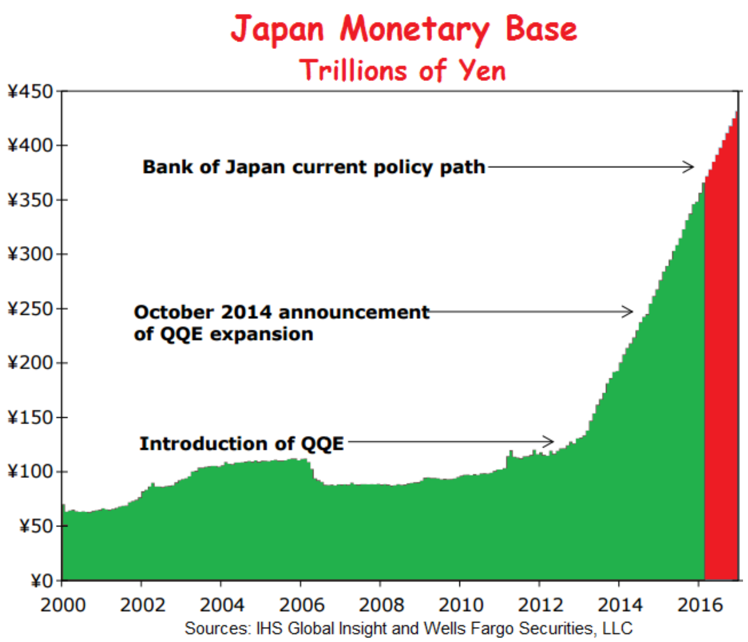
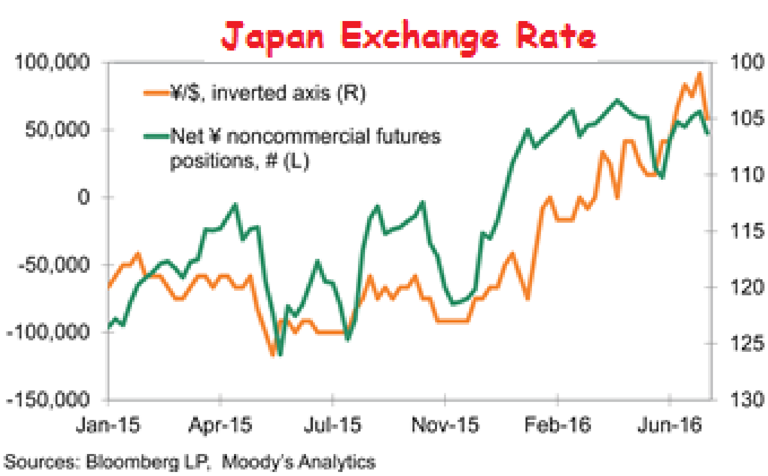
Japan's Economic Outlook



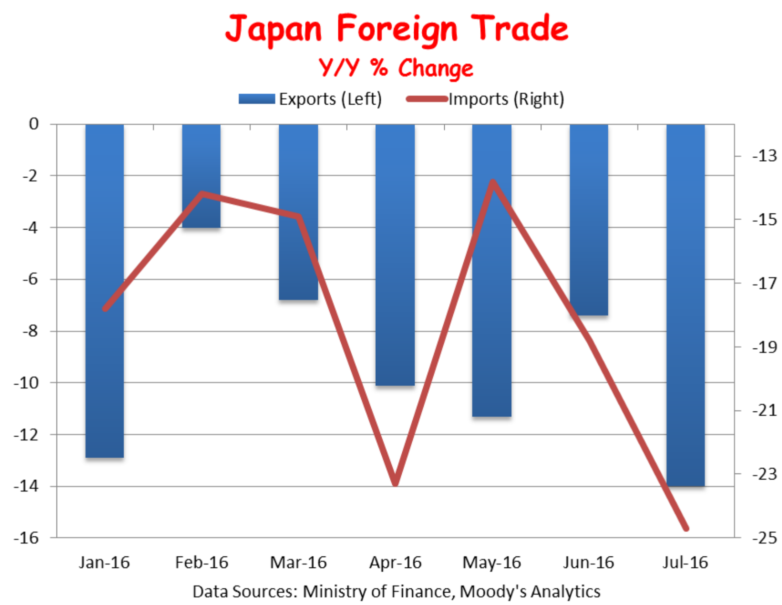


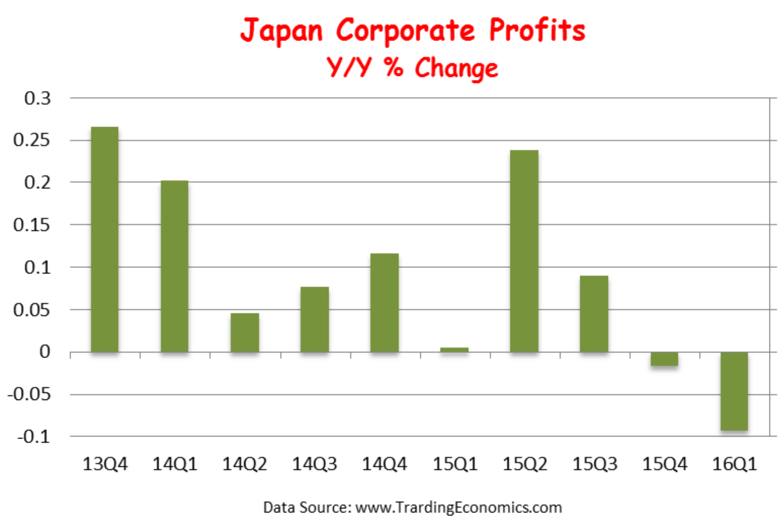


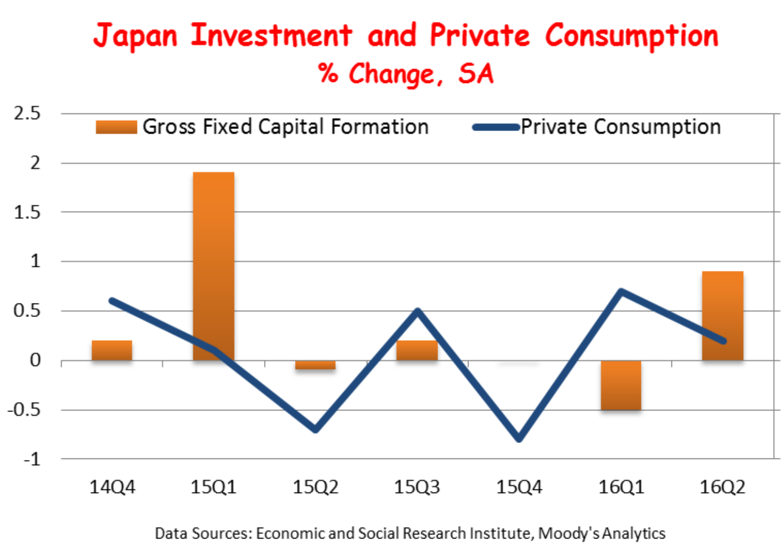
The Japanese economy is stalling. Growth took a major dip in 2014 after a sales tax hike, when private spending plummeted. Although the economy is no longer in recession, it is still very weak. After dropping to negative territory in 2014, year-over-year GDP growth reached only 0.6% in 2015 and has averaged just 0.35% in the first two quarters of 2016. Given the fragile state of Japan's economy, the government has postponed any further tax increases until October 2019. Conditions are expected to remain weak this year, with economic growth hovering around 0.5%.

Japan's slowdown is largely the result of weak domestic demand. Prime Minister Shinzo Abe, who was re-elected in December 2014, 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. Currently, the Bank of Japan's stimulus program involves increasing the monetary base at an annual rate of ¥80 trillion.

Unfortunately, despite the government's quantitative easing efforts, the yen has strengthened considerably; heightened global financial uncertainty resulting from China's slowdown and the Brexit has caused foreign investors to flee toward safe haven assets. This trend is expected to continue until global economic conditions stabilize and foreign investors' risk aversion subsides. Meanwhile, Japan's central bank is expected to maintain its ultra-loose monetary policy stance and may even increase its stimulus efforts further in the near term.





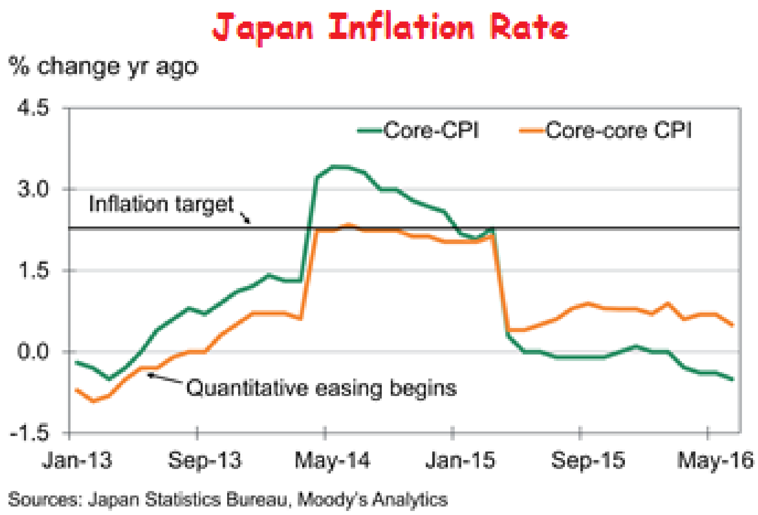


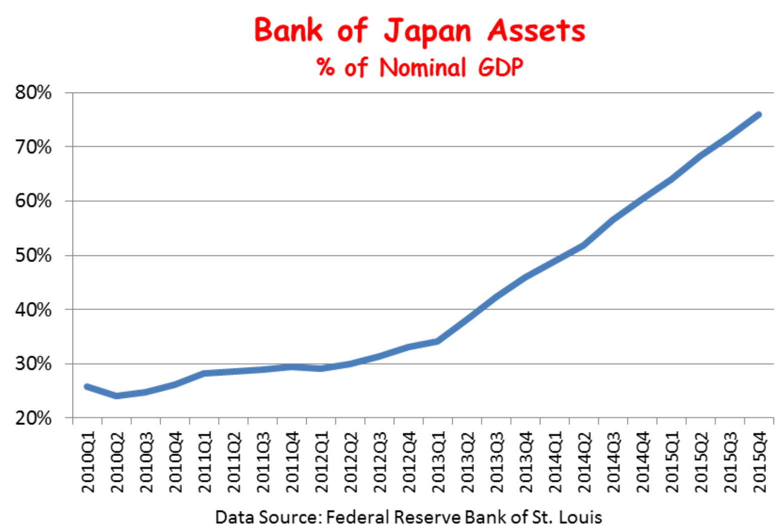
Reduced price-competiveness from the stronger yen, coupled with falling demand from Japan's leading export markets, including the U.S. and China, has caused Japan's exports growth to remain in negative territory for almost a year. Given that the yen is expected to strengthen further in the near term, global demand for Japanese exports will likely continue to decline in the coming months. Reduced external demand, along with cooling economic conditions in the U.S. and China's slowdown, will continue to weigh heavily on Japan's exports growth in the near term.

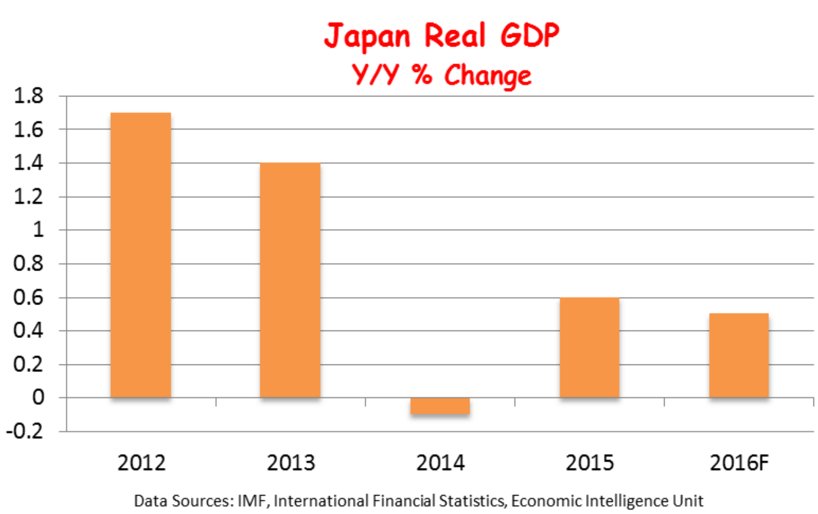
In addition to reducing corporate profits through lower exports, the stronger yen has also reduced profits for firms with overseas operations. As a result, Japan's corporate profits have experienced negative year-over-year growth since the end of last year and will likely continue to decline in the near term given the upward trend in the yen. Not surprisingly, declining corporate profits have weighed heavily on investment spending and prevented firms from increasing wages.

Meanwhile, Japan's imports growth has remained in negative territory for almost two years. Although some of the decline in imports is due to falling oil prices, reduced domestic demand is also at play; lack of wage growth is hurting the consumer sector, with household spending and confidence levels sputtering. Given that corporate profits are expected to continue to decline in the near term, wage growth and consumer spending will likely remain weak as well.

The weakness in Japan's domestic economy has prompted the government to recently announce a ¥28 trillion fiscal stimulus package; however, only around ¥6.2 trillion of this is new spending. As a result, the additional stimulus is expected to have little impact on Japan's economic growth.







The weakness in Japan's domestic economy, along with falling oil prices, has resulted in a significant decline in inflation. After remaining below target for over a year, Japan's inflation rate dropped into negative territory in April. 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 raised imported inflation. Unfortunately, the strengthening yen has reversed this trend and prices will likely continue to decline until the domestic economy strengthens and yen stabilizes.

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 deflation persists.

Unfortunately, the central bank's massive monetary easing has created concern of a financial crisis. Asset purchases have skyrocketed and reached over three-fourths of Japan's GDP. The government's new stimulus measures, along with the delay to a sales tax hike, are expected to increase government debt further in the near term.

Overall, the Japanese economy is struggling to gain momentum. While the economy has exited recession, it is still very weak. Uncertain global economic conditions will continue to push foreign investors toward safe-haven assets and place upward pressure on the yen, causing profits, investment and spending to remain weak in the near term. Economic growth is therefore expected to continue its stalling pattern and remain around 0.5% this year.