Weekly Economic Commentary

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Japan Check-In: Will the Weak Q3 GDP Reading Draw a Policy Response?

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Highlights

The much weaker than expected Q3 GDP reading in Japan is a modest threat to overall global growth for 2014 and into 2015.

We continue to believe the global economy will continue to expand in 2014, 2015, and beyond.

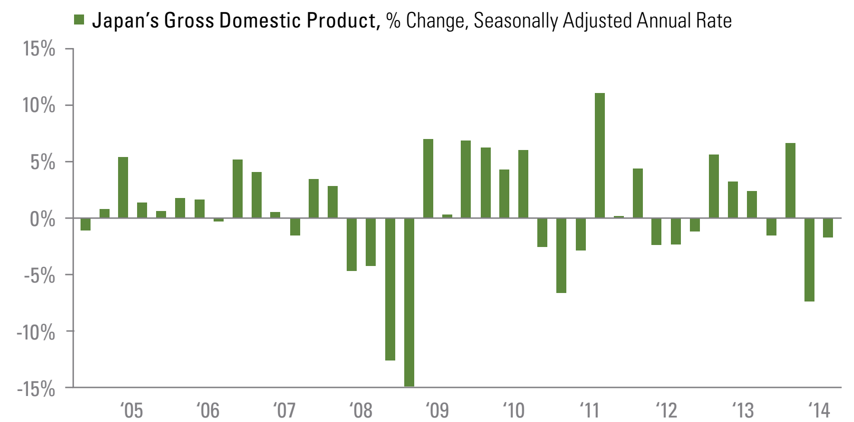
The pace and composition of the policy response from Japan in the coming weeks and months are critical.

Value-Added Tax (VAT)

The VAT is a tax on consumption of goods and services. It is a widely used tax across the world, in places like Canada, Mexico, the Eurozone, Japan, China, and Norway, but it is not used here in the United States.

Japan reported a 1.6% annualized decline in real gross domestic product (GDP) in the third quarter of 2014 over the weekend of November 14–16, 2014. Policymakers in Japanese Prime Minister Shinzō Abe's government and at the Bank of Japan (BOJ), as well as most market participants, expected a solid gain in GDP in Q3, not a decline. The consensus of economists polled by Bloomberg News was looking for a 2.2% gain in GDP in Q3, after the Japanese economy contracted more than 7% in Q2 2014 in response to a big value-added tax (VAT) increase imposed in April 2014. (We'll discuss the VAT in more detail below.) As a result of the unexpected decline in GDP in Q3 [Figure 1], Japan's economy has met the unofficial definition of recession (i.e., two consecutive quarters of negative GDP) and has entered its fourth recession since 2007. How long Japan's economy remains in recession—and more importantly, the policy response to the latest recession—may help to determine the trajectory of global growth in 2015 and beyond.

1 Japan's Economy Has Entered Its Fourth Recession Since 2007 and Awaits a Policy Response



Source: LPL Financial Research, Cabinet Office of Japan, Haver Analytics 11/17/14

The Consumer Disappoints

Consumer spending, which accounts for 60% of Japan's economy, rose just 1.5% in the third quarter, after the VAT increase led to a 19% drop in consumer spending in the second quarter of 2014. Most market participants—and probably the BOJ and the Abe administration—expected

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a better performance from the Japanese consumer in Q3. Housing, which accounts for around 1% of Japan's economy, contracted at a 24% annualized rate in Q3 after the 34% drop in Q2. Both are stunningly awful readings and speak to how fragile the Japanese consumer economy is. Overall domestic demand, which includes consumption (60% of Japan's economy), housing (1%), business capital spending (3%), and government spending (20%), fell 2% in Q3 after the post-VAT 11% drop in Q2 2014. Exports, one of the beneficiaries of the BOJ's quantitative easing (QE) program (via the weaker yen), increased by 5% in Q3; but imports, which were crushed in Q2 as the VAT increase dampened consumer demand, rose 3% in Q3, leaving net exports as only a small plus for GDP in Q3. The trade sector is one of the best hopes for restarting the Japanese economy, but the other sectors (most importantly the consumer) must contribute as well.

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The disappointing response from Japan's consumer and housing sector post-VAT increase, and the tepid although positive contribution from the export sector, will likely inform how the policymakers in the world's fourth largest economy respond. Over the past several weeks, Japan's prime minister has made it clear that the second of the planned two-step increase in the VAT — the first took the VAT from 5% to 8% while the second (planned for October 2015) would take it from 8% to 10% — is likely to be postponed until early 2017. An "expert panel" on the VAT will issue its findings later this week (November 16–22, 2014) and is likely to recommend the postponement. This will give more time for the Japanese government, and the BOJ, to try to solidify the Japanese economy to better withstand the next tax increase.

On the political front, Prime Minister Abe is likely to call an early election in Japan in the coming weeks, to seek support from the Japanese people to continue pursuing his administration's Three Arrows (fiscal, monetary, and regulatory) approach to Japan's decades-old economic problems. Abe's tenure as prime minister (he has been in office since December 2012) is the longest since the mid-2000s, and has provided much needed political stability in Japan, which has seen 10 prime ministers hold office since 2000. Abe himself held the post for a year in 2007, at the start of a six-year period that saw Japan elect six prime ministers. Voter rejection of Abe and his Liberal Democratic Party could cause markets to reconsider Japan's commitment to extract itself from years of deflation and recession.

QE in a Better Perspective

The weak Q3 GDP data puts the surprise move by the BOJ in late October 2014 to expand its quantitative easing (QE) program into better perspective. Most observers (ourselves included) expected the BOJ to wait until early 2015 before expanding its QE program aimed at ending decades of deflation and recession in Japan. Even though most of the Japanese economic data released in September and October 2014 have exceeded expectations [Figure 2], the BOJ saw something in the data that suggested the Japanese economy needed an additional jolt of stimulus. The weak Q3 GDP data keep the pressure on the BOJ to do more, which should keep exerting downward

Japan's Debt-to-GDP Ratio

The VAT increase was aimed at stabilizing Japan's precarious fiscal situation. Japan's fiscal woes are well known, and driven in part by poor demographics. In 2013, Japan's debt-to-GDP ratio stood at over 200%, nearly triple the U.S. debt-to-GDP ratio of around 70% [Figure 3]. In the early 1990s, at the start of Japan's decades-long bout with deflation and recession, Japan's debt-to-GDP ratio stood at just under 50% of GDP. Since then, extremely weak economic growth (less than 1% per year), a rapidly aging population, and a long bout of deflation has sent Japan's debt-to-GDP ratio to over 200% of GDP. The bad news is that the economy remains weak and the demographics are getting worse. The good news is that the Japanese themselves own almost all the debt of the Japanese government (unlike in the United States, where 50% of the debt is owned by outside entities), thus Japan's central government can still borrow in global financial markets with some ease. The Japanese authorities have now finally acknowledged the long-standing economic and fiscal problems and have begun to address them. Still, Japan's fiscal fate should serve as a long-term warning to other central governments around the globe—including our own—facing similar economic and budget issues.

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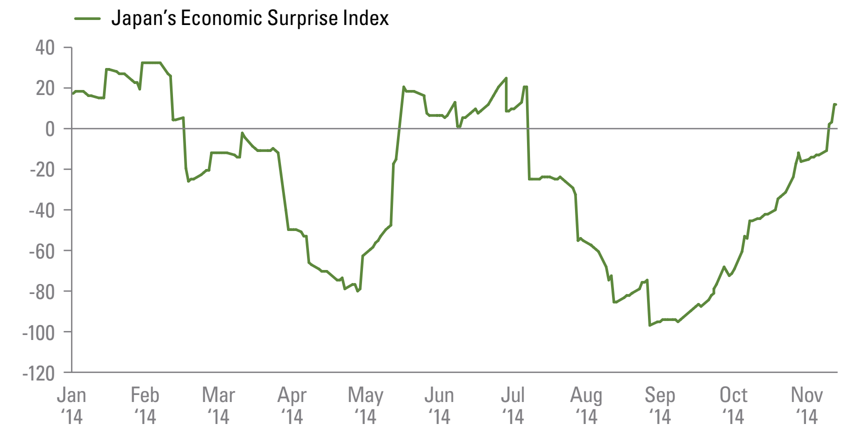
2 Japan's Real GDP Growth in Q3 Fell Short of Expectations, Despite a Run of Better Than Expected Economic Data

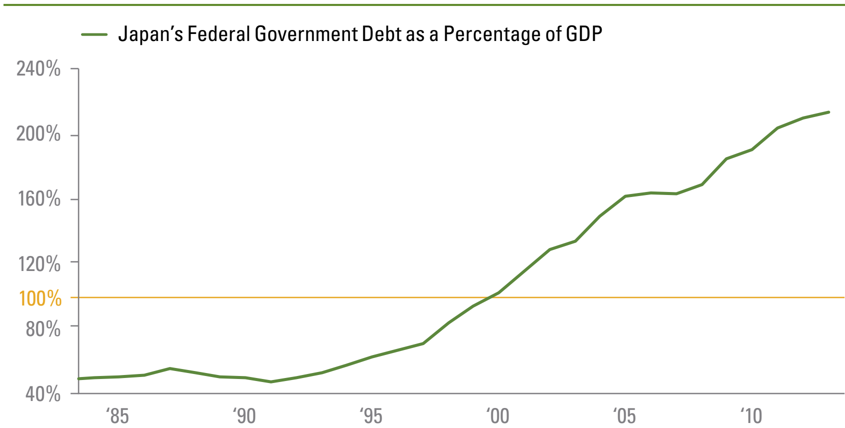


Source: LPL Financial Research, Bloomberg, Citigroup 11/17/14

pressure on the yen. As 5% percent of U.S. goods exports head to Japan, and 6% of U.S. imports come from Japan, this leaves the United States with a small but persistent trade deficit with Japan.

On balance, the much weaker than expected Q3 GDP reading in Japan is a modest threat to overall global growth for 2014 and into 2015, but it does not change our view that the global economy will continue to expand in 2014, 2015, and beyond. However, unlike the Eurozone—which has yet to forcefully respond to its economic malaise—Japan has at least recognized the issue and is moving on several fronts to try and address the problems that can be tackled with fiscal, monetary, regulatory, and structural reform. More needs to be done, however, and the pace and composition of the policy response from Japan in the coming weeks and months are critical. We will continue to monitor the situation closely. ■

3 At More Than 200%, Japan's Debt-to-GDP Ratio Is Nearly Three Times That of the United States



Source: LPL Financial Research, Bank of Japan, Haver Analytics 11/17/14

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

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