JAPAN GLOBAL ECONOMIC OUTLOOK

Capital Market Dynamics Foreign Exchange ►

Amid elevated global financial market uncertainty and resultant safe-haven flows, the Japanese yen (JPY) began 2016 with a strengthening bias against the US dollar (USD). Nevertheless, we believe that the JPY will resume its prior depreciating trend on the back of Japan's fundamental economic weakness — inadequate structural reform, massive public sector indebtedness, aggressive monetary easing, and unattractive interest rate differentials relative to other major economies. Moreover, the gradual internationalization of the Chinese renminbi in global trade activity is a structural factor weighing on the JPY. However, occasional bouts of investor risk aversion may temporarily support the JPY and Japanese securities over the course of 2016. We expect USDJPY to close 2016 at 131, around 8% weaker since the end of 2015.

Asia-Pacific
Regional Outlook
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Sovereign Debt & Credit Ratings ►

Japan's sovereign debt profile is weak, with gross public debt estimated at 248% of GDP in 2015-17. In September 2015, Standard & Poor's downgraded Japan's sovereign credit rating by one notch to "A+", assessing that the government's strategy to revive economic growth and end deflation has not been successful enough to support the prior rating. Fitch and Moody's lowered their ratings to "A" in April 2015 and to "A1" in December 2014, respectively. Despite Japan's private sector wealth, large institutional savings, strong external position, and stable financial system, sovereign credit quality is weighted down by the country's public sector indebtedness, muted economic performance, and unfavourable demographics.

Economic Outlook Growth ►

Japan's economic performance remains subdued despite Prime Minister Shinzo Abe's enduring efforts to revive growth. Nevertheless, revised data show that the economy has avoided another technical recession; real GDP grew by 0.3% q/ q (+1.7% y/y) in the third quarter, following a 0.1% q/q contraction (+0.7% y/y) in the April-June period. The government's supplementary budget will provide short-term support to the economy. The country's output likely expanded by 0.7% in 2015 as a whole. In 2016-17, economic gains will likely average 1.0% y/y. The gradual pick-up will reflect improving export sector performance, greater private sector investment given higher corporate profits, and the increasing purchasing power of Japanese consumers due to higher employment and rising incomes. Long-term consumer spending prospects — and the economy's potential growth — are adversely impacted by a shrinking labour force.

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Inflation & Monetary Context ►

An ultra-accommodative monetary policy stance will remain in place for the foreseeable future; however, further stimulus in the form of quantitative easing is unlikely. Monetary authorities remain confident that the Bank of Japan's price stability target of 2% y/y will be achieved with the help of the current asset purchase program, which is set to increase the monetary base by ¥80 trillion annually. According to policymakers' estimates, inflation will reach the target between October 2016 and March 2017. However, in our view price pressures will remain more muted until April 2017 when the second hike in the consumption tax rate (from 8% to 10%) will temporarily lift inflation. Headline inflation remained low at 0.3% y/y in November, though core inflation — excluding food and energy — has picked up to 0.9% y/y. We expect the headline rate to accelerate gradually to 1.0% by the end of 2016.

Fiscal & Current Account Balance ►

Japan's fiscal profile remains structurally weak. Regardless, in mid-December the Cabinet approved a ¥3.5 trillion supplementary budget for the ongoing fiscal year (April-March) to support the economy; new debt will not be issued for financing the additional spending as it will be funded by tax revenues. The country's fiscal deficit will likely average close to 5% of GDP in 2015-17. Despite frail public finances, the Japanese government has no difficulty refinancing its debt obligations at low rates and 91% of public debt is held domestically. On the external side, the trade deficit has narrowed substantially as low oil prices have reduced the import bill and the weak yen has provided some support to exports. A strong primary income account balance will maintain the current account surplus at around 3¼% of GDP in 2015-17.

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Institutional Framework & Political Environment Governance ►

In September 2015, Shinzo Abe was re-elected as the head of the Liberal Democratic Party and he will continue to serve as prime minister for another three-year term until 2018. A snap general election took place in December 2014 and the Liberal Democratic Party with its junior partner, the Komeito party, maintained their dominant position in parliament. Accordingly, the Abe administration will be able to continue to focus on economic revival strategies.

Financial Sector ►

Japan's financial sector has a large exposure to government debt securities; 55% of government bonds are held by domestic banks and insurance companies. Credit growth remains relatively stable with outstanding bank lending up by 2.3% y/y in November. The banking sector's non-performing loans ratio of 1.6% in the first quarter of 2015 (according to the International Monetary Fund; latest data available) is low; the Tier 1 Capital ratio of 12.5% suggests sufficient capital adequacy. The central bank's recent stress testing exercise indicated that the country's financial system has strong resilience to potential adverse economic shocks.

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