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CIO Viewpoint

Japan fails to blossom as vaccine rollout lags

Investment Solutions

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The world's third-largest economy has one of the lowest rates of Covid infections among developed nations and is just two months from hosting the Olympic Games. Japan should be poised for an economic boom. Yet the country is battling to accelerate vaccinations and faces political uncertainties.

The country's experience of the pandemic has so far proven far less deadly than elsewhere. Japan has recorded 12,926 Covid-related deaths as of 31 May, or a mortality rate that peaked at 0.89 deaths per million people, compared with a UK peak of 18.5 per million, 10.3/ million in the US, and 8.0/million in the European Union. In Asia, that compares with a peak of 0.46/million fatalities in South Korea and 0.1/million in Singapore.

However, Japan's vaccination process is proving slower than many other nations with just 6.4% of the country's residents inoculated with at least a first dose. This is attributed to two factors: until recently, only Pfizer-BioNTech's vaccine was approved for use and the country requires a medical doctor to administer shots.

Meanwhile, the nation's state of emergency in nine prefectures including Tokyo, scheduled to end 31 May, will continue until 20 June the government said last week. Around 40% of Japan's population is still living under lockdown restrictions as more prefectures have declared a state of emergency since the middle of May.

The slow vaccine rollout has already undermined economic performance. The country recorded a contraction in gross domestic product of -5.1% in the first quarter. Tokyo's 2021 Olympic Games, scheduled to start on 23 July, would ordinarily offer the economy a boost. But already postponed from last year, the games have triggered opposition from the Japanese public who are increasingly against the event while the pandemic continues.

Much of the GDP uptick for past Olympic hosts comes from construction projects before the event, as well as tourist spending. In 2016, the Bank of Japan estimated that the games would add as much as an average 0.3 percentage points to real annual GDP growth, based on the lift to previous hosts such as London, Athens and Beijing. That will simply not happen now.

Stéphane Monier
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Key takeaways

- A slow vaccination rollout, continuing lockdowns and uncertainty over the Olympic Games are weighing on Japan's recovery
- Japan's fiscal stimulus spending is second only to the US, financed by record bond issuance
- Given Japan's lagging rebound, the BoJ has left its medium-term inflation outlook unchanged
- We remain underweight in Japanese equities as corporate reforms, supportive demand and strong balance sheets don't offset low profitability and high valuations. We expect the improving Japanese trade balance and dollar weakness to offer the yen some support.

On your marks...

Less than two months from the games' opening, the government and International Olympic Committee insist that the event can happen in a bubble of vaccinated athletes. The government must also decide whether Japanese residents may attend as spectators. Foreign visitors are already banned.

Japan will host a "safe and secure games," says Prime Minister Suga Yoshihide. The decision to go-ahead, and its political implications for Japan's less-than popular government, also depends on the city of Tokyo. Either way, no authority is keen to shoulder the responsibility and costs of cancelling.

For the full year, and assuming the Olympics take place, we expect growth of 3% as the pandemic rebound kicks-in. However, if the Olympics were scrapped, Japan may see its annual growth fall as much as 1.7 percentage points, according to Bloomberg data.

Mr Suga, who took over as prime minister from Abe Shinzo in September 2020, has other political challenges. His approval rating among voters has fallen to 32%. A recent reprimand over lobbying meals offered to Mr Suga's eldest son and party bureaucrats has not helped. The country must hold elections for the parliament's lower chamber before 21 October and Mr Suga's unpopularity, and expected loss of seats, may push his party into looking for an alternative when his mandate as head of the Liberal Democrat Party ends in September. Last week Mr Abe reiterated his support for Mr Suga while speculating on four suitable successors.

As a result, in the run-up to the election Japan finds itself in something of a limbo. Since 2012, the LDP has relied on the electoral efficiency of its coalition partner party, Komeito, whose religious roots have tempered right-wing ambitions in the LDP and parliament to overhaul the country's constitution. Longer-term and, put simplistically, the range of political possibilities is widening.

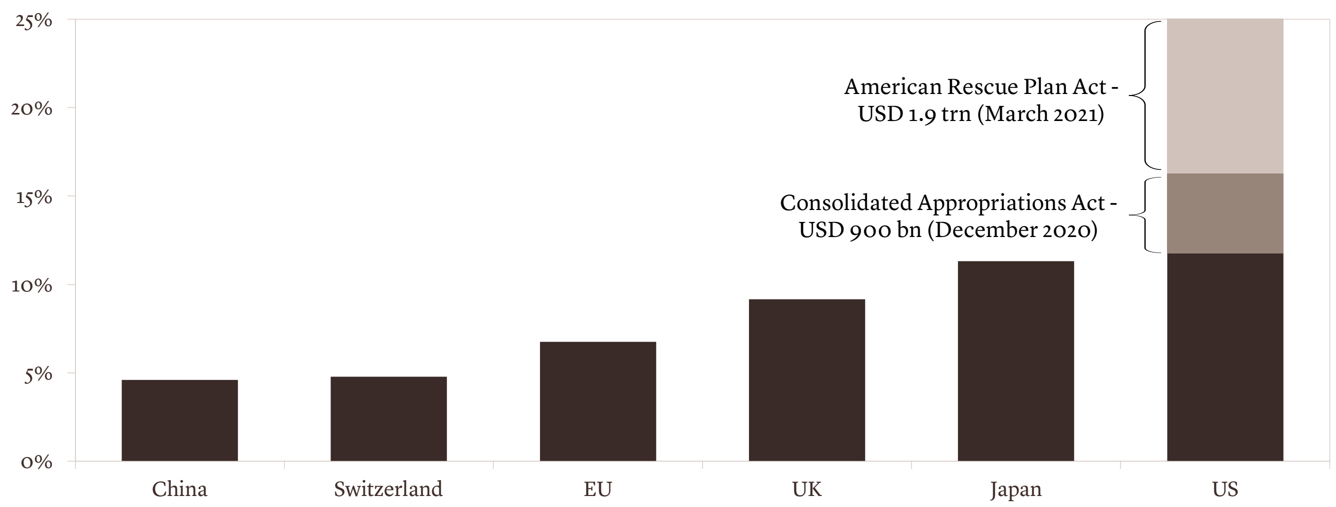
Fiscal stimulus

At face value, Japan has spent the equivalent of around 10% of its GDP on fiscal stimulus since the start of the pandemic. Since then, the Japanese government deployed three economic relief packages, worth a total of 286 trillion yen (USD 2.6 trillion). By these measures, Japan's spending is second only to the US (see chart).

The Japanese government has issued record amounts of bonds to finance the spending. Issues totalled 112 trillion yen in 2020, more than doubling the previous record of 52 trillion yen in 2009. Government debt is of course not a pandemic phenomenon, nor is it unique to Japan. However, Japanese government debt leapt from 238% of GDP in 2019 to 266% last year, second only to Venezuela worldwide.

Holding almost half of the government bonds in circulation as part of its mandate to maintain 10-year benchmark sovereign bond at a yield of around 0%, the BoJ's balance sheet would be vulnerable to any rise in interest rates.

Japan's fiscal spending is second only to the US



Sources: IMF, Bloomberg, Lombard Odier

The BoJ has kept interest rates close to zero for more than two decades and pushed rates negative for the first time in January 2016. The central bank confirmed in April that its 2% inflation target won't be reached under the current governor's term, which expires in 2023. Haruhiko Kuroda's "bazooka," or ultra-loose monetary policy in place since taking over in 2013 has lifted the stock market and weakened the yen. The pandemic shutdowns have kept year-on-year consumer price inflation negative, and as the speed of Japan's economic recovery lags the US, European Union and China, "medium-to long-term inflation expectations are likely to be more or less unchanged." The BoJ's next monetary policy outlook report is scheduled for 16 July.

Asset outlook

Japan's corporations have used 20 years of aggressive monetary policy to reduce debt, restructure balance sheets and increase cash flows. Recent Japanese stock performance has been positive, benefitting from the global recovery that started in China, and accompanying shift into cyclical stocks. This improved investor sentiment towards the Japanese equity market.

However, the Japanese market trails US and world indices. In yen terms, the TOPIX has returned 7% year to date, and 2% in US dollars, reflecting the weakening Japanese currency against the dollar. That compares with the MSCI World's 11% return this year.

In addition, industrial stocks account for around 24% of the Japanese equity market, almost 13 points more than in the MSCI World. Globally, industrial names have benefitted from stimulus and rising demand as economies recovered. Still, in the months ahead, we expect high valuations and cost inflation to limit further outperformance in this sector.

We therefore remain underweight Japanese equities. While broad, corporate reforms offer tactical opportunities, South-East Asian demand and strong balance sheets have not yet been enough to offset historically low levels of profitability in Japanese companies and limited protection for foreign investors. In addition, the initial earnings momentum during the global recovery may stall in Japan due to its continuing Covid restrictions. In contrast, other cyclical markets, such as the eurozone or the UK, are already enjoying broad rebound.

Longer term, given Japan's inflationary monetary policy, we expect value assets to benefit most and see price-to-earnings per share reaching 14.5 times next year, offering only a very modest upside to the TOPIX. Specifically, we expect the TOPIX to reach a level of around 2,000 points on a 12-month horizon, representing a 4% rise from today.

We expect the yen to rise against the dollar, based largely on Japan's improving trade balance. Nevertheless, the risk to this expectation is the recent increase in appetite from Japanese firms for international mergers and acquisitions.

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