Economic Research

January 2022

Market Monitor – Japan

Recovery Clouded by Downside Risks

GDP shrinks on a quarterly basis in Q3 2021 due to state of emergency and global supply chain constraints

Due to the state of emergency to curb the spread of the Delta variant, which targeted up to 21 prefectures, as well as global supply chain bottlenecks, Japan saw GDP decline at an annualised quarter-on-quarter rate of 3.6% in Q3 2021, after seeing growth for the previous quarter. Household consumption dropped 5.3% quarter-on-quarter in Q3 2021, while exports fell 3.5%. At the same time, private investment also dropped by 8.8% quarter-on-quarter.

After the state of emergency ended in late September, the consumer confidence index rose to 39.2 in October and remained at this level in November, up from 37.8 in September. Nonetheless, real household spending recorded a 0.6% year-on-year drop in October, following a 1.9% drop in September. Against this backdrop, the Japanese parliament approved an extra budget worth about JPY 36 trillion for the 2021 fiscal year in December. The extra budget spending featured cash pay-outs for families with children and funds for the promotion of tourism. It also aims to boost growth in green and digital transformation and to strengthen semiconductor factories and supply chains. This extra budget will also be source of funding for the JPY 79 trillion economic package unveiled by Japanese prime minister Fumio Kishida in November.

The Bank of Japan (BOJ) maintained benchmark policy rates unchanged at its December meeting, although it announced that it would end additional purchases of commercial paper by March 2022 as scheduled. It also said it would extend loans for small and medium-sized firms by six months to September 2022.

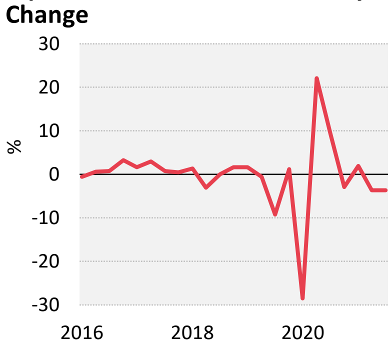
Going forward, market participants generally expect the Japanese economy to see more improvements in 2022, with GDP growth averaging 3.1%, following an estimated 1.8% growth in 2021. However, the emergence of the Omicron variant may pose uncertainties to Japan's economic recovery. In late November, the Japanese government reimposed a

Q3 2021 sees contraction due to state of emergency and continued global supply chain bottlenecks.

BOJ keeps policy rates unchanged at December policy meeting but dials back on some Covid-19 support measures.

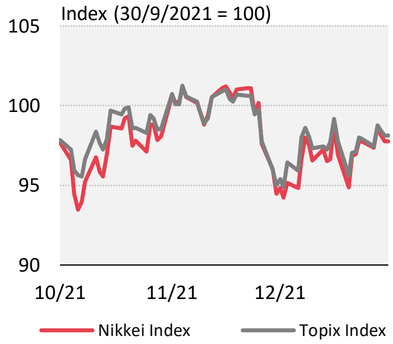
Emergence of virus variants may create uncertainties affecting the trajectory of Japan's economic recovery.

Japan GDP Annualized Quarterly Change



Source: Bloomberg, data as of 31/12/2021 ban on the entry of foreign visitors until the end of December in the hope of limiting domestic contagion. Returning Japanese nationals and foreign residents are required to quarantine in designated facilities. Prime minister Fumio Kishida has said such measures might remain in place until early January 2022. If the spread of the Omicron variant worsens, the Japanese government will need to re-tighten restrictions, denting business and consumer sentiment once again. Moreover, precautionary measures to curb the spread of Omicron by other governments may also lengthen global supply chain bottlenecks, potentially lowering demand for Japanese exports and adding further uncertainties to Japan's economic outlook.

Japan Equity Indices

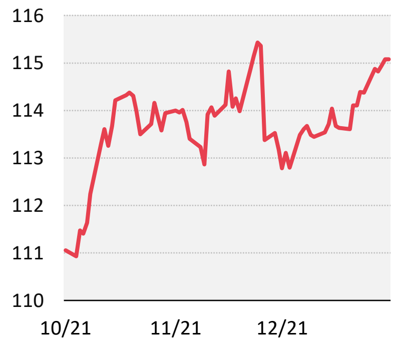


Source: Bloomberg, data as of 31/12/2021

Japan's financial market performance in 2022 will hinge on central bank policies and investor risk appetite

Japan's equity market continued to see gains in 2021, which is mainly attributable to accommodative policies by major central banks, including the BOJ, as well as an improved outlook for company earnings amid strong demand for exports. Nonetheless, the benchmark indices saw a divergent performance, mainly due to the BOJ's decision at its March meeting to purchase exchange-traded funds (ETFs) that track the Tokyo Stock Price Index (TOPIX). The Nikkei 225 Index recorded a 4.9% gain between end-2020 and 30th December, while the TOPIX saw a 10.4% gain over the same horizon. Nonetheless, the emergence of the Omicron variant in late November undermined investor confidence. When compared to the end of Q3 2021, the Nikkei 225 Index and TOPIX had declined by 2.2% and 1.9% respectively as of 30th December.

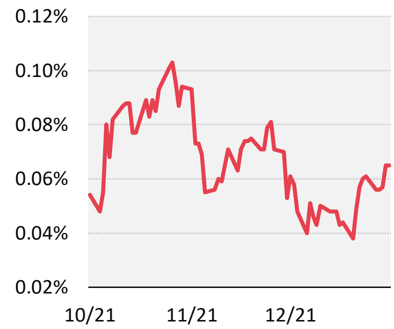
USD/JPY



Source: Bloomberg, data as of 31/12/2021

In the foreign exchange market, the Japanese yen weakened against the US dollar, as the Federal Reserve (Fed) stepped up its tapering off of asset purchases and signalled more rate hikes ahead for 2022, and as global equity markets performed solidly throughout the year. The yen depreciated against the US dollar by 10.3% to JPY 115.08 per dollar between end-2020 and 31st December 2021. When compared to the end of Q3 2021, the yen had depreciated against the dollar by 3.3%.

10-year Japanese Government Bond Yield



Source: Bloomberg, data as of 31/12/021

In the bond market, the benchmark 10-year Japanese government bond yield rose alongside its US Treasury counterpart in 2021, with market participants expecting normalisation by the Fed amid higher inflationary pressure. Nonetheless, the Omicron variant triggered some risk aversion among investors. The 10-year government bond yield edged up by about 5 basis points to 0.065% between end-2020 and end-2021. But when compared to the end of Q3 2021, the 10-year government bond yield was nearly flat.

Looking ahead, the performance of the yen and Japan's equity market will be influenced by investors' changing risk appetite and the divergent policy stances of the BOJ and the Fed. As the Fed is expected to start raising the fed funds rate in 2022, the US dollar will continue to strengthen. Meanwhile, market participants generally expect the BOJ to remain accommodative, and the yen is expected to continue weakening against the US dollar. Nonetheless, uncertainties stemming from virus variant may prompt investors to seek safe haven assets like the yen. This will partly offset the downward trend of the yen against the dollar and may increase volatility in the equity market. Moreover, the upcoming rise in fiscal spending will increase the Japanese government's debt burden. This may create upward pressure on Japanese government bond yields in the longer run and partly offset the BOJ's efforts to contain the rise in financing costs for enterprises.

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