Economic Research

April 2022

Market Monitor – Japan

Road to Recovery Still Clouded by Downside Risks

Japan's economy sees mild rebound in 2021 but faces downside risks in 2022

With Covid-19 restrictions ending in October, Japan's economy saw a solid rebound in the last quarter of 2021. In Q4 2021, GDP rose at an annualised rate of 4.6% quarter on quarter, after a 2.8% drop in the previous quarter. As the economy reopened, household consumption saw a strong rebound in Q4 2021, with an annualised quarterly growth of 10.2%. For 2021 as a whole, Japan's GDP saw year-on-year growth of 1.6%, after a 4.6% drop in 2020.

Nonetheless, as the sixth wave of Covid-19 loomed in early January 2022, the government declared a quasi-state of emergency to curb the spread of the virus. At the peak of the sixth wave, up to 36 of Japan's 47 prefectures were under the quasi-state of emergency. Consumer sentiment was negatively impacted. The country's consumer confidence index has fallen for three consecutive months to reach 35.3 in February, the lowest level since May 2021. General market expectation is that Japan's GDP will see another quarterly contraction in Q1 2022. At the same time, inflation momentum is picking up amid surging energy prices, though it is still mild relative to other advanced economies. The consumer price index (CPI) saw year-on-year growth of 0.9%, the highest yearly increase since May 2019.

Risk of prolonged Ukraine crisis and lingering Covid-19 impacts pose uncertainties for outlook

As the sixth wave of Covid-19 is expected to impact the Japanese economy, the Bank of Japan (BOJ) kept the benchmark policy rates unchanged at its March meeting as expected, contrasting with rate hikes by the Federal Reserve (Fed) and Bank of England. The BOJ also said that it needed to monitor how developments in Ukraine would affect Japan's economy through financial markets and commodity prices.

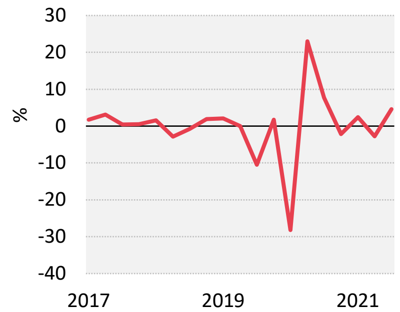
In late February, Japan's House of Representatives approved a record JPY 107.6 trillion budget for the fiscal year 2022 to fund measures mitigating the impact of Covid-19 as

GDP sees rebound in Q4 2021 as state of emergency is lifted, but market generally expects to see another quarterly contraction in Q1 2022 as sixth wave of Covid-19 looms.

BOJ keeps policy rates on hold at March meeting.

Japan's recovery trajectory in upcoming quarters will still be subject to uncertainties despite monetary and fiscal policy support.

Japan GDP Annualized Quarterly Change



Source: Bloomberg, data as of 31/3/2022) well as to meet rising social security and national defence costs. Going forward, with the quasi-state of emergency being lifted in all remaining 18 prefectures from 21st March, Japan is expected to see recovery in Q2 2022. Meanwhile, the continued accommodative policy stance of the BOJ and fiscal support are also expected to provide support to the economy in upcoming quarters. Nonetheless, the risk of a prolonged crisis in Ukraine and heightened tensions between Russia and the US and its allies may pose uncertainties for Japan's economic recovery trajectory, as rising energy and food prices can adversely impact corporate profits and household income. Higher energy and commodity prices may partly offset the potential boost to Japan's exports from a weaker yen.

Japan's equity market corrects amid US rate hike expectation and geopolitical tensions

Japan's equity market saw a correction in the Q1 2022, mainly because global investors increasingly priced in rate hikes by the Fed and because Russia's invasion of Ukraine in late February spurred risk aversion in the market. As of 31st March, the Nikkei 225 Index recorded a 3.4% drop when compared to the level at the end of December 2021, while the TOPIX saw a 2.3% drop over the same horizon.

In the foreign exchange market, the Japanese yen weakened against the US dollar, as the Fed kicked off rate hikes and projected a more aggressive rate hike path at its March meeting. As of 31st March, the yen had depreciated against the US dollar by 5.4% when compared to the level at end of December 2021, reaching JPY 121.7per dollar.

In the bond market, the benchmark 10-year Japanese government bond yield continued to rise alongside its US Treasury counterpart in Q1 2022, even though the BOJ maintained a targeted upper limit for the 10-year government bond yield at around zero. To defend the yield cap, the BOJ announced 'fixed rate purchase operations' to purchase unlimited 10-yeaar Japanese government bonds on 10th February and 28th March. The operation announced on 28th March was to purchase bonds for three consecutive days. As of 31st March, the 10-year Japanese government bond yield stood at 0.21%, about 15 basis points higher than the level at the end of December 2021.

Looking ahead, the performance of the yen will be impacted by the divergent policy stances of the BOJ an d the Fed. Meanwhile, the performance of Japan's equity market will hinge on the development of the Ukraine crisis and the Fed's pace of normalisation. As US treasury yields will continue to edge higher amid ongoing interest rate hikes and investors may carry on adjusting their fixed income portfolio, the 10-year Japanese government bond yield may well continue to remain above the BOJ's target of around zero in the months ahead. However, as the BOJ may intervene the market, the rise of the 10-year government bond yield will be limited at around 0.25%.

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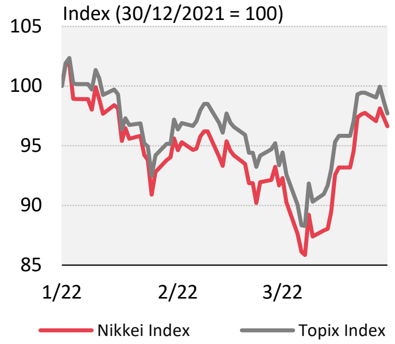
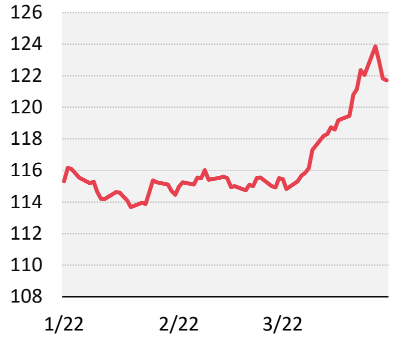
Japan Equity Indices



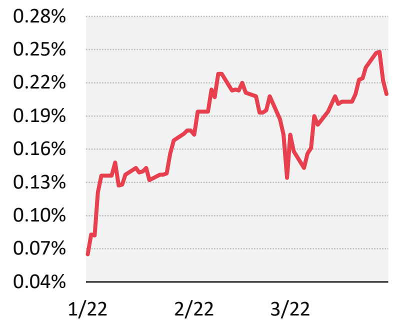
Source: Bloomberg, data as of 31/3/2022

USD/JPY



Source: Bloomberg, data as of 31/3/2022

10-year Japanese Government Bond Yield



Source: Bloomberg, data as of 31/3/2022

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