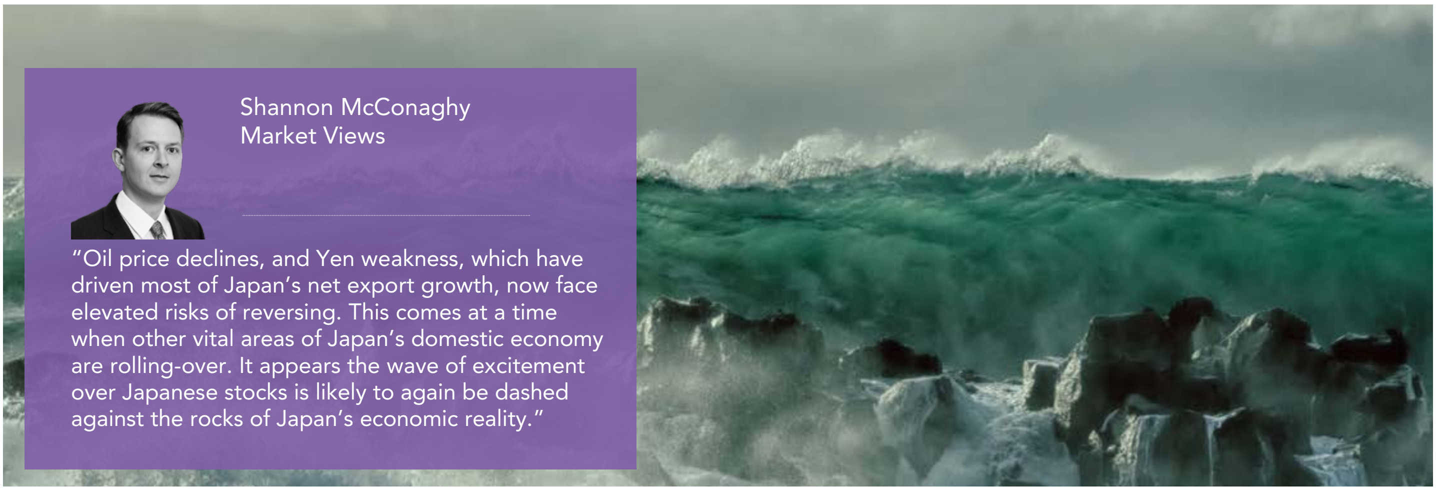
JAPAN'S NET EXPORTS FACE OIL & YEN RISKS



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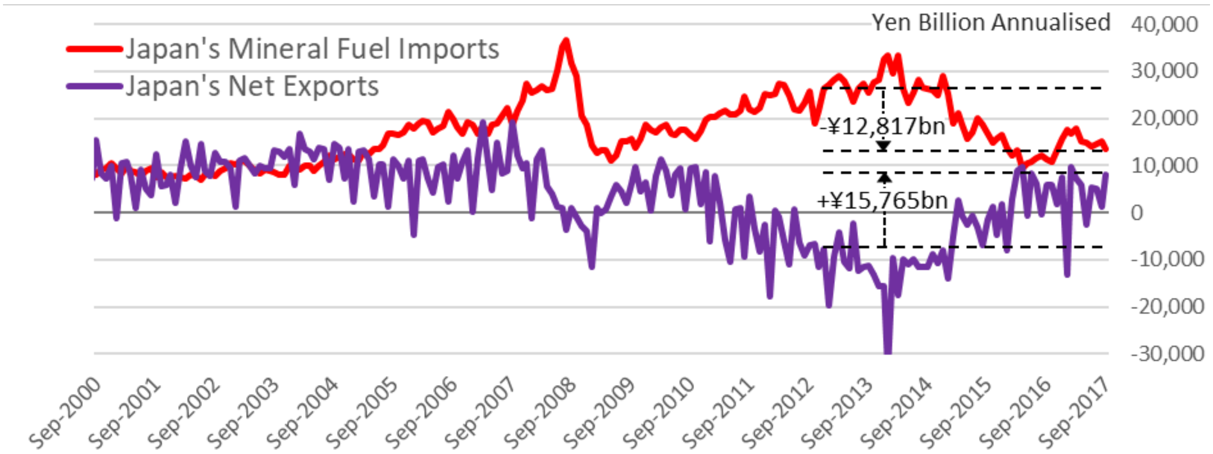
Market Views

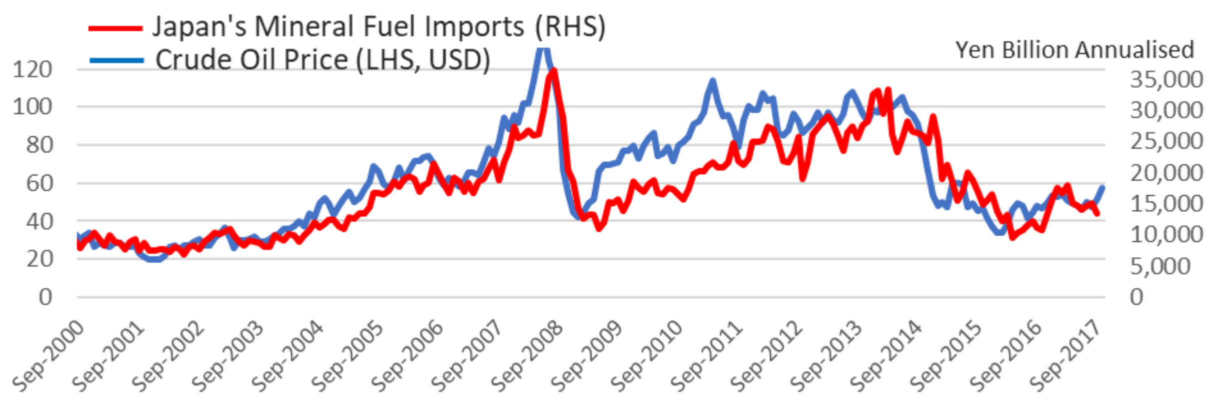
"Oil price declines, and Yen weakness, which have driven most of Japan's net export growth, now face elevated risks of reversing. This comes at a time when other vital areas of Japan's domestic economy are rolling-over. It appears the wave of excitement over Japanese stocks is likely to again be dashed against the rocks of Japan's economic reality."

This is the fourth note in the *Iron Coffin Lid* series, our earlier concerns, around private consumption and real estate investment in Japan, have been further supported by an -11.6% YoY fall in construction orders in September and credit card data indicating consumer spending declined by -5.3% YoY in the first half of October (NOWCAST,Inc/JCB,Co,Inc).

As these vital areas of Japan's domestic economy roll-over, today we look at Japan's net external sector, the third large contributor to its GDP recovery since 2012. Again much of the recovery here has come from unsustainable growth drivers which now face the risk of reversal. Over 81% of the increase in Japan's net exports from 2012 (or ¥12,817bn of the ¥15,765tn increase) has come from the decline in mineral fuel import costs as shown in the chart below.

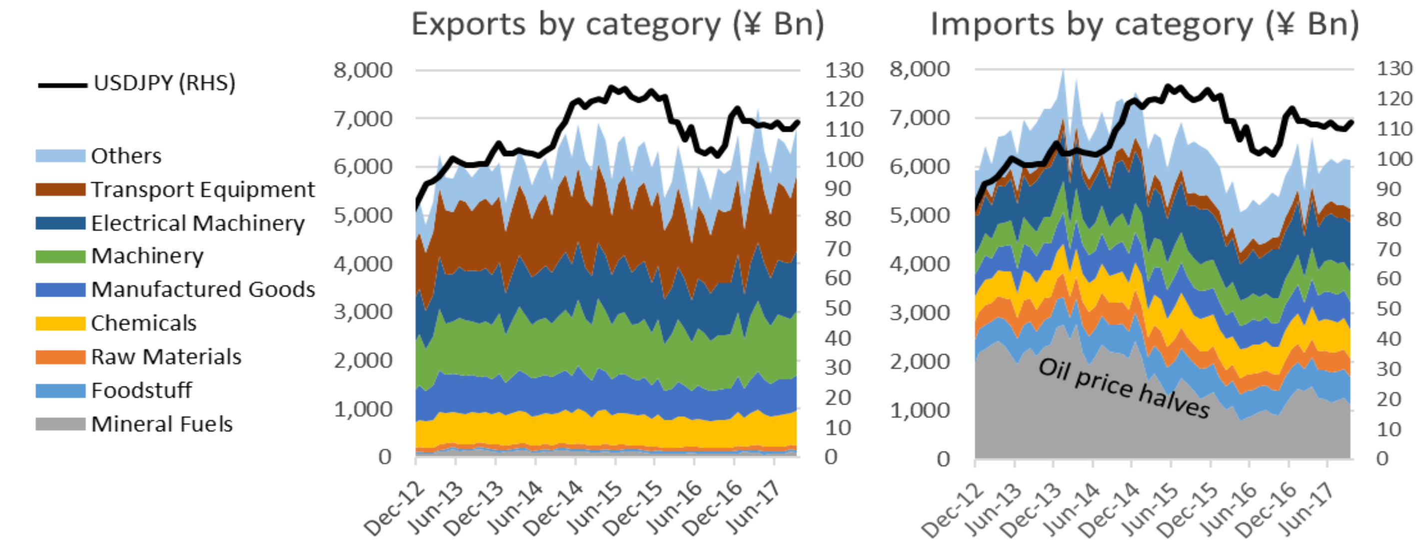


Japan's mineral fuel import costs closely follow the price of oil but with around a 3 month lag, see chart below. It is unlikely that oil prices will continue to decline in perpetuity to be a sustainable net export growth driver for Japan. Indeed, the recent rise in the oil price is likely to weigh on Japan's net exports within its GDP from early next year.

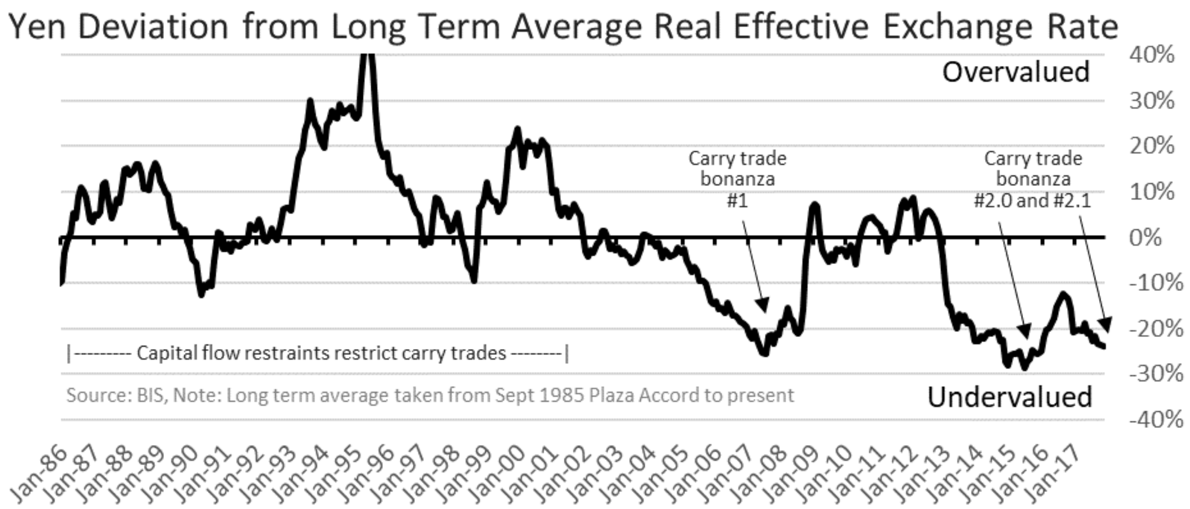


We can also envisage factors that may drive oil prices higher. Earlier this year we [wrote]() of our suspicions that US shale production would peak as *"frac-hits (new wells interfering with legacy wells) caused decline rates to accelerate"* . While this week we [highlighted]() that the recent shift of the oil futures curve into backwardation would also further hamper shale production by making sources of funding more difficult. On top of shale production constraints there are potentially more severe risks of a shock rise in oil price due to middle eastern geo-political events. What is clear, is that there are unlikely to be any further benefits from falling oil prices near term while the risks of reversal are building.

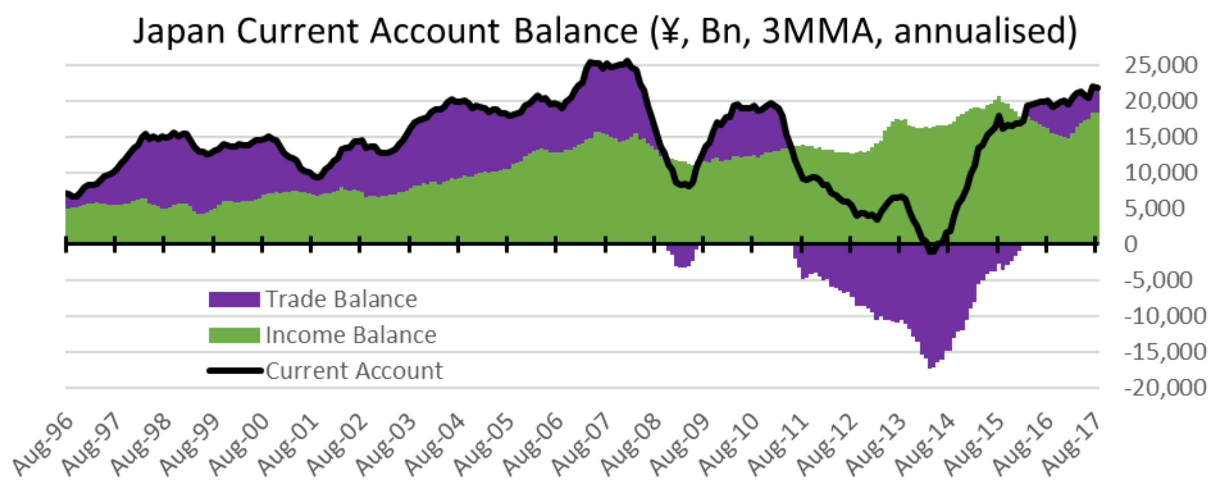
The remainder of the recovery in Japan's net exports since 2012 have largely come from currency translation effects. As you can see in the chart below, Japan's exports in Yen terms have increased almost exactly in line with the rise in USDJPY, which implies most of the export growth is a simple translation increase (trade is largely priced in USD). While Japan's imports have not risen in line with the rise in USDJPY due to the decline in USD oil prices, discussed previously.



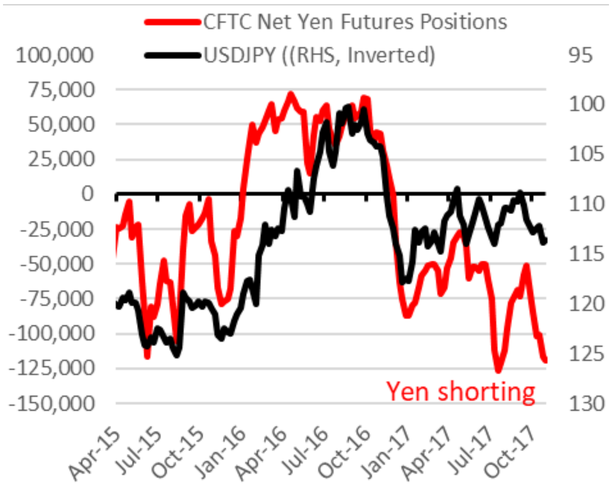
It is unlikely that Japan will be able to generate sustained export translation growth via a perpetually devaluing Yen. As the chart below shows, the Yen is already 24% undervalued. The only time it has been more undervalued, in 2015, the Bank of Japan's Kuroda said *"if you look at the real effective exchange rate, it shows that the Yen is already very weak" …"further declines on a real effective exchange rate basis are not likely to happen".* Even if Japan's real effective exchange rate were to remain 24% undervalued, the nominal effective Yen exchange rate would still have to rise every year that Japan's inflation rate falls below its trade partners. Other valuation metrics show the Yen as even more undervalued, Japan is the cheapest major developed economy on the [Big Mac Index](), 36% cheaper than the US. On a Purchasing Power Parity basis Japan is 30% undervalued versus the US dollar (Bloomberg).

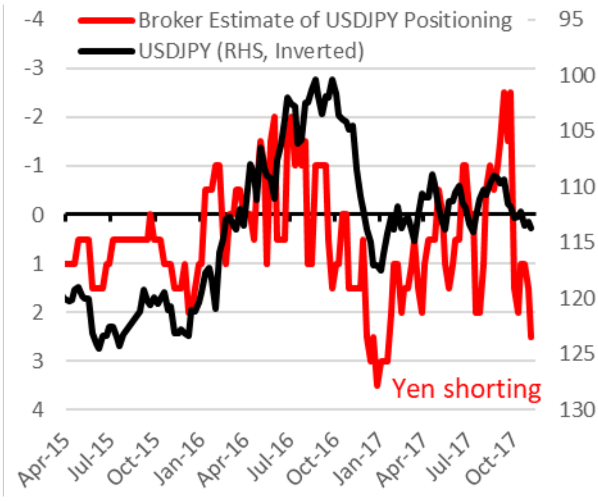


There is also substantial risk of the Yen strengthening back to fair value, as carry trade pressures that have weakened the Yen should once again prove unsustainable. Funds sent overseas for carry only weaken the Yen in the short term. Over time these flows further increase Japan's already world's largest net foreign investment position. Indeed, Japan's foreign assets have "*increased by roughly 50% during the past five years and are now more than twice the country's GDP"* ([Nikkei]()). The net "income balance" generated by these foreign positions now dominate Japan's current account surplus, as shown below. It is likely that increasing amounts of Japan's foreign investment income will be repatriated, as the elderly, who largely own the assets, face ongoing Yen living expenses in Japan. To stop the Yen from strengthening Japan would need ever increasing foreign carry outflows to offset the increasing "income balance" that these flows create. It is clear that Japan's carry trade driven Yen devaluation is again structurally unsustainable and likely to reverse.



An important timing element to follow is changes within FX hedge ratios. Institutions in Japan have reduced their FX hedges in the first three quarters of this year, selling Yen and increasing their naked carry positions. This trend has slowed recently and our conversations indicate some have even tactically increased hedges again, buying Yen. Critically they implement stop loss policies on naked carry positions, this generates large Yen buying if the Yen were to strengthening beyond certain levels. This has amplified Yen strengthening trends in the past. In simple terms when hedge ratios are lowered in Japan, like they have been this year, risks of rapid Yen strength increase. Another timing element is foreign fund positioning. The most recent Yen weakness, since September, has been driven by foreigners, with a dramatic increase in net shorts in CFTC Yen futures and net shorts in cash positioning according to a broker positioning estimate. This type of extreme Yen short positioning has historicaly preceeded periods of Yen strength.





While it is clear that the Yen is primed for a period of rapid strengthing, it is not possible to predict exactly when that may happen. As such, long positions in the Yen, and/or short positions in equities of export oriented companies, are opportunities to watch out for as catalysts for Yen strength present themselves.

For now the concluding observation I would make is that past oil price declines, and Yen weakness, which have driven most of Japan's net export growth, now face elevated risks of reversing. This comes at a time when other vital areas of Japan's domestic economy are rolling-over. It appears the wave of excitement over Japanese stocks is likely to again be dashed against the rocks of Japan's economic reality.

FORMATION

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