Japanese Slowdown Taking Hold

Months after exiting its sixth recession in two decades, Japan is entering a fresh downturn in growth.

Losing Traction There is still a belief in some quarters that global growth is picking up, with the U.S. economy in the lead until the temporary government shutdown got in the way. After all, having pulled out of recession, the U.K. has been growing at a decent clip in recent quarters. Also, our observation in this publication that the "green shoots in Europe" had begun to mature *(↗Vol. XVIII, No. 7, July 2013)* has since been vindicated by the incoming data, most recently confirming the end of the long Spanish recession, which we predicted in the same report.

"As Japan exits its third recession in five years," we noted as the Bank of Japan (BoJ) launched the "first arrow" of Abenomics six months ago, "deflationary pressures are retreating further, having begun to ebb before Abenomics appeared on the horizon" *(↗International Cyclical Outlook, Vol. XVIII, No. 4, April 2013)*. Regardless, the news released the following month about Japan's annualized GDP growth jumping to about 4% in the previous quarter, and data showing its subsequent exit from deflation, were widely hailed as quick victories for Abenomics, effectively putting the cart before the horse.

Last month, against the backdrop of brighter growth prospects in China, Taiwan and Korea, we highlighted the "dimming growth outlook outside [the] U.K. and East Asia" *(↗International Cyclical Outlook, Vol. XVIII, No. 9, September 2013)*. So, have the improvements started to spread beyond Europe and East Asia?

Unfortunately, the answer is no. Rather, following our recent observation that "the Japanese economic growth outlook ... has faded a bit since the early spring" *(↗International Cyclical Outlook, Vol. XVIII, No. 9, September 2013)*, it is now evident that Japan is entering a new slowdown, even with Abenomics continuing, as we discuss later *(↗pages 6 to 10)*. It is not so much that Abenomics itself is losing traction. The point is that the endogenous cyclical forces – whose upturn predated Abenomics and were largely responsible for the Japanese revival in the first place – have now entered a downturn.

Ironically, there is a danger that, exactly 17 years after the last sales tax hike from 3% to 5%, another badly-timed sales tax increase – this time from 5% to 8% – will again trigger a new Japanese recession. Will history repeat itself? The answer depends on the progression of the Japanese Long Leading Index (JALLI), whose growth rate has already declined to a seven-month low (Chart 1a, seventh line).

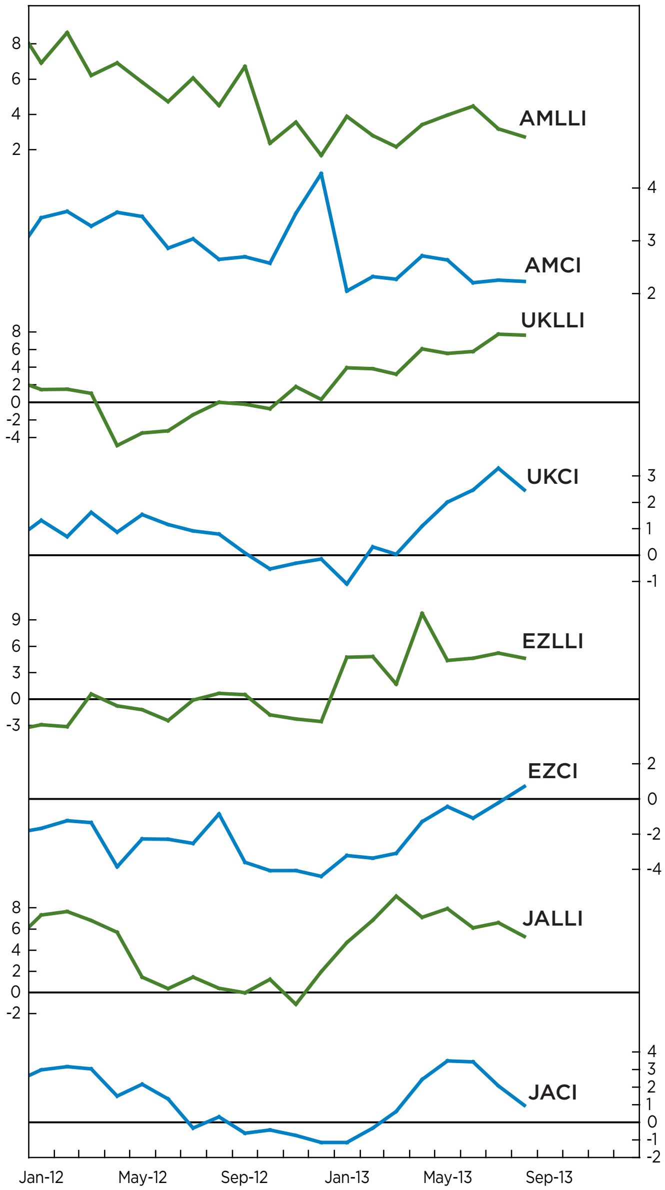
The JALLI is not the only forward-looking index whose growth rate is now ebbing. So is growth in

Divergent Outlooks

	Current Growth	Consensus Growth Outlook	ECRI Growth Outlook
↗U.S.	Recessionary	Slow	Recessionary
↗Brazil	Slow	Slow/Average	Slow
↗Canada	Slow	Slow	Slow
↗Mexico	Recessionary/Slow	Slow	Recessionary/Slow
↗Germany	Slow	Slow/Average	Slow
↗Russia	Recessionary	Recessionary	Recessionary/Slow
↗France	Recessionary	Recessionary	Recessionary
↗U.K.	Slow	Slow/Average	Slow/Average
↗Italy	Recessionary	Recessionary/Slow	Recessionary/Slow
↗Spain	Recessionary	Slow	Slow
↗Switzerland	Slow	Slow	Slow
↗Sweden	Slow	Slow	Slow
↗Austria	Recessionary/Slow	Slow	Slow
↗China	Slow	Slow/Average	Slow
↗India	Slow	Slow	Slow
↗Japan	Slow/Average	Slow/Average	Slow
↗Korea	Slow	Slow	Slow
↗Australia	Slow	Slow	Slow
↗Taiwan	Slow	Slow/Average	Slow/Average
↗New Zealand	Slow	Slow	Slow
↗South Africa	Slow	Slow	Slow

FOCUS: Japan Slowing

Chart 1a: International Indexes, Growth Rates (%)



the American Long Leading Index (AMLLI), which declined again in August (Chart 1a, top line), due in large measure to the continued decline in U.S. Long Leading Index growth (*Chart 5b, page 13*), and secondarily to the drop in Brazilian Long Leading Index growth (*Chart 6b, page 14*). Under the circumstances, growth in the American Coincident Index (AMCI), which also slipped in its latest reading (second line), is likely to stay in a cyclical downswing.

Across the pond, the U.K. is in a different position, as its growth prospects continue to brighten, with U.K. Long Leading Index (UKLLI) growth staying in a cyclical upswing (third line). Thus, U.K. Coincident Index growth (fourth line), which turned up following the upturn in UKLLI growth, is likely to remain in a cyclical uptrend.

In Continental Europe, the picture is more uneven, with growth in the Eurozone Coincident Index entering a clear upswing (sixth line), following the earlier upturn in Eurozone Long Leading Index (EZLLI) growth (fifth line). However, EZLLI growth eased in August, slipping further below its April high, as growth prospects worsened again for France and Italy, even as they stayed decidedly optimistic for Spain. Meanwhile, the overall growth outlook, though having dimmed slightly since the spring, remained fairly positive for Germany, where near-term growth prospects for machinery and equipment investment have also brightened, as we discuss later (*page 19*).

Part of the reason for the better German outlook is the stabilization, following a cyclical downswing, in Chinese growth, whose prospects have also improved modestly. However, Chinese inflation is turning up already, consistent with our warning in this publication last month (*Vol. XVIII, No. 9, September 2013*), based on the upturn in ECRI's Chinese Alternative Future Inflation Gauge. Thus, Chinese policymakers have only limited leeway to stimulate growth further.

Cycles always turn, and this is especially true following extremes. So it is no surprise that many of the most badly beaten down economies started to turn around. Examples include the U.K., Japan, and now Spain.

While German growth is being helped by improvement in China, some important export-driven economies have been having more trouble. Specifically, Japan was badly hit by downturns in net exports to the Eurozone and China, contributing in significant measure to its last recession. Though Japanese export growth has picked up this year, it is likely to fade in the coming months, as we discuss in the next section (*pages 6 to 10*).

Trade Off A key reason why the global economy is struggling is the weakness of the U.S. as a locomotive of global growth. The U.S. has effectively been missing in action, and a firming in China cannot make up for it, let alone upturns in the U.K. and Spain.

As Chart 1b shows, U.S. import growth slipped into negative territory in late 2012; the dark blue lines in the top panel depict year-over-year (yoy) growth in U.S. goods and services imports, while the overlapping light blue lines represent yoy growth in U.S. goods imports. Since last October, both measures have hovered mostly in negative territory, plunging as deep as *-6%* last March. Though they finally crept marginally above zero this summer, they have never been this weak except around U.S. recessions.

