Yen 4Sight

Highlights

- The BoJ is expected to ease policy at its meeting on 29 July. But helicopter money is not on its way.
- The latest Reuters Tankan and flash manufacturing PMI signalled that the economy started Q3 on a weak footing.
- Alongside the BoJ's announcement, Friday brings the key month-end top-tier releases, including June IP, household spending and CPI data.

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Interest and exchange rate forecasts

End period	22-Jul	Q316	Q416	Q117
BoJ ONR %	-0.10	-0.20	-0.20	-0.30
BoJ JGBs ¥trn	328	340	360	380
10Y JGB %	-0.22	-0.25	-0.25	-0.30
JPY/USD	106	105	105	102
JPY/EUR	117	113	113	114

Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

BoJ ready to ease again?

Ahead of the BoJ's policy announcement on Friday, there appears to be no shortage of reasons to expect new monetary stimulus. Economic growth appears again to have been underwhelming in the second quarter. With business sentiment downbeat, the strong yen weighing on exports, and little reason to expect consumer spending suddenly to accelerate, GDP growth looks set at best to be modest over the near term. In addition, headline inflation is back in negative territory, with the strong yen injecting a new deflationary impulse. And with Bernanke – who at the turn of the millennium made the case for helicopter money as a valid option for treating what he saw as Japan's 'self-induced paralysis' – having made a highly visible visit to Tokyo earlier this month, there have been expectations in some quarters that Kuroda has something big up his sleeve.

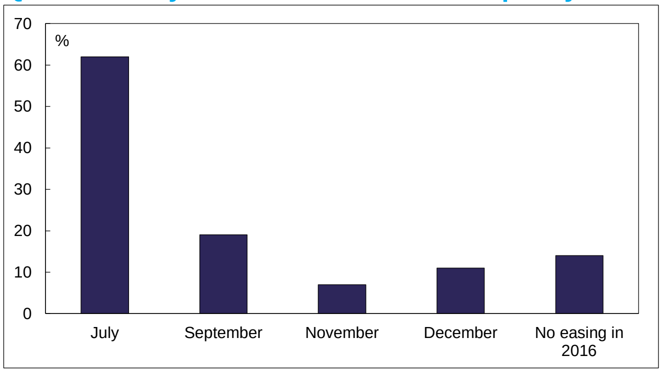
Helicopter money is not on its way

Despite the speculation, any hopes that the BoJ will unveil some form of helicopter money seem bound to be dashed. Indeed, the past week's broadcast of an interview conducted with Kuroda last month saw him insist that the current institutional frameworks, which clearly demarcate boundaries for fiscal and monetary policy, should be maintained, stating that there is 'no need and no possibility for helicopter money'. Certainly, Kuroda would likely argue that, in some key respects, the economy is now on a firmer footing than at the turn of the millennium when Bernanke made his case for money-financed fiscal transfers. And notably, the BoJ's preferred measure of underlying inflation (excluding fresh foods and energy) has been in positive territory for almost three years, and is likely to remain close to 1%Y/Y over coming quarters.

But BoJ likely to take further action

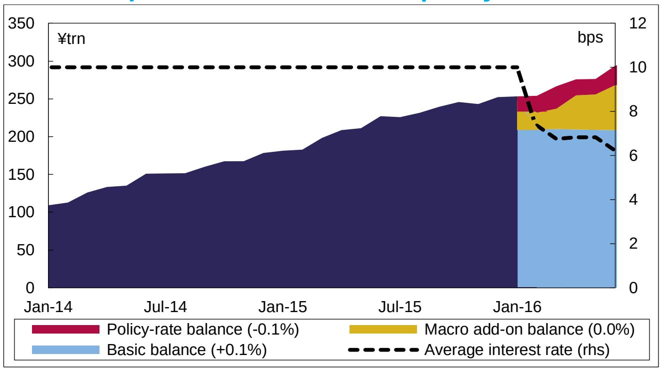
Admittedly, this measure of inflation has edged lower over recent months, while various indicators of inflation expectations – market participants, households and businesses alike – have fallen back. And while it cannot be ruled out that the BoJ will leave policy unchanged, with policy makers aware of the downside risks to the economic outlook, not least associated with the persistently strong yen, we do expect the BoJ to act on 29 July. Indeed, with a recent QUICK survey of forex market participants reporting that almost two thirds of respondents anticipate further easing this month, inaction by the BoJ would risk triggering renewed appreciation beyond the more than 2½-year high of ¥99/$ hit earlier in the month. But as Kuroda

QUICK survey: When will the BoJ ease policy?



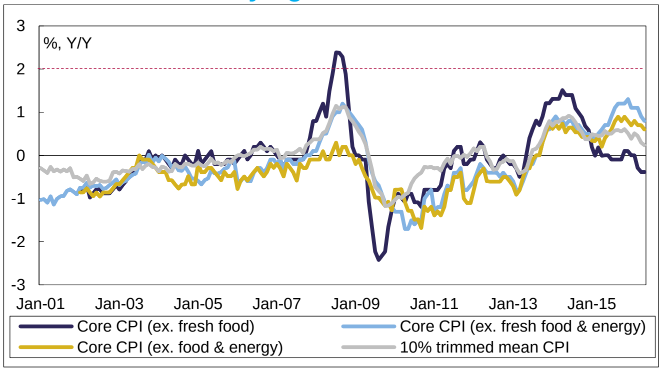
Source: QUICK forex market survey, conducted 11th-14th July 2016

Banks' deposits held at BoJ and policy rate



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Measures of underlying inflation



Source: BoJ, MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

has stated repeatedly this year, any additional easing is most likely to take place within the current policy framework of 'QQE with a negative rate'. Notwithstanding the likelihood of a modest increase in issuance related to the forthcoming fiscal stimulus package, concerns that the BoJ will soon be unable to maintain its JGB purchases at the current targeted rate seem to rule out an increase in government bond purchases. So, the next step seems more likely to be – as appears to be priced in – a further cut in the policy rate, perhaps by 10bps to -0.2%. While this would represent a further hit to banks' lending margins, given the tiered rate system the impact on the average interest rate applied to deposits held at the central bank would be less than the headline rate would imply. Indeed, the average interest rate on excess reserves would likely remain firmly in positive territory, probably declining by just 1-2bps in Q3 from the average rate of about 6½bps in Q2.

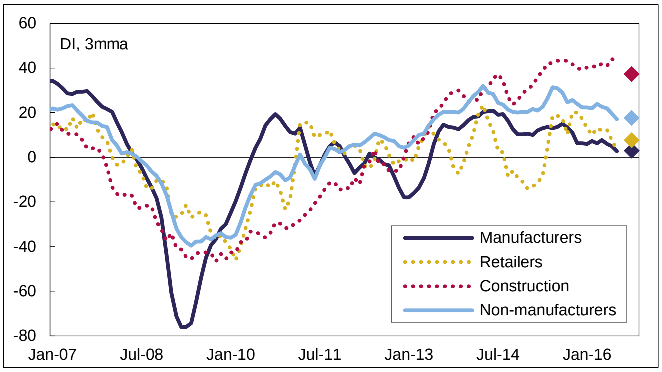
Mixed messages on fiscal support package

The size of the forthcoming fiscal stimulus package also remained a key subject of speculation in the past week, with the yen briefly weakening to a near-seven-week low of ¥107.5/$ as more than one report suggested that the headline figure could be much larger than initially thought, perhaps as high as ¥20trn (4% of GDP). While such a number would tally with Abe's recent pledge to take 'bold' action, other reports suggested it was wide of the mark, and that the bulk of such a package could anyway come from quasi-fiscal measures – for which the additional investment generated by the policy initiatives might be questionable – while actual new extra public spending might even be smaller than previously expected (perhaps little more than ½% of GDP). Indeed, given reports that there might be only limited new JGB issuance, that might seem more plausible. Certainly, the extent to which the fiscal package will provide a boost to GDP growth will need to be judged on the precise detail of the package – rather than the headline figure – when it is eventually announced, possibly to coincide with the BoJ's Policy Board announcement.

Surveys highlight weakness at the start of Q3

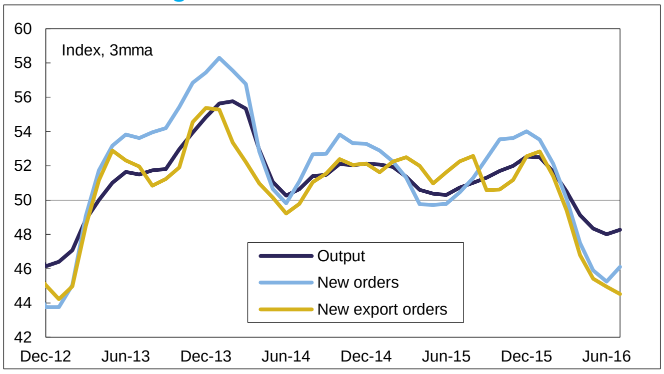
Despite the uncertainty about the size and nature of the monetary and fiscal support, the past week's data served to highlight the case for giving the economy some kind of shot in the arm. Certainly, the first of the sentiment surveys for July signalled a disappointing start to the second half the year. In particular, the Reuters Tankan survey showed the headline non-manufacturing DI declining for the fourth consecutive month to +15, almost 10pts lower than the average since the start of 2015 and the lowest since the launch of QQE in April 2013. While construction firms assessed conditions to be more favourable, other sub-sectors such as retail remained downbeat. Meanwhile, on the back of concerns about the impact of the stronger yen, manufacturers anticipated a deterioration in business conditions over the coming three months, with the relevant DI forecast to fall from +3 to zero in October, which would be the weakest since April 2013. Moreover, although the flash manufacturing output PMI posted a surprise increase in July, at 49.3 it remained in mild recessionary territory. And echoing the Reuters Tankan, the new export orders PMI fell further to a 3½-year low of just 44.0 suggesting that the risks to the near-term outlook from the forex market remain significant.

Reuters Tankan: Business conditions*



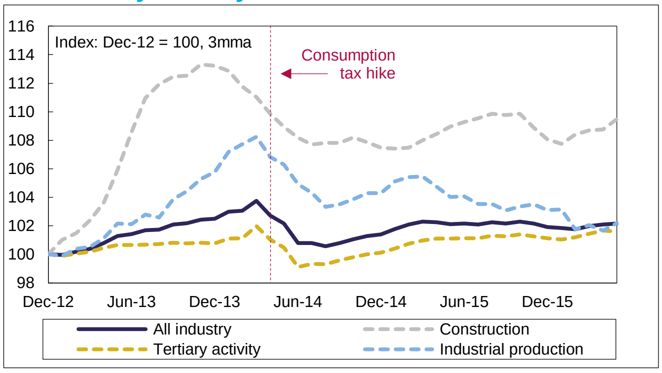
*Large enterprises. Diamonds represent survey forecast for October.
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing PMI*



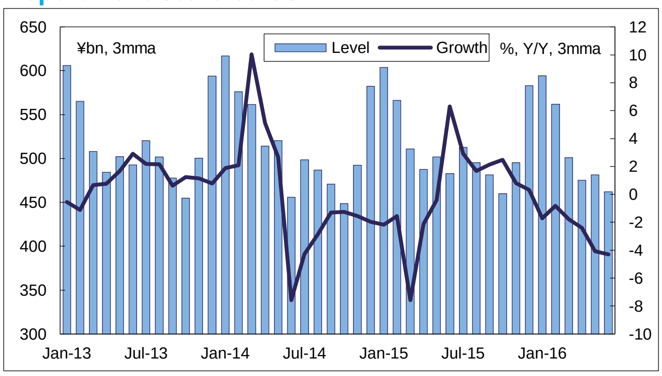
*July figures are flash estimates.
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

All industry activity



Source: METI and Daiwa Capital Markets Europe Ltd.

Department store sales



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

All industry activity contracts in May

Japan's manufacturing sector had a bad time of it again in the second quarter too. Indeed, having declined by more than 2½%M/M in May, industrial output looks to be on track to have subtracted from GDP growth for the fourth quarter out of the past five. And tertiary activity was also weaker in May with the 0.7%M/M decline fully reversing the increase in April. But output from the construction sector held up relatively well that month, rising for the second successive month and by 1½%M/M despite a near-4% drop in public sector building work. Indeed, tallying with the upbeat reading from the sector in the Reuters Tankan, private sector construction output was up on average in the first two months of Q2 by more than 3% compared with Q1. And so while all-industry activity fell in May at the steepest pace since the post-tax hike retrenchment in April 2014, overall output was still up on average in the first two months of Q2 by 0.3% compared to Q1. So, in the absence of a contraction of ½%M/M in June, all-industry activity would be consistent with another quarter of positive albeit likely very modest GDP growth last quarter.

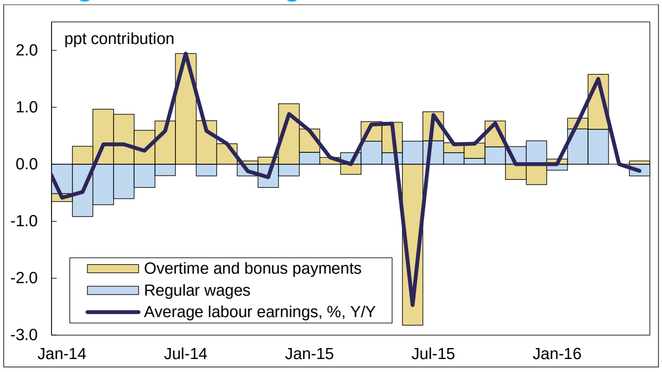
Department store sales disappoint

Admittedly, the first of the hard data releases for June was disappointing, with nationwide department store sales down compared with a year earlier for the fourth consecutive month and by 3½%Y/Y. Sales of big-ticket items and clothing fared poorly as labour earnings growth remained subdued. Indeed, regular wage growth was revised down in May to -0.2%Y/Y, the weakest rate since 2014, while a recent Keidanren report suggested that on average summer bonus payments at major firms rose at the softest pace for four years. Store sales are also more typically affected by moves in stock prices, with the BoJ recently lending credence to studies suggesting that a 10% drop in stock prices could knock about 0.2-0.3ppt off full-year consumption growth. So, the near-20% drop in the TOPIX index in the first half of 2016 seems likely to have had a non-negligible impact on spending. And while department store sales data are not always a perfect guide to consumption growth, given subdued consumer sentiment and seemingly absent wage growth, we continue to expect household consumption to remain lacklustre over coming quarters.

Overseas visitors still supporting growth

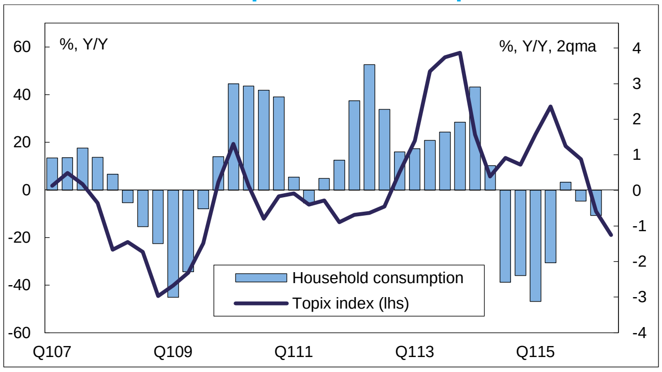
Over recent months, there has also been a decline in the average amount spent by individual foreign visitors too, most notably by those from China after that country's authorities applied high duties on large-scale purchases by tourists of foreign goods from the start of April. Indeed, spending per Chinese visitor in Q2 was down more than 20%Y/Y. Nevertheless, given the increase in the number of visitors from that country in Q2 to a near-record 1.6mn, their overall spending was only just slightly lower than a year earlier. Moreover, with the total number of foreign tourists rising to almost 2mn in June, and a record 6m in Q2, overall spending by overseas visitors last quarter was the firmest since Q315. So, while the annual rate of growth slowed to just 7%Y/Y, down from average growth of 65%Y/Y since the start of 2014, tourist spending seems likely to have remained a welcome source of support to annual GDP growth in Q2.

Average labour earnings



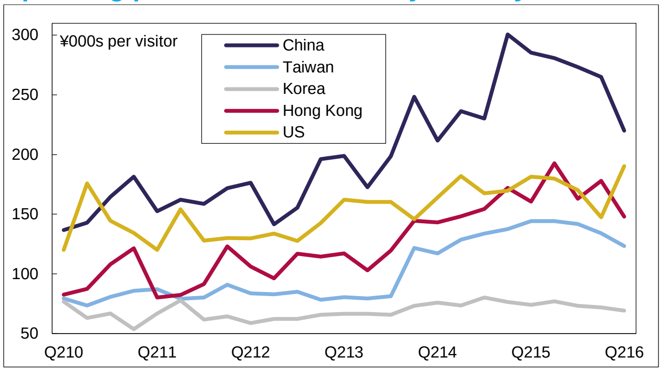
Source: MHLW, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Household consumption and stock prices



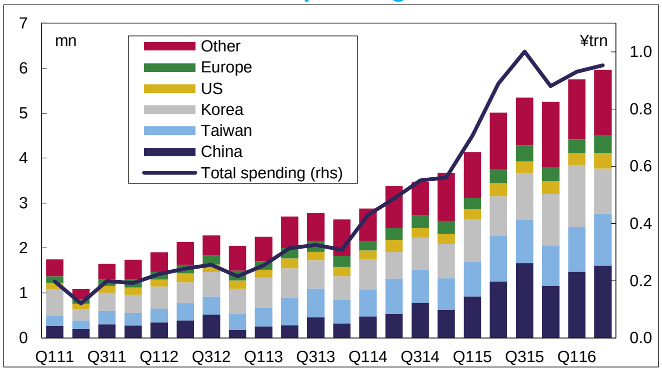
Source: Cabinet Office, Bloomberg and Daiwa Capital Markets Europe Ltd.

Spending per overseas visitor by country



Source: JNTO, JTA and Daiwa Capital Markets Europe Ltd.

Overseas visitors and spending



Source: Thomson Reuters, JNTO, JTA and Daiwa Capital Markets Europe Ltd.

BoJ to revise down its near-term forecasts

Despite the patchy recent data, and the downside skew in risks to the outlook, the BoJ might well continue to consider the economy to be on a 'moderate recovery trend' when it publishes its updated Outlook Report in the coming week. This notwithstanding, its GDP growth forecast for FY16 will need to be downwardly revised to reflect the government's decision to delay next year's consumption tax hike to October 2019. In April, the BoJ estimated that front-loading of spending ahead the tax hike would push GDP growth up by 0.4ppt this year. So, at a minimum, we would expect the BoJ's growth forecast to be revised down to 0.8%, although a larger downwards revision would seem in order. But equally, with the BoJ assessing that the likely retrenchment from the tax hike would push down GDP growth in FY17 by 0.6ppt, its forecast for that year might well be revised up to 0.7%. And while the BoJ will undoubtedly pay lip-service to the downside risks posed in particular by recent yen appreciation, it will likely remain confident that a closing output gap will help shift inflation onto higher path in due course. And if the BoJ indeed continues to assess that it is on track to meet its 2% inflation target – albeit perhaps again a little later than previously thought – Kuroda will arguably be more justified to deliver an incremental change to policy rather than the shock-and-awe tactic favoured at the start of his tenure.

BoJ economic forecasts: April's Interim Report*

%, Y/Y	Core CPI		GDP
	(incl. consumption tax hike)	(excl. consumption tax hike)	
FY16	0.5 *(-0.3-0.8)*		1.2 *(0.3-1.6)*
FY17	2.7 *(1.6-3.0)*	1.7 *(0.6-2.0)*	0.1 *(0.0-0.4)*
FY18	1.9 *(0.7-2.1)*		1.0 *(0.4-1.2)*

**Full forecast range in parentheses.*
Source: BoJ

The week ahead in Japan and US

The coming week looks set to be an eventful one in Japan, with the aforementioned conclusion of the BoJ's latest Policy Board meeting and publication of its updated economic forecasts to be accompanied on Friday by a deluge of month-end top-tier data releases. In particular, headline CPI is expected to have remained unchanged at -0.4%Y/Y in June. But the BoJ's preferred core measure of CPI (excluding fresh foods and energy) is expected to have declined to an eleven-month low of 0.7%Y/Y. Meanwhile, the latest IP figures are likely to show that output fell for the third consecutive month in June, to leave it subtracting from GDP growth in Q2 for the fourth quarter out of the past five. June household spending and retail sales will provide further insight into private consumption growth in the second quarter, while the unemployment rate is likely to remain unchanged at 3.2%, a rate last lower in 1995. Ahead of these figures, June's goods trade report will be published on Monday. Meanwhile, in the JGB market, a 40Y auction will be conducted on Tuesday, followed by a 2Y auction on Thursday.

In the US, all eyes in the coming week will be on the conclusion of the latest two-day FOMC meeting on Wednesday, although the Fed is overwhelmingly expected to keep the FFR range unchanged at 0.25-0.50%. Likely of more interest will be the post-meeting press statement, which will be watched closely for the Committee's assessment of post-UK-referendum risks and therefore any hints about the likely timing for future rate increases. Data-wise, the most noteworthy release comes on Friday with the advance GDP estimate for Q2. Expectations are for growth to have accelerated to an annualised rate of 2½%Q/Q, which would be the firmest rate for a year and a touch stronger than the average since the start of the decade. And the release on Thursday of advance goods trade, wholesale and retail inventories data for June will also be watched. Other data due in the coming week include the Conference Board's consumer confidence survey (Tuesday), durable goods orders (Wednesday) and several housing market indicators. Supply-wise, the Treasury will sell 2Y notes (Monday), 5Y notes (Tuesday), 2Y floating-rate notes (Wednesday) and 7Y notes (Thursday).

Economic calendar

Key data releases – July/August

18	19	20	21	22
NATIONAL HOLIDAY – MARINE DAY	BOJ CURRENT ACCOUNT BALANCES BY SECTOR (JUN)	20Y JGB AUCTION NATIONWIDE DEPARTMENT STORE SALES Y/Y% MAY -5.1 JUN -3.5 BOJ SENIOR LOAN OFFICER OPINION SURVEY (JUL)	3M TB AUCTION RETUERS TANKAN – LARGE MANUFACTURERS DI JUN 3 JUL 3 NON-MANUFACTURERS DI JUN 17 JUL 15 ALL INDUSTRY ACTIVITY INDEX M/M% APR 0.8 MAY -1.0	AUCTION FOR ENHANCED LIQUIDITY MANUFACTURING PMI JUN 48.1 JUL P 49.0
25	26	27	28	29
GOODS TRADE BALANCE ¥BN MAY 270 JUN N/A	40Y JGB AUCTION (APPROX ¥0.4TRN) SERVICES PPI Y/Y% MAY 0.2 JUN N/A		3M TB AUCTION (APPROX ¥4.4TRN) 2Y JGB AUCTION (APPROX ¥2.3TRN)	NATIONAL CPI Y/Y% MAY JUN -0.4 -0.4 *EX FRESH FOOD* *-0.4 -0.4* *EX FOOD/ENERGY* *0.6 0.5* *EX FRESH FOOD/ENERGY* *0.8 0.7* TOKYO CPI Y/Y% JUN JUL -0.5 -0.5 *EX FRESH FOOD* *-0.5 -0.4* *EX FOOD/ENERGY* *0.4 0.3* UNEMPLOYMENT RATE % MAY 3.2 JUN 3.2 JOB-TO-APPLICANT RATIO MAY 1.36 JUN 1.37 HOUSEHOLD SPENDING Y/Y% MAY -1.1 JUN -0.5 RETAIL SALES Y/Y% MAY -2.1 JUN -1.3 INDUSTRIAL PRODUCTION Y/Y% MAY -0.4 JUN -3.0 CONSTRUCTION ORDERS Y/Y% MAY 34.5 JUN N/A HOUSING STARTS Y/Y% MAY 9.8 JUN N/A BOJ POLICY BOARD ANNOUNCEMENT AND OUTLOOK REPORT
01	02	03	04	05
MANUFACTURING PMI (JUL F)	10Y JGB AUCTION CONSUMER CONFIDENCE (JUL) MONETARY BASE (JUL)	SERVICES PMI (JUL) COMPOSITE PMI (JUL)	3M TB AUCTION 10Y JGBI AUCTION	AVERAGE WAGES (JUN) COINCIDENT INDEX (JUN P) LEADING INDEX (JUN P)
08	09	10	11	12
6M TB AUCTION ECONOMY WATCHERS (JUL)	30Y JGB AUCTION MACHINE TOOL ORDERS (JUL P)	3M TB AUCTION MACHINE ORDERS (JUN) GOODS PPI (JUL) TERTIARY ACTIVITY INDEX (JUN)	NATIONAL HOLIDAY – MOUNTAIN DAY	

Source: BoJ, MoF, Bloomberg & Daiwa Capital Markets Europe Ltd.

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