Yen 4Sight

Highlights

- October's consumption-related indicators were a touch firmer than expected, but still signalled a subdued trend.
- Manufacturing and construction output both look on track to provide ongoing support to GDP growth in Q4.
- The coming week brings the second estimate of Q3 GDP, with benchmark revisions that are set to see notable upward adjustments to the levels of investment and GDP.

Emily Nicol
+44 20 7597 8331
Emily.Nicol@uk.daiwacm.com

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Interest and exchange rate forecasts

End period	02-Dec	Q416	Q117	Q217
BoJ Policy rate %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.04	0.00	0.00	0.00
JPY/USD	114	114	116	118
JPY/EUR	121	120	120	122

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

Consumption indicators beat expectations…

Japanese household consumption has repeatedly disappointed over the past couple of years, having oscillated around a broadly flat trend since the initial post-tax hike retrenchment in mid-2014. Indeed, despite having risen in each quarter so far in 2016, private consumption in Q3 was still more than 4% below its pre-tax hike peak. And the past week's consumption-related indicators, while exceeding expectations, provided mixed messages at the start of Q4. Strikingly, the value of retail sales in October rose at the strongest pace in more than two years, leaving it up 0.9% on a 3M/3M basis. But given previous weakness retail sales were still slightly lower than a year earlier, although the 0.1%Y/Y decline was the softest for thirteen months. In addition, the annual rate of decline in real household spending also eased in October, by more than 1½ppts to -0.4%Y/Y, the smallest drop in six months.

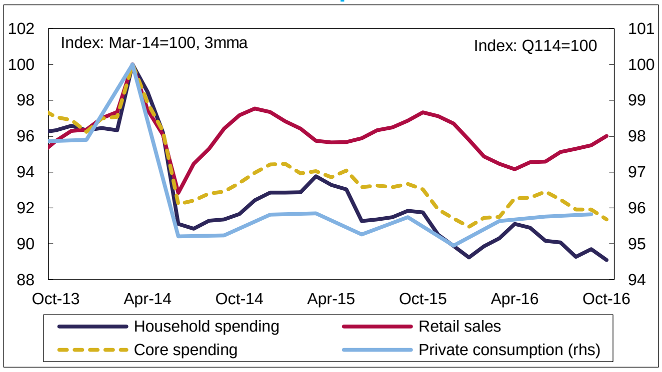
…but still maintain broadly subdued trend

The improvement in household spending in October was principally due to a pickup in expenditure on services, which rose on a year-on-year basis for the first month in six. In contrast, spending on durable and, in particular, semi-durable goods continued to decline compared with a year earlier. And so the eye-catching monthly increase in retail sales looks to have reflected price effects, with the value of clothing sales rising at the fastest pace for 5½ years, while higher energy prices also seemingly provided a boost. Indeed, in real terms household spending fell 1.0%M/M, with spending on 'core' items – which typically best tracks the national accounts measure of consumption – down 1.5%M/M. Admittedly, this largely reflected a double-digit decline in expenditure on education that month which followed a notable increase in September. Nevertheless, when smoothing out the monthly volatility, core spending was still down more than 1%3M/3M with overall spending down to a new post-tax-hike low on the same basis. So, overall, there was certainly no compelling evidence from these data to suggest that consumption has broken out of its sluggish post-tax-hike trend.

Manufacturing production flat in October…

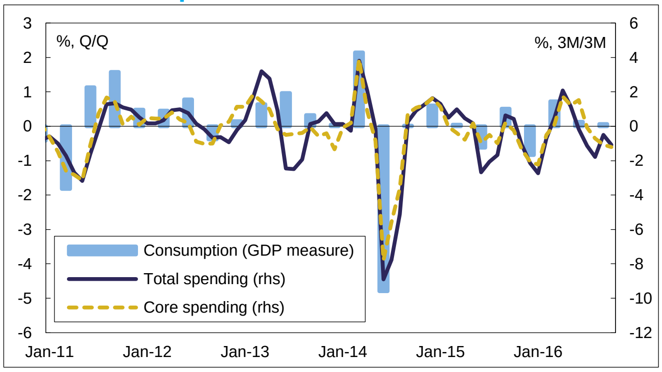
Against the backdrop of still-subdued domestic demand, it was perhaps not surprising to see the recovery in industrial production pause at the start of Q4 too, with growth of just 0.1%M/M leaving output down 1.3% compared with a year earlier. The performance among the key export oriented sectors was certainly mixed, with a marked pick up in output in the electronic parts and devices sector (+4.6%M/M) reportedly

Measures of household expenditure



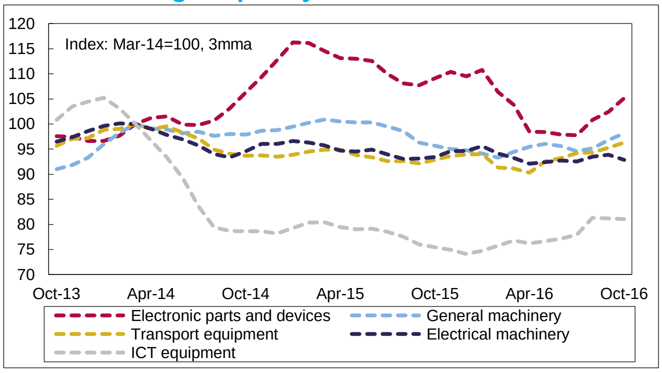
Source: Cabinet Office, MIC, METI, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Household expenditure



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

Manufacturing output by subsector



Source: METI and Daiwa Capital Markets Europe Ltd.

on the back of demand for smartphones from China offset by weakness in the general and electrical machinery sectors. Overall, however, having posted its third consecutive monthly rise, manufacturing output was still up more than 2%3M/3M, the highest such rate since March 2014.

…but set to shift higher over the remainder of Q4

Furthermore, with shipments rising by more than 2%M/M, and inventories declining by more than 2%M/M, conditions appear in place for continued near-term gains in production. Indeed, the survey forecasts a rise of 4½%M/M in output in November followed by a modest decline in December. While these forecasts are typically overdone, the final manufacturing PMI survey for November saw the output component revised higher from the flash estimate, by 0.1pt to 52.4. And while this was still almost 1pt lower on the month, the average so far in Q4 was more than 2½pts higher than the average in Q3, while there was a notable upwards revision to the new orders component to its highest level since January. So, on the whole, recent data suggest that manufacturing output continues to boost GDP growth in Q4.

Construction sector to provide ongoing support

There are certainly good reasons to be optimistic about the near-term outlook for the construction sector. Various sentiment surveys suggest that business conditions are the most favourable for decades, while profit growth in the sector was particularly strong last quarter at almost 40%Y/Y. And the latest construction activity data reported the second successive quarter of growth of around 2%Q/Q in Q3 thanks in particular to stronger private sector building work. Moreover, the more than 13%Y/Y increase in housing starts in October, the firmest since June 2015, signalled that residential investment is set to provide ongoing – and probably increasing – support for GDP growth for a while to come. And as the summer's fiscal stimulus package starts to feed through, the prospect of increased public sector construction activity was reflected in the rise of more than 15%Y/Y in total construction orders too.

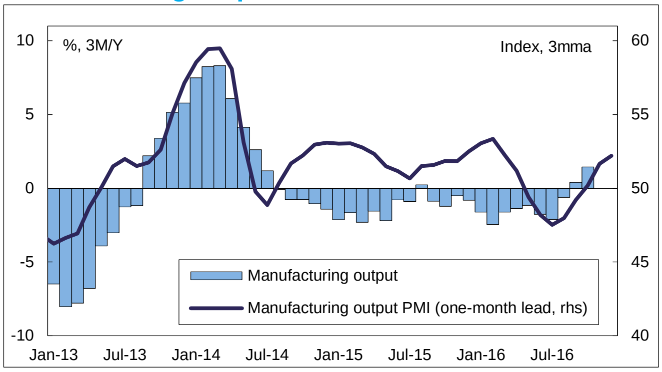
Labour market indicators remain positive

On the whole, the latest labour market data were undeniably positive too, with a further increase of 60k in the total number of workers employed in October taking the gain compared to a year earlier to an impressive 630k and more than 2mn since Abe took office in 2012. And with a further welcome increase in the labour force – reflecting increased participation from male and female workers alike – to a series high, the unemployment rate remained unchanged at 3.0%, a 22-year low. Despite the record high labour force participation, the job-to-applicant ratio rose further to 1.40, the highest since 1991, suggesting that the labour market continues to tighten. And so, with the MoF's Q3 survey of financial statements of corporations suggesting that the labour share of corporate income remains well below its long-run average, and given fiscal incentives and other government policies such as hikes in the minimum wage and efforts to clamp down on overtime, ongoing, albeit likely gradual, increases in regular wages should be forthcoming.

Sales and profit growth bounce back in Q3

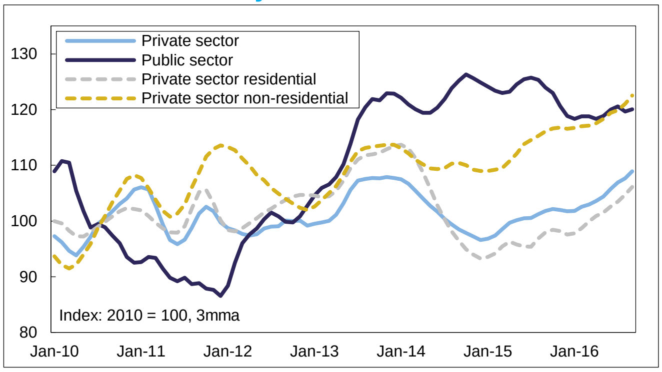
In many ways the MoF's survey revealed an improved performance for Japan's corporate sector last quarter, suggesting that firms might be well placed to pass on some of

Manufacturing output and PMI



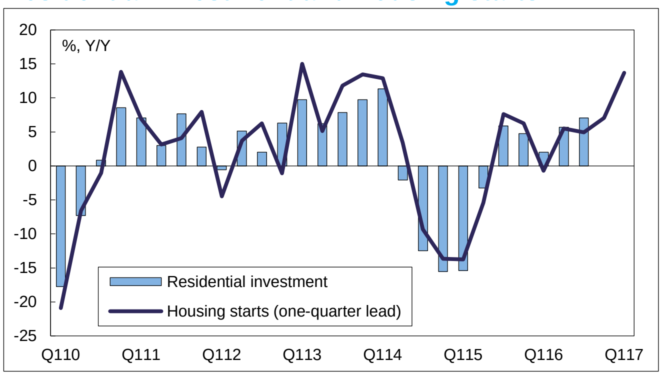
Source: METI, Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Construction activity



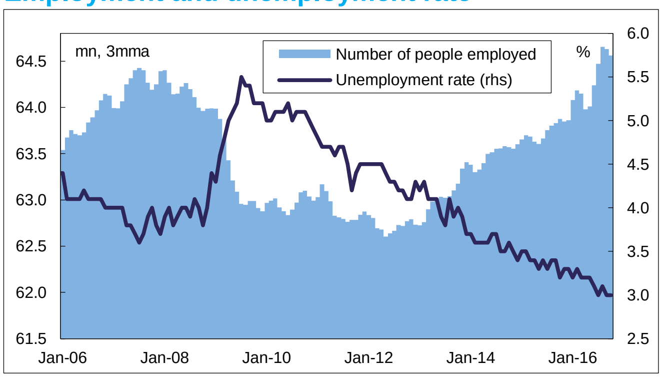
Source: METI and Daiwa Capital Markets Europe Ltd.

Residential investment and housing starts*



**Q117 figure based on October's figure. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Employment and unemployment rate



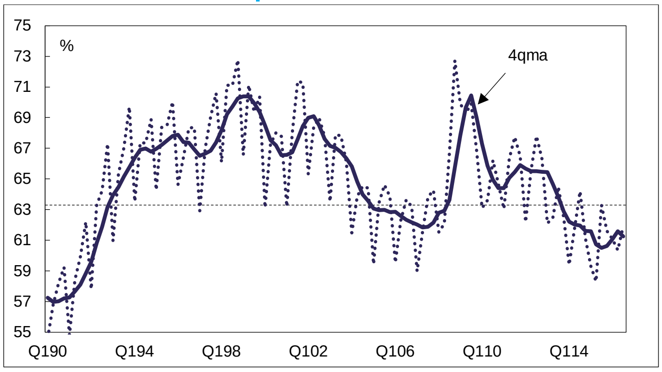
Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

the fruits of increased profit growth to their workforce. For example, total sales rose for the first quarter in seven in Q3 and by 0.8%Q/Q, to leave the annual rate of decline easing notably to just -1.5%Y/Y. Moreover, profits were up almost 8%Q/Q for the second successive quarter with solid growth in the manufacturing and non-manufacturing sectors alike, to leave them up 11½%Y/Y, the strongest such increase in more than a year. And the MoF's survey had some better news on capital spending too, with the indicator of capex which aligns most closely with the national accounts measure of investment up 0.4%Q/Q, the first quarterly increase in four, thanks to a more than 2%Q/Q increase in the non-manufacturing sector. As a result, when the second estimate of GDP is published on 8 December, real capital spending growth (initial estimate 0.0%Q/Q) might well be nudged higher. However, as the survey also suggested that private sector inventories were a touch weaker than implied in the preliminary GDP release, in the absence of revisions related to classification adjustments (see below), we would not expect to see any significant change from the 0.5%Q/Q GDP growth rate initially estimated.

GDP series to get a significant boost from R&D

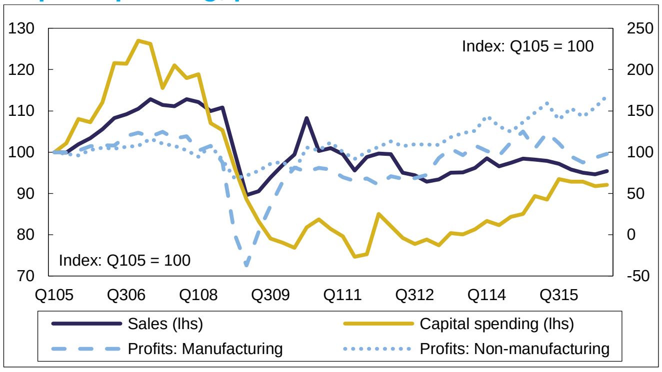
The coming week's national accounts release brings scheduled benchmark revisions, which will also include classification changes to bring them in line with the worldwide System of National Accounts 2008 (SNA2008) already adopted by many major economies. And while OECD countries that previously made the adjustments saw the level of nominal GDP upwardly revised on average by 2.3%, Japanese GDP is expected to see a more significant shift. Indeed, according to the Cabinet Office's initial estimate, the *level* of GDP in 2011 will be revised up by more than 4% (about ¥20trn) to ¥491trn. The most significant methodological change relates to R&D, for which certain aspects have up to now not been included in Japan's national accounts. So, while the proposed changes are expected to have a positive impact on the level of all expenditure components, private and public sector investment look set to see the biggest revisions, together accounting for more than half of the initial estimated increase in GDP. And although there is a significant degree of uncertainty how this will affect the past profile of GDP *growth*, given the outperformance over recent years in the US and euro area of intellectual property investment compared with spending on equipment and machinery, we might well see significantly stronger private sector capex growth than previously estimated.

Labour share of corporate income



Source: MoF and Daiwa Capital Markets Europe Ltd.

Capital spending, profits and sales



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

Impact on GDP level in 2011 due to SNA2008*

	Current level (¥trn)	Expected revision (¥trn)	Contribution to expected increase (ppt)
GDP	**471.6**	**19.8**	**4.2**
- Private consumption	284.2	2.0	0.4
- Residential investment	13.4	0.9	0.2
- Non-residential investment	63.1	6.3	1.3
- Private inventories	-1.9	2.9	0.6
- Government consumption	96.1	3.1	0.7
- Public investment	20.5	3.4	0.7
- Net exports	-4.0	1.3	0.3

**Estimated by Cabinet Office in September 2016.*
Source: Cabinet Office

The week ahead in Japan and the US

The coming week in Japan looks set to be another busy one, with a key focus the aforementioned second estimate of Q3 GDP on Thursday. The week will also bring various sentiment surveys which will provide an update on economic conditions in the fourth quarter, including November's composite PMI and consumer confidence indicators (Monday) and economy watchers survey (Thursday). And ahead of the BoJ's quarterly Tankan on 14 December, December's Reuters monthly Tankan (Wednesday) will also be worth watching, as well the MoF's business sentiment survey for Q4 (Friday). Also of interest will be October's average labour earnings figures on Tuesday, followed by the BoJ's consumption activity index on Wednesday. In the JGB market, a 30Y auction will be conducted on Thursday.

In the US, the coming week gets underway with more top-tier data, with the release on Monday of November's non-manufacturing ISM to be followed on Tuesday by October's final trade report and factory orders figures, as well as revised productivity and labour costs data for Q3. Meanwhile, Wednesday brings October's JOLTS report and consumer credit numbers, followed by the usual weekly jobless claims figures on Thursday and December's preliminary University of Michigan's consumer sentiment survey on Friday. Ahead of the Fed's seven-day blackout period starting Tuesday, FOMC members Dudley, Evans and Bullard are due to speak at various events on Monday. And in the UST market, there are no bond auctions scheduled.

Daiwa Capital Markets

Economic calendar

Key data releases – November/December

28	29	30	01	02
	2Y JGB AUCTION UNEMPLOYMENT RATE % SEP 3.0 OCT 3.0 JOB-TO-APPLICANT RATIO SEP 1.38 OCT 1.40 HOUSEHOLD SPENDING Y/Y% SEP -2.1 OCT -0.4 RETAIL SALES Y/Y% SEP -1.7 OCT 2.5	INDUSTRIAL PRODUCTION Y/Y% SEP 1.5 OCT -1.3 VEHICLE PRODUCTION Y/Y% SEP 1.4 OCT -3.9 HOUSING STARTS Y/Y% SEP 10.0 OCT 13.7 CONSTRUCTION ORDERS Y/Y% SEP 16.3 OCT 15.2	3M TB AUCTION 10Y JGB AUCTION MOF CAPITAL SPENDING SURVEY Y/Y% Q2 3.1 Q3 -1.4 MANUFACTURING PMI OCT 51.4 NOV F 51.3 VEHICLE SALES Y/Y% OCT 0.8 NOV 13.9 BOJ BOND MARKET SURVEY	MONETARY BASE Y/Y% OCT 22.1 NOV 21.5
05	**06**	**07**	**08**	**09**
SERVICES PMI OCT 50.5 NOV N/A COMPOSITE PMI OCT 51.3 NOV N/A CONSUMER CONFIDENCE OCT 42.3 NOV N/A	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.4TRN) AVERAGE WAGES Y/Y% SEP 0.0 OCT 0.2	6M TB AUCTION (APPROX ¥3.5TRN) REUTERS TANKAN* - MANUFACTURING DI NOV 14 DEC N/A NON-MANUFACTURING DI NOV 15 DEC N/A BOJ CONSUMPTION ACTIVITY INDEX M/M% SEP 0.1 OCT N/A	3M TB AUCTION (APPROX ¥4.4TRN) 30Y JGB AUCTION (APPROX ¥0.8TRN) GDP Q/Q% Q2 0.2 Q3 F 0.5 CURRENT ACCOUNT BALANCE ¥TRN SEP 1.5 OCT N/A BANK LENDING Y/Y OCT 2.4 NOV N/A BANKRUPTCIES* Y/Y% OCT -8.0 NOV N/A ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI OCT 46.2 NOV 45.5 FUTURE CONDITIONS DI OCT 49.0 NOV N/A	BSI SURVEY Q3 1.9 Q4 N/A M3 MONEY SUPPLY Y/Y% OCT 3.2 NOV N/A
12	**13**	**14**	**15**	**16**
TERTIARY ACTIVITY (OCT) MACHINE ORDERS (OCT) GOODS PPI (NOV)	5Y JGB AUCTION	BOJ TANKAN (Q4) INDUSTRIAL PRODUCTION (OCT F) CAPACITY UTILISATION (OCT)	3M TB AUCTION 20Y JGB AUCTION	1Y TB AUCTION
19	**20**	**21**	**22**	**23**
GOODS TRADE BALANCE (NOV) FLOW OF FUNDS (Q316) BOJ POLICY BOARD MEETING (19-20 DECEMBER 2016)	BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY ALL INDUSTRY ACTIVITY (OCT) OVERSEAS VISITORS (NOV)		NATIONAL HOLIDAY – EMPEROR'S BIRTHDAY

**Approximate date of release. Source: BoJ, MoF, Bloomberg & Daiwa Capital Markets Europe Ltd.*

Economic Research

Key contacts

London

Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Associate Economist	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Danielle Pettet*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Junjie Tang*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

DAIR <GO>

All of the research published by the London and New York research teams is available on our Bloomberg page at DAIR <GO>. If you are unable to access the research on this page, please contact Danielle Pettet on +44 207 597 8332.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope