

Yen 4Sight

Highlights

- Surveys suggest that firms are upbeat about business conditions, and point to ongoing economic expansion in Q1.
- February's trade report showed that exports maintained a steady upward trend in the middle of the first quarter.
- The coming week brings February's CPI, IP, household spending and labour market data, all on Friday.

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	24-Mar	Q217	Q317	Q417
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.07	0.05	0.05	0.05
JPY/USD	111	114	116	118
JPY/EUR	120	121	123	125

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

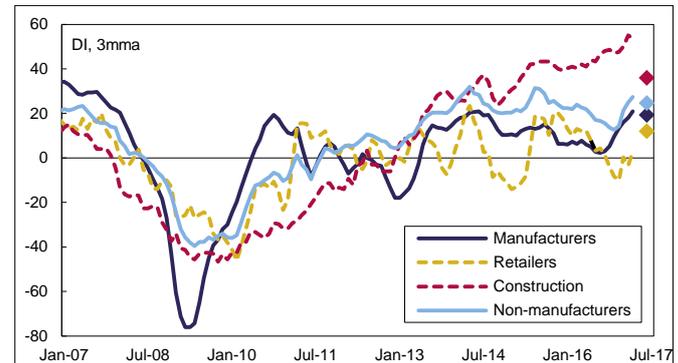
Manufacturing sentiment at a three-year high

With Japanese GDP having risen for four consecutive quarters in 2016, the first calendar year to see growth in every quarter since 2005, the past week's economic releases, including March business sentiment surveys and the February trade report, strongly suggested that positive momentum, not least in the manufacturing sector, was maintained in the first quarter of 2017. For example, the monthly Reuters Tankan – which provides a guide to the more comprehensive quarterly BoJ Tankan due on 3 April – indicated that large Japanese manufacturers were their most optimistic about conditions since before the consumption tax hike three years ago, with the relevant DI rising 5pts on the month to +25. And, while the flash manufacturing PMI declined slightly in March, this was only the second drop in the past ten months and left the index at a still-healthy 53.6, consistent with ongoing expansion in the sector at an annual rate close to 2%. Certainly, on average in the first quarter, the manufacturing PMI and Reuters Tankan DI stood at their respective highest levels since Q114, pointing to another quarter of decent growth in the sector at the start of 2017.

Construction firms and retailers upbeat too

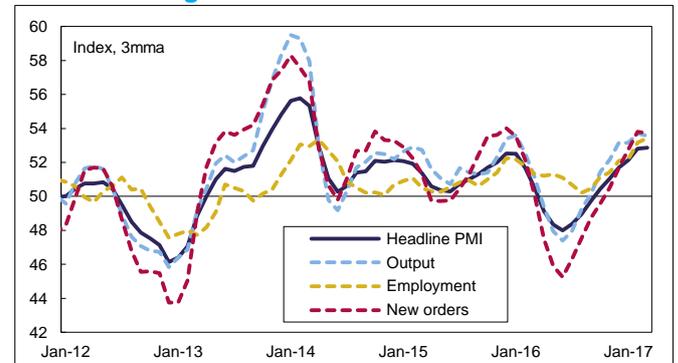
The Reuters Tankan also suggested that conditions in the non-manufacturing sector remained favourable, with the headline DI unchanged in March to leave the average index in Q1 at +27, its highest level since Q215 and up 13pts from Q4. Certainly, retailers were on average much more upbeat in Q1 than in the final quarter of last year and anticipated further improvements over the coming three months too. And with the government's supplementary budget measures likely to have started to feed through to the real economy more substantively from the turn of the year, it was no major surprise to see that conditions in the construction sector were assessed still to be highly favourable too. Indeed, the past week's all-industry activity release showed overall construction output rising at its fastest monthly pace for more than 6½ years in January, suggesting that this sector will make a non-negligible contribution to GDP growth in Q1. And while all-industry activity rose just 0.1%M/M in January, if the latest surveys are to be believed we might expect an acceleration in output over the remainder of the quarter. So, it is certainly not inconceivable that overall GDP growth in Q117 outpaced the 0.3%Q/Q rate of the previous two quarters.

Reuters Tankan: Business conditions*



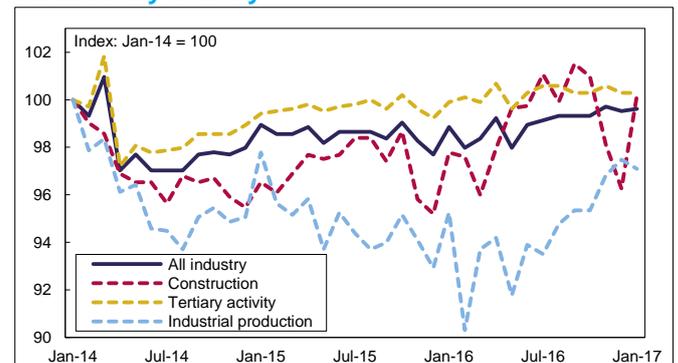
*Large enterprises. Diamonds represent survey forecasts for June 2017.
 Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing PMI*



*Flash figures for March 2017. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

All industry activity



Source: METI and Daiwa Capital Markets Europe Ltd.



Trade surplus at near-seven-year high

While Japanese manufacturing output had a softer start to the year, this arguably reflected some temporary payback for the fortunes seen through the second half of last year as the fortunes of the global manufacturing sector took a turn for the better. Certainly, the past week's February trade report suggested that Japanese exporters were once again benefiting from the improved global environment that month. Indeed, the value of exports was up a stronger-than-expected 11.3%Y/Y, the most in more than two years, while the value of imports rose just a little more 1%Y/Y. As a result, having dropped into deficit in January, the headline trade balance registered its largest surplus in almost seven years, at more than ¥800bn. And, while that was flattered by calendar effects, on an adjusted basis the surplus still leapt, from circa ¥200bn in January to ¥680bn, once again the largest since early 2010.

Exports to Asia boosted by Lunar New Year effect

Of course, the improvement from January partly reflected the impact of the timing of the Lunar New Year: exports to China were up more than 28%Y/Y in February from just 3%Y/Y the previous month, while exports to Asia were up more than 20%Y/Y having risen just 6%Y/Y previously. However, even looking through these monthly distortions, this still suggests that the notable recovery in shipments to Asia seen at the end of last year was maintained in early 2017. Exports to the EU and US had a better month too in February. By type of good, the improvement in exports was led by general and electrical machinery, suggesting that a turn for the better in the global investment cycle might well be starting to play to Japan's strengths. But while firmer than of late, the value exports of cars was still subdued, up just 1.4%Y/Y having been down on an annual basis in each of the previous eight months.

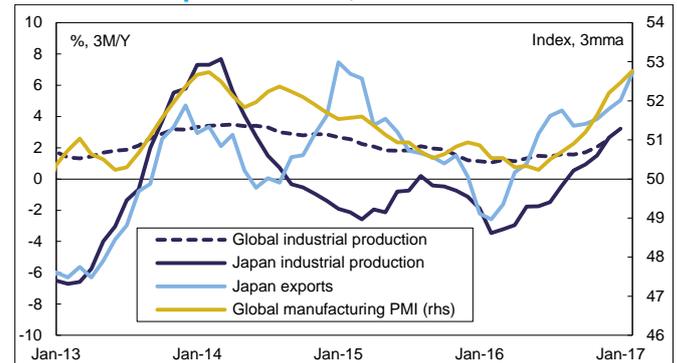
Exports volumes rise at firmest pace for 15 years

Of course, the headline trade numbers were skewed by the significant price shifts seen over the past year. But, adjusting for such effects, the trade performance was even more encouraging. In particular, according to BoJ data, having dropped 1%M/M in January the volume of exports rose 6½%M/M in February, the most in fifteen years. And the volume of imports fell more than 6%M/M having risen 3½%M/M at the start of the year. So, looking through the recent holiday-related volatility, the trend in the volume of goods exports remains far stronger than that of imports. Moreover, with the number of overseas visitor numbers exceeding 2mn in February for the fourth month out of the past five, we expect exports of services to remain a broadly positive source of growth in Q1 too. So, there is a good chance that net trade will make another solid contribution to GDP growth in Q1 for the third consecutive quarter. And while there remain downside risks, not least associated with President Trump's protectionist threats, we continue to expect external demand to play a key role in Japan's recovery in the coming fiscal year too.

The week ahead in Japan and the US

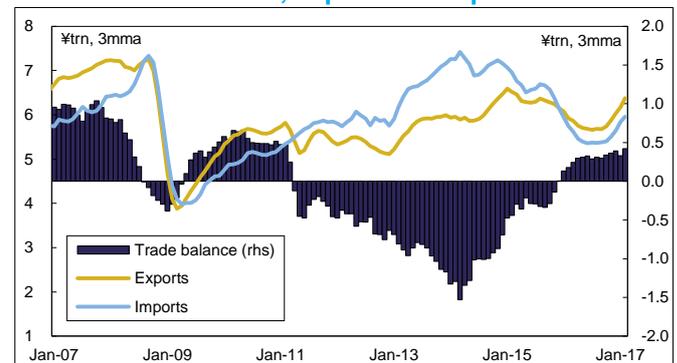
The coming week will be a busy one for Japanese economic news, with the latest tranche of month-end top-tier releases due on Friday. In particular, February's inflation figures are expected to show that headline CPI edged slightly lower to 0.3%Y/Y on the back of lower fresh food price inflation, while

World and Japanese trade, IP and PMI



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

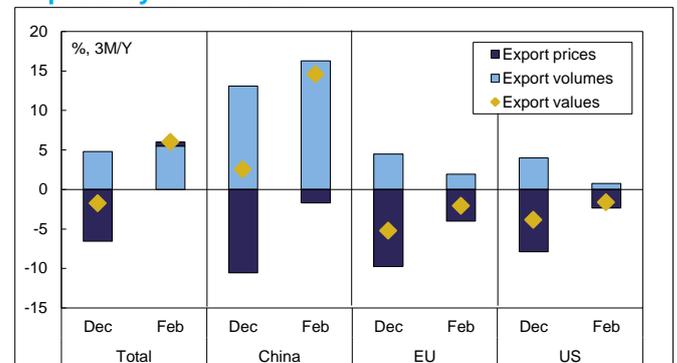
Goods trade balance, export and import values*



*Seasonally adjusted data.

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

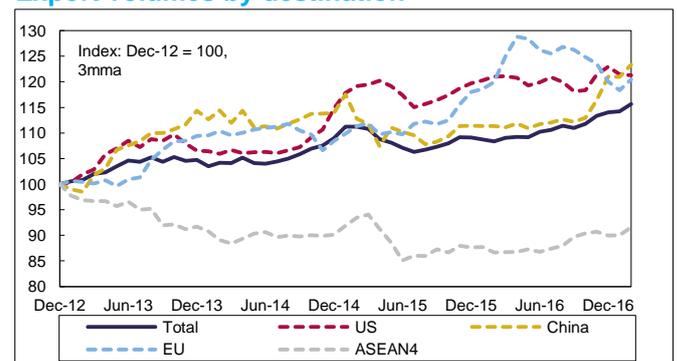
Exports by destination



*Non-seasonally adjusted data.

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

Export volumes by destination*



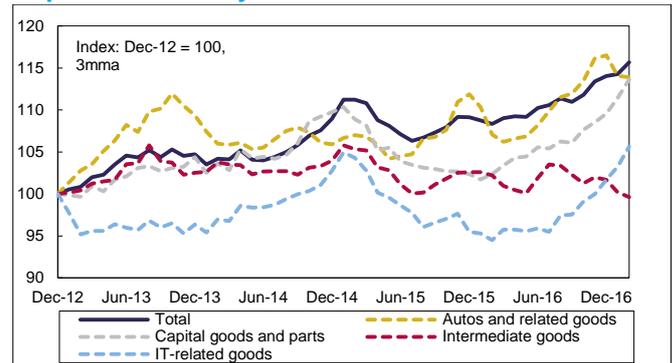
*Seasonally adjusted data. Daiwa estimate for February 2017.

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

the BoJ's forecast measure of core CPI (excluding fresh foods) is expected to have inched slightly higher to 0.2%Y/Y, which would be the strongest rate for almost two years. The latest labour market data are expected to show that the unemployment rate remained unchanged at 3.0% in February, a rate that was last lower in 1994, while household spending is likely to report some payback for the strength at the start of the year. Meanwhile, consistent with the stronger export data that month, IP is forecast to have jumped in February to more than offset the modest decline in January. In the JGB market, a 2Y auction will be conducted on Thursday.

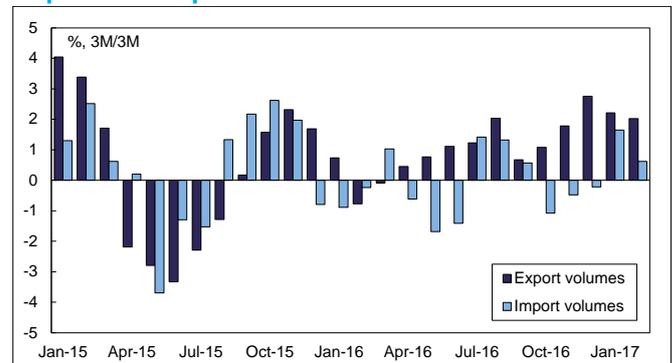
It will be a relatively busy week for US economic data too, kicking off on Tuesday with the advanced goods trade report for February and the Conference Board's consumer confidence survey for March. Tuesday will also bring the S&P CoreLogic home price index, followed on Wednesday by pending home sales figures. Focus on Thursday, meanwhile, will be on the third and final reading of Q4 GDP, which is expected to broadly align with the current estimate of annualised growth of 1.9%Q/Q. And the week comes to an end with the release of February's personal income and spending figures, which will include the Fed's closely watched PCE deflators. In the markets, the Treasury will sell 2Y notes on Monday, 5Y notes on Tuesday and 7Y notes on Wednesday.

Export volumes by sector*



*Seasonally adjusted data. Daiwa estimate for February 2017.
Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export and import volumes*



*Seasonally adjusted data.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Economic calendar

Key data releases – March/April

20	21	22	23	24
NATIONAL HOLIDAY – VERNAL EQUINOX		40Y JGB AUCTION GOODS TRADE BALANCE ¥BN JAN 204 FEB 680 ALL INDUSTRY ACTIVITY M/M% DEC -0.2 JAN 0.1	3M TB AUCTION	MANUFACTURING PMI FEB 53.3 MAR P 52.6 REUTERS TANKAN - LARGE MANUFACTURERS DI FEB 20 MAR 25 LARGE NON-MANUFACTURERS DI FEB 26 MAR 26
27	28	29	30	31
SERVICES PPI Y/Y% JAN 0.5 FEB N/A	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.5TRN)	RETAIL SALES Y/Y% JAN 1.0 FEB 1.0	2Y JGB AUCTION (APPROX ¥2.2TRN)	NATIONAL CPI Y/Y% JAN FEB 0.4 0.2 EX FRESH FOOD 0.1 0.2 EX FRESH FOOD/ENERGY 0.2 0.1 TOKYO CPI Y/Y% FEB MAR -0.3 -0.2 EX FRESH FOOD -0.3 -0.2 EX FRESH FOOD/ENERGY 0.0 0.1 UNEMPLOYMENT RATE % JAN 3.0 FEB 3.0 JOB-TO-APPLICANT RATIO JAN 1.43 FEB 1.43 HOUSEHOLD SPENDING Y/Y% JAN -1.2 FEB -1.7 INDUSTRIAL PRODUCTION Y/Y% JAN 3.7 FEB P 4.0 HOUSING STARTS Y/Y% JAN 12.8 FEB N/A CONSTRUCTION ORDERS Y/Y% JAN 1.1 FEB N/A
03	04	05	06	07
BOJ TANKAN (Q1) MANUFACTURING PMI (MAR F) VEHICLE SALES (MAR)	3M TB AUCTION 10Y JGB AUCTION MONETARY BASE (MAR)	6M TB AUCTION SERVICES PMI (MAR) COMPOSITE PMI (MAR)	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY CONSUMER CONFIDENCE (MAR)	AVERAGE WAGES (FEB) COINCIDENT INDEX (FEB P) LEADING INDEX (FEB P)
10	11	12	13	14
ECONOMY WATCHERS SURVEY (MAR) CURRENT ACCOUNT (FEB)	10Y JGBI AUCTION MACHINE TOOL ORDERS (MAR P)	MACHINE ORDERS (FEB) BANK LENDING (MAR) GOODS PPI (MAR)	3M TB AUCTION 30Y JGB AUCTION M3 MONEY SUPPLY (MAR)	INDUSTRIAL PRODUCTION (FEB F) CAPACITY UTILISATION (FEB)

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

Economic Research

Key contacts

London

Head of Research	<i>Grant Lewis</i>	+44 20 7597 8334
Head of Economic Research	<i>Chris Scicluna</i>	+44 20 7597 8326
Emerging Markets Economist	<i>Saori Sugeno</i>	+44 20 7597 8336
Economist	<i>Emily Nicol</i>	+44 20 7597 8331
Associate Economist	<i>Mantas Vanagas</i>	+44 20 7597 8318
Research Assistant	<i>Danielle Pettet</i>	+44 20 7597 8332

New York

Chief Economist	<i>Mike Moran</i>	+1 212 612 6392
Junior Economist	<i>Lawrence Werther</i>	+1 212 612 6393

Hong Kong

Economist	<i>Kevin Lai</i>	+852 2848 4926
Research Associate	<i>Christie Chien</i>	+852 2848 4482
Economic Assistant	<i>Olivia Xia</i>	+862 2773 8736

London Translation

Head of Translation, Economic and Credit	<i>Mariko Humphris</i>	+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](https://twitter.com/DaiwaEurope)

This research report is produced by Daiwa Securities Co. Ltd., and/or its affiliates and is distributed by Daiwa Capital Markets Europe Limited in the European Union, Iceland, Liechtenstein, Norway and Switzerland. Daiwa Capital Markets Europe Limited is authorised and regulated by The Financial Conduct Authority and is a member of the London Stock Exchange and Eurex Exchange. Daiwa Capital Markets Europe Limited and its affiliates may, from time to time, to the extent permitted by law, participate or invest in other financing transactions with the issuers of the securities referred to herein (the "Securities"), perform services for or solicit business from such issuers, and/or have a position or effect transactions in the Securities or options thereof and/or may have acted as an underwriter during the past twelve months for the issuer of such securities. In addition, employees of Daiwa Capital Markets Europe Limited and its affiliates may have positions and effect transactions in such securities or options and may serve as Directors of such issuers. Daiwa Capital Markets Europe Limited may, to the extent permitted by applicable UK law and other applicable law or regulation, effect transactions in the Securities before this material is published to recipients.

This publication is intended for investors who are not Retail Clients in the United Kingdom within the meaning of the Rules of the FCA and should not therefore be distributed to such Retail Clients in the United Kingdom. Should you enter into investment business with Daiwa Capital Markets Europe's affiliates outside the United Kingdom, we are obliged to advise that the protection afforded by the United Kingdom regulatory system may not apply; in particular, the benefits of the Financial Services Compensation Scheme may not be available.

Daiwa Capital Markets Europe Limited has in place organisational arrangements for the prevention and avoidance of conflicts of interest. Our conflict management policy is available at <http://www.uk.daiwacm.com/about-us/corporate-governance-regulatory>. Regulatory disclosures of investment banking relationships are available at <https://daiwa3.bluematrix.com/sellside/Disclosures.action>.