Yen 4Sight

Highlights

- Headline CPI edged higher on the back of energy and food prices. But underlying inflationary pressures remain weak.
- April's trade report was weaker. But the latest sentiment surveys overall signalled ongoing economic recovery ahead.
- The coming week will bring labour market, household spending and IP data for April. The MoF's Q1 capital spending survey will also be worth watching.

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Interest and exchange rate forecasts

End period	26-May	Q217	Q317	Q417
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.04	0.05	0.05	0.05
JPY/USD	112	112	112	114
JPY/EUR	124	120	120	123

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

Headline CPI edges higher in April

Japan's economic recovery over the past year or so has provided policymakers plenty to cheer about. But despite the longest expansion in GDP for almost a decade, solid employment growth and an associated drop in the unemployment rate to the lowest since 1994, inflation has remained a source of disappointment. And while the BoJ currently forecasts core CPI to average almost 1½%Y/Y in FY17, April's inflation figures served to highlight the scale of the task ahead. Admittedly, the main measures of inflation edged higher last month. For example, the headline CPI rate rose 0.2ppt to 0.4%Y/Y, while the BoJ's new preferred measure of core CPI (excluding fresh foods and energy) and its forecast measure of core CPI (excluding fresh foods) rose 0.1ppt to 0.0%Y/Y and 0.3%Y/Y respectively, with the latter at its highest rate since 2014. But the core CPI measure which also excludes processed food prices, and is thus most consistent with core measures used in the other major economies, was still firmly in negative territory, unchanged in May at 0.3%Y/Y, the lowest rate for almost four years, a time when Kuroda's QQE had barely got underway.

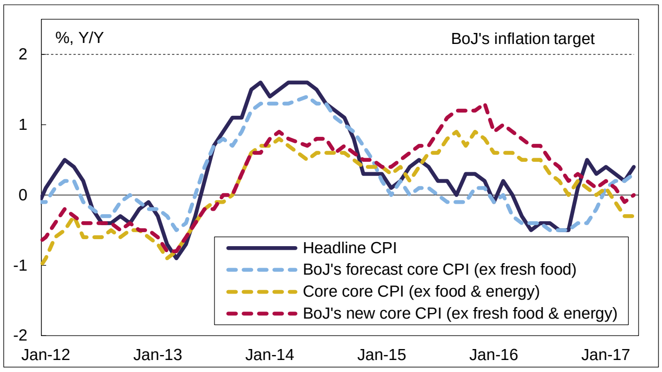
Underlying price pressures remain subdued

Plenty of the detail of the CPI data suggested that underlying inflationary pressures remain subdued, with services inflation edging down to zero, the lowest since August 2013, as the impact of last year's increase in public school fees wore off. In addition, non-energy industrial goods price inflation remained firmly in negative territory (-0.8%Y/Y) despite a slight easing in the drag from prices of mobile phone handsets, which nevertheless still fell more than 14%Y/Y. And given rising competition in the sector and the slightly increased weight in the CPI basket, prices of handsets as well as phone charges – which together subtracted 0.2ppt from headline CPI in April – are expected to remain a drag over the near term too.

Pipeline pressures being absorbed

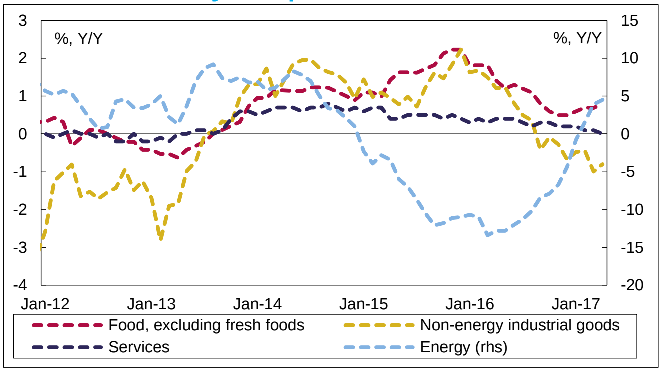
The BoJ anticipates prices of other durable goods to rise gradually as past yen depreciation and increases in prices of commodities and intermediate goods work their way through the pipeline. However, such increased costs still seem to be largely absorbed by firms at various points along the supply chain. The principal source of import price pressure is currently energy: on a yen basis, total import prices were up around 11%Y/Y in April, underpinned by a near-50%Y/Y increase in petroleum prices. That pushed headline producer price inflation to a more than three-year high last month, while final domestic

National CPI: Headline and core measures



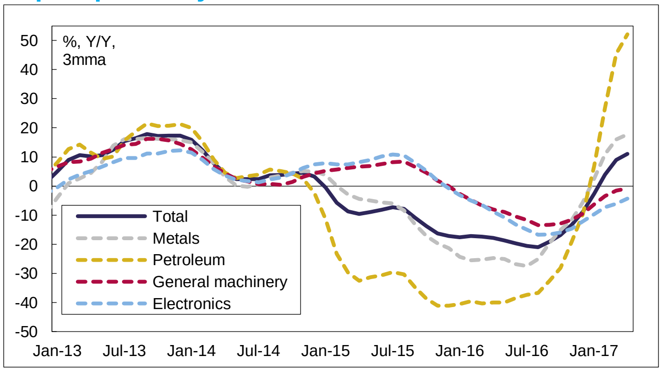
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

National CPI: Key components



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

Import prices by selected sector



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

consumer goods producer price inflation rose to an 8½-year high of 1.2%Y/Y. But while overall final consumer goods price inflation posted the first positive reading for almost two years, that rate of 0.2%Y/Y is hardly indicative of significant pressure in the CPI pipeline. Meanwhile, as expected, the month-ahead Tokyo CPI figures suggested that nationwide inflation will increase further in May due to higher electricity prices. And, not least since that component will continue to rise over coming months, we expect national CPI inflation to maintain a gradual upward trend well into the second half of the year, with core CPI likely to rise close to 1%Y/Y by around September.

Core CPI likely to remain well below 2%

Thereafter, however, we have significant doubts that inflation will rise significantly higher than 1%Y/Y. There seems no reason to believe that firms will be less willing to absorb any increased costs, not least since inflation expectations remain stubbornly low and well below levels reached during the Abenomics honeymoon period ahead of the 2014 consumption tax hike. Indeed, business inflation expectations tally with those of investors, with the most recent QUICK survey of financial market participants suggesting that core CPI will be below 1%Y/Y in two years' time. In addition, persistent weakness of labour earnings growth, due to efforts to constrain working hours and underwhelming increases in base pay emerging from this year's shuntō round, will likely serve to limit cost pressures and restrain demand. As such, we think that inflation will likely struggle to shift significantly higher than just half the BoJ's 2% target over coming years.

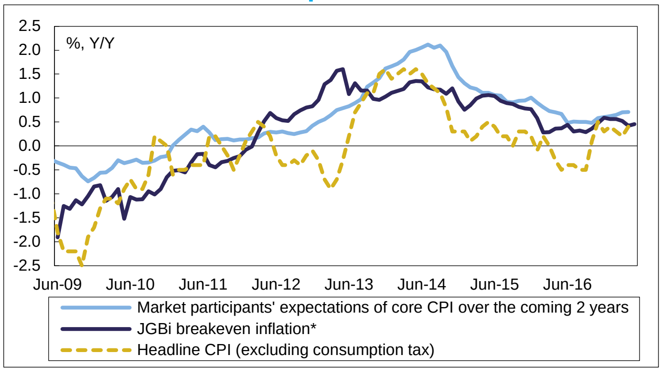
Trade surplus impacted by higher import prices

While import prices are likely to have a bearing on the near-term inflation outlook, their steady rise over recent months has been evident in the trade balance. Indeed, with stronger domestic demand having boosted the volume of imports too, the total value of imports rose by more than 15%Y/Y in April with almost two-thirds of this increase attributed to imported energy. So, while the value of exports was still up a healthy 7½% compared with a year earlier, the headline unadjusted trade surplus narrowed by ¥130bn to ¥482bn in April. And adjusting for seasonal effects, the surplus fell to a sixteen-month low of just ¥98bn.

Export volumes weaker at start of Q2 too

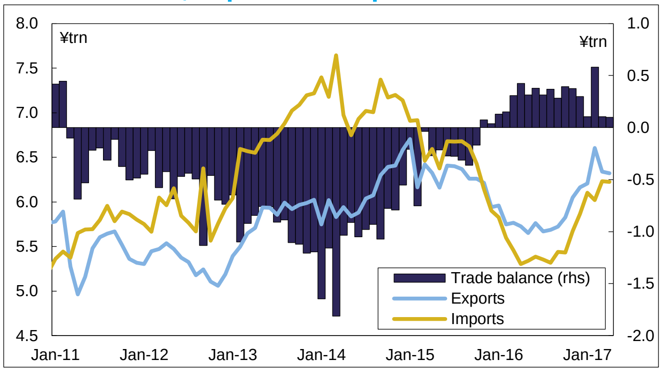
The deterioration in the trade balance at the start of the second quarter appears not solely to reflect price effects, with the BoJ's trade figures – adjusted for both seasonal and price effects – reporting the second successive monthly decline in the volume of exports. The weakness was principally driven by a double-digit decline in shipments to Japan's smaller export partners. Indeed, export volumes to China were up by almost 4%M/M in April, while shipments to the US rose by almost 1%M/M. By type of good, shipments of intermediate and capital goods were stronger, with the latter trending on a three-month basis to its highest level since August 2012. And, overall, despite the drop in April, total export volumes were still up 2½% on a three-month basis to the highest level since 2008. Furthermore, given expectations of ongoing solid growth in external demand in response not least to the favourable shift in the global investment cycle, we would expect to see a bounce back in overall exports over coming months. So, there is a good

Measures of inflation expectations



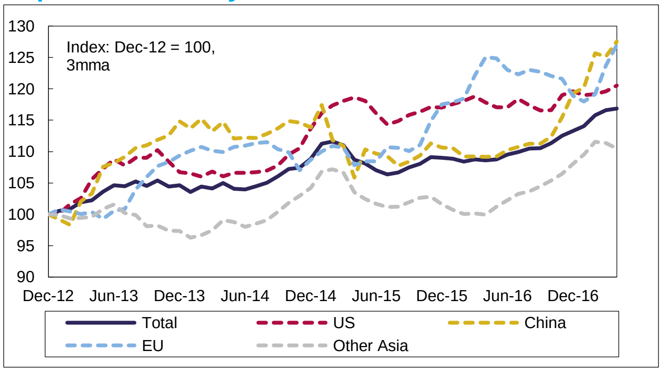
Source: BoJ, QUICK, Bloomberg and Daiwa Capital Markets Europe Ltd.

Trade balance, export and import values



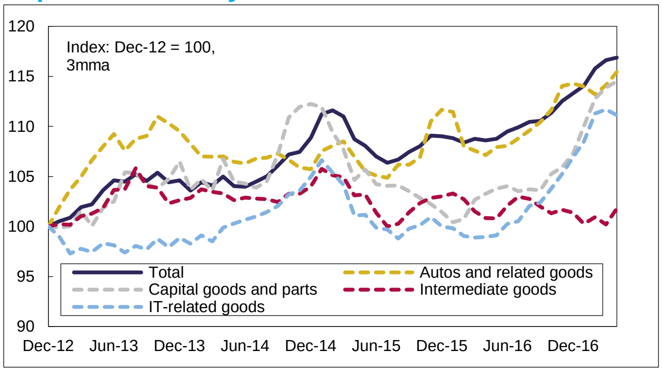
Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export volumes by destination



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Export volumes by sector



Source: BoJ and Daiwa Capital Markets Europe Ltd.

chance that net trade will provide a positive contribution to GDP growth in Q2 for the fourth consecutive quarter.

Manufacturers not quite so upbeat in May

Admittedly, according to the flash manufacturing PMI survey, growth in new export orders moderated to a five-month low in May. This mirrored similar retreats in the survey's output, new orders and employment indices. But all of these indicators remain well above their long-run averages and consistent with ongoing expansion in the sector. The PMIs broadly tallied with the latest Reuters Tankan, with large manufacturers reportedly a touch less optimistic about business conditions in May as the headline DI dropped to a three-month low. But this represented the first fall for nine months after a near-decade high was reached in April. And within the manufacturing survey detail, there was a notable improvement in sentiment in the autos sector, with the relevant index jumping to a seven-year high. Furthermore, the METI production survey for March had already flagged the prospect of a slowdown in May as payback for a predicted surge in April.

Non-manufacturers more optimistic

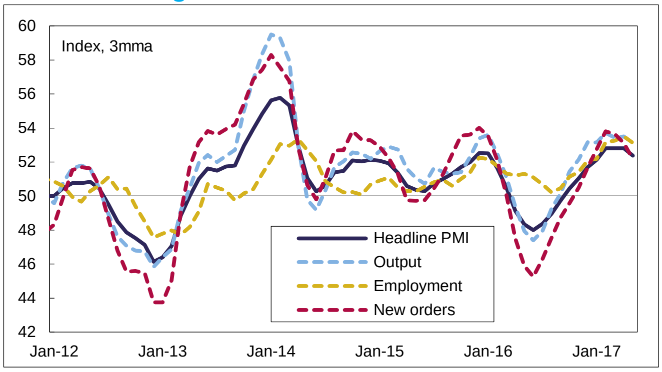
Of course, given the importance of the services sector – which accounts for roughly three-quarters of output – the trajectory of the near-term recovery will likely reflect to a greater extent conditions in the non-manufacturing sector. And from this perspective the Reuters Tankan was more encouraging, with the respective DI rising for the second successive month to a level matching the nineteen-month high reached in January. This was underpinned by greater optimism among Japanese retailers, which tallied with the past week's department store sales figures, which reported the first month of positive year-on-year growth for fourteen months in April. And overall, the Reuters Tankan survey was consistent with a modest step up in the pace of expansion in Q2.

The week ahead in Japan and the US

The coming week will be a busy one for top-tier Japanese releases, kicking off on Tuesday with the latest labour market and household spending figures for April. Having declined to a 23-year low in March, the unemployment rate is expected to have remained unchanged at 2.8%. Meanwhile, household expenditure is expected to have risen in April following a sharp decline previously. Industrial production, data due Wednesday, is similarly expected to have bounced back at the start of Q2 after a near-2%M/M drop in March. Ahead of the second estimate of Q1 GDP (due 8 June), the data focus on Thursday will be the MoF's survey of corporations' financial statements, which will provide an update on private capex growth in Q1. Thursday will also bring the final manufacturing PMI for May and vehicle sales figures for the same month. Finally, Friday will see the release of the latest consumer confidence survey for May. In the JGB market, a 2Y auction will be conducted on Tuesday, followed by a 10Y auction on Thursday.

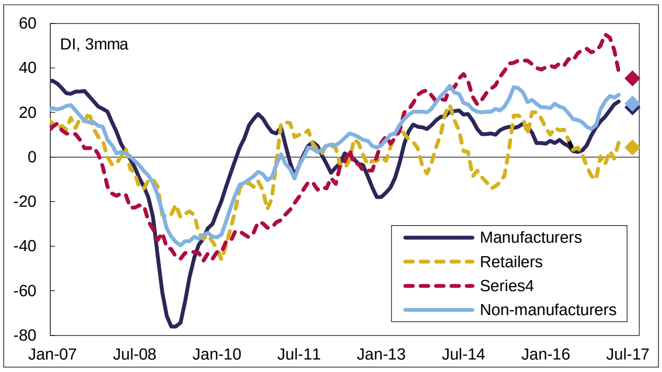
In the US, when markets re-open after Monday's Memorial Day holiday it will be a busy week for top-tier releases, kicking off on Tuesday with the monthly personal income and spending figures for April and the Conference Board's latest consumer sentiment survey for May. Thursday, meanwhile, will bring the manufacturing ISM for May, along with the latest vehicle sales and construction spending figures, revised productivity and costs data and the ADP employment report. Of course, likely of most interest will be Friday's May labour market report, with non-farm payrolls expected to have increased by 180k, broadly in line with the average of the past year or so, to leave the unemployment rate at 4.4%, a rate last lower in 2001. This notwithstanding, average hourly wage growth seems unlikely to be any stronger than the recent range. Friday will also bring April's trade report. There are no UST bond auctions scheduled in the coming week.

Manufacturing PMI



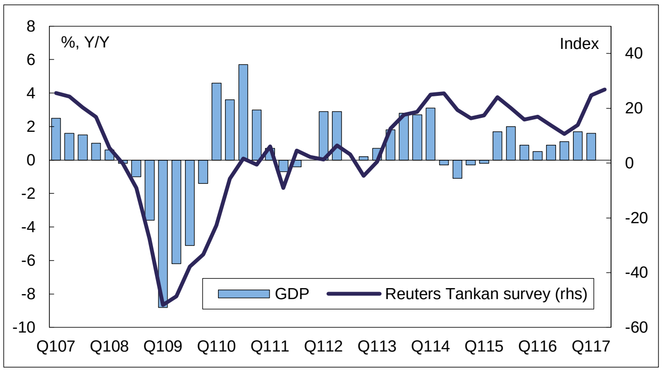
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Reuters Tankan: Business conditions*



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

GDP and Reuters Tankan*



**Reuters Tankan DI is a composite index calculated using the sector shares of output. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Economic calendar

Key data releases – May/June

22	23	24	25	26
GOODS TRADE BALANCE ¥BN MAR 106 APR 98	AUCTION FOR ENHANCED LIQUIDITY MANUFACTURING PMI APR 52.7 MAY P 52.0 ALL INDUSTRY ACTIVITY M/M% FEB 0.7 MAR -0.6 DEPARTMENT STORE SALES Y/Y% MAR -0.9 APR 0.7	REUTERS TANKAN - LARGE MANUFACTURING DI APR 26 MAY 24 LARGE NON-MANUFACTURING DI APR 28 MAY 30	3M TB AUCTION 40Y JGB AUCTION	NATIONAL CPI Y/Y% MAR APR 0.2 0.4 *EX FRESH FOOD* *0.2 0.3* *EX FRESH FOOD/ENERGY* *-0.1 0.0* TOKYO CPI Y/Y% APR MAY -0.1 0.2 *EX FRESH FOOD* *-0.1 0.1* *EX FRESH FOOD/ENERGY* *-0.1 0.0* SERVICES PPI Y/Y% MAR 0.8 APR 0.7
29	**30**	**31**	**01**	**02**
	2Y JGB AUCTION (APPROX ¥2.2TRN) UNEMPLOYMENT RATE % MAR 2.8 APR 2.8 JOB-TO-APPLICANT RATIO MAR 1.45 APR 1.46 HOUSEHOLD SPENDING Y/Y% MAR -1.3 APR -0.7 RETAIL SALES Y/Y% MAR 2.1 APR 2.2	INDUSTRIAL PRODUCTION M/M% MAR -1.9 APR P 4.1 HOUSING STARTS Y/Y% MAR 0.2 APR -1.5 CONSTRUCTION ORDERS Y/Y% MAR 1.1 APR N/A	3M TB AUCTION (APPROX ¥4.4TRN) 10Y JGB AUCTION (APPROX ¥2.3TRN) CAPITAL SPENDING SURVEY – EXCLUDING SOFTWARE Y/Y% Q4 3.8 Q1 3.9 MANUFACTURING PMI APR 52.7 MAY F 52.0 VEHICLE SALES Y/Y% APR 5.4 MAY N/A	CONSUMER CONFIDENCE APR 43.2 MAY 43.5 MONETARY BASE Y/Y% APR 19.8 MAY N/A
05	**06**	**07**	**08**	**09**
SERVICES PMI (MAY) COMPOSITE PMI (MAY)	30Y JGB AUCTION AVERAGE WAGES (APR)	6M TB AUCTION COINCIDENT INDEX (APR P) LEADING INDEX (APR P)	3M TB AUCTION 5Y JGB AUCTION GDP (Q1 F) BANK LENDING (MAY) CURRENT ACCOUNT (APR) ECONOMY WATCHERS SURVEY (MAY)	TERTIARY ACTIVITY (APR) M3 MONEY SUPPLY (MAY)
12	**13**	**14**	**15**	**16**
MACHINE ORDERS (APR) GOODS PPI (MAY)	20Y JGB AUCTION MOF'S BUSINESS SENTIMENT SURVEY (Q2)	3M TB AUCTION INDUSTRIAL PRODUCTION (APR F) CAPACITY UTILISATION (APR)	1Y TB AUCTION BOJ POLICY BOARD MEETING (15-16 JUN 2017)	BOJ POLICY ANNOUNCEMENT

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

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