Daiwa Capital Markets

Yen 4Sight

- GDP growth moderated to 0.3%Q/Q in Q3. While consumption, residential investment and public spending fell, net exports and inventories helped to sustain the economic expansion.
- Growth was again above potential and could well remain so for a while, but there remains little sign that inflation is headed towards 2%.
- The trade report for October, due Monday, will be the highlight of a sparse diary in the coming week.

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Interest and exchange rate forecasts

End period	17-Nov	Q417	Q118	Q218
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.04	0.05	0.05	0.05
JPY/USD	113	113	114	115
JPY/EUR	133	133	135	136

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

Seventh successive quarter of GDP growth

For an economy whose modest growth over the past few decades was regularly punctuated by often-substantive falls in GDP, Japan's recent run of unbroken growth has been notable. But while production remained buoyant, soft spending data raised uncertainty about the vigour of the expansion last quarter. In the event, the preliminary national accounts for Q3, released in the past week, revealed a moderation in GDP growth from an unrevised 0.6%Q/Q (2.6% annualised) in Q2 to 0.3%Q/Q (1.4% annualised), broadly meeting expectations. That represented the seventh consecutive quarter of expansion, marking the longest such run since 1999-2000.

Abe on track to meet his ¥600trn target?

Despite a slower expansion on the quarter, annual real GDP growth rose 0.3ppt to 1.7%Y/Y. Real gross national income (GNI), which better measures residents' spending power, rose a stronger 0.6%Q/Q thanks to increased investment income from abroad, also taking its annual growth rate to 1.7%Y/Y. And with the GDP deflator up 0.3%Q/Q partly due to the impact of the weaker yen on import prices, nominal GDP rose 0.6%Q/Q and 1.7%Y/Y, taking its cumulative increase since Abe took office to 10.8%. Should nominal GDP continue to rise as it did in Q3 – something that admittedly might seem a big ask – Abe's ¥600trn target for the end of the current decade would be met sometime in 2021 when, if current political trends continue, he would likely finally step down as Prime Minister.

Consumer spending falls in Q3

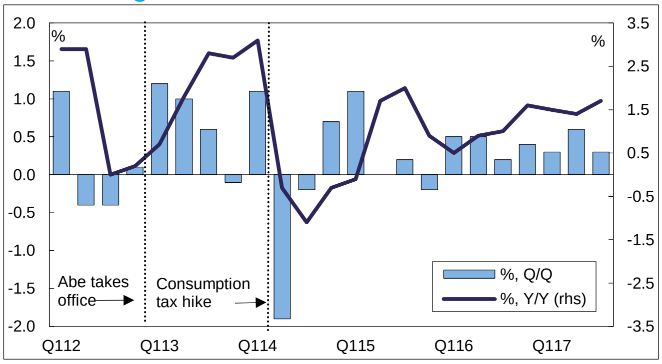
Just as the headline rate broadly met expectations, there was little surprise in the composition of growth in Q3. As monthly indicators had suggested, the six-quarter winning streak in consumer expenditure came to an end with private consumption down 0.5%Q/Q in Q3, due to lower spending on durables (down 1.2%Q/Q) and services (down 0.7%Q/Q). And with its growth in Q2 revised down to 0.7%Q/Q, the annual rate of expansion in consumption slowed to 0.7%Y/Y, the weakest in four quarters. To some extent, the fall in Q3 represented payback from the strong growth in the first half of the year – the firmest since the surge ahead of the consumption tax hike in 2014 – as well as the impact of very unfavourable weather. So, we expect private consumption to resume its uptrend in Q4 supported by ongoing growth in household incomes – real employee compensation rose 0.5%Q/Q in Q3 to be up 1.6%Y/Y – and well above-average levels of consumer sentiment.

Q3 GDP: Key figures*

	%Q/Q	contr	%Y/Y	contr
GDP	**0.3**		**1.7**	
Final sales	0.1	0.1	1.7	1.7
Domestic demand	-0.2	-0.2	1.0	1.0
- Private consumption	-0.5	-0.3	0.7	0.4
- Residential investment	-0.9	0.0	1.5	0.1
- Non-residential investment	0.2	0.0	3.0	0.5
- Government consumption	-0.1	0.0	0.4	0.1
- Public investment	-2.5	-0.1	0.8	0.0
Net exports	-	0.5	-	0.7
- Exports	1.5	0.2	6.4	1.0
- Imports	-1.6	0.2	2.3	-0.3
Private inventories	-	0.2	-	-0.1

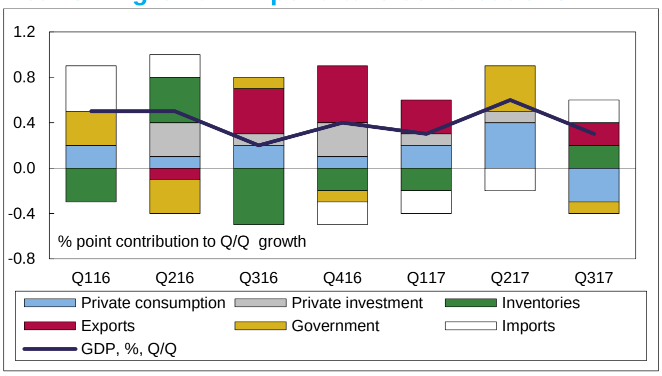
*Contributions (in ppts) might not add up to the headline growth rates due to rounding. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Real GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Real GDP growth: Expenditure contributions



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Residential investment and public spending drag

Certain other domestic demand components also weighed on growth in Q3. Like private consumption, residential investment also broke a six-quarter winning streak, falling 0.9%Q/Q but remaining up 1.5%Y/Y. Meanwhile, Q3 also saw a decline in public investment (down 2.5%Q/Q) and, to a much lesser extent, public consumption (down 0.1%Q/Q). The drop in the former was not surprising in light of the near-6%Q/Q surge reported in Q2 thanks to last year's supplementary budget.

Net exports & inventories drove growth in Q3

With several expenditure components retreating, it was left to net exports and inventories to provide most of the momentum driving the economy forward. Solid trading partner growth saw exports rise 1.5%Q/Q and 6.4%Y/Y. Goods were responsible for the increase, growing 2.3%Q/Q, while exports of services fell 1.9%Q/Q (but still up a respectable 4.0%Y/Y). With domestic demand soft – down 0.2%Q/Q after an increase of 0.9%Q/Q in Q2 – imports fell 1.6%Q/Q. So, net trade added 0.5ppt to quarterly growth in Q3, the most in more than three years. Meanwhile, private inventories added 0.2ppt, but as the first positive contribution from this source since Q216 we do not expect adverse payback in Q4. Finally, the provisional estimates suggested that non-residential investment rose 0.2% Q/Q in Q3 – a fourth consecutive quarter of growth – to be up 3.0%Y/Y. If anything, non-residential capex ran a little stronger than suggested by recent sluggish core machine orders, albeit more in line with the generally upbeat surveys of firms' investment intentions. The extra capex and inventory information garnered from the MoF survey of corporates, due 1st December, will likely lead to revisions.

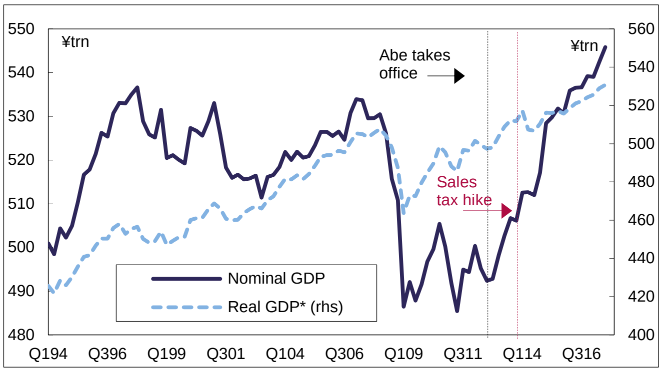
Producer prices rise most in more than three years

Unlike growth, the big picture on inflation from the national accounts was not particularly encouraging, with the small increase in the GDP deflator on the quarter being the first so far this year to leave the annual rate still up only 0.1%Y/Y. And other deflators confirmed minimal price pressure too. The private consumption deflator was unchanged in Q3 while the overall domestic demand deflator – typically the best guide to underlying price pressures – rose 0.2%Q/Q and 0.5%Y/Y, a similar outcome to the core CPI last quarter. So, if there was any positive inflation news in the past week it came from second-tier data, with goods PPI in October rising more than expected, up 0.3%M/M. Coming on top of an upwardly revised September reading, this lifted annual producer goods inflation to 3.4%Y/Y – the highest since September 2014 – with final consumer goods PPI up 2.0%Y/Y, the most since January 2014. Given that the goods PPI and core CPI often exhibit a contemporaneous relationship, this might suggest that a small increase in annual core CPI inflation is possible when the October data are released later this month. That said, for this to happen, the core CPI will need to rise by more than the 0.1%M/M increase in October 2016 – an occurrence seen only in one month in the last three years.

Economic optimism remains strong

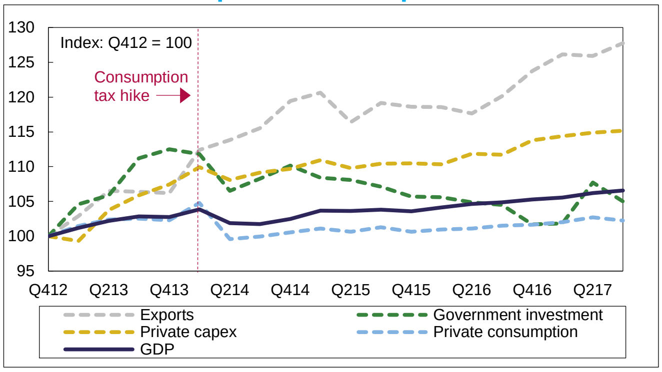
Looking ahead, surveys strongly suggest that Japan will extend its expansion in Q4. The October Economy Watchers survey,

GDP levels



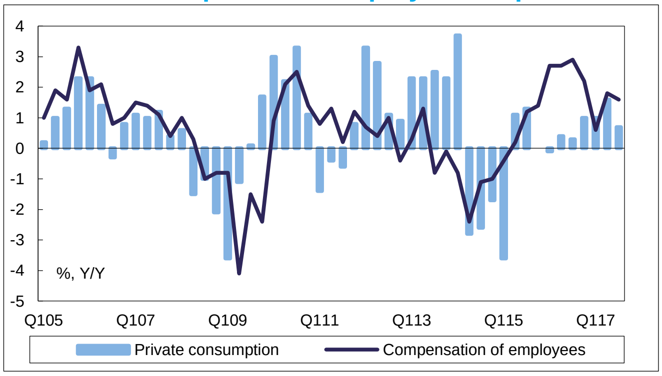
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Real GDP and expenditure components



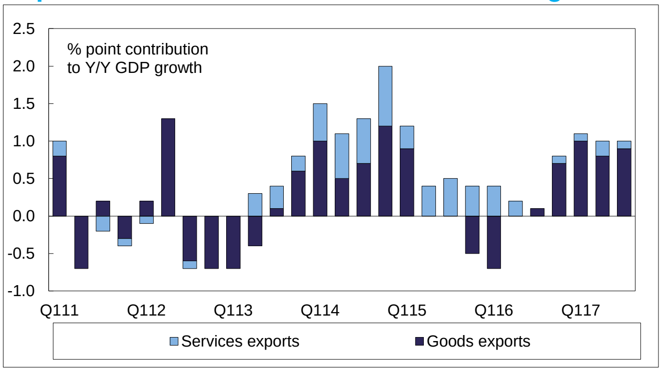
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Private consumption and employee compensation



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Exports: Contributions to annual real GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

released in the past week, was certainly upbeat. The overall current conditions index rose a further 0.9pts to 52.2 – the best reading since February 2014, driven by a 4.1pt lift in the business index to 56.4. Even more encouraging was a 3.9pt rise in the overall expectations index to 54.9 – the best since December 2013. In the detail, the indices for households (up 4.2pts to 54.4) and businesses (up 3.4pts to 55.7) suggested significantly greater optimism this month. And similarly, the Reuters Tankan for November suggested that business conditions in manufacturing and non-manufacturing sectors alike far more favourable than the respective norms.

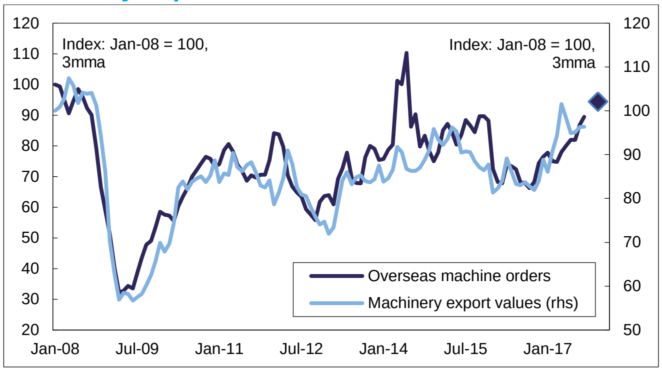
Moderate expansion to continue

Overall, therefore, it's hard to argue that the economy remains in an expansion phase, one which in the view of Japan's government – and based on an assessment of a range of monthly data rather than just GDP – coincided with Abe's return to office at end-2012, making this the second-longest post-war recovery on that basis. Leading indicators and economic fundamentals alike suggest that the expansion will continue in the absence of new adverse shocks. While it is unlikely to be particularly vigorous, consumer spending will likely resume its uptrend supported by ongoing moderate income gains. The global economic upswing should underpin ongoing growth in exports, while high operating rates in the manufacturing sector suggest that domestic non-residential capex will continue to rise gradually too. But growth in other expenditure components might prove more elusive, e.g. residential investment seems likely to take a breather from its recent spurt, while public investment seems likely to slip back further as the impact of the FY16 supplementary budget fades. So, GDP growth over coming quarters might yet struggle to beat the 0.3%Q/Q rate in Q3.

BoJ reaction to data likely to be muted

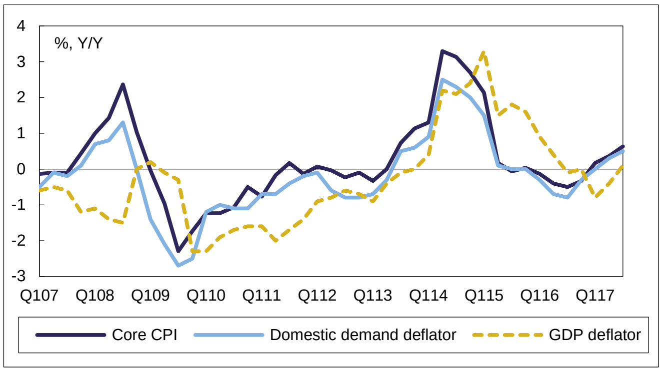
As demonstrated by the continued strong performance of the labour market in Q3, GDP growth of 0.3%Q/Q is likely again to have surpassed Japan's potential rate, which the BoJ currently estimates to be just 0.5%-1.0%Y/Y. Moreover, barring major negative revisions in the second estimate of the national accounts next month, the BoJ will probably expect growth to accelerate further above potential over the near term, and thus might well also maintain confidence in its sanguine 1.9%Y/Y growth forecast for FY17. Of course, there remain significant concerns that inflation will soon peak below 1%Y/Y and thus remain well short of the BoJ's target over the medium term. And there are additional concerns about the suitability of key elements of the BoJ's current policy-settings, not least its judgement on the appropriate slope of the yield curve and its continued purchases of ETFs at a time when the main Nikkei and Topix indices are at their highest levels in a quarter of a century. Nevertheless, keeping its fingers crossed that an increasingly positive output gap will at some point trigger a marked step up in inflation, BoJ rhetoric over coming weeks is unlikely to change from that communicated recently. And so, a sudden volte face on policy seems unlikely too.

Machinery exports and overseas orders*



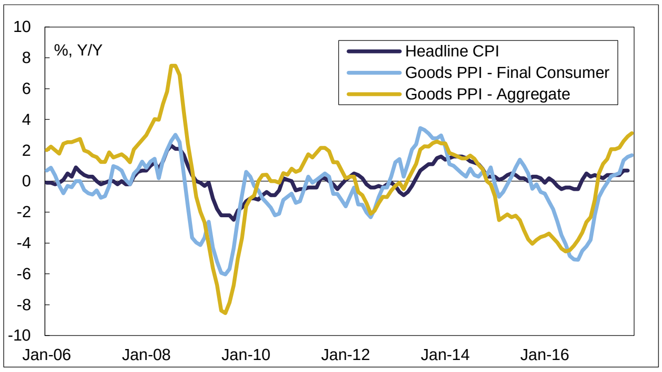
*Diamond represents survey forecast for October-December 2017. Source: Cabinet Office, MoF and Daiwa Capital Markets Europe Ltd.

Inflation: Core CPI and deflators



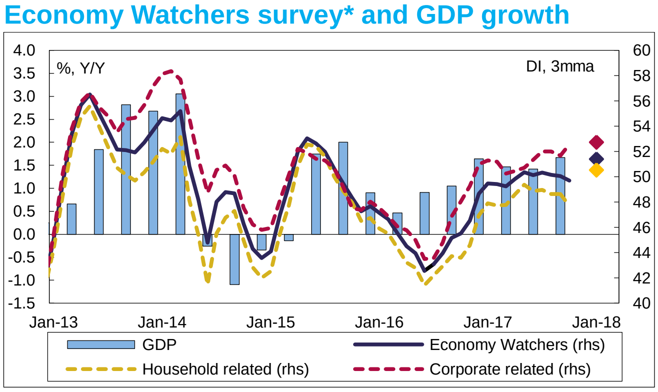
Source: MIC, Cabinet Office and Daiwa Capital Markets Europe Ltd.

Inflation: Selected CPI and PPI indices



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

Economy Watchers survey* and GDP growth



*Diamonds represent forecast indices. Source: Cabinet Office & Daiwa Capital Markets Europe Ltd.

The week ahead in Japan and the US

This coming week's Japanese economic diary is relatively light, in part due to Thursday's public holiday. Most interest will probably centre on Monday's October trade report to see whether the strong performance in Q3 has carried into Q4. On Tuesday the All Industry Index for September will be released, casting light on construction activity. The final results of the Monthly Labour Survey for September will be released on Wednesday and the preliminary manufacturing PMI for November will be released on Friday (the headline index stood at a robust 52.8 last month). In the bond market the MoF will auction enhanced liquidity on Tuesday.

The coming week's US economic diary is compressed by Thursday's Thanksgiving holiday. Data-wise, the Conference Board will publish its leading index for October on Monday, with October existing home sales following on Tuesday. And Wednesday sees the release of October durables goods orders, the final University of Michigan consumer survey results for November, the weekly jobless claims report and – ahead of a probable rate hike next month – the minutes of the October FOMC meeting. In addition, a short session for bond markets on Friday will coincide with the release of the flash manufacturing and services sector PMIs for November. Aside from the data, the focus for markets will be the progress of the US tax reform through the Senate and a speech by soon-to-depart Fed Chair Yellen on Tuesday. In the bond market the Treasury has a 2-year FRN auction on Tuesday.

Economic calendar

Key data releases – November/December

13	14	15	16	17
MACHINE TOOL ORDERS Y/Y% SEP 45.0 OCT 49.9 GOODS PPI Y/Y% SEP 3.1 OCT 3.4	5Y JGB AUCTION	1Y TB AUCTION GDP Q/Q% Q2 0.6 Q3 P 0.3 GDP DEFLATOR Y/Y% Q2 -0.4 Q3 P 0.1 INDUSTRIAL PRODUCTION Y/Y% AUG 5.3 SEP F 2.6 CAPACITY UTILISATION M/M% AUG 3.3 SEP -1.5	3M TB AUCTION 20Y JGB AUCTION MACHINE TOOL ORDERS Y/Y% SEP 45.0 OCT F 49.8	
20	**21**	**22**	**23**	**24**
GOODS TRADE BALANCE ¥BN SEP 240 OCT 207 EXPORTS Y/Y% SEP 14.1 OCT 15.7 IMPORTS Y/Y% SEP 12.1 OCT 20.2	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥550BN) DEPARTMENT STORE SALES Y/Y% SEP 4.4 OCT N/A ALL INDUSTRY ACTIVITY M/M% AUG 0.1 SEP -0.4	3M TB AUCTION (APPROX ¥4.4TRN)	NATIONAL HOLIDAY - LABOUR THANKSGIVING DAY	MANUFACTURING PMI OCT 52.8 NOV P N/A LEADING INDEX AUG 107.2 SEP F N/A COINCIDENT INDEX AUG 117.7 SEP F N/A
27	**28**	**29**	**30**	**01**
SERVICES PPI (OCT)	40Y JGB AUCTION	RETAIL SALES (OCT)	3M TB AUCTION 2Y JGB AUCTION INDUSTRIAL PRODUCTION (OCT P) VEHICLE PRODUCTION (OCT) HOUSING STARTS (OCT) CONSTRUCTION ORDERS (OCT)	UNEMPLOYMENT RATE (OCT) JOB-TO-APPLICANT RATIO (OCT) NATIONAL CPI (OCT) TOKYO CPI (NOV) HOUSEHOLD SPENDING (OCT) CAPITAL SPENDING SURVEY (Q3) MANUFACTURING PMI (NOV F) VEHICLE SALES (NOV) BOJ BOND MARKET SURVEY (NOV)
04	**05**	**06**	**07**	**08**
MONETARY BASE (NOV) CONSUMER CONFIDENCE (NOV)	10Y JGB AUCTION SERVICES PMI (NOV) COMPOSITE PMI (NOV)	6M TB AUCTION	3M TB AUCTION 30Y JGB AUCTION LEADING INDEX (OCT P) COINCIDENT INDEX (OCT P) BOJ CONSUMPTION ACTIVITY INDEX (DEC)	GDP (Q3 F) GDP DEFLATOR (Q3 F) BANK LENDING (NOV) AVERAGE WAGES (OCT) ECONOMY WATCHERS SURVEY (NOV)

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

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