Yen 4Sight

Highlights

- The BoJ made a modest tweak to its JGB purchases, but in our view its overall monetary stance is unchanged.
- New BoJ estimates suggest that Japan's economy is now operating above trend by more than at any time since Q108.
- Wage growth remained sluggish in November but consumer spending seems to have picked up in Q4.
- The November machinery orders report will be of note over the coming week. PPI and tertiary activity reports are also due.

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Interest and exchange rate forecasts

End period	12 Jan	Q118	Q218	Q38
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.07	0.05	0.05	0.05
JPY/USD	111	114	115	116
JPY/EUR	135	135	136	137

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

The BoJ tweaked its bond purchases

After returning from the national holiday at the start of the week, markets were somewhat excited on Tuesday when the BoJ unexpectedly reduced its buying of longer-term bonds at its latest purchase operation. Compared with the previous operations, purchases of JGBs with residual maturities of 10-to-25-years, and 25-years-plus, were reduced by ¥10bn, to ¥190bn and ¥80bn respectively. The yen rallied on the news and JGB yields nudged higher, as some investors viewed the move as a noteworthy shift in the Bank's policy ahead of the Board's next announcement on 23 January. Were they right?

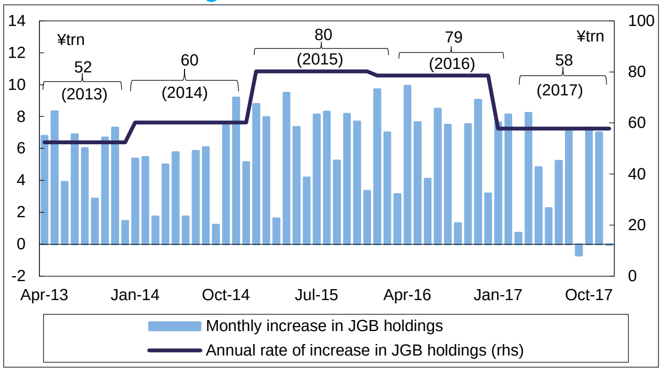
Change is unlikely a prelude to shift in yield target

In our view this 'tweak' should prove to be no big deal. It was certainly consistent with a continuation of last year's trend, which saw the BoJ increase its JGB holdings by less than ¥60tn, significantly below its stated guideline of ¥80tn – which is now merely an intermediate reference point for achieving the principal aim of around-zero 10-year yields. With the BoJ's share of the JGB market having risen above 40% and its unlimited fixed-rate purchase facility credible, the BoJ no longer needs to buy as many bonds as it previously did to achieve its aim. And given the sub-target inflation outlook, which will be reaffirmed by the BoJ when it releases updated forecasts following the next policy meeting, we don't think this week's move increases the likelihood that the 10-year yield target will be increased soon. Given the uncertainty injected by this modest policy change, and against the backdrop of rising global yields, however, the market will likely trade a little nervously in the run-up to the meeting. And the next scheduled purchase operations of 10-to-25-year and 25-year-plus JGBs at the start and end of the coming week will be closely watched.

BoJ's estimate of potential growth little changed

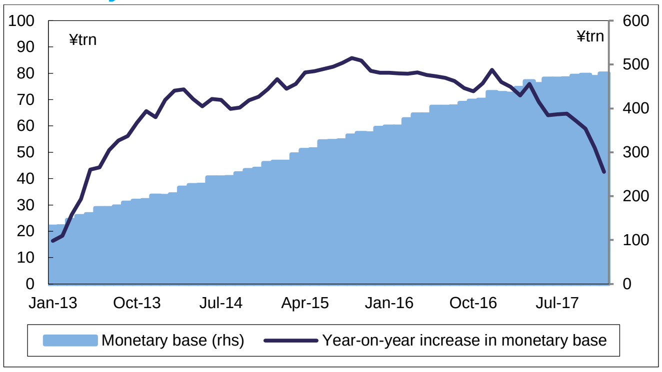
While it is well aware that there is a long way to go before its 2% inflation target will be met, the BoJ will continue to claim publicly that it expects to get there in the end. To justify its optimism, it will continue to cite the output gap, updated estimates of which, along with its assessment of potential GDP growth, the Bank published in the past week. To start with, the economy's growth potential was estimated at 0.85%Y/Y, in line with that estimated over the past three years and consistent with the Bank's usual characterisation that it lies somewhere in the ½-1% range. Positive contributions continue to be made by increases in productive capital stock and employment, as well as

BoJ JGB holdings*



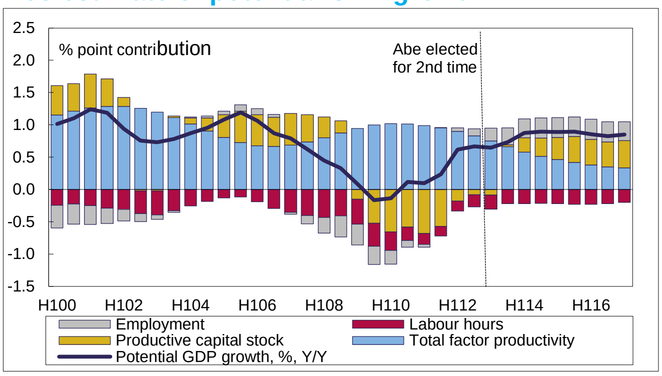
*AnnuSource: BoJ & Daiwa Capital Markets Europe Ltd.

Monetary base



Source: BoJ & Daiwa Capital Markets Europe Ltd.

BoJ estimate of potential GDP growth



Source: BoJ & Daiwa Capital Markets Europe Ltd improved effectiveness in the way that those factors are put to work (i.e. total factor productivity). But, as has been the case for more than thirty years, fewer hours worked on average by those in employment remains a drag on trend growth.

The positive output gap widened in Q3

With potential growth running a little less than 1%Y/Y and GDP up more than 2%Y/Y, the BoJ's estimate of the economy's positive output gap has unsurprisingly increased over the past year. According to the Bank, the economy was running 1.35% above trend in Q3 – it had been 0.13% below trend a year earlier – representing the most pressure on capacity since Q108. The estimates suggest that further tightening of the labour market made the largest contribution to the more positive output gap in Q3, but that the 'capital input' gap also widened a little too. At face value this bodes well for continued growth in capex, as suggested by various business surveys. And while the relationship between spare capacity and prices appears to have weakened significantly since Japan entered deflation two decades ago, the larger positive output gap will bolster sentiment amongst the more optimistic BoJ Board members that an increase in inflation expectations – and eventually inflation – will follow.

Consumer spending on firmer path in Q4

Recent data suggest that the output gap might have widened further in Q4. While household spending was weak over the first two months of the quarter, the BoJ's Consumption Activity Index – which combines both demand- and supply-side indicators to provide a more reliable guide to the national accounts measure of private consumption – suggested that this component of spending likely returned to growth following a drop in Q3. In particular, the real travel-adjusted index – which nets out the spending of tourists – rose 0.6%M/M in November, building on a 0.4%M/M gain in October and lifting the annual rate to a four-month high of 1.4%Y/Y. On this measure, spending in the first two months of Q4 was running 0.1% above the average monthly level seen in Q3, suggesting a small positive contribution to GDP growth. Indeed, even a flat outcome in December would leave this index up 0.2%Q/Q.

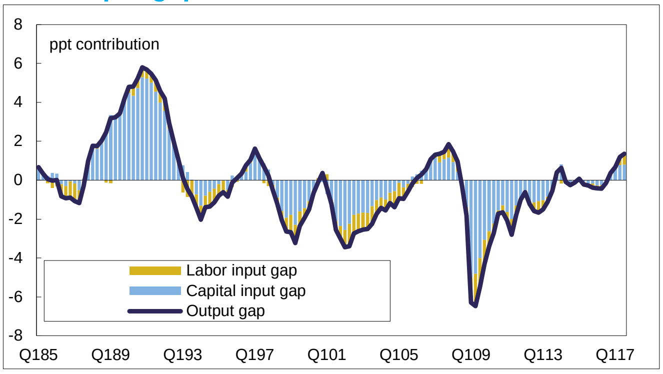
Confidence is no barrier to spending

Certainly, sentiment appears to present no obstacle to consumer spending continuing the improved showing evident in November. While the Cabinet Office measure of consumer confidence edged down 0.2pt to 44.7 in December, this was still a strong result considering that the previous outcome had been a three-year high. Indeed, within the detail the income-growth index was steady at 43.0, maintaining its highest level for more than a decade and suggesting that households are relatively upbeat about the prospects for the coming wage round. Very modest declines were recorded in other components, including the index measuring respondents' willingness to buy durable goods, which slipped 0.2pt from November's three-year high to a still-robust 43.8.

Underlying wage growth remains moderate

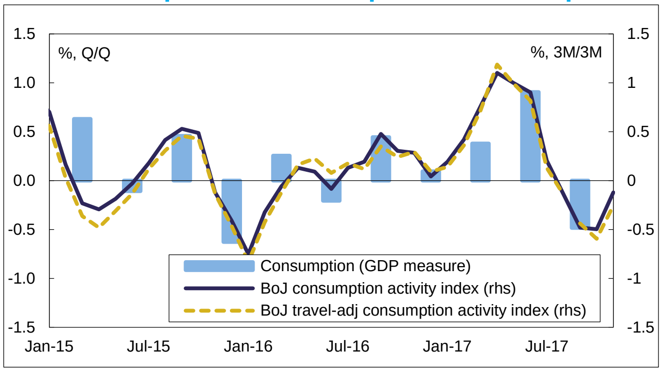
Ultimately, consumers cannot spend income they haven't got and in this respect the monthly Labour Survey for November again failed to point to a broad-based lift in wage growth despite the tight labour market. Growth in total labour cash

BoJ output gap estimate



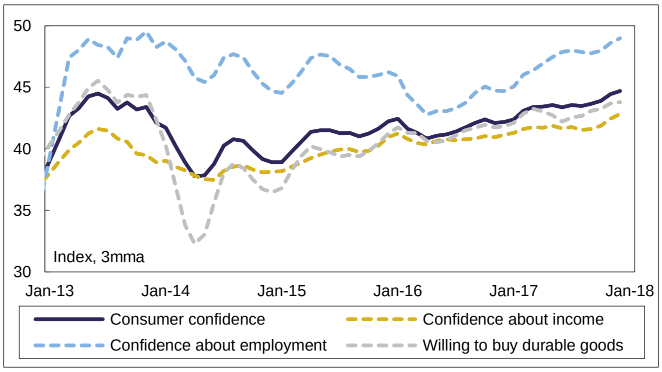
Source: BoJ & Daiwa Capital Markets Europe Ltd.

BoJ consumption index and private consumption



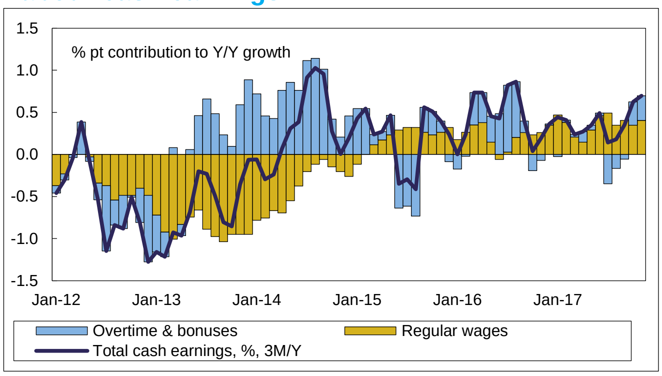
Source: BoJ, Cabinet Office & Daiwa Capital Markets Europe Ltd

Consumer confidence



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Labour cash earnings



Source: MHLW and Daiwa Capital Markets Europe Ltd.

earnings (per person) rose to 0.9%Y/Y in November. But the pick-up owed in part to a 7.5%Y/Y rise in special earnings (bonuses) from just 0.2%Y/Y in October. Growth in contracted earnings also rose, to 0.6%Y/Y, thanks to increased overtime. But scheduled earnings growth edged up 0.1ppt to a still-tepid 0.4%Y/Y, with the rate for full-time workers just 0.1%Y/Y. And average hourly earnings for part-timers rose 1.5%Y/Y – the slowest rate in fifteen months, albeit likely reflecting mere noise around a clear uptrend. These preliminary estimates can be subject to substantial revision (as occurred last month). But we expect wage growth to remain well within the recent range for a few months yet. The key uncertainty is how firms respond to the government's enhanced tax incentives to offer stronger wage rises in the coming spring pay round. We expect higher headline settlements than recent years. But wage growth seems highly likely to remain well below rates required to deliver the BoJ's 2% inflation target on a sustained basis.

Labour input still expanding

Among other detail in the Labour Survey, the number of regular employees rose 2.6%Y/Y in November, down slightly from the previous month, but with strong growth still seen in education (6.4%Y/Y), hospitality (6.1%Y/Y) and construction (4.6%Y/Y). Growth in full-time employees rose to a strong 3.1%Y/Y whereas growth in part-time employees slowed to 1.7%Y/Y, suggesting a favourable shift in firms' behaviour in response to labour market tightness and a recent labour reform. We expect growth in full-time employment eventually to be revised lower, but to remain relatively elevated by historical standards.

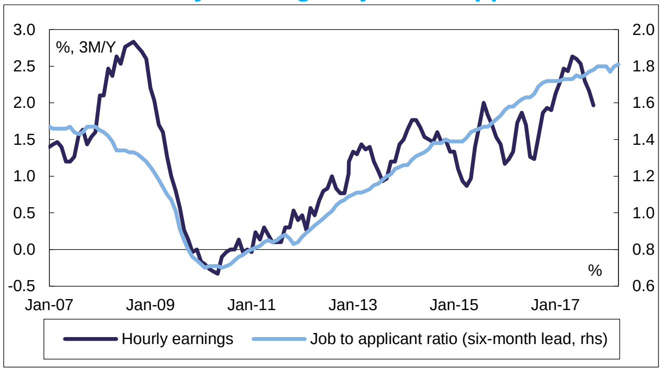
Survey data still point to above-trend growth

Labour demand is likely to remain solid judging by this week's Economy Watchers survey. While the survey reported a slight decline in business optimism in December from a downwardly-revised level in November, the survey remains very much consistent with above-trend economic growth. For example, the overall current conditions index declined just 0.2pt to 53.9 in December – apart from November's reading this was still the highest since March 2014. The modest decline in December was driven by a small fall in the household index to 52.3, while the business index rose to 55.5 – just short of the October high. And while the forward-looking expectations index declined 0.7pts to 52.7, other than in the previous two months this reading has not been beaten since May 2015.

Bank lending growth slows further in December

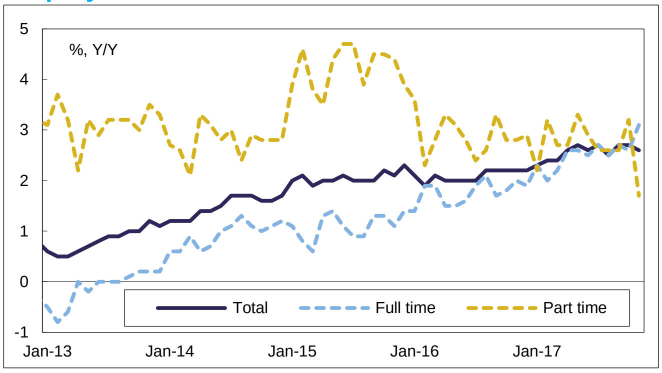
Finally, the BoJ's bank lending figures for December showed the value of total loans up 2.5%Y/Y, slowing for a fifth month after growth reached an eight-year high in July. As in previous months, the slowdown was led by lending at the major city banks, up just 1.2%Y/Y, the slowest since November 2016. To some extent, that may reflect continued growth in large firm corporate profitability and retained earnings, reducing the need to seek finance. At regional and shinkin banks, growth in lending was steady at 3.5%Y/Y and 2.6%Y/Y respectively. The BoJ is mindful that downward pressure on margins, related to its negative policy rate and yield curve control, might eventually lead to a tightening in financial conditions, particularly at regional banks, which are most reliant on domestic net interest income. However, for now there is no obvious sign that the available quantity or price of credit is weighing on the economy.

Part-time hourly earnings & jobs-to-applicant ratio



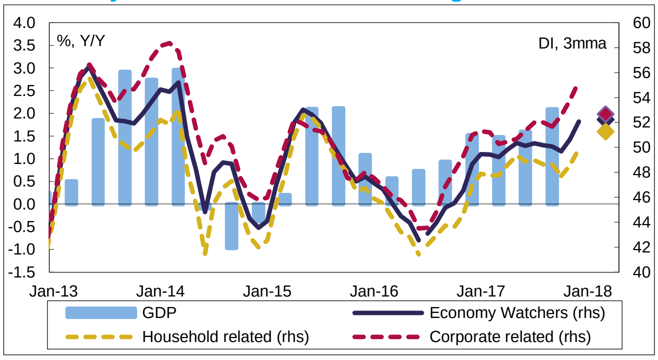
Source: MHLW and Daiwa Capital Markets Europe Ltd..

Employees



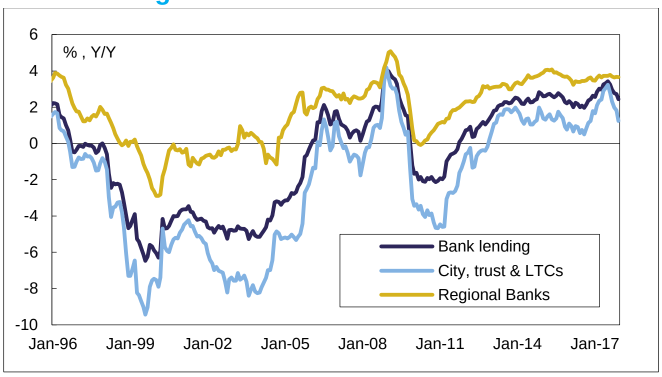
Source: MHLW and Daiwa Capital Markets Europe Ltd..

Economy Watchers indices & GDP growth*



**Diamonds represent the projected reading based on the forecast indices.*
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Bank lending



Source: BoJ and Daiwa Capital Markets Europe Ltd.

The week ahead in Japan and the US

Japan's economic diary for the coming week is sparsely populated. There may be some interest in Monday's BoJ Regional Economic Report as the market begins to look ahead to the following week's BoJ Board meeting and revised Outlook Report. And, as far as data are concerned, most interest will probably centre on Wednesday's November machinery orders report, especially in light of the solid rebound reported in October and the steady recent uptrend in private investment. That aside, Tuesday's December goods PPI inflation data and November Tertiary Industry Index will hold some interest, as will Thursday's final IP report for November. In the bond market, the MoF will auction 5-year JGBs on Tuesday and 30-year JGBs on Thursday. And certainly, after the past week's events, the BoJ's scheduled purchase operations, particularly of 10-to-25-year and 25-year-plus JGBs on Monday and Friday, will remain closely watched.

In the US, following Monday's holiday for Martin Luther King Jr Day, the coming week's economic diary kicks off on Tuesday with the New York Fed manufacturing survey for January. The following day brings the December IP report – which is expected to report a fourth consecutive monthly increase in output – as well as the January NAHB housing index and the first Fed Beige Book for this year. On Thursday, the Philadelphia Fed's manufacturing survey for January will be released alongside December housing starts and building permits. The week will conclude with the University of Michigan's preliminary consumer survey results for January. Aside from economic data, the Q4 corporate reporting season will continue to heat up and there are a couple of speeches by Fed officials scheduled before the blackout period begins ahead of the 31 January FOMC meeting. In the bond market the Treasury will auction 10-year TIPS on Thursday.

Economic calendar

Key data releases – January

08	09	10	11	12
NATIONAL HOLIDAY - COMING-OF-AGE DAY	AVERAGE WAGES Y/Y% OCT 0.2 NOV 0.9 CONSUMER CONFIDENCE NOV 44.9 DEC 44.7 BOJ OUTPUT GAP ESTIMATE (JAN)	6M TB AUCTION 10Y JGB AUCTION	3M TB AUCTION LEADING INDEX OCT 106.5 NOV P 108.6 COINCIDENT INDEX OCT 116.4 NOV P 118.1 BOJ CONSUMPTION ACTIVITY INDEX M/M% OCT 0.5 NOV 0.5	40Y JGB AUCTION CURRENT ACCOUNT ¥TRN OCT 2.4 NOV 1.7 BANK LENDING Y/Y% NOV 2.7 DEC 2.4 ECONOMY WATCHERS SURVEY - CURRENT CONDITIONS DI NOV 55.1 DEC 53.9 - FUTURE CONDITIONS DI NOV 53.4 DEC 52.7
15	16	17	18	19
M3 MONEY SUPPLY Y/Y% NOV 3.4 DEC 3.4 MACHINE TOOL ORDERS Y/Y% NOV 46.8 DEC P N/A BOJ REGIONAL ECONOMIC REPORT (JAN)	5Y JGB AUCTION (APPROX ¥2.2TRN) PPI Y/Y% NOV 3.5 DEC 3.2 TERTIARY ACTIVITY M/M% OCT 0.3 NOV N/A	1Y TB AUCTION (APPROX ¥2.3TRN) CORE MACHINE ORDERS Y/Y% OCT 2.3 NOV -0.5	3M TB AUCTION (APPROX ¥4.4TRN) 30Y JGB AUCTION (APPROX ¥0.8TRN) INDUSTRIAL PRODUCTION Y/Y% OCT 0.5 NOV F 0.6 CAPACITY UTILIZATION M/M% OCT 0.2 NOV N/A	
22	23	24	25	26
AUCTION FOR ENHANCED LIQUIDITY REUTERS TANKAN (JAN) BOJ POLICY BOARD MEETING (22-23 JANUARY)	ALL INDUSTRY ACTIVITY (NOV) MACHINE TOOL ORDERS (DEC F) BOJ SENIOR LOAN OFFICER OPINION SURVEY (JAN) DEPARTMENT STORE SALES (DEC) BOJ POLICY ANNOUNCEMENT AND OUTLOOK REPORT	TRADE BALANCE (DEC) EXPORTS (DEC) IMPORTS (DEC) MANUFACTURING PMI (JAN P) LEADING INDEX (NOV F) COINCIDENT INDEX (NOV F)	3M TB AUCTION 20Y JGB AUCTION	NATIONAL CPI (DEC) TOKYO CPI (JAN) SERVICES PPI (DEC) BOJ POLICY BOARD MINUTES (20-21 DECEMBER)
29	30	31	01	02
	2Y JGB AUCTION UNEMPLOYMENT RATE (DEC) JOB-TO-APPLICANT RATIO (DEC) HOUSEHOLD SPENDING (DEC) RETAIL SALES (DEC)	INDUSTRIAL PRODUCTION (DEC P) BOJ SUMMARY OF OPINIONS (22-23 JANUARY MEETING)	VEHICLE PRODUCTION (DEC) CONSUMER CONFIDENCE (JAN) HOUSING STARTS (JAN) CONSTRUCTION ORDERS (DEC) MANUFACTURING PMI (JAN F)	MONETARY BASE (JAN)

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

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