Japan | Economic Research | 19 January 2018

Yen 4Sight

Highlights

- Indicators released over the past week have increased the likelihood that GDP growth remained above trend in Q4.
- The focus in the coming week will be the BoJ Board meeting and new Outlook Report. We expect no change in the Bank's broad policy stance but some tweaking of the language regarding JGB purchases. Near-term GDP forecasts will likely be revised higher.
- Data-wise, the focus will be goods trade (Wednesday) and CPI (Friday).

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Interest and exchange rate forecasts

End period	19 Jan	Q118	Q218	Q318
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.

Ahead of the BoJ, the upbeat dataflow continues

With the first monetary policy announcement of the year approaching, and the BoJ also updating its economic forecasts, the past week maintained the broadly upbeat dataflow of recent weeks. Collectively, the figures suggested that domestic demand momentum remains firm, with consumption and capex both on track to make a positive contribution to GDP growth in Q4. And with net exports also supportive, there is every chance that the economy maintained an above-trend pace of expansion at the end of last year.

A buoyant BoJ "Beige Book"

Certainly, the BoJ's latest quarterly Regional Economic Report (the equivalent of the Fed's Beige Book) suggested that growth remained firm and encouragingly broad-based. Six regions reported that their economy had been 'expanding' or 'expanding moderately', and the remaining three judged that their economy had continued to 'recover moderately'. Three of the nine – Tohoku, Hokuriku, and Kinki – revised up their economic assessment from that made in October. In the case of Tohoku and Hokuriku, the common thread was stronger expenditure on, and production of, business-oriented machinery. The Kinki region cited strengthened momentum in exports and the improvement in private consumption.

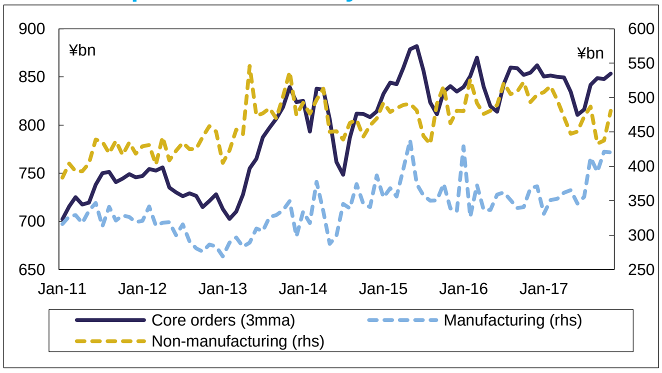
Core machine orders up strongly in November

The assessment of solid demand for capital goods was reinforced by the machine orders report for November. The closely-followed core orders series – which excludes ships and other volatile categories – rose 5.6%M/M, contrasting with market expectations that there would be payback from the 5.0%M/M increase reported in October, to lift annual growth up to a healthy 4.1%Y/Y. Within the detail, orders by manufacturers were little changed on the month but still up 14.2%Y/Y at a high level. Core orders in the non-manufacturing sector jumped 9.8%M/M, further paring the sharp decline recorded back in September, although they were still down 3.9%Y/Y. The positive global backdrop saw foreign orders extend their uptrend, rising 4.9%M/M and 15.0%Y/Y, pointing to ongoing growth in machinery exports ahead.

Machine orders now likely to rise in Q4

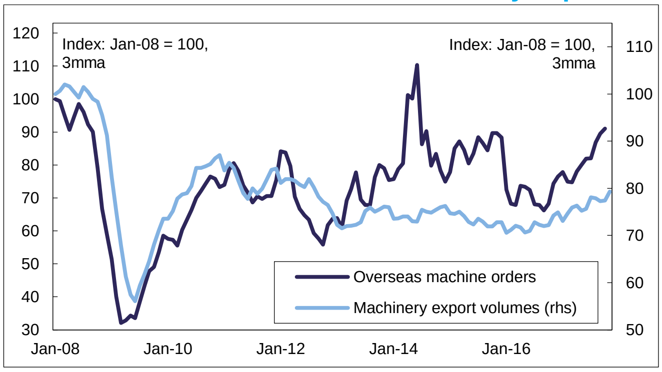
With the average level of core machinery orders over the first two months of Q4 3.1% above the Q3 average, a flat December would still deliver growth of 4.0%Q/Q over the quarter as a whole.

Domestic private machinery orders



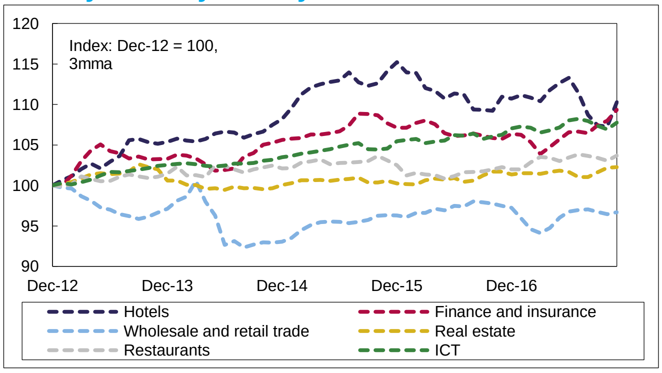
Source: Cabinet Office & Daiwa Capital Markets Europe Ltd.

Overseas machine orders and machinery exports



Source: Cabinet Office, MoF & Daiwa Capital Markets Europe Ltd.

Tertiary industry activity



Source: METI & Daiwa Capital Markets Europe Ltd

So, core machinery orders are almost certain to beat the rather pessimistic forecast of firms in the September Cabinet Office survey, which had pointed to a 3.5%Q/Q decline last quarter. This squares well with elevated business sentiment and profitability, surveys of capex expectations and the BoJ's assessment that capital and labour are both being utilised above trend. It also suggests that non-residential capex stands a good chance of recording a fifth consecutive increase in Q4.

The service sector had a strong November

The other significant upside surprise this week came from tertiary activity, which rose a sharp 1.1%M/M in November, lifting annual growth to 1.7%Y/Y from 0.9%Y/Y in October. More than half of growth in the sector came from rebounds in wholesale and retail trade, while ICT, transport and postal activities, and living and amusement-related services all punched above their weight. With the average level of the tertiary activity in the first two months of Q4 0.5% above the Q3 average, the services sector – like manufacturing – looks to have made a positive contribution to GDP growth last quarter.

More evidence of consumer spending rebound

Further evidence of broad-based growth in GDP in Q4 came from the Cabinet Office's synthetic consumption index – of all monthly indicators, the one that has the closest correlation with the national accounts measure of private consumption. This indicator rose 1.1%M/M in November, to take the Q4 average up 0.5% compared with the average in Q3. Even given a flat December reading, assuming no revisions this indicator will post growth of 0.7%Q/Q in Q4. Foreign visitors appeared to spend more in the final quarter too. Total tourist arrivals rose 23%Y/Y in December, reaching about 7.5mn in Q4 and a record 28.7mn in 2017 as a whole, thanks to continued strong growth from Korea, China and ASEAN countries. And the recent downward trend in the average spend per visitor was interrupted, with their total spending in Q4 rising above ¥1.1trn, up more than 29%Y/Y, the strongest rate since Q116.

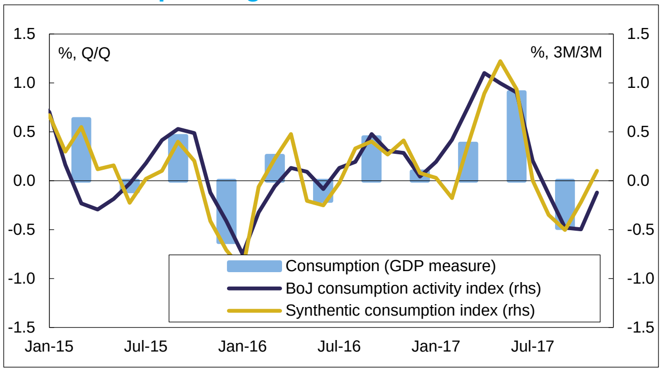
Goods pipeline price pressures have likely peaked

Moving to inflation, Japan's goods PPI increased 0.2%M/M in December, lowering annual producer inflation by 0.5ppt to 3.1%Y/Y. Inflation in the manufacturing sector slowed 0.4ppt to 2.4%Y/Y with final consumer goods inflation down 1.1ppt to a six-month low of 0.9%Y/Y. Given the near contemporaneous directional relationship between the goods PPI and core CPI, this might indicate that the BoJ's forecast measure of core inflation will struggle to build on the 0.9%Y/Y increase reported in November. Indeed, a rare third consecutive 0.2%M/M increase in core CPI would be required to lift core inflation to 1.0%Y/Y to December.

Import price inflation easing as yen effect fades

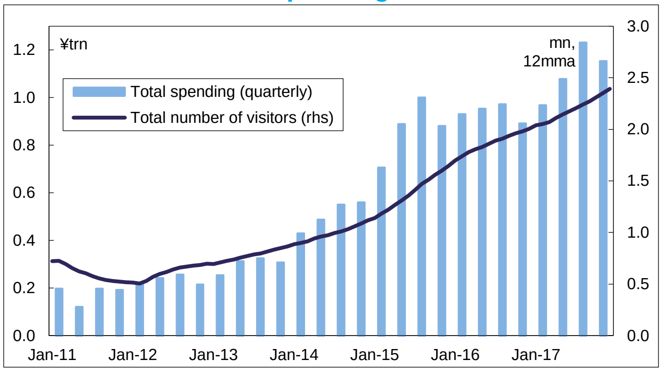
Recent increases in producer prices had been partly due to yen depreciation in late 2016. But this impact appears to be starting to wane. While import prices in yen terms rose a solid 1.9%M/M in November, their annual growth rate slowed by more than 3ppts to 7.1%Y/Y. Even against a background of rising commodity prices and a likely very gradual uplift in global inflation, Japan's import price inflation is likely to moderate further in coming months, especially if the yen maintains its recent strength.

Consumer spending



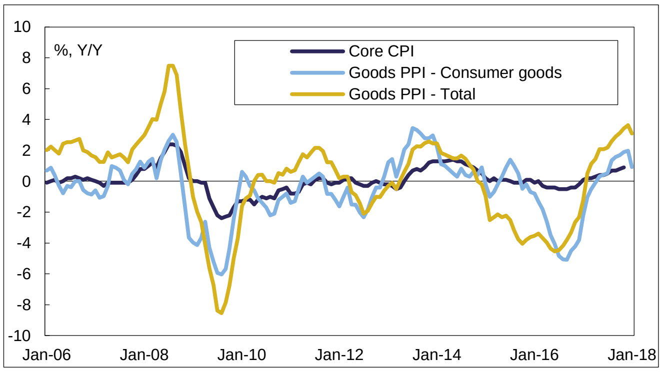
Source: Cabinet Office, BoJ & Daiwa Capital Markets Europe Ltd.

Tourism arrivals and spending



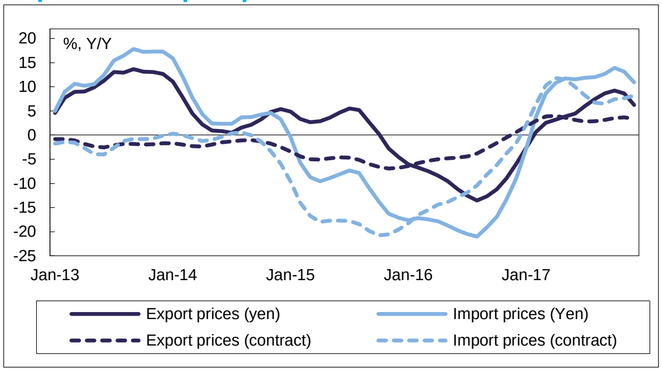
Source: BoJ, Cabinet Office & Daiwa Capital Markets Europe Ltd

Inflation: Goods PPI vs CPI



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

Export and import prices



Source: BoJ and Daiwa Capital Markets Europe Ltd.

BoJ unlikely to change policy stance this month

The key focus for investors in the coming week will be the conclusion on Tuesday of the BoJ's latest Policy Board meeting and release of its first Outlook Report for 2018. Despite above-trend growth, with core CPI inflation still less than half the BoJ's 2% target, we expect the Bank to retain its existing main policy settings i.e. the -0.1% interest rate on banks' marginal excess reserves and the pledge to keep 10Y JGB yields 'at around zero per cent'. Board member Kataoka will likely again argue for an easier stance to try to drive a more rapid lift in inflation to target. Our view is in line with market expectations. Indeed, the latest JCER ESP survey showed that very few analysts expect any change in the these policy settings in 2018, and a Bloomberg survey taken this week also suggested that the majority of respondents expect no change in policy this year.

Time to acknowledge slower JGB buying

Ahead of the BoJ's December Board meeting we had argued that there was scope for some tweaks to policy. Those arguments apply with even greater force this month. In light of the further slight reduction in the size of the Bank's longer-term JGB purchases at the operations in 2018, in the absence of significant upward pressure on JGB yields, we think it is clear that the Bank has no intention to meet the ¥80trn annual rate of increase in its holdings specified in its policy statement. Indeed, this follows a year in which actual purchases amounted to just ¥58trn. So, while the Bank will likely re-commit to maintaining purchases 'at more or less the current pace', this could be the month that it explicitly acknowledges that this will result in net purchases closer to last year's total than ¥80trn, or, better still, formally de-link achievement of the yield curve control target to a specific level of JGB purchases.

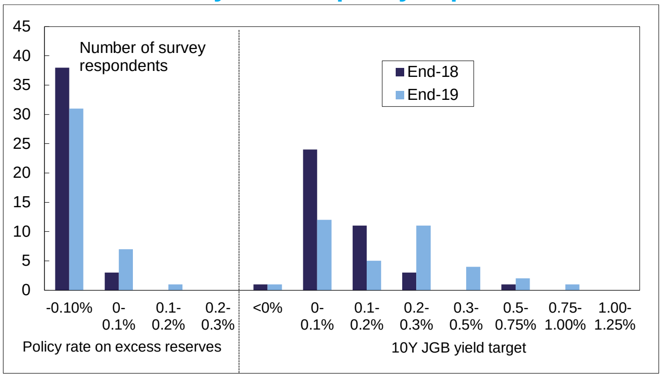
ETF purchases seem less likely to be trimmed

In a similar fashion, the BoJ might finally wish to tweak its programme of ETF purchases. We continue to think that there is little sense in the Bank continuing to support an equity market that has risen to levels not seen since the early 1990s. While it seems unlikely that the Policy Board would decide to bring such purchases to an abrupt halt, a reduction in the annual pace – which was doubled to ¥6trn in mid-2016 – would be neither a large surprise nor unwelcome. That said, the BoJ may be reluctant to make too many tweaks to policy settings at a single meeting, especially in light of recent yen strengthening.

Outlook Report may forecast firmer growth

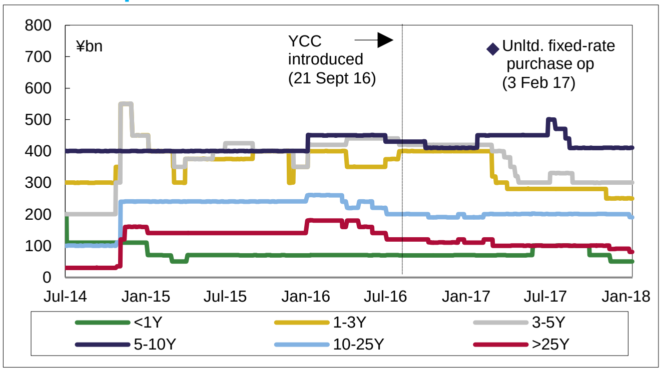
The updated quarterly Outlook Report will cast light on the prospects for a more substantive change in BoJ policy – albeit likely not until next year (at the earliest). Given stronger-than-expected GDP growth in Q3, positive signs for Q4 and benign trends abroad, it would not be surprising to see a modest upward revision to the Board's collective sense of growth prospects in FY17 and perhaps FY18 (the median forecasts in October were 1.9%Y/Y and 1.4%Y/Y respectively). Until it has seen the outcome of the spring wage round, it seems unlikely to revise up significantly its forecasts of inflation (the median Board member forecasts of core inflation in October were 0.8%Y/Y, 1.4%Y/Y and 1.8%Y/Y for FY17, FY18 and FY19 respectively, the latter excluding the impact of the scheduled hike in consumption tax). Nevertheless, it will continue to suggest that it expects the 2% target to be met around FY19.

JCER ESP survey* of BoJ policy expectations



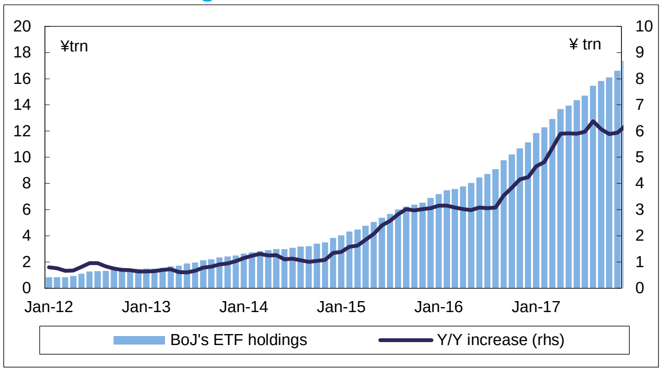
*January 2018. Source: JCER and Daiwa Capital Markets Europe Ltd..

BoJ JGB purchases*



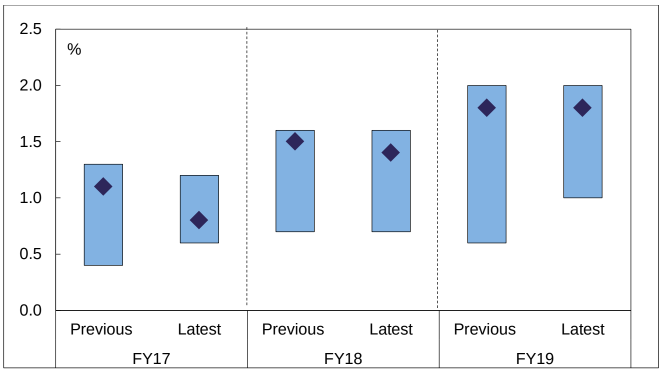
*Amount purchased at most recent operation per maturity basket.
Source: BoJ and Daiwa Capital Markets Europe Ltd..

BoJ ETF holdings



Source: BoJ and Daiwa Capital Markets Europe Ltd.

BoJ CPI forecasts*



* Previous is July forecast, Latest is October forecast, Diamonds represent the median forecast. Bars represent range of individual Board member forecasts.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

The week ahead in Japan and the US

The highlight in Japan in the coming week is Tuesday's announcement of the outcome of the BoJ's first Policy Board meeting for 2018 and the publication of the Bank's updated Outlook Report. As noted above, we see scope for a minor tweak to the Bank's policy communication – recognising the reality of the Bank's JGB purchases in recent months. We also expect it to extend by one year its special fund-supply facilities. But the broad thrust of the Bank's policy stance will very likely be unchanged. Revisions to the projections issued in the Outlook Report will likely be minor. On the data front, the week begins on Monday with the Reuters Tankan for January. On Tuesday the BoJ will release its latest Senior Loan Officer survey while the All Industry Activity index for November will also be published. On Wednesday we receive the trade balance for December, which should report a slowdown in export growth in light of softer Chinese import data released earlier in the month. The first Markit manufacturing PMI reading for 2018 is also released on Wednesday. On Friday, the main focus will be the release of the national CPI for December and the Tokyo CPI for January, with the BoJ's forecast core measure of national inflation expected to have remained unchanged at 0.9%Y/Y at the end of the year. The minutes of the BoJ's December Board meeting are also released that day. In the bond market, the MoF will auction enhanced liquidity on Monday and 20Y JGBs on Thursday.

In the US, on the assumption that a government shutdown is averted, the key day of the coming week data-wise will be Friday, which will bring the release of the advance estimate of Q4 GDP – likely to see growth come in close to the solid 3.2%Q/Q annualised pace in Q3 – and durable goods orders for December. Earlier in the week, December existing home sales and January's flash Markit PMI will be released on Wednesday. Advance goods trade and inventory reports are due on Thursday, together with December new home sales and the Conference Board's leading index for the same month. Aside from economic data, the Q4 corporate reporting season will gather pace. There are no Fed speeches scheduled with the Fed now in the blackout period ahead of the 31 January FOMC meeting. In the bond market, the Treasury will auction 2Y notes on Tuesday, 2Y FRNs and 5Y notes on Wednesday and 7Y notes on Thursday.

Daiwa Capital Markets

Economic calendar

Key data releases – January

15	16	17	18	19
M3 MONEY SUPPLY Y/Y% NOV 3.4 DEC 3.1 MACHINE TOOL ORDERS Y/Y% NOV 46.8 DEC P 48.3 BOJ REGIONAL ECONOMIC REPORT (JAN)	5Y JGB AUCTION (APPROX ¥2.2TRN) PPI Y/Y% NOV 3.5 DEC 3.1 TERTIARY ACTIVITY M/M% OCT 0.3 NOV 1.1	1Y TB AUCTION (APPROX ¥2.3TRN) CORE MACHINE ORDERS Y/Y% OCT 2.3 NOV 4.1	3M TB AUCTION (APPROX ¥4.4TRN) 30Y JGB AUCTION (APPROX ¥0.8TRN) INDUSTRIAL PRODUCTION Y/Y% OCT 0.5 NOV F 0.5 CAPACITY UTILIZATION M/M% OCT 0.2 NOV 0.0	
22	**23**	**24**	**25**	**26**
AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.55TRN) REUTERS TANKAN LARGE MANUFACTURING DI DEC 27 JAN N/A LARGE NON-MANUFACTURING DI DEC 34 JAN N/A BOJ POLICY BOARD MEETING (22-23 JANUARY)	ALL INDUSTRY ACTIVITY M/M% OCT 0.3 NOV 0.9 MACHINE TOOL ORDERS Y/Y% NOV 46.8 DEC F 48.3 DEPARTMENT STORE SALES Y/Y% NOV -1.8 DEC 2.2 BOJ SENIOR LOAN OFFICER OPINION SURVEY (JAN) BOJ POLICY ANNOUNCEMENT AND OUTLOOK REPORT	TRADE BALANCE ¥BN NOV 364 DEC 264 EXPORTS Y/Y% NOV 16.2 DEC 9.8 IMPORTS Y/Y% NOV 17.2 DEC 12.4 MANUFACTURING PMI DEC 54.0 JAN P N/A LEADING INDEX OCT 106.5 NOV F 108.6 COINCIDENT INDEX OCT 116.4 NOV F 118.1	3M TB AUCTION (APPROX ¥4.4TRN) 20Y JGB AUCTION (APPROX ¥1.0TRN)	NATIONAL CPI Y/Y% NOV DEC 0.6 1.1 *EX FRESH FOOD* *0.9* 0.9 *EX FRESH FOOD/ENERGY* *0.3* 0.4 TOKYO CPI Y/Y% DEC JAN 1.0 1.1 *EX FRESH FOOD* *0.8* 0.8 *EX FRESH FOOD/ENERGY* *0.4* 0.4 SERVICES PPI Y/Y% NOV 0.8 DEC 0.8 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)	3M TB AUCTION 10Y JGB AUCTION VEHICLE PRODUCTION (DEC) CONSUMER CONFIDENCE (JAN) HOUSING STARTS (JAN) CONSTRUCTION ORDERS (DEC) MANUFACTURING PMI (JAN F)	MONETARY BASE (JAN)
05	**06**	**07**	**08**	**09**
SERVICES PMI (JAN) COMPOSITE PMI (JAN)	10Y JGBI AUCTION	6M TB AUCTION AVERAGE WAGES (DEC) LEADING INDEX (DEC P) COINCIDENT INDEX (DEC P) BOJ CONSUMPTION ACTIVITY INDEX (JAN)	3M TB AUCTION 30Y JGB AUCTION BANK LENDING (JAN) CURRENT ACCOUNT (DEC) ECONOMY WATCHERS SURVEY (JAN)	M3 MONEY SUPPLY (JAN)

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

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