

# Yen 4Sight

- Japan's economy grew just 0.1%Q/Q in Q4. Historical growth was revised slightly lower too. Barring positive revisions, the BoJ's forecast of 1.9%Y/Y in FY17 is likely too optimistic.
- Consumer spending and business capex rose in Q4, but residential investment, public spending and inventories weighed. Machine orders were disappointingly soft in December.
- The January trade and CPI reports will provide the main economic focus in Japan over the coming week.

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### Interest and exchange rate forecasts

End period	16 Feb	Q118	Q218	Q318
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.06	0.07	0.07	0.07
JPY/USD	106	112	114	116
JPY/EUR	133	137	139	142

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

## GDP inched higher in Q4

While investors in the past week took their cue from the US, the preliminary Q4 national accounts were Japan's data highlight. After two quarters in which the economy grew at an above-trend pace, a moderation was expected. In the event, the estimates – which could be revised significantly once capex and inventory data from the MoF corporate survey are incorporated next month – suggested that GDP grew just 0.1%Q/Q (0.5% annualised). While still marking a rare eighth consecutive quarter of expansion, growth was roughly half the expected rate. Modest downward revisions to previous quarters also accumulated to lower annual growth through Q317 by 0.2ppt to 1.9%Y/Y. From that base, the soft outcome for Q4 meant that annual growth slowed to 1.5%Y/Y. Moreover, real gross national income (GNI), which better measures residents' spending power, fell 0.3%Q/Q due to a sharp lift in investment income outflows abroad, to send the annual rate back down 0.7ppt to 1.3%Y/Y, the average of the past two years.

## Nominal GDP unchanged in Q4

In terms of prices, the headline GDP deflator was weak, down 0.1%Q/Q and unchanged from a year earlier. However, yen depreciation and higher energy prices in Q4 saw the import price deflator rise 2.7%Q/Q and 8.4%Y/Y, which (perhaps counter-intuitively) subtracted from the headline numbers. The domestic demand deflator, which provides a better gauge of the economy's capacity to generate inflation, rose 0.3%Q/Q and 0.5%Y/Y. Nevertheless, given the subdued GDP deflator, nominal GDP was unchanged in Q4, thus making no further progress to achieving PM Abe's goal of ¥600trn for the end of the decade. Indeed, while nominal GDP rose 1.6%Y/Y, at that pace of expansion, Abe's target will not be met until 2023.

## Consumer spending growth resumes in Q4

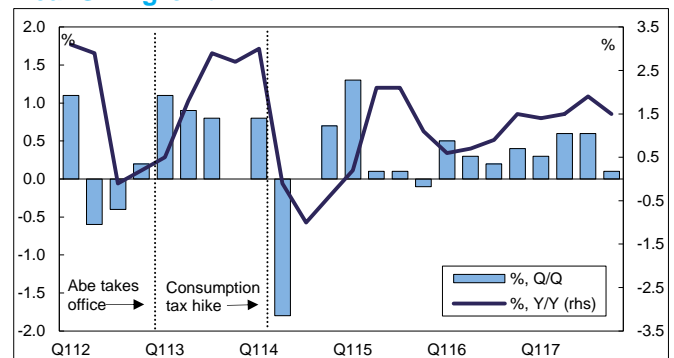
Turning to the good news, as the more reliable monthly indicators suggested, private consumption resumed its positive trend with growth of 0.5%Q/Q in Q4. Spending on durables was especially strong (up 3.6%Q/Q), while spending on services was more sedate (up 0.3%Q/Q). While the rebound did not quite reverse the 0.6%Q/Q drop in Q3 (0.1ppt larger than estimated previously), this was still sufficient to lift annual private consumption growth by 0.4ppt to 1.1%Y/Y, broadly consistent with employee compensation, which rose in real terms by 1.2%Y/Y (albeit falling 0.5%Q/Q in Q4).

## Q4 GDP: Key figures\*

	%Q/Q	contr	%Y/Y	contr
<b>GDP</b>	<b>0.1</b>		<b>1.5</b>	
Final sales	0.2	0.2	1.3	1.3
Domestic demand	0.1	0.1	1.3	1.3
-Private consumption	0.5	0.3	1.1	0.6
-Residential investment	-2.7	-0.1	-2.2	-0.1
-Non-residential investment	0.7	0.1	3.0	0.4
-Government consumption	-0.1	0.0	0.2	0.0
-Public investment	-0.5	0.0	0.8	0.0
Net exports	-	0.0	-	0.3
-Exports	2.4	0.4	6.8	1.1
-Imports	2.9	-0.4	5.5	-0.8
Private inventories	-	-0.1	-	0.2

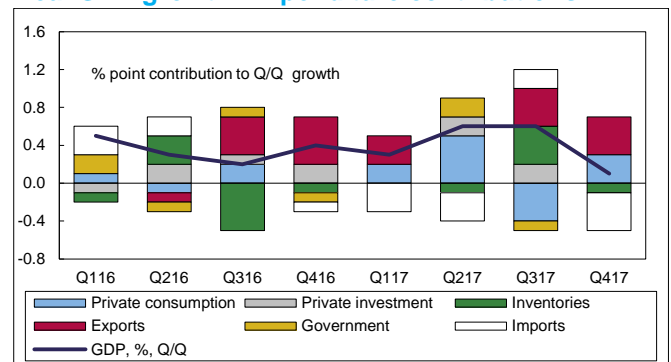
\*Contributions (in ppts) might not add up to the headline growth rates due to rounding. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

## 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.



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## Residential investment and public spending drag

Private non-residential investment also contributed positively to GDP growth in Q4, rising 0.7%Q/Q to mark a fifth consecutive increase, albeit one that we would treat with caution ahead of the release of the MoF corporate survey. In contrast, as in Q3, residential investment and public spending weighed on growth. Indeed, consistent with the decline reported in housing starts, residential investment fell a sharp 2.7%Q/Q and 2.2%Y/Y. Public investment fell 0.5%Q/Q and public consumption fell 0.1%Q/Q. Meanwhile, the preliminary estimates also assume a 0.1ppt negative contribution to growth from private inventories following the 0.4ppt positive contribution made in Q3. As a result, private domestic demand rose 0.3%Q/Q in Q4 following growth of 0.2%Q/Q in Q3, casting the GDP report in a slightly stronger light than the headline growth figure.

## Net exports provide no lift in Q4

Strong trading partner demand saw exports maintain their very positive trend in Q4 with growth of 2.4%Q/Q and 6.8%Y/Y. Goods exports grew 2.1%Q/Q, while exports of services rose 3.4%Q/Q driven by growth in tourism reflected in a 7.6%Q/Q and 24.0%Y/Y lift in consumer spending by non-residents. But after declining in Q3, imports rebounded to rise 2.9%Q/Q and up 5.5%Y/Y in Q4. As a result, after contributing 0.5ppt to quarterly growth in Q3, net exports made no contribution in Q4 (indeed, unrounded, the contribution was slightly negative).

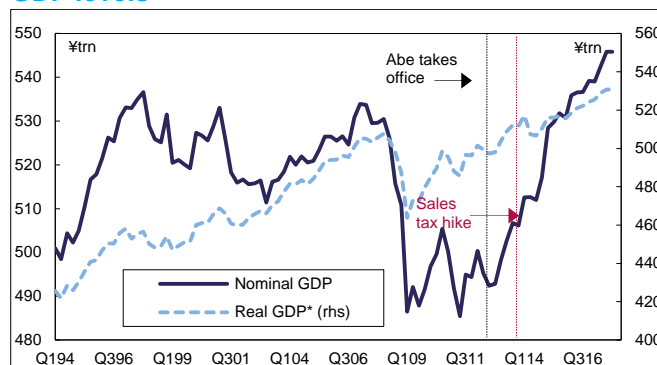
## Moderate expansion to continue

Barring positive revisions, the Q4 national accounts suggest that the BoJ's GDP growth forecast of 1.9%Y/Y in FY17 is too optimistic. And its forecast for FY18 (1.4%Y/Y) looks too strong to us too. Certainly, a currently robust global economy and upbeat domestic confidence indicators provide good reason to expect that – while there will be volatility from one quarter to the next – GDP will maintain its uptrend. However, real income growth is unlikely to rocket ahead. External demand will eventually slow as the Fed continues to tighten. Concerns about longer-term growth potential and adverse demographics will likely continue to weigh to some extent on domestic demand. And growth in economic activity will also be constrained by very tight conditions in the labour market. So, full-year growth of about 1%Y/Y in FY18 seems more likely.

## Machinery orders also disappointed

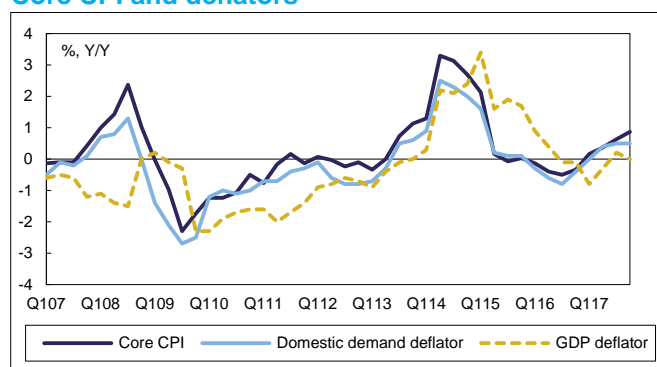
Observers hoping for accelerated business capex in the New Year will have been disappointed by the December machinery orders report. Excluding ships and other volatile categories, core orders fell 11.9%M/M, more than reversing strong gains in October and November to be down 5.0%Y/Y. Weakness was widespread throughout the report, with even foreign orders having a soft month, declining 13.2%M/M albeit still up 10.5%Y/Y. The poor December outturn means that core machinery orders fell 0.1%Q/Q in Q4. Looking ahead, forecasts submitted by 280 machinery manufacturers pointed to a very modest 0.6%Q/Q increase in core orders in Q1, which implies that orders would be little changed from a year earlier after being down 1.7%Y/Y in Q4. Over the past year, however, actual business investment in equipment has been quite a bit stronger than this survey suggested. And we think that there is every chance this will remain the case in Q1.

## GDP levels



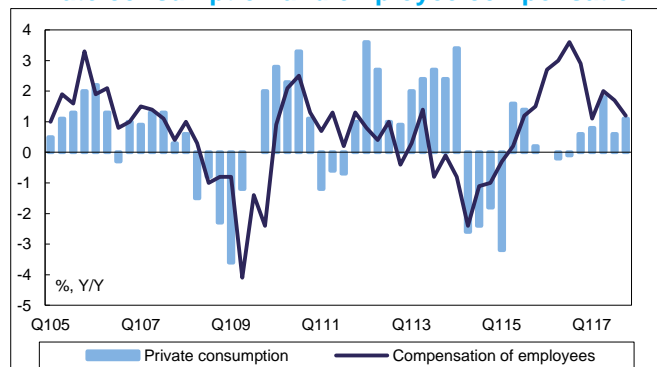
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

## Core CPI and deflators



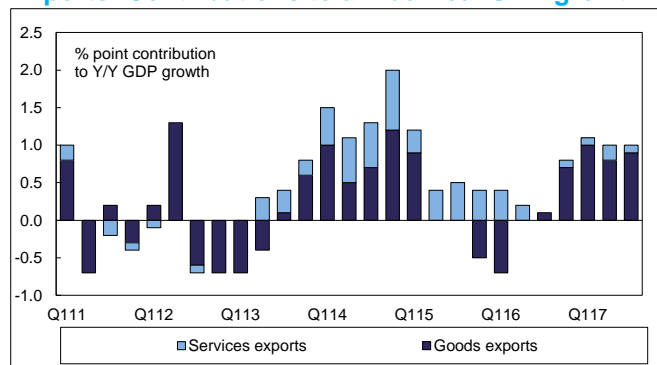
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

## 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.

## Capacity utilisation still rising in the factory sector

The final IP report for December confirmed a strong expansion across most sub-sectors at year-end. Indeed, production of general machinery was up 5.0%M/M, and growth in total IP was revised up 0.2ppt to 2.9%M/M, leaving it up 1.8%Q/Q in Q4 and 4.4%Y/Y. New detail showed that capacity utilization rose significantly, up 1.5%Y/Y to the highest level since January 2014, consistent with numerous indicators pointing to an absence of slack and thus a need for firms to increase capex.

## Data suggest that BoJ will stay the course

Policy-wise, the soft GDP report – which suggested that growth was only just consistent with the BoJ's 0.5-1.0%Y/Y range of trend growth estimates – should help dampen talk of the BoJ joining the ranks of those central banks looking to normalize monetary policy. Indeed, just as we suspect the BoJ will likely have to nudge down its growth forecast, we think it will also need to revise down its inflation outlook. One factor that might force its hand is the yen. Growth in import prices has slowed significantly over recent months, to 4.9%Y/Y in January from as much as 15.4%Y/Y in September. Further yen appreciation seems bound to weigh more heavily on prices of imported items even if inflation in contract currencies remains stable.

## New BoJ leadership will be in no mood to tighten

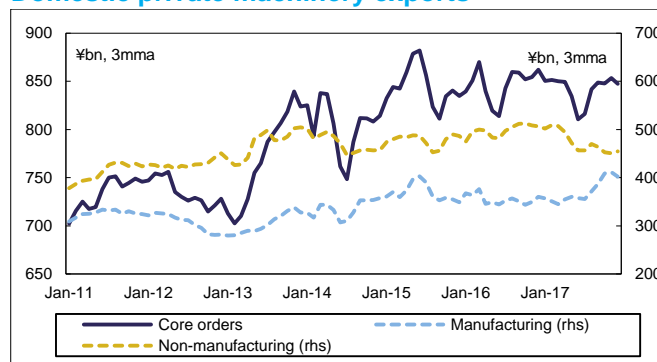
The likelihood that the BoJ will maintain its current policy settings was underscored by confirmation that PM Abe has nominated Haruhiko Kuroda for a second five-year term as BoJ Governor. Masayoshi Amamiya (Executive Director at the BoJ and a key architect of Yield Curve Control) and Masazumi Wakatabe (Professor at Waseda University, Abenomics cheerleader and advocate of super-easy policy) have been chosen to fill the Deputy Governor roles currently held by the departing Hiroshi Nakaso and Kikuo Iwata. Assuming the nominations are confirmed by the Diet, the first Policy Board meeting under the new leadership team will be held on 22-23 April, when the BoJ will finalise its updated Outlook Report.

## The week ahead in Japan and the US

The coming week's Japanese economic diary kicks off with the January trade report and February Reuters' Tankan on Monday. Provisional trade data for the first twenty days of the month suggest that export growth remained solid but import growth slowed after a surge in December. On Wednesday, the flash manufacturing PMI for February is due along with all industry activity data for December. But most notable will be Friday's national CPI report for January (and Tokyo CPI for February). Higher food prices seem likely to have lifted headline inflation in January. But while the PMIs hinted at additional pressures, the BoJ's forecast core CPI will do well to match December's 0.9%Y/Y pace as last January's rare 0.2%M/M increase will roll out of the calculation. In the bond market, the MoF will auction enhanced liquidity on Tuesday and 20Y JGBs on Thursday.

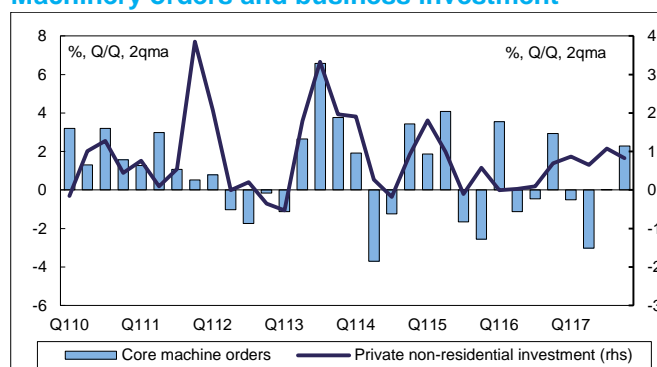
In the US, after Monday's Presidents' Day holiday, the first economic reports of note are due Wednesday with the January FOMC minutes, existing home sales data for January, and the flash PMIs for February. On Thursday, the Conference Board will report its leading index for January. In the bond market the Treasury will auction 2Y Notes on Tuesday, 2Y FRNs and 5Y Notes on Wednesday and 7Y Notes on Thursday.

## Domestic private machinery exports



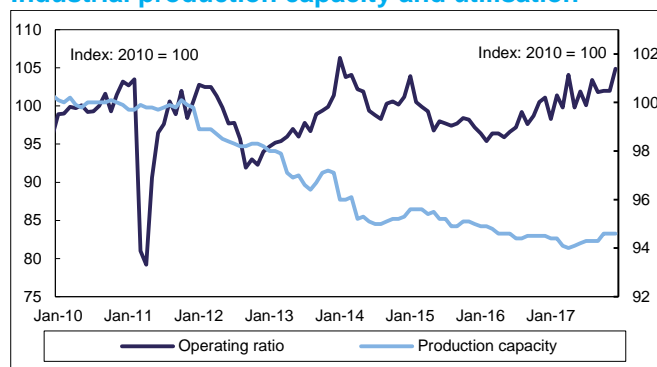
Source: Cabinet Office, MoF and Daiwa Capital Markets Europe Ltd.

## Machinery orders and business investment



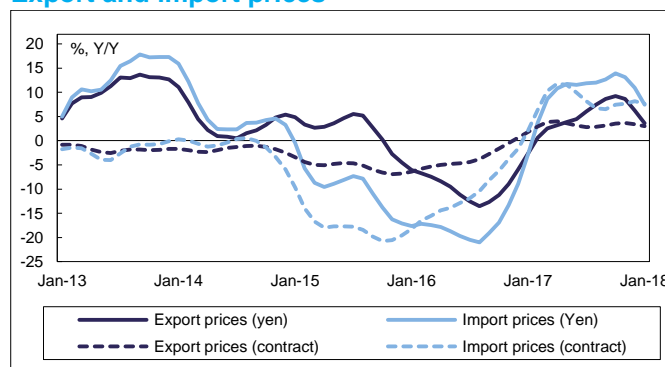
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

## Industrial production capacity and utilisation\*



\*Production capacity shows amount of capacity when facilities are in full operation. Operating ratio shows the index of production relative to production capacity. Source: METI and Daiwa Capital Markets Europe Ltd.

## Export and import prices



Source: BoJ & Daiwa Capital Markets Europe Ltd.

# Economic calendar

## Key data releases – February/March

12	13	14	15	16
NATIONAL FOUNDATION DAY OBSERVED	GOODS PPI Y/Y% DEC 3.1 JAN 2.7 MACHINE TOOL ORDERS Y/Y% DEC 48.3 JAN P 48.8	5Y JGB AUCTION  GDP Q/Q% Q3 0.6 Q4 P 0.1 GDP DEFLATOR Y/Y% Q3 0.1 Q4 P 0.0	3M TB AUCTION  CORE MACHINE ORDERS Y/Y% NOV 4.1 DEC -5.0 INDUSTRIAL PRODUCTION M/M% NOV 0.5 DEC F 2.9 CAPACITY UTILIZATION M/M% NOV 0.0 DEC 2.8	AUCTION FOR ENHANCED LIQUIDITY 1M TB AUCTION
19	20	21	22	23
TRADE BALANCE ¥BN DEC 87 JAN 144 EXPORTS Y/Y% DEC 9.3 JAN 9.4 IMPORTS Y/Y% DEC 14.9 JAN 7.8	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.55TRN)  MACHINE TOOL ORDERS Y/Y% DEC 48.3 JAN F 48.8	MANUFACTURING PMI JAN 54.8 FEB P N/A ALL INDUSTRY ACTIVITY M/M% NOV 1.0 DEC 0.4	3M TB AUCTION (APPROX ¥4.4TRN) 20Y JGB AUCTION (APPROX ¥1.0TRN)	NATIONAL CPI Y/Y% DEC JAN 1.0 1.3 <i>EX FRESH FOOD</i> 0.9 0.8 <i>EX FRESH FOOD/ENERGY</i> 0.3 0.3  SERVICES PPI Y/Y% DEC 0.8 JAN 0.8
26	27	28	01	02
LEADING INDEX (DEC F) COINCIDENT INDEX (DEC F)	2Y JGB AUCTION	RETAIL TRADE (JAN) INDUSTRIAL PRODUCTION (JAN P) VEHICLE PRODUCTION (JAN) HOUSING STARTS (JAN) CONSTRUCTION ORDERS (JAN)	3M TB AUCTION 10Y JGB AUCTION  MANUFACTURING PMI (FEB F) CONSUMER CONFIDENCE (FEB) VEHICLE SALES (FEB) CAPITAL SPENDING (Q4)	JOB-TO-APPLICANT RATIO (JAN) UNEMPLOYMENT RATE (JAN) HOUSEHOLD SPENDING (JAN) TOKYO CPI (FEB) MONETARY BASE (FEB)
05	06	07	08	09
SERVICES PMI (FEB) COMPOSITE PMI (FEB)	30Y JGB AUCTION	6M TB AUCTION  LEADING INDEX (JAN P) COINCIDENT INDEX (JAN P) BOJ CONSUMPTION ACTIVITY INDEX (FEB)	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY  CURRENT ACCOUNT BALANCE (JAN) NATIONAL ACCOUNTS (Q4 F) BANK LENDING (FEB)  BOJ POLICY BOARD MEETING (08-09 MARCH)	MONEY SUPPLY M2 (FEB) ECONOMY WATCHERS SURVEY (FEB)  BOJ POLICY ANNOUNCEMENT

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

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