Daiwa Capital Markets

Yen 4Sight

- Domestic economic reports again played second fiddle to trade policy and geopolitical worries over the past week.
- If the US-China trade dispute has any impact on Japan, it will likely occur via the financial conditions and confidence channels.
- Core machinery orders rose in February and are set for growth in Q1. But growth in consumer spending appears modest at best.
- The coming week sees the release of the March trade and CPI reports. The BoJ's Senior Loan Officer Survey is also of interest.

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Interest and exchange rate forecasts

End period	13 Apr	Q218	Q318	Q418
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.04	0.07	0.07	0.07
JPY/USD		105	104	108
JPY/EUR		127	127	134

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

Economic data continue to play second fiddle

Given a sparse local diary it always seemed likely that global news would dominate Japanese markets this week. And so it proved, with markets continuing to gyrate as sentiment about the US-China trade dispute waxed and waned depending on the tone of President Trump's commentary. Investors also paid attention to the US response – and Russia's reaction – to the alleged use of chemical weapons in Syria. Away from the limelight, new data hinted that the trade dispute might be impacting business confidence in Japan. But the latest machinery orders data provided a positive surprise. The consumption picture in Q1, however, looks a little murkier.

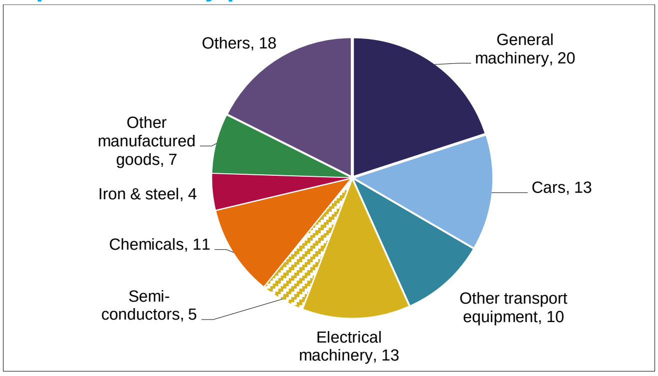
Trade spat has little direct impact on Japan

At this point it is far from clear where US trade policy will settle, with President Trump's rhetoric seemingly changing on an almost daily basis. What is clear is that the direct impact of recent changes in trade policy is likely to have a minimal direct impact on the Japanese economy. For example, with respect to steel, which is threatened with a 25% tariff on shipments to the US, iron and steel products account for just 4% of Japan's total exports to all countries, and only about 5% of those exports are destined for the US. And, making high value-added items which are not easily substitutable, Japanese producers might expect to retain market share. So, of greater concern would be an escalation of the dispute between the US and China – each of which accounts for 19% of Japan's merchandise trade exports – with potential to affect Japanese corporate subsidiaries, and export demand for components and, ultimately, final goods and services. And such a dispute would also risk an inevitable spill-over to global demand as a whole.

Financial conditions & confidence more important

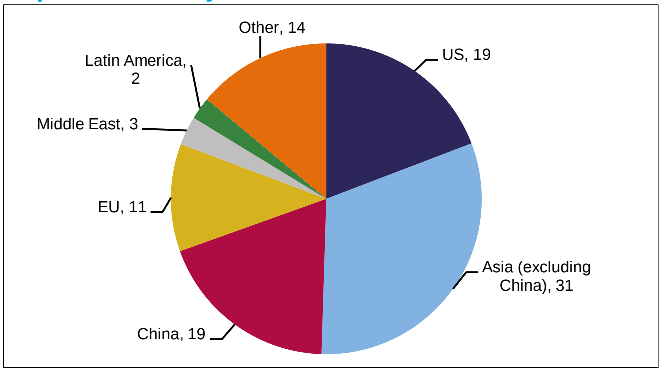
With gross exports having contributed on average a little more than 0.3ppt to quarterly increases in Japanese GDP since global trade picked up in H216, a world tariff war could switch off a key growth engine. Even if it never gets to that point, however, the US-China dispute could affect Japan's economy via financial conditions and animal spirits. As far as financial conditions are concerned, since the beginning of the year the Topix has declined more than 4.0%, in contrast to the S&P500 which has been broadly flat (in local currency terms). At least some of this decline likely reflects a reaction to developments in US trade policy, not least because a more cautious risk environment saw the yen appreciate by around 5% against the US dollar from the start of the year. While these moves are not yet large enough to dramatically impact the economic outlook,

Export shares by product*



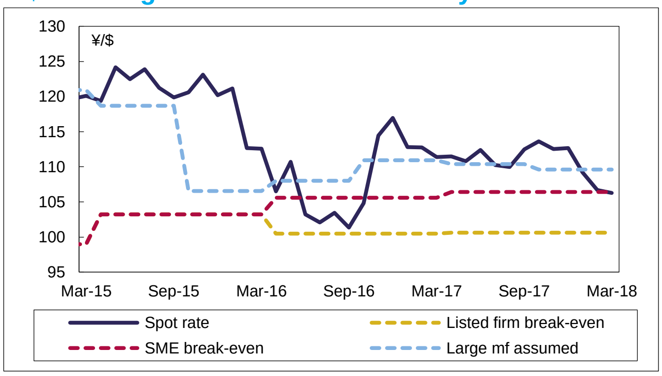
*% share, 2017. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd

Export shares by destination*



*% share, 2017. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd

¥/$ exchange rate: Actual and survey indices*



*Assumed rate from BoJ Tankan, for large manufacturers. Break-even rates from Cabinet Office Annual Survey of Corporate Behaviour. Source: BoJ, Cabinet Office, Bloomberg and Daiwa Capital Markets Europe Ltd.

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yen appreciation is especially unhelpful to a BoJ that is battling to lift inflation towards its 2% target. And while most listed exporting firms appear comfortable with current exchange rates, the Cabinet Office's recent Annual Survey of Corporate Behaviour suggested an average break-even exchange rate for SMEs of ¥106.4.

BoJ surveys still seem upbeat

To date, the BoJ's surveys suggest that trade concerns are having little impact on sentiment in Japan. As we discussed last week, the Tankan reported that firms remain upbeat, with the overall business conditions index for all firms rising to a 26-year high in Q1. The past week's BoJ quarterly Regional Economic Report was also positive with all regions citing an increasing trend for business investment, generally firmer consumer spending, and growth in household incomes. Six regions reported that their economy had been expanding or expanding moderately, and three indicated a moderate recovery. Two of the nine regions – Kyushu-Okinawa and Shikoku – slightly revised up their overall economic assessment from that made in January, with improved private consumption cited as the cause. Hokkaido's assessment was revised down slightly, but that was due to a weakening in construction activity associated with the completion of repairs from the typhoon that struck in 2016.

Economy Watchers survey mixed in March

In contrast, the Cabinet Office Economy Watchers' survey has recently indicated a more cautious mood. The good news is that the overall current conditions index rose 0.3pt to 48.9 in March, with the household index rising 0.7pt to 47.7. However, the corporate sector index fell a further 0.3pt to an 11-month low of 50.0. After a cumulative 7.5pt decline in the prior two months, the manufacturing index edged up 0.2pt to 49.6. But the outlook indices suggested that respondents are becoming less certain of a near-term improvement. The overall expectations index – which tries to gauge the direction of business conditions over the next month or so – declined 1.8pts to an 11-month low of 49.6, with the manufacturing, non-manufacturing indices and household indices falling similarly.

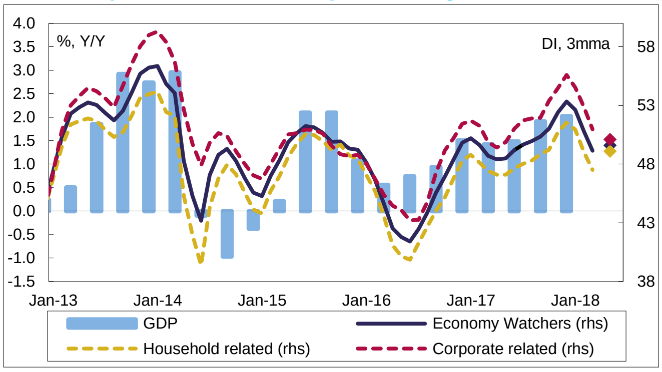
Consumer confidence steady in March

The Cabinet Office consumer confidence survey for March suggests that there has been little change in sentiment at the consumer level, however. Indeed, the headline index was steady at the robust 44.3 recorded in February. In the detail, the income growth index receded from last month's more than 10-year high to a 6-month low of 42.6 – perhaps reflecting disappointment with recent wage settlements. The employment and spending intentions indices edged higher nonetheless.

Core machinery orders rise in February

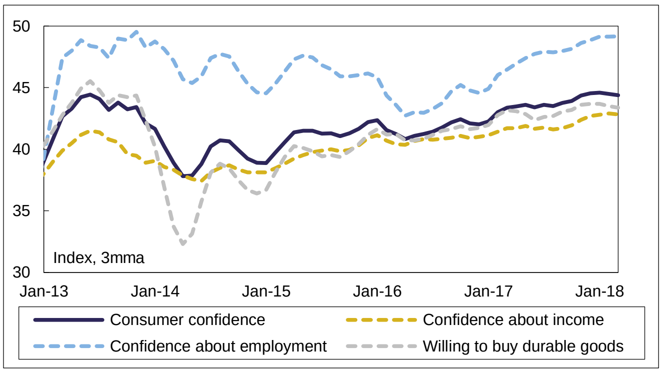
If business sentiment is more cautious, it is yet to be reflected in capex decisions. Indeed, this week's machinery orders report for February provided a small positive surprise. Total machinery orders fell 2.3%M/M, partly unwinding the 4.5%M/M rise in January, but remained up 9.4%Y/Y. Core private orders – which exclude ships and other volatile categories – rose a further 2.1%M/M in February and were up 2.4%Y/Y. In the detail, orders by manufacturers surged 8.0%M/M and were up 21.4%Y/Y, thus maintaining a strong trend. By contrast, core orders in the non-manufacturing sector were unchanged in February and down

Economy Watchers survey & GDP growth*



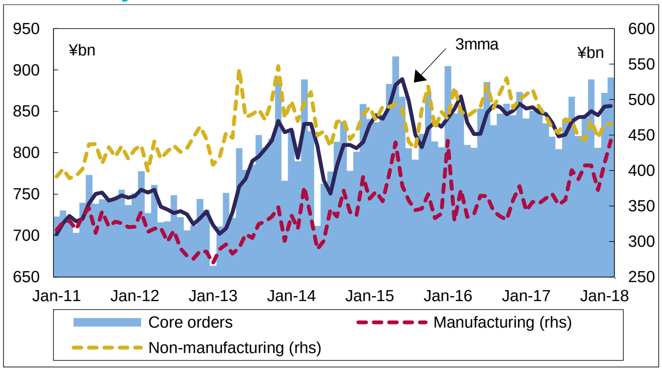
*Diamonds represent March reading of the respective outlook index, Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Consumer confidence



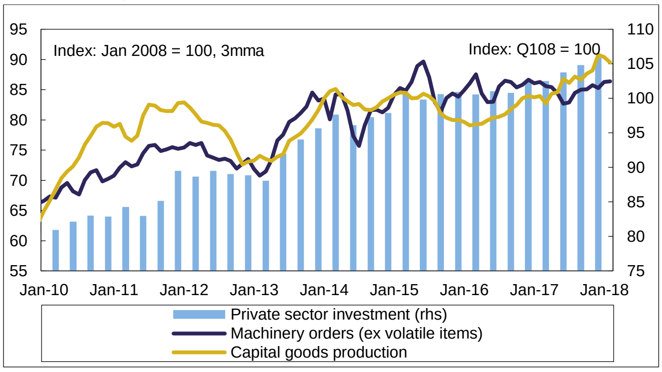
Source: Cabinet Office & Daiwa Capital Markets Europe Ltd

Machinery orders



Source: Cabinet Office & Daiwa Capital Markets Europe Ltd

Machinery orders



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

10.4%Y/Y. Foreign orders fell 7.8%M/M, retracing much of the 11.6%M/M increase recorded in January, but even so were still up 14.8%Y/Y. Public sector orders rebounded from a steep decline in January to be up 6.7%Y/Y.

Capex on track for further increase in Q1

The upside surprise in core private machine orders in February means that, to date, orders in Q1 are running 4.4% above the Q4 average. So, barring a collapse in orders in March, growth in Q1 seems likely to exceed the modest 0.6%Q/Q rise forecast in the Cabinet Office's survey of firms. While the quarterly correlation between machinery orders and realised investment is not especially close, this outcome still bodes well for a continuation of the uptrend in business capex seen throughout 2017 – a trend that is increasingly underpinned by very tight labour market conditions and high rates of capacity utilisation.

Consumption growth likely modest at best in Q1

The picture regarding consumption in Q1 appears somewhat murkier. The Cabinet Office's Synthetic Consumption Index – the indicator with the strongest correlation with the national accounts measure of private consumption – rose 0.5%M/M in February, but spending over the first two months of 2018 was still down 0.1% from the monthly average in Q4. By contrast, the BoJ's Consumption Activity Index – another good indicator – reported growth of 0.3% on that basis. Assuming no revisions, a flat outcome for the Synthetic Consumption Index in March would leave Q1 spending unchanged from Q4, suggesting that private consumption is likely to make no more than a small positive contribution to GDP growth in Q1.

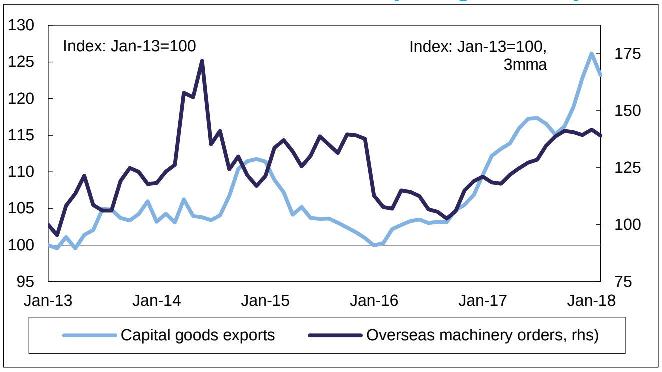
Bank lending continues to slow

Another softer reading was seen in bank lending, where the recent moderation seems surprising given the uptrend in capex. The trend continued in March, with loans up 2.0%Y/Y, marking an eighth consecutive monthly slowdown. As previously, the easing in growth was led by lending at the major city banks – now up just 0.3%Y/Y, the weakest rate since December 2012. As before, we think that the slowdown reflects continued above-average levels of corporate profitability and retained earnings. Growth in lending at regional banks edged down to a comparatively robust 3.3%Y/Y and that at shinkin banks was unchanged at 2.5%Y/Y. The BoJ's Senior Loan Officer Survey due in the coming week may cast some further light on what is driving the slowdown in lending growth at the major banks.

PPI inflation slows with weaker import prices

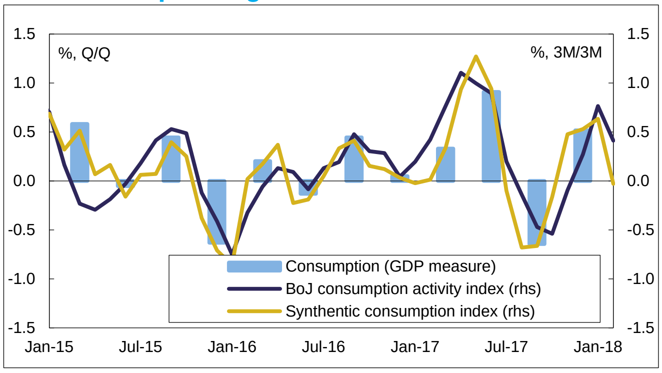
Finally, inflation-wise, the impact of a firmer yen was evident in the latest producer goods price data. The headline PPI fell 0.1%M/M in March, lowering annual inflation to 2.1%Y/Y. A 1.7%M/M drop in petroleum/coal prices and a 1.9%M/M decline in non-ferrous metal prices led to a 0.2%M/M fall in prices of manufactured goods (now up just 1.7%Y/Y). Agricultural prices also fell modestly in March, but utilities prices rose. Yen strength meant that import prices (in local currency terms) fell for a third consecutive month, with the 1.7%M/M decline in March causing annual growth to slow 2.6ppts to 1.8%Y/Y, the weakest pace since December 2016. With prices of final consumer goods down 0.1%Y/Y – the first negative reading for a year – and imported consumer goods prices down 2.0%Y/Y, watch for possible future pass-through from the yen to CPI.

Overseas machine orders & capital goods exports



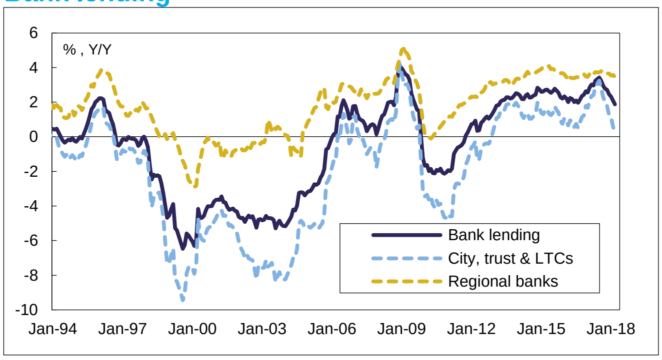
Source: Cabinet Office, BoJ, Thomson Reuters & Daiwa Capital Markets Europe Ltd.

Consumer spending



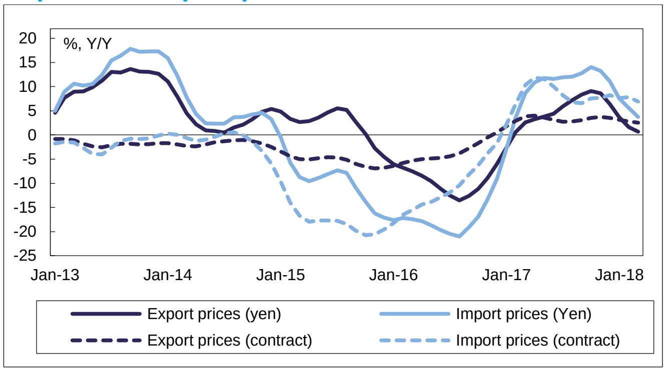
Source: BoJ, Cabinet Office, Thomson Reuters & Daiwa Capital Markets Europe Ltd.

Bank lending



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

Export and import prices



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

The week ahead in Japan and the US

The coming week's Japanese economic diary is again relatively sparse. And so, for much of the week, attention in Japan might well focus on the visit of PM Abe to the US – from Tuesday to Friday – for discussions with President Trump. Any utterances by President Trump on trade matters will certainly be closely watched. Data-wise, meanwhile, the final IP report for February is released on Tuesday – the preliminary report suggested that output rose 4.1%M/M, failing to reverse fully the drop of 6.8%M/M in January. The following day, the March trade report should show a pick-up in growth of exports as Asian demand returns following the Lunar New Year holidays. However, while preliminary data for the first twenty days of the month showed exports up 5.8%Y/Y, import growth was stronger at 9.9%Y/Y. On Friday, attention will turn to the national CPI report for March, which will help to set the tone for the following week's BoJ policy review and revised Outlook Report. In light of the advance Tokyo CPI for March, the recent uptrend in national measures of core inflation has likely been disrupted, headline CPI likely to retreat perhaps as much as 0.4ppt from 1.5%Y/Y the previous month, and the BoJ's forecast core measure (which excludes prices of fresh food) also set to decline, albeit probably by just 0.1ppt to 0.9%Y/Y. On Friday, we will also receive the Tertiary Industry Index for February and the BoJ will release the latest edition of its Senior Loan Officer Survey, which could shine more light on the slowdown in lending at the major city banks since mid-2017. In the bond market, the MoF will auction 5-year JGBs on Tuesday and 20-year JGBs on Thursday.

Turning to the US, the March retail sales report will be of particular interest on Monday, while the New York Fed's manufacturing survey and NAHB housing index for April are also due that day. On Tuesday, the March IP and housing starts/building permits reports take centre stage. The Fed's Beige Book of economic anecdotes will be released on Wednesday. On Thursday the Philadelphia Fed will release its manufacturing survey for April and the Conference Board will release its leading index for March. In the bond market, the Treasury will auction 5-year TIPS on Thursday.

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Economic calendar

Key data releases – April/May

09	10	11	12	13
CURRENT ACCOUNT BALANCE ¥BN JAN 2023 FEB 1024 CONSUMER CONFIDENCE FEB 44.3 MAR 44.3 ECONOMY WATCHERS SURVEY - CURRENT CONDITIONS DI FEB 48.6 MAR 48.9 - FUTURE CONDITIONS DI FEB 51.4 MAR 49.6	AUCTION FOR ENHANCED LIQUIDITY MACHINE TOOL ORDERS Y/Y% FEB 39.5 MAR P 28.1	CORE MACHINE ORDERS Y/Y% JAN 2.9 FEB 2.4 PPI Y/Y% FEB 2.6 MAR 2.1 BANK LENDING Y/Y% FEB 2.1 MAR 2.0	3M TB AUCTION 30Y JGB AUCTION M3 MONEY SUPPLY Y/Y% FEB 2.7 MAR 2.8 BOJ REGIONAL ECONOMIC REPORT (APR)	
16	**17**	**18**	**19**	**20**
	5Y JGB AUCTION (APPROX ¥2.0TRN) INDUSTRIAL PRODUCTION M/M% JAN -6.8 FEB F 4.1 CAPACITY UTILIZATION M/M% JAN -7.3 FEB N/A	1Y TB AUCTION (APPROX ¥2.1TRN) TRADE BALANCE ¥BN FEB -202 MAR 93 EXPORTS Y/Y% FEB 1.8 MAR 5.5 IMPORTS Y/Y% FEB 16.6 MAR 6.2	3M TB AUCTION (APPROX ¥4.4TRN) 20Y JGB AUCTION (APPROX ¥1.0TRN)	NATIONAL CPI Y/Y% FEB MAR 1.5 1.1 *EX FRESH FOOD* *1.0 0.9* *EX FRESH FOOD/ENERGY* *0.5 0.5* TERTIARY ACTIVITY INDEX M/M% JAN -0.6 FEB 0.0 REUTERS TANKAN- LARGE MANUFACTURERS DI MAR 28 APR N/A LARGE NON-MANUFACTURERS DI MAR 35 APR N/A BOJ SENIOR LOAN OFFICER SURVEY (APR)
23	**24**	**25**	**26**	**27**
MANUFACTURING PMI (APR P)	2Y JGB AUCTION SERVICES PPI (MAR) MACHINE TOOL ORDERS (MAR F)	ALL INDUSTRY ACTIVITY (FEB)	3M TB AUCTION BOJ POLICY BOARD MEETING (26 - 27 APRIL)	JOB-TO-APPLICANT RATIO (MAR) UNEMPLOYMENT RATE (MAR) TOKYO CPI (MAR) INDUSTRIAL PRODUCTION (MAR) RETAIL SALES (MAR) VEHICLE PRODUCTION (MAR) HOUSING STARTS (MAR) CONSTRUCTION ORDERS (MAR) BOJ POLICY ANNOUNCEMENT
30	**01**	**02**	**03**	**04**
	MANUFACTURING PMI (APR F) VEHICLE SALES (APR)	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY MONETARY BASE (APR) SERVICES PMI (APR) COMPOSITE PMI (APR) CONSUMER CONFIDENCE (APR)		

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

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