Yen 4Sight

- Japan's GDP fell 0.2%Q/Q in Q1 and growth in Q4 was revised significantly lower, so annual growth slowed sharply to 0.9%Y/Y.
- Residential investment and inventories weighed on growth in Q1, as did a small fall in business capex. But firms' forecast for machinery orders in Q2 was upbeat.
- Headline and core inflation fell in April.
- The coming week brings the April trade report and May Tokyo CPI, with final March Labour Survey results also of note.

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Interest and exchange rate forecasts

End period	11 May	Q218	Q318	Q418
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.06	0.07	0.07	0.07
JPY/USD	111	107	104	108
JPY/EUR	131	129	125	133

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

Japan's real GDP contracts in Q1

Contrasting with the firmer US data which fuelled a sell-off in the Treasury market over the past week, the latest top-tier Japanese economic reports will have sorely disappointed the BoJ's policymakers. The first release of note was Wednesday's preliminary national accounts for Q1. As we and the market had expected, real GDP contracted for the first time since Q415. But the contraction of 0.2%Q/Q (0.6%Q/Q annualised) was slightly larger than expected. So, the BoJ will have to take a crumb of comfort from the fact that these preliminary estimates are often subject to substantial revision, with the updated capex and inventory information available from the MoF's corporate survey on 1 June set to be closely watched.

Revisions compound the disappointment

Indeed, a key feature of the Q1 report was the sizeable revision made to growth in Q4. A less positive picture for both private consumption and non-residential investment combined to see the estimate of real GDP growth slashed to just 0.1%Q/Q from 0.4%Q/Q previously. From that base, the soft outcome for Q1 meant that the annual GDP growth rate slowed to 0.9%Y/Y – no better than the BoJ's latest point estimate of trend growth. While growth for FY17 as a whole stands at a more respectable 1.5%Y/Y, this is still 0.4ppt below the median BoJ Board member's estimate in the Outlook Report published earlier this month. Real gross national income (RGNI), which better measures residents' spending power, fell an even greater 0.7%Q/Q in Q1 thanks largely to an increase in investment income flows to the rest of the world. As a result, annual growth in RGNI slowed to 0.5%Y/Y from 1.6%Y/Y in Q4.

Abe's ¥600trn nominal GDP target further off track

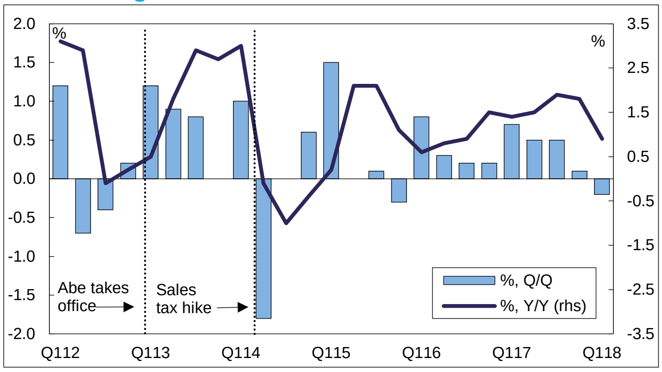
In terms of prices, the headline GDP deflator was weak, down 0.2%Q/Q, although favourable base effects mean that the annual rate picked up to 0.5%Y/Y. While the import price deflator rose 1.2%Q/Q and 2.7%Y/Y to subtract from the headline numbers, the domestic demand deflator – which provides a better gauge of the economy's capacity to generate inflation – rose a tepid 0.1%Q/Q and 0.9%Y/Y. With both real GDP and the GDP deflator down in Q1, nominal GDP fell 0.4%Q/Q – this from a Q4 level that was revised down slightly – thus moving further from PM Abe's goal of ¥600trn being achieved by the end of the decade. Indeed, should nominal GDP continue to trend higher at the 1.4%Y/Y pace of Q1, Abe's target will not be met until the end of 2024.

Q1 GDP: Key figures*

	%Q/Q	*contr*	%Y/Y	*contr*
GDP	**-0.2**	**-**	**0.9**	**-**
Final sales	0.0	0.2	0.7	0.7
Domestic demand	-0.2	-0.2	0.7	0.7
-Private consumption	0.0	0.0	0.2	0.1
-Residential investment	-2.1	-0.1	-5.7	-0.2
-Non-residential investment	-0.1	*0.0*	2.4	*0.4*
-Government consumption	0.0	*0.0*	0.3	*0.1*
-Public investment	0.0	0.0	1.3	0.1
Net exports	-	0.1	-	0.2
-Exports	0.6	0.1	4.8	0.8
-Imports	0.3	-0.1	3.7	-0.6
Private inventories	-	-0.1	-	0.3

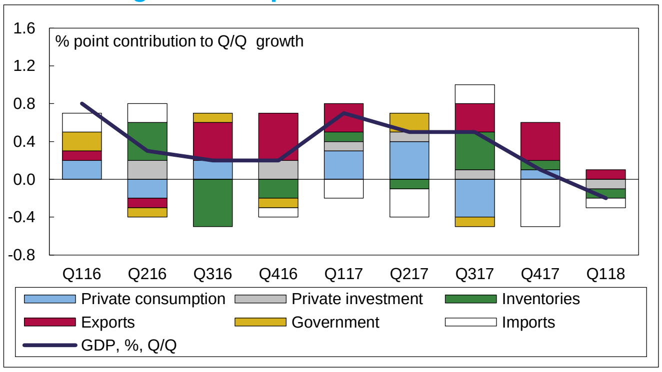
**Contributions (in ppts) might not add up to the headline growth rates due to rounding. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.*

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.

Consumer spending flat in Q1

Turning to the detail, private consumption is estimated to have been stable in Q1 – a slightly better result than expected in light of the monthly indicators, but now coming off a Q4 in which its growth was revised down 0.3ppt to just 0.2%Q/Q. Indeed, annual growth in consumer spending slowed to just 0.2%Y/Y, the weakest result since Q316. Spending on services rose 0.3%Q/Q in Q1, but declines were recorded across all classes of goods (especially semi-durable goods, where spending fell 2.0%Q/Q). If there was any good news, it was that compensation of employees rose in Q1 by 0.9%Q/Q and 3.2%Y/Y– the fastest annual pace of growth since Q297. In real terms, compensation rose a slightly more moderate 0.7%Q/Q and 2.0%Y/Y. Still, these figures suggest scope for a future lift in consumer spending from the slow pace of recent quarters.

Net exports provide a small lift to GDP

Meanwhile, net exports made a small but welcome positive contribution to growth in Q1 (rounding up to 0.1ppt), with a 0.6%Q/Q lift in exports exceeding a 0.3%Q/Q rise in imports. That was thanks to a 1.2%Q/Q (5.2%Y/Y) increase in goods exports. Indeed, despite a further strong increase in the number of overseas visitors in Q1, services exports declined 1.7%Q/Q (but were still up 3.3%Y/Y) as average per-visitor spending fell for the second consecutive quarter. Elsewhere, both public consumption and public investment were essentially unchanged in Q1, so that annual growth in all public spending slowed to 0.5%Y/Y from 0.7%Y/Y previously.

Residential investment and business capex drag

There were several sources of weakness in expenditure in Q1. As subdued housing starts suggested, residential investment fell 2.1%Q/Q to be down a whopping 5.7%Y/Y. More surprising was a 0.1%Q/Q decrease in private non-residential investment, marking the first drop since Q316 and lowering its annual growth rate by 1.2ppts to 2.4%Y/Y. This estimate should be interpreted with some caution ahead of the release of the MoF's corporate survey. But it meant that, for now, domestic demand declined 0.2%Q/Q in Q1. And while its annual growth rate still stands at 0.7%Y/Y, there has been no advance since Q217. Meanwhile, private inventories are presently estimated to have made a 0.1ppt negative contribution to growth in Q1. As a result, private domestic demand fell 0.3%Q/Q in Q1, reversing the growth that had been achieved in Q4.

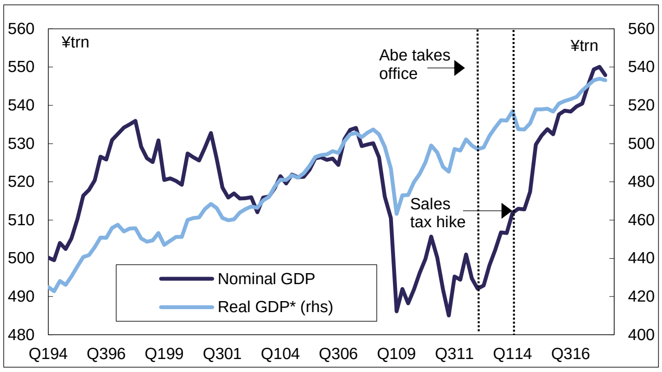
Moderate expansion to continue

Looking ahead, it seems reasonable to think that a relatively robust global economy, upbeat domestic confidence indicators – even if off their recent highs in most cases – rising wages and elevated profitability will allow GDP to resume its prior uptrend in Q2, especially as poor weather was one factor weighing on growth in Q1. However, with growth in economic activity likely to be held back supply-side constraints, particularly by very tight conditions in the labour market, we expect full-year growth to be closer to 1%Y/Y in FY18 – only modestly above the BoJ's estimate of trend – than the BoJ's recent forecast of 1.4%Y/Y.

Machinery orders fall back in March

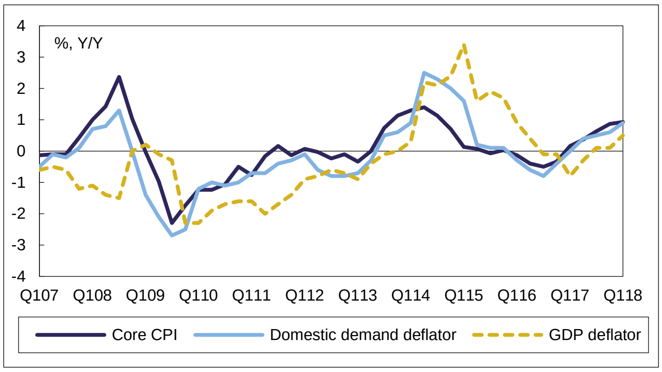
One area for continued optimism is business investment, even though machinery orders in March missed expectations with the

GDP levels



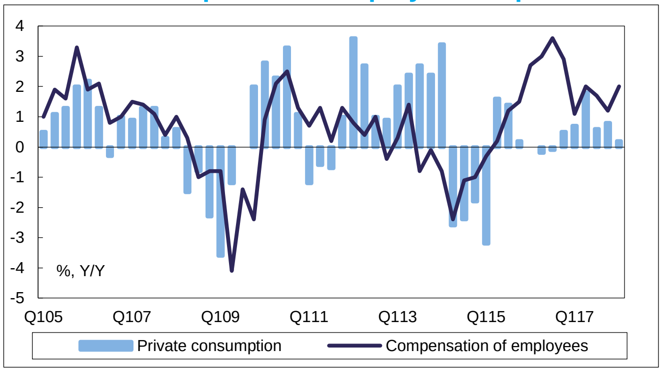
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Core CPI and national accounts deflators



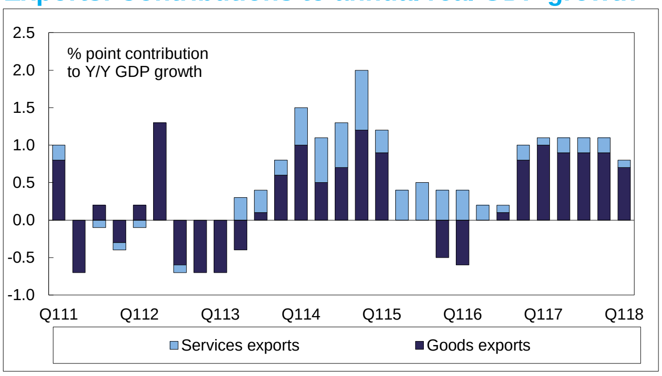
Source: MIC, Cabinet Office and Daiwa Capital Markets Europe Ltd.

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.

core series suffering slightly greater payback from the gains seen in over the prior two months. Core private orders – which exclude ships and other volatile items – fell 3.9%M/M in March and were down 2.4%Y/Y. In the detail, orders by manufacturers plunged 17.5%M/M, more than reversing the 8.0%M/M rise in February, and so were up just 1.5%Y/Y. By contrast core orders by non-manufacturers rose 2.2%M/M in March but were still down 4.9%Y/Y. Foreign orders fell 7.2%M/M – similar to the decline reported in February – but were still up 5.7%Y/Y.

Firms' forecast for Q2 very positive, however

Despite the decline in March, core private machinery orders still grew 3.3%Q/Q in Q1 (and 2.9%Y/Y). This compares favourably with the modest 0.6%Q/Q growth that had been forecast by firms three months earlier. Moreover, the Cabinet Office's new survey reveals that firms expect core orders to rise by a substantial 7.1%Q/Q in Q2. While the quarterly correlation between machinery orders and realised investment is not especially close, this outcome still bodes well for a continuation of the trend growth in business capex that has been a feature of the past year or so, notwithstanding the soft initial estimate for Q1 (which, as noted, could yet be revised higher).

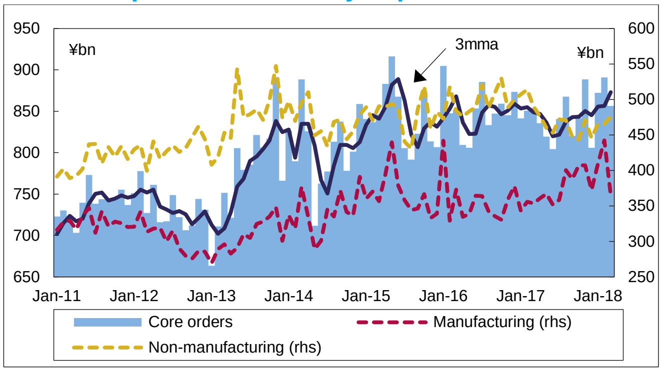
Falling fresh food prices weigh on CPI in April

Another disappointing report to confront the BoJ this week was the national CPI. In keeping with what had been signalled by the advance Tokyo CPI, both headline and core consumer price inflation fell in April. The headline index fell a seasonally-adjusted 0.4%M/M for a second consecutive month, lowering the annual inflation rate by 0.5ppt to 0.6%Y/Y – 0.1ppt below market expectations. As in March, the headline decline was largely driven by prices of fresh food, which fell an unadjusted 6.7%M/M and are now down 1.5%Y/Y.

Core CPI inflation also softens in April

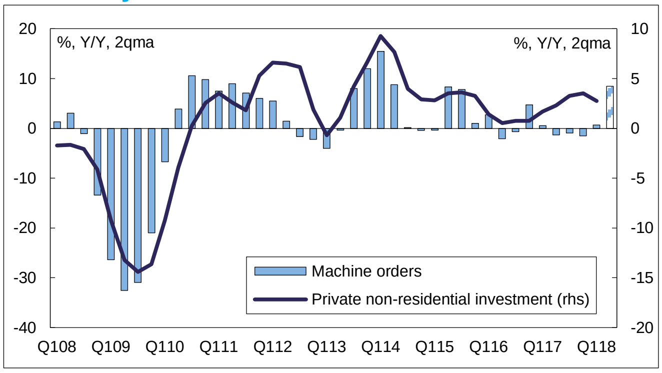
Sadly, lower food prices do not provide the full explanation for the softening in inflation. Excluding fresh food, the CPI still fell 0.1%M/M for a second consecutive month. So, the annual rate of core inflation on this measure – as forecast by the BoJ in its quarterly Outlook Report – fell 0.2ppt to 0.7%Y/Y. The BoJ's preferred measure, which excludes both fresh food and energy prices, also fell 0.1%M/M in April, lowering annual inflation by 0.1ppt to 0.4%Y/Y. And the core measure that strips out prices of all food items and energy (as watched closely in other major economies) also suffered a second consecutive 0.1%M/M decline, so annual inflation on this measure fell 0.2ppt to a mere 0.1%Y/Y. Annual energy price inflation eased to 5.3%Y/Y, while prices for non-energy industrial goods fell 0.2ppt to just 0.2%Y/Y. Prices in the service sector rose 0.3%Y/Y, thus returning to February's recent 'high', but nowhere near the level required if the BoJ is to meet its inflation target. Indeed, service sector inflation will very likely need to exceed 2%Y/Y since global competition and productivity growth will continue to constrain inflation in the goods sector.

Domestic private machinery exports



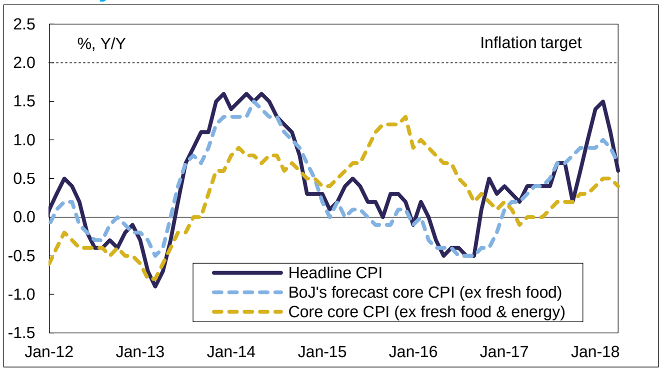
Source: Cabinet Office, MoF and Daiwa Capital Markets Europe Ltd.

Machinery orders and business investment*



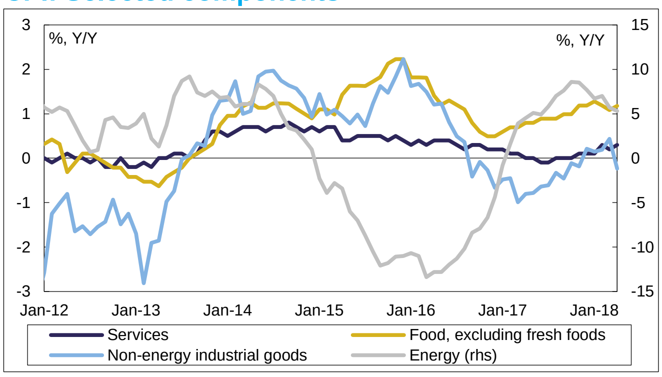
**Last bar includes firms' forecast for core orders in Q2.*
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

CPI: Key indices



Source: MIC, Thomson-Reuters and Daiwa Capital Markets Europe Ltd.

CPI: Selected components



Source: MIC, Thomson-Reuters and Daiwa Capital Markets Europe Ltd.

The week ahead in Japan and the US

The coming week's Japanese economic diary is somewhat sparsely populated. The data flow kicks off on Monday with the release of the trade report for April, which will cast some light on whether net exports might become a more positive source of GDP growth in Q2. The preliminary data for the first twenty days of the month (export values up 10.0%Y/Y), as well as the details of China's April trade report, suggest that Japan's annual export growth should have picked up somewhat during the month. However, the preliminary twenty-day data also suggested that import growth was faster still (up 12.7%Y/Y). On Wednesday, the final report of the Monthly Labour Survey for March will be of interest to see whether it confirms the unexpectedly positive labour income growth (total earnings up 2,1%Y/Y, regular earnings up 1.3%Y/Y) reported in the preliminary release. The same day, the flash manufacturing PMI for May will also be released alongside the All Industry Activity Index for March. The Reuters Tankan for May will be the sole release of note on Thursday. On Friday, the week's diary concludes with the advance Tokyo CPI for May which will provide some indication of whether the recent moderation of core inflation has been halted. In the bond market, the MoF will auction 20-year JGBs on Tuesday and enhanced liquidity (maturities of 5 to 15.5 years) on Thursday.

Turning to the US, a mixed bag of releases kicks off with the Richmond Fed's manufacturing survey on Tuesday followed by the flash May manufacturing and services PMI and April new home sales on Wednesday. More notably, Wednesday will also bring the minutes from the April FOMC meeting, perhaps casting some light on prospects for next month's meeting (although they will predate recent softer-than-expected wage and CPI reports). On Thursday, the April existing home sales report will be the main focus along with the usual weekly claims data. The week concludes with the advance durable goods orders report for April and final University of Michigan consumer survey outcome for May. As far as the former is concerned, lower aircraft sales will likely weigh on headline orders. Of greater interest will be core capex orders, which have broadly tracked sideways in recent months following a solid lift in Q317. In the bond market, the Treasury will auction 2-year notes on Tuesday, 2-year FRN's and 5-year notes on Wednesday and 7-year notes on Thursday.

Economic calendar

Key data releases – May/June

14	15	16	17	18
PPI Y/Y% MAR 2.1 APR 2.0	30Y JGB AUCTION TERTIARY ACTIVITY INDEX M/M% FEB 0.1 MAR -0.3	GDP Q/Q% Q4 0.1 Q1P -0.2 GDP DEFLATOR Y/Y% Q4 0.0 Q1P 0.5 INDUSTRIAL PRODUCTION M/M% FEB 2.0 MAR F 1.4 CAPACITY UTILISATION M/M% FEB 3.3 MAR 0.5	1Y TB AUCTION 5Y JGB AUCTION CORE MACHINE ORDERS Y/Y% FEB 2.4 MAR -2.4	3M TB AUCTION OVERSEAS VISITORS Y/Y% MAR 18.2 APR 12.5 NATIONAL CPI Y/Y% MAR APR 1.1 0.6 *EX FRESH FOOD* *0.9 0.7* *EX FRESH FOOD/ENERGY* *0.5 0.4*
21	**22**	**23**	**24**	**25**
GOODS TRADE BALANCE ¥TRN MAR 0.80 APR 0.44 EXPORTS Y/Y% MAR 2.1 APR 8.7 IMPORTS Y/Y% MAR -0.6 APR 9.8	20Y JGB AUCTION (APPROX ¥1.0TRN)	MANUFACTURING PMI APR 53.8 MAY N/A ALL INDUSTRY ACTIVITY M/M% FEB 0.4 MAR 0.1	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.6TRN) REUTERS TANKAN- LARGE MANUFACTURERS DI APR 21 MAY N/A LARGE NON-MANUFACTURERS DI APR 36 MAY N/A	3M TB AUCTION (APPROX ¥0.44TRN) TOKYO CPI Y/Y% APR MAY 0.5 0.5 *EX FRESH FOOD* *0.6 0.6* *EX FRESH FOOD/ENERGY* *0.3 0.3*
28	**29**	**30**	**31**	**01**
SERVICES PPI (APR)	40Y JGB AUCTION UNEMPLOYMENT RATE (APR) JOB-TO-APPLICANT RATIO (APR)	RETAIL SALES (APR) CONSUMER CONFIDENCE (MAY)	2Y JGB AUCTION INDUSTRIAL PRODUCTION (APR P) VEHICLE PRODUCTION (APR) HOUSING STARTS (APR) CONSTRUCTION ORDERS (APR)	CAPITAL SPENDING (Q1) MANUFACTURING PMI (MAY F) VEHICLE SALES (MAY)
04	**05**	**06**	**07**	**08**
	10Y JGB AUCTION HOUSEHOLD SPENDING (APR) SERVICES PMI (MAY) COMPOSITE PMI (MAY)	AVERAGE WAGES (APR)	6M TB AUCTION BOJ CONSUMPTION ACTIVITY INDEX (APR)	3M TB AUCTION CURRENT ACCOUNT BALANCE (APR) GOODS TRADE BALANCE (APR) GDP (Q1 F) GDP DEFLATOR (Q1 F) BANK LENDING (MAY) ECONOMY WATCHERS SURVEY (MAY)

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

Economic Research

Key contacts

London		
Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Associate Economist	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Jodene Adjei*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Olivia Xia*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

DAIR <GO>

All of the research published by the London and New York research teams is available on our Bloomberg page at DAIR <GO>. If you are unable to access the research on this page, please contact Jodene Adjei on +44 207 597 8332.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope