

Yen 4Sight

- As expected the BoJ left its policy settings unchanged. And while it acknowledged the recent softening of core inflation, it still expects to achieve 2% inflation, albeit at an unspecified date.
- Consumer spending and machinery orders rose strongly in April and manufacturing shipments posted a solid gain too.
- The MoF/Cabinet Office survey pointed to slight weakening of business conditions but firms were upbeat about H218.
- The focus in the coming week will be May trade and CPI reports.

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Interest and exchange rate forecasts

End period	15 Jun	Q218	Q318	Q418
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.04	0.05	0.07	0.07
JPY/USD	110	107	104	108
JPY/EUR	128	129	125	133

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

BoJ policy settings unchanged

Déjà vu. There were no major surprises from the BoJ's latest policy meeting. Predictably, the Board made no changes to its key policy parameters i.e. the -0.1% interest rate on banks' excess reserves and target of around zero per cent for 10-year JGB yields. And perhaps not surprisingly in light of recent disappointing data and ongoing worries about global trade tensions, the BoJ retained its stated JGB, ETF and REIT purchase targets at ¥80trn, ¥6trn and ¥90bn respectively. That said, based on the pace seen over the first five months of the year, the BoJ's JGB net purchases will amount to little more than ¥50trn this year (the BoJ reduced its purchases of 3- to 5-year JGBs by ¥30bn at the latest operation in the past week).

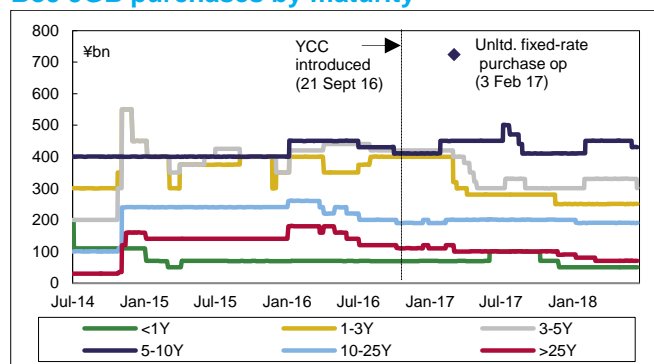
BoJ still expects to hit 2% target at some point

In its description of the economy the BoJ remained constructive on GDP growth, continuing to hold to the view that a "virtuous cycle from income to spending" is facilitating a continued moderate expansion. While noting downside risks related to the impact of US policy on global markets, the Bank maintained a positive assessment of external demand. And domestically, the BoJ views consumer spending and business capex to be still on an increasing trend. Looking ahead, supported by accommodative financial conditions, the Bank expects the economy to continue its moderate expansion. So while the Bank acknowledged that core CPI inflation is in a "0.5-1.0%" range at present – rather than "around 1%" as described at the previous meeting – the Bank maintained its judgement that core inflation will continue on an uptrend and increase toward 2% (Kataoka again registering a dissent against that forecast). In keeping with the April Outlook Report, the Bank was not brave enough to forecast a date at which the inflation target might be achieved.

Consumer spending solid in April

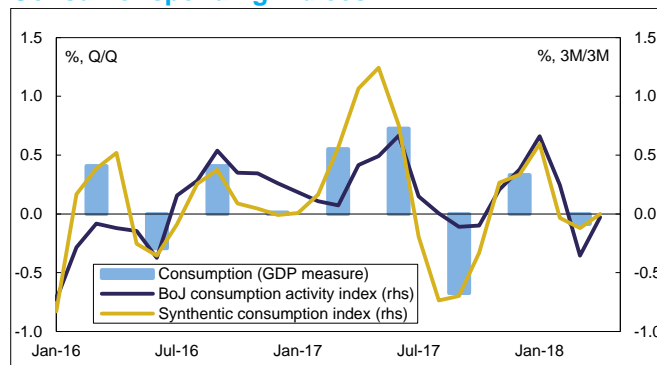
Data-wise, the past week saw more evidence that the economy picked up pace in April. The Cabinet Office Synthetic Consumption Index – which, of all indicators, is the one with the best correlation with the national accounts measure of private consumption – pointed to a 1.0%M/M lift in spending in April. And while still down 0.2%Y/Y, it stood 0.8% above the average reading during Q1. This clearly provides a good base for a return to positive growth in Q2, even if some payback likely occurred in May. A similarly positive assessment of the broader service sector was provided by the Tertiary Industry Activity Index, which also rose 1.0%M/M in April. This outcome was above market expectations and lifted the index to a level

BoJ JGB purchases by maturity



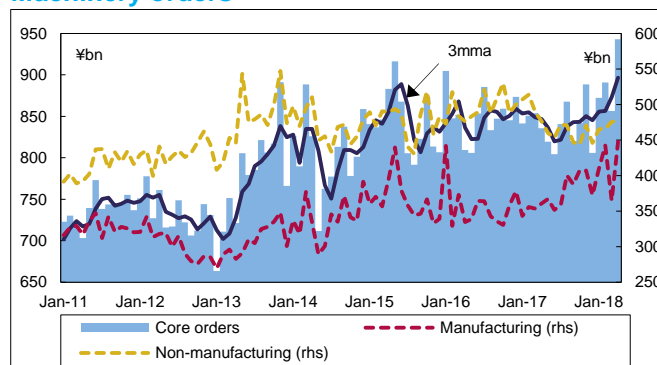
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Consumer spending indices



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Machinery orders



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.



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0.9% above the Q1 average – again boding well for a return to positive GDP growth in Q2.

Machinery orders add to sign of April lift

Early in the week the Cabinet Office machinery orders report added to the list of improved economic indicators. Following a weak March outturn, the April reading was very encouraging – a result that had, in fact, been signaled by the previous month's survey of firms, but which markets had understandably discounted as being perhaps a bit too optimistic. Total machinery orders rose 12.6M/M in April, more than reversing the 7.9M/M decline reported in March, and so were up 9.7%Y/Y. Importantly, thanks to a sharp lift in orders in the manufacturing sector, core private orders – which exclude ships and other volatile categories – increased a very substantial 10.1M/M and were up 9.6%Y/Y.

Capex orders likely to be up solidly in Q2

This strong outcome left the level of core orders in April 8.0% above the Q1 average. The Cabinet Office's survey of firms had indicated that firms expect core orders to rise 7.1%Q/Q in Q2. On the face of it, the April report suggests that orders are on track to post an outcome in the vicinity of that forecast, even though it would not be surprising to see some negative payback in May. With the economy operating at a high rate of capacity utilisation, including an exceptionally tight labour market, the environment remains conducive to a continued uptrend in business capex provided that overall demand conditions in the global economy remain favourable.

IP growth revised up slightly in April

Other data consistent with a return to positive economic growth in Q2 were the final industrial production figures for April. Growth in output was revised up a modest 0.2ppt to 0.5%M/M, while the annual rate revised up by 0.1ppt to 2.6%Y/Y. Even so, the slightly firmer April base means that even if output was to decline 1.3%M/M in May – as indicated by METI's reading of the forecast provided by firms – an increase in production of close to 1.0%Q/Q – almost fully reversing the dip in the sector in Q1 – remains likely in Q2.

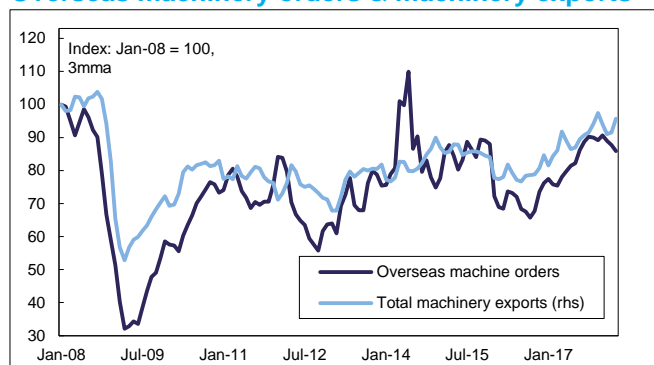
Inventories fall, capacity use at four-year high

Elsewhere in the final IP report, growth in shipments was revised down 0.2ppt to 1.6%M/M in April, while firms' inventories were estimated to have declined 0.6%M/M. As a result, the inventory-shipments ratio declined 2.8%M/M in April, reversing a 2.7%M/M increase in March – a development that reduces risks to future output. Meanwhile, the operating rate index – published for the first time – rose 1.8%M/M in April and was up 0.7%Y/Y to its highest level since January 2014, explaining why manufacturers continue to forecast strong growth in capex.

MoF survey suggests weaker business conditions

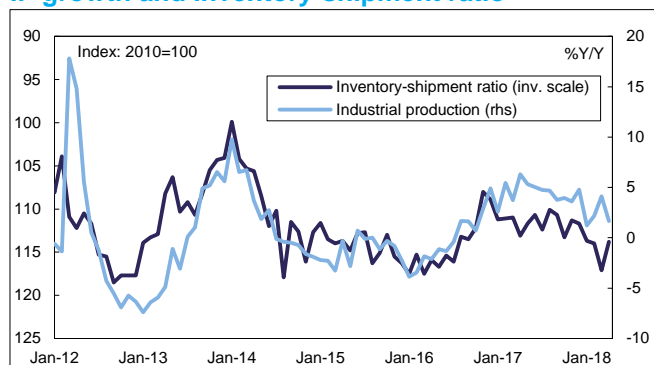
In this respect, the past week's MoF/Cabinet Office Business Outlook Survey cast some further light on the expectations of the business sector in advance of next month's more comprehensive BoJ Tankan survey. In keeping with the recent Economy Watcher indices and PMIs, the MoF/Cabinet Office survey suggested that firms perceive that business conditions

Overseas machinery orders & machinery exports



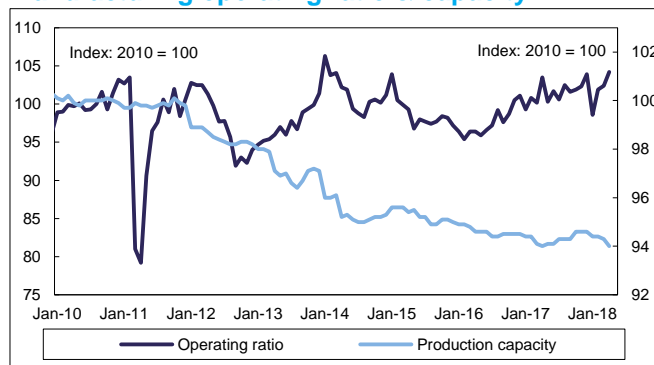
Source: MoF, Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

IP growth and inventory-shipment ratio



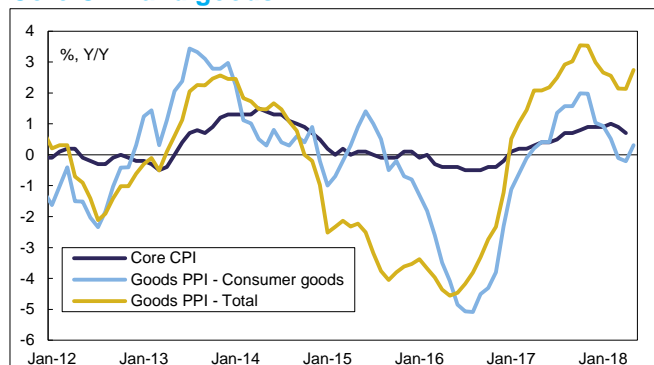
Source: METI and Daiwa Capital Markets Europe Ltd

Manufacturing operating ratio & capacity



Source: METI and Daiwa Capital Markets Europe Ltd

Core CPI* and goods PPI



*Core CPI excluding fresh food prices and consumption tax. Source: BoJ and Daiwa Capital Markets Europe Ltd.

have deteriorated somewhat in recent months. For example, amongst large firms, a net 2.0% of respondents reported a deterioration in overall business conditions in Q2 – the first worsening reported since Q217. This outcome occurred despite a net 7.2% of firms reporting an improvement in domestic economic conditions, indicating that concerns about factors outside Japan are weighing on sentiment (developments in US trade policy and European political uncertainty amongst the most likely candidates).

Firms more optimistic about H218, however

The good news is that large firms are much more optimistic about prospects over the remainder of this year, with a net 6.9% of respondents forecasting an improvement in business conditions in Q3 and a further 7.9% expecting an improvement in business conditions in Q4 (firms operating in the manufacturing sector were slightly more optimistic than those in the non-manufacturing sector). On balance, firms expect domestic conditions to continue to improve across both quarters. Expectations amongst medium-sized firms were very similar to their larger counterparts, but, as usual, smaller firms were much less optimistic. As in other recent surveys, firms of all size and in both the manufacturing and non-manufacturing sectors signaled that they have insufficient staff for their needs.

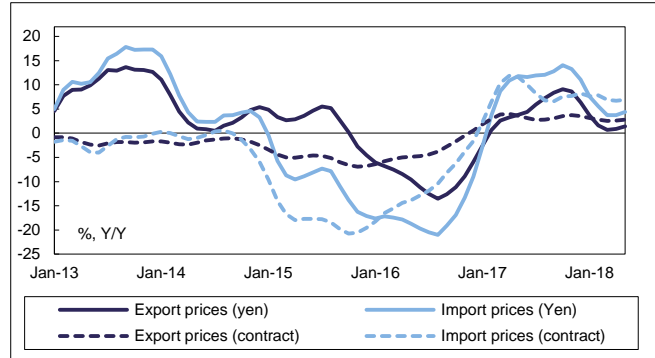
MoF capex forecasts revised higher

Elsewhere in the survey, firms forecast sales to grow 2.1%Y/Y in FY18 (led by 3.0%Y/Y growth among manufacturers), up from a forecast of 1.5%Y/Y previously. Ordinary profits are expected to fall 1.5%Y/Y in FY18, slightly more pessimistic than the previous forecast. This largely reflects a forecast 3.1%Y/Y decline in profits in manufacturing, all of which is expected to take place in the first half of the year. Even so, firms forecast that spending on plant and machinery and software will rise 5.4%Y/Y in FY18, a slightly more upbeat outlook than made at the comparable time in each of the past two years. Spending amongst manufacturers is forecast to rise 15.1%Y/Y (a forecast that seems to have received some early support from the aforementioned lift in April machinery orders) but non-manufacturer capex is forecast to be little changed.

Goods PPI picks up in May

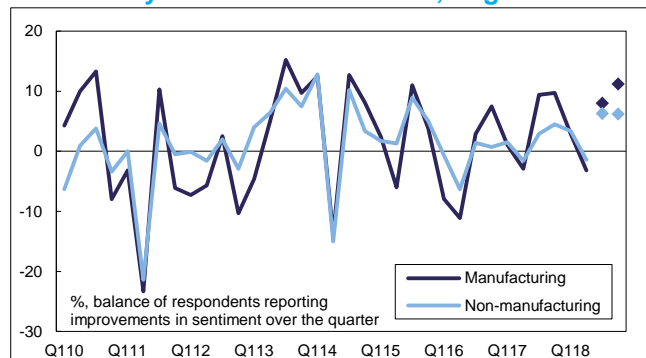
Finally, ahead of the coming week's CPI report, the May producer goods price data gave an update on pipeline inflation pressures. There was some better news for the BoJ as goods PPI rose a larger-than-expected 0.6%M/M, pushing the annual rate of producer goods inflation up 0.6ppt to a four-month high of 2.7%Y/Y. Within the detail, a 4.3%M/M increase in the price of petroleum was a key driver, while chemicals and non-ferrous metals prices rose 1.1%M/M apiece. A slightly weaker currency and increased prices for petroleum and metals saw annual inflation of imported goods in yen terms rise 1.5ppts to a six-month high of 6.5%Y/Y. But that was still well down on last year's peak of 15.6%Y/Y reached in October. Indeed, prices of imported consumer goods were down 1.0%Y/Y having been unchanged on an annual basis the previous month. More encouragingly, domestic consumer goods inflation leapt 0.9ppt to 0.7%Y/Y, pushing overall consumer goods PPI up 0.4ppt, albeit merely to 0.3%Y/Y, still well below last autumn's peak of 2.0%Y/Y and hardly suggestive of a meaningful new impulse to CPI.

Export and import producer goods inflation



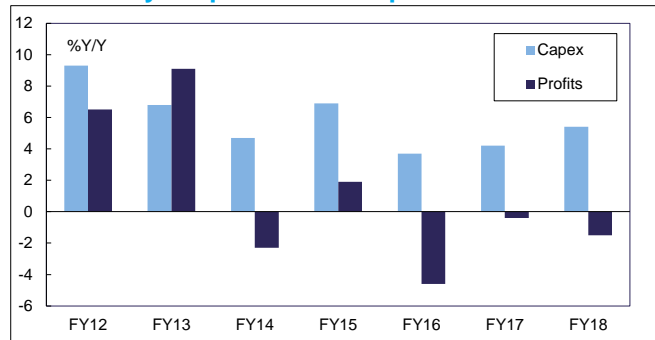
Source: BoJ and Daiwa Capital Markets Europe Ltd.

MoF survey: Business conditions, large firms



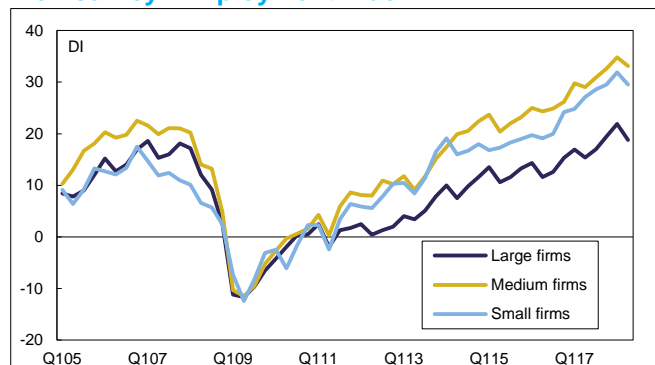
Diamonds represent the survey outlook indices for Q318 and Q418.
 Source: MoF, Cabinet Office and Daiwa Capital Markets Europe Ltd

MoF survey: Capex & current profit forecasts*



*Figures are from Q2 survey each year, Capex is software and plant & equipment, Source: MoF/Cabinet Office and Daiwa Capital Markets Europe Ltd.

MoF survey: Employment index



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

The week ahead in Japan and the US

The coming week's Japanese economic diary is relatively sparsely populated. The diary kicks off on Monday with the release of the trade balance for May. According to provisional data for the first twenty days of the month, export values rose 5.9%Y/Y, but import growth was stronger at 8.1%Y/Y. The only other important economic release in the coming week is the May CPI report, due on Friday. In light of the advance data from the Tokyo area, key measures of annual core inflation seem likely to remain down on the highs reached in the first quarter, with risks of a further move lower. The preliminary manufacturing PMI for June and the All Industry Index for April will also be released on Friday. Meanwhile, BoJ Governor Kuroda, together with ECB President Draghi, Fed Chair Powell and RBA Governor Lowe, will participate on a 'Policy Panel' on Wednesday at the ECB's Sintra Forum. In the bond market, the MoF will auction 30-year JGBs on Tuesday and 5-year JGBs on Thursday.

Turning to the US, the focus in the early part of the week will be on the housing market, beginning with the June NAHB housing index on Monday and May housing starts and permits on Tuesday. The existing home sales report for May follows on Wednesday. On Thursday the Philadelphia Fed will publish its manufacturing survey for June and the Conference Board's leading index for May will also be released. A relatively quiet week for US data concludes on Friday with the flash Markit manufacturing and service sector PMIs for June, which generally attract much less market attention than their European counterparts. In the bond market the US Treasury will auction 30-year TIPS on Thursday.

Economic calendar

Key data releases – June/July

11	12	13	14	15
M3 MONEY SUPPLY Y/Y% APR 2.8 MAY 2.7 CORE MACHINE ORDERS Y/Y% MAR -2.4 APR 9.6	AUCTION FOR ENHANCED LIQUIDITY MOF'S BUSINESS SENTIMENT SURVEY – ALL INDUSTRY Q/Q% Q1 3.3 Q2 -2.0 GOODS PPI Y/Y% APR 2.0 MAY 2.7 TERTIARY ACTIVITY INDEX M/M% MAR -0.3 APR 1.0		3M TB AUCTION INDUSTRIAL PRODUCTION Y/Y% MAR 2.5 APR F 2.6 CAPACITY UTILISATION M/M% MAR 0.5 APR 1.8 BOJ POLICY BOARD MEETING (14 – 15 JUNE)	BOJ MONETARY POLICY ANNOUNCEMENT
18	19	20	21	22
GOODS TRADE BALANCE ¥BN APR 625 MAY -205 EXPORTS Y/Y% APR 7.8 MAY 7.5 IMPORTS Y/Y% APR 5.9 MAY 8.0	12M TB AUCTION (APPROX ¥2.1TRN) 30Y JGB AUCTION (APPROX ¥0.7TRN)	REUTERS TANKAN LARGE MANUFACTURERS DI MAY 22 JUN N/A LARGE NON-MANUFACTURERS DI MAY 39 JUN N/A OVERSEAS VISITORS BOJ MINUTES OF THE MONETARY POLICY MEETING (HELD ON 26-27 APRIL)	5Y JGB AUCTION (APPROX ¥2.0TRN) MACHINE TOOL ORDERS Y/Y% APR 22.8 MAY 14.9	3M TB AUCTION (APPROX ¥4.4TRN) NATIONAL CPI Y/Y% APR 0.6 MAY 0.6 MANUFACTURING PMI MAY 52.8 JUN P N/A ALL INDUSTRY ACTIVITY M/M% MAR 0.0 APR 0.9
25	26	27	28	29
BOJ SUMMARY OF OPINIONS (FROM THE POLICY MEETING HELD ON 14-15 JUNE)	20Y JGB AUCTION SERVICES PPI (MAY)	FLOW OF FUNDS (Q1)	2Y JGB AUCTION RETAIL SALES (MAY) DEPARTMENT STORE SALES (MAY)	3M TB AUCTION JOB-TO-APPLICANT RATION (MAY) UNEMPLOYMENT RATE (MAY) TOKYO CPI (JUN) INDUSTRIAL PRODUCTION (MAY) CONSTRUCTION ORDERS (MAY) HOUSING STARTS (MAY) CONSUMER CONFIDENCE (JUN)
2	3	4	5	6
MANUFACTURING PMI (JUN F) VEHICLE SALES (JUN)	10Y JGB AUCTION MONETARY BASE (JUN) BOJ TANKAN INFLATION OUTLOOK OF ENTERPRISES		30Y JGB AUCTION	3M TB AUCTION HOUSEHOLD SPENDING (MAY) AVERAGE WAGES (MAY) LEADING INDEX (MAY P) COINCIDENT INDEX (MAY P) BOJ CONSUMPTION ACTIVITY INDEX

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

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