Yen 4Sight

Highlights

- As expected Shinzo Abe was elected to lead the LDP for an historic third term, ensuring the continuation of Abenomics.
- The BoJ made no changes to either its policy settings or its description of the economy.
- Net exports are likely to make a negative contribution to GDP growth in Q3. Core CPI inflation nudged higher in August.
- The key day in the coming week is Friday, which features the latest IP, construction, labour market and Tokyo CPI reports.

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Interest and exchange rate forecasts

End period	21 Sep	Q418	Q119	Q219
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.13	0.12	0.12	0.12
JPY/USD	113	114	114	114
JPY/EUR	133	128	128	128

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

A positive week for Japanese markets

The past holiday-shortened week was a positive one for Japanese markets, e.g. with the Topix rallying 4%. Rather than any news that emanated from Japan, that, however, had more to do with the general risk rally seen across global markets, higher UST yields and a weaker yen. Indeed, the local news featured few surprises, with PM Abe re-elected to lead the LDP, the BoJ leaving policy settings steady, and most key local economic data printing close to market expectations.

Abe re-elected to lead LDP for historic 3rd term

The main event was the LDP election, which gave Shinzo Abe an unprecedented third three-year term at the head of the ruling party. Facing a challenge from Shigeru Ishiba – formerly Minister of Defence, Secretary General of the LDP, and Minister for Regional Revitalisation – Abe won 224 of the 405 votes from party members, as well as 329 of the 402 votes cast by LDP Diet members (which, notably, did not include that of the popular Shinjiro Koizumi). As a result, he won a decisive 68% of the total votes available. So, the path is clear for Abe to remain as Prime Minister through to 2021 and, by extension, to become Japan's longest-serving leader.

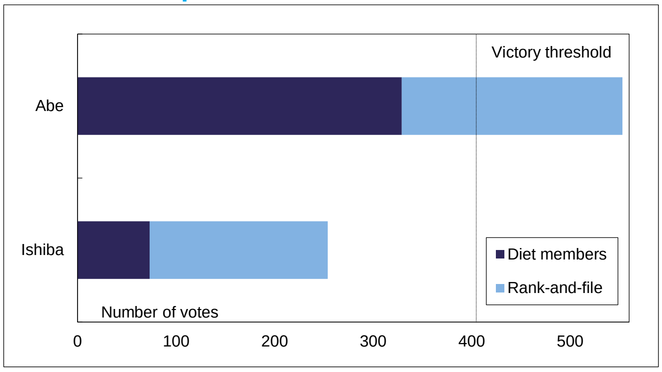
A full calendar will constrain Abe's policy options

By winning a majority of votes from rank-and-file members – something that couldn't be taken for granted a few weeks ago – the win should have helped somewhat to replenish Abe's authority, which had eroded over past quarters as scandals took their toll. But, starting shortly with a cabinet reshuffle, Abe will now have to repay key ministers and faction leaders upon whose support his campaign relied for success. And scope for assertive (or controversial) policy will be constrained by an eventful calendar that includes prefectural and municipal elections (April), the imperial abdication and succession (Golden Week), the G20 summit (June) and a Diet upper house election (July). So, although Abe continued to call for swift Constitutional revision during his leadership campaign, he is unlikely to push forcefully – indeed, first he'll need to achieve consensus within the LDP on this issue. And while he is likely to continue with incremental Abenomics reforms, advocate extra public spending to respond to recent natural disasters, and boost the defence budget, only with a highly adverse shock would the consumption tax hike in October 2019 be postponed.

BoJ makes no change to policy settings

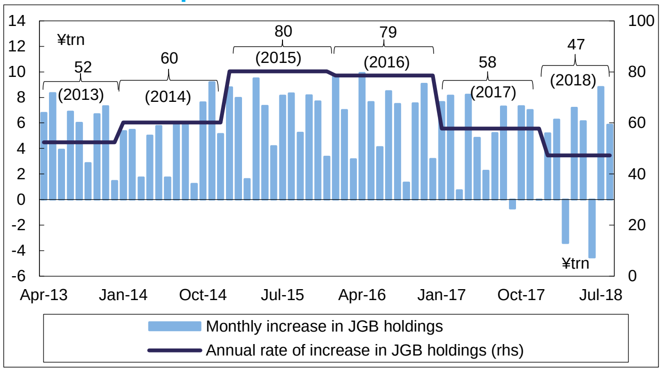
Turning to monetary policy, as widely expected, the BoJ's latest

LDP leadership election result



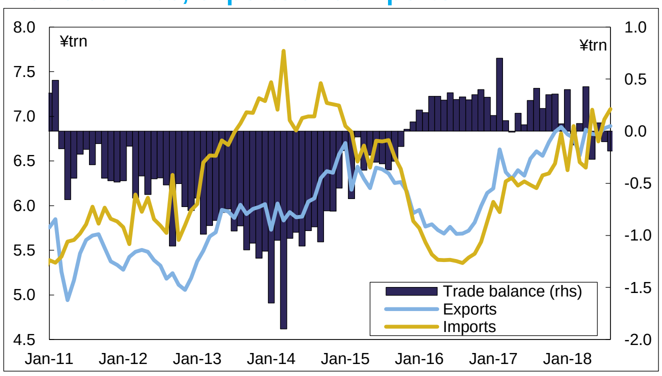
Source: NHK and Daiwa Capital Markets Europe Ltd.

BoJ: JGB net purchases



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Trade balance, exports and imports*



*Seasonally adjusted data in values. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Board meeting made no changes to its key 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'. Having last month made tweaks to how policy is applied – a reduction in the amount of bank excess reserves subject to the negative rate, a commitment to conduct JGB purchases "in a flexible manner", willingness to allow a wider range of 10Y yield movement (+/-20bps), and new forward guidance committing to maintain low interest rates "for an extended period" – there was no further fine-tuning. As regards asset purchases, the Board re-committed to increase the BoJ's ETF and J-REIT holdings at annual rates of ¥6trn and ¥90bn respectively. And it again characterised the expected annual increase in its JGB holdings as being "about ¥80trn" even though net purchases are running at a pace less than ¥50trn this year. Indeed, in his press conference, Kuroda insisted that the BoJ wouldn't be following the global trend for monetary tightening. Nevertheless, on Friday, the BoJ scaled back its purchases of >25Y JGBs at the latest operation by ¥10bn to ¥50bn, which saw 30Y+ yields rise about 4bps to 0.9% for the first time since July 2017.

BoJ economic assessment also unchanged

Ahead of the release of the Tankan on 1 October, the Board was unwilling to make significant amendments to its economic outlook. According to the BoJ, the economy is still "expanding moderately". And the Bank expects moderate expansion to continue, as domestic demand remains underpinned by accommodative monetary policy and government spending, and exports remain supported by "firm growth" in trading partner economies. As regards prices, the Board – with the exception of Kataoka – continues to believe that inflation will rise gradually to 2% thanks to a sustained positive output gap and an expected increase in medium- to long-term inflation expectations. The list of risks to the outlook was familiar, and included uncertainties related to US macroeconomic policies, protectionism, Brexit, and developments in EM and commodity-exporting countries. But in his press conference, Kuroda stated that the BoJ would watch also for any negative economic impacts of recent natural disasters, noting in particular concerns about the effects on the tourism industry.

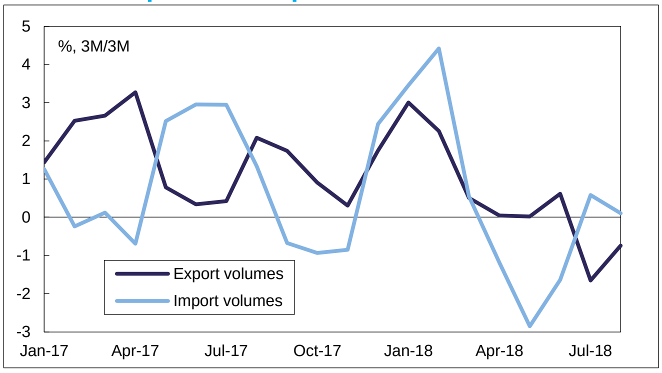
Another small trade deficit in August

The past week's economic data suggested no need for the BoJ to revise its view, even if they were a mixed bag. Indeed, the August trade report was disappointing: after adjusting for seasonal factors, the MoF reported a trade deficit of ¥190.4bn in August – the third deficit in the past four months – following a slightly upwardly-revised deficit of ¥102.3bn in July. Export values rose 0.4%M/M and 6.6%Y/Y in August, but were outpaced by a 1.6%M/M, 15.4%Y/Y jump in imports. As last month, a significant driver of the surge in import values was mineral fuels (now up 46.5%Y/Y), largely due to higher prices. But growth in imports of general machinery almost doubled to 13.0%Y/Y with imports of transport equipment up a strong 24.2%Y/Y driven by a jump in imports of aircraft.

GDP shaping up for a softer Q3

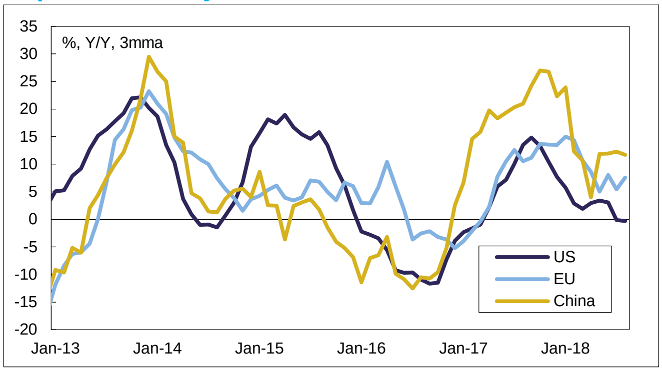
As usual a better guide to the real trend was provided by the BoJ's goods export and import volume figures. The BoJ estimates that real exports rose 2.1%M/M in August. But that left the average level over July and August 0.4% below the

BoJ real export and import volumes



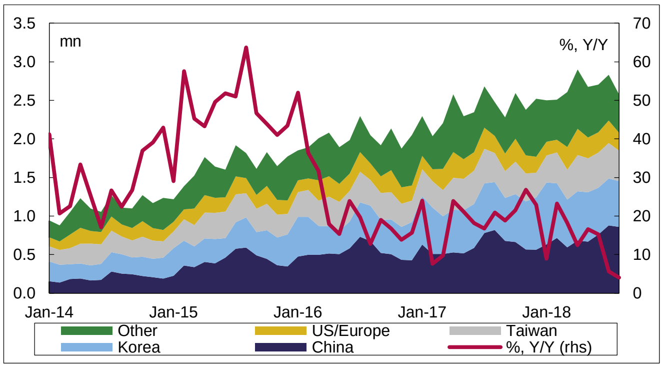
Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export values by destination



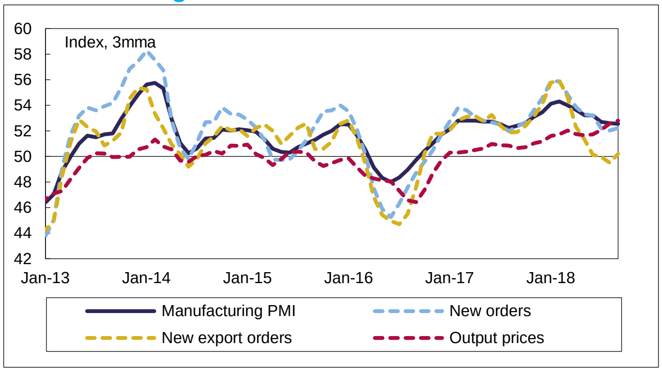
Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Vistor arrivals



Source: JNTO and Daiwa Capital Markets Europe Ltd.

Manufacturing PMIs



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

monthly average in Q2. On the same basis, real imports rose 1.2%M/M in August, taking the average for July and August 2.0% above the Q2 average. This suggests that net goods exports will make a negative contribution to GDP growth in Q3. Meanwhile, in terms of services exports, 12-month tourism arrivals topped 31m for the first time in August. But the growth rate has slowed significantly over recent months, dropping to 4.1%Y/Y from an average annual rate above 15%Y/Y in the first half of the year reflecting slower growth in visitors from China and Taiwan and a drop in numbers from South Korea. Add to that evidence of a soft start to the quarter for consumption, and there is a strong likelihood of payback from the well-above-trend economic GDP growth reported in Q2.

Manufacturing PMI improves further in September

Turning to the factory sector, however, the flash manufacturing PMI for September pointed to a further modest improvement in business conditions with the headline index up 0.4pt to 52.9, just below where it stood in June. In the detail, the output (52.8) and employment (51.3) PMIs fell back a little. But, encouragingly, the new orders index rose to a five-month high of 53.4 and the new export orders index rose more than 1pt to a healthy six-month high of 50.9. The pricing PMIs were mixed with the input prices index up 0.3pt to 61.5 but the output prices index down 0.1pt to 52.8 – the latter nonetheless still the second highest reading this decade.

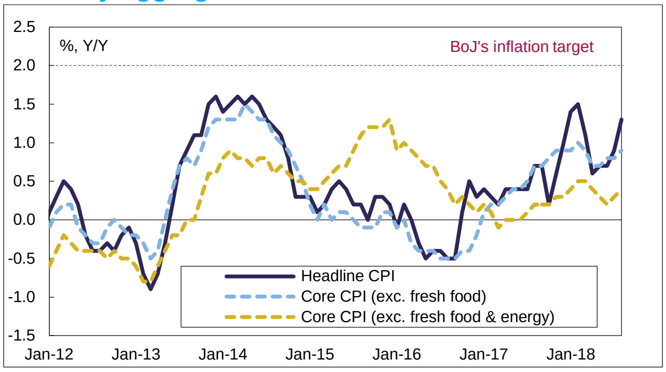
CPI inflation leaps in August

In terms of hard inflation data, however, the headline CPI rate leapt in August. Due to a further rise in fresh food prices (now up 8.7%Y/Y) due to inclement weather, annual CPI inflation rose a greater-than-expected 0.4ppt to a six-month high of 1.3%Y/Y. The core inflation index forecast by the BoJ in its quarterly Outlook Report – which simply excludes fresh food prices from the CPI – rose 0.3%M/M, nudging the annual rate up 0.1ppt to a five-month high of 0.9%Y/Y. But the BoJ's recently preferred measure of core prices, which excludes fresh food and energy prices – the latter up 7.4%Y/Y – rose 0.2%M/M, causing annual inflation to tick up 0.1ppt to 0.4%Y/Y. The core measure that strips out prices of all food items and energy rose 0.2%M/M and just 0.2%Y/Y, following two months in which it had recorded no annual change in prices at all.

Some pick-up in inflation in the service sector

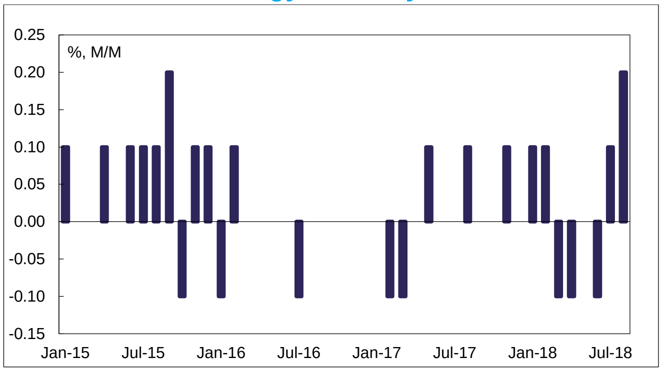
Elsewhere in the detail, prices of non-energy industrial goods fell 0.2%Y/Y. Better news was seen in the service sector where inflation rose 0.3ppt to 0.5%Y/Y – the fastest pace since November 2015. In part this was due to hotel charges – a volatile component – rising 10.2%Y/Y. But elsewhere, clothing services prices were up 1.6%Y/Y and the pace of price declines in the communications sector slowed to 1.9%Y/Y. Some of the slight strengthening in services inflation might be linked to the increase in wage growth over the past year. On that score, the final results of the Monthly Labour Survey for July saw growth in total labour cash earnings (per person) revised up 0.1ppt to a firm 1.6%Y/Y, although growth in contracted earnings was unrevised at a softer 1.1%Y/Y. Even so, services inflation would likely need to at least quadruple from its current pace if the BoJ is to come close to achieving its 2% target for inflation – a development that, in our opinion, still seems unlikely to occur in the foreseeable future.

CPI: Key aggregates



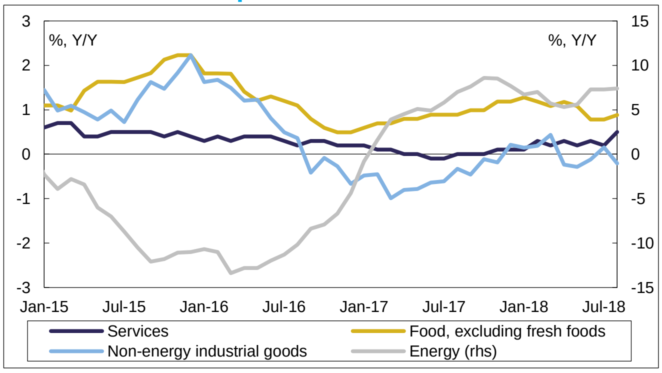
Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

CPI ex food and energy: monthly inflation



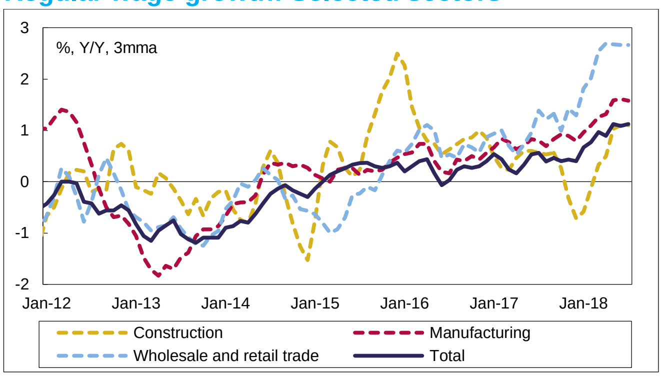
Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

CPI: Selected components



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

Regular wage growth: Selected sectors



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

The coming week in Japan and the US

The coming week's Japanese diary again gets off to a slow start, not least due to Monday's public holiday. The services PPI for August will be released on Tuesday, after which there are no major economic reports scheduled on either Wednesday or Thursday. However, BoJ Governor Kuroda is scheduled to give speeches in Osaka on Tuesday and Tokyo on Thursday. As is often the case, Friday brings a raft of important economic reports. As far as activity is concerned a key focus will be the August IP report, where we will be following developments in both production and inventories with interest. Also on Friday we will receive August readings on retail trade, housing starts and construction orders, as well as an update on the labour market. Meanwhile, the advance Tokyo CPI reading for September will provide an early read on whether the recent modest uplift in core inflation has been sustained. In the bond market the MoF will auction 40Y JGBs on Wednesday and 2YJGBs on Friday.

Turning to the US, the focus over the coming busy week will be on the two-day FOMC meeting that concludes on Wednesday. With a further 25bp rate hike viewed by the market as a done deal, the main focus for investors will be on the Fed's updated forecasts, and associated commentary, and what this implies for the likelihood of further policy action at future meetings. (The June median dot plot signalled two 25bps hikes by end-2018, a further three in 2019, and one more in 2020). On the data front we have more regional manufacturing surveys due early in the week. The Conference Board's latest consumer survey will be of some interest on Tuesday, while August new home sales are released on Wednesday. On Thursday we will receive a final reading on Q2 GDP growth, while advance trade, durable goods orders and inventory reports for August will cast some light on how GDP growth is shaping up in Q3. The durable goods orders report will also be of interest to see whether it verifies anecdotal stories – such as those in the Fed's Beige Book – which have pointed to some firms delaying investment decisions due to uncertainties about the global trading environment. On Friday further light on Q3 GDP growth will be cast by the personal spending and income report for August, while the latest development in the core PCE deflator will be analysed closely. The Chicago PMI and final University of Michigan consumer survey results for September complete a busy diary. In the bond market the US Treasury will auction 2Y notes on Monday, 5Y notes on Tuesday and 7Y notes on Thursday.

Economic calendar

Key data releases – September/October

17	18	19	20	21
NATIONAL HOLIDAY - RESPECT FOR THE AGED DAY	1Y TB AUCTION BOJ POLICY BOARD MEETING (18-19 SEPTEMBER)	TRADE BALANCE ¥BN JUL -102.3 AUG -190.4 OVERSEAS VISITORS MN JUL 2.8 AUG 2.6 BOJ POLICY BOARD ANNOUNCEMENT	20Y JGB AUCTION BOJ FLOW OF FUNDS (Q2)	3M TB AUCTION NATIONAL CPI Y/Y% JUL AUG 0.9 1.3 *EX FRESH FOOD* *0.8 0.9* *EX FRESH FOOD/ENERGY* *0.3 0.4* MANUFACTURING PMI AUG 52.5 SEP P 52.9 ALL INDUSTRY ACTIVITY INDEX M/M% JUN -0.9 JUL 0.0 DEPARTMENT STORE SALES Y/Y% JUL -6.1 AUG -0.2

24	25	26	27	28
	SERVICES PPI JUL 1.1 AUG 1.1 BOJ GOVERNOR KURODA SCHEDULED TO SPEAK IN OSAKA BOJ MINUTES (30-31 JULY MEETING)	40Y JGB AUCTION (APPROX ¥0.4 TRN)	TRADE – FIRST 10 DAYS OF MONTH EXPORTS Y/Y% AUG 11.1 SEP N/A IMPORTS Y/Y% AUG 15.5 SEP N/A BOJ GOVERNOR KURODA SCHEDULED TO SPEAK IN TOKYO	2Y JGB AUCTION (APPROX ¥2.1 TRN) 3M TB AUCTION (APPROX ¥4.3TRN) JOBLESS RATE % JUL 2.5 AUG 2.5 JOB-TO-APPLICANT RATIO JUL 1.63 AUG 1.63 TOKYO CPI Y/Y% AUG SEP 1.2 1.1 *EX FRESH FOOD* *0.9 0.9* *EX FRESH FOOD/ENERGY* *0.6 0.6* RETAIL SALES Y/Y% JUL 1.5 AUG 2.1 INDUSTRIAL PRODUCTION M/M% JUL -0.1 AUG P 1.5 CONSTRUCTION ORDERS Y/Y% JUL -9.3 AUG N/A HOUSING STARTS Y/Y% JUL -0.7 AUG 0.3

01	02	03	04	05
BOJ TANKAN (Q3) MANUFACTURING PMI (SEP F) VEHICLE SALES (SEP)	10Y JGB AUCTION CONSUMER CONFIDENCE (SEP) BOJ INFLATION EXPECTATIONS TANKAN (Q3) MONETARY BASE (SEP)	SERVICES PMI (SEP) COMPOSITE PMI (SEP) BOJ OUTPUT GAP & POTENTIAL GROWTH (Q2)	ENHANCING LIQUIDITY AUCTION	3M TB AUCTION HOUSEHOLD SPENDING (AUG) BOJ CONSUMPTION ACTIVITY INDEX (AUG) AVERAGE WAGES (AUG) BANKRUPTCIES (SEP) TRADE – FIRST 20 DAYS OF MONTH (SEP)

08	09	10	11	12
	6M TB AUCTION ECONOMY WATCHERS (SEP) CURRENT ACCOUNT (AUG)	MACHINE ORDERS (AUG)	30Y JGB AUCTION GOODS PPI (SEP) BANK LENDING (SEP)	3M TB AUCTION TERTIARY ACTIVITY (AUG) M3 MONEY SUPPLY (SEP)

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

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