

Yen 4Sight

Highlights

- Total machinery orders rose solidly in November, but the closely-watched series of core private orders was flat.
- Service sector activity appears to be tracking positively in Q4.
- Lower food and fuel prices weighed on CPI inflation in December, while other prices were flat overall.
- On Wednesday the BoJ will likely revise down its near-term growth and inflation forecast, but leave policy settings steady.

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Interest and exchange rate forecasts

End period	18 Jan	Q119	Q219	Q318
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.02	0.05	0.10	0.10
JPY/USD	109	108	110	108
JPY/EUR	124	122	126	123

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

A disappointing machine orders report

Ahead of the year's first BoJ Policy Board meeting, which concludes on Wednesday, the past week brought a handful of top-tier economic data, on activity and inflation, to set the tone. One focus was the November report for machinery orders, a useful leading indicator for business capex. After a strong rebound of 19.5%M/M in October, total machinery orders rose a further 8.3%M/M, so annual growth stood at a firm 5.6%Y/Y. But the detail of the report failed to pass muster, with the closely-watched series of core private orders – which excludes ships and other volatile categories – merely flat following a smaller-than-hoped 7.6%M/M rebound in October. So, core private orders were up just 0.8%Y/Y, down from growth of 4.5%Y/Y in October. Core orders by manufacturers fell 6.4%M/M and were unchanged from a year earlier while those in the non-manufacturing sector rose 2.5%M/M and 1.4%Y/Y. Despite concerns about global demand, foreign orders rose a strong 18.5%M/M in November to be up a strong 18.6%Y/Y.

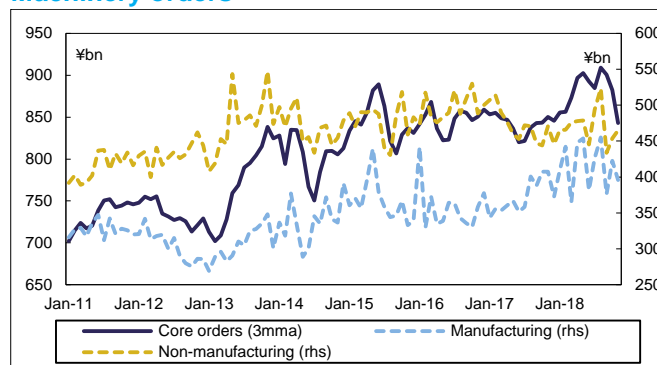
Total capex orders still tracking positive in Q4

Given the flat November, the average level of core private orders in the first two months of Q4 was some 4.2% below the Q3 average. That's a highly unfavourable comparison with the forecast of firms shown in the Cabinet Office survey published with the September data, which foresaw a strong 3.6%Q/Q increase in core private orders in Q4. It also seems at odds with the positive capex forecasts presented in the BoJ's last Tankan survey – spending which remains necessitated by widespread labour shortages and a high level of capacity utilisation. At least in the short term, perhaps some comfort can be taken from the fact that total machinery orders are tracking ahead of the 1.7%Q/Q growth that firms had forecast for Q4.

Industrial output also heading for strong Q4

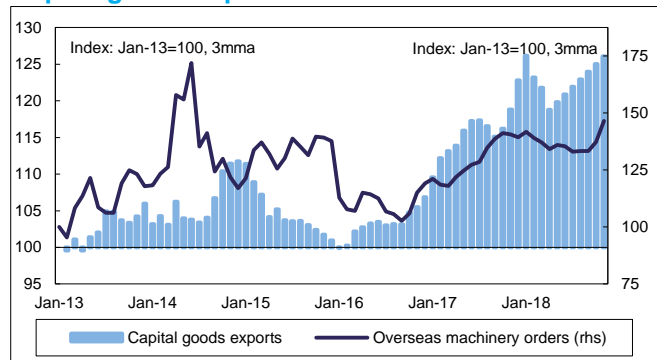
Happily, manufacturing output is well on track for a firm rebound in Q4. The final IP report for November revealed a 1.0%M/M contraction in output, just 0.1ppt smaller than previously estimated. So, production is on track for growth of about 2%Q/Q in Q4, even if output in December proves flat rather than expands 2.2%M/M as indicated by the forecast of firms (which is usually far too optimistic). Encouragingly, output of capital goods was trending higher a similar rate. The final report also indicated a 1.2%M/M decline in shipments (up 0.9%Y/Y) but also a 2.2%M/M decline in the inventory ratio (also down 0.3%Y/Y) to the lowest since end-2017 to suggest that stocks will not represent a meaningful restraint on expansion over the near term.

Machinery orders



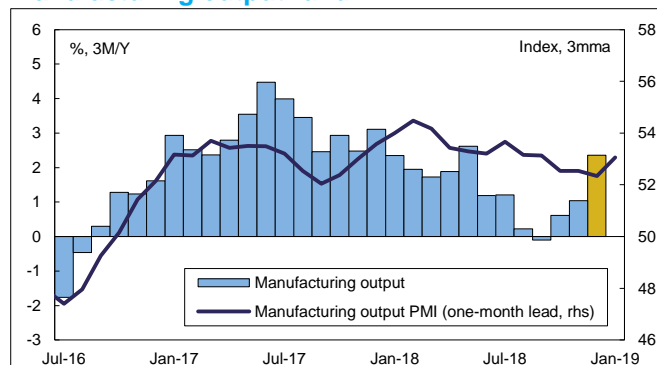
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Capital goods exports and overseas orders



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

Manufacturing output* and PMI



*December's output figure is Daiwa forecast. Source: METI, Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.



Service sector also on track for positive Q4

The service sector, which accounts for more than 70% of all activity, is also on track for solid growth in Q4. Following an upwardly-revised 2.2%M/M increase in October – 0.3ppt greater than first estimated – the Tertiary Industry Activity Index fell a less-than-expected 0.3%M/M in November. Business services made a positive contribution to growth on the month but this was offset by negative contributions from most other sectors (notably finance and insurance and wholesale trade). The average index in October and November was 1.3% above the Q3 average, strongly suggestive of a substantive contribution to GDP growth.

Overseas visitor arrivals recovering

The recovery in services activity in Q4 likely in part owes to a rebound in tourist arrivals and spending after natural disaster-related disruption in Q3. According to the JNTO, the number of visitor arrivals surpassed 2.6m in December to be up 4.4%Y/Y. For the full calendar year growth in arrivals in 2018 stood at 8.7%Y/Y – sturdy, but still less than half of the pace seen in 2017. While arrivals from China – who make up the largest number of visitors and spend the most per person – rose 13.9%Y/Y, arrivals from South Korea fell 5.6%Y/Y. And partly as a result, JNTA data showed that the total value of tourist spending rose 5.7%Y/Y in Q4, a recovery from the 3.2%Y/Y decline recorded in Q3.

CPI ends 2018 on a soft note

In terms of inflation, as expected, the headline CPI fell a seasonally-adjusted 0.2%M/M in December, in part due to a further 2.7%M/M decline in prices of fresh food (now down 9.4%Y/Y). As a result, the annual inflation rate fell a further 0.5ppt to just 0.3%Y/Y, marking the weakest outcome since October 2017. Unfortunately for the BoJ, the measure used in its quarterly Outlook Report forecast – which excludes fresh food prices from the CPI – also fell, albeit a smaller 0.1%M/M, lowering annual inflation by a greater-than-expected 0.2ppt to a seven-month low of 0.7%Y/Y.

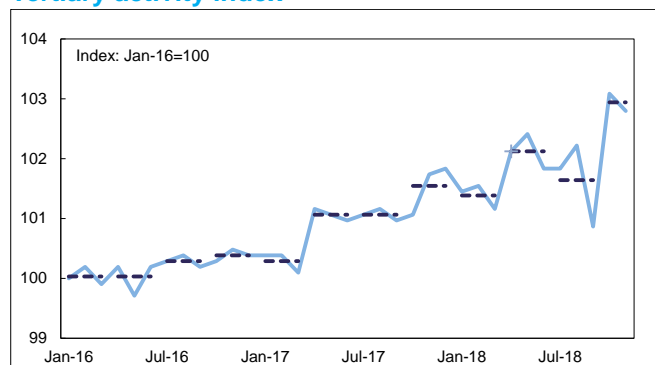
Favoured core inflation measures also soft

Additional downward pressure on the CPI flowed from a 4.3%M/M decline in fuel prices. So, the BoJ's preferred core measure, which excludes both fresh food and energy prices, reported no overall change for a fourth consecutive month, leaving annual inflation steady at 0.3%Y/Y – disappointingly, unchanged from a year earlier. The measure of core prices that strips out prices of all food items and energy (as monitored in many other countries) likewise recorded its fourth consecutive month of stability, leaving annual inflation in that measure at an even weaker 0.1%Y/Y – by some margin the lowest of major economies. Elsewhere in the detail, prices of non-energy industrial goods were unchanged from a year earlier while inflation in the services sector was stable at 0.3%Y/Y, up 0.2ppt from a year earlier but still no higher than back in February 2018.

Lower fuel prices enter inflation pipeline

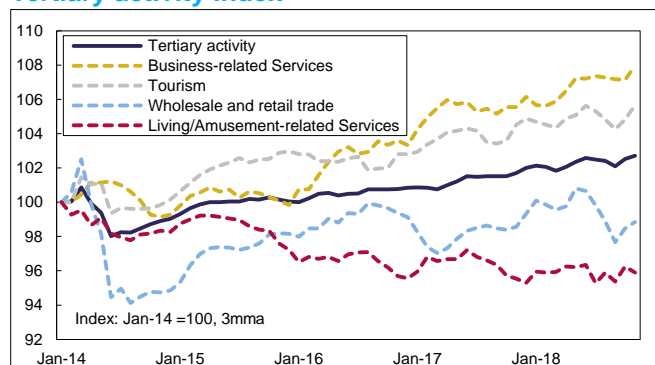
The BoJ's goods PPI report provided further evidence that lower fuel prices are reducing pressure in the inflation pipeline. The headline index fell 0.6%M/M in December – the largest decline since January 2016 – so that annual

Tertiary activity index*



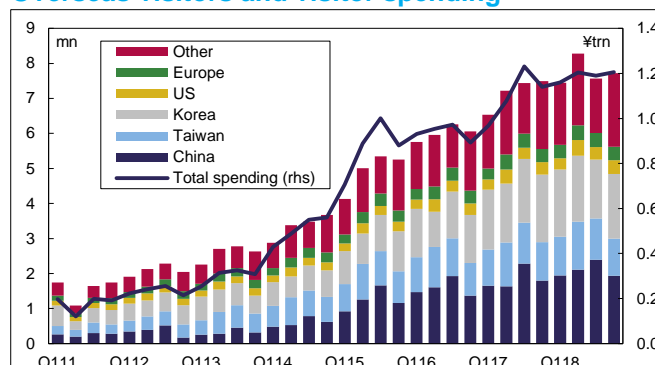
*Dashed dark blue line represents quarterly averages. Source: METI, and Daiwa Capital Markets Europe Ltd.

Tertiary activity index



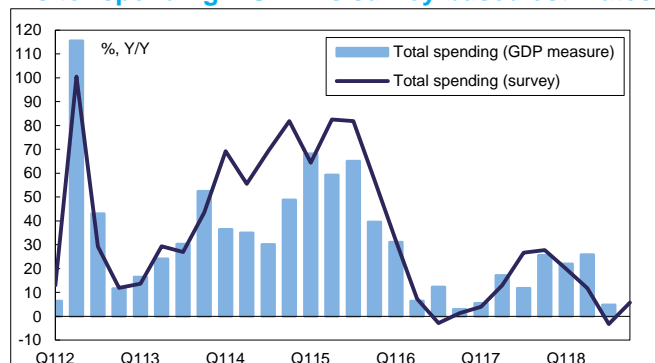
Source: METI, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Overseas visitors and visitor spending



Source: JNTO, JNTA and Daiwa Capital Markets Europe Ltd.

Visitor spending – GDP vs survey-based estimates



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

inflation slowed 0.8ppt to 1.5%Y/Y. In large part this reflected a 7.1%M/M drop in prices for petroleum and coal. But lower prices were also recorded for chemicals, non-ferrous metals and machinery. In a similar vein, measured in yen terms, import prices fell 3.9%M/M in December to leave the annual rate up 3.3%Y/Y, the least since March. Strikingly, consumer goods prices were down 0.9%M/M and 1.2%Y/Y, the biggest annual drop since 2016.

BoJ likely to lower GDP and inflation forecasts

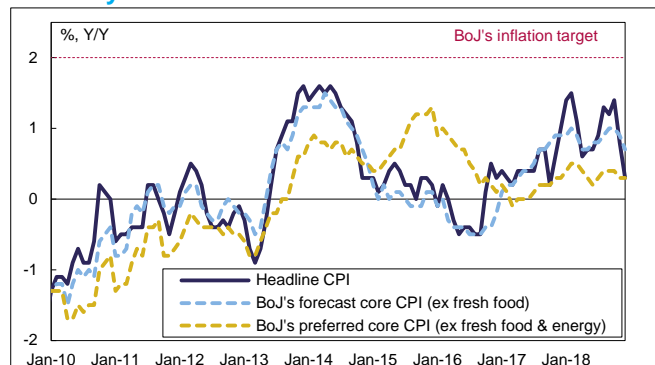
When the BoJ's Policy Board meets in the coming week, it will again confront a weakened economic outlook. Some disappointing activity data – especially the lower base provided by the Q3 GDP report – will require a downward adjustment to its forecast for growth, at least for FY18 (currently 1.4%Y/Y). The inertia of underlying inflation, step down in oil prices, and government plans to abolish pre-school education fees, demands a downwards revision to the BoJ's inflation projections. In our view, the Bank's forecast for core CPI in FY19 of 1.4%Y/Y (excluding the impact of the consumption tax hike) could be as much as 1ppt too high. But the updated Outlook Report will likely see the Board's median view nudged only modestly lower, with comfort still taken from its estimate of a positive output gap and tight labour market. So, the BoJ will remain constructive about the medium-term inflation outlook, albeit still reluctant to place a date on when the current 2% target might actually be achieved. And it is also highly unlikely to adjust its key policy settings. Instead, Kuroda can note the flexibility afforded by the current framework, including the wide range (+/-20bps) around its zero percent 10Y yield target.

The week ahead in Japan and the US

While the BoJ policy meeting is the main event, the coming week also brings noteworthy new data, beginning on Monday with the Reuters Tankan for January. Wednesday's December goods trade report will likely strongly suggest that net exports made a negative contribution to GDP growth in Q4. The final results of the Monthly Labour Survey for November will also be released that day, and the BoJ will publish its latest Senior Loan Officer Survey. The flash manufacturing PMIs for January will be released on Thursday, together with the All Industry Activity Index for November. The advance Tokyo area CPI report for January will complete the week's diary on Friday. In the bond market the MoF will auction enhanced liquidity (maturities of 1-5 years) on Tuesday and 20-year JGBs on Thursday.

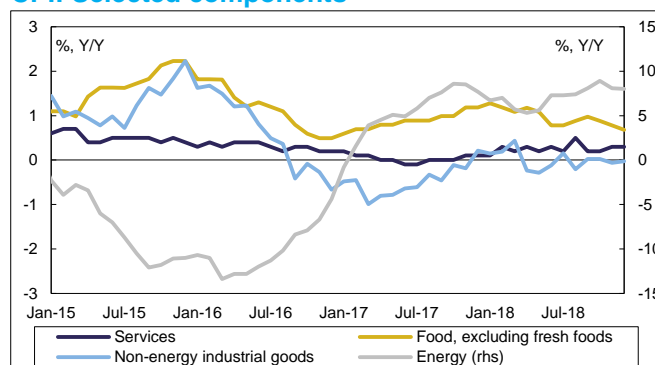
In the US, the coming week's economic diary remains somewhat uncertain given the government shutdown with numerous delayed reports that could make an appearance if a resolution was suddenly to emerge. As things stand, following Monday's Martin Luther King Jnr holiday, the first scheduled report of the week is Tuesday's existing home sales report for December. The Richmond Fed's manufacturing survey will be released on Wednesday while the flash PMI indices for January are released on Thursday, together with the Conference Board's Leading Index for December and the Kansas City Fed manufacturing survey for January. Friday will bring new home sales data for December, while the advance durable goods orders report for December appears likely to be delayed. In the bond market, issuance by the Treasury will be restricted to bills.

CPI: Key measures*



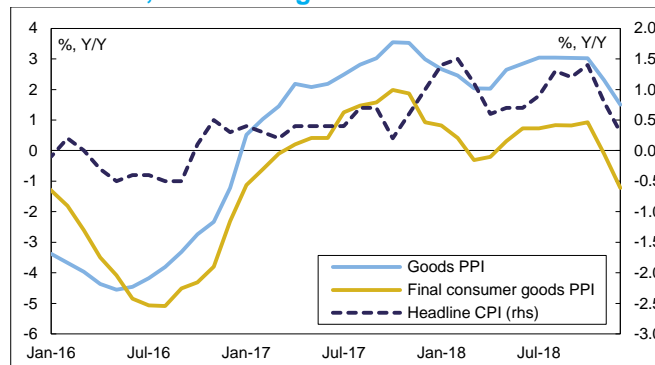
*Excludes impact of consumption tax hike. Source: MIC and Daiwa Capital Markets Europe Ltd.

CPI: Selected components*



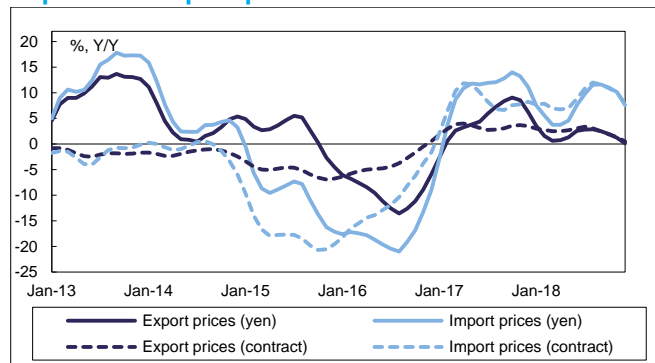
*Excludes impact of consumption tax hike Source: MIC and Daiwa Capital Markets Europe Ltd.

Goods PPI, consumer goods PPI and CPI*



*Excludes impact of consumption tax hike. Source: BoJ, MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Import and export prices



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

Economic calendar

Key data releases – January/February

14	15	16	17	18
NATIONAL HOLIDAY – COMING OF AGE DAY	M3 MONEY SUPPLY Y/Y% NOV 2.1 DEC 2.1	5Y JGB AUCTION MACHINE ORDERS M/M% OCT 7.6 NOV 0.0 TERTIARY ACTIVITY INDEX M/M% OCT 2.2 NOV -0.3 GOODS PPI Y/Y% NOV 2.3 DEC 1.5 OVERSEAS VISITORS MN NOV 2.45 DEC 2.63	1Y TB AUCTION	3M TB AUCTION ENHANCING LIQUIDITY AUCTION NATIONAL CPI Y/Y% NOV DEC 0.8 0.3 EX FRESH FOOD 0.9 0.7 EX FRESH FOOD/ENERGY 0.3 0.3 INDUSTRIAL PRODUCTION M/M% OCT 2.9 NOV F -1.0 CAPACITY UTILISATION M/M% OCT 4.0 NOV 1.0
21	22	23	24	25
REUTERS TANKAN - MANUFACTURING DI DEC 31 JAN N/A NON-MANUFACTURING DI DEC 26 JAN N/A	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.6TRN) BOJ POLICY BOARD MEETING (22-23 JANUARY 2019)	TRADE BALANCE ¥TRN NOV -0.5 DEC -0.4 ALL INDUSTRY ACTIVITY INDEX M/M% OCT 1.9 NOV -0.5 AVERAGE WAGES Y/Y% OCT 1.5 NOV F 2.0 DEPARTMENT STORE SALES Y/Y% NOV -0.6 DEC N/A BOJ SENIOR LOAN OFFICER SURVEY (JAN) BOJ POLICY ANNOUNCEMENT AND OUTLOOK REPORT	20Y JGB AUCTION (APPROX ¥1.0TRN) MANUFACTURING PMI DEC 52.6 JAN P N/A	3M TB AUCTION (APPROX ¥4.34TRN) TOKYO CPI Y/Y% DEC JAN 0.3 0.1 EX FRESH FOOD 0.9 0.9 EX FRESH FOOD/ENERGY 0.6 0.6
28	29	30	31	01
SERVICES PPI (DEC) BOJ MINUTES (19-20 DECEMBER MEETING)	40Y JGB AUCTION	RETAIL SALES (DEC) CONSUMER CONFIDENCE (JAN)	2Y JGB AUCTION INDUSTRIAL PRODUCTION (DEC) HOUSING STARTS (DEC) CONSTRUCTION ORDERS (DEC) BOJ SUMMARY OF OPINIONS (22-23 JANUARY MEETING)	3M TB AUCTION UNEMPLOYMENT RATE (DEC) JOB-TO-APPLICANT RATIO (DEC) MANUFACTURING PMI (JAN F)
04	05	06	07	08
MONETARY BASE (JAN)	10Y JGB AUCTION SERVICES PMI (JAN) COMPOSITE PMI (JAN)		30Y JGB AUCTION 6M TB AUCTION BOJ CONSUMPTION ACTIVITY INDEX (DEC)	3M TB AUCTION AVERAGE WAGES (DEC) HOUSEHOLD SPENDING (DEC) ECONOMY WATCHERS SURVEY (JAN) BANK LENDING (JAN) CURRENT ACCOUNT (DEC)

*Approximate date of release. Source: BoJ, MoF, Bloomberg, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

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