Yen 4Sight

Highlights

- The BoJ agreed a new loan facility for banks in areas affected by the Kumamoto quake. But despite its weaker economic forecasts, the BoJ's main policy measures were unchanged.
- CPI slipped back into negative territory in March. And despite upside surprises to household spending and IP data, GDP might well have contracted in Q1.
- Amid the Golden Week holidays, the manufacturing and services PMIs for April are due for release.

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Interest and exchange rate forecasts

End period	29-Apr	Q216	Q316	Q416
BoJ IOER %	-0.1	-0.1	-0.2	-0.2
BoJ JGBs ¥trn	308	325	345	370
10Y JGB %	-0.08	-0.10	-0.10	-0.15
JPY/USD	107	110	108	105
JPY/EUR	123	125	124	122

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

BoJ offers a token gesture of support...

After the BoJ's surprise announcement of a negative-rate framework in January was followed by a run of disappointing economic data, marked yen appreciation and the Kumamoto earthquake, expectations had risen among market participants that the past week's policy meeting would bring further action. But there was certainly no consensus in terms of what the Policy Board would deliver, with numerous options seemingly on the table. In the event, what was unveiled was very much at the lower end of expectations. The BoJ announced new support for banks in the region affected by the Kumamoto quake, with a special lending facility modelled on that previously available to banks in the region affected by the great north-east quake and tsunami in 2011. In particular, the BoJ will provide loans to these banks at a zero interest rate. And twice the amount drawn under the facility will be cut from the amount of their excess reserves facing the negative deposit rate. While this was a welcome gesture of solidarity for the affected region, with just ¥300bn – merely 0.06% of GDP – available under the facility, it will have no significant macroeconomic impact.

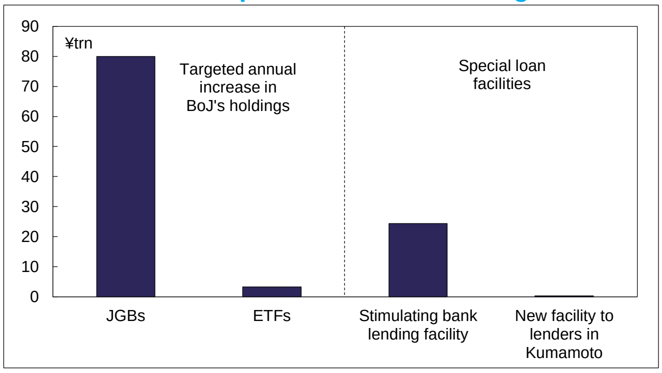
...but keeps main policy tools unchanged

Importantly, the BoJ left its asset purchase programme and main interest rates unchanged. So, for example, contrary to expectations in some quarters, it failed to increase the rate of its purchases of ETFs. And it also refrained from action to make its special 'stimulating lending facility' of cheap long-term loans more attractive. Indeed, in his post-meeting press conference, Kuroda stated that, while it was a potential policy tool, the BoJ had not at this meeting discussed an ECB-style negative interest rate on such lending. One reason for its inertia this month no doubt relates to its desire to see the new negative-rate framework bed-in. But with the average interest rate applied to banks' reserves at the BoJ having edged only slightly lower since the introduction of the negative policy rate – to +7bps in March – Kuroda also argued that the direct impact on banks' earnings so far had been negligible and that calls for action to neutralise such effects were misplaced.

Kuroda still insists 2% inflation target is in sight

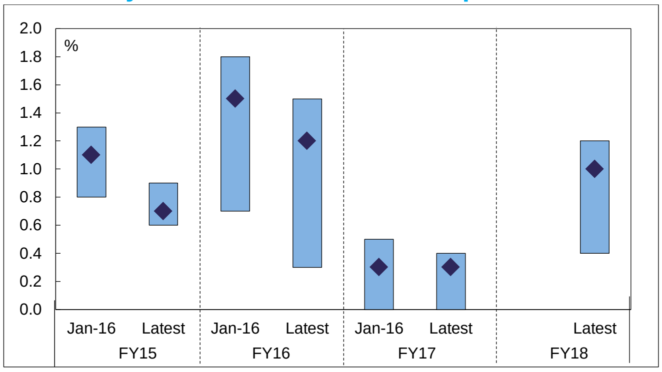
A further reason for the BoJ's lack of action was its maintenance of the pretence that, on current policy, it remains on track to meet its 2% inflation target, albeit now during FY17, a little later than previously thought. But, of course, Kuroda emphasised that the BoJ remains ready to ease policy further

BoJ: Size of asset purchases and lending facilities



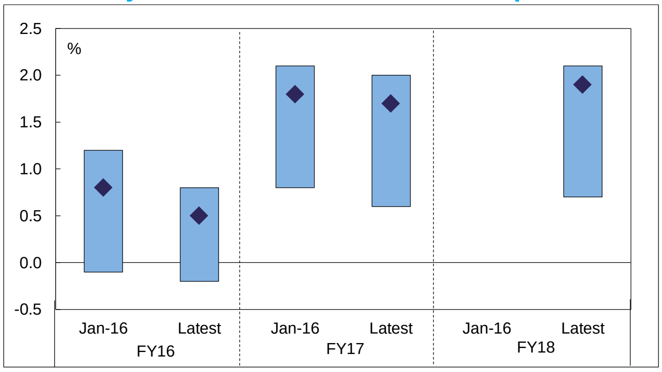
Source: BoJ and Daiwa Capital Markets Europe Ltd.

BoJ Policy Board GDP forecast comparison*



**Bars show full range of Policy Board members' forecasts. Diamonds show median forecast. Source: BoJ and Daiwa Capital Markets Europe Ltd.*

BoJ Policy Board core CPI forecast comparison*



**Bars show full range of Policy Board members' forecasts. Diamonds show median forecast. Source: BoJ and Daiwa Capital Markets Europe Ltd.*

in terms of asset purchases and/or interest rates if inflation veers off track. And we would not be surprised if any *future* cuts in the policy rate were indeed accompanied by a new negative rate on its lending facilities to soften the impact on the banks.

But BoJ acknowledges weaker outlook for growth

While the BoJ perhaps surprisingly maintained its assessment that the economy remained on a gradual recovery path consistent with eventually meeting the inflation target, it did at least downgrade its GDP and inflation forecasts right across the horizon. But they still look too optimistic to us. For example, on the back of an expectation of continued sluggish exports, the BoJ's median growth forecast for FY16 was cut by 0.3ppt, to a still significantly above-potential 1.2%. Our expectation is for growth to be just half that rate. Moreover, despite the BoJ's working assumption that the consumption tax will be hiked again as currently planned in April 2017, the BoJ continues to expect the economy to eke out very marginally positive growth in FY17. In contrast, a contraction on an annual basis would seem more likely.

Inflation forecast downgraded too

As well as acknowledging a softening of the growth outlook, the BoJ also revised down its profile for future inflation, recognising that energy prices will likely remain a drag on headline inflation for longer than previously thought. And also given recent disappointing wage growth and the likelihood that this year's wage settlements will be weaker than those last year, the Policy Board cut its median forecast for core CPI (excluding fresh foods) in FY16 by 0.3ppt to 0.5%. While it stated that the risks to its growth and inflation outlook are skewed to the downside, the BoJ's median forecast for FY17 underlying core inflation (i.e. excluding the consumption tax) was cut just 0.1ppt to 1.7%, a full percentage point higher than our own expectation, which takes account of the likely deflationary impact of the tax hike. As and when the BoJ's forecasts have to be revised down again – most likely in July – we would expect it to ease policy.

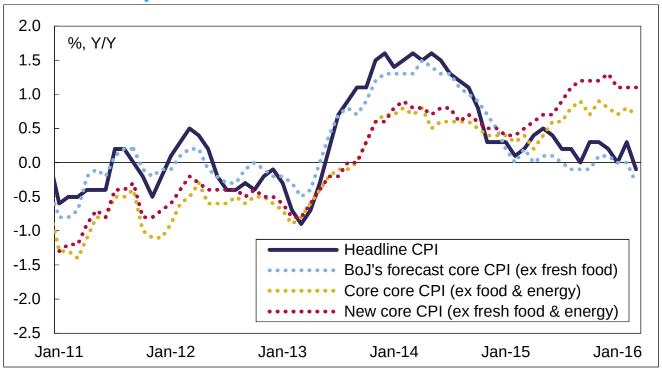
CPI back below zero, underlying inflation steadier

While there was at least a sprinkling of upside surprises, the past week's data still provided reminders of the challenges ahead for the BoJ. For example, headline CPI declined a steeper-than-expected 0.4ppt in March to -0.1%Y/Y, the first negative reading since May 2013, while the BoJ's forecast measure of core CPI fell 0.3ppt to -0.3%Y/Y, the lowest rate since the launch of QQE in April 2013. Admittedly, the weakness principally reflected a steeper year-on-year decline in energy prices, down more than 13%Y/Y in March, the largest drop since 2009. And so, when excluding both fresh food and energy prices, the BoJ's new preferred core CPI rate was unchanged at 1.1%Y/Y, the eighth consecutive reading above 1%Y/Y. In justifying its rose-tinted economic forecasts, the BoJ will also be able to point to the share of the core CPI basket with prices higher than a year earlier, which in March rose to a multi-year high.

Energy prices to remain a drag on inflation

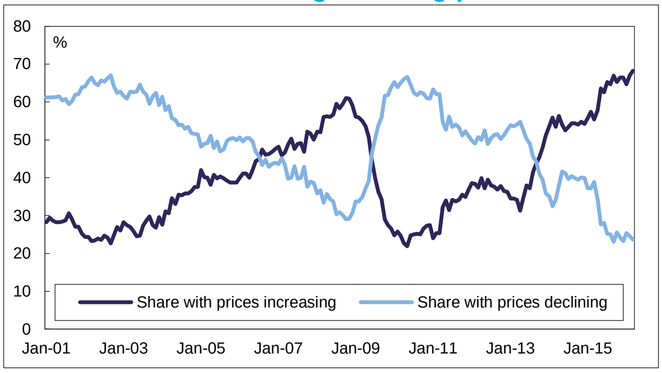
However, having traded close to ¥112/$ at the start of the week but subsequently jumped following the BoJ's announcement to end the week close to ¥107, the past week saw the yen's

Consumer price inflation*



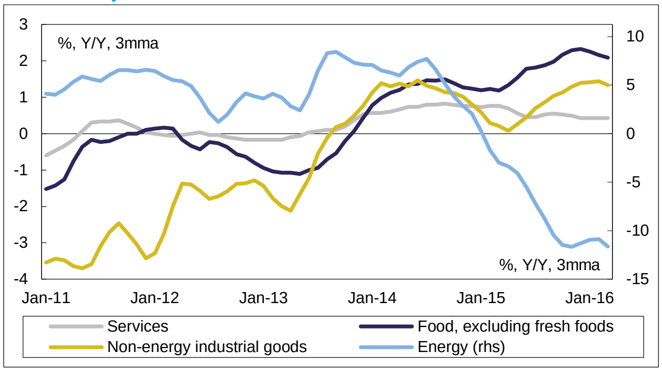
*Excluding consumption tax.
Source: MIC, BoJ and Daiwa Capital Markets Europe Ltd.

Share of items with rising or falling prices*



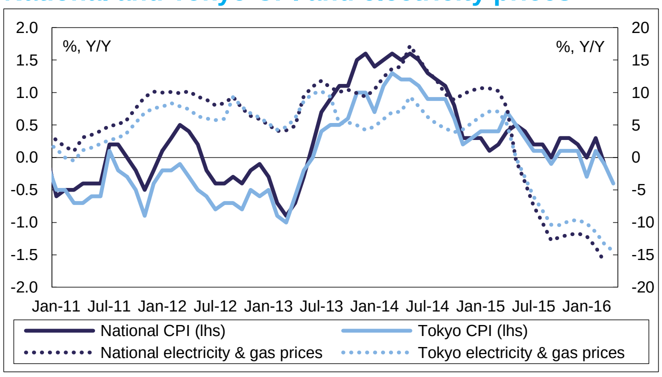
*Share of items in core CPI basket. Excluding consumption tax.
Source: MIC, BoJ and Daiwa Capital Markets Europe Ltd.

CPI components*



*Excluding consumption tax.
Source: MIC, BoJ and Daiwa Capital Markets Europe Ltd.

National and Tokyo CPI and electricity prices*



*Excluding consumption tax.
Source: MIC, BoJ and Daiwa Capital Markets Europe Ltd.

steepest appreciation since 2008. And if the yen continues to strengthen any recent improvements in underlying inflation would seem likely to dissipate before too long. Indeed, the March CPI data suggested that yen strength had already taken a toll on imported prices, with, for example, household durable goods inflation slipping back into negative territory (down 2.7ppts to -2.6%Y/Y), clothing inflation edging lower (down 0.5ppt to 1.8%Y/Y) and food price inflation further moderating (to a six-month low of 2.0%Y/Y). And, over the near term, headline CPI will also be dragged lower by cuts in energy prices – indeed, the one-month ahead Tokyo CPI release showed that electricity prices were down more than 14½%Y/Y in April, the steepest pace of decline since the series began in 1971. So, while the recent pickup in the oil price should help alleviate some downward pressure, we continue to expect nationwide CPI to edge lower over coming months, with the BoJ's forecast core rate of CPI only returning to positive territory in the final quarter of the year.

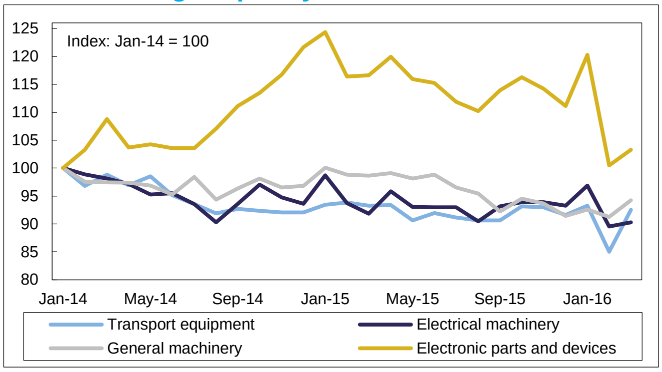
IP bounces back in March, but contracts in Q1

With economic activity having recently been so weak, it is also not difficult to see why inflation is struggling to shift onto a higher plane. Admittedly, industrial output was much firmer at the end of Q1, with a more-than 3½%M/M rise in March the strongest since the post-quake rebound in 2011. While the increase was broad based, there was a notable pickup in output from the autos subsector, up more than 8½%M/M to fully reverse the decline in February. Nevertheless, with overall production having fallen more than 5%M/M in February, manufacturing output still contracted more than 1%Q/Q in Q116, the sharpest decline since Q215. Given the disruption to supply chains resulting from the Kumamoto quakes, industrial production looks set to drop once again in April, and so we give little credence to the (normally unreliable) METI survey suggesting an increase of 2.6%M/M. Indeed, the flash manufacturing output PMI fell to a more-than three-year low in April, with the new orders component signaling further weakness over coming months too.

Household expenditure remains subdued in Q1

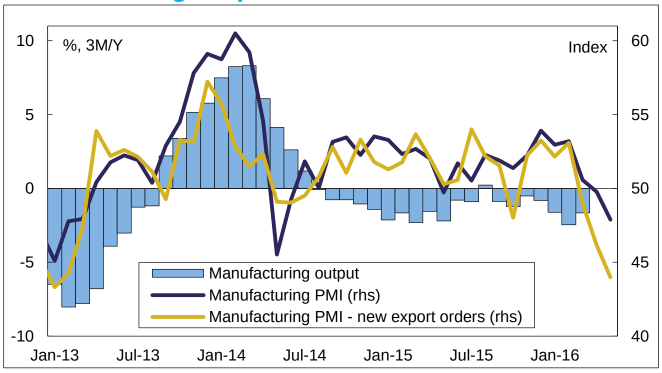
While headline household expenditure suggested a further modest improvement in March, rising for the second successive month and by ½%M/M, this principally reflected a near-23% increase in spending related to housing. Indeed, when stripping out these more volatile items, core spending – which typically correlates more closely with the national accounts measure of consumption – fell back in March, by 0.7%M/M, to leave it broadly flat over the first quarter as a whole and almost 13% below its pre-tax hike peak. And while retail sales finally broke their four-month losing streak, rising 1.4%M/M in March, over Q1 as a whole they were down more than 2%Q/Q. Admittedly, this weakness seems to have been exacerbated by the fall in the oil price earlier in the year, with the value of fuel sales down almost 8%Q/Q. The BoJ has also argued that the household spending figures have repeatedly underestimated the strength of overall consumption due to sample bias. But with expenditure having been likely further impacted in Q1 by irregular weather patterns and disruption to auto supply chains, there is a non-negligible risk that private consumption remained a drag on GDP growth in Q1. And given the likely negative wealth effect from the decline in stock prices since the start of the year, consumption might well remain subdued over coming quarters too.

Manufacturing output by selected subsectors



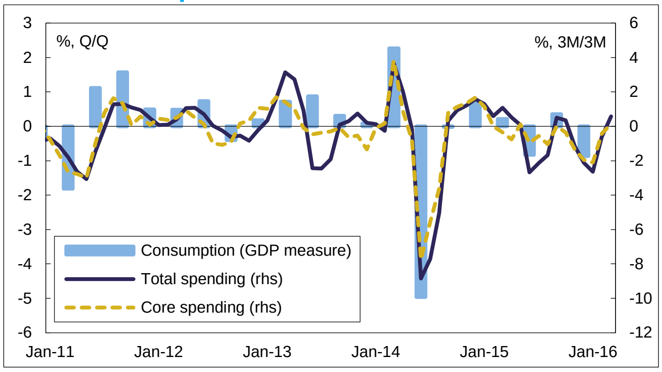
Source: METI and Daiwa Capital Markets Europe Ltd.

Manufacturing output and PMI*



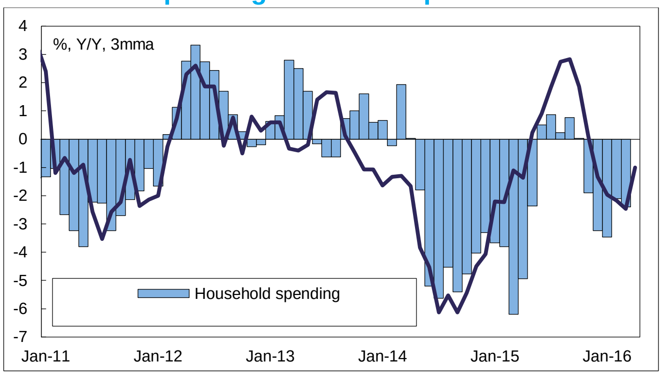
**PMI components have one-month lead.*
Source: METI, Markit and Daiwa Capital Markets Europe Ltd.

Household expenditure



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

Household spending and real disposable income

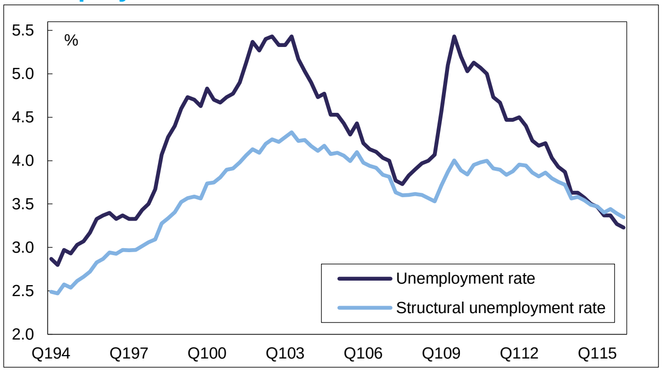


Source: MIC and Daiwa Capital Markets Europe Ltd.

Labour market indicators remain mixed

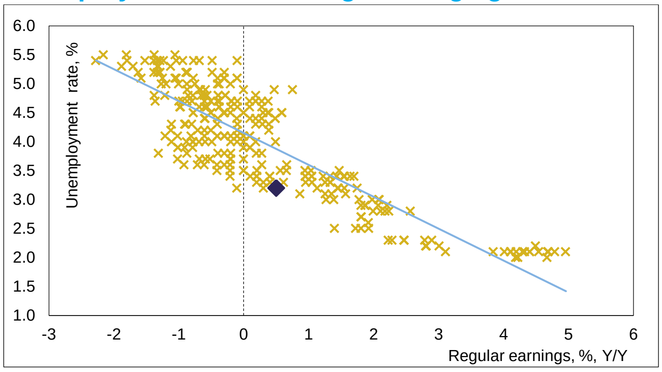
Thanks to a slight rise in labour income, there was at least a modest improvement in real household disposable income at the end of FY15, with the first year-on-year increase in seven months. And at face value, the past week's labour market data also offered some cause for optimism, with the unemployment rate down 0.1pt to 3.2%, a rate last lower in 1995 and slightly below the BoJ's, and our own, estimate of structural unemployment. However, this reflected people leaving the labour force, with employment falling for the second successive month and by 130k. And while the labour market evidently remains tight with the job-to-applicant ratio rising 0.2pt in March to 1.30, its firmest since 1991, with this year's wage negotiations proving to be a damp squib, there remains little reason to expect it to generate wage growth consistent with the BoJ's inflation target for the foreseeable future.

Unemployment rate



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

Unemployment rate and regular wage growth*



**Diamond shows March 2016 unemployment rate and February regular earnings growth. Light blue line represents the average trade-off between wages and unemployment since 1991. Source: MIC, MHLW and Daiwa Capital Markets Europe Ltd.*

The coming two weeks in Japan and US

Given the Golden Week national holidays, the coming week's data calendar will be very light, with just the release on Monday of April vehicle sales data and the final manufacturing PMI survey for the same month, followed on Friday by the equivalent services and composite PMIs. The data focus at the start of the week commencing 9 May will be March's labour earning figures, expected to show that average wage growth remained subdued at the end of the fiscal year. That day also brings the latest consumer confidence indicator, which will be followed on Thursday 12 May by April's economy watchers survey and bank lending figures. Thursday also brings the BoJ's summary of opinions from its end-April Policy Board meeting. In the JGB market, meanwhile, a 10Y auction will be conducted on 10 May, followed by a 30Y auction on 12 May.

The coming week in the US looks set to be a busy one for top-tier releases, kicking off on Monday with April's manufacturing ISM survey and March construction spending figures. Tuesday brings the latest vehicle sales data, followed by a raft of releases on Wednesday including April's non-manufacturing ISM, March's full trade report and factory orders figures, and the latest ADP employment report. And the week will conclude with the release of the comprehensive labour market report on Friday, which is expected to show the non-farm payrolls increased by 200k in April, to leave the unemployment rate unchanged at 5.0%.

The week commencing 9 May should be quieter on the data front in the US, with just wholesale trade data and the JOLTS survey due on Tuesday, followed by the monthly Federal budget statement on Wednesday and import price figures on Thursday. Friday, meanwhile, brings several releases of note including April retail sales figures and business inventories data for March, as well as the preliminary University of Michigan's consumer sentiment survey for May. In the bond markets, the US Treasury will sell 3Y notes on Tuesday 10 May, 10Y notes on Wednesday 11 May, and 30Y bonds on Thursday 12 May.

Due to the Golden Week national holidays, the publication of the next Yen 4Sight will be 13 May.

Economic calendar

Key data releases – April/May

25	26	27	28	29
AUCTION FOR ENHANCED LIQUIDITY SERVICES PPI Y/Y% FEB 0.2 MAR 0.2		3M TB AUCTION 2Y JGB AUCTION ALL INDUSTRY ACTIVITY M/M% JAN 1.2 FEB -1.2 10-DAY TRADE EXPORTS Y/Y% MAR 0.5 APR -16.6 IMPORTS Y/Y% MAR -6.6 APR -34.3	NATIONAL CPI Y/Y% FEB MAR 0.3 -0.1 *EX FRESH FOOD* *0.0 -0.3* *EX FOOD/ENERGY* *0.8 0.7* *EX FRESH FOOD/ENERGY* *1.1 1.1* TOKYO CPI Y/Y% MAR APR -0.1 -0.4 *EX FRESH FOOD* *-0.3 -0.3* *EX FOOD/ENERGY* *0.6 0.6* JOBLESS RATE % FEB 3.3 MAR 3.2 JOB-TO-APPLICANT RATIO FEB 1.28 MAR 1.30 HOUSEHOLD SPENDING Y/Y% FEB 1.2 MAR -5.3 RETAIL SALES Y/Y% FEB 0.4 MAR -1.1 INDUSTRIAL PRODUCTION Y/Y% FEB -1.2 MAR 0.1 HOUSING STARTS Y/Y% FEB 7.8 MAR 8.4 CONSTRUCTION ORDERS Y/Y% FEB -12.4 MAR 19.8 BOJ POLICY BOARD MEETING AND OUTLOOK REPORT	NATIONAL HOLIDAY – SHOWA DAY
02	**03**	**04**	**05**	**06**
MANUFACTURING PMI MAR 49.1 APR F 48.0 VEHICLE SALES Y/Y% MAR -3.2 APR N/A	NATIONAL HOLIDAY – CONSTITUTION DAY	NATIONAL HOLIDAY – GREENERY DAY	NATIONAL HOLIDAY – CHILDREN'S DAY	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.2TRN) SERVICES PMI MAR 50.0 APR N/A COMPOSITE PMI MAR 49.9 APR N/A MONETARY BASE Y/Y% MAR 28.5 APR N/A
09	**10**	**11**	**12**	**13**
AVERAGE WAGES (MAR) CONSUMER CONFIDENCE (APR)	3M TB AUCTION 10Y JGB AUCTION	6M TB AUCTION COINCIDENT INDEX (MAR P) LEADING INDEX (MAR P)	3M TB AUCTION 30Y JGB AUCTION BANK LENDING (APR) CURRENT ACCOUNT (MAR) ECONOMY WATCHERS SURVEY (APR) 20-DAY TRADE (APR) BOJ SUMMARY OF OPINIONS (27-28 APRIL MEETING)	TERTIARY ACTIVITY (MAR) M3 MONEY SUPPLY (APR)
16	**17**	**18**	**19**	**20**
GOODS PPI (APR) MACHINE TOOL ORDERS (APR)	5Y JGB AUCTION INDUSTRIAL PRODUCTION (MAR F) CAPACITY UTILISATION (MAR) DEPARTMENT STORE SALES (APR)	1Y TB AUCTION GDP (Q1 P)	3M TB AUCTION 20Y JGB AUCTION MACHINE ORDERS (MAR) HOUSING LOANS (Q1) ALL INDUSTRY ACTIVITY (MAR)	

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

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