Daiwa Capital Markets

Yen 4Sight

Highlights

- Sentiment surveys have signalled a notable deterioration in economic conditions in Q2, while April's trade report revealed a disappointing start to the quarter for exporters.
- Headline CPI has slipped further into negative territory. But the BoJ's new preferred core inflation rate remains close to 1%Y/Y.
- Alongside a likely announcement on the consumption tax hike, the coming week brings further top-tier data releases including April IP, retail sales and labour market figures.

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Interest and exchange rate forecasts

End period	27-May	Q216	Q316	Q416
BoJ IOER %	-0.1	-0.1	-0.2	-0.2
BoJ JGBs ¥trn	312	325	345	370
10Y JGB %	-0.11	-0.10	-0.10	-0.15
USD/JPY	110	110	110	110
EUR/JPY	122	122	121	121

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

Surveys point to a loss of momentum in Q2

While the first estimate of Japan's Q1 GDP growth surpassed expectations, growth of 0.4%Q/Q merely reversed the contraction in the final quarter of 2015. Over the past year, the economy has appeared simply to be oscillating around a broadly flat trend. And recent indicators strongly suggest that economic output has contracted again in Q2, perhaps fully reversing the expansion at the start of the year. Certainly, the theme of the latest Reuters Tankan survey – which provides a guide to the BoJ's influential quarterly survey – was one of weakness. While tertiary activity has been on a gradual upward trend over recent years and sentiment in the sector has been at an elevated level, the survey index for non-manufacturers signalled a further deterioration in conditions in May, falling for the third month out of the past four to the weakest level this year. While construction firms still judge that conditions are highly favourable, retailers continue to feel downbeat, with concerns about subdued domestic demand and a possible dampening effect of the stronger yen on tourist spending.

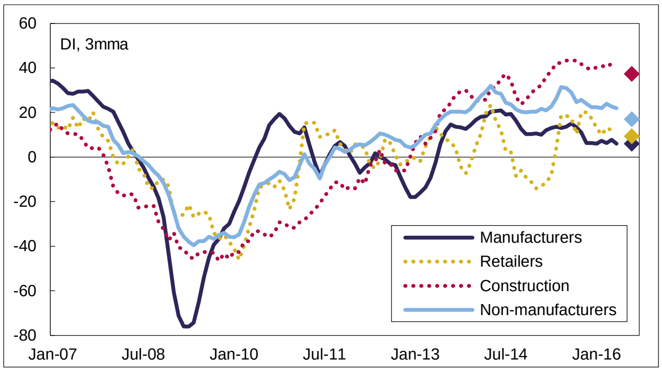
Manufacturers notably more downbeat

Of course, the impact of the stronger yen is being felt most acutely among Japanese manufacturers. Reflecting this, the respective Reuters index took a big step down in May to its lowest level for more than three years, with marked declines seen in the key export-oriented sectors. In particular, the relevant autos DI fell the most in almost two years, while the general machinery and electrical machinery DIs declined to their lowest levels since H113. While the weakness in May was likely exaggerated to some extent by the disruption to production caused by the Kumamoto earthquakes last month, according to this survey, manufacturers anticipate only limited improvement over the coming three months.

PMIs signals another quarterly decline in IP

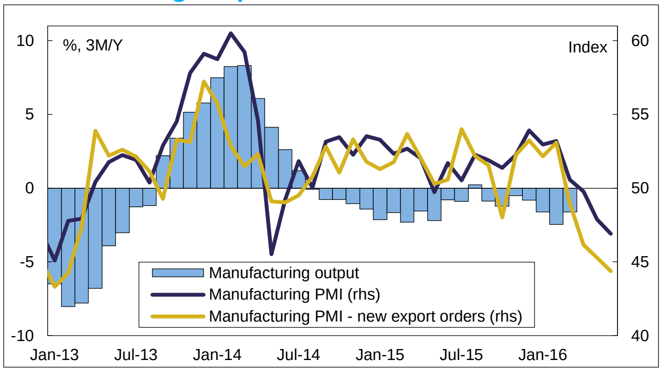
The Reuters Tankan survey tallied with the findings of the flash manufacturing PMI too, which showed the headline PMI declining 0.6pt in May to 47.6, its third consecutive sub-50 reading and lowest since 2012. Perhaps with the impact of the Kumamoto earthquake on supply chains also still weighing, the survey's output component was also down to its lowest since 2012. This left the average index over the first two months of Q2 more than 6½pts lower than the average in Q1, when output in the sector fell more than 1%Q/Q. But the survey was hardly offered encouragement about the production outlook in June either, with the new orders PMI down for the fifth

Reuters Tankan: Business conditions*



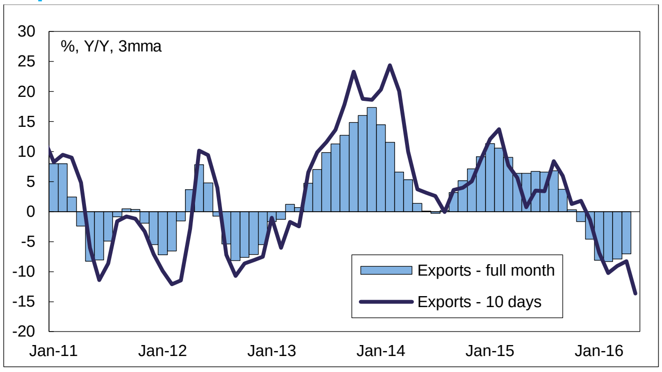
*Large firms. Diamonds represent survey forecast for August 2016.
Source: Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing output and PMIs*



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

Export values*



*Non-seasonally adjusted data.
Source: MoF and Daiwa Capital Markets Europe Ltd.

consecutive month to just 44.1 and the new export orders index also firmly in contractionary territory. Indeed, trade data for the first ten days of May reported a notable weakening in the value of exports, with the rate of decline down more than 8ppts to almost 25%Y/Y. And while that partly reflects the near-10%Y/Y shift in the value of the yen against the dollar over that period, with the value of imports up roughly 2½Y/Y the headline trade balance will almost certainly have deteriorated this month.

Trade surplus at multi-year high on lower imports

The full-month trade report for April, however, showed that the headline surplus rose to a more-than six-year high of ¥823bn, while the adjusted trade balance recorded a sixth consecutive surplus and the largest since before the 2011 quake. The improvement principally reflected a big drop in the value of imports, down more than 3½%M/M and 23%Y/Y, the steepest year-on-year decline since October 2009. This was again underpinned by a sharp decline in the value of imported fuels (-50%Y/Y) not least reflecting shifts in the oil price, with the impact of the stronger yen also reflected in a steeper drop in the value of other imports. But the volume of imports was also much weaker, down 4%M/M and more than 7%Y/Y on the BoJ's measure to the lowest level for thirteen months, suggesting that domestic demand had a subdued start to Q2.

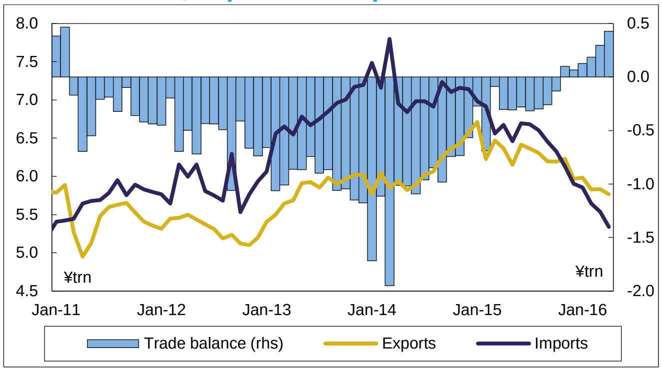
Exports continued to disappoint at the start of Q2

The export performance in April was also disappointing, down 1.6%M/M in volume terms, the steepest drop since December, and 4½% lower than a year earlier. The weakness in April was largely driven by a near-4%M/M drop in shipments to the EU. While this was to some extent likely payback for the strength seen over recent months, supply-chain disruption to the autos sector since the start of the year associated with the explosion at a steel plant and the Kumamoto quake will also have played a role. Looking through the monthly volatility, the level of exports to that region was still up 8½% on a three-month basis to a 4½-year high. In contrast, exports to China and the ASEAN4 countries were seemingly firmer at the start of Q2, up almost 3½%M/M and 2%M/M respectively. But this followed the broadly flat trend over the past year or so, with IT-related exports in particular having being impacted by sluggish demand for smart-phones across the region. Furthermore, with export prices of a wide range of goods having declined sharply over recent months not least due to the strengthening yen, the total value of exports was down 10%Y/Y.

Headline CPI slips to a near-three year low

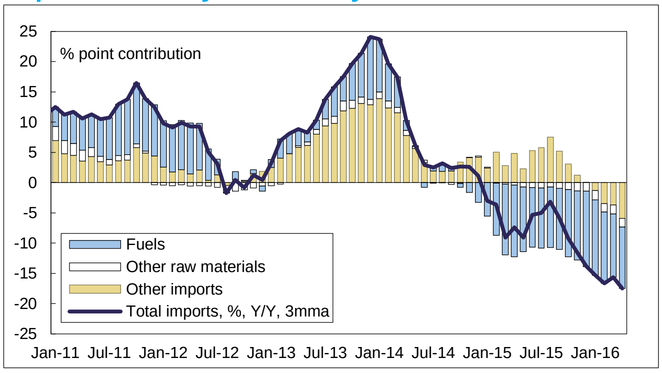
The impacts of past shifts in global energy prices and the stronger yen were also inevitably evident in the latest inflation numbers. With respect to consumer prices, there was a further downward slide in headline CPI at the start of Q2, down 0.2ppt to -0.3%Y/Y, the lowest rate since May 2013. Admittedly, the additional weakness in the latest month reflected lower food price inflation which fell to its lowest rate since the start of 2014, with a notable moderation in fresh food price inflation, down more than 5ppts to just 0.2%Y/Y. So, when excluding fresh food prices, the BoJ's forecast core measure of CPI was unchanged at -0.3%Y/Y, while the 'core core' rate (which strips out food and energy prices) was also unchanged at 0.7%Y/Y. And although the BoJ's new preferred core measure of CPI (excluding prices of fresh foods and energy) slipped back below 1%Y/Y for the first time since July arguably hinting at new weakness, the BoJ is likely to argue that, at 0.9%Y/Y,

Trade balance, export and import values*



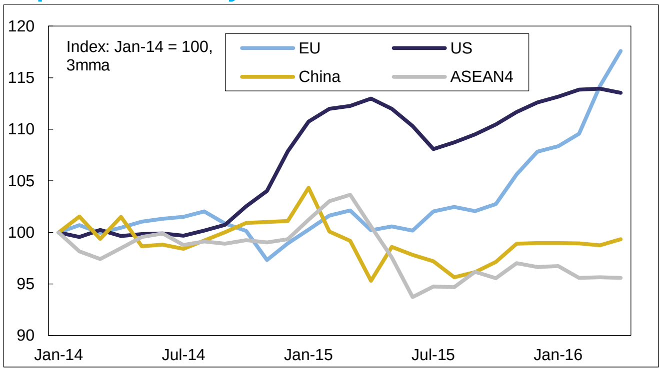
*Seasonally adjusted data.
Source: MoF and Daiwa Capital Markets Europe Ltd.

Import values by commodity



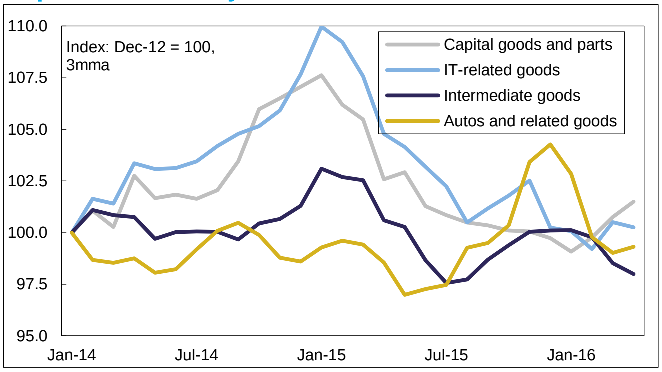
Source: MoF and Daiwa Capital Markets Europe Ltd.

Export volumes by destination*



*Seasonally adjusted data.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Export volumes by sector*



*Seasonally adjusted data.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

underlying price trends remain firmer than the headline inflation numbers suggest.

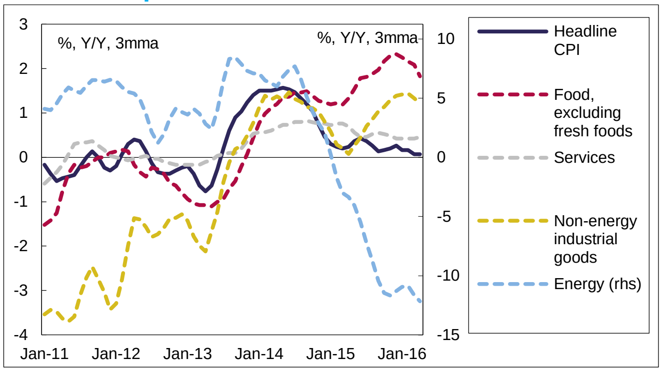
Downside inflationary risks still to the fore

Within the detail there were, however, signs that the stronger yen is providing a new disinflationary impulse with, for example, prices of household durable goods down compared with a year earlier for the second successive month and inflation of other durable goods prices easing to the softest rate in eight months. And the share of the core CPI basket with prices rising compared with a year edged down slightly in April, albeit still remaining well within the historically elevated range of the past year. Furthermore, despite the recent rise in global oil prices reflected in hikes in gasoline prices each week since the end of February, the one-month ahead Tokyo measure of CPI slipped further into negative territory in May to -0.5%Y/Y, the lowest since April 2013. Nevertheless, the drag from energy prices (roughly 1ppt in April) should gradually ease from now through to the end of the year when – principally as a result of that shift – we anticipate that nationwide CPI should also return to positive territory. Indeed, at the start of next year, headline inflation will plausibly be somewhere between ½-1%Y/Y. However, the BoJ's expectation that core CPI will rise to the 2% target in FY17 still seems most unlikely to be fulfilled.

New monetary and fiscal stimulus in the pipeline

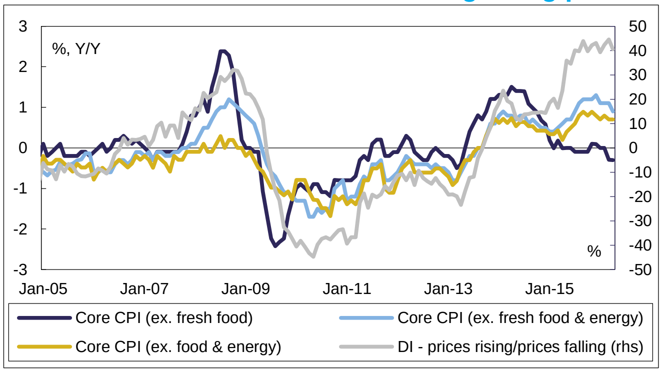
One factor to have a bearing on the outlook for inflation is fiscal policy. And after this week's G7 Summit set the scene, in the coming week – most likely on 1 June to coincide with the end of the current Diet session – Abe looks set to announce significant new stimulus. That seems bound to include a commitment to boost public spending, while postponement of the 2ppt consumption tax hike currently scheduled for April 2017 is also anticipated by most market participants if the most recent QUICK bond market survey is anything to go by. Whatever the particular balance between spending and tax measures, new stimulus in the order of at least ¥5trn (1% of GDP) might be expected to be provided. That should represent welcome support for GDP growth and inflation from the back end the year on. Given the mounting evidence of a retrenchment in economic activity in the second quarter, however, the BoJ would still also be expected to add to its own stimulus, with a further rate cut of 10bps perhaps most likely to come in July when it updates – and downgrades – its own forecasts.

Consumer price inflation



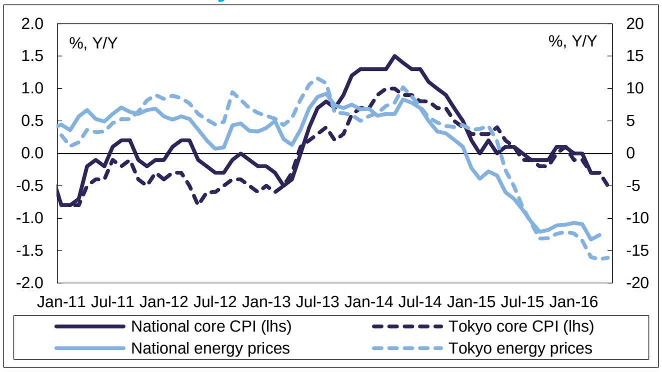
Source: MIC and Daiwa Capital Markets Europe Ltd.

Core CPI & share of items with falling/rising prices*



*DI is share of increasing items minus share of decreasing items in the core CPI basket. Source: BoJ, MIC and Daiwa Capital Markets Europe Ltd.

National and Tokyo CPI



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

The week ahead in Japan and US

Aside from the likely aforementioned decision on the consumption tax on Wednesday, the coming week will be a busy one on the data front with the remainder of the month-end top-tier releases. Monday kicks off with April's retail sales figures, followed on Tuesday by household spending, industrial production and unemployment data for the same month. The data focus on Wednesday will be the MoF's capital spending survey, which will provide a guide to any likely revisions to the second estimate of Q1 GDP. The final manufacturing PMI is also due Wednesday, followed on Friday by the equivalent services and composite surveys. Also of interest on Friday will be April's labour earnings figures, with average wage growth expected to be just half the 1.5%Y/Y rate recorded in March. In the JGB market, a 2Y auction will be conducted on Tuesday, followed by a 10Y auction on Thursday.

Following Monday's Memorial Day holiday the coming week will be an eventful one for US economic data. Tuesday will be busy with April personal income and spending numbers and the associated PCE deflators, March Case Shiller home price indices, and May Conference Board consumer confidence, Chicago PMI and Dallas Fed survey indices. Wednesday brings the May manufacturing ISM index and Fed Beige Book, while Thursday brings the latest ADP employment index and usual weekly claims figures. But Friday sees the main event, with the May labour market report expected to show nonfarm payrolls rising only slightly above the April reading of 160k, the unemployment rate unchanged at 5.0% and average hourly earnings a touch softer than the previous month. Friday also brings the May non-manufacturing ISM and final April trade and factory orders figures. No UST auctions are scheduled in the coming week.

Economic calendar

Key data releases – May/June

23	24	25	26	27
GOODS TRADE BALANCE ¥BN MAR 295 APR 427 MANUFACTURING PMI APR 48.2 MAY P 47.6 ALL INDUSTRY ACTIVITY M/M% FEB -0.9 MAR 0.1	AUCTION FOR ENHANCED LIQUIDITY		3M TB AUCTION 40Y JGB AUCTION REUTERS TANKAN - LARGE MANUFACTURERS DI APR 10 MAY 2 LARGE NON-MANUFACTURERS DI APR 23 MAY 19 SERVICES PPI MAR 0.2 APR 0.2	NATIONAL CPI Y/Y% MAR APR -0.1 -0.3 *EX FRESH FOOD* *-0.3 -0.3* *EX FOOD/ENERGY* *0.7 0.7* *EX FRESH FOOD/ENERGY* *1.1 0.9* TOKYO CPI Y/Y% APR MAY -0.4 -0.5 *EX FRESH FOOD* *-0.3 -0.5* *EX FOOD/ENERGY* *0.6 0.5*
30	**31**	**01**	**02**	**03**
RETAIL SALES Y/Y% MAR -1.0 APR -1.2	2Y JGB AUCTION (APPROX ¥2.3TRN) UNEMPLOYMENT RATE % MAR 3.2 APR 3.2 JOB-TO-APPLICANT RATIO MAR 1.30 APR 1.30 HOUSEHOLD SPENDING Y/Y% MAR -5.3 APR -1.1 INDUSTRIAL PRODUCTION Y/Y% MAR 0.2 APR P -5.1 CONSTRUCTION ORDERS Y/Y% MAR 19.8 APR N/A HOUSING STARTS Y/Y% MAR 8.4 APR 4.0	CAPITAL SPENDING SURVEY Y/Y% Q4 8.9 Q1 4.1 MANUFACTURING PMI APR 48.2 MAY F 47.6 VEHICLE SALES Y/Y% APR 7.2 MAY N/A BOJ BOND MARKET SURVEY (MAY)	3M TB AUCTION (APPROX ¥4.4TRN) 10Y JGB AUCTION (APPROX ¥2.4TRN) MONETARY BASE Y/Y% APR 26.8 MAY N/A	AVERAGE EARNINGS Y/Y% MAR 1.5 APR 0.8 SERVICES PMI APR 49.3 MAY N/A COMPOSITE PMI APR 48.9 MAY N/A
06	**07**	**08**	**09**	**10**
	30Y JGB AUCTION	6M TB AUCTION GDP (Q1 F) BANK LENDING (MAY) ECONOMY WATCHERS SURVEY (MAY) CURRENT ACCOUNT BALANCE (APR)	3M TB AUCTION 5Y JGB AUCTION MACHINE ORDERS (APR) MACHINE TOOL ORDERS* (MAY) M3 MONEY SUPPLY (MAY)	TERTIARY ACTIVITY (APR) GOODS PPI (MAY)
13	**14**	**15**	**16**	**17**
BSI SURVEY (Q2)	1Y TB AUCTION INDUSTRIAL PRODUCTION (APR F) CAPACITY UTILISATION (APR)	3M TB AUCTION BOJ POLICY BOARD MEETING (15-16 JUNE 2016)	BOJ POLICY ANNOUNCEMENT	AUCTION FOR ENHANCED LIQUIDITY DEPARTMENT STORE SALES* (MAY)

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

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