Daiwa Capital Markets

Yen 4Sight

Highlights

- Real GDP rebounded a disappointing 0.3%Q/Q in Q4, leaving activity unchanged from a year earlier.
- Growth was driven by business capex and consumption. Net exports subtracted from growth.
- The domestic demand deflator was again subdued and the goods PPI points to weakening pipeline price pressures.
- National CPI inflation, machinery orders, PMI and trade reports will be the main economics focus in the coming week.

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Interest and exchange rate forecasts

End period	15 Feb	Q119	Q219	Q318
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.02	0.00	0.00	0.00
JPY/USD	110	109	110	108
JPY/EUR	125	125	126	123

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

Only a modest rebound in GDP in Q4

On a relatively quiet week for domestic data, the preliminary national accounts for Q4 provided a disappointing stock-take of economic conditions at the end of 2018. Analysts expected a rebound in output after adverse weather and the Hokkaido earthquake contributed to a sharp contraction in Q3. But the accounts suggest that the rebound was meek, with real GDP in Q4 up a moderate 0.3%Q/Q (1.4%Q/Q ann.), reversing less than half of the contraction of 0.7%Q/Q the previous quarter – a decline that was 0.1ppt larger than estimated previously.

Economy posted no growth over past 4 quarters

Unfortunately, while revisions to earlier quarters were a touch more favourable, this result meant that there was zero GDP growth between Q417 and Q418. Real gross national income (RGNI), which better measures residents' overall spending power, also rose 0.3%Q/Q in Q4 with investment income receipts from the rest of the world and investment income outflows growing at a similar pace during the quarter. However, across the full year, RGNI declined 0.8%Y/Y, with investment income outflows growing more than twice as fast as investment income receipts. Of course, we need to caution that these estimates are subject to the possibility of substantial revision, with additional information on investment and private inventories to be obtained from the MoF's quarterly survey of corporations, due on 1 March.

BoJ growth forecast for FY18 still too high

In calendar year terms, real GDP still grew 0.7% in 2018, but this was much weaker than the 1.9% lift in 2017 and at best no faster than the economy's potential growth rate. Moreover, the BoJ Board's recently downgraded forecast for FY18 – a median expectation of 0.9%Y/Y – is likely still to prove too optimistic. In the absence of positive revisions, and an optimistic assumption of further growth of 0.5%Q/Q in Q119, GDP growth in FY18 would come in at just 0.6%Y/Y– in line with the forecast of the most pessimistic member of the BoJ's Board. Yet our colleagues in Tokyo expect growth in Q119 to be a damp squib, at just 0.1%Q/Q. At the margin, this provides yet another setback for the BoJ's inflation forecast.

Consumer spending helps lift domestic demand

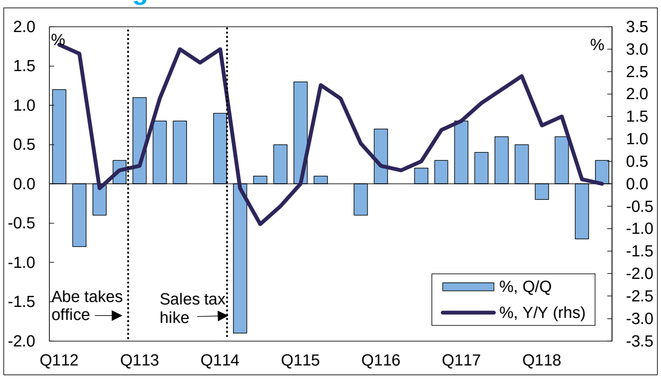
As expected the rebound in real GDP growth owed to a lift in domestic demand, while net exports and private inventories subtracted from growth – indeed, as it turns out, by more

Q4 GDP: Key figures

	%, Q/Q	*contr*	%, Y/Y	*contr*
GDP	**0.3**	**-**	**0.0**	**-**
Final sales	0.5	0.5	0.3	0.3
Domestic demand	0.7	0.6	0.5	0.5
-Private consumption	0.6	0.3	0.8	0.4
-Residential investment	1.1	0.0	-2.3	-0.1
-Non-residential investment	2.4	*0.4*	3.4	*0.5*
-Government consumption	0.8	*0.2*	1.4	*0.3*
-Public investment	-1.2	-0.1	-4.8	-0.3
Net exports	-	-0.3	-	-0.5
-Exports	0.9	0.2	0.3	0.1
-Imports	2.7	-0.5	3.6	-0.6
Private inventories	-	-0.2	-	-0.4

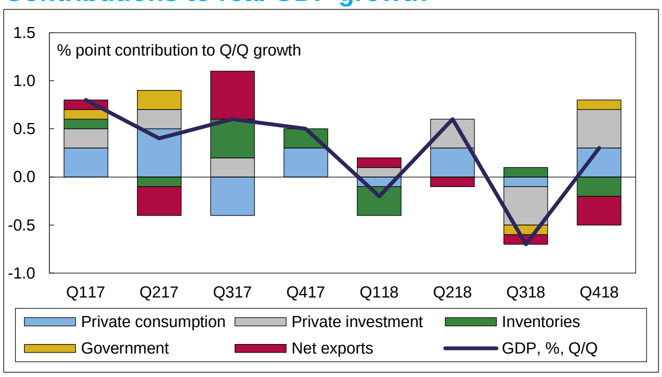
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Real GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Contributions to real GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

than we had expected. Domestic demand rose 0.7%Q/Q in Q4, albeit only lifting annual growth by 0.2ppt to 0.5%Y/Y. After declining an unrevised 0.2%Q/Q in Q3, private consumption increased 0.6%Q/Q in Q4 – an outcome that was much as we had expected and sufficient to lift annual growth by 0.2ppt to 0.8%Y/Y. While consumers spent less on non-durable goods during the quarter, spending on durables rose 3.3%Q/Q and spending on services rose 1.0%Q/Q – the latter following a 0.8%Q/Q decline in Q3.

Employee compensation growth firms in Q4

While the solid lift in consumer spending was welcome, growth remains modest considering developments in household incomes. Higher wages contributed to a rise of 0.7%Q/Q in real employee compensation in Q4, with the annual rate up to a solid 2.5%Y/Y– three times the pace of growth in private consumption. This suggests that the BoJ's much-desired 'virtuous cycle' from income to spending is operating with less force than policymakers would desire.

Business investment posts solid rebound

Somewhat encouragingly, the other key driver of growth in Q4 was business investment. After declining 2.7%Q/Q in Q3, the preliminary accounts indicated a 2.4%Q/Q rebound in non-residential investment in Q4 – spending that likely to some extent continues to be motivated by the need to employ labour-saving technology. This outcome was sufficient to lift annual capex growth to 3.4%Y/Y from just 1.2%Y/Y previously. And in nominal terms, the share of GDP accounted for by non-residential investment reached a new post-bubble era high. That said, this estimate is based only on supply-side data and, as noted above, is subject to significant revision once the results of the MoF corporate survey are incorporated. Meanwhile, residential investment grew 1.1%Q/Q – a second consecutive quarter of positive growth, but leaving output down 2.3%Y/Y nonetheless.

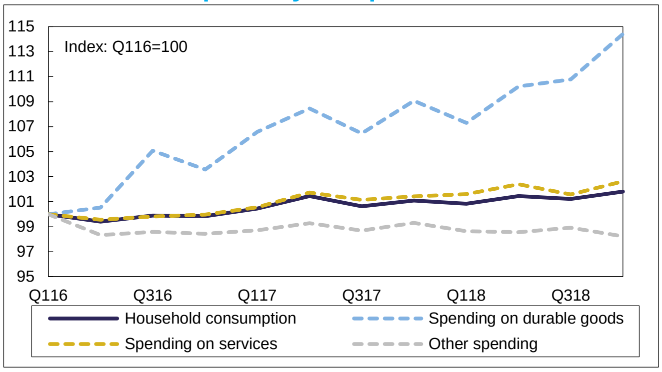
Public investment and inventories weigh on Q4

News regarding public spending was positive, on balance. Public consumption rose a solid 0.8%Q/Q and 1.4%Y/Y, and so made a disproportionate contribution to overall growth. Public investment spending declined 1.2%Q/Q and 4.8%Y/Y, but this category accounts for less than one-fifth of overall public spending. Meanwhile, private inventories subtracted a preliminary 0.2ppt from GDP growth in Q4. While that might ordinarily be viewed as positive for future output, at least in the near term, given the current global environment it is difficult to see why firms would intentionally seek to boost their inventory levels. Still, this meant that final sales increased 0.5%Q/Q in Q4, although annual growth in final sales was still very weak at just 0.3%Y/Y.

Net exports also subtract from growth in Q4

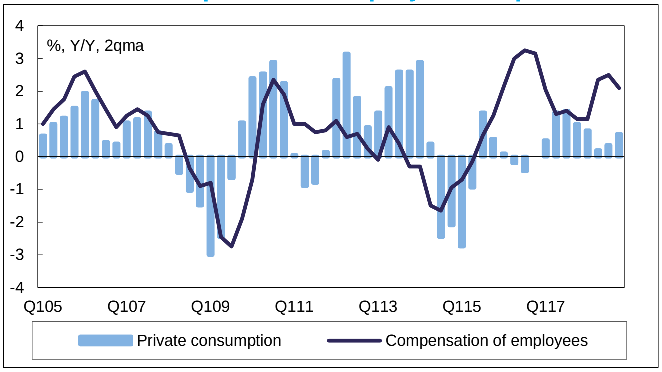
The soft external environment was reflected in the performance of net exports, which subtracted 0.3ppt from GDP growth in Q4 – the third consecutive negative contribution and the largest since Q217. In aggregate, exports rose 0.9%Q/Q, but their annual growth slowed to just 0.3%Y/Y from 1.6%Y/Y in Q3. This contrasts with average export growth of more than 6%Y/Y during 2017 and the first half of 2018. Exports of goods increased 1.4%Q/Q

Private consumption by component



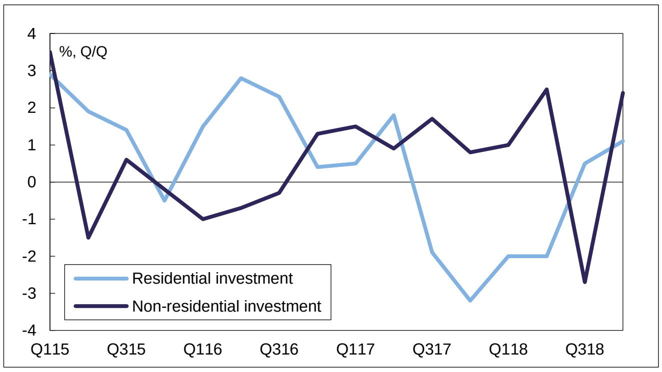
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd

Private consumption and employee compensation



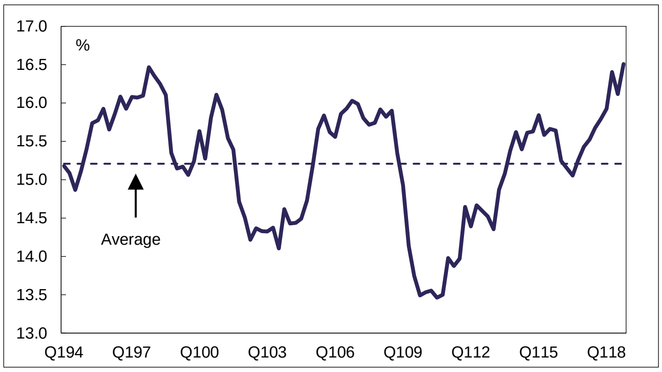
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Private investment



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd .

Non-residential investment: Share of nominal GDP



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

but exports of services fell a surprising 1.3%Q/Q. After being impacted negatively by natural disasters in Q3, spending by non-residents (i.e. largely tourists) rebounded 6.7%Q/Q, lifting their annual growth back to 10%Y/Y. Unfortunately, this means that exports of other services recorded a fourth consecutive quarter of negative growth. Meanwhile, imports rose a much stronger 2.7%Q/Q in Q4, lifting annual growth to 3.6%Y/Y, thus accounting for the overall negative contribution from the sector.

Inflation momentum remains weak

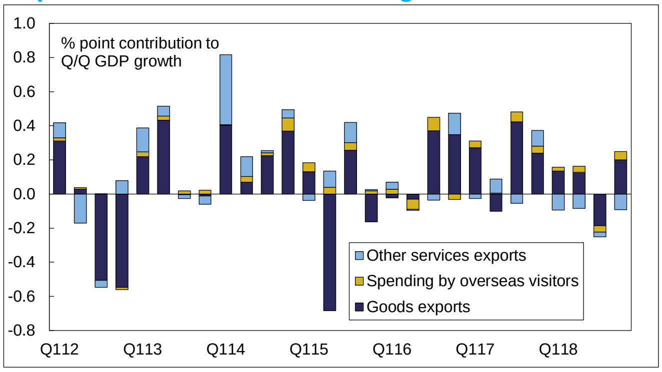
The preliminary estimates indicated that nominal GDP rose 0.3%Q/Q in Q4. Even so, the value of output fell 0.3%Y/Y and was still more than ¥50tn short of PM Abe's target of a ¥600bn economy. The implicit GDP deflator fell 0.1%Q/Q and was down 0.3%Y/Y. The domestic demand deflator was a little firmer, but still only rose a measly 0.1%Q/Q and 0.5%Y/Y. Import prices also edged up 0.1%Q/Q – a marked slowdown from the previous pace as the positive impulse from energy prices faded. And the BoJ's goods PPI report suggests that pipeline pressures have weakened further in early 2019. The headline index fell a further 0.6%M/M in January, so that the annual pace of inflation slowed to a two-year low of 0.6%Y/Y. Measured in yen terms, import prices slumped 5.0%M/M, only partly due to lower prices for energy, and were down 1.6%Y/Y. And final prices for consumer goods fell 1.1%M/M to be down 1.8%Y/Y – the weakest outcome since December 2016.

The week ahead in Japan and the US

The coming week's Japanese economic diary begins on Monday with the machinery orders report for December, including firms' forecasts for Q1 – of particular interest given the recent worsening in business sentiment, on which the following day's Reuters Tankan for February will cast more light. On Wednesday attention will turn to the external sector with the release of the trade balance and overseas visitor reports for January – over the first twenty days of the month, the value of exports fell a steep 8.9%Y/Y while imports fell 8.4%Y/Y. Thursday's focus will be February's preliminary manufacturing PMI, which saw a sharp decline the previous month. Finally, Friday brings the national CPI for January, which may point to some better – but likely short-lived – inflation news for the BoJ in light of the advance results from the Tokyo region. The final Monthly Labour Survey for December will also be released that day. In the bond market the MoF will auction 20Y JGBs on Tuesday and enhanced liquidity (maturities of 5-to-15.5 years) on Thursday.

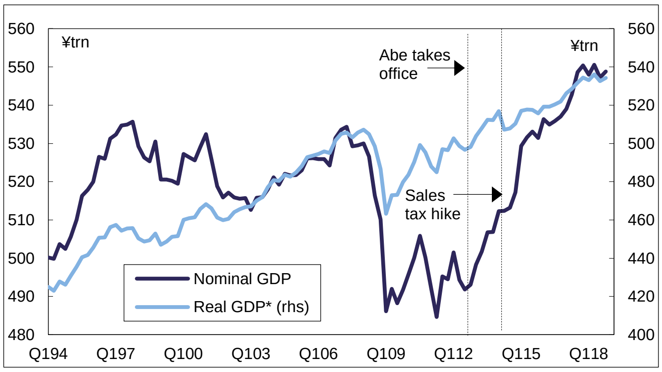
In the US, following Monday's Presidents' Day holiday, the economic diary begins on Tuesday with February's NAHB housing survey. Wednesday brings the minutes of last month's FOMC meeting. Thursday brings the delayed durable goods orders report for December as well as the Philadelphia Fed's manufacturing survey for February. Also that day existing home sales data for January, the Conference Board's leading Index for the same month, and the preliminary Markit PMI reports for February are also due. While no reports are scheduled for Friday, several FOMC members will speak at a Fed conference on 'The future of the Federal Reserve's balance sheet'. In the bond market the US Treasury will auction 2-year FRNs on Wednesday and 30-year TIPS on Thursday.

Exports: Contributions to GDP growth



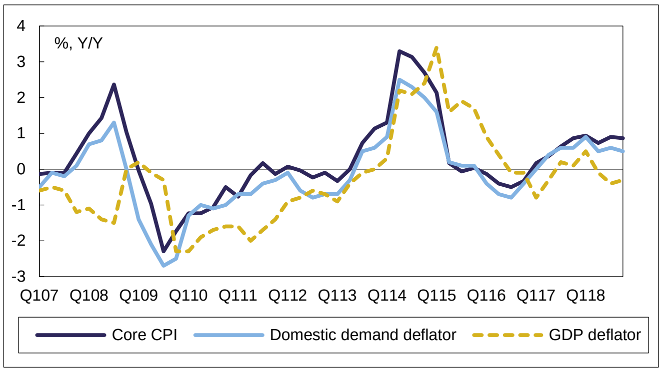
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd

Nominal and real GDP



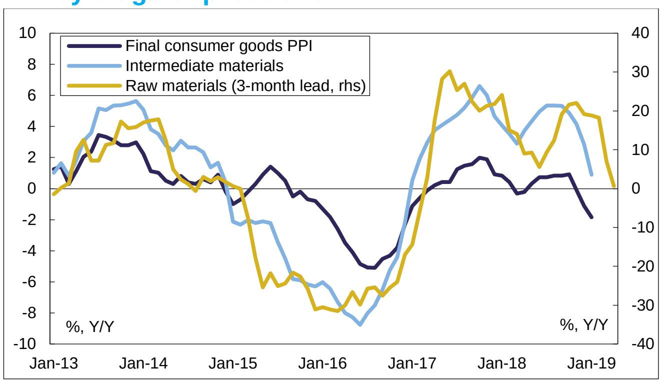
**2011 prices. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd*

Selected measures of inflation



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

PPI by stage of production



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

Economic calendar

Key data releases – February/March

11	12	13	14	15
NATIONAL HOLIDAY – FOUNDATION DAY	TERTIARY ACTIVITY INDEX M/M% NOV -0.4 DEC -0.3 M3 MONEY SUPPLY Y/Y% DEC 2.1 JAN 2.1	5Y JGB AUCTION GOODS PPI Y/Y% DEC 1.5 JAN 0.6	GDP Q/Q% Q3 -0.7 Q4 P 0.3	10Y JGBI AUCTION 3M TB AUCTION INDUSTRIAL PRODUCTION M/M% NOV -1.0 DEC F -0.1 CAPACITY UTILISATION M/M% NOV 1.0 DEC -1.9
18	**19**	**20**	**21**	**22**
MACHINE ORDERS M/M% NOV 0.0 DEC -1.1 DEPARTMENT STORE SALES* Y/Y% DEC -0.7 JAN N/A	20Y JGB AUCTION (APPROX ¥1.0TRN) 1Y TB AUCTION (APPROX ¥1.9TRN) REUTERS TANKAN – MANUFACTURERS DI JAN 18 FEB N/A NON-MANUFACTURERS DI JAN 31 FEB N/A	TRADE BALANCE ¥BN DEC -184 JAN 171 OVERSEAS VISITORS MN DEC 2.6 JAN N/A	AUCTION FOR ENHANCED LIQUIDITY (APPROX ¥0.6TRN) MANUFACTURING PMI JAN 50.3 FEB P N/A ALL INDUSTRY ACTIVITY M/M% NOV -0.3 DEC -0.2	3M TB AUCTION (APPROX ¥4.34TRN) NATIONAL CPI Y/Y% DEC JAN 0.3 0.2 *EX FRESH FOOD* *0.7 0.8* *EX FRESH FOOD/ENERGY* *0.3 0.4* AVERAGE WAGES Y/Y% NOV 1.7 DEC F 1.8
25	**26**	**27**	**28**	**01**
SERVICES PPI (JAN)	AUCTION FOR ENHANCED LIQUIDITY		2Y JGB AUCTION INDUSTRIAL PRODUCTION (JAN P) RETAIL SALES (JAN) HOUSING STARTS (JAN) CONSTRUCTION ORDERS (JAN)	3M TB AUCTION TOKYO CPI (FEB) UNEMPLOYMENT RATE (JAN) JOB-TO-APPLICANT RATIO (JAN) CAPITAL SPENDING SURVEY (Q4) CONSUMER CONFIDENCE (FEB) MANUFACTURING PMI (FEB F) VEHICLE SALES (FEB) BOJ BOND MARKET SURVEY (FEB)
04	**05**	**06**	**07**	**08**
MONETARY BASE (FEB)	10Y JGB AUCTION SERVICES PMI (FEB) COMPOSITE PMI (FEB)		6M TB AUCTION 30Y JGB AUCTION BOJ CONSUMPTION ACTIVITY INDEX (JAN)	3M TB AUCTION GDP (Q4 F) HOUSEHOLD SPENDING (JAN) BANK LENDING (FEB) CURRENT ACCOUNT (JAN) ECONOMY WATCHERS SURVEY (FEB)

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

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