Daiwa Capital Markets

Yen 4Sight

Highlights

- The BoJ left policy unchanged. While noting recent weakness in exports and production, the Bank's outlook remained positive.
- The MoF's Business Outlook Survey pointed to less favourable business conditions and a slightly less upbeat outlook for capex.
- Machine orders fell sharply in January. While service sector activity grew, consumer spending made a soft start to Q1.
- The focus in the coming week will be new data on trade (Monday) and CPI inflation and the manufacturing PMI (Friday).

Chris Scicluna
+44 20 7597 8326
chris.scicluna@uk.daiwacm.com

Emily Nicol
+44 20 7597 8331
emily.nicol@uk.daiwacm.com

Interest and exchange rate forecasts

End period	15 Mar	Q219	Q319	Q419
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.03	0.00	0.00	0.00
JPY/USD	112	110	107	105
JPY/EUR	126	126	121	118

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

BoJ leaves policy unchanged again, as expected

As widely expected, the latest BoJ Board meeting delivered no changes to the policy settings that were last tweaked in July last year. So, the -0.1% marginal interest rate on excess bank reserves remained, as did the commitment to purchase JGBs so that 10Y yields remain at around 0%. And the BoJ again pledged to conduct its JGB purchases in 'a flexible manner' so that its holdings will increase at an annual pace of about ¥80tn – a rate that the BoJ has continued to fall well short of so far this year. The usual two out of nine Board members – Kataoka and Harada – dissented from those decisions. But the Bank's ETF and REIT purchase targets were confirmed unanimously.

Acknowledgement of export and IP weakness

In the accompanying statement, Japan's economy was still described as "expanding moderately". But as expected, the Bank acknowledged that exports and IP had both "shown some weakness recently", having been affected by a slowdown in overseas economies (the latter now described as growing "moderately on the whole" rather than "firmly on the whole"). But the Bank's description of private consumption and business investment remained positive. Moreover, labour market conditions continued to be described as "tightening steadily" and financial conditions "highly accommodative".

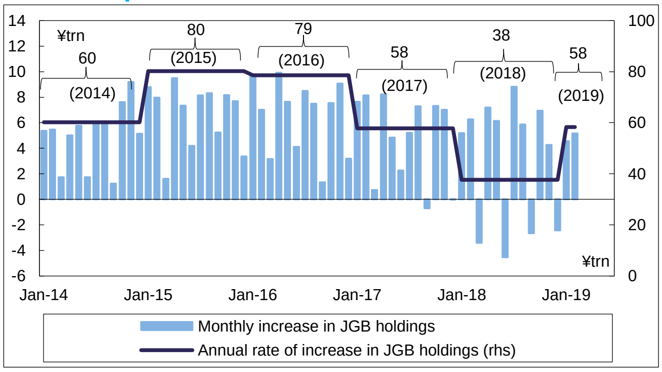
But BoJ medium-term outlook little changed

Looking ahead, perhaps optimistically, the Bank continues to expect Japan's economy to continue its moderate expansion. While acknowledging the likelihood of some further near-term weakness, exports are expected to resume a similarly moderate uptrend. So, with domestic demand still expected to remain on its own uptrend, the output gap remaining positive and inflation expectations forecast to increase over time, the Bank continues to expect annual CPI inflation to increase toward the 2% target, the achievement of which Governor Kuroda insisted the BoJ would remain fully committed despite earlier comments from Finance Minister Aso that an excessive focus on it might be 'problematic'. As a result, the Bank is unlikely to contemplate additional policy easing at this stage, not least due to worries about the potential for negative side effects on the financial sector.

MoF survey indicates weaker conditions in Q1

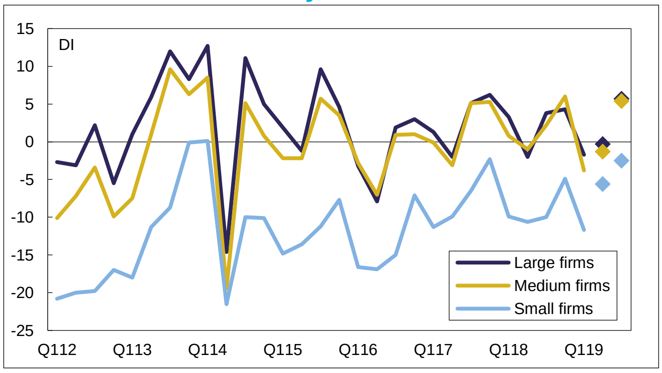
The economic outlook will determine whether the high hurdle for further policy action is eventually scaled. In this context,

BoJ JGB purchases



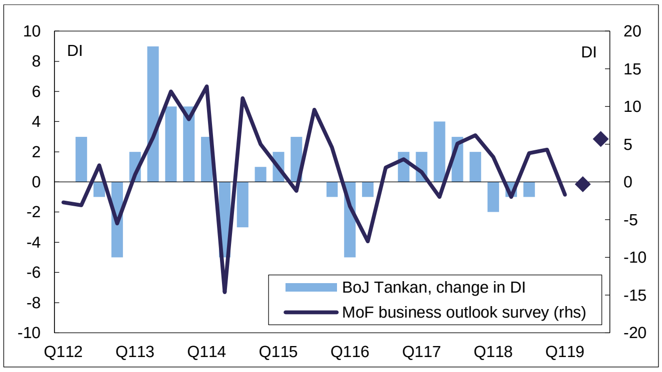
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Business outlook survey: Overall conditions*



**Balance of respondents reporting improvements over the quarter. Diamonds represent firms' forecasts for Q2 and Q3. Source: MoF, Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Business conditions*



**Large firms. MoF survey represents balance of respondents reporting improvements over the quarter. Diamonds represent firms' forecasts for Q2 and Q3. Source: MoF, Cabinet Office, BoJ and Daiwa Capital Markets Europe Ltd.*

the MoF/Cabinet Office Business Outlook Survey – often a good indicator of the direction of movement of the more comprehensive BoJ Tankan survey (due 1 April) indicated that, on balance, firms perceive overall business conditions to have worsened in recent months. For example, amongst large firms, a net 1.7% of respondents judged business conditions to have weakened, driven by the net 7.3% of manufacturers that reported a deterioration (the most since Q216), with a similar proportion reporting weaker domestic conditions too. So, on 1 April the key Tankan diffusion indices also would seem likely to cast business conditions in a less favourable light, albeit that conditions will likely continue to be described very favourably by historical standards.

Business conditions expected to improve in Q3

Looking ahead, on balance, large firms indicated that they expect little change in overall business conditions in Q2, followed by an improvement in Q3 when demand will likely rise ahead of October's consumption tax hike. As usual, medium-sized firms were slightly less upbeat than their larger counterparts. And small firms did not share the optimism of their larger counterparts at all, with these firms expecting conditions to deteriorate further over the coming two quarters. However, firms continued to report worsening labour shortages and an expectation that shortages would become more acute still, albeit at a notably slower pace.

Sales and profit outlook weakens

Elsewhere in the survey, respondents provided their fifth and final estimate of sales, profits and capex for FY18, as well as their first tentative estimate for FY19. Firms now forecast sales growth of 2.4%Y/Y in FY18, while growth of just 0.1%Y/Y is forecast in FY19. Ordinary profits are forecast to decline 1.7%Y/Y in FY18, compared with the 0.4%Y/Y increase forecast previously. This largely reflects the performance of manufacturers, who now expect their profits to decline 5.8%Y/Y. In FY19 profits are forecast to fall 0.4%Y/Y, led by a 1.8%Y/Y decline at manufacturing firms.

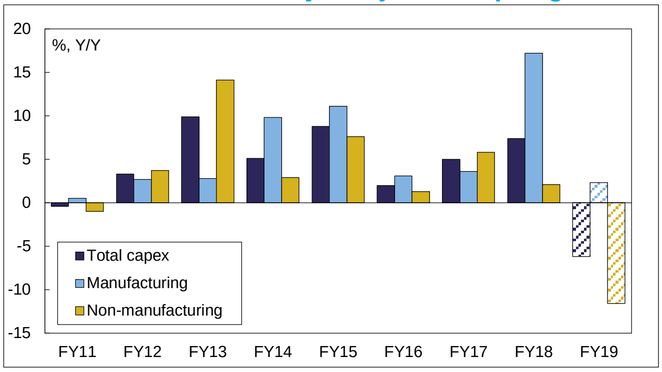
FY18 capex downgraded, FY19 forecast soft

Given widespread labour shortages and high absolute levels of profitability, firms estimate that spending on plant and machinery and software will grow 7.4%Y/Y in FY18, albeit down from the 9.1%Y/Y increase forecast previously. This is mostly due to an expected 17.2%Y/Y lift in spending in the manufacturing sector, whereas non-manufacturers forecast spending to increase just 2.1%Y/Y. But the opening forecast for the new fiscal year was very cautious, with spending expected to be down 6.2%Y/Y in FY19, driven especially by the non-manufacturing sector. This is a little weaker than the typical opening forecast over the past decade, probably reflecting the high level of investment that is already taking place and uncertainty regarding the economic outlook. It is, however, little different to the first forecast made for FY18.

Machinery orders disappoint in January

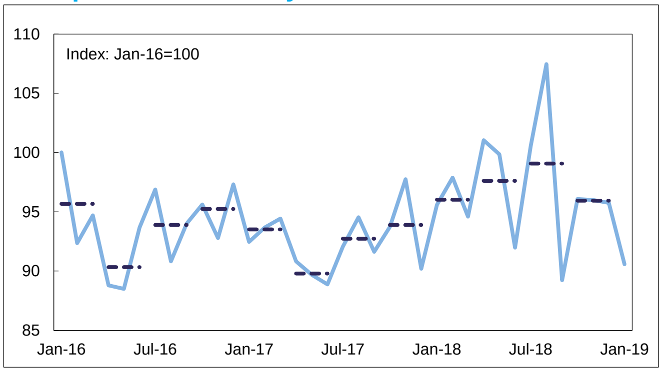
Certainly, like most Japanese indicators, machinery orders have made a poor start to the year. Total orders – which are especially volatile from month to month – fell 7.9%M/M in January and were down 9.1%Y/Y. The more closely-watched series of core private orders – which excludes ships and other volatile categories – fell 5.4%M/M and 2.9%Y/Y. Core

Business outlook survey: Projected capex growth*



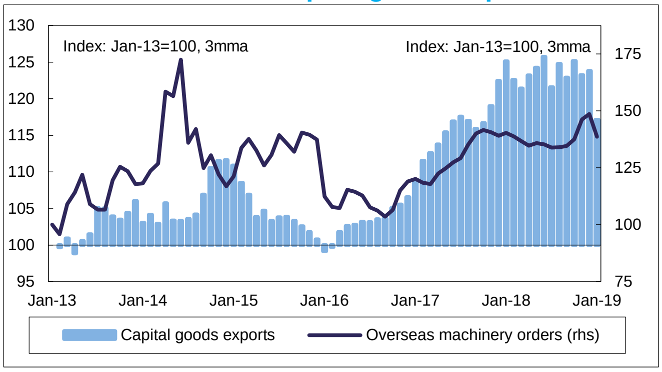
*Final estimate for each year, except FY19, for spending on software and plant and equipment. Source: MoF, Cabinet Office and Daiwa Capital Markets Europe Ltd.

Core private machinery orders*



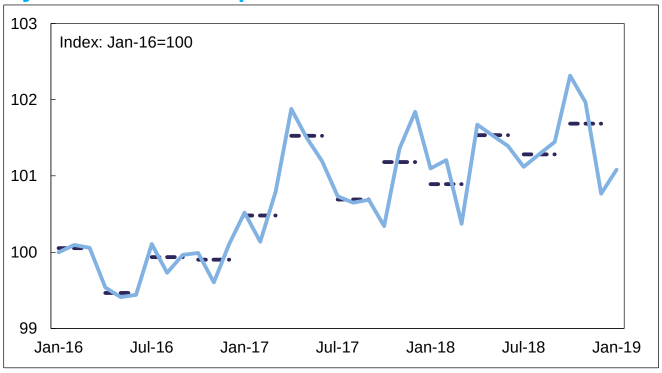
*Dashed lines represent quarterly averages. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Overseas orders and capital goods exports



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

Synthetic Consumption Index*



*Dashed lines represent quarter averages. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

non-manufacturing orders slumped 8.0%M/M, but remained slightly higher than a year earlier. Private orders from manufacturers fell just 1.9%M/M but were down 7.5%Y/Y. As in December, a particularly notable source of weakness was foreign orders – down 18.1%M/M for the second month in a row and leaving these orders down 22.7%Y/Y.

Core machine orders likely down sharply in Q1

Given the weak outcome for January, core private orders are now running 5.6% below the average recorded in Q4. The Cabinet Office's latest survey of 280 machinery manufacturers, published with last month's machinery orders report, had seen firms forecast a 1.8%Q/Q decline in core private orders in Q1. So unfortunately, while it is still very early in the quarter, firms' pessimistic expectations may prove not to have been downbeat enough.

Consumer spending may also decline in Q1

Meanwhile, the Cabinet Office Synthetic Consumption Index – the best available monthly indicator of private consumption spending – provided cause to worry about how consumer spending is shaping up too. The report included some notable revisions to prior months reflecting the downward revision to private consumption in the latest national accounts. Following a newly estimated 1.2%M/M decline in December, this indicator points to only a modest 0.3%M/M lift in spending in January. As a result, spending in January was 0.6% below the average level in Q4. Barring further revisions, this means that consumer spending will likely need to rise strongly in February if growth across Q1 is to stand much chance of being positive.

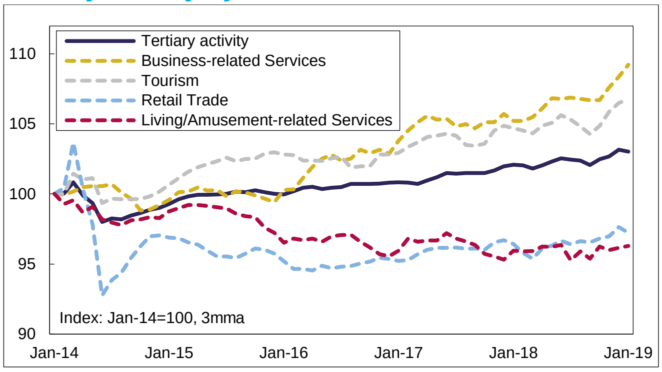
Service sector grows in January, however

In somewhat better news, METI's Tertiary Industry Activity Index for January beat expectations. The headline index increased 0.4%M/M – albeit after a 0.5%M/M contraction in December that was larger than estimated previously – so annual services sector growth picked up to 1.1%Y/Y. The largest contributions were made by wholesale trade and the living/amusement sectors – both soft in December – while the largest drag came from retailers. Unfortunately, despite the pick-up in January, overall activity was still fractionally below the Q4 average. Given very weak indications from the industrial sector, services will have to do much better over February and March if GDP is to advance in Q1.

Producer prices up as crude oil rebounds

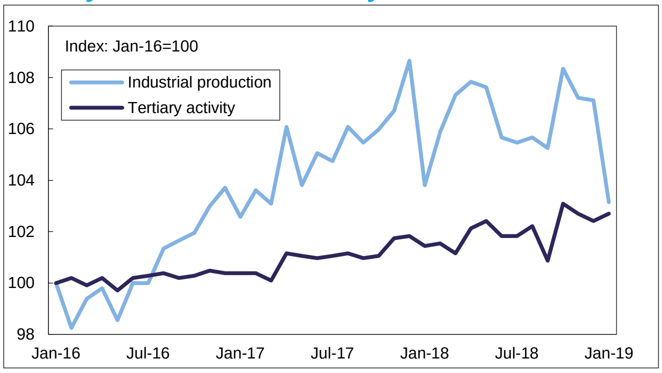
The past week's only pricing news came in the form of the BoJ's goods producer prices report. Following back-to-back downside surprises, the PPI rose a slightly larger-than-expected 0.2%M/M in February, sufficient to lift annual growth 0.2ppt to 0.8%Y/Y. Petroleum and coal prices rose 1.6%M/M reflecting the turnaround in the crude oil market. Prices for non-ferrous metals also rose for the first time in three months. In a similar vein, in yen terms, import prices rose 1.1%M/M in February – they had fallen more than 9% over the previous two months – so that the pace of annual decline slowed to 0.7%Y/Y from 1.8%Y/Y previously. Prices for energy products edged up 1.2%M/M – they had fallen more than 10%M/M in both December and January – while metals prices also increased. Final prices for consumer goods rose 0.3%M/M in February – the first increase since October – so that annual deflation on this measure slowed 0.6ppt to -1.1%Y/Y.

Tertiary activity by subsector



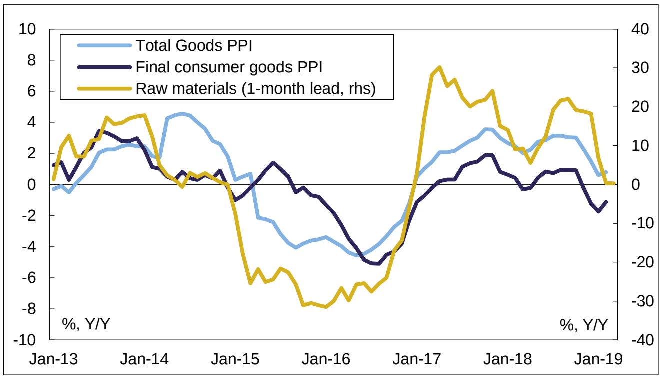
Source: METI and Daiwa Capital Markets Europe Ltd.

Tertiary and industrial activity



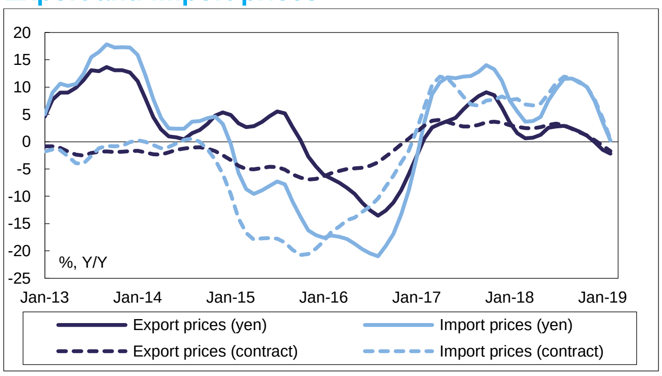
Source: METI and Daiwa Capital Markets Europe Ltd.

Goods PPI



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

Export and import prices



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

The week ahead in Japan and US

The coming week features a relatively small number of potentially market-moving economic releases. Perhaps the most notablle will be Monday's trade report for February, especially in light of the very disappointing performance of exports in January – an outcome almost certainly partly due to the impact of regional holidays. The final IP report for January will also be released on Monday, setting the base for what appears likely to be a very weak quarter for manufacturers. On Wednesday, the Reuters Tankan survey for March will provide a further take on business sentiment, while overseas visitor arrivals data for March will cast light on whether tourism receipts are continuing to provide a buffer against what has been a weakening trend in other service sector exports. Following a holiday for the Vernal Equinox on Thursday, the week will conclude on Friday with the release of the nationwide CPI for February and the preliminary results of the manufacturing PMI survey for March. The CPI report is expected to see the headline inflation rate rise 0.1ppt to 0.3%Y/Y, but the BoJ's forecast core rate (excluding fresh food prices) might well slip back by 0.1ppt to 0.7%Y/Y. Meanwhile, the manufacturing PMI will hopefully point to at least some improvement after declining sharply over the first two months of this year. In the bond market, the MoF will auction 1-year Treasury bills and 20-year JGBs on Tuesday and enhanced liquidity (maturities 1-5 years) on Friday.

The focus in the US in the coming week will be firmly on the Fed, with the conclusion of the two-day FOMC meeting on Wednesday. Given recent communications it goes without saying that the Fed will almost certainly leave its policy settings unchanged. So, most interest will be on the Fed's revised Summary of Economic Projections and Fed Chair Powell's post-meeting press conference to see what meeting participants have in mind regarding policy over the remainder of this year and beyond. Certainly, we expect more dovish dot plots than the previous set issued in December, with the dots back then showing the median expectation for two interest rate hikes this year and a further 25bp hike in 2020 – given current uncertainties, the Fed will likely play down the importance of the central forecast and suggest a readiness to be patient before determining its next move. On the data front, the week begins with the NAHB housing index for March on Monday, followed by factory orders figures for January on Tuesday. The Philadelphia Fed's manufacturing survey for March and the Conference Board's leading indicator for February will be released on Thursday. On Friday, the week concludes with February existing home sales and January wholesale trade reports, as well as the preliminary PMIs for March. In the bond market, the US Treasury will auction 10-year TIPS on Thursday.

Daiwa Capital Markets

Economic calendar

Key data releases – March/April

11	12	13	14	15
M3 MONEY SUPPLY Y/Y% JAN 2.1 FEB 2.1	5Y JGB AUCTION MOF'S BUSINESS OUTLOOK SURVEY – ALL INDUSTRY BSI Q4 4.3 Q1 -1.7	MACHINE ORDERS M/M% DEC -0.1 JAN -5.4 TERTIARY ACTIVITY M/M% DEC -0.5 JAN 0.4 GOODS PPI Y/Y% JAN 0.6 FEB 0.8	3M TB AUCTION ENHANCING LIQUIDITY AUCTION BOJ POLICY BOARD MEETING (14-15 MARCH 2019)	BOJ POLICY BOARD ANNOUNCEMENT
18	**19**	**20**	**21**	**22**
TRADE BALANCE ¥NN JAN -370 FEB 86 INDUSTRIAL PRODUCTION M/M% DEC -0.1 JAN F -3.7 CAPACITY UTILISATION M/M% DEC -1.9 JAN N/A DEPARTMENT STORE SALES* Y/Y% JAN -2.9 FEB N/A	1Y TB AUCTION (APPROX ¥1.9TRN) 20Y JGB AUCTION (APPROX ¥1.0TRN) FLOW OF FUNDS (Q4)	REUTERS TANKAN - MANUFACTURING DI FEB 13 MAR N/A NON-MANUFACTURING DI FEB 22 MAR N/A OVERSEAS VISITORS* MN FEB 2.6 MAR N/A BOJ MINUTES (22-23 JANUARY 2019 MEETING)	NATIONAL HOLIDAY - VERNAL EQUINOX DAY	3M TB AUCTION (APPROX ¥4.32TRN) ENHANCING LIQUIDITY AUCTION (APPROX ¥0.4TRN) NATIONAL CPI Y/Y% JAN FEB 0.2 0.3 *EX FRESH FOOD* *0.8 0.7* *EX FRESH FOOD/ENERGY* *0.3 0.4* MANUFACTURING PMI FEB 48.9 MAR P N/A
25	**26**	**27**	**28**	**29**
ALL INDUSTRY ACTIVITY (JAN)	40Y JGB AUCTION SERVICES PPI (FEB)		2Y JGB AUCTION	TOKYO CPI (MAR) UNEMPLOYMENT RATE (FEB) JOB-TO-APPLICANT RATIO (FEB) RETAIL SALES (FEB) INDUSTRIAL PRODUCTION (FEB) HOUSING STARTS (FEB) CONSTRUCTION ORDERS (FEB)
01	**02**	**03**	**04**	**05**
BOJ TANKAN (Q1) MANUFACTURING PMI (MAR F) VEHICLE SALES (MAR)	10Y JGB AUCTION BOJ TANKAN: INFLATION OUTLOOK OF ENTERPRISES (Q1) MONETARY BASE (MAR)	3M TB AUCTION SERVICES PMI (MAR) COMPOSITE PMI (MAR) BOJ OUTPUT GAP AND POTENTIAL GROWTH ESTIMATE	30Y JGB AUCTION	3M TB AUCTION AVERAGE WAGES (FEB) BOJ CONSUMPTION ACTIVITY INDEX (FEB) HOUSEHOLD SPENDING (FEB) BOJ CONSUMER SENTIMENT SURVEY COINCIDENT INDEX (FEB P) LEADING INDEX (FEB P)

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

Economic Research

Key contacts

London		
Head of Research	*Grant Lewis*	+44 20 7597 8334
Head of Economic Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Associate Economist	*Mantas Vanagas*	+44 20 7597 8318
Research Assistant	*Jodene Adjei*	+44 20 7597 8332
New York		
Chief Economist	*Mike Moran*	+1 212 612 6392
Junior Economist	*Lawrence Werther*	+1 212 612 6393
Hong Kong		
Economist	*Kevin Lai*	+852 2848 4926
Research Associate	*Christie Chien*	+852 2848 4482
Economic Assistant	*Olivia Xia*	+862 2773 8736
London Translation		
Head of Translation, Economic and Credit	*Mariko Humphris*	+44 20 7597 8327

DAIR <GO>

All of the research published by the London and New York research teams is available on our Bloomberg page at DAIR <GO>. If you are unable to access the research on this page, please contact Jodene Adjei on +44 207 597 8332.

Access our research blog at:
http://www.uk.daiwacm.com/research-zone/research-blog

Follow us
@DaiwaEurope