Yen 4Sight

Highlights

- While exports rebounded in February, the underlying trend has clearly weakened in recent months.
- Unfortunately, both the manufacturing PMI and Reuters Tankan pointed weaker business conditions in March.
- CPI inflation remained very subdued in February with key aggregates printing at or below market expectations.
- The focus in the coming week will be on February IP and labour market reports and March Tokyo CPI (all released Friday).

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Interest and exchange rate forecasts

End period	22 Mar	Q219	Q319	Q419
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.08	0.00	0.00	0.00
JPY/USD	110	110	107	105
JPY/EUR	125	126	121	118

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

Global developments driving Japanese markets

Over the past week, Japan's markets were dominated by news generated offshore – not least reported developments in US-China trade discussions, the Fed's capitulation to the market's dovish view regarding future interest rates, and the continued uncertainty that surrounds Brexit. For much of the week, the local news flow was relatively light, but data seemed to confirm that economic conditions have deteriorated and that core inflation may well have peaked, at least for this year. So, while the BoJ is clearly very reluctant to ease monetary policy further, the risks remain biased in this direction.

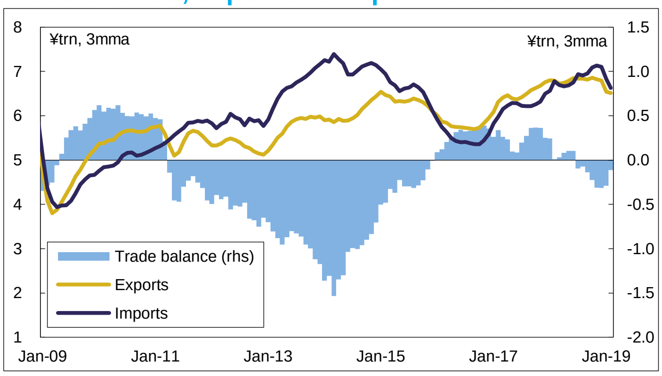
Trade balance returns to surplus in February

The local diary kicked off with the merchandise trade report for February, which was of particular interest in light of the exceptionally weak performance of exports in January. As expected, this report suggested that much of last month's result was likely due to volatility associated with regional holidays. Indeed, the value of exports rebounded 6.7%M/M, following a slightly-revised 6.3%M/M decline in January. Even so, exports were still down 1.2%Y/Y and 4.5%3M/Y, marking the weakest three-month period since November 2016. So, as the BoJ acknowledged after its March policy meeting, the underlying performance of the export sector has clearly weakened in recent months. Meanwhile, the value of imports rose just 0.1%M/M in February and was down 6.7%Y/Y. As a result, Japan reported a seasonally-adjusted trade surplus of ¥116bn – the first surplus since June last year.

Net exports may contribute to GDP growth in Q1

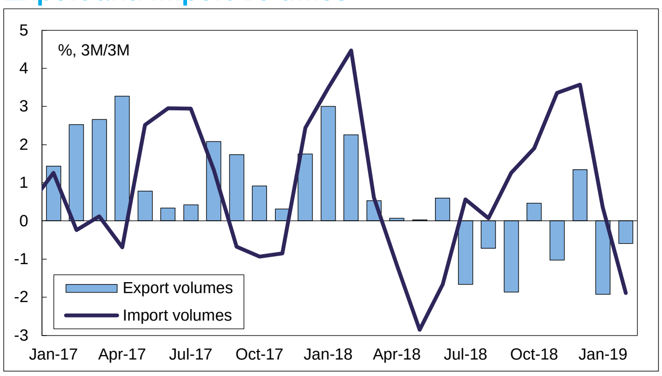
After adjusting for both seasonal and price effects, the BoJ estimated that export volumes had rebounded 6.0%M/M in February following a decline of 5.3%M/M in January. Even so, on this measure, export volumes were still down 0.2%Y/Y. Moreover, even if the level of export volumes in February were to be maintained in March, they would be down 1.8%Q/Q in Q1. On the same basis, the volume of imports fell 3.2%M/M in February and was down 5.8%Y/Y. Again, assuming that import volumes in March were to remain at February's level, volumes would decline 3.9%Q/Q over Q1 as a whole. At face value this suggests that while, both exports and imports are likely to contract in Q1, net goods exports could yet make a positive contribution to GDP growth (if so, for the first time since Q118). That said, if export and import volumes in March are similar to their average readings over the past three months, the extent of that positive contribution will likely be relatively small.

Trade balance, export and import values



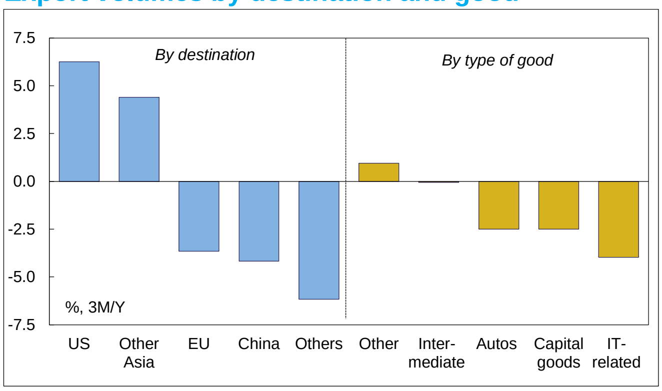
Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export and import volumes



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

Export volumes by destination and good*



**Data for February 2019. Source: BoJ and Daiwa Capital Markets Europe Ltd.*

Exports to China and the EU have declined

Additional detail released by the BoJ cast light on the source of the weakness in export volumes in recent months. While exports to the US and Asia (ex-China) have exceeded year-earlier levels over the past three months combined – by 5% in the case of the US – exports to China, the EU and Japan's other trading partners have declined. By commodity type, only the 'other' category – which includes consumption goods – posted positive export growth over the same period, with exports of motor vehicles, capital goods and IT-related goods all notably weaker than a year earlier.

Tourist arrivals still trending (gradually) higher

As far as services exports are concerned, the total number of overseas visitor arrivals fell 0.09mn to 2.60mn in February, causing annual growth to slow 3.7ppts to 3.8%Y/Y. Much of the slowdown appears to reflect volatility associated with the timing of the Lunar New Year holiday, as growth in arrivals from China slowed to just 1.0%Y/Y from 19.3%Y/Y previously. Excluding arrivals from China, growth in arrivals strengthened to an eight-month high of 4.9%Y/Y.

Manufacturing PMI details concerning

Moving to the factory sector, industrial output slumped a revised 3.4%M/M in January – only slightly less than first estimated. And the preliminary results of the manufacturing PMI survey for March suggest that a large decline in output is likely in Q1 as a whole. The headline PMI was steady at last month's 32-month low of 48.9, with the detail of the report indicating a further weakening of prospects for activity. In particular, the output index fell 0.5pt to a 34-month low of 46.9. Worse still, the new orders PMI fell 0.8pt to 46.6 and the new export orders index fell 0.9pt to 46.8 – also the weakest outcomes seen in almost three years. The employment PMI rose 0.2pt to 51.8, reflecting the fact that firms remain understaffed. The other area of strength concerned prices, with the output price index up 0.4pt to 52.1, thus erasing the decline recorded in February.

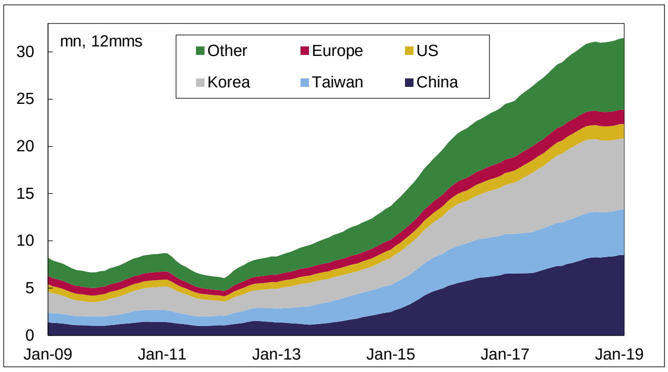
Reuters survey points to weaker BoJ Tankan

The Reuters Tankan survey for March told a similar story, with the headline diffusion index (DI) for the manufacturing sector falling a further 3pts to +10 – the lowest since October 2016. Almost all sub-sectors recorded weaker conditions, with sentiment remaining negative in the steel and metals business and turning negative in the electrical machinery and precision machinery industries for the first time in over 2½ years. After falling sharply last month, the headline DI for the non-manufacturing sector was steady at February's 26-month low of +22, with all sub-industries maintaining a net positive assessment. Looking ahead, the forward-looking 'forecast' DI for each sector was just 1pt stronger than the current DI, indicating that firms expect at best a marginal improvement in conditions over the next three months. These results point to some slippage in the BoJ's closely followed quarterly Tankan indices on 1 April.

Inflation remains subdued in February

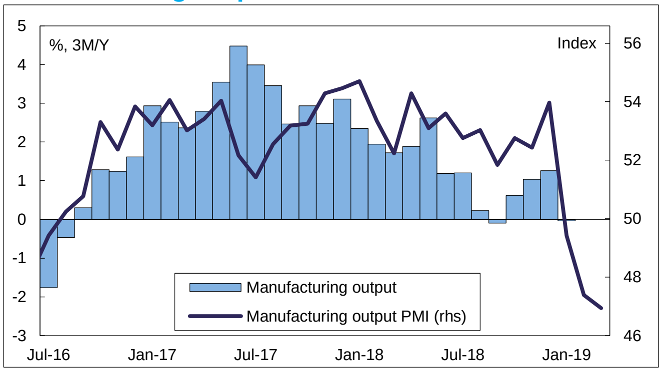
Turning to the February CPI report, all of the key aggregates printed either at or below market expectations, and were at or below their January readings. In seasonally-adjusted

Overseas visitors



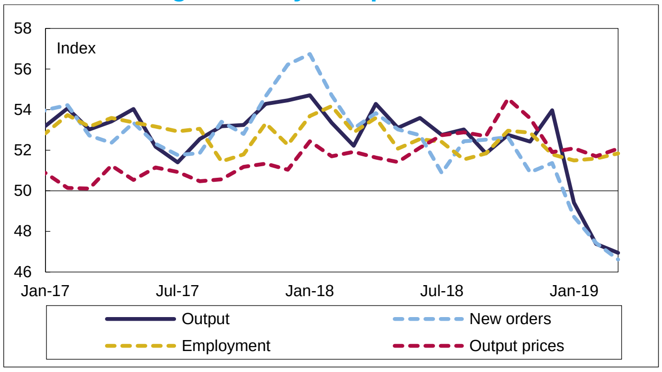
Source: JNTO, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing output and PMI



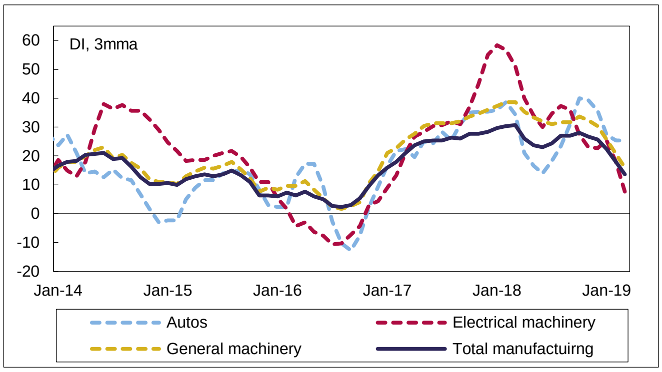
Source: METI, Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing PMI: Key components



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

Reuters Tankan: Business conditions



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

terms the headline index was unchanged in February, so that the annual inflation rate remained at the fifteen-month low of 0.2%Y/Y reached in January. The headline CPI index was weighed down by a further 2.9%M/M decline in the price of fresh food. As a result, the measure used by the BoJ in its quarterly Outlook Report forecast – which excludes fresh food prices from the CPI – rose 0.1%M/M in February. But this was insufficient to prevent a disappointing 0.1ppt decline in the annual inflation rate to 0.7%Y/Y, thus erasing the small increase reported in January.

BoJ's preferred core CPI steady at a low level

Elsewhere in the detail, energy prices rose a further 0.4%M/M with a negligible decline in petroleum prices readily offset by further increases in the prices of electricity and gas. Even so, the BoJ's preferred measure of core prices, which excludes both fresh food and energy prices, also rose 0.1%M/M in February. This was sufficient to leave annual inflation on this measure steady at 0.4%Y/Y – in line with market expectations – but, unfortunately, 0.1ppt weaker than where it had stood a year earlier. Prices for non-energy industrial goods and services edged up in February, but annual inflation in the former remained steady at 0.2%Y/Y while unfavourable base effects meant that annual service sector inflation fell 0.1ppt to 0.4%Y/Y. So, in summary, it remains the case that core inflation is nowhere near the BoJ's 2% target – and shows no sign of moving there in the foreseeable future – despite persistent and extreme tightness in the labour market.

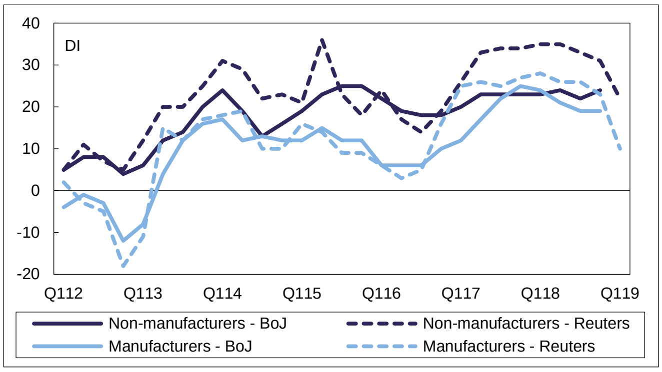
BoJ share of total JGB market steady in Q4

Rounding out this week's economic reports, the BoJ released flow of funds data for Q418, casting new light on the central bank's imprint on the JGB market. Reflecting the slowdown in the pace of the BoJ's net asset purchases last year, its share of the JGB market (including T-bills) was unchanged at 43% – the first time this has not risen since Q112. But this is largely due to the BoJ reducing its total holdings of T-bills steadily over the past nine quarters, by a cumulative ¥45trn. The flip-side to that net selling has been a notable increase in foreigner ownership of Japanese T-bills, with the share of the market taken by overseas investors rising to a record high of more than 70%. After stripping out T-bills, the BoJ's holdings of JGBs continued to rise at the end of last year to ¥466trn, taking its share of the market to a new high of 46% compared with 43% at end-2017 and just 12% before QQE was launched in Q113.

Limited portfolio rebalancing beyond banks

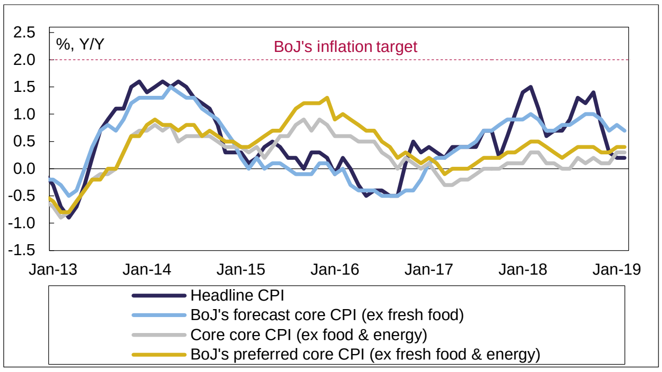
While Japanese banks continued to scale back their JGB holdings, there remained only limited portfolio rebalancing elsewhere. Private insurers and pension funds remained net purchasers of JGBs in Q4, with insurance firms holding around one fifth of the outstanding stock. And Japanese households' and firms' currency and deposit holdings remained near record highs at the end of last year, to account for more than 50% and 23% of their respective total financial assets. However, with household holdings of domestic equities and shares having risen to their highest on record in Q318 (11% of total assets) the sharp correction in global markets at the end of last saw the total value of households' financial assets fall compared with a year earlier in Q418 for the first time since Q216 and by 1.3%Y/Y, the most since Q209.

Tankan Business conditions: BoJ vs Reuters*



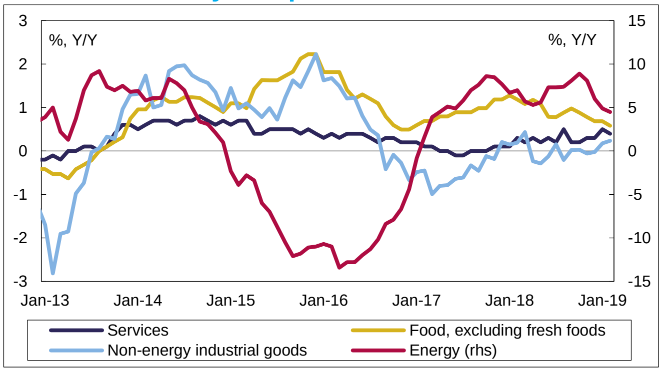
*Reuters Tankan uses end of quarter values. Source: BoJ, Thomson-Reuters and Daiwa Capital Markets Europe Ltd.

National CPI: Headline and core measures*



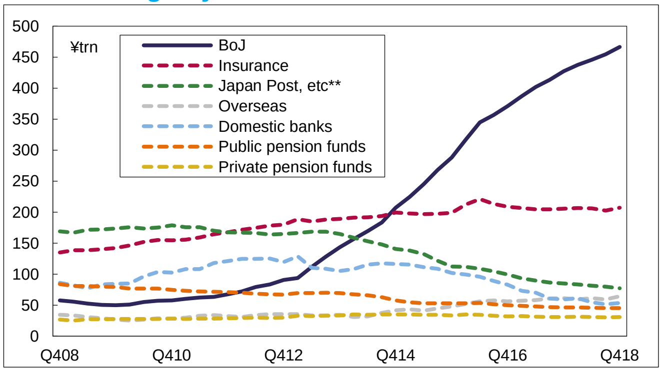
*Excludes impact of consumption tax. Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

National CPI: Key components*



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

JGB holdings by sector



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

The week ahead in Japan and US

The coming week's Japanese economic diary gets off to a slow start, with Monday's release of the All Industry Activity Index for January and Tuesday's release of the services PPI for February the only data entries over the first four days of the week. More noteworthy perhaps, the summary of opinions expressed at the BoJ's March policy meeting will also be released on Tuesday. And, as is so often the case, the week will conclude with a plethora of reports, including most notably the IP and household labour survey reports for February and the advance Tokyo CPI for March. The IP report is of particular importance, as the scale of the expected rebound from January's 3.4%M/M slump in output will have a large bearing on the overall result for Q1. Friday will also bring news on retail sales, housing starts and construction orders for February. In the bond market the MoF will auction 40-year JGBs on Tuesday and 2-year JGBs on Thursday.

In the US, following a quiet Monday, a busy Tuesday will see the release of the Conference Board's consumer survey for March, housing starts and permits for February and the S&P/CoreLogic house price index for January. The full trade balance for January will be released on Wednesday while the 'final' estimate of Q4 GDP growth and the February pending home sales report will be the focus on Thursday. On Friday we will receive personal spending data for January, along with the core PCE deflator for that month (personal income data for February will also be released). That day will also bring new home sales data for February, the final results of the University of Michigan's consumer survey for March and the Chicago PMI for March (there are several other lower-profile regional manufacturing surveys scattered across the week too). In the bond market the US Treasury will auction 2-year notes on Tuesday, 2-year FRNs and 5-year notes on Wednesday and 7-year notes on Thursday.

Economic calendar

Key data releases – March/April

18	19	20	21	22
TRADE BALANCE ¥NN JAN -370 FEB 116 INDUSTRIAL PRODUCTION M/M% DEC -0.1 JAN F -3.4 CAPACITY UTILISATION M/M% DEC -1.9 JAN -4.7	1Y TB AUCTION 20Y JGB AUCTION FLOW OF FUNDS (Q4)	REUTERS TANKAN - MANUFACTURING DI FEB 13 MAR 10 NON-MANUFACTURING DI FEB 22 MAR 22 OVERSEAS VISITORS MN JAN 2.69 FEB 2.60 BOJ MINUTES (22-23 JANUARY 2019 MEETING)	NATIONAL HOLIDAY - VERNAL EQUINOX DAY	3M TB AUCTION ENHANCING LIQUIDITY AUCTION NATIONAL CPI Y/Y% JAN FEB 0.2 0.2 *EX FRESH FOOD* *0.8 0.7* *EX FRESH FOOD/ENERGY* *0.4 0.4* MANUFACTURING PMI FEB 48.9 MAR P 48.9 DEPARTMENT STORE SALES Y/Y% JAN -2.9 FEB 0.4
25	**26**	**27**	**28**	**29**
ALL INDUSTRY ACTIVITY M/M% DEC -0.4 JAN -0.4	40Y JGB AUCTION (APPROX ¥0.4TRN) SERVICES PPI Y/Y% JAN 1.1 FEB 1.2 BOJ SUMMARY OF OPINIONS (14-15 MARCH MEETING)		2Y JGB AUCTION (APPROX ¥2.0TRN)	TOKYO CPI Y/Y% FEB MAR 0.6 0.9 *EX FRESH FOOD* *1.1 1.1* *EX FRESH FOOD/ENERGY* *0.7 0.7* UNEMPLOYMENT RATE % JAN 2.5 FEB 2.5 JOB-TO-APPLICANT RATIO JAN 1.63 FEB 1.63 RETAIL SALES Y/Y% JAN 0.6 FEB 1.0 INDUSTRIAL PRODUCTION M/M% JAN -3.4 FEB 1.2 HOUSING STARTS Y/Y% JAN 1.1 FEB N/A CONSTRUCTION ORDERS Y/Y% JAN 19.8 FEB N/A
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 (Q4)	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)
08	**09**	**10**	**11**	**12**
ECONOMY WATCHERS SURVEY (MAR) CONSUMER CONFIDENCE (MAR) CURRENT ACCOUNT BALANCE (FEB) BOJ REGIONAL ECONOMIC REPORT (APR)	6M TB AUCTION 5Y JGB AUCTION MACHINE TOOL ORDERS* (MAR P)	MACHINE ORDERS (FEB) GOODS PPI (MAR) BANK LENDING (MAR)	ENHANCING LIQUIDITY AUCTION M3 MONEY SUPPLY (MAR)	3M TB AUCTION

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

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