Daiwa Capital Markets

Yen 4Sight

Highlights

- Q1 GDP surprised on the upside, but the underlying detail of the report was weak.
- The latest trade and machine orders data raised questions about growth in Q2, but inflation jumped in April.
- The coming week brings the usual month-end deluge of data on Friday including IP, retail sales and unemployment for April.

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Interest and exchange rate forecasts

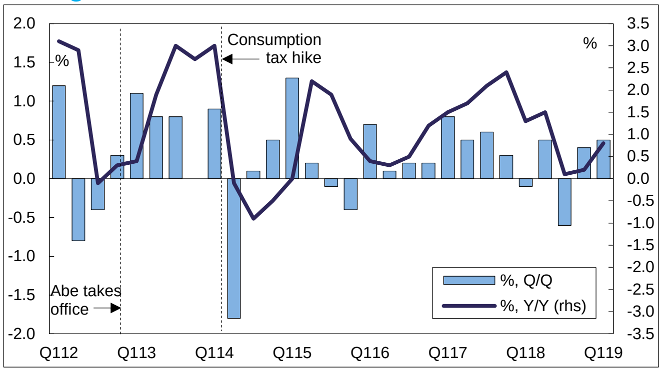
End period	24 May	Q219	Q319	Q418
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.09	-0.07	-0.07	-0.10
JPY/USD	110	110	107	105
JPY/EUR	123	126	121	118

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

GDP growth exceeded expectations in Q1

After Japan's government recently revised down its economic assessment to "worsening" for the first time in more than six years, and monthly activity releases confirmed a soft start to the year, the past week's first estimate of Q1 GDP surprised significantly to the upside. Growth of 0.5%Q/Q (2.1%Q/Q annualised) was the fastest for three quarters and contrasted markedly with the consensus expectation of a modest contraction. So, the annual growth rate rose 0.6ppt to 0.8%Y/Y, broadly in line with Japan's potential rate, and growth in FY18 as a whole of 0.6%Y/Y was bang in line with the BoJ's most recent forecast. Nominal GDP growth was even firmer in Q1 at 0.8%Q/Q and 0.9%Y/Y – although this still left output roughly ¥45trn short of Prime Minister Abe's long-held target of a ¥600trn economy.

GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

But domestic demand was weak

While the surprise growth in Q1 reduced the likelihood that Abe will postpone October's scheduled 2ppt consumption tax increase to 10%, the detail of the report was much weaker than the headline figure implied. In particular, private consumption declined 0.1%Q/Q, with growth revised lower in the previous two quarters too, to leave it up just 0.3% compared with a year earlier. And it was only thanks to an increase in spending on non-durable goods that the drop wasn't steeper. Non-residential investment declined 0.3%Q/Q to leave it up just 1.6%Y/Y compared with growth of 4%Y/Y previously. In contrast, residential investment rose for the third consecutive quarter (1.1%Q/Q), while public sector investment increased for the first quarter in seven (1.5%Q/Q). But, stripping out the modest positive contribution from private sector inventories, final domestic demand provided no support to growth in Q1.

GDP expenditure breakdown*

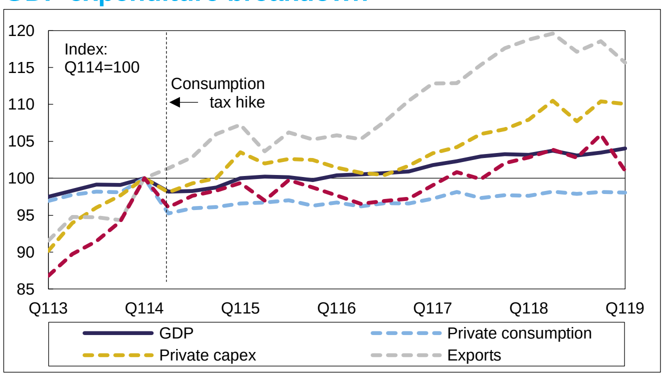
	%, Q/Q	contr	%, Y/Y	contr
GDP	**0.5**		**0.8**	
Final domestic demand	-	0.0	-	0.6
- Private consumption	-0.1	-0.1	0.3	0.2
- Residential investment	11	0.0	12	0.0
- Non-residential investment	-0.3	0.0	16	0.3
- Government consumption	-0.2	0.0	0.8	0.2
- Public investment	15	0.2	-2.4	-0.1
Net exports	-	0.4	-	-0.2
- Exports	-2.4	-0.5	-2.7	-0.5
- Imports	-4.6	0.9	-19	0.3
Private inventories	-	0.1	-	0.3

**Figures may not sum due to rounding. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.*

Net trade boosted by slump in imports

So, the acceleration in GDP at the start of the year was principally due to net trade, which provided the first positive contribution (0.4ppt) for a year and the largest since Q317. However, this was no cause for cheer, being only due to a notable decline in imports. Indeed, consistent with softer domestic demand, the 4.6%Q/Q drop in imports was the steepest since Q209 and added a whopping 0.9ppt to GDP growth. Despite modest support from the services sector as spending by tourists increased slightly, total exports were also very weak in Q1, with the 2½%Q/Q decline the largest since Q215.

GDP expenditure breakdown



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

All industry activity suggests weaker first quarter

The positive GDP growth rate also contrasted markedly with the monthly profile of economic output in the first quarter. For example, manufacturing production fell in two of the first three months of the year to leave output 2½%Q/Q lower than in Q4. Tertiary activity similarly fell in two of the three months to be unchanged in Q1 from Q4. And so, the only positive contribution came from construction, where output rose 1.9%Q/Q in Q1, the most since Q217. Despite declining in March, public sector construction rose a healthy 3.1%Q/Q, while private sector residential building was up 2.0%Q/Q and private non-residential work up 3.2%Q/Q. Nevertheless, with all-industry activity having fallen in two of the first three months of 2019, it fell 0.4%Q/Q, almost 1ppt weaker than GDP growth. So, while there are often discrepancies between the two sets of data, production-side figures suggest a significant possibility of a downward revision to growth when the second estimate of Q1 GDP is released on 10 June.

Export growth remained weak in April

In the absence of a downwards revision to Q1 GDP, we would expect to see negative payback in Q2. Certainly, the boost from net trade is unlikely to be repeated this quarter – a view supported by April's goods trade report. Despite rising on the month, the value of exports was down almost 2½%Y/Y, with shipments to China down more than 6%Y/Y. And exports to the EU fell more than 2½%Y/Y, the biggest drop since September. This weakness was in part offset by an acceleration in exports to the US, which rose more than 9½%Y/Y, the fastest pace for six months, with strong gains in shipments of autos and semiconductor machinery offsetting weakness to China.

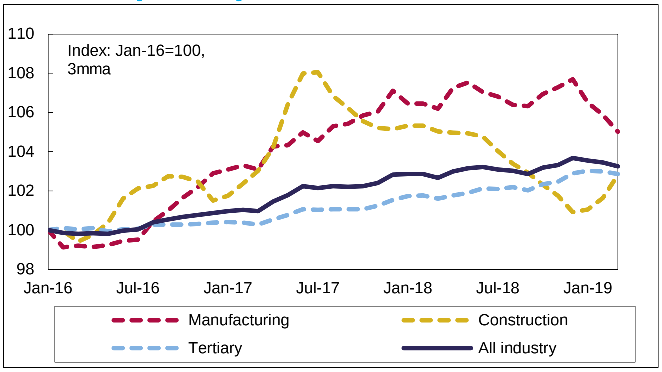
Net trade a drag on growth at the start of Q2

Excluding seasonal and price effects, the BoJ's export data were more encouraging, with volumes up 1.4%M/M in April to leave the level 1.7% higher than the average in Q1. But import volumes were up a slightly stronger 1.6%M/M. And if the BoJ's numbers are to be believed, April's report suggests net exports provided a modest drag on GDP growth at the start of Q2. It's worth noting, however, that the implied positive contribution from net trade to GDP growth from the BoJ's monthly figures in Q1 was much smaller than the outcome reported in the national accounts. Meanwhile, April saw a record monthly number of tourist arrivals, at 2.93mn, which should provide welcome support to growth from services exports.

Capital spending to remain subdued?

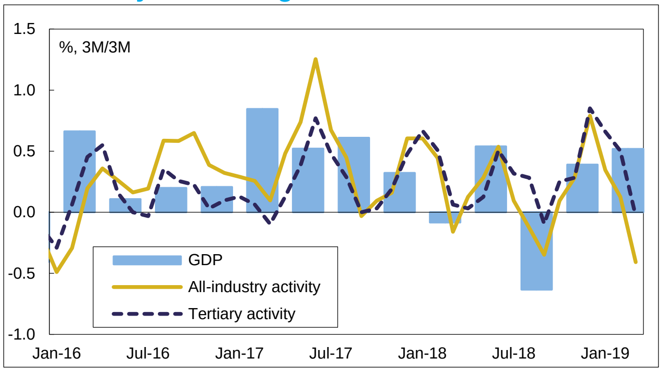
With respect to domestic demand, the latest machinery orders data raised expectations that non-residential investment will remain subdued over the near term. Admittedly, the latest monthly figures were more positive than expected, with core orders rising for the second successive month in March and by 3.8%M/M, the most since October. This reflected a near-13½%M/M surge in orders placed by non-manufacturers, underpinned in part by a 40%M/M rise in orders from construction firms. However, over the first quarter as a whole, private sector orders declined 3.2%Q/Q for the second successive quarter, suggesting that private sector capex might provide a drag on growth in Q2. And, while the Cabinet Office is forecasting a strong rebound in orders in Q2 (15.7%Q/Q), and

All industry activity



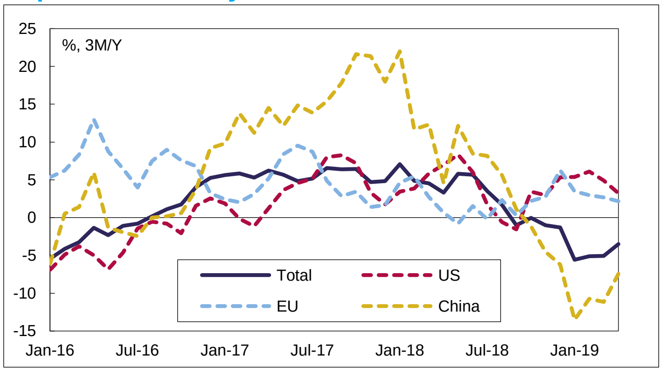
Source: METI and Daiwa Capital Markets Europe Ltd.

All industry and GDP growth



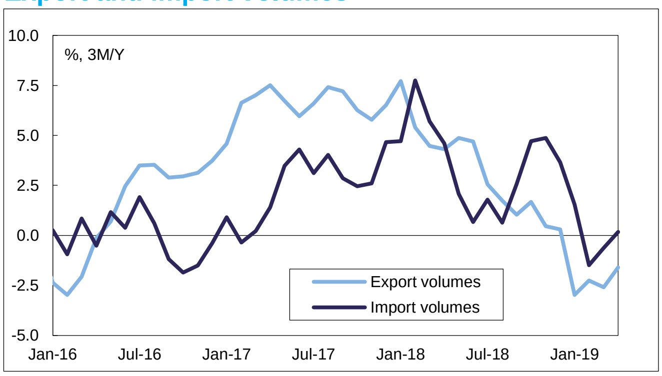
Source: Cabinet Office, METI and Daiwa Capital Markets Europe Ltd.

Export volumes by destination*



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

Export and import volumes



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

the planned consumption tax hike should see some purchases brought forward over coming months, the uncertain economic outlook might suggest firms will remain cautious about their investment plans over the near term.

Consumption to boost GDP ahead of tax hike

We should see a boost to government spending over coming quarters. And households are likely to frontload spending ahead of the consumption tax hike. In the two quarters preceding the April 2014 tax increase, durable goods consumption rose a whopping 14.4%. And the recent divergence between employee compensation and consumption growth suggests scope for increased near-term spending. So, while the government at the end of the past week downgraded its economic assessment in its latest monthly report, we still expect to see positive GDP growth this quarter and next.

Surveys provide mixed messages about outlook

Admittedly, surveys provided mixed messages in the past week. Certainly, the flash manufacturing PMI had a negative tone, with the headline index down 0.6pt to 49.6, back in contractionary territory for the third month out of the past four. And the output component fell 0.4pt to 48.4, the fifth consecutive sub-50 reading. In contrast, the Reuters Tankan suggested that manufacturers were more upbeat about conditions in May, with the relevant DI rising 4pts to 12, a three-month high. This survey suggested that manufacturers were more optimistic about the coming three months too, although we note that it was conducted before the escalation in the China-US trade war. Non-manufacturers were also reportedly more upbeat about conditions in May, with the relevant index up for a second month and by 3pts to 27, a four-month high. But overall, surveys suggest that conditions remain less favourable than the norms of recent years, and consistent with moderate, not vigorous, GDP growth ahead.

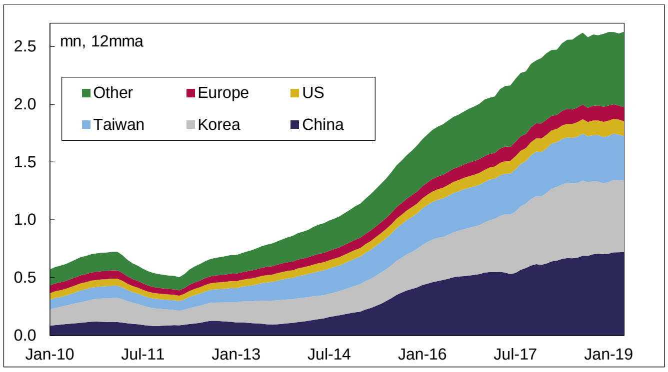
Headline inflation measures jump

Turning to price developments, at face value, the past week's GDP report and monthly CPI figures were more encouraging. For example, the GDP deflator rose 0.3%Q/Q in Q1 – the largest increase since Q317 – to be up 0.2%Y/Y, the first positive reading for a year. Meanwhile, consumer prices rose for the first month in three in April (0.1%M/M). Due to base effects, that was sufficient to take the annual headline inflation rate up 0.4ppt to a six-month high of 0.9%Y/Y. The core CPI measure used in the BoJ's forecasts (which excludes fresh food prices) rose 0.1ppt, also to 0.9%Y/Y, the highest since November. Stripping out energy too, the BoJ's preferred core measure rose 0.2ppt to 0.6%Y/Y, the highest since June 2016.

But CPI boosted by temporary effects

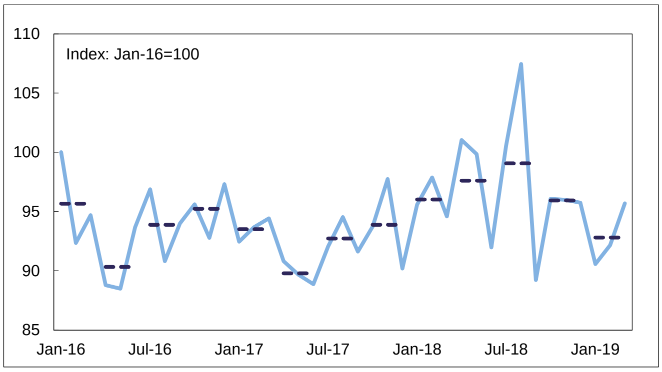
The rise in all key inflation measures might look like good news for the BoJ. But, under the bonnet, little has changed. Much of the upward pressure in the CPI rates came from a temporary boost to prices related to the extended Golden Week holiday from the end of April. Prices of package tours rose more than 15%Y/Y, while hotel charges were almost 4% higher than a year ago. As such, recreational services added 0.14ppt to the headline CPI rate. Overall, services inflation rose 0.2ppt to a three-month high of 0.5%Y/Y, but inflation of non-energy industrial goods fell back 0.1ppt to 0.4%Y/Y.

Overseas visitors



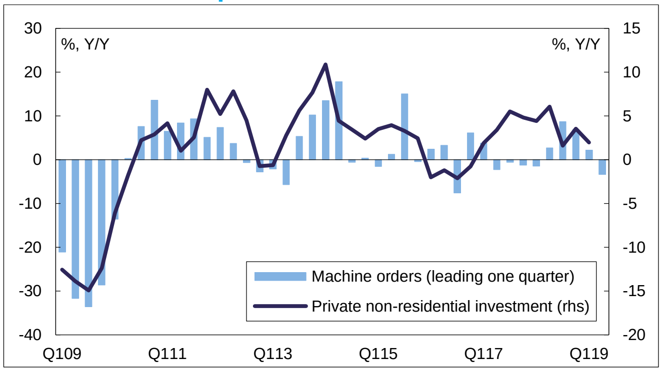
Source: JNTO and Daiwa Capital Markets Europe Ltd.

Core machine orders*



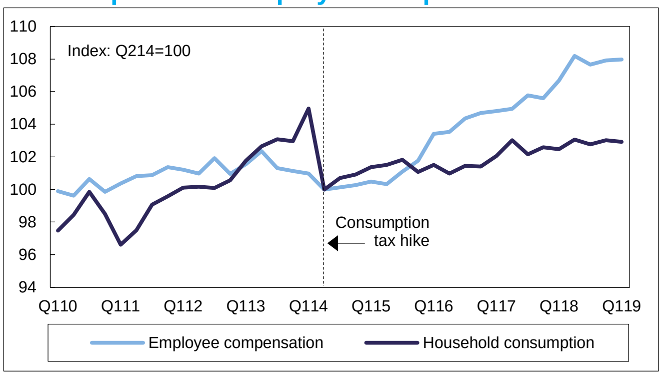
**Dark blue dashed lines are quarterly averages. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Private sector capex and orders



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

Consumption and employee compensation



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

Inflation peaked in April?

While the extended Golden Week holiday might also support inflation in May, we expect this impact to reverse in due course. And energy prices (up 4½%Y/Y in April to add 0.4ppt to CPI) are likely to provide less support to headline CPI over coming quarters due to base effects. Meanwhile, the introduction of free early-years education from October will neutralise much of the upwards pressure on CPI from the consumption tax hike. And comments by Chief Cabinet Secretary Suga in the past week reiterated his claim that government action could see mobile charges cut by more than 40% – an outcome that could knock roughly 1ppt off CPI. Overall, therefore, we think that April will mark the peak in the headline and core rates of CPI, with a steady decline in the BoJ's forecast core CPI measure to below ½%Y/Y anticipated through to the scheduled tax hike in October.

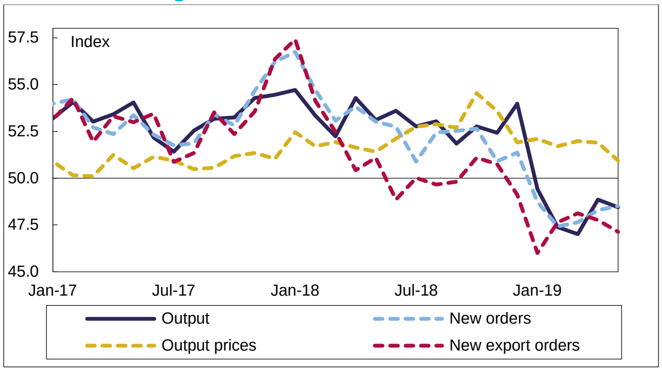
The coming two weeks in Japan and the US

The end of the coming week will be busy with the usual month-end deluge of top-tier releases on Friday, including April's IP, labour market and retail sales figures, Tokyo CPI numbers for May, and consumer confidence for the same month. The following week will also bring several noteworthy releases, including the MoF's financial statements of corporations (3 June), which will feed into the second estimate of Q1 GDP. May's final manufacturing PMI, also due that day, will be followed on the Wednesday by the equivalent services and composite PMIs. A busy end to the week will see April wage and spending figures (the BoJ's consumption activity index and the MIC's household expenditure survey), as well as the Cabinet Office's composite indices of economic conditions for the same month. In the bond market, in the coming week the MoF will auction 40Y JGBs on Tuesday and 2Y JGBs on Thursday. The following week will bring a 10Y JGB auction on Tuesday.

In the US, when markets re-open after Monday's Memorial Day holiday, the dataflow will be dominated by housing market indicators including the FHFA and S&P Corelogic Case-Shiller home price indices (Tuesday) and pending home sales (Thursday). Thursday will also bring revised figures for Q1 GDP – expected to leave growth little changed from the initial estimate of 3.1%Q/Q annualised – as well as advance goods trade and inventories data for April. Friday will bring the latest monthly personal income and spending figures for April, including the deflators closely watched by the Fed. In the bond market, the Treasury will sell 2Y and 5Y fixed-rate notes on Tuesday and 2Y floating-rate and 7Y fixed-rate notes on Wednesday. The key releases in the following week include the manufacturing and non-manufacturing ISM indices on Monday and Wednesday respectively, and the labour market report on Friday. In the bond market, the Treasury will sell 2Y and 5Y fixed-rate notes on Tuesday and 2Y floating-rate and 7Y fixed-rate notes on Wednesday.

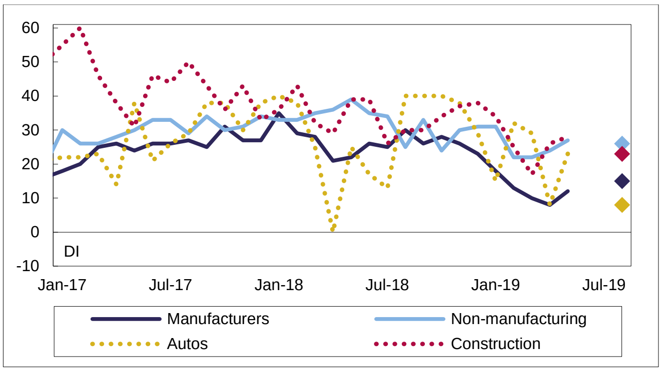
The next edition of the Yen 4Sight will be published on 7 June 2019

Manufacturing PMI



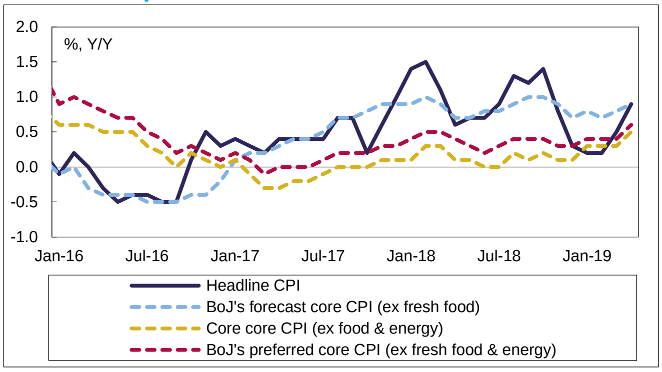
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Reuters Tankan: Business conditions*



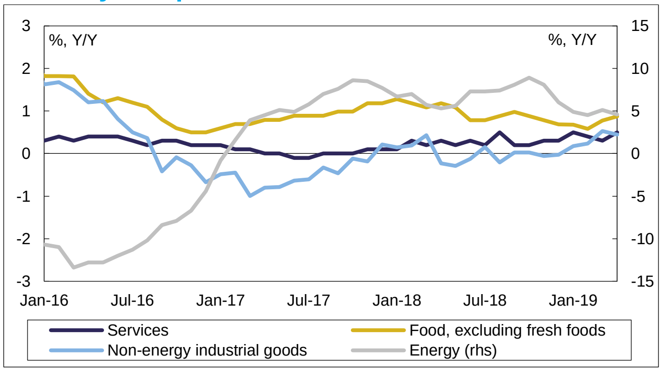
**Diamonds represent survey forecast for August 2019. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Consumer price inflation



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

CPI: Key components



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

Economic calendar

Key data releases – May/June

20	21	22	23	24
AUCTION FOR ENHANCED LIQUIDITY GDP Q/Q% Q4 0.4 Q1 P 0.5 GDP DEFLATOR Y/Y% Q4 -0.3 Q1 P 0.2 INDUSTRIAL PRODUCTION M/M% FEB 0.7 MAR F -0.6 CAPACITY UTILISATION M/M% FEB 1.0 MAR -0.4	HOUSING LOANS Y/Y% Q4 2.4 Q1 2.4 DEPARTMENT STORE SALES Y/Y% MAR 0.1 APR -1.1 OVERSEAS VISITORS MN MAR 2.76 APR 2.93	20Y JGB AUCTION TRADE BALANCE ¥BN MAR -154 APR -111 EXPORTS Y/Y% MAR -2.4 APR -2.4 IMPORTS Y/Y% MAR 1.2 APR 6.4 MACHINE ORDERS M/M% FEB 1.8 MAR 3.8 REUTERS TANKAN – MANUFACTURING DI APR 8 MAY 12 NON-MANUFACTURING DI APR 24 MAY 27	MANUFACTURING PMI APR 50.2 MAY P 49.6	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY NATIONAL CPI Y/Y% MAR APR 0.5 0.9 *EX FRESH FOOD* *0.8 0.9* *EX FRESH FOOD/ENERGY* *0.4 0.6* ALL INDUSTRY ACTIVITY M/M% FEB -0.2 MAR -0.4
27	**28**	**29**	**30**	**31**
	40Y JGB AUCTION (APPROX ¥0.4TRN) SERVICES PPI Y/Y% MAR 1.1 APR 1.0		2Y JGB AUCTION (APPROX ¥2.0TRN)	3M TB AUCTION (APPROX ¥4.28TRN) INDUSTRIAL PRODUCTION M/M% MAR -0.6 APR 0.3 RETAIL SALES Y/Y% MAR 1.0 APR 1.1 UNEMPLOYMENT RATE % MAR 2.5 APR 2.4 JOB-TO-APPLICANT RATIO MAR 1.63 APR 1.63 CONSUMER CONFIDENCE APR 40.4 MAY N/A TOKYO CPI Y/Y% APR MAY 1.4 1.2 *EX FRESH FOOD* *1.3 1.3* *EX FRESH FOOD/ENERGY* *0.9 0.9* HOUSING STARTS Y/Y% MAR 10.0 APR -1.1 CONSTRUCTION ORDERS* Y/Y% MAR 66.1 APR N/A
03	**04**	**05**	**06**	**07**
CAPITAL SPENDING SURVEY (Q1) MANUFACTURING PMI (MAY F) VEHICLE SALES (MAY)	10Y JGB AUCTION MONETARY BASE (MAY)	SERVICES PMI (MAY) COMPOSITE PMI (MAY)	6M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY	3M TB AUCTION BOJ CONSUMPTION ACTIVITY INDEX (APR) HOUSEHOLD SPENDING (APR) AVERAGE WAGES (APR) COINCIDENT INDEX (APR P) LEADING INDEX (APR P) BOJ BOND MARKET SURVEY (MAY)
10	**11**	**12**	**13**	**14**
GDP (Q1 F) ECONOMY WATCHERS SURVEY (MAY) BANK LENDING (MAY)	ENHANCING LIQUIDITY AUCTION M3 MONEY SUPPLY (MAY)	MACHINE ORDERS (APR) GOODS PPI (MAY)	30Y JGB AUCTION TERTIARY ACTIVITY (APR) MOF'S BSI SURVEY (Q2)	3M TB AUCTION INDUSTRIAL PRODUCTION (APR F) CAPACITY UTILISATION (APR)

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

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