Daiwa Capital Markets

Yen 4Sight

Highlights

- Japanese wage figures remain subdued in April, while Tokyo CPI implied that inflation has passed its peak.
- While consumption jumped at the start of Q2, manufacturing output remained subdued.
- The coming two weeks will bring the BoJ's latest policy-setting meeting, along with the latest trade and inflation reports for May.

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Interest and exchange rate forecasts

End period	07 Jun	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.13	-0.10	-0.10	-0.10
JPY/USD	108	107	105	105
JPY/EUR	122	118	116	116

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

BoJ has plenty to mull at its next meeting

Since the BoJ's last policy meeting at end-April, the mood in global financial markets has transformed. Geopolitical tensions and some softer economic data have taken their toll on equities, pushed the yen to its strongest level since the start of the year, and seen major government bonds rally. Rising expectations of a shift in Fed policy have, of course, been pivotal. But with a slowing US economy and fed funds rate cuts bound to have profound ramifications for Japan and other major economies, 10Y JGB yields fell as low as -0.14% for the first time since the BoJ introduced Yield Curve Control and the OIS market priced-in a near-50% probability of a cut in the BoJ's IOER by year-end. In its policy platform for the forthcoming upper house election, Japan's ruling LDP reaffirmed its intention to hike the consumption tax in October – a move that would weigh on activity in Q4 and into 2020. So, the case for additional monetary stimulus by year-end might indeed be strong. But while the latest data suggest conditions for Japanese manufacturers remain challenging, wage growth is absent and inflation has likely passed its peak, current economic conditions are highly unlikely to trigger a policy response from the BoJ when the Policy Board meets on 20 June.

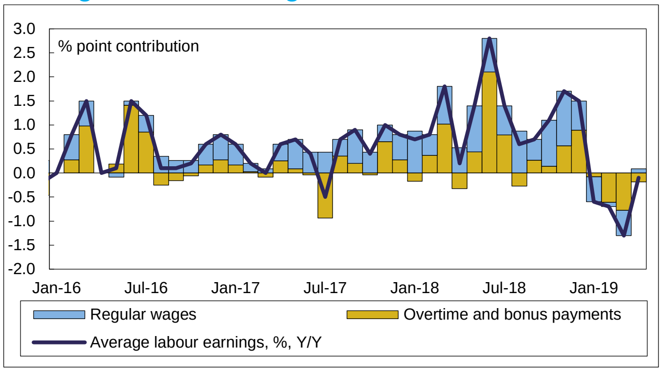
Wages growth remains subdued

At face value, April's labour earnings figures were improved, with the year-on-year decline of 0.1% smaller than expected, up 1.2ppts from March and the best this year. But it still marked the fourth consecutive decline. And while scheduled earnings posted a modest rise (0.1%Y/Y) for the first time this year, this was well below the average growth seen in 2018 (0.9%Y/Y). Admittedly, regular wage growth for full-time workers was firmer (0.8%Y/Y) and broadly in line with last year's average, while part-time scheduled earnings fell by the most since March 2017 (-0.8%Y/Y). But overtime and special payments remained very weak for both sets of workers. And adjusting for inflation, real wages were still down more than 1%Y/Y. As always, we caution that the preliminary wage data can be subject to substantial revision. Moreover, some weakness in the figures likely still relates to sampling issues and the employee count – indeed, based on a common sample, average labour earnings were up 0.5%Y/Y in April, the twenty-first consecutive positive reading albeit one that won't get the BoJ's pulse racing.

Employment growth slowed at start of Q2

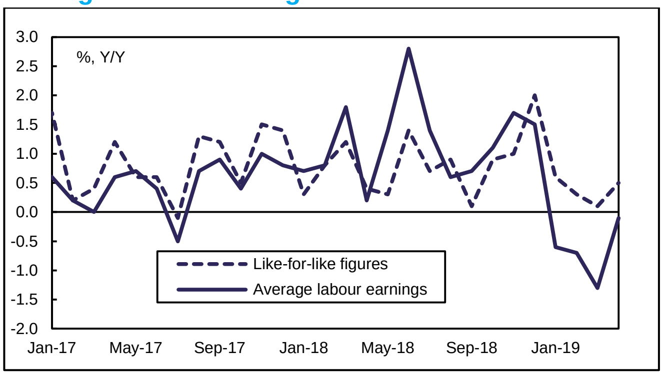
MHLW data suggests that job growth remains firm, with the total number of regular employees up 1.9%Y/Y in April. But the MIC's labour force measure – probably more reliable – suggests

Average labour earnings



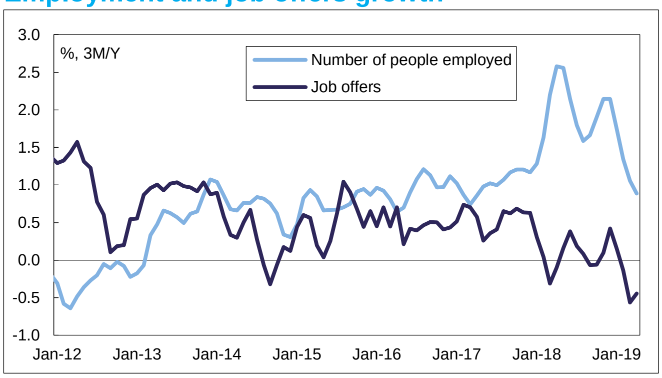
Source: MHLW, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Average labour earnings



Source: MHLW and Daiwa Capital Markets Europe Ltd.

Employment and job offers growth



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

employment growth has slowed, with the rise of 0.5%Y/Y the softest in more than three years. On this basis, the number of people employed fell a sizeable 300k in April. While moves of this magnitude are not unusual – and the drop in employment follows a cumulative increase of 670k in the previous two months – the uptrend in employment has steadily slowed over the past year or so. And although the job-to-applicant ratio was steady for the sixth consecutive month at 1.63 in April – still indicating a very tight labour market – there was a further decline in the number of job offerings, down for the fourth consecutive month to the lowest level since October 2017.

Confidence continues on a downward trend

Concerns about job and wage prospects, as well as overall living standards, have increasingly weighed on confidence over recent quarters. Household sentiment deteriorated further in May, with the Cabinet Office's headline index falling for the eighth consecutive month, to 39.4, the lowest since the start of 2015 and below the long-run average. Expectations for income growth were the lowest since late 2015 and confidence in employment was the weakest for almost three years. The survey also signalled a further waning in households' willingness to buy durable goods, with the relevant indicator posting the largest monthly decline (1.6pts) since March 2014.

Consumption strengthens at the start of Q2

This downbeat message aligned with the latest household spending figures, which showed total expenditure declining 1.4%M/M in April. But this was at odds with the BoJ's consumption activity index, which we think provides a better guide to the national accounts measure of household expenditure. Indeed, adjusting for spending by overseas visitors, the BoJ's measure of consumption activity increased 1.6%M/M, the most since the consumption tax hike in 2014. Spending on durable goods jumped in April, with the relevant index up 4½%M/M, while the equivalent indices for non-durable goods and services were up around 1%M/M. Some strength no doubt reflected payback for the weakness in Q1. But spending will likely remain well supported in May as households enjoyed the extended Golden Week holiday. And consumption should maintain a steady upward trend to end-Q3 as consumers make big-ticket purchases as the consumption tax hike approaches.

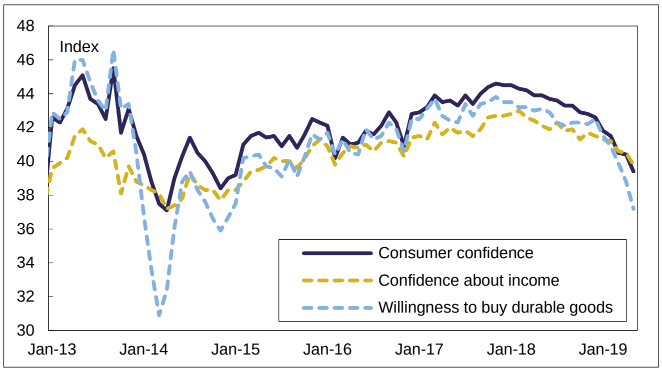
Industrial production rebound underwhelming

Despite an apparent pickup in domestic demand at the start of Q2, and after a marked contraction in Q1, the rebound in manufacturing output in April was underwhelming. Growth of 0.6%M/M in total production merely reversed the decline in March to leave it still down more than 1%Y/Y. The improvement was principally driven by production of transport equipment (4.2%M/M) and ICT equipment (7.1%M/M). In contrast, production of general machinery (-8½%M/M) and electronics parts and devices (-7½%M/M) fell sharply. So, while output of consumer durable and construction goods largely reversed the decline in March, output of capital goods continued to weaken, falling for the third month out of the past four.

Fall in inventory ratio slightly more encouraging

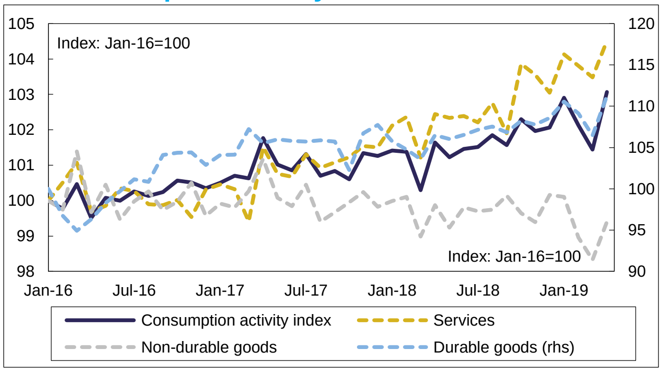
The weakness in capital goods output in April likely in part reflected the steady rise in inventories over the past six months, which in April reached their highest level for two years. Similarly, inventories of intermediate goods reached a near-three-year

Consumer confidence



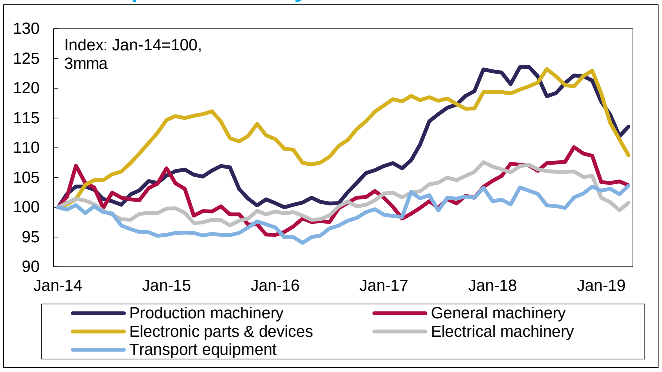
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

BoJ consumption activity index



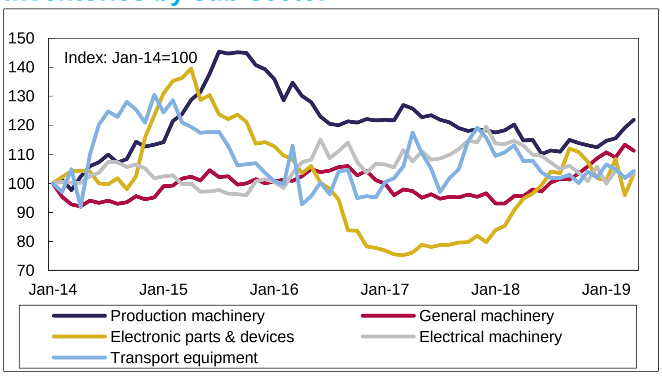
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Industrial production by sub-sector



Source: METI and Daiwa Capital Markets Europe Ltd.

Inventories by sub-sector



Source: METI and Daiwa Capital Markets Europe Ltd.

high. But inventories of consumer and construction goods fell, to leave overall inventories unchanged in April. This was still up more than 1%Y/Y, principally reflecting double-digit increases in the ICT equipment and general machinery sectors. But given the welcome pickup in shipments in April (1.7%M/M), the inventory-shipment ratio fell a notable 2½%M/M to its lowest level since November, raising cautious optimism about the near-term production outlook. Nevertheless, the METI's production projections for May look typically overoptimistic (+1.5%M/M adjusted for the usual bias; +5.6%M/M unadjusted), particularly in light of the extended Golden Week holiday.

PMIs point to continued manufacturing weakness

Certainly, the final May manufacturing PMI was more downbeat. Despite a modest upwards revision from the flash estimate, the headline index fell 0.4pt on the month to 49.6, back in contractionary territory for the third month out of the past four, while the output component declined 0.2pt to 48.4, the fifth consecutive sub-50 reading. And with orders reportedly hit by subdued domestic and external demand, the survey suggested that manufacturers were the most downbeat about the outlook for 6½ years. So, while we expect manufacturing output to rise in Q2 after the steep decline in Q1, this survey reminded that growth in the sector is likely to be at-best moderate.

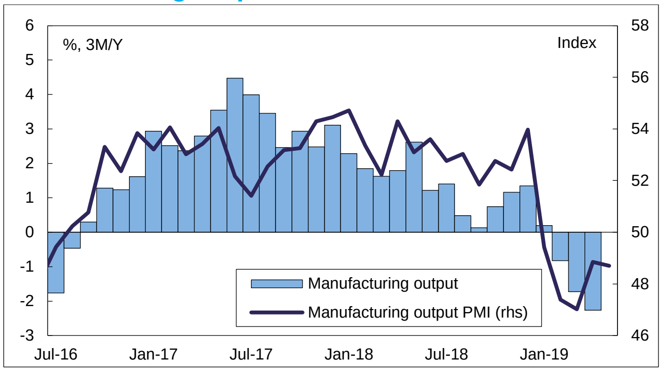
Composite PMI consistent with modest growth

Japanese non-manufacturers, in contrast, appear to be faring much better in 2019. Improved sales in the first quarter saw profits in the sector rise 20%Q/Q, the strongest in almost nine years to a new high. And the services PMI suggested that conditions in the sector were again more stable than in manufacturing last month. Admittedly, the headline index fell for the third consecutive month in May. But the decline was negligible, leaving it at 51.7, the thirty-second consecutive above-50 reading and broadly in line with the average of the past year. The composite PMI was therefore also little changed in May, dropping just 0.1pt to 50.7. And the composite new orders PMI nudged slightly higher to 51.6. While these indices aligned with their averages so far this year, they remain consistent with modest, rather than vigorous, growth in Q2. And we expect to see some moderation from the growth rate of 0.5%Q/Q recorded in the Q1 preliminary estimate.

Q1 GDP likely to be confirmed at 0.5%Q/Q

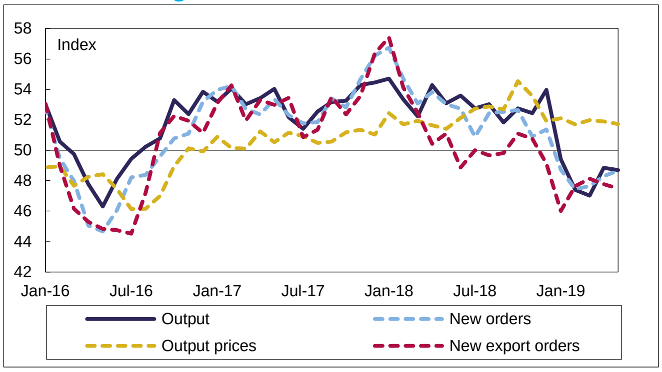
Of course, initial estimates of Japan's national accounts are often subject to sizeable revisions. This partly reflects the partial inclusion of corporations' financial figures in the first release. But the MoF's Q1 survey of corporations released in the past week was surprisingly upbeat, suggesting that capex rose for the second successive quarter in Q1 and by 1.1%Q/Q, underpinned by a near-3%Q/Q increase in capital spending by non-manufacturers. This contrasted with a decline of 1.0%Q/Q in nominal non-residential investment reported in the preliminary GDP report. Real private non-residential investment also fell in the initial GDP estimate, by 0.3%Q/Q. So, when revised national accounts figures are published on Monday, we might well see a modest upwards revision to capex growth in Q1. This notwithstanding, given the survey's implied adjustments to inventories, on balance, we expect no revision to overall GDP growth of 0.5%Q/Q in Q1.

Manufacturing output and PMI



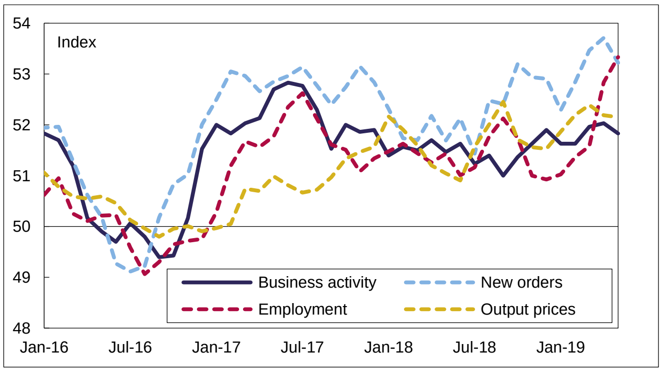
Source: METI, Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing PMIs



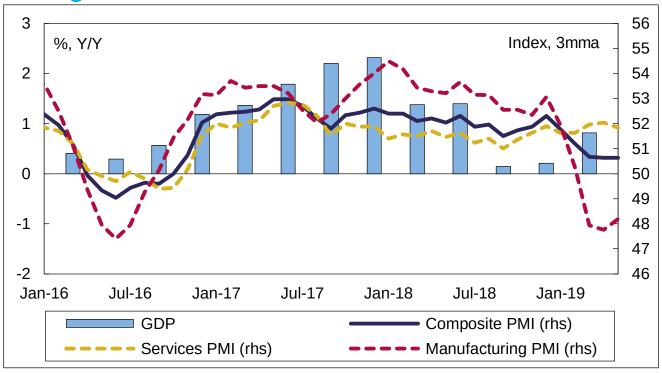
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Services PMIs



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

GDP growth and PMIs



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

Inflation has likely peaked

Turning to inflation, the advance May CPI for Tokyo was disappointing, if not unexpected, with key aggregates suggesting that inflation has passed it peak. The headline index fell 0.2%M/M in May, leaving the annual rate down 0.2ppt at 1.1%Y/Y. The core measures also fell back with, for example, the BoJ's forecast core rate (excluding fresh food prices) down 0.2ppt to 1.1%Y/Y, and its new preferred core measure (excluding food and energy) down to just 0.8%Y/Y. This in part reflected a moderation in prices of package tours, which in April had seen a temporary boost related to the extended Golden Week holiday. A softer increase in electricity prices also played a role. And given also the sharp downwards adjustment in the oil price recently – down around 20% in yen terms from a year earlier – energy prices are likely to provide less support to headline CPI over coming quarters too.

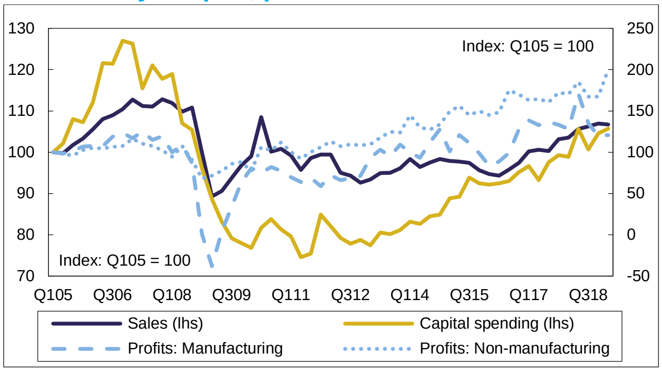
The coming two weeks in Japan and the US

As well as Monday's aforementioned second estimate of Q1 GDP, the coming two weeks brings plenty of data to provide insight into economic momentum in Q2, while May's national inflation figures and the BoJ policy meeting on 20 June will be other highlights. In terms of the activity data, the coming week will bring April's machine orders (Wednesday), tertiary output (Thursday) and final IP (Friday), followed by May's trade report (19 June) and April's all industry release (20 June). There will be plenty of sentiment indicators too, including the economy watchers survey for May (Monday) and the MoF's BSI for Q2 (Thursday). And the Reuters Tankan and flash manufacturing PMI for June follow on 18 and 21 June respectively. Turning to inflation, goods PPI figures for May on Wednesday will precede the more noteworthy national CPI release on 21 June. This is likely to show that headline and core inflation edged lower in May, with the BoJ's forecast measure of core CPI (excluding fresh foods) expected to fall 0.1ppt to 0.8%Y/Y.

These data are likely to add to evidence of a slowdown in GDP in Q2, and suggest that inflation has passed its peak. But the BoJ is likely to maintain its view that Japan's economy remains on an expanding trend with rising underlying price pressure. As such, we expect no meaningful changes to policy – i.e. the -0.1% marginal interest rate on banks' excess reserves and the 0% target for 10Y JGB yields. But with the BoJ's forward guidance currently foreseeing extremely low rates maintained only at least through spring 2020, a later date might seem more appropriate this time around. Meanwhile, in the bond market, in the coming week the MoF will auction 30Y JGBs on Thursday. The following week will bring a 5Y JGB auction on Tuesday.

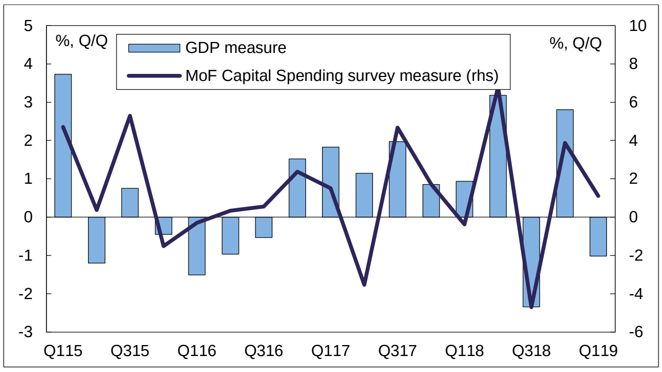
In the US, the main event in the coming two weeks will be the conclusion of the FOMC meeting on 19 June. While the Fed Funds Rate target range looks set to be left unchanged at 2.25-2.50%, the updated forecasts, dot-plots, statement and press conference will be closely watched for hints of likely easing over coming months. Data-wise, the coming week brings CPI (Wednesday), retail sales and IP figures (Friday). Sentiment surveys include the NFIB small business indices (Tuesday) and the preliminary University of Michigan consumer confidence index (Friday). The following week will be dominated by housing market data. In the bond market, the Treasury will sell 3Y notes on Tuesday, 10Y notes on Wednesday and 30Y bonds on Thursday. The following week, a 15Y TIPS auction will be held on Thursday.

MoF survey: Capex, profits and sales



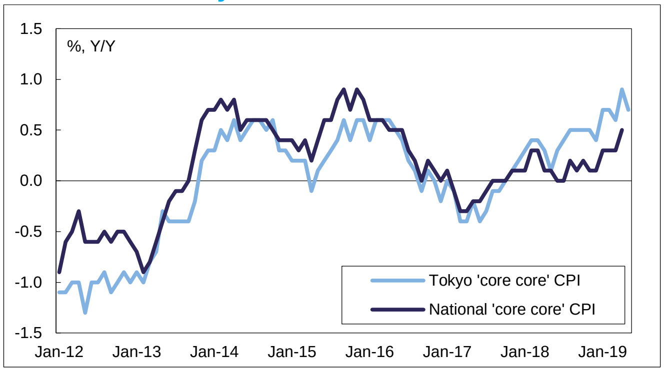
Source:MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Private sector non-residential investment



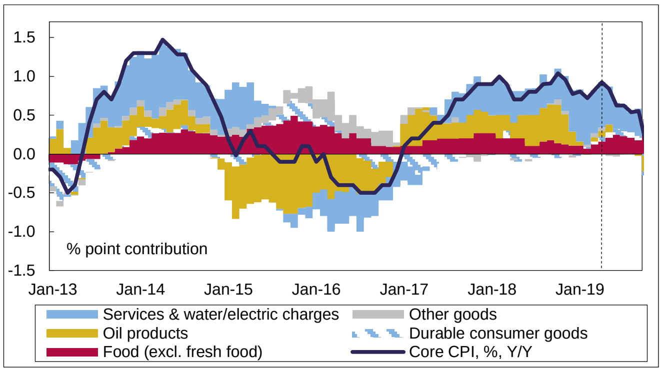
Source: Cabinet Office, MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

National and Tokyo core CPI*



**Excluding fresh foods and energy. Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

National core CPI forecast*



**Excluding fresh foods. Source: MIC, Thomson Reuters and Daiwa Securities*

The next edition of the Yen 4Sight will be published on 21 June 2019

Daiwa Capital Markets

Economic calendar

Key data releases – May/June

27	28	29	30	31
	40Y JGB AUCTION SERVICES PPI Y/Y% MAR 1.1 APR 0.9		2Y JGB AUCTION	3M TB AUCTION INDUSTRIAL PRODUCTION M/M% MAR -0.6 APR 0.6 RETAIL SALES Y/Y% MAR 1.0 APR 0.5 UNEMPLOYMENT RATE % MAR 2.5 APR 2.4 JOB-TO-APPLICANT RATIO MAR 1.63 APR 1.63 CONSUMER CONFIDENCE APR 40.4 MAY 39.4 TOKYO CPI Y/Y% APR MAY 1.3 1.1 *EX FRESH FOOD* *1.3 1.1* *EX FRESH FOOD/ENERGY* *0.9 0.8* HOUSING STARTS Y/Y% MAR 10.0 APR -5.7 CONSTRUCTION ORDERS Y/Y% MAR 66.1 APR -19.9
03	**04**	**05**	**06**	**07**
CAPITAL SPENDING SURVEY – CAPEX EX SOFTWARE Y/Y% Q4 5.5 Q1 6.9 PROFITS Y/Y% Q4 -7.0 Q1 10.3 SALES Y/Y% Q4 3.7 Q1 3.0 MANUFACTURING PMI APR 50.2 MAY F 49.8 VEHICLE SALES Y/Y% APR 2.5 MAY 4.8	10Y JGB AUCTION MONETARY BASE Y/Y% APR 3.1 MAY 3.6	SERVICES PMI APR 51.8 MAY 51.7 COMPOSITE PMI APR 50.8 MAY 50.7	6M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY	3M TB AUCTION BOJ CONSUMPTION ACTIVITY INDEX M/M% MAR -0.7 APR 1.4 HOUSEHOLD SPENDING Y/Y% MAR 2.1 APR 1.3 AVERAGE WAGES Y/Y% MAR -1.3 APR -0.1 COINCIDENT INDEX MAR 99.4 APR P 101.9 LEADING INDEX MAR 95.9 APR P 95.5
10	**11**	**12**	**13**	**14**
GDP Q/Q% Q4 0.4 Q1 F 0.5 ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI APR 45.3 MAY 45.5 BANK LENDING Y/Y% APR 2.4 MAY N/A CURRENT ACCOUNT ¥TRN MAR 1.3 APR N/A	ENHANCING LIQUIDITY AUCTION (APPROX ¥0.6TRN) M3 MONEY SUPPLY Y/Y% APR 2.2 MAY 2.2	MACHINE ORDERS M/M% MAR 3.8 APR -0.8 GOODS PPI Y/Y% APR 1.2 MAY 0.7	30Y JGB AUCTION (APPROX ¥0.7TRN) TERTIARY ACTIVITY M/M% MAR -0.4 APR 0.4 MOF'S BUSINESS OUTLOOK SURVEY – ALL INDUSTRY BSI Q1 -1.7 Q2 N/A	3M TB AUCTION (APPROX ¥4.33TRN) INDUSTRIAL PRODUCTION M/M% MAR -0.6 APR F 0.6 CAPACITY UTILISATION M/M% MAR -0.4 APR N/A
17	**18**	**19**	**20**	**21**
DEPARTMENT STORE SALES* (MAY)	5Y JGB AUCTION REUTERS TANKAN (JUN)	1Y TB AUCTION GOODS TRADE BALANCE (MAY) OVERSEAS VISITORS (MAY) BOJ POLICY BOARD MEETING (19-20 JUNE 2019)	ALL INDUSTRY ACTIVITY (APR) BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION NATIONAL CPI (MAY) MANUFACTURING PMI (JUN P)

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

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