Yen 4Sight

Highlights

- The BoJ left monetary policy and its economic assessment unchanged, but Kuroda restated his readiness to ease further if necessary.
- Machine orders have held up but exports have fallen sharply and GDP growth in Q2 will be weak. Inflation has likely peaked.
- Coming days will bring month-end activity and spending data for May (Thursday and Friday), and the Q2 BoJ Tankan (Monday).

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Interest and exchange rate forecasts

End period	26 Jun	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.14	-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 leaves powder dry

While all eyes were on the Fed last Wednesday as it signalled rate cuts ahead, the following day's announcements from the BoJ were mundane. There were no surprises in the policy statement, with all key parameters unchanged. So, the -0.1% marginal rate on excess bank reserves was untouched, as was the commitment to purchase JGBs so 10Y yields remain around zero per cent. There was also no change to the BoJ's guidance that extremely low levels of short- and long-term interest rates would be maintained "for an extended period of time, at least through spring 2020". And the BoJ pledged again to buy JGBs in "a flexible manner" so its holdings rise at an annual pace of about ¥80tn, more than double the rate so far this year. The usual two out of nine Board members – Kataoka and Harada – dissented from those decisions. But the Board agreed unanimously to keep buying ETFs and J-REITs at annual rates of ¥6tn and ¥90bn respectively.

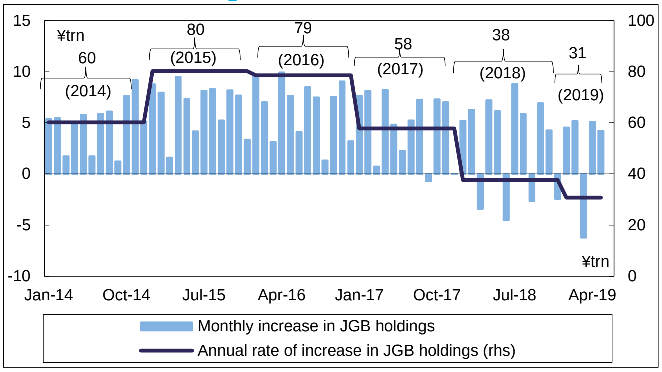
Kuroda insists 10Y yield target range is flexible

So, the BoJ's policy statement was run-of-the-mill. But in his press conference, Governor Kuroda insisted the Board would not hesitate to ease policy again if necessary, restating that a range of options was feasible, including a cut in the -0.10% short-term policy rate, a widening of the +/-0.20% 10Y yield target range, increased purchases of ETFs, and/or a more aggressive increase in the monetary base via bond purchases. And Kuroda suggested that, for now, the 10Y yield target range should be treated flexibly, giving the green light to a move below -0.20% at some point. Given its financial stability concerns, and its view that short-term rates have the most powerful impact on GDP and inflation, however, the BoJ would ideally maintain a clearly upwards-sloping yield curve. So, a cut in the -0.10% interest rate on excess reserves would still seem the most likely formal step if easing was deemed appropriate.

BoJ leaves economic assessment unchanged

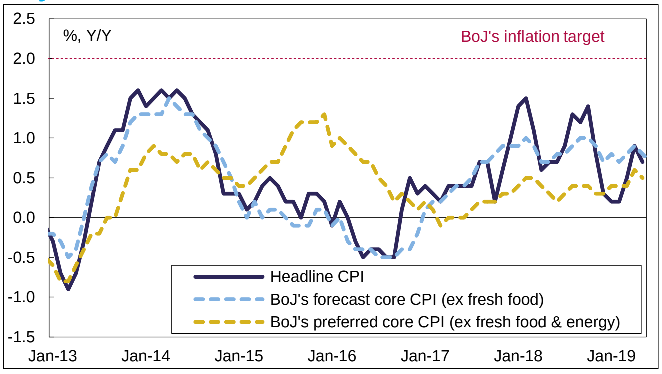
As for policy, the BoJ also made no changes to its economic assessment, which was essentially copied and pasted from its April Outlook Report summary. So, the BoJ judged that Japan's economy "is likely to continue on a moderate expanding trend, despite being affected by the slowdown in overseas economies". And with domestic demand still expected to remain on an uptrend, the Bank continued to expect annual CPI inflation to increase gradually toward the 2% target "mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising". As previously, of course, the risks to both economic activity and inflation were

BoJ's JGB holdings



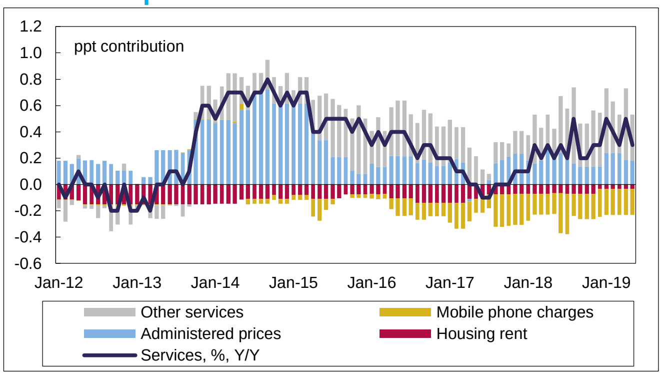
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Key inflation measures



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

Consumer price inflation of services



Source: MIC and Daiwa Capital Markets Europe Ltd.

viewed to be skewed to the downside with those associated with overseas economies judged to be "significant".

Inflation looks to have peaked for now

For the foreseeable future, core inflation seems unlikely to break clearly out of the 0.5-1.0%Y/Y range seen since the middle of 2017. Indeed, the May national CPI figures, released at the end of last week, suggest that inflation peaked in April. In particular, while consumer prices overall were unchanged on a seasonally-adjusted basis, base effects saw the annual headline rate decline 0.2ppt from April's six-month high to 0.7%Y/Y. With food prices higher, all core indices fell 0.1%M/M to push the respective annual rates lower too. So, the annual core inflation measure used in the BoJ's forecasts (which excludes fresh food prices) fell 0.1ppt to 0.8%Y/Y. Stripping out energy too, the BoJ's preferred core measure fell 0.1ppt to 0.5%Y/Y. And excluding all food and energy prices, the core measure which aligns most closely with those reported by other major economies fell 0.2ppt to a paltry 0.3%Y/Y.

Golden Week effect reverses, handsets weigh

The drop in inflation in May was widely anticipated as the boost to prices in April had related principally to the extended Golden Week holiday and seemed bound to reverse. Having added almost 0.1ppt to inflation in April, recreational services subtracted the same amount in May, as inflation of hotel charges fell 4ppts to -0.2%Y/Y and package tour inflation fell 8.5ppts to 6.6%Y/Y. Overall, services inflation fell back 0.2ppt from April's three-month high to 0.3%Y/Y, and inflation of non-energy industrial goods fell 0.1ppt to 0.4%Y/Y, with prices of mobile phones down more than 10%Y/Y. A drop of more than 2ppts in household energy inflation to an eight-month low of 3.6%Y/Y also subtracted 0.1ppt from inflation.

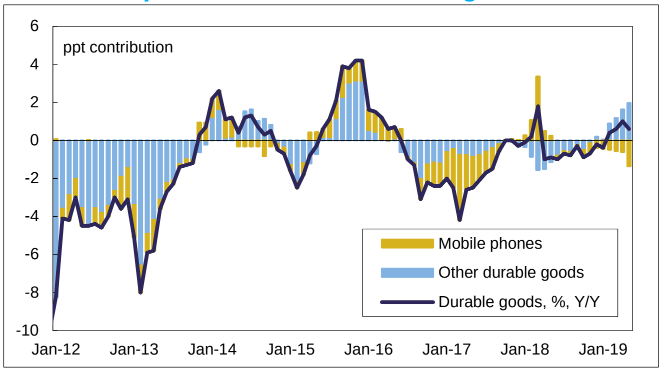
Core inflation set to edge lower

Looking ahead, we expect inflation to drift lower over coming months. Base effects mean that energy prices are likely to subtract from annual rates while yen appreciation could also weigh. The introduction of free early years education from October will neutralise much upwards pressure on CPI from the consumption tax hike. And government efforts to reduce mobile phone charges – e.g. MIC stated that it will require operators to cut cancellation fees by 90% in autumn – will also play a role. So, a further decline in the BoJ's forecast core CPI measure to about ½%Y/Y over coming months seems possible. And underlying weakness seems likely to persist into the New Year if and when activity contracts after the consumption tax hike.

GDP growth revised slightly higher

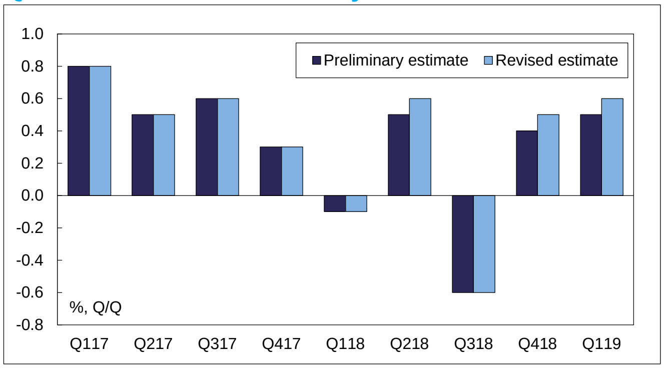
The BoJ will at least have taken comfort from the seemingly robust GDP performance in the first quarter, with revised figures suggesting that growth was 0.1ppt stronger than initially estimated at 0.6%Q/Q. Similar upwards revisions to GDP in Q2 and Q4 last year left the annual rate a touch firmer too at 0.9%Y/Y, the strongest in three quarters, albeit broadly in line with Japan's potential rate of growth. Within the detail, the improvement reflected stronger private sector capex, which was now assessed to have increased 0.3%Q/Q in Q1 to mark the ninth quarterly rise out of the past ten. But, overall, domestic demand was very subdued at the start of the year, with household and government consumption down 0.1%Q/Q,

Consumer price inflation of durable goods



Source: MIC and Daiwa Capital Markets Europe Ltd.

Q1 GDP release: Preliminary vs revised estimates



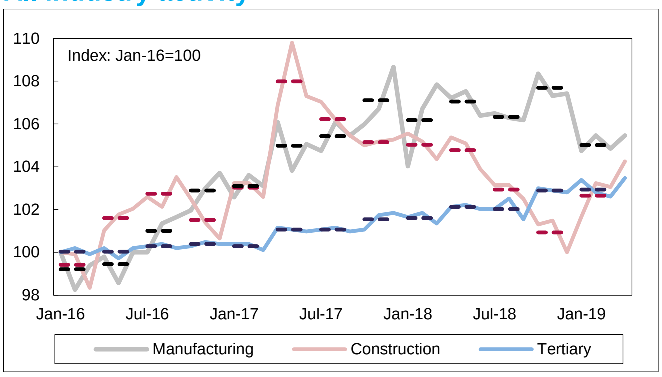
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Q1 GDP growth and expenditure components*

	%, Q/Q	contr	%, Y/Y	contr
GDP	**0.6**		**0.9**	
Final domestic demand	-	0.2	-	0.8
- Private consumption	-0.1	0.0	0.5	0.3
- Residential investment	0.6	0.0	0.6	0.0
- Non-residential investment	0.3	0.1	2.7	0.5
- Government consumption	-0.1	0.0	0.9	0.2
- Public investment	1.2	0.1	-2.9	-0.2
Net exports	-	0.4	-	-0.2
- Exports	-2.4	-0.5	-2.7	-0.5
- Imports	-4.6	0.9	-1.9	0.3
Private inventories	-	0.1	-	0.2

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

All industry activity*



**Dashed lines represent quarterly averages. Source: METI and Daiwa Capital Markets Europe Ltd.*

while growth in housing and public sector investment was nudged slightly lower. So, GDP growth in the first quarter was principally thanks to net trade, which added 0.4ppt. But this was hardly a good news story, as it reflected the steepest drop in imports for a decade (-4.6%Q/Q) on the back of subdued domestic demand. Indeed, external demand was weak in Q1, with exports down 2.4%Q/Q, the most since Q215.

All industry activity rebounds at start of Q2

The weakness of domestic demand in Q1 tallied with the all-industry activity index, which fell 0.4%Q/Q, the most since the 2014 tax hike. But the figures for the start of Q2 were more positive with a rise of 0.9%M/M. Tertiary activity was up 0.8%M/M, the strongest for six months, supported in part by increased tourism and 'ceremonial-related services' ahead of the extended Golden Week holiday. After a slight dip in March, construction activity rose 1.2%M/M in April thanks to growth of 5.0%M/M in public sector output. And industrial production rose 0.6%M/M, admittedly disappointingly subdued and merely reversing the fall in March, leaving it still down 1.0%Y/Y. The increase in April was driven principally by production of autos, up 7.2%M/M, the most since February 2018, to account for 0.5ppt of total IP growth. But while production of ICT equipment (10.7%M/M) also provided support, other key export-oriented sectors saw production drop: general and electrical machinery output fell by 8.2%M/M and 17%M/M respectively, while output of electronic parts and devices was down more than 7½%M/M.

Machine orders beat expectations in April

More encouragingly, on the demand side machine orders exceeded expectations in April. In particular, private sector core orders rose for a third consecutive month in April (up 5.2%M/M), leaving them up 2½%Y/Y, the first such increase this year. The pickup in part reflected a rebound in orders placed by manufacturers (up 16.3%M/M after a drop of 11.4%M/M in March), with extra strength in the particularly volatile ship building and other transport equipment sub-sectors. Orders placed by non-manufacturers also rose for a second month (1.3%M/M) to their highest level since October 2016.

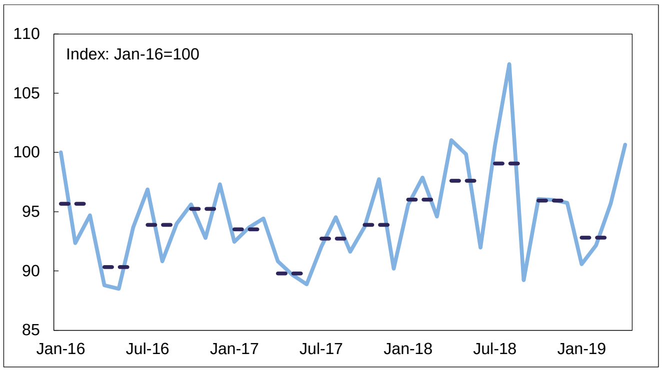
…and set for growth over Q2 as a whole

Some of this vigour at the start of Q2 likely reflected front-loading of orders ahead of the extended Golden Week. But while we expect payback over the remainder of the quarter, we need significant declines over May and June (circa 8%M/M in both months) to avoid a positive outturn for Q2 as a whole – indeed, the level of orders in April was 8½% higher than the average in Q1. So, while the Cabinet Office's projected rise of 15.7%Q/Q in Q2 looks too strong, we expect positive orders growth this quarter, implying continued moderate capex growth into Q3. That would seem appropriate as businesses bring forward spending ahead of October's tax hike.

Exports plunge in May

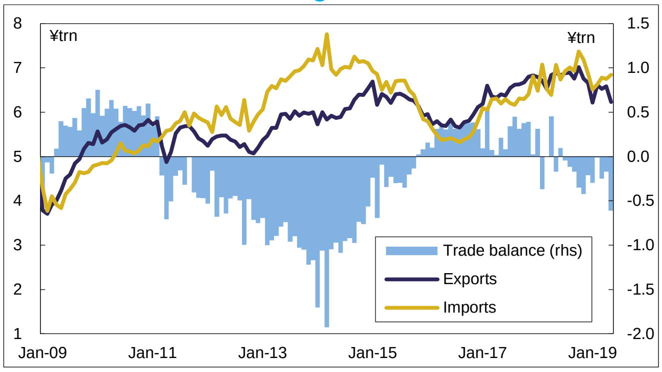
While private investment looks set to post a rise in Q2, however, exports are on track for a notable decline. On a seasonally adjusted basis, having grown 0.8%M/M in April, the value of exports plunged 5.3%M/M in May, the most since January. With imports up 1.3%M/M, the adjusted trade deficit widened more than ¥400bn to a hefty ¥609bn, the biggest in four years.

Private sector core machine orders*



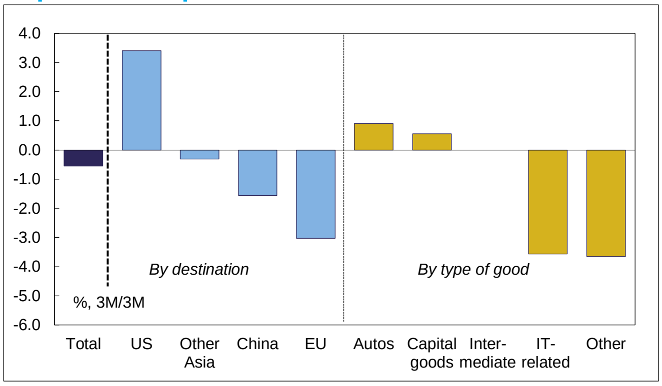
*Dashed dark blue lines are quarterly averages. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Goods trade: Headline figures*



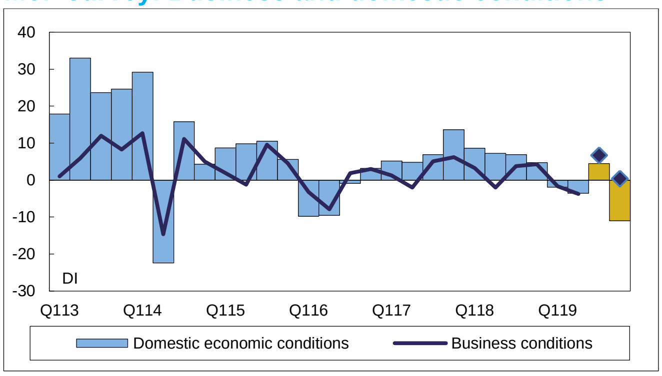
*Non-seasonally adjusted data. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export and import volumes*



*Seasonally adjusted data.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

MoF survey: Business and domestic conditions*



*Large enterprises. Survey forecasts for Q319 and Q419. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Asian demand particularly weak

Compared to a year earlier, the value of exports in May was down for a sixth successive month and by 7.8%Y/Y. Exports to China were again a drag, down for a third month and by a hefty 9.7%Y/Y, with exports of general machinery down a marked 17.1%Y/Y. Weighed also by exports to Korea and ASEAN countries, shipments to Asia overall fell a steeper 12.1%Y/Y with capital goods again notably weak (exports of semi-conductor manufacturing machinery were down over 40%Y/Y). Exports to Western Europe fell 9.5%Y/Y. But benefiting from a near-10%Y/Y rise in exports of autos and 7.7%Y/Y in general machinery, shipments to the US rose 3.3%Y/Y.

Net trade bound to subtract from growth in Q2

Adjusting for prices, the picture in May was no less discouraging. According to the BoJ, export volumes fell 4.4%M/M, the most since February 2015, to be down 4.7%Y/Y. In marked contrast, import volumes rose 4.0%M/M, the most in seven months, to be up 2.5%Y/Y. And looking at the first two months of Q2 together, the volume of exports was down 0.4% on the Q1 average with imports up 3.9% on a similar basis. So, while exports in May were undeniably hampered by the extended Golden Week holiday and should rebound somewhat in June, it seems inconceivable that net trade will be anything other than a significant drag on GDP growth in Q2.

Surveys signal ongoing manufacturing weakness

While it left its economic assessment unchanged last week, a downwards revisions at the Policy Board meeting at end-July – when the BoJ's forecasts will be updated – would be no surprise. A key input will be its latest Tankan, to be released on 1st July. But other recent surveys already give an indication of what to expect. With external demand still weak, most point to ongoing sluggishness particularly in manufacturing:

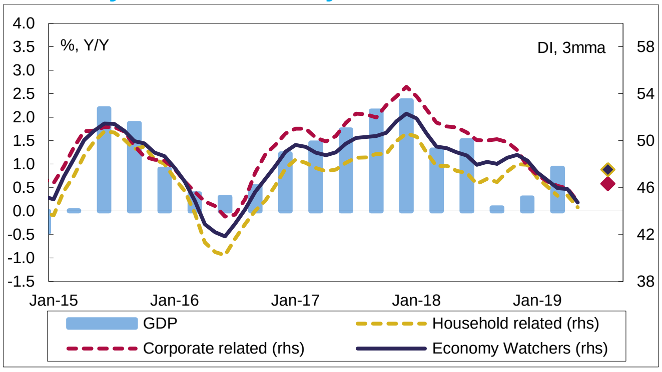
- The flash manufacturing PMI fell to a three-month low of 49.5 in June, with the new orders index down the most since January to a three-year low (47.3).

- The economy watchers survey headline index fell 1.2pts in May to 44.1, a near-three-year low, with falls in both household- and corporate-related demand.

- The MoF/Cabinet Office Business Outlook Survey suggested that a net 3.7% of large firms – the most in three years – judged business conditions to have deteriorated in Q2. While somewhat more optimistic about Q3, they were downbeat about Q4 due to the impact of the consumption tax hike.

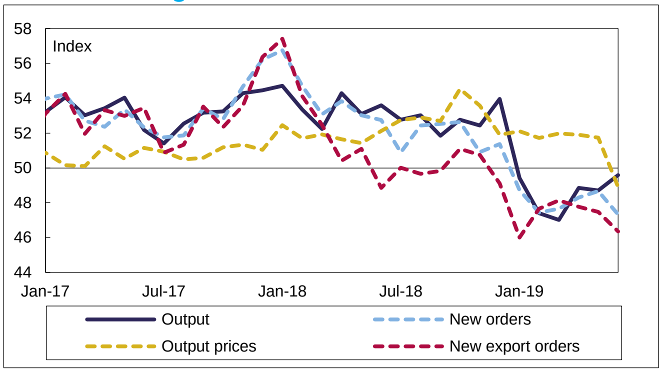
- The Reuters Tankan manufacturing index fell in June by 6pts – the most in more than a year – to 6, the lowest since September 2016. While the forecast manufacturing index for three months ahead wasn't quite so bad, it still fell 4pts to 11, the lowest since end-2016. The survey's index of conditions amongst non-manufacturers weakened too, down 5pts to 22 to match the bottom of the range of the past 2½ years. And the forecast for conditions among non-manufacturers three months ahead also fell 5pts, to 21, just 1pt above the recent low.

Economy watchers survey indices & GDP



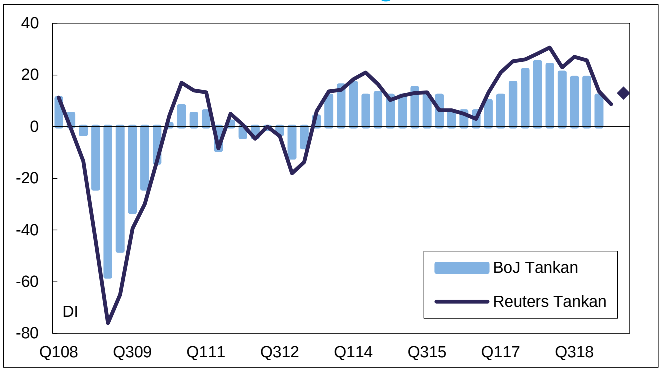
Diamonds represent Economy Watchers survey forecast indices for three months ahead. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing PMIs*



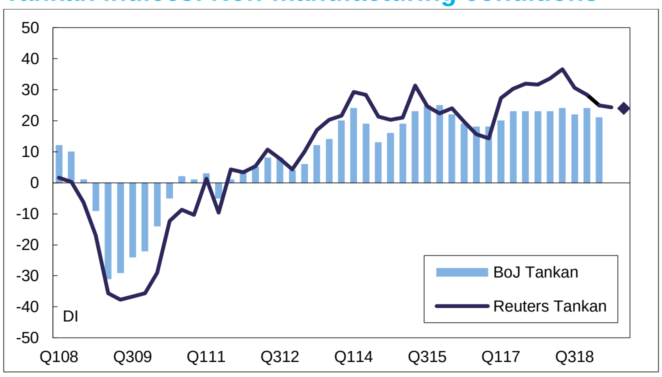
Flash estimates for June 2019. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tankan indices: Manufacturing conditions*



Quarterly averages for Reuters Tankan. Diamond represents Reuters Tankan survey forecast for three months ahead. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tankan indices: Non-manufacturing conditions*



Quarterly averages for Reuters Tankan. Diamond represents Reuters Tankan survey forecast for three months ahead. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

The coming ten days in Japan

The coming ten days weeks brings plenty of top-tier Japanese economic data, including the usual month-end deluge of spending and activity data May over the coming couple of days. In particular, thanks in part to favourable weather as well as brisk sales during the extended Golden Week holiday, retail sales for May (due Thursday) are expected to post a rise following weakness at the start of the quarter. In contrast, IP (due Friday) is expected to have gone into retreat not least as production was similarly impacted by the extended Golden Week holiday. Friday will also bring labour market figures for May, Tokyo CPI numbers for June – which are expected to show slight declines in the headline and core rates from the previous month – and the BoJ's summary of opinions from the past week's Policy Board meeting.

The main focus at the start of the coming week will be the BoJ's Tankan survey for Q2 (Monday), which will be accompanied by the final manufacturing PMI and consumer confidence indicators for June. The Tankan's key measures of current and expected conditions are all expected to decline. These survey results will be followed by the services PMI (Wednesday), along with the BoJ's estimate of the output gap for Q1. The back end of the coming week will bring the BoJ's latest consumption activity release, as well as the Cabinet Office's composite index of business conditions for May. In the markets, the MoF will conduct a 20Y JGB auction on Tuesday 25 June and a 2Y JGB auction on Thursday 27 June. Meanwhile, a 10Y and 30Y JGB auction will be held on Tuesday 2 July and Thursday 4 July respectively.

The next edition of the Yen 4Sight will be published on 05 July 2019

Economic calendar

Key data releases – June/July

17	18	19	20	21
	5Y JGB AUCTION REUTERS TANKAN – MANUFACTURING DI MAY 12 JUN 6 NON-MANUFACTURING DI MAY 27 JUN 22	1Y TB AUCTION GOODS TRADE BALANCE ¥BN APR -170 MAY -609 OVERSEAS VISITORS MN APR 2.9 MAY 2.8 BOJ POLICY BOARD MEETING (19-20 JUNE 2019)	ALL INDUSTRY ACTIVITY M/M% MAR -0.3 APR 0.9 BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION NATIONAL CPI Y/Y% APR MAY 0.9 0.7 *EX FRESH FOOD* *0.9 0.8* *EX FRESH FOOD/ENERGY* *0.6 0.5* MANUFACTURING PMI MAY 49.8 JUN P 49.5 AVERAGE WAGES Y/Y% MAR -1.3 APR F -0.3 DEPARTMENT STORE SALES Y/Y% APR -1.1 MAY -0.8
24	**25**	**26**	**27**	**28**
	20Y JGB AUCTION (APPROX ¥0.9TRN) SERVICES PPI Y/Y% APR 1.0 MAY 0.8 BOJ MINUTES (24-25 APRIL MEETING)		2Y JGB AUCTION (APPROX ¥2.0TRN) RETAIL SALES Y/Y% APR 0.4 MAY 1.2 BOJ FLOW OF FUNDS (Q1)	3M TB AUCTION (APPROX ¥4.3TRN) UNEMPLOYMENT RATE % APR 2.4 MAY 2.4 JOB-TO-APPLICANT RATIO APR 1.63 MAY 1.63 INDUSTRIAL PRODUCTION M/M% APR 0.6 MAY P 0.7 HOUSING STARTS Y/Y% APR -5.7 MAY -4.2 CONSTRUCTION ORDERS Y/Y% APR -19.9 MAY N/A TOKYO CPI Y/Y% MAY JUN 1.1 1.0 *EX FRESH FOOD* *1.1 1.0* *EX FRESH FOOD/ENERGY* *0.8 0.7* BOJ SUMMARY OF OPINIONS (19-20 JUNE MEETING)
01	**02**	**03**	**04**	**05**
BOJ TANKAN (Q2) MANUFACTURING PMI (JUN F) CONSUMER CONFIDENCE (JUN) VEHICLE SALES (JUN)	10Y JGB AUCTION BOJ TANKAN – INFLATION OUTLOOK OF ENTERPRISES (Q2) MONETARY BASE (JUN)	SERVICES PMI (JUN) COMPOSITE PMI (JUN) BOJ OUTPUT GAP AND POTENTIAL GROWTH ESTIMATE (Q2)	30Y JGB AUCTION	BOJ CONSUMPTION ACTIVITY INDEX (MAY) HOUSEHOLD SPENDING (MAY) COINCIDENT INDEX (MAY P) LEADING INDEX (MAY P)
08	**09**	**10**	**11**	**12**
MACHINE ORDERS (MAY) BANK LENDING (JUN) ECONOMY WATCHERS SURVEY (JUN) CURRENT ACCOUNT (MAY)	3M TB AUCTION 5Y JGB AUCTION AVERAGE WAGES (MAY P) M3 MONEY SUPPLY (JUN)	GOODS PPI (JUN)	ENHANCED LIQUIDITY AUCTION TERTIARY ACTIVITY (MAY)	3M TB AUCTION INDUSTRIAL PRODUCTION (MAY F) CAPACITY UTILISATION (MAY)

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

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