

Yen 4Sight

Highlights

- Despite stronger IP and spending figures in May, the BoJ's Tankan survey provided a more downbeat assessment of economic conditions in Q2 and beyond.
- Tokyo inflation data and surveys suggest that price pressures continue to wane.
- The coming fortnight brings the BoJ's Regional Economic Report, and new data on all industry activity, wages and inflation.

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Interest and exchange rate forecasts

End period	05 Jul	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.17	-0.17	-0.20	-0.20
JPY/USD	108	107	105	105
JPY/EUR	122	118	116	116

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

Surveys signal a more downbeat outlook

While the BoJ recently maintained its view that the economy "is likely to continue on a moderate expanding trend", there seems good reason to expect it to make a more cautious assessment when it updates its economic forecasts later this month. Certainly, despite some more positive IP and spending figures in May, the past week's BoJ Tankan survey presented a lacklustre assessment of conditions Q2 and signalled a further loss of momentum heading into H219 too. This tallied with a further deterioration in consumer confidence. And against the backdrop of weakening global demand, the Tokyo inflation figures and various surveys added to evidence that price pressures continue to weaken.

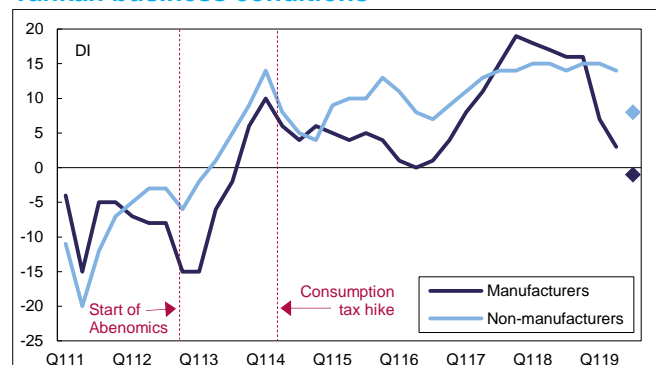
Manufacturers particularly downbeat in Q2...

Perhaps inevitably given the global backdrop, the Tankan suggested that the deterioration in business conditions last quarter was principally driven by manufacturers, with the headline index for large firms in the sector down for the fifth quarter out of the past six and by 5pts to +7, its lowest level since Q316. The weakness was most evident in the export-oriented sub-sectors with, for example, the headline indices for production machinery down 14pts to +17, autos down 10pts to +5, and processed metals down 19pts to -11. While large manufacturers expected conditions to be little changed this quarter, a more downbeat assessment from SMEs saw the overall manufacturing DI forecast fall a further 4pts in Q3 to -1, which would be first time pessimists have outweighed optimists in the sector for six years. This tallied with the persistently weak manufacturing PMI, which signalled ongoing contraction in production in June as well as a further decline in new orders at end-Q2.

...despite upwards surprise to IP in May

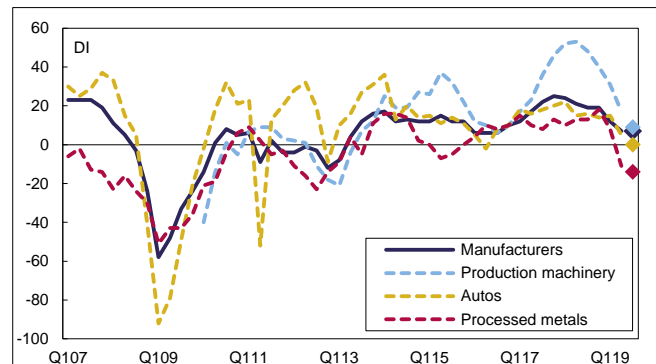
There was, however, some rare goods news from the manufacturing sector, with industrial production comfortably beating expectations in May, rising 2.3%/M/M, the most in fifteen months, after a rise of 0.6%/M/M the prior month. The detail suggested that all major sub-sectors upped production. Following a surge in April, output of autos was up a further 1.6%/M/M to leave the average for the first two months of Q2 up 8.8% above the Q1 average. Production of electrical machinery was up for a fourth successive month in May and by a vigorous 4.4%/M/M. But the increases in output of general machinery (1.9%/M/M) and electronic parts and devices (6.6%/M/M) were insufficient to reverse the declines the prior month. Overall, the

Tankan business conditions*



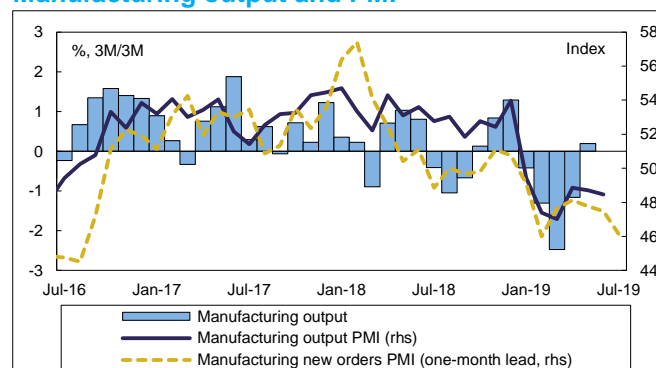
*All enterprises. Diamonds represent survey forecasts for Q319.
 Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tankan business conditions: Manufacturers*



*Large enterprises. Diamonds represent survey forecasts for Q319.
 Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing output and PMI



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



average level of total production for the first two months was 1.6% above the Q1 average. So, while METI anticipates a sizeable decline in June (1.7%M/M), that would still suggest IP growth of more than 1.0%Q/Q in Q2, providing decent support to GDP, albeit insufficient to reverse little more than half of the 2.5%Q/Q decline in the sector in Q1.

Non-manufacturing conditions steady, for now

Turning to the non-manufacturing sector, sentiment among firms has remained remarkably stable over recent years, supported to a large extent by elevated optimism in construction. But while confidence at large firms in that sector slipped to a near-three-year low in Q2, the headline index for large non-manufacturers in aggregate ticked higher, rising 2pts to +23. This in part reflected a notable improvement in hospitality-related services – with the relevant index up 9pts to +17, its highest level since the start of 2017 – possibly reflecting the extended Golden Week celebration. Retailers were also their most upbeat for six quarters, although this improvement is expected to prove temporary – large, medium and small non-manufacturers all forecast a deterioration in conditions in Q3 to their weakest for three years.

Consumption boosted by Golden Week holiday

Consumption-related figures suggest that spending in Q2 was boosted by the extended holiday. Indeed, the MIC's family income and expenditure survey reported a headline-grabbing 4%Y/Y surge in spending in May, the strongest in four years, with the monthly increase (5½%M/M) the biggest since the pre-consumption tax jump in March 2014. Admittedly, the BoJ's consumption activity data – which have offered a more reliable guide of late – were softer. In particular, the headline index fell 0.4%M/M, while the measure adjusted for spending by overseas visitors, was down a steeper 0.7%M/M. But to some extent this reflected payback for strength in April. And on this measure, spending on durable goods posted a second successive notable rise to leave it so far in Q2 averaging more than 4% above the Q1 level. So, despite the differing messages for spending in May, both the BoJ and MIC reports suggest a pickup in consumption in the second quarter – with core household spending and the adjusted BoJ activity index trending around 0.8% above the respective averages in Q1 – following modest contraction in the first quarter.

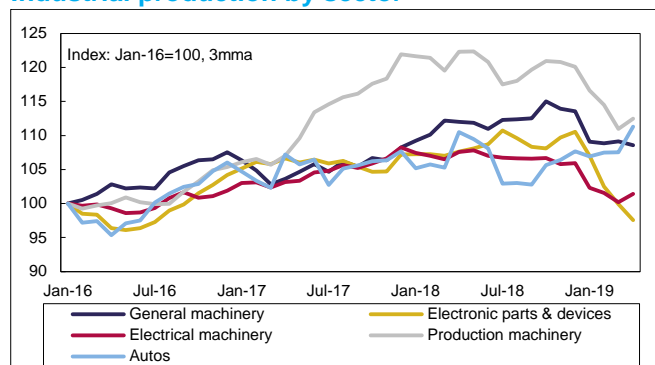
Households more downbeat about outlook

We expect to see a pickup in spending on big-ticket items ahead of the scheduled consumption tax hike in October. But underlying household expenditure growth will likely remain subdued. Certainly, the near-term outlook for spending appears to be clouded by the ongoing decline in consumer confidence. June's survey was undeniably downbeat, with the headline sentiment index declining for the ninth consecutive month to its weakest level since November 2014. And while the weakness was widespread, there was another notable deterioration in households' willingness to buy durable goods, with the relevant index falling to its lowest reading since the previous consumption tax hike in April 2014.

Profit projections down, but capex plans up

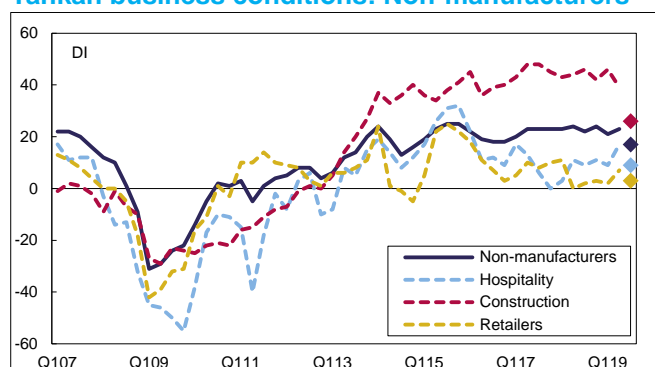
Given the more subdued outlook for external and domestic demand, the Tankan survey suggested that firms were

Industrial production by sector



Source: METI and Daiwa Capital Markets Europe Ltd.

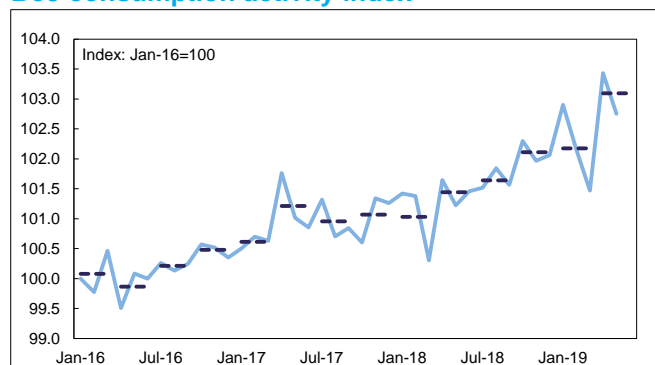
Tankan business conditions: Non-manufacturers*



*Large enterprises. Diamonds represent survey forecasts for Q319.

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

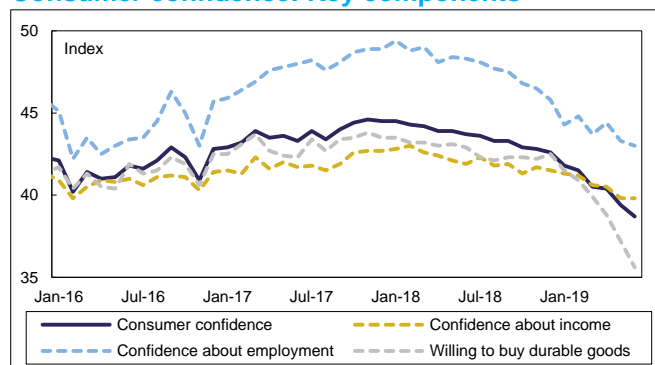
BoJ consumption activity index*



*Dark blue dashed lines are quarterly averages.

Source: BoJ and Daiwa Capital Markets Europe Ltd.

Consumer confidence: Key components



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

unsurprisingly more downbeat about their profit expectations for the current fiscal year than they were three months ago. This was particularly evident in the manufacturing sector, where large enterprises on aggregate revised down their profits forecast by almost 6ppts to a drop of 8.1%Y/Y. And on aggregate, firms were projecting the weakest profits growth for a decade. But such pessimism is the norm for this time of year. And firms were broadly more upbeat about their fixed investment plans – in particular, large manufacturers forecast an increase of 12.9%Y/Y this year, while in aggregate firms forecast a rise of 2.3%Y/Y. Admittedly, large manufactures are likely to revise down their forecast over coming quarters in line with the usual pattern. And overall, anticipated capex growth was below the equivalent forecasts in FY17 and FY18.

Capacity constraints ease very slightly

Stronger capex growth would be consistent with ongoing evidence that firms have capacity constraints. But the Tankan suggested that those constraints are not quite as tight as reported three months ago. While it still suggested that labour shortages across firms of all sizes and sectors remained acute, the survey's employment conditions index rose 3pts to -32, the highest in a year. This tallied with recent monthly labour market indicators, e.g. the job-to-applicant ratio edged slightly lower in June (albeit at 1.62 it remained close to a multi-decade high), while employment growth has slowed considerably since the end of last year. The BoJ estimates that the positive output gap narrowed in Q1. And the Tankan composite indicator of spare capacity fell slightly in Q2, suggesting that underlying pressure on wages and inflation might be expected to wane.

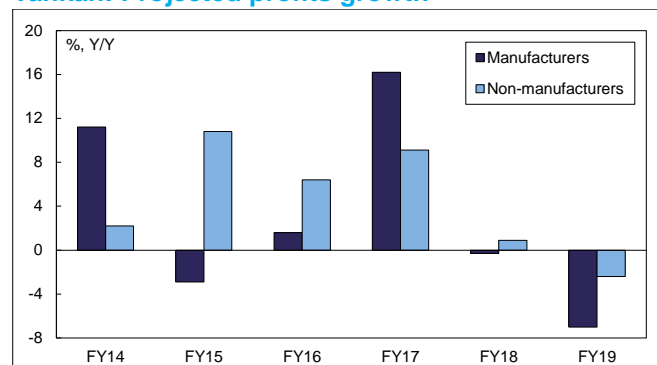
Tokyo's core CPI falls to six-month low

The first inflation data for June, from Tokyo, saw the headline rate moving sideways, at 1.1%Y/Y, down 0.2ppt from April's recent peak. Higher inflation of fresh food offset the impact of lower energy prices. So, excluding such items, Tokyo inflation on the BoJ's preferred core measure also remained unchanged, at just 0.8%Y/Y. But the Tokyo core rate that aligns with the BoJ's forecast measure (i.e. excluding fresh food prices) dropped 0.2ppt to 0.9%Y/Y, a six-month low. Services inflation was unchanged at 0.7%Y/Y, the average rate of the past twelve months. But goods inflation fell 0.2ppt for the second successive month to 1.6%Y/Y, with mobile telephony once again weighing on inflation, with charges down 5.8%Y/Y and handset prices down 9.1%Y/Y. We expect a similar pattern in the national figures when they are published on 19 July. In particular, the BoJ's forecast measure of core CPI is likely to have declined to just 0.6%Y/Y in June, a near-two-year low. And it might well fall a touch further ahead of the consumption tax hike in October as energy inflation has a diminishing effect, and mobile phone prices continue to decline.

Predictably, inflation target still lacks credibility

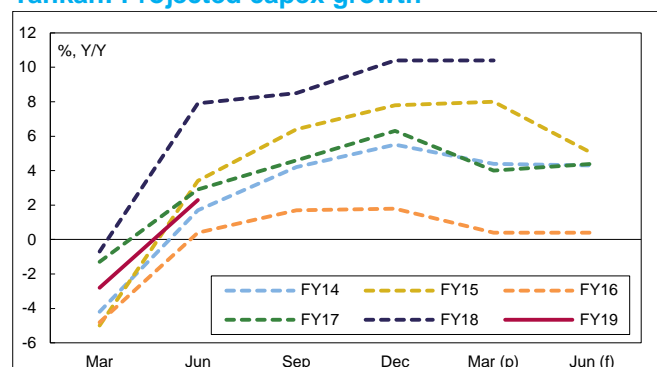
The Tankan's inflation indicators certainly point to a weaker pricing environment, especially among manufacturers. Indeed, firms in the sector on aggregate reported a decline in output prices last quarter for the first time since 2017. Non-manufacturers had a little more success in passing rising costs on to customers, although the relevant DI merely moved sideways for a third consecutive quarter. So, Japanese firms unsurprisingly strongly doubt the BoJ's ability to achieve its 2%

Tankan: Projected profits growth*



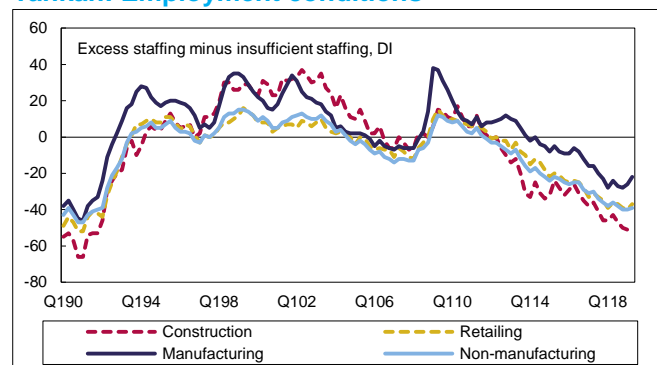
*All enterprises. Figures for FY19 based on July Tankan.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Tankan: Projected capex growth*



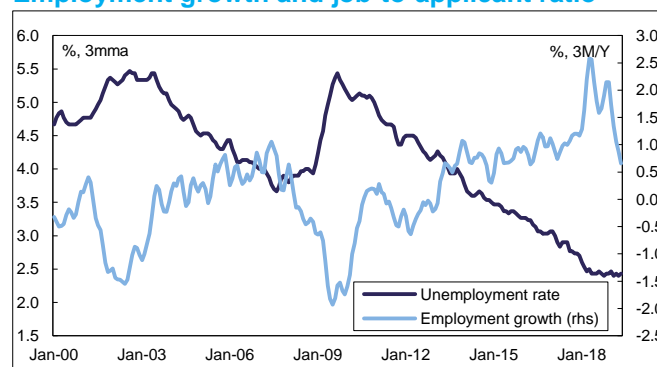
*All enterprises. Source: BoJ and Daiwa Capital Markets Europe Ltd.

Tankan: Employment conditions



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Employment growth and job-to-applicant ratio



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

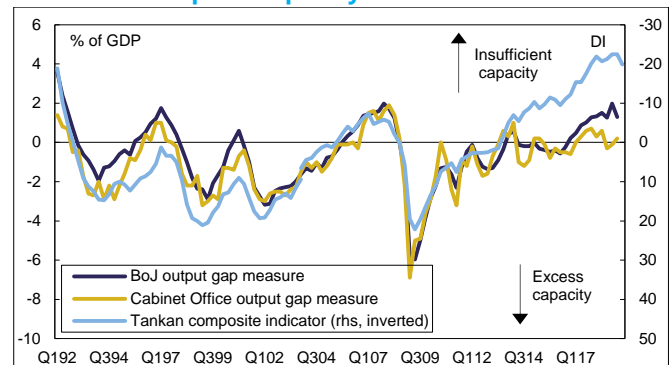
inflation target, even within a 5-year horizon, with the average expectation of inflation five years ahead unchanged at just 1.1%Y/Y. Large firms are even more sceptical about the inflation outlook across the horizon, with manufacturers and non-manufacturers alike expecting inflation of just 0.7%Y/Y five years ahead, almost half the rate anticipated when the survey began at the start of 2014. As usual firms' expectations regarding their own output prices remained even weaker, forecasting a rise in prices over the coming year of just 0.7%Y/Y. And large manufacturers still forecast a cumulative decline in prices over the coming five years of 0.3%.

The coming two weeks in Japan

The coming two weeks bring a number of key Japanese economic data, kicking off on Monday with May machine orders figures, the June economy watchers survey and the BoJ's latest quarterly Regional Economic Report. On Tuesday, the focus will turn to wage figures for May, which are expected to report the fifth consecutive year-on-year decline, while goods PPI data on Wednesday are expected to report a further moderation in price pressures along the pipeline in June. The back end of the coming week turns to activity in May, with tertiary sector figures due Thursday and final industrial production data due Friday. After a quiet start to the following week with Japanese markets closed for the Marine Day holiday on Monday 15 July, Thursday will bring the trade report for June – which will provide a guide to what to expect from net trade in Q2 – and the BoJ's latest senior loan officer survey. Friday, meanwhile, brings national CPI figures for June alongside all industry activity data for May. In the markets, the MoF will conduct a 5Y JGB auction on Tuesday 9 July and a 20Y JGB auction on Wednesday 17 July.

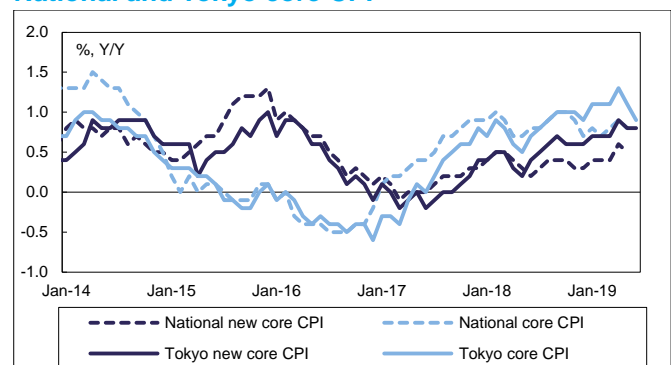
*The next edition of the Yen 4Sight
will be published on 19 July 2019*

Measures of spare capacity



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

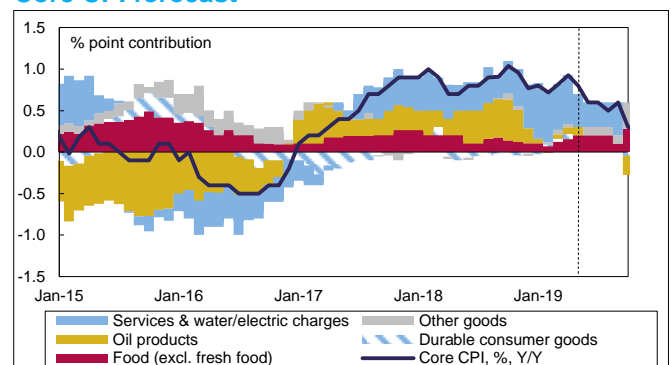
National and Tokyo core CPI*



*Core CPI measure excludes fresh foods. New core CPI excludes fresh foods and energy. Both measures exclude consumption tax hike effect.

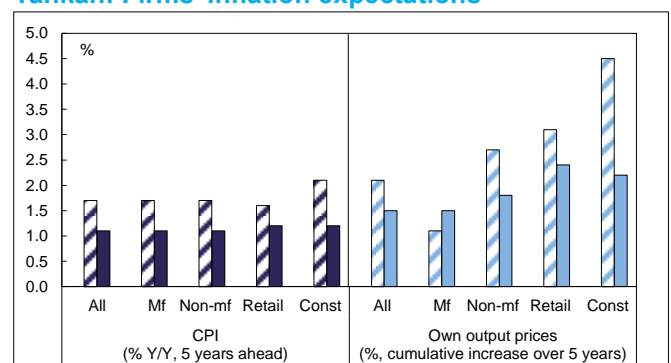
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Core CPI forecast*



*Core CPI excluding fresh foods. Source: BoJ and Daiwa Securities

Tankan: Firms' inflation expectations*



*All enterprises. Dashed bars refer to Q114 survey, solid bars refer to Q219 survey. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Economic calendar

Key data releases – June/July

24	25	26	27	28
	20Y JGB AUCTION SERVICES PPI Y/Y% APR 1.0 MAY 0.8 BOJ MINUTES (24-25 APRIL MEETING)		2Y JGB AUCTION RETAIL SALES Y/Y% APR 0.4 MAY 1.2 BOJ FLOW OF FUNDS (Q1)	3M TB AUCTION UNEMPLOYMENT RATE % APR 2.4 MAY 2.4 JOB-TO-APPLICANT RATIO APR 1.63 MAY 1.62 INDUSTRIAL PRODUCTION M/M% APR 0.6 MAY P 2.3 HOUSING STARTS Y/Y% APR -5.7 MAY -8.7 CONSTRUCTION ORDERS Y/Y% APR -19.9 MAY -16.9 TOKYO CPI Y/Y% MAY 1.1 JUN 1.1 EX FRESH FOOD 1.1 0.9 EX FRESH FOOD/ENERGY 0.8 0.8 BOJ SUMMARY OF OPINIONS (19-20 JUNE MEETING)
01	02	03	04	05
BOJ TANKAN – LARGE MANUFACTURERS DI Q1 12 Q2 7 LARGE NON-MANUFACTURERS DI Q1 21 Q2 23 MANUFACTURING PMI MAY 49.8 JUN F 49.3 CONSUMER CONFIDENCE MAY 39.4 JUN 38.7 VEHICLE SALES Y/Y% MAY 4.8 JUN -0.9	10Y JGB AUCTION BOJ TANKAN – INFLATION OUTLOOK OF ENTERPRISES (Q2) MONETARY BASE Y/Y% MAY 3.6 JUN 4.0	SERVICES PMI MAY 51.7 JUN 51.9 COMPOSITE PMI MAY 50.7 JUN 50.8 BOJ OUTPUT GAP AND POTENTIAL GROWTH ESTIMATES (Q2)	30Y JGB AUCTION	BOJ CONSUMPTION ACTIVITY INDEX M/M% APR 1.7 MAY -0.4 HOUSEHOLD SPENDING Y/Y% APR 1.3 MAY 4.0 COINCIDENT INDEX APR 102.1 MAY P 103.2 LEADING INDEX APR 95.9 MAY P 95.2
08	09	10	11	12
MACHINE ORDERS M/M% APR 5.2 MAY N/A BANK LENDING Y/Y% MAY 2.6 JUN N/A ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI MAY 44.1 JUN 43.8 CURRENT ACCOUNT ¥TRN APR 1.6 MAY N/A BOJ REGIONAL ECONOMIC REPORT (JUL)	3M TB AUCTION (APPROX ¥2.3TRN) 5Y JGB AUCTION (APPROX ¥1.9TRN) AVERAGE WAGES Y/Y% APR -0.3 MAY P N/A M3 MONEY SUPPLY Y/Y% MAY 2.3 JUN N/A	GOODS PPI Y/Y% MAY 0.7 JUN N/A	ENHANCED LIQUIDITY AUCTION (APPROX ¥0.6TRN) TERTIARY ACTIVITY M/M% APR 0.8 MAY 0.1	3M TB AUCTION (APPROX ¥4.33TRN) INDUSTRIAL PRODUCTION M/M% APR 0.6 MAY F 2.3 CAPACITY UTILISATION M/M% APR 1.6 MAY N/A
15	16	17	18	19
NATIONAL HOLIDAY – MARINE DAY		20Y JGB AUCTION DEPARTMENT STORE SALES* (JUN)	1Y TB AUCTION TRADE BALANCE (JUN) BOJ SENIOR LOAN OFFICER SURVEY (JUL)	3M TB AUCTION ENHANCING LIQUIDITY AUCTION NATIONAL CPI (JUN) ALL INDUSTRY ACTIVITY (MAY)

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

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