Japan | Economic Research | 19 July 2019

Yen 4Sight

Highlights

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- Ahead of the BoJ's end-July Policy Board meeting, the latest inflation figures showed core CPI declining to a two-year low.
- The latest trade report suggested net exports provided a notable drag on GDP growth in Q2. But consumption appears stronger.
- The coming fortnight will bring the BoJ's policy announcement and updated economic forecasts, as well as IP, retail and labour market figures for June.

Interest and exchange rate forecasts

End period	19 Jul	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.14	-0.17	-0.20	-0.20
JPY/USD	108	107	105	105
JPY/EUR	121	118	116	116

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

Core inflation falls to a near-two-year low

Ahead of the BoJ's end-July policy meeting when it will publish updated GDP and inflation forecasts, focus at the end of the past week was on June's CPI figures. But there were no surprises, with underlying price pressures highly subdued. Consumer prices were unchanged on the month on a seasonally-adjusted basis, so the headline inflation rate was also unchanged, at 0.7%Y/Y, less than half its peak reached last year. With fresh food prices having jumped over the month, the BoJ's forecast core measure (which excludes those items) declined 0.2ppt to 0.6%Y/Y, a near-two year low. Stripping out energy too, the BoJ's preferred core inflation measure was unchanged at a similarly underwhelming 0.5%Y/Y. And excluding all food and energy prices, the core-core measure – which aligns most closely with figures reported by other major economies – remained at just 0.3%Y/Y. So, underlying inflation in Japan remains well below levels prevailing among its peers.

Higher food prices offset weaker energy inflation

Within the detail, upwards pressure from fresh food prices was offset by energy inflation (down 2.5ppts to 1.2%Y/Y, the smallest rise since the start of 2017). That in part reflected a fall in gasoline prices, while electricity prices rose the least in a year. With two leading telecoms companies having introduced reduced mobile phone tariff plans in June, there was also a steeper pace of decline in mobile phone charges (-5.8%Y/Y). But this was in part offset by higher hotel prices, leaving services inflation up 0.1ppt to 0.4%Y/Y. In contrast, non-energy industrial goods inflation edged down 0.1ppt to 0.4%Y/Y.

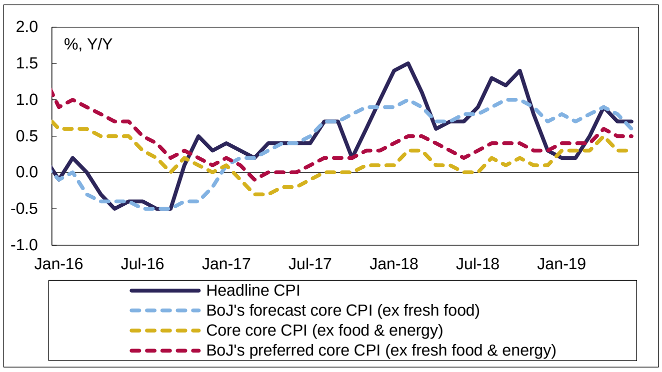
Near-term inflation outlook remains subdued

Looking ahead, energy prices will subtract from inflation over the near term, with lower oil prices compounding the impact of a further cut in electricity tariffs at five of the ten major electrical power firms this month. So, a further decline in the BoJ's forecast measure of core CPI to 0.5%Y/Y or below over the near term is likely. Recent yen strength is a downside risk too. And despite the anticipated step-up later this year on the back of the consumption tax hike – most of which will anyway be offset by the abolition of certain public school fees – underlying price pressure will remain subdued for the foreseeable future.

Wage growth remains weak

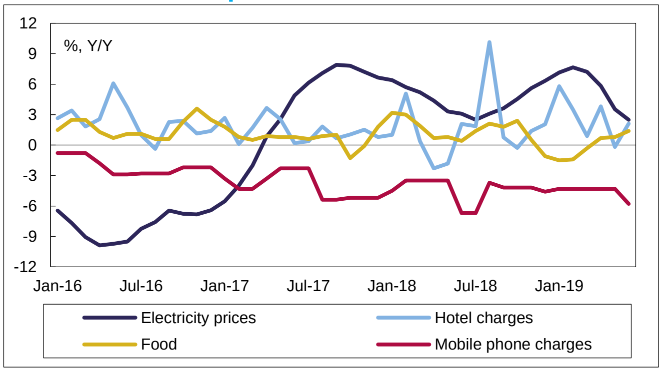
Certainly, wage data suggest that the BoJ's long-awaited boost to prices from labour market tightness remains elusive. Average labour earnings posted a fifth consecutive year-on-year

Headline and core inflation



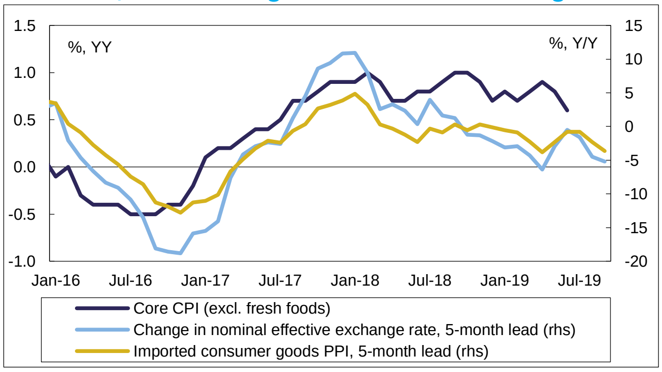
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Selected CPI components



Source: MIC and Daiwa Capital Markets Europe Ltd.

Core CPI, consumer goods PPI and exchange rate



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

drop in May (-0.2%Y/Y). So, when adjusting for inflation, real wages were down 1.0%Y/Y. The drop in scheduled earnings (0.6%Y/Y) matched the biggest since 2014. Admittedly, some of the weakness likely still relates to sampling issues – data based on a common sample suggest that average labour earnings growth accelerated 0.5ppt to 1.2%Y/Y in May, with regular wage growth at 0.6%Y/Y. The May data also appear to have been distorted by the extended Golden Week holiday, with scheduled hours worked down more than 4½%Y/Y, the most since the series began in 1991. This notwithstanding, a sudden acceleration in labour earnings over coming months seems highly unlikely, not least given expected weakness in summer bonuses. And while Rengo data suggest that this year's Shunto delivered the same pay rises as last year (2.07%Y/Y), this headline figure exceeded actual total wage growth in 2018 by about 1.4ppts.

Trade balance surprises on upside in June…

A more cautious approach to wage-setting would tally with the current uneasy economic backdrop, with external demand top of the list of current concerns for businesses, markets and the BoJ alike. Admittedly, there was a notable improvement in Japan's trade balance in June, with the adjusted deficit narrowing ¥607bn to just ¥14.4bn, the smallest in four months, while the unadjusted trade balance recorded its largest surplus since April 2018. There was a big pickup in the value of exports in June too, up 4.8%M/M. But this didn't even fully reverse the weakness in May, and left export values down on an annual basis for the seventh consecutive month and by 6.7%Y/Y, the second sharpest drop since January. In the detail, exports to the US rose for a ninth month in a row, up 4.8%Y/Y. However, there was a steeper pace of decline in the value of shipments to China (down 10.1%Y/Y, the most since January), as well as a hefty decline in exports to Korea (-14.8%Y/Y, the biggest drop since January 2016, even before the latest export restrictions hit). The pace of decline to the EU also intensified (-6.7%Y/Y).

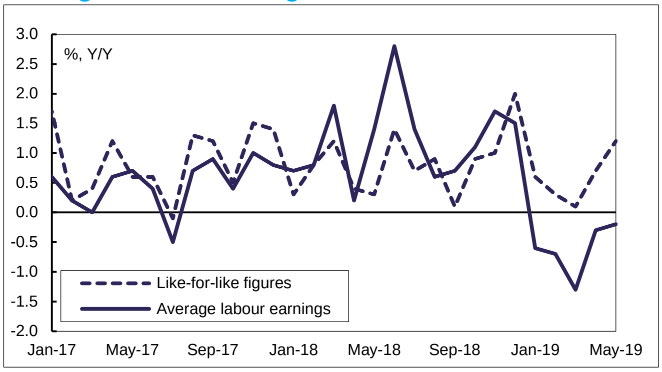
…but net exports still a notable drag in Q2

When adjusting for price effects, the BoJ's measure of export volumes suggested that the rebound in June was somewhat more modest at 4.0%M/M. So, this left exports up just 0.1% over the second quarter as a whole. Moreover, despite a whopping 6.8%M/M drop in import volumes in June – the steepest since the post-consumption tax hike slump in April 2014 – they were still up more than 2% in Q2. So, having been the main driver of growth in Q1, accounting for two-thirds of the 0.6%Q/Q increase in GDP, net goods exports appear to have provided a notable drag last quarter.

Machine orders weaker in May too

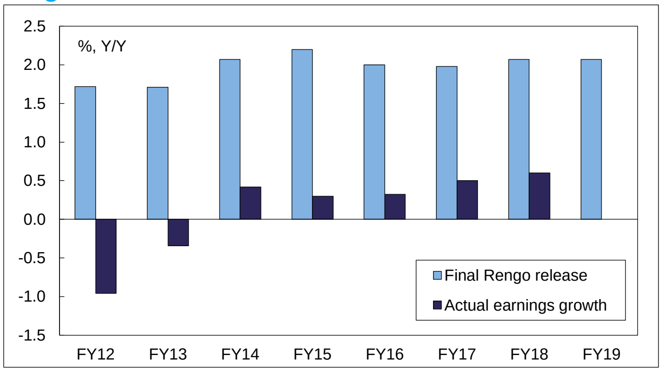
Unsurprisingly, Japanese machinery orders from abroad have weakened considerably over recent months. Indeed, such orders in April and May trended 16% below the Q1 level. But private sector core orders – a useful guide to private sector capex – also fell in May and by 7.8%M/M, the steepest drop since September, to leave them down more than 3½%Y/Y. Nevertheless, the decline in core orders in May followed three consecutive increases. So, over the first two months of Q2, orders trended more than 4% above the Q1 level, admittedly well below the survey forecast increase of more than 15%Q/Q but still consistent with a pickup in private investment over

Average labour earnings



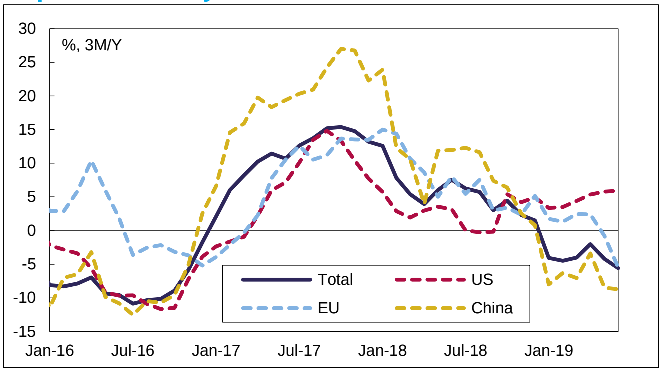
Source: MHLW, Bloomberg and Daiwa Capital Markets Europe Ltd.

Wage settlements



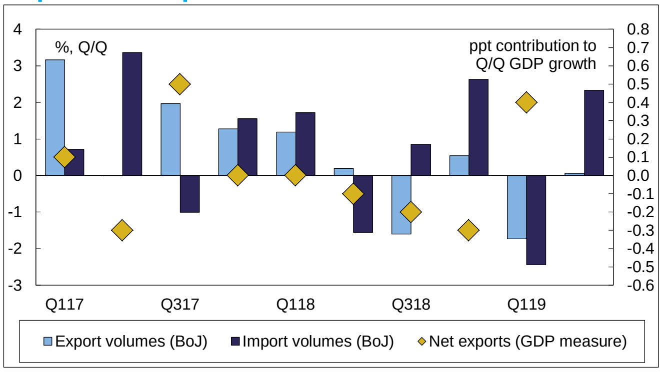
Source: Rengo, MHLW and Daiwa Capital Markets Europe Ltd.

Export values by destination



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

Export and import volumes



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

coming quarters. A step up in public sector orders – trending more than 50% above the Q1 level – was also notable.

Consumption giving a boost to GDP

What matters most for GDP growth is household consumption, which accounts for roughly two-thirds of demand. Following an unexpected decline in Q1, private spending started Q2 on the front foot. In April, the Cabinet Office's synthetic consumption index – the best gauge to the national accounts measure of household expenditure – rose 1.8%M/M, the most since the pre-consumption tax hike surge five years ago. So, given only modest payback in May, down 0.2%M/M, consumption on this measure in the first two months of Q2 was trending 1.6% above the Q1 level. The BoJ's consumption activity index, the MIC's household spending data and METI's retail sales figures similarly imply positive household consumption growth in Q2.

All industry activity points to positive growth in Q2

Despite stronger household spending, tertiary sector activity missed expectations in May, declining 0.2%M/M, to leave it up just 0.5%Y/Y, the softest annual pace since September. Oddly despite the extended Golden Week holiday, tourism-related activity on this measure declined more than 4%M/M, while wholesale and retail trade was also weaker. But construction was again stronger in May, with output rising more than 1.0%M/M for the fourth time this year. So, with industrial production up 2.1%M/M, the most in fifteen months, all industry activity rose for the second successive month in May and by 0.3%M/M. As such, total output on this measure in April and May trended 0.6% above the level in Q1, strongly suggesting positive GDP growth in Q2. We caution, however, that these data failed to tally in Q1, when the 0.4%Q/Q drop in all industry activity contrasted with GDP growth of 0.6%Q/Q.

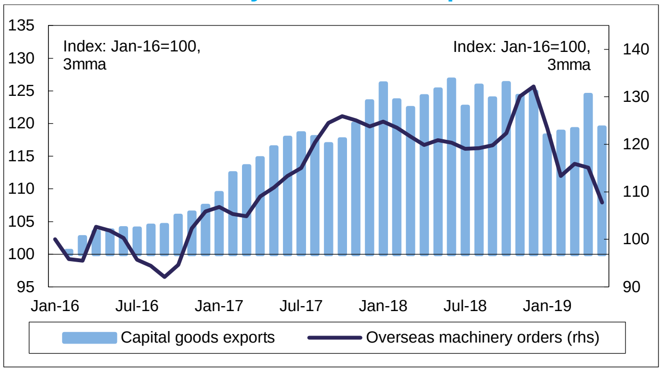
Surveys suggest subdued sentiment

Despite a rebound in manufacturing output in Q2, surveys suggest that conditions remained tough in the sector at the start of Q3. As in other recent surveys, this was the message from the Reuters Tankan, with the headline business conditions indicator declining in July by 3pts to a three-year low of 3. The survey index for expectations in the sector in three months' time fell a steep 7pts – the most in almost three years – to 4, likewise the lowest since 2016. The headline index for non-manufacturers improved modestly in July, rising 3pts to 25. But the June reading had matched the lowest since 2016. And the respective forecast indicator dropped 5pts for the second successive month to fall to a three-year low of 16. A significant deterioration was anticipated by retailers, whose forecast index dropped a whopping 22pts to -9, the first negative reading for the sub-sector since 2017, which likely reflects apprehension about demand once the consumption tax is hiked in October.

BoJ to tweak only slightly its growth forecasts…

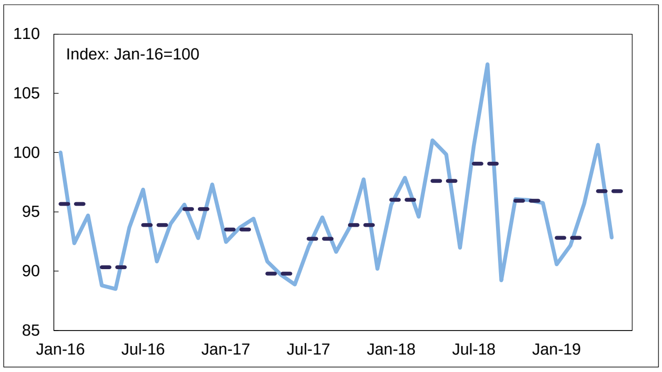
This downbeat assessment tallied with the BoJ's Tankan published at the start of the month, which will guide the Policy Board's updated forecasts and policy deliberations when it meets on 29-30 July. Taken together with weaker trade data, it would seem appropriate for the BoJ to acknowledge to a greater extent the downside risks posed by the external environment. Nevertheless, it will no doubt maintain a broadly

Overseas machinery orders and exports



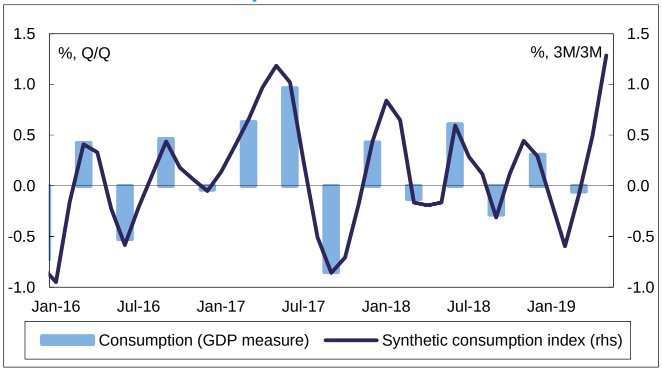
Source: BoJ, Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Private sector machine orders*



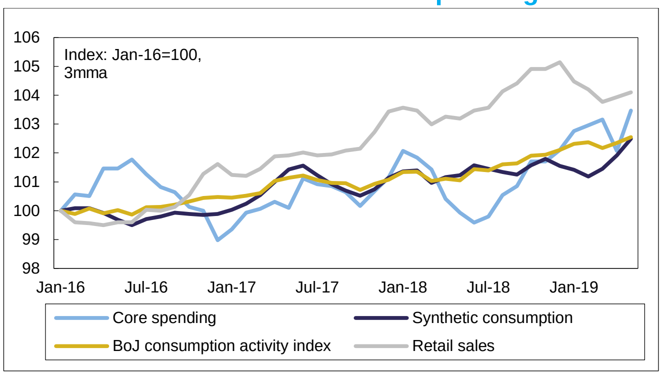
**Dark blue dashed lines are quarterly averages. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Household consumption



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

Selected measures of consumer spending



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

upbeat assessment of the outlook for domestic demand. As such, we expect to see only modest downward revisions made to its GDP growth forecasts. Given its usual tendency for optimism, the BoJ also seems unlikely to amend significantly its inflation forecast, although it will concede again that core CPI will remain persistently sub-target across the forecast horizon.

...and maintain current policy framework

So, while the Fed is set to cut rates this month, and the ECB is preparing options to ease further, the BoJ will maintain a 'wait and see' approach on 30 July. Certainly, its economic forecasts are unlikely to prompt a change in its main policy parameters. Indeed, the BoJ remains concerned that negative side-effects of further rate cuts on the financial sector might more than negate any economic benefits. Nevertheless, Kuroda will no doubt reiterate the BoJ's readiness to act if required, and re-emphasise the flexibility already afforded by the current framework. Of course, we do not rule out (an appropriate) change to the BoJ's forward guidance, which presently states that the current extremely low levels of short- and long-term interest rates will be maintained "for an extended period of time, at least through spring 2020".

Upper House election to deliver no surprises

On the political front, Sunday's Upper House election – the third under the Abenomics era – where 124 of the 245 seats are up for grabs, is highly unlikely to upset the status quo. Abe's approval rating remains remarkably stable despite negative headlines on a range of topics, from scandals related to a nationalist educational group and vet school, to erroneous wage data, and, last month, concerns flagged by the FSA about the adequacy of the pension system. The primacy of Abe's LDP largely reflects the lack of coherent and credible opposition, with the principal opposition Constitutional Democratic Party (CDP) languishing far behind in the polls. Despite coordination between the CDP and other opposition parties to ensure that they do not compete against each other in the 32 single-seat electoral districts, a recent Nikkei poll indicated an LDP lead in about 70% of these districts.

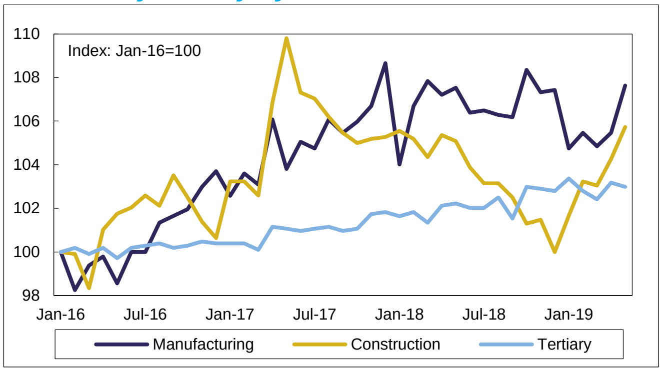
Abe to secure two-thirds super-majority?

So while the LDP has few new policy initiatives, and restated its intention to raise the consumption tax to 10% in October in its election platform, it appears on track with its coalition partner Komeito, to take more than the 63 seats required to retain a simple majority. Of greater interest and uncertainty will be the government's ability to secure the 86 seats required to get a two-thirds super-majority that would take Abe a step closer to achieving his long-held ambition to amend the constitution. One certainty, however, is that it seems highly unlikely to prevent Abe from becoming Japan's longest serving Prime Minister later this year.

Looking ahead…

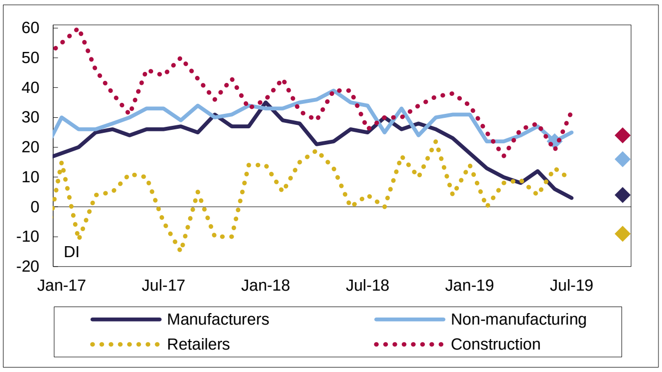
The main event over the coming few weeks will be the aforementioned conclusion of the BoJ's Policy Board meeting on 30 July. While we expect modest downward revisions to its GDP growth forecasts across the horizon – currently at 0.8%Y/Y in FY19. 0.9%Y/Y in FY20 and

All industry activity by sector



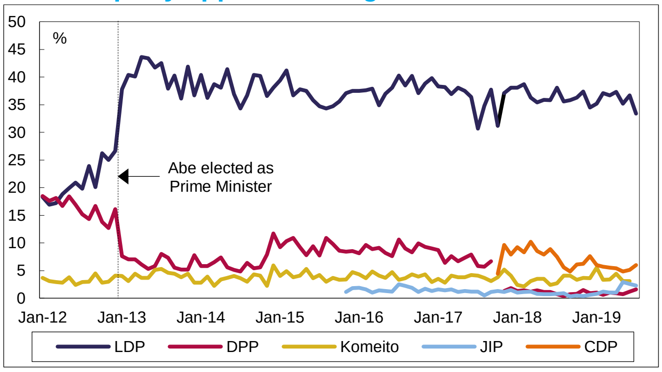
Source: METI and Daiwa Capital Markets Europe Ltd.

Reuters Tankan: Business conditions*



**Diamonds represent survey forecast three-months ahead.*
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Political party approval ratings



Source: NKK and Daiwa Capital Markets Europe Ltd.

FY1.2%Y/Y in FY21 – the BoJ's inflation projections – currently at 1.1%Y/Y in FY19, 1.4%Y/Y in FY20 and 1.6%Y/Y in FY21 – seem unlikely to be amended. So, we see little chance that the main policy parameters will be tweaked at this meeting. However, with all major central banks now highly alert to the downside risks to the outlook, Kuroda will no doubt reiterate the Bank's readiness to act if necessary. Data-wise, the usual tranche of end-month top-tier releases are due on 29 and 30 July, including June retail sales, industrial production and unemployment figures. Before then, the coming week will bring the flash manufacturing and services PMIs for July on Wednesday. In the markets, the MoF will conduct a 40Y JGB auction on Tuesday 23 July, a 2Y JGB auction on Thursday 25 July.

The next edition of the Yen 4Sight
Is due to be published on 9 August 2019

Economic calendar

Key data releases – July/August

08	09	10	11	12
MACHINE ORDERS M/M% APR 5.2 MAY -7.8 BANK LENDING Y/Y% MAY 2.6 JUN 2.3 ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI MAY 44.1 JUN 44.0 CURRENT ACCOUNT ¥TRN APR 1.6 MAY 1.3 BOJ REGIONAL ECONOMIC REPORT (JUL)	3M TB AUCTION 5Y JGB AUCTION AVERAGE WAGES Y/Y% APR -0.3 MAY P -0.6 M3 MONEY SUPPLY Y/Y% MAY 2.3 JUN 2.0	GOODS PPI Y/Y% MAY 0.6 JUN -0.1	ENHANCED LIQUIDITY AUCTION TERTIARY ACTIVITY M/M% APR 0.8 MAY -0.2	3M TB AUCTION INDUSTRIAL PRODUCTION M/M% APR 0.6 MAY F 2.0 CAPACITY UTILISATION M/M% APR 1.6 MAY 1.7
15	**16**	**17**	**18**	**19**
NATIONAL HOLIDAY – MARINE DAY		20Y JGB AUCTION OVERSEAS VISITORS MN MAY 2.77 JUN 2.88	1Y TB AUCTION TRADE BALANCE ¥BN MAY -622 JUN -14 EXPORTS Y/Y% MAY -7.8 JUN -6.7 IMPORTS Y/Y% MAY -1.5 JUN -5.2 REUTERS TANKAN - MANUFACTURING DI JUN 6 JUL 3 - NON-MANUFACTURING DI JUN 22 JUL 25 BOJ SENIOR LOAN OFFICER SURVEY (JUL)	3M TB AUCTION ENHANCING LIQUIDITY AUCTION NATIONAL CPI Y/Y% MAY JUN 0.7 0.7 *EX FRESH FOOD* *0.8 0.6* *EX FRESH FOOD/ENERGY* *0.5 0.5* ALL INDUSTRY ACTIVITY M/M% APR 0.8 MAY 0.3
22	**23**	**24**	**25**	**26**
	40Y JGB AUCTION (APPROX ¥0.4TRN) AVERAGE WAGES Y/Y% APR -0.3 MAY F -0.2 DEPARTMENT STORE SALES Y/Y% MAY -0.8 JUN N/A	MANUFACTURING PMI JUN 49.3 JUL P N/A SERVICES PMI JUN 51.9 JUL P N/A COMPOSITE PMI JUN 50.8 JUL N/A	2Y JGB AUCTION (APPROX ¥2.0TRN) SERVICES PPI Y/Y% MAY 0.8 JUN N/A	3M TB AUCTION (APPROX ¥4.32TRN) TOKYO CPI Y/Y% JUN JUL 1.1 1.0 *EX FRESH FOOD* *0.9 0.8* *EX FRESH FOOD/ENERGY* *0.8 0.7*
29	**30**	**31**	**01**	**02**
RETAIL SALES (JUN)	INDUSTRIAL PRODUCTION (JUN P) UNEMPLOYMENT RATE (JUN) JOB-TO-APPLICANT RATIO (JUN) BOJ POLICY BOARD ANNOUNCEMENT AND OUTLOOK REPORT	CONSUMER CONFIDENCE (JUL) HOUSING STARTS (JUN) CONSTRUCTION ORDERS (JUN)	10Y JGB AUCTION MANUFACTURING PMI (JUL F) VEHICLE SALES (JUL)	3M TB AUCTION MONETARY BASE (JUL) BOJ MINUTES (19-20 JUNE MEETING)

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

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