Daiwa Capital Markets

Yen 4Sight

Highlights

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- As the BoJ maintained a broadly upbeat economic assessment, Q2 GDP surprised on the upside, boosted by consumption.
- But IP contracted sharply in June. And surveys suggest a further deterioration in economic conditions at the start of Q3.
- Over the coming fortnight, July's trade report and the flash PMIs will provide an update on conditions in Q3. July CPI figures are also due.

Interest and exchange rate forecasts

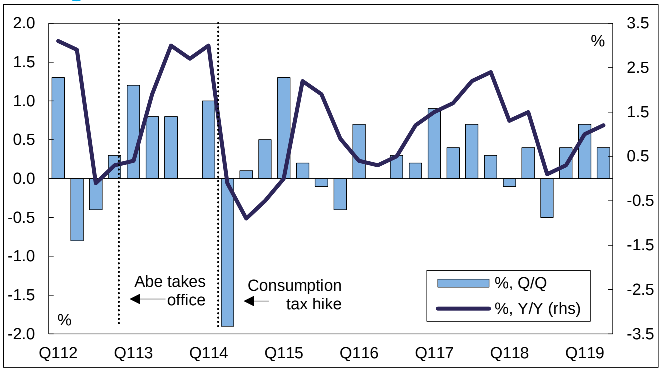
End period	09 Aug	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.23	-0.20	-0.20	-0.20
JPY/USD	106	106	105	105
JPY/EUR	118	118	116	116

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

GDP surprises on the upside in Q2

At the BoJ's end-July policy meeting, the Policy Board maintained a broadly upbeat assessment of Japan's economy. And its optimism was seemingly justified by the first estimate of Q2 GDP, which rose a stronger-than-expected 0.4%Q/Q (1.8%Q/Q annualised). Admittedly, similar to the global trend, this marked a moderation from upwardly revised growth of 0.7%Q/Q in Q1. Nevertheless, it marked the third consecutive increase. So, output was up 1.2%Y/Y, the fastest annual pace for a year and a touch firmer than estimates of Japan's (admittedly low) potential rate of growth. The year-on-year increase in nominal GDP growth was even firmer in Q2 at 1.6%Y/Y. But this still left output more than ¥40trn short of Prime Minister Abe's long-held target of a ¥600trn economy.

GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Consumption growth at two-year high

Growth in the second quarter was underpinned by a pickup in domestic demand. In particular, private consumption accelerated ½ppt to 0.6%Q/Q in Q2, the strongest for two years and accounting for almost three-quarters of GDP growth. Spending received a boost from the extended Golden Week holiday. And with households having an eye on the scheduled consumption tax hike in October, spending on durable goods was up more than 4%Q/Q having dipped the previous quarter. Private non-residential investment also stepped up, rising for the third consecutive quarter and by a stronger 1½%Q/Q. And with government spending up around 1%Q/Q, final domestic demand boosted quarterly GDP by a substantive 0.7ppt. Against the backdrop of stronger domestic demand, imports were up by more than 1½%Q/Q in Q2. So, with exports having merely moved sideways over the quarter as external demand stagnated, net trade subtracted (a somewhat smaller than expected) 0.3ppt from growth.

GDP growth and expenditure contributions

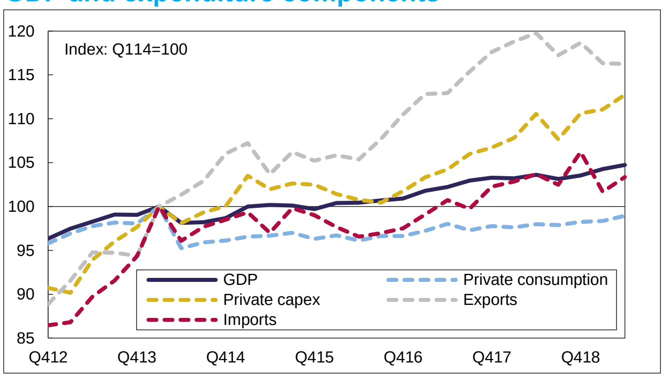
	%, Q/Q	contr	%, Y/Y	contr
GDP	**0.4**		**1.2**	
Final domestic demand	-	0.7	-	1.5
- Private consumption	0.6	0.3	1.0	0.6
- Residential investment	0.2	0.0	2.9	0.1
- Non-residential investment	1.5	0.2	2.4	0.4
- Government consumption	0.9	0.2	1.9	0.4
- Public investment	1.0	0.0	-0.2	0.0
Net exports	-	-0.3	-	-0.4
- Exports	-0.1	0.0	-2.9	-0.5
- Imports	1.6	-0.3	-0.4	0.1
Private inventories	-	-0.1	-	0.2

Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Economic momentum slowed in June

Notwithstanding the positive performance over the quarter as a whole, there are signs that economic momentum weakened considerably towards the end of Q2. The Cabinet Office's preliminary June composite business conditions indicators – calculated from 29 data series related to production, jobs, spending and financial conditions – were notably more downbeat. Indeed, the coincident index posted the steepest monthly drop since the consumption tax was last hiked in April 2014, to 100.4, matching the more-than two-year low hit in January. Moreover, looking ahead, the leading index declined to its lowest level since early 2010.

GDP and expenditure components



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Industrial production back in reverse

The end to the quarter was particularly disappointing for Japan's manufacturers. While output returned to positive growth in the second quarter (0.6%Q/Q), industrial production declined a sizeable 3.6%M/M in June, the most since the start of 2018. While the weakness was broad based, the near-9%M/M drop in vehicle production and 7%M/M% decline in the machinery sector accounted for more than half the monthly fall in overall output. Moreover, a further rise in inventories for the fourth month out of the past five to their highest level since early-2009 hardly bodes well for the near-term production outlook. Admittedly, stock levels vary considerably across sub-sectors – i.e. general machinery inventories were still up more than 13%Y/Y, but stocks were down in the electrical machinery, electronics parts and devices and autos sectors. Overall, we expect manufacturing production to remain subdued over coming months – indeed, adjusted for its survey's usual bias, METI projected growth of just 0.2%M/M in July.

Surveys more downbeat about outlook

With the global environment challenging, surveys have flagged ongoing concerns in the manufacturing sector at the start of Q3. The manufacturing PMI recorded a third successive sub-50 reading in July, with a steeper pace of contraction indicated by the output component. According to this survey, new orders, domestic and external alike, remain weak. The Economy Watchers survey similarly suggested a marked deterioration in manufacturing conditions in July, with the relevant diffusion index declining to its lowest for more than three years. Admittedly, both surveys signalled more stable conditions in the non-manufacturing sector at the start of Q3. So, the composite PMI remained in expansionary territory in July (50.6), albeit at a four-month low. But the deterioration in the headline Economy Watchers current conditions balance was more severe, falling for a third month to 41.2, matching the weakest reading since the post-quake trough in 2011.

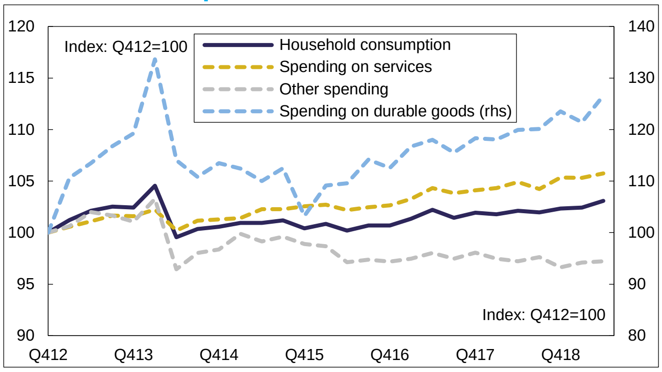
Consumer confidence at more than 5-year low

Economy Watchers also saw a further deterioration in household-related demand at the start of Q3. Although some of this weakness was attributed to bad weather, there is a general sense that the economic backdrop, associated with the heightened geopolitical tensions and unease surrounding the forthcoming consumption tax hike, has worsened. Certainly, consumer confidence has been on a steepening downward trend since the start of the year, with the headline indicator in July falling to the lowest since the consumption tax was last hiked in 2014. But while there was another notable waning reported in households' willingness to buy durable goods, consumers were more downbeat about their employment and wage prospects too.

Wage growth still subdued despite June pickup

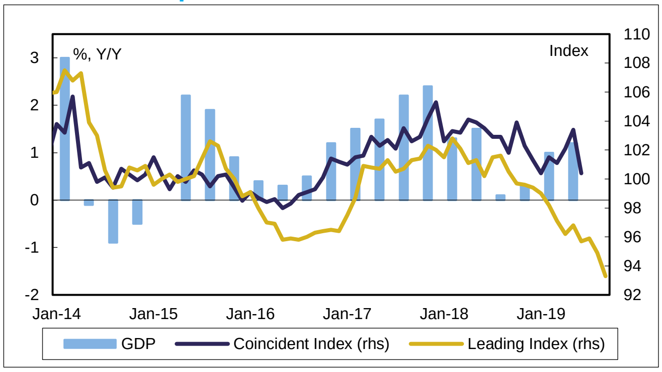
Of course, the labour market has been a source of strength over recent years. And in June, the unemployment rate fell 0.1ppt to 2.3%, matching the 26-year low reached in February, as the number of people employed rose back to 67mn, only just off the record high. But while still suggestive of a very tight labour market, the job-to-applicant ratio fell

Private consumption



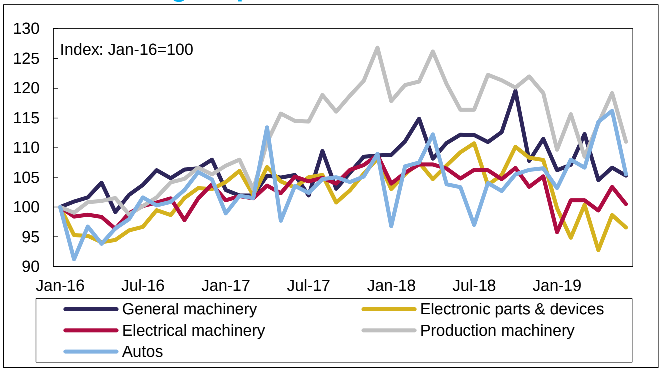
Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

GDP and composite business conditions indices*



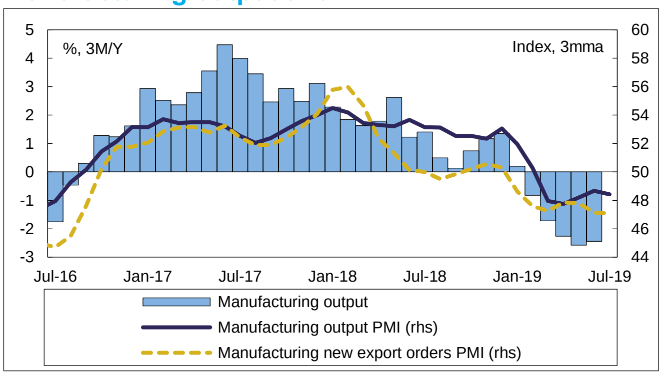
**Leading index has three-month lead. Source: Cabinet Office, Bloomberg and Daiwa Capital Markets Europe Ltd.*

Manufacturing output



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

Manufacturing output and PMI



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

for a second month in a row in June, by 0.1pt to 1.61, a twelve-month low. This principally reflected a further decline in the number of job offers, to the lowest level since October 2017. Wage growth has been soft since the start of the year too, with total labour earnings averaging a decline of 0.7%Y/Y in the first five months of the year. Admittedly, there was a marked improvement in June, with wages rising 0.5%Y/Y. And adjusting for sampling discrepancies, wages were up 1.1%Y/Y, a six-month high. But while above the average of the past two years, this remains well below levels needed to shift inflation to a higher path. Indeed, underlying (regular) wage growth has largely moved sideways over the past six months at less than ½%Y/Y.

Risks to the outlook skewed to the downside

Nevertheless, we expect demand brought forward ahead of the consumption tax hike again to support Japan's expansion in Q3. Certainly, there were tentative signs of a pickup in spending on big-ticket items in July, with vehicle sales up more than 6½%Y/Y, the strongest rise for nine months. Public spending will further support growth over coming quarters too. But this boost might well be negated by the more challenging external environment. Moreover, once the sales tax has increased at the start of Q4, GDP will almost certainly go into reverse, with a non-negligible risk that Japan will experience another technical recession. So, while the full-year GDP growth forecast of our colleagues in Japan is now a touch firmer for this fiscal year, it remains below 1%. And they expect growth to slow to just ½% in FY2020, below both Japan's potential rate and almost half the BoJ's central projection.

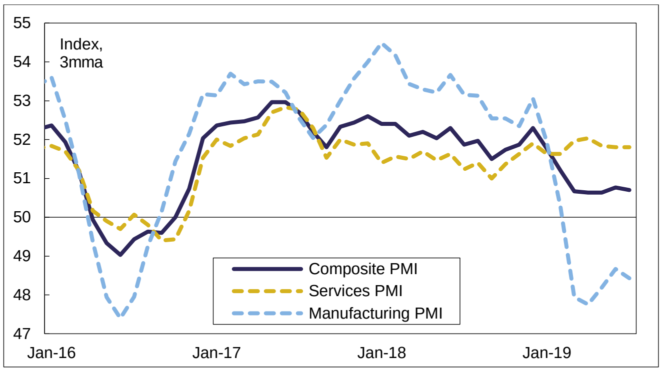
Inflation set to remain below target

The BoJ acknowledges that the risks to its growth and inflation outlooks are skewed to the downside. And its end-July forecast update saw the Policy Board's median projection for core inflation (i.e. CPI less fresh food) lowered by 0.1ppt in FY19 and FY20 to 1.0%Y/Y and 1.3%Y/Y respectively. But with the output gap judged to remain positive, the BoJ still expects further improvement in FY21, with its forecast unrevised at 1.6%Y/Y. Yet disinflationary influences appear to be on the rise. The recent decline in the oil price – down by almost 25%Y/Y in yen terms – will compound the impact of the cut in electricity tariffs last month, so energy prices will subtract from inflation to a greater extent over coming months. And if sustained, yen appreciation – which in the past week provoked the MoF to threaten "to take action if we judge [it] is likely to have a negative a negative impact on our economy" – would weigh more heavily on CPI too. As such, excluding the consumption tax, core inflation seems bound to weaken over the near term, and could well remain less than half the BoJ's 2% target for the foreseeable future.

Policy parameters unchanged at the end of July

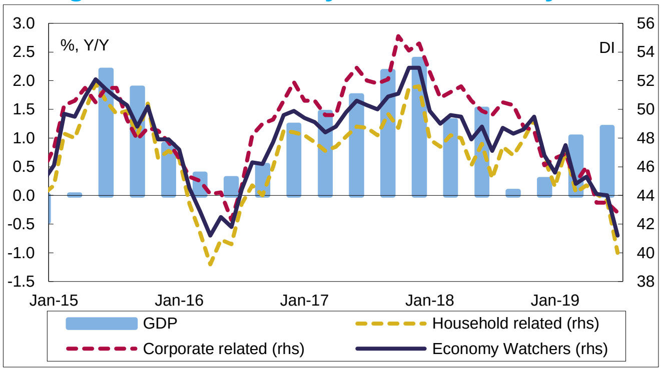
The Policy Board predictably maintained a 'wait and see' stance at its July policy-setting meeting, leaving its main yield curve control parameters unchanged. But as most other major central banks looked set to loosen policy, the BoJ strengthened slightly its commitment to ease policy further if required, stating that it "will not hesitate to take

Headline PMIs



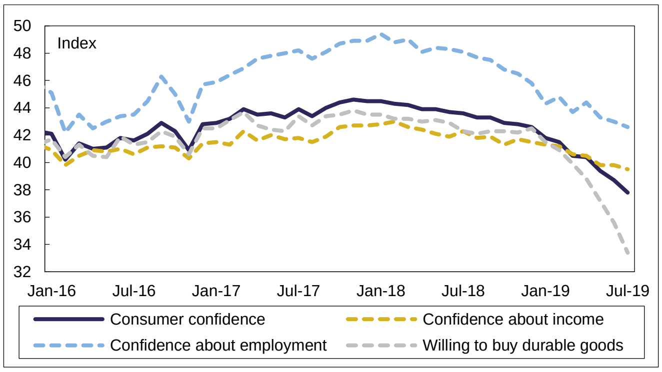
Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

GDP growth and Economy Watchers survey



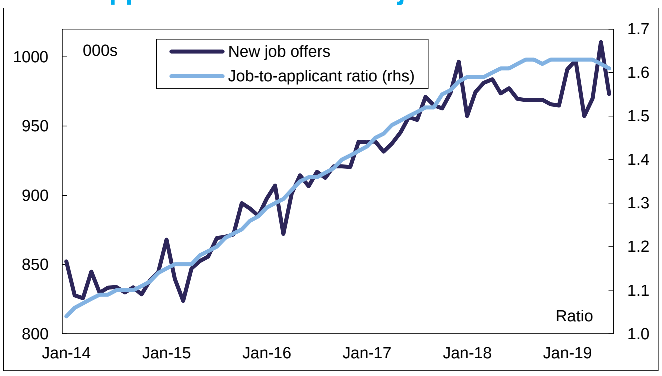
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Consumer confidence



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

Job-to-applicant ratio and new job offers



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

additional easing measures if there is a greater possibility that the momentum to achieving the price stability target will be lost". Of course, Governor Kuroda has for some time noted that new measures could entail a cut in the short-term policy rate, a lower 10Y yield target range, expanded asset purchases and/or an accelerated expansion of the monetary base – i.e. steps that would fit comfortably within the current yield curve control framework.

But financial markets testing the BoJ

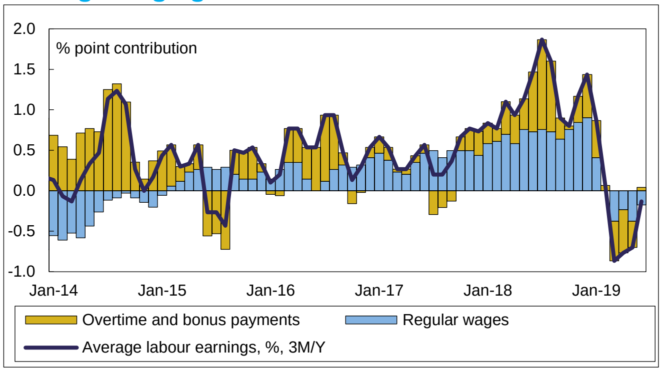
When yield curve control was introduced in 2016, however, it was constructed in recognition that the short end of the curve is most relevant for generating inflation, and that an upwards-sloping yield curve was desirable, particularly for the health of financial institutions. Yet, reflecting global developments, for a while, the JGB yield curve has been inverted up to 7Y. And in recent days, 10Y JGB yields moved below -0.20% – the floor of the BoJ's informal target range – for the first time since August 2016. In a bid to arrest further unfavourable shifts of the yield curve, the BoJ at the end of the past week reduced buying of its 3-5Y and 10-25Y bonds and increased purchases of 1-3Y securities. Reductions in purchases in the 5-10Y zone seem likely to be made too. But if the economic outlook deteriorates significantly, and/or the yen appreciates sharply, short-term interest rates, including the current -0.10% policy rate, might have to come into sharper focus.

Looking ahead…

When Japanese markets re-open on Tuesday, focus will be on the July producer price inflation figures for any further insight into the impact of the decline in the oil price and stronger yen on import prices. June tertiary and industrial output figures will also be published, along with machine orders data for the same month. The following week will bring the trade report for July, along with the first of the August sentiment surveys with the Reuters Tankan and flash PMIs likely to show a further deterioration in conditions in the middle of the third quarter. Focus at the end of that week will be on national CPI figures for July, with expectations for headline and core inflation to edge lower. In the markets, the MoF will conduct a 5Y JGB auction on Thursday 15 August and a 20Y JGB auction on Tuesday 20 August.

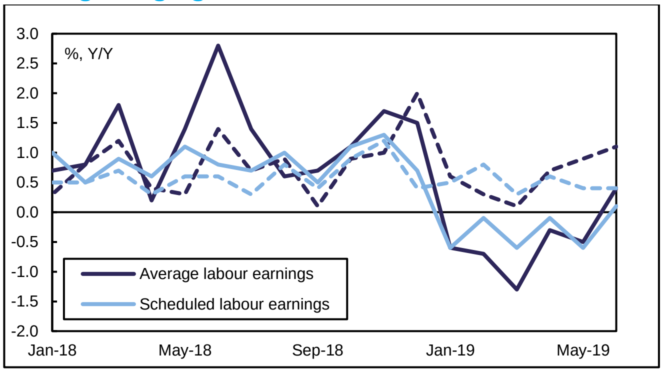
The next edition of the Yen 4Sight
Is due to be published on 23 August 2019

Average wage growth



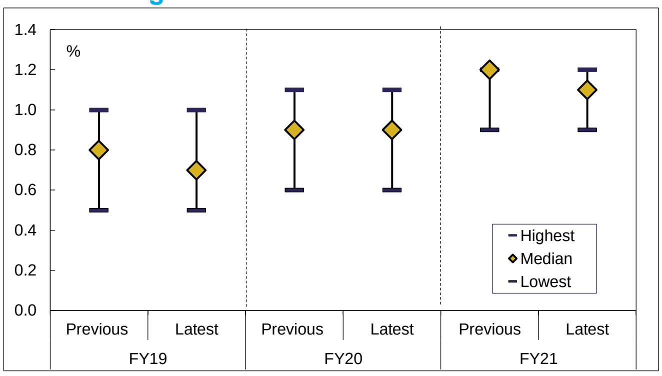
Source: MHLW, Bloomberg and Daiwa Capital Markets Europe Ltd.

Average wage growth*



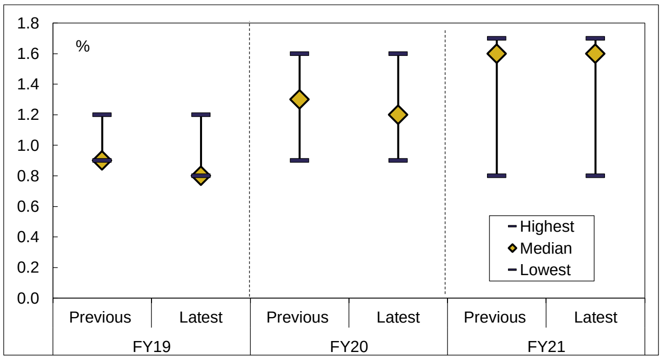
**Dashed lines are like-for-like earnings. Source: MHLW, Bloomberg and Daiwa Capital Markets Europe Ltd.*

BoJ's GDP growth forecast



Source: BoJ and Daiwa Capital Markets Europe Ltd.

BoJ's core CPI forecast*



**Core CPI excluding fresh foods, impact of consumption tax and free education policy. Source: BoJ and Daiwa Capital Markets Europe Ltd.*

Economic calendar

Key data releases – August

05	06	07	08	09
SERVICES PMI JUN 51.9 JUL F 51.8 COMPOSITE PMI JUN 50.8 JUL F 50.6	30Y JGB AUCTION AVERAGE WAGES Y/Y% MAY -0.5 JUN P 0.4 HOUSEHOLD SPENDING Y/Y% MAY 4.0 JUN 2.7 COINCIDENT INDEX MAY 103.4 JUN P 100.4 LEADING INDEX MAY 94.9 JUN P 93.3	BOJ CONSUMPTION ACTIVITY M/M% MAY -0.4 JUN 0.0 BOJ SUMMARY OF OPINIONS (29-30 JULY MEETING)	10Y JGBI AUCTION 6M TB AUCTION ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI JUN 44.0 JUL 41.2 BANK LENDING Y/Y% JUN 2.3 JUL 2.3	3M TB AUCTION GDP Q/Q% Q1 0.7 Q2 P 0.4 GDP DEFLATOR Y/Y% Q1 0.1 Q2 P 0.4
12	**13**	**14**	**15**	**16**
NATIONAL HOLIDAY – MOUNTAIN DAY OBSERVED	GOODS PPI Y/Y% JUN -0.1 JUL N/A TERTIARY ACTIVITY M/M% MAY -0.2 JUN N/A	MACHINE ORDERS M/M% MAY -7.8 JUN N/A	5Y JGB AUCTION (APPROX ¥1.9TRN) INDUSTRIAL PRODUCTION M/M% MAY 2.0 JUN F -3.6 CAPACITY UTILISATION M/M% MAY 1.7 JUN N/A	3M TB AUCTION (APPROX ¥4.3TRN)
19	**20**	**21**	**22**	**23**
1Y TB AUCTION GOODS TRADE BALANCE (JUL) REUTERS TANKAN (AUG) NATIONWIDE DEPARTMENT STORE SALES* (JUL)	20Y JGB AUCTION		ENHANCING LIQUIDITY AUCTION MANUFACTURING PMI (AUG P) SERVICES PMI (AUG P) COMPOSITE PMI (AUG P) ALL INDUSTRY ACTIVITY (JUN)	3M TB AUCTION NATIONAL CPI (JUL)
26	**27**	**28**	**29**	**30**
	SERVICES PPI (JUL)			INDUSTRIAL PRODUCTION (JUL P) RETAIL SALES (JUL) UNEMPLOYMENT RATE (JUL) JOB-TO-APPLICANT RATIO (JUL) TOKYO CPI (JUL) HOUSING STARTS (JUL) CONSTRUCTION ORDERS (JUL)

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

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