Japan | Economic Research | 23 August 2019

Daiwa Capital Markets

Yen 4Sight

Highlights

- Headline inflation fell further while core CPI measures showed underlying price pressures remained very subdued.
- Net trade remained a drag on growth at the start of Q3. Surveys provided mixed messages about broader economic conditions but largely suggest weak underlying momentum.
- The coming week will bring IP, household consumption and unemployment figures for July, all due on Friday.

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Interest and exchange rate forecasts

End period	23 Aug	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.25	-0.25	-0.25	-0.25
JPY/USD	106	106	105	105
JPY/EUR	118	118	116	116

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

BoJ increasingly off track

When the BoJ Policy Board met at the end of July, it appeared to strengthen its easing bias, stating that it "will not hesitate to take additional easing measures if there is a greater possibility that the momentum to achieving the price stability target will be lost". And with the past week's CPI figures suggesting that the BoJ still has a mountain to climb to sustain inflation at even just half the target level, July's trade report and surveys highlighting that risks to the near-term growth outlook are skewed to the downside, and 10Y JGB yields below the bottom of the Policy Board's target range ("about double the range of between -0.1% and +0.1%"), further policy adjustment as soon as next month would seem increasingly likely.

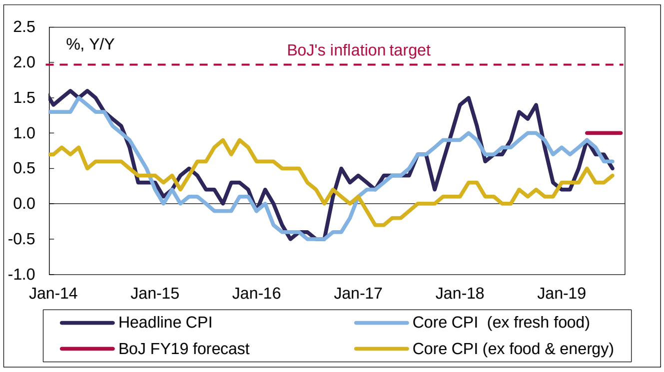
Inflation well off track

Despite a modest rise in consumer prices in July (0.1%M/M) for the first month in three, the annual rate of headline CPI declined a slightly larger-than-expected 0.2ppt to 0.5%Y/Y, just one-quarter of the BoJ's 2% inflation target. Admittedly, this reflected a drop in fresh food price inflation that month (down 3.5ppts to -0.7%Y/Y). So, when stripping out such items, the BoJ's forecast measure of core inflation was unchanged at 0.6%Y/Y, albeit matching the lowest rate for two years. Moreover, when also excluding energy prices, the BoJ's new preferred core CPI indicator edged slightly higher, by 0.1ppt to 0.6%Y/Y. But while the core-core measure – which excludes all food and energy to align most closely with figures reported by other major economies – was also nudged higher, at just 0.4%Y/Y it suggests that underlying inflation in Japan remains well below levels prevailing among its peers.

Core components provide mixed messages

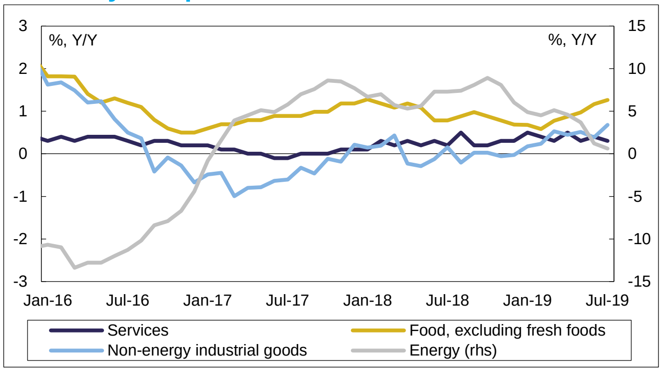
Within the detail, non-energy industrial goods inflation picked up 0.3ppt to 0.7%Y/Y, the highest rate for more than three years. But this move largely reflected a pickup in the price of mobile phone handsets, which has seen significant volatility over recent months – in July prices of such items rose 0.2%Y/Y following a decline of more than 9%Y/Y in June. And with mobile phone charges remaining a modest drag, and the increase in hotel prices also moderated, services inflation edged lower in July to just 0.3%Y/Y. Energy inflation also eased further, with the 0.6%Y/Y increase half the pace seen in June and the softest since the start of 2017.

Headline and core CPI



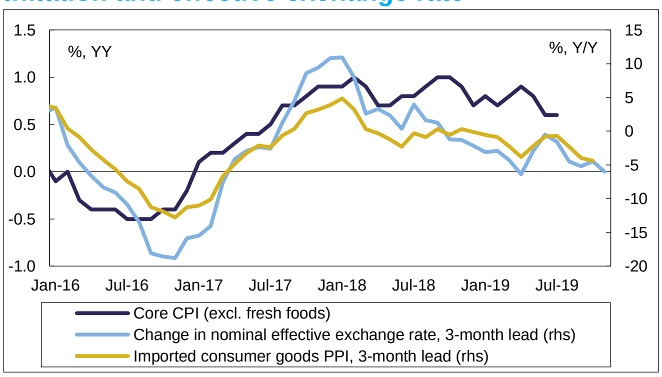
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

CPI – key components



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

Inflation and effective exchange rate



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

Risks to inflation outlook skewed to downside

Looking ahead, energy prices are likely to subtract from annual inflation over the near term. So, a further modest decline in the BoJ forecast measure of core CPI over coming months seems highly likely. Recent yen appreciation seems likely to add a disinflationary impulse too. This was illustrated in the latest goods producer price figures, which showed that headline PPI declined 0.6%Y/Y in July, with import prices in yen terms down a hefty 8.1%Y/Y, both the steepest drops since late-2016, and prices of imported consumer goods down 4.4%Y/Y. So, with much of the direct inflationary impact of the consumption tax hike to be offset by the abolition of certain public school fees, and GDP set to shift into reverse in the fourth quarter, there seems no reason to expect inflation to be anything other than very subdued for the foreseeable future.

Widespread decline in activity in June

Of course, the BoJ still hopes that a positive output gap will help to boost underlying price pressures. Yet, there are signs that economic momentum has weakened considerably over recent months. For example, the solid headline GDP growth figure for Q2 masked a slowdown at the end of the quarter. All industry activity declined 0.8%M/M in June, the sharpest monthly drop since September, to leave output 0.3% lower than a year earlier. And without the further rise in public sector construction (2½%M/M) to its highest level for fourteen months, the drop would have been steeper. Industrial production posted the largest monthly decline (-3.3%M/M) in seventeen months. Activity in the tertiary sector also slipped back (-0.1%M/M), with notable weakness in finance and retail. And private sector construction (-2.3%M/M) fell by the most since April 2014.

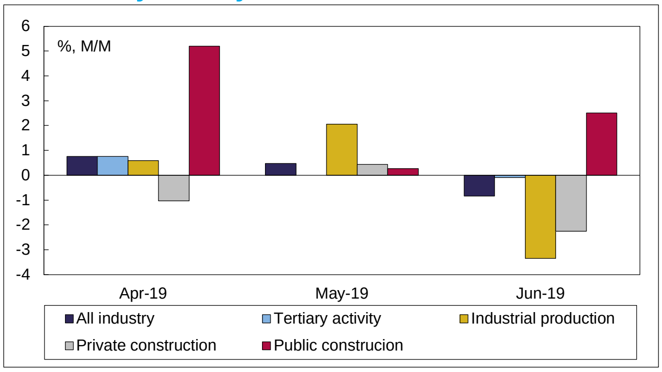
Exports boosted by one-off factors in July

The ongoing challenges facing Japanese manufacturers were evident in July's trade figures. Admittedly, the value of exports beat expectations, with a decline of just 0.2%M/M following a more than 5%M/M decline in June, to leave them down just 1.6%Y/Y, following a fall of more than 6½%Y/Y in June. Nevertheless, this still marked the eighth consecutive year-on-year decline. And the detail suggested a boost from several one-off factors. For example, the improvement in shipments to the US (up 8½%Y/Y) was supported by a jump in aircraft exports (+27%Y/Y), while exports of semi-conductor machinery to that country were up a whopping 144%Y/Y. Meanwhile, exports to the EU were driven by a surge in car shipments (up more than 50%Y/Y), while ships and aircraft also provided a boost. Shipments to Asia, meanwhile, remained weak in July, down more than 8%Y/Y, the ninth consecutive annual drop. And the near-7%Y/Y drop in exports to Korea, tentatively suggested that the intensification of the trade dispute between the two countries was taking an additional toll.

Net trade remained a drag on GDP at start of Q3

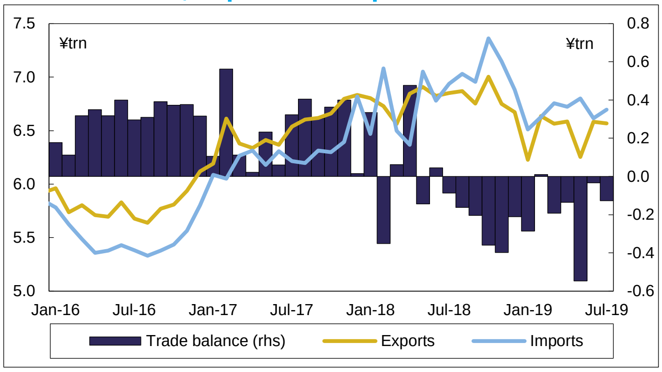
When stripping out seasonal and price effects, the BoJ's trade data suggested that the performance was somewhat more encouraging, with export volumes up a stronger 0.9%M/M, to leave them ½% higher compared with a year earlier. But with import volumes almost 4½% higher in July – the largest monthly increase since October – the BoJ figures still suggested that net trade remained a drag on growth at the start of Q3.

All industry activity



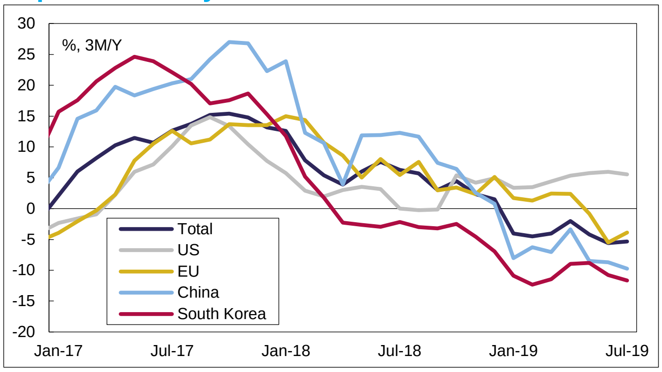
Source: METI and Daiwa Capital Markets Europe Ltd.

Trade balance, export and import values*



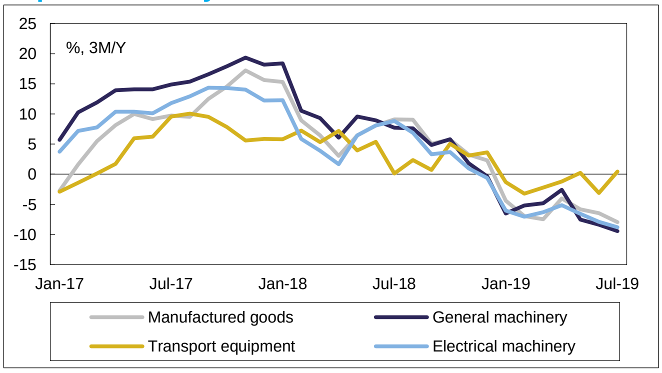
**Seasonally adjusted data. Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Export values by destination



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

Export values by sector



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

Orders supported by non-manufacturers

With the trade uncertainty weighing significantly on global investment intentions, Japanese machinery orders from abroad have weakened considerably over recent quarters. And while the latest figures showed a pickup in June, they were still on average in Q2 down a sizeable 14½% from the average in Q1, the second successive double-digit quarterly decline. Orders placed by domestic manufacturers have also been on a downtrend over recent quarters, with weakness across the key-export oriented sectors. But orders placed by non-manufacturers – which rose 30%M/M, the most since 1996 – were given a notable boost in June by large-scale orders in the electricity supply and transportation sub-sectors. So, total private sector core orders – which provides a useful guide to future private sector capex – rose a much stronger-than-expected 13.9%M/M in June, the largest increase since the start of 2003, to leave them 12½% higher than a year earlier and at their highest level for eleven years. And while orders are notoriously volatile, this left them up 7½% over the second quarter as a whole, the strongest such increase for six years.

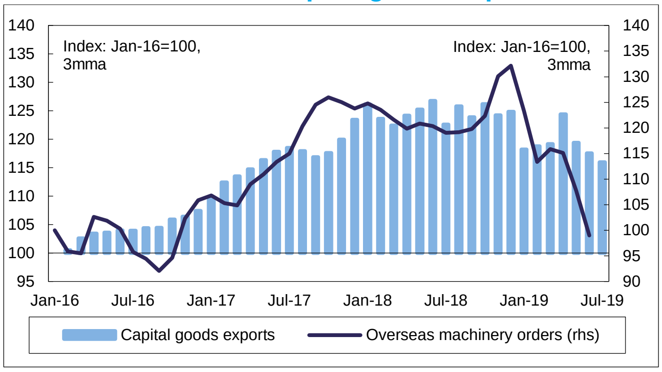
Flash PMIs point to stronger services in Q3

The near-term trajectory for private sector capex remains somewhat clouded by significant downside risks to the economic outlook. And while the past week's flash PMIs and Reuters Tankan offered different assessments of conditions in August, neither suggested a sustained improvement is on the cards. Admittedly, there was a notable increase in the headline services PMI this month, up 1.6pts to 53.4, matching the level last seen in October 2017, which itself was the highest since the summer of 2015. So, while the manufacturing output PMI remained in contractionary territory, the composite PMI rose 1.1pts to 51.7, the strongest reading since December. So, in the first two months of Q3, the composite PMI was on average ½pt higher than the average in the first two quarters of the year at 51.2, suggesting that – probably supported by demand brought forward ahead of October's consumption tax hike – GDP is on track for another quarter of positive growth in Q3.

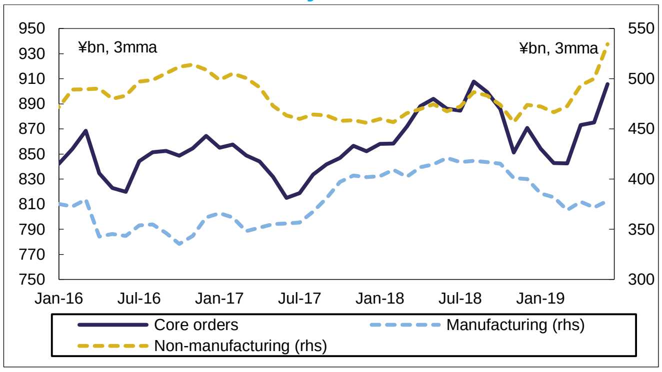
But Tankan signalled significant deterioration

We caution, however, that the services PMI in July was eventually revised down significantly from the flash estimate. And, in marked contrast, the Reuters Tankan – which captures developments in a wider range of sub-sectors than the PMI, including retail and construction – indicated a significant deterioration in the non-manufacturing sector in August, with the headline diffusion index down a whopping 12pts in August – the largest monthly drop for more than four years – to +13, the lowest since October 2016. Indeed, this in part reflected another sizeable decline in the wholesale and retail DI, down 22pts to -5, the lowest since 2016. The survey also signalled a further marked weakening in the manufacturing sector, with the respective headline DI declining 7pts in August – the most for sixteen months – to -3, the first time pessimists have outweighed optimists in the sector since April 2013. If this downtrend is maintained in September, the BoJ's quarterly Tankan survey at the beginning of October would seem highly likely to be weak, adding pressure on the Policy Board to act if it hasn't already done so next month.

Overseas orders and capital goods exports

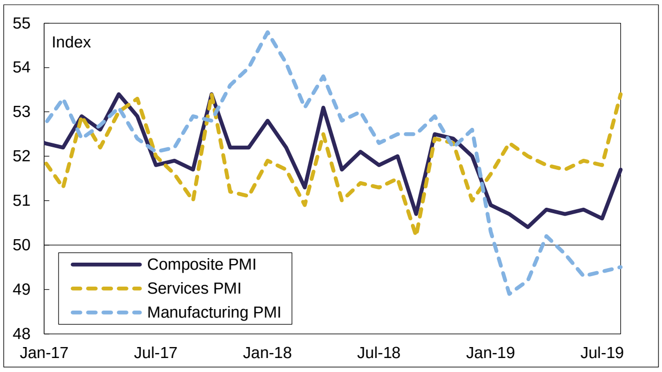


Private sector machinery orders



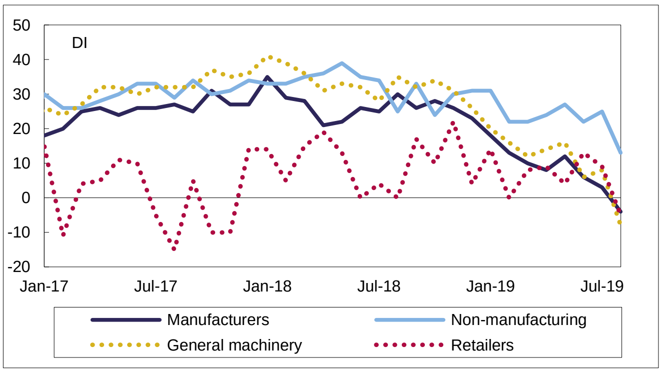
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Headline PMIs*



**August figures are flash estimates. Source: Markit, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Reuters Tankan – business conditions



Source: Thomson Reuters

Looking ahead…

The main focus in the coming week will be Friday's deluge of month-end top-tier releases, including July industrial production, retail sales, labour market and housing starts figures, as well as the Tokyo CPI numbers for August. Following the sharp decline in June, IP is expected to have rebounded somewhat. But retail sales are likely to have remained subdued at the start of Q3. The following week will be a busy one too, kicking off on Monday with the MoF's survey of corporations' financial statistics, which will feed through to the second estimate of Q2 GDP on 9 September. That day will also bring vehicle sales figures, the final manufacturing PMI and the BoJ's bond market survey, all for August. The end of that week will see a number of key July releases, with the BoJ's consumption activity index, household spending and average earnings figures. In the markets, the MoF will conduct a 2Y JGB auction on Thursday 29 August, a 10Y JGB auction on Tuesday 03 September and a 30Y JGB auction on Thursday 05 September.

The next edition of the Yen 4Sight
Is due to be published on 6 September 2019

Daiwa Capital Markets

Economic calendar

Key data releases – August/September

19	20	21	22	23
1Y TB AUCTION GOODS TRADE BALANCE ¥BN JUN -34 JUL -127 EXPORTS Y/Y% JUN -6.6 JUL -1.6 IMPORTS Y/Y% JUN -5.2 JUL -1.2 REUTERS TANKAN – LARGE MANUFACTURERS DI JUL 3 AUG -4 LARGE NON-MANUFACTURERS DI JUL 25 AUG 13	20Y JGB AUCTION	NATIONWIDE DEPARTMENT STORE SALES Y/Y% JUN -0.9 JUL -2.9	ENHANCING LIQUIDITY AUCTION MANUFACTURING PMI JUL 49.4 AUG P 49.5 SERVICES PMI JUL 51.8 AUG P 53.4 COMPOSITE PMI JUL 51.2 AUG P 51.7 ALL INDUSTRY ACTIVITY M/M% MAY 0.5 JUN -0.8	3M TB AUCTION NATIONAL CPI Y/Y% JUN JUL 0.7 0.5 *EX FRESH FOOD* *0.6 0.6* *EX FRESH FOOD/ENERGY* *0.5 0.6*
26	**27**	**28**	**29**	**30**
AVERAGE WAGES* Y/Y% MAY -0.5 JUN F 0.4	ENHANCING LIQUIDITY AUCTION (APPROX ¥0.5TRN) SERVICES PPI Y/Y% JUN 0.7 JUL 0.6		2Y JGB AUCTION (APPROX ¥2.0TRN)	3M TB AUCTION (APPROX ¥4.28TRN) INDUSTRIAL PRODUCTION M/M% JUN -3.3 JUL P 0.3 RETAIL SALES Y/Y% JUN 0.5 JUL -0.6 UNEMPLOYMENT RATE % JUN 2.3 JUL 2.3 JOB-TO-APPLICANT RATIO JUN 1.61 JUL 1.61 TOKYO CPI Y/Y% JUL AUG 0.9 0.6 *EX FRESH FOOD* *0.9 0.8* *EX FRESH FOOD/ENERGY* *0.8 0.7* HOUSING STARTS Y/Y% JUN 0.3 JUL -5.4 CONSTRUCTION ORDERS Y/Y% JUN -4.2 JUL N/A
02	**03**	**04**	**05**	**06**
MOF'S CAPITAL SPENDING SURVEY (Q2) MANUFACTURING PMI (AUG F) VEHICLE SALES (AUG) BOJ BOND MARKET SURVEY (AUG)	10Y JGB AUCTION MONETARY BASE (AUG)	SERVICES PMI (AUG F) COMPOSITE PMI (AUG F)	30Y JGB AUCTION	3M TB AUCTION HOUSEHOLD SPENDING (JUL) BOJ CONSUMPTION ACTIVITY INDEX (JUL) AVERAGE WAGES (JUL) COINCIDENT INDEX (JUL P) LEADING INDEX (JUL P)
09	**10**	**11**	**12**	**13**
6M TB AUCTION ENHANCING LIQUIDITY AUCTION GDP (Q2 F) BANK LENDING (AUG) CURRENT ACCOUNT (JUL) ECONOMY WATCHERS SURVEY (AUG)	M3 (AUG)	5Y JGB AUCTION MOF'S BSI SURVEY (Q3)	MACHINE ORDERS (JUL) TERTIARY ACTIVITY (JUL) GOODS PPI (AUG)	3M TB AUCTION ENHANCING LIQUIDITY AUCTION INDUSTRIAL PRODUCTION (JUL F) CAPACITY UTILISATION (JUL)

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

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