Daiwa Capital Markets

Yen 4Sight

Highlights

- Against the backdrop of weaker consumer confidence and bad weather, consumption declined sharply at the start of Q3.
- While IP rose in July, it maintained a downward trend. And surveys point to ongoing weakness ahead.
- Looking ahead, updated GDP figures might well see growth nudged slightly lower in Q2. But all eyes will be on the BoJ's policy meeting, which concludes on 19 September.

Emily Nicol
+44 20 7597 8331
Emily.Nicol@uk.daiwacm.com

Chris Scicluna
+44 20 7597 8326
Chris.Scicluna@uk.daiwacm.com

Interest and exchange rate forecasts

End period	06 Sep	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.20	-0.20	-0.20
10Y JGB %	-0.26	-0.25	-0.25	-0.25
JPY/USD	107	106	105	105
JPY/EUR	118	118	116	116

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

Economic backdrop supports case for BoJ easing

When the BoJ's latest policy-setting meeting is held in less than two weeks' time, the case for the Policy Board to take new action might appear strong. Having stated at its end-July meeting 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", headline inflation fell to just ½%Y/Y in July. And the one-month-ahead Tokyo CPI implied a further decline in August. Economic data on the whole suggest a loss of growth momentum at the start of Q3, with a striking weakening in consumption (see below). Developments in financial markets have been unhelpful for the BoJ too, with the stronger yen undesirable, and a flatter yield curve and 10Y JGB yields well below the lower bound of the BoJ's informal target range ("about double the range of between -0.1% and +0.1%") also strengthening the case for a change of tactics.

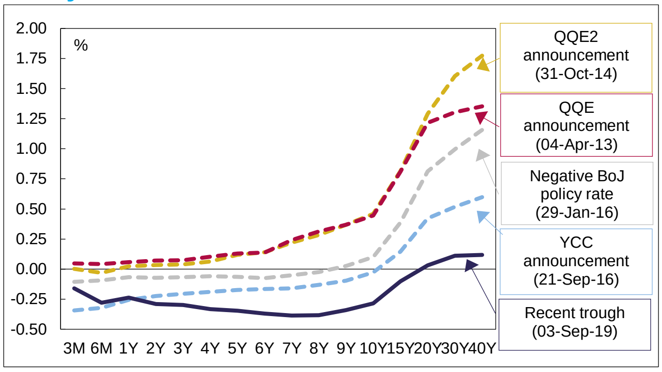
Financial markets testing the BoJ

Indeed, the ability of the BoJ to optimally control the yield curve came under increased scrutiny in the past week, as 10Y yields fell to within a whisker of the record low of -0.30% despite back-to-back reductions in its purchases of JGBs at the 5-10Y zone. So, while he had previously emphasised the flexibility within the framework, BoJ Governor Kuroda acknowledged in an interview in the Nikkei newspaper that "if there's no limit at all, the interest rate target of 'around zero' will become meaningless". Kuroda also accepted that ultra-long yields had "fallen a bit too far" with adverse consequences for insurers and pension funds – something that yield curve control was originally intended to prevent. And at the shorter end of the curve, which the BoJ believes is most relevant for GDP and inflation, concerns about the adverse impact of the negative policy rate on profitability of the regional banks persist.

BoJ evaluating options but may leave powder dry

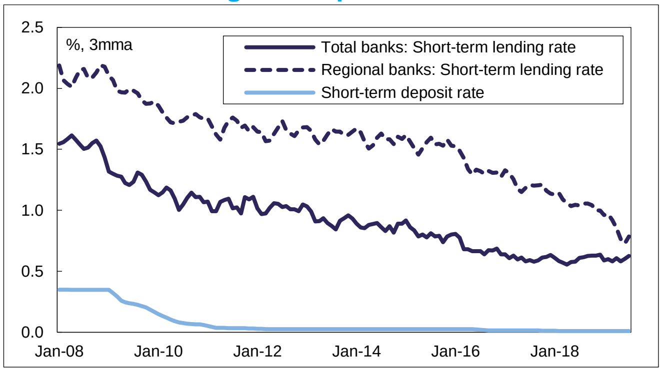
What precisely the BoJ might do next, however, is unclear, with Kuroda noting that "We're considering a variety of possibilities, including combinations of [measures] and improved versions". But he was clear that the BoJ would "adjust the volume and timing of our ultra-long bond market operations as necessary", giving a boost to 30Y yields, which had already started rising on the back of global bond market moves. But Kuroda also hinted that the BoJ might remain tolerant of 10Y JGB yields around recent low levels. And while falling inflation and a stronger yen might suggest the need for a short-term policy rate cut, concerns that the BoJ might be close to the so-called 'reversal rate' – below which policy becomes increasingly contractionary

JGB yield curve



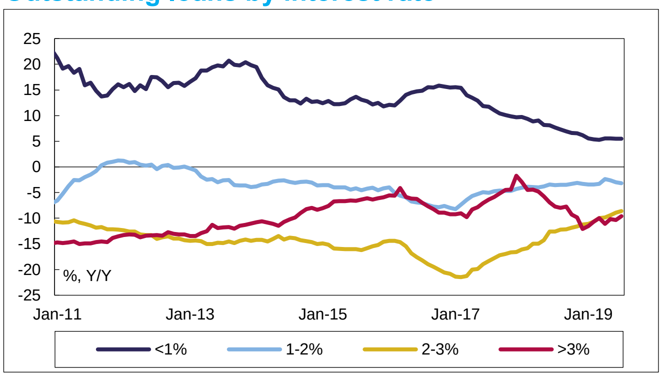
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Short-term lending and deposit rates



Source: BoJ and Daiwa Capital Markets Europe Ltd.

Outstanding loans by interest rate



Source: BoJ and Daiwa Capital Markets Europe Ltd.

– could well limit action this month to a mere amendment of its forward guidance, which currently states that "the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020". Of course, if and when demand weakens following next month's consumption tax hike, substantive easing will be harder to resist.

Consumption slumped in July

By no means has it been all bad news for the BoJ of late. Japan's economy held up in Q2, supported not least by private consumption as spending on durable goods ramped up ahead of the tax hike. But while bad weather likely played a role, the past week's monthly consumption figures suggested that the effect of the tax hike might have already started to fade. The BoJ's consumption activity index declined for the second successive month in July and by 2½%M/M, the steepest drop since the post-2014 consumption tax hike slump, with a sizeable fall in the durable goods index (-6.7%M/M). This left the headline year-on-year rate negative (-0.8%Y/Y) for the first time since October 2016. The household spending survey similarly reported a further decline in July by 0.9%M/M following a near-3%M/M drop previously. And when excluding the more volatile items, core spending fell a steeper 1.9%M/M, with notable declines in spending on household goods (-14.7%M/M) and clothing (-8.4%M/M).

Summer bonuses weigh on wages

Labour earnings figures offer little cause for optimism about the near-term spending outlook too. Headline wage growth fell back into negative territory in July, down 0.7ppt to -0.3%Y/Y, with a notable drop in summer bonus payments, down more than 2%Y/Y that month. Admittedly, underlying wage growth was more positive, with scheduled earnings up 0.6%Y/Y, from a decline of 0.1%Y/Y previously and the first positive reading this year. And data based on a common sample suggest that regular wage growth accelerated to 0.9%Y/Y in July. But while the unemployment rate declined in July to 2.2%, the lowest rate since 1992 – a level that in the past was consistent with much stronger wage growth – the job-to-applicant ratio fell further in July to the lowest since March 2018. And with new job offers down for the second successive month, the new job-to-applicant ratio fell to its lowest since 2017.

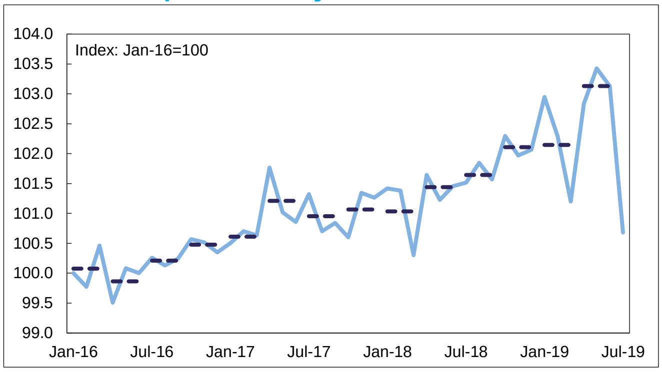
Confidence at lowest since last sales tax hike

Against this backdrop, Japanese consumers expressed greater unease about near-term employment opportunities in the latest confidence survey, with the relevant index falling in August to the lowest for 2½ years. Sentiment about income growth also remained at its weakest for more than four years. And as the tax hike approaches, they were less willing to buy durable goods over coming months, with the relevant survey component falling to the lowest since the previous consumption tax hike and the second lowest since the global financial crisis.

Manufacturing posted subdued rebound in July

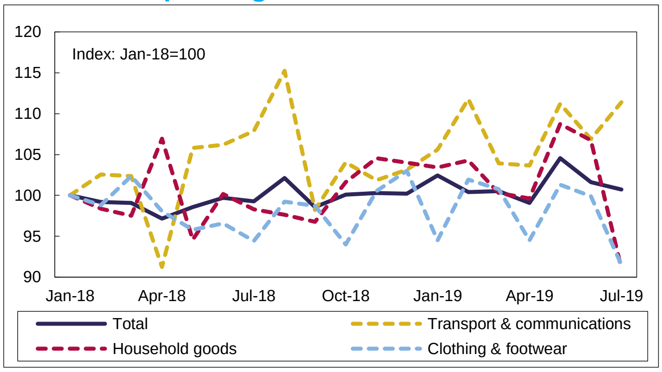
Given downside risks to domestic demand and an ever-challenging external environment, Japanese manufacturers seem highly unlikely to step up their production over the near term. Certainly the rebound in July was disappointing given the more than 3%M/M drop in June. Indeed, the 1.3%M/M rise left output up just 0.7%Y/Y and still below the Q2 average. And

BoJ consumption activity index*



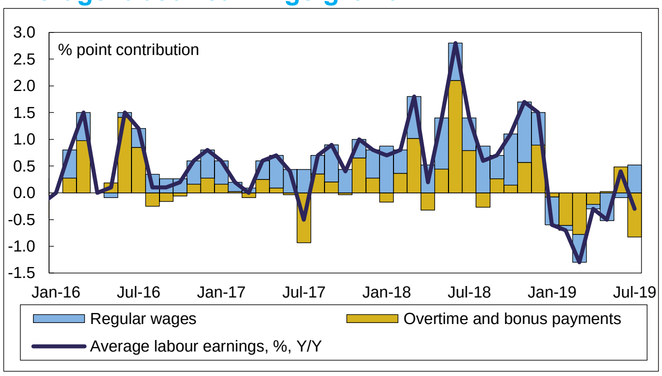
*Dark blue dashed line represents quarterly average.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Household spending



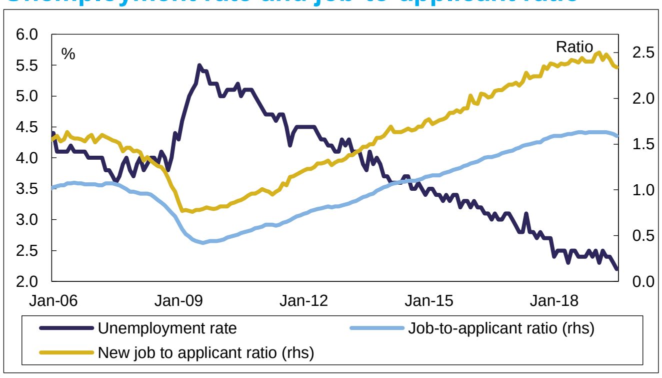
Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Average labour earnings growth



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

Unemployment rate and job-to-applicant ratio



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

the improvement principally reflected exceptional growth of more than 8½%M/M in business-oriented machinery output.

IP set to remain weak in Q3

Growth in production in July was accompanied by a welcome pickup in shipments at double the rate. So, inventories fell for the first month in six. But this principally reflected a further drop in stocks of ICT equipment (-16.4%M/M). And the total level of inventories remains close to the highs seen during the global financial crisis, raising further questions about the near-term production outlook. Certainly, the past week's final manufacturing PMI offered little optimism, with the headline index revised down to 49.3 in August. And while the output component rose to a six-month high, at 48.9 it remained in contractionary territory for the eighth consecutive month, with a steeper pace of decline implied by the new orders index too.

Services PMIs buck the survey trend

In contrast, the services PMI bucked the downward trend of other sentiment surveys in August, with the headline activity index rising a sizeable 1½pts to 53.3, the highest since October 2017. As such, the composite PMI rose to 51.9, an increase of 1.3pts from July, the highest level since December and more than 1pt higher than the average so far this year. 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 51.3, suggesting that on balance GDP is on track for another quarter of positive growth in Q3. But the detail of the survey was less encouraging about the near-term outlook, with the new orders PMI at a near-three-year low, while expectations of future output fell to its weakest level since 2012.

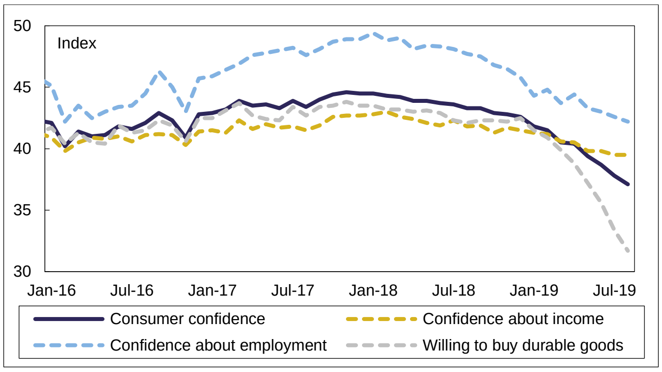
Composite indices consistent with weaker GDP

Notwithstanding the PMIs, on the whole the recent data flow implies a subdued economic performance at the start of the third quarter. That was reflected in the Cabinet Office's latest composite indices of business conditions. In particular, the coincident index fell for the second successive month in July, to 99.8, the lowest level since September 2016. And while the leading index edged slightly higher in July, at 99.6 it was still the second-lowest since early 2010 at a level consistent with significantly lower GDP growth.

Q2 GDP likely to be nudged only slightly lower

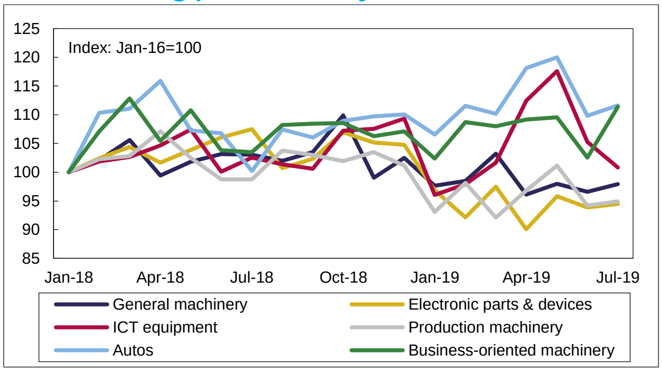
Japanese GDP figures can often be subject to significant revisions between the initial and final national accounts releases, not least due to the extra information on business investment. But while the past week's MoF capital spending survey implied a notable deterioration in firms' sales and profits growth – with the latter down a hefty 12%Y/Y, the steepest drop since the post-quake slump in 2011 – investment held up well in the second quarter. In particular, nominal capital spending rose for the third consecutive quarter in Q2 and by a seemingly solid 1.5%Q/Q, underpinned by notable investment in software in the non-manufacturing sector. The preliminary GDP report had seen nominal non-residential investment rise 1.4%Q/Q in Q2, while real private non-residential investment also rose by 1.5%Q/Q. So, when revised national accounts figures are published on Monday, we might well see limited revisions to capex growth in Q2. This notwithstanding, given the survey's implied adjustments to inventories, we expect to see a downwards revision to GDP growth by 0.1ppt to 0.3%Q/Q.

Consumer confidence



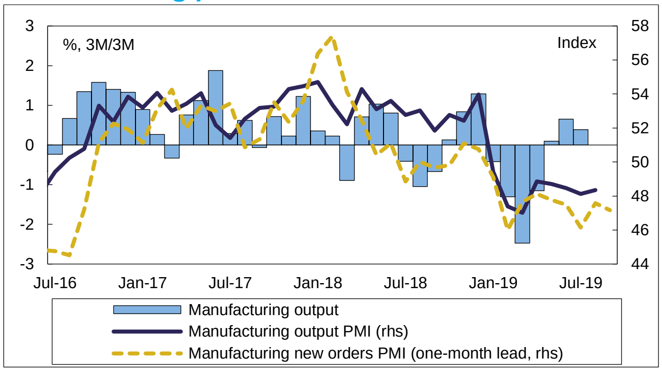
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Manufacturing production by subsector



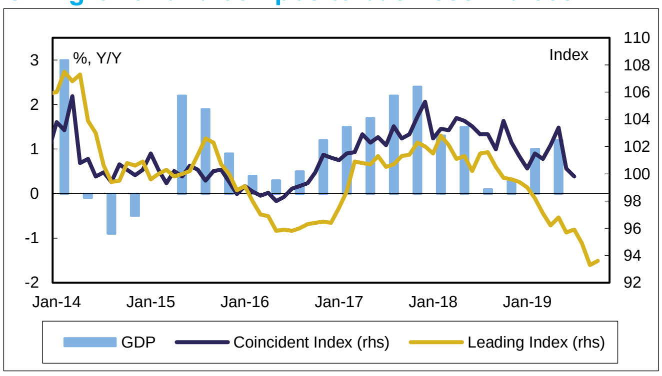
Source: METI and Daiwa Capital Markets Europe Ltd.

Manufacturing production and PMI



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

GDP growth and composite business indices*



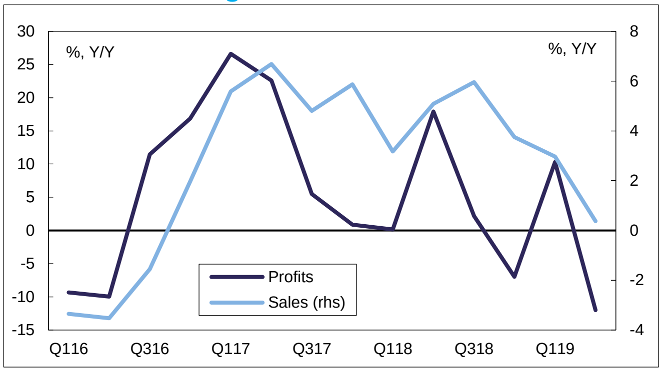
**Leading index has three-month lead. Source: Cabinet Office, Thomson Reuters and Daiwa capital Markets Europe Ltd.*

Looking ahead…

Looking ahead, the main focus at the start of the coming week will be Monday's revised GDP figures, with growth in Q2 expected to be nudged slightly lower to 0.3%Q/Q, nevertheless still marking the third consecutive quarter of expansion. Monday will also bring the latest economy watchers survey. And that will be followed by the MoF's business sentiment indicators (Wednesday) which will give an insight into expected business conditions in Q419 and Q120 in the aftermath of the tax increase. The back end of the coming week will bring more insight into conditions in the current quarter, with July's machine orders, tertiary activity and revised manufacturing output figures due.

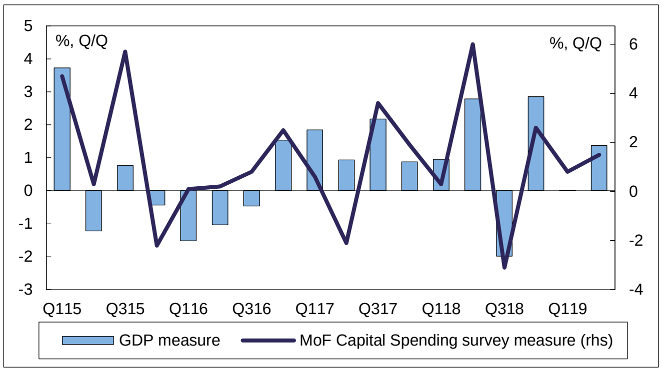
The following week will see the August trade report published on Wednesday. But the main event will be the BoJ Policy Board announcement on Thursday 19 September. Against the backdrop of monetary policy easing by the Fed and ECB, a deteriorating economic outlook and recent unwelcome shifts in financial markets, the case for pre-emptive loosening of monetary policy ahead of October's consumption tax hike is non-negligible. That week will conclude with the latest national CPI figures for August on Friday, which seem likely to post a further decline in the headline and BoJ forecast measures. In the markets, the MoF will conduct a 5Y JGB auction on Wednesday 11 August and a 20Y JGB auction on Wednesday 18 August.

Profits and sales growth



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

Private sector investment



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

The next edition of the Yen 4Sight is due to be published on 20 September 2019

Economic calendar

Key data releases – September

02	03	04	05	06
MOF'S CAPITAL SPENDING SURVEY Y/Y% Q1 6.1 Q2 1.9 PROFITS Y/Y% Q1 10.3 Q2 -12.0 SALES Y/Y% Q1 3.0 Q2 0.4 MANUFACTURING PMI JUL 49.4 AUG F 49.3 VEHICLE SALES Y/Y% JUL 6.7 AUG 4.0 BOJ BOND MARKET SURVEY (AUG)	10Y JGB AUCTION MONETARY BASE Y/Y% JUL 3.7 AUG 2.8	SERVICES PMI JUL 53.4 AUG F 53.3 COMPOSITE PMI JUL 51.7 AUG F 51.9	30Y JGB AUCTION	3M TB AUCTION HOUSEHOLD SPENDING Y/Y% JUN 2.7 JUL 0.8 BOJ CONSUMPTION ACTIVITY INDEX M/M% JUN 0.0 JUL N/A AVERAGE WAGES Y/Y% JUN 0.4 JUL -0.3 COINCIDENT INDEX JUN 100.4 JUL P 99.8 LEADING INDEX JUN 93.3 JUL P 93.6
09	**10**	**11**	**12**	**13**
6M TB AUCTION (APPROX ¥2.3TRN) ENHANCING LIQUIDITY AUCTION (APPROX ¥0.4TRN) GDP Q/Q% Q1 0.4 Q2 F 0.3 BANK LENDING Y/Y% JUL 2.5 AUG N/A CURRENT ACCOUNT ¥TRN JUN 1.9 JUL N/A ECONOMY WATCHERS SURVEY – CURRENT CONDITIONS DI JUL 41.2 AUG N/A FUTURE CONDITIONS DI JUL 44.3 AUG N/A	M3 MONEY SUPPLY Y/Y% JUL 2.0 AUG N/A	5Y JGB AUCTION (APPROX ¥1.9TRN) MOF'S BSI SURVEY – BUSINESS CONDITIONS Q/Q Q2 -3.7 Q3 N/A	MACHINE ORDERS M/M% JUN 13.9 JUL N/A TERTIARY ACTIVITY M/M% JUN -0.1 JUL N/A GOODS PPI Y/Y% JUL -0.6 AUG N/A	3M TB AUCTION (APPROX ¥4.28TRN) ENHANCING LIQUIDITY AUCTION (APPROX ¥0.6TRN) INDUSTRIAL PRODUCTION M/M% JUN -3.3 JUL F 1.3 CAPACITY UTILISATION M/M% JUN -2.6 JUL N/A
16	**17**	**18**	**19**	**20**
NATIONAL HOLIDAY – RESPECT FOR THE AGED DAY	NATIONWIDE DEPARTMENT STORE SALES* (AUG)	1Y TB AUCTION 20Y JGB AUCTION TRADE BALANCE (AUG) BOJ POLICY BOARD MEETING (18-19 SEPT 2019)	ALL INDUSTRY ACTIVITY (JUL) BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION NATIONAL CPI (AUG) BOJ FLOW OF FUNDS (Q2)
23	**24**	**25**	**26**	**27**
NATIONAL HOLIDAY – AUTUMNAL EQUINOX	MANUFACTURING PMI (SEP P) SERVICES PMI (SEP P) COMPOSITE PMI (SEP P)	40Y JGB AUCTION SERVICES PPI (AUG)		3M TB AUCTION 2Y JGB AUCTION TOKYO CPI (SEP)

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

Economic Research

Key contacts

London		
Head of Research	*Chris Scicluna*	+44 20 7597 8326
Emerging Markets Economist	*Saori Sugeno*	+44 20 7597 8336
Economist	*Emily Nicol*	+44 20 7597 8331
Credit Analyst	*Israel da Costa*	+44 20 7597 8355
Research Assistant	*Katherine Ludlow*	+44 20 7597 8318
New York	*Mike Moran*	+1 212 612 6392
Chief Economist	*Lawrence Werther*	+1 212 612 6393
Junior Economist		
Hong Kong	*Kevin Lai*	+852 2848 4926
Economist	*Eileen Lin*	+852 2773 8736
Research Associate		
London Translation	*Mariko Humphris*	+44 20 7597 8327
Head of Translation, Economic and Credit		

DAIR <GO>

All of the research published by the London and New York research teams is available on our Bloomberg page at DAIR <GO>. If you are unable to access the research on this page, please contact Katherine Ludlow on +44 207 597 8318.

Access our research blog at:
https://www.uk.daiwacm.com/ficc-research/recent-blogs

Follow us
@DaiwaEurope