

Yen 4Sight

Highlights

- The BoJ kept its main policy parameters unchanged, but pledged to re-examine the case for easing in October.
- Core CPI fell to a 2-year low in August. Exports also fell again. And the Reuters Tankan pointed to weakness further ahead.
- Looking ahead, the Tankan survey on 1 October will provide important food for thought for the BoJ as it assesses the case for additional easing.

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Interest and exchange rate forecasts

End period	20 Sep	Q319	Q419	Q120
BoJ ONR %	-0.10	-0.10	-0.20	-0.20
10Y JGB %	-0.26	-0.25	-0.25	-0.25
JPY/USD	108	107	105	105
JPY/EUR	119	119	116	116

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

BoJ keeps powder dry

With market movements ahead of the meeting having been more favourable, and the BoJ able to maintain a broadly upbeat assessment of the economic backdrop, the past week's Policy Board announcement brought no changes to its policy framework. In particular, the main yield curve control parameters were left unchanged, with the short-term policy rate left at -0.1%, while the commitment to purchase bonds (at an annual pace of ¥80trn) so that 10Y JGB yields will remain at around 0% was also maintained. Of course, the BoJ again pledged to conduct its JGB purchases in "a flexible manner". And after Governor Kuroda in his press conference stated that the Bank would continue to adjust its market operations to try to achieve a steeper curve, the BoJ on Friday reduced its purchase amounts by a combined ¥50bn across three maturity buckets – the first time it's lowered its Rinban purchases in three segments all at once.

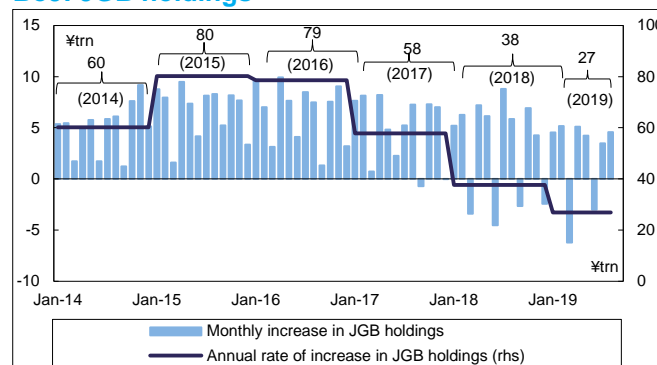
But hints at policy review in October

While it maintained the wording on its (arguably valueless) forward guidance that it "intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through spring 2020", the Policy Board reiterated its commitment to further easing if required should greater downside risks to achieving its price stability target materialise. And in this respect, the BoJ suggested that end-October might bring the decisive event, stating that, given the increasing downside risks to the economic outlook and the uncertainty surrounding the impact of the consumption tax hike, it will "re-examine economic and price developments at the next [monetary policy meeting]".

BoJ more inclined towards easing now

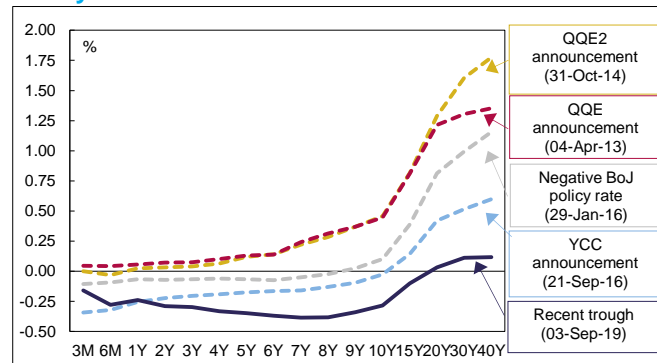
In line with his usual sanguine approach, Kuroda continued to downplay the likely economic impact of the tax hike and stated that he did not see the need for a major revamp of the policy framework, restating that the Bank would need to assess the relative benefits and the costs of each of its tools. Nevertheless, he also admitted that the BoJ was more inclined towards easing now than at the last meeting. And with upcoming data releases set to play a key role in this decision, the BoJ's quarterly Tankan survey (1 October) and Regional economic report (15 October) should be particularly closely watched.

BoJ: JGB holdings



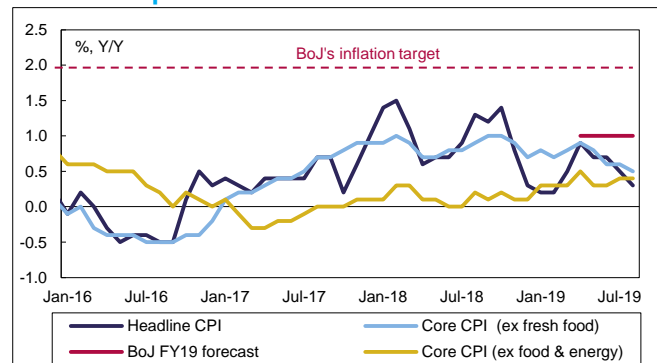
Source: BoJ and Daiwa Capital Markets Europe Ltd.

JGB yield curve



Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Consumer price inflation



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



Core CPI at two-year low

While Kuroda attempted to allay concerns about the subdued inflation outlook, claiming that price momentum had been maintained so far, the past week's inflation figures were hardly supportive of this view. Indeed, headline CPI declined for the second successive month by 0.2ppt to 0.3%Y/Y, a six-month low. But while this partly reflected lower fresh food prices (-4.8%Y/Y), the BoJ's forecast measure of core CPI (excluding fresh foods) fell 0.1ppt to 0.5%Y/Y, a two-year low. When also excluding energy prices, the BoJ's preferred core CPI was unchanged at 0.6%Y/Y, while the core measure excluding all food and energy – which aligns most closely with figures reported by other major economies – also moved sideways. At 0.4%Y/Y, that measure suggests that underlying inflation in Japan remains considerably weaker than its peers.

Inflation to remain subdued

Admittedly, there was a surprising step up in non-energy industrial goods inflation in August, of 0.3ppt to 1.0%Y/Y, the strongest in more than three years. But this was largely offset by an easing in services inflation to a ten-month low of 0.2%Y/Y on the back of lower hotel charges – an effect that we strongly expect to reverse throughout the period of the Rugby World Cup. But weak labour earnings – average wage growth in July was revised down to -1.1%Y/Y, the second lowest reading for more than four years – suggests domestically generated inflation will remain subdued going forward. Producer price data also suggest still significant disinflationary pressure down the pipeline as the impact of yen strengthening continues to weigh on costs of imported items. So, while the jump in the oil price at the start of the past week might limit to some extent the likely downwards shift in energy inflation, we expect the BoJ's forecast core CPI measure to edge lower still over coming months, falling to just above zero percent in October when excluding the impact of the consumption tax hike. And while this might well represent the trough on such a basis, we see only limited increases in core CPI as likely thereafter.

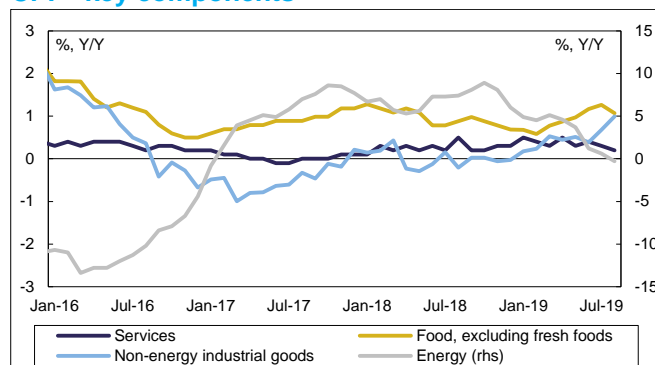
Economic growth losing momentum

Recent data suggest economic activity has lost momentum since the start of the year too. For example, updated national accounts figures saw GDP growth revised lower in both Q119, by 0.2ppt to 0.5%Q/Q, and Q219, by 0.1ppt to 0.3%Q/Q, on the back of a weaker assessment of private sector capex. And the past week's all industry activity figures failed to offer convincing evidence that the economy was on an upward trend at the start of Q3, with total output rising just 0.2%M/M in July following a 0.7%M/M decline in June. While there was a moderate rebound in manufacturing production that month, as well as modest growth in tertiary activity, there was further weakness in the construction sector, with work in the private sector falling to its lowest level since April 2017. And overall, all industry output was 0.2% below the average level in Q2.

Exports weighed by weaker external demand...

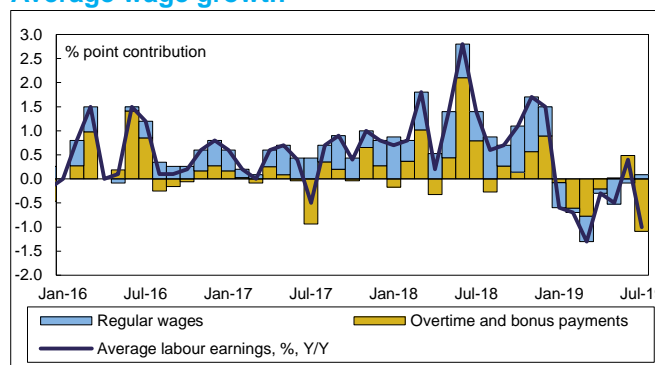
As noted by the BoJ, downside risks from abroad appear to be increasing. This was again highlighted by August's trade report, which showed the value of exports declining for the second successive month and by a steeper 2.8%M/M, to leave them more than 8% lower than a year earlier, the steepest year-on-year drop since January. The weakness was broad based, with, for example, exports to China down more than

CPI – key components



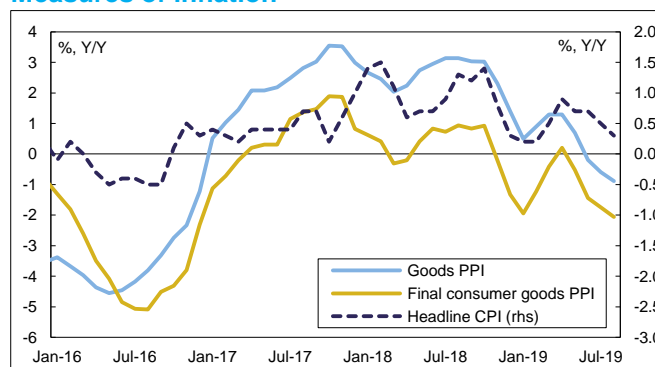
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Average wage growth



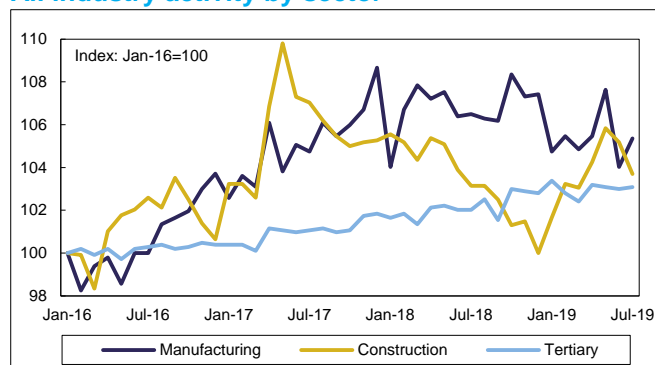
Source: MHLW, Bloomberg and Daiwa Capital Markets Europe Ltd.

Measures of inflation



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

All industry activity by sector



Source: METI and Daiwa Capital Markets Europe Ltd.

12%Y/Y weighed by a near-40%Y/Y drop in shipments of semiconductor manufacturing machinery. Exports to the US were almost 4½%Y/Y lower, with a notable drop in shipments of autos (13%Y/Y). Shipments to the EU were also down more than 1%Y/Y, with weaker demand particularly for general and electrical machinery. And while the pace of decline moderated slightly, exports to South Korea were down a hefty 9.6%Y/Y.

...but net trade on track to boost growth

Admittedly, some of the weakness in August reflected price effects. Indeed, export volumes were down a slightly smaller 6%Y/Y. And when also adjusting for seasonal effects, the BoJ's trade figures suggested a more moderate decline on the month too. So, on average so far in Q3, export volumes were almost 2% higher compared with the average in Q2. And with imports on average so far in Q3 broadly flat compared with the average in Q2, net goods trade appears on track to provide a positive contribution to GDP growth in the current quarter.

Overseas visitors from South Korea slump

While Japan's services exports have benefitted from the rise in tourism over recent years, the past week's overseas visitor numbers flagged a downside risk to this source of growth as a result of the trade dispute with South Korea. Indeed, having accounted for roughly one quarter of tourist arrivals in 2018, August saw a noteworthy slump in visitors from that country, down a whopping 48%Y/Y to 309k, the lowest for more than three years. So, despite still strong growth in visitors from China (+16.3%Y/Y), Taiwan (+6.5%Y/Y) and the US (+14.6%Y/Y), overall the number of visitors was down more than 2%Y/Y, only the second annual decline since the start of 2013. Of course, the Rugby World Cup this month and next should compensate for ongoing weakness from South Korea.

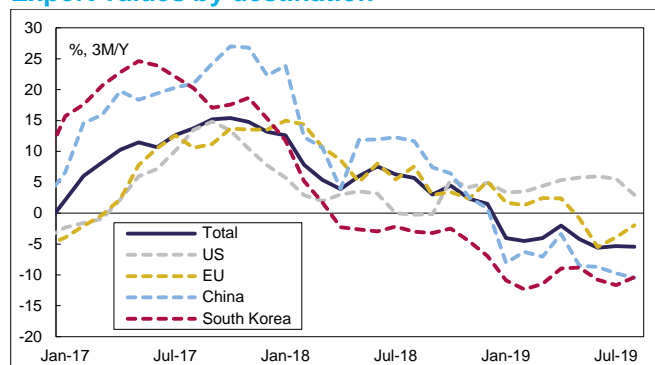
Machine orders point to subdued capex in Q4

While overseas demand for machine orders has unsurprisingly remained weak (down 16%Y/Y) in July in the face of subdued global investment intentions, recent data suggested that domestic private capex has remained supportive of growth in Q3 ahead of October's consumption tax hike. But private sector core machine orders – often a useful guide to domestic business investment roughly three months ahead – fell sharply (6.6%M/M) in July, leaving them up just 0.3%Y/Y. Within the detail, domestic orders from manufacturers were up for the first month in three, with a relatively broad-based rise of 5.4%M/M taking the level 1.5% above the Q2 average. However, following an extraordinary 30.5%M/M surge in June flattered by one-offs from the transportation and postal sector, core orders from non-manufacturers inevitably recoiled in July, dropping 15.6%M/M to move almost 3.0% below the Q2 average. And overall, the level of core private orders was roughly 1.0% below the Q2 average, suggesting that a likely rise in business capex over Q3 will be followed by an inevitable decline in Q4.

Reuters Tankan flags weakness in manufacturing

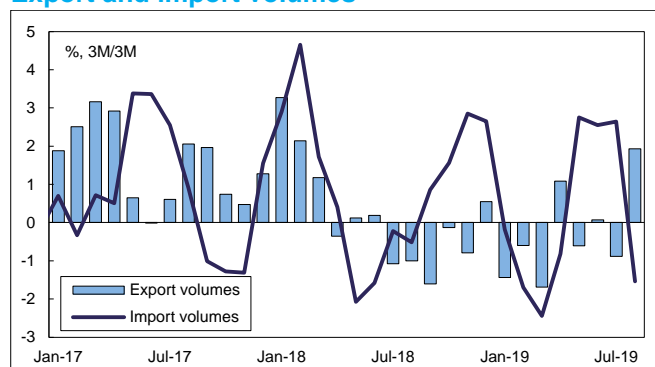
Weaker investment intentions ahead are hardly surprising given the steady deterioration in business sentiment seen over the past year. And with the external environment still extremely uncertain, this downward trend in sentiment remained particularly evident in the manufacturing sector at the end of the third quarter. Indeed, the monthly Reuters Tankan – which often provides a good guide to the quarterly BoJ Tankan, the

Export values by destination



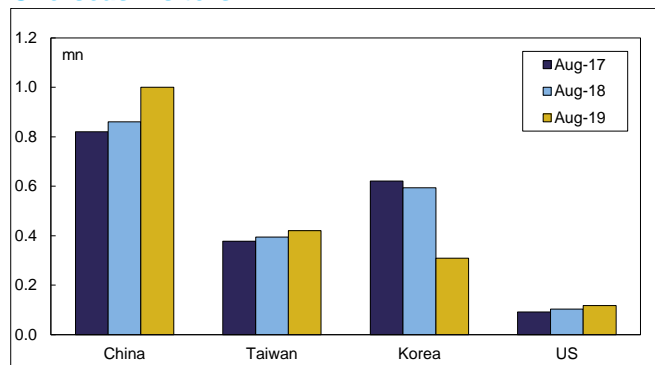
Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export and import volumes



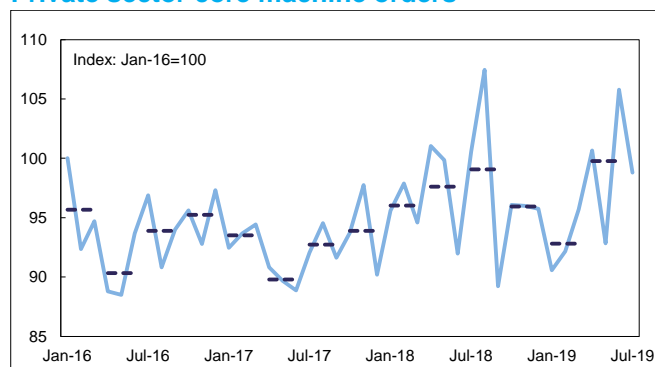
Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Overseas visitors



Source: JTNO and Daiwa Capital Markets Europe Ltd.

Private sector core machine orders



*Dashed dark blue represent quarterly average. Source: Cabinet Office, Thomson Reuters and Daiwa capital Markets Europe Ltd.

latest edition of which could prove decisive in determining the near-term path of monetary policy – showed the headline manufacturing DI falling 3pts to -7, the lowest for 6½ years.

Non-manufacturers downbeat about the outlook

In contrast, the survey was somewhat more upbeat about retailing this month, no doubt reflecting increased demand ahead of the imminent tax hike, with the diffusion index rising 15pts on the month to +10. As such, despite a further notable deterioration in conditions reported by construction firms (the relevant index fell 7pts to +20), the headline non-manufacturing DI increased 6pts from the near-three-year low hit in August to +19. This, however, was still considerably weaker than the level at the start of this year. And on average over the third quarter as a whole, the index was the weakest since 2016. Moreover, reflecting the anticipated decline in domestic demand after next month's tax hike, firms were predictably more downbeat about the outlook over the coming three months, with the headline non-manufacturing DI forecast to fall to its lowest since 2012.

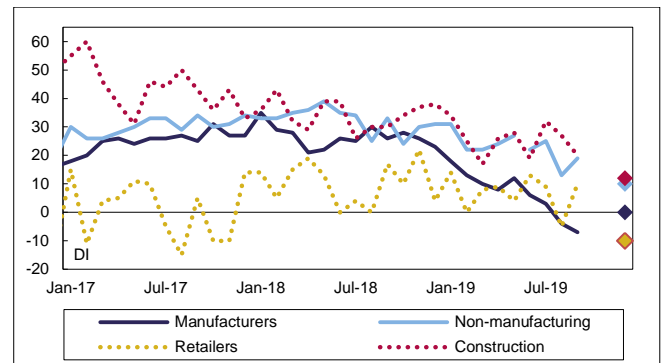
Looking ahead...

Looking ahead, the main data focus in the coming week will be Tuesday's flash PMIs for September, which might well see a further boost to services activity ahead of October's consumption tax hike. But the headline manufacturing PMI seems likely to remain firmly in contractionary territory for the fifth consecutive month. Likely of more interest that day, however, will be Kuroda's speech to business leaders in Osaka, while Policy Board member Masai will speak on Thursday – both will be watched closely for further insight into near-term monetary policy.

The following week will see the long-awaited increase in the consumption tax, by 2ppts to 10% on 1 October. And it will also bring plenty of notable economic data. On Monday, the BoJ's Summary of Opinions from the past week's Policy Board meeting will be accompanied by August industrial production and retail sales figures. The following day, labour market figures for the same month are due. But, of course, most focus that day will be on the BoJ's Q3 Tankan survey. In line with the Reuters Tankan, we expect to see a further notable drop in the headline manufacturing index from +7 in Q2 to its lowest since 2013, while the non-manufacturing index might well fall (from +16) to its lowest since the post-2014 tax hike. The following day will also bring a further section of the Tankan survey with firms' specific forecasts for inflation and their own output prices.

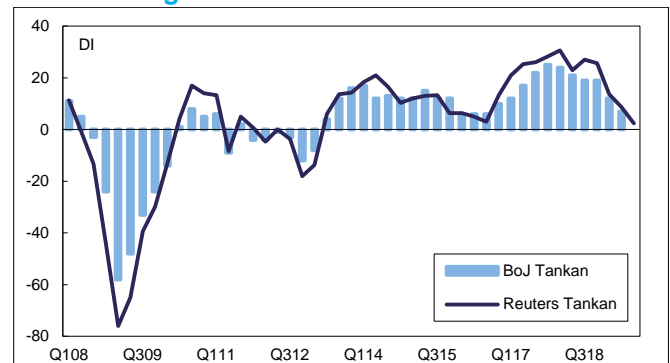
In the markets, the MoF will conduct a 40Y JGB auction on Wednesday 24 September and a 2Y JGB auction on Friday 27 September, followed by a 10Y JGB auction on 1 October.

Reuters Tankan: Business conditions*



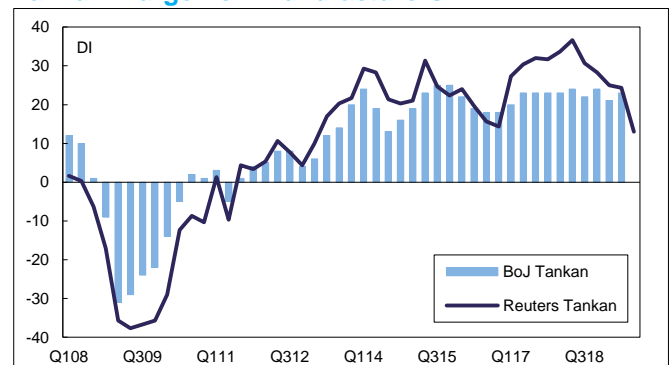
*Diamonds represent survey forecast for December 2019. Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tankan: Large manufacturers*



*Reuters Tankan is quarterly average. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tankan: Large non-manufacturers*



*Reuters Tankan is quarterly average. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

*The next edition of the Yen 4Sight
is due to be published on 4 October 2019*

Economic calendar

Key data releases – September/October

16	17	18	19	20
NATIONAL HOLIDAY – RESPECT FOR THE AGED DAY		1Y TB AUCTION 20Y JGB AUCTION TRADE BALANCE ¥BN JUL -104 AUG -131 OVERSEAS VISITORS Y/Y% JUL 2.9 AUG 2.5 BOJ POLICY BOARD MEETING (18-19 SEP 2019)	ALL INDUSTRY ACTIVITY M/M% JUN -0.7 JUL 0.2 BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION (APPROX ¥4.27TRN) NATIONAL CPI Y/Y% JUL AUG 0.5 0.3 EX FRESH FOOD 0.6 0.5 EX FRESH FOOD/ENERGY 0.6 0.6 AVERAGE WAGES Y/Y% JUN 0.4 JUL -1.0 NATIONWIDE DEPARTMENT STORE SALES Y/Y% JUL -2.9 AUG 2.3 BOJ FLOW OF FUNDS (Q2)
23	24	25	26	27
NATIONAL HOLIDAY – AUTUMNAL EQUINOX	MANUFACTURING PMI AUG 49.3 SEP P N/A SERVICES PMI AUG 53.3 SEP P N/A COMPOSITE PMI AUG 51.9 SEP P N/A BOJ GOVERNOR KURODA TO SPEAK IN OSAKA	40Y JGB AUCTION (APPROX ¥0.4TRN) SERVICES PPI Y/Y% JUL 0.5 AUG 0.5 BOJ MINUTES (29-30 JULY MEETING)	BOJ POLICY BOARD MEMBER MASAI TO SPEAK	3M TB AUCTION (APPROX ¥4.27TRN) 2Y JGB AUCTION (APPROX ¥2.0TRN) TOKYO CPI Y/Y% AUG SEP 0.6 0.5 EX FRESH FOOD 0.7 0.6 EX FRESH FOOD/ENERGY 0.7 0.6
30	01	02	03	04
INDUSTRIAL PRODUCTION (AUG P) RETAIL SALES (AUG) CONSTRUCTION ORDERS (AUG) HOUSING STARTS (AUG) BOJ SUMMARY OF OPINIONS (18-19 SEP 2019 MEETING)	10Y JGB AUCTION TANKAN (Q3) UNEMPLOYMENT RATE (AUG) JOB-TO-APPLICANT RATIO (AUG) MANUFACTURING PMI (SEP F)	TANKAN – INFLATION OUTLOOK OF ENTERPRISES (Q3) CONSUMER CONFIDENCE (SEP) MONETARY BASE (SEP)	ENHANCING LIQUIDITY AUCTION SERVICES PMI (SEP F) COMPOSITE PMI (SEP F)	3M TB AUCTION
07	08	09	10	11
COINCIDENT INDEX (AUG P) LEADING INDEX (AUG P)	ENHANCING LIQUIDITY AUCTION AVERAGE WAGES (AUG) HOUSEHOLD SPENDING (AUG) BOJ CONSUMPTION ACTIVITY INDEX (AUG) ECONOMY WATCHERS SURVEY (SEP)	6M TB AUCTION	30Y JGB AUCTION MACHINE ORDERS (AUG) BANK LENDING (SEP) GOODS PPI (SEP)	3M TB AUCTION M3 MONEY SUPPLY (SEP)

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

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