Daiwa Capital Markets

Yen 4Sight

Highlights

- As the consumption tax hike came into effect, there were signs that consumers had front-loaded spending over the summer.
- But consumer confidence continues to deteriorate. And the BoJ's Tankan predictably pointed to less favourable business conditions.
- Looking ahead, the latest wage and CPI figures are likely to highlight the subdued inflationary outlook, while the BoJ's regional report and Reuters Tankan will also be watched.

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Interest and exchange rate forecasts

End period	04 Oct	Q419	Q120	Q220
BoJ ONR %	-0.10	-0.20	-0.20	-0.20
10Y JGB %	-0.22	-0.25	-0.25	-0.25
JPY/USD	107	105	105	105
JPY/EUR	119	116	116	116

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

Consumption tax hike comes into effect

With the twice postponed consumption tax hike having finally come into force in the past week, much focus has been on whether Japan's economy is strong enough to withstand the 2ppts increase to 10%. Certainly, the global economic backdrop is more challenging than it was the last time the tax was increased in April 2014. Moreover, having immediately slumped after that tax hike and failed to gain meaningful upward momentum thereafter, private consumption has still yet to return to its pre-tax hike level. Of course, the government is better prepared this time around, and many offsetting measures – including lower tax rates applied to certain items and the abolition of public school fees for early years education – should limit the impact to some extent. But, there is bound to be payback for purchases of (typically big-ticket) items brought forward ahead of the hike. And quite how far the economy contracts in response in Q4 and beyond remains to be seen.

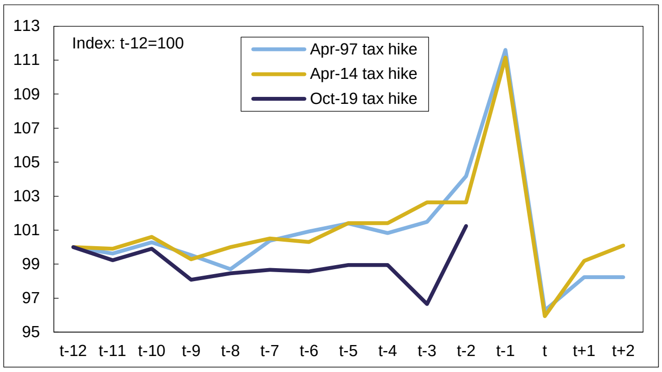
Sales boosted by pre-tax-hike-related demand

At face value, the past week's retail sales figures indicated a clear jump in purchases related to the tax hike in August. Sales rose (4.8%M/M), which was the fastest monthly pace since the pre-tax hike surge in March 2014. While the pickup was widespread, there was a rise of more than 5½%M/M in sales of general merchandise, an 8%M/M increase in clothing purchases and a near-17½%M/M rise in spending on household appliances. But the strength in August was likely flattered somewhat by better weather at the start of the month and followed a particularly weak reading in July. So, while all evidence points to a further boost to demand in September and a solid contribution from household consumption to GDP growth in Q3, retail sales are currently on track for a much smaller increase than seen in the quarters preceding the 1997 and 2014 tax hikes. This pattern was evident in vehicle sales figures, which might also have reflected some additional offsetting tax reliefs on car purchases.

Consumer confidence on steady downtrend

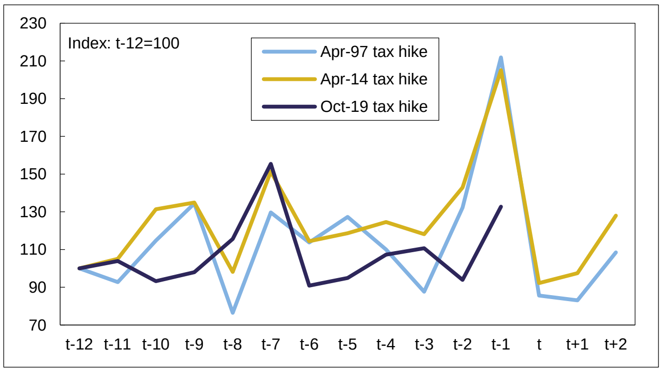
While the recent spending pattern might suggest a more modest payback in the quarter following the tax hike this time around, the latest Cabinet Office consumer confidence survey suggested that households are much more downbeat about the near-term outlook. In particular, the headline index fell for the twelfth consecutive month in September to the lowest level since mid-2011 in the aftermath of the Great East Japan Earthquake. And the largest drop in confidence related to households' willingness to buy durable goods, with the relevant

Retail sales*



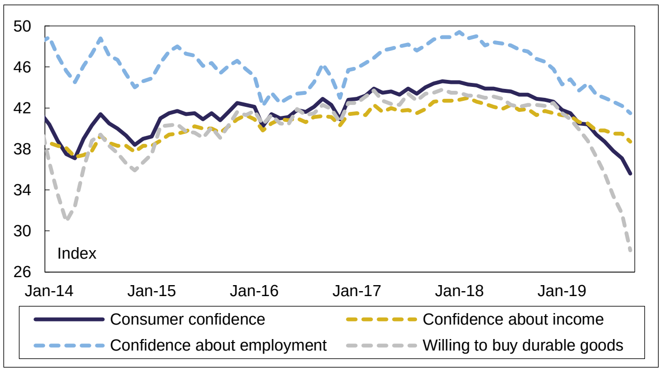
*t represents month the consumption tax was increased.
Source: METI, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Vehicle sales*



*t represents month the consumption tax was increased.
Source: JMMT, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Consumer confidence



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

index falling to the lowest since the Global Financial Crisis. Admittedly the decline over Q3 (6pts) was more modest compared with the drop immediately before the 2014 tax hike, but still suggested with very weak underlying consumption growth.

Manufacturing output on track to contract in Q3

Not least given weaker external demand, the past week's IP release illustrated the struggles facing manufacturers ahead of the consumption tax hike. Total output declined a larger-than-expected 1.2%M/M in August, largely reversing July's increase to leave the level of output down a sizeable 4.7%Y/Y, the steepest drop since May 2015. So, on average so far in Q3 the level of production was almost 1% lower than the average in Q2. And the detail pointed to a weak near-term outlook too. For example, despite moving sideways in August, the level of inventories remained close to the 10½-year high reached in July. As such, with shipments having fallen last month, the inventory-shipment ratio rose to a more than decade high in August. So, while we expect a temporary boost to output ahead of October's tax hike, the METI's forecast for growth of 1.9%M/M in September looked typically overoptimistic. Moreover, this would still leave manufacturing output down over the third quarter as whole.

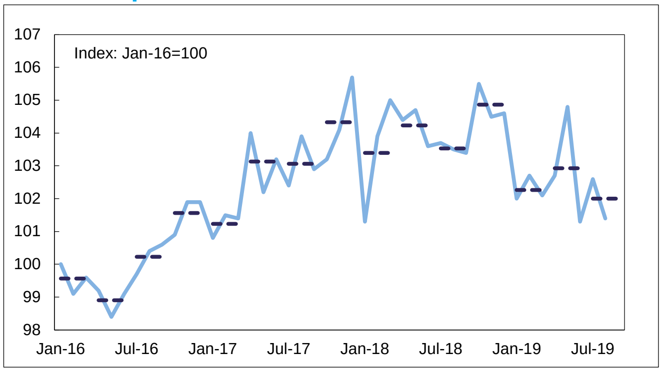
Manufacturers most downbeat for six years

Such an outcome would be consistent with the deterioration in business conditions reported over the past quarter. Certainly, the past week's BoJ Tankan survey showed the headline DI for large manufacturers falling for a third consecutive quarter in Q3, by 2pts to +5, a more than six-year low. The most significant worsening of sentiment in Q3 was seen in the petroleum and nonferrous metals sectors (with the DIs down 30pts and 18pts respectively). But certain key export-oriented sectors also reported notable falls in Q3 as the more challenging external environment continued to take its toll. As is often the case, medium- and small-sized manufacturers were more downbeat than their large counterparts, with the respective indices down 3pts apiece to +2 and -4. So, the overall manufacturing DI suggested that pessimists in the sector outweighed optimists for the first time in three years. And, manufacturers of all sizes forecast further modest deterioration in Q4 too.

Non-manufacturers forecast a hit to demand ahead

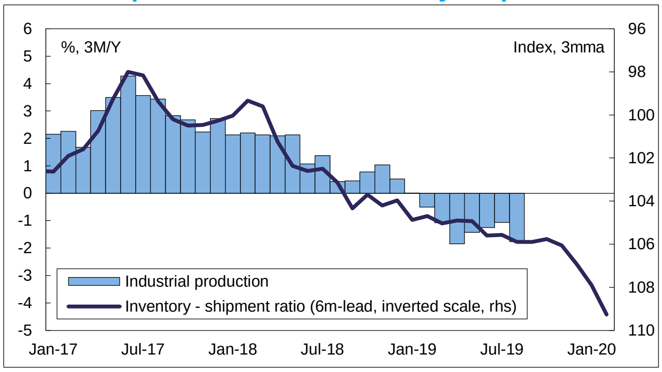
While the Tankan's respective DI for large non-manufacturers also slipped back in Q3, the 2pt drop to +21 suggested that conditions remained much more favourable than in the manufacturing sector, and well above the long-run average. And medium- and small-sized firms in the sector reported no change to conditions last quarter. Of course, given the anticipated hit to demand in the aftermath of the tax hike, non-manufacturers were notably more downbeat about the near-term outlook. For example, large non-manufacturers forecast a drop of 6pts in Q4 – which would mark the largest drop since Q314 – to +15, with the retailers DI projected to decline 5pts to -1, which would be the first negative reading for almost five years. And the anticipated worsening of conditions for SMEs in the sector was greater still, with the indices forecast to fall 9pts to +9 and +1 respectively.

Industrial production*



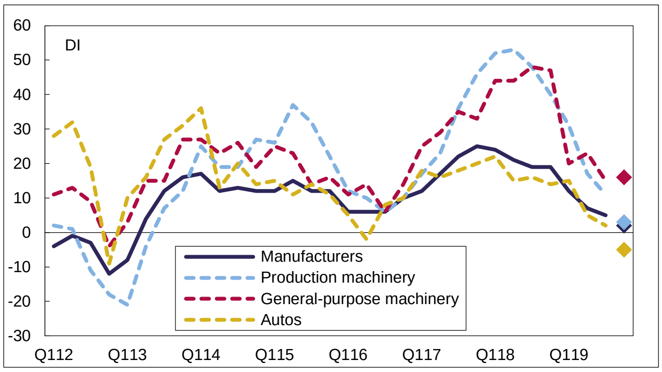
*Dashed dark blue lines represent quarterly averages. Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Industrial production and inventory-shipment ratio



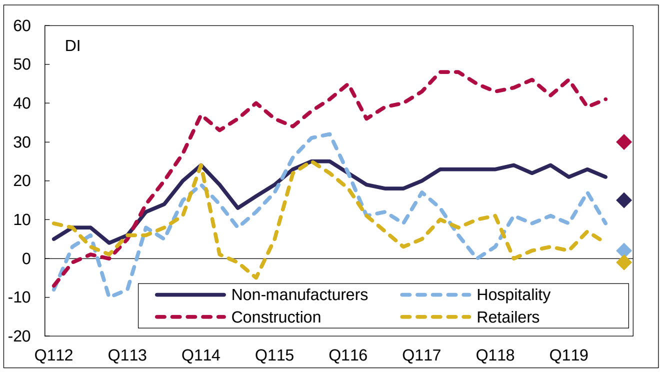
Source: METI, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

BoJ Tankan: Business conditions*



*Large manufacturers. Diamonds represent survey forecast for Q419. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

BoJ Tankan: Business conditions*



*Large non-manufacturers. Diamonds represent survey forecast for Q419. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Firms more pessimistic about sales and profits

So, perhaps unsurprisingly, the Tankan suggested that firms are generally less optimistic about the outlook for sales and are even more downbeat about profits. Indeed, after a modest increase in FY18, on average, firms expect profits to fall 6.7%Y/Y this year, which would be the first decline since 2011. But while large manufacturers were a touch less optimistic about their investment intentions over the year as a whole, they were still forecasting growth of almost 12%Y/Y (admittedly well down on the equivalent forecast of 17.5%Y/Y in FY18). And overall firms nudged up slightly their full-year forecast by 0.1ppt to 2.4%Y/Y, albeit this would still mark the softest growth for three years.

Spare capacity diminishing?

Of course, increased capex growth would not be inappropriate in light of ongoing evidence that firms have insufficient capacity. This notwithstanding, the Tankan suggested that constraints were little changed from three months ago, and not quite so acute for manufacturers. Indeed, the survey's manufacturing production capacity index rose 1pt to 0, while the equivalent employment index increased 2pts to -20, both the highest for two years. Overall, however, the Tankan's composite indicator of spare capacity was unchanged in Q3. And with the BoJ's estimate of the output gap in Q2 having narrowed to its lowest for two years, and the Cabinet Office's measure implies an even smaller positive output gap, upward pressure on wages and inflation from excess demand might be diminishing.

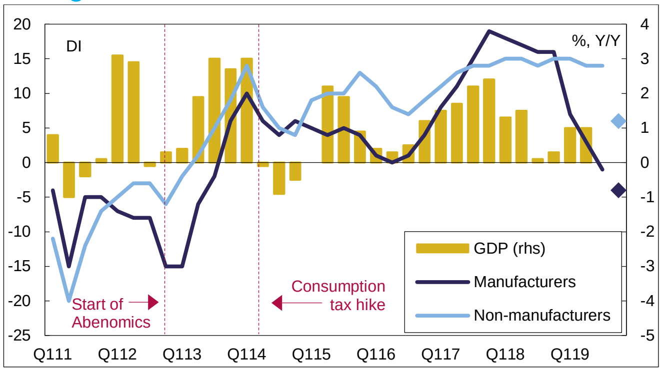
Tankan signals weaker pricing environment

Certainly, the Tankan's inflation indicators again pointed to a weaker pricing environment. Firms reported a notable easing in input and output price pressures in Q3 to their lowest for two years. And large manufacturers reported a steeper decline in output prices last quarter and expect their prices to decline over the coming five years by a cumulative 0.3%. Firms in aggregate were not so downbeat, forecasting a rise in their prices over the five-year forecast horizon, although the cumulative increase of 1.3% was downwardly revised from three months ago. As such, firms remain predictably unconvinced that the BoJ will achieve its 2% inflation target, even within a 5-year horizon. Indeed, the average expectation of inflation was unchanged across the horizon, with the 1.1%Y/Y forecast five years ahead the same rate in eleven of the past twelve quarters – hardly consistent with the BoJ's suggestion that inflation expectations will be supportive of a gradual upward trend in underlying inflation.

Tokyo inflation falls to a sixteen-month low

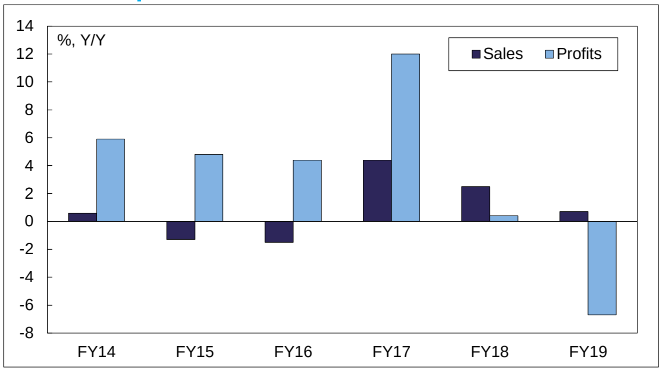
The Tokyo CPI figures for September also provided a reminder that things are currently heading in the wrong direction. In particular, consumer prices fell 0.1%M/M in September, to leave annual inflation down 0.2ppt to 0.4%Y/Y, a sixteen-month low. The BoJ's forecast CPI rate (excluding fresh foods) was also 0.2ppt lower at 0.5%Y/Y, likewise the weakest since April 2018. When also excluding energy prices, the BoJ's preferred core measure fell a more modest 0.1ppt to 0.6%Y/Y, nevertheless the lowest rate so far this year. Looking ahead, we expect energy inflation to provide a greater drag on annual inflation in the fourth quarter. So, while the consumption tax hike will add about 1.1ppt to the unadjusted national rate from October, excluding that effect a further modest decline in the BoJ forecast measure of core CPI over coming months seems

GDP growth and BoJ Tankan business conditions*



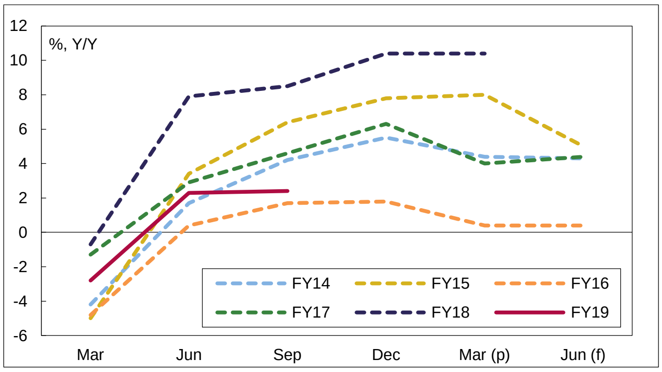
*All enterprises. Diamonds represent survey forecast for Q419. Source: BoJ, Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Sales and profits*



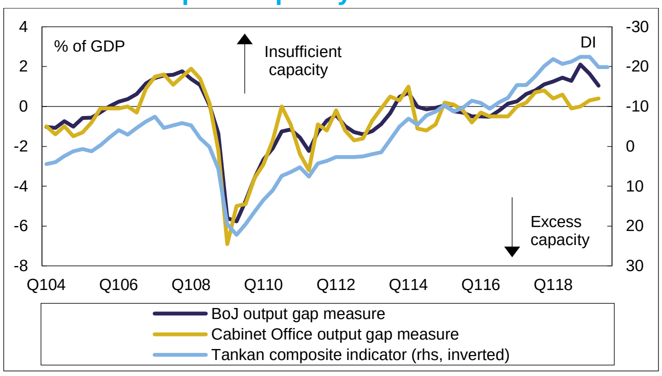
*All enterprises. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

BoJ Tankan: Investment intentions*



*All enterprises. Source: BoJ and Daiwa Capital Markets Europe Ltd.

Measures of spare capacity



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

highly likely. Indeed, on that basis, the national BoJ forecast measure could well fall to just 0.1%Y/Y in October, when the Government's free early years education policy kicks in. And with GDP set to shift into reverse in the fourth quarter, and growth likely to be subdued thereafter, there seems no reason to expect inflation to be anything other than very subdued for the foreseeable future.

BoJ reduced monthly JGB purchases

When the BoJ's Policy Board met last month it recognised that the inflation outlook warranted particularly close attention, and implied that the forthcoming meeting at the end of this month might prove decisive when the Board 're-examine[s] economic and price developments'. Of course, under its yield curve control framework, the BoJ continually tweaks policy by amending asset purchases. And, with Kuroda having recently underscored his preference for a steeper yield curve the announcement by the BoJ in the past week that it had reduced its monthly purchase target ranges for 3-5Y, 5-10Y, 10-25Y and >25Y bonds saw JGBs sell off across the curve. Nevertheless, this adjustment was short lived, with weak US data subsequently sending 10Y yields back below the BoJ's preferred target range (about double the range of between -0.1% and +0.1%) and the curve flattening. As such, while the past week's Tankan was not as bad as some had feared, in line with the shift in market expectations that the Fed will cut rates again this month, there is now greater expectation that the BoJ will act more decisively at the end of the month too. At the end of the week, the market-implied probability of a 10bps cut in the short-term policy rate, to -0.20%, had risen to more than 90%.

Looking ahead…

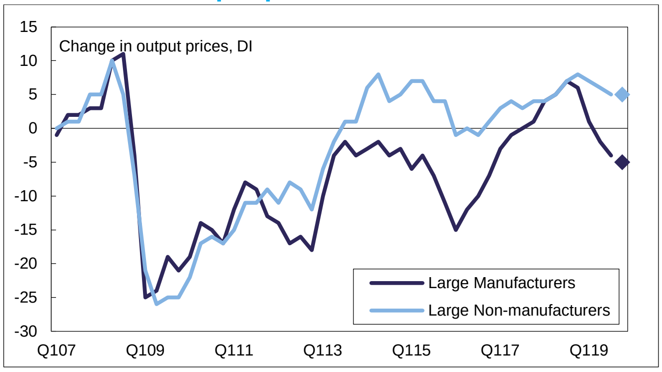
Looking ahead, the coming week will bring a number of releases of note, including the latest wage figures and the BoJ's consumption activity index for August on Tuesday, which is likely to report signs of front-loading of spending ahead of the increase in the consumption tax. Thursday's Reuters Tankan survey – the first to capture conditions after the tax hike – will also be closely watched for insights into the extent of the deterioration in business conditions at the start of Q4. That day will also bring machine orders data for August, as well as goods PPI figures for September.

Focus at the start of the following week will be on the BoJ's Regional Economic Report on Tuesday, which will play a role in the Policy Board's decision at its end-October meeting. That day will also bring August tertiary activity figures, as well as final IP data. The only other noteworthy release that week will be Friday's national CPI figures for September. These are expected to show that the headline and BoJ's forecast core CPI measures fell further that month to just 0.2%Y/Y and 0.4%Y/Y, largely due to lower energy inflation.

In the markets, the MoF will conduct a 30Y JGB auction on Thursday 10 October, followed by a 5Y JGB auction on Thursday 17 October.

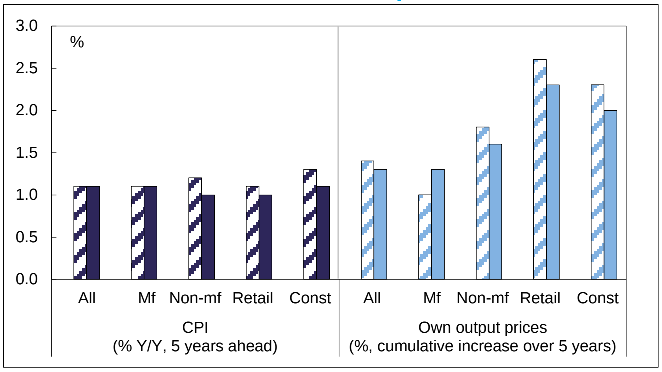
The next edition of the Yen 4Sight is due to be published on 25 October 2019

BoJ Tankan: Output prices



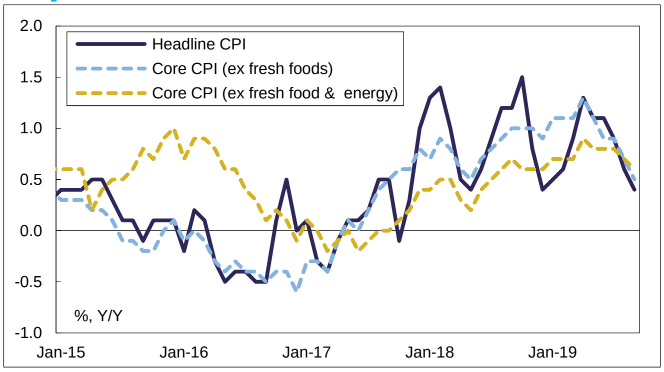
**Large firms. Diamonds represent survey forecast for Q419. Source: BoJ, Thomson Reuters and Daiwa capital Markets Europe Ltd.*

BoJ Tankan: Firms' inflation expectations*



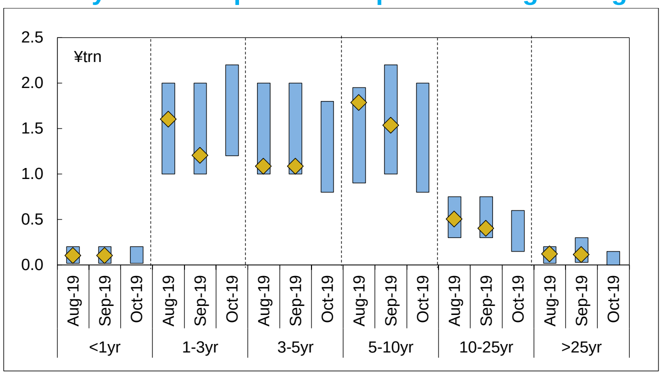
**All enterprises. Dashed bars refer to Q316 survey, solid bars refer to Q319 survey. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Tokyo CPI



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

Monthly BoJ JGB purchase operation target range*



**Diamonds represent actual monthly purchases. Source: BoJ and Daiwa capital Markets Europe Ltd.*

Economic calendar

Key data releases – September/October

30	01	02	03	04
INDUSTRIAL PRODUCTION M/M% SEP 1.3 AUG P -1.2 RETAIL SALES Y/Y% JUL -2.0 AUG 2.0 CONSTRUCTION ORDERS Y/Y% JUL 26.9 AUG -25.9 HOUSING STARTS Y/Y% JUL -4.1 AUG -7.1 BOJ SUMMARY OF OPINIONS (18-19 SEP 2019 MEETING)	10Y JGB AUCTION TANKAN – LARGE MANUFACTURERS DI Q2 7 Q3 5 LARGE NON-MANUFACTURERS DI Q2 23 Q3 21 UNEMPLOYMENT RATE % JUL 2.2 AUG 2.2 JOB-TO-APPLICANT RATIO JUL 1.59 AUG 1.59 MANUFACTURING PMI AUG 49.3 SEP F 48.9 VEHICLE SALES Y/Y% AUG 4.0 SEP 12.8	CONSUMER CONFIDENCE AUG 37.1 SEP 35.6 MONETARY BASE Y/Y% AUG 2.8 SEP 3.0 TANKAN – INFLATION OUTLOOK OF ENTERPRISES (Q3)	ENHANCING LIQUIDITY AUCTION SERVICES PMI AUG 53.3 SEP F 52.8 COMPOSITE PMI AUG 51.9 SEP F 51.5	3M TB AUCTION
07	**08**	**09**	**10**	**11**
COINCIDENT INDEX JUL 99.7 AUG P 99.4 LEADING INDEX JUL 93.7 AUG P 91.7	ENHANCING LIQUIDITY AUCTION (APPROX ¥0.6TRN) AVERAGE WAGES Y/Y% JUL -1.0 AUG -0.2 HOUSEHOLD SPENDING Y/Y% JUL 0.8 AUG 0.9 BOJ CONSUMPTION ACTIVITY INDEX M/M% JUL -2.5 AUG N/A ECONOMY WATCHERS SURVEY CURRENT CONDITIONS DI AUG 42.8 SEP 43.3 FUTURE CONDITIONS DI AUG 39.7 SEP 39.4	6M TB AUCTION (APPROX ¥2.3TRN)	30Y JGB AUCTION (APPROX ¥0.7TRN) MACHINE ORDERS M/M% JUL -6.6 AUG 0.0 BANK LENDING Y/Y% AUG 2.2 SEP N/A GOODS PPI Y/Y% AUG -0.9 SEP -1.1 REUTERS TANKAN – MANUFACTURING DI SEP -7 OCT N/A NON-MANUFACTURING DI SEP 19 OCT N/A	3M TB AUCTION (APPROX ¥4.33TRN) M3 MONEY SUPPLY Y/Y% AUG 2.0 SEP N/A
14	**15**	**16**	**17**	**18**
NATIONAL HOLIDAY – HEALTH AND SPORTS DAY	TERTIARY ACTIVITY (AUG) INDUSTRIAL PRODUCTION (AUG F) BOJ REGIONAL ECONOMIC REPORT (OCT)		1Y TB AUCTION 5Y JGB AUCTION	3M TB AUCTION NATIONAL CPI (SEP)
21	**22**	**23**	**24**	**25**
GOODS TRADE BALANCE (SEP) ALL INDUSTRY ACTIVITY (AUG)		BOJ SENIOR LOAN OFFICER SURVEY (OCT)	20Y JGB AUCTION MANUFACTURING PMI (OCT P) SERVICES PMI (OCT P) COMPOSITE PMI (OCT P) BOJ FINANCIAL SYSTEM REPORT (OCT)	3M TB AUCTION

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

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