Daiwa's View

Ascertaining the essence ahead of FOMC meeting and BOJ MPM

➢ BOJ to lower price projections and strengthen forward guidance

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Slightly more than a month since Sep MPM, news reporting that BOJ will not provide additional easing

As in September, in October the results of the FOMC meeting in the early morning and the BOJ's Monetary Policy Meeting (MPM) in the early afternoon are being reported on the same day. However, although only slightly more than a month has passed, the external environment and market conditions have changed significantly since the September meeting. The market is assuming a third consecutive rate cut at the October FOMC meeting, but it has started to consider the possibility of a rate cut suspension in the near future. Therefore, the biggest focal point is the revision to the statement. Regarding the BOJ, meanwhile, news came out before the blackout period reporting that the BOJ would not provide additional easing at its October MPM. On 23 October, the Dow Jones stated that some BOJ policymakers saw almost no advantages to an October rate cut. On 24 October, Bloomberg reported that the BOJ was considering not providing additional easing at its October policy meeting. On 25 October, Jiji Press said that the BOJ was to decide to defer deepening negative rates at the October MPM. And, on 27 October, *Nikkei* reported that the BOJ was likely to decide to defer additional easing at the October meeting. This is very different from the situation at the time of the September meeting, when media reports and market speculations of a deepening of negative interest rates did not disappear until just before the meeting, and anxiety regarding the decision remained until the results were announced.

The biggest change over the last month was the de-escalation of US-China trade tension

The biggest change is that the US-China trade tension, which was the biggest concern, has eased with the partial agreement on 11 October. Although the market was pessimistic the week preceding the agreement as the September ISM Manufacturing Index fell below 50 for the second consecutive month, it has been optimistic since 11 October, leading to a global stock rally. Unlike the "Halloween Easing" five years ago, oil price trends are now relatively stable. And the yen is also steady at around the upper half of the Y108/$ level, even after factoring in the Fed's 25bp rate cut in October. I think that structural changes to Japan's current account surplus are acting as medium-/long-term yen-appreciation deterrents. Therefore, even before the September meeting we thought there was a good chance the BOJ would be able to ride it out without doing anything at the October meeting. Things are now trending in that direction.

With shift to service economy, real economy has not worsened as much as manufacturers' sentiments expected

Increasing possibility that early August to early September was the worst period

Looking back, the global decline in long-term interest rates in Japan, the US, and Germany (10-year yield of -0.295% in Japan, +1.40% level in US, and -0.70% in Germany in early Sep) driven by speculations of easing was excessive, as such a move diverged from the fundamentals (firm US economy and signs of partial bottoming-out of global economy). I feel the market is overreacting to manufacturing sentiment indices in the US, Europe, and China, which are announced in the first week of every month. With the shift to the service economy, the weight of non-manufacturing is increasing in each country. Therefore, the real economy has not worsened as much as sentiment indicators indicated. Unless uncertainty intensifies again, there is an increasing likelihood that the worst period will turn out to have been the time from early August to early September, when the market was in risk-off mode as President Donald Trump declared the fourth imposition of punitive tariffs on Chinese products. If the US-China summit meeting is held at the APEC Summit meeting on 16 November, and the imposition of the fourth punitive tariff (from 15 Dec) is postponed, preventive interest rate cuts by the Fed will likely end by the end of the year.

Before Sep MPM, BOJ appears to have seriously considered deepening of negative interest rates

In essence, fundamentals in both Japan and US have not weakened

Nevertheless, before the September meeting, the BOJ appears to have seriously considered packaged measures for deepening negative interest rates and mitigating the side effects. The reversal of US/European long-term interest rates in mid-September was seen metaphorically as a "divine wind," but in essence, the fundamentals in both Japan and the US were not as weak as sentiment indicators, which are easily influenced by uncertainties. After all, the decline in long-term interest rates in Japan was caused by overseas factors, and speculations of additional easing by the BOJ were excessive. Regarding the new wording in the September statement[1], I believe the BOJ strengthened its stance regarding taking action in order to avoid giving the impression that the BOJ alone had no response to downside risk in the global economy. However, the market seems to have assumed that additional easing would be implemented.

★6th paragraph of statement at Sep MPM (19 Sep 2019)

Given that, recently, slowdowns in overseas economies have continued to be observed and their downside risks seem to be increasing, the Bank judges that it is becoming necessary to pay closer attention to the possibility that the momentum toward achieving the price stability target will be lost. Taking this situation into account, the Bank will reexamine economic and price developments at the next MPM, when it updates the outlook for economic activity and prices.

In BOJ *terminology*, "assessment" and "consideration" are different from "examination"

As of Sep MPM, policy change was not declared

In BOJ *terminology*, the words "assessment" and "consideration" are used on the assumption of policy changes, but "examination" is always for things that are implemented, so there is a clear difference between the terms. The central bank had prepared for the option of seeing no need to deepen negative rates as a result of its "examination" of economic/price trends. At the regular press conference in September, BOJ governor Haruhiko Kuroda stated that the central bank was leaning more toward additional easing than in the previous meeting. However, he did not declare that he would change the policy. He did not use wording similar to ECB President Mario Draghi who said the ECB was "ready to do whatever it takes" in July 2012. Such remarks were simply lip service as Kuroda's comments remained confined to the realm of "what if," such as if there were heightened concerns about a loss of momentum on the price front, or if further easing became necessary.

Outlook report will examine domestic demand amid downside risk of overseas economies

September BOJ Tankan confirmed solid capex

It is under these circumstances that the BOJ will announce its *Outlook for Economic Activity and Prices* report (*Outlook* report) on 31 October. Due to insufficient time since the implementation of the consumption tax hike, the October examination will not be capable of fully grasping the impact of the tax hike. Therefore, the main theme will be to what extent the downside risk of overseas economies will have an adverse impact on domestic demand, particularly on capex. The September BOJ Tankan confirmed that (1) the firmness of domestic demand is supporting the non-manufacturing sector, while the manufacturing sector is weak reflecting weakness in external demand and (2) the strength of capex is being maintained better than weak sentiments would indicate. Nevertheless, as indicated by the October IMF *World Economic Outlook*, a recovery of the global economy has been delayed and the slowdown has not yet stopped. Although the IT inventory cutbacks are about to end, Japan's production in the July-September period is expected to decline. In the October-December period as well, it is difficult to envisage a recovery due to the effects of the consumption tax hike amid lingering weakness in external demand.

Continued growth is expected at around potential growth rate

If the BOJ follows the current scenario, it will not have to make a major revision to the prospect of continued growth at around the potential growth rate (+ 0.7%) over the next two years. On the other hand, the BOJ's output gap has been maintained at +1% (Chart 2), although it has recently narrowed in positive territory. Therefore, although it will take time, we do not think the price hike scenario will collapse. Regarding the examination of momentum, the BOJ will probably judge that the possibility is not strong at the moment that the momentum toward achieving the price stability target will be lost.

[1] Refer to our 20 Sep 2019 report: *Daiwa's View: BOJ to examine economic/price developments at Oct MPM*.

Chart 1: Projections by BOJ Policy Board Members (median) and Our Forecasts (y/y)

	Real GDP			Core CPI*		
	Jul 2019 (BOJ projections)	**Oct 2019****	Our forecasts	Jul 2019 (BOJ projections)	**Oct 2019****	Our forecasts
FY19	+0.7 %	**+0.7 %**	+0.8 %	+1.0 %	**+0.8 %**	+0.6 %
FY20	+0.9 %	**+0.8 %**	+0.6 %	+1.3 %	**+1.1 %**	+0.5 %
FY21	+1.1 %	**+1.1 %**	+0.8 %	+1.6 %	**+1.5 %**	+0.8 %

Source: BOJ, various materials; compiled by Daiwa Securities.
**Including impact of consumption tax hike.*
*** Our estimates for policy board member projections.*

Oct core CPI in Tokyo's 23 wards shows sluggish momentum for price hikes

BOJ to lower its price projections in Oct *Outlook* report

October core CPI in Tokyo's 23 wards (released on 29 Oct), which garnered attention as data following the consumption tax hike, rose by 0.5% y/y. The growth rate was unchanged from September and lower than the market estimate of +0.7%. According to the Ministry of Internal Affairs and Communications, the boost caused by the consumption tax hike was +0.72ppt, the impact of free education was -0.55ppt, and the impact from other factors was +0.34ppt, which was lower than the +0.45ppt contribution in September. Looking at daily price movements (average for seven days) via the Nikkei CPINow T-index (Chart 3), we found that prices dropped sharply in the last week of September in order to meet the last-minute demand, and have been gradually recovering since the beginning of October. Although the growth rate returned to +0.96% y/y on 25 October, it is still below +1.0%, forcing us to admit sluggish momentum for price hikes. In addition to the downward revision to our FY19 core CPI forecast to +0.6%, we expect the BOJ to lower its price projections in the October *Outlook* report (Chart 1).

BOJ to decide to strengthen forward guidance at Oct MPM as a result of "examination"

Intention to continue examination and stance of taking action without hesitation will be maintained

In light of the above, I forecast that the BOJ will decide to strengthen forward guidance at the October MPM alongside the downward revision to price projections as a result of the "examination." We anticipate something extra, rather than just a calendar-based extension (from the current spring 2020 to, for example, the end of 2020). For example, it may be possible to change the expression of interest rate levels and improve the way of linking with specific indicators. There is a possibility that the wording for this part will become lengthy, as it would be decided by majority vote. Strengthening of forward guidance is not included in the four options of additional easing. I think this is a way to emphasize the BOJ's intention to continue with easing, although the central bank would not call it additional easing. In addition, the BOJ is likely to maintain (1) its intention to examine uncertainties of the global economy and the impact of the consumption tax hike and (2) its stance of taking action without hesitation if conditions for additional easing are satisfied. This will be included in the October statement in the form of rephrasing of the newly-added wording in the September statement.

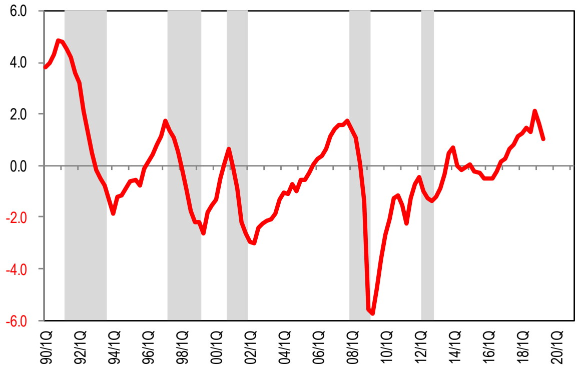
Market speculations of additional easing are strong, but important factor is timing when Fed ends preventive rate cuts

Therefore, market speculations of additional easing will likely persist. If so, we would focus on the January 2020 *Outlook* report, as the impact of the consumption tax hike can be analyzed by then. However, whether the Fed will end preventive rate cuts by end-2019 is also important. We would like to draw attention to the possibility that the atmosphere could change if the tightness of the financial environment and downside risks are alleviated after a change in the Fed's monetary policy operations to a risk management approach. Although views on the market outlook are divided, this is key to discerning the essence.

Another focal point is how BOJ will rein in excessive yield decline in superlong zone

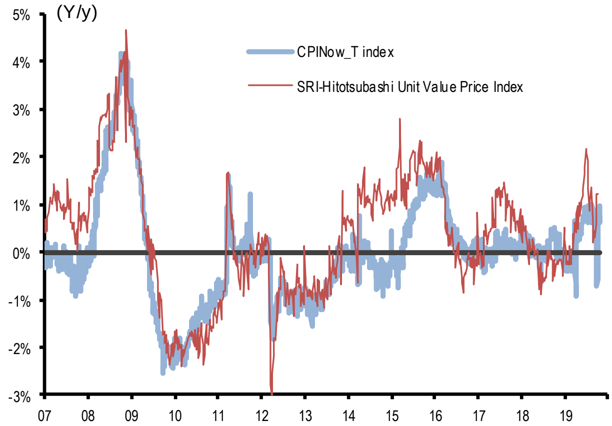
Another focal point at the October MPM is how the BOJ will send messages in order to prevent an excessive yield decline in the superlong zone. As the US/European long-term interest rates have risen recently, rushing to curb interest rate declines appears to have somewhat lost its meaning. However, if there is no message, the market may be disappointed and superlong yields may slide rapidly. Therefore, we expect Mr. Kuroda to reiterate his remarks about giving consideration to the yield decline in the superlong zone. It is possible that the BOJ's statement will once more include an opinion that a sharp decline in returns at life insurers and pension funds would have a negative impact on consumer sentiment, in line with the conclusion of the "Comprehensive Assessment" in September 2016, although we may not see it in the October statement.

Chart 2:BOJ's Output Gap Since 1990



Source: BOJ; compiled by Daiwa Securities.
Note: Shade indicates economic recession period.

Chart3: POS Data–based Price-related Indicators



Source: NowcaSTats, SRI Hitotsubashi University; compiled by Daiwa Securities.

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[Standard & Poor's]

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