Yen 4Sight

Highlights

- The BoJ kept its main policy parameters unchanged, while inflation ticked slightly higher in November.
- The decline in consumption in October was more modest than after the 2014 tax hike. But IP and exports remain weak.
- November IP, retail sales and labour market figures will be released over the festive season.

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Interest and exchange rate forecasts

End period	20-Dec	Q120	Q220	Q320
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	0.00	-0.05	-0.10	-0.10
JPY/USD	109	108	106	105
JPY/EUR	122	120	118	117

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

Deterioration not as bad as had been feared

The BoJ is likely to be broadly satisfied with recent economic and financial market developments. While Japan's economy is bound to have contracted in Q4, there are signs that the impact of the consumption tax hike was not quite as marked as many had feared. Underlying price pressures – according to the BoJ's preferred core inflation measure at least – have edged higher. Financial market moves have been favourable, with 10Y JGB yields close to the BoJ's zero percent central target, the yen weaker, and Japan's main equity indices up 9% or more so far this quarter. And with the government's fiscal stimulus to support demand over coming quarters, the case for further BoJ policy action has, for now at least, receded.

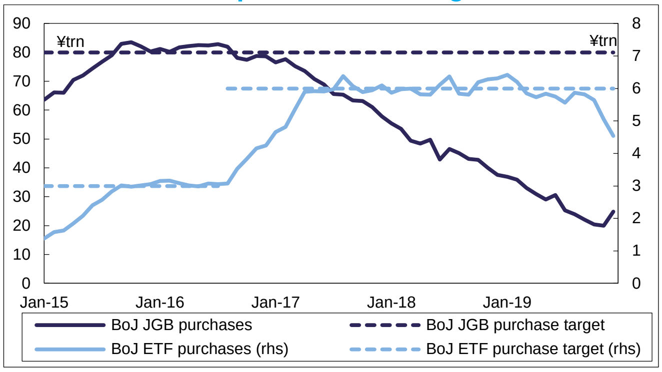
BoJ left policy and assessment unchanged

As such, the past week's BoJ meeting predictably saw the main policy parameters – in terms of interest rates, yield target, asset purchases and forward guidance – unchanged. The BoJ's economic assessment appeared little changed too, with the Board judging the economy to have remained on a moderate expanding trend despite the fluctuations associated with the consumption tax hike, ongoing weakness in exports, and the additional recent disruption to manufacturing caused by October's super-typhoon. The BoJ expects the moderate expansion trend to continue, not least thanks to "active government spending". However, while the Fed and ECB recently assessed downside risks to the outlook to be not quite as acute as they were previously, the BoJ is still wary, maintaining its view that downside risks concerning overseas economies remain significant.

BoJ to continue scaling back asset purchases?

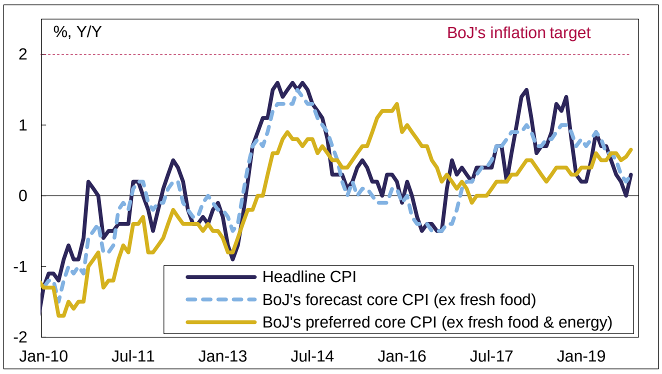
In the absence of a significant worsening of conditions, the BoJ will leave its main policy parameters unchanged for the foreseeable future. Of course, Kuroda reiterated in the past week that policy could be eased further. But he is mindful of the potential adverse side effects of current measures. And with an eye to supporting liquidity in the ETF market – of which the BoJ's holdings account for more than two-thirds – the Policy Board finally fleshed out some details of its forthcoming lending programme. In particular, the BoJ will be prepared to lend ETFs for up to one year at an interest rate to be determined by auction or by the BoJ itself. Having already slowed its ETF purchases significantly since early October – its stock is on track to rise by ¥1.5trn less than the stated full-year target of ¥6trn – the lending programme is likely to give the BoJ confidence to further scale back its purchases next year too.

BoJ JGB and ETF purchases vs target*



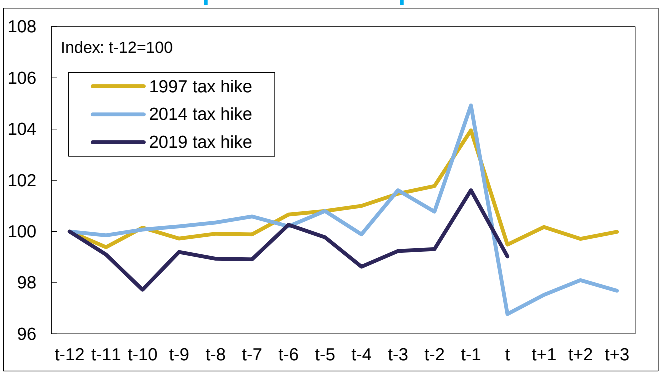
*Monthly figures are based on 12mms.
Source: BoJ and Daiwa Capital Markets Europe Ltd.

Headline and core inflation*



*Excluding impact of consumption tax hike and government education policies.
Source: MIC, BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Private consumption: Pre- and post-tax hike*



*t represents the month the consumption tax rate was increased. Synthetic consumption index. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Inflation ticks slightly higher

The November inflation figures could provide the BoJ with further justification for standing pat. With prices up 0.2%M/M, the headline annual CPI rate rose 0.3ppt in November to 0.5%Y/Y, a four-month high. Admittedly, this principally reflected higher inflation of fresh food – when excluding that category, the BoJ's core CPI measure was just 0.1ppt higher at 0.5%Y/Y. And as the consumption tax hike on certain utilities only kicked in last month, when adjusting for recent policy changes, core inflation moved sideways at 0.2%Y/Y. Nevertheless, the BoJ's preferred core inflation measure, excluding energy and fresh foods, was again a touch firmer, rising 0.1ppt in November to its highest level since mid-2016 (0.7%Y/Y adjusted for the tax hike and education fees), more than double the rate seen this time last year, if obviously still well below the BoJ's 2% inflation target.

Decline in consumption smaller than in 2014

While the impact of the tax hike on inflation has been modest, activity data suggest a significant hit to growth at the start of Q4. Indeed, the 4½%M/M decline in IP in October was the steepest since the 2011 quake and tsunami. And tertiary activity fell 4.6%M/M, twice the rate of increase in September. But some of those declines will have been caused by the super-typhoon. And while the government in the past week downgraded its economic assessment, like the BoJ it judges the impact of the tax hike to be smaller than in 2014. This view tallies with the Cabinet Office synthetic consumption figures, the best monthly guide to the national accounts measure of consumption. The 2.6%M/M drop in this indicator was only marginally larger than the increase in September and was significantly smaller than the initial decline seen after the April 2014 tax hike (7.8%M/M).

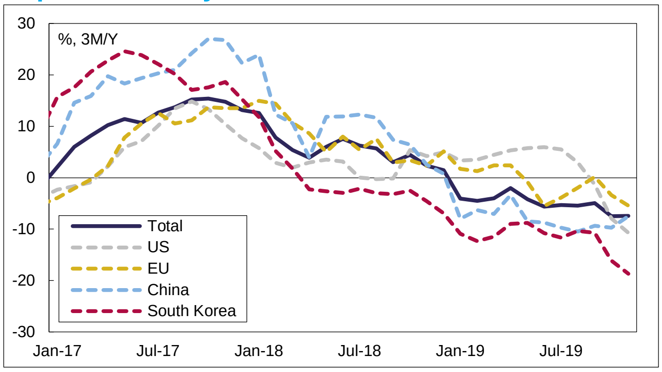
Exports continue to weaken…

Concerns regarding external demand, however, will not have been assuaged by November's trade report. The value of exports fell for the fourth month out of the past five to leave them almost 8% lower than a year earlier – admittedly a modest improvement from the decline of more than 9%Y/Y in October. There was a further weakening in demand from the US, with the 12.9%Y/Y drop – the steepest since August 2016 – largely reflecting a near-17%Y/Y drop in autos shipments. Despite a pickup in demand for Japanese cars from the EU, growth in total exports to the region still remained in negative territory (-7.5%Y/Y). And while the decline in shipments to China moderated in November (down 5ppts to -5.4%Y/Y), a further notable fall in goods exports to South Korea (-17.0%Y/Y) illustrated the impact of the strains in relations. The rift continues to weigh on services exports too, with the number of Korean visitors (205k) in November again down more than 65%Y/Y.

…but net trade on track to support GDP growth

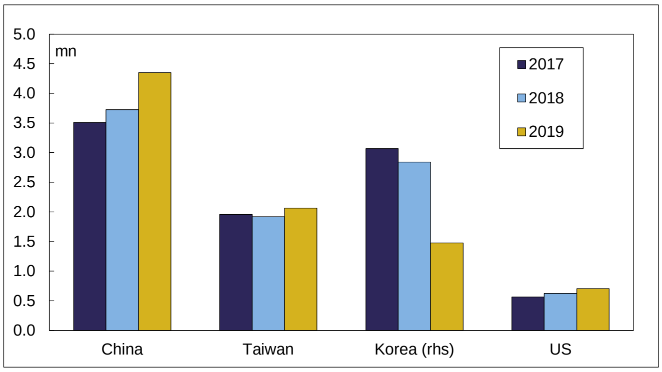
Adjusting for price and seasonal effects, the BoJ's data suggested a more marked deterioration in exports in November, with volumes down more than 1½%M/M for the second successive month. So, exports appear on track for a notable contraction in Q4 – indeed, in October and November volumes were trending 2½% below the Q3 average. Nevertheless, given the slump in domestic demand, import volumes were down a steeper 3.3% on an equivalent basis, suggesting that net trade is likely to provide much needed support to GDP growth in Q4.

Export values by destination



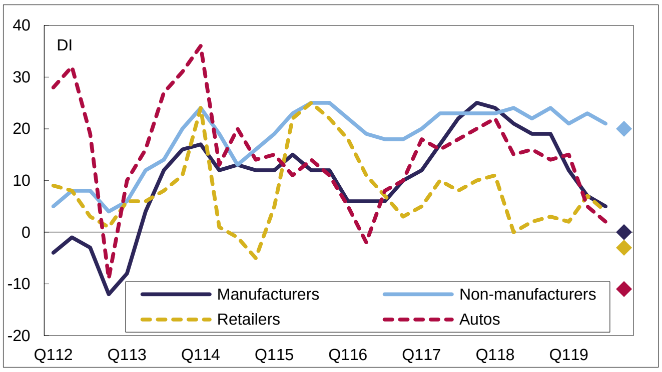
Source: MoF, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Overseas visitors



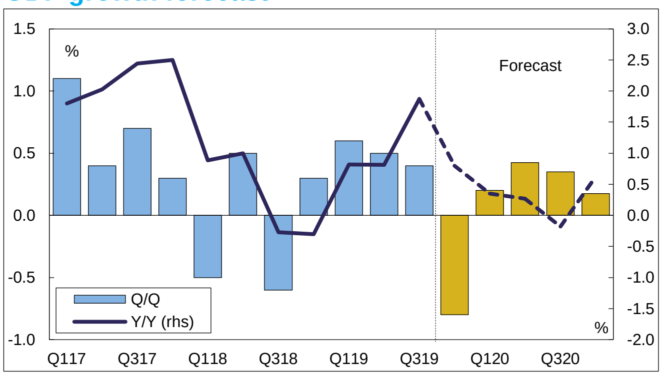
Source: JNTO and Daiwa Capital Markets Europe Ltd.

BoJ Tankan: Business conditions*



**Diamonds are survey forecast for Q120. Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

GDP growth forecast



Source: Cabinet Office and Daiwa Securities

Tankan inevitably pointed to weaker Q4

Not least given softer external demand, the BoJ's Tankan saw manufacturers flag their concerns. Indeed, the headline business conditions DI for large manufacturers declined for the seventh quarter out of the past eight in Q4 and by a larger-than-expected 5pts to 0, the lowest since the start of Abenomics. Firms in the sector forecast a further deterioration in Q1 too. In contrast, the Tankan suggested that conditions in the non-manufacturing sectors have held up relatively well – the headline DI for large firms merely fell 1pt to +20, much smaller than the declines seen after the tax hikes in 1997 and 2014 (-6pts and -5pts respectively). While non-manufacturers forecast a further deterioration in Q1, the respective index was still expected to remain significantly above the long-run average. Meanwhile, recent sentiment surveys – including the December flash PMIs – point to an improvement as the quarter has progressed in both manufacturing and services.

But Japan should avoid near-term recession

Notably perhaps, the Tankan suggested that firms were more upbeat about their investment intentions for the fiscal year as a whole than they were three months ago, forecasting growth of 3.3%Y/Y, albeit half the pace recorded in FY18. Admittedly, the latest machine orders data cast some doubt over the near-term private capex outlook, with orders having fallen in October to the lowest level for more than four years. But that likely reflects temporary factors. Public sector orders (up more than 40%Y/Y in October) should receive a further boost over coming quarters from the government's fiscal stimulus. And foreign orders rose at the firmest annual rate for ten months in October, to hint at a possible improvement in the external demand environment too – albeit perhaps only for capital goods. Overall, therefore, we remain cautiously optimistic that Japan will escape technical recession.

Japan scorecard 2019

	Indicator	End 2018		Latest
Activity	Real GDP (%Y/Y)	-0.3	↑	1.7
	- Consumption	0.0	↑	1.4
	- Private Non-Residential Capex	2.0	↑	5.4
	- Exports	1.1	↓	-1.1
	- Real Private Demand	0.1	↑	2.1
	Industrial Production (%Y/Y)	-2.0	↓	-7.7
	Unemployment Rate %	2.4	↔	2.4
	Job-to-Applicant Ratio	1.63	↓	1.57
	Employment growth (%Y/Y)	1.8	↓	0.9
	Tankan All-firm Business Conditions	16	↓	4
	Consumer Confidence Index	42.6	↓	38.7
	Economy Watchers Outlook Index	46.8	↓	39.4
Financial	Nikkei 225	20018	↑	23817
	10-year JGB Bond Yield (%)	0.00	↔	0.00
	Average Loan Interest Rate	0.73	↓	0.68
	Monetary Base (%Y/Y)	4.8	↓	3.3
	Bank Lending (%Y/Y)	2.4	↓	2.1
	USD/JPY	109.7	↓	109.4
	Real Effective Exchange Rate	76.3	↓	75.5
	JGBi 10Y breakeven rate %	0.21	↓	0.19
Nominal	Headline CPI (%Y/Y)	0.3	↔	0.3
	CPI ex fresh food (%Y/Y)	0.7	↓	0.3
	CPI ex fresh food/energy (%Y/Y)	0.3	↑	0.7
	Goods PPI (%Y/Y)	1.4	↓	-1.5
	Services PPI (%Y/Y)	1.1	↓	0.4
	GDP deflator (%Y/Y)	-0.6	↑	0.6
	Domestic demand deflator (%Y/Y)	0.2	↔	0.2
	Nominal GDP (%Y/Y)	-0.9	↑	2.3
	Labour Cash Earnings (%Y/Y)	1.5	↓	0.0
	- Contracted Earnings (%Y/Y)	0.6	↓	0.2
	Tankan Inflation Expectations 1-year	0.9	↓	0.8
	Tankan Inflation Expectations 3-year	1.1	↓	1.0

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Looking back…

As year-end approaches, a quick snapshot of recent data (see scorecard opposite) points to a year of some progress for policymakers, despite the major challenges faced by the industrial sector. Of course, the poor export and IP figures in part reflect the significant weakness in external demand that all major manufacturing centres have had to face up to in 2019. But the effects of natural disasters and the tax hike have also taken a toll on output recently. Data also point to a slowing in job growth. But that partly reflects the tightness of the labour market, the flipside of which has been the ongoing uptrend in business capex. And together with stronger personal consumption, firm investment saw GDP accelerate to its fastest annual rate in seven quarters in Q3. With economic growth above potential, underlying inflation has edged up slightly too. In the markets, equities have fared better on the truce in Trump's trade wars. And 10Y JGB yields and the yen are effectively little changed from this time last year. All in all, therefore, nothing to suggest a need for panic at the BoJ at the start of 2020. Expect no change to policy parameters and a continued decline in its net asset purchases – of JGBs and ETFs – in coming months.

Looking ahead…

The festive period in Japan will bring a number of top-tier releases, with the most noteworthy being the industrial production, retail sales and labour market figures for November all due on 27 December. The IP release is unlikely to bring much cheer, with an anticipated further fall of 2.0%M/M in November set to leave output down more than 8%Y/Y, which would mark the steepest annual drop since early 2013. And while retail sales are expected to have bounced back last month, this would still leave sales down compared with a year earlier. Meanwhile, labour market indicators are expected to be little changed, with the unemployment rate at 2.4% and the job-to-applicant ratio at 1.57. Finally, that day will also bring Tokyo inflation data for December. In the markets, a 2Y JGB auction will be conducted on Tuesday 24 December.

Daiwa Capital Markets

Economic calendar

Key data releases – December/January

16	17	18	19	20
MANUFACTURING PMI NOV 48.9 DEC P 48.8 SERVICES PMI NOV 50.3 DEC P 50.6 COMPOSITE PMI NOV 49.8 DEC 49.8 TERTIARY ACTIVITY M/M% SEP 2.3 OCT -4.6 BOJ TANKAN – INFLATION OUTLOOK OF ENTERPRISES (Q4)	20Y JGB AUCTION	1Y TB AUCTION GOODS TRADE BALANCE ¥BN OCT -48.2 NOV -60.8 OVERSEAS VISITORS MN OCT 2.50 NOV 2.44 BOJ POLICY BOARD MEETING (18-19 DEC 2019)	BOJ POLICY BOARD ANNOUNCEMENT	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY NATIONAL CPI Y/Y% OCT NOV 0.2 0.5 *EX FRESH FOOD* *0.4 0.5* *EX FRESH FOOD/ENERGY* *0.7 0.8* DEPARTMENT STORE SALES Y/Y% OCT -17.5 NOV -6 FLOW OF FUNDS (Q3)
23	**24**	**25**	**26**	**27**
ALL INDUSTRY ACTIVITY M/M% SEP 1.5 OCT -4.3	2Y JGB AUCTION (APPROX ¥2.0TRN)	SERVICES PPI Y/Y% OCT 2.1 NOV N/A	HOUSING STARTS Y/Y% OCT -7.4 NOV N/A CONSTRUCTION ORDERS Y/Y% OCT 6.4 NOV N/A	INDUSTRIAL PRODUCTION M/M% OCT -4.5 NOV N/A RETAIL SALES M/M% OCT -14.2 NOV N/A UNEMPLOYMENT RATE % OCT 2.4 NOV N/A JOB-TO-APPLICANT RATIO OCT 1.57 NOV N/A TOKYO CPI Y/Y% NOV DEC 0.8 0.8 *EX FRESH FOOD* *0.6 0.6* *EX FRESH FOOD/ENERGY* *0.7 0.7* BOJ SUMMARY OF OPINIONS (18-19 DECEMBER 2019)
30	**31**	**01**	**02**	**03**
		NATIONAL HOLIDAY - NEW YEAR'S DAY		
06	**07**	**08**	**09**	**10**
MANUFACTURING PMI (DEC F) VEHICLE SALES (DEC)	3M TB AUCTION 10Y JGB AUCTION	SERVICES PMI (DEC F) COMPOSITE PMI (DEC F) AVERAGE WAGES (NOV) CONSUMER CONFIDENCE (DEC)	6M TB AUCTION 30Y JGB AUCTION	3M TB AUCTION HOUSEHOLD SPENDING (NOV) BOJ CONSUMPTION ACTIVITY INDEX (NOV) COINCIDENT INDEX (NOV P) LEADING INDEX (NOV P)
13	**14**	**15**	**16**	**17**
	BANK LENDING (DEC) CURRENT ACCOUNT (NOV) ECONOMY WATCHERS SURVEY (DEC)	5Y JGB AUCTION	1Y TB AUCTION MACHINE ORDERS (NOV) GOODS PPI (DEC)	3M TB AUCTION TERTIARY ACTIVITY (NOV)

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

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