Yen 4Sight

Highlights

- While the drop in GDP in Q4 was predictable, it was larger than expected and the steepest since the previous sales tax hike in 2014.
- Monthly data, including machine orders and trade figures, point to ongoing weakness at the start of 2020.
- Key forthcoming releases include January CPI inflation (21 February), IP and retail sales figures (28 February).

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Interest and exchange rate forecasts

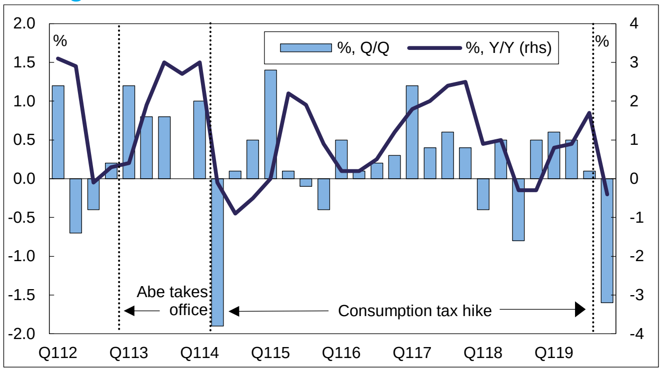
End period	20-Feb	Q120	Q220	Q320
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.05	-0.07	-0.10	-0.10
JPY/USD	112	110	108	108
JPY/EUR	121	120	118	118

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

GDP contracts sharply in Q4

Japan's Q4 GDP data were bound to be viewed as a key litmus test of the wisdom of pressing ahead with October's sales tax hike. And despite the various policy measures taken to soften the blow, the tax increase conspired with the super typhoon to deliver a particularly dire performance in the final quarter of last year. GDP fell 1.6%Q/Q (6.3%Q/Q annualised) in Q4, only marginally softer than the tax-hike-related drop in Q214 and the fourth steepest quarterly decline since the early 1980s. And with growth in Q3 having been almost revised away (down 0.3ppt from the previous estimate to just 0.1%Q/Q), this left GDP down 0.4%Y/Y, compared with annual growth of 1.7%Y/Y in Q3. This notwithstanding, full-year growth of 0.7%Y/Y in 2019 was still broadly in line with the BoJ's estimate of potential.

GDP growth



Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Consumption and capex inevitably weaker

Predictably, the weakness in Q4 reflected a hit to domestic expenditure, with the quarterly decline in GDP fully accounted for by private consumption. Indeed, the 2.9%Q/Q decline was also the steepest since the 2014 tax hike. Most striking was the drop in spending on durable goods of almost 13%Q/Q, again only a fraction smaller than in Q214. Overall, this left private consumption at its lowest level for 3½ years and 4% lower than the pre-tax hike peak in 2014. The fall in private non-residential private investment also knocked a further 0.6ppt off quarterly GDP growth, while housing investment declined by the most in two years. Exports were also down (-0.1%Q/Q) for the third quarter out of the past four. But given the notable decline in imports (-2.6%Q/Q) related to weaker domestic demand, net trade added 0.5ppt to growth, the first positive contribution for three quarters. Stocks also provided modest support. And while fiscal policy was somewhat supportive, public investment merely added 0.1ppt to growth, while government consumption (0.2%Q/Q) was the softest for three quarters.

GDP growth and expenditure components*

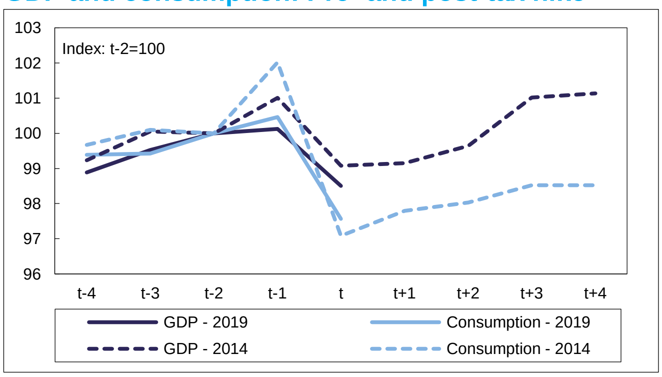
	%, Q/Q	contr	%, Y/Y	contr
GDP	**-1.6**		**-0.4**	
Final domestic demand	-	-2.1	-	-0.8
- Private consumption	-2.9	-1.6	-1.9	-1.0
- Residential investment	-2.7	-0.1	-0.2	0.0
- Non-residential investment	-3.7	-0.6	-3.3	-0.5
- Government consumption	0.2	0.0	2.2	0.4
- Public investment	1.1	0.1	6.3	0.3
Net exports	-	0.5	-	0.4
- Exports	-0.1	0.0	-2.2	-0.4
- Imports	-2.6	0.5	-4.3	0.8
Private inventories	-	0.1	-	0.0

**Contributions may not sum due to rounding. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.*

Impact of tax hike so far in same ballpark as 2014

With a retrenchment in GDP in the aftermath of October's tax hike inevitable, and the impact of the weather to some extent a mitigating factor, it is too soon to judge whether the latest tax hike was a major policy error. With the net burden of the tax hike on household disposable income significantly lower this time than in 2014, the effects need not be long-lasting. Looking at Q4 alone, the impact on consumption was commensurate to that in 2014, with a 1½ppt drop in spending per 1ppt increase in the tax rate. But given that front-loading ahead of October's tax hike was much less evident than in 2014, the weakness of

GDP and consumption: Pre- and post-tax hike*



**t represents the quarter the consumption tax was increased. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.*

spending in Q4 was arguably more striking. Indeed, on average over the two quarters either side of the tax hike, consumption was marginally weaker than over the equivalent period in 2014. On a similar basis, while residential investment fared better, non-residential investment appears to have been significantly weaker compared to 2014, and the external environment was notably less supportive too.

Consumption particularly weak in December

Unsurprisingly, Japanese officials remain cautiously optimistic that the economy will resume an upward trend this quarter. But the monthly profile of spending suggests that this might be a struggle. Notably, having posted only a very modest rebound in November, the Cabinet Office's synthetic consumption index was down more than 1%M/M in December, falling to its lowest level since April 2014. As such, it will require growth of at least 0.3%M/M in each month of Q1 to avoid a further quarterly contraction.

Machine orders slump at year-end

The outlook for private sector non-residential investment is also unclear. Machine orders data – which offer a guide to capex growth roughly three months ahead – imply ongoing weakness in the first quarter of 2020. Indeed, core orders fell a much steeper-than-expected 12½%M/M in December, the most for fifteen months, caused by a drop of more than 21%MM in orders placed by non-manufacturers. Of course, orders figures are notoriously volatile. And the slump at the end of last year followed a surge in November (18%M/M) thanks partly to a one-off boost from the transportation sector. Nevertheless, core orders were still down more than 2%Q/Q over the fourth quarter as a whole, the fourth quarterly decline out of the past five. And the Cabinet Office forecasts a further notable fall (5.2%Q/Q) in private sector orders in Q1, which would leave them at their lowest level for 4½ years. Public sector orders in Q4 were also disappointingly weak (-11½%Q/Q) and are expected to fall further in Q1 despite the government's fiscal support package.

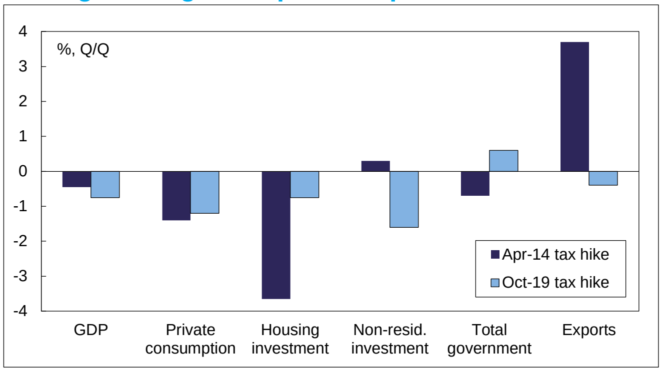
Exports fall in January

Of course, a key downside risk to the near-term economic outlook relates to external demand, including the impact of the coronavirus. The goods trade report for January suggested a weak performance at the start of the year too, with the value of exports down a sizeable 3.7%M/M, the most in eight months, to the lowest level since November 2016. Admittedly, the year-on-year decline in exports (2.6%Y/Y) was less than had been expected and the smallest since July, nevertheless still marking the fourteenth consecutive drop. The pace of decline in shipments to the US also eased despite still weak shipments of autos, while a jump in miscellaneous items exported to the EU helped to offset significant weakness in machinery. In contrast, shipments to South Korea, meanwhile, continued to decline at a double-digit pace. And perhaps unsurprisingly, the value of exports to China fell sharply in January, by more than 7ppts to -6.4%Y/Y. But to what extent this reflects a drop in demand due to the timing of the Lunar New Year holidays is difficult to decipher.

Net trade to weigh on growth in Q1

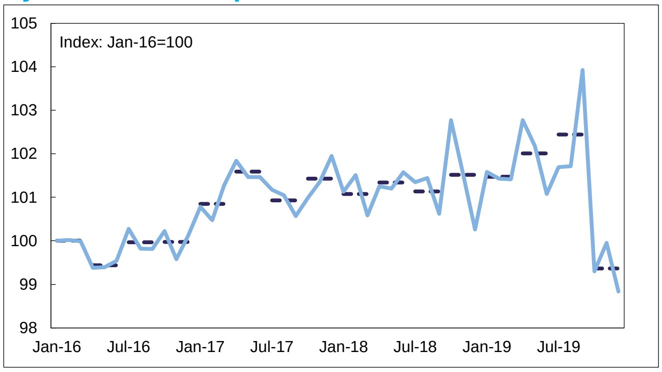
When adjusting for price and seasonal effects, the BoJ's figures implied an even weaker trade performance in January, with

Average GDP growth pre- and post-tax hike*



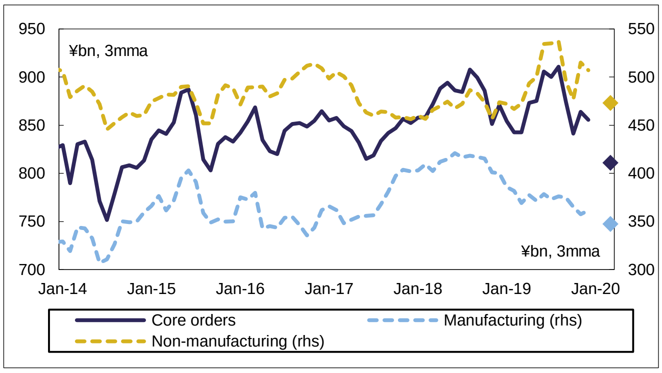
*Average growth in the quarter immediately before and after the consumption tax hikes. Source: Cabinet Office and Daiwa Capital Markets Europe Ltd.

Synthetic consumption index



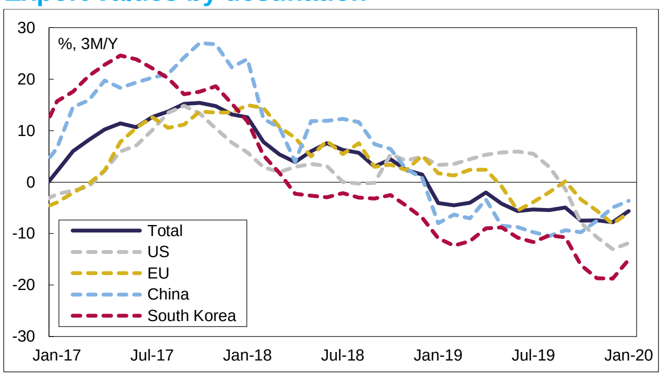
Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Private sector machine orders*



*Diamonds represent Cabinet Office forecasts for Q120. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export values by destination



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

export volumes down 4.6%M/M, the most for almost five years. So, while subdued domestic demand also resulted in a sizeable drop in import volumes last month (2.9%M/M), these figures suggest that net trade was a drag on GDP growth at the start of the year. And with the coronavirus having caused significant disruption to activity across Asia this month, external demand for Japanese goods looks set to remain weak throughout Q1.

Overseas visitors held up in January

Travel restrictions now in place will also take their toll on Japan's services exports. Anecdotal evidence suggests a sharp drop so far in February – for example, the number of visitors to Hokkaido's annual Sapporo Snow Festival of a little more than 2mn was down by roughly 700k on the previous year and the lowest in a decade. Nevertheless, overseas visitor numbers for January showed that the number of arrivals from China was up 23%Y/Y to 925k, accounting for more than one third of the total. Visitors from Hong Kong (up 42%Y/Y) and Taiwan (up 19%Y/Y) accounted for a further 25%. However, given a further notable decline in visitors from Korea (-59%Y/Y), a trend that has been in place since the escalation of the spat between the two countries intensified last summer, this left total overseas arrivals down more than 1%Y/Y at 2.66mn.

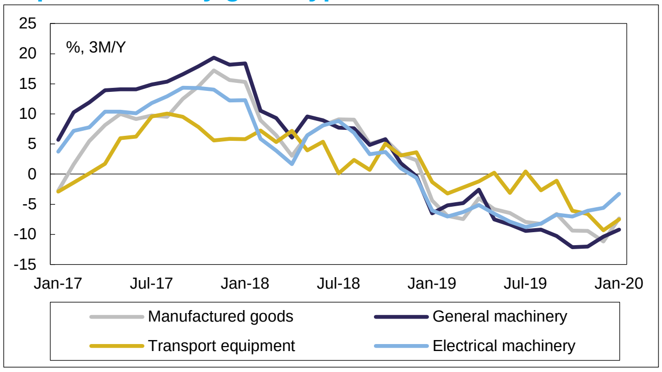
Survey suggests conditions no firmer in Q1

Despite prominent downside risks to the outlook, the latest Reuters Tankan survey for February – the first to fully capture heightened concerns about the coronavirus – reported no deterioration whatsoever in overall business conditions over the past month. Indeed, the headline non-manufacturing diffusion index (DI) edged marginally higher (by 1pt to +15), as did the equivalent manufacturing DI (up 1pt to -5). Within the detail, however, there was a notable worsening in sentiment in the chemicals sector (the relevant DI was down 17pts to its lowest level since the Global Financial Crisis) from which more than one quarter of exports go to China and almost 70% are shipped to Asia as a whole. Retailers were also more downbeat. And overall, the survey also suggested no material improvement in business sentiment so far in Q1 compared to Q4, with limited recovery anticipated over the coming three months too. Overall, therefore, hard data and surveys alike suggest a significant risk that Japan's economy is now in technical recession.

Looking ahead…

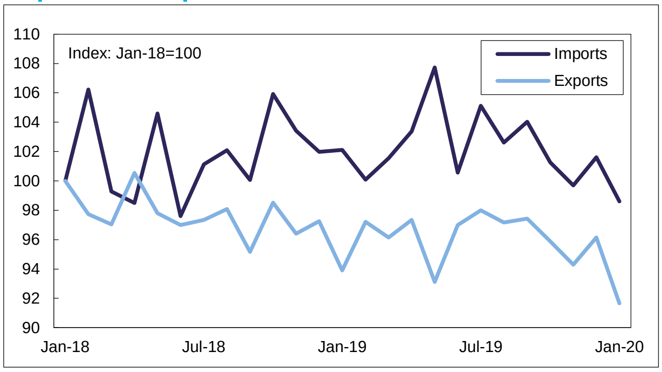
The immediate data focus will be January's inflation figures (due 21 February). Not least given the shift in energy and commodity prices over the past month, these are expected to show that headline inflation took a step down at the start of the year, back close to ½%Y/Y. Attention then turns to the deluge of top-tier releases for January at the end of the month. In particular, industrial production is expected to have reversed much of the increase in December to mark the third monthly decline out of the past four. Retail sales and labour market figures for the same month are also due, while the Tokyo CPI numbers will provide a guide to price pressures in February. Finally, the MoF's capital spending survey (due 2 March) will offer insights into the likelihood of revisions to the second estimate of Q4 GDP (due 9 March).

Export values by good-type



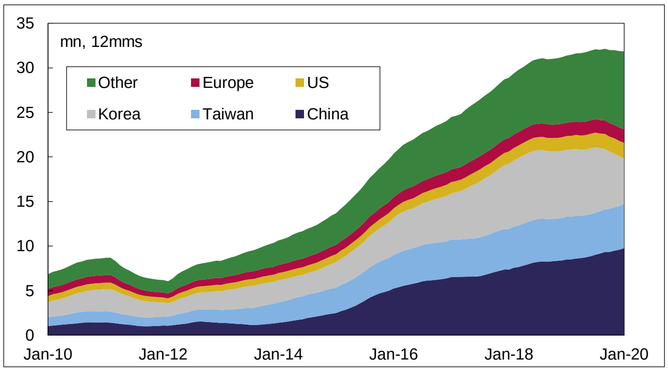
Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Export and import volumes



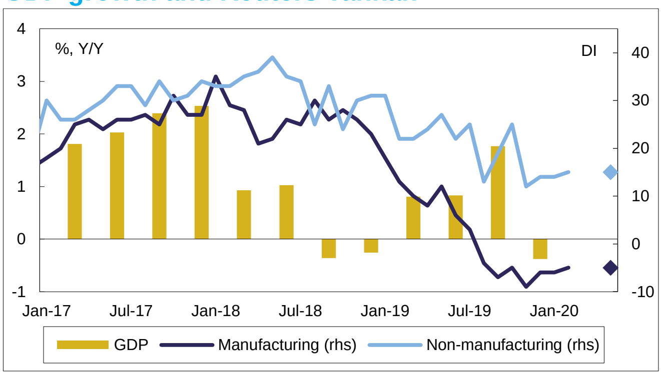
Source: BoJ, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Overseas visitors



Source: JTNA and Daiwa Capital Markets Europe Ltd.

GDP growth and Reuters Tankan*



**Diamonds represent survey forecast for May 2020. Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Daiwa Capital Markets

Economic calendar

Key data releases – February/March

17	18	19	20	21
GDP Q/Q% Q3 0.1 Q4 P -1.6 REUTERS TANKAN - MANUFACTURING DI JAN -6 FEB -5 NON-MANUFACTURING DI JAN 14.0 FEB 15.0 INDUSTRIAL PRODUCTION M/M% NOV -1.0 DEC F 1.2	5Y JGB AUCTION	1Y TB AUCTION GOODS TRADE BALANCE ¥BN DEC -107 JAN -224 MACHINE ORDERS M/M% NOV 18.0 DEC -12.5 OVERSEAS VISITORS MN DEC 2.53 JAN 2.66	20Y JGB AUCTION	3M TB AUCTION (APPROX ¥4.4TRN) NATIONAL CPI Y/Y% DEC JAN 0.8 0.6 *EX FRESH FOOD* *0.7 0.7* *EX FRESH FOOD/ENERGY* *0.9 0.8* MANUFACTURING PMI DEC 48.8 JAN P N/A SERVICES PMI DEC 51.0 JAN P N/A COMPOSITE PMI DEC 50.1 JAN P N/A ALL INDUSTRY ACTIVITY M/M% NOV 0.9 DEC 0.3 DEPARTMENT STORE SALES Y/Y% DEC -5.0 JAN N/A
24	**25**	**26**	**27**	**28**
NATIONAL HOLIDAY – EMPEROR'S BIRTHDAY	SERVICES PPI DEC 2.1 JAN N/A	ENHANCING LIQUIDITY AUCTION (APPROX ¥0.5TRN)		3M TB AUCTION (APPROX ¥4.4TRN) 2Y JGB AUCTION (APPROX ¥2.0TRN) TOKYO CPI Y/Y% JAN FEB 0.6 0.6 *EX FRESH FOOD* *0.7 0.7* *EX FRESH FOOD/ENERGY* *0.9 0.9* UNEMPLOYMENT RATE % DEC 2.2 JAN 2.2 JOB-TO-APPLICANT RATIO DEC 1.57 JAN N/A RETAIL SALES Y/Y% DEC -2.6 JAN N/A INDUSTRIAL PRODUCTION M/M% DEC 1.2 JAN N/A HOUSING STARTS Y/Y% DEC -7.9 JAN N/A CONSTRUCTION ORDERS Y/Y% DEC 21.4 JAN N/A
02	**03**	**04**	**05**	**06**
MOF CAPITAL SPENDING SURVEY (Q4) MANUFACTURING PMI (FEB F) VEHICLE SALES (FEB) BOJ BOND MARKET SURVEY (FEB)	10Y JGB AUCTION MONETARY BASE (FEB) CONSUMER CONFIDENCE (FEB)	SERVICES PMI (FEB F) COMPOSITE PMI (FEB F)	30Y JGB AUCTION	3M TB AUCTION HOUSEHOLD SPENDING (JAN) BOJ CONSUMPTION ACTIVITY (JAN) COINCIDENT INDEX (JAN P) LEADING INDEX (JAN P)
09	**10**	**11**	**12**	**13**
6M TB AUCTION GDP (Q4 F) ECONOMY WATCHERS SURVEY (FEB) BANK LENDING (FEB) CURRENT ACCOUNT (JAN)	5Y JGB AUCTION M3 MONEY SUPPLY (FEB)		20Y JGB AUCTION BSI (Q1) GOODS PPI (FEB)	3M TB AUCTION TERTIARY ACTIVITY (JAN)

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

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