

Japan Economic Update – Recovery Pauses on 3rd Wave

1) Incidence of Covid-19 amongst Japan's population remains much lower than in other major economies

While new coronavirus cases rose sharply in a 3rd wave over the winter – triggering new restrictions on activity as daily deaths reached record highs – Japan has continued to fare much better than most other countries with just 0.3% of the population infected since the pandemic began, compared with almost 8% in the US.

2) While activity rebounded from earlier lows, the pandemic continues to weigh on the economy

After plunging in Q220, economic activity rebounded by more than many had expected in Q3 and data point to further progress in Q4. Even so, GDP likely ended last year down 3%Y/Y and the resurgent virus and extension of the state of emergency in several prefectures means that GDP will likely take a small backward step in Q1.

3) Pre-Covid-19 GDP levels unlikely to be recaptured before 2023

Supported by continued fiscal stimulus – which will likely be boosted further if the Tokyo Olympics is cancelled – and the BoJ's ultra-accommodative policy settings, a sustained recovery should re-emerge in the second half of this year provided that global vaccination efforts successfully halt the spread of coronavirus. Even so, it will likely take until some time in 2023 for Japan to recapture pre-pandemic levels of activity.

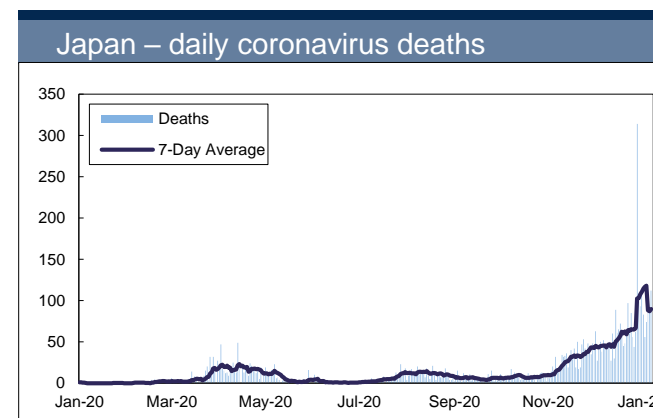
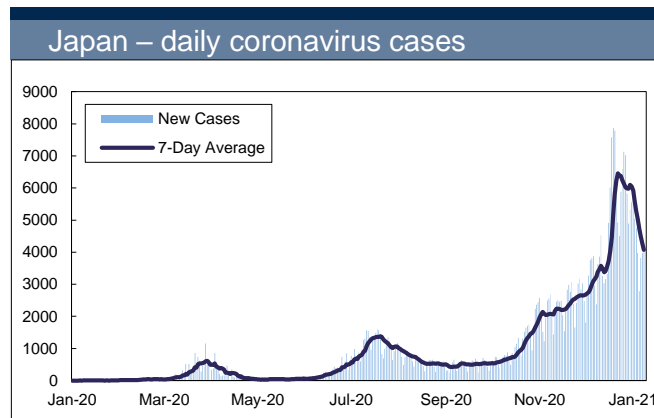
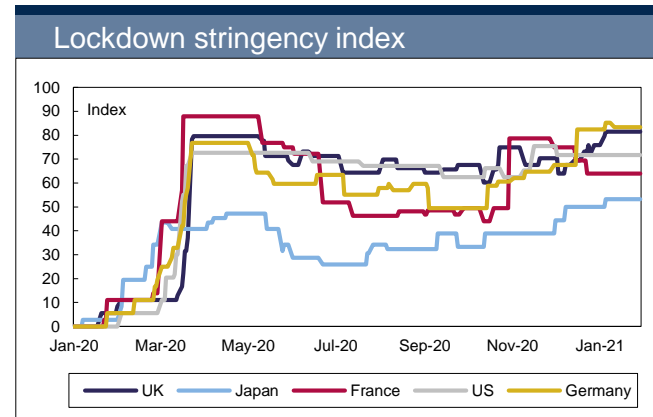
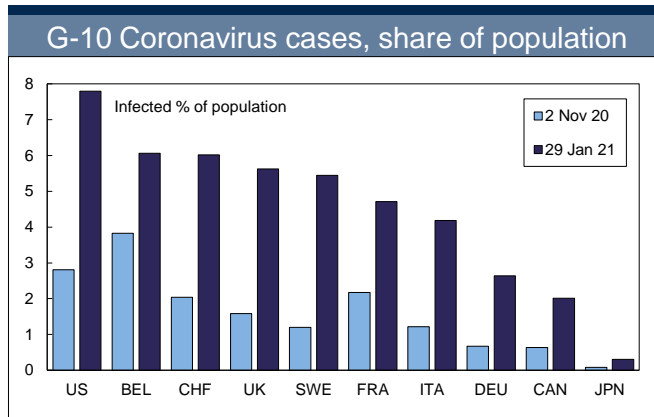
4) While inflation dropped to multi-year lows, the BoJ will only modestly tweak its policy framework

Sadly the pandemic has undone years of progress towards building the economic conditions necessary to lift inflation to the BoJ's target. However, given worries about negative side-effects, the BoJ won't cut rates further. So with monetary policy likely needing to remain accommodative for the rest of this decade, the BoJ's review of monetary policy is likely to see tweaks to how its asset purchase and yield curve control policies are conducted.

5) Time is of essence for PM Suga with a LDP leadership vote and General Election ahead later this year

The honeymoon of PM Suga has proven very short-lived with his Cabinet approval rating turning negative on balance due to dissatisfaction with the handling of the upsurge in coronavirus cases. Suga will likely face an LDP leadership vote in September to determine whether he will lead the party into the General Election in October.

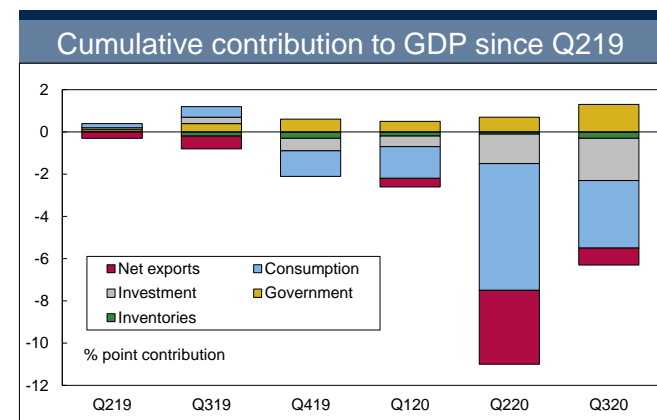
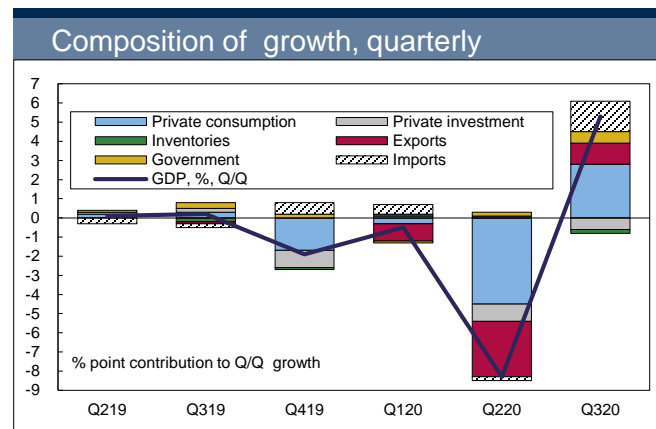
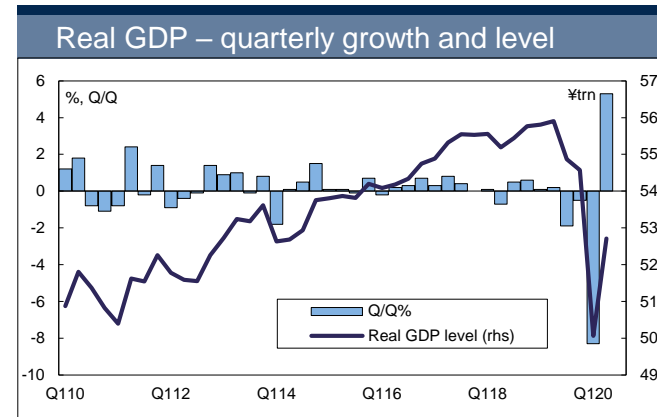
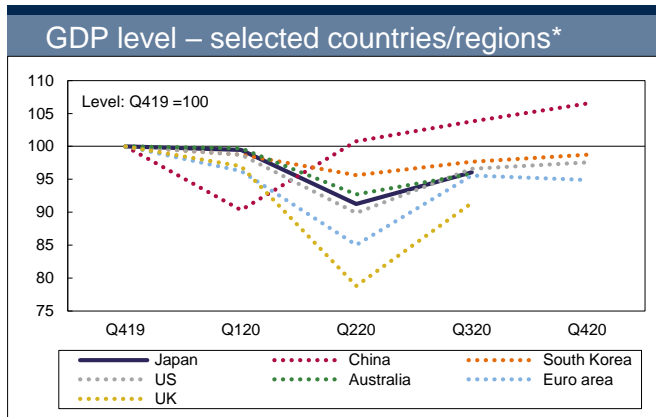
Japan's incidence of Covid-19 has grown, but by much less than elsewhere, and remains low overall



Source: Refinitiv, Blavatnik School of Government Oxford University, Bloomberg, Wikipedia and Daiwa Capital Markets Europe Ltd.

- As in other countries, new coronavirus cases in Japan climbed sharply over the winter, triggering new restrictions on activity. Even so, incidence of coronavirus has grown by much less than in most other major economies and remains very low overall – just 0.3% of the population have been infected, compared with 8% in the US.

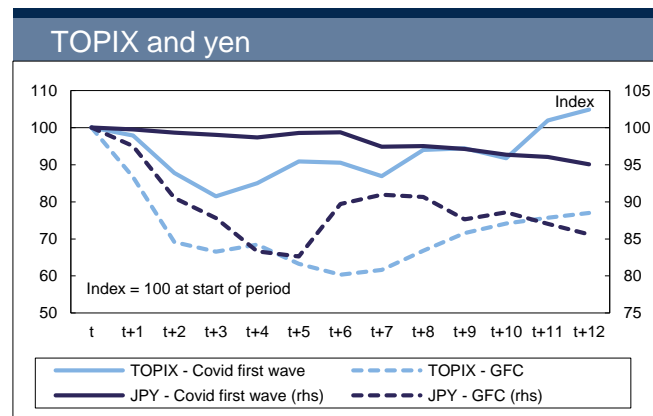
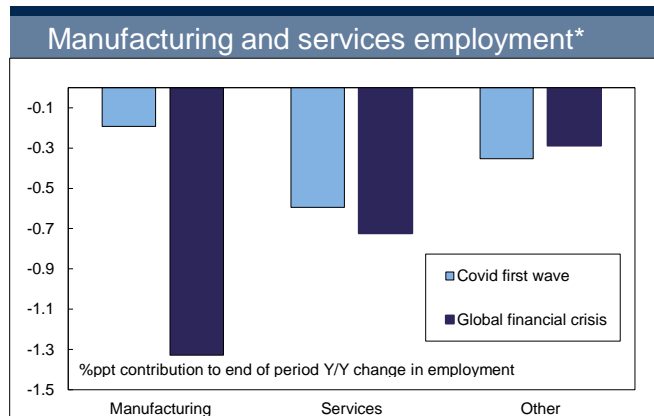
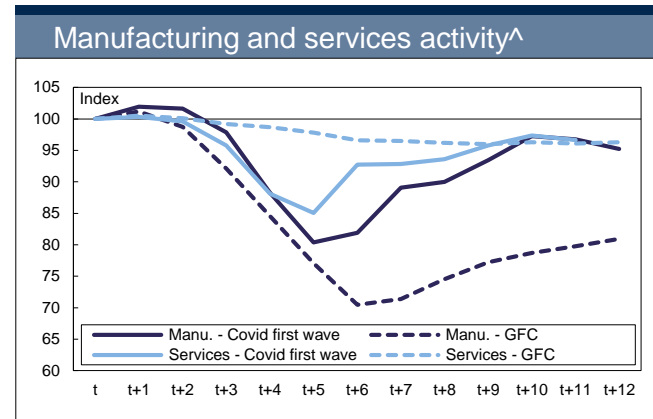
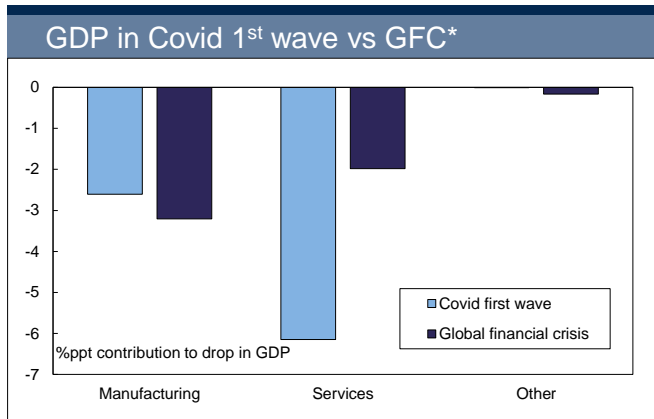
Japan's GDP rose 5.3%Q/Q in Q3, but still 4% below end-19



* Daiwa forecasts for Q4 for Euro area, UK, Japan, Australia & NZ. for Source: Refinitiv, Bloomberg, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- After slumping 8.3%Q/Q in Q220 during the first wave of the pandemic, Japan's GDP rebounded 5.3%Q/Q in Q320, led by a partial recovery in consumer spending and exports. This left output almost 4% below where it had started the year – not dissimilar to the experience of the US, the euro area and Australia.

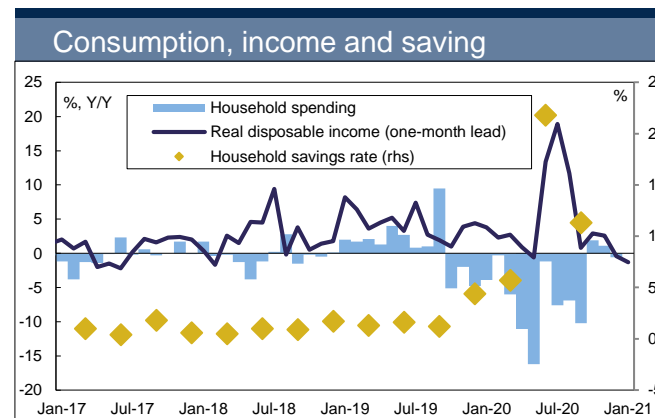
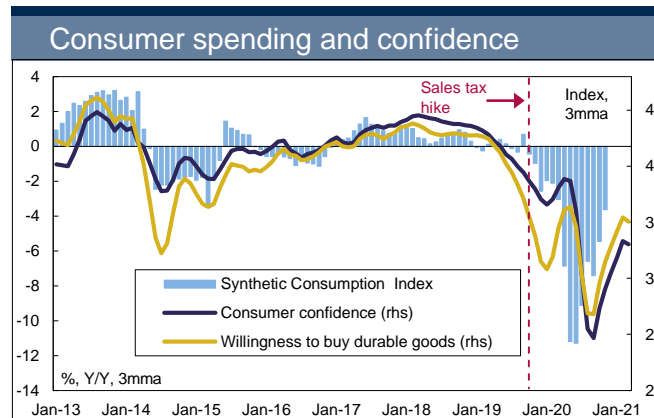
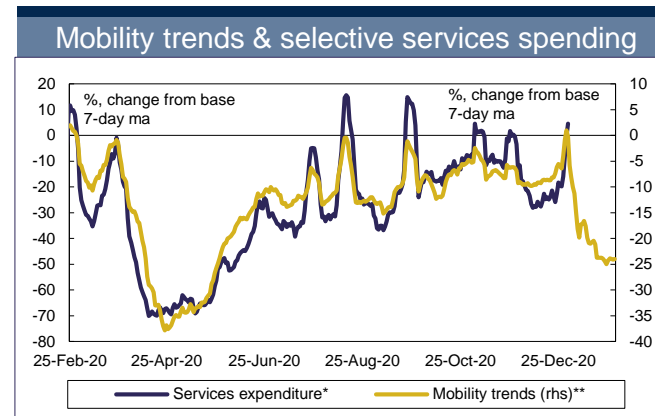
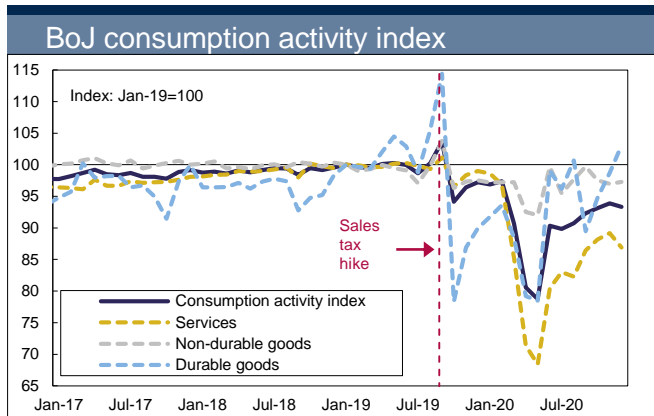
Comparing the pandemic to the GFC



*Period of Covid first wave is defined as Q419 to Q220, period of GFC is defined as Q308 to Q209, ^t = December 2019 for Covid first wave and August 2008 for GFC.
Source: Refinitiv, Bloomberg, METI, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Whereas manufacturing activity was hit much harder by the GFC than was the service sector, the pandemic has had a similar impact on both sectors, at much greater cost to the economy given the much greater weight of services in overall activity. The TOPIX and yen were affected much more by the GFC.

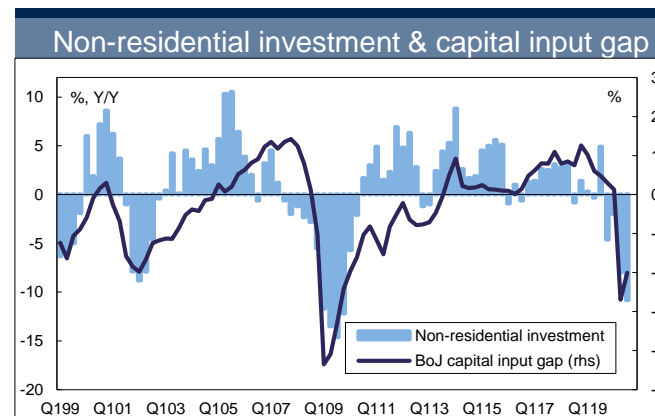
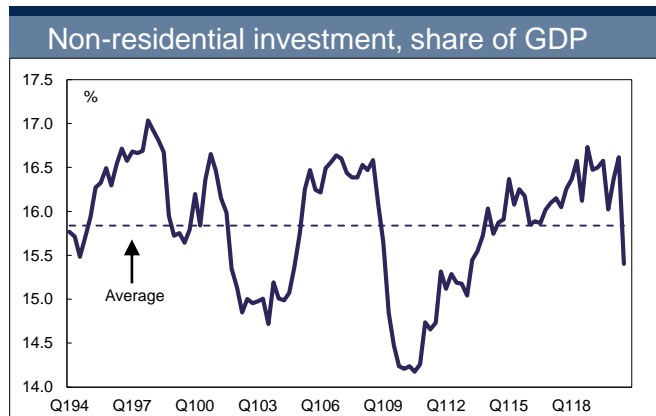
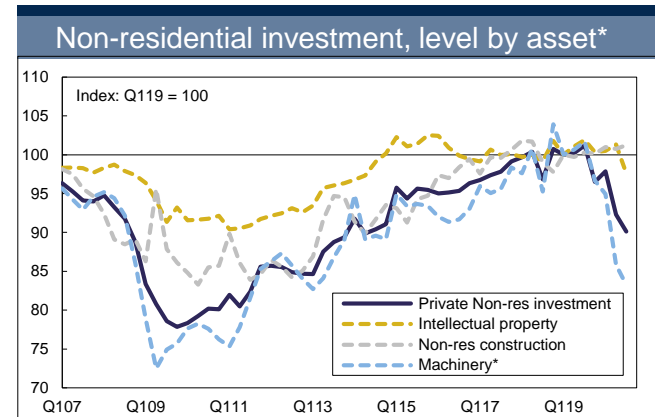
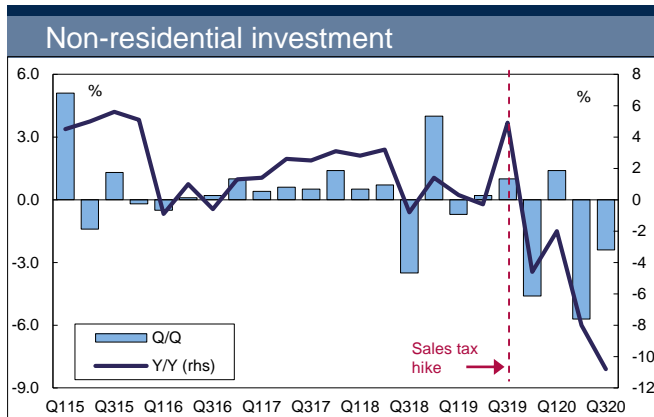
Consumer spending on services likely weakening again



*Expenditure on public transport, accommodation, meals out and other entertainment services. **Travel for retail and recreation. The base is the median of the corresponding day of the week during period 3 Jan – 6 Feb 2020.
Source: Refinitiv, Bloomberg, Cabinet Office, BoJ, MIC, Google mobility report, Japan's Ministry of Internal Affairs and Daiwa Capital Markets Europe Ltd.

- While spending on durable goods has rebounded sharply, spending on clothing and other personal items remains weak and services demand is weakening again from well below pre-pandemic levels. Many households saved cash pay-outs from the government given low confidence and uncertainty.

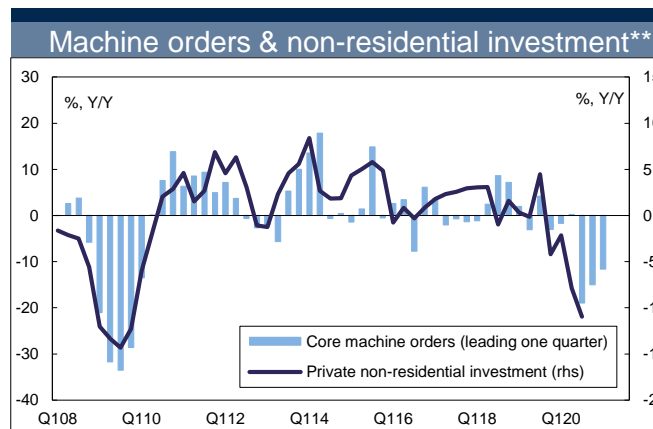
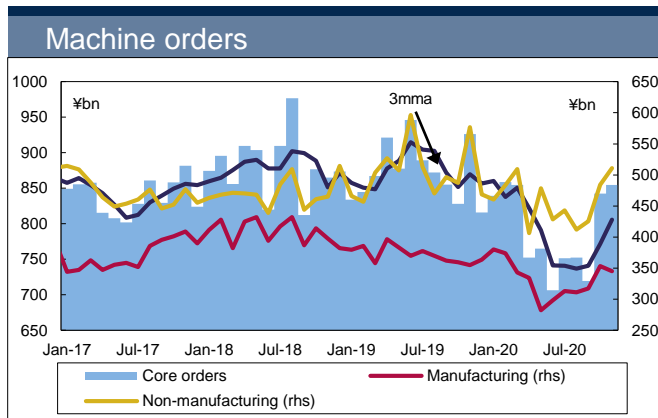
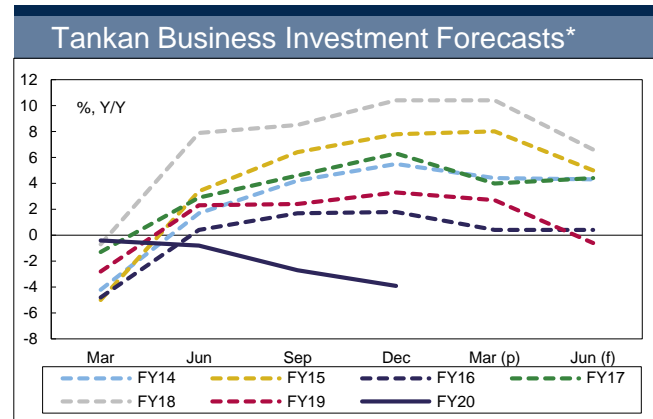
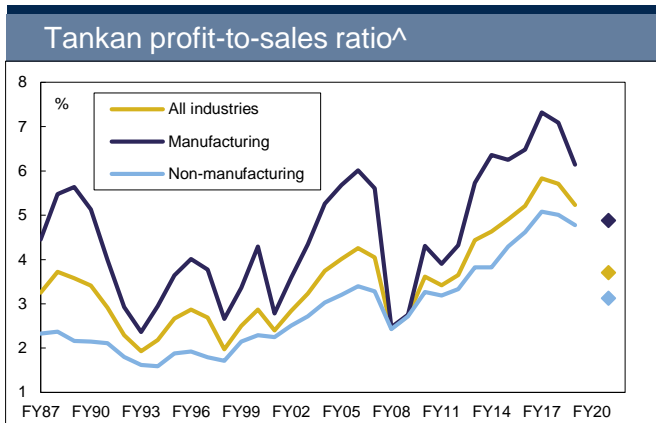
Business investment continued to fall in Q3



*Machinery includes transport equipment. Source: Refinitiv, Bloomberg, Cabinet Office, BoJ and Daiwa Capital Markets Europe Ltd.

- Business investment, already off its peak after the consumption tax hike, immediately weakened further once the pandemic began. The decline was driven by spending on machinery and equipment, which fell sharply, whereas spending on intellectual property fell modestly and non-residential construction has remained steady.

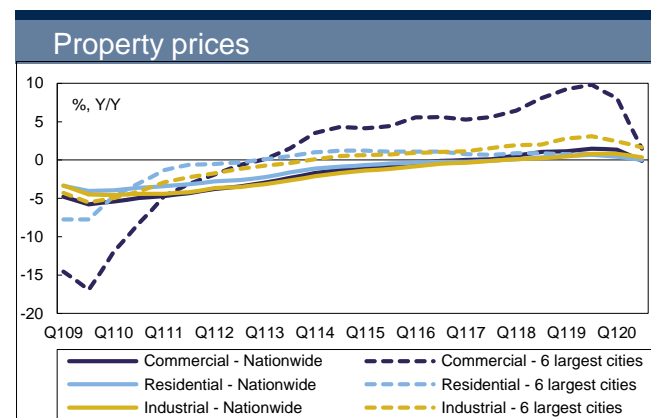
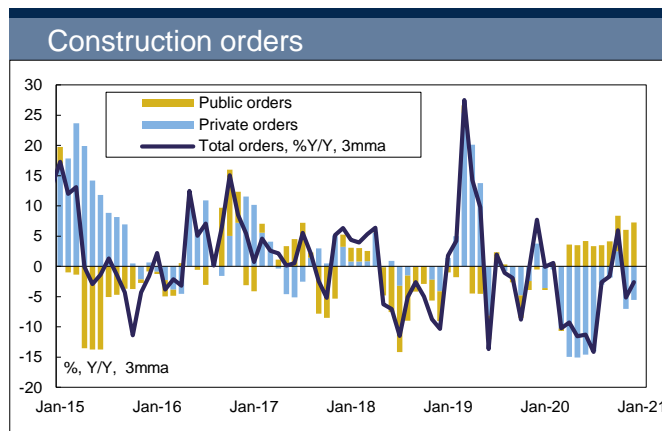
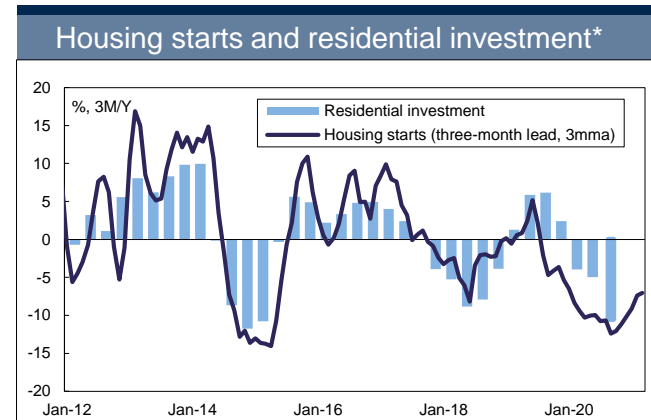
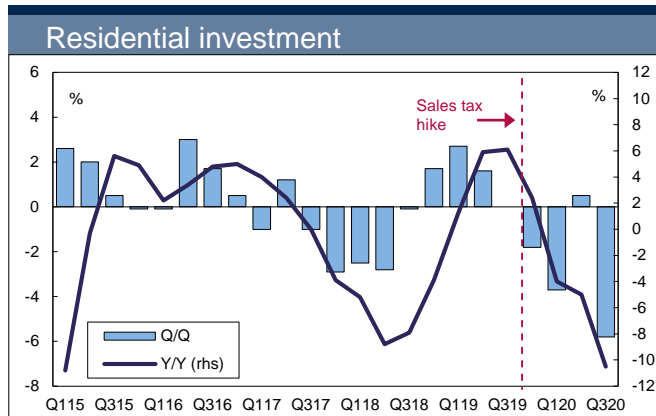
Signs that business capex has hit its low point, however



[^]All firms, diamonds represent latest forecast for FY20, ^{*}All firms, fiscal year, fixed investment including land. ^{**} Includes Daiwa estimate for Dec 20 orders.
Source: Refinitiv, Bloomberg, Cabinet Office, BoJ, and Daiwa Capital Markets Europe Ltd.

- Firms responding to the BoJ's Q4 Tankan survey forecast a 3.9%Y/Y decline in business capex in FY20 – a modest fall considering the decline in profitability. Given the fall in capex over the first half of the year, this suggests that spending has already troughed, as perhaps indicated by the recent lift in machine orders.

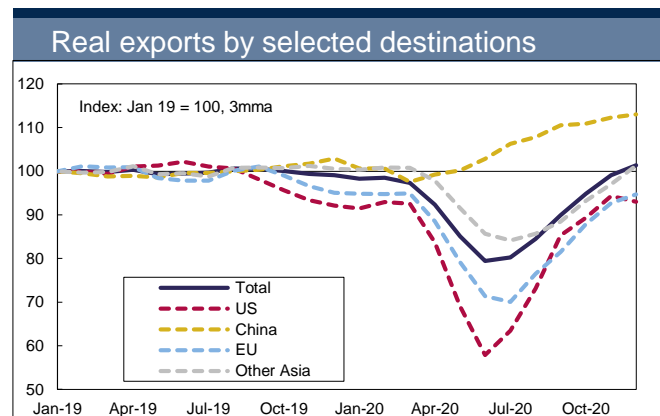
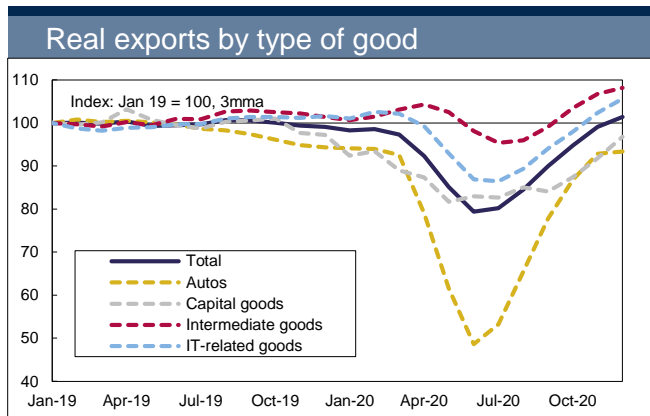
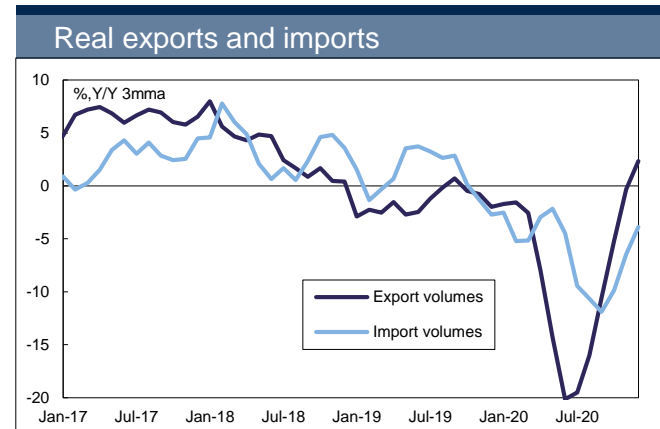
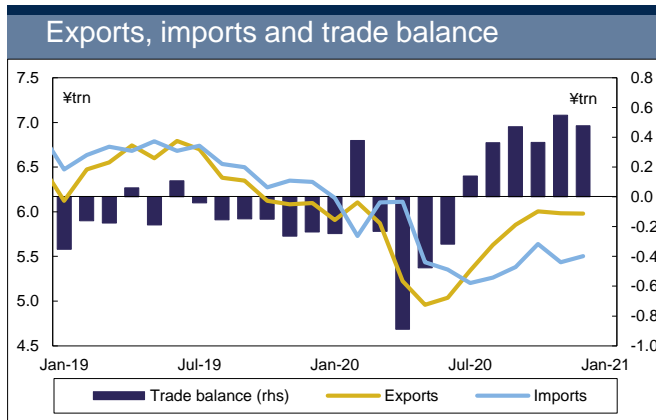
Residential building has continued to decline



*Housing starts advanced 3 months. Source: Refinitiv, Bloomberg, Cabinet Office, MLIT and Daiwa Capital Markets Europe Ltd.

- Residential investment declined after the 2019 consumption tax hike. Initially the onset of the pandemic imparted only marginal additional weakness, but homebuilding fell sharply in Q3 and housing starts hit an 8-year low in December. Unsurprisingly, property prices have begun to weaken too.

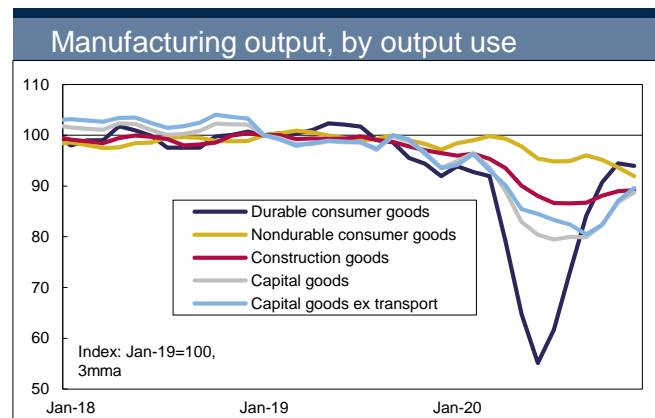
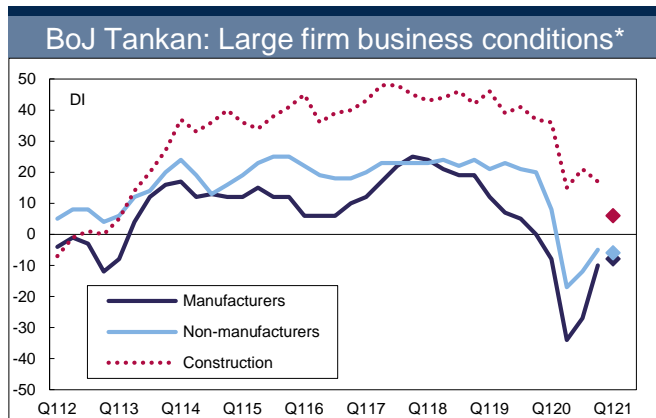
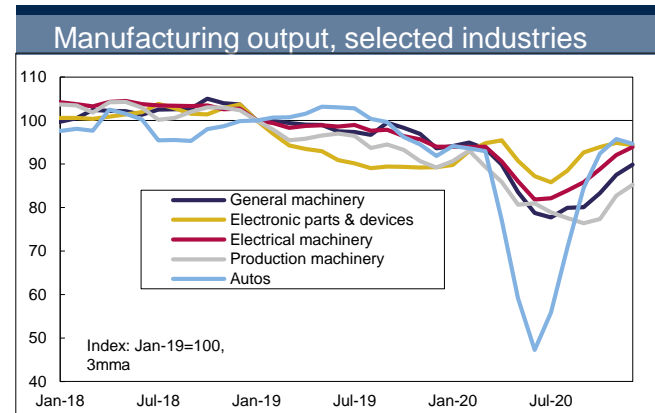
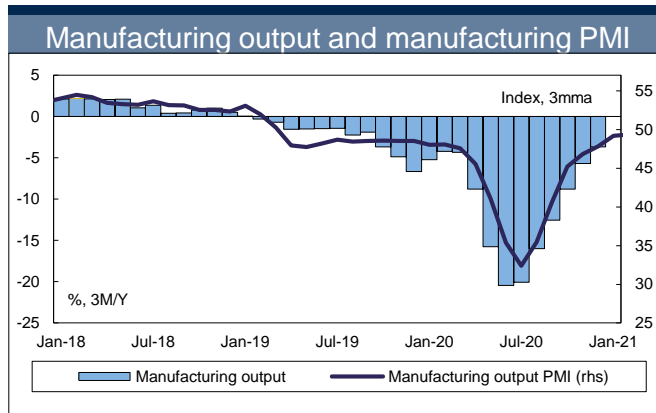
Goods exports have recovered, particularly thanks to China



Source: Refinitiv, BoJ, MoF and Daiwa Capital Markets Europe Ltd.

- The volume of exports fell by about one quarter over the first three months of the pandemic, led by a halving of auto exports. However, exports have since recovered with the BoJ's real export series surpassing pre-pandemic levels in Q4, with strong demand from China making up for weak demand from Europe.

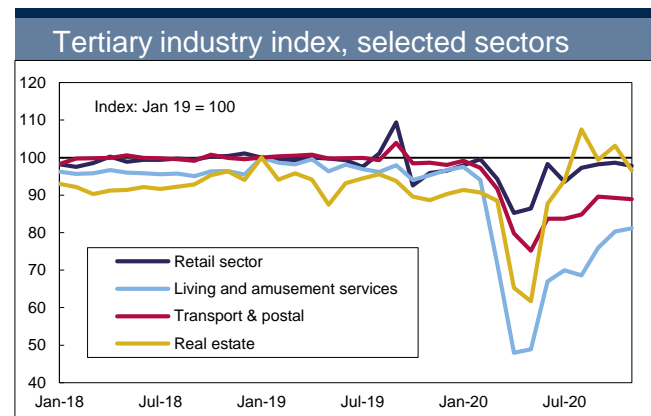
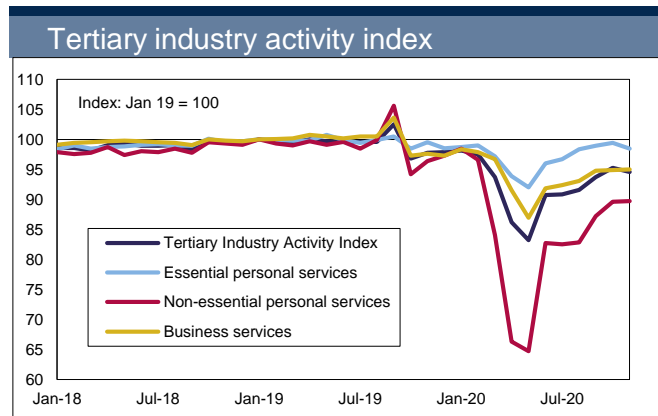
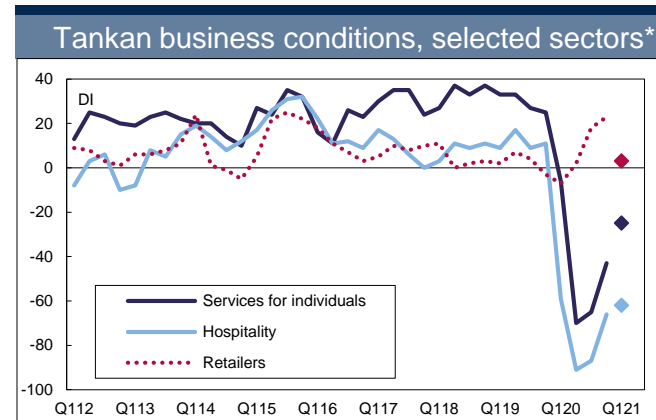
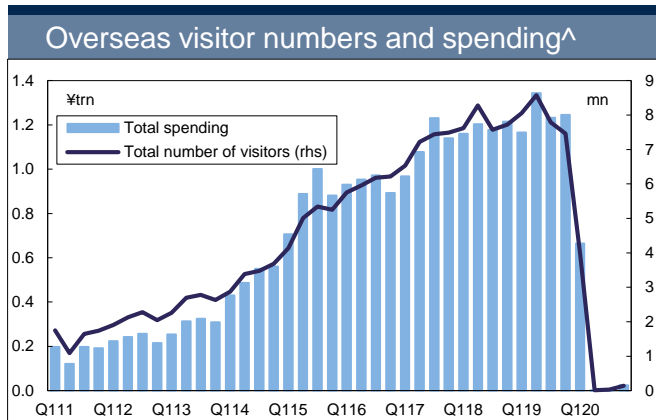
Manufacturing has benefitted from the rebound in exports



* Diamonds represent forecast index. Source: Refinitiv, Markit IHS, METI, BoJ and Daiwa Capital Markets Europe Ltd.

- The recovery in exports has been paralleled in the manufacturing sector, with output rebounding over 8%Q/Q in Q3 and a further 6%Q/Q in Q4, albeit remaining below pre-pandemic levels. Some loss of momentum was observed at the end of last year, so survey data will be important to monitor over coming months.

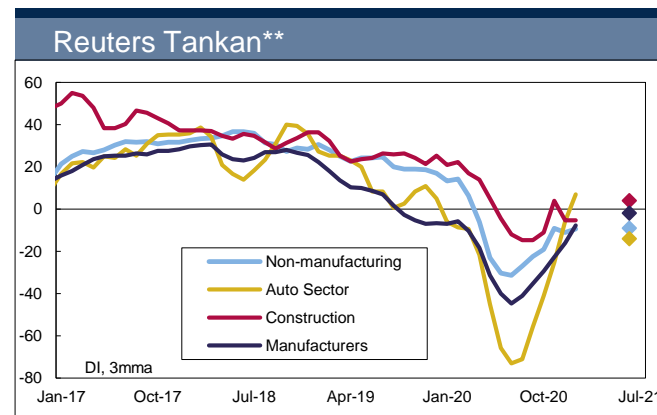
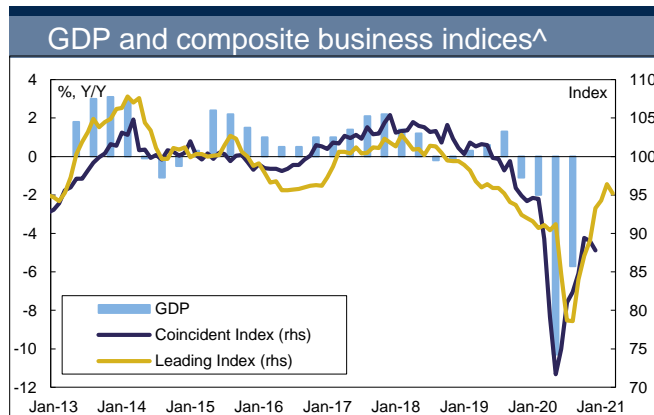
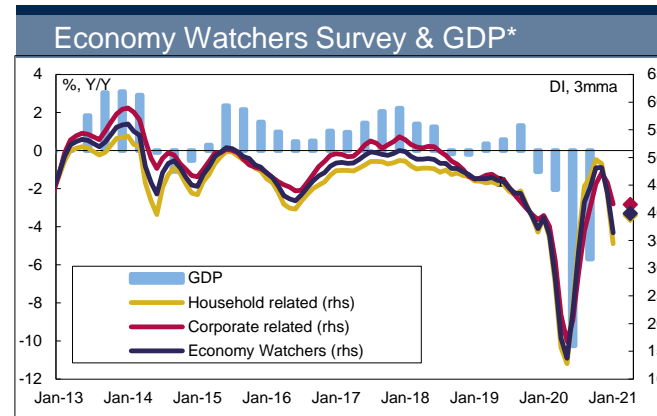
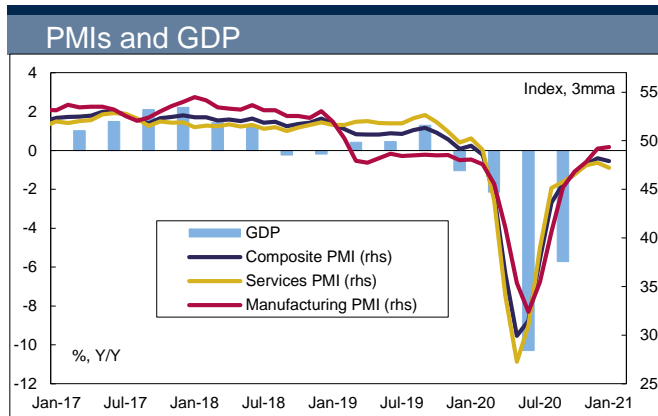
The halt to tourism continues to weigh on the service sector



[^]Average spending per visitor from Q220 onward is assumed to be same as Q120 due to survey cancellation. ^{*}Large enterprises. Diamonds represent survey forecast for Q121.
Source: Refinitiv, JNTO, JNTA, BoJ, METI and Daiwa Capital Markets Europe Ltd.

- With the border still largely closed, the number of overseas visitors to Japan remained down almost 98%Y/Y in December, decimating an industry that had been contributing ¥5trn to the economy each year. Despite government initiatives, the hospitality sector remains very pessimistic about the outlook.

Some sentiment and activity indicators have softened of late



* Diamonds are latest readings for the outlook index. ^Leading index has three-month lead. **Diamonds represent latest reading of forecast index. Source: Refinitiv, IHS Markit, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- A substantial rebound in key sentiment indices from their Q2 lows was interrupted late last year as increasing coronavirus infections led to the re-imposition of restrictions on activity. These indicators are likely to soften further in the near term at least, consistent with the likelihood of a modest contraction of activity in Q1.

We expect it will take at least two years to recover the GDP loss suffered in FY20

GDP growth forecast*				
YY growth	FY19	FY20	FY21	FY22
Private consumption	-0.9	-6.7	2.4	3.1
Private residential investment	2.5	-7.0	0.4	-0.9
Private non-residential investment	-0.6	-8.0	2.6	3.2
Public consumption	2.0	2.5	1.5	1.4
Public investment	1.5	3.3	1.0	2.2
Exports	-2.6	-12.9	9.8	4.9
Imports	-1.1	-7.0	2.5	3.6
GDP growth, %, YY	-0.3	-5.5	3.2	2.7
BoJ GDP growth forecast (October)	-	-5.6	3.9	1.8

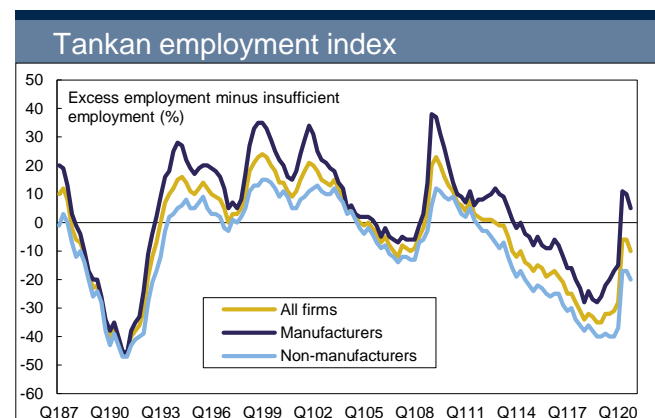
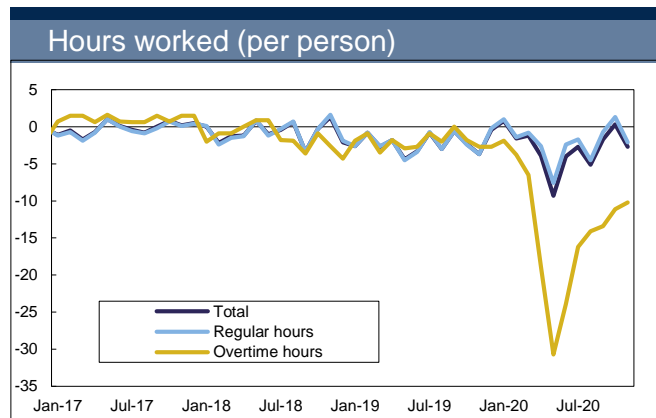
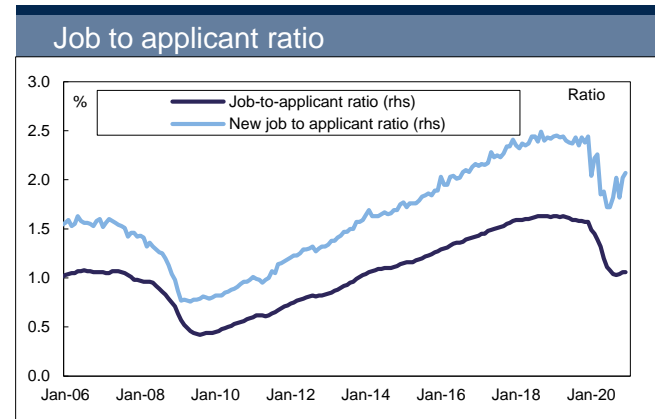
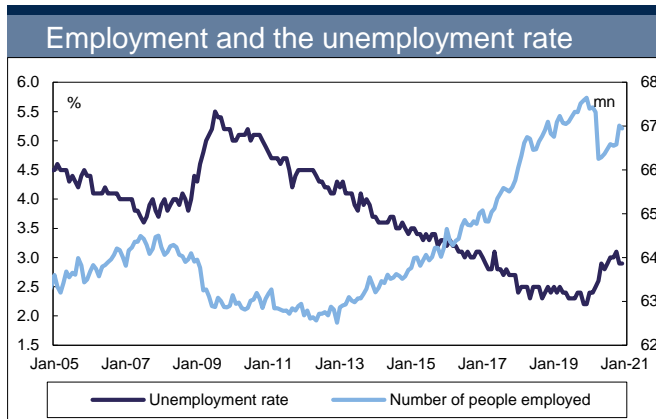
*Figures may not sum due to rounding. Source: Cabinet Office and DIR



*Dashed line represents forecast. Source: Cabinet Office, Refinitiv and Daiwa Capital Markets Europe Ltd.

- We expect the contraction in FY20 to be about as deep as the BoJ envisaged in its January Outlook Report.
- Looking further ahead, our forecast for growth in FY21 is weaker than the BoJ's forecast, with more of the recovery likely to be delayed until FY22.
- While growth is set to be well above potential this year and next, at this stage it is likely to be sometime in 2023 before Japan will recapture the level of GDP seen prior to the consumption tax hike and pandemic.

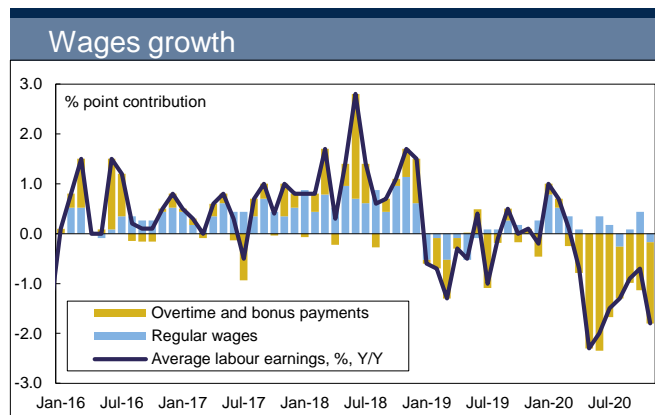
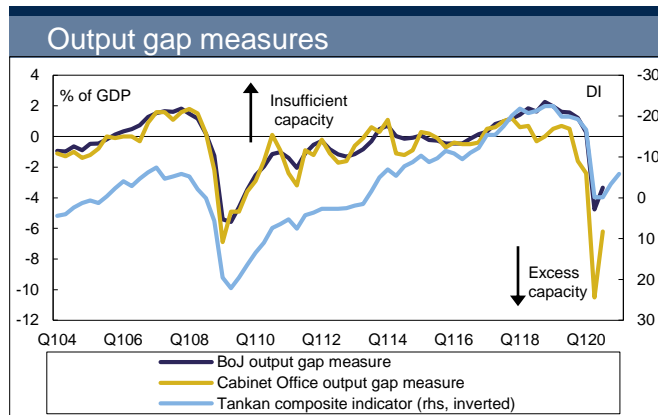
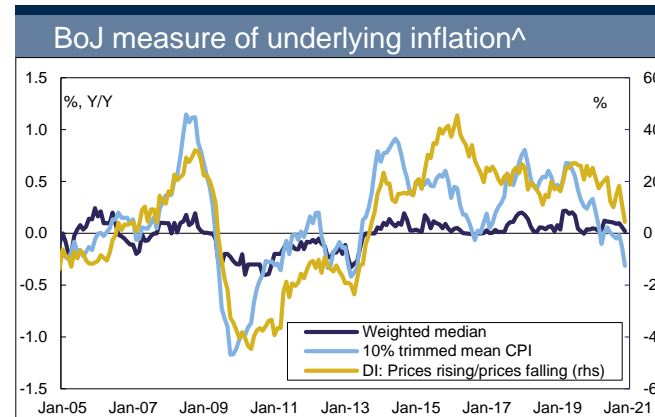
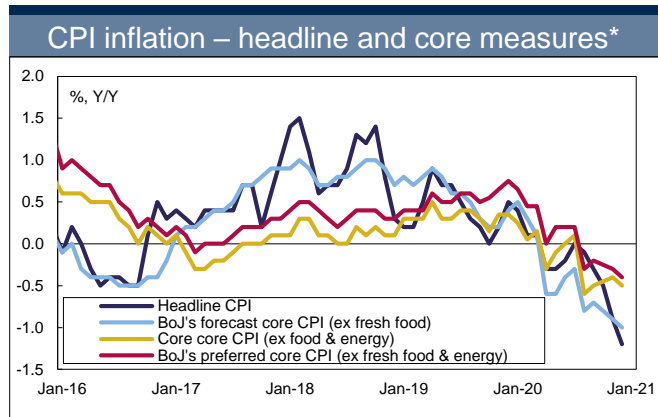
Japan's labour market has shown resilience



Source: Refinitiv, MIC, MHLW, BoJ and Daiwa Capital Markets Europe Ltd.

- Household employment fell at the onset of the pandemic but has recovered about half of those losses since. As a result, the unemployment rate ended last year at 2.9% - up just 0.7ppts from a year earlier. Firms' reduced demand for labour remains manifest mostly in sharp reduction in over-time hours worked.

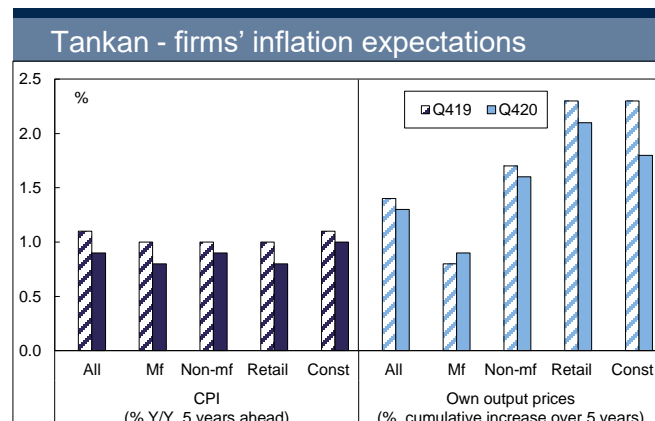
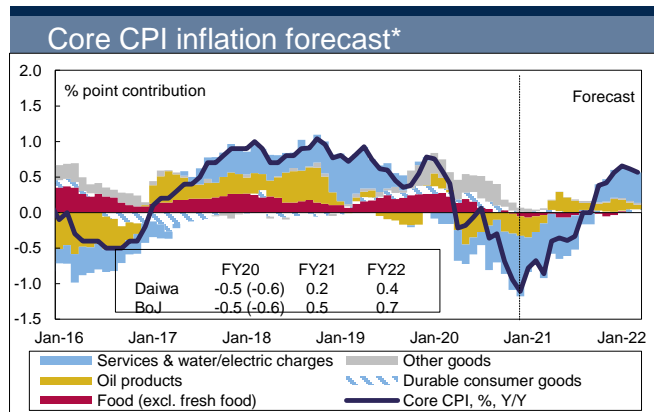
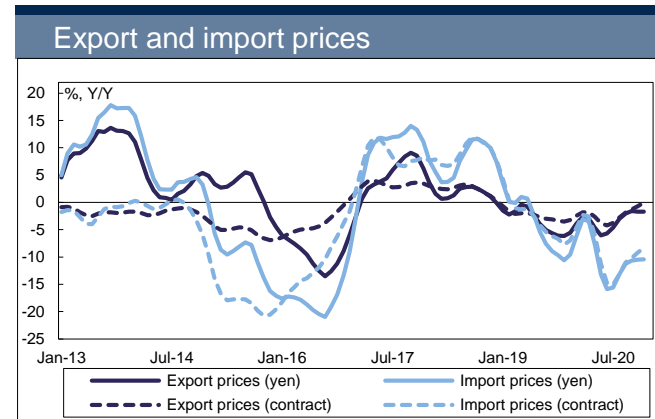
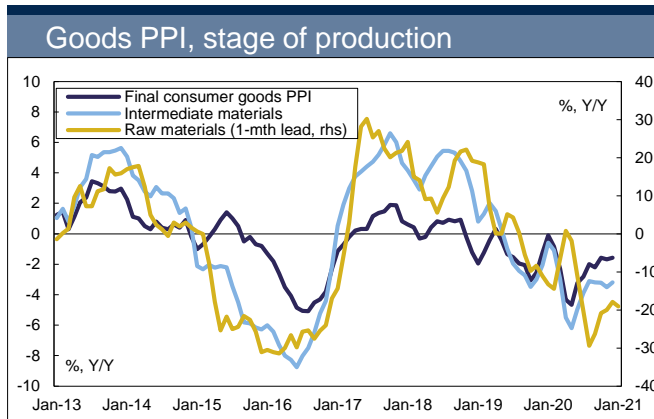
The pandemic and policy reaction has weakened inflation



* Excluding impact of changes in consumption tax. ^Excludes impact of changes in the consumption tax and government policy changes to education fees. Source: Refinitiv, MIC, BoJ, Cabinet Office, MHLW and Daiwa Capital Markets Europe Ltd.

- Excluding the impact of last year's consumption tax hike, inflation was very weak even prior to the pandemic, albeit much improved from the pre-Abenomics era. The BoJ's preferred measure fell to a more than 7-year low reflecting weak demand, lower energy prices and government policy measures to support the economy.

Inflation is likely to remain low for the foreseeable future



* Figures in brackets exclude consumption tax hike and free education policies. Source: Refinitiv, BoJ, MIC, and Daiwa Capital Markets Europe Ltd.

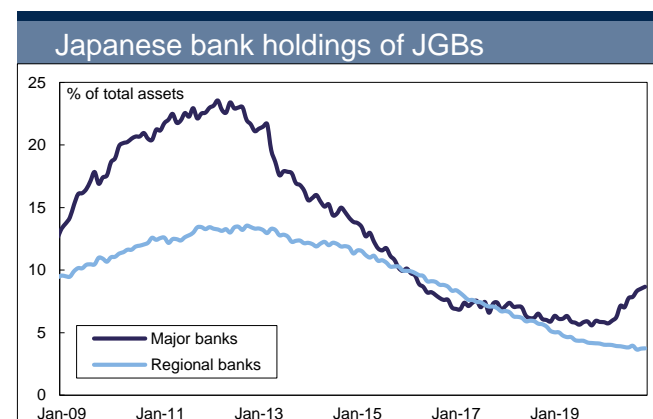
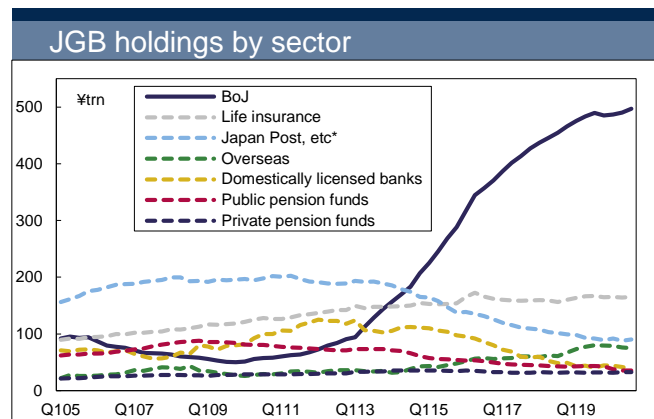
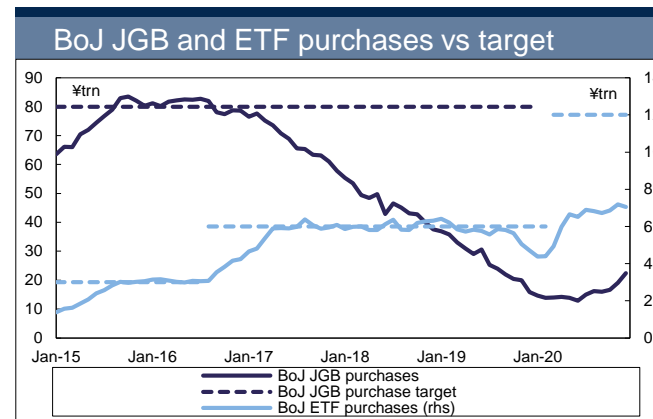
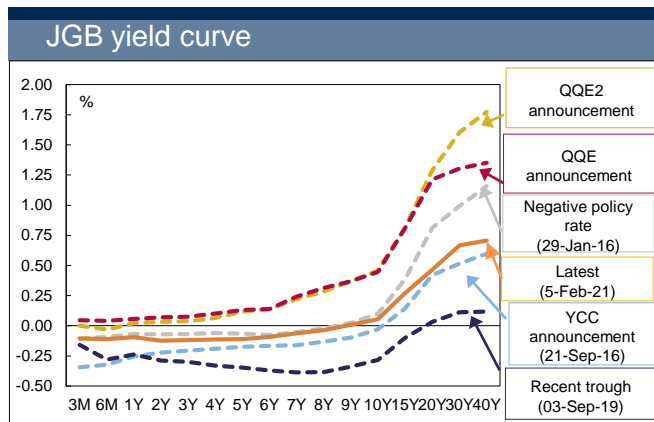
- The suspension of the Government's hospitality subsidies will help lift inflation in the near term. However, inflation is likely to remain well below the BoJ's 2% target in the medium term given the setback to the economy and inflation expectations caused by the pandemic.

Current BoJ Monetary Policy Framework

Yield Curve Control	QQE	Loan facilities
<ul style="list-style-type: none"> ■ Negative policy rate (-0.1%) on marginal excess reserves ■ 10Y yield target of 'around zero per cent' - although yields may now move upward and downward (+/-0.2%) to some extent, mainly depending on developments in economic activity and prices ■ JGBs with a wide range of maturities eligible for purchase, but no guideline for the average maturity ■ JGB purchases under fixed-rate operations to achieve yield target 	<ul style="list-style-type: none"> ■ JGBs will be purchased at an unlimited pace to achieve target for 10Y JGB yield ■ BoJ ETF holdings to increase at an annual rate of about ¥6trn with an upper limit of ¥12trn ■ BoJ J-REIT holdings to increase at an annual rate of about ¥90bn with an upper limit of ¥180bn ■ BoJ will raise holdings of CP and corporate bonds by an additional ¥15trn until September 2021, with the split depending on market conditions. Aside from the additional purchases, amounts of CP and corporate bonds outstanding will be maintained at about ¥2.0trn and ¥3.0trn respectively 	<ul style="list-style-type: none"> ■ 'Stimulating bank lending' facility, 'Growth-supporting funding' facility, and special facility for banks located in earthquake affected areas, all offering loans at zero per cent interest rate ■ Up to ¥110trn 'Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus' facility, providing 0% loans to financial institutions that make loans. Facility available until end-September 2021
<ul style="list-style-type: none"> ■ Inflation over-shooting commitment: The BoJ commits itself to expanding the monetary base until inflation exceeds 2%Y/Y and stays above 2%Y/Y in a stable manner 		

Source: BoJ and Daiwa Capital Markets Europe Ltd.

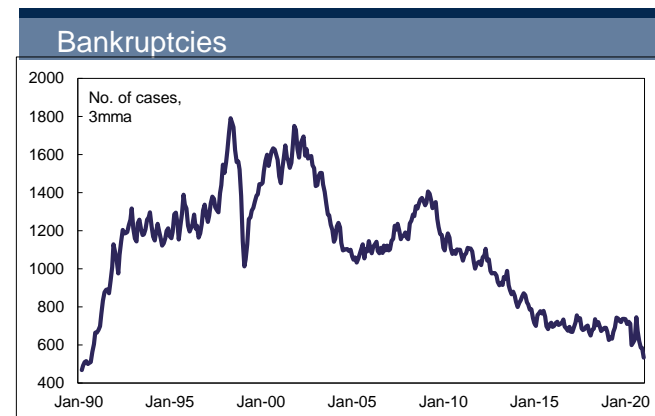
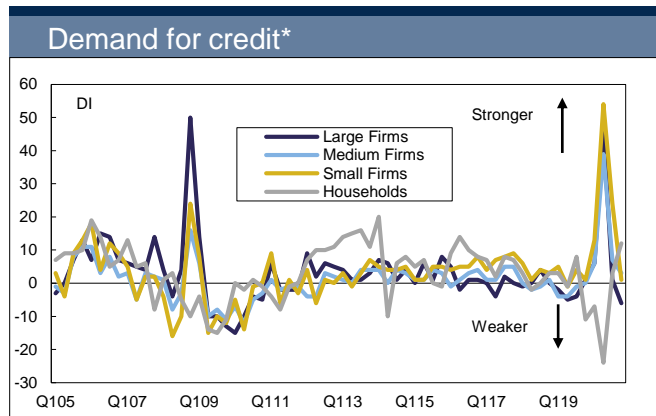
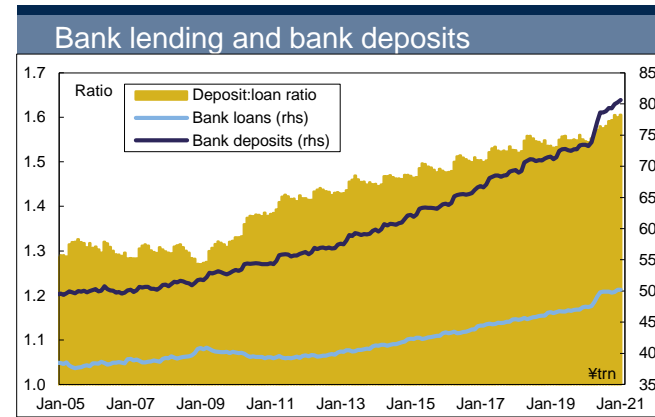
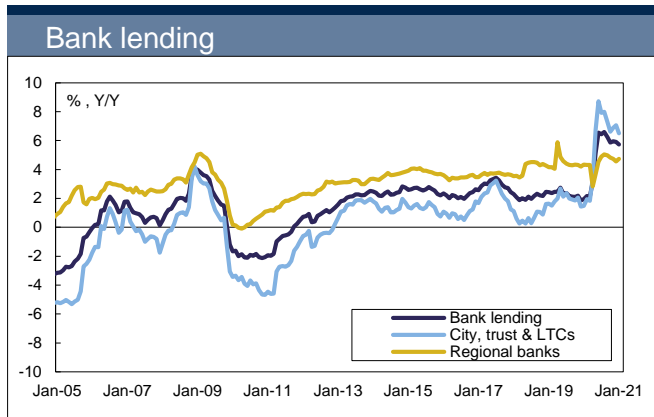
The BoJ's asset purchases remain well below policy caps



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

- While the BoJ's rinban purchases picked up as part of its pandemic response, purchases in 2020 amounted to ¥22trn – a quarter of the earlier peak. Likewise, while the BoJ's ETF purchases have picked up, they are tracking only slightly above the pre-pandemic target of ¥6trn.

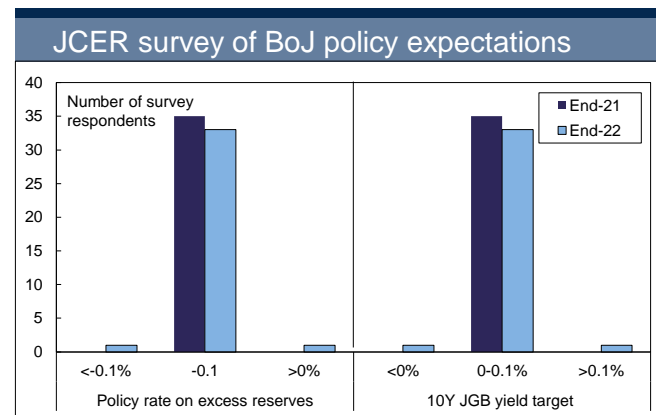
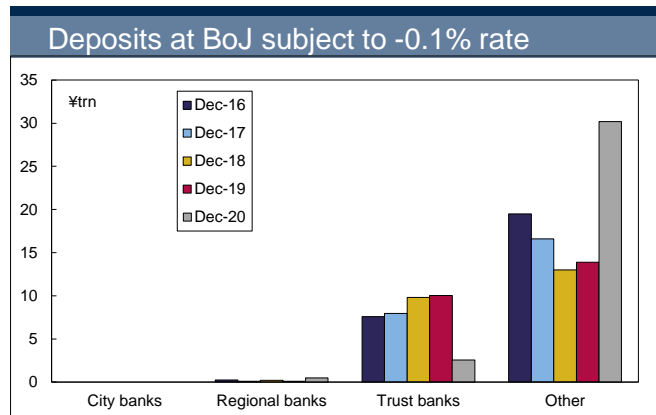
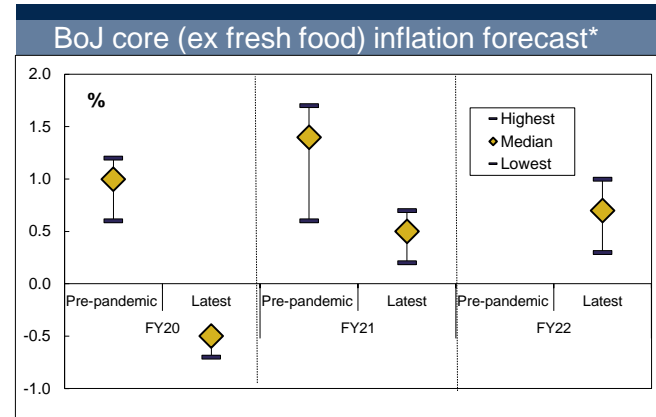
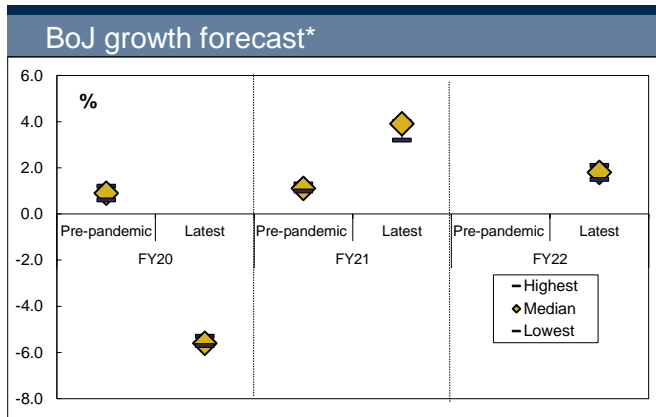
Japan's banking sector continues to play a stabilizing role



*BoJ Senior Loan Officer Survey. Source: Refinitiv, BoJ, Bloomberg and Daiwa Capital Markets Europe Ltd.

- While household demand for credit fell, firms scrambled to secure liquidity at the onset of the pandemic. To meet that demand, banks loosened their credit standards, supported by government guarantees. Corporate bankruptcies fell to a 30-year low. Credit demand began to normalise in Q3 with fewer banks easing credit conditions.

Even a pandemic hasn't been enough to encourage further BoJ rate cuts, despite a poor inflation outlook



*Pre-pandemic refers to the BoJ's January 2020 forecast. Source: BoJ, Bloomberg, JCER and Daiwa Capital Markets Europe Ltd.

- As a result of the pandemic, even the most optimistic BoJ Board member expects inflation to remain at just half of the 2% target by FY22 and so most local forecasters see no scope for tighter policy settings. Equally, almost nobody expects a further lowering of the Bank's yield targets despite the weak outlook.

BoJ monetary policy review – potential changes

- On 18 December, the BoJ announced it would conduct an “Assessment for Further Effective and Sustainable Monetary Easing to Achieve the Price Stability Target of 2%”.
- The Bank made clear that there is no need to change the basic framework of “QQE with Yield Curve Control”, which it believes to be working well.
- The findings of the review are expected to be released on 19 March. The Bank will be wary of making large changes and anxious that any additional flexibility not be interpreted as a step towards policy normalization.

Yield Curve Control	QQE	Loan facilities
<ul style="list-style-type: none"> ■ The Bank could decide to amend (e.g. widen) the (+/-0.2%) range within which the 10Y yield is allowed to fluctuate. ■ To offset any tendency for yields to move higher in the near term, the Bank could attempt to strengthen its forward guidance to make clear that policy target rates will not be raised for an extended period. 	<ul style="list-style-type: none"> ■ Given the impact of JGB and ETF purchases on liquidity and market functioning, the bank may decide to slow their purchase rates ■ The Bank could decide to remove numerical targets for ETF purchases – as is currently the case for JGB purchases – and simply purchase on an as-needed basis 	<ul style="list-style-type: none"> ■ No changes likely
<ul style="list-style-type: none"> ■ We expect no change to the cash or 10Y yield policy rates or to the broad target of monetary policy i.e. the BoJ will remain committed to expanding the monetary base until inflation exceeds 2%Y/Y and stays above 2%Y/Y in a stable manner 		

Source: Daiwa Capital Markets Europe Ltd.

The Government extended its fiscal support with the 3rd supplementary FY20 budget announced on 8 December

Key direct Government economic measures announced at beginning of pandemic:

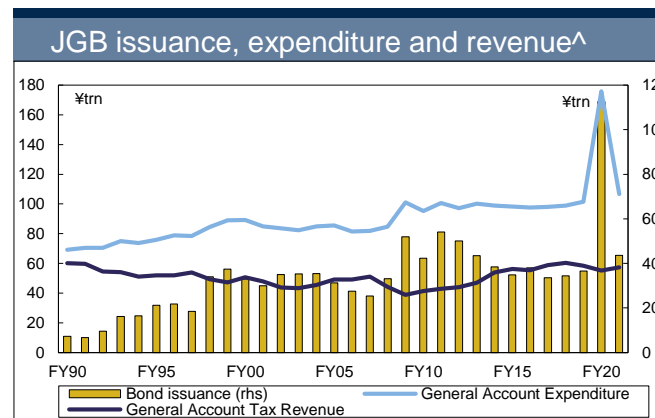
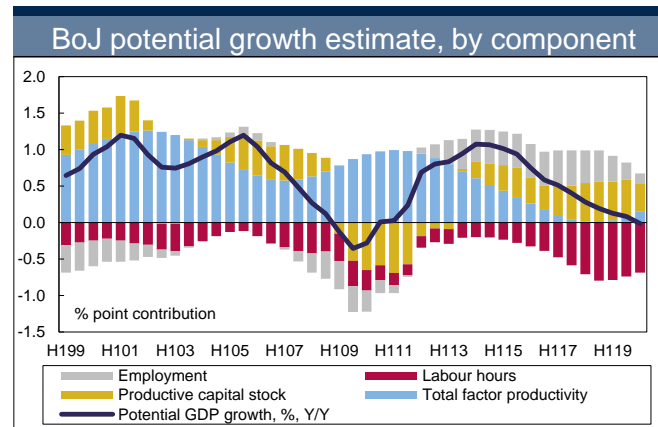
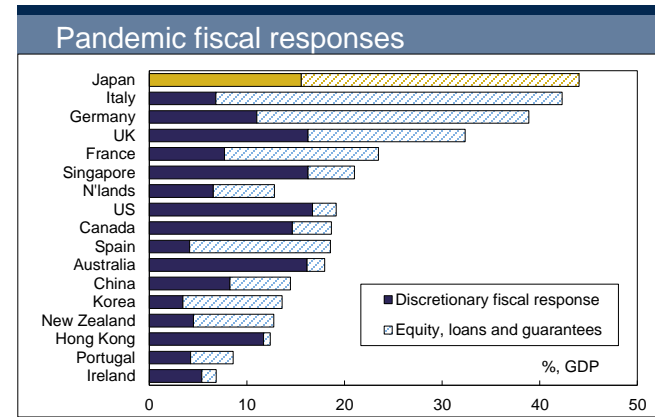
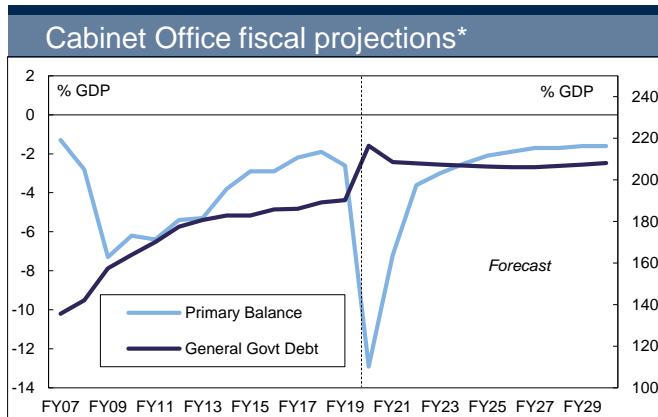
- ¥5.1trn (1.0% of GDP) on health-related spending, including transfers to local government.
- ¥54.4trn (10.1% of GDP) of additional non-health spending, including cash handouts to individuals and SMEs, significant subsidies for financial institutions' lending, incentives to accelerate recovery in the service sector and to boost infrastructure investment, and transfers to local government.
- ¥26.2trn (4.8% of GDP) to fund the 1-year deferral of tax revenue and social security premiums by affected firms and households.
- ¥15.7trn (2.9% of GDP) of guarantees offered on bonds/borrowing made by the Development Bank of Japan and Japan Finance Corporation, amongst others.
- ¥109trn (20.3% of GDP) of quasi-fiscal operations, mostly concessional loans/guarantees to affected firms through public and private financial institutions.

Additional Government support following 3rd Supplementary Budget announced 8 December:

- ¥4.5trn (0.8% of GDP) on health-related spending, including transfers to local government.
- ¥19.6trn (3.7% of GDP) of additional non-health spending, subsidies for financial institutions' lending, incentives to accelerate business restructuring and investment in green technology and transfers to local government.
- ¥27.7trn (5.2% of GDP) of additional quasi-fiscal operations, mostly concessional loans/guarantees to affected firms through public and private financial institutions.

Source: MoF, IMF and Daiwa Capital Markets Europe Ltd.

The pandemic has further weakened the public finances, which are also compromised by weak potential growth

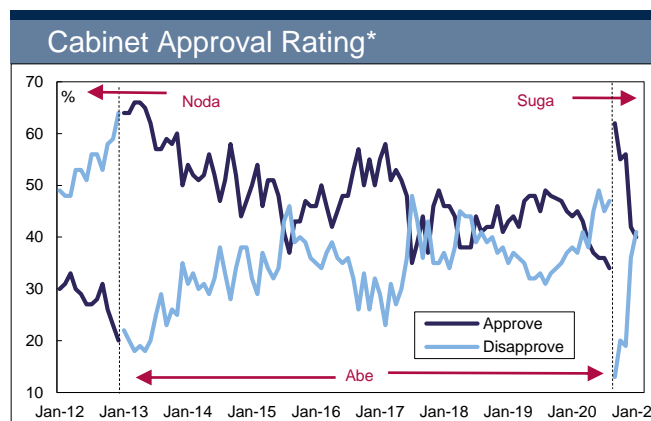


* Projection made in January 2021, baseline case. ^Includes forecast for FY20 and FY21; Source: Cabinet Office, BoJ, MoF, IMF and Daiwa Capital Markets Europe

- The government responded to the pandemic with one of the largest fiscal packages of all countries, setting back efforts to strengthen the public finances. Optimistically, the Cabinet Office forecasts the primary deficit to fall to around 1.6% of GDP in FY30. General government debt is forecast to remain well above 200% of GDP.

Vaccinations, Olympics and elections in focus in 2021

Key dates in 2021	
Jan	Feb Vaccinations of 3.7mn healthcare workers to start late in the month?
Mar 7 th State of emergency in 10 prefectures scheduled to end 19 th BoJ Meeting & publication of findings of monetary policy review 31 st : Deadline to enact FY21 budget	Apr 27 th : BoJ Meeting and Outlook Report Vaccinations of 36mn people aged over 65 years to start?
May	Jun 18 th : BoJ Meeting
Jul 23 rd : Olympics opening ceremony 16 th : BoJ Meeting and Outlook Report Tokyo Assembly election by 22 nd Vaccinations of under 65s to start?	Aug 8 th : Olympics closing ceremony 24 th : Paralympics opening ceremony
Sep LDP Presidential election due no later than 30 th September 5 th : Paralympics closing ceremony 22 nd : BoJ Meeting Digital policy agency: launch target	Oct Lower house election required on or before 21st October 28 th BoJ Meeting and Outlook Report
Nov	Dec 17 th BoJ Meeting



NHK Political Party Support*

Party name	%
Liberal Democratic Party	37.8
Constitutional Democratic Party	6.6
Komeito	3.0
Japan Restoration Party	1.1
Communist Party	2.9
Democratic Party for the People	0.5
Social Democratic Party	0.5
Reiwa Shinsengumi	0.5
Other political organizations	40.5

* Latest poll is January 2021; Source: NHK and Daiwa Capital Markets Europe

- A new Lower House election is scheduled for October this year. While the LDP will most likely win this, it remains to be seen whether current PM Suga is still the head of the party when the election is held, given sliding approval ratings due to dissatisfaction with the handling of the latest surge in coronavirus cases.

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