Daiwa Securities

Daiwa's View

Lost momentum; the role of gov't and BOJ

➢ Thoughts on gov't and BOJ response based on March Tankan

Fixed Income Research Section
FICC Research Dept.

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp

Daiwa Securities Co. Ltd.

Lost momentum; the role of gov't and BOJ

March Tankan, the first data of new fiscal year, is suggestive in many ways, despite being past data

The new fiscal year in Japan has started amid the ongoing COVID-19 outbreak. The first announcement of economic data in the new fiscal year is always the BOJ's March Tankan survey. The base date for survey responses was 11 March, and the response rate was around 70%. Therefore, respondents have not fully factored in the subsequent spread of the virus and lockdowns in Europe and the US or the partial suspension of operations at automakers' plants starting April. In a situation like this in which circumstances are changing from one moment to the next, this is past data. However, although it is impossible to make fully informed decisions based on the Tankan alone, it is suggestive in many ways. It always has a 99.0% response rate, on a nationwide company basis, which is extremely high compared to statistics from public agencies, and it gives us an idea of the efforts being made by BOJ staff.

Business conditions DI of large manufacturers lowest in seven years

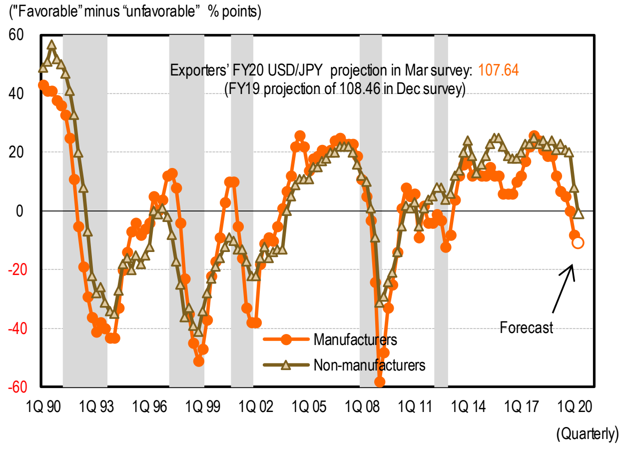
Deterioration in auto and electric machinery not so large

Weakness in Europe and US not reflected

Underlying strength prevented rapid development of catastrophic situation

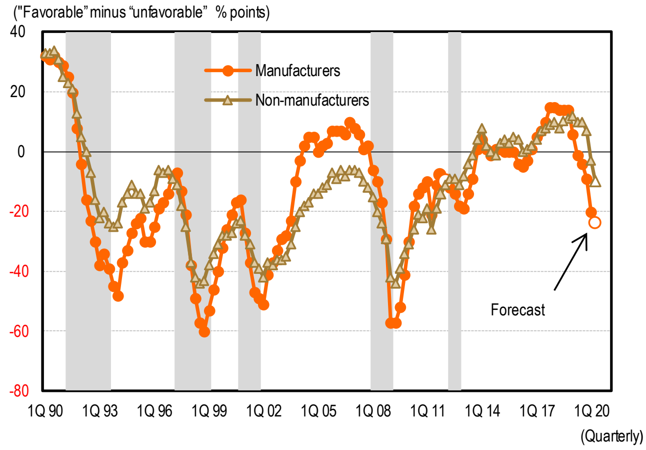
Firstly, the business conditions DI ("favorable" minus "unfavorable") of large manufacturers in the March survey worsened by eight points to -8 from the previous survey. The reading declined for the fifth consecutive quarter, falling into negative territory. That is the lowest level in seven years (Chart 1). Although the recovery had been on track to continue with a better employment and income environment under Abenomics, the reading has reverted to close to the starting point (-12 as of Dec 2012) due to the global COVID-19 outbreak. Based on the historical DI of the Indexes of Business Conditions, the economy appears to have peaked in October 2018 (or May 2019). Still, the degree of decline is smaller than that in past recession phases. By sector, the deterioration in motor vehicles (down 6pt) and electrical machinery (down 7pt), both of which have been affected by the disruption of supply chains due to the Wuhan quarantine, was not that substantial. Deterioration in overseas data for judging product supply/demand conditions was slight when only the weakness in China is factored in. It is therefore possible that it does not fully reflect weakness in Europe and the US. Although I am concerned about how much of a drop will be seen in the coming June survey, I feel the underlying strength of Japan's manufacturing industry is what has allowed it to avoid a catastrophic situation from developing in a short period of time.

Chart 1: Business Conditions DI Among Large Manufacturers in BOJ Tankan



Source: BOJ, Reuters; compiled by Daiwa Securities.

Chart 2: Business Conditions DI Among Large Non-manufacturers in BOJ Tankan



Source: BOJ, Reuters; compiled by Daiwa Securities.

Record-level deterioration in DI of large non-manufacturers

Gov't should implement rapid support measures for companies hurt by COVID-19 pandemic

On the other hand, the business conditions DI of large non-manufacturers was at +8, the lowest level since March 2012. It fell by 12 points, the biggest decline since December 2009 after the global financial crisis, reflecting the substantial impact of travel bans and weaker consumption due to people refraining from going outside (as well as there being fewer inbound tourists). The figure is expected to fall into negative territory to -1 (down 9 pt). Deterioration is unlikely to stop. The non-manufacturing sector had been maintaining the soundness of Japan's economy until last year, but it has now collapsed. The rapid plunge in this sector is one of the particular characteristics of this survey. By sector, the COVID-19 outbreak had a significant impact on accommodations, eating and drinking services (down 70 pt to -59, the lowest level since the start of this survey), services for individuals (down 31 pt), and transport & postal activities (down 24 pt, especially in aviation). The government took measures to prevent the spread of the virus at the risk of an economic slump. It should implement rapid support measures targeting companies in these sectors, which have been hit hard by the pandemic.

Forecast DI at small enterprises worsened more than large companies

Meanwhile, the business conditions DI at small enterprises continued to worsen. Specifically, manufacturers saw the actual DI decline to –15 (down 6pt from Dec), alongside a forecast DI of –29 (down 14pt). Non-manufacturers saw the actual DI worsen to -1 (down 8pt), with a forecast DI of -19 (down 18pt). Another characteristic of this survey is that the decline in the forecast DI of both small manufacturers and non-manufacturers is larger than that of large companies. Confronted with the suddenness of recent events, many companies appear to be facing severe financing conditions due to (1) suspended production caused by difficulty in procuring parts and (2) a plunge in sales owing to weaker inbound demand and a mood of self-restraint. In order to avoid the risk of bankruptcies, the government needs to decide on economic measures as quickly as possible, including financing measures for SMEs, frameworks for income compensation to secure employment, and cash handouts to low-income groups.

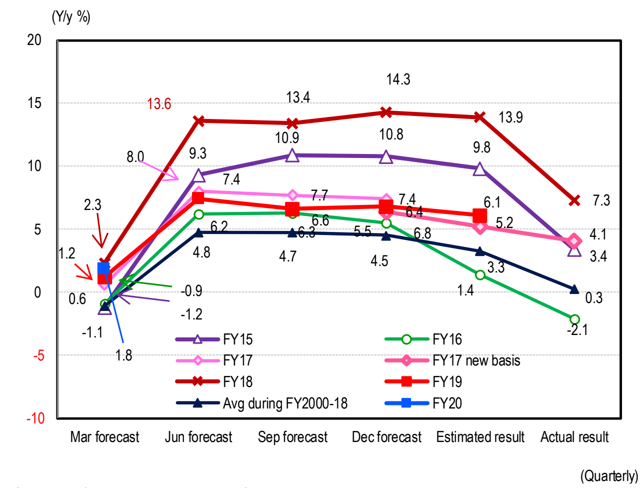
Respondents projecting forex rates were quite calm

Capex plans are unexpectedly solid amid contracting global economy

More detailed information to be confirmed by BOJ's Regional Economic Report on 9 Apr

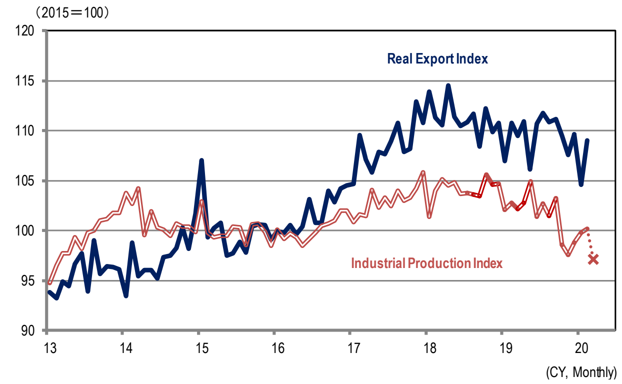
As for business plans, the average FY20 USD/JPY forex rate projected by exporters was Y107.64, in line with the actual rate. Respondents therefore appear to be quite calm. As for capex plans, which attract attention when confirming corporate activity, the FY19 plan among large companies (all industries, incl. land purchase costs) is forecast at +6.1% y/y (revision rate vs. Dec figure is -0.7%, Chart 3), higher than the market average estimate of around +4.0%. Amid the contraction of the drastically changing global economy, the extent of the downward revision was slight. In particular, the upward revision to software investment among large manufacturers is notable. At the beginning of FY20, large firms plan to increase capex by 1.8% y/y, unexpectedly maintaining solidness in comparison with the market average estimate of -1.1%. More detailed information will be confirmed when the BOJ's Regional Economic Report is released on 9 April. However, if the situation remains uncertain, companies will probably suddenly lean towards a cautious stance. On the other hand, the capex plan among small firms (all industries, incl. land purchase costs) is forecast at –0.3% (revision rate of +2.0%). Compared to past figures, the pace of the upward revision is fast. The figure did not worsen. The FY20 plan of -11.7% is relatively high compared to past figures. While this figure has a tendency for upward revision in the June survey, it would be good to keep in mind that things could be different in FY20.

Chart 3: Capex Plan at All-industry Large Firms in BOJ Tankan



Source: BOJ; compiled by Daiwa Securities.

Chart 4: Real Exports and Production in Japan



Source: BOJ, Ministry of Economy, Trade and Industry (METI); compiled by Daiwa Securities.
Note: X indicates METI's estimate for March production (-3.1%).

March Tankan characterized by a deterioration in sentiment, but with results divided by sector

Measures needed for hard-hit sectors, such as accommodations, eating and drinking services and transport

As mentioned above, the March Tankan showed deterioration in corporate sentiment, reflecting the COVID-19 pandemic. However, the results were divided by sector. In comparison to the weak sentiment, capex plans were unexpectedly solid partly because of the timing of the survey. DIs were characterized by (1) a decline into negative territory among large manufacturers, but not yet reaching a catastrophic level, (2) a record-level plunge among large non-manufacturers, with accommodations, eating and drinking services falling to the lowest level since the start of this survey, and (3) substantial deterioration in the forecast DI of small firms. If we do not see signs of an end to the spread of the virus, deterioration of sentiment is unlikely to stop. Sectors that have been particularly hurt are accommodations, eating and drinking services, services for individuals, and transport & postal activities. An important role of the government is to take prompt action to maintain employment and provide income compensation in order to avoid bankruptcies in these sectors and SMEs. We await the emergency economic package to be decided by the cabinet around 10 April.

Economic/price projections to be lowered in April *Outlook Report* due to severe circumstances

BOJ needs to revise wording regarding possibility of momentum being lost

The BOJ already made a downward revision to its economic assessment at an emergency meeting on 16 March, saying "Japan's economic activity has been weak recently due mainly to the impact of the outbreak of the novel coronavirus (COVID-19)." The economic stage has clearly changed due to the pandemic. In the April *Outlook for Economic Activity and Prices* report (*Outlook Report*), the BOJ is likely to make downward revisions to its economic/price projections, in recognition of the severe circumstances. Since its July 2019 meeting, the BOJ has continued to show the stance that it will "not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost." Factors in determining the momentum were the output gap and inflation expectations. However, the momentum has already been lost due to the economic recession. First, the BOJ needs to revise its wording (incl. that regarding forward guidance). The role of the April Outlook Report will probably be (1) to clarify our understanding of the current economic situation (although we had previously assumed it would be a summarization of the impact of the consumption tax hike, this has probably changed markedly) and (2) to paint a picture of how things will recover after an economic contraction (we are assuming the demand shocks will be temporary) by factoring in the effects of the government's economic package. In order to emphasize cooperation with the government, a new paragraph may be added to the April BOJ statement.

What BOJ can do will probably be limited to what was decided at March meeting

BOJ needs to emphasize cooperation with gov't and respond flexibly

In preparation for an increase in downside risk, the central bank is likely to maintain its stance that it will conduct additional easing without hesitation, although this will depend on the conditions of the pandemic. That said, the spread of the virus cannot be prevented by the BOJ's monetary policy (additional easing), even if the bank lowers economic/price projections and revises its wording regarding forward guidance. What it can do will probably be limited to what was decided at the March meeting—(1) the further ample supply of funds, (2) measures to support corporate financing, and (3) aggressive asset purchases. Its JGB purchase operation plan for April has already shown a stance towards an ample supply of funds. If assistive financing measures are judged to be insufficient, it is highly likely that the BOJ will imply a further increase in the asset purchase amount. It may need to respond flexibly to the current situation, amid unlimited measures by the Fed and ECB.

Explanatory Document of Unregistered Credit Ratings

In order to ensure the fairness and transparency in the markets, Credit Rating Agencies became subject to the Credit Rating Agencies' registration system based on the Financial Instruments and Exchange Act. In accordance with this Act, in soliciting customers, Financial Instruments Business Operators, etc. shall not use the credit ratings provided by unregistered Credit Rating Agencies without informing customers of the fact that those Credit Rating Agencies are not registered, and shall also inform customers of the significance and limitations of credit ratings, etc.

■ The Significance of Registration

Registered Credit Rating Agencies are subject to the following regulations:
1) Duty of good faith.
2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
3) Prohibition of the ratings in cases where Credit Rating Agencies have a close relationship with the issuers of the financial instruments to be rated, etc.
4) Duty to disclose information (preparation and publication of rating policies, etc. and public disclosure of explanatory documents).

In addition to the above, Registered Credit Rating Agencies are subject to the supervision of the Financial Services Agency ("FSA"), and as such may be ordered to produce reports, be subject to on-site inspection, and be ordered to improve business operations, whereas unregistered Credit Rating Agencies are free from such regulations and supervision.

■ Credit Rating Agencies

[Standard & Poor's]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: S&P Global Ratings ("Standard & Poor's")
The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating Information" (http://www.standardandpoors.co.jp/unregistered) in the "Library and Regulations" section on the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

Credit ratings may change depending on various factors, including issuers' performance, changes in external environment, performance of underlying assets, creditworthiness of counterparties and others. Standard & Poor's conducts rating analysis based on information it believes to be provided by the reliable source and assigns credit ratings only when it believes there is enough information in terms of quality and quantity to make a conclusion. However, Standard & Poor's does not perform an audit, due diligence or independent verification of any information it receives from the issuer or a third party, or guarantee its accuracy, completeness or timeliness of the results by using the information. Moreover, it needs to be noted that it may incur a potential risk due to the limitation of the historical data that are available for use depending on the rating.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of March 7th, 2017, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of S&P Global Ratings Japan Inc. (http://www.standardandpoors.co.jp)

[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

Credit ratings are Moody's Investors Service's ("MIS") current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. MIS defines credit risk as the risk that an entity may not meet its contractual, financial obligations as they come due and any estimated financial loss in the event of default. Credit ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit ratings do not constitute investment or financial advice, and credit ratings are not recommendations to purchase, sell, or hold particular securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information, is given or made by MIS in any form or manner whatsoever.

Based on the information received from issuers or from public sources, the credit risks of the issuers or obligations are assessed. MIS adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MIS considers to be reliable. However, MIS is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of April 16th, 2018, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Moody's Japan K.K. (https://www.moodys.com/pages/default_ja.aspx)

[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.com/site/japan)

Assumptions, Significance and Limitations of Credit Ratings

Ratings assigned by Fitch are opinions based on established criteria and methodologies. Ratings are not facts, and therefore cannot be described as being "accurate" or "inaccurate". Credit ratings do not directly address any risk other than credit risk. Credit ratings do not comment on the adequacy of market price or market liquidity for rated instruments. Ratings are relative measures of risk; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on relative ranking of vulnerability to default, do not imply or convey a specific statistical probability of default.

In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The assignment of a rating to any issuer or any security should not be viewed as a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating or the results obtained from the use of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate. Despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

For the details of assumption, purpose and restriction of credit ratings, please refer to "Definitions of ratings and other forms of opinion" on the website of Fitch Rating Japan Limited.

This information is based on information Daiwa Securities Co. Ltd. has received from sources it believes to be reliable as of September 27th, 2019, but it does not guarantee accuracy or completeness of this information. For details, please refer to the website of Fitch Rating Japan Limited (https://www.fitchratings.com/site/japan)

February 2020

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Conflicts of Interest: Daiwa Securities Co. Ltd. may currently provide or may intend to provide investment banking services or other services to the company referred to in this report. In such cases, said services could give rise to conflicts of interest for Daiwa Securities Co. Ltd.

Daiwa Securities Co. Ltd. and Daiwa Securities Group Inc.: Daiwa Securities Co. Ltd. is a subsidiary of Daiwa Securities Group Inc.

Other Disclosures Concerning Individual Issues:
1) As of 26 April 2016, Daiwa Securities Co. Ltd., its parent company Daiwa Securities Group Inc., GMO Financial Holdings, Inc., and its subsidiary GMO CLICK Securities, Inc. concluded a basic agreement for the establishment of a business alliance between the four companies.
As of end-December 2017, Daiwa Securities Group Inc. owned shares in GMO Financial Holdings, Inc. equivalent to approximately 9.3% of the latter’s outstanding shares. Given future developments in and benefits from the prospective business alliance, Daiwa Securities Group Inc. could boost its stake in GMO Financial Holdings, Inc. to up to 20% of outstanding shares.

2) Daiwa Real Estate Asset Management is a subsidiary of Daiwa Securities Group Inc. and serves as the asset management company for the following J-REITS: Daiwa Office Investment Corporation (8976), Daiwa Securities Living Investment Corporation (8986).

3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

5) Daiwa Securities Group Inc. and Credit Saison Co., Ltd. entered into a capital and business alliance, effective 5 September 2019. In line with this alliance, Daiwa Securities Group Inc. is to acquire up to 5.01% of Credit Saison’s total common shares outstanding (excl. treasury shares; as of 31 Jul 2019).

6) NEC (6701): NOTICE REGARDING U.S. PERSONS: This report is not intended for distribution to or use by any person in the United States. Securities issued by NEC Corporation have been suspended from registration in the U.S. and are subject to an order of the U.S. Securities and Exchange Commission dated June 17, 2008, pursuant to Section 12(j) of the Securities Exchange Act of 1934. This document is not a recommendation or inducement of any purchase or sale of such securities by any person or entity located in the U.S. Daiwa Securities Co. Ltd. disclaims any responsibility to any such person with respect to the content of this document. Any U.S. person receiving a copy of this report should disregard it.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association