Japan Economic Update – A muted and uneven recovery

1) The incidence of Covid-19 amongst Japan's population has been less than in many countries

While they recently edged higher, coronavirus case numbers remain low in Japan, most recently averaging about 700 per day. As a result, just 0.1% of Japan's population has been infected with the virus since the pandemic began, compared with 2.8% of the population in the US. Deaths due to the pandemic remain very low too.

2) Even so, Japan's economy contracted a record 7.9%Q/Q in Q2

While the health impact has been much less severe in Japan, the economic impact has still been huge. Exports, consumer spending and capex slumped as the first wave of the pandemic caused world-wide lockdowns, with financial market volatility contributing to a big loss of confidence. Still, most other major economies fared worse.

3) Indicators suggest that the economy has rebounded only partially in Q3, near-term outlook is weak

Hard data and sentiment surveys indicate that the economy rebounded in Q3, although at this stage it looks like the economy has reversed less than half of last quarter's slump. It is likely that it will take a couple of years for output to return to the levels seen at the start of this year, especially if the pandemic worsens in the interim.

4) The pandemic has caused a significant set-back to BoJ's already difficult task of lifting inflation

Sadly the pandemic has undone years of progress towards building the economic conditions necessary to lift inflation to the BoJ's target. However, the BoJ seems reluctant to cut interest rates further, instead relying on its liquidity operations – and ongoing fiscal stimulus – to provide support for businesses.

5) Once the pandemic is over, the economy will continue to face long-term challenges

The pandemic has further weakened the public finances (and will probably do so further as additional stimulus is rolled out). This will make it more difficult for Japan to deal with its longer-term challenges, such as coping with an aging population and weak productivity.

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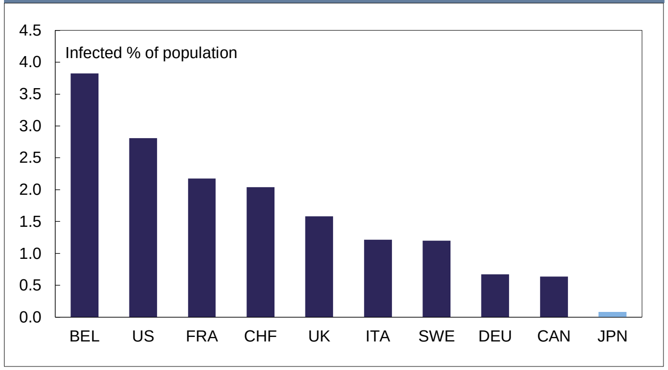
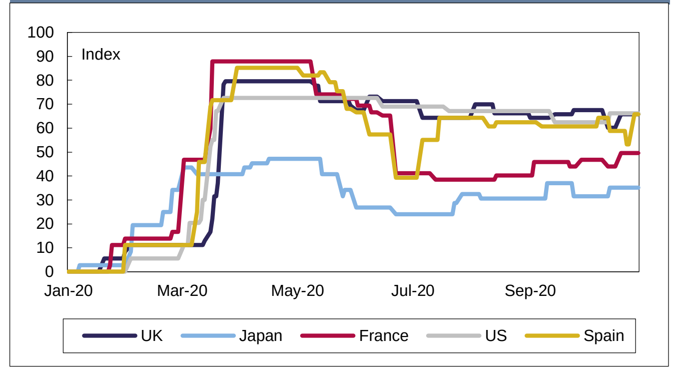
Japan’s incidence of Covid-19 has been relatively low

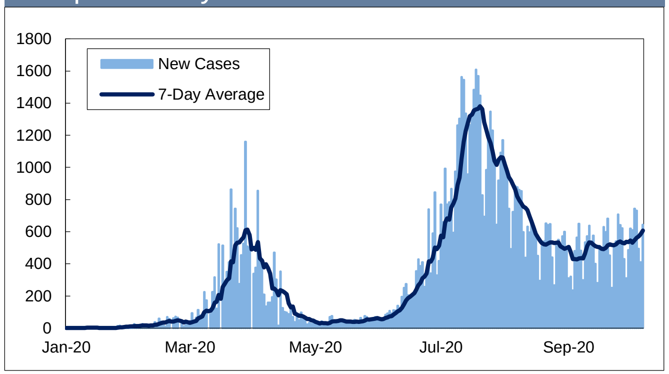
G-10 Coronavirus cases, share of population*



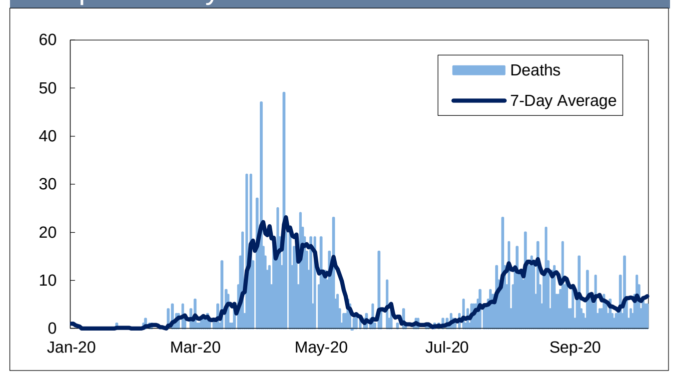
Lockdown stringency index



Japan – daily coronavirus case numbers



Japan – daily coronavirus death numbers



* As of 2 November. Source: Thomson Reuters, Blavatnik School of Government Oxford University, Bloomberg, Wikipedia and Daiwa Capital Markets Europe Ltd.

- Following a 2nd wave of infections in the summer, new cases declined to around 500 per day in mid-September, but have moved close to 700 per day recently. Even so, Japan’s incidence of coronavirus remains low – less than 0.1% of the population have been infected, compared with 2.8% in the US and 3.8% in Belgium.

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The Government and BoJ quickly sought to soften the blow

Key direct Government economic measures:

- ¥5.1trn (1.0% of GDP) on health-related spending, including transfers to local government.
- ¥54.4trn (10.3% 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 (4.9% of GDP) to fund the 1-year deferral of tax revenue and social security premiums by affected firms and households.
- ¥15.7trn (3.0% of GDP) of guarantees offered on bonds/borrowing made by the Development Bank of Japan and Japan Finance Corporation, amongst others.
- ¥109trn (20.7% of GDP) of quasi-fiscal operations, mostly concessional loans/guarantees to affected firms through public and private financial institutions.

Key BoJ policy responses:

- The BoJ policy response began with an extraordinary Policy Board meeting on 16 March.
- Committed to unlimited JGB purchases to ensure that 10-year JGB yield remains around 0%.
- Doubled ETF and J-REIT purchases to an upper limit of ¥12trn and ¥180bn respectively.
- CP and corporate bond purchases were temporarily increased by ¥7.5trn each.
- Introduced a ¥110trn programme of 0% loans to banks to support lending to corporates.
- Participated in coordinated major central bank provision of US$ liquidity via swap lines.
- Committed to introducing further easing measures if necessary, with expectation that interest rates remain at current or lower levels.

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

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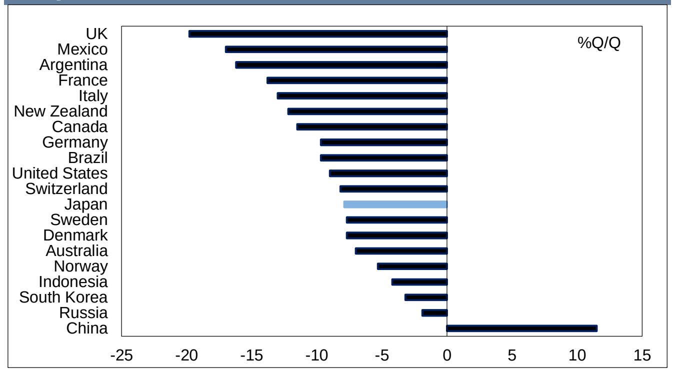
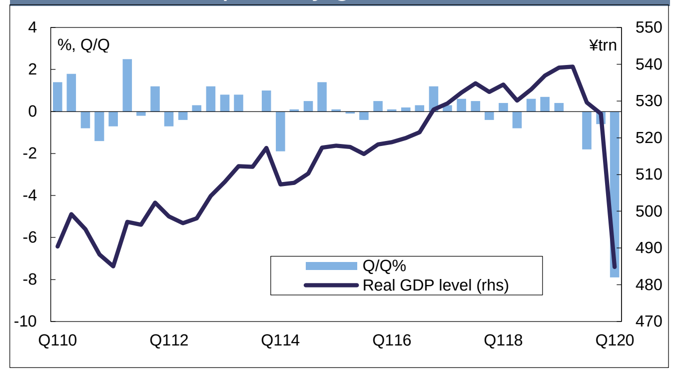
Even so, Japan’s GDP contracted almost 8%Q/Q in Q2

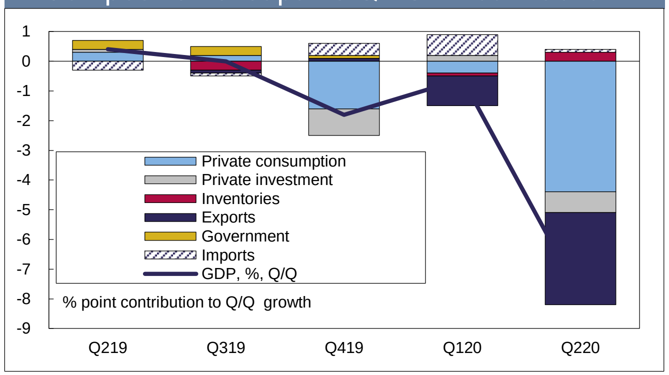
Q220 GDP Growth – selected countries



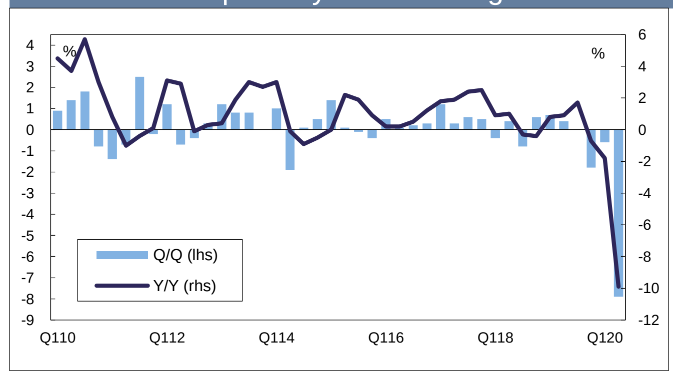
Real GDP – quarterly growth and level



Composition of Japan’s Q2 GDP contraction



Real GDP – quarterly and annual growth



Source: Thomson Reuters, Bloomberg, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Japan’s GDP contracted by a record 7.9%Q/Q in Q2 to the lowest level since the 2011 great quake. Even so, this made Japan one of the least impacted countries in the G-20. As to be expected, exports, private consumption and business capex bore the brunt of the downturn, slumping 18.5%Q/Q, 7.9%Q/Q and 4.7%Q/Q respectively.

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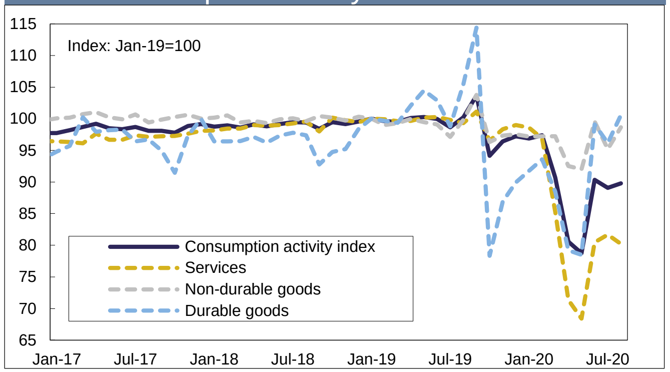
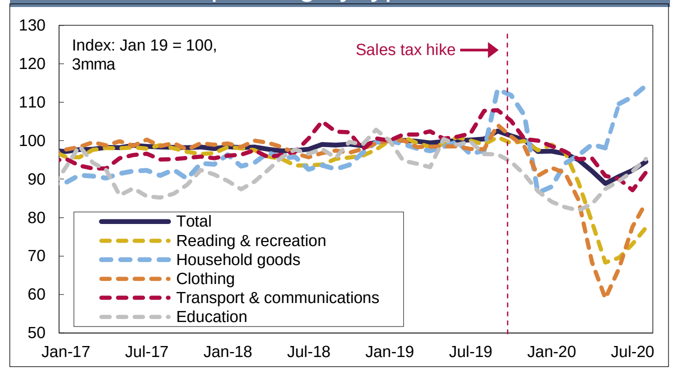
Consumers cut spending on services, but bought durables

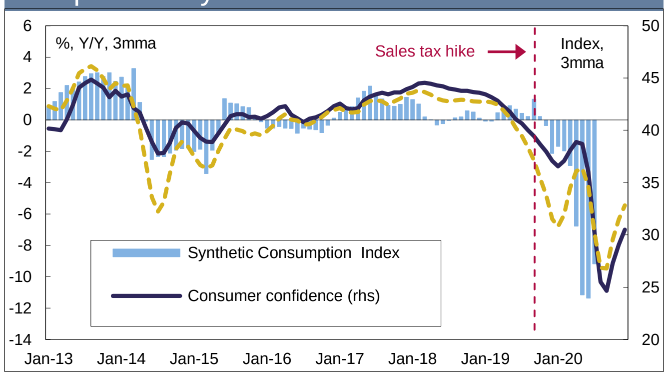
BoJ consumption activity index



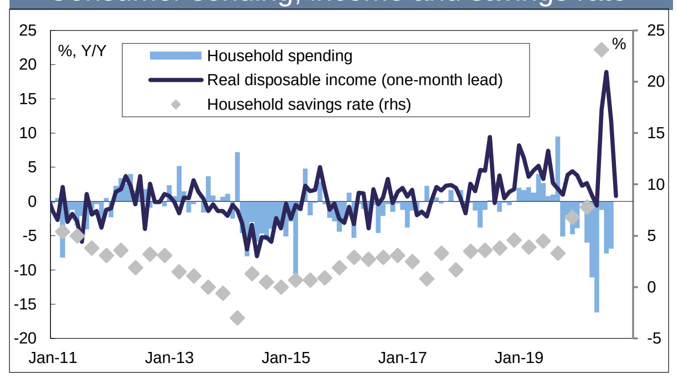
Household spending by type



Japan – daily coronavirus case numbers



Consumer sending, income and savings rate



Source: Thomson Reuters, Bloomberg, Cabinet Office, BoJ, MIC and Daiwa Capital Markets Europe Ltd.

- Big-ticket purchases fell sharply after last year's tax hike and again as the pandemic took hold. However, these purchases have rebounded sharply, whereas services demand has remained well below pre-pandemic levels. Given weak confidence most households appear to have saved the cash payouts from the government.

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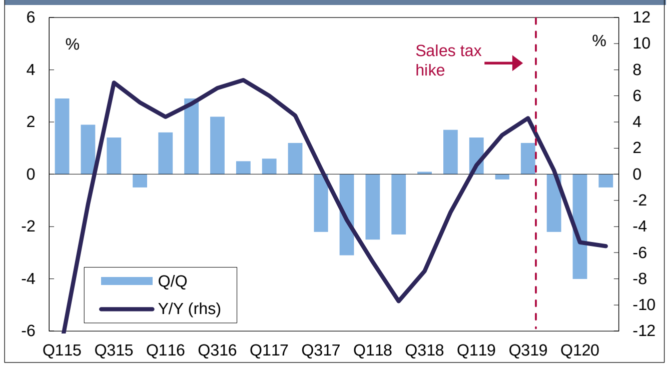
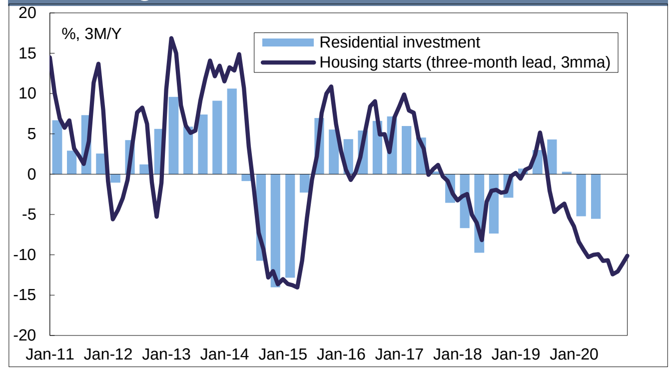
Residential building has continued its post tax hike decline

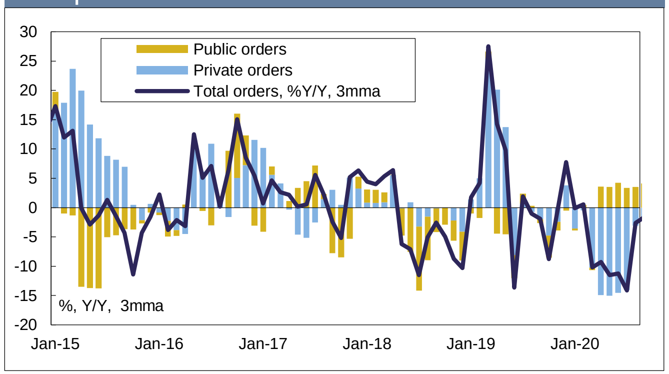
Residential investment



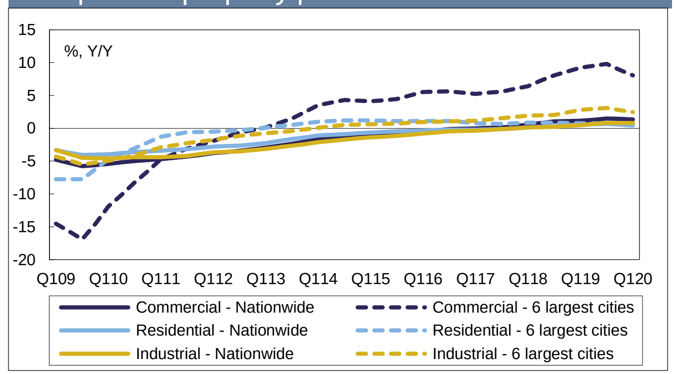
Housing starts and residential investment*



Japan – Construction orders



Japanese property prices



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

- Residential investment declined after last year's consumption tax hike. Given decision lags, the onset of the pandemic imparted only marginal additional weakness in Q2. However, over the past three months housing starts have declined 11%Y/Y, suggesting that further declines are likely in the near term.

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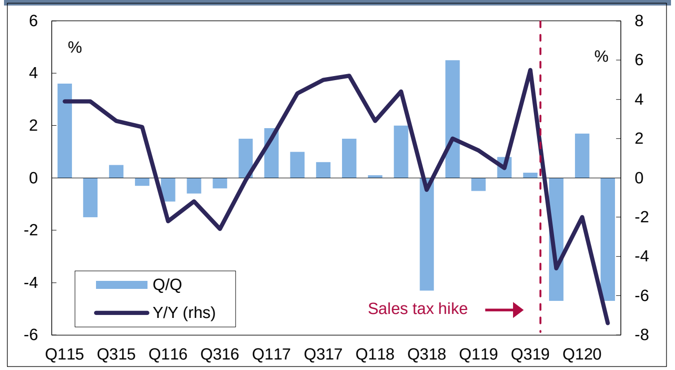
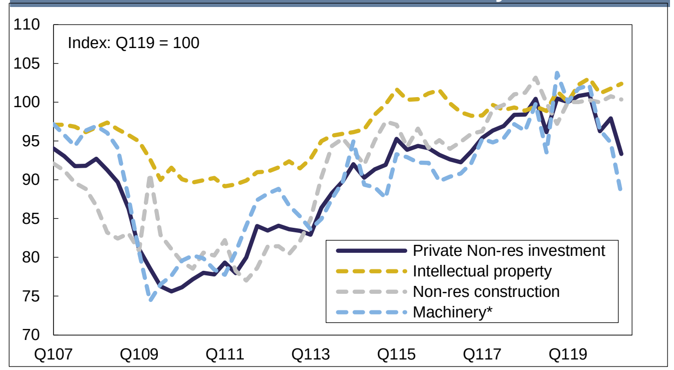
Business investment has taken another leg lower

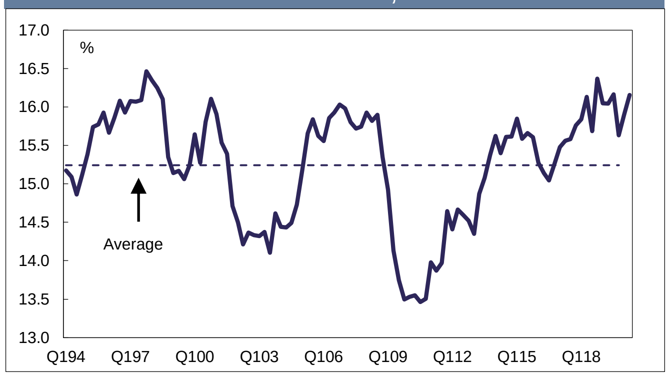
Non-residential investment



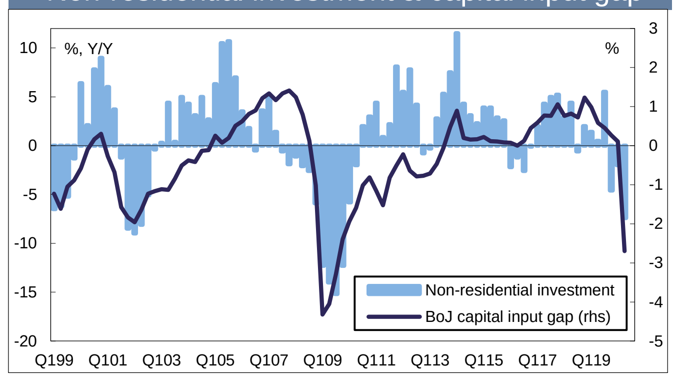
Non-residential investment, level by asset*



Non-residential investment, share of GDP



Non-residential investment & capital input gap



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

- Business investment also fell after the consumption tax hike, recovering only modestly in Q120, before declining at the onset of the pandemic. Spending on machinery and equipment – especially transport equipment – fell sharply, whereas non-residential construction and intellectual property has remained steady.

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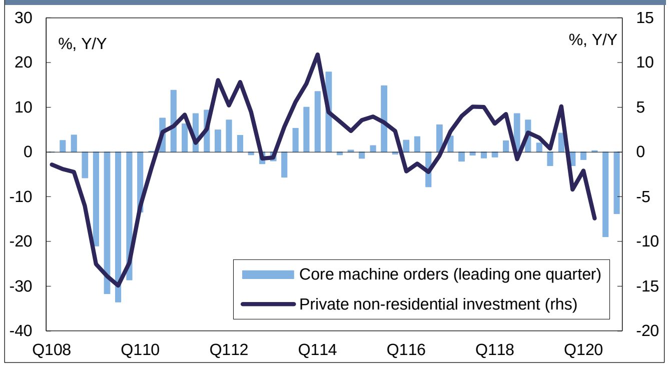
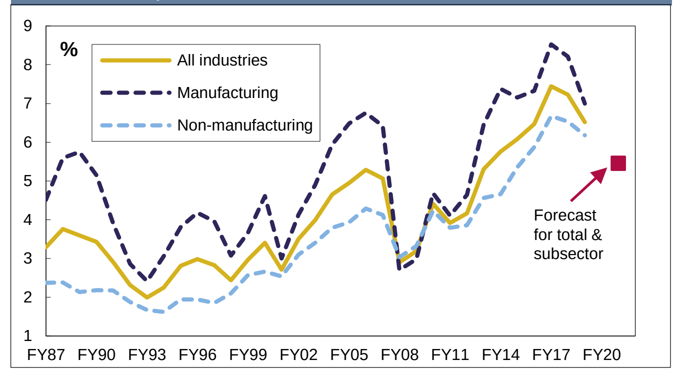
The near-term outlook for business capex appears soft

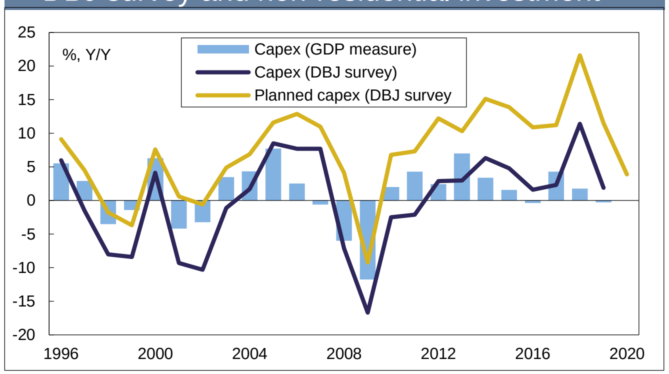
Machine orders and non-residential



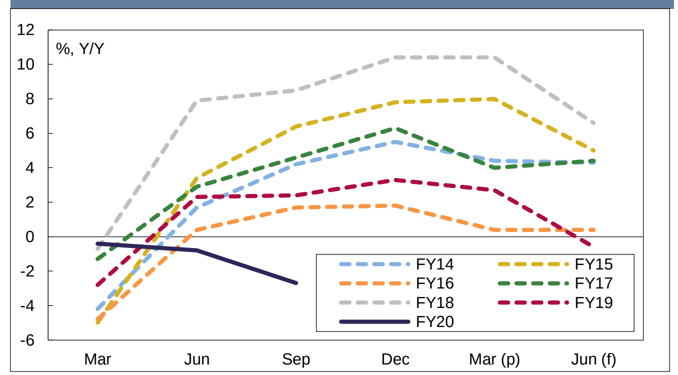
Tankan profit-to-sales ratio



DBJ survey and non-residential investment



Tankan Business Investment Forecasts*



*All firms, fiscal year, fixed investment including land. Source: Thomson Reuters, Bloomberg, Cabinet Office, BoJ, DBJ and Daiwa Capital Markets Europe Ltd.

- The BoJ's Q3 Tankan pointed to a 2.7%Y/Y decline in business capex in FY20, reflecting reduced profitability and a weaker business outlook. If anything, that still feels optimistic, especially given the 4.7%Q/Q decline already reported in Q2. Corrected for its usual over-optimism, the DBJ survey also points to a fall in capex.

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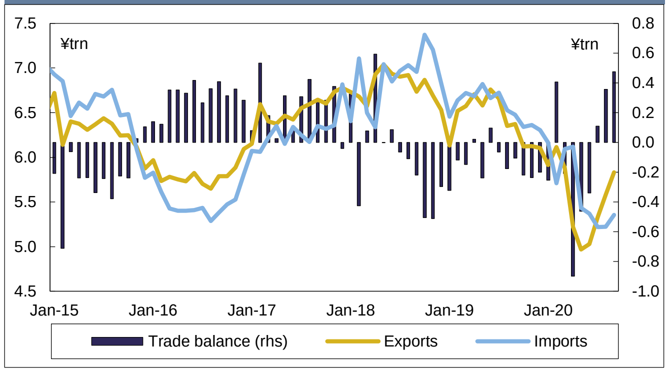
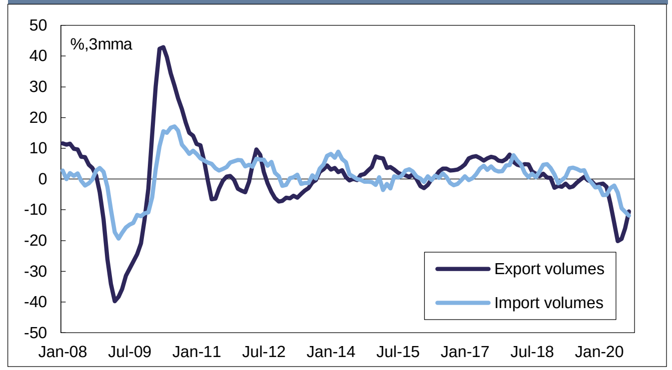
Merchandise exports fall sharply, led by a slump in autos

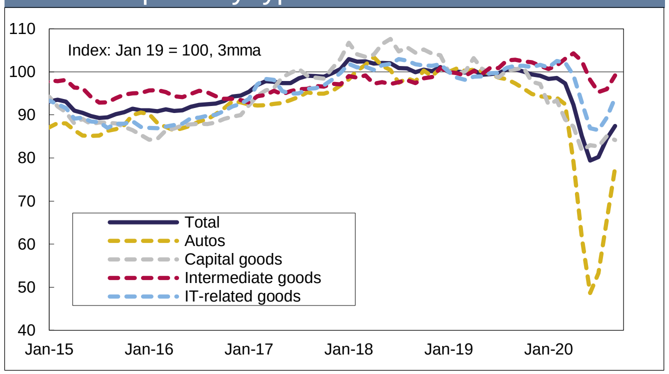
Exports, imports and trade balance



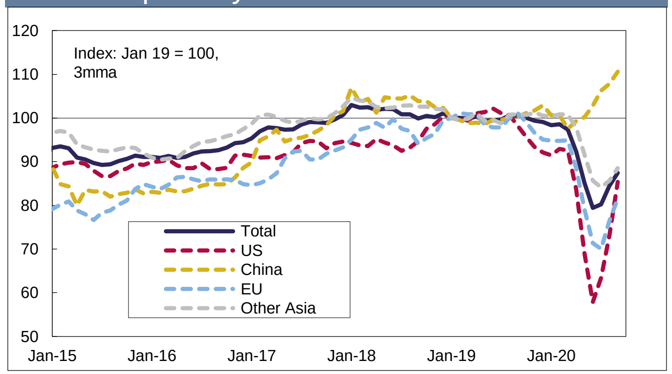
Real exports and imports



Real exports by type



Real exports by selected destinations



Source: Thomson Reuters, 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. Exports to the US and Europe were hit especially hard. Volumes have recovered substantially in recent months, but remained down 5.1%Y/Y in September despite exports to China rising over 10%Y/Y.

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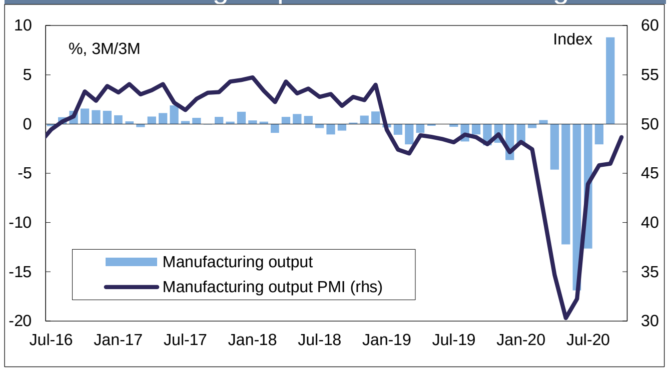
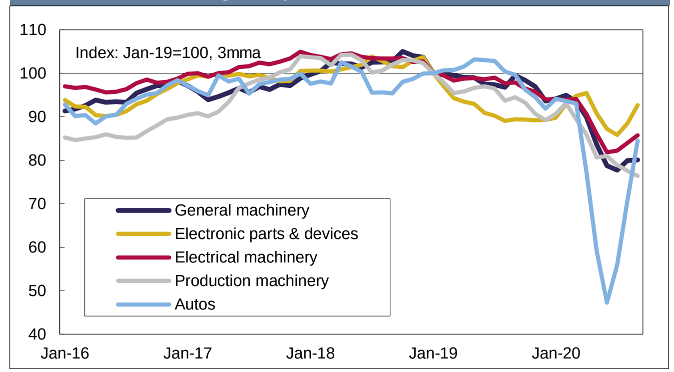
Manufacturing was hit hard by the slump in exports

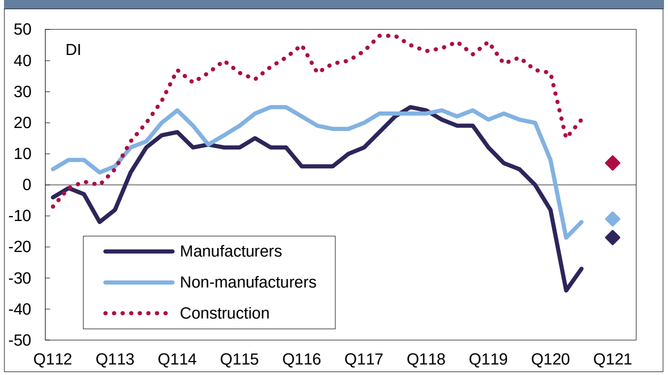
Manufacturing output and manufacturing PMI



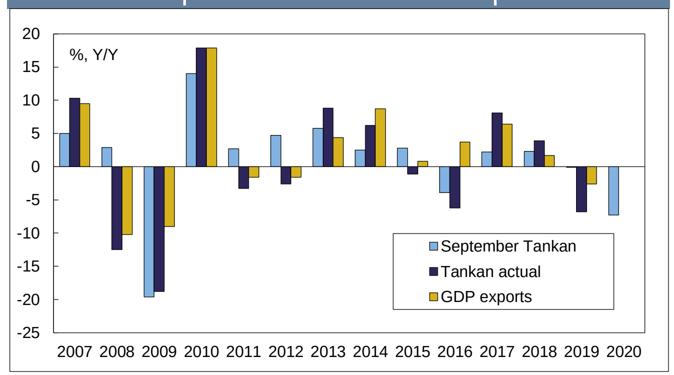
Manufacturing output, selected industries



BoJ Tankan: Business conditions



Tankan exports index and GDP exports



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

- The slump in exports was paralleled in the manufacturing sector, with output declining almost 17%Q/Q in Q2. Production of autos halved during the height of the lockdown while most categories of machinery output were weaker too. In line with the manufacturing PMI, output rebounded a provisional 8.8%Q/Q in Q3.

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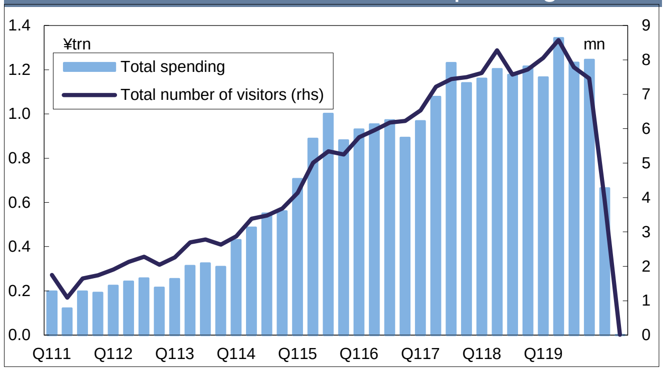
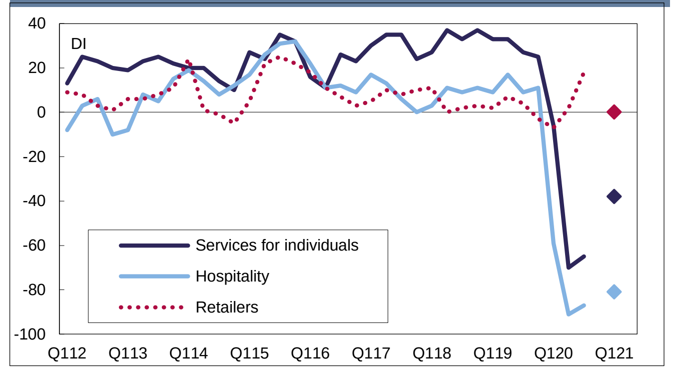
The halt to tourism has weighed hugely on the service sector

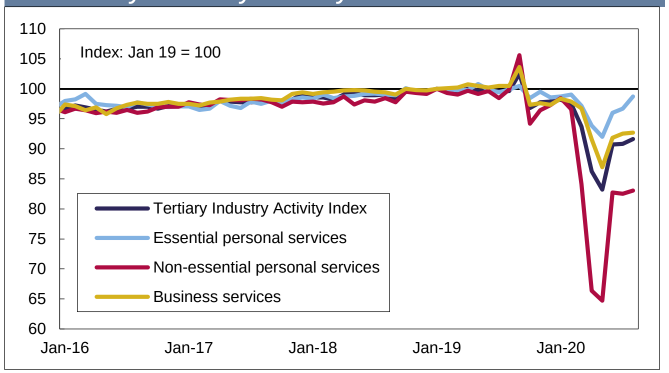
Overseas visitor numbers and spending^



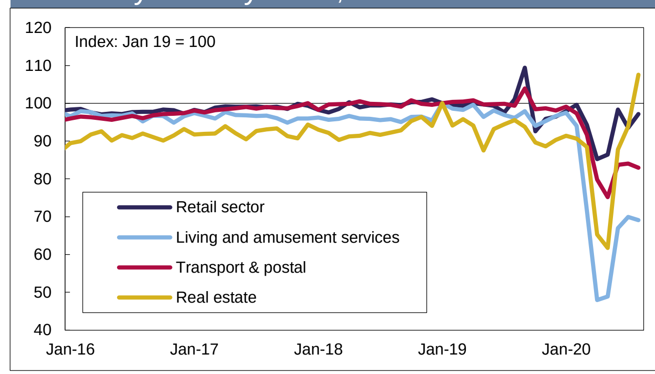
Tankan business conditions, selected sectors*



Tertiary industry activity index



Tertiary industry index, selected sectors



^Average spending per visitor in Q220 is assumed to be same as previous quarter. *Large enterprises. Diamonds represent survey forecast for Q420. Source: Thomson Reuters, JNTO, JNTA, BoJ, METI and Daiwa Capital Markets Europe Ltd.

- With the border largely closed, the number of overseas visitors to Japan has declined by over 99%, decimating an industry directly contributing ¥5trn to the economy each year. Despite various initiatives, such as the "Go-to-Travel" campaign, the hospitality sector remains very pessimistic about the outlook.

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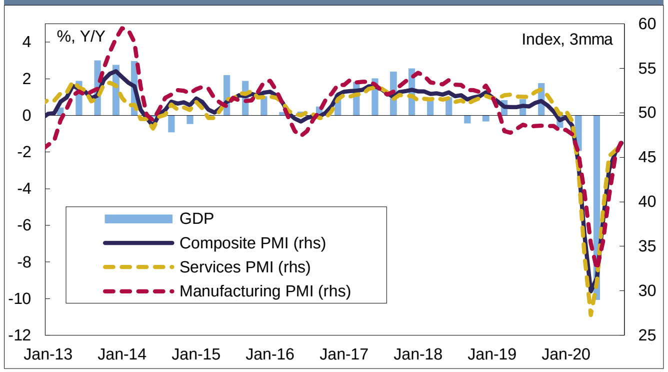
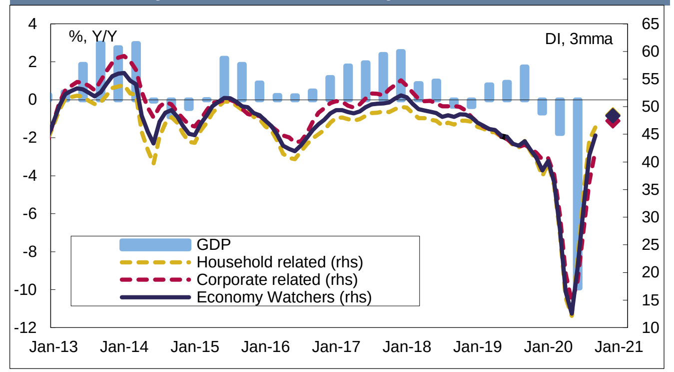
Key sentiment indicators – while still low – are improving

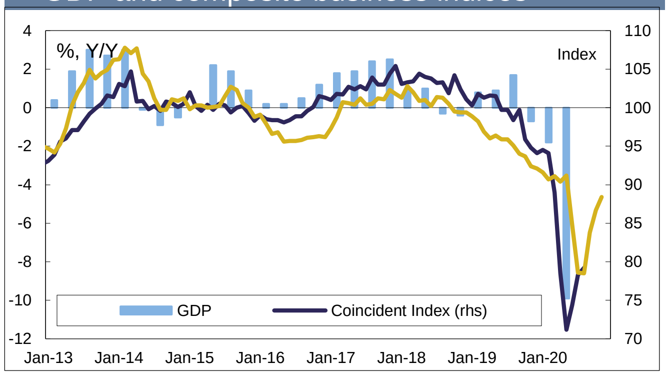
PMIs and GDP



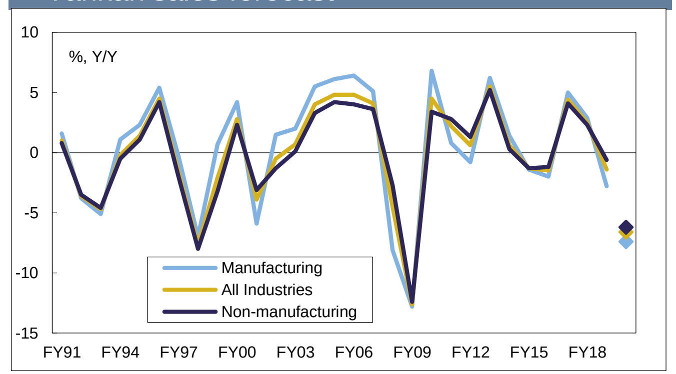
Economy Watchers Survey & GDP*



GDP and composite business indices^



Tankan sales forecast**



* Diamonds are latest readings for the outlook index. ^Leading index has three-month lead. **Diamonds are firms' forecast for FY20. Source: Thomson Reuters, IHS Markit, Cabinet Office, BoJ and Daiwa Capital Markets Europe Ltd.

- After declining to just 25.8 in April – the lowest reading on record – the composite PMI has subsequently rebounded to 46.7 in October. The Economy Watchers Survey has behaved similarly. The Cabinet Office business indices are off their lows but firms still expect a hefty decline in sales in FY20.

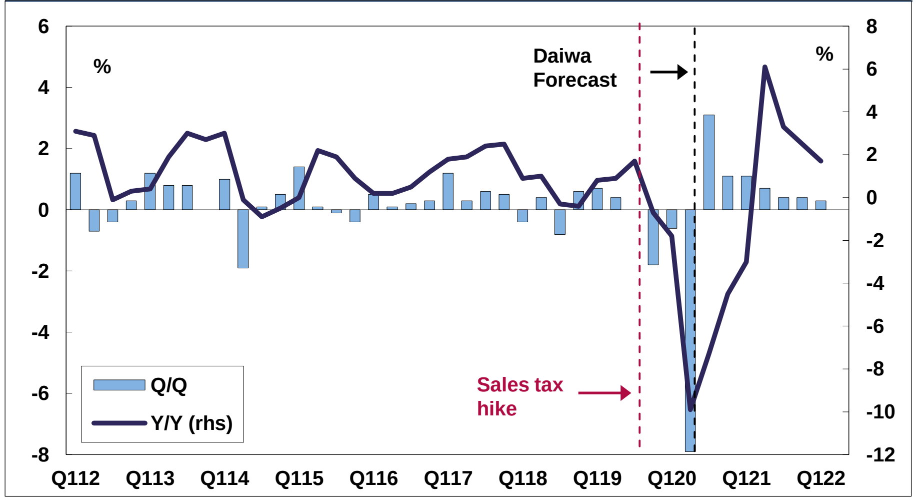
We expect only a partial GDP recovery in FY21

GDP growth forecast*

Contribution to Y/Y growth	FY18	FY19	FY20	FY21
Private consumption	0.0	-0.3	-3.2	1.9
Private residential investment	-0.1	0.0	-0.2	0.0
Private non-residential investment	0.3	0.0	-0.9	0.3
Public consumption and investment	0.0	0.7	0.2	0.3
Private inventories	0.0	-0.1	0.1	-0.1
Net trade	*-0.1*	*-0.2*	*-2.0*	*1.1*
Exports	0.3	-0.5	-2.6	1.7
Imports	-0.4	0.3	0.6	-0.6
GDP growth, %, Y/Y	**0.3**	**0.0**	**-6.1**	**3.4**
BoJ GDP growth forecast (October)	-	-	-5.5	3.6

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

GDP growth forecast*



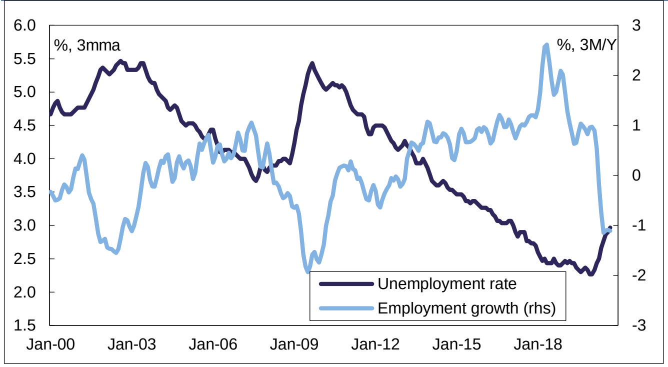
Source: Cabinet Office, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

- We expect the contraction in FY20 to be slightly deeper than the BoJ envisaged in its October Outlook Report.
- Off that weaker base, our forecast for growth in FY21 is also slightly weaker than the BoJ's forecast. Growth next year is likely to be led by a recovery in private consumption and net exports.

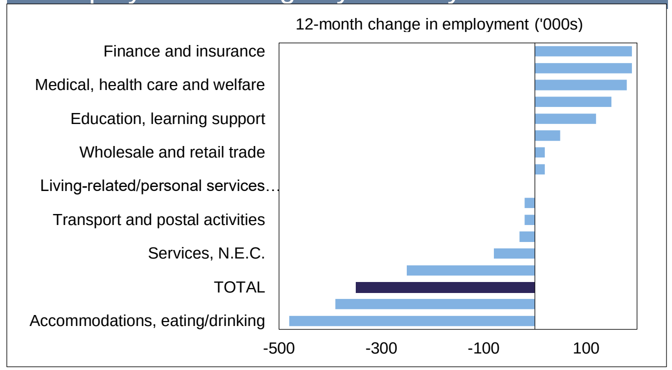
Daiwa Capital Markets

Japan's labour market is showing reasonable resilience

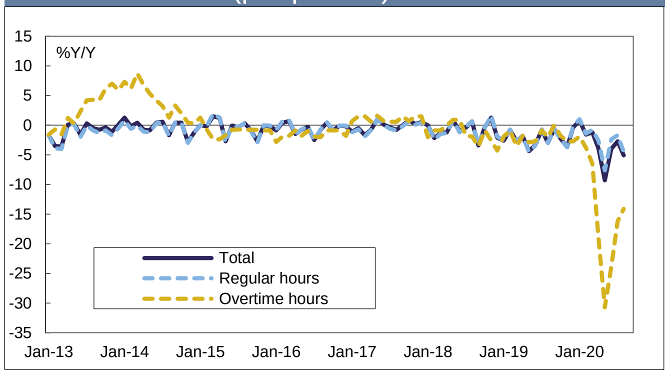
Employment and the unemployment rate



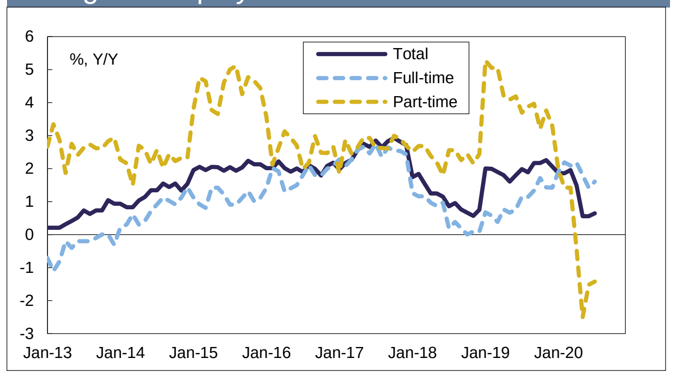
Employment change by industry



Hours worked (per person)



Regular employment

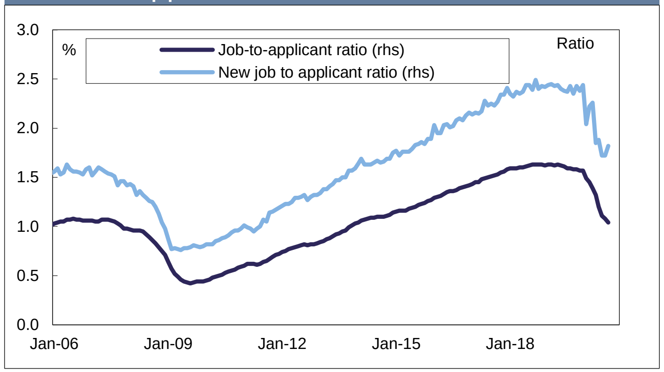


Source: Thomson Reuters, MIC, MHLW and Daiwa Capital Markets Europe Ltd.

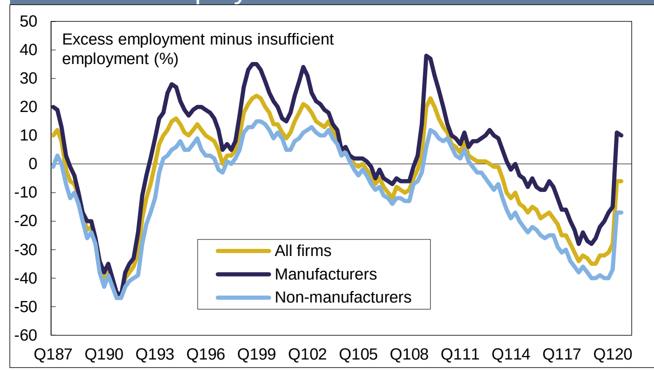
- Household employment fell by nearly 1.2m during March and April, recovering only slightly since then. As a result, the unemployment rate has increased from a 3-decade low to a 3-year high of 3.0%. To date firms' reduced demand for labour has been manifest mostly in very sharp reductions in over-time hours worked.

The labour market is likely to be soft in the near term

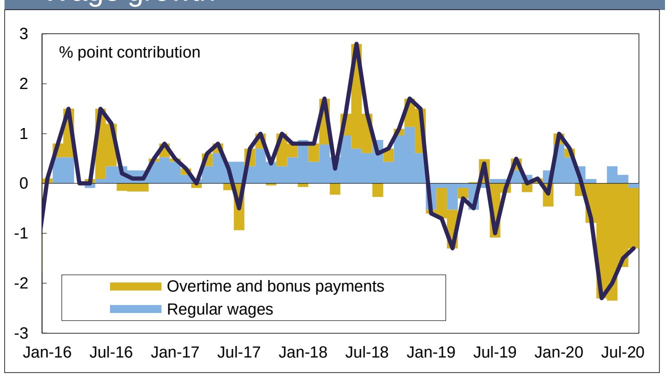
Job-to-applicant ratio



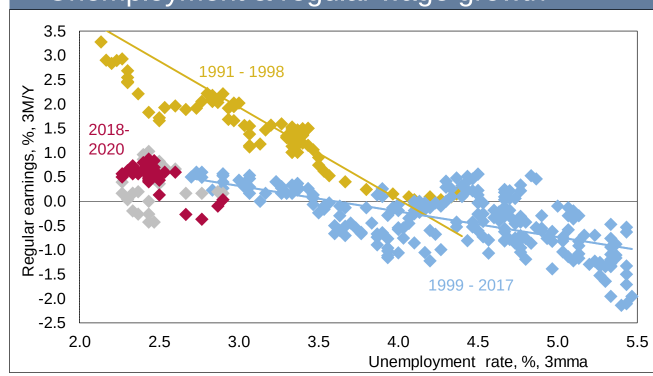
Tankan employment index



Wage growth



Unemployment & regular wage growth*

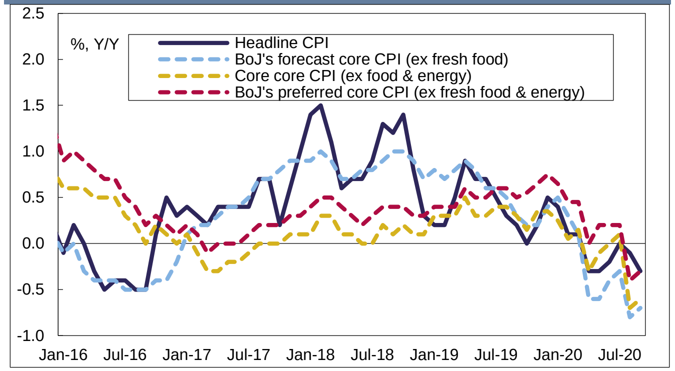


*Red diamonds are like-for-like wage figures. Light grey diamonds are headline wage figures. Source: Thomson Reuters, MHLW, MIC, BoJ and Daiwa Capital Markets Europe Ltd.

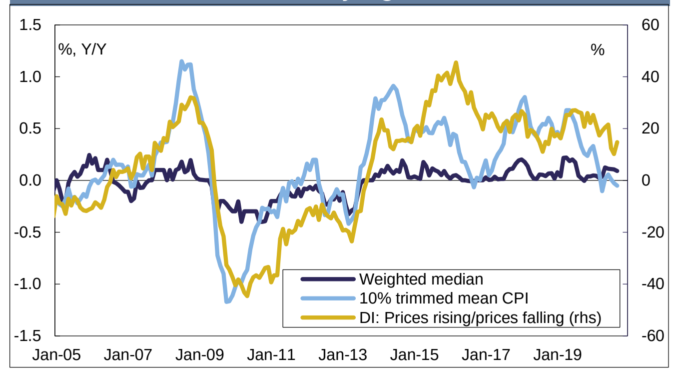
- The job-to-applicant ratio has declined from a historic highs and the Tankan survey suggests that manufacturers have a surplus of staff for the first time since the GFC. So the prospect of wage growth picking up towards 3% – as is likely to be required to sustain CPI inflation of 2% – seems very bleak indeed.

The pandemic has weakened inflation further still

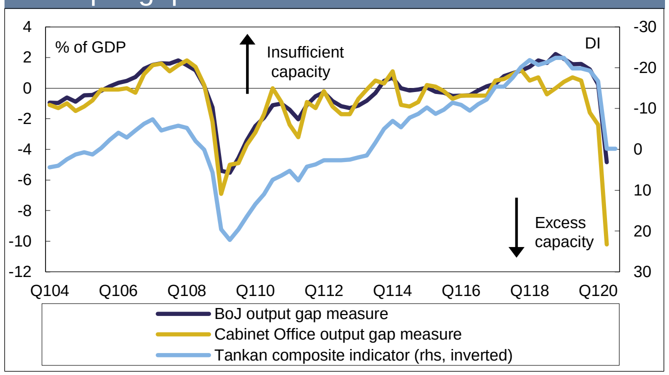
CPI inflation – headline and core measures*



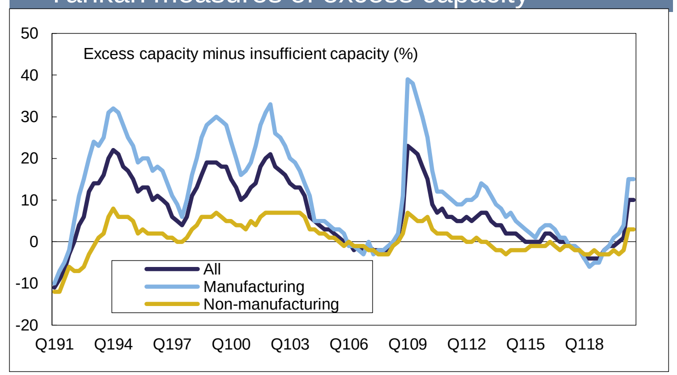
BoJ measure of underlying inflation^



Output gap measures



Tankan measures of excess capacity



* Excluding impact of changes in consumption tax. ^Excludes impact of changes in the consumption tax and government policy changes to education fees. Source: Thomson Reuters, MIC, BoJ, Cabinet Office 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. Inflation has fallen further reflecting weaker demand, the feed-through of lower commodity prices and the impact of government policy measures to support the economy.

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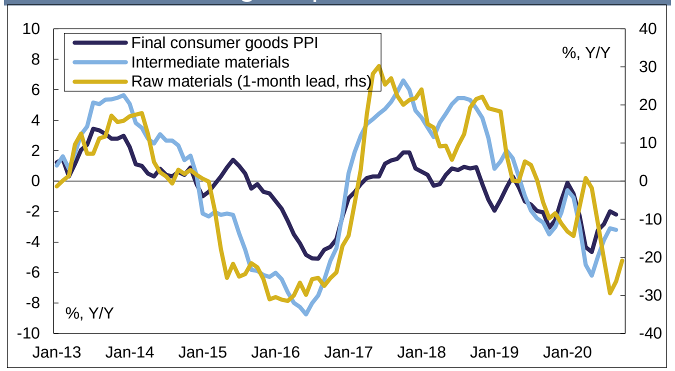
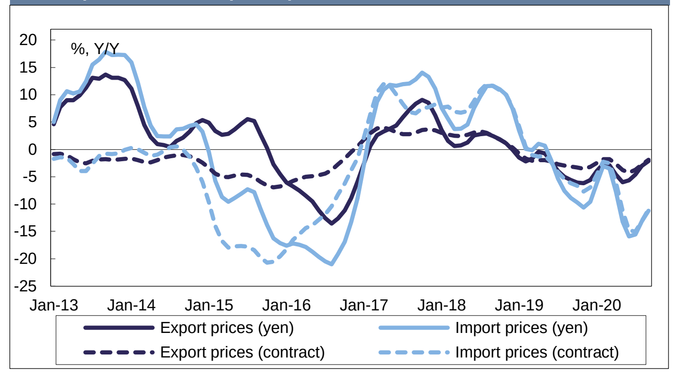
Inflation is likely to remain low for the foreseeable future

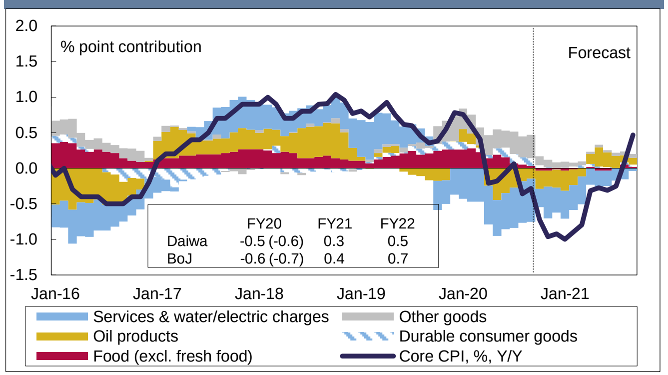
Goods PPI, stage of production



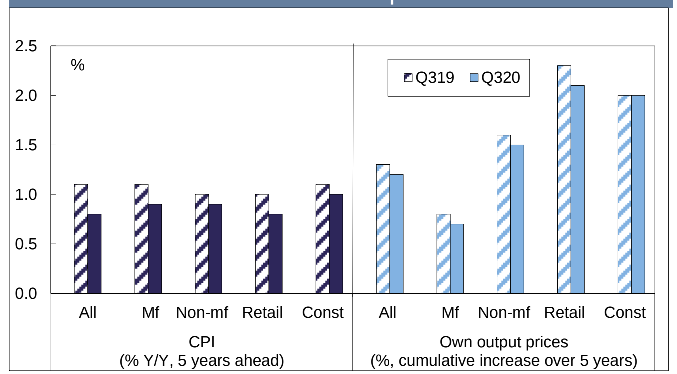
Export and import prices



Core CPI inflation forecast



Tankan - firms' inflation expectations



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

- A slump in some industrial commodity prices – notably fuel – weighed on inflation. Core inflation is likely to remain negative in the near term, given the impact of a soft economy and government measures to boost demand in the hospitality sector. Inflation is likely to remain below the BoJ's 2% target in the medium term too.

BoJ monetary policy framework

Yield Curve Control	QQE	Loan facilities
▪ 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	▪ 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 up to ¥12trn ▪ BoJ J-REIT holdings to increase at an annual rate of up to ¥180bn ▪ BoJ will raise holdings of CP and corporate bonds to about ¥9.5trn and ¥10.5trn respectively	▪ '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-March 2021.

- 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.

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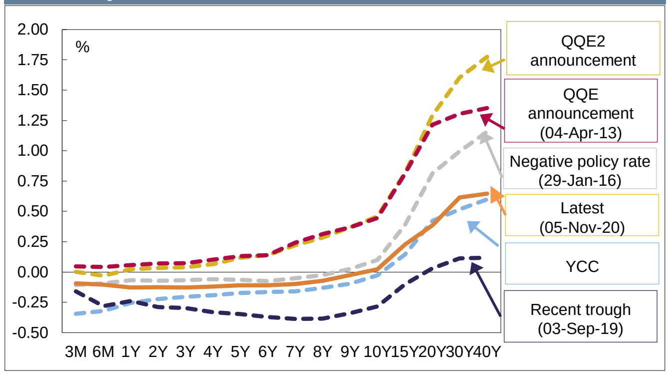
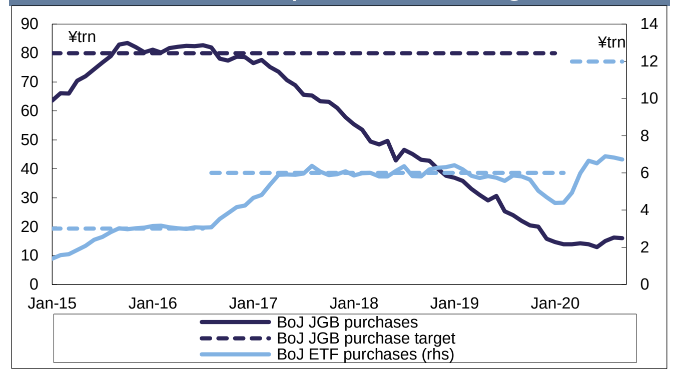
The BoJ’s asset purchases have been well below policy caps

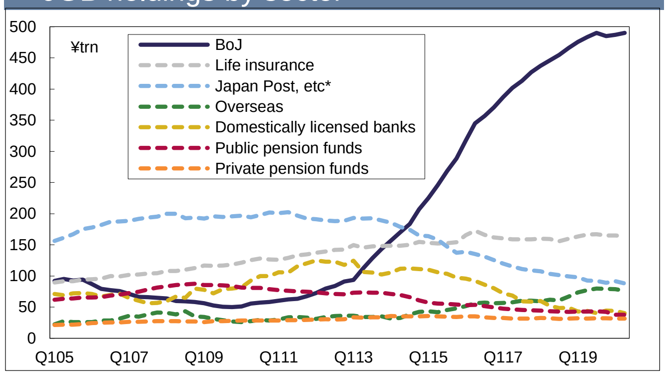
JGB yield curve



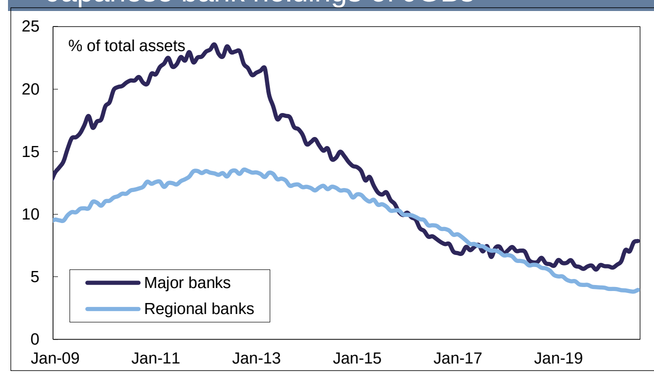
BoJ JGB and ETF purchases vs target



JGB holdings by sector



Japanese bank holdings of JGBs



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

- While the BoJ’s rinban purchases picked up as part of the pandemic response, the full-year increase in 2020 will likely be less than ¥20trn. The BoJ holds about 49% of the JGB market, worth almost 90% of GDP. While its ETF purchases also picked up, they are only slightly above the pre-pandemic target of ¥6trn.

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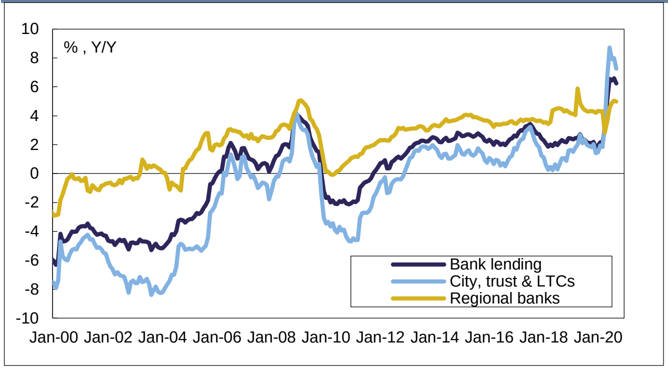
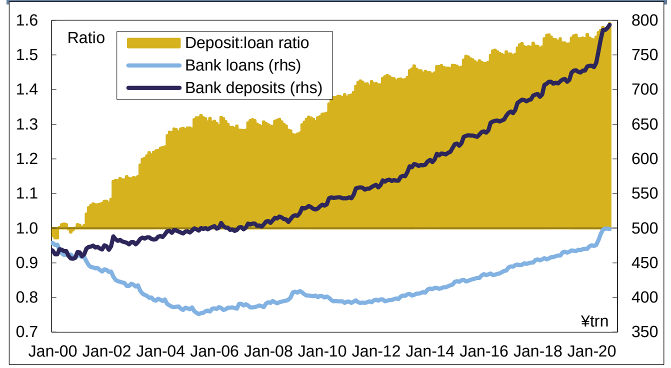
Japan's banking sector played a stabilizing role

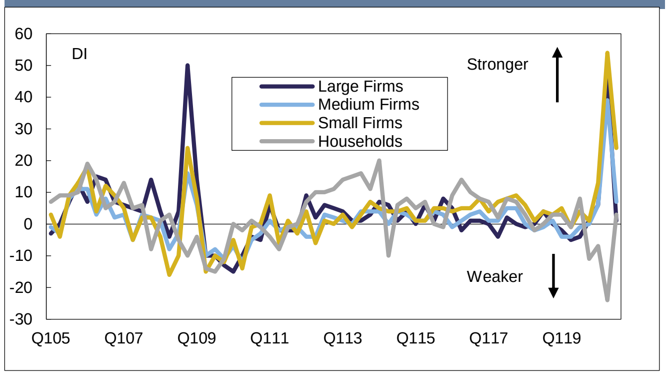
New bank lending



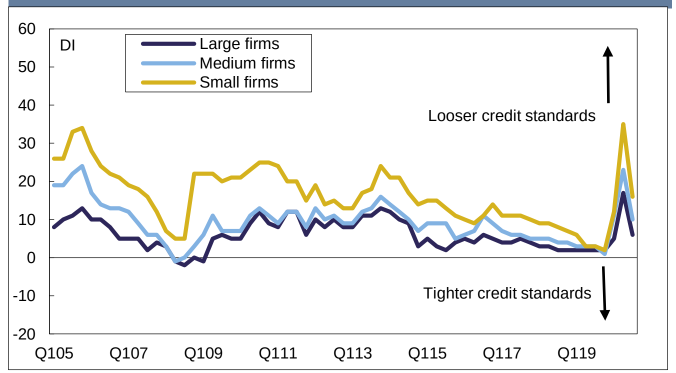
Bank lending and bank deposits



Demand for credit*



Credit standards*



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

- While household demand for credit fell, firms scrambled to secure liquidity at the onset of the pandemic. To accommodate that demand, banks loosened their credit standards, supported by government guarantees. Credit demand began to normalise in Q3. And fewer banks eased credit conditions than had done so in Q2.

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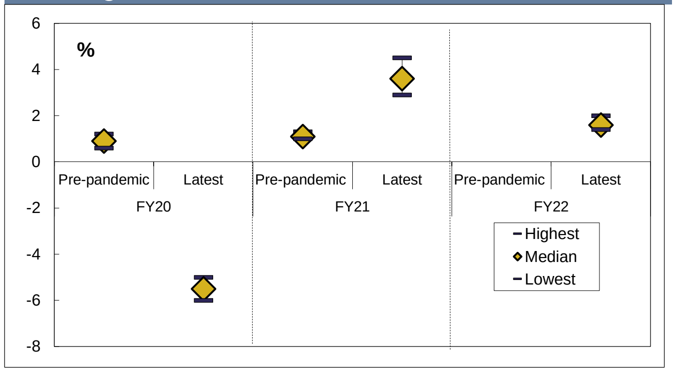
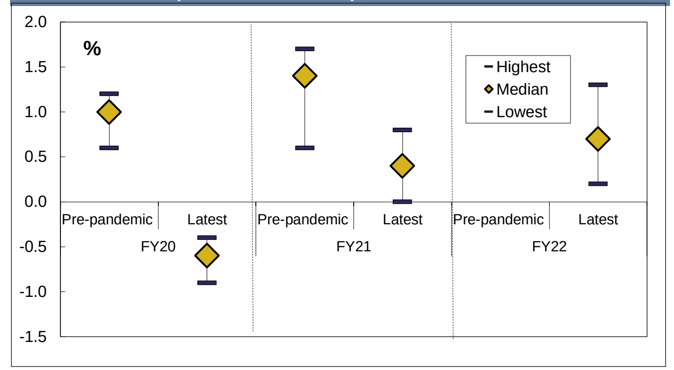
BoJ reluctant to cut rates further despite poor outlook

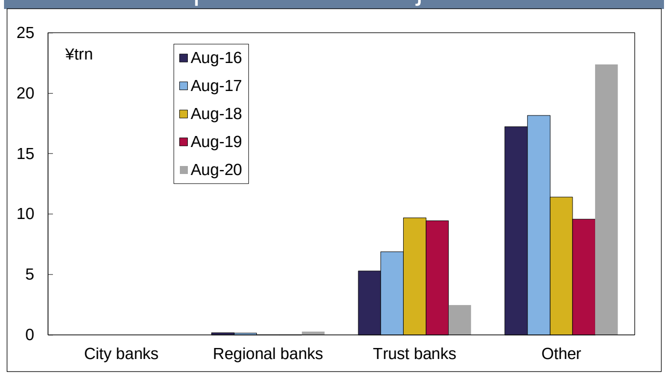
BoJ growth forecast*



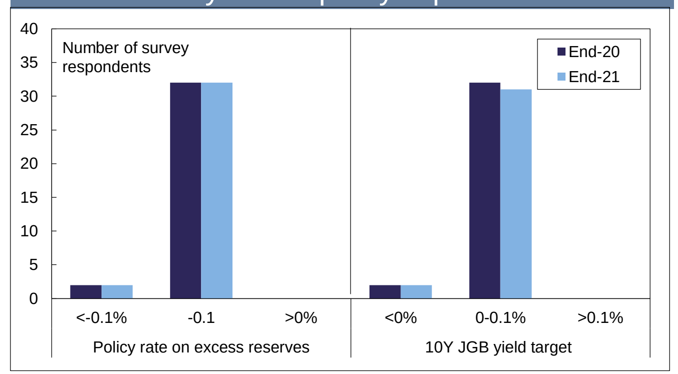
BoJ core (ex fresh food) inflation forecast*



Share of deposits at BoJ subject to -0.1% rate



JCER survey of BoJ policy expectations



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

- Even prior to the pandemic, the BoJ Board's forecasts suggested that inflation would remain below the 2% policy target across the forecast horizon. Revisions since the onset of the pandemic means that the median Board member expects core inflation to be just 0.7%Y/Y in FY22.

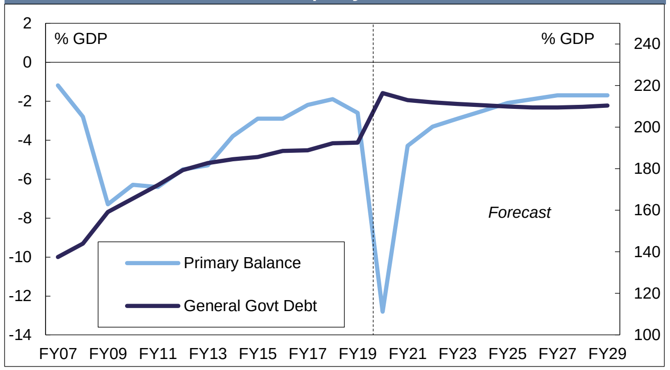
New PM Suga provides continuity with the Abe era

Biography	Likely Key Initiatives
▪ Born in 1948 in Akita. ▪ Educated at Hosei University, Tokyo, Bachelor of Laws. ▪ Elected to Yokohama City Council in 1987. ▪ Elected to Lower House of Diet in 1996. ▪ Became parliamentary secretary to Ministry of Economy, Trade and Industry in 2003. ▪ Became Senior Vice Minister for Internal Affairs and Communications in 2005. ▪ Became Minister for Internal Affairs and Communications in 2006. ▪ Appointed Chief Cabinet Secretary by PM Shinzo Abe in 2012. ▪ Elected leader of the LDP and Prime Minister in 2020.	▪ Before election as PM stated that he would continue with “Abenomics” approach of monetary easing, fiscal stimulus and structural reforms. ▪ When elected as PM he said “I want to break down bureaucratic sectionalism, vested interests and the blind adherence to precedent”. ▪ The set up of a Digital Agency to modernise government IT systems. ▪ Consolidation of the regional bank sector. ▪ Extended support for the tourism sector. ▪ Mobile rate cuts. ▪ Reduced regulation of events. ▪ Agricultural transformation. ▪ Extended public support for infertility treatment. ▪ Deep cuts in nursery school waiting lists.

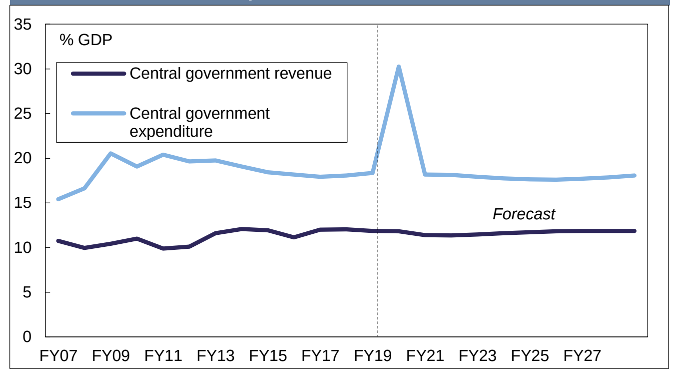
Source: Daiwa Capital Markets Europe Ltd.

The pandemic has further weakened the public finances

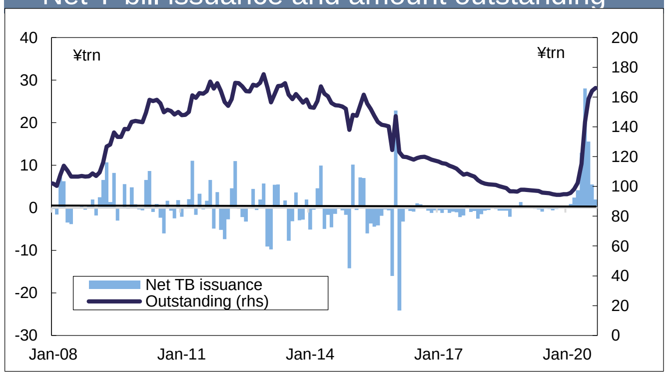
Cabinet Office fiscal projections



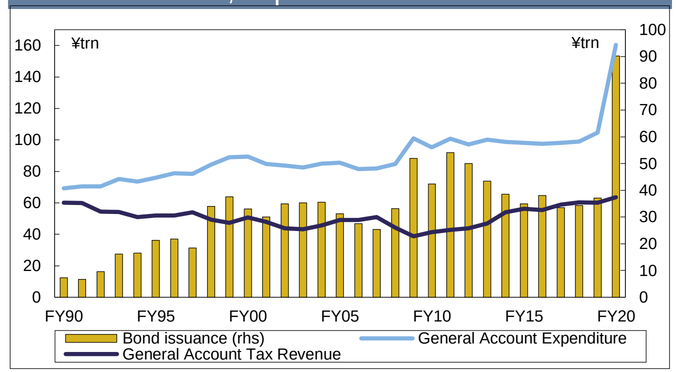
Government expenditure and revenue



Net T-bill issuance and amount outstanding



JGB issuance, expenditure and revenue

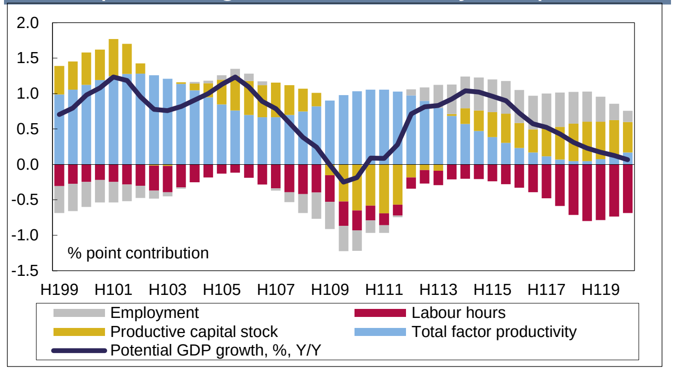


* Projection made in July 2020, baseline case. Source: Cabinet Office, BoJ , MoF and Daiwa Capital Markets Europe

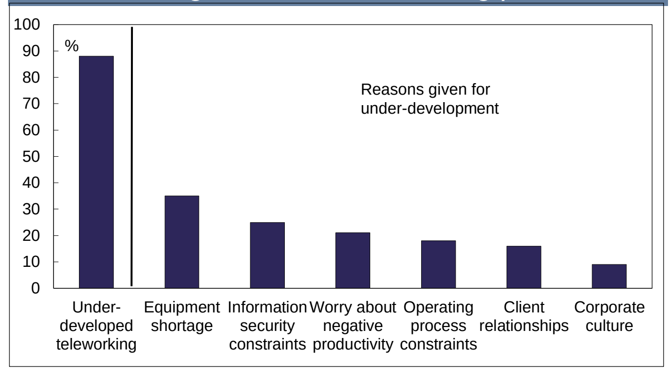
- The pandemic has provided a set-back for the government's efforts to strengthen the public finances. Optimistically, assuming no further fiscal stimulus, the Cabinet Office forecasts the primary deficit to fall to around 2% of GDP in FY29. General government debt is forecast to remain well above 200% of GDP.

Opportunities and risks ahead

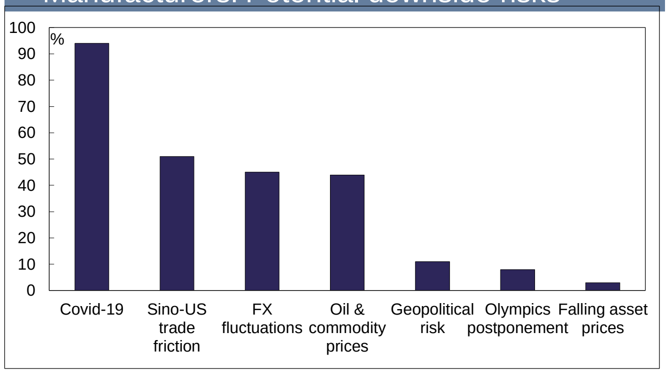
BoJ potential growth estimate, by component



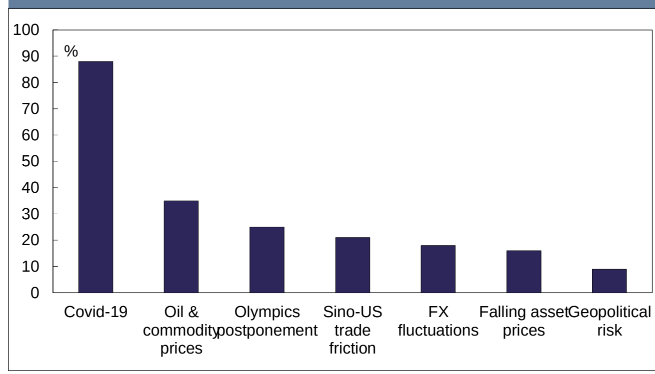
Teleworking as a constraint during pandemic^



Manufacturers: Potential downside risks*



Non-manufacturers: Potential downside risks*



^Measures % of firms citing underdeveloped teleworking as a constraint. *% of firms citing each category as a top-3 business risk Source: DBJ and Daiwa Capital Markets Europe Ltd.

- When asked in June, 94% of manufacturers and 84% of non-manufacturers cited Covid-19 as one of the three biggest downside risks. Non-manufacturers were also worried about commodity prices and the postponement of the Tokyo Olympics, whereas manufacturers worried about Sino-US trade friction and FX fluctuations.

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