

Japan Economic Update

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

While new waves of coronavirus cases have occurred in the winter and spring – triggering new restrictions on activity as daily deaths reached record highs – Japan has continued to fare much better than most other countries with just 0.6% of the population infected since the pandemic began, compared with over 10% in the US.

2) As in Europe, Japan's recovery has been set back this year by new waves of coronavirus

While Japan's economic output had returned to within 1% of the pre-pandemic level in Q420, new waves of coronavirus have provided a setback this year with output contracting 1.0%Q/Q in Q1 and a further modest contraction now also likely in Q2.

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

A strong global economic recovery, together with domestic fiscal and monetary stimulus, should allow Japan's recovery to resume in the second half of this year provided that global vaccination efforts successfully halt the spread of coronavirus. Even so, it could take until mid-2023 for Japan to recapture the pre-pandemic peak of activity, which occurred before the consumption tax hike in October 2019.

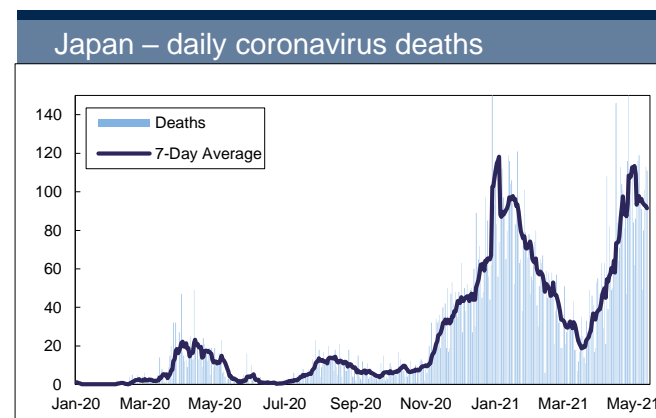
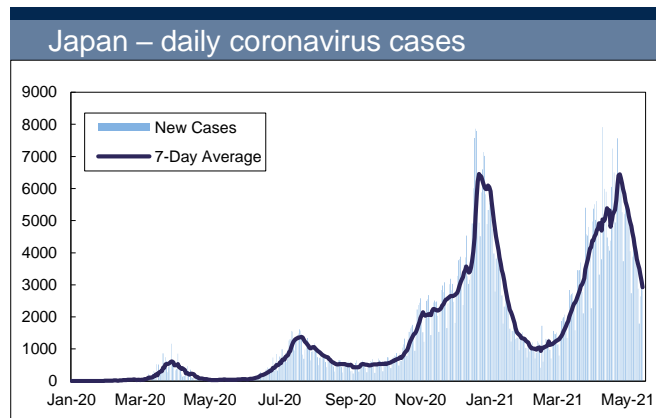
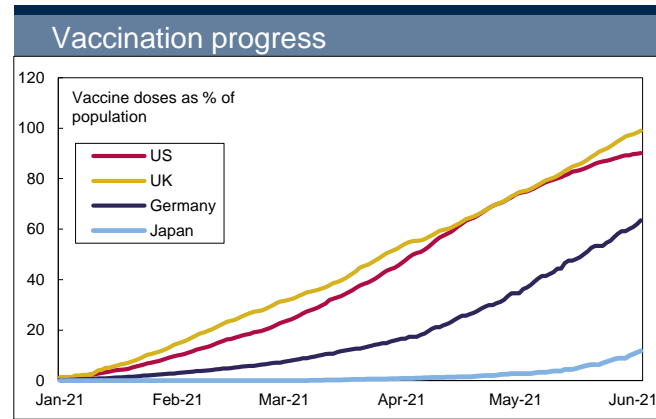
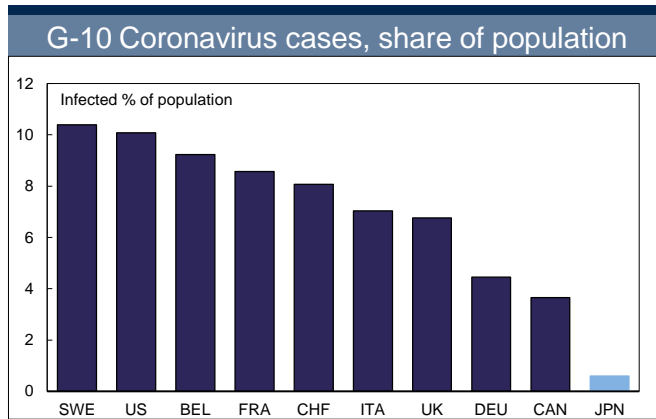
4) Beyond the unwinding of base effects, the outlook for inflation remains weak

Sadly the pandemic has undone years of progress towards building the economic conditions necessary to lift inflation to the BoJ's target, with Government policy measures contributing to low inflation in the near term. However, as long as some uptrend in inflation re-emerges, albeit painfully slow, the BoJ will refrain from cutting rates further given worries about possible negative side-effects, even though it insists it is ready to do so if needed.

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 hitting new lows of late 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.

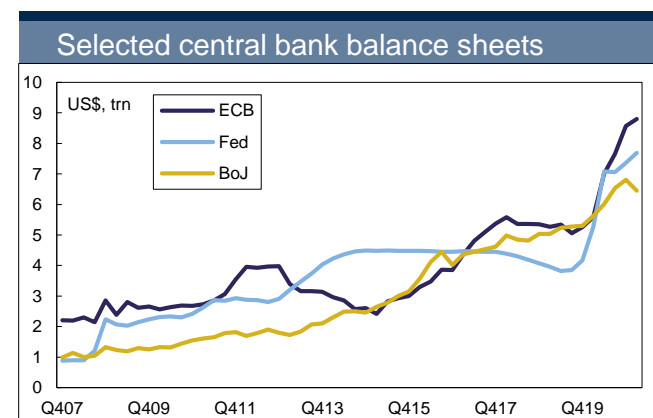
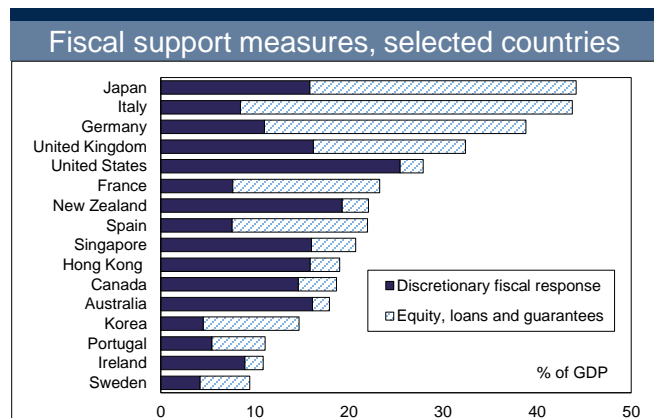
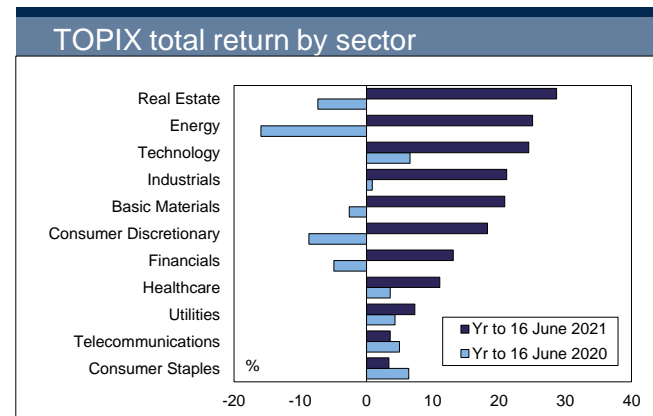
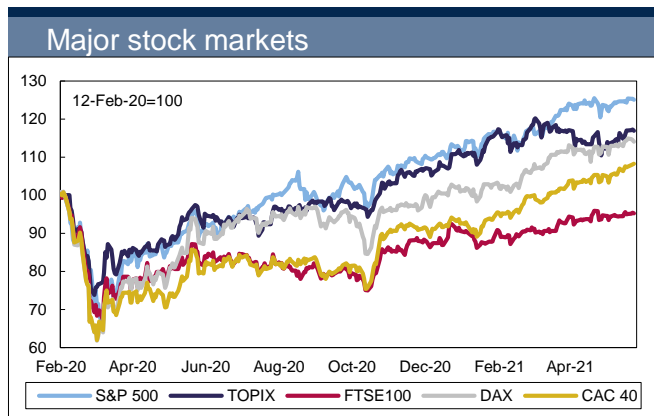
Despite the recent wave Japan's incidence of Covid-19 remains very low. But so does its rate of vaccination



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

- Coronavirus cases climbed sharply in Japan over the winter and spring, triggering multiple rounds of restrictions on activity. Even so, the incidence of coronavirus remains very low – just 0.6% of the population have been infected, compared with over 10% in the US. This may partly explain the lack of urgency in Japan's vaccination drive.

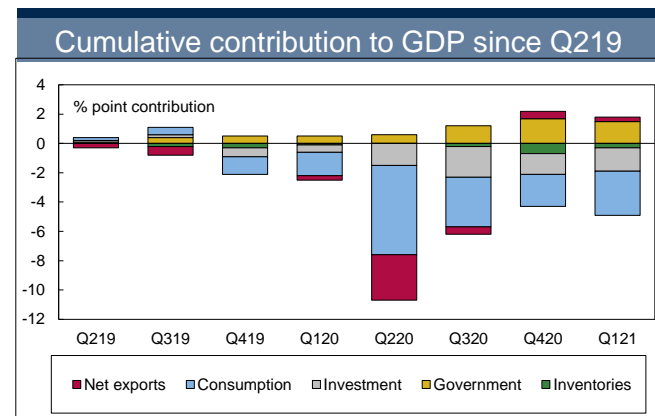
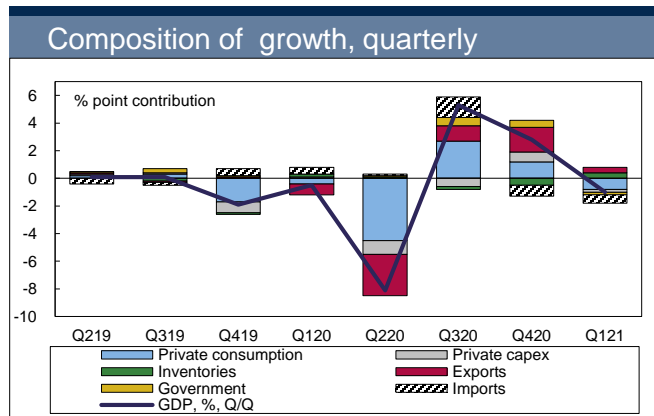
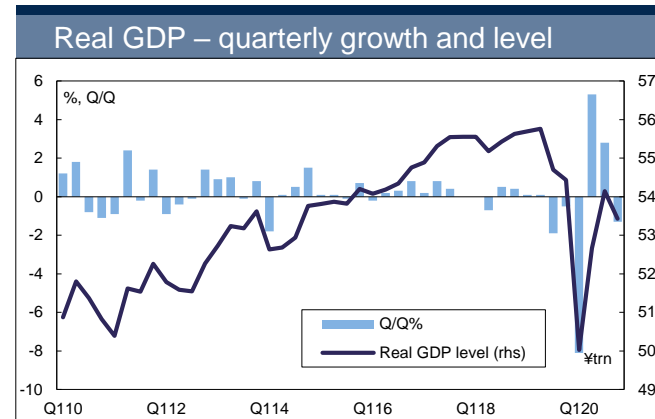
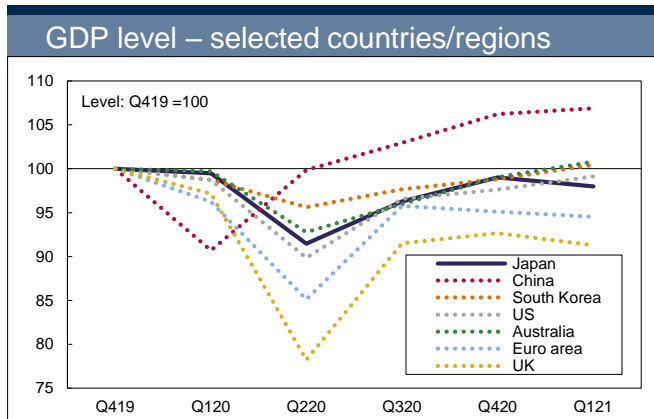
Japanese (and global) stock prices have reached new highs



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

- Japan has deployed substantial fiscal and monetary support to compact the economic impact of the pandemic. In concert with the support deployed in other countries, Japan's stock market quickly recovered its initial pandemic-induced slump and since gone on to set a record high.

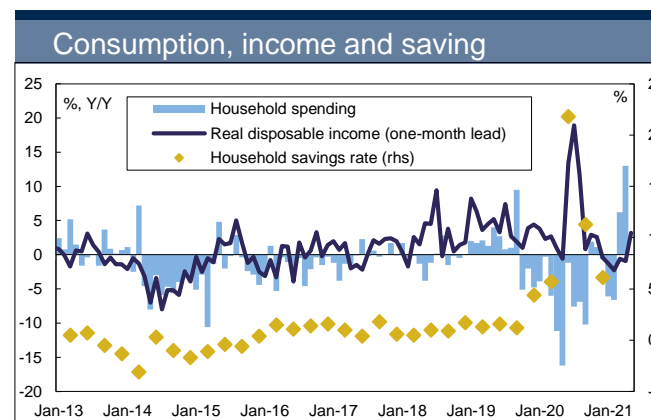
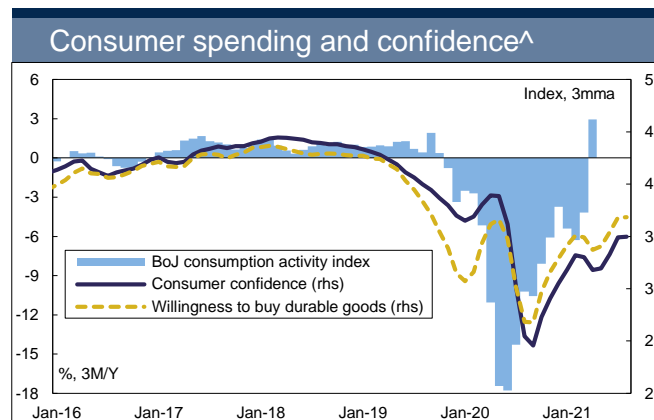
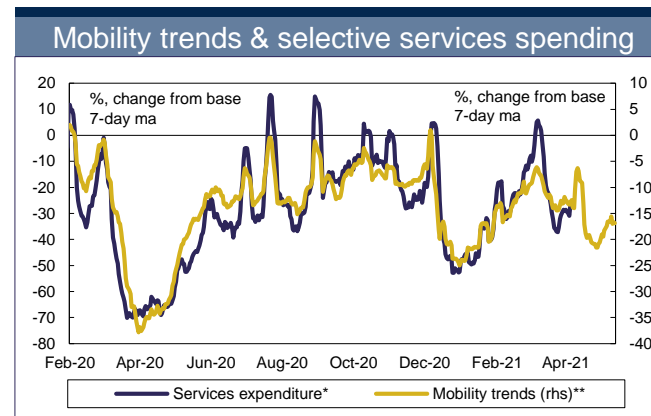
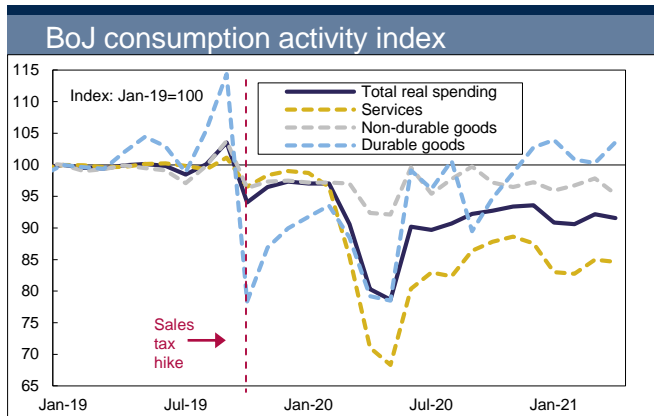
Japan's GDP still tracking below pre-pandemic levels



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

- While Japan's economy recovered to 99% of its pre-pandemic level in Q4, helped by increased government spending, new waves of coronavirus led to some backtrack in Q1 (with a further contraction likely in Q2). Japan's performance is superior to that in Europe but lags some other nations, including the US and South Korea.

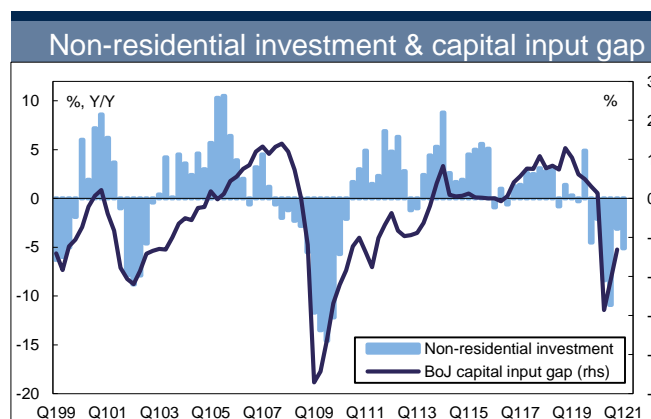
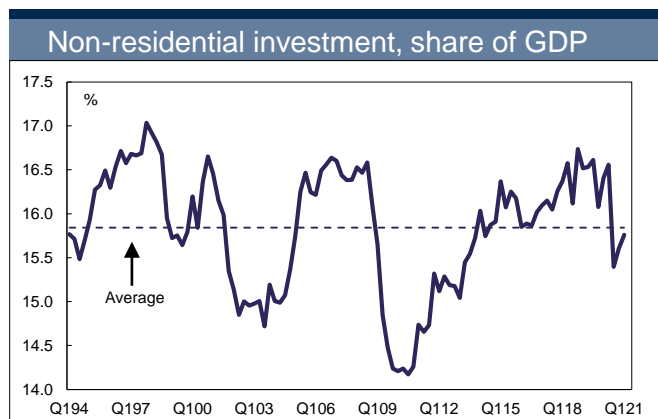
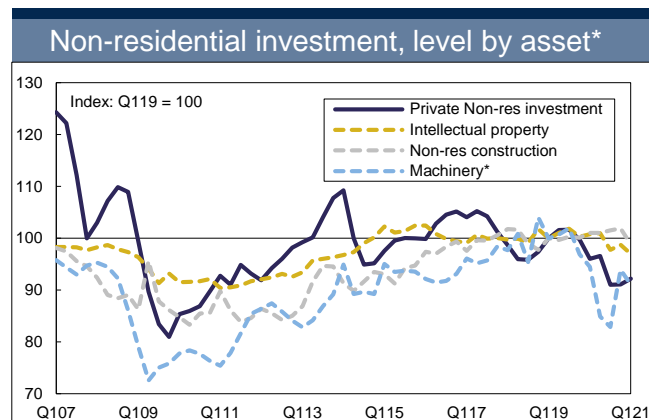
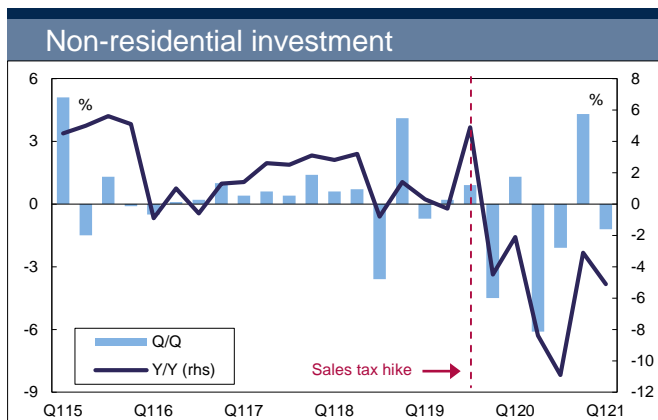
Consumer spending on services likely weakening again



*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.
 ^Consumer confidence advanced 3 months. 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 rebounded sharply, spending on clothing and other personal items remains weak, and services demand is falling back again from well below pre-pandemic levels. Many households saved cash pay-outs from the government given low confidence and uncertainty.

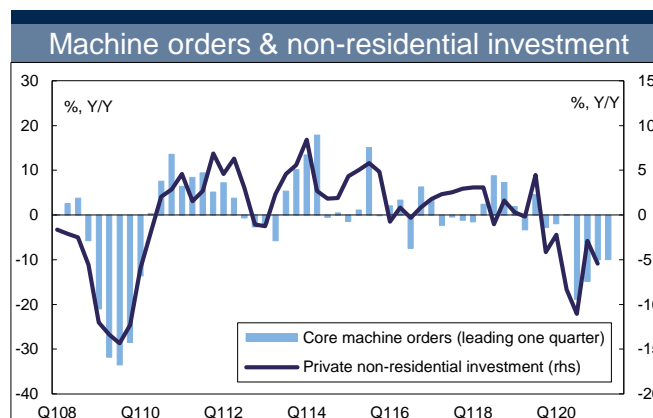
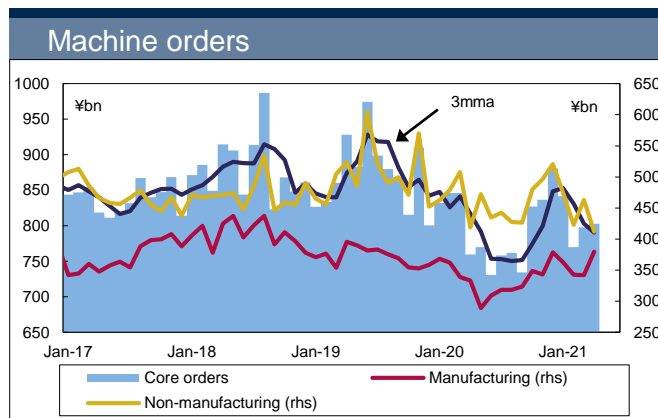
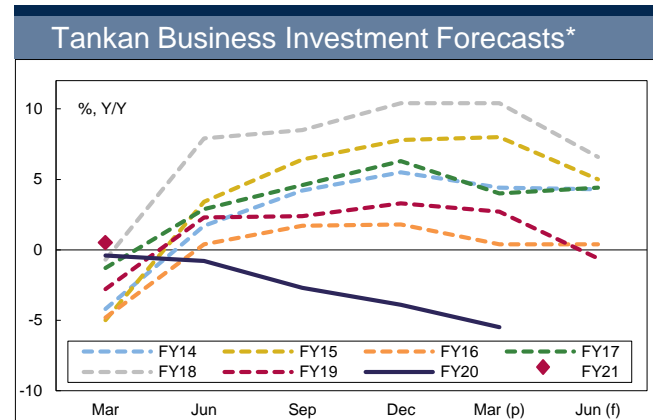
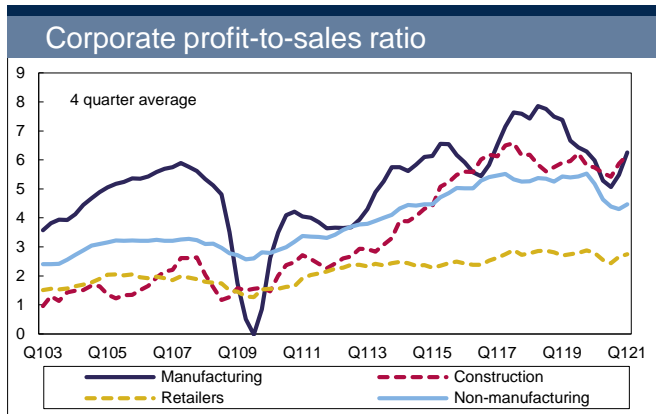
Business capex recovery faltered in Q1



*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, weakened further once the pandemic began as spending on machinery fell sharply. While capex has moved off its lows, the recovery faltered somewhat in Q1 as a new wave of coronavirus cases impacted the economy.

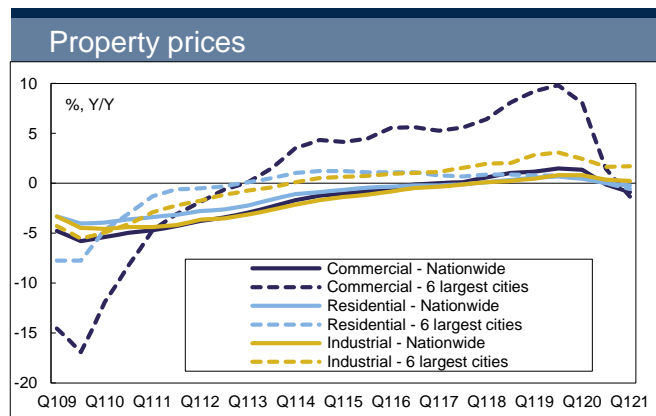
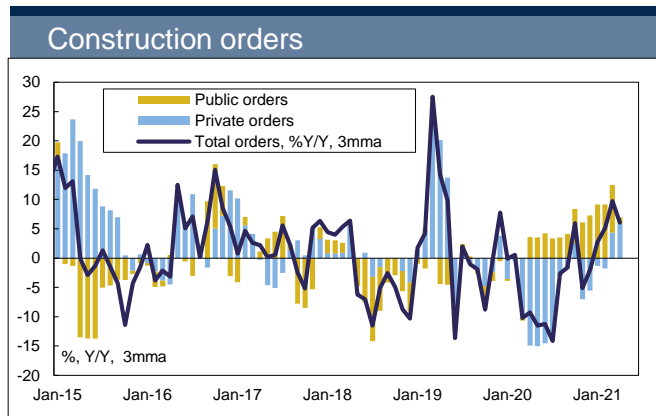
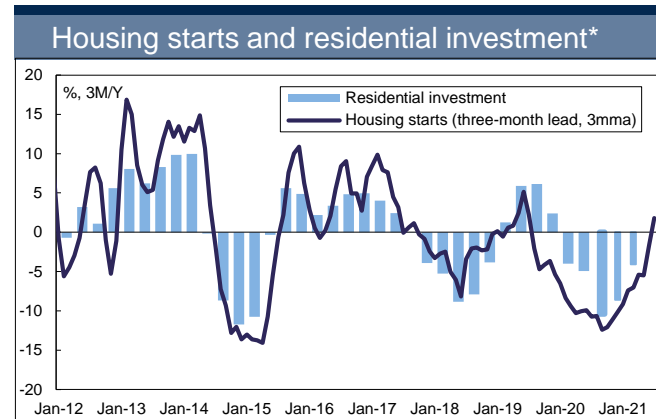
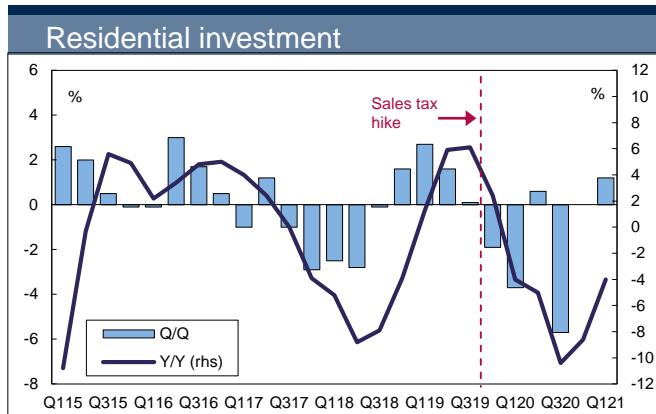
But there are signs that capex has now passed its trough



^MoF corporate survey, *All firms, fiscal year, fixed investment including land. Source: Refinitiv, Bloomberg, Cabinet Office, BoJ, and Daiwa Capital Markets Europe Ltd.

- Firms' profits have begun to recover, especially in the manufacturing and construction sectors, and the BoJ's Q1 Tankan survey reported an atypically positive first reading on capex expectations for the new fiscal year. Domestic machinery orders are also off their lows, albeit a little softer in recent months.

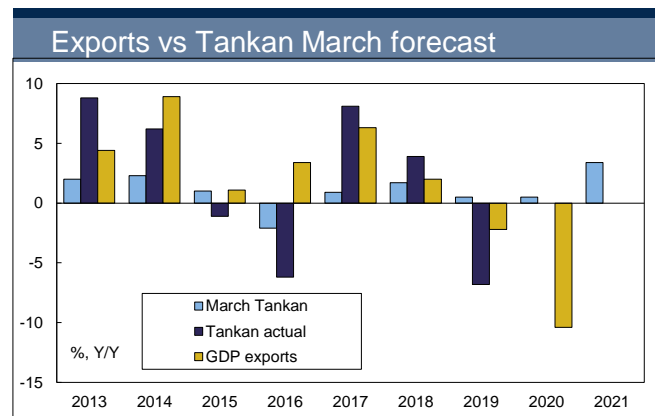
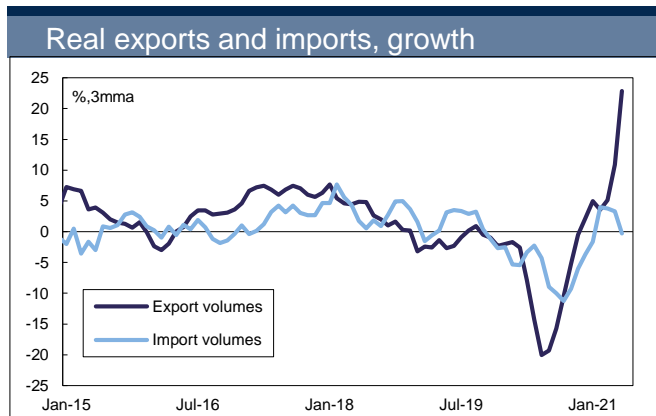
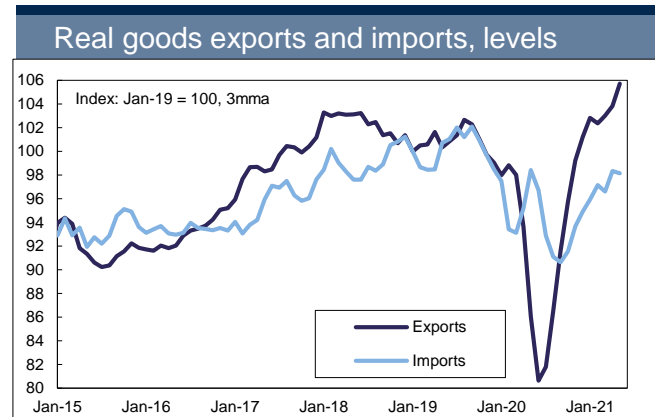
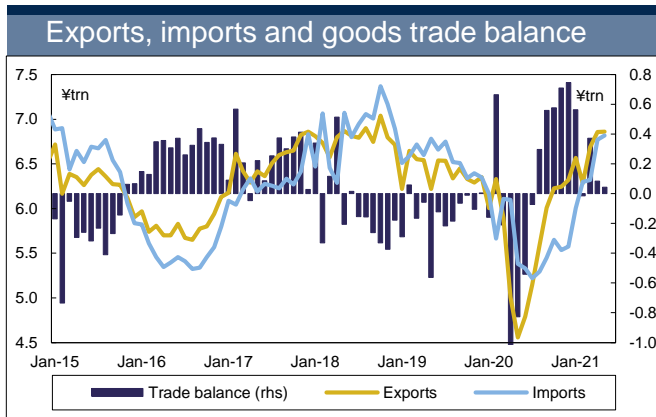
Residential building activity appears to be turning up



*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.

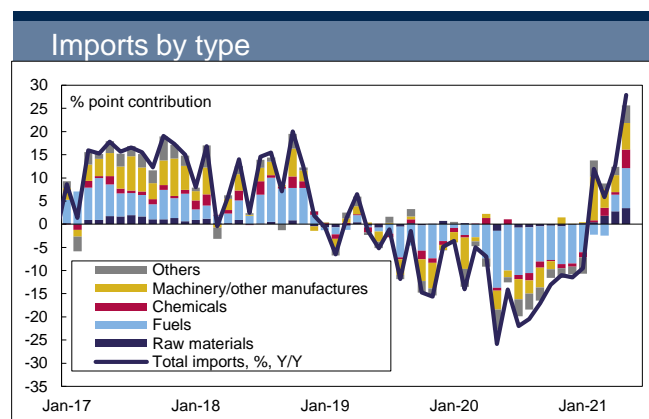
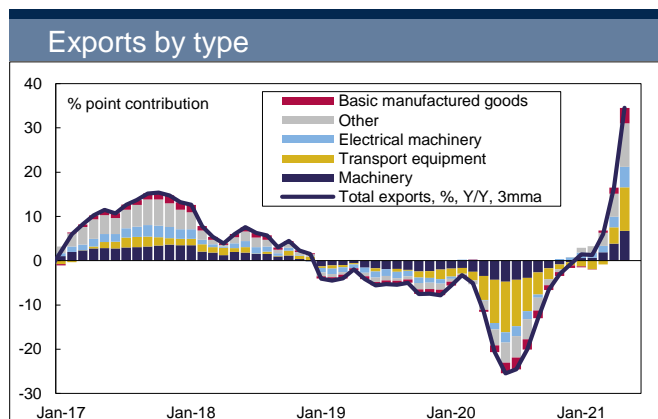
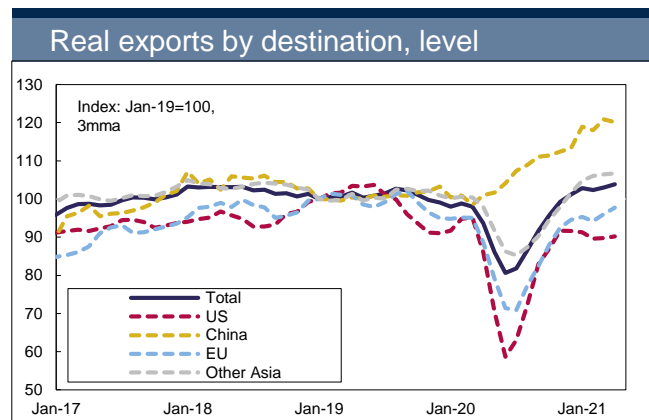
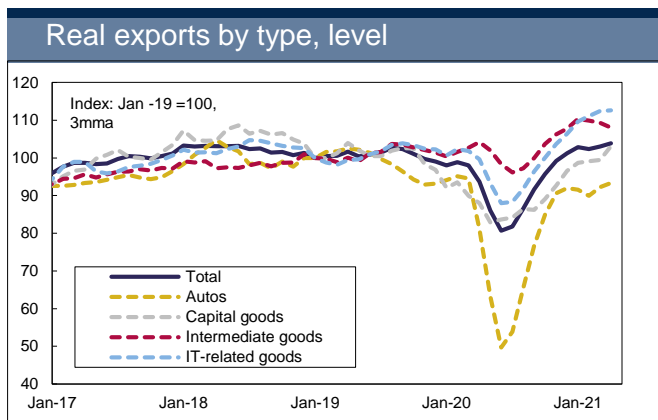
Real goods exports now exceed the pre-pandemic high



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. However, exports have since recovered with the BoJ's real export series surpassing pre-pandemic levels in Q4, and rising to new record highs this year.

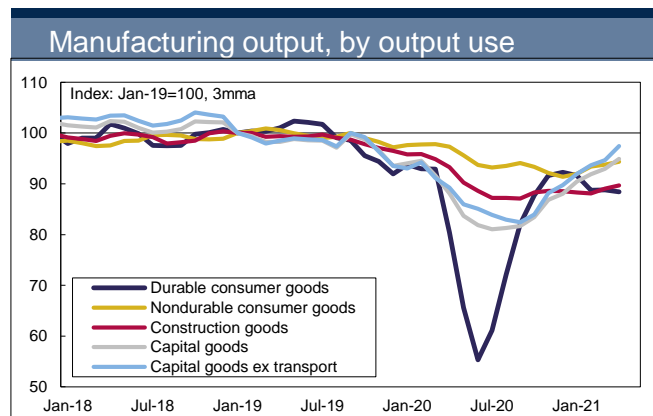
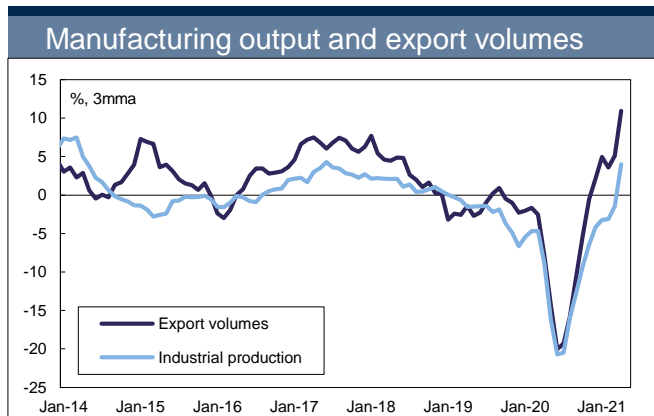
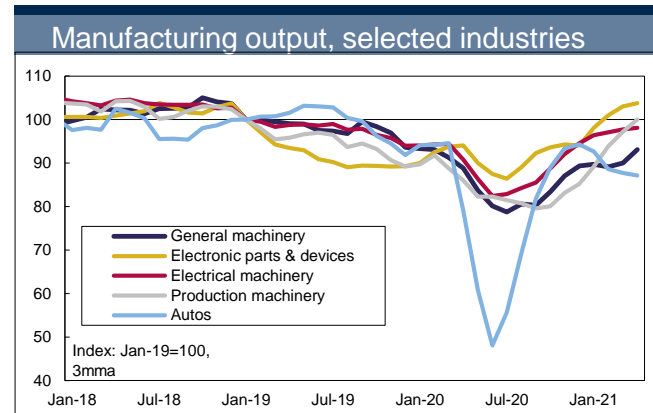
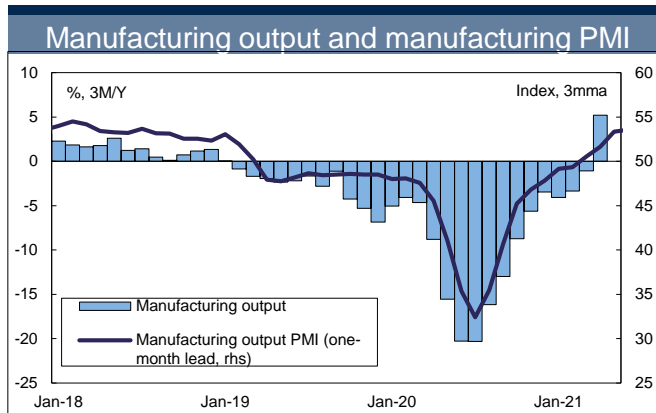
Export recovery driven by China and IT-related goods



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

- Japan's exports to China were barely impacted by the pandemic and have since grown strongly to new highs, driven in particular by increasing demand for IT-related goods. Japan's import recovery mostly reflects the pickup in demand for capital goods and certain other manufactured items.

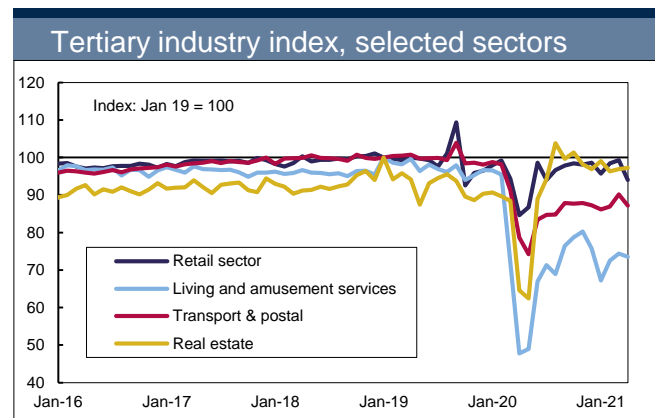
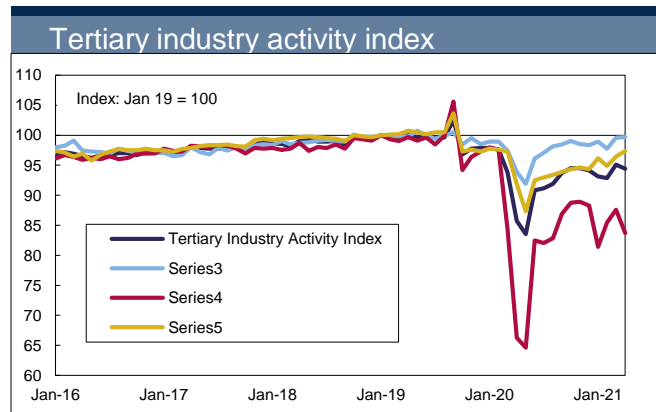
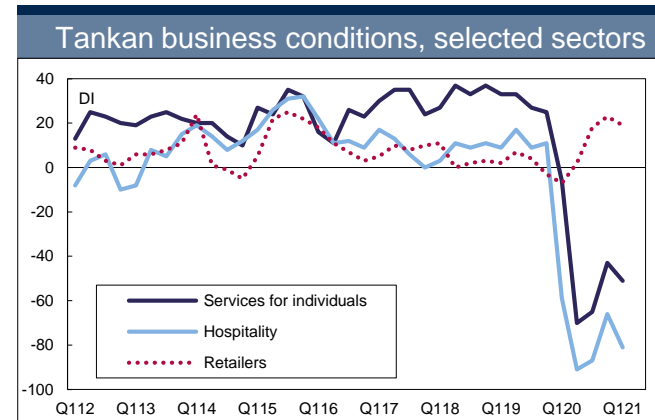
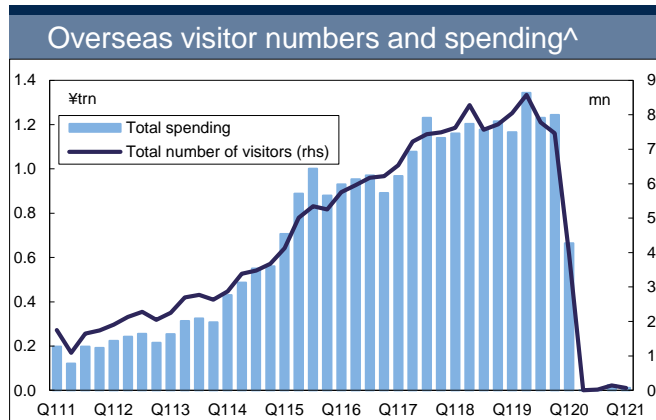
Manufacturing benefitting from rebound in external demand



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 now above pre-pandemic levels (but still below pre-consumption tax hike levels). Indicators point to continued growth through Q2 despite the ongoing pandemic.

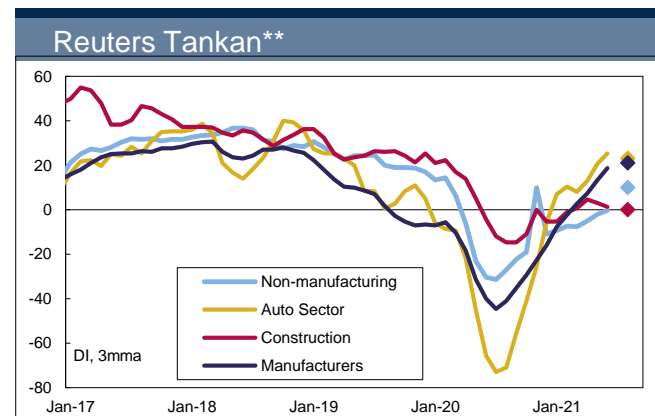
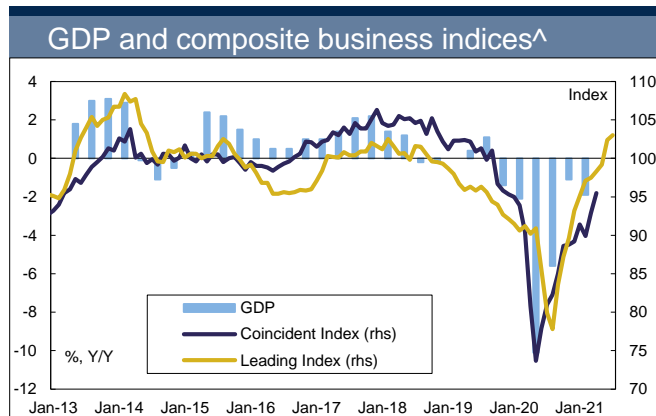
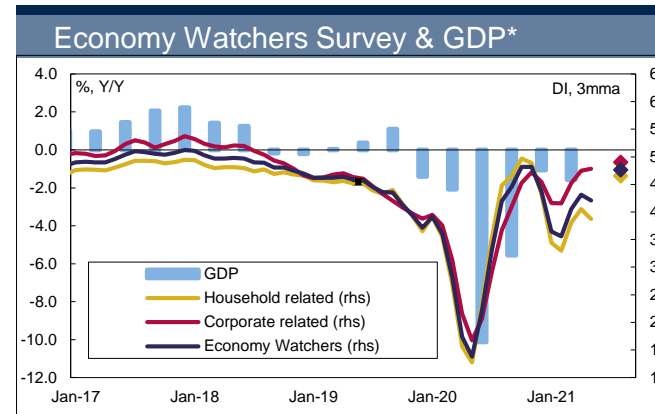
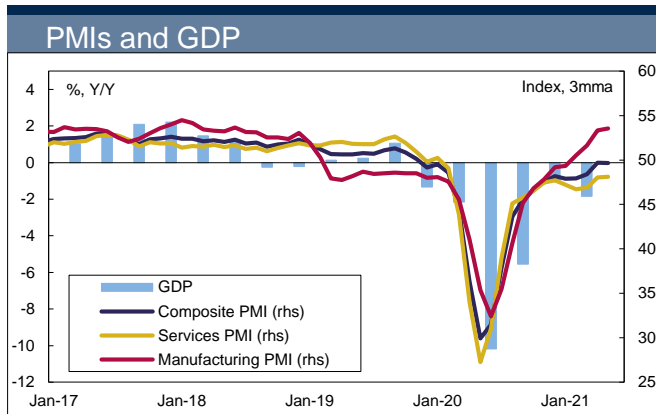
The halt to tourism continues to weigh on the service sector



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

- With the border largely closed, the number of overseas visitors to Japan remains less than 1% of pre-pandemic numbers, more than decimating an industry that had been contributing ¥5trn to the economy each year. Conditions are unlikely to improve until some time after global vaccinations are well advanced

Some sentiment and activity indicators have softened of late



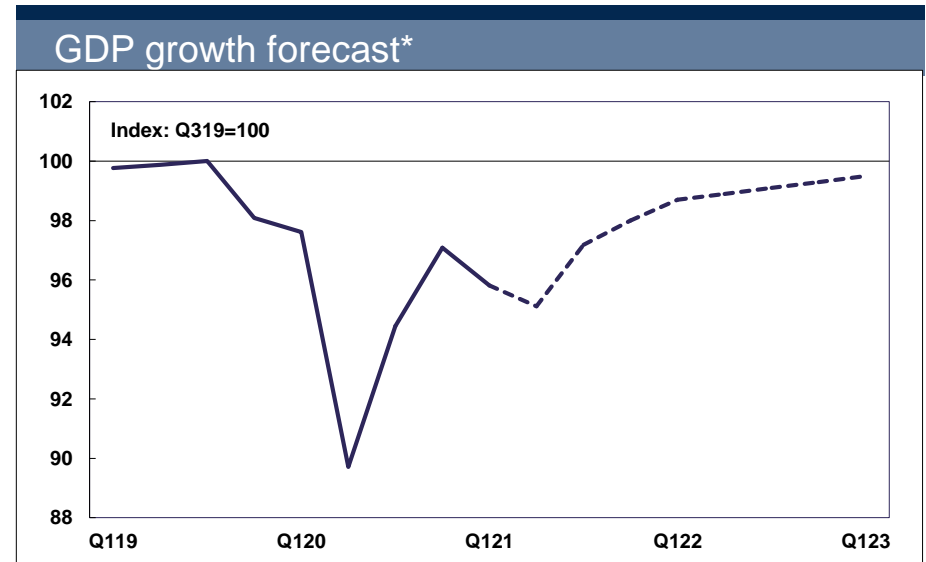
* Diamonds are latest readings for the outlook index. ^Leading index has three-month lead. **Diamonds represent latest reading of forecast index. Source: Refinitiv, IHS Markit, Cabinet Office and Daiwa Capital Markets Europe Ltd.

- Key indicators of activity and sentiment have largely recovered from their early-pandemic lows. But some have softened a little of late as they have begun to pick up the disruption caused by the latest wave of coronavirus cases and associated restrictions on trading activity.

We expect it will take until sometime in FY24 before the economy returns to its pre-consumption tax peak

GDP growth forecast*				
Y/Y growth	FY19	FY20	FY21	FY22
Private consumption	-1.0	-6.0	1.3	4.8
Private residential investment	2.5	-7.1	0.7	2.2
Private non-residential investment	-0.6	-6.9	4.6	5.3
Public consumption	2.0	3.2	1.1	0.1
Public investment	1.5	4.3	1.1	0.5
Exports	-2.2	-10.5	14.1	5.4
Imports	0.2	-6.9	4.8	7.0
GDP growth, %, Y/Y	-0.5	-4.6	3.1	3.3
BoJ GDP growth forecast (April)	-	-4.9	4.0	2.4

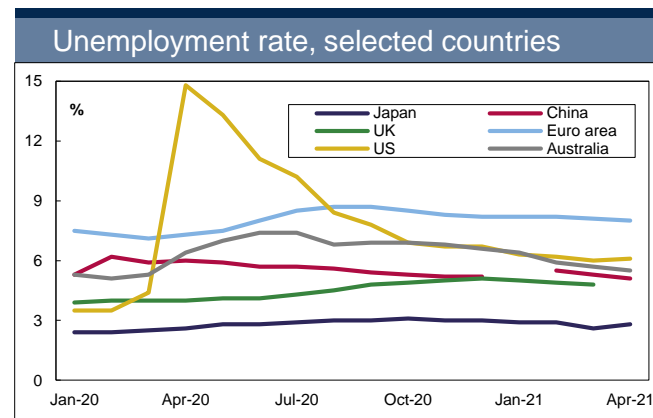
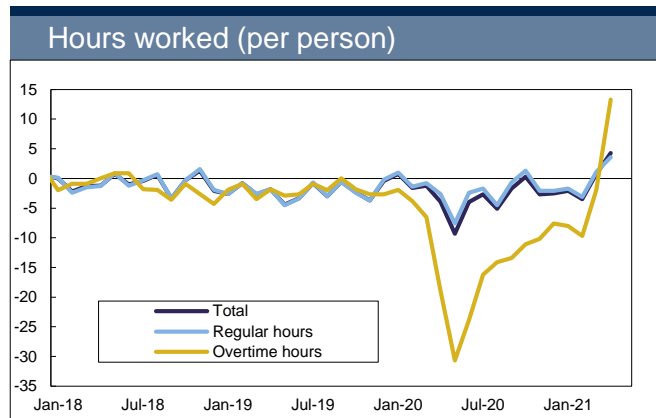
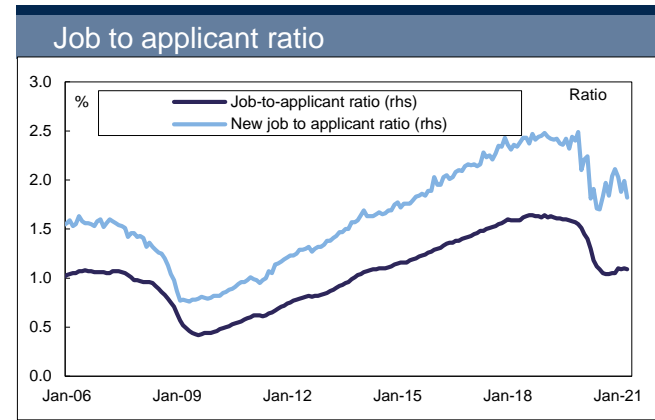
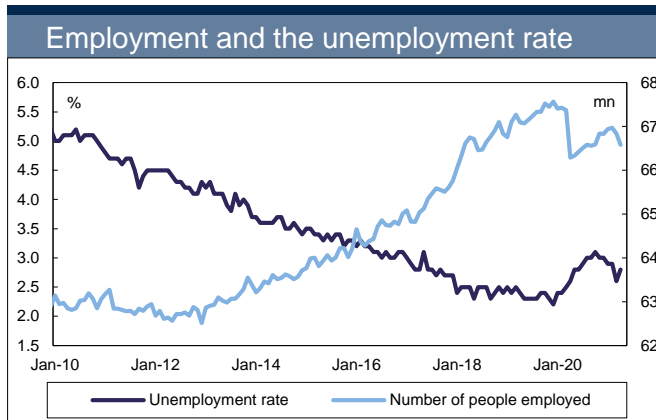
*Figures may not sum due to rounding. Source: Cabinet Office and DIR



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

- Pandemic-related restrictions mean that activity will likely decline in the current quarter. Presuming that service sector activity begins to rebound in Q3, we expect strong growth in exports and a rebound in capex to underpin GDP growth of 3.1% in FY21, while a rebound in consumer spending will drive growth of 3.3% in FY22.
- 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.

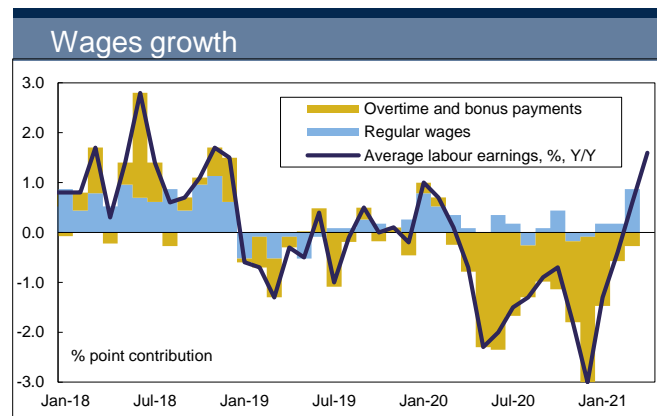
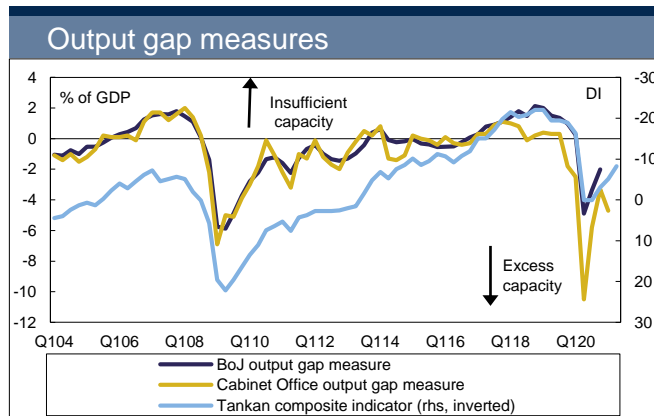
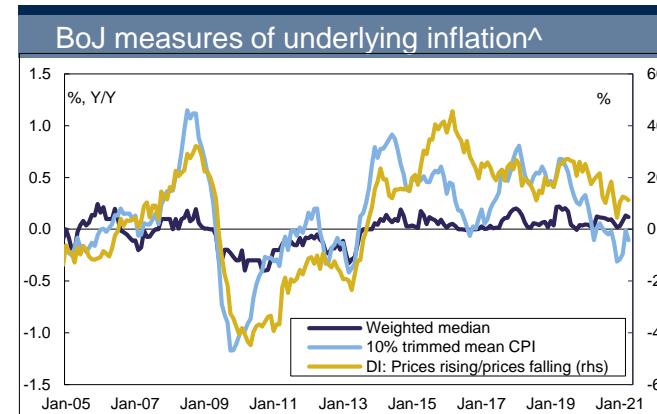
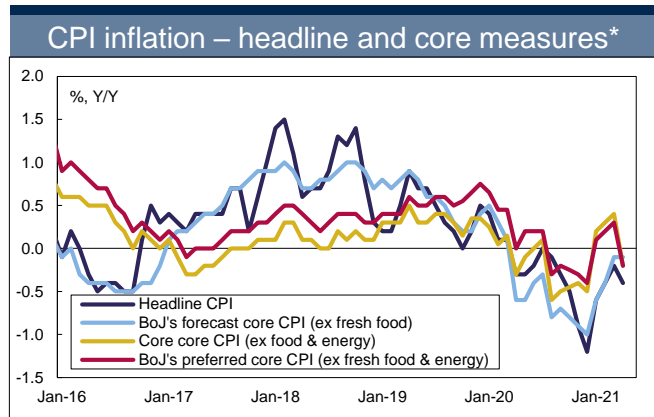
Japan's labour market remains resilient



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

- Household employment remains about 1mn (1.5%) below the pre-pandemic peak. Even so, at 2.8%, the unemployment rate is just 0.6ppts above the pre-pandemic low. Firms' temporarily reduced demand for labour was manifest mostly in a sharp reduction in over-time hours worked.

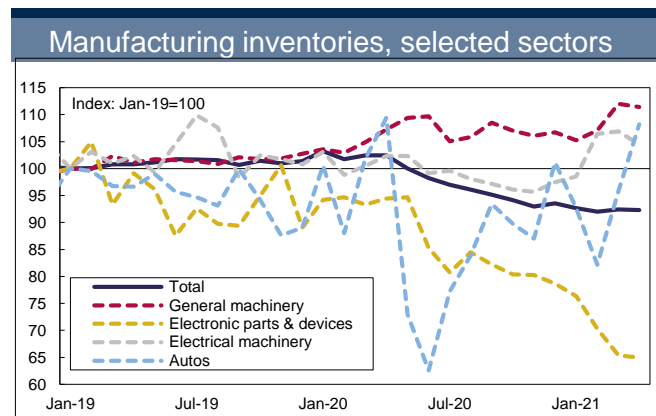
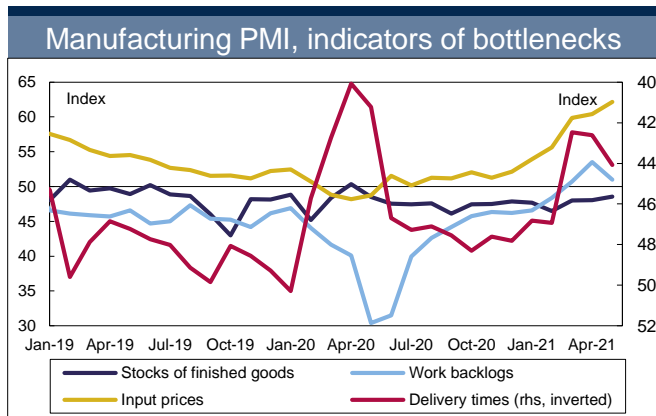
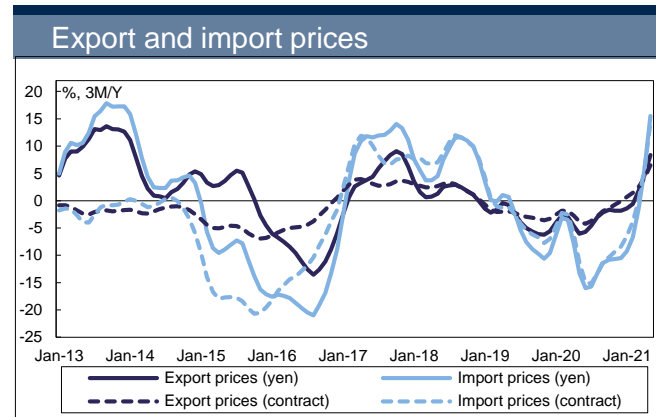
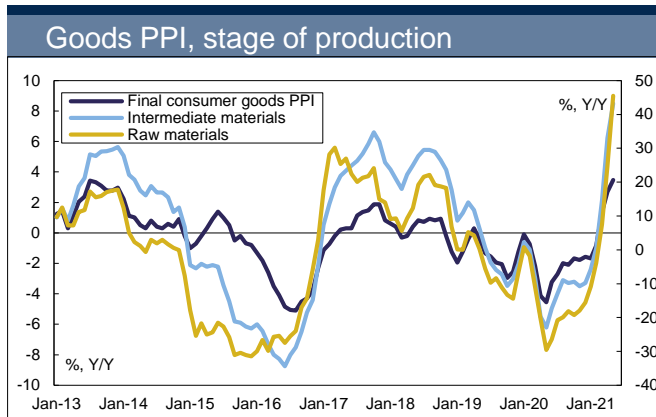
The pandemic has weakened underlying inflation



* 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.

- Underlying inflation was only mildly positive prior to the pandemic and has weakened since. While underlying inflation should lift gradually as the recovery firms, a recent sharp decline in mobile phone call charges has depressed the headline and core CPI measures, making it harder for the BoJ to lift inflation expectations.

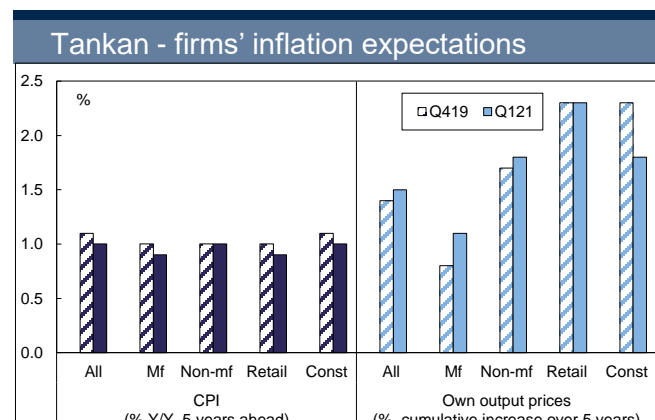
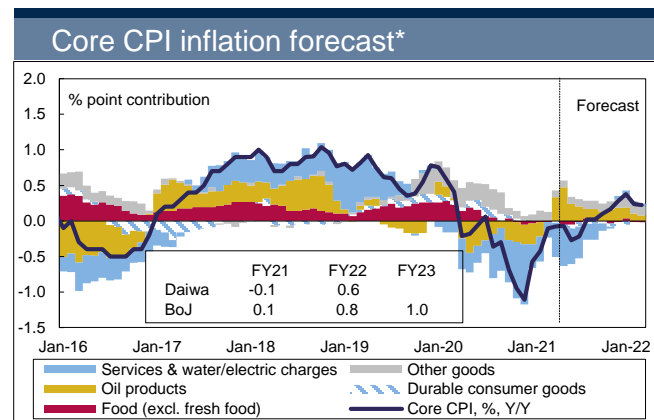
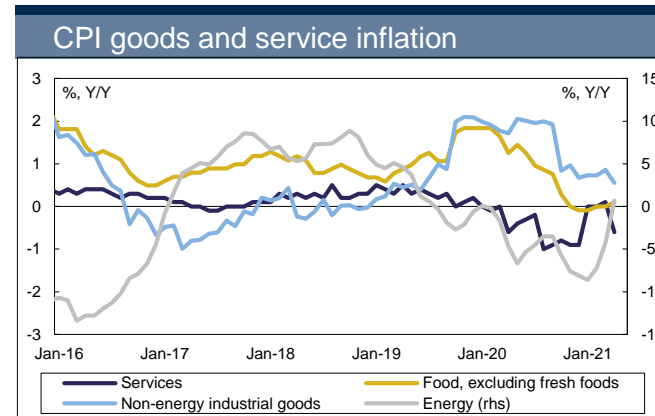
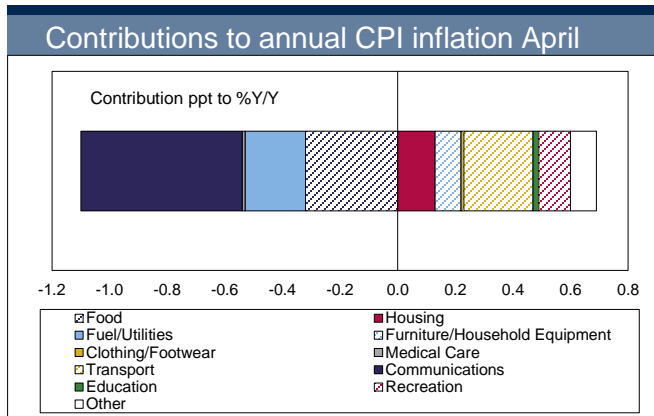
Base effects, a rally in commodity prices and supply bottlenecks lifting pipeline inflation



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

- Pipeline inflation pressures have emerged due to a sharp rebound in global commodity prices, a weaker yen and supply-side bottlenecks (semi-conductors shortages and freight bottlenecks are of particular note).

Despite the pipeline pressures, CPI inflation is likely to remain low



*Core CPI excluding fresh foods. Source: Refinitiv, BoJ, MIC, and Daiwa Capital Markets Europe Ltd.

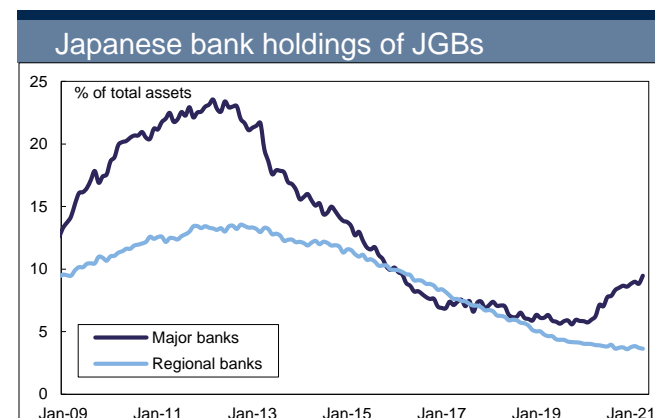
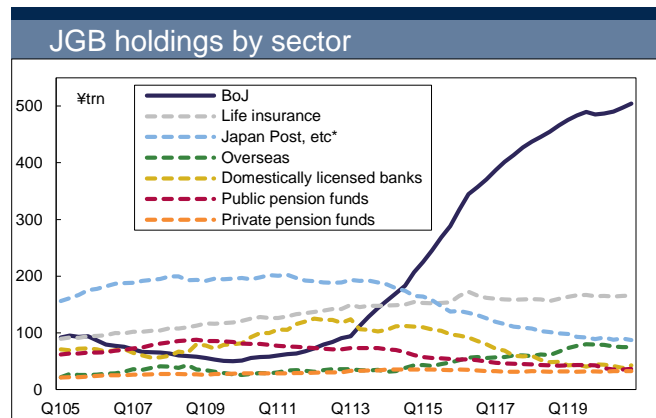
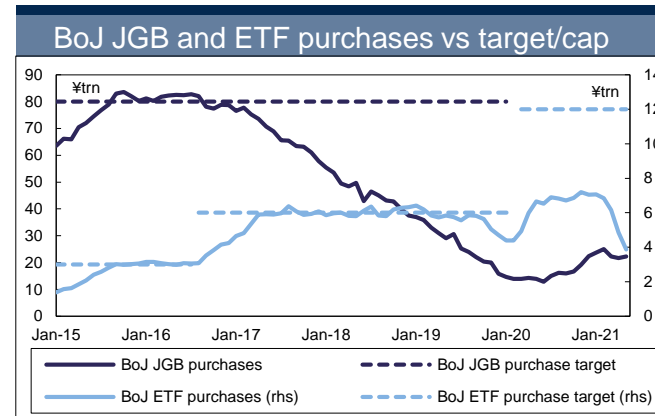
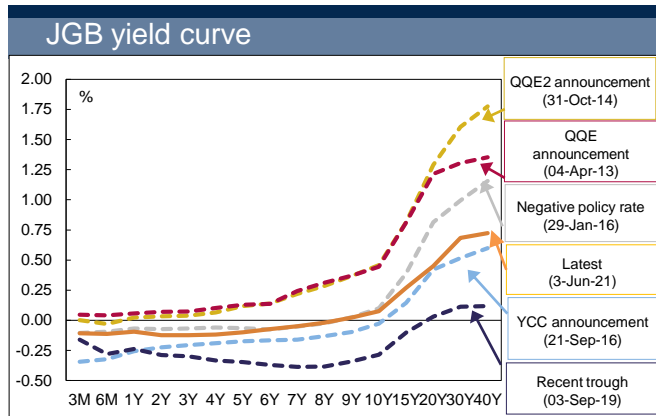
- Core inflation is likely to turn modestly positive late this year and pick up further next year as the impact of mobile call charge reductions disappears. However, inflation is likely to remain well below the BoJ's 2% target in the medium term given the setback to the economy and inflation expectations caused by the pandemic.

BoJ Monetary Policy Framework following latest review

Yield Curve Control	QQE	Loan facilities
<ul style="list-style-type: none"> ■ Negative policy rate (-0.1%) on marginal excess reserves ■ New mechanism in place to mitigate impact on bank profits if policy rate needs to be reduced further in the future ■ 10Y yield target of ‘around zero per cent’ - although yields may now move upward and downward by up to 0.25%, 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 as required at an unlimited pace to achieve target for 10Y JGB yield ■ BoJ ETF holdings to increase as required with an upper limit of ¥12trn ■ BoJ J-REIT holdings to increase as required 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 (likely to be extended)
<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.

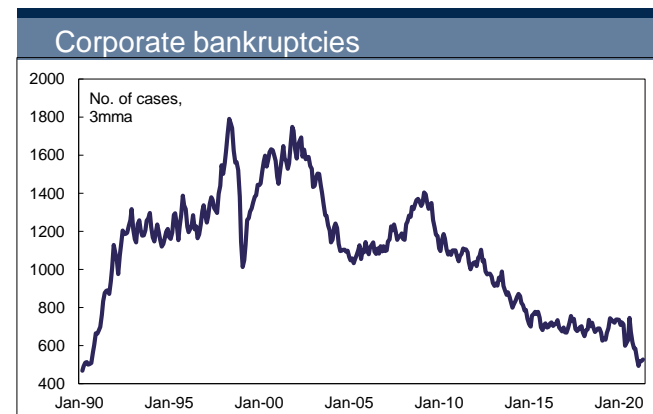
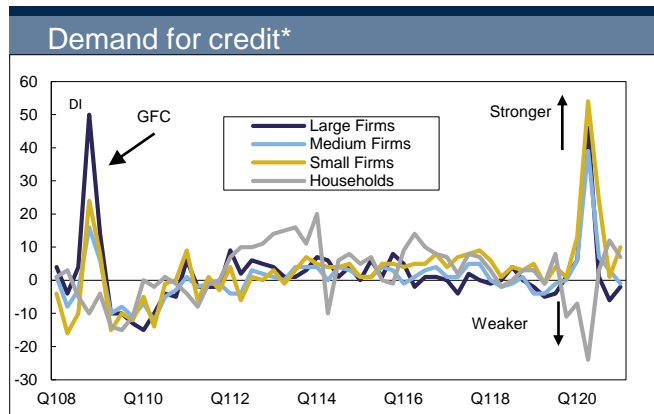
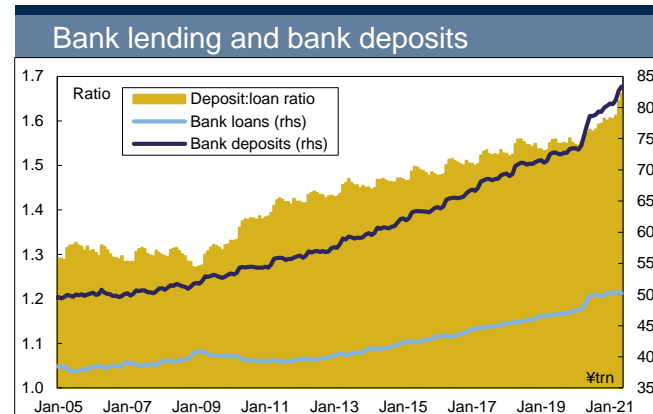
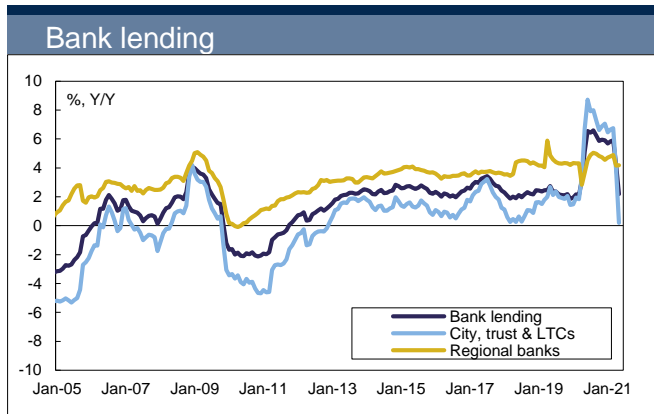
The BoJ's asset purchases have slowed



*Category includes agricultural cooperatives, etc. Source: Refinitiv, Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

- While the BoJ's rinban purchases picked up as part of its pandemic response, total purchases over the past 12-months were just ¥22trn – a quarter of the earlier peak. The BoJ's annual ETF purchases have slowed to less than ¥4trn – well below the policy cap – with purchases in May amounting to less than ¥0.1trn.

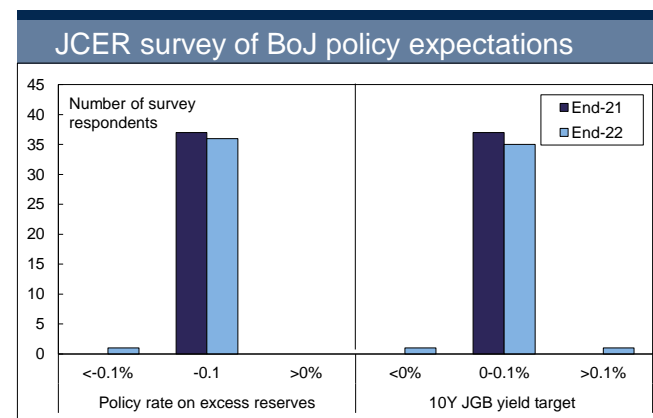
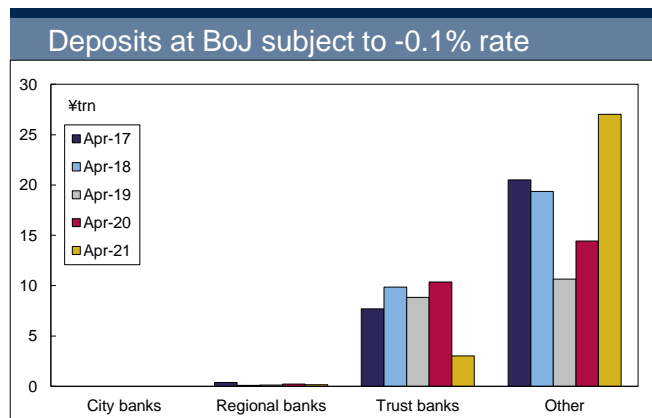
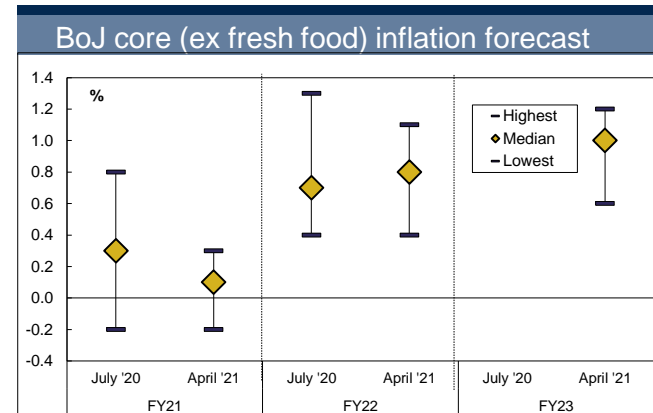
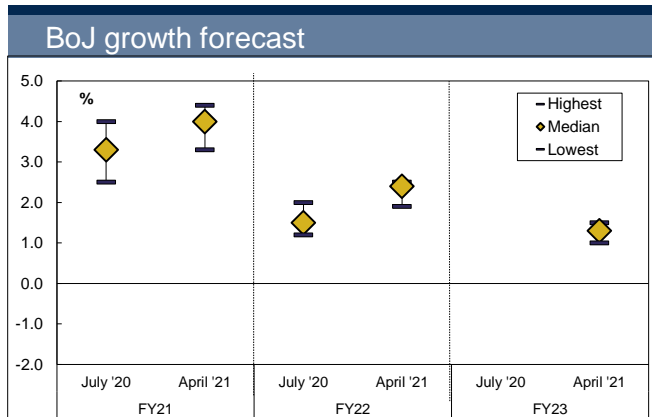
Japan's bank lending growth slowing as liquidity needs dissipate while need for capex funding still low



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

- Bank lending growth has slowed as firms' need for emergency liquidity has dissipated while demand for funding for investment remains low. Supported by the banking sector and government guarantees, remarkably corporate bankruptcies are sitting at a 30-year low.

The pandemic was sufficient to drive the BoJ to deliver further rate cuts, despite a weak inflation outlook

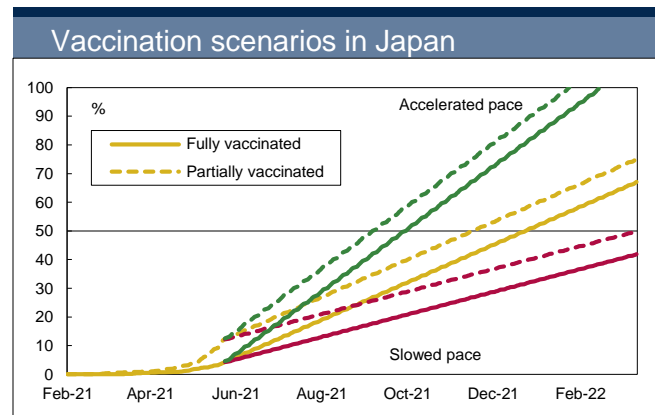
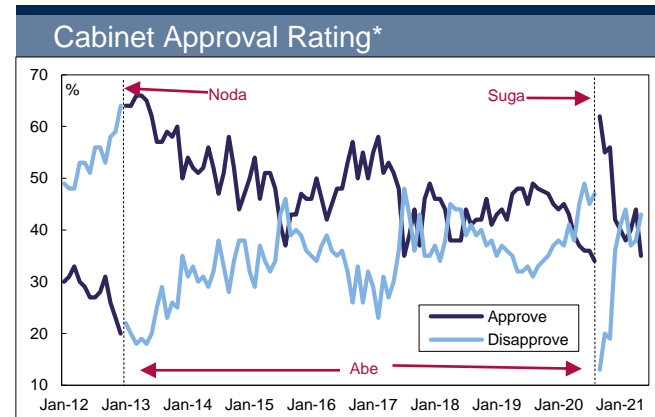


Source: BoJ, Bloomberg, JCER and Daiwa Capital Markets Europe Ltd.

- Even the most optimistic BoJ Board member expects inflation to remain at around half of the 2% target by FY23, and so unsurprisingly 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.

Vaccinations, Olympics and elections in focus in 2021 -

Key dates in 2021	
May	Jun 18th: BoJ Meeting Japan should have more than enough vaccine doses for health workers and over 65s by month end Vaccinations of under 65s may start late in the month or in July
Jul 23 rd : Olympics opening ceremony 16 th : BoJ Meeting and Outlook Report Tokyo Assembly election by 22 nd Optimistically, Japan aims to have fully vaccinated all over 65s by the end of the month	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 Japan aims to have obtained enough vaccine doses for all aged 16 and over by month end	Oct Lower house election required on or before 21st October 28 th BoJ Meeting and Outlook Report
Nov	Dec 17 th BoJ Meeting



* Latest poll is January 2021; Source: NHK, Our World in Data and Daiwa Capital Markets Europe Ltd.

- 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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