Daiwa Securities

Economic Commentary

Context before the BOJ's Dec policy meeting, analysis of Tankan

- BOJ is communicating carefully; Deputy Governor Himino's speech schedule has been moved up
  Some support a Dec rate hike, but the bank staff is in no hurry and likely to hold off
  BOJ considering a rate hike within FY24, but has yet to settle on timing
- Tankan supports BOJ's view that domestic economy is on track
  No change in inflation expectations, companies continue passing on higher prices
  Business sentiment better than expected; recurring profit has also improved from the last survey

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BOJ December meeting, pre-blackout context

During the second week of December, it was announced on the afternoon of the 9th that Deputy Governor Himino's speech at a meeting with local leaders (known as *Kinkon*) is set for 14 January next year in Yokohama. Before Mr. Ueda became BOJ governor, it was normal for the Deputy Governor's *Kinkon* schedule to be announced about a month in advance. The BOJ had explained that the schedule was announced just before the event to be able to respond in case it was summoned by the Diet when it was in session. That the media was notified and the public announcement made around the same time is evidence that the BOJ is committed to communicating carefully. However, given that there is no precedent for a board member speaking at the *Kinkon* prior to the January policy meeting, it would not be surprising if this were seen as laying the groundwork for a January rate hike, although that is likely not the BOJ's intention. Members other than the Governor usually speak at the *Kinkon* twice a year. Since Mr. Himino was named Deputy Governor on 20 March 2023, he has only spoken at *Kinkon* twice, on 6 December 2023 and 28 August 2024, a clear decline in those appearances. With an additional rate hike looming, this presents a valuable opportunity to hear the Deputy Governor's own analysis and insightful opinions.

On the 13th, prior to the blackout period for the BOJ's December policy meeting, the BOJ will hold a briefing for the press, and the media will report on that briefing with quotes from BOJ officials. On the evening of the 11th, Bloomberg reported, "The BOJ is in no rush to hike rates, and sees low risk of inflation accelerating even if there is no rate hike this month, according to sources," and on the 12th at 2:30 PM, Reuters reported, "The BOJ will assess the situation until just before December meeting as the argument for postponing a rate hike has strengthened, according to sources." Neither story repudiated the Jiji Press article on the 4th suggesting the possibility of no more rate hikes this year, an indication that bank staff is not in a hurry to hike. However, there was new information indicating there are board members leaning toward a December rate hike. They are likely considering early action out of concern that waiting to assess Trump risks could make it hard to act. That said, it is unlikely they would oppose the chairman's proposal to maintain the status quo. If the purpose of Governor Ueda's interview in the *Nikkei* on 30 November was to reduce market expectations for a December rate hike, the BOJ got what it wanted: on the 12th, the OIS market was pricing in rate hike probabilities of 16% by December, 72% by January, and 94% by March. It is hard to imagine the BOJ making a decision that would change this trend. It is still fresh in the market's memory that one year ago, Governor Ueda had to walk back his “challenging” remarks at the Diet and wound up taking no action at the December 2023 meeting.

Meanwhile, the dollar has continued to strengthen against the yen, driven by expectations that the US will slow its pace of rate cuts next year and that the BOJ will put off hiking rates as it assesses risks from the Trump presidency. With the domestic economy on track, the BOJ is exploring the possibility of a rate hike within the fiscal year. Your author sees January as the most likely timing, with March still also a possibility, and thinks the BOJ has yet to decide when. All we can do is keep a close eye on the upcoming data and communications from the BOJ.

Takeaways from the December Tankan survey: corporate pricing behavior, business conditions, and profits

On 13 December, the BOJ released its December Tankan survey. The most important set of economic data prior to the December policy meeting, the survey confirmed that the Japanese economy is on track.

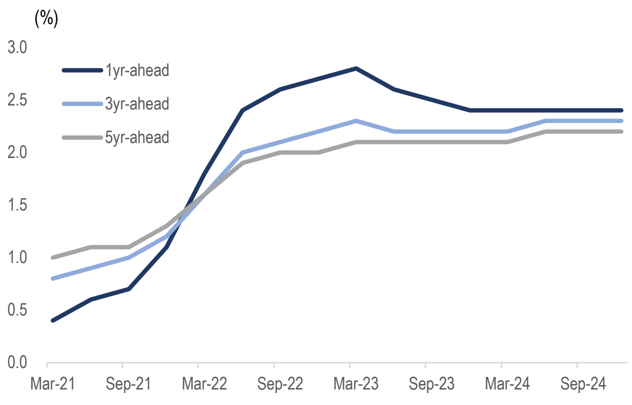
The key questions for this latest survey were: 1) whether there were any changes in corporate pricing behavior or expected inflation rates, given that import prices are declining y/y while some input costs like labor are rising, and 2) how rising raw material prices, labor costs, and weakening external demand, particularly from China, have been affecting business conditions and earnings. The deadline for responding to the survey was 27 November, and over 70% of responses were received by then.

Overall, the Tankan results show that the general price outlook five years ahead (companies of all sizes and all industries) remains flat at +2.2% (unchanged from the previous survey) and that companies have continued passing on higher prices, indicating that corporate pricing behavior and expected inflation rates are tracking the BOJ's view. The business conditions DI worsened for large non-manufacturers but improved for large manufacturers and small firms, a favorable result. Additionally, there was no sign of deterioration in recurring profit plans, an indication that corporate activity remains relatively strong at this point. This should make the BOJ even more confident that the domestic economy is on track.

Inflation outlook of enterprises on track, price pass-throughs continue

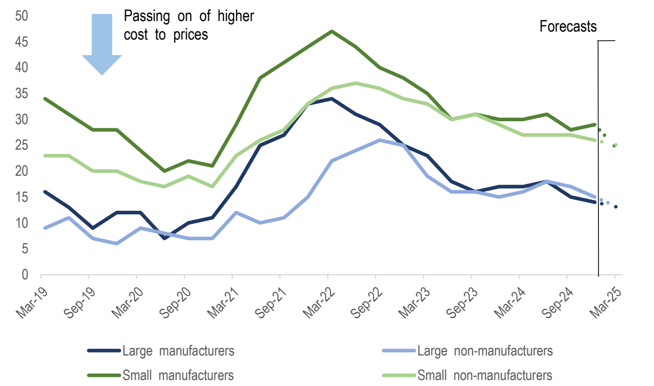
The 5-year inflation outlook of enterprises that the BOJ focuses on is the general price outlook (companies of all sizes and all industries), and that remains flat at +2.2% (unchanged from the previous survey). The outlook for output prices has risen, particularly in non-manufacturing, and the survey confirmed an increased willingness to reflect higher labor costs in sales prices. The pseudo terms of trade, measured by the difference between the input price DI and output price DI, indicates that, except for small manufacturers, large and small companies have continued their price pass-throughs. The corporate pricing behavior and expected inflation rates shown by Tankan seem to be on track with the BOJ's view.

Chart 1: Outlook for General Prices (all company sizes, all industries)



Source: BOJ; compiled by Daiwa.

Chart 2: Input Price DI - Output Price DI (Pseudo Terms of Trade)



Source: BOJ; compiled by Daiwa.

Business conditions DI strong, recurring profit plans improved from the last survey

The business conditions DI for large manufacturers improved to +14 (from +13), but that for large non-manufacturers worsened to +33 (from +34). On the other hand, small firms showed improvement in both manufacturing, at +1 (from ±0), and non-manufacturing, at +16 (from +14). There were concerns that sentiment was likely to worsen due to weak external demand, but it actually improved slightly, a better-than-expected outcome. Looking next at the distribution of the business conditions DI by industry, although the change from the previous survey (horizontal axis:

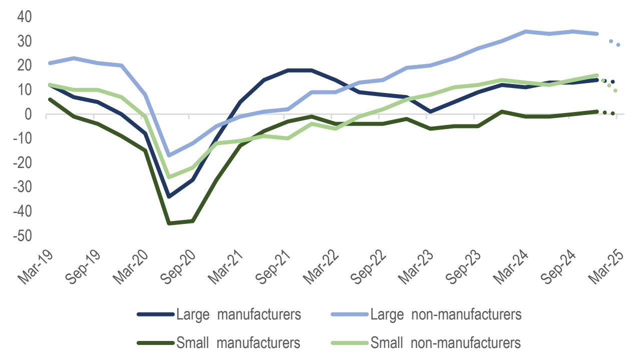
improvement - deterioration) varied, most industries showed favorable business conditions (vertical axis: favorable - unfavorable). The deterioration at large non-manufacturers can be attributed to weakened consumer sentiment brought by rising food prices and to slower growth in inbound demand, namely in retail and accommodation and food services. However, the business conditions DI is still high and conditions are not poor.

FY24 recurring profit plans call for y/y declines of 4.0% for large companies and 1.6% for small companies, an improvement from the previous survey. The positive revision from the September to December survey is smaller than usual and not a particularly good result compared to recent years, but if revisions continue at this rate, a y/y increase in earnings is possible for FY24. The supply-demand balance for products and services at large manufacturers showed a deterioration of -2 in both domestic and external demand, while small manufacturers had a -1 deterioration in external demand. Although supply-demand should improve going forward and corporate sentiment is not presently weak, be aware that continued weakness in external demand could pressure profits.

Chart 3: Business Conditions DI (by company size)

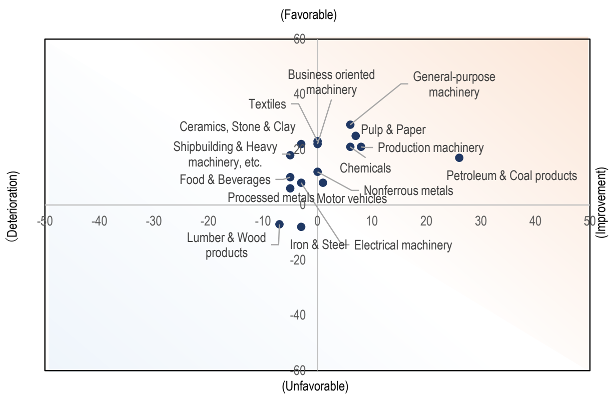
Source: BOJ; compiled by Daiwa.
Note: Dotted lines indicate forecast DI in Dec survey.

Chart 4: Business Conditions DI (by company size, industry)



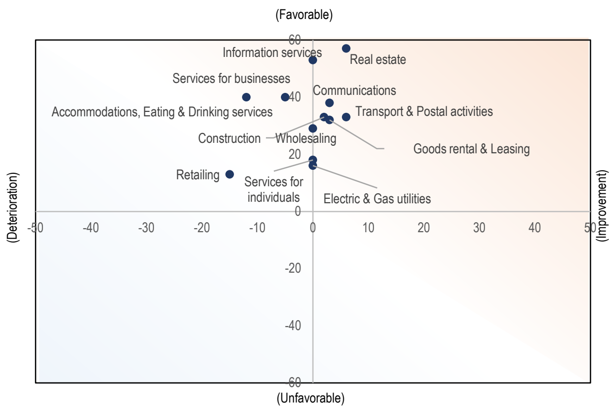
Source: BOJ; compiled by Daiwa.
Note: Dotted lines indicate forecast DI in Dec survey.

Chart 5: Business Conditions DI by Industry (large manufacturers)



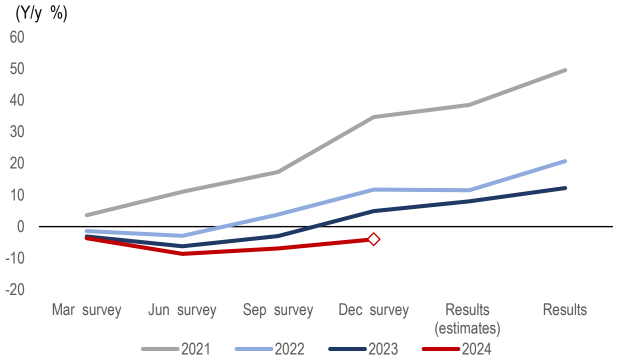
Source: BOJ; compiled by Daiwa.
Note: "Favorable – Unfavorable" indicates business conditions DI level, while "Improvement – Deterioration" denotes change from previous survey.

Chart 6: Business Conditions DI by Industry (large non-manufacturers)



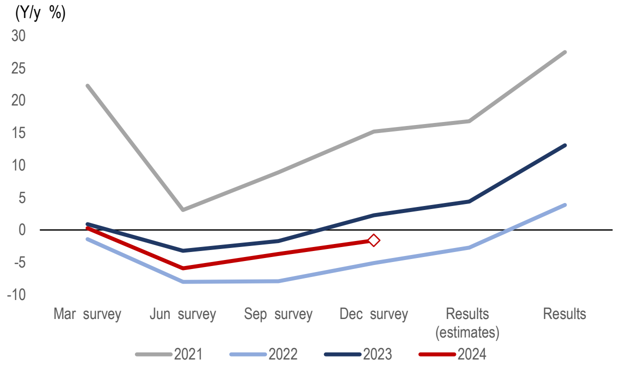
Source: BOJ; compiled by Daiwa.
Note: "Favorable – Unfavorable" indicates business conditions DI level, while "Improvement – Deterioration" denotes change from previous survey.

Chart 7: Recurring Profit Plans (large companies, all industries)



Source: BOJ; compiled by Daiwa.

Chart 8: Recurring Profit Plans (small companies, all industries)



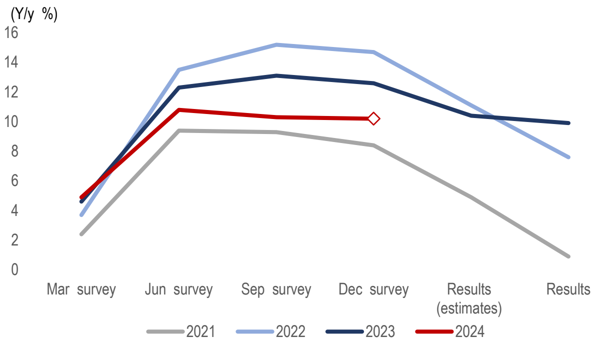
Source: BOJ; compiled by Daiwa.

Forecast fixed investment remains high, but there is uncertainty over whether these plans will be realized

The forecast fixed investment for companies of all sizes and all industries + financial institutions (excl. land investment but incl. software and R&D), a figure conceptually similar to the capex component of GDP, remains high at +10.2% y/y (previously +10.3%). Companies still seem to have a willingness to invest in labor-saving and DX initiatives to deal with structural labor shortages, but it is important to note that the forecast fixed investment figures in the Tankan survey are nominal and nothing more than planned.

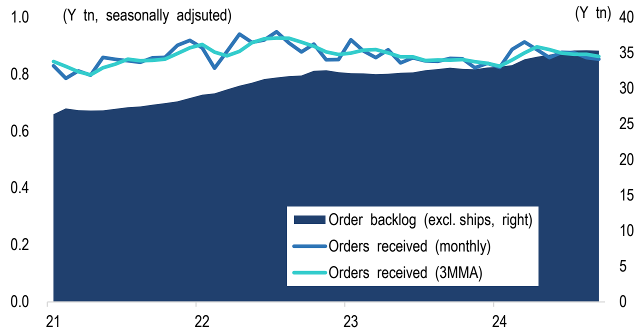
Machinery orders, a leading indicator of machinery investment, have recently been in a downward trend. Backlogs are accumulating as labor shortages make it harder to realize capex plans. With the corporate goods price index currently around 3.5% y/y, the forecast fixed investment in Tankan of +10.2% y/y is still strong in real terms, but there are concerns about how much of those plans can be realized. While labor shortages are increasing the willingness to invest, they are also a constraint on realizing investment plans. The extent to which these strong capex plans are being realized must be verified using GDP and other data.

Chart 9: Fixed Investment Plans (all company sizes, all industries + financial institutions)



Source: BOJ; compiled by Daiwa.

Chart 10: Machinery Orders Received, Order Backlog



Source: Cabinet Office; compiled by Daiwa.

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