【NEWS RELEASE】

September 10, 2018
SMBC Nikko Securities Inc.

Quarterly Economy Outlook for FY 2018-2019（Update）

September 10, 2018 (JST), "SMBC NIKKO Japan Economic Outlook for FY 2018-2019 " has been released, responding to The Second Preliminary GDP (April-June 2018 period).

Solid Domestic Economy and Heightening Overseas Risks

- **Real GDP: +1.0% in FY18 and +1.0% in FY19**
- **Nominal GDP: +1.2% in FY18 and +2.4% in FY19**

Summary

- **GDP growth outlook**

We update our economic outlook in light of the 2nd preliminary estimate of Apr-Jun 2018 GDP. We forecast real GDP growth of +1.0% in FY18 and +1.0% in FY19, which is unchanged from our previous estimates.

- **Domestic economy is solid**

Domestic demand in the Japanese economy is strong. Private consumption is a function of income, so while it does not give rise to economic cycles, sharp growth in employee incomes is stabilizing the economy. For capex, the ratio of capital stock to GDP is at the lowest level in 20 years, meaning the economy suffers from underinvestment. The upward leg of the capital stock cycle is still in the early stages and should be sustainable. On the other hand, the recovery in external demand is slowing from the torrid pace seen in 2017. There is still risk of fallout from trade disputes and the Turkey shock, so we advise caution.

For inflation, upward price momentum is gradually strengthening, centered on goods and services for which supply-demand is improving. Even so, we do not expect the BOJ's 2% inflation target to be reached until at least FY21. Wages are rising on the back of rising prices and productivity. We expect wage growth to gradually accelerate based on moderate inflation and productivity improvements driven by personnel shortages.

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At its July monetary policy meeting, the BOJ introduced a new framework to enhance the sustainability of monetary easing. By allowing greater fluctuations in interest rates and ETF purchases, the BOJ has ultimately given itself room to continue QE for longer by reducing JGB and ETF purchases. That said, BOJ purchases of JGBs are already running at a lower pace than new JGB issuance, meaning it would have been able to continue JGB purchases even without the new framework (taken to its logical extreme, QE could be continued indefinitely). In this regard, the policy adjustment ultimately appears to be a rescue for financial institutions by allowing interest rates to rise.

In terms of future interest-rate hikes, the BOJ has newly introduced forward guidance. Its forward guidance at present is that "The Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time". The market currently takes "an extended period of time" to mean one year and eight months, forecasting a rate hike in Apr 2020. This would be six months after the consumption tax hike, which looks reasonable to us. If this forecast remains unchanged, there should be no increases in long-term interest rates driven by rate-hike expectations.

That said, the BOJ's decision to allow some fluctuation in interest rates means that domestic interest rates are likely to be even more strongly influenced by overseas interest rates. Moving forward, we think overseas interest rates are likely to be a more important factor than the JGB market and BOJ moves.

- **Heightening overseas risks**

Overseas risks now include the Turkey shock in addition to trade disputes. On the trade war front, we calculate combined macro (GDP growth) impact from four trade policy measures—1) US tariffs on steel and aluminum imports, 2) US tariffs against China, 3) Chinese retaliatory tariffs, and 4) US tariffs on automobile imports—at -0.35ppt for the US, -0.96ppt for China, and -0.09ppt for Japan. China, which has relatively smaller scope for levying tariffs against the US, stands to be more heavily impacted. That said, the impact on GDP growth is essentially a one-year phenomenon and will not persist in the long term. We therefore advise against excessive pessimism.

Meanwhile, the Turkey shock is fundamentally different from typical emerging market crises. Typical crises are caused by dollar shortages, usually when US rate hikes mean that investment money is sucked up from around the world into the US. This time though, US interest rates are not rising; in fact, they are falling. The US is not sucking up funds from around the world—investment money is fleeing from Turkey of its own accord, scared off by deteriorating external balances and inflation. Rising long-term interest rates signify that markets are calmly working to stem deterioration in external balances in place of the Turkish central bank. Real long-term interest rates have risen to 6.2% at present, closing on the real growth rate of 7.4%. We would expect the market adjustment to finish if slowdowns in economic indicators are confirmed.

Of note, claims against Turkey at European banks amount to only 2.1% of total lending even at Spanish banks, which have the largest exposures, and exposures for Italy, Germany, and France are less than 0.5%. We therefore see little risk that the Turkey shock will spill over to Europe and the rest of the world.

Quarterly forecasts for Japanese economy

《Actual》←┆→《Forecasts》　　《A》←┆→《F》 (Unit:%)

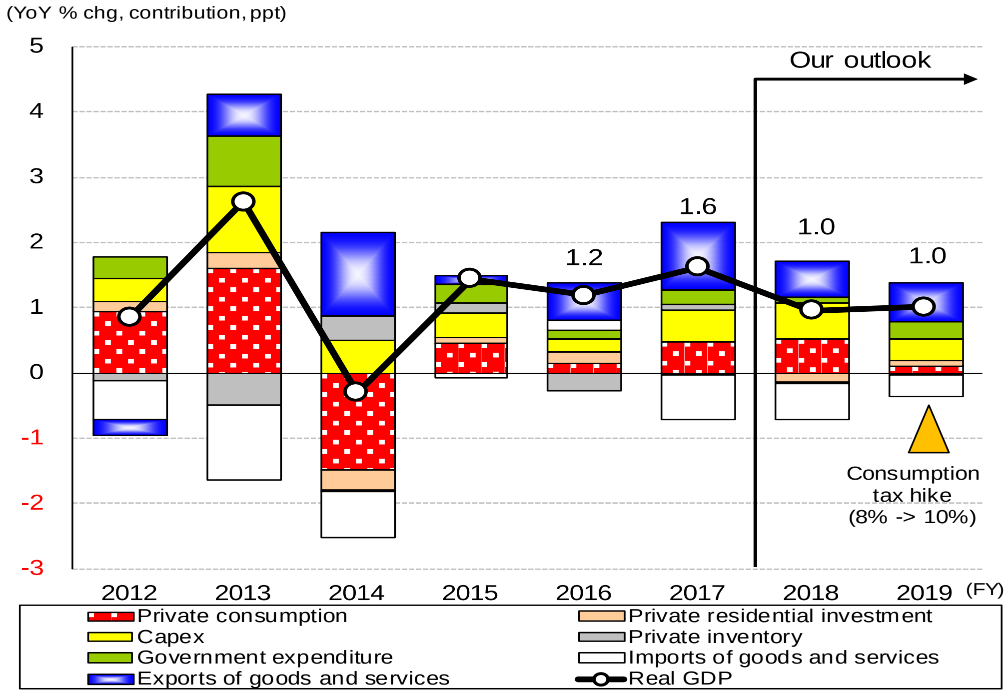
	2017 1Q	2017 2Q	2017 3Q	2017 4Q	2018 1Q	2018 2Q	2018 3Q	2018 4Q	2019 1Q	2019 2Q	2019 3Q	2019 4Q	2020 1Q	FY16	FY17	FY18	FY19	Comparison with previous forecasts (as at 20 August 2018) FY18	FY19
Real GDP growth (QoQ)	0.7	0.5	0.6	0.2	-0.2	0.7	-0.3	0.4	0.3	0.3	0.5	-0.3	0.4						
(annual rate)	2.7	2.0	2.3	0.9	-0.9	3.0	-1.1	1.8	1.2	1.3	2.1	-1.4	1.6	1.2	1.6	1.0	1.0	-0.2	-0.1
Domestic demand, contribution (QoQ)	0.6	0.8	0.0	0.4	-0.3	0.9	-0.3	0.4	0.4	0.4	0.7	-1.2	0.4	0.4	1.2	1.0	1.0	-0.2	-0.1
Private consumption (QoQ)	0.5	0.8	-0.7	0.3	-0.2	0.7	0.0	0.3	0.2	0.1	0.8	-2.5	0.3	0.3	0.8	0.9	0.2	-0.3	-0.1
Capex (QoQ)	0.7	0.2	1.3	0.9	0.7	3.1	-1.5	0.5	0.5	0.8	0.8	0.5	0.5	1.2	3.1	3.5	2.0	0.9	0.0
Residential investment (QoQ)	0.9	1.3	-1.4	-3.0	-2.5	-2.4	0.5	2.0	2.0	3.5	1.0	-5.0	-3.0	6.2	-0.4	-4.2	3.6	-1.6	-0.6
Public investment (QoQ)	-0.2	5.3	-2.8	-0.6	-0.4	0.0	0.2	0.5	0.4	-0.2	0.2	3.0	3.0	0.9	1.4	-0.4	3.2	-1.1	0.7
Foreign demand, contribution (QoQ)	0.1	-0.3	0.6	-0.1	0.1	-0.1	0.0	0.0	-0.1	-0.1	-0.2	0.9	0.0	0.8	0.4	0.0	0.0	0.0	0.0
Exports (QoQ)	1.9	0.2	2.1	2.1	0.6	0.2	0.5	0.5	0.8	0.8	0.8	0.8	0.8	3.6	6.3	3.3	3.4	-1.8	-0.2
Imports (QoQ)	1.4	1.9	-1.5	3.3	0.2	0.9	0.5	0.5	1.2	1.2	2.0	-4.0	1.0	-0.8	4.1	3.1	1.8	-0.6	-0.4
Nominal GDP growth (QoQ)	0.2	0.8	0.8	0.3	-0.4	0.7	-0.3	1.4	-0.1	1.3	0.2	1.0	0.0	1.0	1.7	1.2	2.4	-0.2	0.0
Industrial production (QoQ)	3.9	5.6	4.4	4.1	2.5	1.5	1.9	1.3	3.8	4.0	4.1	1.0	1.0	1.5	4.1	2.1	2.5	0.0	0.0
Trade balance (Y tn, SAAR)	4.6	3.7	7.5	6.9	4.1	3.2	4.6	5.2	5.6	5.9	4.9	10.3	10.4	4.8	5.5	4.7	7.9	-1.4	-1.2
Unemployment rate (%)	2.9	2.9	2.8	2.7	2.5	2.4	2.4	2.3	2.3	2.2	2.2	2.1	2.1	3.0	2.7	2.3	2.2	-0.1	0.0
Core CPI (YoY)	0.2	0.4	0.6	0.9	0.9	0.8	0.8	1.1	1.1	1.1	1.1	2.2	2.3	-0.2	0.7	0.9	1.7	0.0	0.0
(Ex effects of consumption tax hike)	0.2	0.4	0.6	0.9	0.9	0.8	0.8	1.1	1.1	1.1	1.1	1.2	1.3	-0.2	0.7	0.9	1.2	0.0	0.0
IOER (Eop)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0
YCC 10y JGB yields target (Eop)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.1	0.0	0.0
US real GDP growth (QoQ annualized)	1.8	3.0	2.8	2.3	2.2	4.2	3.0	2.8	2.4	2.3	2.0	2.1	2.1	2.0	2.5	3.1	2.2	0.6	-0.1
US unemployment rate (%)	4.6	4.3	4.3	4.1	4.1	3.9	3.9	3.8	3.8	3.7	3.7	3.6	3.6	4.9	4.3	3.9	3.7	-0.1	0.0
US core CPI (YoY)	2.2	1.8	1.7	1.8	1.9	2.2	2.4	2.4	2.3	2.3	2.2	2.2	2.2	2.2	1.9	2.2	2.3	0.2	0.1
Fed rate (Eop)	0.875	1.125	1.125	1.375	1.625	1.875	2.125	2.375	2.375	2.625	2.875	3.125	3.125	0.625	1.375	2.375	2.375	0.25	0.25

Assumptions: Forex rate (annual mean): Y111.7/USD in FY18, Y114.6/USD in FY19; Crude oil price (WTI annual mean): $70/bbl in FY18 and $65.8/bbl in FY19.

Note: 1) US GDP on a calendar basis, US unemployment rate is the average for the period, and FF rate at end of year. 2) Actual figures from Cabinet Office, MIC, METI, BOJ. Forecasts by SMBC NIKKO.

Source: Cabinet office; Ministry of Economy, Trade and Industry (METI); Ministry of Internal Affairs and Communications (MIC); Bank of Japan (BOJ); SMBC NIKKO forecast

Outlook for Real GDP growth



Source: CAO, SMBC NIKKO forecast

APPENDIX

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NR:Not Rated

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