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【NEWS RELEASE】

March 8, 2019
SMBC Nikko Securities Inc.

Quarterly Economy Outlook for FY 2018-2020（Update）

March 8, 2019 (JST), *"SMBC NIKKO Japan Economic Outlook for FY 2018-2020"* has been released, responding to the second preliminary of GDP (October-December 2018 period).

Robust Japanese economy and three risks

- **Real GDP: +0.6% in FY18, +1.0% in FY19 and +1.0% in FY20**
- **Nominal GDP: +0.2% in FY18, +1.0% in FY19 and +1.6% in FY20**

Summary

- **GDP growth outlook**

We revise our economic outlook in light of the second preliminary estimate for Oct-Dec 2018 GDP. We forecast real GDP growth of +0.6% YoY in FY18, +1.0% in FY19, and +1.0% in FY20. Compared with our previous estimates, we lift FY18 by 0.1ppt but trim FY19 by 0.1ppt. For FY18, we upgrade our view on inventory, while for FY19 we downgrade our view on exports and public sector investment.

- **Ongoing recovery for Japanese economy**

We expect a sustained recovery for Japan's economy, with growth of 1% into FY20. We see an absence of excesses in the economy driving a stable and prolonged recovery. Capex is the keystone of the economic cycle and we see no sign of excess production capacity with the capital stock/GDP ratio at its lowest in 20 years. The business cycle is usually driven by the investment cycle, so if capex stops circulating, then the real economy will come to a halt as well. In other words, we think the economy is on a rebound trend. This has been a characteristic of the global economy in recent years.

Private consumption, another pillar of domestic demand, is at historically high levels as increased wages and employment lifts purchasing power. We expect the spring wage negations to lift wages by roughly +2.7%, which should translate into a gain of about +1.9% for the macro wage (wages across the whole economy). The consistently tight labor market has

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increased labor force participation and therefore labor supply. We expect private consumption to grow as favorable wages/employment conditions sustain increased purchasing power.

- We expect inflation to slow in 2019 on lower energy prices, reduced mobile phone fees, and free preschool education after the consumption tax hike. We thus expect the BOJ to maintain current monetary policy. Given that the theoretical target for the long-term interest rate is currently about 0%, the BOJ will likely try to keep the 10y JGB yield at around 0% too. We also expect the BOJ to continue ETF purchases above the current rate of Y6tn. We assume the Y/$ rate moves within the Y108-112 range throughout the year.

- **Risks factors**

Risk factors include 1) the consumption tax hike, 2) Chinese economic slowdown, and 3) financial market turmoil and the US economy

We expect the consumption tax hike to add a Y2.2tn burden to household budgets. We also assume a government stimulus package of Y4.8tn for a net increase in fiscal spending of +Y2.6tn. Net government spending fell about -Y8tn last time the tax was raised, which hurt the economy, but this time should be different, in our view.

The current slowdown in the Chinese economy largely owes to a lull in stimulus policy. Autos sales dropped off after the end of tax breaks, and infrastructure spending fell as the central government prioritized debt reduction. However, the autos drop-off is roughly 80% done and is beginning to taper. The government has also rolled out more demand stimulus, so autos demand is likely to recover. It has also adjusted policy so that local governments can issue bonds for increased fund procurement. It has therefore revised policy from reduced spending through 2018, and now aims to get the economy out of the lull with fiscal expansion.

We believe recent turmoil in financial markets is closely related to the US economy. Given that this economy is already in a state of excess demand, persistent growth over 2% (potential growth rate) would expand the inflation gap and drive up the long-term interest rate. A long-term interest rate above the neutral rate results in a volatility surge and directly impacts financial markets (given the dominance of low-volatility strategies). This is the macroeconomic backdrop for the market slump in autumn 2018, so a potential surge in the US economy could have the same implications. Among other things, we will watch monetary policy by the Federal Reserve to see if the US economy can execute a soft landing to a growth rate that is just right at about 2%.

Quarterly forecasts for Japanese economy

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

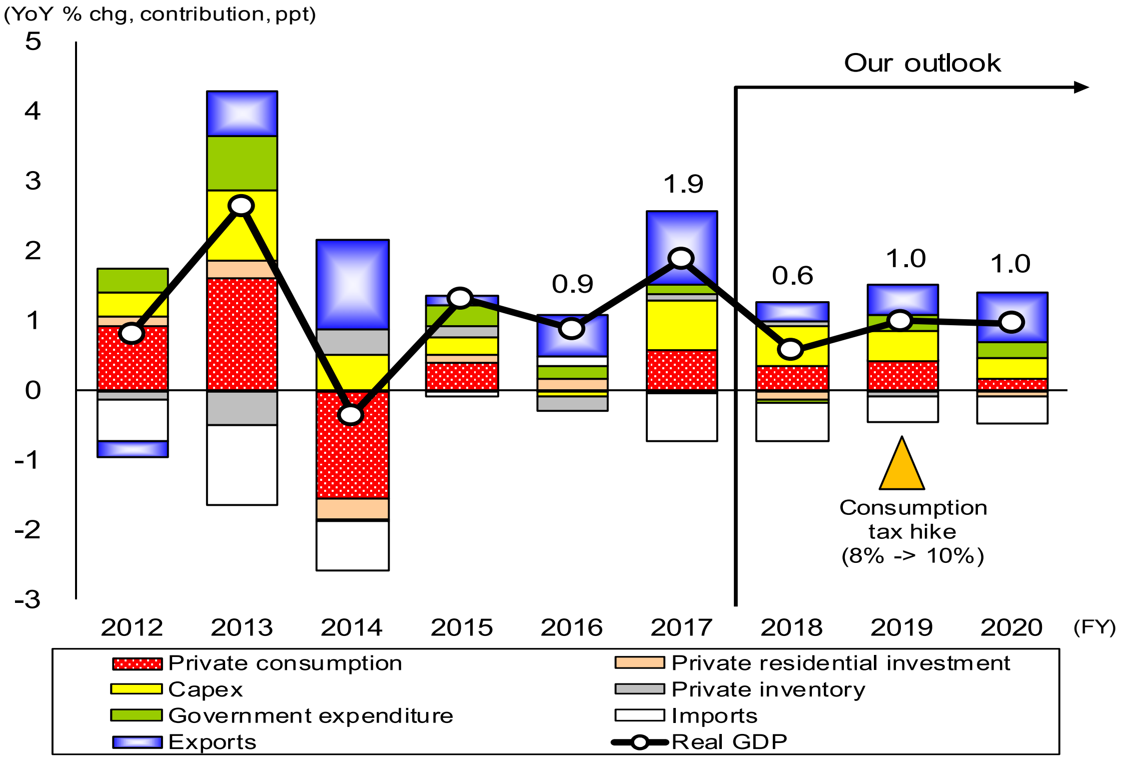
	2018 1Q	2018 2Q	2018 3Q	2018 4Q	2019 1Q	2019 2Q	2019 3Q	2019 4Q	2020 1Q	2020 2Q	2020 3Q	2020 4Q	2021 1Q	FY17	FY18	FY19	FY20	Comparison with previous forecasts (as at 20 Feb 2018) FY18	FY19	FY20
Real GDP growth (QoQ)	-0.1	0.5	-0.6	0.5	0.0	0.9	-1.1	2.3	-1.1	0.3	0.4	0.3	0.3							
(annual rate)	-0.4	1.9	-2.4	1.9	-0.1	3.5	-4.2	9.5	-4.2	1.3	1.7	1.3	1.3	1.9	0.6	1.0	1.0	0.1	-0.1	0.0
Domestic demand, contribution (QoQ)	-0.2	0.6	-0.5	0.8	0.1	0.8	-1.0	1.7	-1.0	0.3	0.4	0.3	0.3	1.5	0.6	1.0	1.0	0.1	-0.1	0.0
Private consumption (QoQ)	-0.2	0.6	-0.2	0.4	0.4	0.8	-2.2	2.7	-2.0	0.2	0.4	0.3	0.3	1.1	0.7	0.8	0.3	-0.1	-0.1	0.0
Capex (QoQ)	-2.0	-2.0	0.6	1.1	3.0	2.0	-4.0	-3.0	-1.0	0.5	0.5	0.5	0.5	-1.3	-4.4	-0.5	-2.7	0.0	0.0	0.0
Residential investment (QoQ)	1.0	2.5	-2.6	2.7	0.2	0.8	1.0	0.6	0.0	0.5	0.5	0.5	0.5	5.5	4.4	3.6	2.7	0.3	-0.1	-0.2
Public investment (QoQ)	-0.7	-0.7	-2.3	-1.7	0.5	1.0	2.0	1.0	0.0	-0.2	-0.5	-0.5	-0.5	0.5	-4.0	2.2	0.4	-0.4	-0.4	0.0
Foreign demand, contribution (QoQ)	0.1	-0.1	-0.1	-0.3	-0.1	0.0	-0.1	0.6	-0.1	0.0	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Exports (QoQ)	0.4	0.4	-1.4	1.0	-0.5	1.2	0.8	0.8	0.8	1.0	1.0	0.8	0.8	6.4	1.7	2.5	4.0	-0.3	-0.6	0.0
Imports (QoQ)	0.0	1.3	-0.7	2.7	0.0	1.0	1.5	-2.5	1.2	1.0	1.0	1.0	1.0	4.0	3.1	2.0	2.2	-0.1	-0.4	0.0
Nominal GDP growth (QoQ)	-0.3	0.4	-0.5	0.4	-0.4	1.0	-1.0	2.8	-1.4	0.6	0.6	0.6	0.2	2.0	0.2	1.0	1.6	0.0	-0.1	0.0
Industrial production (QoQ)	2.0	1.3	-0.1	0.7	2.3	1.4	3.1	3.6	1.1	0.8	2.5	1.0	4.1	1.0	1.0	2.3	2.1	0.0	0.0	0.0
Trade balance (Y tn, SAAR)	4.2	2.8	0.5	-2.2	3.1	4.1	3.5	3.3	3.1	3.9	4.7	5.3	5.9	1.3	1.1	3.5	5.0	-0.2	-0.4	-0.4
Unemployment rate (%)	2.5	2.4	2.4	2.4	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.4	2.5	2.4	2.3	0.1	0.1	0.1
Core CPI (YoY)	0.9	0.8	0.9	0.9	0.6	0.3	0.2	0.7	0.8	1.0	1.2	0.6	0.8	0.7	0.8	0.5	0.9	0.0	0.0	0.0
(Ex effects of consumption tax hike)	0.9	0.8	0.9	0.9	0.6	0.3	0.2	-0.3	-0.2	0.0	0.2	0.6	0.8	0.7	0.8	-0.0	0.4	0.0	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	0.0
YCC 10y JGB yields target (Eop)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
US real GDP growth (QoQ annualized)	2.2	4.2	3.4	2.6	2.7	2.6	2.5	2.3	2.2	2.2	2.2	2.2	2.2	2.5	3.1	2.5	2.2	-0.1	0.0	0.0
US unemployment rate (%)	4.1	3.9	3.8	3.8	3.6	3.6	3.6	3.6	3.6	3.5	3.5	3.4	3.4	4.4	3.9	3.6	3.5	0.0	0.0	0.0
US core CPI (YoY)	1.9	2.2	2.2	2.2	2.1	2.0	2.0	2.0	2.0	2.2	2.3	2.2	2.2	1.9	2.1	2.0	2.2	0.0	0.0	0.0
Fed rate (Eop)	1.625	1.875	2.125	2.375	2.375	2.375	2.375	2.625	2.625	2.875	2.875	2.875	2.875	1.375	2.375	2.625	2.875	0.00	0.00	0.00

Assumptions: Forex rate (annual mean): Y110.9/USD in FY18, Y112.6/USD in FY19, Y115.0/USD in FY20; Crude oil price (WTI annual mean): $60.7/bbl in FY18, $54.9/bbl in FY19 and $58.9/bbl in FY20.

Notes: 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 estimates

Outlook for Real GDP growth



Source: CAO, SMBC NIKKO forecast

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