【NEWS RELEASE】

November 20, 2019
SMBC Nikko Securities Inc.

Quarterly Economy Outlook for FY 2019-2020

November 20, 2019 (JST), *"SMBC NIKKO Japan Economic Outlook for FY 2019-2020"* has been released, responding to the first preliminary of GDP (July-September 2019 period).

Japan Economy to Bottom as Risks Gradually Fade

- **Real GDP: FY19 +0.8%, FY20 +1.0%**
- **Nominal GDP: FY19 +1.1%, FY20 +1.3%**

Summary

- **GDP growth outlook**

  We revise our outlook to reflect the first preliminary Jul-Sep 2019 GDP data. We now forecast real GDP growth of 0.8% YoY in FY19 and 1.0% in FY20, an upward revision of 0.1ppt versus our previous outlook for FY20 (9 Sep), to factor in additional economic measures by the government.

- **Current state of the economy**

  Jul-Sep 2019 real GDP growth (annualized basis) was up 0.2% QoQ, fairly low given it was just prior to the hike in consumption tax. We regard this as a positive development, however, as it means less chance of a post-hike pullback given that 1) the pre-hike rush was fairly small, and 2) inventories fell sharply.

  Japan's economy has been correcting for a year on export decline. The lower exports owed not to US-China trade friction but to the correcting global chip cycle, which in turn owed to falling demand for durable IT goods (mobile phones, servers). That said, IT demand has since turned up and the chip cycle has recovered since March this year. We therefore expect Japan's economic cycle to bottom very soon.

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- **Outlook for the economy**

As points of interest, we highlight the US economy and US-China trade tension as external factors and the probability of a pullback by the domestic economy after the hike in consumption tax.

The US economy is the world's largest economy running a current account deficit, and it tends to drive the global economy. Some suggest the current slowing here could turn into recession because of yield inversion and other factors. However, there is no theory that says inverted yields cause recession. That is because there is no way for inverted market rates to inflict a recession so long as investment spreads in the real economy are still positive. Spreads in the US are still positive, so a recession is unlikely, in our view. The US economic slowdown merely reflects reduced investment demand after the rate increase last year (investment demand is very rate-sensitive). However, rates have come down a lot in 2019 so far, so we expect investment demand to rebound very soon. Manufacturing indices have in fact started turning up.

US-China trade tension should ease as talks become more conciliatory. China growth is already slowing and it could take another hit if more foreign-owned firms (account for 40% of exports from China) relocate to avoid the steep US tariffs. Meanwhile, Trump wants China to buy more US agricultural produce to improve his chances of reelection. Thus, China wants the US to withdraw tariffs and the US wants China to buy $50bn in produce. We think this looks like a reasonable deal and worth the compromise for both. While the structural issues with China may have to wait, it would make sense for Trump to restart those negotiations after the election, especially as the Chinese economy is likely to weaken with time.

Consumption tax hikes in Japan have never caused economic recession. That is because most consumer goods are actually imported, so their demand does not affect domestic production. The pre-hike demand rush this time was fairly small, making a post-hike pullback even less likely. The real concern is prices. Higher prices generally reduce purchasing power and thus consumption, but post-hike consumer prices this time were up only 0.6% YoY, less than the 3.4% rise last time. Purchasing power has actually increased thanks to the government's scheme for cashless purchases (5% point reward) and allowance for post-hike promotions by retailers. We thus do not expect much of a post-hike pullback in consumption this time.

The most important factors for the economy are exports and capex (which both involve domestic production). We expect exports to recover and note that capex plans by firms are solid. We therefore expect the Japanese economy to begin recovering from the Jan-Mar 2020 quarter.

- **Risks**

A surge in US long rates is the major risk to Japan's economy. Given the “excess demand” in the US economy, long rates could rise too far on increased expectations for overheating and inflation if the economy headed for recovery and the Fed did not signal tightening. In this case, the rising rates could put the Fed behind the curve, and reproduce the economic slowdown seen over the past year.

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Quarterly forecasts for Japanese economy

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

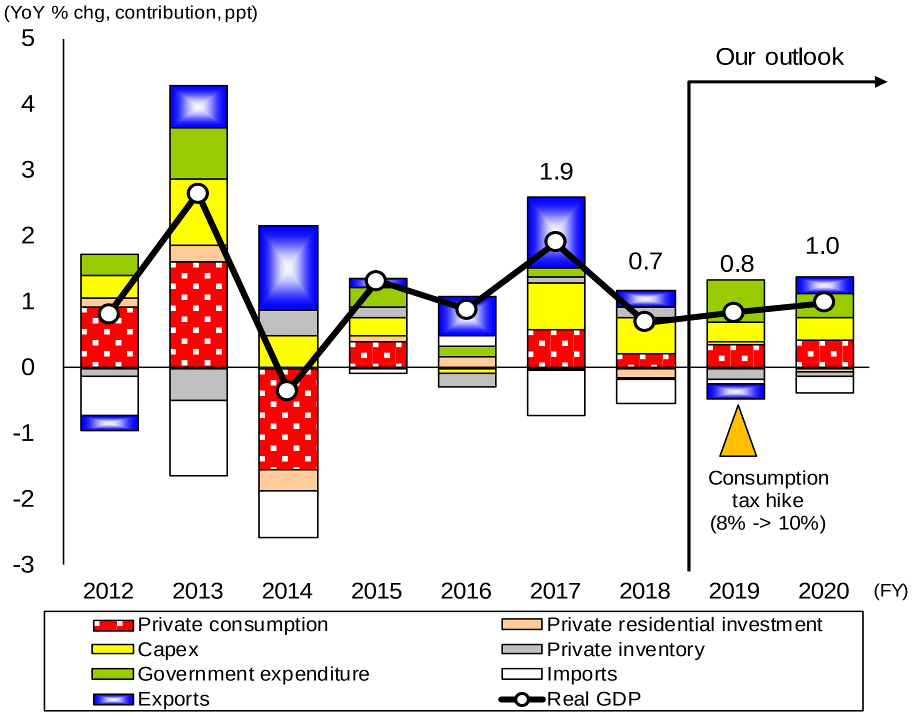
	2018				2019				2020				2021				Comparison with previous forecasts (as at 9 Sep 2019)	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	FY18	FY19	FY20	FY19	FY20
Real GDP growth (QoQ)	-0.1	0.5	-0.5	0.4	0.5	0.4	0.1	-0.5	0.5	0.4	0.5	0.1	0.3					
(annual rate)	-0.6	2.2	-2.0	1.5	2.0	1.8	0.2	-1.9	1.9	1.6	1.9	0.4	1.2	0.7	0.8	1.0	0.0	0.1
Domestic demand, contribution (QoQ)	-0.2	0.5	-0.4	0.8	0.1	0.7	0.2	-0.6	0.4	0.4	0.5	0.1	0.4	0.7	0.8	1.0	0.0	0.1
Private consumption (QoQ)	-0.1	0.3	-0.1	0.3	0.0	0.6	0.4	-1.0	0.3	0.3	0.5	-0.2	0.2	0.4	0.6	0.8	0.0	0.0
Capex (QoQ)	-2.4	-1.5	0.4	1.1	1.1	0.5	1.4	-2.5	-1.2	-0.5	0.0	0.5	0.5	-4.3	1.4	-1.9	0.8	-1.0
Residential investment (QoQ)	0.5	3.3	-3.2	3.2	-0.4	0.7	0.9	0.0	0.5	0.5	0.8	0.5	0.5	3.5	1.9	2.1	1.4	0.4
Public investment (QoQ)	-0.7	-1.1	-2.5	-1.0	1.8	2.1	0.8	0.5	1.0	1.0	0.5	0.3	0.0	-4.0	3.8	3.2	0.7	3.3
Foreign demand, contribution (QoQ)	0.1	0.0	-0.1	-0.4	0.4	-0.3	-0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports (QoQ)	0.9	0.7	-1.8	1.1	-2.0	0.5	-0.7	0.0	0.5	0.3	0.4	0.4	0.4	1.6	-1.2	1.5	0.0	-0.9
Imports (QoQ)	0.6	0.8	-1.2	3.8	-4.1	2.1	0.2	-0.5	0.4	0.6	0.7	0.7	0.7	2.2	0.4	1.4	1.4	-0.5
Nominal GDP growth (QoQ)	-0.2	0.2	-0.4	0.4	0.9	0.4	0.3	-0.7	0.2	0.7	0.7	0.4	0.2	0.5	1.1	1.3	0.3	-0.1
Industrial production (QoQ)	-0.9	0.8	-0.7	1.3	-2.5	0.7	0.3	2.5	-2.0	0.0	2.0	1.0	1.0	0.2	0.2	2.1	0.0	0.0
Trade balance (Y tn, SAAR)	0.2	1.6	-1.8	-3.9	-1.8	-2.8	-1.4	-1.2	-0.1	-0.4	-0.7	-0.4	-0.2	-1.5	-1.4	-0.4	-1.0	1.2
Unemployment rate (%)	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.4	2.4	2.3	0.1	0.0
Core CPI (YoY)	0.9	0.8	0.9	0.9	0.8	0.8	0.5	0.6	0.7	0.6	0.8	0.7	0.9	0.8	0.6	0.8	-0.5	-0.4
(Ex effects of consumption tax hike)	0.9	0.8	0.9	0.9	0.8	0.8	0.5	-0.3	-0.2	-0.3	-0.1	0.7	0.9	0.8	0.2	0.3	-0.4	-0.4
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	0.0	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
US real GDP growth (QoQ annualized)	2.5	3.5	2.9	1.1	3.1	2.0	1.9	2.2	2.1	2.1	2.1	2.1	2.1	2.7	2.1	2.1	-0.1	0.0
US unemployment rate (%)	4.1	3.9	3.8	3.8	3.9	3.6	3.6	3.6	3.6	3.5	3.5	3.4	3.4	3.9	3.6	3.4	0.0	0.0
US core CPI (YoY)	1.9	2.2	2.2	2.2	2.1	2.1	2.3	2.3	2.2	2.3	2.3	2.3	2.3	2.2	2.2	2.3	0.0	0.0
Fed rate (Eop)	1.625	1.875	2.125	2.375	2.375	2.375	1.875	1.875	1.875	2.125	2.125	2.125	2.125	2.375	1.875	2.125	0.30	0.20

Assumptions: Forex rate (annual mean): JPY108.8/USD in FY19 and JPY113.3/USD in FY20; Crude oil price (WTI annual mean): USD57.4/bbl in FY19 and USD58.5/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 (CAO), MIC, METI, BOJ. Forecasts by SMBC NIKKO.

Sources: CAO; 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



Sources: CAO, SMBC NIKKO forecasts

APPENDIX

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