14 August 2017 (No. of pages: 5)

Japanese report: 14 Aug 2017

Apr-Jun 2017 1st Preliminary GDP Estimate

Growth accelerates considerably at +4.0% q/q annualized. Domestic demand now leads growth.

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Summary

- The real GDP growth rate for Apr-Jun 2017 (1st preliminary est) grew by +4.0% q/q annualized (+1.0% q/q), exceeding market consensus (+2.4% q/q annualized, +0.6% q/q). All major domestic demand related GDP components exhibited growth, including personal consumption, capex, housing investment, government consumption, and public investment. On the other hand, contribution from overseas demand, which led growth throughout CY2016 fell for the first time in seven quarters by -0.3%pt q/q. Meanwhile, terms of trade improved due to import prices settling down somewhat, and the GDP deflator grew for the first time in two quarters (+0.2% q/q) as a result of moderate progress in domestic price pass-through. Nominal GDP grew for the first time in two quarters by +4.6% q/q annualized (+1.1% q/q).

- We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to continue its expansion centering on personal consumption, while overseas demand is expected to maintain steady growth backed by the recovery in the world economy, providing support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution, due to fears that China's economy may slow down after the National Congress of the Communist Party in fall, and increased geopolitical risk. Meanwhile, we also urge caution regarding the slowdown of the US economy accompanying the Fed's tight money policy, and the problem of capital outflows from the emerging nations. Domestic demand components are expected to lead growth in the future. Until now the driving force behind Japan's economic growth was overseas demand, but there is a very good chance that this role is now shifting to domestic demand.

Growth accelerates considerably at +4.0% q/q annualized

The real GDP growth rate for Apr-Jun 2017 (1st preliminary est) grew by +4.0% q/q annualized (+1.0% q/q), exceeding market consensus (+2.4% q/q annualized, +0.6% q/q). All major domestic demand related GDP components exhibited growth, including personal consumption, capex, housing investment, government consumption, and public investment. (Note: growth in imports is a negative contribution to growth rate). As was the case during the 1st quarter, growth was led notably by domestic demand (contribution was +1.3%pt q/q). On the other hand, contribution from overseas demand, which led growth throughout CY2016 fell for the first time in seven quarters by -0.3%pt q/q. Meanwhile, terms of trade improved due to import prices settling down somewhat, and the GDP deflator grew for the first time in two quarters (+0.2% q/q) as a result of moderate progress in domestic price pass-through. Nominal GDP grew for the first time in two quarters by +4.6% q/q annualized (+1.1% q/q).

2017 Jan-Mar GDP (1st Preliminary Estimate) **Chart 1**

		2016			2017	
		Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
Real GDP	Q/q %	0.3	0.3	0.4	0.4	1.0
Annualized	Q/q %	1.4	1.3	1.7	1.5	4.0
Personal consumption	Q/q %	0.1	0.4	0.1	0.4	0.9
Private housing investment	Q/q %	3.2	2.8	0.3	0.9	1.5
Private non-housing investment	Q/q %	0.7	0.0	2.2	0.9	2.4
Change in private inventories (contribution to real GDP growth)	Q/q % pts	0.3	-0.4	-0.2	-0.1	0.0
Government consumption	Q/q %	-1.3	0.2	0.0	-0.1	0.3
Public investment	Q/q %	-0.8	-0.8	-2.5	0.6	5.1
Exports of goods and services	Q/q %	-0.9	2.1	3.1	1.9	-0.5
Imports of goods and services	Q/q %	-1.2	-0.2	1.4	1.3	1.4
Domestic demand (contribution to real GDP growth)	Q/q % pts	0.3	-0.1	0.1	0.2	1.3
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.1	0.4	0.3	0.1	-0.3
Nominal GDP	Q/q %	0.0	0.1	0.5	-0.0	1.1
Annualized	Q/q %	0.1	0.4	2.1	-0.2	4.6
GDP deflator	Y/y %	0.4	-0.1	-0.1	-0.8	-0.4

Source: Cabinet Office; compiled by DIR.
Notes: 1) Due to rounding, contributions do not necessarily conform to calculations based on figures shown.
2) Q/q figures seasonally adjusted.

Domestic demand becomes driving force

Performance by demand component in the Apr-Jun 2017 results shows private sector final consumption expenditure exhibiting growth for the sixth consecutive quarter by +0.9% q/q. In addition to continued improvements in the employment environment due to the labor shortage, the issue of higher prices for fresh foods, which had been weighing down consumption, appears to be resolving. Coupled with improvement in consumer confidence, this has contributed to a comeback in personal consumption. Looking at personal consumption by sector we see durables recording growth for the sixth consecutive quarter at +2.4% and services growing for the twelfth consecutive quarter at +0.6%. Favorable results continue due to the gradual dissipation of the negative effects of pre-consumption over demand and Eco-car related tax breaks, which helped to increase consumption since 2009 along with the Ecopoint program effecting household electronics, as well as last-minute demand prior to the increase in consumption tax. In addition, non-durables grew for the first time in five quarters at +1.8%, but semidurables suffered a setback at -2.5% due to a reactionary decline after the major growth experienced during the previous quarter.

Housing investment grew for the sixth consecutive quarter at +1.5% q/q. Housing investment has continued its growth trend with the help of a variety of factors, including low interest housing loans, growth in the construction of rental housing as a strategy in dealing with inheritance tax, and construction of the Olympic Village, which began in January to house athletes during the 2020 Tokyo Olympics and Paralympics. Housing investment helped to increase overall performance.

Capital expenditure is maintaining its growth trend at +2.4% q/q. Capital expenditure continues to grow backed by the high level of corporate earnings and recovery of the world economy. Behind this positive transition to favorable performance for capital expenditure lies growth in factory operating rates associated with recent increases in exports, and the growing seriousness of the shortage of manpower.

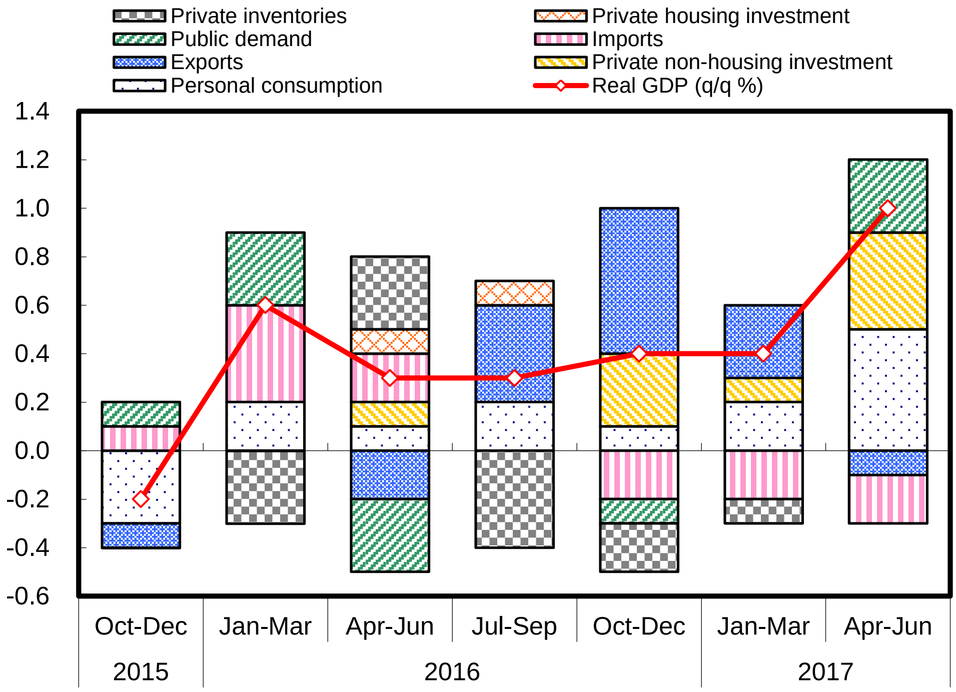
Meanwhile, private sector inventory continues to mark time with a contribution to GDP growth of +0.0%pt. Material & supplies inventory, which is provisional on the 1st preliminary GDP estimate, contributed +0.3%pt, while work in progress inventory contributed +0.0%, and finished goods inventory contributed -0.2%pt. Distribution inventory contributed -0.1%pt.

Public investment experienced a major acceleration of its growth rate in comparison to the previous period at +5.1% q/q. It appears that implementation of the FY2016 supplementary budget has progressed. Government consumption is up by +0.3%, and on average is continuing its growth trend.

Exports declined for the first time in four quarters at -0.5% q/q. According to trade statistics for the Apr-Jun period, exports to the EU grew, while exports to the US appear to be about to peak out. Meanwhile, exports to Asia declined with ICs showing signs of taking a breather from their recent growth trend. This brought overall performance for exports down. On the other hand, imports grew for the third consecutive quarter at +1.4% thanks to the comeback in domestic demand. As a result, contribution of overseas demand to GDP growth decreased for the first time in seven quarters at -0.3%pt.

The GDP deflator grew for the first time in two quarters at +0.2% q/q. The domestic demand deflator grew for the first time in two quarters at +0.1% as a result of moderate progress in domestic price pass-through, while in addition, terms of trade also improved due to an increase in prices of natural resources and a lull in yen depreciation. Nominal GDP also grew for the first time in two quarters by +4.6% q/q annualized (+1.1% q/q).

Contribution to Real GDP (% pt; seasonally adjusted basis) Chart 2



Source: Cabinet Office; compiled by DIR.

Growth continues led by domestic demand. Caution regarding deteriorating overseas demand

We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to continue its expansion centering on personal consumption, while overseas demand is expected to maintain steady growth backed by the recovery in the world economy, providing support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution, due to fears that China's economy may slow down after the National Congress of the Communist Party in fall, and increased geopolitical risk. Meanwhile, we also urge caution regarding the slowdown of the US economy accompanying the Fed's tight money policy, and the problem of capital outflows from the emerging nations. Domestic demand components are expected to lead growth in the future. Until now the driving force behind Japan's economic growth was overseas demand, but there is a very good chance that this role is now shifting to domestic demand.

Personal consumption is expected to continue in a moderate expansion phase. The supply of labor is becoming increasingly tight, and this should provide underlying support for personal consumption through growth in employee compensation. However, caution is advised here as corporations may try to compensate for the cost of wage increases by flattening the wage curve and placing restrictions on overtime. This could create a slowdown in the pace of growth in employee compensation, as well as the expansion of consumption.

Housing investment is expected to experience a lull in its growth trend, and then move into a gradual descent from its current plateau. Interest on housing loans remains low, and therefore should provide continued underlying support. However, housing starts, which had rapidly expanded with the expectation that there would be a rush to purchase homes before the additional increase in consumption tax originally planned for April 2017, are expected to decrease in the future, especially for condominiums in urban areas, and housing investment is also expected to begin declining after that point. Caution is required regarding a possible reactionary decline following the initially positive effect of inheritance tax strategies on growth in the construction of rental housing.

Capex is expected to see moderate growth. Operating rates in the manufacturing sector are on the rise due to the expansion of exports thanks to the recovery in the world economy. However, if uncertainty grows regarding the future of the world economy, corporations are likely to lose their willingness to invest in capex, hence caution is required. On the other hand, research & development, which is in growth phase, is expected to continue pushing up overall capex figures in the future. Meanwhile, investment in labor-saving and rationalization due to the continuing labor shortage is expected to continue its growth trend centering on the non-manufacturing industries.

As for public investment, we expect a gradual comeback to accompany implementation of the government's FY2016 supplementary budget.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone. US exports appear to be about to peak out, while exports to the EU and Asia are maintaining a firm undertone. As for exports to Asia, there is danger that the current weakening will continue, centering on components used to manufacture products whose final destination is the US. On the other hand, exports of electronic parts and other products oriented toward domestic demand in China are expected to maintain favorability, and this is expected to compensate for the slowdown in other parts of Asia.

However, caution is required regarding overseas demand due to possible downside risk. As for the US, the Fed is continuing to implement its tight money policy. Meanwhile, there are signs of demand for Japan's major export to the US, passenger vehicles, peaking out, and the tight money policy may bring further downward pressure on the economy. The Fed's tight money policy may also cause an acceleration of capital flows from emerging nations. On the other hand, though there is little chance of China's economy slowing down much before the National Congress of the Communist Party to be held this fall, after that point there is risk that the economy could come under downward pressure due to a reactionary decline in demand, which had been kept artificially high until now by the implementation of economic measures. Other issues include geopolitical risk such as rising tensions in North Korea. All of these risks require caution. Our main scenario sees the world economy continuing its moderate growth. However, if uncertainty grows regarding the future of the world economy, Japan's exports are likely to decline, bringing the risk of downward pressure on Japan's economy.

IMPORTANT

Attention
This cover letter is an unofficial translation. The official document is in Japanese.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in materials presented along with this cover letter, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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