

Soft flash PMIs add to rising concerns over Japan's recovery

The October flash composite PMI fell below neutral for the first time since December 2022 in Japan, which is all the more concerning given that the cooling of service activity caused most of the decline



49.9

Flash Jibun Bank PMI Composite

(vs 52.1 in September)

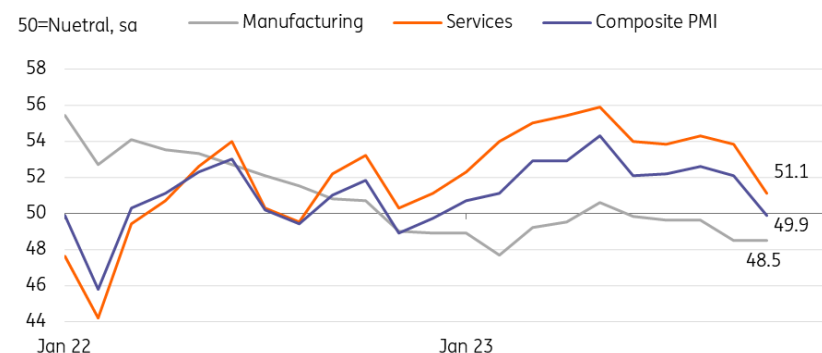
Manufacturing PMI unchanged at 48.5 for a second month

The manufacturing index has remained in contraction territory for the past five months, showing the ongoing weakness in manufacturing activity. Output fell to 47.6 (vs 48.7 in September), probably related to production halts of auto factories due to parts shortages. Yet, new orders rose and so recovery in manufacturing is expected in the coming months.

Service PMI down to 51.1 in October (vs 53.8 in September)

Service activity has been the main driver of the outperformance of Japan's economy among other developed markets. The index stayed above 50 for 14 months in a row, but we see some cooling down of service PMI after recording the historical high of 55.9 in May. Employment expanded and input prices softened slightly, and we still believe that the service sector-led recovery should continue and the services job market will likely tighten.

PMI weakened, driven by service



Source: CEIC

BoJ Watch

With growing concerns over global commodity prices, the government is planning to extend its energy subsidy programs again to the end of April next year. Fuel and utility subsidy programs were originally scheduled to end in September, but the government has now extended them until year-end. Despite efforts to curb inflation, we see upside risks increasing rapidly.

As JGB 10Y yields floated higher, moving along with the UST yield, the Bank of Japan's yield curve control has been challenged. Local media leaked the news that the BoJ is considering another tweak to the YCC policy. Meanwhile, the central bank announced today that it will conduct an unscheduled bond operation on Wednesday and offer one trillion of 5Y loans to commercial banks aimed to supply more liquidity and eventually bring yields down.

The weak JPY is clearly another concern for the BoJ. Currently, the USDJPY remains below 150, but the market is cautious about potential intervention by authorities. In terms of levels, 150 is the market-specified level, triggering FX interventions – but at this point, we think the volatility of the currency should be a more important factor for intervening in the market than the level itself.

The BoJ is badly trapped in the YCC policy. The BoJ appeared to provide more liquidity for fear of a sharp rise in interest rates, but at the same time, the global higher-for-longer trend and rise in inflation have put more pressure on the sustainability of the YCC policy. We think scrapping the YCC policy is too radical for the BoJ, but they could have other options for the change:

1. Shifting the formal 10Y upper limit from 0.5% to 0.75% while keeping the flexible cap at 1%;
2. Bringing the anchor year forward from the current 10Y to 5Y;
3. Adjusting its forward guidance of the statement.

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