



Daily Note: 27 June 2008

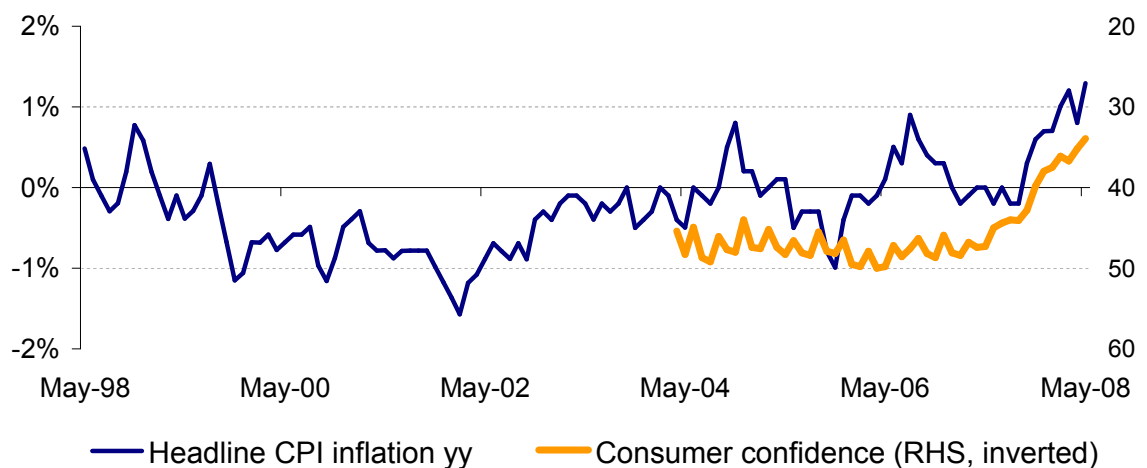
Tough times for Japan's consumers

WE SUGGEST: JGBs vulnerable to more inflation shocks

SUMMARY: Japanese inflation reached a ten-year high of 1.3% in May, driven by food and energy prices. Inflation is eroding real incomes, sapping consumer confidence and pointing to very weak consumer spending in coming months. A slackening labour market is adding to consumer concerns. The Japanese economy is likely to experience a shallow recession this year, recovering next.

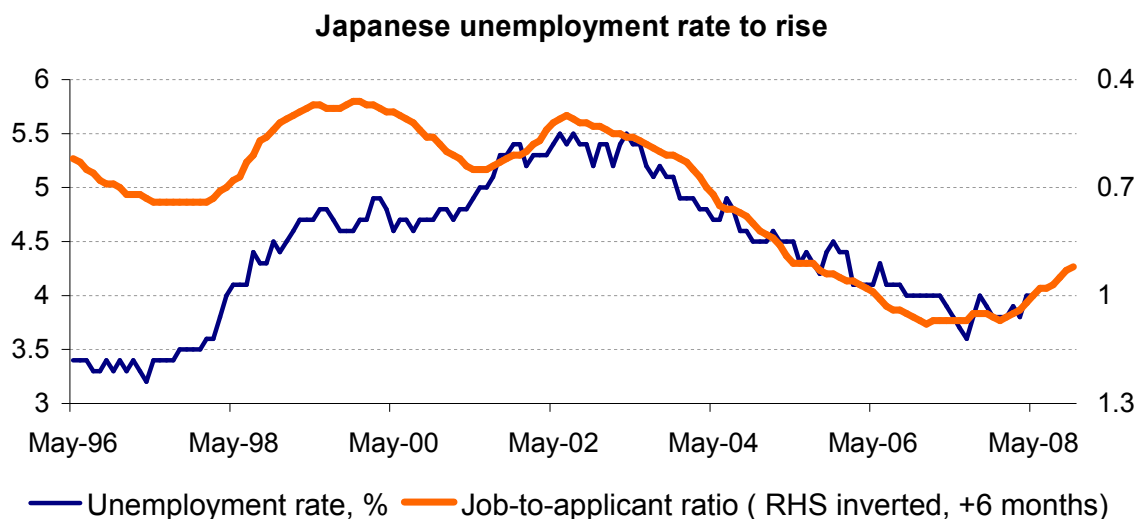
The increasingly poor outlook for Japanese consumption is underlined by today's data. First headline CPI inflation rose to 1.3% in May, from 0.8% last month. Although low compared with inflation in the US and euro-zone, the Japanese inflation rate is still the highest for ten years. As elsewhere, food and energy prices are the main upward influences on inflation. Excluding food and energy core CPI inflation was unchanged in the month at -0.1%, maintaining the trend of gradual underlying deflation. But the rise in headline inflation is undermining consumer confidence and over 70% of households now expect inflation to be above 2% in 12 months' time, compared with around 20% a year ago. Today's Tokyo CPI measure for June recorded a big jump in the 12-monthly rate to 1.5% from 0.9% in May, suggesting that nation-wide CPI inflation will rise further next month.

Rising inflation saps consumer confidence



Higher inflation is eroding real incomes growth, with nominal cash earnings up just 0.6% in the 12 months to April. Also today unemployment data showed the rate steady at 4.0%. But the job-to applicant ratio, an indication of labour market conditions, fell for the fourth month in a row in May, to 0.92, its lowest level for over three years. As the chart below shows, a falling job to applicant ratio points to rising unemployment in coming months. So despite a 0.8% rise in Q1, consumption growth will be negligible for the rest of the year. Although of mixed quality the monthly indicators of retail

spending also published this morning were generally weak. For example, household spending is recorded as down 3.2% in the 12 months to May and large retailers' sales are down 2.1% over the same period.



Meanwhile today's industrial production data recorded a 2.9% monthly rise in May. The monthly series is volatile, but the underlying trend remains modest expansion, with the 12-monthly rate of output growth at 1.2%. Data out earlier this week showed export volumes continuing to trend flat. In value terms exports are falling year on year to both the US and European Union, but continuing to rise strongly to other Asian economies, especially China. But as these economies slow as they deal with inflation, demand for Japanese exports will fade too.

After a 1% quarterly growth spurt in Q1 the Japanese economy is now hitting the buffers. Next Tuesday's *Tankan* survey will give a fuller picture of business confidence and investment intentions. Market expectations are for a significant drop in the main confidence measures, in line with the recent fall in the *Shoko Chukin* small business confidence measure. GDP growth will probably be zero or less for much of the rest of this year, although any recession should be short-lived.

Michael Taylor

michael.taylor@lombardstreetresearch.com