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May Industrial Production

Soft patch continues with stagnant exports and inventory adjustment

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Summary

- The May 2015 indices of industrial production was down by -2.2% m/m, its first decline in two months, in comparison to the +0.5% forecasted as of last month. Results were well below market consensus (-0.8%), revealing negative performance.

- This month's results indicate that the moderate recovery phase, which has continued in production since bottoming out in August of 2014, has hit a temporary lull. The main causes are thought to be stagnant exports and inventory adjustment, with the soft patch expected to continue for a while. According to the METI forecast survey, June production is expected to be up by +1.5% in comparison to the previous month, with July up by +0.6% in a continuation of the moderate recovery. However, considering the realization rate of the METI forecast in recent months, as well as its amendment rate, it is quite possible that results will be marking time.

- As for the future of industrial production, the growth trend is expected to continue supported by the underlying strength of exports once it has gotten through this temporary adjustment. Domestic demand should improve with the positive employment environment and the collapse in energy prices. However, there tends to be a time lag before real income pushes consumption up due to the ratchet effect, while in addition, the high level of inventory rate and lead time required before exports to the US and China can recover means that possibilities are good that production will continue in a temporary lull.

Industrial Production (m/m %; SA basis) **Chart 1**

	2014					2015				
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
Industrial Production	-0.8	1.4	0.4	-0.6	0.2	4.1	-3.1	-0.8	1.2	**-2.2**
Market consensus (Bloomberg)										-0.8
DIR estimate										-0.8
Shipments	-2.1	3.2	0.1	-0.7	-0.2	5.5	-4.4	-0.6	0.6	**-1.9**
Inventories	0.9	-0.4	-0.1	1.1	-0.1	-0.4	1.1	0.4	0.4	**-0.8**
Inventory ratio	7.0	-5.4	1.0	3.1	-2.9	-3.3	4.0	0.9	-1.0	**1.9**

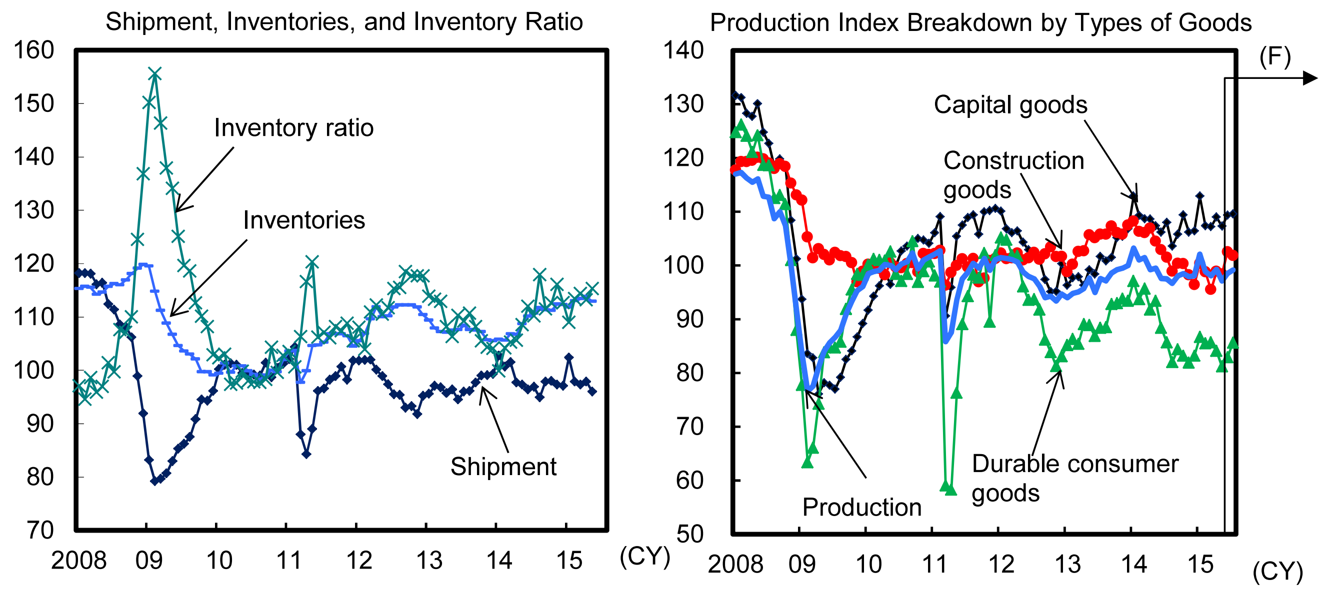
Source: Ministry of Economy, Trade, and Industry; Bloomberg; compiled by DIR.

May 2015 production index suffers a decline for the first time in two months, with the future seeing a good possibility of marking time

The May 2015 indices of industrial production was down by -2.2% m/m, its first decline in two months, in comparison to the +0.5% forecasted as of last month. Results were well below market consensus (-0.8%), revealing negative performance. The shipment index was also down for the first time in two months at -1.9% m/m, while the inventory index was at -0.8% m/m, its first decline in four months. However, the inventory ratio was up by +1.9% m/m.

This month’s results indicate that the moderate recovery phase, which has continued in production since bottoming out in August of 2014, has hit a temporary lull. The main causes are thought to be stagnant exports and inventory adjustment, with the soft patch expected to continue for a while. According to the METI forecast survey, June production is expected to be up by +1.5% in comparison to the previous month, with July up by +0.6% in a continuation of the moderate recovery. However, considering the realization rate of the METI forecast in recent months, as well as its amendment rate, it is quite possible that results will be marking time.

Shipments, Inventories, Inventory Ratio, and Shipment Index Breakdown (2010 = 100; SA basis) **Chart 2**



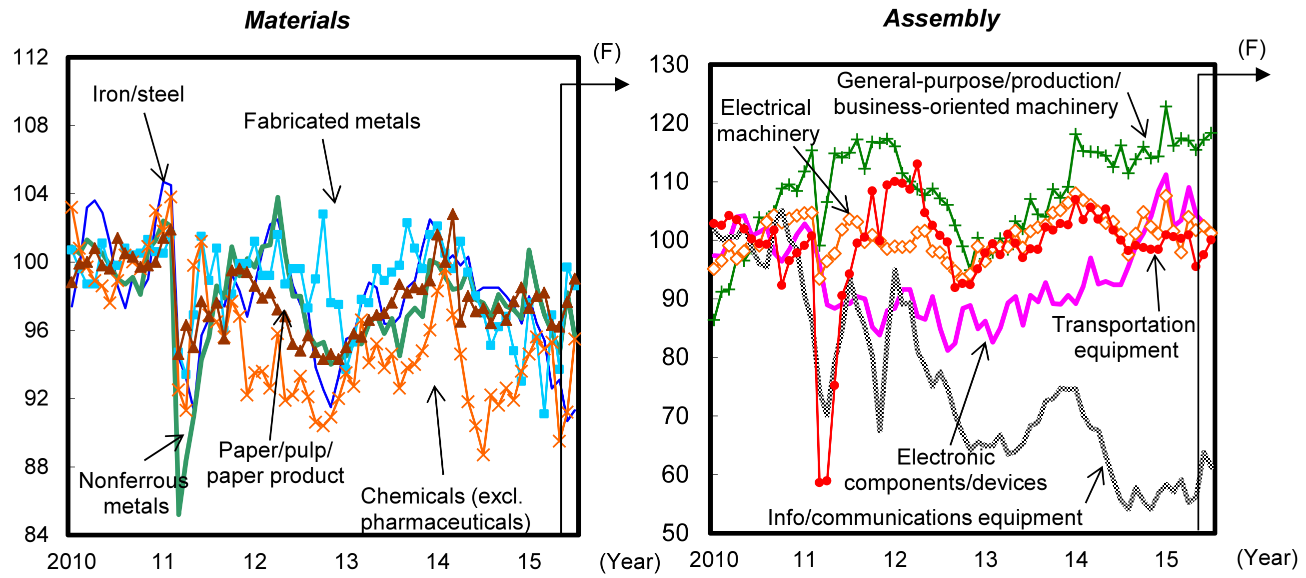
Source: Ministry of Economy, Trade, and Industry (METI), compiled by DIR.

A wide range of industries report declines in production, centering on transport equipment, which was undergoing inventory adjustment

As for production index performance by industry in May, twelve out of the total of fifteen industries recorded production declines. Transport equipment, which was holding onto a fairly high level of inventory, was undergoing adjustment (-5.4% m/m), while chemicals (excluding pharmaceuticals) also saw production declines (-6.1%). Meanwhile, electronic parts and devices, which had continued an especially high level of production in recent months, also appears to have entered an adjustment phase (-4.3%), as well as General-purpose, production and business oriented machinery (-1.4%).

Looking at May production index performance by types of goods, virtually all areas saw production declines. Durable consumer goods were down considerably by -3.4% m/m, with capital goods down by -1.6%, construction goods down by -0.5%, and non-durable consumer goods down by -1.0%. However, capital goods (excluding transport equipment) saw a small increase in production at +0.4% m/m.

Production by Industry (2010 = 100; SA basis) **Chart 3**



Source: Ministry of Economy, Trade, and Industry (METI); compiled by DIR.
F: METI's forecast survey.

Manufacturing industry shows feeble sense of direction in forecast survey

Looking at METI's production forecast survey by industry for June, production plans in most industries see increases, with information and communications electronics equipment (+13.2% m/m), fabricated metals (+6.4%), and non-ferrous metals (+3.7%) expecting fairly large-scale production increases. The July forecast is mixed, with some industries seeing moderate increases in production continuing for the second consecutive month, including transport equipment (+2.1% m/m in June and +2.6% in July), chemicals (+1.9% in June and +4.7% in July), and pulp, paper and paper products (+1.5% in June and +1.4% in July). On the other hand, information and communications electronics equipment, which expects production increases in June, will then suffer declines in July (-3.9%). Other industries will also see a downturn in July, including fabricated metals (-1.1%), and non-ferrous metals (-2.6%), with electronic parts and devices expecting production declines for two consecutive months at -1.3% m/m in June and -2.8% in July.

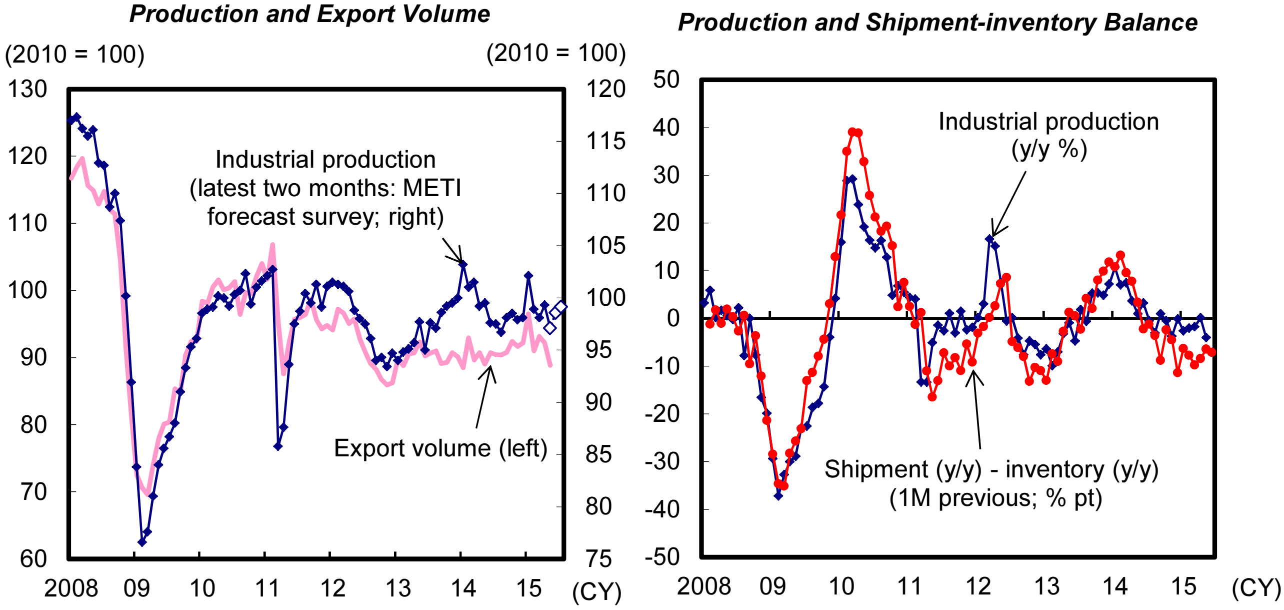
Looking at the forecast survey by types of goods, June is expected to see a continuation of production increases in a broad range of industries, with capital goods (excluding transport equipment) at +1.9% m/m and construction goods at +4.2%. Durable consumer goods are expected to be up by +2.1% and non-durable consumer goods expect to be up by +2.1%. As for July, construction goods expect to see a small turn for the worse at -0.7% m/m, but other areas are expected to continue production increases, with capital goods (excluding transport equipment) +0.2% m/m, durable consumer goods at +3.3%, and non-durable consumer goods up by +2.2%.

Future sees return to growth trend once temporary adjustment has passed

As for the future of industrial production, the growth trend is expected to continue supported by the underlying strength of exports once it has gotten through this temporary adjustment. Exports to the US will be headed back toward normality after distribution was clogged up for some time due to the strike on the west coast. Possibilities are good that recovery will continue reflecting favorable domestic demand in the US. A bright spot appeared in the EU economy, which had been in a downtrend up to this point, due to support of the monetary easing policy. Furthermore, a new policy in China reducing the ratio of cash reserves to deposits is expected to bring a certain amount of support to the economy, which had been in a slowdown. Domestic demand should improve with the positive employment environment and the collapse in energy prices, which should push up real income.

However, there tends to be a time lag before real income pushes consumption up due to the ratchet effect, while in addition, the high level of inventory rate and lead time required before exports to the US and China can recover means that possibilities are good that production will continue in a temporary lull.

Production, Export Volume, and Shipment-inventory Balance **Chart 4**



Source: Ministry of Economy, Trade, and Industry (METI); Cabinet Office; compiled by DIR.