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June Machinery Orders

Jul-Sep period sees non-manufacturing orders achieving major growth

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Summary

- According to statistics for machinery orders in June, the leading indicator for domestic capex and private sector demand (excluding ships and electrical power), orders declined for the third consecutive month at -1.9% m/m contrary to expectations according to market consensus (+3.6%). Non-manufacturing (excluding ships and electrical power) grew for the first time in four months at +0.8%, while manufacturing suffered a decline for the first time in five months at -5.4%, pulling down overall results along with it.

- As a result, the Apr-Jun 2017 period now expects private sector demand (excluding ships and electrical power) to decline by -4.7% q/q, with manufacturing orders up by +3.7%, and non-manufacturing orders (excluding ships and electrical power) down by -9.9%. Non-manufacturing orders have clearly been in a declining trend recently in comparison to manufacturing orders.

- The Cabinet Office forecast for the Jul-Sep 2017 period sees private sector demand (excluding ships and electrical power) moving back into the positive range at +7.0% q/q. Looking at orders by source of demand we see manufacturing down by -1.8% and non-manufacturing (excluding ships and electrical power) up by +13.5%. Non-manufacturing is expected to make a comeback from its former declining trend to achieve major growth.

- Machinery orders, the leading indicator for capex, are expected to experience ups and downs in the future. Operating rates in the manufacturing industry have been in a growth trend since the second half of last year, but although investments in maintenance and repair appear promising, propensity to invest in capacity increase is not great. Meanwhile, the non-manufacturing industries are expected to carry out investments in transport and distribution infrastructure with the continuing growth in foreign visitors to Japan, as well as expectations regarding the 2020 Tokyo Olympics and Paralympics.

Machinery Orders (m/m %; SA) **Chart 1**

	2016						2017					
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Machinery orders (private sector)*	5.6	-5.9	0.3	3.4	-2.8	2.1	-3.2	1.5	1.4	-3.1	-3.6	-1.9
Market consensus (Bloomberg)												3.6
DIR estimate												1.4
Manufacturing orders	0.9	-3.1	-3.3	0.4	8.1	0.8	-10.8	6.0	0.6	2.5	1.0	-5.4
Non-manufacturing orders*	6.5	-3.1	0.7	2.7	-5.6	2.1	0.7	1.8	-3.9	-5.0	-5.1	0.8
Overseas orders	-9.0	-0.7	2.8	7.1	16.3	-12.1	3.2	-1.1	-2.8	17.4	-5.2	-3.1

Source: Cabinet Office, Bloomberg; compiled by DIR.
*excl. those for ships and from electric utilities.
Note: Figures on market consensus from Bloomberg

June orders: manufacturing declines, while non-manufacturing achieves growth

According to statistics for machinery orders in June, the leading indicator for domestic capex and private sector demand (excluding ships and electrical power), orders declined for the third consecutive month at -1.9% m/m contrary to expectations according to market consensus (+3.6%). Non-manufacturing (excluding ships and electrical power) grew for the first time in four months at +0.8%, while manufacturing suffered a decline for the first time in five months at -5.4%, pulling down overall results along with it.

As a result, the Apr-Jun 2017 period now expects private sector demand (excluding ships and electrical power) to decline by -4.7% q/q, with manufacturing orders up by +3.7%, and non-manufacturing orders (excluding ships and electrical power) down by -9.9%. Non-manufacturing orders have clearly been in a declining trend recently in comparison to manufacturing orders.

The Cabinet Office forecast for the Jul-Sep 2017 period sees private sector demand (excluding ships and electrical power) moving back into the positive range at +7.0% q/q. Looking at orders by source of demand we see manufacturing down by -1.8% and non-manufacturing (excluding ships and electrical power) up by +13.5%. Non-manufacturing is expected to make a comeback from its former declining trend to achieve major growth.

Manufacturing orders decline for the first time in five months

Looking at orders by source of demand in June, the manufacturing industries declined for the first time in five months at -5.4% m/m. Manufacturing orders appear to be taking a breather from the moderate growth experienced until now due to increased operating rates associated with the expansion of exports. As for performance by industry, declines were seen in other manufacturing (-14.1% m/m) and information & communications electronics equipment (-26.8%). This is thought to be a reactionary decline in response to two consecutive months of growth in April and May. On the other hand, some industries achieved growth in comparison with the previous month, including textile mill products (+338.4%), and automobiles, parts & accessories (+12.7%). Textile mill products are thought to have pulled in large-scale orders.

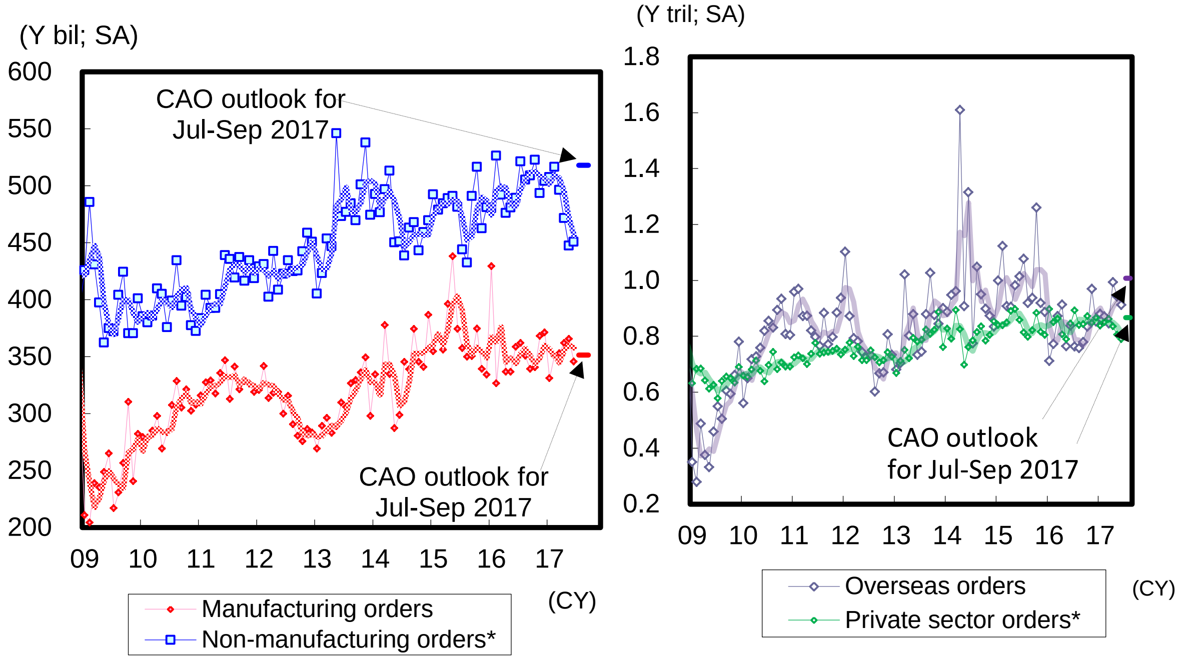
During the Apr-Jun period, growth was notable in general-purpose & production machinery (+11.5%), automobiles, parts & accessories (+11.4%), and other manufacturing (+15.1%). As for general-purpose & production machinery, production increases have continued for machine tools and manufacturing equipment used in the production of semiconductors and flat panel displays. Meanwhile, automobiles, parts & accessories performed well due to favorable domestic sales of new cars.

Non-manufacturing orders achieve growth for the first time in four months

Non-manufacturing orders (excluding ships and electrical power) grew for the first time in four months by +0.8% m/m. Non-manufacturing orders had been in a declining trend, but June performance has moved back into the positive range though by just a tad. Looking at performance by industry, month-to-month growth was seen in other non-manufacturing (+16.0%), and telecommunications (+28.8%). As for telecommunications, once all is averaged out, the industry is marking time. On the other hand, some industries experienced month-to-month declines, including agriculture, forestry & fishing (-6.8%), and goods leasing (-21.1%).

Looking back at the Apr-Jun period, we see that there were declines in transportation & postal activities (-12.1% q/q), as well as construction (-29.0%), and other non-manufacturing (-21.1%). As for transportation & postal activities, the industry was given a major lift during the first half of FY2016 with orders for railway cars, but since then orders have been disappointing, helping to push down overall performance.

Orders by Demand Source (seasonally adjusted figures) **Chart 2**

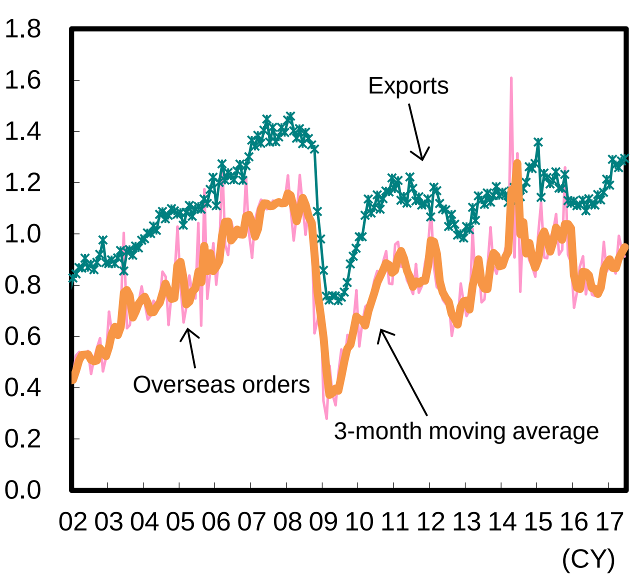


Source: Cabinet Office (CAO); compiled by DIR.
*excl. those for ships and from electric utilities.
Note: Thick lines 3M/MA basis.

Overseas orders decline for second consecutive month

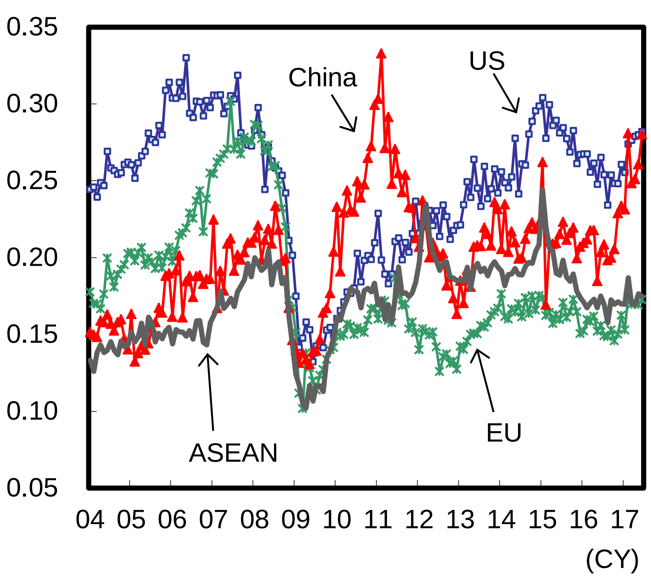
Overseas orders declined for the second consecutive month at -3.1% m/m. According to the Cabinet Office, orders for industrial machinery and motors grew, while orders for electronics & telecommunications equipment, and heavy electric machinery declined.

General Machinery: Overseas Orders and Exports (Y tril; SA) **Chart 3**



Source: Cabinet Office, Ministry of Finance; compiled by DIR.
Notes: 1) Exports seasonally adjusted by CAO, general machinery exports by DIR.
2) Thick line for overseas orders 3M/MA basis.

General Machinery: Exports by Trading Partner (Y tril; SA) **Chart 4**



Source: Ministry of Finance; compiled by DIR.
Note: SA by DIR.

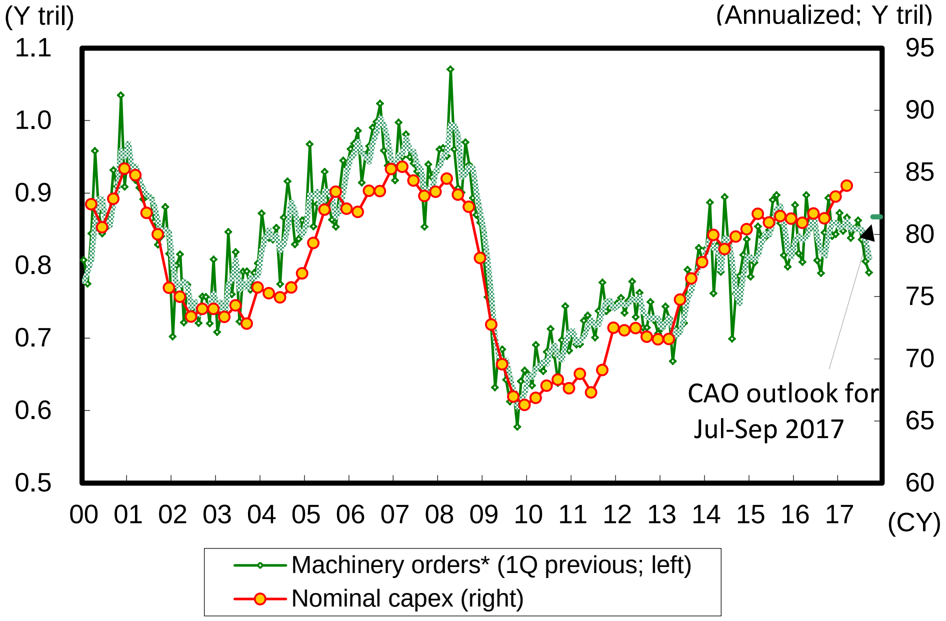
Machinery orders to experience ups and downs in future

Machinery orders, the leading indicator for capex, are expected to experience ups and downs in the future. Operating rates in the manufacturing industry have been in a growth trend since the second half of last year, but although investments in maintenance and repair appear promising, propensity to invest in capacity increase is not great. Meanwhile, the non-manufacturing industries are expected to carry out investments in transport and distribution infrastructure with the continuing growth in foreign visitors to Japan, as well as expectations regarding the 2020 Tokyo Olympics and Paralympics. In addition, recurring profit levels are high, and investments in rationalization and labor saving are seen in response to the tight labor market.

We expect three types of machinery to do well in the future due to investments in labor saving equipment. We suggest keeping an eye on the following. In the area of IT investment computers will be a focus, including general use computers and computer programs. Computers account for approximately one fourth of overall private sector demand. Potential demand is thought to be huge, with an accumulation of order backlog of nearly 3 tril yen and a balance which has doubled over a period of ten years. Large-scale systems development projects take place over the long-term, and this type of project could mean a structural change in terms of demand. In cases where there is a shortage of IT engineers, orders often cannot be processed quickly, and this could become a barrier to further growth in orders received. Next on our list are conveying, elevating, and materials handling machinery, such as conveyor belts, and transport machinery including cargo handling equipment. We suggest keeping an eye on this area in the future where investment in distribution centers is going. A serious labor shortage in the areas of transport and postal services is expected to contribute to growth for the overall industry. The third area of focus as regards investment in labor saving is industrial robots. Although robots now account for only a small portion of overall investment, they could become the representative type of labor saving investment in the future if orders from the non-manufacturing industries grow significantly.

The future of overseas demand according to our main scenario sees a continuation of gradual expansion backed by the continued underlying strength of growth in overseas economies. On the other the Fed’s interest rate hikes and asset reduction could bring an economic downturn in the US, while at the same time causing market turmoil in the emerging nations. Meanwhile, caution is also advised in regard to downside risk in China’s economy after the Fall 2017 National Congress of the Communist Party.

Domestic Demand and Nominal Capex (seasonally adjusted figures) Chart 5



Source: Cabinet Office (CAO); compiled by DIR.
Note: Excluding those for ships and from electric utilities; thick lines 3M/MA basis.

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.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* 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.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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