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July Machinery Orders

Growth achieved for first time in four months; non-manufacturing shows signs of making a comeback

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Summary

- According to statistics for machinery orders in July, the leading indicator for domestic capex and private sector demand (excluding ships and electrical power), orders grew for the first time in four months by +8.0% m/m while at the same time exceeding market consensus (+4.1%). Non-manufacturing (excluding ships and electrical power) grew for the second consecutive month at +4.8%, while manufacturing grew for the first time in two months at +2.9%.

- The Cabinet Office forecast for the Jul-Sep 2017 period sees private sector demand (excluding ships and electrical power) up by +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 showing signs of making a comeback, but the hurdle is high, requiring performance of +14.6% in comparison to July performance in the months of August and September.

- 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						
	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul
Machinery orders (private sector)*	-5.9	0.3	3.4	-2.8	2.1	-3.2	1.5	1.4	-3.1	-3.6	-1.9	8.0
Market consensus (Bloomberg)												4.1
DIR estimate												3.5
Manufacturing orders	-3.1	-3.3	0.4	8.1	0.8	-10.8	6.0	0.6	2.5	1.0	-5.4	2.9
Non-manufacturing orders*	-3.1	0.7	2.7	-5.6	2.1	0.7	1.8	-3.9	-5.0	-5.1	0.8	4.8
Overseas orders	-0.7	2.8	7.1	16.3	-12.1	3.2	-1.1	-2.8	17.4	-5.2	-3.1	9.1

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

July orders: both manufacturing and non-manufacturing achieve growth

According to statistics for machinery orders in July, the leading indicator for domestic capex and private sector demand (excluding ships and electrical power), orders grew for the first time in four months by +8.0% m/m while at the same time exceeding market consensus (+4.1%). Non-manufacturing (excluding ships and electrical power) grew for the second consecutive month at +4.8%, while manufacturing grew for the first time in two months at +2.9%.

The Cabinet Office forecast for the Jul-Sep 2017 period sees private sector demand (excluding ships and electrical power) up by +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 showing signs of making a comeback, but the hurdle is high, requiring performance of +14.6% in comparison to July performance in the months of August and September.

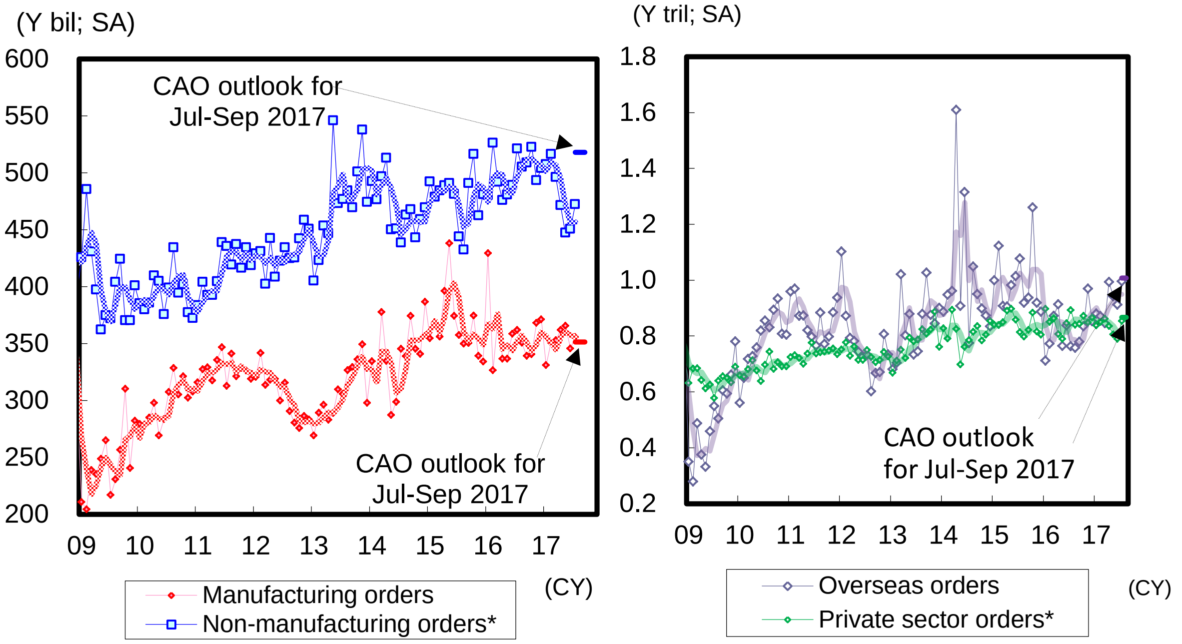
Manufacturing orders grow for the first time in two months

Looking at orders by source of demand in July, the manufacturing industries grew for the first time in two months at +2.9% m/m. Manufacturing orders are seen marking time. As for performance by industry, growth was seen in non-ferrous metals (+189.7% m/m), and other manufacturing (+6.7%). Non-ferrous metals are thought to have brought in large-scale orders. On the other hand, some industries suffered declines in comparison with the previous month, including general-purpose & production machinery (-8.6%), and textile mill products (-79.2%). General-purpose & production machinery has been in a decline for three consecutive months ever since entering a lull in the growth phase it was in as of the beginning of the year. In terms of production related facilities, business oriented machinery was also down for the second consecutive month by -6.7%. Meanwhile, textile mill products appear to have experienced a reactionary decline after the previous month’s large-scale orders (+338.4% in June).

Non-manufacturing orders show signs of a comeback

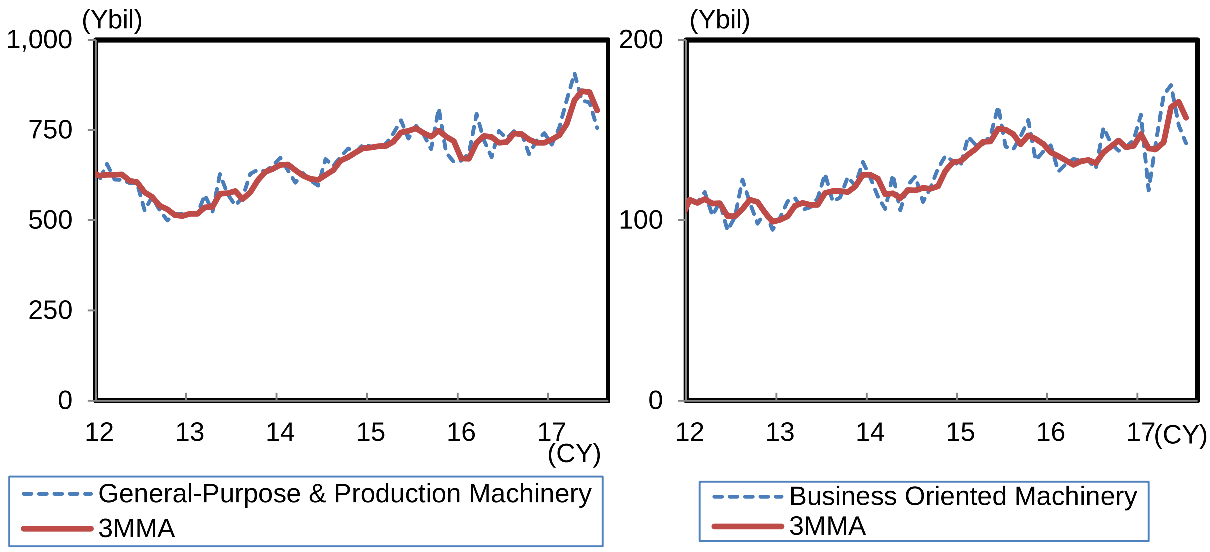
Non-manufacturing orders (excluding ships and electrical power) grew for the second consecutive month by +4.8% m/m. Non-manufacturing orders had been in a declining trend, but, now appear to be near bottoming out. Looking at performance by industry, month-to-month growth was seen in transportation & postal activities (+64.9%), and construction (+10.1%). As for transportation & postal activities, orders for railway cars are seen as having pushed up overall performance. On the other hand, some industries experienced month-to-month declines, including other non-manufacturing (-23.2%), and telecommunications (-21.0%).

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



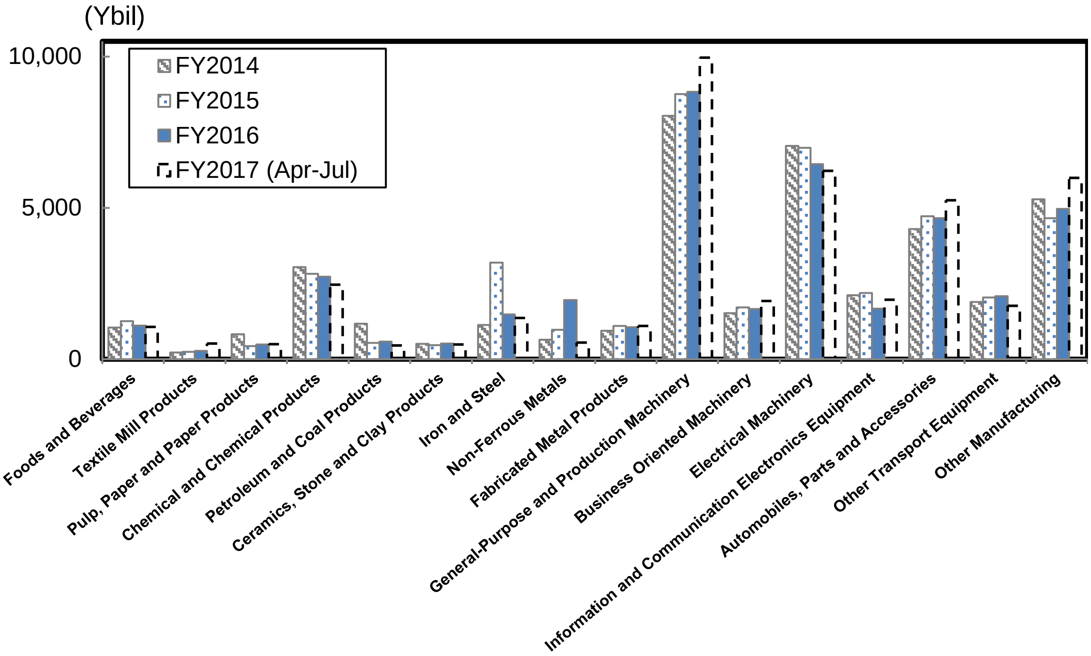
Source: Cabinet Office (CAO); compiled by DIR.
*excl. those for ships and from electric utilities.
Note: Thick lines 3M/MA basis.

Order Amounts for General-Purpose & Production Machinery (Left), and Business Oriented Machinery (Right) (Seasonally Adjusted) — Chart 3



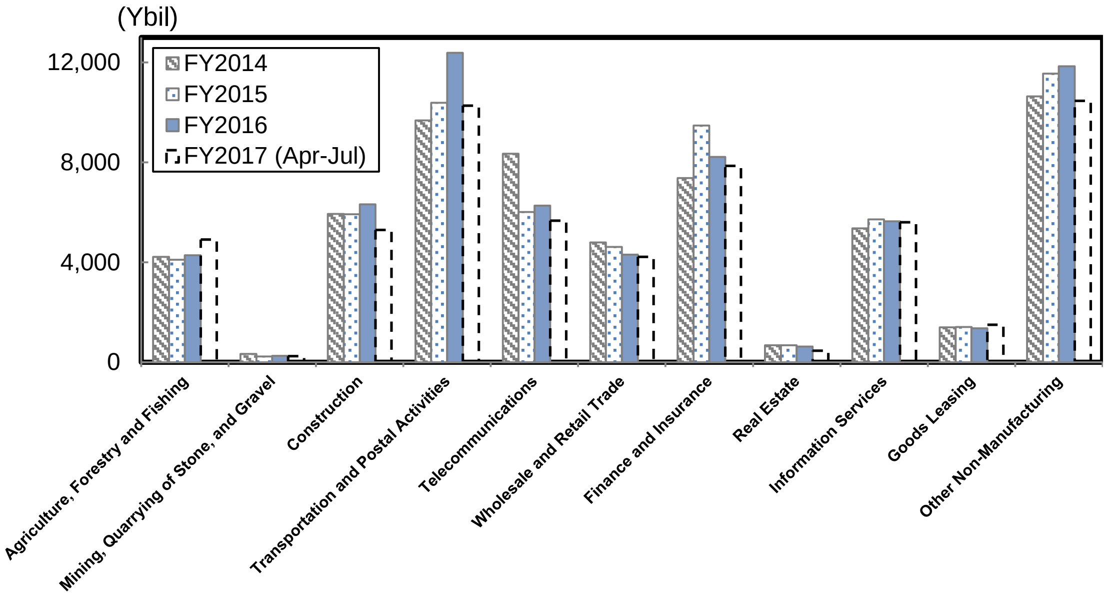
Source: Cabinet Office (CAO); compiled by DIR.

Order Amounts by Industry (Manufacturing) (FY2014 – FY2017 Apr-Jul) **Chart 4**



Source: Cabinet Office (CAO); compiled by DIR.
Note: Figures for FY2017 Apr-Jul are converted to fiscal year.

Order Amounts by Industry (Non-Manufacturing) (FY2014 – FY2017 Apr-Jul) **Chart 5**

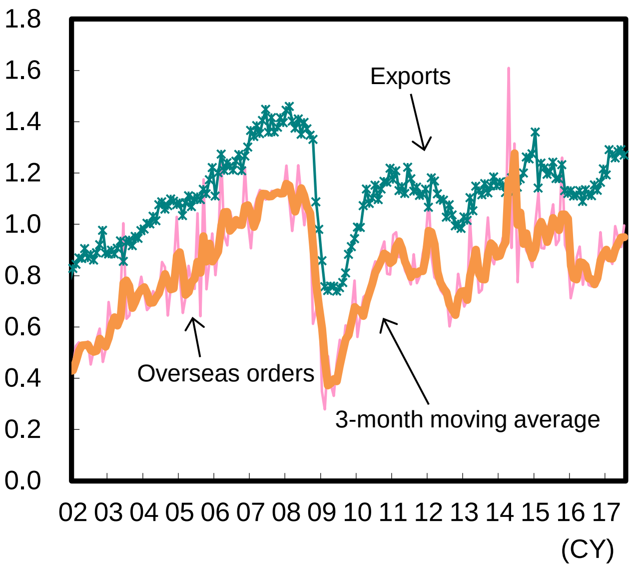


Source: Cabinet Office (CAO); compiled by DIR.
Note: Figures for FY2017 Apr-Jul are converted to fiscal year.

Overseas orders achieve growth for first time in three months

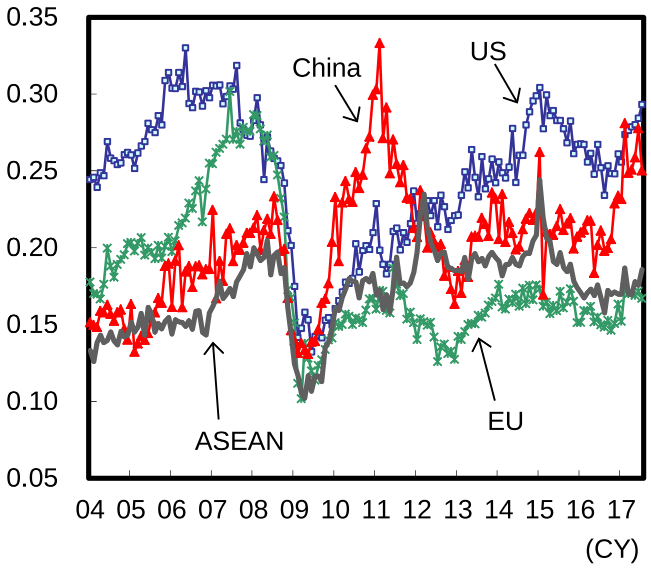
Overseas orders grew for the first time in three months at +9.1% m/m. According to the Cabinet Office, orders for industrial machinery and motors declined, while orders for electronics & telecommunications equipment, as well as railway cars, achieved growth.

General Machinery: Overseas Orders and Exports
(Y tril; SA) **Chart 6**



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 7**



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

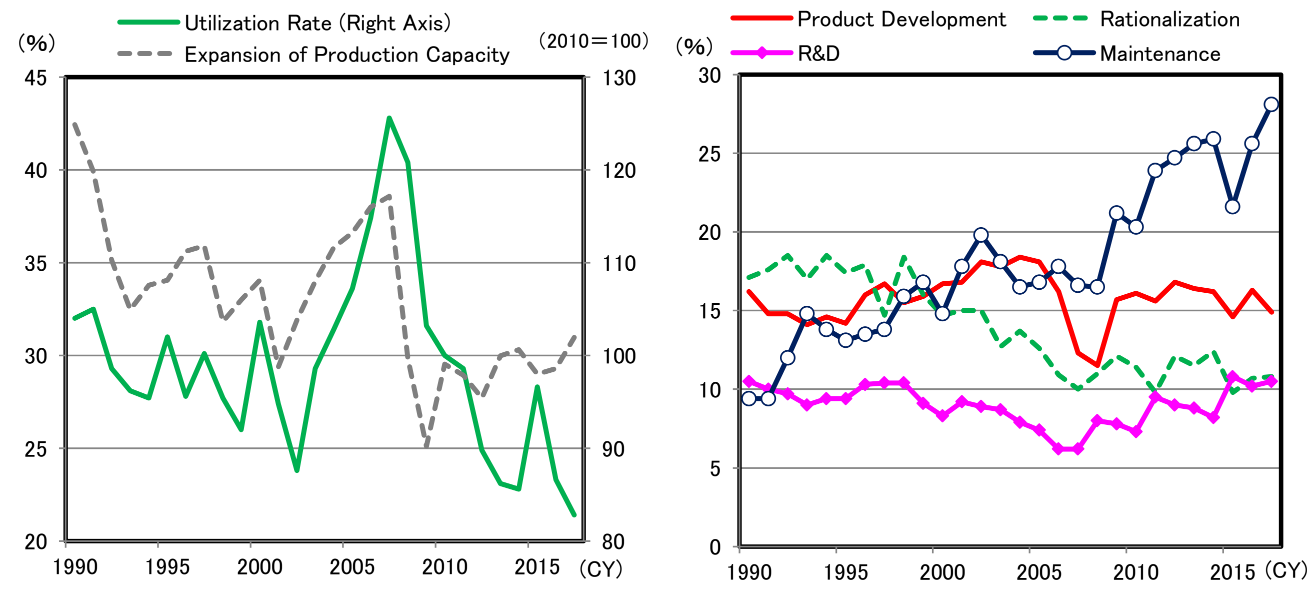
Machinery orders to experience ups and downs in future

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. According to the Development Bank of Japan's Survey on Planned Capital Spending (Large Corporations) issued in August, the major motive for investment in the manufacturing industry in FY2017 investment plans is maintenance & repair (28.1% of respondents). This is the highest this type of investment has ever been.

Chart 8 shows the proportion of capital investment motive attributed to maintenance & repair and capacity increase, as well as capacity utilization of production facilities. Until the 2000s, there tended to be direct linkage between capacity increase and capacity utilization. Since the 2010s, while operating rate continued moderate growth, the proportion of capacity increase declined. Meanwhile, the proportion of capital investment motive attributed to maintenance & repair continued to grow.

These results suggest that corporations are tending more toward responding to growth in capacity utilization by performing maintenance on existing equipment and facilities, replacing parts and so on, rather than carrying out investment in capacity increase. Behind this tendency lies the fact that although capacity utilization is growing, said growth is moderate. In predicting whether manufacturing industry machinery orders will shift into a growth trend in the future, whether or not the growth trend in capacity utilization can be maintained is a question requiring close monitoring.

Planned Capital Investment by Investment Motive (Percentage of Total) **Chart 8**



Source: Development Bank of Japan, Ministry of Economy, Trade and Industry; compiled by DIR.
Note: Capacity utilization is the average during the period, FY2017 is the average from the months of April to June.

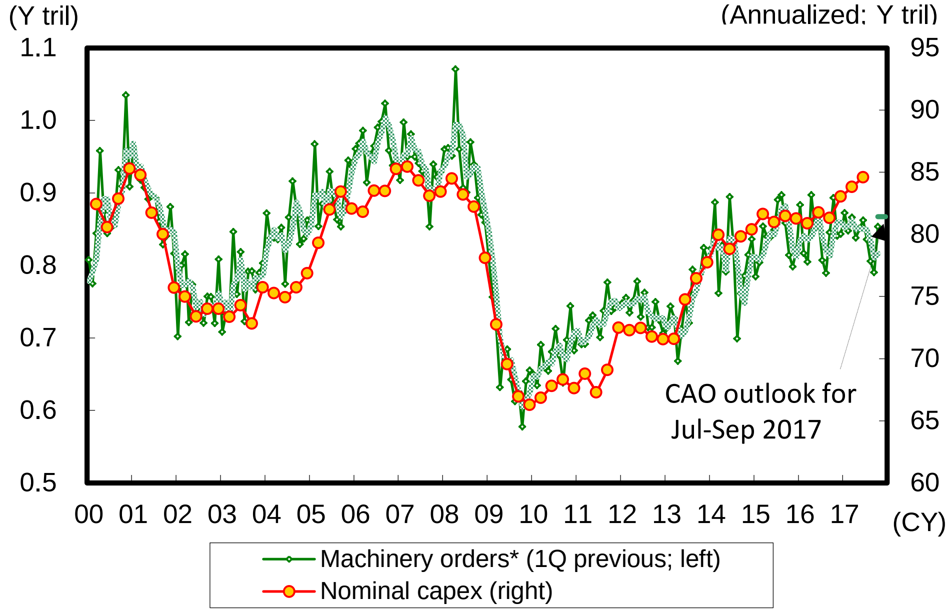
Meanwhile, the non-manufacturing industries are expected to carry out investments in transport and distribution infrastructure with the continuing growth in foreign visitors to Japan, as well as expectations regarding the 2020 Tokyo Olympics and Paralympics.

In addition, recurring profit levels are high, having recorded historic highs for three consecutive quarters, encouraging more investment in rationalization and labor saving, which is seen as a 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 hand, 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 October 2017 National Congress of the Communist Party.

Domestic Demand and Nominal Capex (seasonally adjusted figures) — Chart 9



Source: Cabinet Office (CAO); compiled by DIR.

Note: Excluding those for ships and from electric utilities; thick lines 3M/MA basis.