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Oct-Dec 2014 2nd Preliminary GDP Estimate

Both capex and inventories record lows; results fall below consensus

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Summary

- The real GDP growth rate for Oct-Dec 2014 (2nd preliminary est) was revised downward from the 1st preliminary estimate (+2.2% q/q annualized, +0.6% q/q) to +1.5% q/q annualized (+0.4% q/q). Results also fell below market consensus at +2.2% q/q annualized despite predictions that there would be almost no change in comparison to the 1st preliminary report, while capex also shifted into a downward trend, thereby reflecting a somewhat negative tone.

- In terms of source of demand, the downward revision in capex and inventories brought downward pressure on the overall GDP figure. Capital expenditure was down by -0.1% q/q, a complete turnaround in comparison to the figures reported in the 1st preliminary estimate (+0.1%), making this the third consecutive quarter to experience a decline. Despite corporate statistics having produced expectations for an upward revision in capex, the figure was ultimately revised downwards, thereby becoming a factor in GDP results falling below market consensus. Inventory investment was also expected to bring a positive contribution on the 1st preliminary estimate at +0.2%pt q/q, but finally was revised downwards to -0.2%pt, bringing a negative contribution to GDP. However, the downward revision of inventory investment is also a sign that inventory adjustment is progressing, hence these results by no means paint an overly pessimistic picture.

2014 Oct-Dec GDP (2nd Preliminary Estimate) **Chart 1**

		2013	2014				
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	
						First	Second
Real GDP	Q/q %	-0.3	1.3	-1.6	-0.7	0.6	0.4
Annualized	Q/q %	-1.2	5.1	-6.4	-2.6	2.2	1.5
Personal consumption	Q/q %	-0.2	2.2	-5.0	0.3	0.3	0.5
Private housing investment	Q/q %	2.6	2.4	-10.3	-7.0	-1.2	-1.2
Private non-housing investment	Q/q %	1.3	5.9	-5.0	-0.2	0.1	-0.1
Change in private inventories (contribution to real GDP growth)	Q/q % pts	0.0	-0.5	1.4	-0.8	0.2	-0.2
Government consumption	Q/q %	0.1	-0.3	0.4	0.2	0.1	0.3
Public investment	Q/q %	0.6	-2.2	1.1	2.1	0.6	0.8
Exports of goods and services	Q/q %	-0.2	6.5	-0.3	1.5	2.7	2.8
Imports of goods and services	Q/q %	3.0	6.9	-5.3	1.0	1.3	1.3
Domestic demand (contribution to real GDP growth)	Q/q % pts	0.2	1.6	-2.7	-0.7	0.3	0.2
Foreign demand (contribution to real GDP growth)	Q/q % pts	-0.5	-0.3	1.1	0.1	0.2	0.2
Nominal GDP	Q/q %	-0.1	1.4	0.3	-0.9	1.1	1.0
Annualized	Q/q %	-0.3	5.6	1.2	-3.5	4.5	3.9
GDP deflator	Y/y %	-0.3	0.1	2.2	2.0	2.3	2.4

Source: Cabinet Office; compiled by DIR.

Notes: 1) Due to rounding, contributions do not necessarily conform to calculations based on figures shown.
2) Q/q figures seasonally adjusted basis.

Real GDP growth rate revised downwards from 1st preliminary report

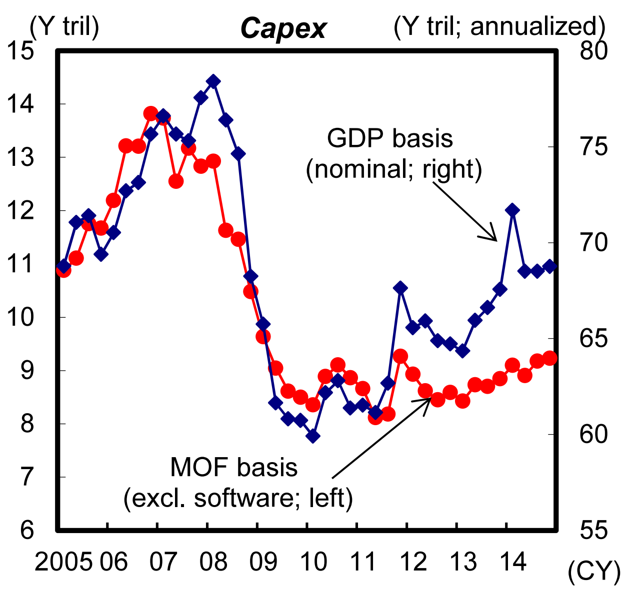
The real GDP growth rate for Oct-Dec 2014 (2nd preliminary est) was revised downward from the 1st preliminary estimate (+2.2% q/q annualized, +0.6% q/q) to +1.5% q/q annualized (+0.4% q/q). Results also fell below market consensus at +2.2% q/q annualized despite predictions that there would be almost no change in comparison to the 1st preliminary report, while capex also shifted into a downward trend, thereby reflecting a somewhat negative tone.

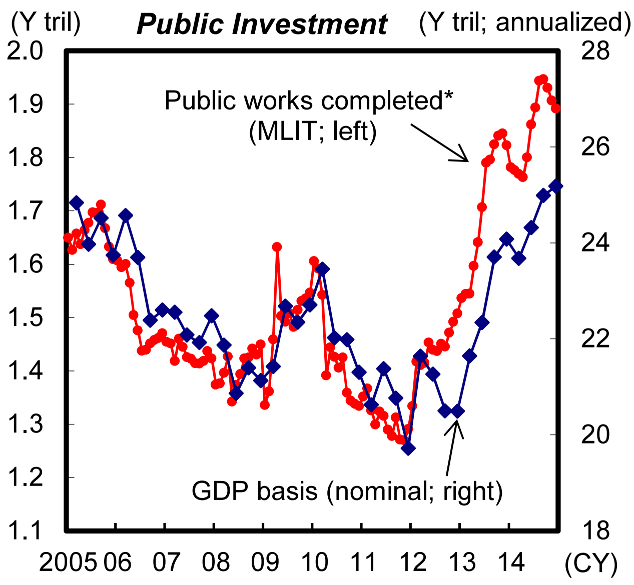
Downward revision of both capex and inventory investment

In terms of source of demand, the downward revision in capex and inventories brought downward pressure on the overall GDP figure. Capital expenditure was down by -0.1% q/q, a complete turnaround in comparison to the figures reported in the 1st preliminary estimate (+0.1%), making this the third consecutive quarter to experience a decline. Despite corporate statistics having produced expectations for an upward revision in capex, the figure was ultimately revised downwards, thereby becoming a factor in GDP results falling below market consensus. Inventory investment was also expected to bring a positive contribution on the 1st preliminary estimate at +0.2%pt q/q, but finally was revised downwards to -0.2%pt, bringing a negative contribution to GDP. However, the downward revision of inventory investment is also a sign that inventory adjustment is progressing, hence these results by no means paint an overly pessimistic picture.

On the other hand, personal consumption, government consumption, and public investment were revised upwards from the 1st preliminary report, bringing a more positive note to results, and keeping the overall downward revision in GDP to a minimum. The upward revision in personal consumption, showing an acceleration in growth in comparison with the Jul-Sep period, brings an especially positive note to GDP results despite the overall downward revision.

Capex and Public Investment: GDP basis vs. Basic Statistics **Chart 2**





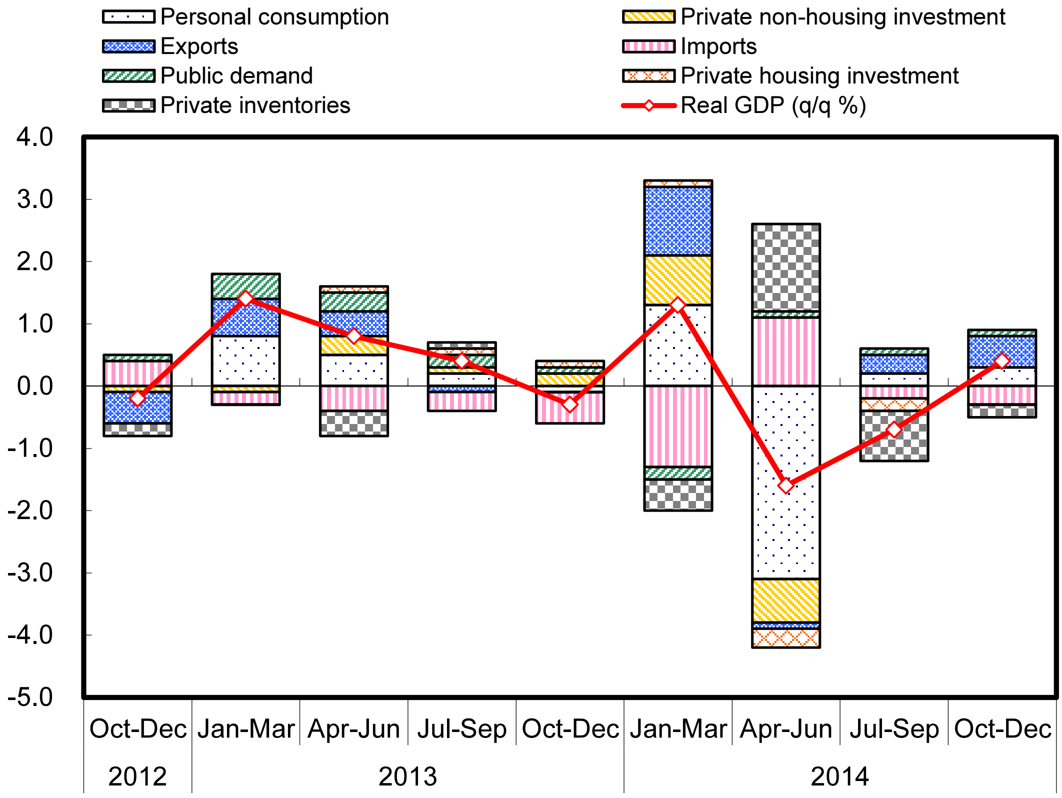
Source: Cabinet Office, Ministry of Finance (MOF), *Financial Statement Statistics of Corporations by Industry for Oct-Dec 2014*, Ministry of Land, Infrastructure, Transport and Tourism (MLIT), "Synthetic construction indexes" (available in Japanese); compiled by DIR.

Note: Data on Public Works Completed (right side) seasonally adjusted by DIR.

Personal consumption makes comeback, but capex remains stagnant

Looking at contributions from domestic and overseas demand to the Oct-Dec 2014 real GDP growth rate (quarterly basis), we see that contributions from both domestic and overseas demand made gains, with domestic demand contributing +0.2%pt (+0.3%pt on the 1st preliminary) and overseas demand contributing +0.2%pt (+0.2%pt on the 1st preliminary). As for domestic demand, the revision according to this report brought an increase in contribution from public sector demand in comparison with the 1st preliminary estimate, bringing in +0.1%pt in comparison with the +0.0%pt on the 1st preliminary. Meanwhile, capex and inventory investment were revised downwards, thereby causing the contribution from domestic demand to shrink, resulting in +0.1%pt q/q in comparison with +0.3%pt on the 1st preliminary estimate. These results have not changed our essential conclusion that the Japanese economy has entered a recovery phase after the slowdown in the first half of 2014, but the pace of growth does appear to be more moderate than it did on the 1st preliminary report.

Contribution to Real GDP (% pt; seasonally adjusted basis) **Chart 3**



Source: Cabinet Office; compiled by DIR.

Performance by demand component shows personal consumption up +0.5% q/q, its second consecutive quarter of growth. Looking at personal consumption by category, we see a comeback in durables, which had been sluggish ever since the increase in consumption tax. Durables were up by +1.8% q/q for the first time in three quarters. Meanwhile, services were also up by +0.6% q/q also for the first time in three quarters, thereby helping to push up overall results. The decline during the Apr-Jun period last year after the increase in consumption tax was especially steep, and personal consumption has not yet recovered to the level it was at before the tax hike. Performance is still very gradually making its way back up and out of the lows experienced during the reactionary decline after the tax hike in 2014.

Housing investment declined for the third consecutive quarter at -1.2%, continuing the downtrend it has experienced ever since the reactionary decline after the increase in consumption tax last year. New housing starts, a leading indicator for housing investment as a portion of GDP, bottomed out during the

Jul-Sep period. Pressures stemming from the reactionary decline after last year's consumption tax increase appear to be gradually easing up.

Capex fell by -0.1% q/q for the third consecutive quarter in a continuation of its previous slowdown. Improvements can be seen in operating rates as production begins to recover, and with the progressively weaker yen, corporate earnings continue to improve, especially in the area of major manufacturers. This should provide support for capex spending. However, corporations are still taking a somewhat reserved stance towards investment.

Public investment was up for the third quarter in a row at +0.8% q/q. Front-loading the FY2013 and FY2014 budgets helped to accelerate public investment during the Jul-Sep period, but the positive effect is gradually running out, and growth now shows signs of slowing.

Exports grew for the second consecutive quarter at +2.8% q/q. Exports to the US and Asia helped to push overall figures up, while imports also managed a comeback at +1.3% q/q, winning a second consecutive quarter of growth due to a comeback in domestic demand. Overseas demand (net exports) grew only slightly at +0.2%pt q/q.

GDP expected to continue growth trend in Jan-Mar 2015 period and beyond

Results for the period showed that real GDP attained its first positive growth in three quarters. This indicates that Japan's economy is heading toward a comeback after a period of decline following the increase in consumption tax last year. We expect real GDP to continue this growth trend during the Jan-Mar 2015 period and beyond. We expect Japan's economy to continue expanding gradually.

We also see personal consumption continuing in a growth trend due mainly to improvements in real employee compensation, conditions positively influencing households. Meanwhile, the price of crude oil which has experienced steep declines since the summer of 2014 will bring downward pressure on consumer price, providing added support to growth in personal consumption, which is in turn affected by rising real wages. Meanwhile, housing investment, which suffered from the effects of the reactionary decline last year, is expected to move steadily toward recovery now that housing starts, a leading indicator, are clearly making a comeback.

As for capex, which continued to be slow on this report, a growth trend is expected during the Jan-Mar 2015 period and beyond. In addition to continued improvement in machinery orders, another leading indicator, the BOJ Tankan indicates that capex activities are reflecting a steady undertone. Production, which had been continually worsening since the beginning of 2014, is now making a comeback and operating rates are in a growth trend. Both non-manufacturing, which has reflected a growing sense of deficiency in capex for some time now, and the manufacturing sector will continue to be relieved of any since of surplus in capex, and this should encourage more capex related demand in the future. Meanwhile, as yen continues to be weak, some manufacturers appear to be increasing the percentage of their domestic production, while improvements in corporate earnings due to the major decline in the price of crude oil should also become a factor encouraging an increase in capex spending.

As for exports, moderate growth is seen continuing as overseas economies gradually recover. The major factor pulling exports along is the US whose economy continues to improve. Meanwhile, the expanding US economy is expected to help not only Japan's exports to the US, but exports of Japanese intermediate goods to Asia which is the location of final demand for many goods. One worrisome factor is Europe and China whose economies are still suffering a slowdown. However, Europe's economy is expected to move gradually toward a comeback due to the effects of additional monetary easing on the part of the ECB, and so Japan's exports are seen strengthening their growth trend.