Japanese Economy – after the Great East Japan Earthquake

The minutes of the monetary policy meeting held June 13 to 14 were released by the Bank of Japan (BOJ) on July 15, and reportedly policy board members were unified in their view of the current economy in that "production and domestic private demand had recently been showing some signs of picking up." Many policy board members were outwardly optimistic – one member noted that "such recovery in production was proceeding at a somewhat faster pace than had been projected immediately after the earthquake." On the other hand, with regard to the economic outlook, the members appeared united in their view that "attention should be paid for the time being to the downside risks to economic activity." One member warned that "there was a high likelihood that the recovery path would deviate downward, in terms of the level of economic activity, from that projected prior to the earthquake." Furthermore, numerous members echoed the following sentiment – "In the process of restructuring and diversification of supply chains, the share of Japanese products in global markets might decline, and/or that the shift of Japanese firms' production sites to overseas, as well as changes in the procurement of materials and parts from Japan to other countries, might accelerate."

However, in contrast to such concerns, some figures indicate that the actual economy is improving at a faster pace than originally projected. In the June edition of the Economic Watchers Survey released by the Cabinet Office of the Government of Japan, the diffusion index (DI) for current economic conditions rose 13.6 points month-on-month to 49.5, which represents the largest improvement in the survey's history. This indicates that consumer sentiment is rapidly recovering from its recently abysmal state. Supported by the economic maturing of newly industrialized countries, the wave of emphasis on the technological advancement of products and the establishment of a more efficient production system is gaining momentum. The preliminary figures for machine tool orders for June comfortably surpassed forecasts, increasing 53.5% year-on-year (up 18.8% month-on-month).

Such trends have been mirrored in stock prices. The Nikkei average closed at 10,254 yen on March 11, the day of the earthquake. Later on, it fell as far as about 20% to 8,227 yen on March 15, but as of July 8 had recovered to 10,207 yen (trading hour price).

"There is also optimism with regard to stock prices," says Yasuhiko Kuramochi, General Manager of the Investment Information Department of Mizuho Securities, who analyzes factors behind the firm rise of the Tokyo stock market. First of all, since mid-June, investors have started to take on risk. Kuramochi's take is that "The manufacturing industry's business sentiment had worsened across all regions of the U.S., but it appears to have bottomed out. The bogging down of the supply chain worked to suppress Japanese manufacturers' sentiment, and stock prices factored this in. Following this, the manufacturing index (PMI) of the Institute for Supply Management (ISM) for June showed that sentiment had turned around and one fog had been lifted. Furthermore, as the supply chain has rebounded, employment is expected to make an upturn. The view that the U.S. economy is about to recover from a severe adjustment is gradually taking hold. Moreover, the economies of newly industrialized countries are also spreading their wings. China has announced a rock-solid growth path and will simultaneously strive to suppress inflation. The commodity market for products is also stabilizing in a boxed range and the inflation we'd experienced is starting to run out of steam." On the other hand, Merrill Lynch Japan Securities publication "Investment Strategy Weekly (June 17 Issue)" featured an interview with a U.K. institutional investor. This investor indicated that the perceived sentiment toward Japanese stocks was surprisingly optimistic, attributable to the following 3 points: (1) There are many investors who see Japanese stocks as being undervalued, (2) Although expectations with regard to the government are low, the early recovery of the supply chain and other business efforts made by private companies have been highly evaluated, and (3) Concerns about the U.S. economic slowdown and inflation in Asia have sparked purchasing of Japanese stocks based on the process of elimination. Truth be told, the general view is that purchasing by European, North American and Asian institutional investors drove the recovery of the Nikkei average to 10,207 yen on July 8.

Manufacturing Industry Recovery Outpacing Projections

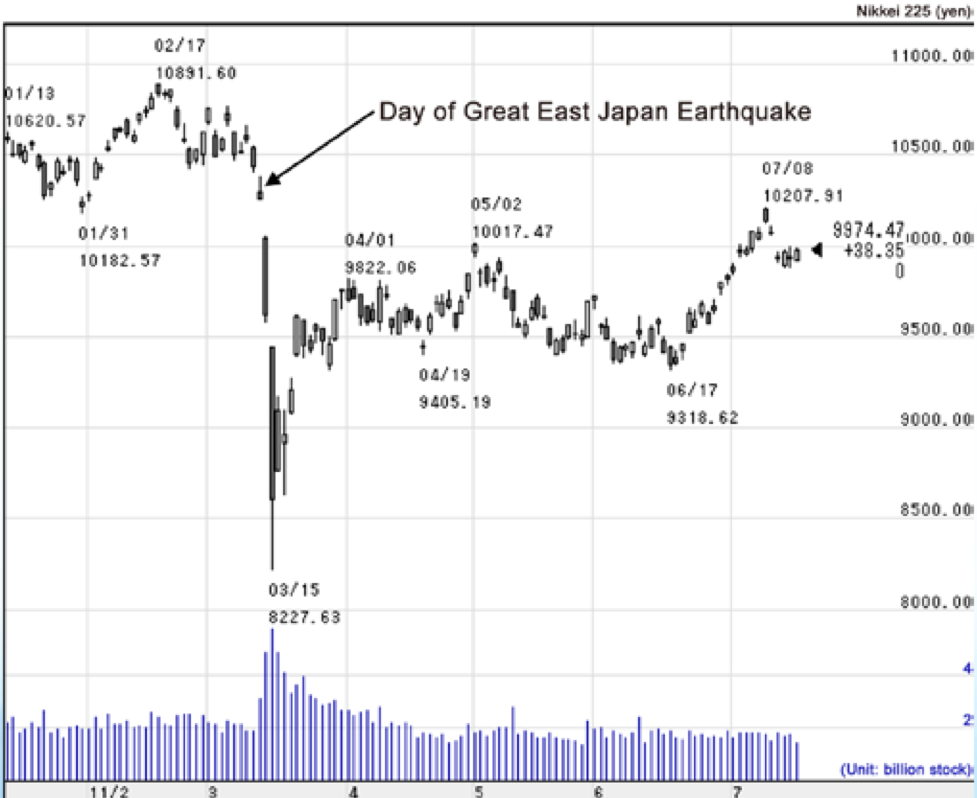
The hot topic for discussion during efforts to restore production activities in the wake of the Great East Japan Earthquake of March 11 has been the supply chain issue. Since the production bases for electronic and automobile parts and related equipment were unfortunately spread across the Tohoku region, the area stricken by the disaster, the media reported global production disruptions primarily in the automotive industry. This bit of news is still fresh in our collective memories. Initially, the automobile industry supply chain stagnation was expected to be resolved by this autumn. However, the recovery is ahead of 'schedule'. This contributed to Citigroup Global Markets Japan (CGMJ) suddenly raising the investment decision rating of Nissan Motor two notches on June 17 from 3M (=Sell/Medium risk) to 1M (=Buy/Medium risk), and also raising the target price from 650 yen to 960 yen. The main reason for this was the analysis that the recovery of Nissan Motor's supply chain was the most rapid of the three major automobile companies. The company's production normalized in June and CGMJ forecasts that Nissan will return to profitability starting from the first half of the fiscal year (April to September). CGMJ projects that its production of a low-cost car model in Thailand, India, China and Mexico using the V-Platform will enable Nissan to further strengthen its presence in newly industrialized countries. With respect to the risk of a demand slowdown in China, CGMJ's take is that since Nissan's production capacity could not keep up with the overly strong demand, a bit of a slowdown may not be such a terrible thing. There are great expectations for Nissan's global production expansion including increased sales in Asia, entry into the commercial car business in North America and the boosting of Russia as a target. With this as a prime example, it seems almost certain that production recovery among manufacturers such as the automobile and electronics industries is progressing more quickly than anyone could have imagined given the circumstances.

Consumption-Related Businesses Return to Form Ahead of Other Industries

The "summer electricity conservation" phenomenon that is spreading throughout Japan as a result of the nuclear power plant issue is cause for concern to companies in the manufacturing business. Companies are endeavoring to overcome this constraint by devising and implementing their own measures such as having employees come in on weekends and take Thursdays and Fridays off instead. On the other side of the coin, this regarding of energy as a precious, limited resource is starting to stimulate consumption. Many consumption-related

Nikkei Stock Average

(January 13, 2011 to July 15, 2011)



stocks are starting to increase in value. Right after the earthquake, restaurants and the retail sector predictably saw a drop in sales as a result of general empathy in what was a most dignified response to the tragedy. However, as this sentiment gradually wanes, expectations for a recovery are on the rise. For example, while this atmosphere of a reduction in consumption immediately following the earthquake invites a temporary standstill, the earnest attempts to conserve energy continue. Many businessmen avoid eating out on the way home from work and some are seen going directly home from the office. Since time spent at home increases, these men take their families out in their cars to nearby areas and shop at home improvement stores, go bowling, or eat out; thus, purchases at road-side stores are climbing. This trend has not gone unnoticed, as there seems to be a growing number of retail stores setting up operations along highways, with full parking facilities, in order to attract customers.

Toridoll, a restaurant chain store, operates a charcoal-grilled chicken, or yakitori restaurant under the same name. In recent years, the company has aggressively opened road-side stores – one of its ventures that stands out is a low-cost, cafeteria-style noodle restaurant named Marugame Seimen. Sales produced by existing stores (comparison among existing stores only) rose 3.8% year-on-year to record the first annual growth in a year, since July 2010. Round One runs amusement facilities that offer a variety of activities including bowling, games and karaoke throughout Japan, but primarily in the Kansai and Tokyo metropolitan areas. Sales produced by existing stores rose 5.8% year-on-year in June, marking the third straight month of growth.

Home Appliance Stores, Residential Properties and Infrastructure Development on the Bandwagon

Home appliance stores are doing particularly well in terms of sales out of industries on recovery trends based on data as of mid-July. K's Holdings is a prime example of this, and their stock prices are setting new records, breaking the highest price recorded this year. Expansion of sales is boosting stock prices. Consolidated net sales for June announced by the company on July 8 showed a 41.9% year-on-year increase and sales at the group's existing stores also climbed 34.2% against the preceding year (comparison among existing stores only). Both went on to record high figures for the month. As a result, sales at existing stores posted a 21.7% year-on-year rise for the first quarter (April to June), greatly exceeding the corporate plan for a 3% increase during the first half of the fiscal year (April to September). The current crossover from the consumption in the restoration areas is certainly strong, but it also reflects the recovery of national sentiment and not just consumption in the areas being restored. This is because in other areas, demand has increased out of a desire to purchase televisions and DVDs – as well as essential home appliances – designed for more efficient energy use. On the other hand, there are future expectations for an actual increase in demand for home ownership in a transition from temporary housing. Restoration-driven demand arising from the Great East Japan Earthquake is forecast to reach approximately 300,000 homes within the next 3 years. Furthermore, major seaport construction in disaster-stricken areas, such as Hachinohe Port, Kamaishi Port, Sendai Shiogama Port and Ibaraki Port, which were ravaged by the Great East Japan Earthquake, has not yet gotten underway since a construction policy on repair procedures is still being fine tuned. However, in light of the execution of the first supplementary budget (up to 160 billion yen for seaport-related expenses), construction to repair large port facilities is expected to start no later than this September. This is crucial, as Hachinohe Port is a distribution base for cement and oil, and further delays in its repair will impact the upcoming restoration process. Damage repair is expected to progress primarily at Hachinohe Port, and marine and engineering companies are also expected to make a comeback in terms of performance.

Full-Scale Recovery of the Economy Seen Happening This Autumn

Immediately after the Great East Japan Earthquake, Japanese analysts, strategists and economists all expected corporate earnings to return to their previous levels starting from Q3 (October to December 2011). However, the supply chain issues are nearer to being sorted out than anticipated – particularly in the car and electronics industries – and the bottoming out of the manufacturing sector seems to be coming ahead of forecasts. The Japanese economy still faces the following concerns four months after the earthquake: (1) Broad-scale power-saving measures in response to the nationwide shortage of electricity due to the drop in production capacity, (2) The high yen pinching exporters' revenues, (3) Cleanup following the Fukushima nuclear plant accident, and (4) Delays pertaining to fiscal expenditure stemming from political turmoil. However, economic recovery led by the private sector is steadily progressing. From October of this year, increased public spending resulting from the implementation of the supplementary budget is expected to assist disaster-stricken areas to transition in real time from "repair-driven demand" to "restoration-driven demand." In addition, countrywide energy conservation measures are boosting demand for LED lights, and a shift to natural energy, including solar and wind power, is most likely to pick up speed. The next step after "repair-driven demand" and "restoration-driven demand" is "building next-generation cities" in the tsunami-stricken areas. It is altogether possible that the next-generation cities will become model cases for new energy and urban development in Japan. The capital that continues to flow into the Japanese stock market from European and North American institutional investors, as well as Asian institutional investors can be said to reflect the "need to buy" based on the conviction that the Japanese economy will regain strength as has been described here.

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