

# JAPAN: INDUSTRIAL BOOM INTACT DESPITE RISING COVID CASES

## SOLID EXTERNAL DEMAND POINTS TO FURTHER UPSIDE IN JAPANESE EXPORTS

Author

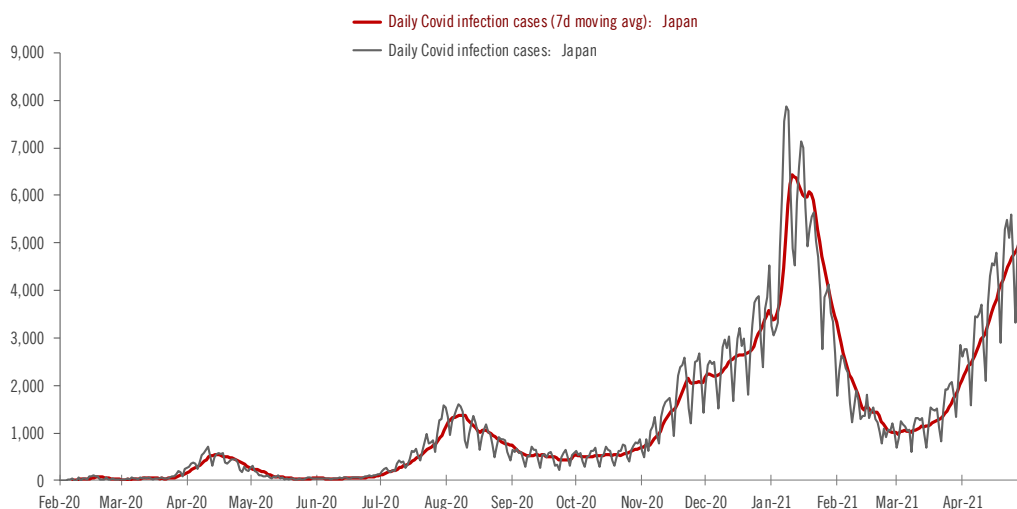
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### SUMMARY

- › The Japanese government announced a state of emergency in a number of major cities for the third time after a resurgence of covid-19 cases in April. The new wave of infections will weigh on the Japanese economy in Q2, especially the services sector.
- › Nevertheless, Japan's industrial sector is still buoyant, boosted by strong external demand. Overseas machinery orders in February were the highest since data were first made available in 1987. Machine tool orders also rose strongly in March. With a strong order pipeline, we expect further upside in Japan's exports in the months ahead.
- › The strong performance of Japan's industrial exports suggests that the global cyclical recovery continues to play out as we expected.

Last Friday (23 April), the Japanese government announced a state of emergency in Tokyo, Osaka, Kyoto and Hyogo prefectures for the third time since the start of the pandemic in 2020 due to another wave of covid infections that has brought daily confirmed cases to over 5,000 (*Chart 1*).

CHART 1: DAILY COVID INFECTION CASES IN JAPAN AND 7-DAY MOVING AVERAGE



Source: PWM - AA&MR, Wind. Data as of 27 April 2021.

While not a full lockdown, the emergency measures impose limits on restaurants and many other businesses. In some cases (e.g., bars and karaoke salons), businesses are required to close entirely. These measures will weigh on the economic recovery in Japan in the near term, especially in the services sector.

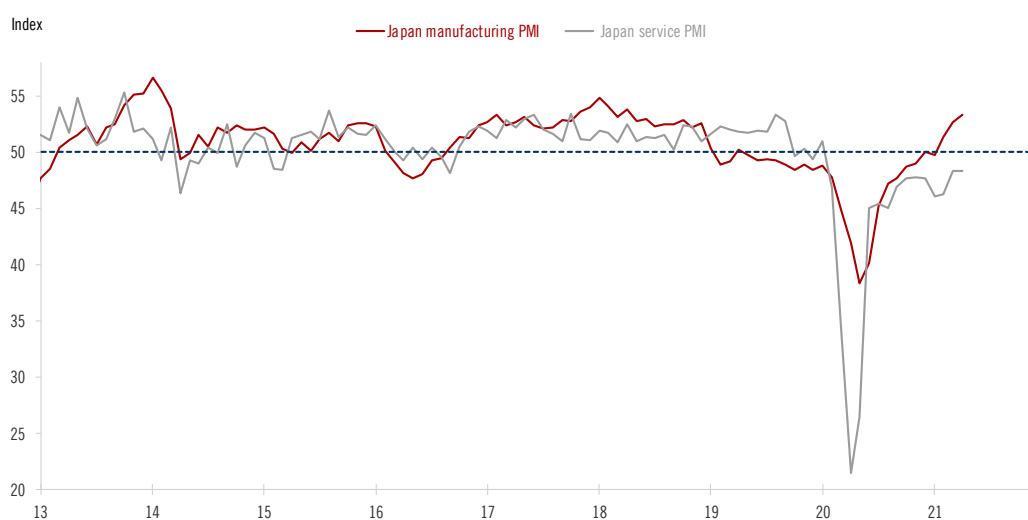
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This new round of containment measures have come in less than three months before the (re)scheduled opening of the Tokyo Olympic Games, which were postponed a year to July 2021. Given the still rapid rise in covid cases and very slow pace of vaccination in Japan (only about 1% of Japanese population have received at least one shot of vaccine so far), the risk that the Olympic Games could be cancelled altogether this year cannot be dismissed. The economic impact of cancellation would likely be small, as it was already decided to prevent foreign spectators from attending.

While the outlook for the service sector looks downbeat in the near term, Japan's industrial sector in Japan may remain buoyant. The preliminary April manufacturing PMI came in at 53.3, up from 52.7 in March. In comparison, the services PMI in April remained below the 50 mark (48.3, unchanged from the previous month (*Chart 2*)). Due to the lag in data releases, figures for Japan's industrial production only go up to February. On a year-over-year (y-o-y) basis, growth in industrial production was still in negative territory that month (-2.0% y-o-y), but improved notably from the contraction of 5.3% in January and the trough of 27% in May 2020.

CHART 2: MANUFACTURING AND SERVICES PMI IN JAPAN



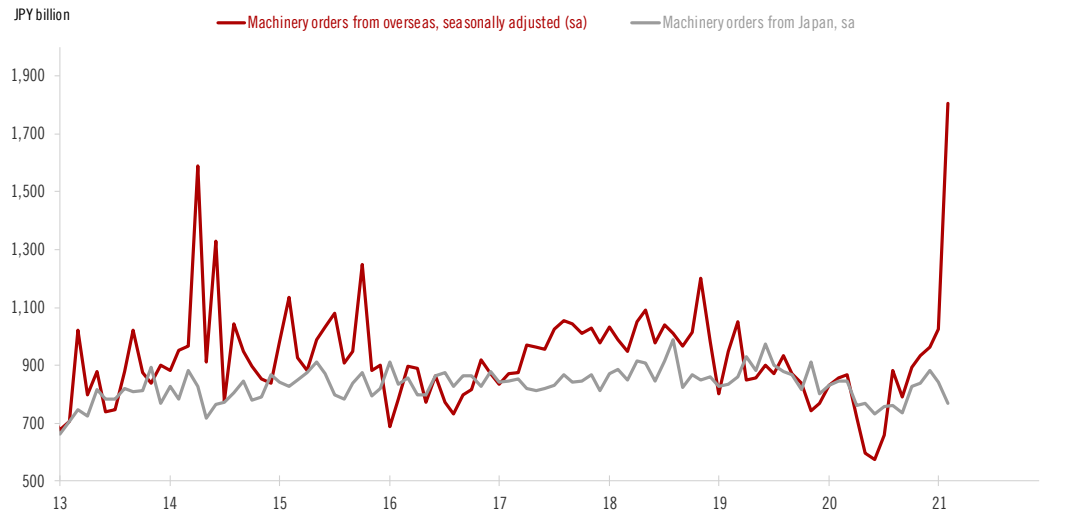
Source: PWM - AA&MR, Markit. Data as of 25 April 2021.

Within Japan's industrial sector, the machinery segment is a particular bright spot. Machinery is the second-largest product category among Japanese exports, accounting for 15% of Japan's total export value in 2019, second only to automobiles. Recent data show strong external demand for machineries made in Japan. For example, overseas machinery orders surged by 115.9% y-o-y in February, up from 15.5% in January. Note that this was not due to any base effect. In absolute terms, overseas machinery orders reached JPY1.8 trn (USD17 bn) in February, the highest monthly reading since data were first made available in 1987 (*Chart 3*).

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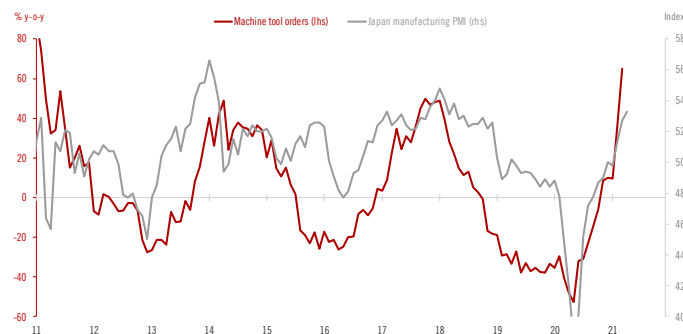
CHART 3: JAPANESE MACHINERY ORDERS BY SOURCE OF DEMAND



Source: PWM - AA&MR, Ministry of Economy, Trade and Industry of Japan

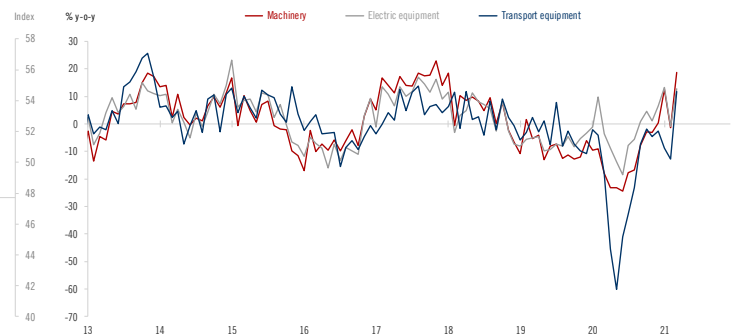
The strength of demand for Japanese machinery products can also be seen in other indicators. For example, Japanese machine-tool orders rose by 65.1% y-o-y in March, up from 51.4% in February (*Chart 4A*). Machine tools are the kind of capital good that is widely used in manufacturing. The strong rise in machine-tool orders points to capacity expansion in the manufacturing sector — mostly overseas, but to some extent in Japan as well. The recent export figures show a similar picture. In March, Japan's exports of machines rose by 18.7% y-o-y, the highest figure for any of the top three product categories (*Chart 4B*). Given the strong order pipeline, there will likely be further upside in Japanese exports, especially in the machinery space.

CHART 4A: GROWTH IN MACHINE TOOL ORDERS AND MANUFACTURING PMI



Source: PWM - AA&MR, Ministry of Economy, Trade and Industry of Japan

CHART 4B: GROWTH IN JAPANESE EXPORTS BY MAJOR PRODUCT CATEGORY



Source: PWM - AA&MR, Ministry of Finance of Japan

To summarise, Japan's domestic economy may be facing some near-term headwinds, especially in the services sector, as a resurgence of covid cases has forced the government to re-impose containment measures in some major cities. However, we expect the industrial sector to remain resilient as external demand remains strong. Robust demand for Japanese machinery suggests that the cyclical global recovery continues to play out as we have expected.

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