

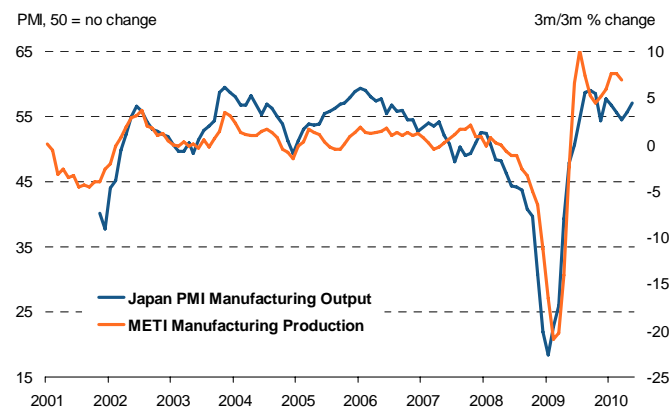
Japan

Manufacturing growth at post-recession high in May, but risk of 'double-dip' recession lingers as services weaken

Manufacturing surge continued in May, boosted by external demand

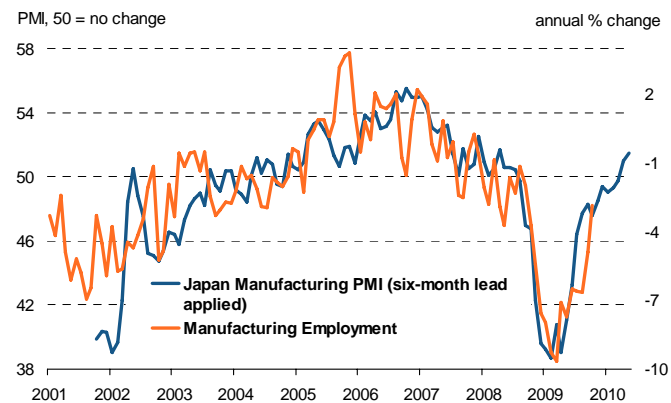
The Nomura/JMMA Manufacturing PMI, compiled by Markit, rose to a post-recession high of 54.7 in May. Manufacturing output grew at the fastest pace in 2010 to-date, fuelled to a large extent by rising exports. The May survey also showed the largest rise in manufacturing employment for two years as firms expanded capacity to meet greater inflows of new business.

Manufacturing Output



Sources: Markit, METI.

Manufacturing Employment

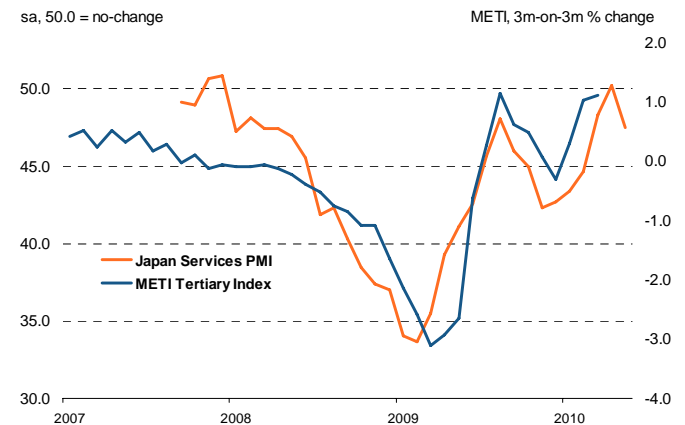


Sources: Markit, Japan's Customs Office.

But services slip back into recession

Meanwhile, a rise in the Nomura Japan Services PMI above the neutral 50.0 threshold in April had pointed to the first rise in business activity in the Japanese service sector since December 2007, as growth in manufacturing spilled over into the wider economy. The combined output of the manufacturing and service sectors rose at a PMI-survey record pace in April as a result of the improvements in the two surveys. However, more recently the PMI for the service sector showed business activity falling again in May, almost entirely offsetting the increase seen in manufacturing during the month.

Japan Services PMI



Sources: Markit, METI.

Inflows of new business in the service sector fell at the fastest rate for three months in May and confidence about the future slipped back from April's high. The only bright spot from the service sector PMI was a further easing in the rate of job cutting. When looked at together with the improvement in the manufacturing employment numbers, the result was the first (albeit marginal) increase in private sector staffing levels since July 2008.

GDP recovery in early 2010

The improvement in the PMIs since they provided an early indication of the bottoming-out of the recession in early 2009 has been subsequently reflected in official

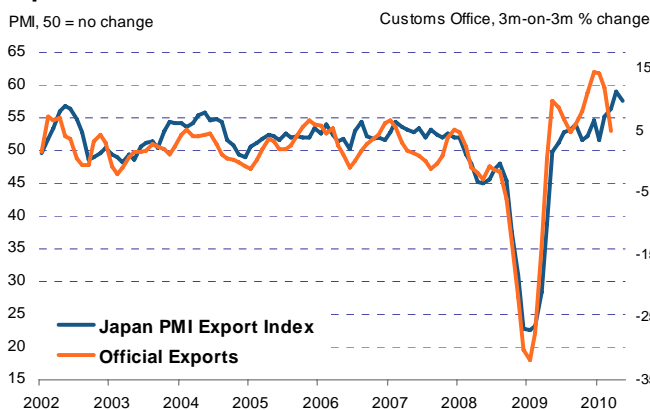
data, which showed that Japan's economy grew 1.2% in 2010 Q1. Although lower than the consensus forecast of 1.4%, the quarterly rise in gross domestic product was greater than that seen in the past two quarters.

However, the GDP data are extremely volatile and unreliable; in that they tend to get revised significantly (the preliminary estimate for growth in Q3 2009 has since been revised down from 1.2% to 0.0%). The PMI surveys suggest that growth in Q1 could be revised down from the initial estimate of 1.2% but that, despite the easing in the service sector, the rate of growth is likely to have picked up further in the spring. Looking ahead, however, the recent data point to increased risks for Japan's economy.

Outlook darkens

Crucially, the downturn in the services PMI highlights the fact that Japan clearly remains highly reliant on external demand as the key driver of growth. Official data, for example, showed net exports accounting for 0.7 percentage points of the 1.2 percentage rise in Q1 GDP, with exports rising by 43.5% on an annual basis in March. This improvement is consistent with the PMI New Export Orders Index, which averaged its highest reading since Q2 2004 in the first quarter of 2010.

Export Volumes



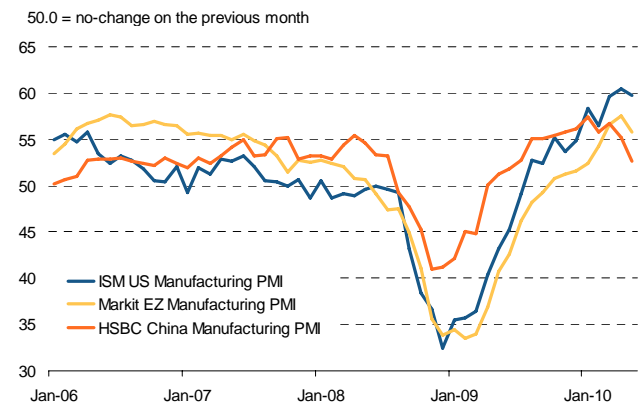
Sources: Markit, Customs Office.

This dependency on external markets makes Japan vulnerable to economic slowdowns in some of its key trading partners, such as the US and China.

In this respect the PMI surveys available for May have already provided some initial signs that the recovery in global manufacturing may be slowing, with the PMI for China the lowest in 12 months and the Eurozone PMI registering a three-month low. An index of growth in external markets, weighted according to the amount of trade that Japan does with each country, has now begun to turn down as a result. Any further cooling of demand,

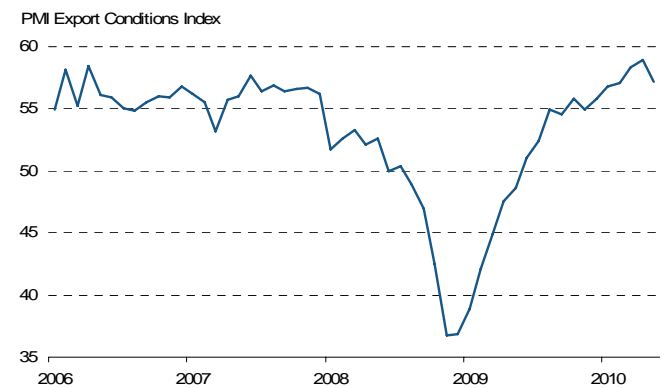
due to further monetary tightening in China or fiscal austerity measures and the financial crisis in Europe, will no doubt further weaken Japan's export sales growth.

Manufacturing PMI business conditions



Sources: Markit, ISM.

Demand conditions in external markets



Source: Markit.

A hope is that the improvement in the labour market signalled by the PMI numbers bodes well for consumer confidence and household spending in coming months, helping the economy to rebalance from external to domestic demand. However, employment tends to be a lagging indicator, and the renewed downturns in service sector activity and new business suggest that increasing numbers of service providers may seek to cut costs by reducing staff numbers again in coming months.

The labour market therefore looks to be an unlikely candidate to help drive growth as we move beyond a manufacturing-led recovery phase, which has been boosted by the rebuilding of inventories.

In the absence of sustainable growth appearing in the service sector, signs of an economic slowdown in China and other key export markets could once again expose the weakness in Japan's dependence on export-led growth and recent data and events in Europe and China have raised the risk of a slide back into recession.

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