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Worrisome Consumption

Disappointing Q2 GDP was revised down further to +1.3% qoq saar, from the prelimanary +1.7%. However, private capital spending, a key driver for economic growth, was revised up. Given the ongoing surge in corporate cash flows, capex is likely to continue to boost GDP growth. Meanwhile, worrisome at the moment is private consumption, which surged in 1H of this year, but could slow significantly in 2H. Employment deteriorated in June and July, and so did household spending. The MOF corporate survery revealed that, despite the ongoing robust sales growth, labor cost restructuring is rather deepening, i.e., growth in employees' salary and wages slowed significantly in Q2, and welfare expenses were cut most drastically ever. Risk is rising for our GDP forecast to be downgraded further.

Weak Q2 GDP Revised Down Further

The Cabinet Office announced that Q2 GDP was revised from the disappointing preliminary number of +0.4% qoq (+1.7% saar), further down to +0.3% qoq (+1.3% saar). Good news, however, was that private capital spending was revised up from flat qoq to +1.2%, as a reflection of the strong MOF corporate survey data, in which all industry capex in Q2 grew 2.1% qoq and 10.7% yoy, the highest rise since Q1 1997. This result is basically consistent with our view that private capex will continue to be a main driver for economic growth. This view is also supported by the fact that corporate cash flows in the MOF survey, a leading indicator of capex, showed a further acceleration in Q2, from Q1's +14.5% yoy to +21.9%, the highest growth since Q1 1989 **(Display 1)**.

True, the core machinery orders, another leading indicator of capex, were disappointing in July, at -11.3% mom, the largest drop since September 2001. Given that Q2 orders saw a record-high of +10.3% qoq, and that this data series is very volatile on a monthly basis, however, we think that the July outcome was not a source of concern at all.

Employment Worsened in June and July

Meanwhile, private inventories and public investment were revised down, leading to a net result of a marginally weaker Q2 GDP than the preliminary release. Given this, we will maintain our GDP forecast for this year at 4.8% (already downgraded from +5.0% at the time of release of the preliminary Q2 GDP). One thing to note, however, is that further downward risks are increasing to our GDP forecast, due to the recent unexpectedly weak employment and private consumption spending.

Unemployment rate worsened significantly in July, from June's 4.6% to 4.9%. Actually, a single-month rise as much as 0.3% point was seen for the first time in six years. More importantly, overall employment declined again in July, by 0.1% yoy, down for two consecutive months, after six straight months of rise until May. It seems that something wrong is happening to the sentiment of corporate management and their hiring behavior, and that labor restructuring pressure has started to strengthen again. Meanwhile, the average salary for all industry continued to fall, by 0.4% yoy in July **(Display 2)**.

Cuts on Welfare Expenses Very Drastic

The MOF corporate survey for Q2 is additional evidence to show that the environment for consumers has started to deteriorate again. In this survey, labor cost for all industry declined 0.2% yoy in Q2, falling for the first time in three quarters (Q1 +2.3%, Q4/03 +0.4%). Broken down by components, the growth rate of employees' salary and wages slowed significantly from Q1's +3.8% yoy to +1.5% yoy in Q2, albeit positive for three consecutive quarters.

Particularly noteworthy were welfare expenses, which fell 9.5% yoy in Q2, down for the eighth quarter in a row and the largest drop ever **(Display 3)**. This represents that labor cost restructuring is rather deepening, despite the ongoing robust sales growth. This is good for firms' profit growth, but is not favorable for consumers.

Slower Consumption a Risk for GDP Forecast

Furthermore, equity prices remain poor recently, meaning that wealth effect has been lost and that consumer sentiment should be negatively affected. There seems to be nothing to support consumption at the moment. In fact, salaried-workers' household spending was disappointing in June and July. The June spending was down 1.3% yoy in real terms, a sharp slowdown from April's +7.2% and May's +5.6%. Despite the positive effects from record-breaking heatwave and the Olympics, the July spending rose only 2.9% yoy **(Display 4)**. Given the fact that department store sales in the Tokyo area showed a larger decline of 2.7% yoy in August than -1.1% in July, August household spending is likely to see a weaker growth than July's.

Private consumption surely surged and boosted GDP in 1H of this year, but could slow significantly in 2H. This means that the odds are risng for our GDP forecast to be downgraded further.

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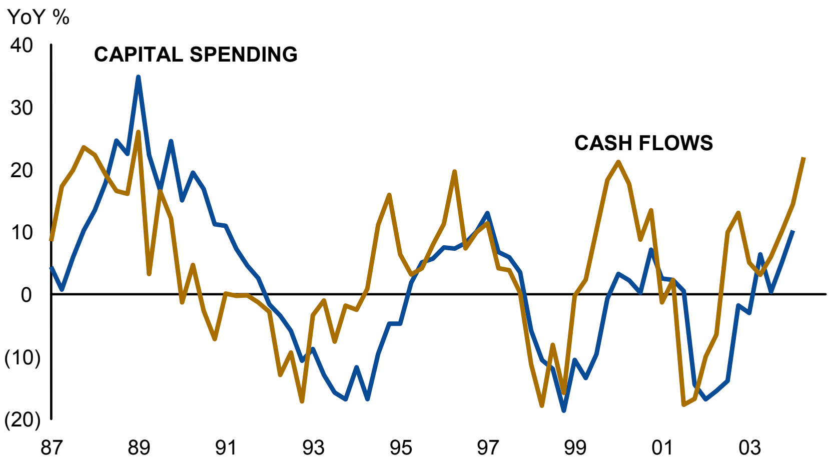
Display 1: Cash Flows and Capital Spending for All Industry

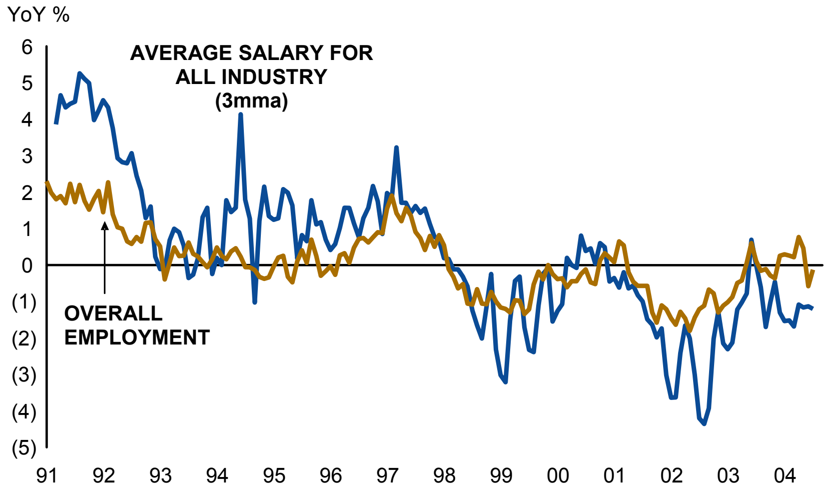
Surging Cash Flows Imply That Capex Will Continue to See Robust Growth



Source: MOF, Alliance Capital, September 20, 2004

Display 2: Average Salary for All Industry and Overall Employment

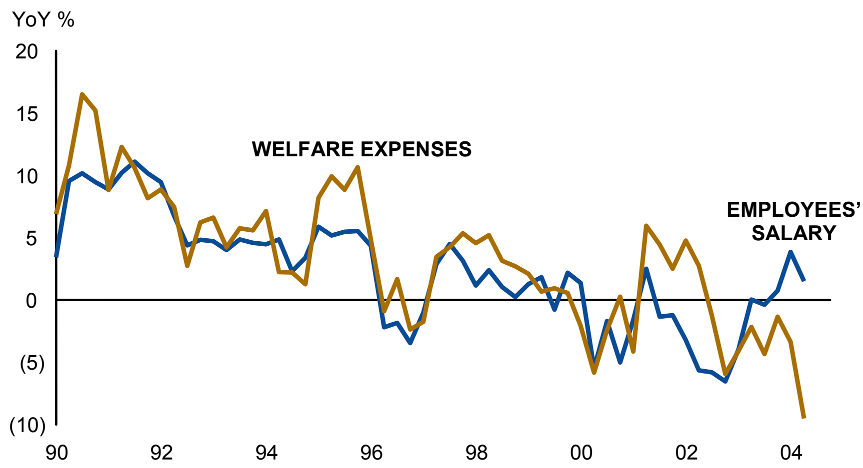
Employment Declined in June and July, Average Salary Continues to Fall



Source: MPHPT, MHLW, Alliance Capital, September 20, 2004

Display 3: Employees' Salary and Welfare Expenses for All Industry

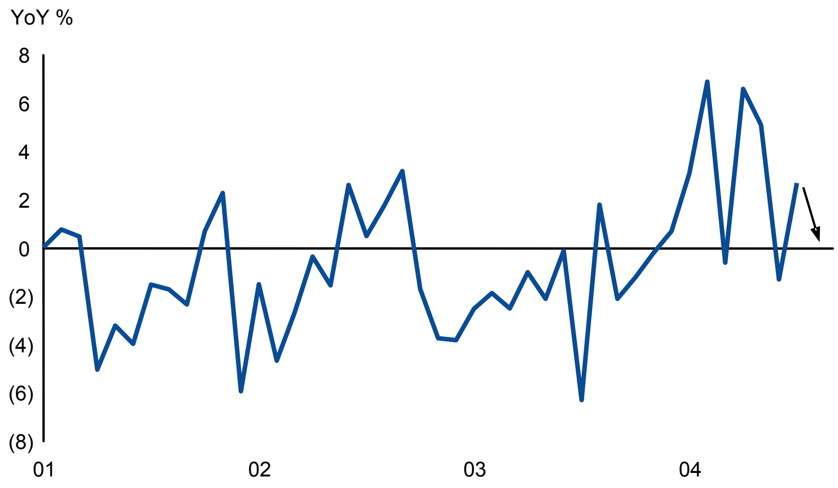
Welfare Expenses Were Cut Most Drastically Ever in Q2



Source: MOF, Alliance Capital, September 20, 2004

Display 4: Salaried-Workers' Household Consumption Spending

Household Spending Surged in 1H, But Has Recently Slowed Significantly



Source: MPHPT, September 20, 2004