Recent Economic Trends as Seen From the *Economy Watchers Survey*

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The apparent economic trough in March 2009 was correctly signaled by the Economy Watchers Survey as early as three months beforehand in December 2008. In fact, the survey's diffusion index of current economic conditions has performed impressively, as seen by its correlation coefficient of over 0.9 with respect to the composite indexes of leading economic indicators two months ahead. Attention is now focused on whether the index will signal a sharp economic slowdown after the yearend when fiscal stimuli fade out. The survey also predicts sluggish household activity and rising unemployment.

1. Predictive Accuracy of the *Economy Watchers Survey*

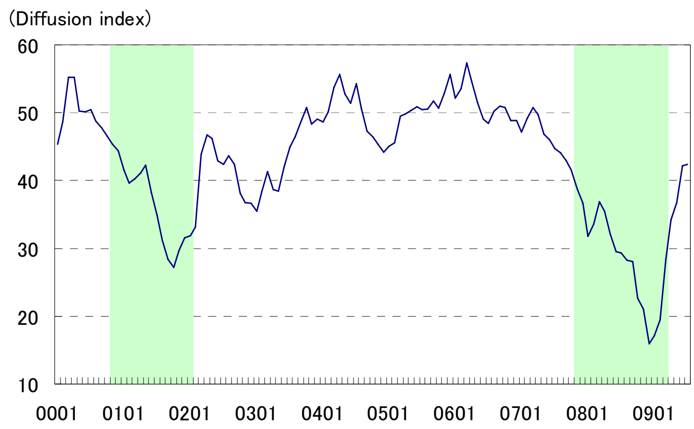
One of the earliest signs that the economy had bottomed out came from the *Economy Watchers Survey*. The survey's headline diffusion index of current economic conditions (assessing how current conditions compare to conditions three months ago), which fell sharply from autumn 2008 and reached a low of 15.9 in December, recovered in 2009 to 42.4 as of July.

Meanwhile, the recession that began in November 2007 appears to have ended in March 2009. In this context, the upturn of the current economic conditions DI after December 2008 can be interpreted as signaling the recession's end three months in advance. [1]

Notably, this is not the first time the diffusion index has correctly predicted cyclical turning points. In fact, since its inception in 2000, the index has signaled all cyclical turning points in advance (the November 2000 peak, January 2002 trough, and October 2007 peak). The index even signaled the two soft phases (2H 2002 to 1H 2003, and 2H 2004 to mid 2005) of the record long economic expansion that began in February 2002.

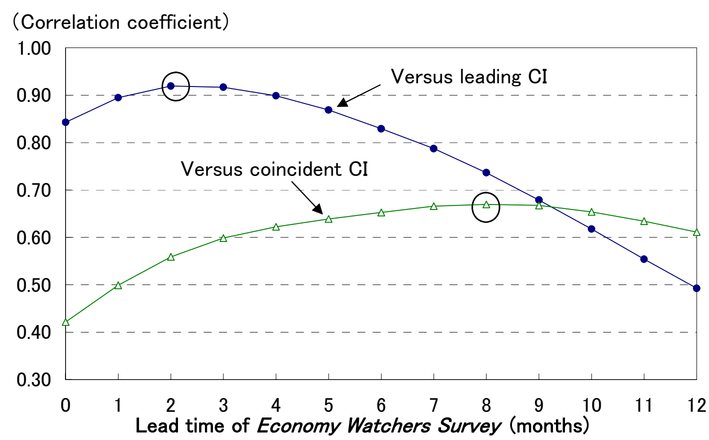
The survey's high sensitivity to economic conditions is attributed to its unique composition of participants—including taxi drivers, convenience store managers, and nightclub operators—who have firsthand knowledge of conditions at the

Exhibit 1 Current Economic Conditions DI



Note: Shadowed areas indicate recession. The latest cyclical trough has not been officially verified, but is assumed to be March 2009.
Source: Cabinet Office, *Economy Watchers Survey.*

Exhibit 2 Correlation Coefficient of Current Economic Conditions DI and Time-Lagged Composite Indexes

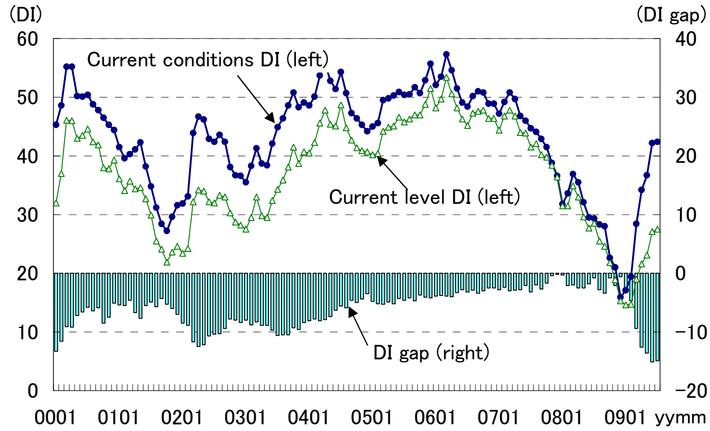


Note: Measurement period is from January 2000 to June 2009.
Source: Cabinet Office, *Indexes of Business Conditions*, and *Economy Watchers Survey.*

economy's leading edge.

To examine the performance of the current economic conditions DI as a leading indicator of the economy, we measured its correlation coefficient with respect to the leading and coincident composite indexes of economic indicators. The correlation coefficient peaks with respect to the coincident CI at a lead time of eight months, and with respect to the leading CI at a lead time of two months, in the latter case topping 0.9. Due to its brief history, the current economic conditions DI has yet to be adopted as a leading economic indicator, but its level of accuracy is impressive nonetheless.

Exhibit 3 Growing Gap Between Current Economic Conditions DI and Current Economic Level DI



Source: Cabinet Office, *Economy Watchers Survey.*

The consensus forecast among private economic forecasters calls for the economy to continue growing in Q3 2009 following on the brisk 3.7% annualized pace in Q2 2009, but then to slow sharply in Q4 as the fiscal stimulus effect wears off. Meanwhile, the current economy DI in July slowed to a 0.2-point improvement from June, while the future economy DI dropped 0.7 point for the first time in seven months. Forecasters will be closely following the next few readings for signs of an impending economic slowdown.

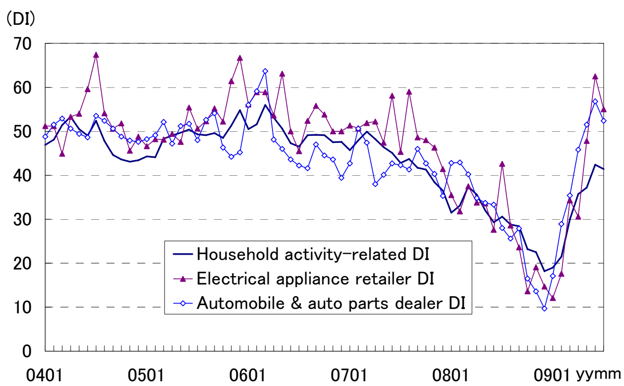
For reference, the survey also releases a DI of the current level of economic activity. Economic data shows the current level of economic activity to be improving but still extremely low. For example, compared to recent peak levels, real GDP and manufacturing output are down by 7.5% and 26.5% respectively. Thus even though the current economic conditions DI shows the economy to be improving, the current economic-level DI remains sluggish, and the gap between the two is widening.

2. Corporate Activity-Related DI Outpaces Household Activity-Related DI

By sector, the current conditions DI for household activity plummeted to 18.2 in December 2008 before climbing to 42.4 in June 2009, topping 40 for first time in 20 months since October 2007. The improvement was strongest among automobile & auto parts dealers and household appliance retailers, largely due to the economic stimulus of the eco car tax incentive and subsidy and the eco point program. However, due to poor weather and smaller summer bonuses, the household activity-related DI fell -1.0 point in July from June for the first time in seven months.

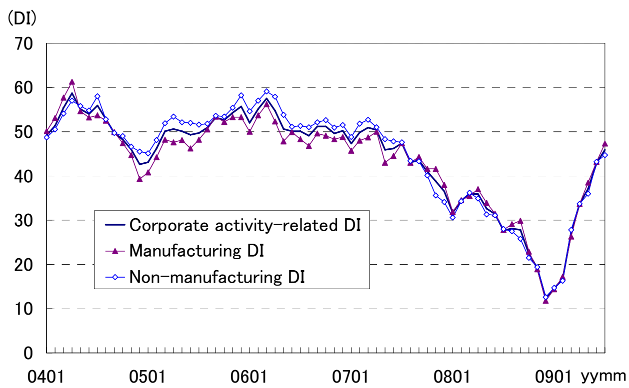
Meanwhile, the corporate activity-related DI for both manufacturing and non-manufacturing also

Exhibit 4 Household Activity-Related DI



Source: Cabinet Office, *Economy Watchers Survey.*

Exhibit 5 Corporate Activity-Related DI

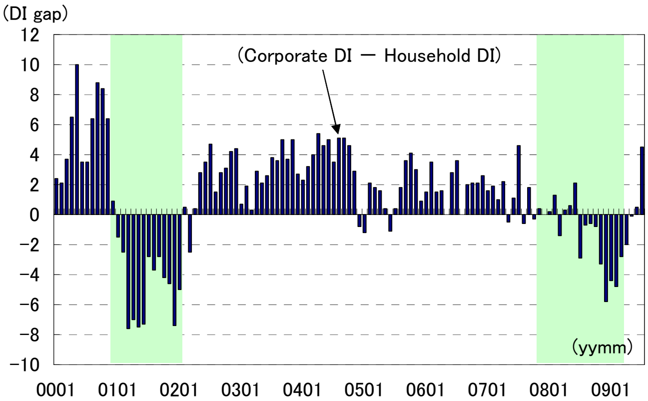


Source: Cabinet Office, *Economy Watchers Survey.*

bottomed out in December 2008, but then rose consistently for the next seven months. The improving business sentiment can be attributed to an export recovery and inventory adjustment in manufacturing, as well as to economic stimulus measures which expanded or moved up public works spending.

While both sectors rebounded in December 2008, the corporate sector has improved more vigorously. After trailing the household sector from summer 2008, the corporate sector finally took the lead in June 2009. In July 2009, the corporate DI rose again while the household DI fell, further widening the gap.

Exhibit 6 Current Conditions DI Gap Between Corporate and Household Sectors



Note: Shadowed areas denote recession. Latest cyclical trough is assumed to be March 2009.
Source: Cabinet Office, *Economy Watchers Survey.*

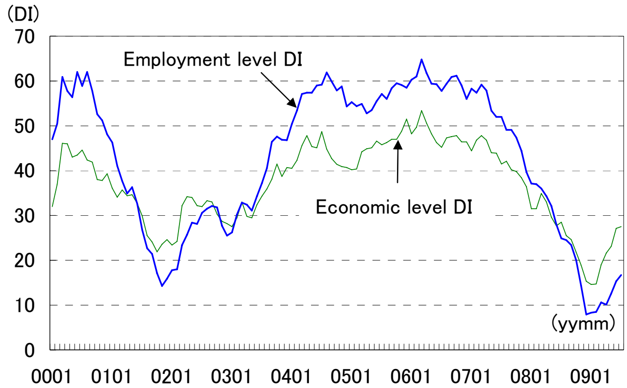
Despite the record length (69 months) of the previous recovery, the recovery ended before the corporate sector's export-led recovery could invigorate the household sector. This performance gap between the two sectors was vividly captured in the *Economy Watchers Survey*—the corporate DI consistently led the household DI during the entire recovery period from 2002 to 2007.

Looking ahead, the corporate sector enjoys a favorable earnings outlook due to the export recovery from early 2008. On the other hand, the household sector, which has been sustained by stimulus packages, faces a poor outlook for personal consumption and residential investment due to the worsening employment and income situation. The corporate DI's widening lead in the *Economy Watchers Survey* suggests that the corporate sector will likely drive the economic recovery in the near future.

3. Employment-Related DI Point to Rising Unemployment

Although a half year has elapsed since the economic trough in March 2009, the employment situation continues to deteriorate. Employment data released on August 28 shows the unemployment rate hitting a record 5.7%, topping the previous high of 5.5%.

Exhibit 7 Employment Level DI Now Trails Behind Current Economic Level DI

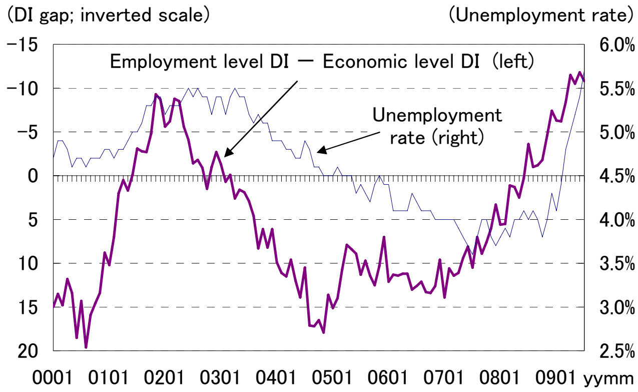


Note: Shadowed areas denote recession. Latest cyclical trough is assumed to be March 2009.
Source: Cabinet Office, *Economy Watchers Survey.*

The *Economy Watchers Survey* compiles employment-related DI by surveying people at the heart of the labor market, including temporary staff employees and Hello Work public employment office workers. Although employment adjustment is entering full swing, the employment level DI has steadily improved after bottoming out in December 2008. However, this is likely because the DI of all sectors in the survey tend to move together. In assessing the employment situation, the critical point is that the employment-related DI are underperforming both the current economic conditions DI, which signals the economy's direction, as well as the current economic level DI, which gauges the level of economic activity. In particular, the gap with the latter has mushroomed.

Typically, when the employment level DI rises above the current economic level DI, the unemployment rate starts to fall; conversely, when it falls below the current economic level DI, the unemployment rate starts to rise. For example, in the previous recovery, the unemployment rate remained high even after the economy bottomed out in January 2002, hitting a high of 5.5% in June and August 2002, and again in April 2003. During this time, the employment level DI remained below the current economic level DI. Later, when the employment level DI rose above the current economic level DI, the unemployment rate began falling. But in July 2008, the employment level DI fell below the current economic level DI again, and the unemployment rate has recently started to accelerate upward.

Exhibit 8 Sluggish Employment Level DI Signals Rising Unemployment Rate



Note: Shadowed areas denote recession. Latest cyclical trough is assumed to be March 2009.
Source: Cabinet Office, *Economy Watchers Survey.*

Since April 2009, the employment-level DI has remained at least 10 points below the current economic level DI for four consecutive months. This relationship is expected to take considerable time to reverse. We predict that the unemployment rate will continue to rise in the near term and reach 6% during 2009. Meanwhile, employment adjustment will remain in progress.

Monthly GDP Trend—June and July 2009

GDP rose 0.6% in June from May for the fourth consecutive monthly gain, due to growth in private consumption and external demand.

In July, GDP fell -0.2% from June, marking the first decline in five months as private demand decreased in private consumption, residential investment, and business fixed investment.

Endnotes

1. Official reference dates of cyclical turning points are determined by the director of the Economic and Social Research Institute (Cabinet Office) after discussion by the Study Group on Indexes of Business Conditions. Typically, the reference date is determined at least one year after the turning point.

2. The *Economy Watchers Survey* also releases a DI for future economic conditions (assessing economic conditions two to three months ahead). However, the time lagged coefficient of correlation is actually inferior to that of the current economic conditions DI.