

# September Tankan: broad recovery intact; shifting allocations in focus

## Broad resilience masks underlying divergence

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### Overview

The Bank of Japan (BOJ)'s September quarter Tankan survey of business sentiment released on 1 October showed a broad-based manufacturing recovery across all sizes of firms. Large manufacturers' diffusion index (DI) improved from the June Tankan's 22 to 24, while sentiment at mid-sized and small manufacturing recovered by six and five points, respectively. This broadening upturn, despite ongoing pipeline cost pressures, is an important signal of economic activity, and is consistent with the BOJ's recent decision to increase the pace of normalisation. However, the large non-manufacturers' DI softened to 35 from 37 after an increase in the June quarter. This may warrant some caution regarding sectors particularly exposed to pass-through of price rises, though a single quarter of decline may not denote a trend and therefore is unlikely to alter the policy interpretation of the data.

### Outlook DI

September's current-to-outlook comparisons indicate some moderation in business conditions over the near term. At the same time, comparisons with June's rolling outlook show modestly improved expectations for different target quarters. For example, the outlook for small-manufacturing enterprises rose from 2 to 12. These observations are not contradictory: firms still expect conditions to moderate from current levels, but they are less pessimistic about the future than they were in June.

### Profits

All-enterprise profit growth was revised to 2.2% from -6.5% in June, which was a substantial upgrade. However, the divergence between healthy double-digit current profit growth in manufacturing(11.6%) and declines in non-manufacturing (-4.5%) warrants caution. Moreover, current profits-to-sales for FY2026 still remain modestly below the FY25 ratio despite improving since June. The key takeaway is that an earnings upgrade should not be interpreted as an economy-wide margin expansion; earnings breadth meanwhile does not yet match sentiment breadth.

### Capex and investment

Capex indicators were also mixed. Headline capex plans for large businesses, excluding software and R&D, were revised down to 11.3%. However, broader measures of investment, including software and R&D but excluding land purchases, were revised higher. On this measure, all-enterprise investment is projected to grow by 9.3% in FY2026, with non-manufacturing rising 11.8%.

The composition of capex plans also showed large manufacturers' software investment plans moderating from June, though they still imply 9.2% year-on-year growth. However, small non-manufacturers showed robust software and R&D intentions, even though their combined investment measure including software and R&D (ex-land) still remains below year-earlier levels.

**Investment allocation** was our key area of focus last quarter, particularly because the June Tankan showed an apparent shift in investment intentions from overseas towards Japan. The September Tankan continued to show a modest domestic tilt, although overseas investment is still projected to grow in absolute nominal terms. However, the decline in overseas investment's share apparent in the June survey did not extend further quarter-to-quarter in September. We may be at a point in the overseas investment cycle where a weak yen may marginally discourage additional reinvestment of overseas-earned revenues, which continue to show signals of increasing at a healthy pace.

## Foreign exchange assumptions

Large manufacturing exporters anticipate a dollar/yen exchange rate of 153.45 for H2. Yen weakness beyond this level could marginally favour preferences towards domestic rather than overseas reinvestment. However, there is no clear evidence that yen strength beyond this level would be the primary catalyst for a turn in large manufacturing revenues, particularly if demand is dampened by relatively tighter monetary policy abroad.

## Labour, prices and financial conditions

Scarcity remains the prevailing condition in the labour market and, according to the employment DI, it has intensified across the board. Labour scarcity sustains the incentive for labour-saving investment, but it also helps to explain why stronger sales do not always translate into stronger margins, unless productivity (from the combination of labour and capital) improves. Meanwhile, quarter-to-quarter cost pressures appear to have eased somewhat (with the relevant DI declining from 62 to 59), reflecting a lower net balance of firms reporting rising rather than falling input prices. Among large manufacturers, the input-price DI is expected to fall further, from 59 to 55. However, large manufacturers' output prices hold firm at 40. Small firms expect their output prices to rise, which is consistent with the broader pass-through of increased costs, albeit with a lag. Financial conditions remain accommodative, consistent with the BOJ's recent policy statement, despite evidence of rising borrowing costs.

## BOJ policy implication

In sum, the September Tankan is consistent with the BOJ's gradual and data-dependent approach to the removal of accommodation, as well as its heightened vigilance on inflation. Evidence of economic resilience, lagged pass-through of input costs and chronic labour supply shortages suggest that inflationary pressures remain intact. The Tankan points to a resilient economy, not obviously handicapped by gradual removal of accommodation thus far.

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