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2012 OUTLOOK
ASIAN MARKET COMMENTARY

Japan: The Long Road to Recovery

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We continue to be neutral on Japan despite low valuations, as the catalyst for outperformance remains elusive.

The tragic events of 2011 will long be remembered in Japan, not only for the destruction and loss of life wrought by the March 11 earthquake and tsunami, but also the psychological scars left by fears of radiation contamination and a sense that the government was slow to respond and misled the populace about the severity of the crisis. As a result, another Japanese prime minister has resigned, and current Prime Minister Yoshihiko Noda is now the sixth prime minister in five years, leaving many both in and outside of Japan wondering where the country is heading, given the challenges it still faces.

From a financial standpoint, 2011 has also seen Japan shaken to its core, not only by natural disasters and other external factors (crisis in Europe, slowing global economy, a strong yen), but also by the emergence of a corporate scandal 20 years in the making at camera maker Olympus,[1] an ugly reminder that corporate Japan is still in need of reform.

Investors have rightfully thrown in the towel, as the outlook remains fraught—external headwinds do not appear to be abating, while the domestic outlook is not inspiring. Even as valuations for Japanese equities are cheap in both absolute and relative terms, for now the needed catalysts to unlock this value remain elusive. We remain neutral on Japanese equities and do not advocate any tactical positioning.

[1] It has been revealed that Olympus misreported its financial statements and used a series of off–balance sheet transactions and inflated payments for acquisitions to hide about $1.5 billion in losses from speculative investments in the early 1990s.

Performance

Exhibit 1 shows the sad state of affairs. Japanese equities began lagging global markets in late 2006, and failed to keep pace over the 2009–10 rally. Japanese equities began 2011 with a sharp rise; however, the devastation wrought by the "triple disaster" in March saw the MSCI Japan Index fall nearly 20% over three days. While Japanese equities did rebound from their post-earthquake levels, the market fell alongside global markets in August and September. In contrast to most markets, Japanese equities failed to participate in the October and late November rally, instead sliding back toward their early 2009 levels. The failure of Japanese equities to rally has been attributed to additional supply chain disruptions due to floods in Thailand (where Japanese firms have outsourced production) and the eruption of the Olympus scandal. However, it could also be a reflection that the global economy—and especially the Chinese economy—is rapidly slowing; indeed, Shanghai is the only other major market that has failed to rally of late.

All in all, Japanese equities have lost 25.0% from their 2011 highs, while year-to-date through November 30, the MSCI Japan Index has returned -18.7%, potentially its worst annual return since 2002, notwithstanding 2008's -42.6% return. This compares with a -6.0% return for the MSCI World Index, -13.6% for Europe ex U.K., and -15.4% for Asia ex Japan, making Japan the worst-performing major market/region (Exhibit 2).

Looking at individual sectors, there really was no place to hide (Exhibit 3). While consumer staples managed to post mildly positive returns and telecommunications was essentially flat year-to-date (due entirely to dividends), these two sectors only account for about 11% of market cap. Utilities (typically a defensive sector) was the worst performer, down 42.6%—not surprising given the near-collapse of Tepco (the owner of the now-infamous Dai-ichi nuclear power plant) and other nuclear power plant operators.

The financial sector was also hit hard, returning -23.2%. Claims on insurance companies following the natural disasters and questions over bank exposures to Europe weighed on the sector, as did the fact that cross shareholdings make Japanese financials a levered play on the Japanese market.[2] The financial sector was the largest negative contributor to index performance due to its heavy weighting, followed by consumer discretionary (which includes the major automakers) and industrials.

However, one bright spot is that small caps in Japan continue to outperform, both at home and abroad (Exhibit 4). While the MSCI Japan Index is down nearly 19% year-to-date through November, the small-to-mid-cap index has returned -11.8%, while small caps alone have returned -9.4%. This compares to -16.2% for global ex U.S. small to mid caps. The outperformance of Japanese small caps is generally attributed to their domestic focus (leaving them less affected by global demand and a strong yen) and their lower exposure to financials. Rock-bottom valuations have also helped.

Finally, yen strength, while a bane for Japanese exporters, also boosted returns for unhedged investors, as the yen has climbed 7.9% against the U.S. dollar, 6.8% against the pound sterling, and 4.3% against the euro over the past 12 months. Indeed, year-to-date, in US$ terms (or any terms other than yen), Japanese equities (-15.0%) have fared better than emerging markets (-17.2%) or Asia ex Japan (-17.6%) equities.

Valuations—Cheap, but Cheap for a Reason

Japanese equities were undervalued prior to the earthquake, and are now even cheaper. Japan's return on equity (ROE)–adjusted price-earnings (P/E) ratio stood at 9.8 on November 30, greater than 2 standard deviations below its post-1992 average of 20.[3] This is down from 12.8 at the end of February 2011, and only slightly higher than the 9.5 ROE-adjusted P/E ratio seen at the end of February 2009.

Given the extreme volatility of Japanese corporate profits, we find the price-to-book (P/B) ratio to be a more straightforward metric. On a P/B basis, the market now trades slightly below book, also similar to its early 2009 multiple and 2 standard deviations below its post-1992 deflation-era average, continuing to place Japan among the cheapest of the 45 markets tracked by MSCI on a P/B basis. To those who feel Japan has "always

[2] According to Goldman, Sachs & Co., cross-shareholding by banks, insurance companies, and corporations still account for 31% of outstanding Japanese equities.

[3] We believe the post-1992 period is the most appropriate for historical valuation comparison, given the secular shifts in the underlying Japanese economy since then. However, for our calculation of the Japanese ROE-adjusted P/E ratio, we assume an average ROE of 9.5%, which is the average level of ROE over the 1974–91 period and a level of ROE achieved over the previous cycle (2004–08). We view this as a reasonable assumption for achievable ROE going forward, given that corporate Japan has largely repaired its balance sheet following the post-bubble deleveraging of 1990–2003. While other ROE assumptions can be made, such as Japan's full-period post-1974 average of 6.5% or the 12% norm expected of a developed equity market, either of these long-term ROE assumptions still results in a current ROE-adjusted P/E ratio roughly 2 standard deviations below average.

been cheap," we note that by early 2006, Japan was valued 1 standard deviation above average, similar to previous peaks in the 1990s (Exhibit 5). This cheapness is also reflected in relative valuations. At the end of November, Japanese equities traded at a 47% discount to the MSCI World ex Japan Index on a relative P/B basis, which is a full standard deviation below the average 32% discount over the post-1992 period. Indeed, Japan is now back to its lowest relative P/B valuation since 2003 and 2002, from which Japan last began to outperform. Also note that by 2006, Japan traded at only a 17% discount, or 1 standard deviation above recent averages.

Japanese small/mid caps, meanwhile, look a bit pricey relative to Japanese large caps (trading near their 2006 peak levels), but still seem attractively priced relative to global small/mid caps, sporting a roughly 40% discount, much lower than their 2009 levels (Exhibit 4). The point here is that while Japanese small caps are no longer depressed relative to the beaten-up large caps, they still appear cheap in absolute terms.

However, many investors are unimpressed by Japan's seemingly low valuations, given the deteriorating fundamentals (Exhibit 6). We concur. After rebounding sharply from losses in 2008–09 as corporate Japan fought tooth-and-nail to cut costs amid a rising yen, earnings per share (EPS) are again declining following the impact of the earthquake. Forward estimates call for a decline of 4.6% for fiscal year 2011 (ending in March 2012) before a 15% rebound in fiscal year 2012 (ending in March 2013). If anything, the risks are to the downside. It is unclear how long rising energy costs, rolling power outages, and supply chain disruption will weigh on earnings. Further, perceived nuclear contamination of Japanese goods could result in long-term brand damage, especially when competitors in Asia (particularly in Korea) have narrowed the perceived quality gap with Japan.

Meanwhile, ROE remains stuck at its depressed long-term average of 6.5% and below the ROE of roughly 10% achieved over the last earnings cycle (and still well below the average ROE of roughly 12% seen in most equity markets). Thus, given that Japanese book value is compounding at a low (and falling) rate, Japan does deserve to trade at a discount to other markets. Still, analysis by Goldman Sachs reveals that the market's implied long-term earnings growth rate in Japan is -0.6%, lower than its October 2008 level of 0.9%, which seems a bit excessive. So for Japan, current valuations have at least priced in earnings weakness, at a time when forward estimates still seem high in other markets. This may help provide more of a floor for Japanese equities on a relative basis.

The only good news in Japan is that dividends are rising, as well as share buybacks. Japan's dividend yield (DY) of 2.7% is also more than double its post-1992 average yield of 1.1%, and remains well above the yield on ten-year Japanese government bonds. While Japanese DYs are low compared to those of Europe and Australia, they are comparable to yields on U.S. equities (2.2%) and emerging markets (2.9%). In other words, for the first time in decades, Japan is not at a yield disadvantage, especially as firms begin to focus more on "shareholder returns." Following the scandal at Olympus, Japanese institutional shareholders have called for more corporate reform.

Weakness at Home, Weakness Abroad

What are the prospects for a strong economic recovery? While the Japanese economy returned to growth in third quarter 2011, consensus GDP growth for the full year is -0.4%, with an expected rebound in 2012 of 2.1%, driven by rebuilding efforts. Ironically, this may put Japan among the fastest-growing developed economies, which itself highlights the difficult external environment next year. The fact is that deflation remains entrenched (both headline and core) and despite signs of rising wages, private consumption remains muted, as the savings rate has risen sharply amid elevated unemployment (Exhibit 7). Should growth in China, Europe, and the United States come in lower than expected (for whatever reason), Japan's domestic economy will be unable to compensate for external weakness.

At the same time, the yen also remains strong, rising to postwar highs both versus the U.S. dollar and in trade-weighted terms. This has been a drag on the economy as well as the stock market, as seen by the negative correlation between the yen and MSCI Japan. While this correlation has begun to weaken, it is still deeply negative (Exhibit 8). Yen strength is arguably a key reason behind the relative weakness of Japanese equities over 2009–10, given the hit to Japanese corporate profits. A weakening of the yen could see Japanese earnings surge to the upside amid even modest top-line growth due to the operational leverage achieved by corporate cost cutting in response to yen strength.

Fundamentally, the yen should weaken, as Japan's trade balance has turned negative. Helping to support the yen are repatriations by Japanese corporates and "safe-haven" flows into the yen, especially from Japanese households, as seen in the reversal of net fixed income portfolio flows (Exhibit 8). With effectively little difference between U.S. and Japanese short-term interest rates, investors have little cost to park their assets in yen, particularly given deflation (i.e., real yields are higher in Japan than elsewhere).

For the yen to weaken, we need to see real interest rates rise elsewhere and market volatility fall, making yen assets less attractive. However, with the Federal Reserve pledging to keep U.S. interest rates at effectively zero until at least mid-2013 and central banks across the developed and emerging worlds now cutting policy rates, the natural tendency is for the yen to remain strong. So far, the Bank of Japan (BOJ) has not followed the lead of the Swiss National Bank and announced a level at which it will cap the yen. Instead, it has engaged in several half-hearted interventions that have been unsuccessful.

Arguably, the bigger macro issues for Japan are demographics and government debt burdens. Eventually, the rapid aging of the population and shrinking domestic savings will result in Japan needing foreign investors to fund its deficits. When this occurs, the domestic interest rate may rise sharply, hurting domestic banks that sit on large amounts of government bonds. The yen may come under pressure as the BOJ is forced to purchase government debt to stabilize the Japanese government bond market (not too dissimilar to what is occurring in Europe). However, Japan still has a few years before it will need to tap foreign savings. Furthermore, Goldman Sachs estimates that a planned consumption tax hike from 5% to 10% implemented over 2014–20 could generate between ¥10 trillion and ¥12.5 trillion (over US$125 billion) in annual revenues, which could help reduce deficits, assuming the monies are saved and not spent (not a foregone conclusion in Japan).

The bottom line is that a fiscal crisis is unlikely to be an issue for 2012, but low growth and large government debts remain long-term risks to Japanese assets that may cap any cyclical rise in Japanese equities.

Outlook: Still Waiting for that Rally

With Japan's dismal performance in 2011 and trough-like valuations, the question has to be asked: is Japan poised for a big rally that catches everyone off guard? Since 1992, there have been five periods in which Japanese equities beat developed markets equities by at least 20 percentage points on a rolling 12-month basis, with Japanese outperformance occurring roughly every three years: 1993, 1996, 1999–2000, 2004, and 2005–06. However, it has now been nearly seven years since Japan has posted meaningful outperformance.[4]

Every dog has its day, and Japan is certainly overdue for some outperformance. Yet we have fallen victim to this mean reversion argument before. In late 2009, we downgraded Japan from a strategic overweight (given long-term macro headwinds) to a tactical overweight based on valuations and oversold relative performance. This view was dependent on a global recovery and a weakening yen, which we acknowledged might not occur.[5] Following the earthquake, we shifted our stance from a tactical overweight to neutral given the lack of clarity on any improvement in Japanese earnings and yen weakness.[6] This view has played out.

So what is next for Japanese equities? As of now, we see three broad scenarios for 2012:

1. Japanese equities continue to suffer, as global growth slows sharply/turns recessionary, and the yen strengthens further.
2. Japan outperforms on the downside (falls less than other markets) given very low valuations, similar to what occurred in 2002.[7]
3. Japan outperforms as the global economy stabilizes/accelerates, the BOJ intervenes heavily to weaken the yen, and Japanese growth/profits surprise to the upside.

Our view is that scenario 3 (Japan strongly outperforms) is less likely given our concerns about the macro environment. Even if growth stabilizes next year, we still find it hard to see Japan rallying sharply absent a weakening yen. While Japan's cheap valuations could result in downside outperformance (perhaps boosted by a still-strong yen), this is not a compelling enough argument to advocate increasing exposure.

Conclusion

The Japanese economy is showing signs of stabilization following the horrific natural disasters in 2011. Still, the road to recovery is long, and there continues to be a lack of clarity on the economic and earnings outlook.

Overall, we remain neutral on Japan and do not advocate any tactical positioning. To outperform on a sustained basis, Japanese equities will require an upturn in the global cycle accompanied by a weakening yen that allows for a strong profit recovery. Given our global macro outlook, we do not see these preconditions on the horizon.

For those who feel that a global recovery is more likely next year amid improved macro conditions, we would still not advocate a large bet on Japan, as we prefer to play this recovery/beta bet through emerging markets and especially Asian equities.

We are, however, comfortable with active management strategies in Japan, as there are extreme discounts available in certain companies and sectors and idiosyncratic opportunities relating to small cap/micro caps, merger & acqui-

[4] In local currency terms, not due to yen strength. Japanese equities did outperform global equities in US$ terms in 2008, right on the three-year schedule, although Japanese equities outperformed in US$ terms consistently over the 2002–05 period.
[5] Please see our October 2009 Market Commentary *Japan: Will the Sun Ever Rise?*
[6] Please see our March 18, 2011, note *The Unfolding Tragedy in Japan: What Should Investors Be Thinking About?*
[7] Japan outperformed by roughly 6 percentage points for calendar year 2002, as MSCI Japan fell 19% while World ex Japan fell 25%. Outperformance was 10.5 percentage points when yen strength is included.

sition, and corporate activism strategies. We are also comfortable with bottom-up driven global equity managers with a Japan tilt in the portfolio, given valuations and prospects for outperformance if our view is wrong. However, a large bet on the market as a whole is not warranted in our opinion.

The contrarian value investor in us sees a market that has lagged for seven years and trades on record-low valuations as bound to surprise on the upside at some point. Thus, a neutral weighting in Japan is justified. However, to unlock the deep value in Japanese equities, both corporate and economic reform are needed. There are tentative signs of the former, but little of the latter.

The biggest risk to Japanese equities is arguably some sort of fiscal crisis brought on by demographic decline. A fiscal crisis in Japan is unlikely in the near term, but remains a significant longer-term risk; indeed, like other democracies, a crisis will probably be needed to trigger serious reform that will eventually lead to the long-awaited secular bull market in Japan. ■

Exhibit 1

MSCI Japan Versus World ex Japan

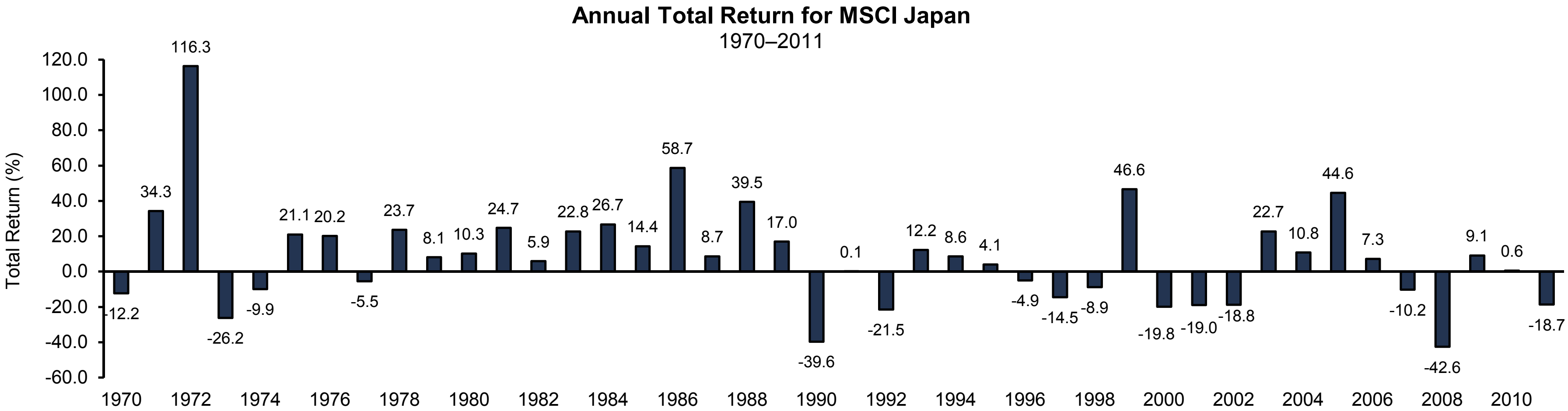
December 31, 2005 – November 30, 2011 • Local Currency • December 31, 2005 = 100

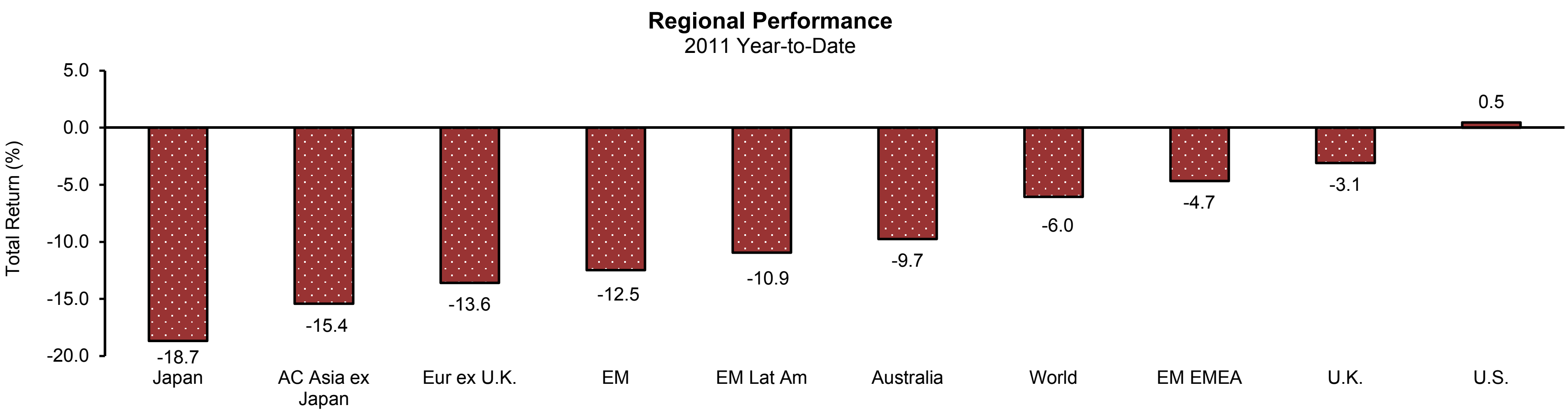
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Graphs based on daily price levels in local currency. Price levels have been rebased to 100 on December 31, 2005.

Exhibit 2

MSCI Japan Performance

Local Currency





Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI developed markets indices are net of dividend taxes. Total returns for MSCI Emerging Markets and All Country indices are gross of dividend taxes. Data for 2011 are through November 30.

Exhibit 3

Sector Performance Attribution for MSCI Japan

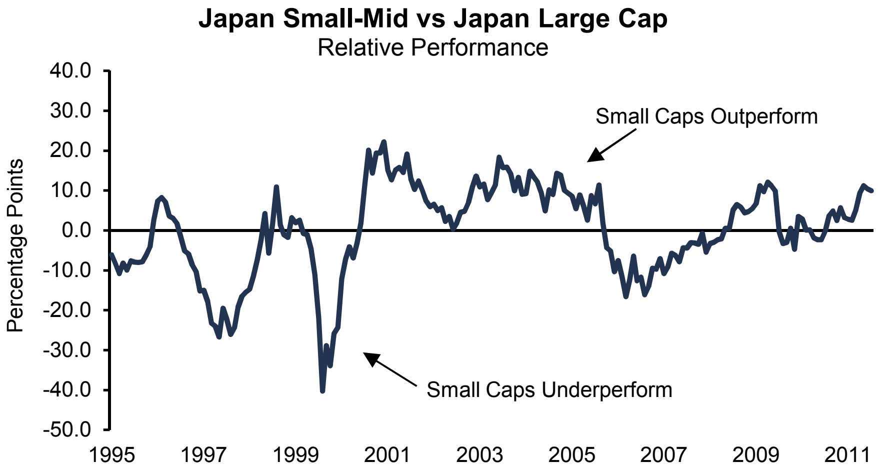
January 1, 2011 – November 30, 2011

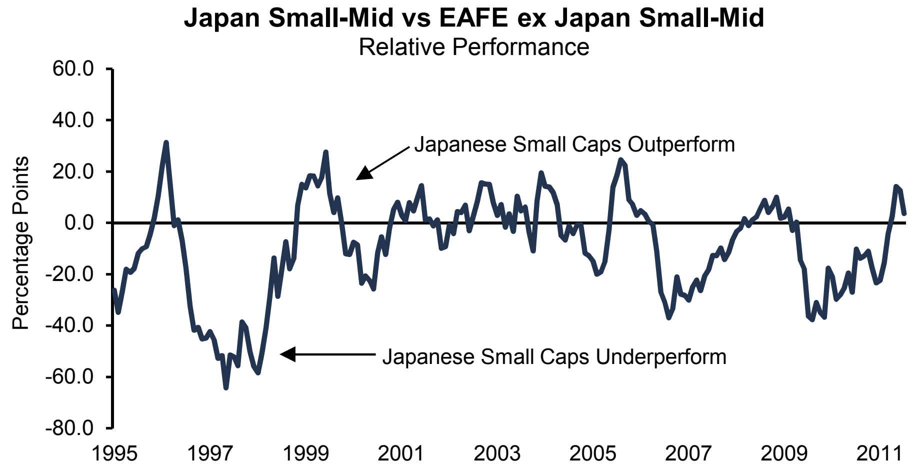
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Contribution represents the sector's percentage point addition to the MSCI Japan Index return of -18.7%. Sector contributions are calculated by multiplying the sector's December 31, 2010, weight by its cumulative local currency return from January 1, 2011, to November 30, 2011. Percentages may not total due to rounding.

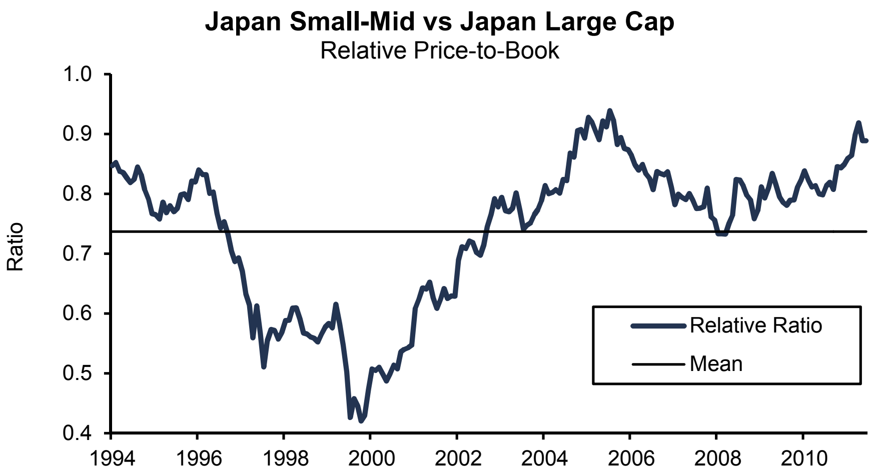
Exhibit 4

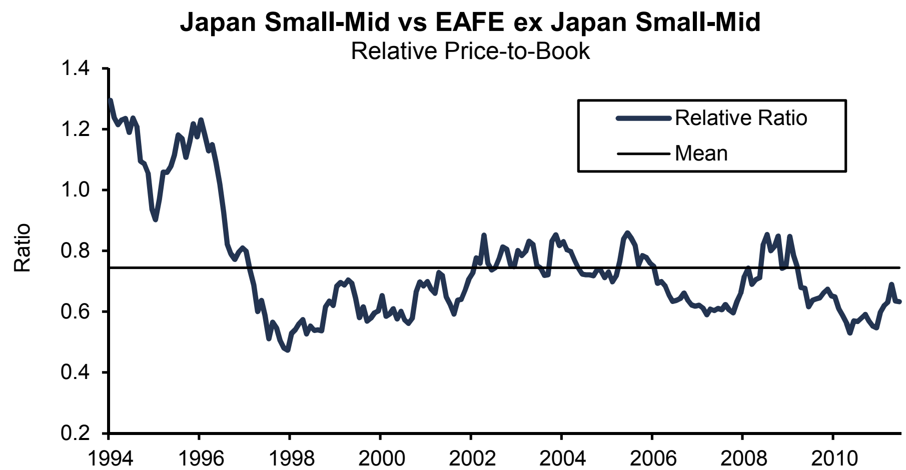
Japanese Small Caps: Rolling 12-Month Relative Performance and Valuation

June 30, 1994 – November 30, 2011







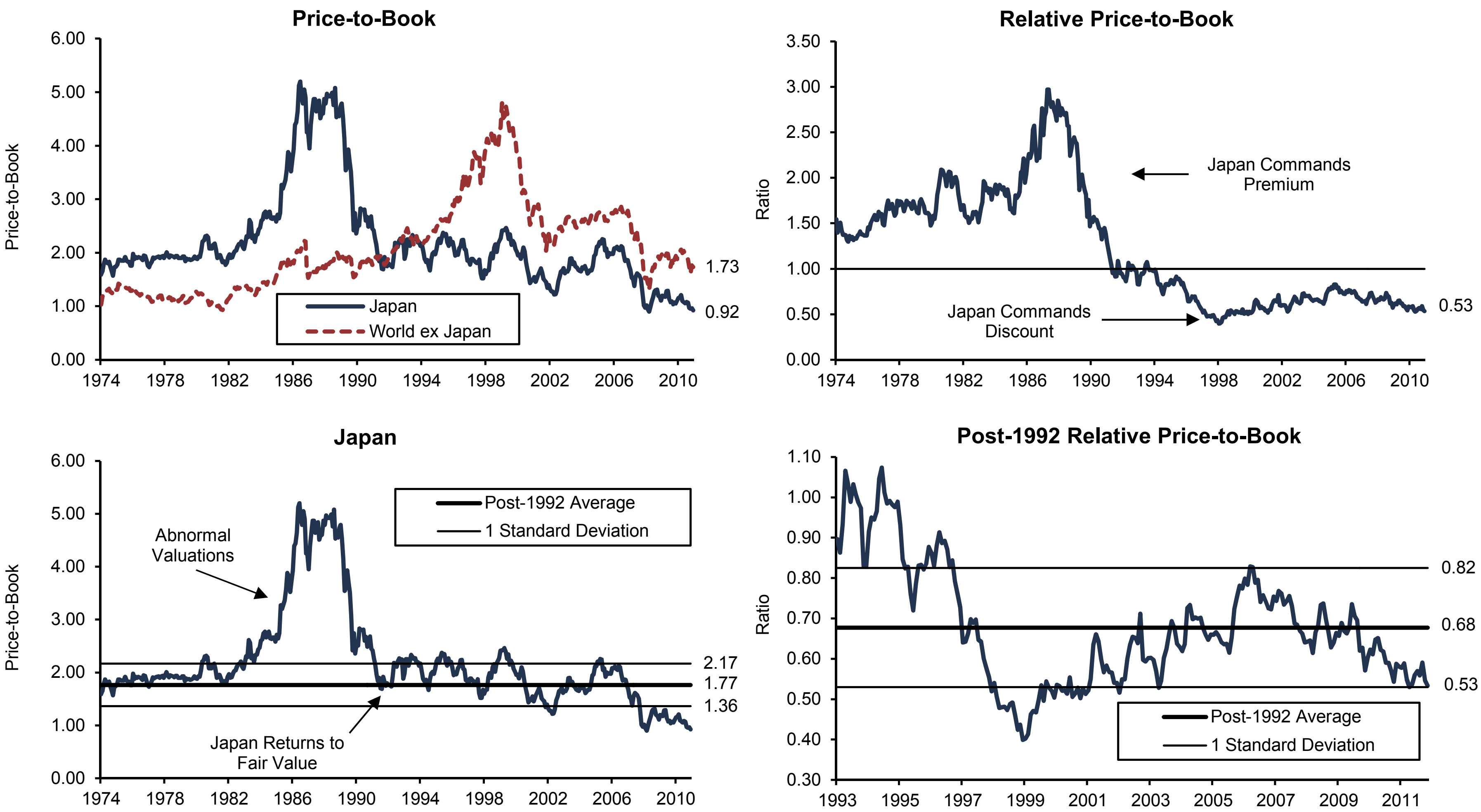


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Relative performance graphs show the percentage point difference between the rolling 12-month total return of each index in local currency terms and begin May 31, 1995.

Exhibit 5

Japan Price-to-Book Valuations

December 31, 1974 – November 30, 2011



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Relative price-to-book (P/B) graphs show Japan's P/B as a percentage of the World ex Japan's P/B. Post-1992 relative P/B data begin January 31, 1993.

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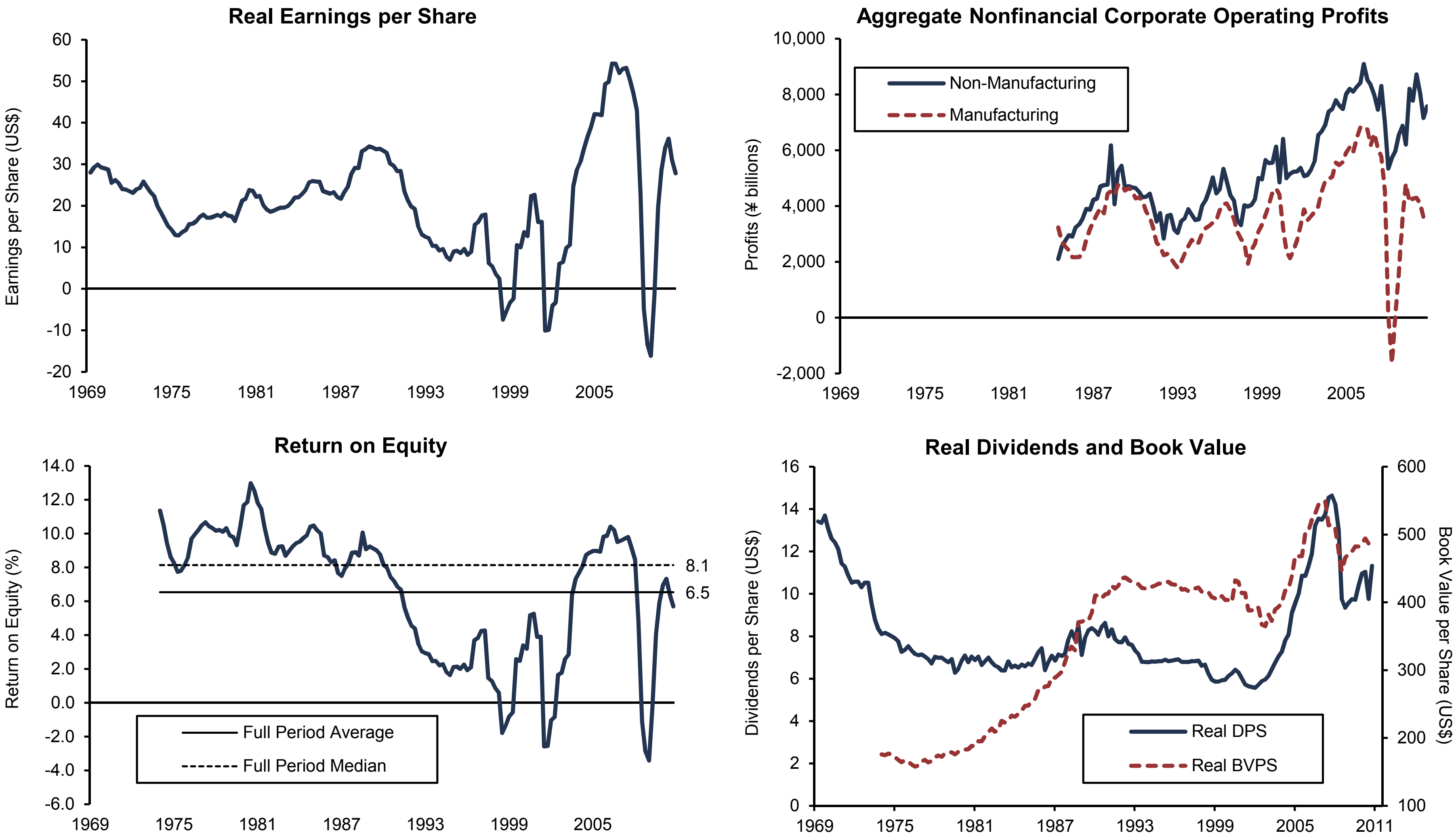
Exhibit 6

Japan Fundamentals

Fourth Quarter 1969 – Third Quarter 2011

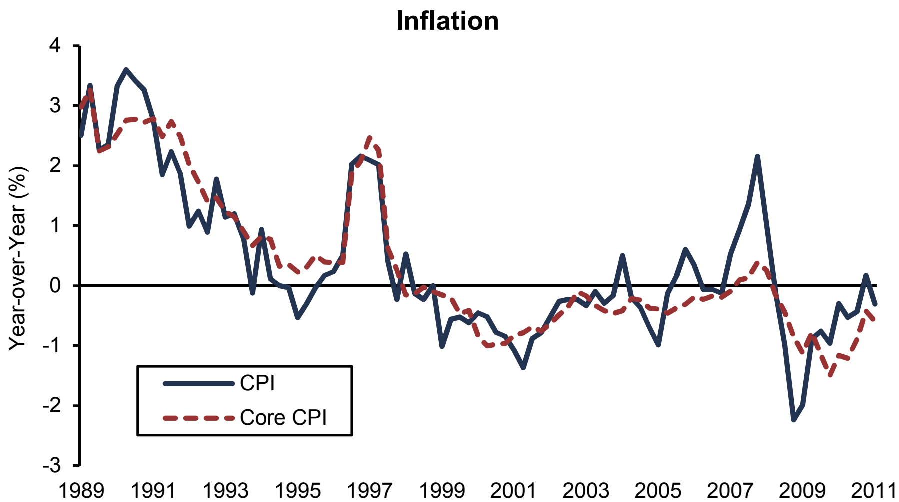


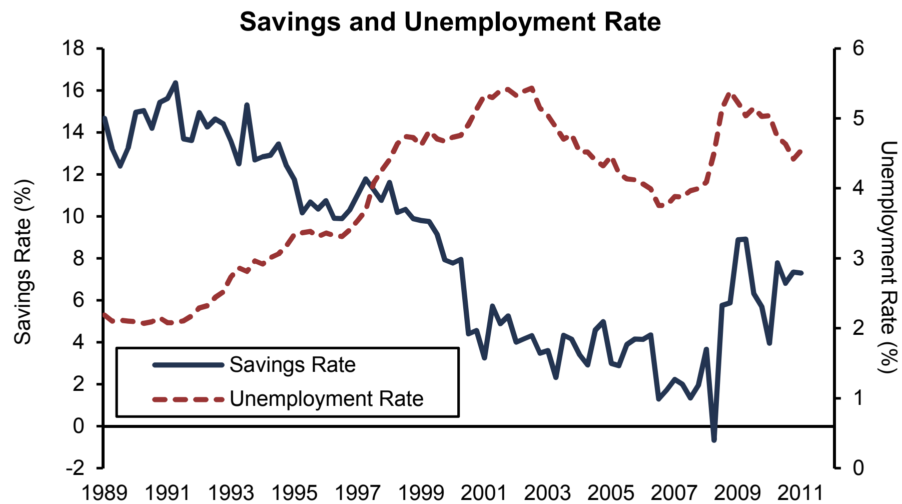
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All data are quarterly. Japan real earnings per share (EPS) are deflated by Japan CPI.

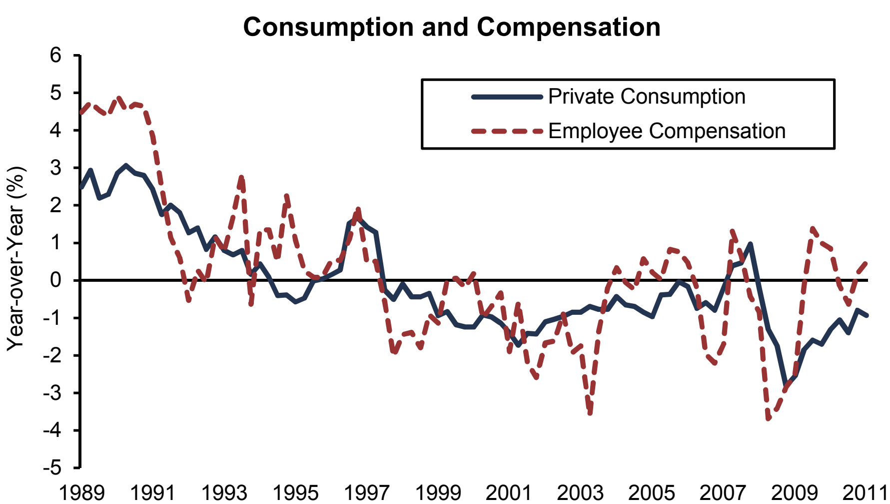
Exhibit 7

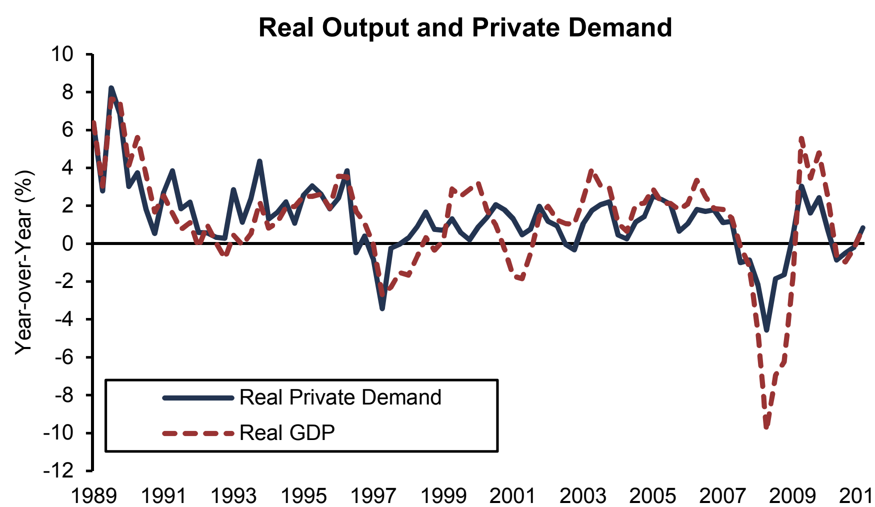
Japanese Economic Indicators

December 31, 1989 – December 31, 2011







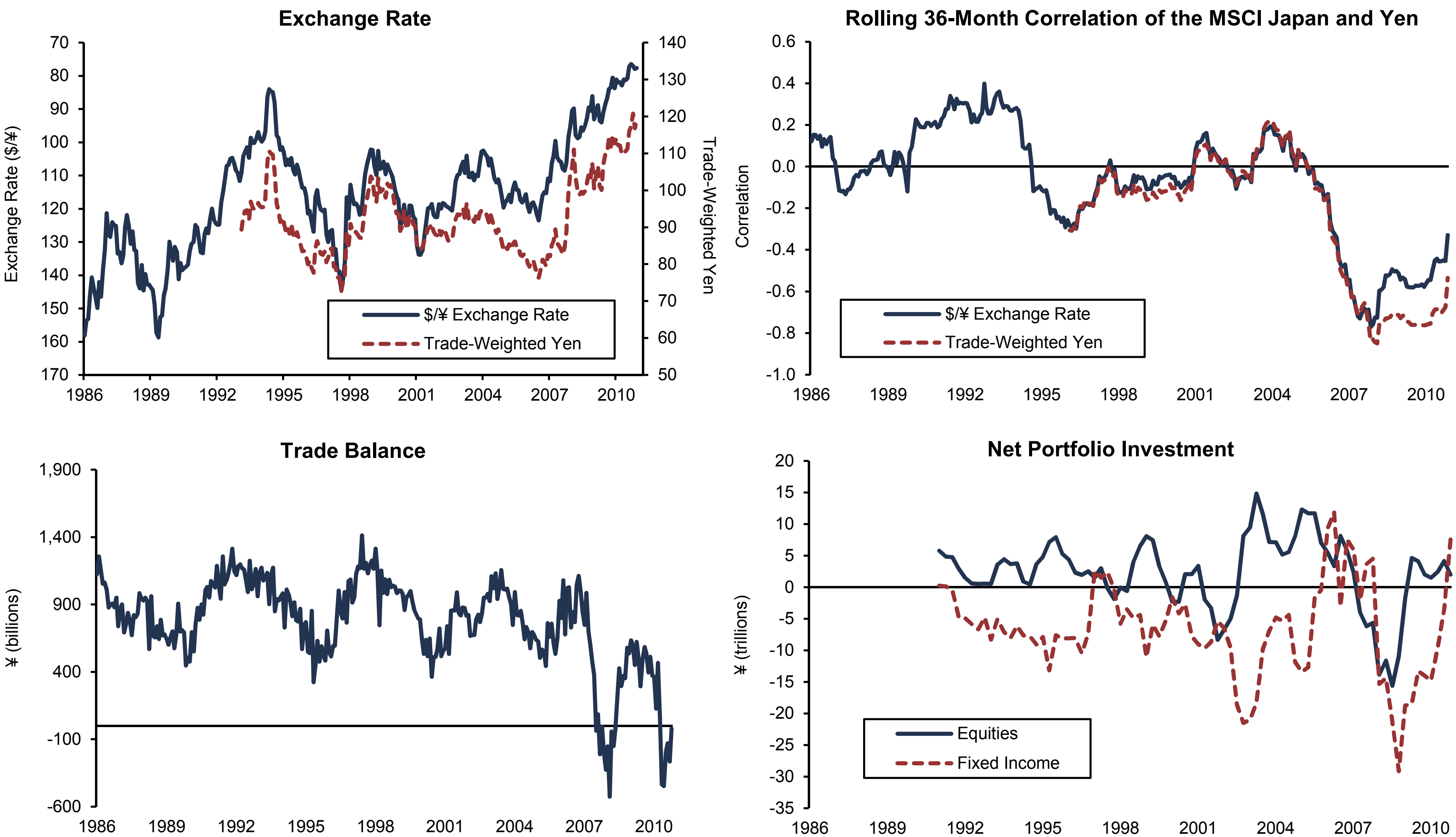


Sources: OECD and Thomson Datastream.
Notes: All data are quarterly. Fourth quarter 2011 data are forecasts from OECD.

Exhibit 8

The Yen

December 31, 1986 – November 30, 2011



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All data are monthly except net portfolio investment, which is quarterly and through third quarter 2011. Trade balance data are through September 30, 2011.