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JAPAN: WILL THE SUN EVER RISE?

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ABSTRACT

1. Japan has again disappointed investors. After a mild spell of outperformance over the first half of 2009, Japanese equities massively underperformed in the third quarter, with the MSCI Japan Index returning -1.2% compared to 17.0% for the World ex Japan Index. The lackluster performance of Japan over the third quarter reflected not only a renewed rise in the yen, but also investor nervousness over the policies of the incoming Democratic Party of Japan (DPJ). Still, for many investors, Japan's underperformance this year may be the last straw.

2. The tactical case for overweighting Japanese equities today rests on the fact that Japan is again oversold, unloved, and undervalued to the point where the market has managed in the past to post subsequent relative outperformance. Defensively, Japan has lagged the recent equity rally, and therefore could be less vulnerable than other markets to a global shakeout.

3. Valuations do seem attractive, even taking into account the secular shift in the Japanese economy. Taken at face value, at the end of September Japanese equities would need to rally some 50% simply to return to their post-1992 average price-to-book (P/B) ratio, compared to only 9% for World ex Japan equities to reach their long-term average. Thus Japan seems to offer compelling prospective returns based on mean reversion.

4. However, it is not realistic to assume Japanese equities can rally 50% while other markets hold flat, as this requires a massive narrowing of Japan's historical discount. Japan trades at a 40% discount to developed equities on a relative P/B basis, only modestly cheaper than Japan's 30% average discount since 1992. Still, Japan's discount today is the lowest since 2004 and leaves substantial room for re-rating before Japan becomes relatively overvalued, as was the case in early 2006. Our analysis suggests that Japan could conceivably outperform developed markets by 20% before relative valuations become stretched.

5. It is tempting to dismiss Japan's recent underperformance as driven by idiosyncratic events that may no longer hold the market back. However, it is also symptomatic of the challenges the market faces in the near term, namely, a strong yen, uncertainty over economic policy, and the need to reorient an export-dependent economy toward domestic demand.

6. The outlook for the Japanese economy does not instill confidence. Unemployment is at a postwar high and wages continue to fall as companies have aggressively cut costs, leading to record deflation in Japan. While the economy may be stabilizing, Japan remains very reliant on government support, both domestically and externally via stimulus-driven demand for exports. The bottom line is that a bet on Japanese equities is increasingly a bet on the global recovery, and especially Asian growth. Any disappointment in the latter puts the Japanese economy at risk.

7. A breakdown in the yen would be a clear catalyst for the Japanese market. The rise in the yen has crippled corporate Japan and is adding to the deflationary pressures in the economy. Fundamentals argue

for a weaker yen. However, with short-term interest rates still near zero in most markets, the yen continues to be supported by interest rate differentials. Thus, the yen may remain high until global growth is strong enough to force central banks, especially the U.S. Federal Reserve, to tighten monetary policy.

8. The changing of the political guard in Japan is a very significant development from a long-term perspective. Despite the pro-consumption, pro-labor leanings of the DPJ being known well in advance, a rash of poorly communicated policy announcements has raised uncertainty and confusion in the markets. Continued signs that the new government is unable implement a reform agenda or adhere to fiscal discipline would be market negative. With the Upper House elections scheduled for 2010, politics could remain messy and a headwind for the Japanese market next year.

9. The strategic argument for Japan revolves around the idea that the 1990–2003 period represented a secular downturn for Japanese equities brought about by the painfully slow deleveraging of the Japanese corporate and financial sector, while today's slump is simply a deep, cyclical downturn brought about by the global recession and a surging yen.

10. Of additional strategic importance today is the fact that the Japanese economy has become more entwined with that of Asia. Therefore, Japan may be the developed economy best suited (aside, perhaps, from Australia) to ride any potential Asian boom or asset bubble that may emerge over the coming decade. If Asia is to drive global growth going forward, Japan will surely benefit.

11. The real threat facing Japan is its ballooning government debt. With dwindling domestic savings as a result of demographic decline, Japan at some point may have to become a net borrower in global government bond markets. Such a development would result in pressure for higher interest rates and a weaker yen, and could spark a fiscal crisis. A close monitoring of the political resolve to tackle Japan's fiscal problems is imperative.

12. Our conclusion is that there is a tactical case for overweighting Japanese equities today, but it may be some months before Japanese equities decisively outperform, given the headwinds facing the market. Still, it may be unwise to write off this market entirely, as powerful rallies often emerge when least expected. Valuation discipline argues that you buy what is cheap, especially after a period of underperformance.

13. From a strategic standpoint, we have become more neutral on Japan. Japanese equities possess the potential for a sustained, powerful bull market, but the economic realities facing Japan mean the timing is very much in doubt. The key to unlocking the deep value in Japanese equities remains economic and corporate reform. Absent such developments, Japan is a tactical play based on depressed valuations and oversold relative performance.

Japan: Will the Sun Ever Rise?

Japan has again disappointed investors. After a mild spell of outperformance over the first half of 2009, Japanese equities massively underperformed in the third quarter, with the MSCI Japan Index returning -1.2% compared to 17.0% for the World ex Japan Index. For many investors, this underperformance may be the last straw. If Japan cannot participate in one of the strongest global equity rallies in recent times, when will it ever shine? Japanese equities have exhibited the most frustrating of investment characteristics: high beta on the downside coupled with low beta on the upside, which is a sophisticated way of saying Japan has painfully underperformed.

Below we take a critical look at the prospects for Japanese equities, putting into context both the market's recent performance and our investment advice as it relates to Japan. Our conclusion is that there is a tactical case for overweighting Japanese equities today, but it may be some months before Japanese equities decisively outperform, given the headwinds facing the market. Still, it may be unwise to write off this market entirely, as powerful rallies often emerge when least expected. (Table A)

From a strategic standpoint, we have become more neutral on Japan; after many false dawns, investors are right to question whether Japanese equities deserve their investment capital. Japanese equities possess the potential for a sustained, powerful bull market, but the economic realities facing Japan mean the timing is very much in doubt. The key to unlocking the deep value in Japanese equities remains economic and corporate reform. Absent such developments, Japan is a tactical play based on depressed valuations and oversold relative performance.

A Cruel September

Japanese equities actually outperformed developed equity markets by some 450 basis points (bps) over the first half of the year, as one would expect in a rally driven by hopes of a global economic recovery to which the Japanese economy and stock market are highly geared. The lackluster performance of Japan in the third quarter, however, reflected not only a renewed rise in the yen, but also investor nervousness over the policies of the incoming Democratic Party of Japan (DPJ).

While the landslide victory of the DPJ in August—ending over a half-century of rule by the Liberal Democratic Party (LDP)—was well discounted in advance, September saw the market wrong-footed by a series of events that hit the financial sector, including a proposed three-year debt moratorium for small businesses, nervousness over bank capital ratio requirements stemming from the G20 meeting, and a surprise rights issue by financial heavyweight Nomura equivalent to 30% of shares outstanding. As a result, financial stocks dropped 14.4% in September while the market as a whole fell 5%, resulting in Japan's 1.2% loss for the quarter.

It is tempting to dismiss Japan's recent underperformance as driven by idiosyncratic events that may no longer hold the market back. And this may well be the case. However, Japan's recent performance is also

symptomatic of the challenges the market faces in the near term, namely, a strong yen, uncertainty over economic policy, and the need to reorient an export-dependent economy toward domestic demand.

The Tactical Case

The tactical case for overweighting Japanese equities today rests on the fact that Japan is again oversold, unloved, and undervalued to the point where in the past the market has managed to post subsequent relative outperformance.

Performance

Tables B and C show the rolling 12-month relative performance of Japanese equities versus various markets, both in local currency and US$ terms. These charts highlight a clear and powerful mean-reverting pattern. Historically, whenever Japan has lagged developed markets by 20 percentage points (ppts) over a 12-month period the market has staged a relative rebound, often coming full circle to produce 20 ppts of relative outperformance. The main exception was during the 1990s, when Japan often suffered steeper relative declines before bouncing back. Relative to Asian markets, Japan's performance has been much more volatile, but nonetheless mean reverting. These charts also imply that once Japan has racked up relative gains of 20 ppts or so, the market is due for a spell of *under*performance.

Although the above is somewhat intuitive, the lessons of mean reversion are often forgotten, or at least neglected, by investors. While momentum can certainly remain in a market's (or asset class') favor, eventually every dog has its day. And today we find that Japan has again lagged behind to a degree from which it has mounted rebounds in the past. This is especially the case against European and Asian markets.

It is worth noting that Japan is less oversold in US$ terms, as the yen's continued strength has buoyed relative performance (albeit if only from currency gains). Still, even in US$ terms Japan is not in the overbought zone that would argue certain underperformance; rather this argues that the yen may no longer boost returns for unhedged investors, including even US$-based investors.

To be clear, the above analysis is based on *relative* performance; Japan may outperform simply by falling less than other markets. Overbought/oversold measures for the Japanese market itself, based on rolling six-month returns and deviation from the 200-day moving average, are currently neutral (Table D). Japan is no longer overbought, but the market is not yet beaten down to the point where history implies the odds of a bounce are high (as was the case earlier in the year). Still, this is in stark contrast to most other markets, which remain strenuously overbought. Thus, it could be argued that Japan is less vulnerable than other markets to a global shakeout, although in the short term such lack of momentum could mean the market is at risk of breaking down further.

Sentiment

Sentiment toward Japan remains very low. According to the October Merrill Lynch Fund Manager Global Survey, fund managers are underweight Japan a net 24% and Japan remains the least favored major market on a 12-month view. This is a far cry from 2004 and 2005 when respondents were net overweight Japan 40% to 50%. Yet sentiment is not nearly as bad as in 2002 and 2003, when the survey showed managers were net *underweight* Japan 40% to 50%. Still, it is safe to say that Japan is not a crowded trade, and a shift from underweight to neutral could spark a "catch-up" rally.

Similarly, earnings expectations are muted. For most markets, analysts are penciling in a return to near-peak levels of earnings for 2010 and 2011. However, consensus forecasts expect Japanese earnings to remain some two-thirds below their 2008 peak, which reflects both the dire state of current earnings and the fact that corporate Japan itself has been reluctant to raise guidance. Such low expectations clearly leave room for upside surprises.

Valuation

Perhaps the reason why manager sentiment is not as poor as in the past is that Japanese valuations have rarely been this low. While Japan seems a wasteland for top-down or momentum-driven managers, for bottom-up, value-driven managers Japan appears fertile ground; nearly one-third of companies in the MSCI Japan Index *still* trade for less than book value,[1] and there are a host of cash-rich and minimally leveraged companies.

Undervaluation is the most commonly cited rationale in favor of Japanese equities. Cynics are right to respond that analysts have been touting Japan's undervaluation for years, only to see the market become "cheaper" in what seems to be a never-ending value trap. However, this characterization is a bit unfair, as Japanese equities have actually shown periods of over- and undervaluation during the past 15 years.

Japanese earnings have been extremely volatile over the past two decades, meaning price-to-earnings (P/E) metrics, including normalized P/E ratios, have been of limited use due to the lack of trend in earnings or profitability. In the current environment, we have found price-to-book (P/B) to be the most useful metric for evaluating the Japanese market.[2]

To make sense of Japanese valuations, it is important to adjust for the secular shift that has taken place in the Japanese economy. Throughout the 1970s and 1980s, Japan consistently commanded a 50%

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[1] Nearly 60% of the MSCI Japan Small Cap Index trades at under book value.

[2] Valuing Japanese equities today is especially challenging given that aggregate earnings per share (EPS) have turned negative (again). However, unlike 2002–03 when the Japanese financial sector imploded, the hit to EPS this cycle seems largely driven by the collapse in manufacturing profits, which have been crushed by plummeting global demand and a surging yen. Non-manufacturing profits have held up reasonably well, and the financial sector remains solvent. (Table G)

premium to developed equities, despite a comparable, if not lower, level of Japanese return on equity (ROE). This likely reflected the emerging market–esque nature of a then fast-growing Japan.

The excesses of the late 1980s "bubble economy" took this premium up to 200%, leaving Japan trading at an outrageous 5 times book value. However, the post-bubble period has seen a secular shift in Japanese valuations mirroring the economy's slide into deflation. Instead of reverting back to a 50% premium, since the early 1990s Japan has *consistently traded at a P/B discount to developed equities*. Such a discount is valid in our opinion, given Japan's structurally lower level of ROE and lower level of economic growth.[3] In other words, the valuations of the late 1980s were anomalous—the Japan of today is far from the "miracle" economy of yore.

Focusing, therefore, on the post-1992 period as the "new normal" for Japan, the market has traded in a clear range around an average P/B ratio of 1.85.[4] At each of the recent market tops, the market was valued above 2.2 times book, or 1 standard deviation above average, while at each of the troughs, the market fell close to or below 1.5 times book, or 1 standard deviation below average. (Table H)

So where are we today? At the end of September 2009, the MSCI Japan Index traded at a P/B ratio of 1.2, up from 0.9 at the end of February 2009, the lowest level since our data begin in 1974. Despite the 33% rise since February, at 1.2 times book Japan still remains more than 1 standard deviation below its post-1992 average, and roughly at the same valuation from which the 2003–05 run-up was launched.

Taken at face value, Japanese equities would need to rally some 50% simply to return to their post-1992 deflation era average P/B ratio. Comparatively, World ex Japan equities need to rise 9% to reach historical average P/B valuations, while Asia ex Japan is already 8% above long-term average. Thus, Japan seems to have a compelling prospective return based on reversion to the mean.

However, it is not realistic to assume Japanese equities can rally 50% while other markets hold flat, as this requires a massive narrowing of Japan's historical discount. Relative valuations do not paint Japan as extraordinarily cheap: Japan trades at a 40% discount to developed equities on a relative P/B basis, only modestly cheaper than Japan's 30% average discount since 1992.[5] Still, Japan's discount today is the lowest since 2004 and leaves substantial room for re-rating before Japan becomes relatively overvalued, as was the case in early 2006 when Japan's discount had narrowed to less than 20%, or 1 standard deviation above average. In other words, Japan could conceivably outperform developed markets by 20% before relative valuations become stretched.

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[3] The post-1974 average ROE for Japanese equities is roughly 6.7% compared to 12% for developed equities, implying that Japanese equities should trade at a 44% discount on a P/B basis. However, the 1974–91 period saw Japanese ROE average 9.4%, while the most recent cycle (2004–08) saw ROE average 8.5%. This is in stark comparison to 1992–2003 when ROE averaged a mere 2.3%. Conceptually, Japan should have traded at a 23% discount in the earlier period and a 42% discount over the most recent cycle.

[4] This is 45% lower than Japan's post-1974 average P/B of 2.3, and 35% below the World ex Japan average P/B of 2.10.

[5] However, Japan's deeper discount seen in the late 1990s/early 2000s partly reflected lingering tech-bubble overvaluation in other developed markets.

To some, the above analysis is less than compelling. The fact that the Japanese stock market has ground lower for over 15 years raises the fundamental question of what constitutes value in such a market. To answer this, we need to ponder why the Japanese stock market has stagnated (to put it mildly). One compelling explanation is that the stock market has simply reflected the underlying trend of the Japanese economy, which has been shrinking in nominal terms (Table I). With the nominal economy stagnant, the stock market appears trapped.[6]

How do you value a stock market tied to an economy in seemingly secular decline? At its most basic level, the underlying economy should serve as a baseline measure of stock market value. While the stock market is inherently more volatile, equities cannot deviate indefinitely from the value of goods and services produced in an economy. To assess this relationship, we have run a regression of Japanese share prices against nominal GDP per capita to produce a "fair-value" level for the stock market.[7] In other words, what should the level of the stock market be for a given level of nominal GDP? Using such analysis, we can gauge whether the stock market is fundamentally lower or higher than justified by the underlying economy, even if that economy is shrinking.

The results can be seen in Table J. The rise in Japanese nominal GDP over the late 1970s and early 1980s actually outpaced the stock market, implying that equities were fundamentally undervalued during this period of rapid economic growth. By the mid-1980s, Japanese equities had risen to a level commensurate with the level of GDP per capita. Throughout the rest of the decade the stock market rapidly outpaced a still strongly rising level of per capita GDP, with our model implying that Japanese equities were 111% overvalued at the peak in 1989.

As the bubble burst and the stock market collapsed, it was not until 1992 that Japanese equities returned to fair economic value. Since then they have oscillated around a gently declining GDP-implied fair value. Throughout the post-bubble period the Japanese market has fallen to a deep undervaluation on four occasions and has risen above GDP fair value at each of the market peaks. And the recent market decline has again sent prices well below economic fair value, with the model implying the MSCI Japan Index remained 35% undervalued the end of September, despite the recent run-up.

We would not, however, stress the precision of such simple econometric analysis. The stock market is not solely driven by the level or pace of economic growth; it is profits that matter most. Still, the key point from this discussion is that Japanese equities do seem fundamentally undervalued relative to the economy, a situation that will not last indefinitely.

[6] Japanese nominal GDP per capita has essentially been flat since the early 1990s, as the economy has been mired in a prolonged deflation, most painfully reflected in the steady decline in property prices. While real GDP per capita has increased over this period (as the economy has in fact expanded), it is nominal GDP that helps drive corporate profits (and in a deflationary environment, real GDP may be overstated). Corporate profits are more closely related to nominal GDP than real GDP, as companies attempt to capture rising prices via profit margins. So while Japan has been growing in real terms (i.e., the volume of goods and services has increased), the nominal value of these goods and services has not, which puts pressure on profit margins and profitability.

[7] Concept courtesy of BCA Research.

Near-Term Headwinds and Catalysts

If the above analysis lays out the tactical case, nothing says the market cannot lag behind further, sentiments worsen, and valuations remain depressed. Indeed, several near-term headwinds remain that may continue to weigh on the market.

The Economy

The outlook for the Japanese economy does not instill confidence. Japan was arguably the hardest hit developed economy over 2008–09 given its dependence on exports and the fact that the paralyzed LDP administration was both late and timid in enacting fiscal stimulus. While private domestic demand fell 2.7% year-over-year at its worst point in early 2009, real GDP collapsed some 8%, reflecting a staggering 48% decline in exports.

For now the Japanese economy is recovering on the back of resumed exports amid the revival of global demand. Consensus real GDP forecasts for Japan expect 1.5% growth in 2010, stronger than the current 1.0% expectations for the European Monetary Union and the United Kingdom, but less than the 2.5% expected for the U.S. economy. Yet Japan is arguably the economy most at risk for an economic relapse next year given its reliance on government support, both domestically and externally via stimulus-driven demand for exports.

Domestic demand conditions remain very weak in Japan. Unemployment is at a postwar record of 5.5% and wages continue to fall as companies have sought to aggressively cut costs. This has led to record deflation in Japan, both at the headline and core level, of -2.3% and -0.8%, respectively (Table K). While recent employment and consumer spending statistics have surprised to the upside, this largely reflects the lagged impact of fiscal stimulus measures, which are expected to fade by year's end. Furthermore, the incoming DPJ administration has already placed a freeze on additional discretionary government expenditures until a new budget can be agreed upon. Decreased government spending is expected to be a drag on growth in early 2010 after being a net contributor in 2009.

The above is not to suggest that the Japanese economy is headed for a renewed tailspin. Much of the painful corporate adjustment has taken place. Rather, with the strong deflationary forces at play (falling wages, high unemployment, weak consumption), it is hard to see domestic demand driving the economy in the near term, leaving Japan again overly reliant on external demand. So far, Japan has been buoyed by its large share of exports to Asia, and especially China, which is now Japan's largest trading partner.[8]

Thus, the more lasting and robust the global economic recovery over 2010, the better the chances of an upside surprise in Japanese growth and easing of deflationary pressures. However, clear downside risks to the economic picture remain, and may weigh on Japanese equities. This is highlighted in Table E, which

[8] Over the first half of 2009 Asia accounted for 53% of total exports; China, 19%; the United States, 16%; and Europe, 14%.

shows the relationship between the relative outperformance of Japanese equities and the relative strength of Japan's index of leading economic indicators (LEI). While no indicator is perfect,[9] it is clear that when Japan's LEI index is rising faster than the OECD composite (and thus the Japanese economy is expected to be stronger), Japanese equities are outperforming and vice versa. The fact that Japan's LEI index has not yet turned upward points to potential further relative underperformance.

The bottom line is that a bet on Japanese equities is increasingly a bet on the global recovery, and especially Asian growth. Any disappointment in the latter puts the Japanese economy at risk.

The Yen

The yen remains crucial to the near-term outlook, and was one of the key risks we addressed in our 2009 outlook.[10] Japanese equities are displaying a record negative correlation to the yen, currently on the order of -80% on a trade-weighted basis (Table L). While in the past Japanese equities have managed to rally alongside the yen, today that is certainly not the case.

Morgan Stanley estimates that the export breakeven rate for Japanese manufacturers is currently ¥96/US$. With the US$/JP¥ rate hovering around ¥90 since the end of September, Japanese manufacturers are operating at a loss. Japanese manufacturing profits were back in the black over the second quarter, largely due to aggressive cost cutting, highlighting how continued yen strength is adding to the deflationary pressures in the economy.

Of great importance is whether continued yen strength will permanently reduce the competitiveness of Japanese exports. Chinese, Korean, and Taiwanese exports have rebounded much more sharply than Japanese exports, as these currencies fell sharply or remained flat over 2008 while the yen surged. Japanese companies have been losing ground to Asian competitors for several years, and the yen's crushing 45% rise in trade-weighted terms since summer 2007 helps explain why many Japanese exporters trade at depressed valuations.

The outlook for the yen remains clouded. Much of the yen's rise over 2007–08 reflected the unwinding of the so-called yen carry trade, whereby hedge funds and Japanese investors alike borrowed in cheap yen to purchase higher-yielding assets abroad. Turmoil in global financial markets saw these trades rapidly unwind and the yen surge.

Fundamentals argue for a weaker yen. Most measures show the yen as overvalued (with propriety models from Morgan Stanley and Goldman Sachs estimating the yen was between 10% and 20% overvalued at the end of September), and Japan is again seeing net portfolio investment outflows and a weakening trade balance. However, with short-term interest rates still near zero in most markets, the yen remains supported by

[9] Given that the stock market itself is one of the ten indicators that make up the composite index of leading economic indicators, there is a bit of double counting involved in this analysis. However, upturns in the relative LEI have reasonably preceded upturns in relative performance.
[10] See our December 2008 Market Commentary *Japan 2009: Darkest Before the Dawn?*

interest rate differentials, especially as *real* interest rates remain high given Japan's sharp deflation. Forward markets are still pricing in gradual yen strength for the next 12 months.

Thus, the yen may remain high until global growth is strong enough to force central banks (and especially the U.S. Federal Reserve) to tighten monetary policy. Continued US$ weakness could also push the yen higher in the near term; data from the International Monetary Market[11] show that speculators outside of Japan are now net long the yen, while according to J.P. Morgan, Japanese retail investors have established record long positions in the U.S. dollar, implying that continued US$ weakness may see forced short-covering buying of the yen. In other words, the yen carry trade is not entirely dead for Mr. and Mrs. Watanabe, but has been replaced by the US$ carry trade for most global investors.

Overall, it seems that the yen should weaken as the global economy recovers, especially if inflation concerns force interest rates to rise elsewhere. Until then, and especially if deflation fears reassert themselves, the yen is likely to remain near current levels. A breakdown in the yen would be a clear catalyst for the Japanese market.

Politics

The changing of the political guard in Japan is a very significant development from a long-term perspective, though in the short term it has caused trouble for the markets. Despite the pro-consumption, pro-labor leanings of the DPJ being known well in advance, a rash of poorly communicated policy announcements has raised uncertainty and confusion in the markets. In addition to the aforementioned debt repayment moratorium for smaller firms, the yen has been whipsawed by comments from the incoming finance minister that the DPJ may tolerate a stronger yen, as it would help in rebalancing the Japanese economy.

The cornerstone of the DPJ's economic agenda is to promote domestic demand by strengthening social support programs (child care and education credits, increased minimum wage). To fund such programs, the DPJ has vowed to cut the pork-barrel government spending on special interests that are rife in Japan. Implicit in this is a commitment by the DPJ to take on Japan's entrenched interests, especially the so-called iron triangle of the bureaucracy, big business, and the LDP. In other words, the Japanese electorate voted for a fundamental shift in how Japan is to be governed, and an acknowledgement that the old system has failed to deliver. Such a vote for "change" is undeniably positive.

However, it remains to be seen if the DPJ can actually implement its policies, or whether the party (itself a mishmash of various opposition politicians) can remain cohesive enough to take on the vested interests. Already there has been some backsliding and watering down of campaign pledges. The debt moratorium proposal seems off the table for now, and instead of being largely self-funded, the government recently announced it may need to issue ¥50 trillion in government bonds to cover its proposed budget.

[11] The International Monetary Market is a part of the Chicago Mercantile Exchange where currency and interest rate futures contracts are traded.

The DPJ remains popular for now (*The Economist* reports the government's approval rating stands at 73%) but investors are clearly not impressed. Uncertainty is generally negative for the markets. Additional signs that the government is unable to adhere to fiscal discipline are negative for both the Japanese government bond (JGB) market and the yen. And with the Upper House elections scheduled for 2010, politics could remain messy and a headwind for the Japanese market next year.

Ironically, the good news for investors is precisely that market expectations are negative. A clearer policy direction and commitment to fiscal discipline could increase investor optimism, while a strong showing in the July elections that reaffirms the DPJ mandate would allow Japan to have a stable political landscape for the first time since Koizumi's snap election in 2005.

In the meantime, the DPJ's pro-household, anti–big business stance clearly favors domestically geared companies in Japan, which tend to be in the small-cap space and have been outperforming of late, especially given the yen's continued strength.

The Strategic Case: Cyclical versus Secular

Tactical considerations aside, are there strategic reasons to implement an overweight to Japan? The key issue is whether Japan is reverting back to the dark days of the 1990s or embarking on a strong, multiyear bull market of its own.

The strategic argument for Japan revolves around the idea that the 1990–2003 period represented a secular downturn for Japanese equities brought about by the painfully slow deleveraging of the Japanese corporate and financial sector, while today's slump is simply a deep, cyclical downturn brought about by the global recession and a surging yen.

Over the 1990s, instead of suffering a sharp, painful restructuring, which would have required debt defaults, bankruptcies, and sharp layoffs, Japan instead chose to maintain social stability, resulting in the infamous "zombie companies" that were kept alive by debt infusions by *keiretsu* banking arrangements. This focus on maintaining the status quo resulted in a secular decline in Japanese profitability, as companies were more focused on staying solvent than maximizing profits, while EPS were massively diluted in what amounted to a prolonged debt-for-equity swap. This death by a thousand cuts culminated in the collapse and restructuring of the Japanese banking system earlier this decade.

Table M highlights how this process has unfolded. Nonfinancial corporate loans, as a percentage of nominal GDP, have fallen from a 1990 peak of 122% to 80% in 2007. This return to basic corporate health allowed EPS to reach record highs over the previous cycle and ROE to return to levels not seen since the 1970s and 1980s (Table G).

Thus, despite the recent collapse in earnings, with the fundamental deleveraging process largely complete, investors should expect Japan to return to profitability as the global economy picks up speed,

rather than to embark on another secular decline. And the scope for improvements in profitability remains huge. Much like in 2003, Japan still remains in some respects the turnaround story of the decade. The dream of foreign investors in Japan has long been an aggressive corporate restructuring that would put conservative balance sheets to work in acquiring rival companies or disposing of underperforming assets. There remains scope for cash-rich companies to pay higher dividends or buy back stock, and for the corporate sector to increase ROE to levels in line with that of other markets.

Of additional strategic importance today is the fact that the Japanese economy has become more entwined with that of Asia. Therefore, Japan may be the developed economy best suited (aside, perhaps, from Australia) to ride any potential Asian boom or asset bubble that may emerge over the coming decade. If Asia is to drive global growth going forward, Japan will surely benefit.

Buying Power

Along with a fundamental story, every bull market also needs buying power. One of the most compelling supports for a long-term bull market in Japanese equities is that Japanese households and institutions have forsaken equities over the past two decades in favor of cash and fixed income. Japanese households hold 55% of their financial assets in cash, compared to only 15% for U.S. households, while holding only 7% of their assets in equities compared to 31% for Americans. Similar discrepancies can be seen between Japanese and U.S. pension funds and investment trust companies; on average these institutional investors are some 20 ppts underweight equities versus their U.S. counterparts, while insurance companies are 13 ppts underweight (Table N).

Clearly a 20-year bear market and persistent deflation create such a preference for fixed income. Encouragingly, after being persistent net sellers for years, the Japanese have emerged as net buyers of their own market (Table O). However, it may take the reemergence of inflation in Japan to truly force an asset allocation shift from bonds to equities, a development that may or may not be around the corner.

Demographics and the Fiscal Time Bomb

The key secular risks to Japan are the challenges posed by a rapidly aging society and massive fiscal deficits. Japan's demographic woes are well known, and perhaps overplayed. Japan certainly faces a sharp projected decline in its population, but it is not alone in this regard. Russia's demographics are worse, while Germany and Italy will also see a sharp drop in population by 2050 (Table P). The populations of Korea and Taiwan are also peaking. Even China will go into demographic decline within the next 20 years.

To some extent, we feel that Japan's shrinking population is already factored into current valuations, especially compared to other markets. Furthermore, retiring baby boomers in Japan pose little direct threat to the stock market given the low level of household equity holdings, something that is not the case in the United States and (to a lesser extent) in Europe. Second, in the near term, retiring Japanese should help open the corporate world to a younger (but not young) generation of managers and leaders. Indeed, the replacement of highly paid "grey workers" with younger workers could actually help reduce labor costs. And

as Table Q shows, even by 2050, Japan will still have a similar percentage of the crucial 25- to 64-year-old working demographic as the United States (44% to 48%, respectively). The critical difference, however, is that these workers will be supporting a substantially higher number of retirees and other dependents.

Demographic decline itself can be manageable. The real threat facing Japan is how to pay for its ballooning government debt. Table M shows that while Japanese corporations and households were deleveraging, the Japanese government borrowed massively as it tried to spend Japan out of its slump. According to the OECD, Japanese general government liabilities have risen from 64% of GDP in 1990 to over 180% today, and are on track to exceed 200% in 2010, by far the highest level in the OECD.[12] Japan has been able to support such debt because deleveraging and risk-adverse households and domestic institutions (including government-run pension plans) soaked up JGB issuance[13] and ultra-low interest rates helped make interest payments feasible.

However, Japan may be hitting the debt wall; already, 20% of the Japanese budget goes to interest payments, while a falling savings rate resulting from an aging society means there is less domestic savings to tap, even as Japan's corporate sector remains a large net saver. Japan's household saving rate has fallen to 2%, and could easily reach zero within the next several years, raising the issue that Japan at some point may have to become a net borrower in global government bond markets. This would certainly result in pressure for higher interest rates from more demanding foreign buyers.

This raises an interesting policy issue. Ideally, the Bank of Japan could begin monetizing government debt, as clearly Japan needs to inflate some of this debt away. But is even modest inflation politically feasible given the large portion of society living on fixed incomes? While rising interest rates generate higher income for retirees, given that JGBs make up a large portion of many institution's assets, rising yields (and therefore falling prices) could also prove painful.

All of the above points to the pressing need for Japan to rein in spending and at some point raise taxes; preferably not via corporate taxes, which are already among the highest in the world. If government deficits are not contained, there are clear negative implications for JGBs and the yen, and large "macro risk" for equity investors. However, the end game, and especially the timing, remains unclear. Can the new government successfully tackle government spending? Can a boom in Asia help Japan grow its way out? Or will Japan eventually be forced into a fiscal crisis? And will Japan be alone, as governments in the United States and Europe face similar, if less extreme, circumstances?

For investors, this secular risk is both real and yet distant. Japan is unlikely to default on its debt in the near term (if ever) and is not on the brink of collapse. However, the risk of just such a fiscal collapse may be the catalyst that creates a firm political resolve toward economic reform in Japan. A weakening yen, meanwhile, could actually provide a boon to the economy. What Japan needs is mild inflation, while falling

[12] For 2008, Italy had the second largest government debt ratio at 115%, compared to an OECD average of 79%.
[13] J.P. Morgan estimates that foreigners hold less than 7% of outstanding JGBs.

bond prices could just be what drives money into the stock market. Still, a close monitoring of the political resolve to tackle Japan's fiscal problems is imperative. Japan needs to create conditions for economic growth, as spending cuts and tax increases by themselves cannot solve Japan's structural problems.

Conclusion: Once Bitten, Twice Shy

It is hard to be optimistic about the prospects for Japanese equities, and even more difficult to be positive about the Japanese economy. The sad reality is that Japan remains trapped in a deflationary funk that shows little hope of reversing in the near term. Japanese equities face considerable near-term headwinds in the shape of a strong yen, a weak earnings environment, and uncertainty regarding the policies and effectiveness of the new government. The burdens presented by Japan's aging society and huge fiscal deficits are a source of systemic risk that still has not been confronted. While some important structural reforms of the Japanese financial system were achieved earlier this decade, serious corporate and economic reform has stalled, and it is unclear whether the newly elected DPJ government will be successful in reorienting the economy toward domestic demand.

However, these economic factors have been the case for much of the past 15 years, and have not prevented Japanese equities from mounting sharp rallies and enjoying bursts of relative outperformance; Japan has been to the brink before. Today Japan again seems primed for such a burst. Valuations and sentiment are clearly depressed and investors are underweight and uninterested in the market. Japan seems the market least priced for a sharp recovery. Thus it offers the most potential for catch-up if growth does surprise and is, in theory, less vulnerable than other markets should conditions disappoint.

The risk, however, is that the squib remains damp and the charge does not fire. Absent a clear, exciting catalyst, investors may simply continue to ignore the market. Japanese fundamentals seem worse than those of Asia, or even possibly the United States. Why bet on Japan today, when one can punt on China?

Because investment discipline teaches investors to buy what is cheap and loathed, and sell what seems priced for perfection, no matter how compelling the arguments. While this can create pain in the short term (and then some, as the late 1990s showed), in the longer term, it pays off, and often in unexpected ways. Alas, in hindsight, this also applied to Japanese equities in early 2006, as the valuation case had narrowed, leaving Japan priced on the assumption that reform momentum would follow through; unfortunately it did not and Japanese equities began to wilt.

Today, however, Japanese equities are certainly not priced as if it is "different this time." And yet, while it may be hard to see amid the strong cyclical headwinds, some things are different. Today Japan is more closely geared to Asia than to the United States and Europe. The Japanese financial, corporate, and household sectors have already gone through a painful deleveraging. Corporate Japan has shown a sharper focus on the bottom line by responding quickly to this downturn by slashing production and workers. And most strikingly, the Japanese electorate has shown its displeasure with the status quo.

Still, from a secular/strategic standpoint, we are admittedly now somewhat neutral on Japan. As the saying goes, "Once bitten, twice shy." The logic behind a renewed, secular bull market in Japanese equities remains valid but is based on a lot of "ifs" and "coulds." *If* Japan was more open to foreign capital and an aggressive corporate restructuring, it *could* be the mother of all merger & acquisition booms; *if* domestic institutions and households switched from fixed income–dominated portfolios in favor of equities, there *could* be massive buying power for the market; *if* Japan would deregulate its labor markets and allow immigration, it *could* reverse its demographic decline. And *if* Asia becomes the driver of global growth for the coming decade, then Japan *could* benefit to a much greater extent than the United States or Europe.

Despite the above, we think it is dangerous to write this market off; and we certainly would *not recommend* that investors drastically underweight Japan. The time to underweight a market is when valuations are high and relative performance overbought. Indeed, the mere fact that we have capitulated somewhat on the long-term Japan story could be the biggest buying signal of them all.

In other words, while there are solid arguments as to why Japanese equities could be on the verge of a multiyear bout of relative outperformance and deserve a strategic overweight in the portfolio, we are lukewarm that such developments are going to occur soon. In some respects, Japan today resembles the Japan of early 2003; beaten up, shunned, and ready for a bounce; albeit with a healthier corporate and financial sector. This time, however, should a large rally occur in Japan that removes the market's favorable valuations, investors would be advised to reduce any tactical overweight to neutral unless there are clear signs of structural economic and corporate reform that imply an overweight should be retained for strategic reasons. Said plainly, Japan is guilty until proven otherwise.

Summary

- Japan has been held back this year by a strong yen and political uncertainty over economic policy. Financial stocks were a large source of third quarter underperformance.

- The tactical case for Japan rests on the market being oversold, unloved, and undervalued. Valuations are compelling, but the market still faces near-term headwinds that may hold it back.

- The domestic economy is weak, leaving Japan reliant on external demand. Thus a bet on Japan is a bet on global recovery, and especially Asian growth. Any disappointment in the latter puts Japan at risk.

- The yen is arguably too strong, and may remain high until other major central banks begin tightening monetary policy.

- Investor nervousness about economic policy may remain in the run-up to the July 2010 Upper House elections. Any backsliding on tough reform and fiscal discipline is also a market negative.

- The strategic case rests on the current downturn being cyclical and not secular, given the largely complete deleveraging of corporate Japan and a sharper focus on the bottom line combined with Japan's closer integration with Asia. Scope for domestic buying of equities remains huge, as does further shareholder-friendly restructuring. However, neither development may be imminent.

- The huge government debt burden is the risk to the secular story; a fiscal crisis poses "macro risk" for investors, and is a long-term negative for JGBs and the yen.

- Overall, we advocate a tactical overweight to Japan today based on valuations and relative performance, but are neutral on the strategic case absent any clear signs of corporate and economic reform.

What To Do?

Given our views on Japan, particularly in light of the current global macroeconomic environment, how should investors approach an allocation to Japanese equities?

Given our advice that investors should play both offense and defensive, and maintain a quality basis throughout portfolios,[14] a tactical Japan bet today could be viewed as similar to an allocation to distressed assets. While there are certainly high-quality, world-class companies in Japan, the market as a whole behaves more like a low-quality, cyclical stock and should be approached as a deep-value, contrarian play.

Alternatively, the market could be viewed as an opportunistic bet on global recovery, with potentially more downside protection than emerging market equities given relative valuations (as was the case over 2008 when Japan outperformed emerging markets equities on a relative basis).

Still, there remains the risk that the Japan bet does not pay off in the near term. In other words, we have reasonably strong conviction that Japanese equities will outperform at some point, but we have low conviction that Japan will decisively outperform in the next few months, especially given our view that the global economy faces many challenges in 2010. Given the headwinds facing the Japanese market, investors need to think carefully about implementation issues, both on a tactical and strategic basis.

- *Invested on a currency-hedged basis?*: Given the outlook for the yen, investors investing in Japan may want to consider doing so on a currency-hedged basis. Yen weakness may be prerequisite for a broad Japanese equity market rally, and therefore could weigh on unhedged returns. Still, further yen strength cannot be ruled out, making a currency hedge potentially costly in the near term. Investors need to asses this trade-off.

[14] See our August 2009 Asset Allocation in the Current Environment report *Now What?!*

- *Large caps versus small caps*: Japanese small caps are more likely to benefit from a strong yen and an economic reorientation toward domestic demand. Small caps remain at a discount to the broader market despite their recent bout of outperformance. Small caps have traded at a discount to large caps throughout the post-1990 deflationary era, but in the past they have commanded a premium. However, a rally in Japanese equities brought about by yen weakness and/or a stronger than expected global growth could see a sharp rotation in favor of large caps. Therefore, a tactical Japan bet seems more geared to broader, large-cap exposure, while a long-term strategic bet would be geared toward small caps. However, it is unclear when such a shift will occur and small caps may remain in favor.

- *Active Japan managers*: Our view remains that skilled managers should be able to deliver long-term value-added in Japan, but manager selection remains paramount. Bottom-up, value-driven managers should find ample opportunities in Japan, while value stocks have historically outperformed the broader market.[15] However, many active managers in Japan were wrong footed by the sharp rotation from small to larger caps over 2006–07. Those managers that outperformed last year correctly made the move into small caps and domestic plays. Another rotation may again occur, while those managers that get the "macro call" wrong in Japan may see underperformance should there be a tactical rebound driven by large-cap banks and exporters.

- *Direct versus indirect Japan exposure*: Instead of taking a direct bet on Japanese equities via index products or dedicated Japan managers, another approach would be to overweight global equity managers that already have a large tilt toward Japan in their portfolios. In theory, such managers could also be well placed to hedge currency exposure and also reduce Japan exposure when the tactical bet has played out. However, this is easier said than done; many global managers today do not hedge currency exposure, and most retain Japan underweights. At a minimum, a tactical Japan bet should be considered in light of any "Japan exposure" already imbedded in the portfolio.

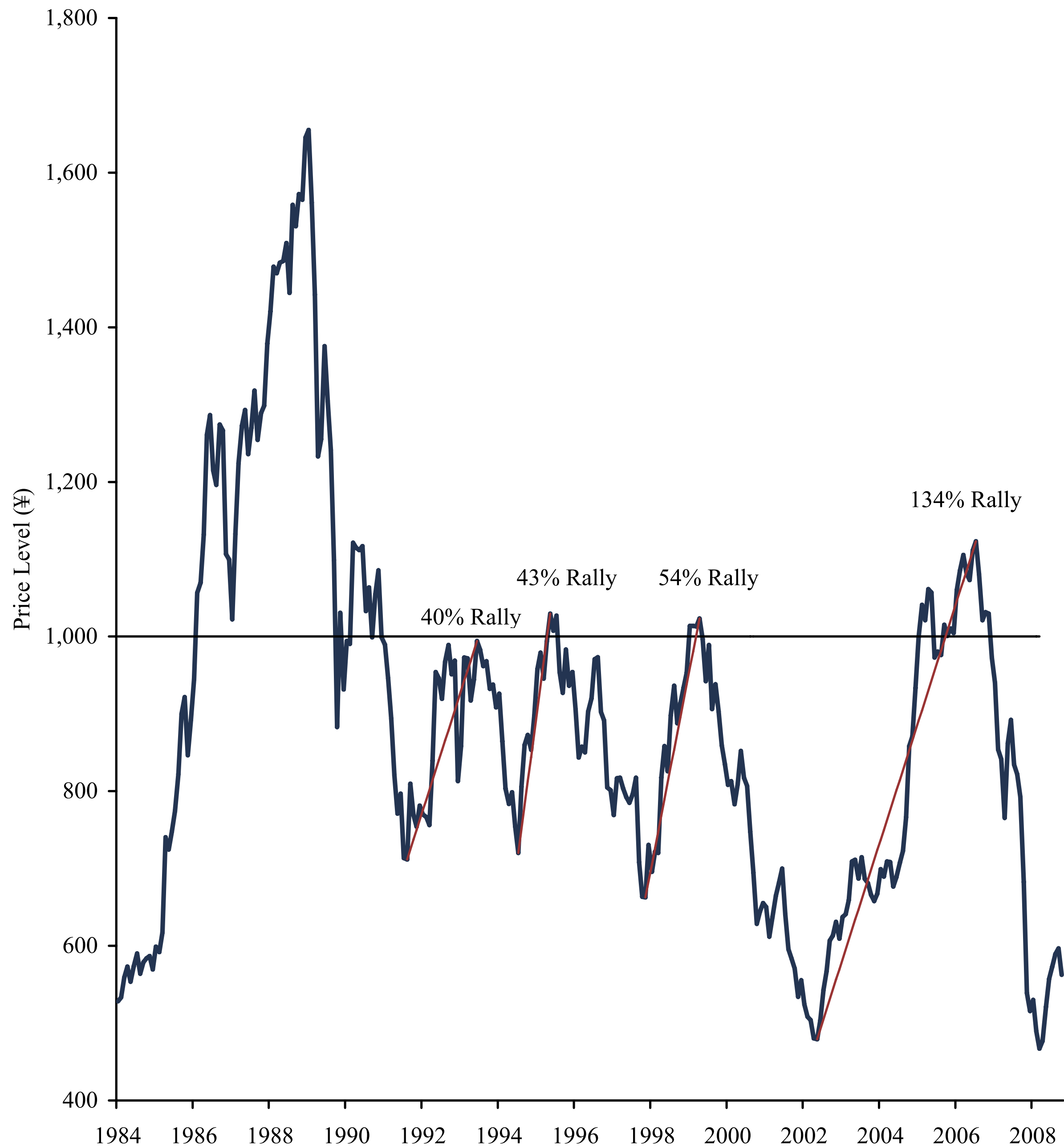
[15] Please see our September 2008 Market Commentary *Value and Japanese Small Caps*.

PERFORMANCE

Table A

MSCI JAPAN INDEX

December 31, 1984 – September 30, 2009



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

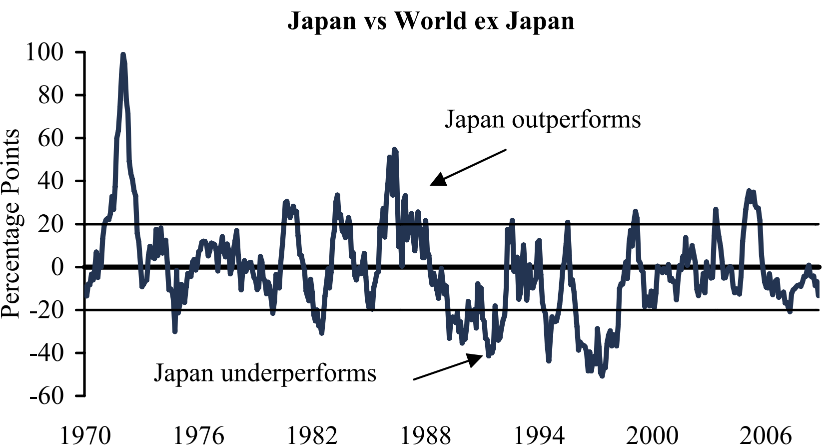
Note: Graph based on monthly data in local currency terms.

Table B

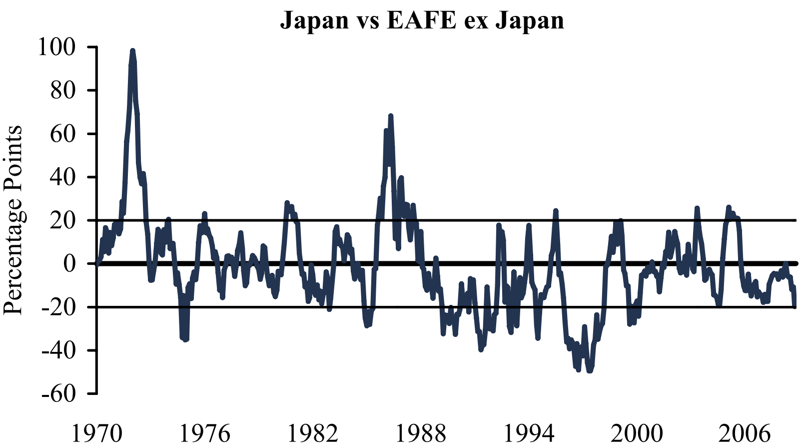
ROLLING 12-MONTH RELATIVE PERFORMANCE IN LOCAL CURRENCY

December 31, 1970 – October 23, 2009

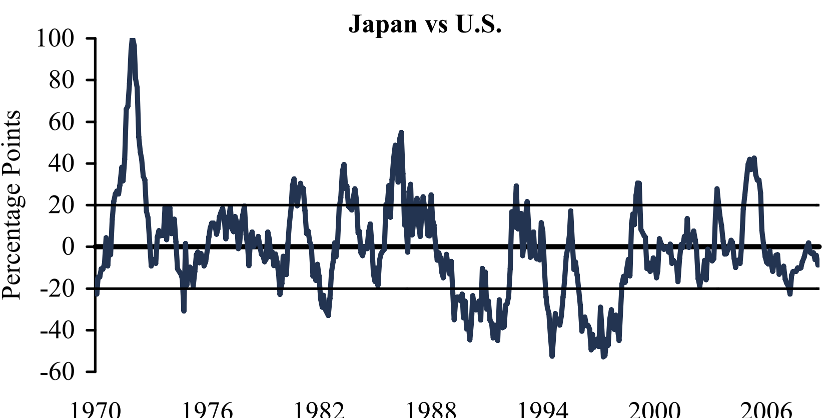
Japan vs World ex Japan



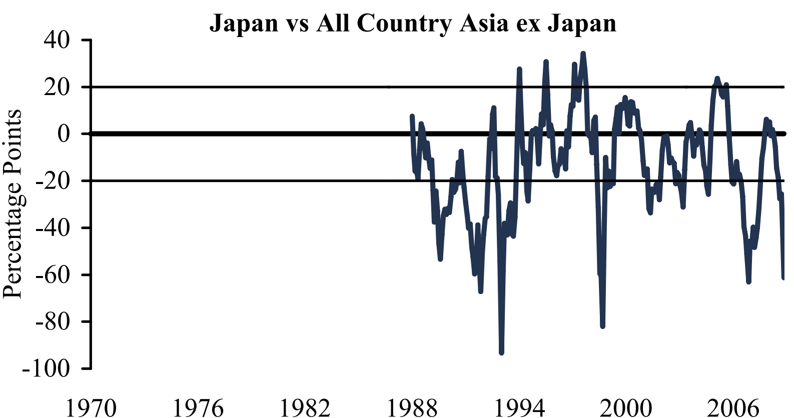
Japan vs EAFE ex Japan



Japan vs U.S.



Japan vs All Country Asia ex Japan



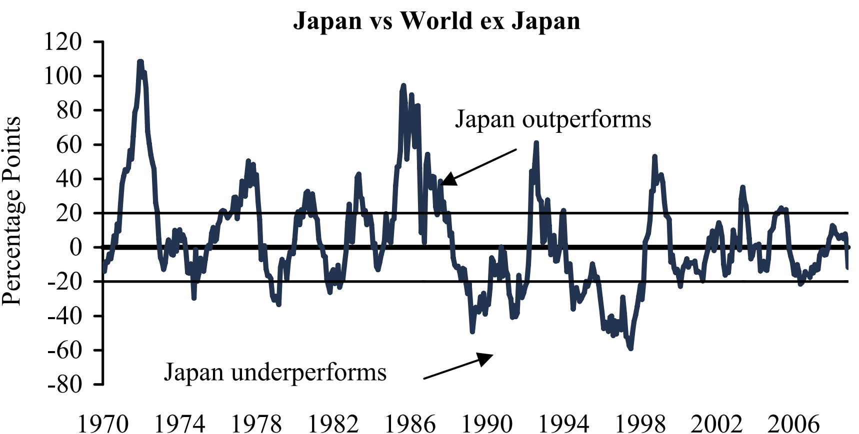
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

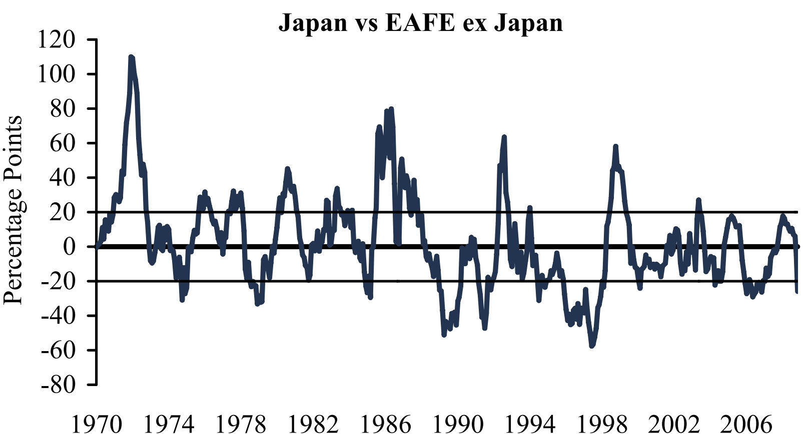
Notes: Graphs show the percentage point difference between the rolling 12-month total return of Japan and each market in local currency terms. Total returns for developed markets indices are net of dividend taxes. Total returns for All Country Asia ex Japan are gross of dividend taxes.

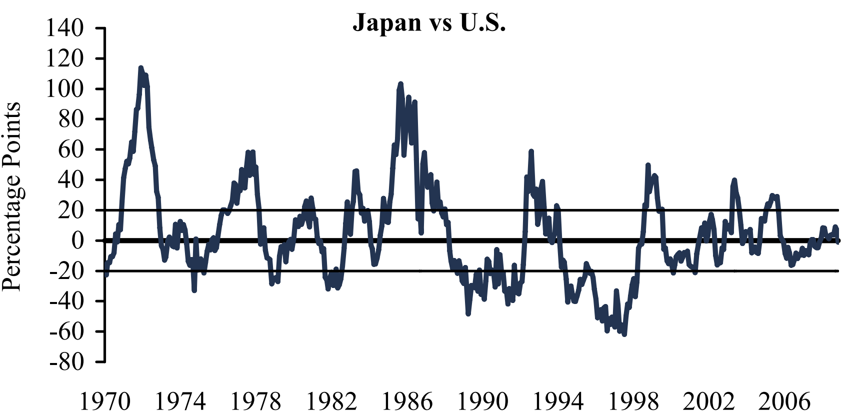
Table C

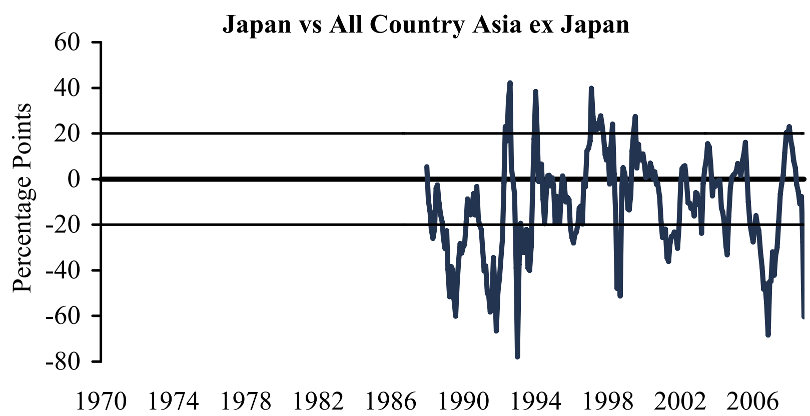
ROLLING 12-MONTH RELATIVE PERFORMANCE IN U.S. DOLLARS

December 31, 1970 – October 23, 2009









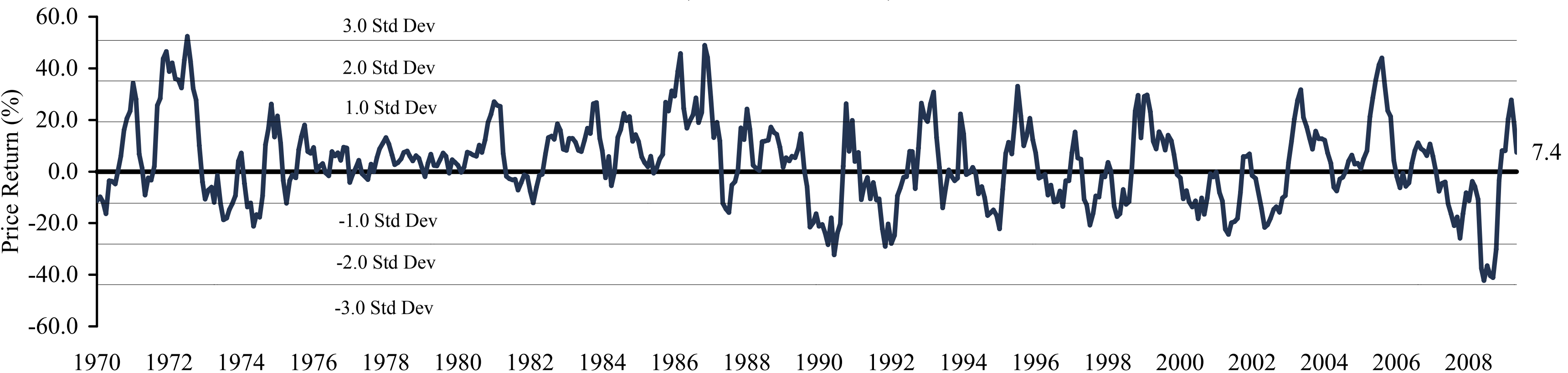
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Graphs show the percentage point difference between the rolling 12-month total return of Japan and each market in U.S. dollar terms. Total returns for developed markets indices are net of dividend taxes. Total returns for All Country Asia ex Japan are gross of dividend taxes.

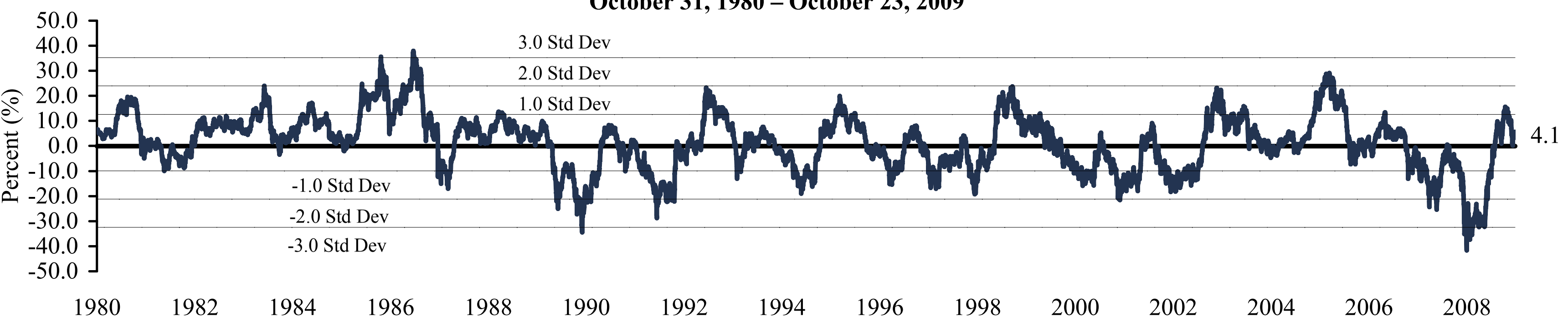
Table D

MSCI JAPAN INDEX MOMENTUM

Rolling Six-Month Performance (Yen)
June 30, 1970 – October 23, 2009



Percentage From 200-Day Moving Average
October 31, 1980 – October 23, 2009



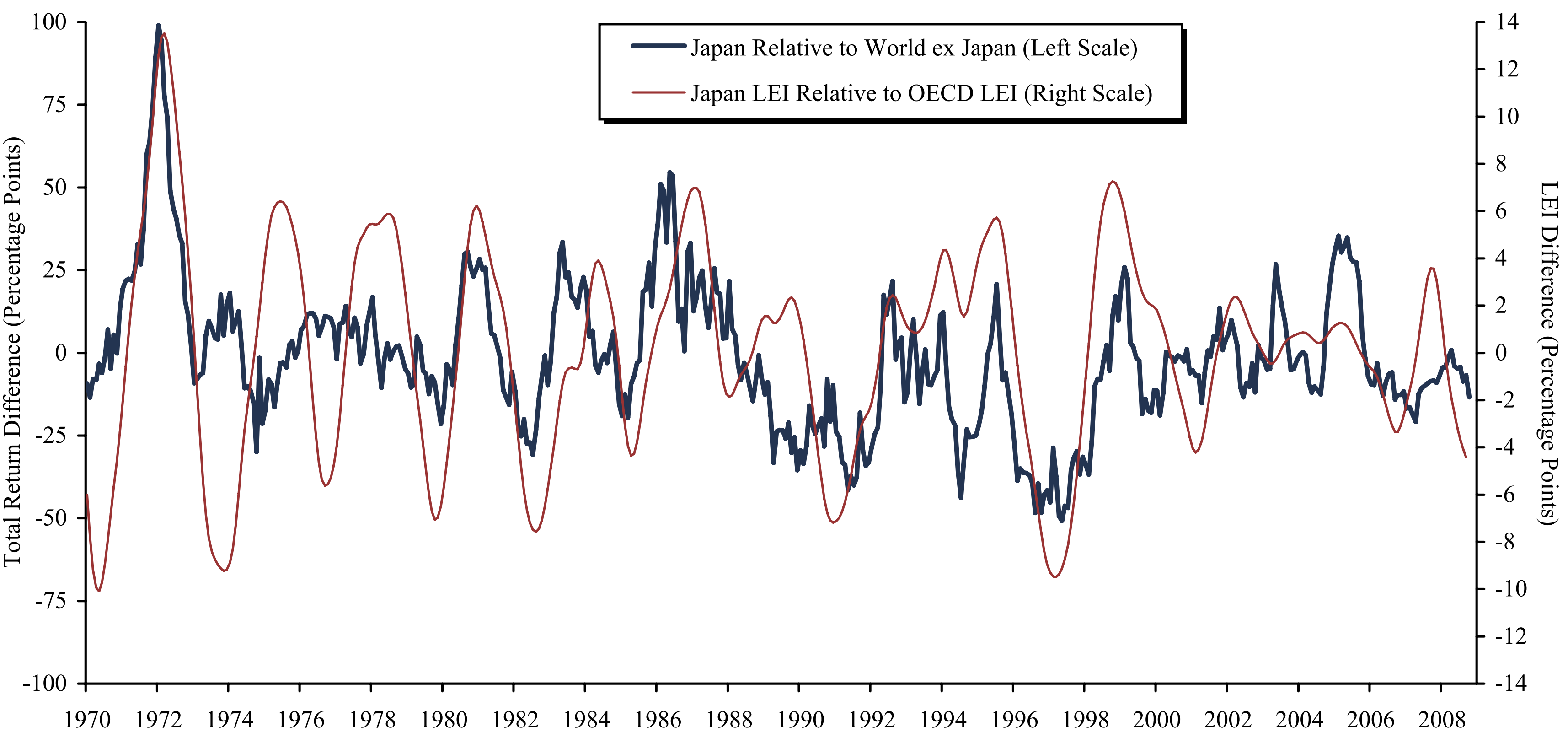
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The top graph uses monthly price returns in yen, with current month as of October 23, 2009. The bottom graph uses daily price returns in yen.

Table E

LEADING ECONOMIC INDICATORS AND RELATIVE PERFORMANCE

December 31, 1969 – September 30, 2009



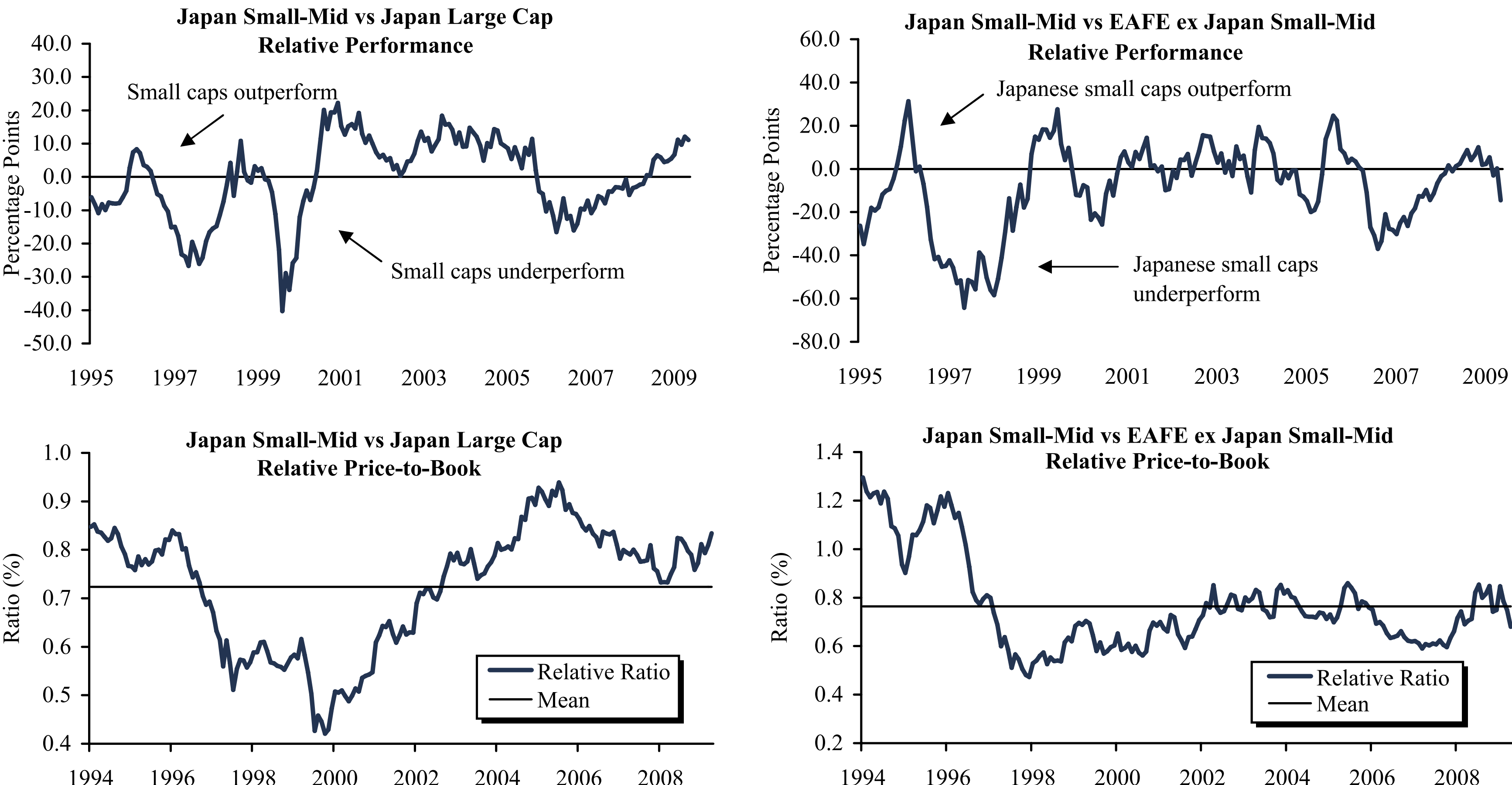
Sources: MSCI Inc., OECD, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The Japan Relative to World ex Japan line shows the percentage point difference between the 12-month percent change in each market's total return in local currency terms. The Relative Leading Economic Indicators (LEI) line shows the percentage point difference between the 12-month percent change in Japan's LEI level and the OECD's LEI level. LEI data are through August 31, 2009.

Table F

JAPANESE SMALL CAPS: ROLLING 12-MONTH RELATIVE PERFORMANCE AND VALUATION

June 30, 1994 – September 30, 2009



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

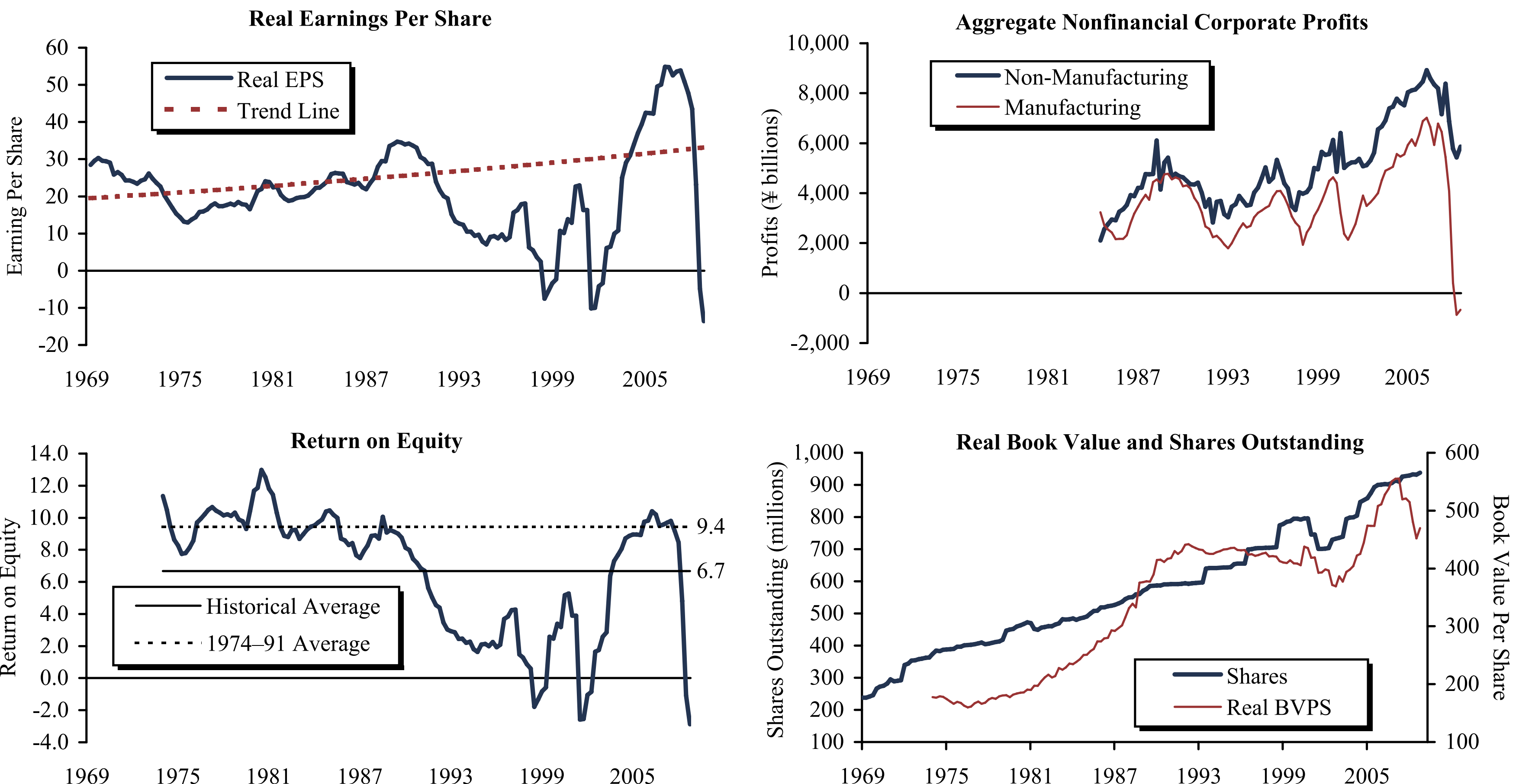
Note: Relative performance graphs show the percentage point difference between the rolling 12-month total return of each index in local currency terms and begin May 31, 1995.

VALUATIONS

Table G

JAPAN FUNDAMENTALS

December 31, 1969 – September 30, 2009



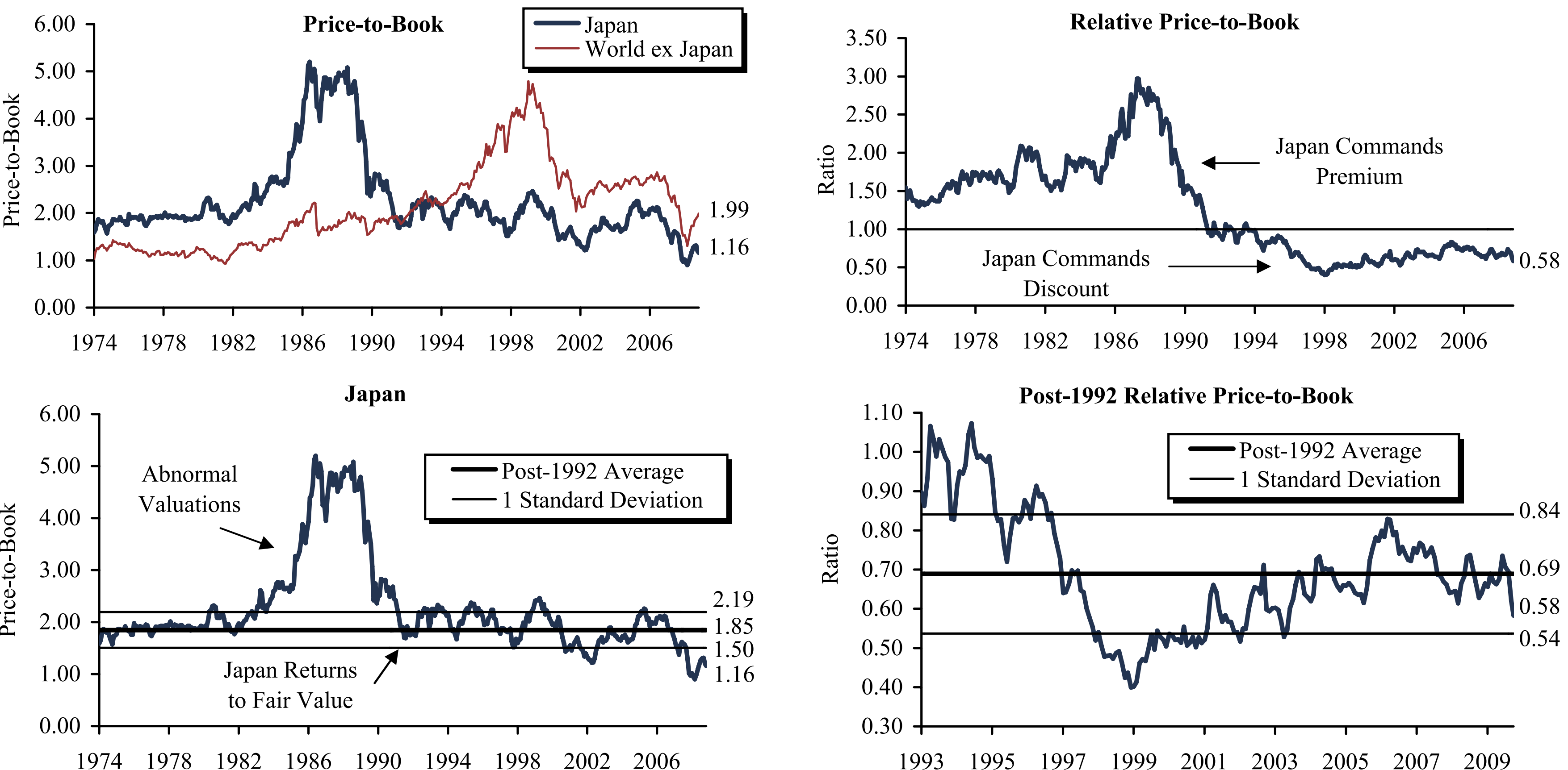
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: All data are quarterly. Japan real EPS are deflated by Japan CPI. Trend-line earnings based upon simple linear regression. Aggregate nonfinancial corporate profits are as of June 30, 2009.

Table H

PRICE-TO-BOOK VALUATIONS

December 31, 1974 – October 23, 2009



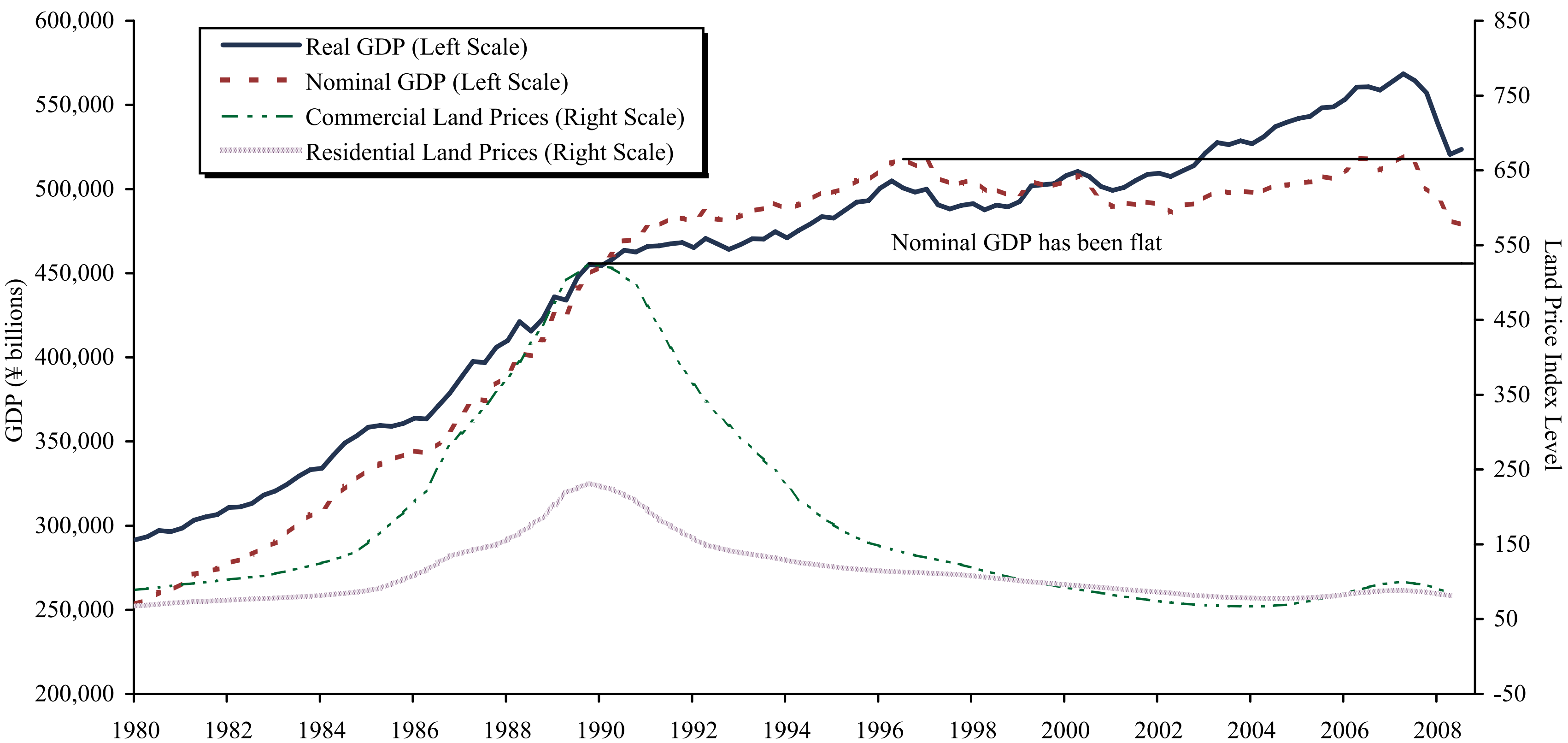
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

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 29, 1993.

Table I

JAPANESE GDP AND LAND PRICES

December 31, 1980 – June 30, 2009



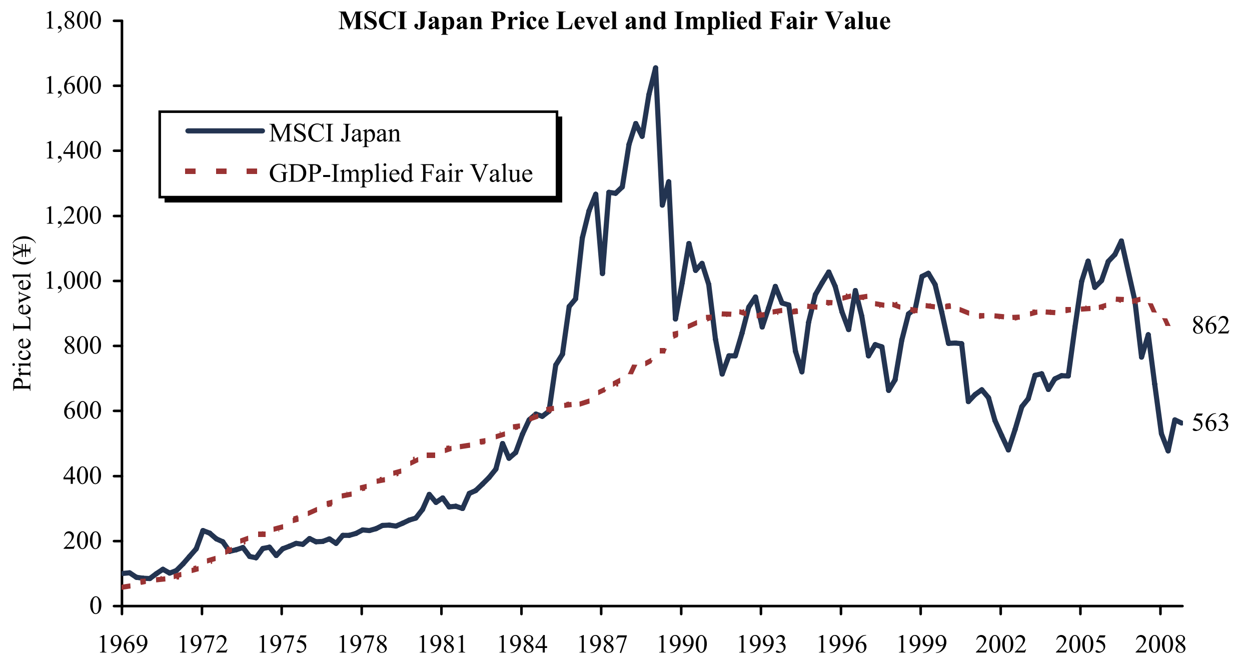
Sources: Nomura Research Institute and Thomson Datastream.

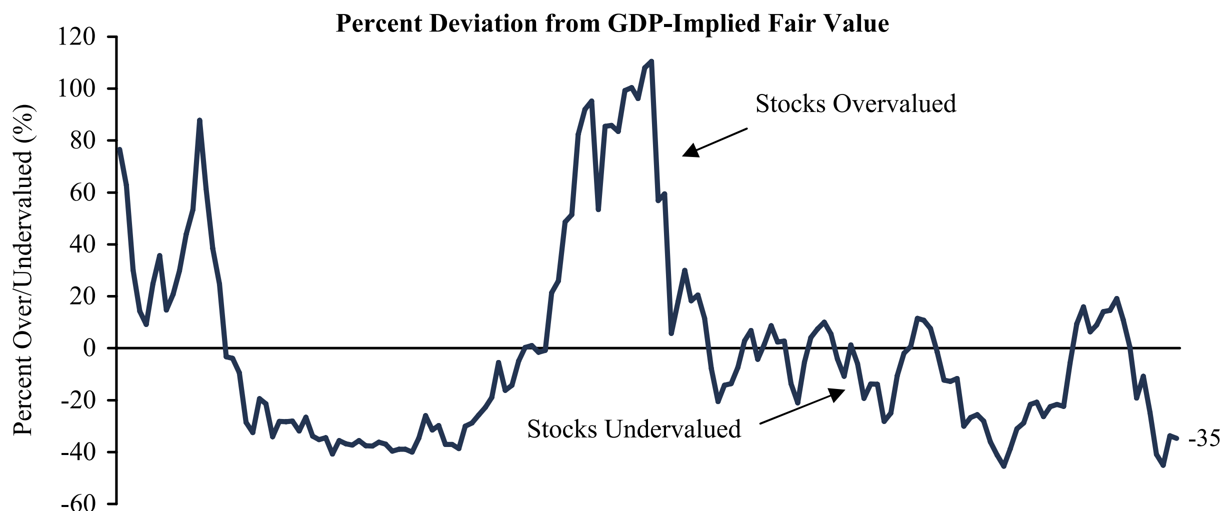
Notes: All data are quarterly. Land price indices are a composite of six major cities. Land Price Index levels are as of March 31, 2009.

Table J

MSCI JAPAN GDP-IMPLIED VALUATION

Fourth Quarter 1969 – Third Quarter 2009





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

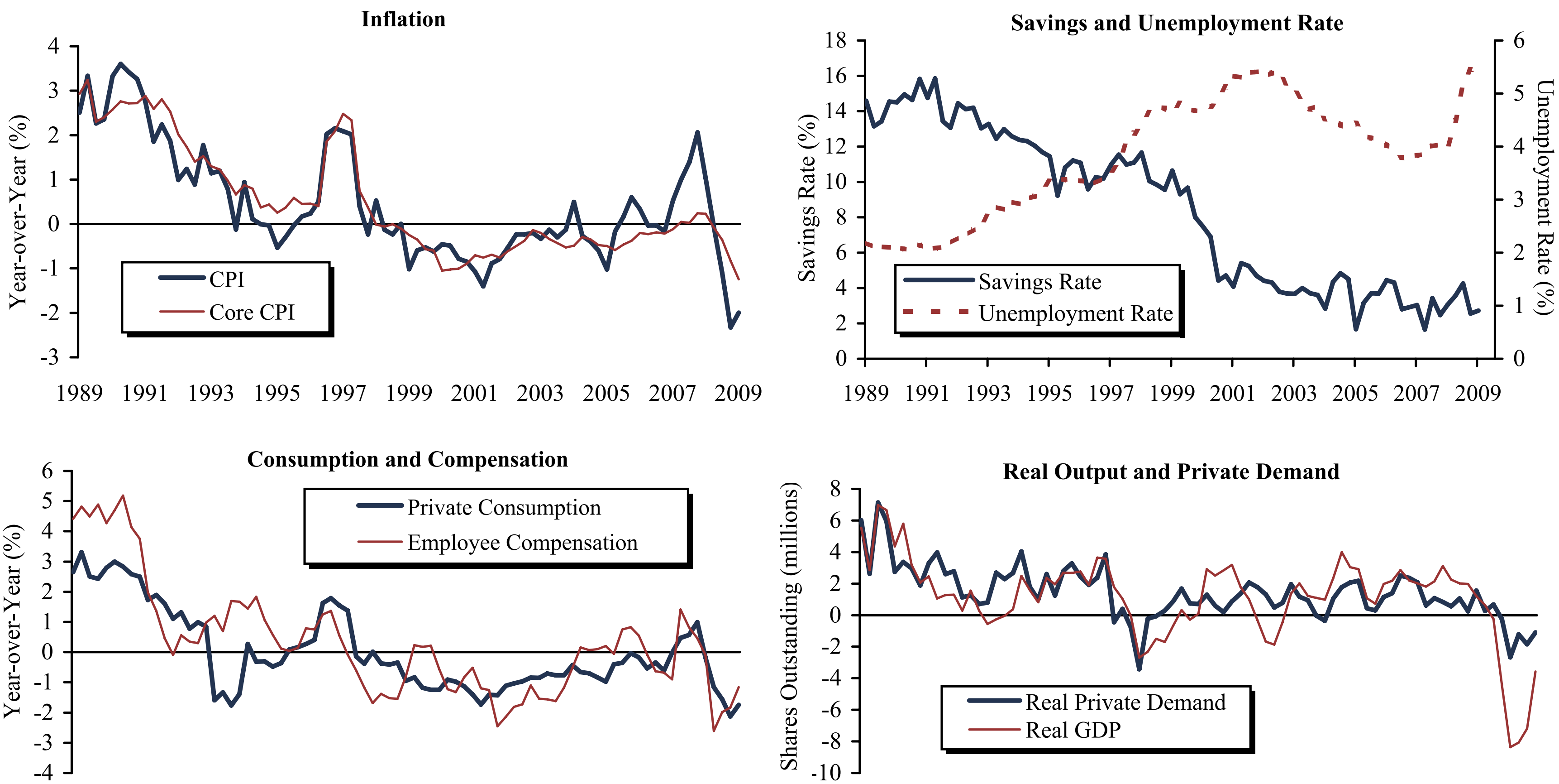
Notes: GDP-implied fair value is derived from a linear regression of stock price levels to the level of nominal GDP per capita. In other words, based on the historical relationship between equities and the economy, what is the implied level of the stock market for a given level of nominal GDP? Third quarter 2009 GDP is an OECD estimate.

ECONOMICS AND FUND FLOWS

Table K

JAPANESE ECONOMIC INDICATORS

December 31, 1989 – December 31, 2009



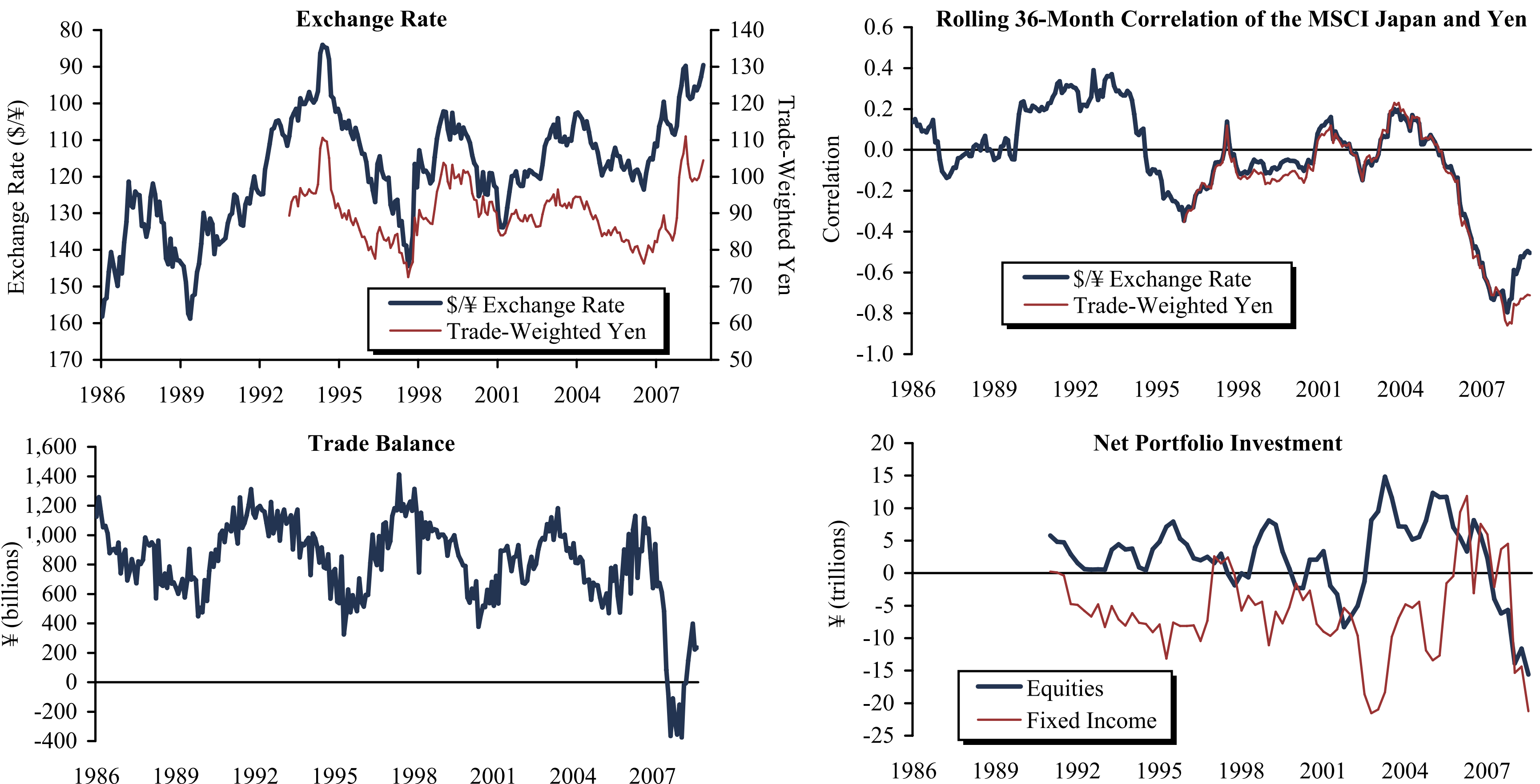
Sources: OECD and Thomson Datastream.

Notes: All data are quarterly. Fourth quarter 2009 data are forecasts from OECD.

Table L

THE YEN

December 31, 1986 – September 30, 2009



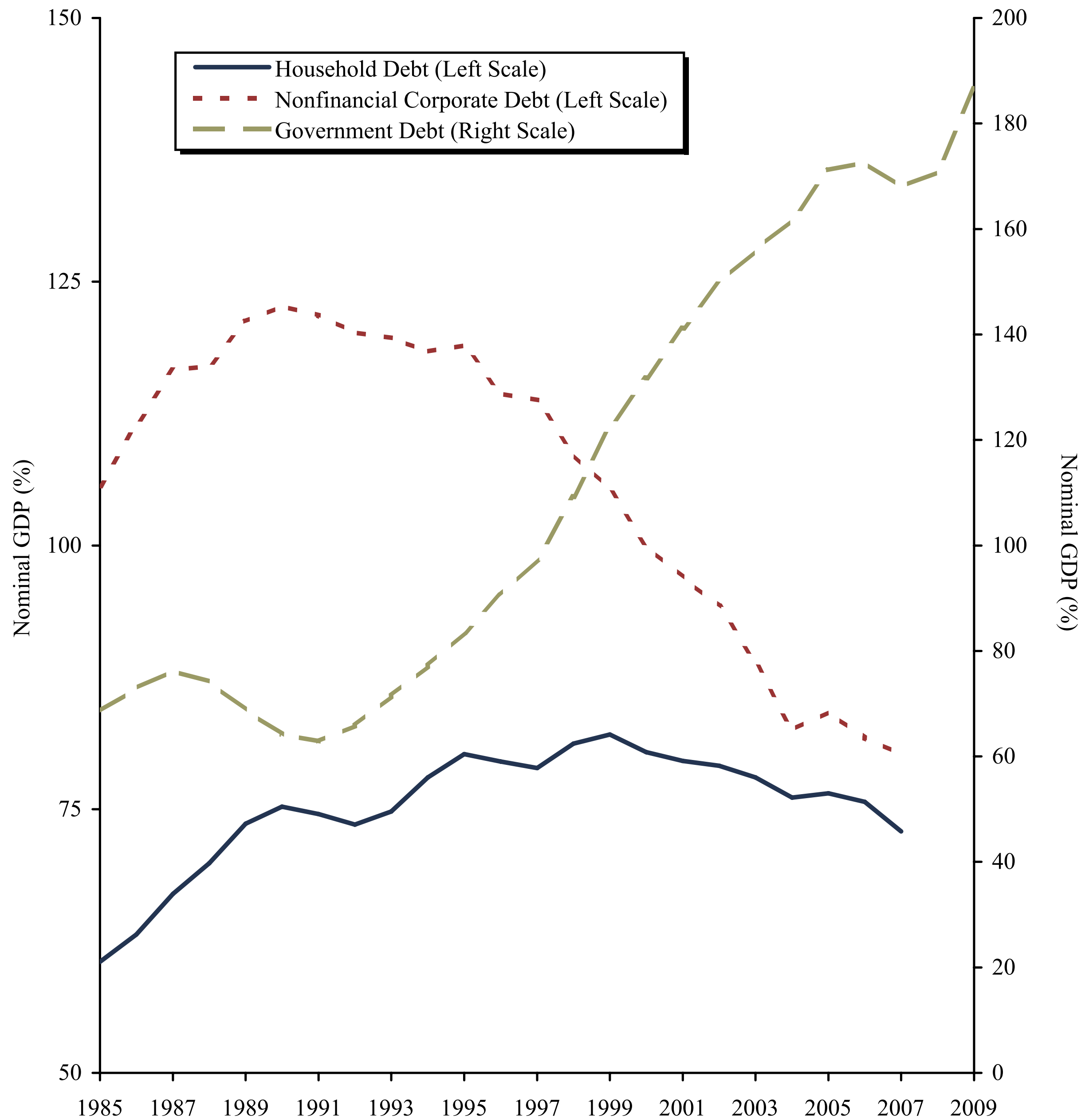
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: All data are monthly except net portfolio investment, which is quarterly and through second quarter 2009. Trade balance data are through August 2009.

Table M

JAPANESE DELEVERAGING

1985–2009



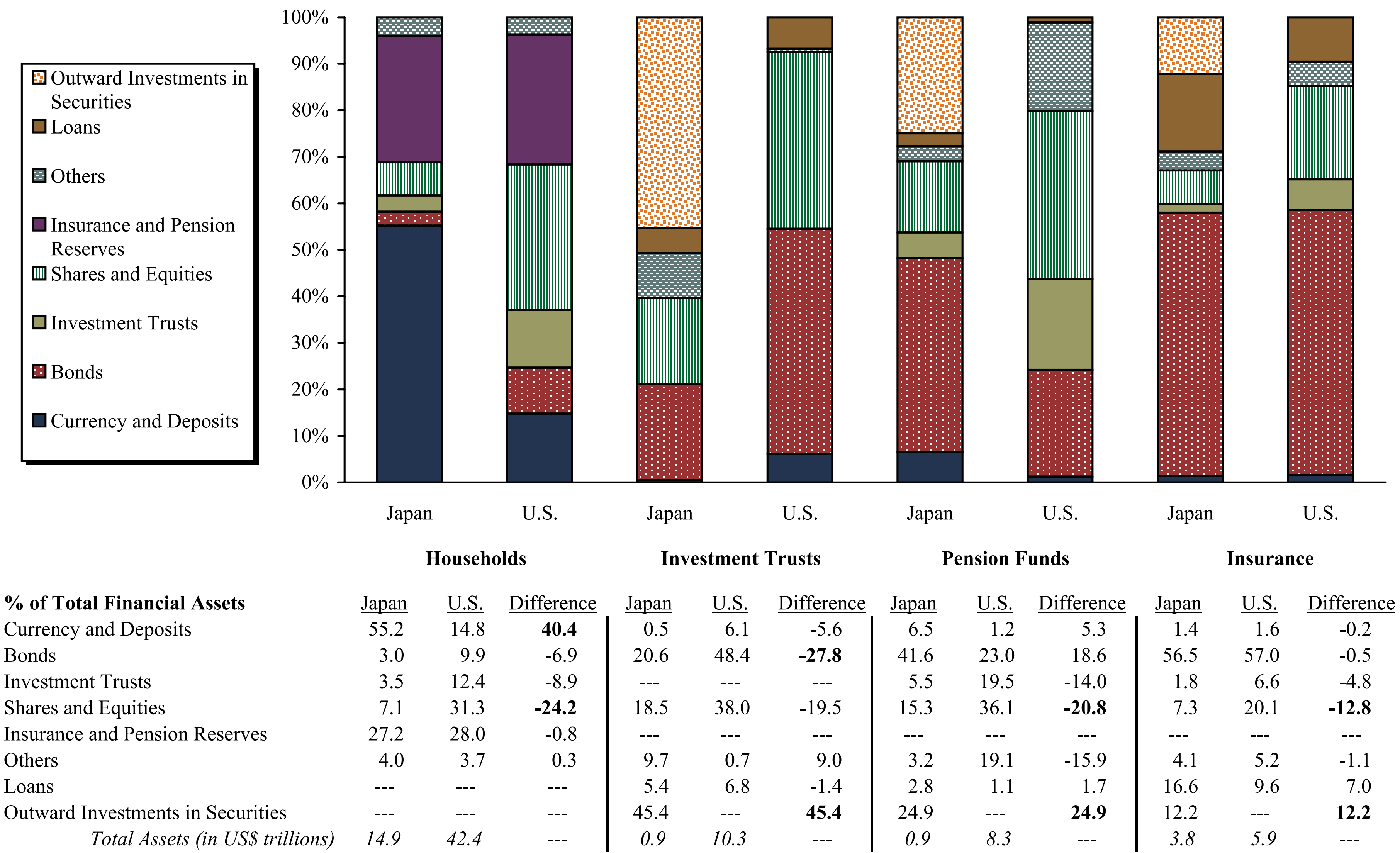
Sources: OECD and Thomson Datastream.

Notes: Government debt is provided by OECD and represents gross liabilities excluding local government debt. Government debt data for 2009 is an OECD estimate. Household debt represents total financial liabilities. Nonfinancial corporate debt represents loans. Household debt and nonfinancial corporate debt are as of 2007.

Table N

FINANCIAL ASSETS HELD BY SECTOR

As of June 30, 2009



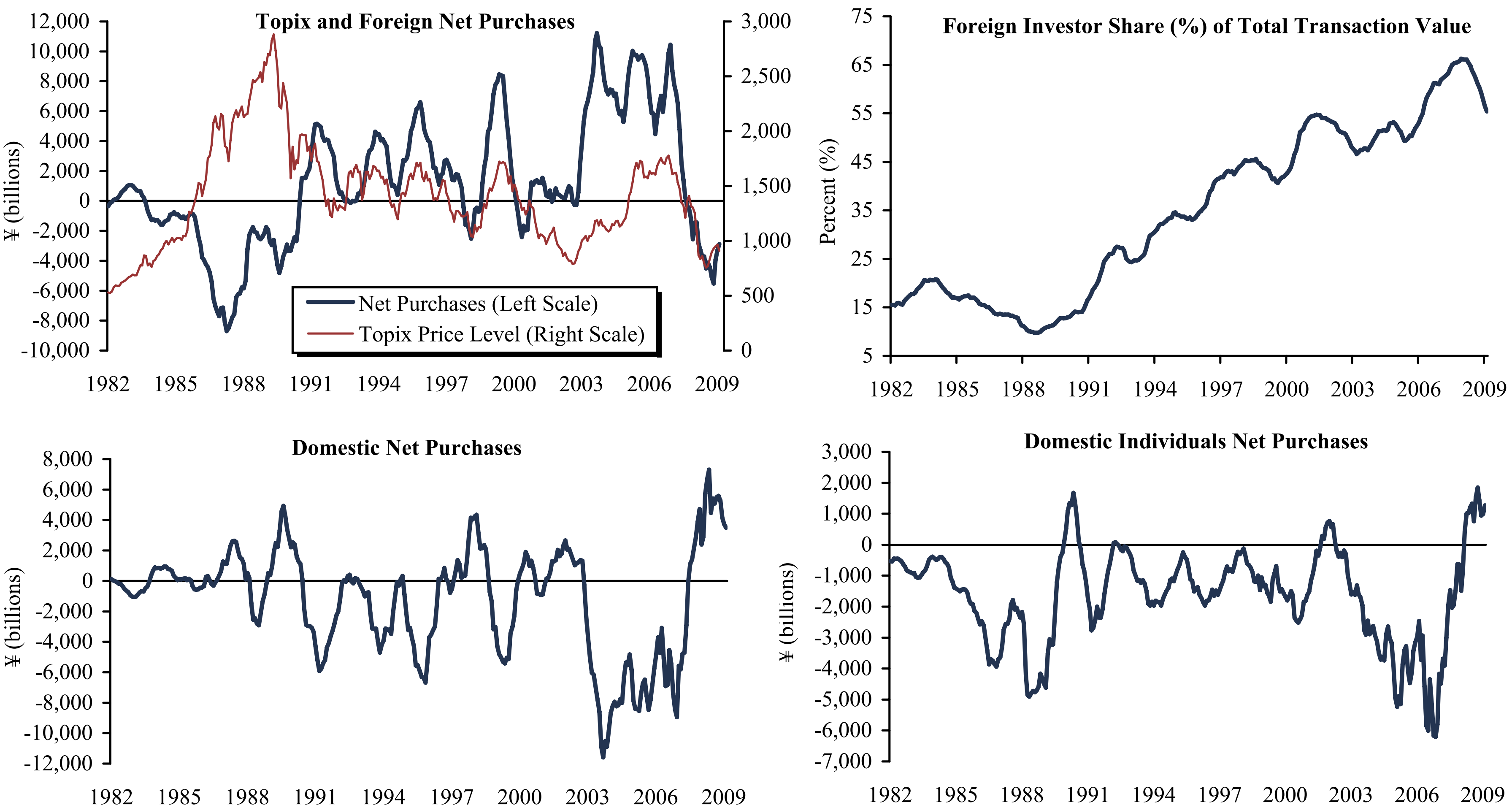
	Households			Investment Trusts			Pension Funds			Insurance		
% of Total Financial Assets	Japan	U.S.	Difference	Japan	U.S.	Difference	Japan	U.S.	Difference	Japan	U.S.	Difference
Currency and Deposits	55.2	14.8	**40.4**	0.5	6.1	-5.6	6.5	1.2	5.3	1.4	1.6	-0.2
Bonds	3.0	9.9	-6.9	20.6	48.4	**-27.8**	41.6	23.0	18.6	56.5	57.0	-0.5
Investment Trusts	3.5	12.4	-8.9	---	---	---	5.5	19.5	-14.0	1.8	6.6	-4.8
Shares and Equities	7.1	31.3	**-24.2**	18.5	38.0	-19.5	15.3	36.1	**-20.8**	7.3	20.1	**-12.8**
Insurance and Pension Reserves	27.2	28.0	-0.8	---	---	---	---	---	---	---	---	---
Others	4.0	3.7	0.3	9.7	0.7	9.0	3.2	19.1	-15.9	4.1	5.2	-1.1
Loans	---	---	---	5.4	6.8	-1.4	2.8	1.1	1.7	16.6	9.6	7.0
Outward Investments in Securities	---	---	---	45.4	---	**45.4**	24.9	---	**24.9**	12.2	---	**12.2**
Total Assets (in US$ trillions)	*14.9*	*42.4*	---	*0.9*	*10.3*	---	*0.9*	*8.3*	---	*3.8*	*5.9*	---

Source: Bank of Japan.

Table O

NET PURCHASES OF JAPANESE EQUITIES BY INVESTOR TYPE

August 31, 1982 – September 30, 2009



Source: Thomson Datastream.

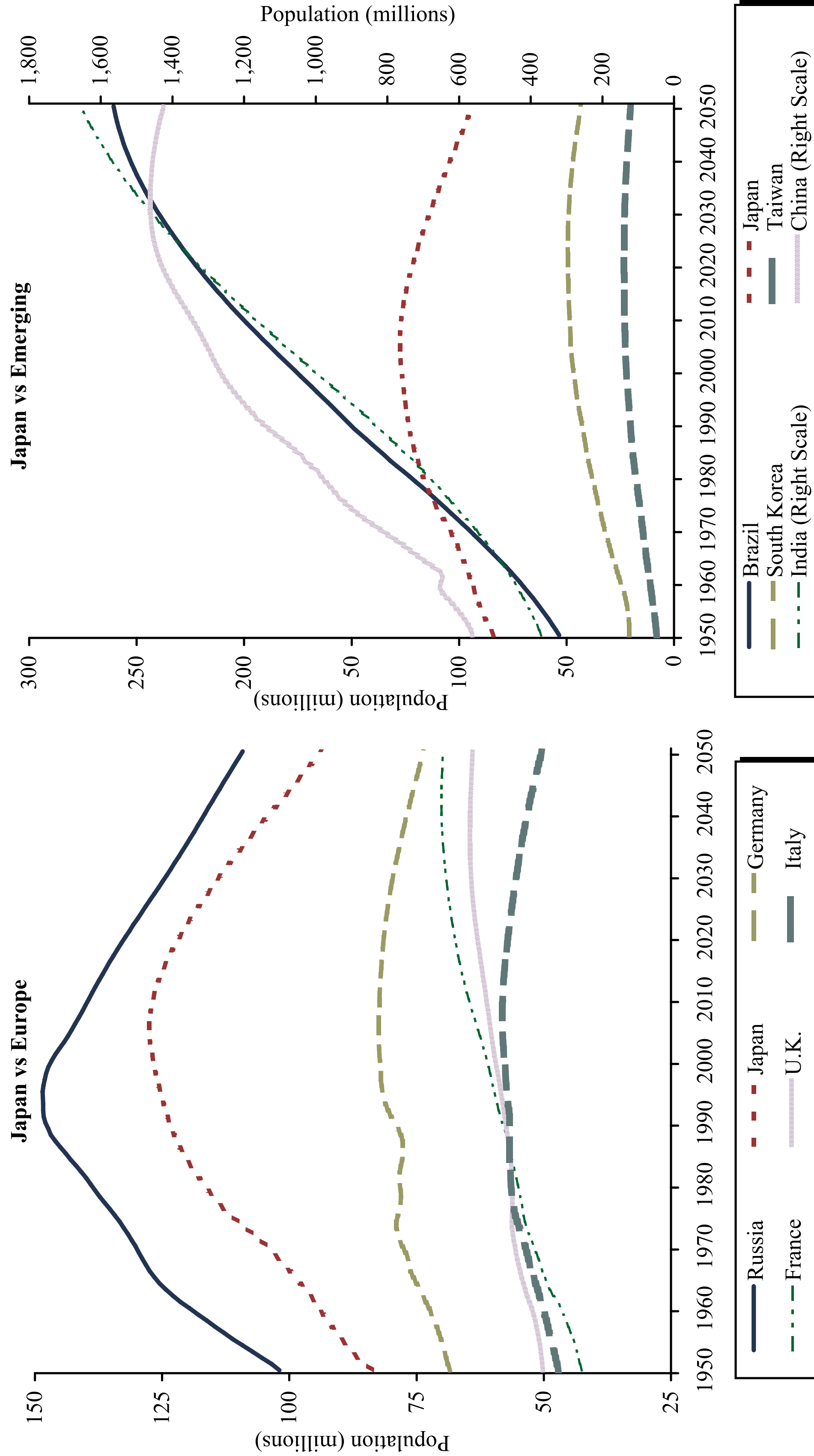
Notes: Transaction values are for the first section of the Tokyo Stock Exchange and exclude proprietary trading. Net purchases are calculated on a rolling 12-month basis.

DEMOGRAPHICS

Table P

COUNTRY POPULATIONS

1950–2050

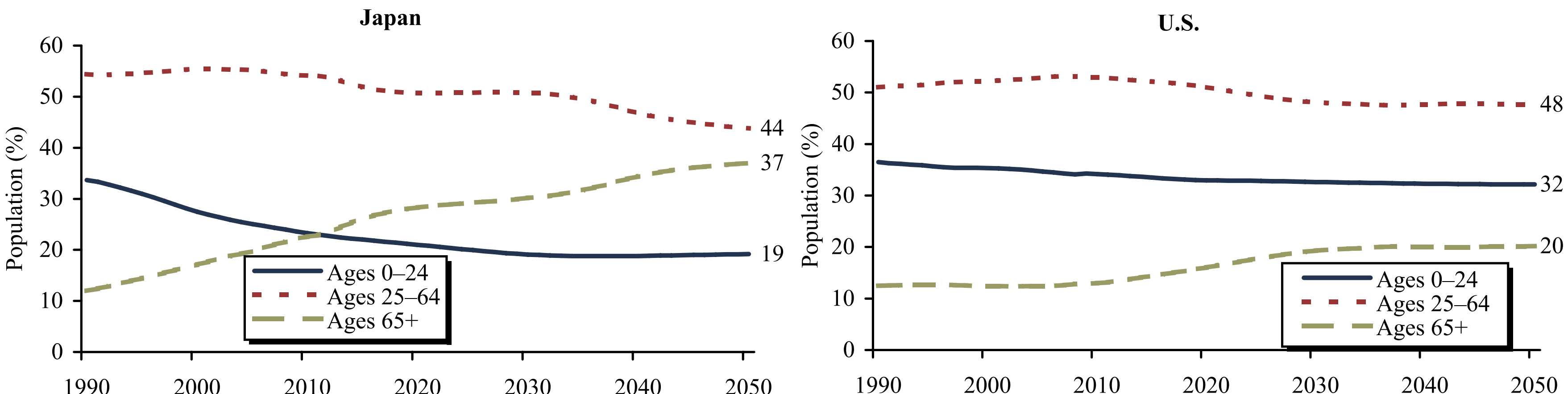


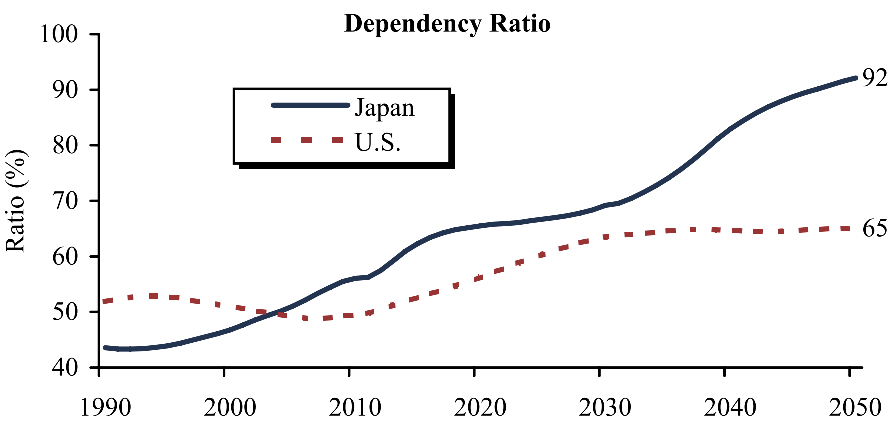
Source: U.S. Census Bureau.

Table Q

DEMOGRAPHICS

1990–2050





Source: U.S. Census Bureau.

Note: The dependency ratio is the number of people aged 0–14 plus the number of people aged 65 and over divided by the number of people aged 15–64.