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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT

JAPAN'S CAUTIONARY TALE

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Japan's Cautionary Tale

"*History may not repeat itself, but it does rhyme a lot.*" - Mark Twain

Investor attitudes in the United States today bear a striking resemblance to the misplaced optimism that engulfed Japan a decade ago. Today, as then, equity markets are rising as government and central bank officials offer repeated assurances they will go to the mat to restore growth. The Nikkei stock market rally of 1993, therefore, may offer a lens (admittedly somewhat dirty and scratched) through which to view the current rally in U.S. equities.

Conditions in Japan circa July 1993 were remarkably similar to the current environment in the United States. The Japanese equity bubble had burst three and a half years earlier, with equity prices in March 1993 less than half their level at the peak. Although the market had staged several rallies since it first turned down, that of 1993 was the first attributed to government and central bank rate cuts. Up to that point, Japanese investors had simply assumed the economy and equity markets would bounce back on their own, as they had so many times before the bubble burst. In late 1992 and early 1993, however, with GDP figures continuing to disappoint, those in positions of authority took dramatic steps to spur economic activity.

The Japanese government passed a ¥10.7 trillion spending package in August 1992—at the time the largest such package ever put together—then topped it with a new ¥13.2 trillion package in April 1993. (Some have argued Japan's stimulus packages were too tilted toward political cronies and thus less effective than they might have been. Yet all stimulus—whether in the form of spending increases or tax cuts—has some political element. Furthermore, in a free-market economy it is not possible for government to dictate where this money goes—witness the huge flows that have recently gone into stock and real estate speculation in the United States, while precious little stimulus seems to be trickling through to the real economy.)

The Bank of Japan (BOJ), meanwhile, reversed its earlier course and begun to slash interest rates with a vengeance. The equity market duly responded to this double dose of stimulus: from March 1993 to June 1993 the Nikkei rose 25%, as investors grew increasingly confident the worst was behind them, and as the fiscal and monetary stimulus worked its way through the system. While the economy showed few concrete signs of recovery, and price-to-earnings ratios remained sky-high—higher, in fact, than their nosebleed levels of the late 1980s—most investors and policymakers were confident the Asian giant was in the midst of shaking off its three-year slump. Government spending and interest rate cuts, they believed, would surely boost the economy sooner rather than later.

A quote from the annual G7 summit meeting in July 1993 captures the mood: "Japan's economy is over the worst, and some recovery is now in sight…Japan has taken a series of stimulative policies including the most recent comprehensive package. Japan will implement fiscal and monetary measures as necessary, to ensure sustained non-inflationary growth led by strong domestic demand, keeping in mind the need for long-term fiscal prudence. This will contribute to the important goal of significantly reducing external imbalances."

In other words, the global community viewed Japan's policy actions as adequate and appropriate to its situation, and believed officials were willing and able to jump-start growth through monetary and fiscal measures. History, of course, has been less kind, painting government and monetary officials as inept, misguided, and culpable for the country's decade-plus stagnation, specifically because they did not act quickly or forcefully enough when the economy initially turned down.

What Japanese officials could or should have done, however, is debatable and somewhat beside the point—for investors, the salient issue is that at the time, Japanese monetary and fiscal policy were viewed as quite robust and up to the task of re-invigorating the economy. Indeed, while the BOJ did not begin to lower rates until 18 months after the equity bubble burst, from July 1991 to September 1993 the bank slashed short-term interest rates from 6% to 1.75%. This compares quite favorably with the Federal Reserve's recent actions, as the Fed cut rates from 6.5% to 1.00% in a similar period of time (see Table F).

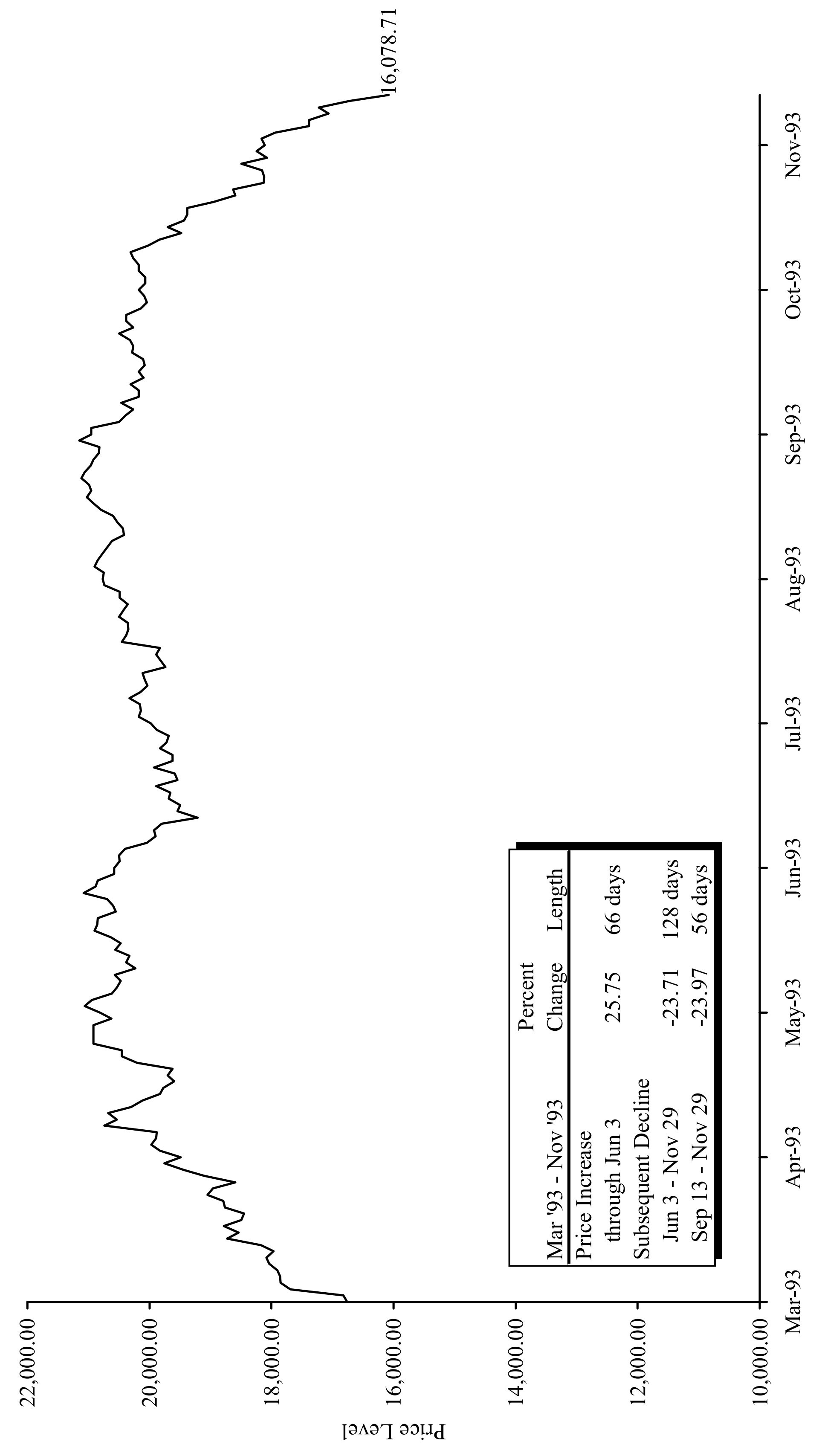
Again, the magnitude of the cuts, while clearly significant, is not so important as the confidence they engendered: investors in July 1993 believed the BOJ and the government would keep pumping money into the system for as long as it took to get the economy moving. This, in turn, encouraged investors to bid up equity prices in anticipation of stronger growth down the road—as well as providing ample liquidity for such speculation—much as is occurring in the United States today. To put it bluntly, while there may be valid reasons to expect an upturn in the U.S. economy, the recent liquidity-driven rally should not be counted among them; in fact, there is little reason to believe rising equity prices will be a more reliable predictor of economic recovery than was the soaring Nikkei in mid-1993.

Although the similarities between the two environments are striking, we fully appreciate the danger of extrapolating the historical outcome in Japan to the current situation in the United States, which is different in so many ways. This is merely a cautionary tale: as we have written elsewhere, we find it implausible that after a boom even more reckless than that of the Japanese market in the late 1980s, the U.S. bear market should peter out within a few years, without inflicting deeper and more prolonged damage both on investors and on the real economy. After the Nikkei's 25% rally in 1993, the index meandered for a few months, then subsequently plunged nearly 24% in a ten-week period ending in late November, setting the first of what were to become a sickening series of new bear-market lows.

Table A

JAPANESE EQUITIES: NIKKEI 225

March 4, 1993 - November 29, 1993



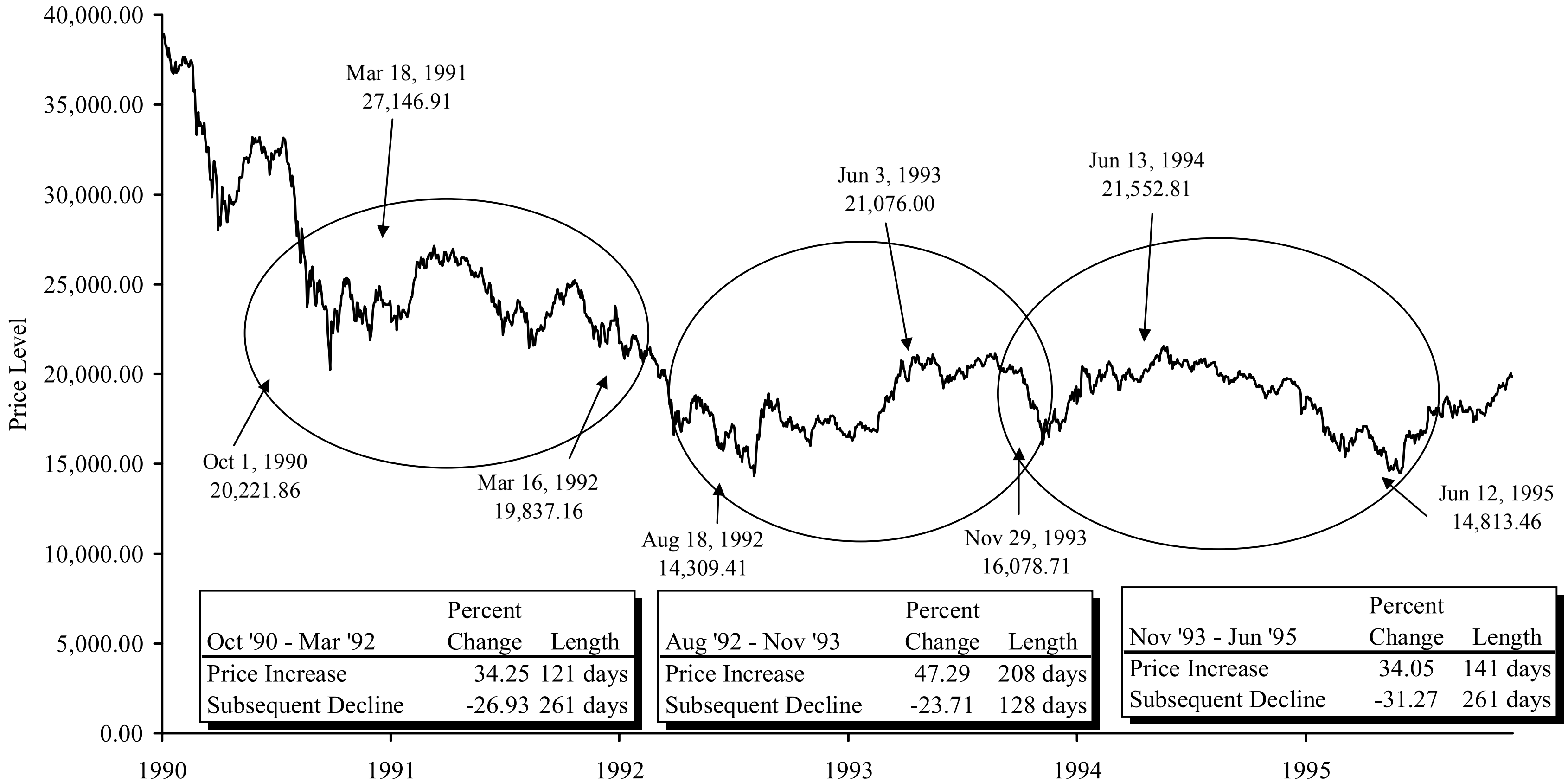
Mar '93 - Nov '93	Percent Change	Length
Price Increase through Jun 3	25.75	66 days
Subsequent Decline		
Jun 3 - Nov 29	-23.71	128 days
Sep 13 - Nov 29	-23.97	56 days

Source: Thomson Datastream.

Table B

NIKKEI 225 BEAR MARKET RALLIES

December 31, 1989 - December 31, 1995



Oct '90 - Mar '92	Percent Change	Length
Price Increase	34.25	121 days
Subsequent Decline	-26.93	261 days

Aug '92 - Nov '93	Percent Change	Length
Price Increase	47.29	208 days
Subsequent Decline	-23.71	128 days

Nov '93 - Jun '95	Percent Change	Length
Price Increase	34.05	141 days
Subsequent Decline	-31.27	261 days

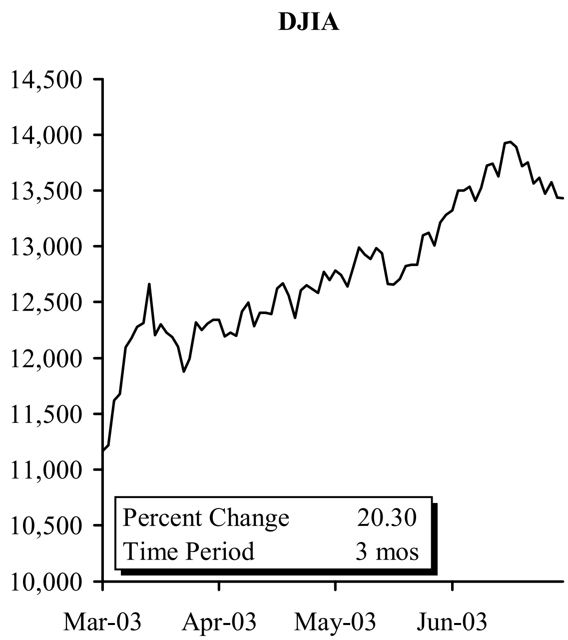
Source: Thomson Datastream.

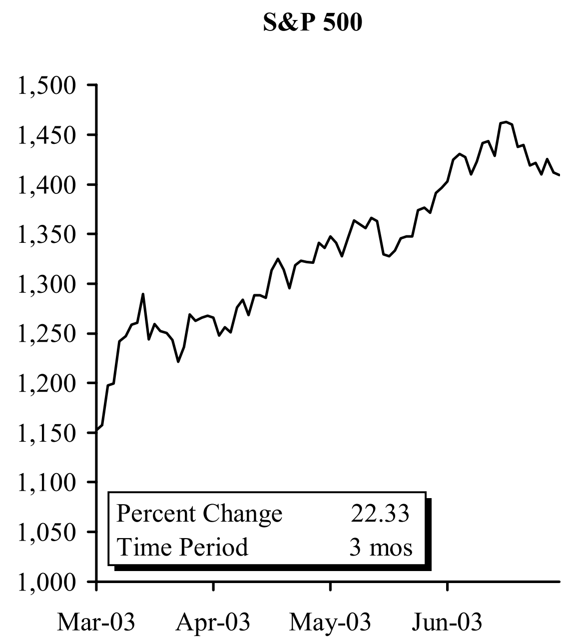
Notes: The subsequent rise represents the increase from the trough through its subsequent 12-month peak. The length of time represents trading days.

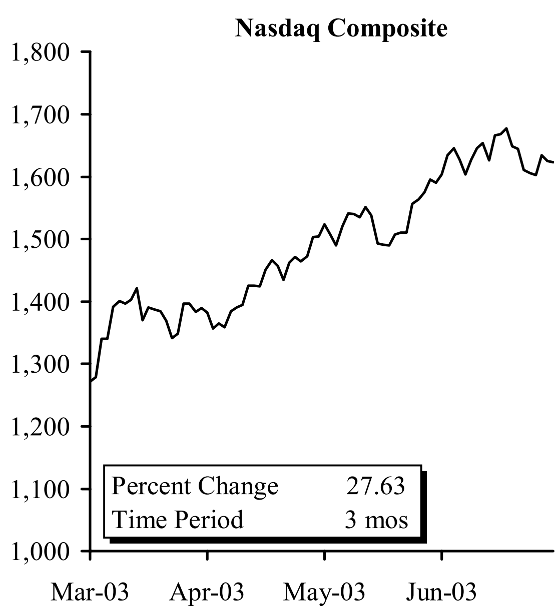
Table C

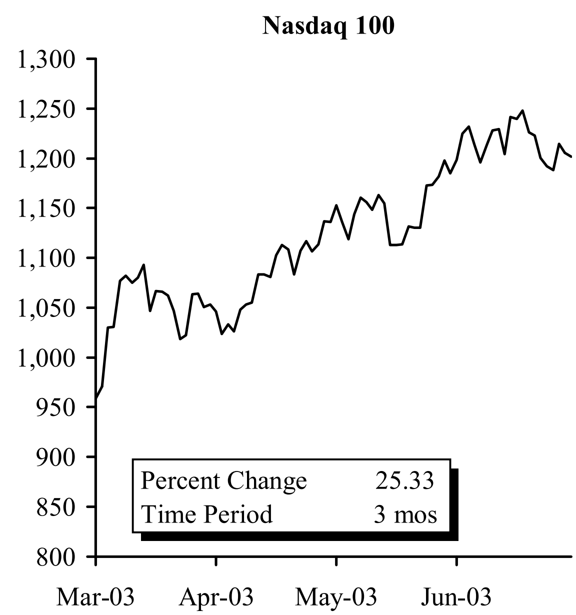
U.S. MARKET PERFORMANCE: DOW JONES INDUSTRIAL AVERAGE, S&P 500, NASDAQ COMPOSITE AND NASDAQ 100

March 11, 2003 - June 30, 2003









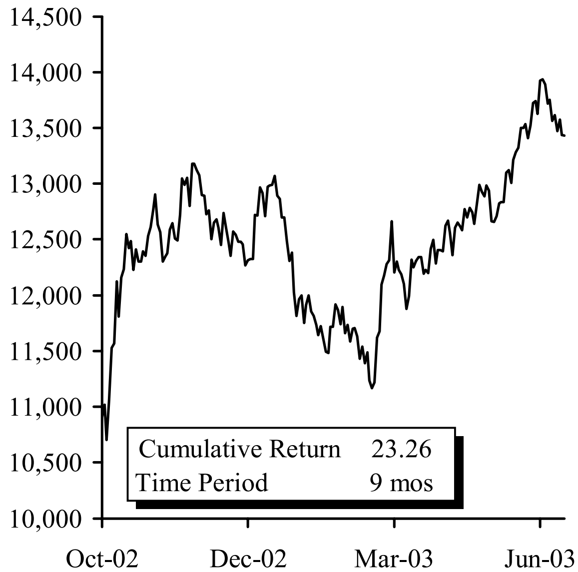
Source: Thomson Datastream.

Table D

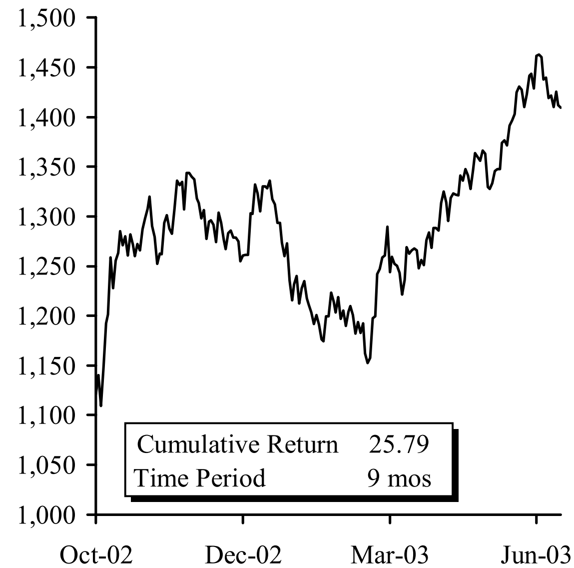
U.S. MARKET PERFORMANCE: DOW JONES INDUSTRIAL AVERAGE, S&P 500, NASDAQ COMPOSITE AND NASDAQ 100

October 7, 2002 - June 30, 2003

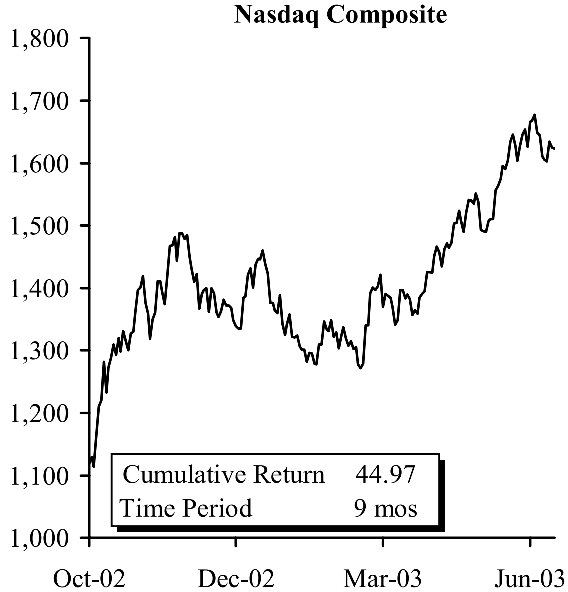
DJIA



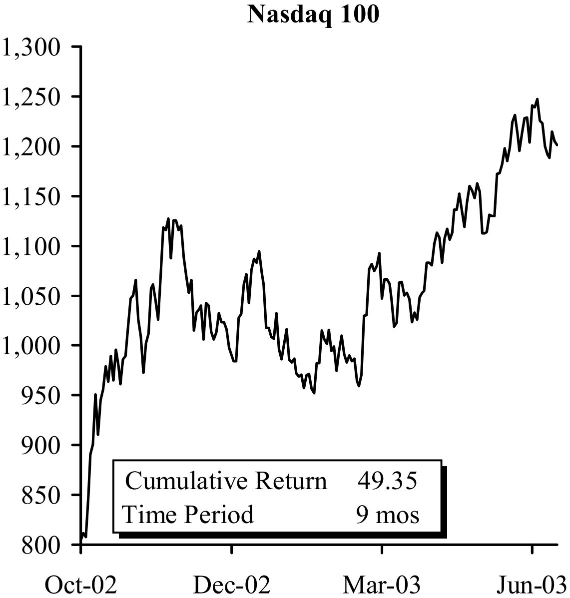
S&P 500



Nasdaq Composite



Nasdaq 100



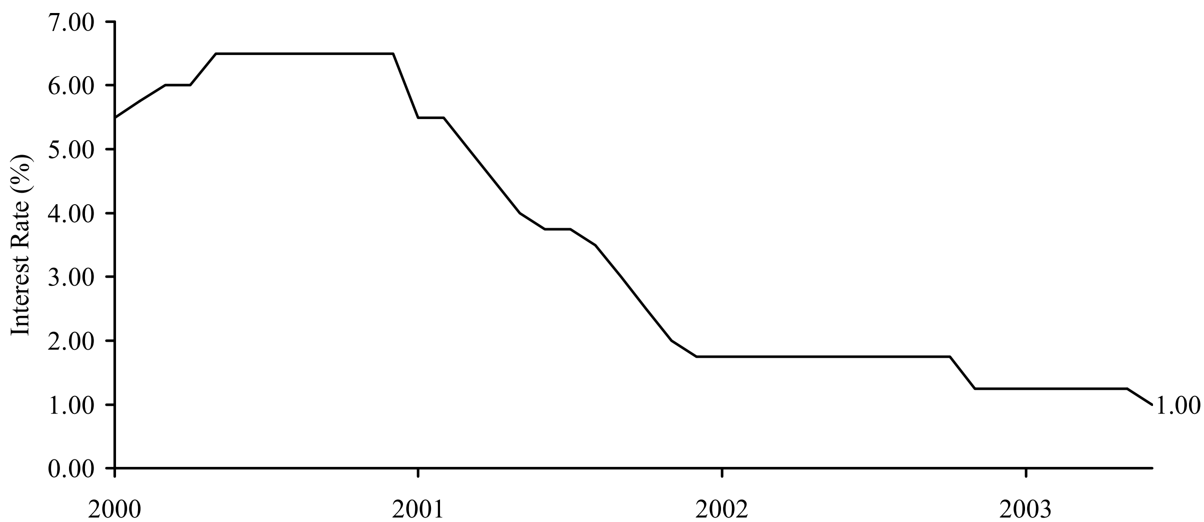
Source: Thomson Datastream.

Table E

U.S. AND JAPANESE INTEREST RATES: FIRST SCENARIO

Japanese Discount Rate (¥)
January 31, 1990 - July 31, 1993

U.S. Federal Funds Target Rate ($)
January 31, 2000 - June 30, 2003

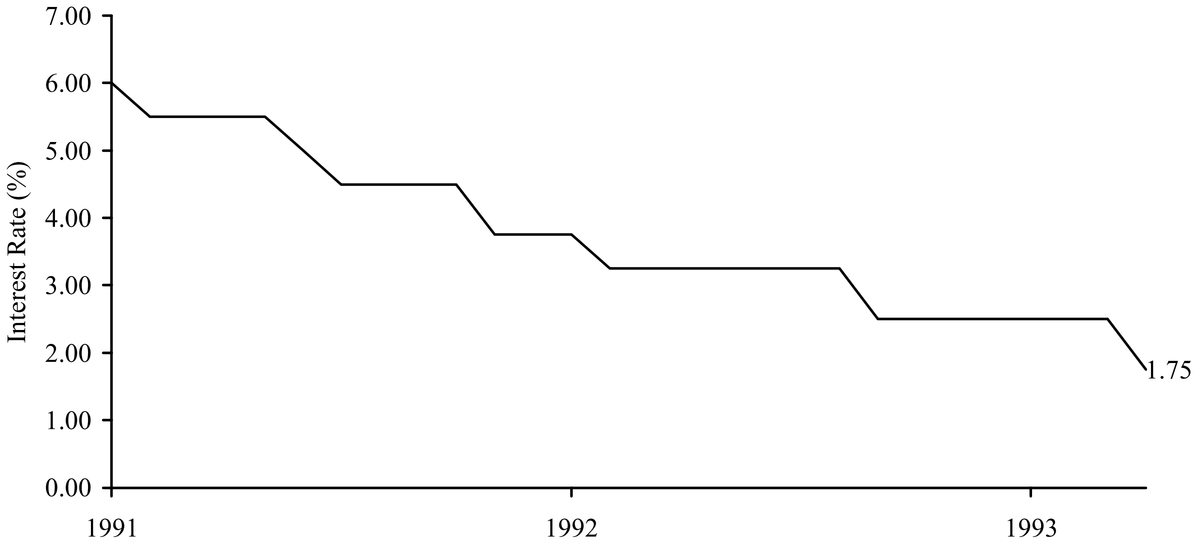


Source: Thomson Datastream.

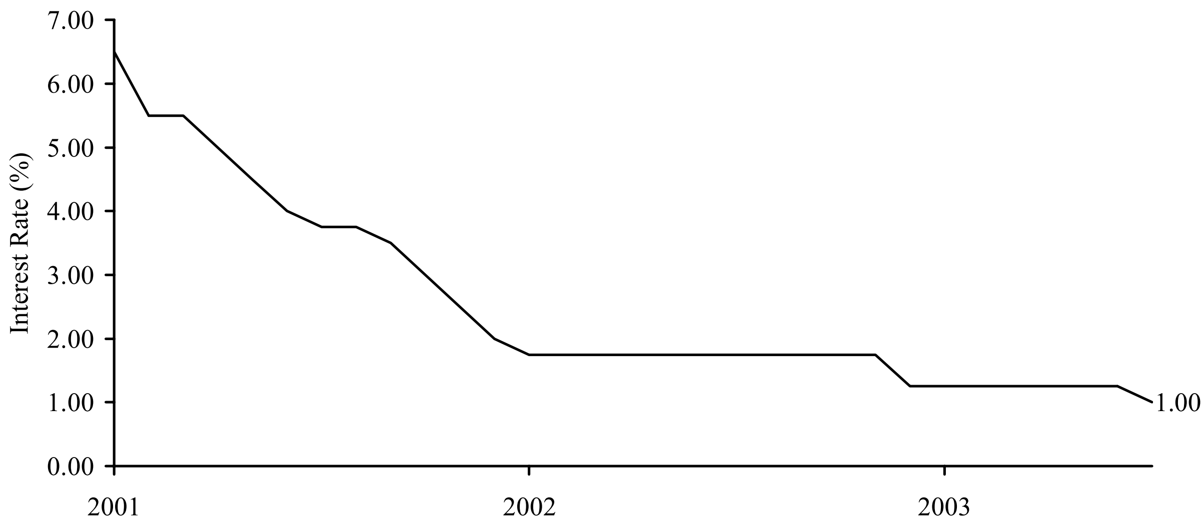
Table F

U.S. AND JAPANESE INTEREST RATES: SECOND SCENARIO

Japanese Discount Rate (¥)
June 30, 1991 - September 30, 1993



U.S. Federal Funds Target Rate ($)
January 1, 2001 - June 30, 2003

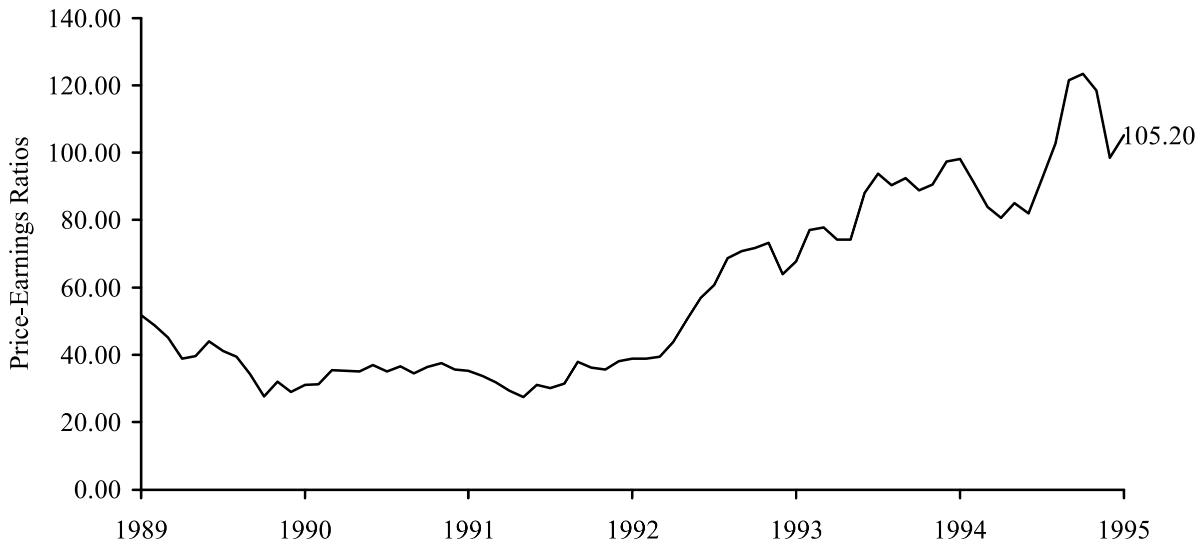


Source: Thomson Datastream.

Table G

U.S. AND JAPANESE VALUATIONS: PRICE-EARNINGS RATIOS

Japanese Price-Earnings Ratios
December 31, 1989 - December 31, 1995



U.S. Price-Earnings Ratios
December 31, 1999 - June 30, 2003

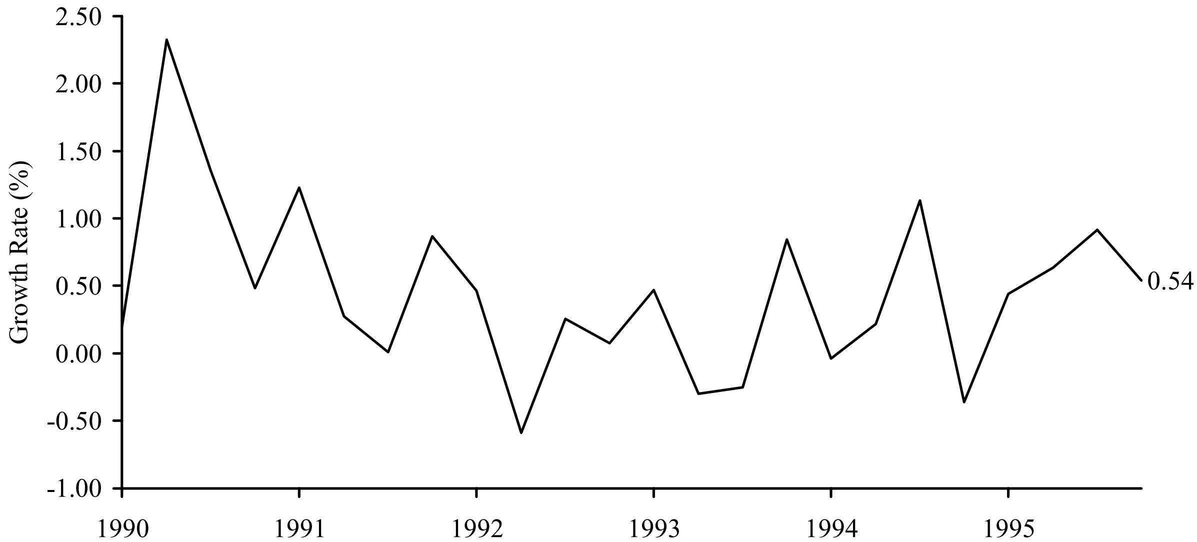
Source: Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Japanese and U.S. valuations are represented by MSCI Japan and MSCI U.S., respectively.

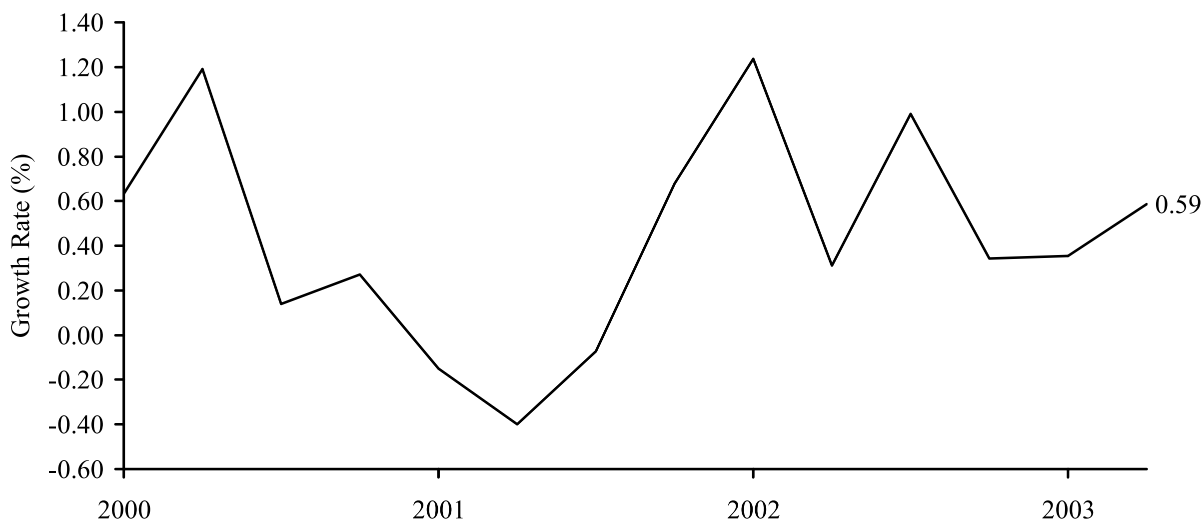
Table H

U.S. AND JAPANESE REAL GROSS DOMESTIC PRODUCT

Japanese GDP (¥)
March 31, 1990 - December 31, 1995



U.S. GDP ($)
March 31, 2000 - June 30, 2003

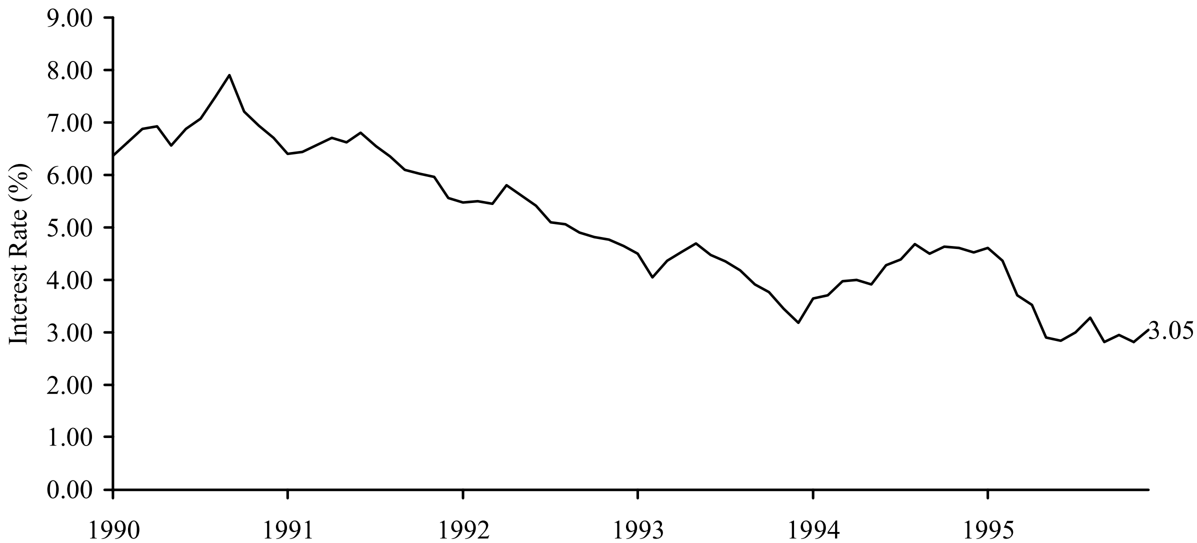


Source: Thomson Datastream.

Table I

U.S. AND JAPANESE BOND MARKETS

10-Yr Japanese Government Bonds (¥)
January 31, 1990 - December 31, 1995



10-Yr U.S. Government Bonds ($)
January 31, 2000 - June 30, 2003

Source: Thomson Datastream.