



C A M B R I D G E A S S O C I A T E S L L C

GLOBAL MARKET COMMENT: ECONOMIC GROWTH IN JAPAN—THE MOMENT PASSES

August 2002

Robert Lang
Marcelo Morales

Copyright © 2002 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC. Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without the prior written authorization of Cambridge Associates LLC. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to Cambridge Associates LLC reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that Cambridge Associates LLC believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. The recipient of this report may not provide it to any other person without the consent of Cambridge Associates LLC. Investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. We can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA Manager Medians are derived from Cambridge Associates LLC's proprietary database covering investment managers. Cambridge Associates LLC does not necessarily endorse or recommend the managers in this universe. Performance results are generally gross of investment management fees and do not include returns for discontinued managers.

Economic Growth in Japan**The Moment Passes**

Indeed how they resemble this fleeting world of ours

The cherry blossoms.

No sooner do we gaze at them in bloom than they have scattered.

—in Saeki Umetomo, ed., Kokin wakashū, ("Collection of Ancient and New Japanese Poems," from the Heian period, 794-1191)

Just a few months ago the Japanese economy appeared to be finally on the mend. Export volume posted two straight record quarters of growth, boosting industrial production 6.0% for the year thus far (see Tables A-C). Even deflation seemed to be in retreat. Prices were flat for five consecutive months, and they actually increased for McDonalds hamburgers, some low-end retail stores, gasoline, and computer chips. Through the end of May, equity investors had been positively ecstatic, as the Nikkei Average outperformed the S&P 500 by 18.6 percentage points (11.6% vs. -7.1%).

These moments of economic growth proved to be as fleeting as the springtime bloom of cherry blossoms in Kyoto, however. Deflationary pressures have resumed, with wholesale prices falling 2.2% for the year ended in July. Export growth could not sustain the rapid pace experienced in the first half of the year, due to declining external demand and the strengthening yen, which appreciated 12% in past six months against the US\$. Real retail sales have been contracting for about five years, as wages and employment continue to deteriorate. Since the end of May, Japanese equity returns have turned negative as well, with the Nikkei falling 9.7% in June and 7.0% in July. Although the Nikkei is still outperforming the S&P 500 for the year thus far, it is now very close to its post-bubble low reached in February this year (see Table D).

Markets have also been dismayed that Prime Minister Junichiro Koizumi has backpedaled on implementing structural reform. He has ceded to a lower-than-expected tax cut, limited the scope of deregulating the postal businesses, and is indicating that he will renege on his earlier promise to lift full government guarantees on certain bank accounts past the April 2003 deadline. Furthermore, Japan's fiscal health appears to be in decline. Rising government spending would probably force Tokyo to issue more debt, expanding the debt-to-GDP ratio beyond its current level of 140%, which is already the highest in the industrialized world.

Bank reform is proceeding at the pace of a stranded sea slug, despite the urgency created by the collapse in the credit creation process. In spite of aggressive monetary easing by the Bank of Japan, lending continues to contract, with total lending outstanding falling 4.6% for the year ended July 31,

2002. For the same time period, M2+CD growth reached 3.3%, while the monetary base expanded at a 25.1% clip. However, the credit multiplier remains sluggish at 7.8, which disrupts the process of transmitting excess reserves to bank lending (see Table E).

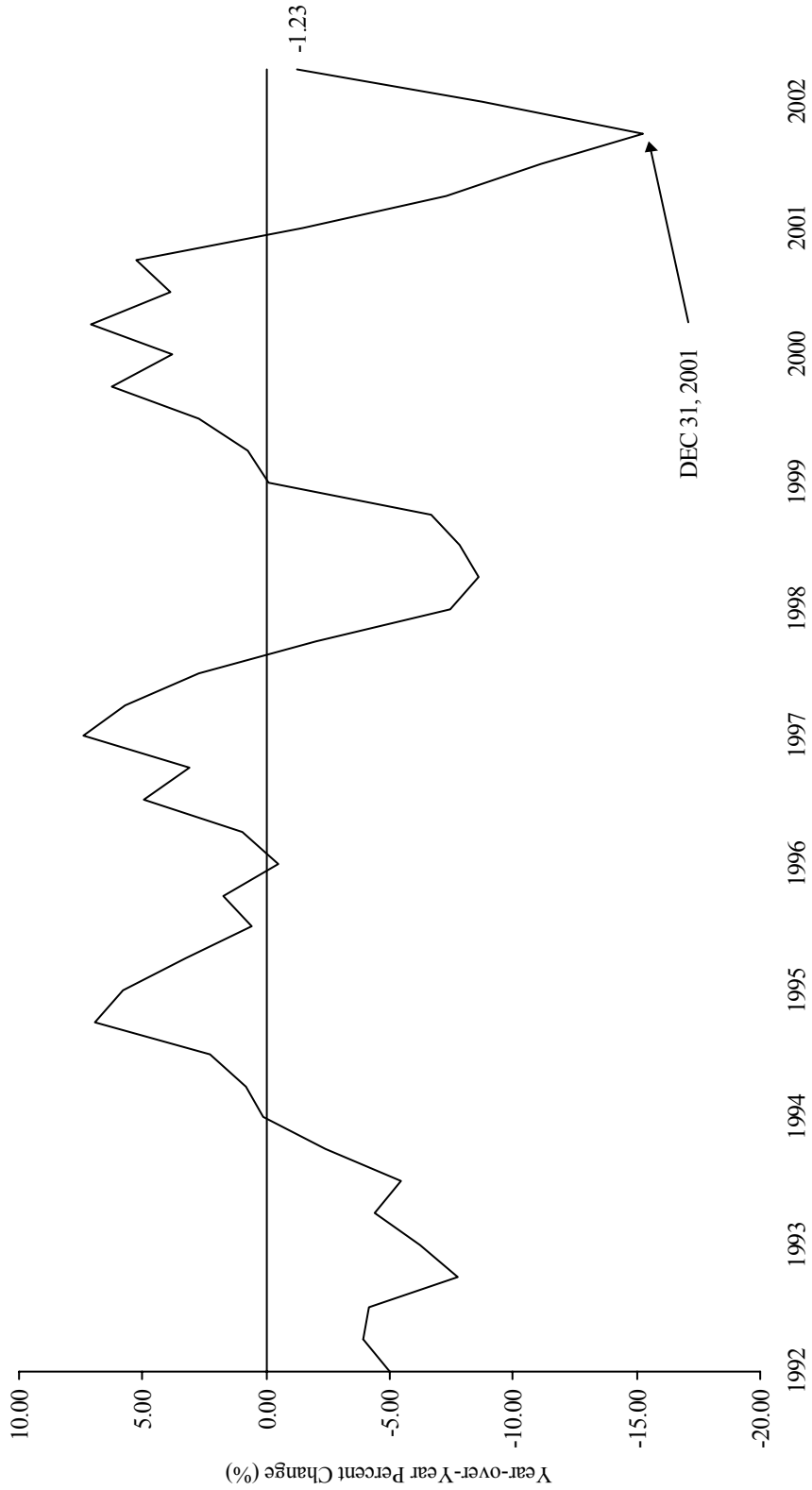
Until the government begins to confront the root causes of structural deflation, Japan's deflation will continue to savage the net worth of banks and their depositors. The dynamics of the deflationary process have unleashed a vicious cycle whereby falling prices pressure corporate profits, which force firms to cut employment and wages, which in turn hurts household income and spending, which further reduces corporate sales, and so on. Structural deflation, at its most fundamental level, will remain entrenched until Japan begins to reallocate labor, production, and capital away from relying upon distorted pricing structures that were created by microeconomic industrial policies that protect inefficient industries and corporations.

Investors should not be lured into the market by a cherry-blossom moment of economic growth or announcement of structural reform. Rather, they should look for signs of a more enduring period of deflation, or the actual implementation of meaningful government reform. Given the government's aversion to reform, it is unlikely to make serious inroads into eliminating deflation or creating an environment that is conducive to corporate earnings growth in the near term. As a consequence, the risks to Japanese equities remain on the downside, though there are individual opportunities in the market. We continue to encourage investors to seek out managers oriented toward bottom-up stock selection, while avoiding those whose portfolios reflect the composition of the index.

Table A

JAPAN INDUSTRIAL PRODUCTION

1992-2002



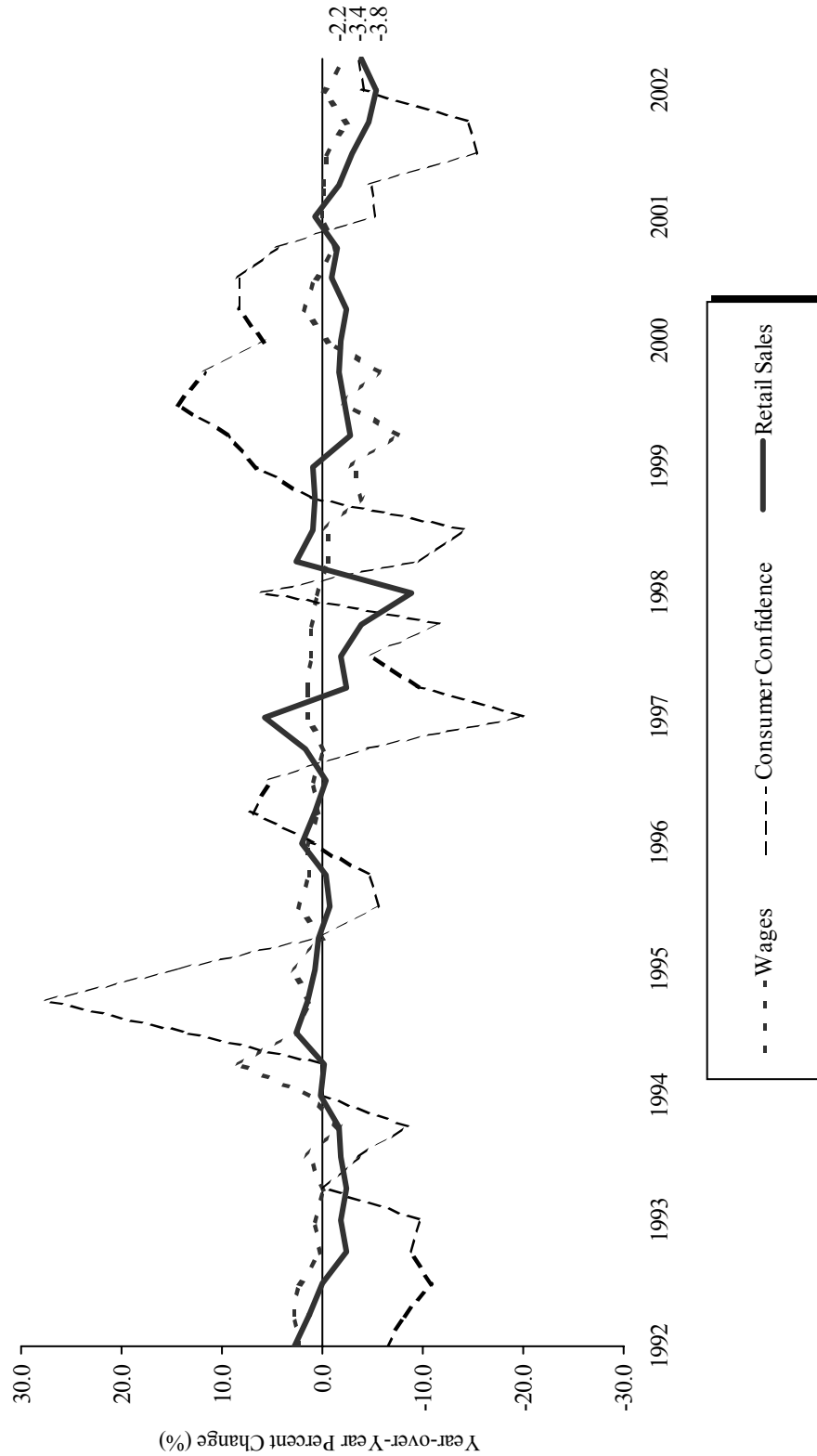
Source: Thomson Datastream.

Notes: Data are as of June 30, 2002. Industrial production represents mining and manufacturing production.

Table B

WAGES, CONSUMER CONFIDENCE AND RETAIL SALES

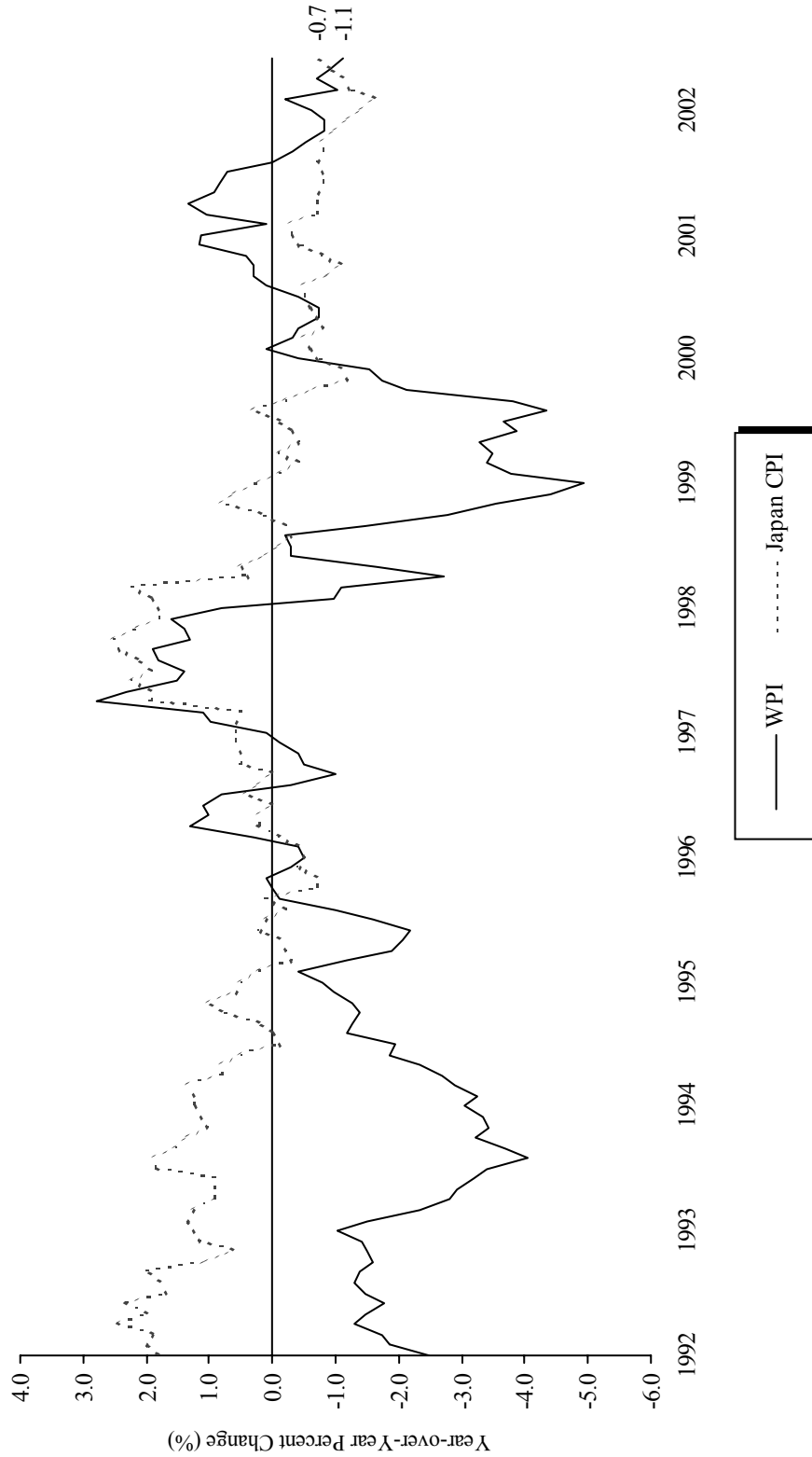
January 1, 1992 - June 30, 2002



Source: Thomson Datastream.

Table C
WHOLESALE PRICE INDEX AND JAPANESE CONSUMER PRICE INDEX

1992-2002

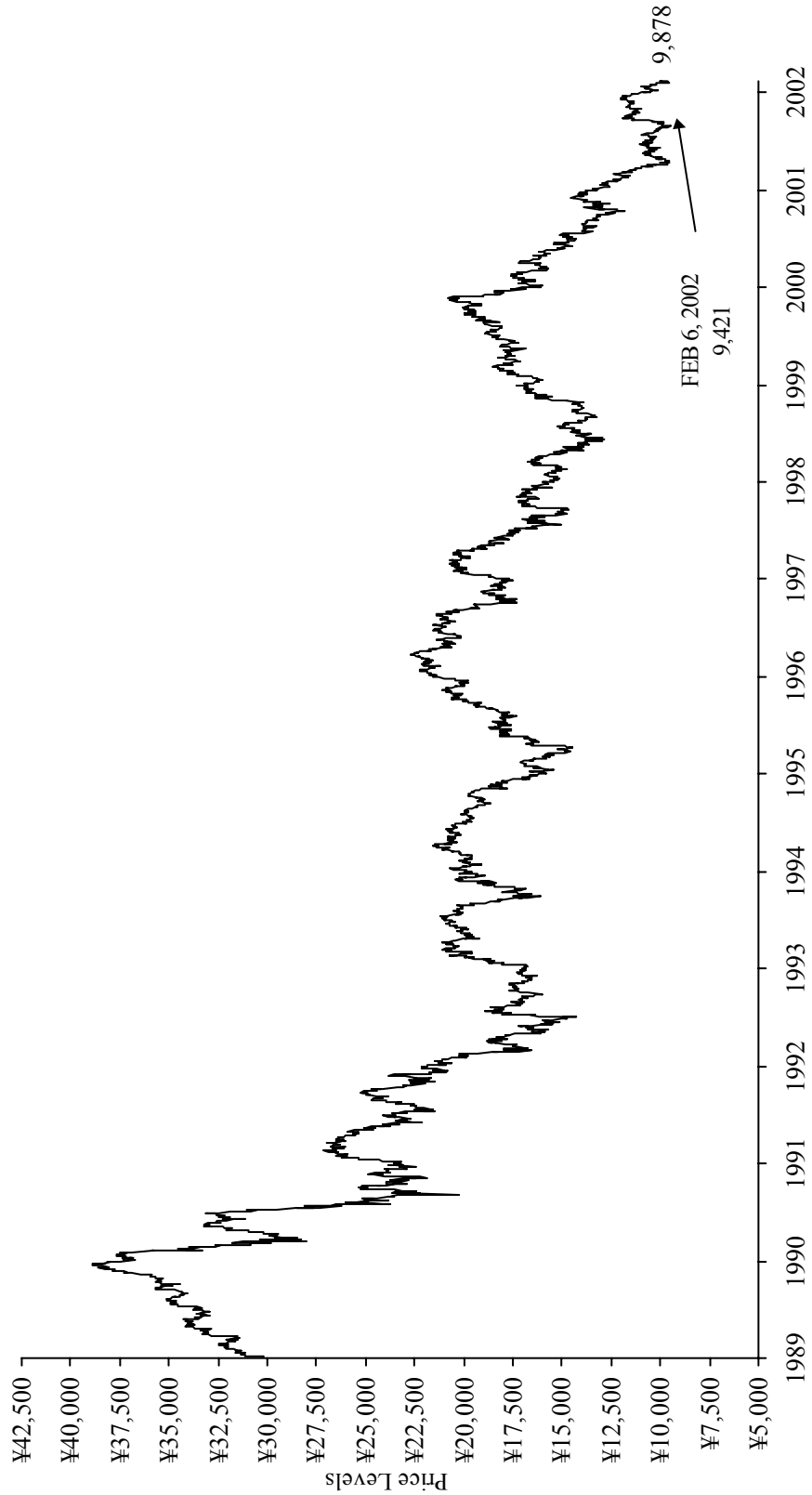


Source: Thomson Datastream.

Note: Data are as of June 30, 2002.

Table D
NIKKEI INDEX

January 1, 1989 - July 31, 2002

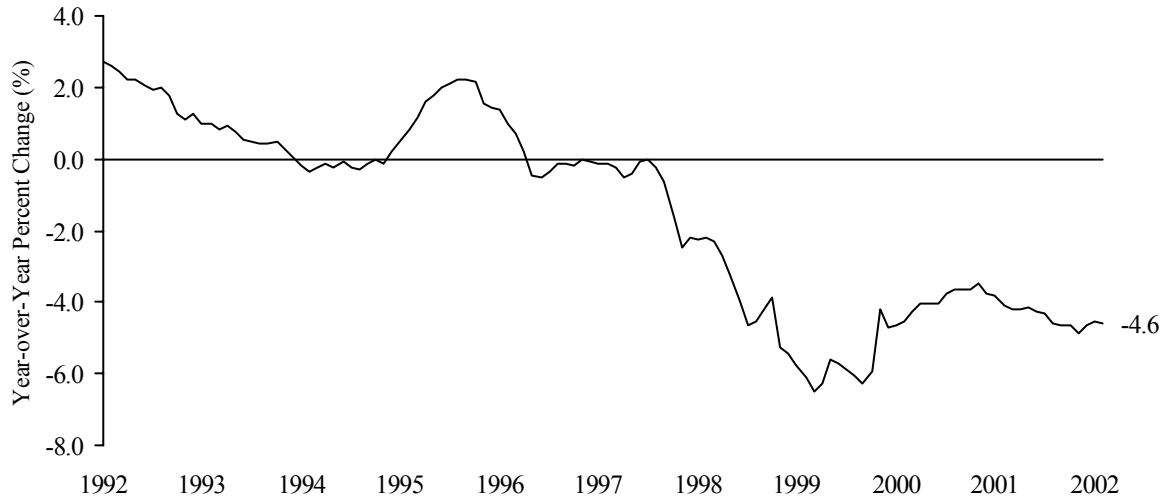


Source: Thomson Datastream.

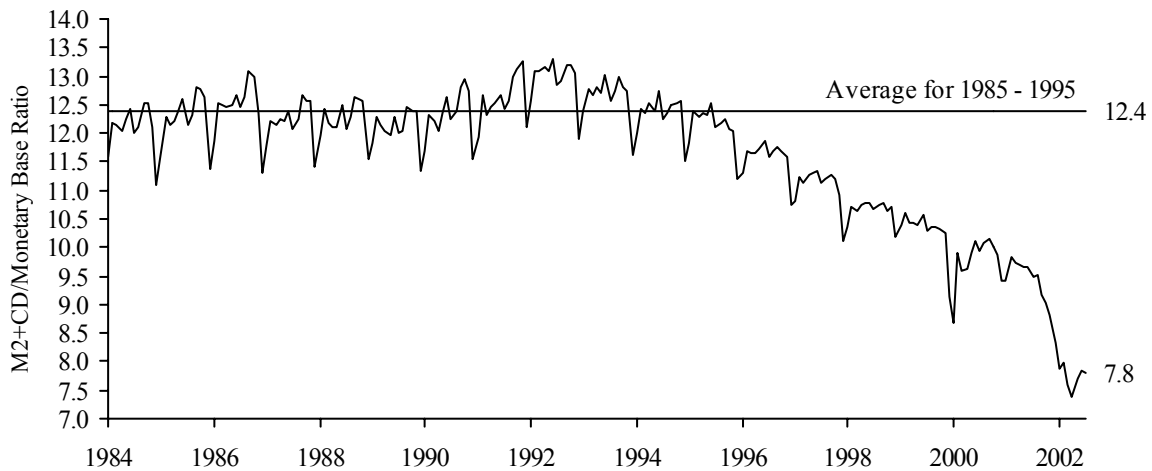
Table E

BANK LENDING AND CREDIT MULTIPLIER

Bank Lending (June 1, 1992 - July 31, 2002)



Credit Multiplier (January 1, 1984 - July 31, 2002)



Sources: Bank of Japan, Morgan Stanley Research, and Thomson Datastream.

Note: The money supply M2+CD used to calculate the credit multiplier (M2+CD/Monetary Base) is not seasonally adjusted.