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GLOBAL MARKET COMMENT: JAPAN—WHEN SHOULD YOU BECOME BULLISH?

April 30, 2001

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Japan - When Should You Become Bullish?

Following the end of the Japanese fiscal year on March 31, money managers are again cranking up their seasonal sales pitch for Japanese equities. They argue that last year's drop in prices has made an already under-owned and undervalued market even cheaper, and that the government is finally grappling with genuine structural reform. This year, however, their conviction seems lukewarm, as if they are motivated more by fear of underperforming the EAFE benchmark (of which Japan is still the largest component, at 24%), rather than by market fundamentals. Although there may be faint stirrings of reform in Tokyo, the macro environment remains inhospitable for equity investors, appealing only to dyed-in-the-wool contrarians. As we have noted repeatedly in recent months, however, this environment is one in which managers with strong, bottom-up stock selection skills should find ample opportunities to add value.

An Inflection Point?

This latest flurry of interest in Japan is attributable to several factors. First, Japanese equities, long unloved and under-owned, returned -24.7% (US$) in the year ended April 30, making a relatively undervalued market even cheaper. According to I/B/E/S, Japan's current P/E ratio of 24.2 times 12-month forward earnings is the lowest ever recorded since the beginning of its Japanese coverage in January 1987. (See Table A. Note: the upper portion of the exhibit shows *trailing* 12-month P/Es.) Japan's current price-to-book ratio of 2.1 compares favorably with that of the United States (3.6) and Europe ex U.K. (3.2), while its price-to-cash ratio of 11.8 is on par with Europe ex U.K. (11.0) and below the United States (14.9). Second, after its first precipitous decline in 1990-92, the Japanese market has meandered within a trading range, with the Topix index periodically rallying to about 1,700 and then dropping back to about 1,200 (21,000 and 14,000 for the Nikkei 225). Since it is now selling again at a level from which it has repeatedly rallied—at least in part because the government has always responded to significant market weakness with stimulative measures—predicting an upturn seems like a reasonably safe bet (see Table B).

Third, momentum for reform may be building in Tokyo. In March, the Bank of Japan (BOJ) promised to shift from targeting interest rates to targeting excess reserves, effectively pushing interest rates back to zero. It also pledged to maintain this level of interest rates until core consumer price growth becomes positive. In April, the Japanese government announced an emergency economic package that declared a moratorium on bad debt, established a stock-purchase mechanism designed to expedite the unwinding of cross-holdings, and presented a structural reform outline for the securities market. Fourth, the new prime minister, Junichiro Koizumi, has been represented in the foreign press as a maverick

reformer who will challenge party elders, eliminate factionalism, control deficit spending, and pull the economy out of its crisis.

We'd Rather Muddle Through, Thanks

Investors should be cautious about reading too much into these reforms, however. First, zero interest rates are unlikely to encourage consumers to spend or borrow. Corporations and households have enjoyed zero interest rates for over two years, and lending activity has yet to increase. Technically insolvent banks are more interested in mending tattered balance sheets than in extending new loans, while corporations are concentrating on working off excess capacity, minimizing capital outlays, and struggling to maintain a positive cash flow. Second, the BOJ's plan does not qualify as "quantitative easing" in the textbook sense, because it does not involve the monetization of new fiscal expansion, nonsterilized yen-selling intervention, or intermediation for corporate financing. Rather than stimulating demand, the BOJ's actions will simply give the banks more breathing room by lowering reserve requirements. To be effective, monetary easing would have to be accompanied by the disposal of banks' non-performing loans and the resolution of corporate debt overhang.

Third, the emergency proposal, though immediately hailed as a landmark package, contains nothing new on structural change or deregulation. Instead, it underscores the government's preference to reduce the amount of debt rather than the number of companies. The plan addresses only non-performing loans that major banks had extended to companies in serious risk of bankruptcy, while neglecting their loans to the large number of other seriously indebted companies. Not only did the plan sidestep this more fundamental problem, it also failed to provide any subsequent resolution: simply removing bad loans from bank balance sheets does not result in the liquidation or reinvigoration of the debtors. Lastly, the plan allows restructured firms to receive new working capital loans, which will have the effect of continuing to shield them from market pressures. As long as Japan continues to allocate capital to unproductive enterprises that cannot earn a competitive return on investment, it will continue to squander resources. On the other hand, shooting the walking wounded would result in sharply higher unemployment, sharply lower living standards, and an even greater propensity for consumers to hoard rather than to spend their incomes. This is why, despite his rhetoric, Mr. Koizumi is unlikely to force through changes that could tip Japan into an economic abyss, even if he had the ability (which is also doubtful since he cannot govern without the support of factions unlikely to agree to any radical proposals—already, for example, he has backed away from his long-standing pledge to privatize the postal service).

A final reason to question the prospects for reform is the enduring sense of complacency among the bulk of the populace. Although real GDP could fall 0.1% this year, Mrs. Watanabe still has no sense of crisis. Low levels of equity ownership have kept consumers relatively immune from the ongoing travails of the stock market, and despite falling equity prices and deflationary pressures, Japanese consumers actually enjoy a better standard of living today than they did five or ten years ago. (Japan still accounts for 45% of the global consumption of luxury goods.) Near a record high, unemployment has not exceeded 5%, and household spending remains steady (see Table C). The sense of crisis seems to be centered primarily in Japan's financial services industry and among foreign investors. This makes us skeptical of foreign money managers' assertions that fundamental change is inevitable because things cannot get much worse. Indeed, the burden of proof falls on Japan's bulls to explain why the economy and equities will not simply muddle along for another decade or so. Without a deeper sense of crisis, it seems unreasonable to expect Japanese officials to adopt drastic reforms likely to alienate the electorate.

A Wish List for Reform

Japanese equities could well rally sharply this summer. However, we doubt any such rally would transmute into a new bull market unless and until the government implements structural change along the following lines:

- Banks must foreclose on the worst borrowers and refuse to extend loans to incorrigible debtors, which involves actual bankruptcy of weak borrowers and the liquidation of their collateral in open auction. Because the bad debt problem cannot be resolved through improved write-offs alone, the government must create incentives for banks to put companies into bankruptcies or force mergers among them. Structural reform demands that industries be reorganized through deregulation.
- Capital markets must pressure companies to maximize shareholder returns, whether through foreign takeovers, buybacks, or sales of cross-holdings.
- The government should adopt measures to stimulate domestic activity and encourage international investment. This could occur by dramatically depreciating the yen, though this may prompt other Asian countries, especially China, to initiate a cycle of competitive devaluation.

While the macro environment is unsupportive, investors can still find some attractive bottom-up stories in Japan. Many firms are repairing their balance sheets; some possess valuable cross-holdings or unrecognized assets; and some are able to exploit current conditions to the detriment of less adaptable competitors. Although the market as a whole may remain in the doldrums until a full-blown crisis forces

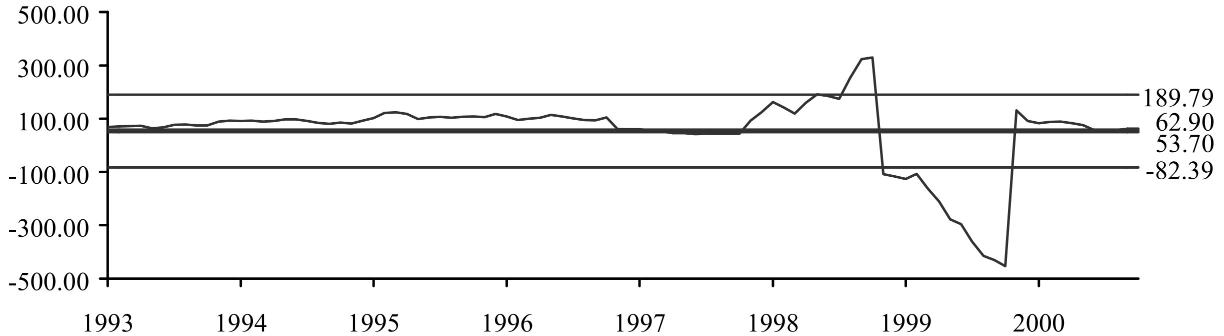
the resolution of underlying problems, opportunistic managers able to identify these situations are most likely to add value. In addition, we would be particularly interested in exploring ways to invest in two developments that seem inevitable: rising inflation and a weaker yen. The structural problems presented by Japan's excess capacity, surplus savings, and debt overhang can only be resolved through deflationary purging or inflationary monetization. The latter, however, unpalatable, is certainly preferable to the former—and its corrosive effects can be more easily concealed from the electorate. Because the liquidation of Japan's excess capacity and rotten loans would result in rising unemployment and the risk of an economic depression, we doubt the authorities will pursue that option, preferring to inflate their way out of trouble gradually and unobtrusively. This should result, however, in a steady weakening of the yen and a steady rise in the value of hard assets.

Table A

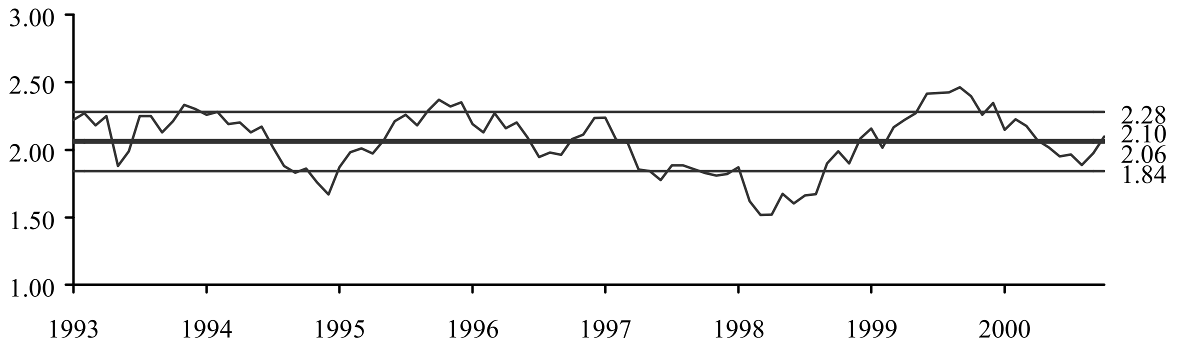
MSCI JAPAN VALUATIONS

July 31, 1993 - April 30, 2001

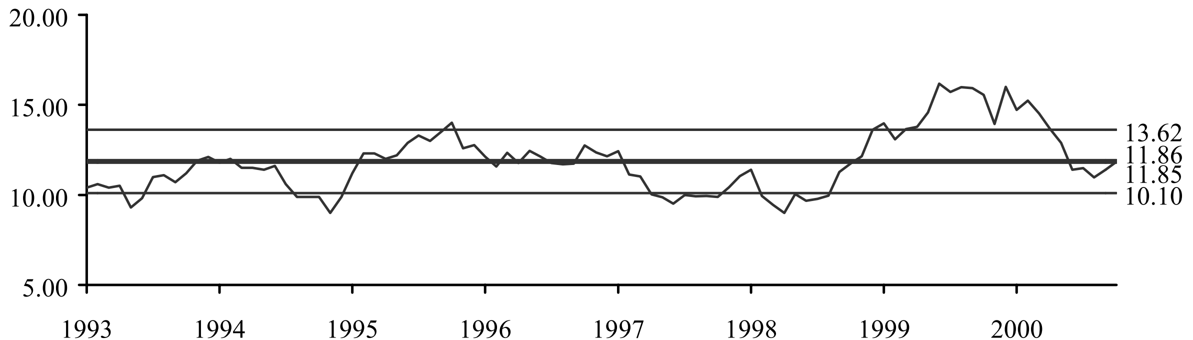
Price-Earnings



Price-to-Book



Price-to-Cash



Mean
One Standard Deviation

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

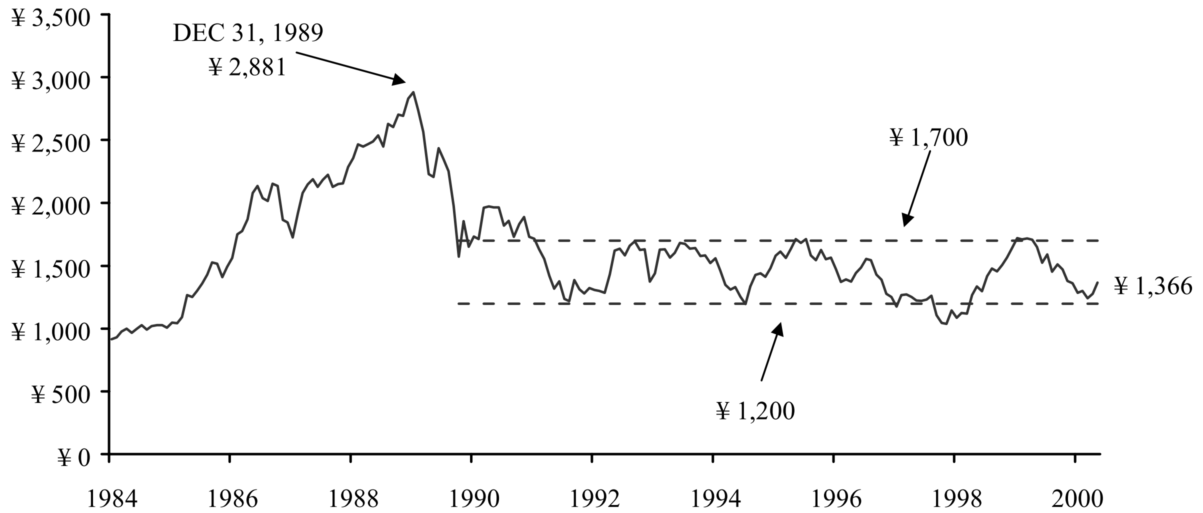
Note: Price-earnings ratio is calculated using trailing earnings.

Table B

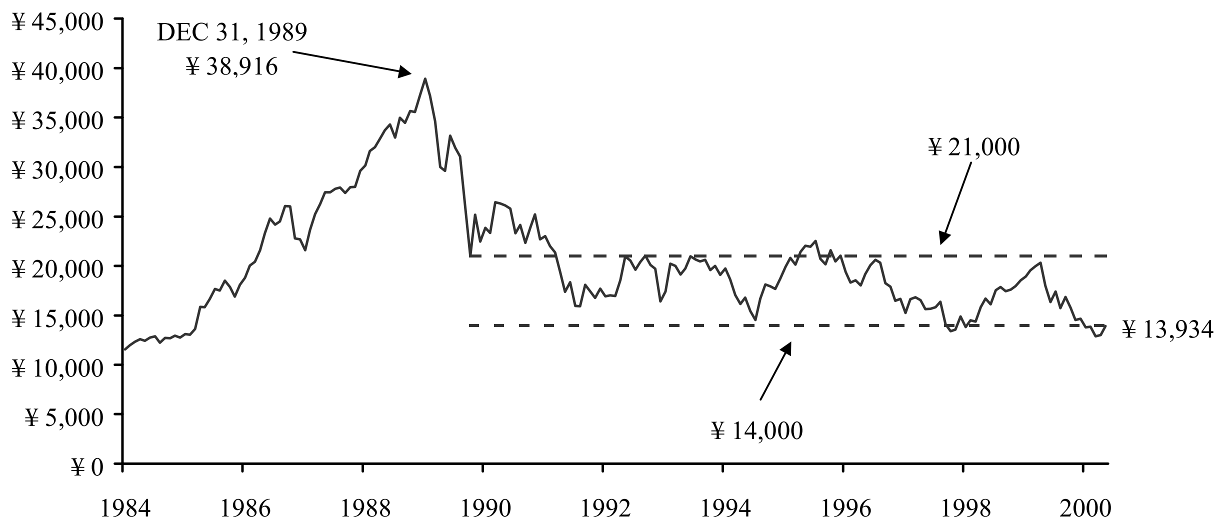
HISTORICAL PRICE LEVELS OF THE NIKKEI 225 AVERAGE AND TOPIX

December 31, 1984 - April 30, 2001

Topix



Nikkei 225

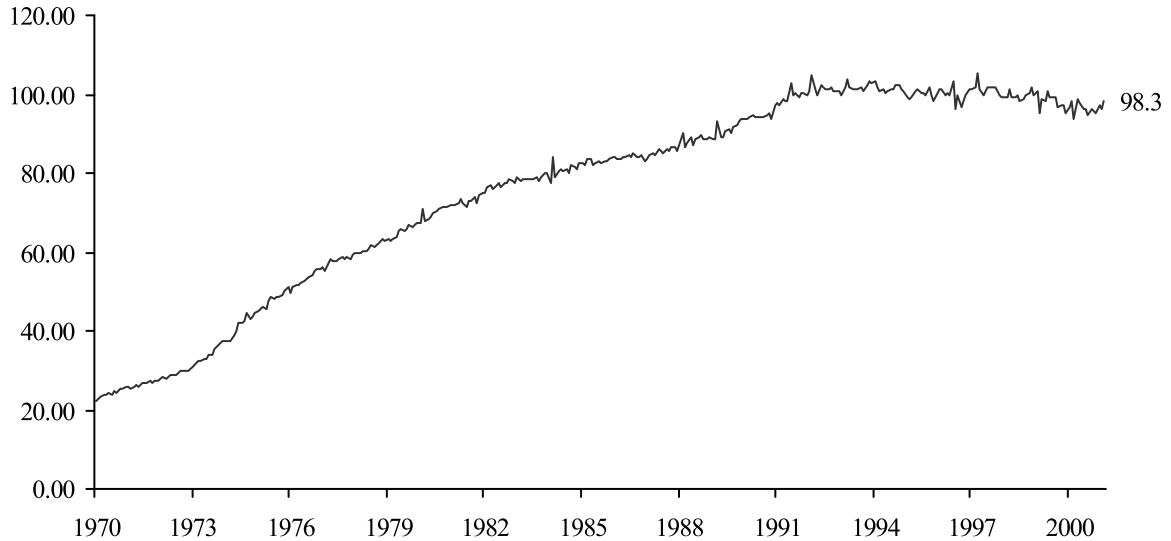


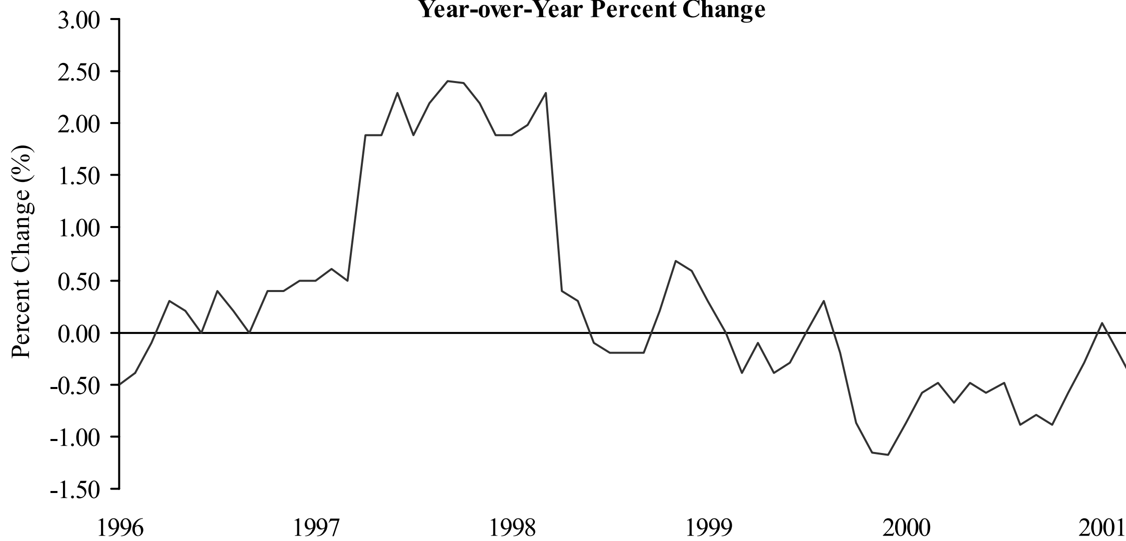
Source: Datastream International.

Table C

JAPANESE HOUSEHOLD LIVING EXPENDITURES INDEX AND CONSUMER PRICE INDEX

January 31, 1970 - February 28, 2001





Source: Datastream International.

Notes: Both the Household Living Expenditures Index and Consumer Price Index are based on seasonally adjusted prices. Consumer Price Index data from January 31, 1996 through March 31, 2001.