

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: JAPANESE EQUITIES: GETTING INTERESTING

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Japanese Equities Getting Interesting

One of the more striking reactions to the nationalization of Resona, Japan's fifth largest bank, is absence of outrage. In the past, whenever the Japanese authorities delayed implementing a tough-minded reform, or bailed out a bankrupt supermarket or retail chain, foreign investors would squawk that the government had reneged on its promise to promote structural reform. In notable contrast, the de facto nationalization of Resona Bank was for the most part greeted with a weary sigh of resignation. While bank shares fell sharply in the immediate aftermath, the Tokyo Stock Exchange (TSE) and Nikkei 225 Average shed only around 1%, a normal trading day by their standards, and bounced back in the succeeding days.

The market's relative resilience in the face of bad news underscores how pessimistic investors have become about Japan. Pronounced pessimism was also on display during the month when the Bank of Japan announced plans to buy asset-backed securities from small and medium enterprises and when the Industrial Revitalization Corporation of Japan (IRCJ) is officially launched (the IRCJ is intended to transform nonperforming loans for financially troubled companies into productive capital). The markets responded indifferently, with the TSE returning 1.1% and the Nikkei, -1.8% for the month.

As Cold and Bitter As Yesterday's Tea

Most surprisingly, perhaps, even equity analysts appear to be withering under the firehose of negative news. Although a few incorrigible optimists repeat their mantra that it's time to back up the truck, the cheerleading has definitely died down, and recent analysis seems to accentuate the negative. Pity the poor analyst who has run out of ways to torture the data. For example, while real GDP is currently enjoying something of a cyclical bounce, growing 2.5% on a year-over-year basis over last two quarters (see Table A), a growing number of pundits seem to believe it won't last. According to them, export growth—the economic driver in 2002—will soon taper off under the pressure of persistent global weakness. They also downplay the relative vigor in domestic demand, with at least one prominent economist arguing that the rising propensity to consume merely shows that consumers are trying to maintain their standard of living in the face of their sliding income (see Table A).

This is not to say that pundits *should* be cheery. This is Japan, after all, where traditional transmission routes of money policy remain ensnared in a dysfunctional financial system. Deflation is firmly entrenched, "eroding prices for goods and services at an annual rate of 1% to 5%, depending on whose data you believe" (*Forbes*, May 26, 2003), banks may be approaching yet another crisis, credit creation is weak, and the over-extended remain over-extended (see Table B).

A Confluence of Negatives

However, as *Forbes* and others point out, the bad news seems pretty well discounted—and perhaps then some—by the stock market, which has fallen over 50% in just three years, while more than half of all Japanese equities (*Forbes* estimates 60%) now have market capitalizations lower than their asset values.

In addition, sentiment has fallen to multi-year lows at the same time equities have become cheaper than they have been in at least 20 to 30 years (see Tables C-F). The ratio of the total market capitalization of the TSE to Japan's real GDP has fallen to 0.42, the lowest since the inception of such data in 1989, and in marked contrast to the United States, where this ratio is 0.82. In addition, the price-to-book (P/B) ratio of MSCI Japan has fallen to a record low of 1.2, one standard deviation below its post 1974-mean of 2.4. Its price-to-cash earnings (P/CE) ratio has dropped to a 20-year low of 8.0, while its dividend yield has returned to its post-1974 average of 1.2. We give more importance to these three metrics relative to price-to-earnings and return-on-equity because with aggregate earnings in negative territory such measures have little value.

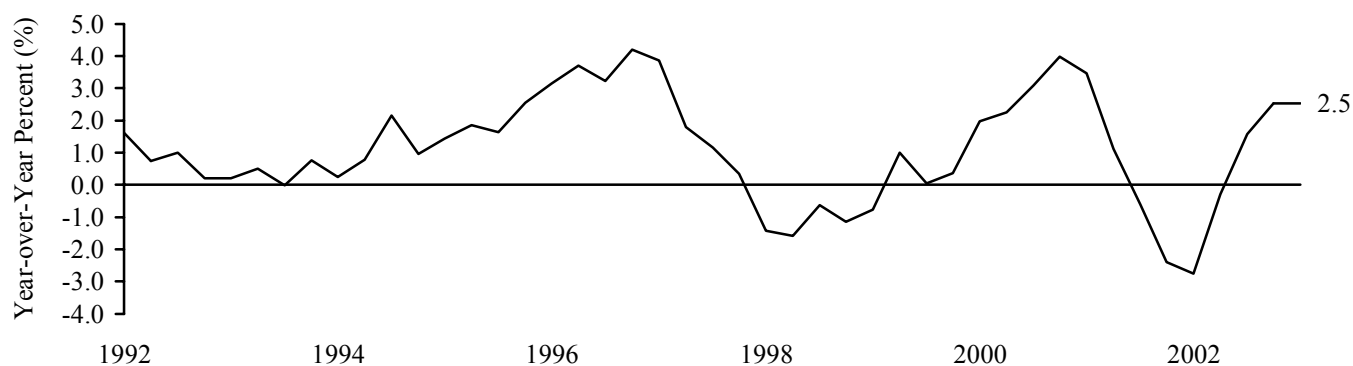
Japan's P/B and P/CE ratios have also reached near-record lows relative to those of the MSCI EAFE Index (which includes Japan). The P/B ratio of Japan/EAFE is now 0.7, only slightly above the record low of 0.6 established in 1998, while the current relative P/CE metric is equivalent to its 23-year low.

Relative to the S&P 500, MSCI Japan's P/B has fallen to 29-year lows, more than one standard deviation below its post-1974 mean of 1.2. Relative dividend yields have risen to 0.7, only slightly below the 0.8 post-1974 record set in December 1998.

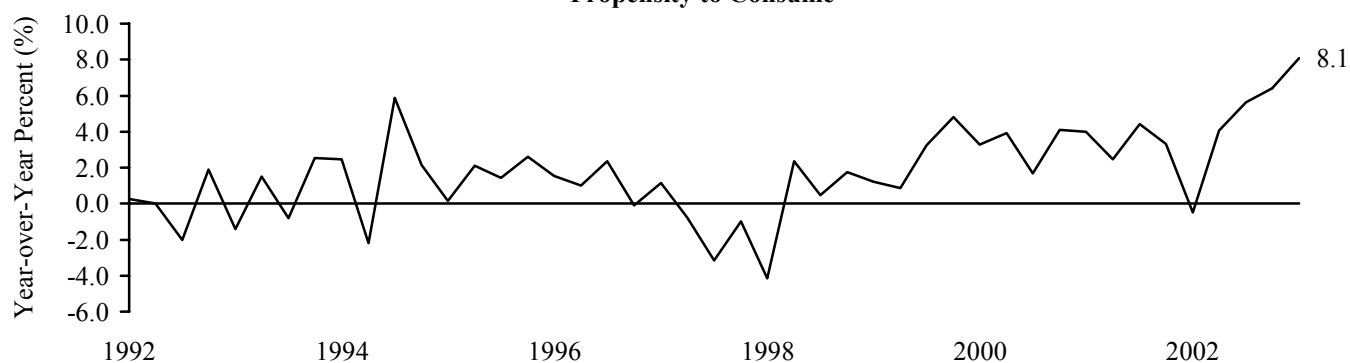
The combination of pervasive gloom, low expectations, relatively attractive valuations, and a refusal to acknowledge the positive changes that are occurring (albeit slowly) in Japan has begun to whet our appetite for Japanese equities. We would certainly recommend against underweighting and would encourage investors to look closely at how they might effectively implement overweight allocations with managers in whom they have confidence. We continue to encourage investors to seek out managers with strong fundamental research and stock-selection capabilities, while avoiding those whose portfolios reflect the composition of the index.

Table A
MACROECONOMIC INDICATORS
1992-2003

Japanese Real Gross Domestic Product



Propensity to Consume

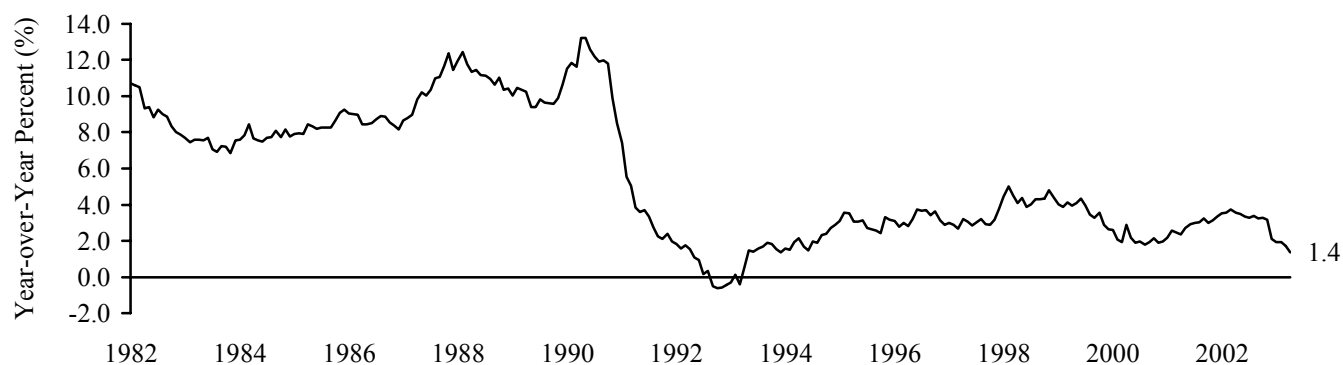
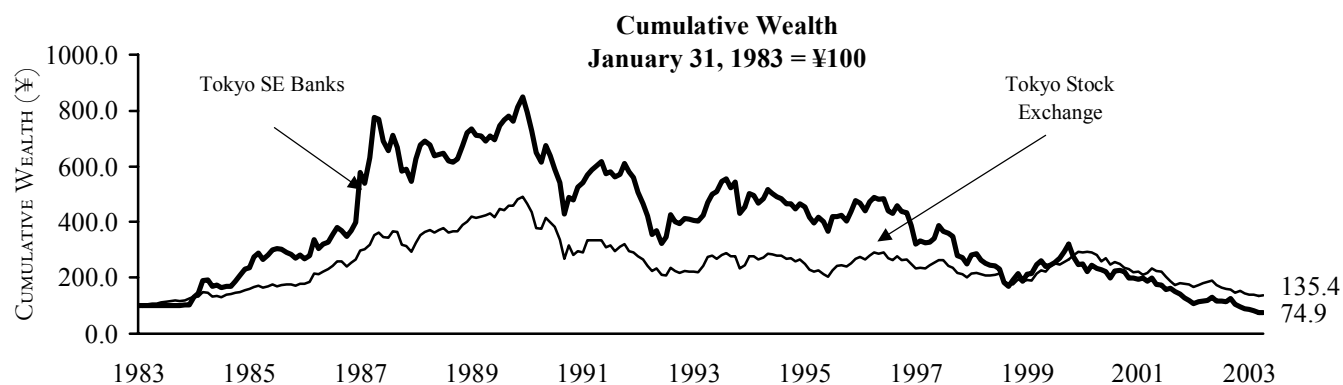
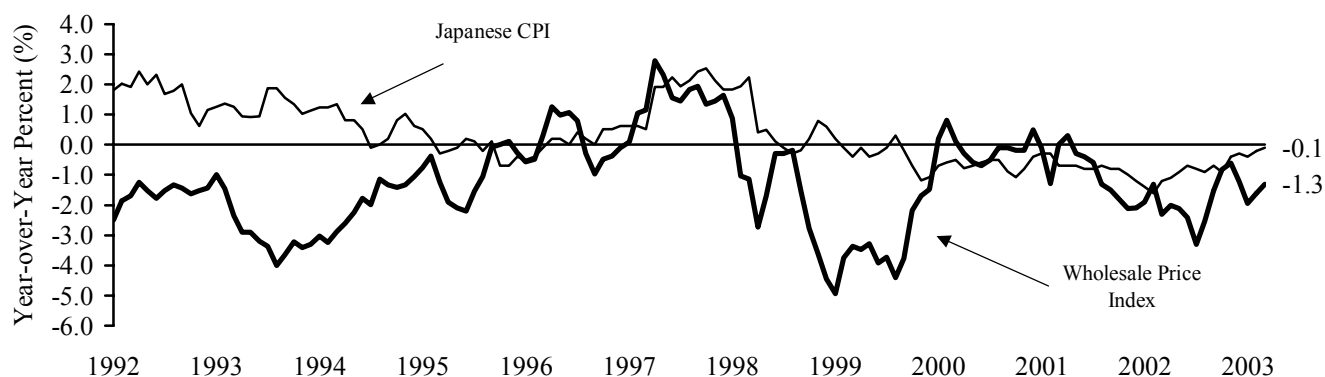


Worker's Household Savings as Percentage of Disposable Income
1988-2003



Source: Thomson Datastream.

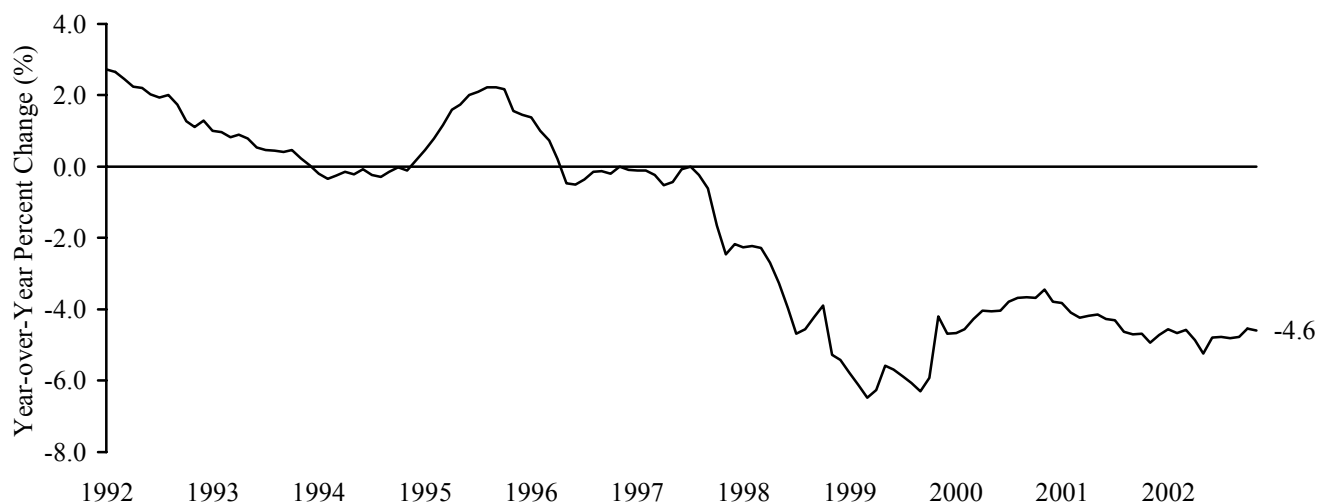
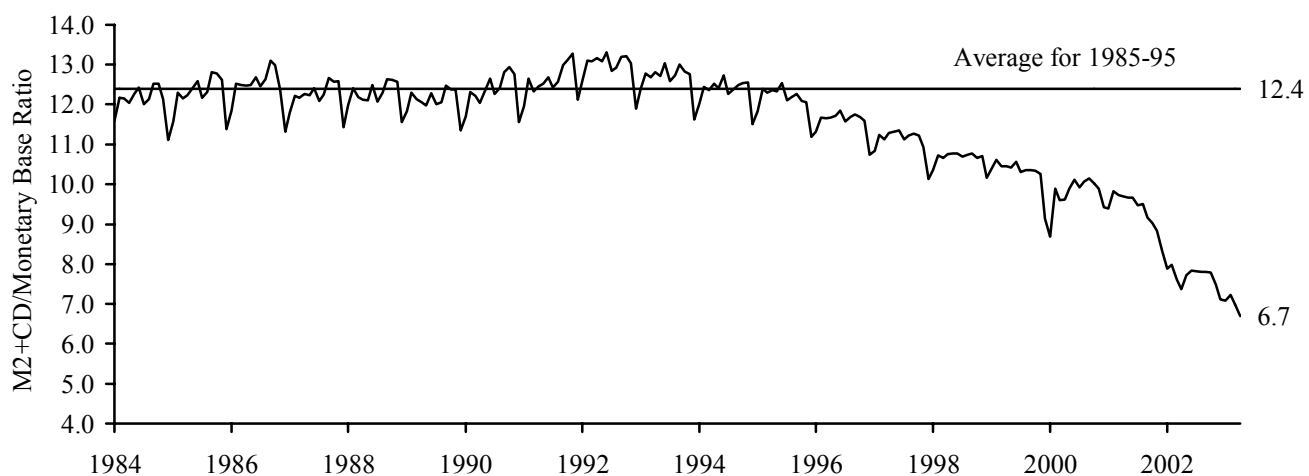
Notes: Data for 2003 are as of March 31. Japanese Real GDP data are seasonally adjusted. Propensity to consume is defined as Japanese personal consumption expenditure as percentage of disposable income. Personal consumption expenditure is in real terms and seasonally adjusted. Disposable income data are in nominal terms and not seasonally adjusted. Worker's household savings data are nominal and not seasonally adjusted.

Table B**FINANCIAL INDICATORS****Japanese Money Supply: M2 Plus CD
January 1, 1982 - April 30, 2003****Japanese Banking Sector and the Tokyo Stock Exchange Cumulative Wealth
February 1, 1983 - April 30, 2003****Wholesale Price Index and Japanese Consumer Price Index
1992-2003**

Source: Thomson Datastream.

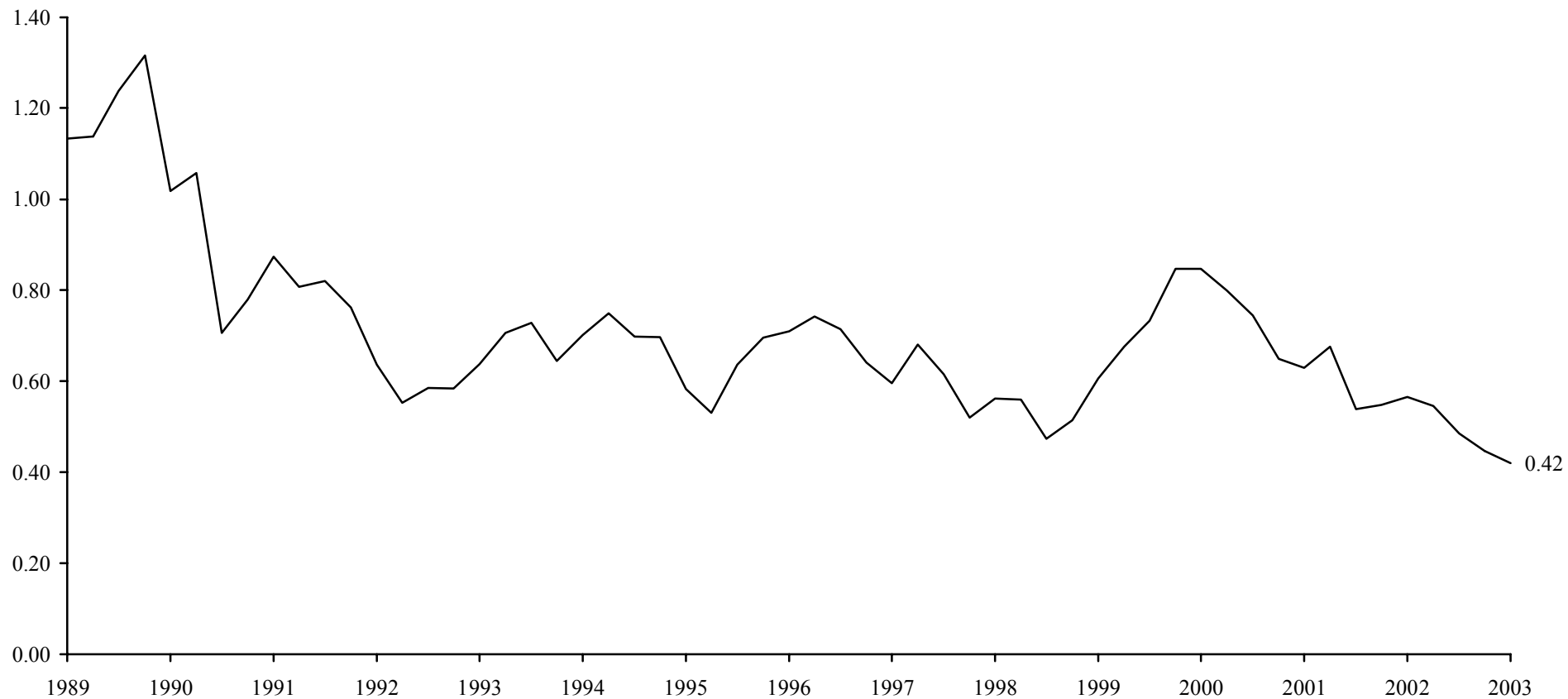
Notes: Japanese money supply are not seasonally adjusted and represent the year-over-year percent changes in monthly money supply M2+CD. Wholesale price index and Japanese consumer price index data are as of March 31, 2003.

Table B (continued)

BANK LENDING AND CREDIT MULTIPLIER**Bank Lending (June 1, 1992 - April 30, 2003)****Credit Multiplier (January 1, 1984 - April 30, 2003)**

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.

Table C**RATIO OF TOKYO STOCK EXCHANGE MARKET VALUE TO JAPANESE REAL GROSS DOMESTIC PRODUCT****First Quarter 1989 - First Quarter 2003**

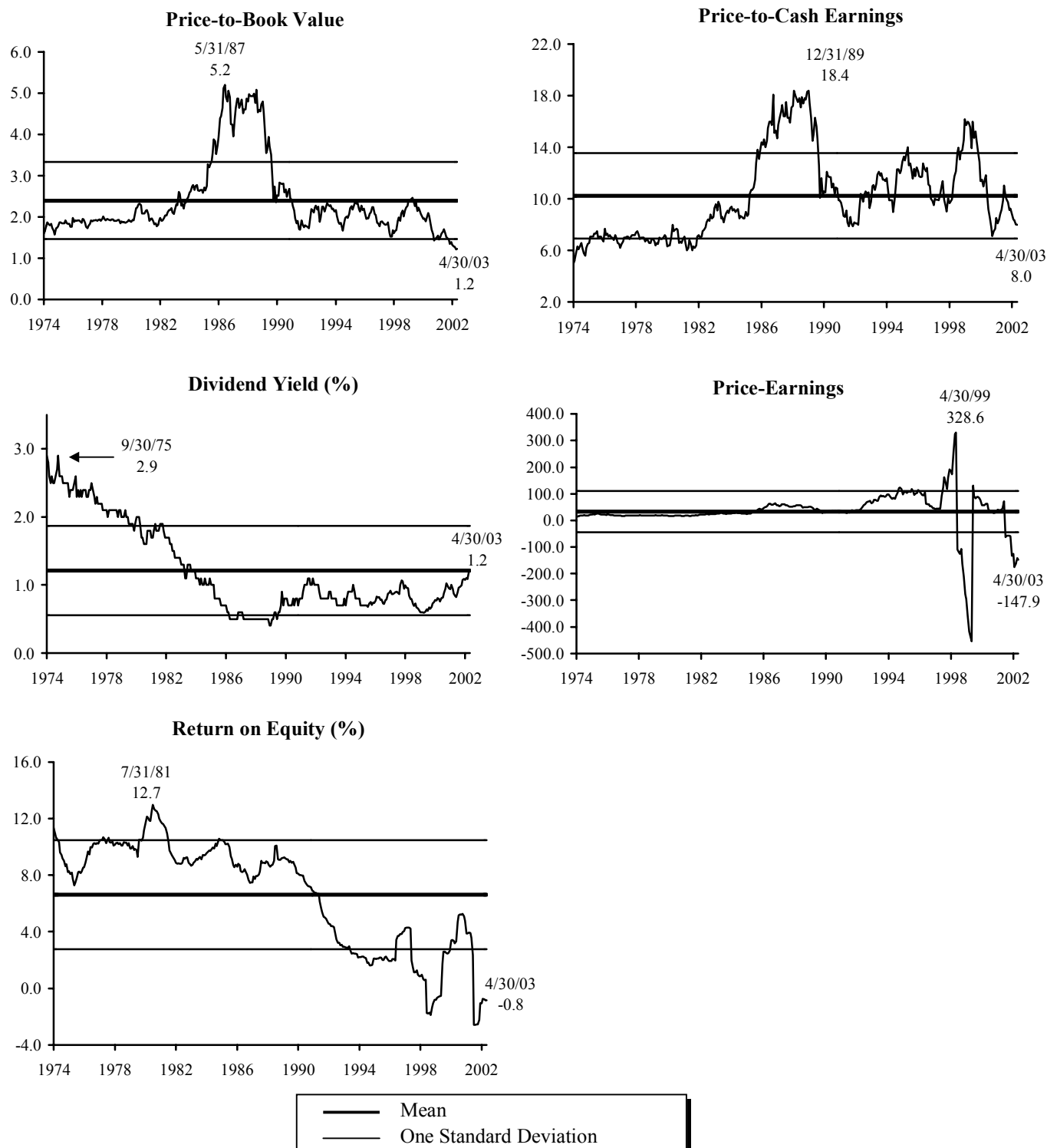
Source: Thomson Datastream.

Note: Japanese real gross domestic product data are seasonally adjusted.

Table D

MSCI JAPAN VALUATIONS

December 31, 1974 - April 30, 2003



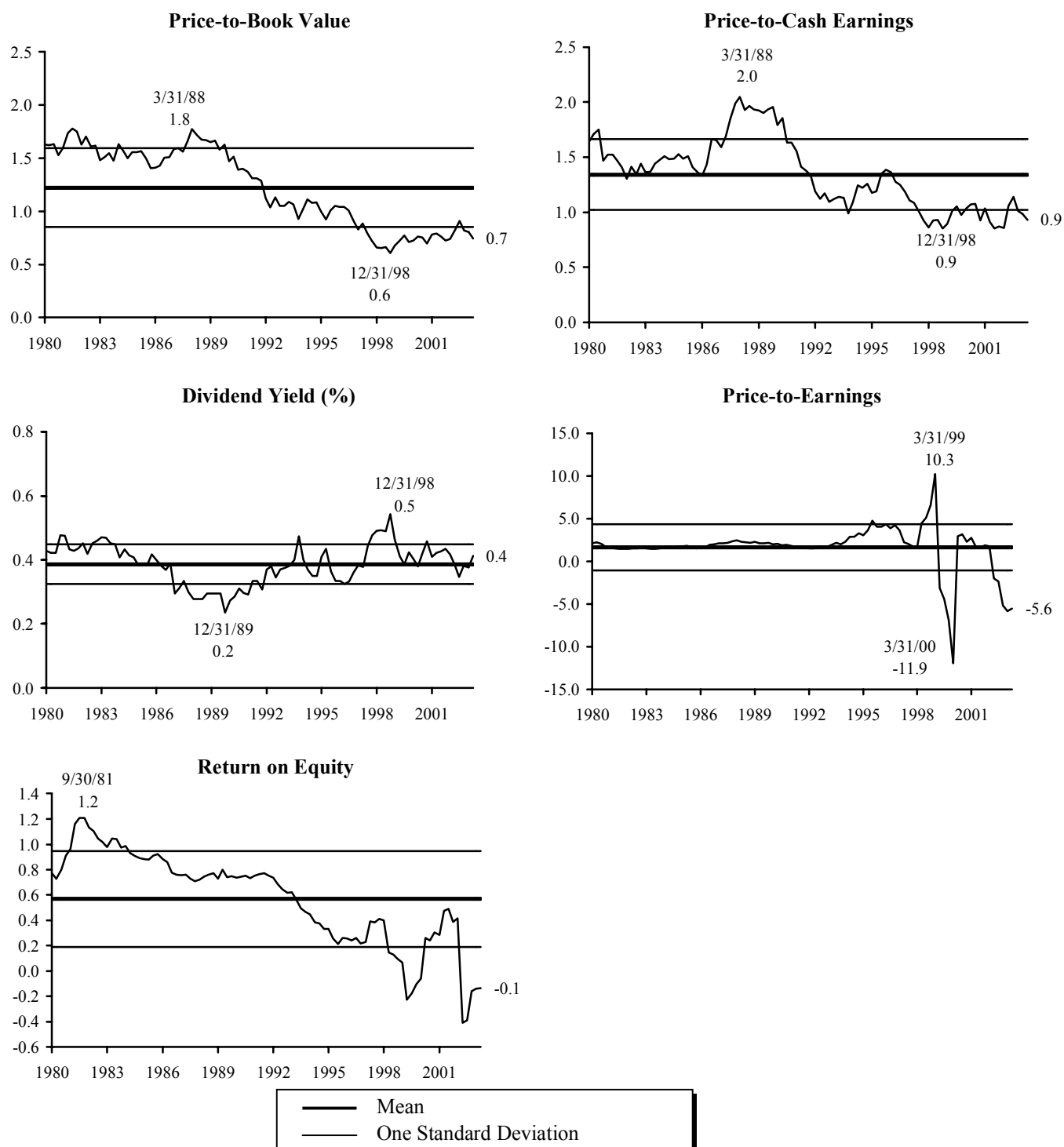
Source: Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: ROE is the earnings per share divided by the book value per share.

Table E

MSCI JAPAN VALUATIONS RELATIVE TO MSCI EAFE

March 31, 1980 - April 30, 2003



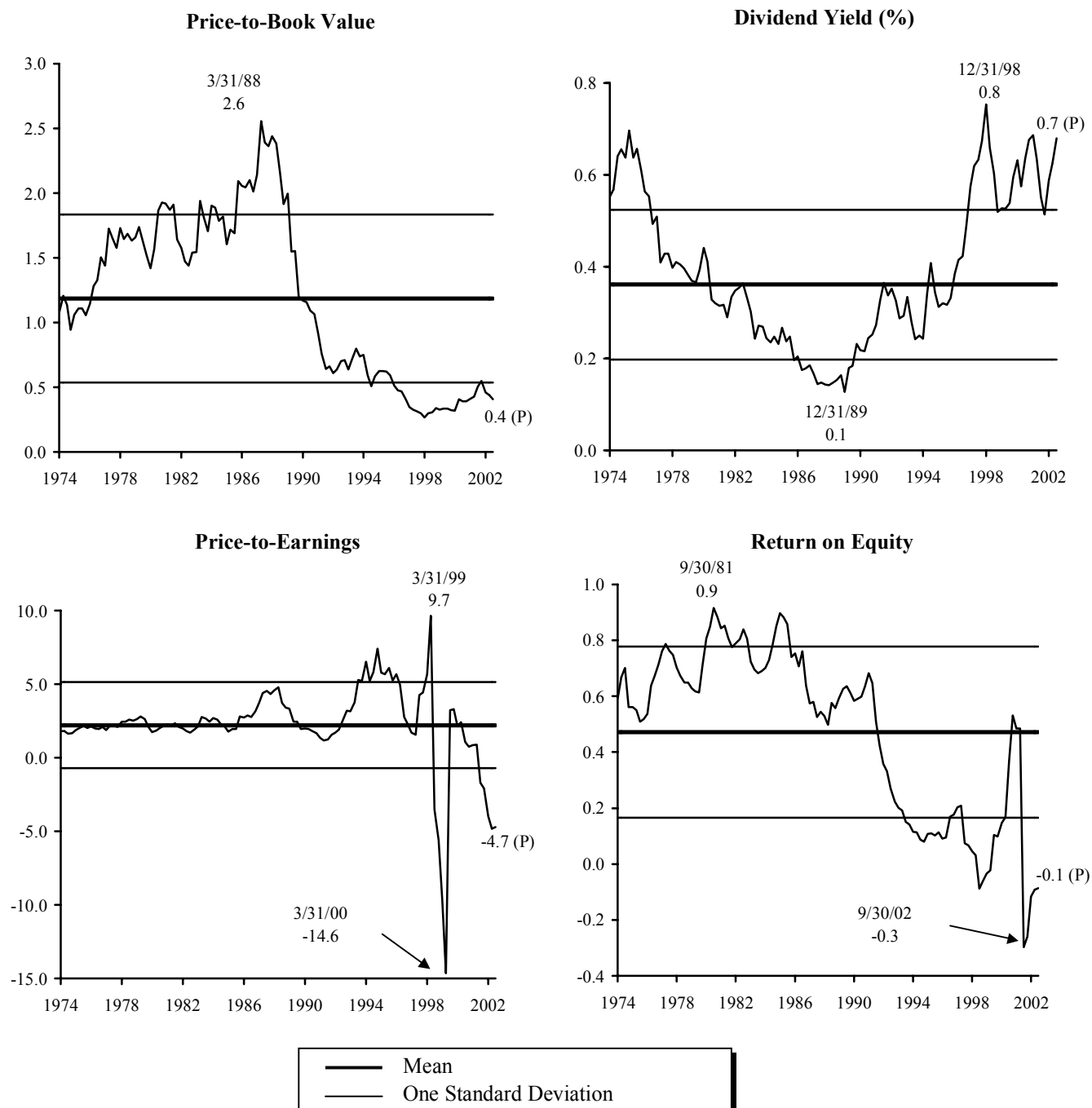
Source: Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: ROE is the earnings per share divided by the book value per share.

Table F

MSCI JAPAN VALUATIONS RELATIVE TO S&P 500

December 31, 1974 - April 30, 2003



Sources: Standard & Poor's, Standard & Poor's Compustat, and Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: (P) Preliminary. ROE is the earnings per share divided by the book value per share.