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GLOBAL MARKET COMMENT

WHAT SHOULD WE DO ABOUT THE JAPANESE EQUITY RALLY?

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What Should We Do About the Japanese Equity Rally?

An unprecedented buying spree by overseas investors has powered the most explosive rally in Japanese equities in the post-bubble era. Is this the Big One—the long-awaited end of the bear market in Japanese equities—or essentially a replay of past equity rallies that ended up fizzling instead of dazzling?

Weighing the Positives and Negatives

The critical question, as it has been in prior abortive economic recoveries, is whether stirrings of activity will kindle domestic demand. Unlike past upturns, government spending has played no (discernable) role in fueling the economy's recent growth. Real GDP expanded at a 3.9% annualized pace in the second quarter, boosted by the twin engines of private investment and net exports, while aggressive restructuring at the corporate level has propelled operating profits to record high growth rates. Furthermore, prices appear to have ceased falling, prompting some fast-acting pundits to predict the end of deflation.

However, the long-familiar litany of ills threatens to extinguish these glowing embers before domestic demand is ignited (see Tables A and B). Consumer spending remains flat, and deflation may prove more entrenched than hoped. Perhaps most troubling, the banking sector remains mired in a state of dysfunction. Bank loans are shrinking at a 5% pace, while the credit multiplier sinks ever lower. However, as the bulls correctly, though perhaps too stridently, point out, the level of nonperforming loans is dropping, the liquidation of cross-share equity holdings has apparently peaked, and banks have reported higher-than-expected core operating profits; since April, bank share prices have jumped 61.6%.

At the micro level, while profits have grown 13.6% for the year ended in the second quarter, there is an enormous performance gap between manufacturing and nonmanufacturing sectors, which posted earnings growth of 36.3% and 1.6%, respectively (see Table C). It is the manufacturing sector, particularly large companies, that is responsible for the cheerful headlines; it has been the driver of profit growth and capital investment, leading the way in cutting costs and reducing debt. Nonmanufacturing companies remain mired in excess debt and are the principal cause of shrinking bank loans. Corporations are flush with cash, though it is far from clear whether they will use it to reduce debt or increase capital expenditures, stock buybacks, or dividend payments.

How investors come down on the balance of economic improvements and ills should not depend on whether they prefer their glass half full or half empty. Investors *should* be skeptical about the sustainability of Japan's economic growth and structural reform, and they *should* poke holes in the paeans of the bulls. The current equity rally could be snuffed out by any number of risks: rising interest rates, the strengthening yen, a marked deterioration in global trade, or a downturn in U.S. equities. Prudent investors should assume structural reform will be a long slog marked with forward baby steps, giant-sized backward steps, but hopefully always with at least some frontward momentum. Despite this indeterminate and cynical interpretation of the macro-economy, however, Japanese equities should outperform over the long term simply because of their prices. Only a few months ago, the market was discounting Armageddon and equities were irresistibly cheap. Now, despite the dramatic run-up, equities in the aggregate remain inexpensive-to-fairly valued, while individual opportunities are ripe with even more potential.

The Year's Equity Rally—Too Fast, Too Furious…Too Late?

This year's four and a half month rally (up 45.0% over 104 days from April 28 to September 18) has been the most explosive in Japan's post-bubble era (see Table D). Since 1989, the Nikkei 225 has enjoyed five other 30%+ cyclical bull markets, on average climbing 45.6% over 193 days. The largest and longest rally occurred from January 1999 to April 2000 (325 days) when the Nikkei jumped 56.6%, while the smallest gain occurred between November 1993 and June 1994, up 34.1%. Against this 13-year backdrop, the current rally has already produced the average gain in half the time.

Despite already purchasing a post-bubble record amount of Japanese equities (see Table E), overseas investors still have the firepower to launch the next phase of a potential up-leg, as anecdotal evidence suggests that managers with a global mandate remain underweight Japanese equities relative to their benchmarks. A survey of 116 products of global ex U.S. equity managers in the Cambridge Associates' database indicates that on average they are underweight Japanese equities by 3.6 percentage points at the end of September (19.5% compared to Japan's 23.1% market cap weight in MSCI EAFE).

The most significant difference between the current and prior rallies is equity valuations. Despite this year's 45% run-up, Japanese equities still look inexpensive-to-fairly valued, particularly compared to other rallies in the post-bubble era (see Tables F and G). MSCI Japan is quite inexpensive based on the 28-year averages of its price-to-book (P/B) and price-to-cash earnings ratios. However, its dividend yield (DY) and price-to-earnings (P/E) suggest the index is roughly fairly valued. Similarly, compared to the S&P 500 Index, MSCI Japan is substantially inexpensive according to its P/B and DY measures, and fairly priced according to its P/E.

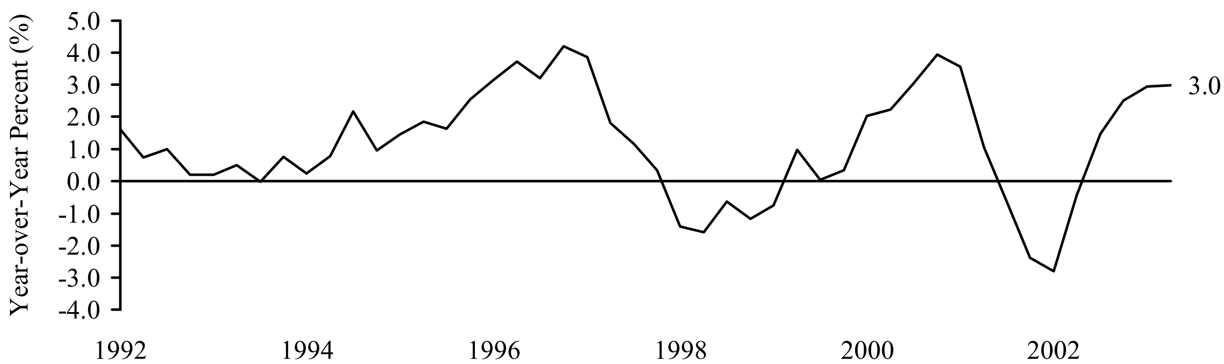
Whether or not this is the Big One or another sucker rally, investors should position their portfolios for the long haul, ensuring that they at least equal-weight the Japanese component of the benchmark. Not only do most valuation measures indicate that the Japanese equity market as a whole is inexpensive-to-fairly valued, there are many individual opportunities in what is essentially a dysfunctional economy. Japanese equities will most assuredly enjoy the tailwinds of continued economic growth, assuming domestic demand is sustainable. If the economy falls victim to one of its considerable risks, attractive valuations should limit downside risks, particularly for portfolios managed by investors skilled at bottom-up stock selection. Either way, don't neglect Japan.

Table A

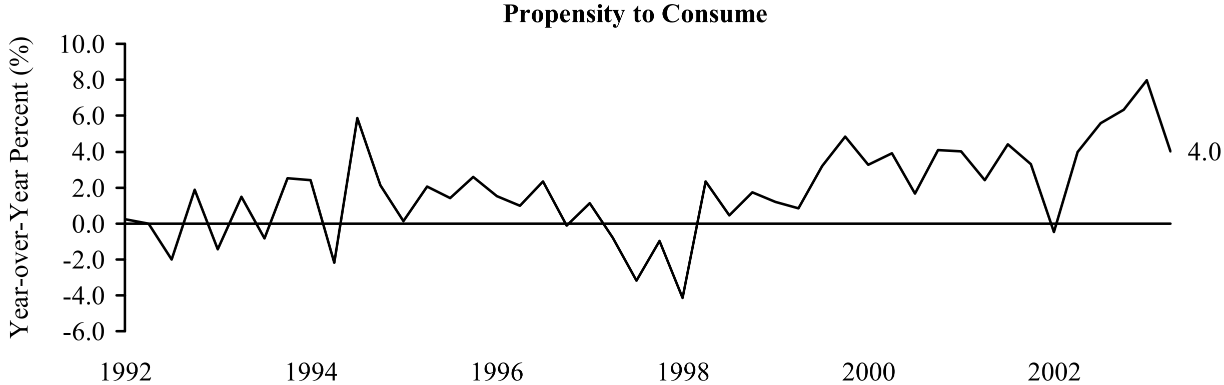
MACROECONOMIC INDICATORS

1992-2003

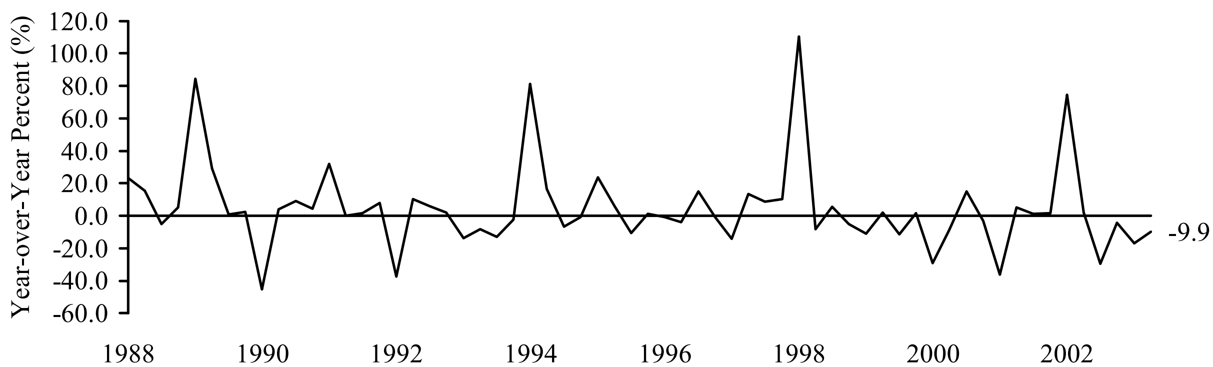
Japanese Real Gross Domestic Product



Propensity to Consume



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



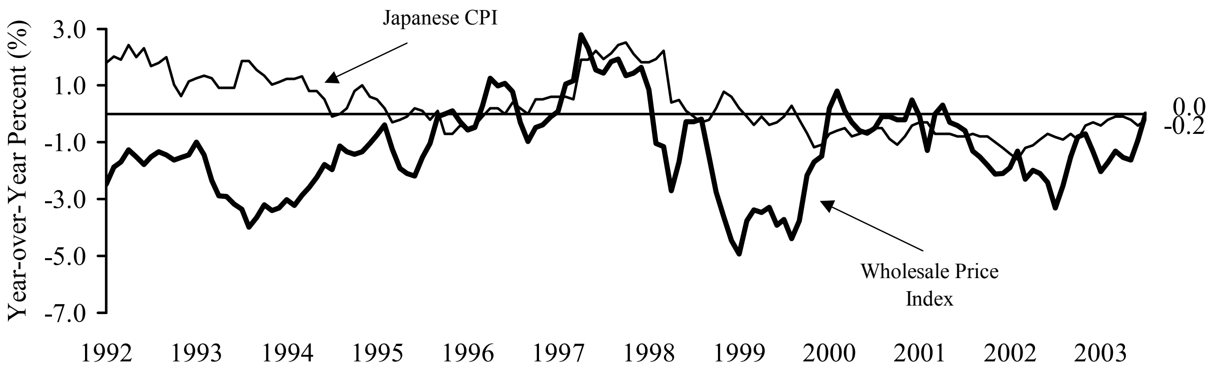
Source: Thomson Datastream.

Notes: Data for 2003 are as of June 30. 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.

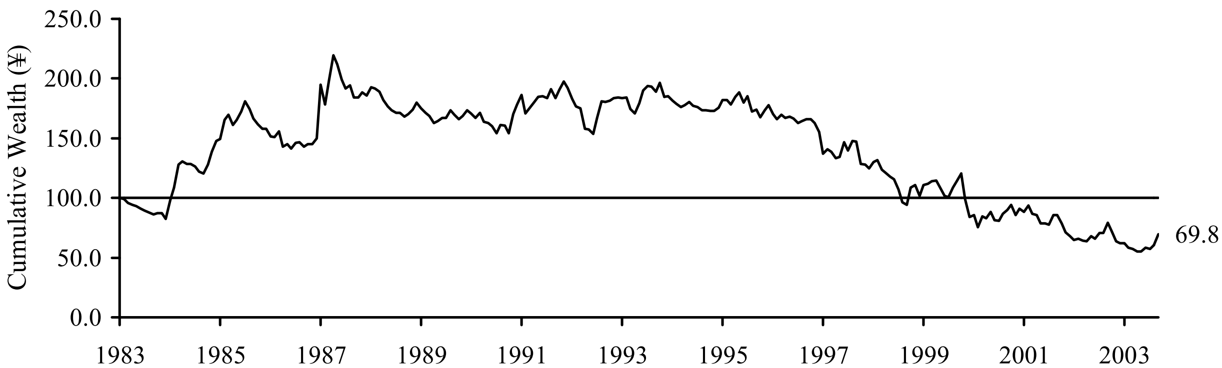
Table B

FINANCIAL INDICATORS

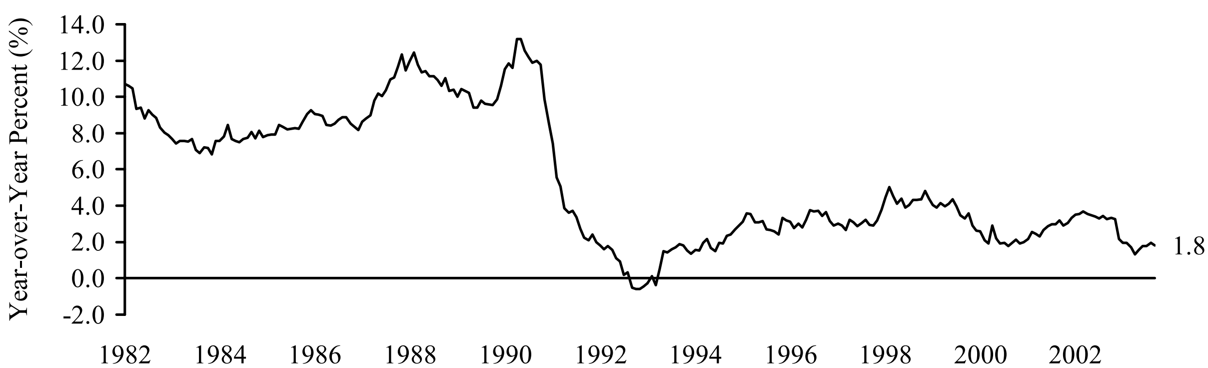
Wholesale Price Index and Japanese Consumer Price Index
1992-2003



Japanese Banking Sector Relative to the Tokyo Stock Exchange
February 1, 1983 - September 30, 2003



Japanese Money Supply: M2 Plus CD
January 1, 1982 - September 30, 2003



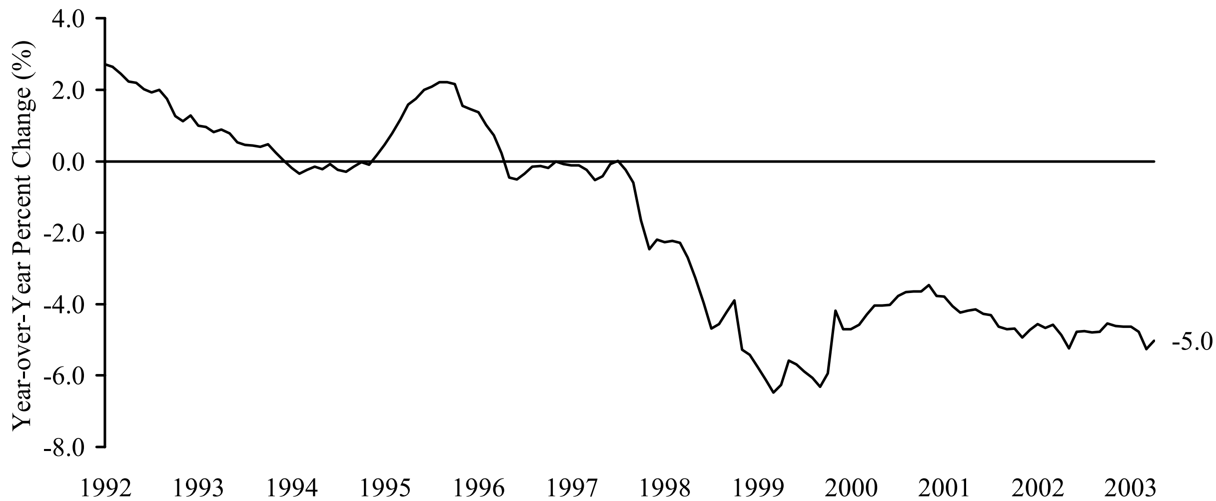
Source: Thomson Datastream.

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 July 31, 2003.

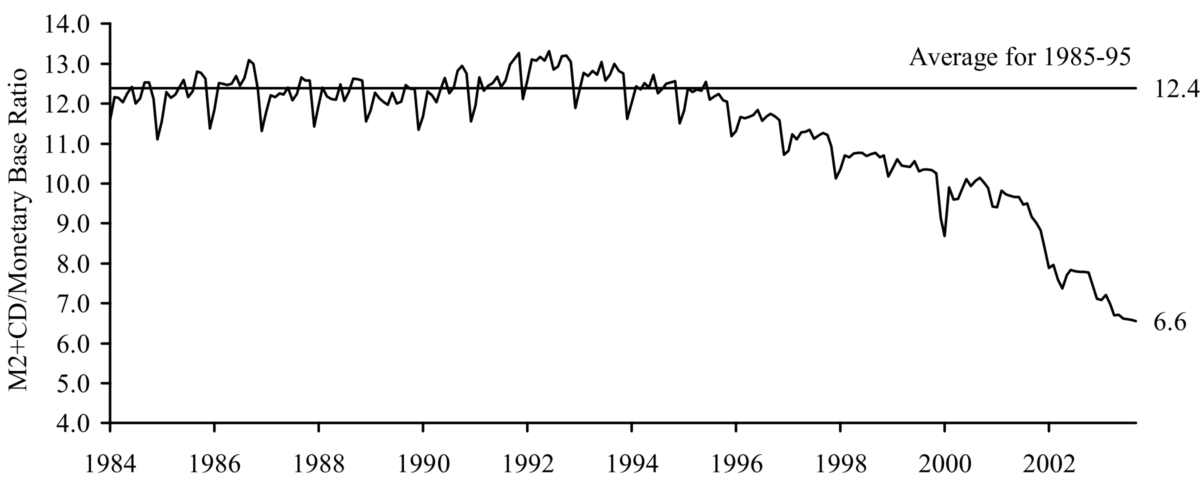
Table B (continued)

BANK LENDING AND CREDIT MULTIPLIER

Bank Lending
June 1, 1992 - September 30, 2003



Credit Multiplier
January 1, 1984 - September 30, 2003



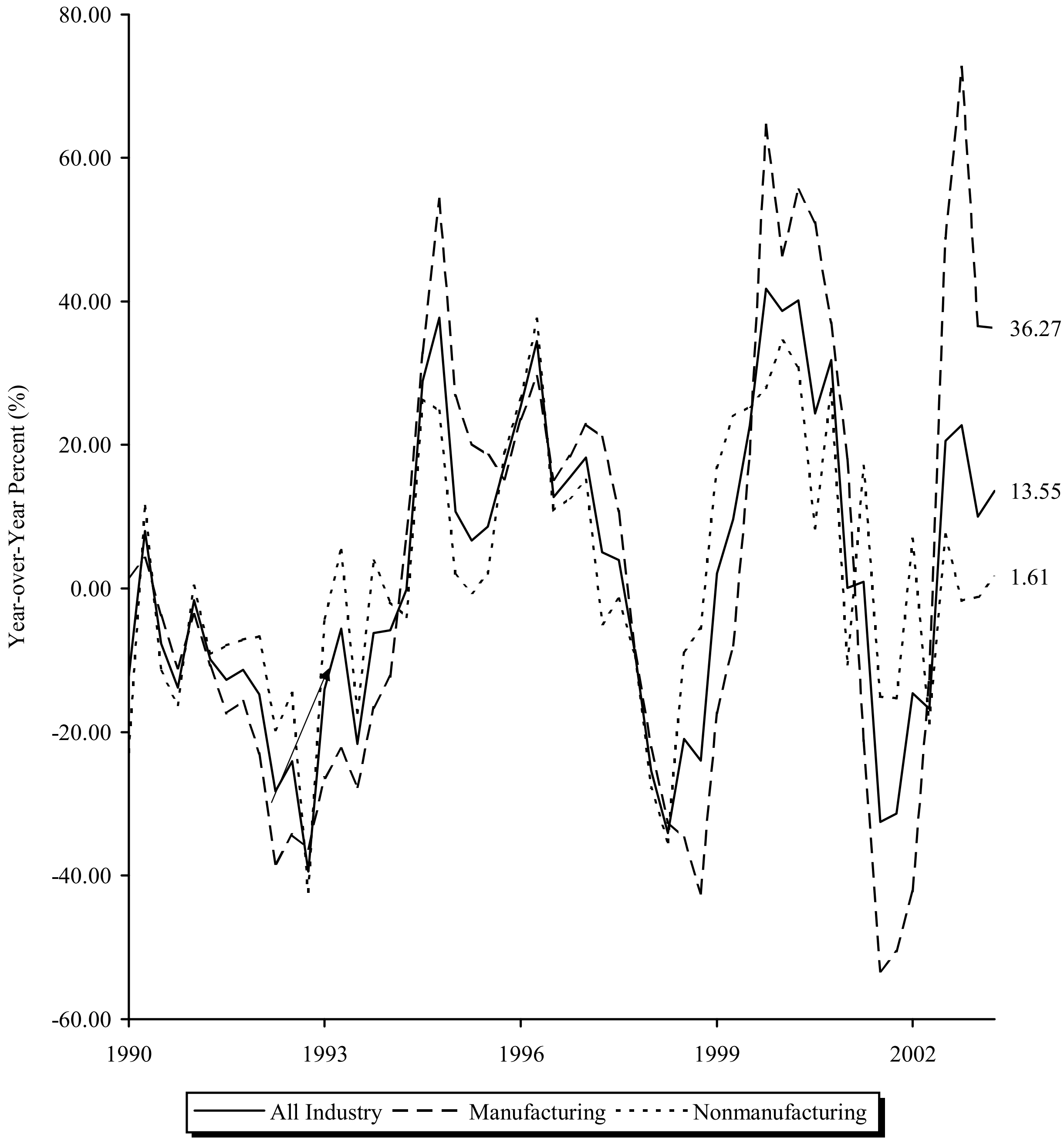
Sources: Bank of Japan, Morgan Stanley Research, and Thomson Datastream.

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

Table C

CURRENT PROFIT GROWTH OF JAPANESE CORPORATIONS

First Quarter 1990 - Second Quarter 2003

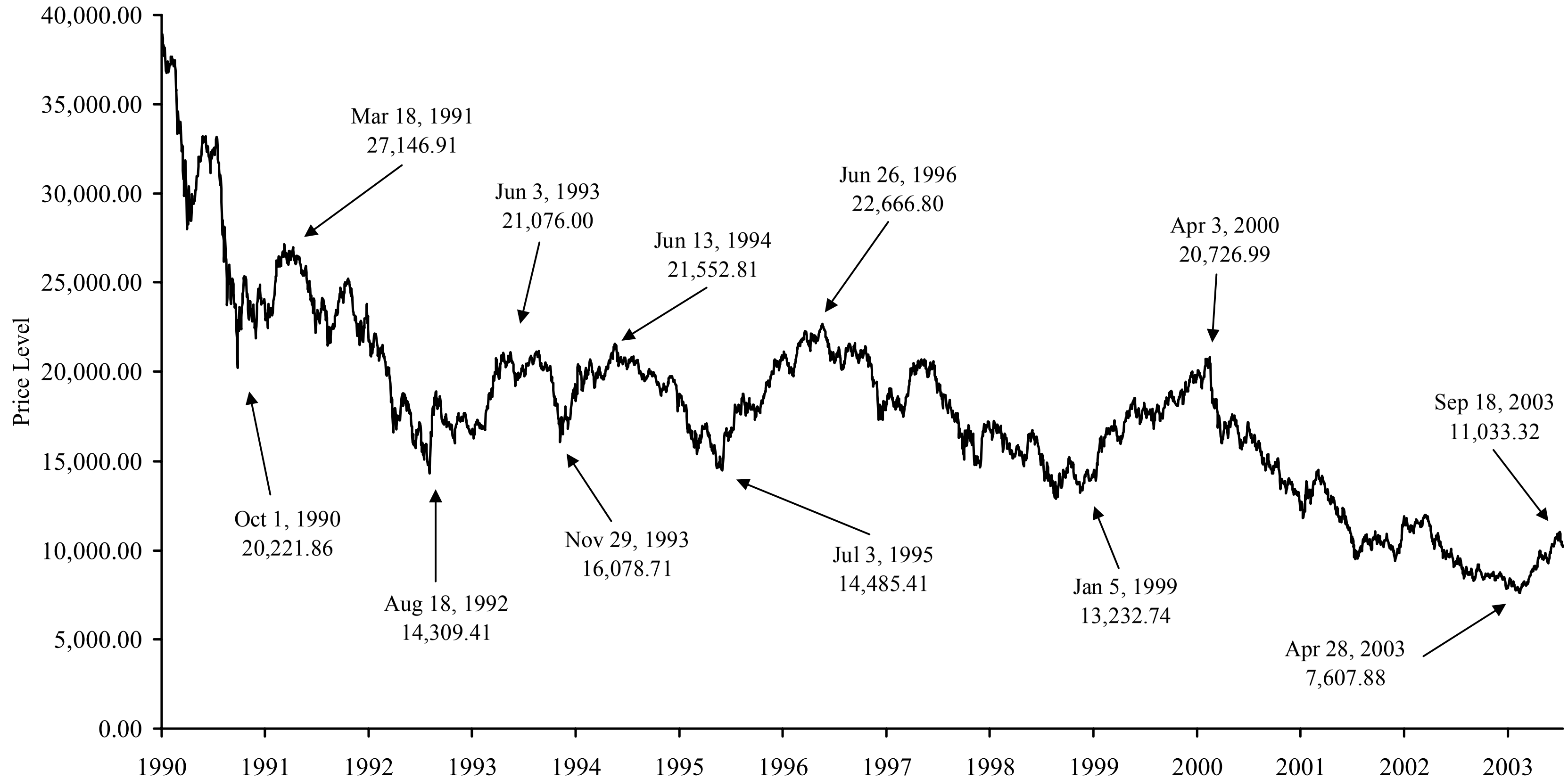


Source: Ministry of Finance of Japan

Table D

NIKKEI 225 BEAR MARKET RALLIES

January 1, 1990 - September 30, 2003



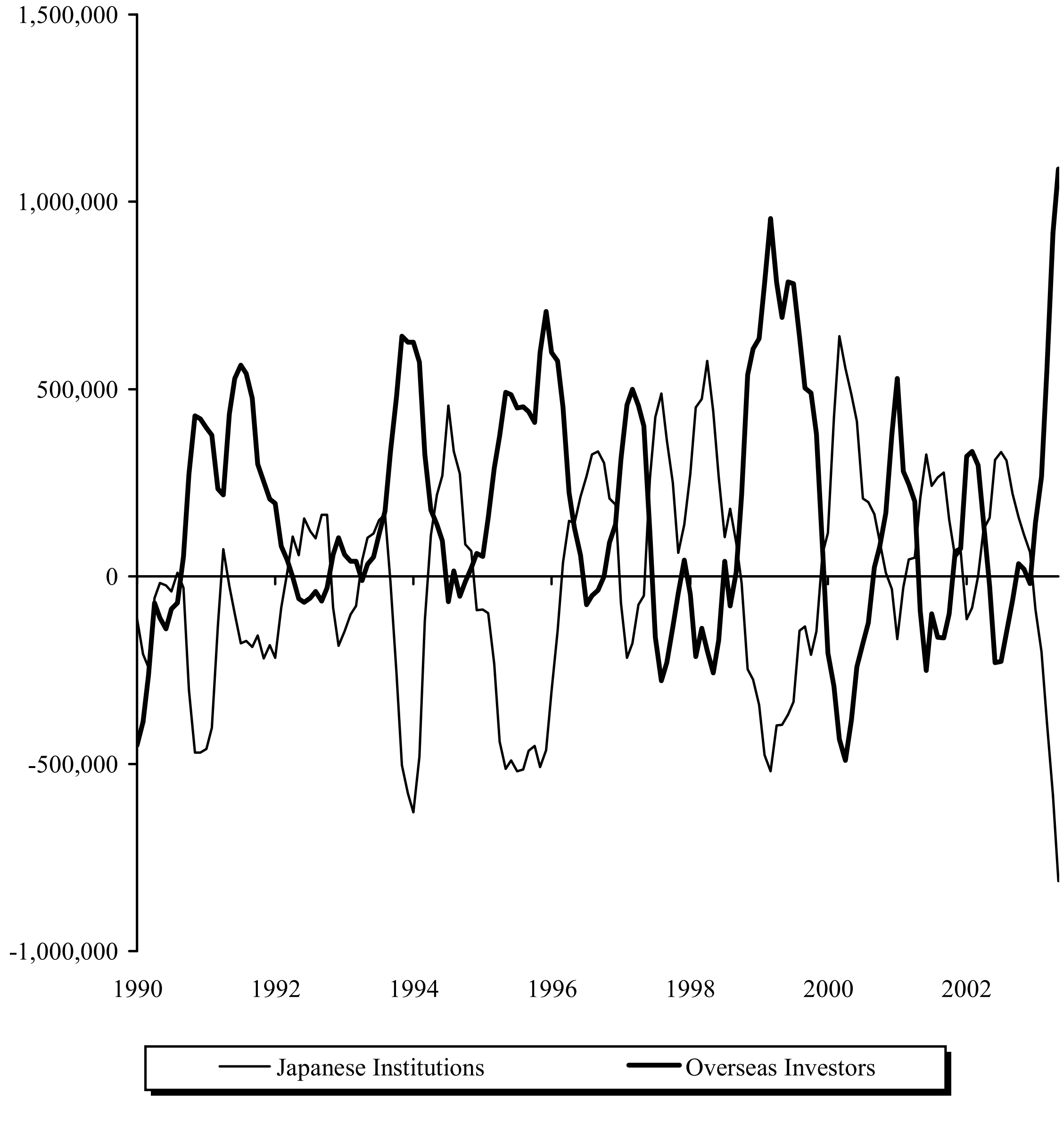
	Oct '90 - Mar '91	Aug '92 - Jun '93	Nov '93 - Jun '94	Jul '95 - Jun '96	Jan '99 - Apr '00	Apr '03 - Sep '03
Price Increase (%)	34.25	47.29	34.05	56.48	56.63	45.02
Length	121 days	208 days	141 days	258 days	325 days	104 days

Source: Thomson Datastream.

Table E

NET PURCHASES OF JAPANESE EQUITIES BY INVESTOR

1990-2003



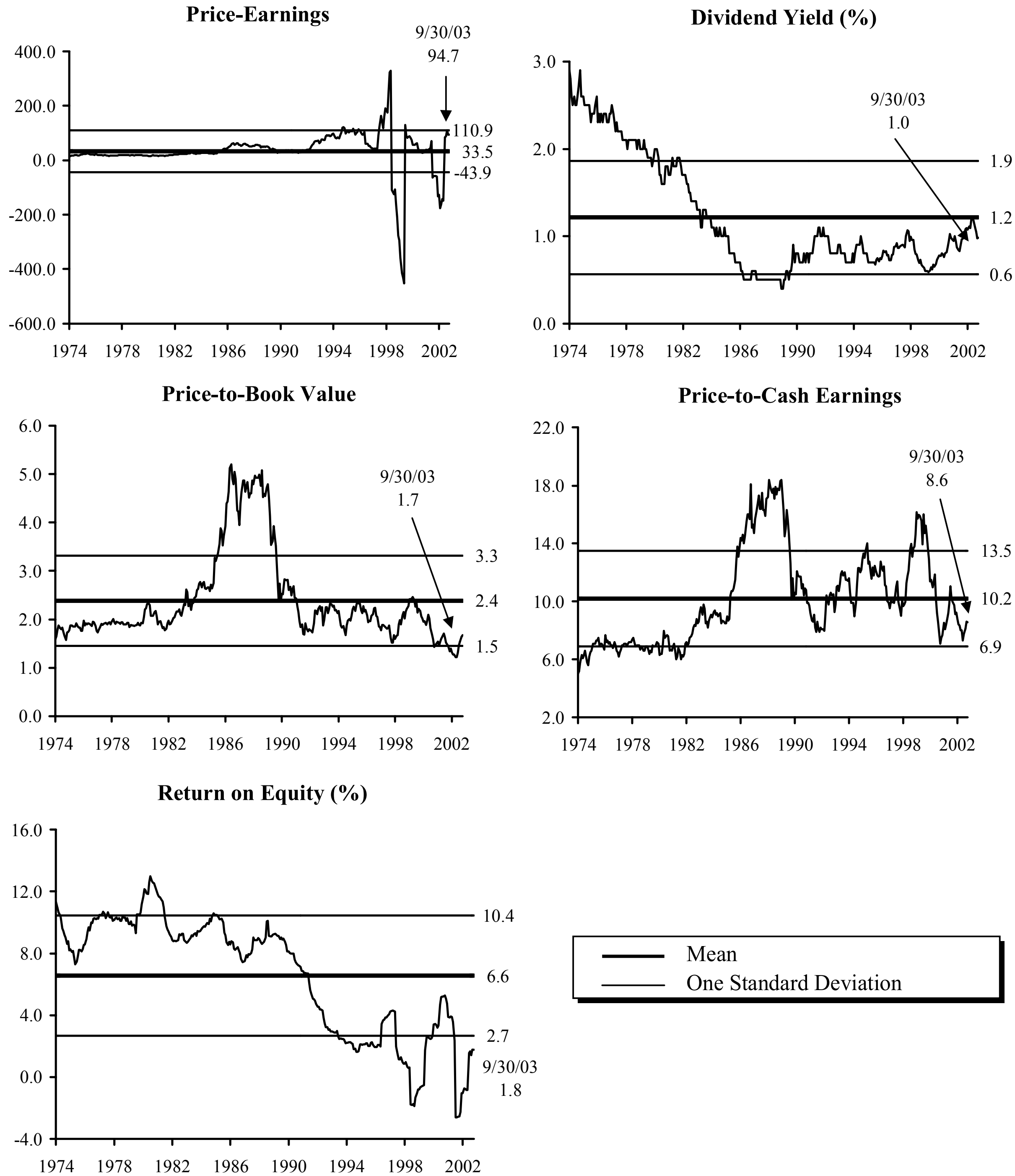
Sources: Morgan Stanley Research and Tokyo Stock Exchange.

Notes: Data represent the sum of weekly data within each month and therefore may not correspond with calendar month end values. Graph represents a five-month moving average. Data for 2003 are through September 26.

Table F

MSCI JAPAN VALUATIONS

December 31, 1974 - September 30, 2003



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

Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.

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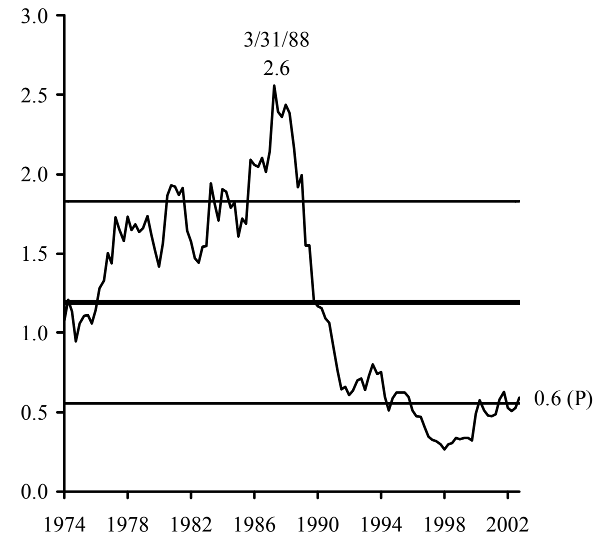
Table G

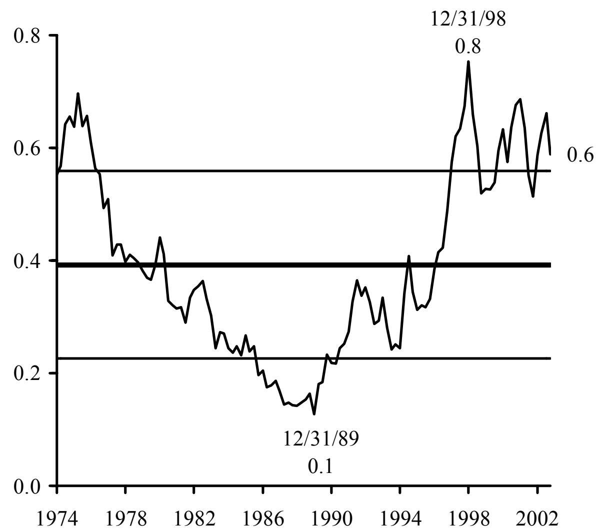
MSCI JAPAN VALUATIONS RELATIVE TO S&P 500

December 31, 1974 - September 30, 2003

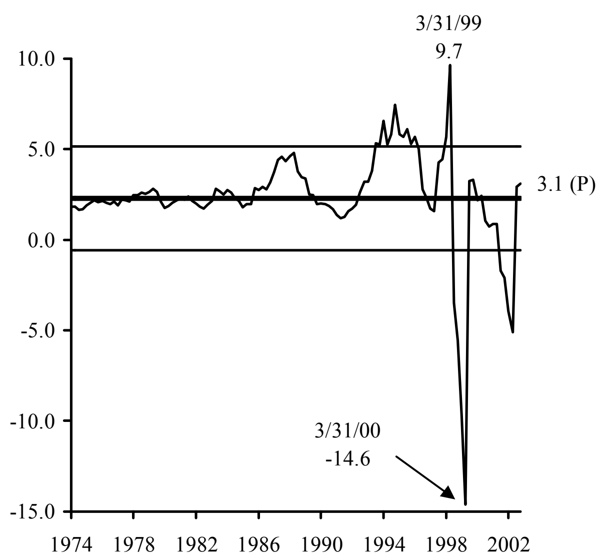
Price-to-Book Value



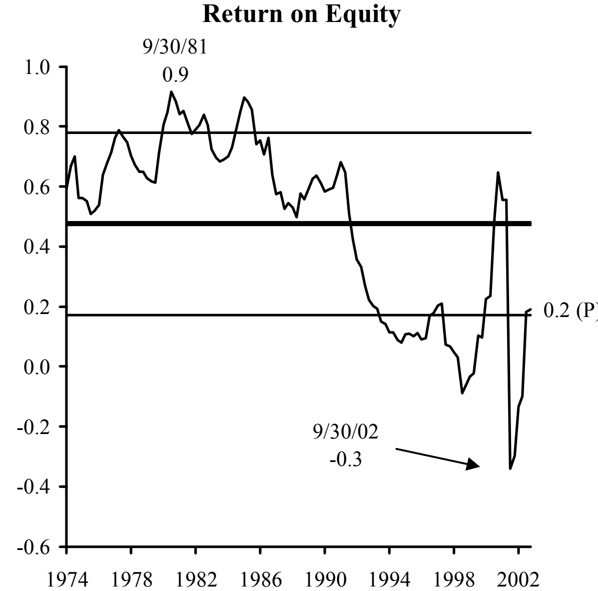
Dividend Yield (%)



Price-to-Earnings



Return on Equity



Mean
One Standard Deviation

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.