C|A

CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

KOIZUMI STEPS DOWN: THE IMPLICATIONS FOR INVESTORS IN THE JAPANESE MARKET

August 2006

Seth Hurwitz
Marcelo Morales
Andrew Kim

Koizumi Steps Down: The Implications for Investors in the Japanese Market

The End of the Koizumi Administration

On September 20, 2006 Junichiro Koizumi will step down as head of Japan's Liberal Democratic Party (LDP), ending his five-and-a-half year tenure as prime minister (the third longest since 1946). Investors in Japanese equities have reaped substantial rewards in recent years thanks in no small part to Koizumi. The prime minister continued deregulation efforts, began privatizing the massive postal system, and must also be credited for the fact that the non-performing loan (NPL) problem and deflation, two of the major factors behind Japan's prolonged economic malaise, were resolved on his watch. However, Koizumi's successor will face significant structural, fiscal, and monetary problems and investors should not blindly assume the new administration will necessarily continue to pursue the Koizumi reform agenda.

The Markets Under the Koizumi Administration

After an initial rocky period, Japanese equities have performed well under Koizumi's leadership (Table A). This performance is due both to improving economic conditions and to the prime minister's success in articulating a reform agenda (privatization, foreign direct investment, etc.) and convincing foreign investors that Japan was a growth story. Indeed, as of December 31, 2005, foreign ownership of Japanese equities stood at 26.7%, its highest level ever, compared with 18.8% five years earlier.[1] The Japanese stock market began its recovery in the spring of 2003 and had returned 115.1% (116.1% in US$) by the end of 2005. As of August 31, 2006, the Tokyo Composite Index (Topix) and Nikkei 225 Index were 20.2% and 15.5% higher, respectively, than the day Koizumi took office (Table B).

Resolution of the NPL problem, which had distorted the markets for years, was central to restoring a properly functioning market. The NPL ratio stood at 8.4% in March 2002 before Koizumi's Minister of State for Economic and Fiscal Policy Heizo Takenaka began pressing the major banks to halve the ratio within three years. The banks met that goal and in fact the NPL ratio had dropped to 1.8% (2.9% among all banks) by March 2006 (Table C). Meanwhile, bank shares rose as investors recognized their improving health and indeed generated returns substantially greater than those of the Topix as a whole: 235.0% versus 101.7% from June 2003 through August 31, 2006 (Table D).

Deflation was the other big bogeyman. Just prior to Koizumi's election the Bank of Japan (BOJ) introduced a "quantitative easing" policy aimed at flooding the banking system with liquidity in order to drive up prices and rid Japan of persistent deflation (Table E). As the economy grew and prices finally started to trend upward consistently (albeit slightly) the BOJ was able first to abandon quantitative easing (March 2006) and then to raise interest rates (July 2006) for the first time in almost six years.

[1] Information available at Tokyo Stock Exchange website (http://www.tse.or.jp/english/index.shtml). Percentages refer to stocks listed on the First Section of the Tokyo Stock Exchange.

Although the Japanese market posted a negative return in the first eight months of this year it was the best performer in the developed world over the 12 months ended August 31, 2006. Moreover, investors looking at Japan have many reasons for optimism: a broad-based economic recovery that is four months shy of being the longest in the post-war era, record corporate profits over the last three years, a pickup in lending and personal consumption, and an active market in transactions and initial public offerings. Meanwhile, valuations look reasonable, with price-earnings ratios of 20.5, far below their historical average, high returns on equity levels (9.3 versus the historical average of 6.6) and dividends (1.1) near their highest level since 1984 (Table F).

Issues for the Next Administration

Still, as the stock market's poor performance this year suggests, investors should by no means rest easy. The new administration faces a variety of structural and other challenges. Twenty percent of Japanese are now over 65, and by 2050, the rate will be nearly one in three.

The difficulties posed by this demographic challenge are exacerbated by Japan's huge fiscal deficit, which stands at approximately 160% of GDP, easily the highest rate among the G-7 countries. Interest payments on the debt have caused Japan to run a continual budget deficit and it is commonly accepted that the consumption tax will need to be raised sometime within the next few years to resolve this problem. The amount and timing of such increase will be tricky and contentious because a false step could derail the economic recovery.

Continuing and indeed accelerating the reform process should be a key element of addressing the demographic, budget, and fiscal issues. Much work remains to be done on privatization, deregulation, and other reform measures aimed at opening Japan's markets more fully and making them more efficient. The U.S. Government, for example, has focused recent bilateral discussions on foreign direct investment (FDI), the education and medical sectors, and labor reform.

To take just one of these areas, while it appears that Koizumi's pledge to double FDI in five years will be achieved, Japan's level of FDI is still negligible compared with that of other developed countries (Table G). Increased foreign investment not only can provide capital, jobs, and technological and other know-how to Japan, it may also help increase the focus on shareholder value in a country where shareholders are still viewed more as one stakeholder among many than as the owners of companies.

Foreign policy issues, meanwhile, could significantly impact the Japanese investment climate. Suspected North Korean nuclear and ballistic missile development combined with the regime's usual truculence remains a pressing concern. Political relations with China have worsened during Koizumi's tenure, capped off by the prime minister's visit to the controversial Yasukuni shrine on August 15, 2006, the 61st anniversary of the end of World War II. Nevertheless, economic ties between the two countries have continued to grow.

Kaoru Yosano, the current minister of state for economic and fiscal policy and financial services, recently warned of "reform fatigue" and reform has indeed taken a back seat to foreign policy, social, and tax issues in the run-up to the LDP election. However, continued initiatives to open the market further and increase investment opportunities are vital to ensure that domestic savers have the means to earn the returns needed to provide for their own financial security as they reach retirement age, thus mitigating their increasing demands on the state.

The Candidates

Chief Cabinet Secretary Shinzo Abe is the very clear front runner to succeed Koizumi. At this juncture only a major misstep by Abe or some other unforeseeable event would derail his candidacy. A decisive Abe victory would perhaps offer the greatest likelihood of strong leadership though it is doubtful that anyone can achieve Koizumi's stature in the short term. Abe is most known for his hawkish views on foreign policy. He has been active on the issue of Japanese abducted many years ago by North Korea and visited the Yasukuni shrine earlier this year. Although Abe has mentioned his commitment to the reform process, his rhetoric thus far has focused primarily on national security, demographic issues, and the social implications of economic changes, such as income disparity.

The other two apparent candidates will be Taro Aso, the foreign minister, and Sadakazu Tanigaki, the finance minister. Should either win or should another candidate emerge at the last minute, he is more likely to be beholden to the various LDP factions. Since many elements within the LDP remain opposed to reform, this could have negative implications for the market.

Whichever candidate wins, decisions made during the first nine months of the new administration will reflect positioning for the July 2007 Upper House election. Given this timetable and apparent public concern over the social costs of economic reform, it might be too much to expect substantial progress on the reform agenda before that election. One can certainly make the counterargument that it would be in the new prime minister's interest (particularly in Abe's case) to move boldly in order to assume Koizumi's mantle. It is extremely doubtful, however, that Takenaka will be in the next Cabinet and unlikely that there will be anyone charged with a similar mandate.

Conclusion

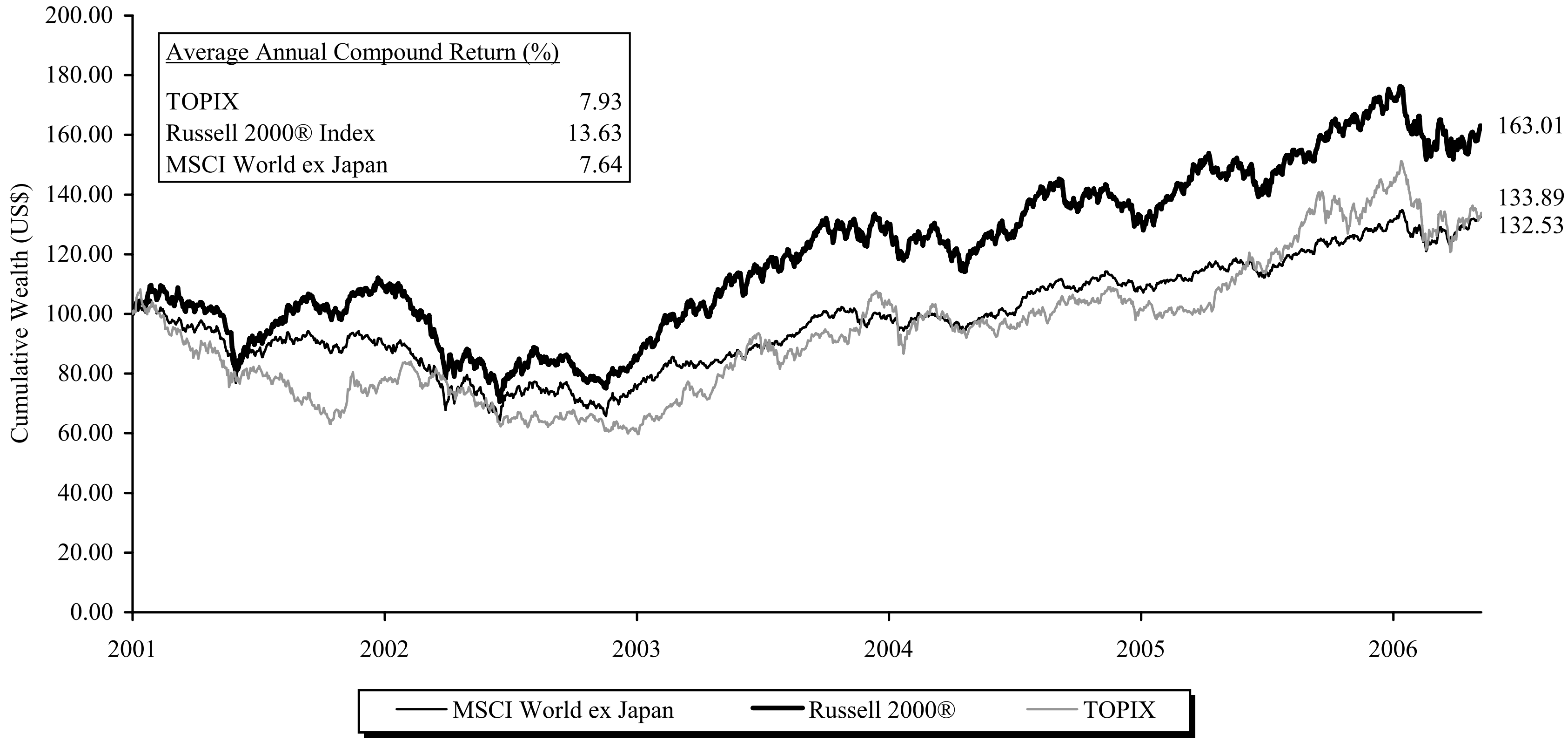
In addition to creating the conditions that would inspire confidence in domestic investors, the Japanese government also needs to sustain the market's appeal to foreigners, who are important sources of capital, technology, and know-how. To frame the issue more concretely, foreign investors now account for a record percentage of stock ownership (26.7%) and of equities trading (60+%) on the Tokyo Stock Exchange. Thus, the health of Japan's stock markets and of its economy generally is more than ever tied to their continued participation. Despite the great strides made under Koizumi's leadership, much work remains for his successor and investors should be alert to any intimations of diminished enthusiasm for reform since this would almost certainly lead to a deterioration in the investment climate.

Table A

RELATIVE PERFORMANCE OF TOPIX UNDER KOIZUMI ADMINISTRATION

April 26, 2001 - August 31, 2006

Cumulative Wealth Index
(April 25, 2001 = $100)



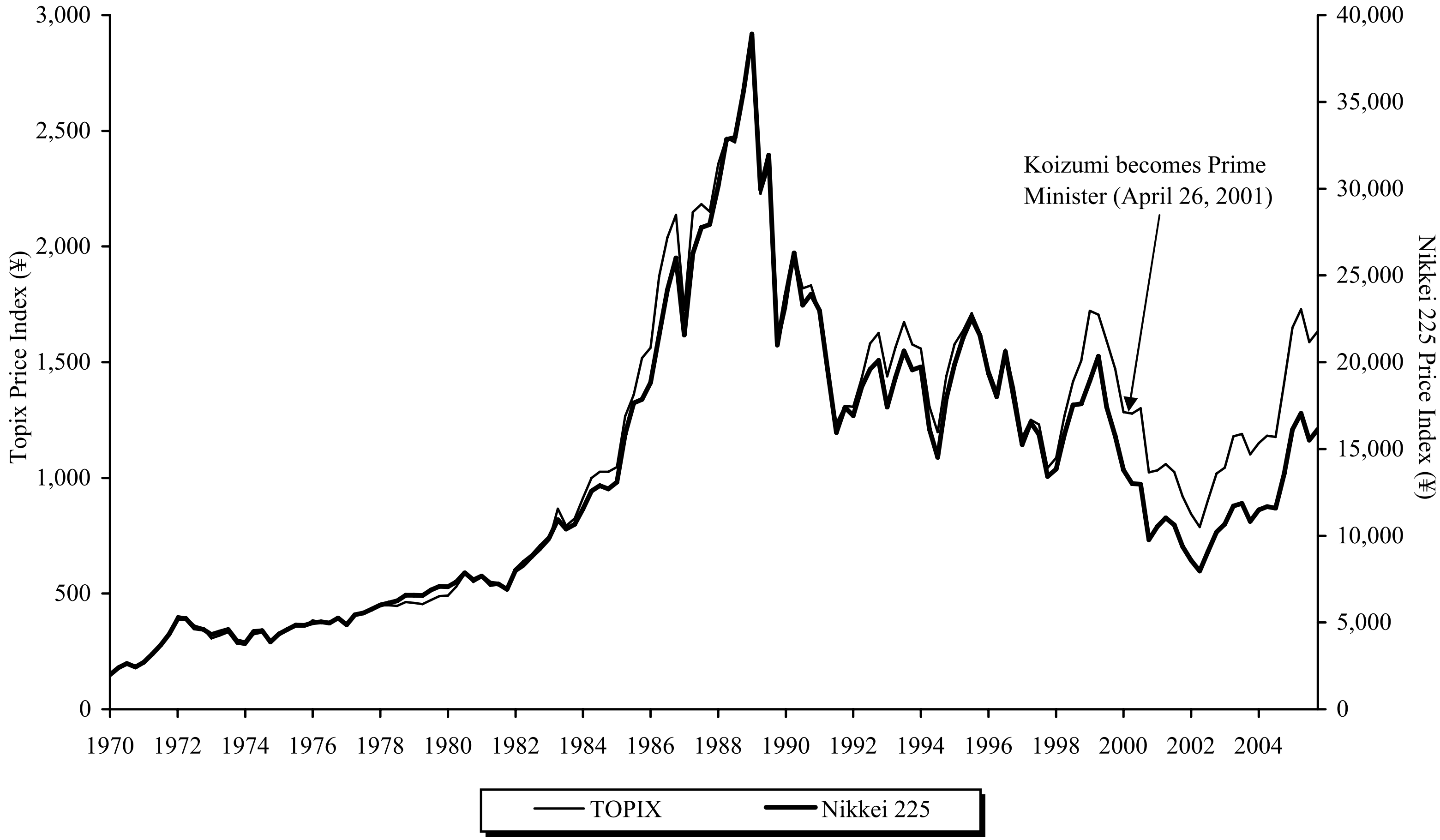
Sources: Frank Russell Company, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: All data are in U.S. dollars.

Table B

HISTORICAL PERFORMANCE OF THE TOPIX AND NIKKEI 225 INDICES

December 31, 1970 - August 31, 2006

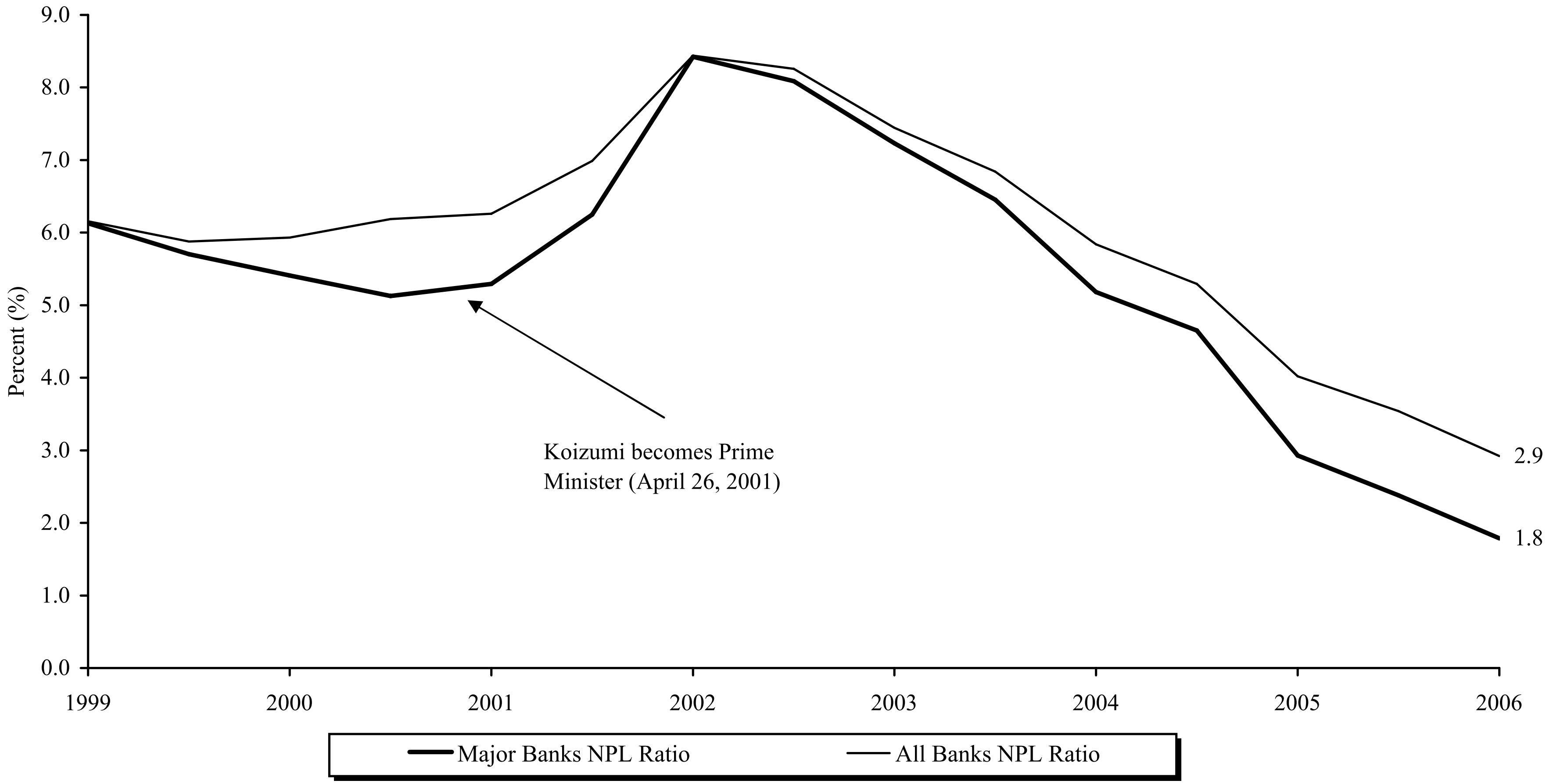


Source: Thomson Datastream.

Table C

PERCENTAGE OF NON-PERFORMING LOANS, JAPANESE BANKS

March 31, 1999 - March 31, 2006



Source: Ministry of Finance.

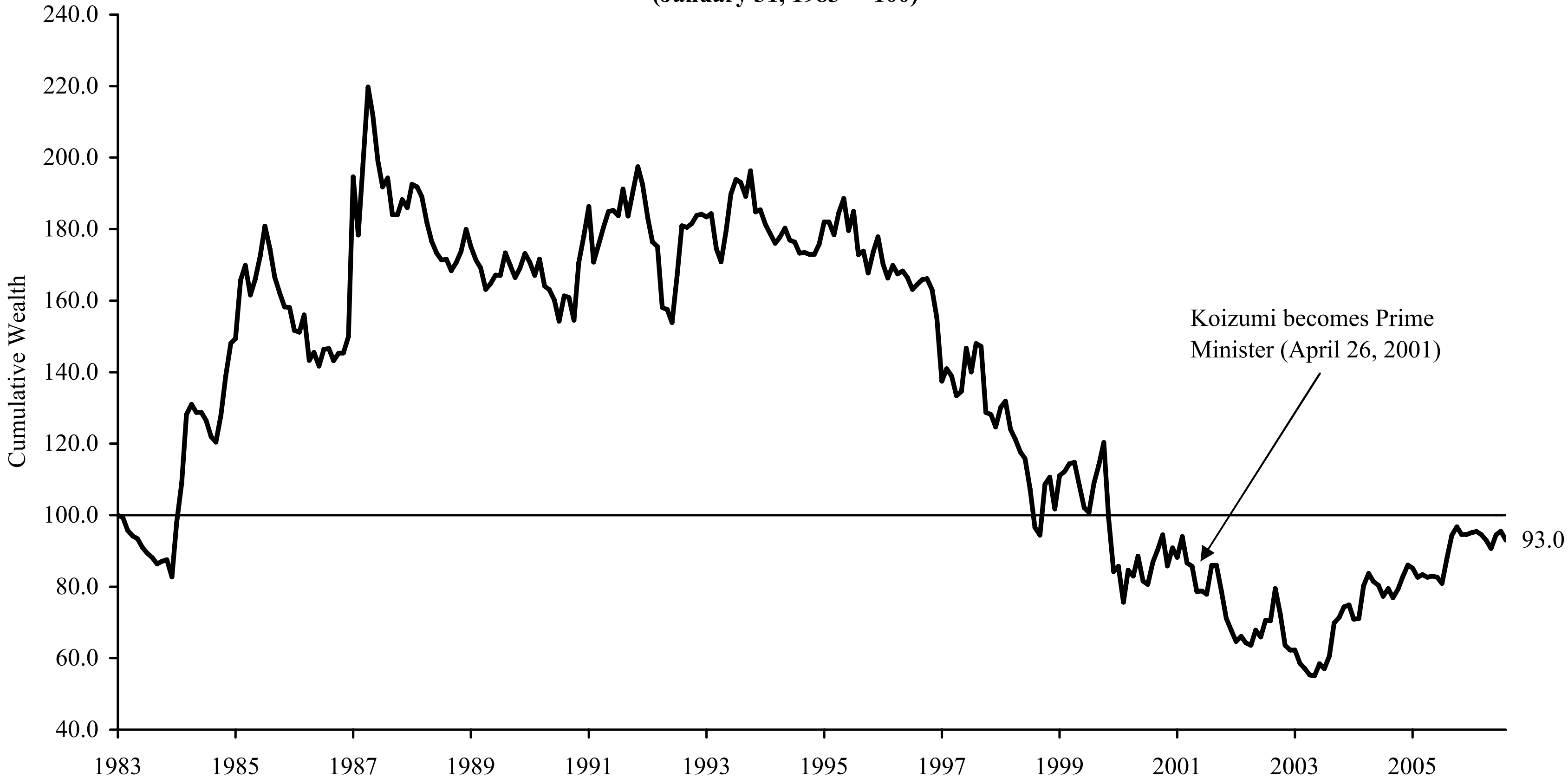
Note: Data are reported on March 31and September 30 of each year and run through March 31, 2006.

Table D

JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

February 1, 1983 - August 31, 2006

Cumulative Wealth Index
(January 31, 1983 = 100)



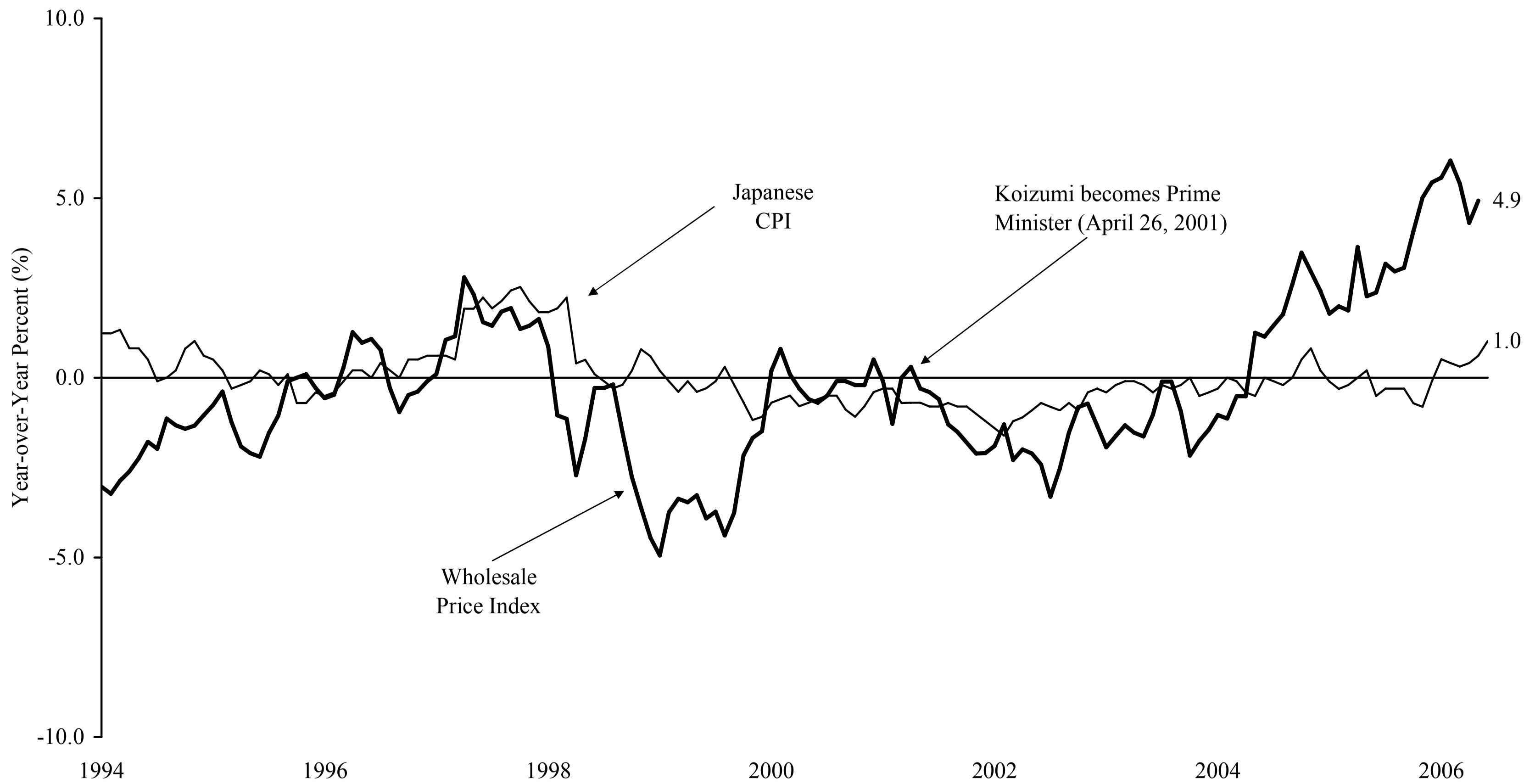
Source: Thomson Datastream.

Note: Returns are denominated in Japanese yen.
100m

Table E

JAPANESE WHOLESALE PRICE INDEX AND JAPANESE CONSUMER PRICE INDEX

January 1, 1994 - June 30, 2006



Source: Thomson Datastream.

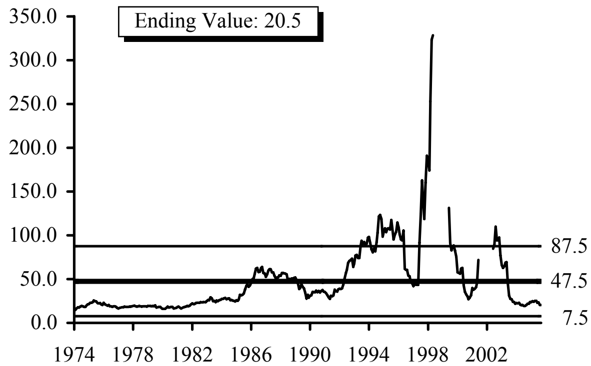
Note: Data for the Japanese Wholesale Price Index are through May 31, 2006.

Table F

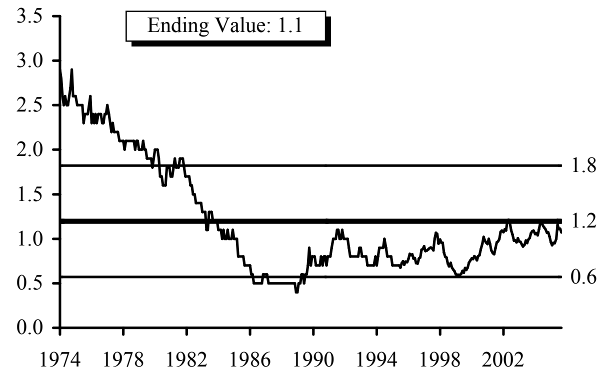
MSCI JAPAN INDEX

December 31, 1974 - August 31, 2006

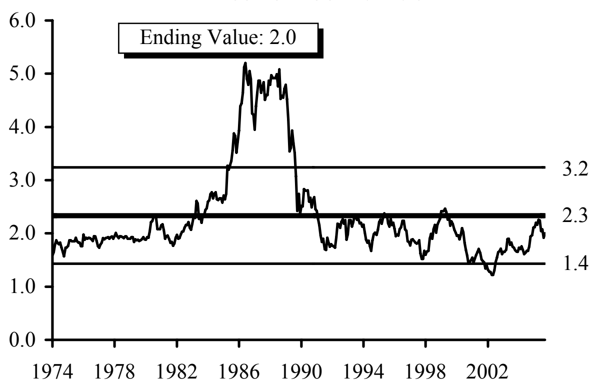
Price-Earnings



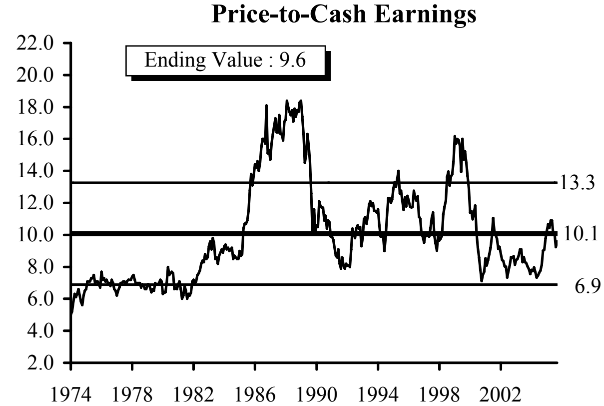
Dividend Yield (%)



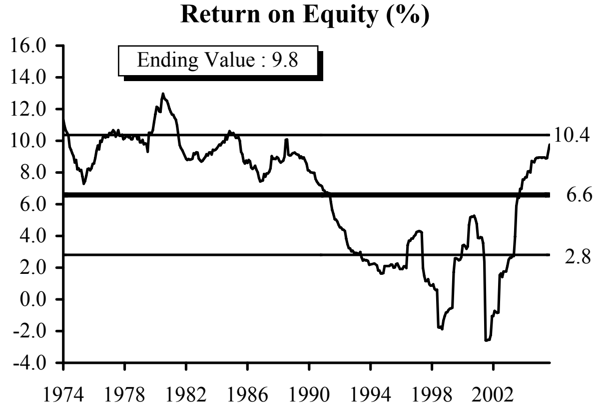
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Mean
One Standard Deviation

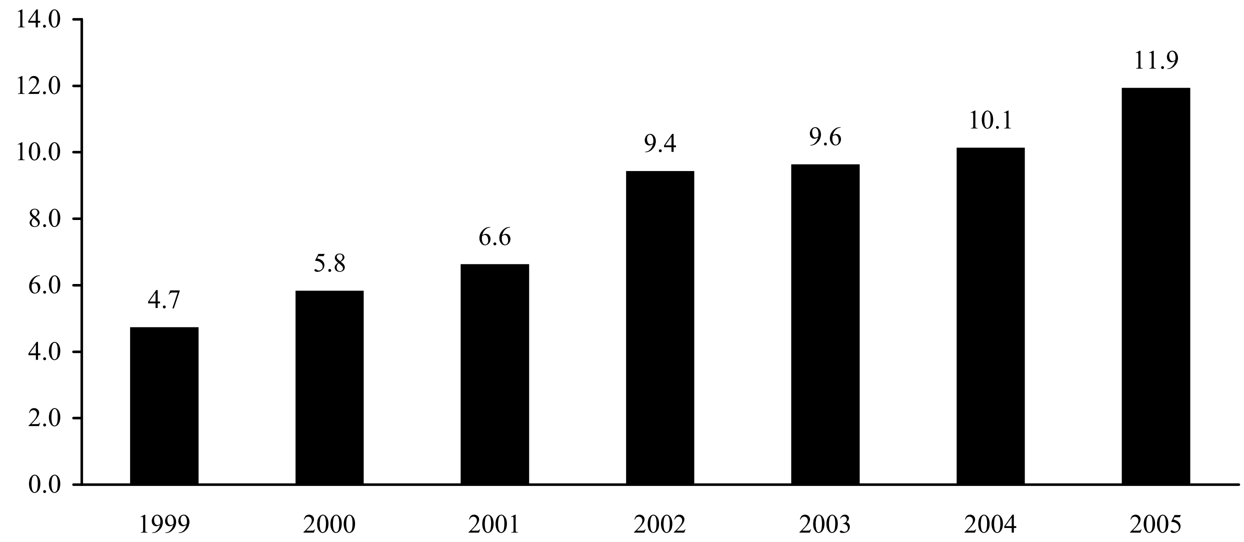
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Return on equity is calculated by dividing the index's price-book ratio by its price-earnings ratio. Gaps in the P/E graph represent periods for which negative P/Es have been removed.
028q

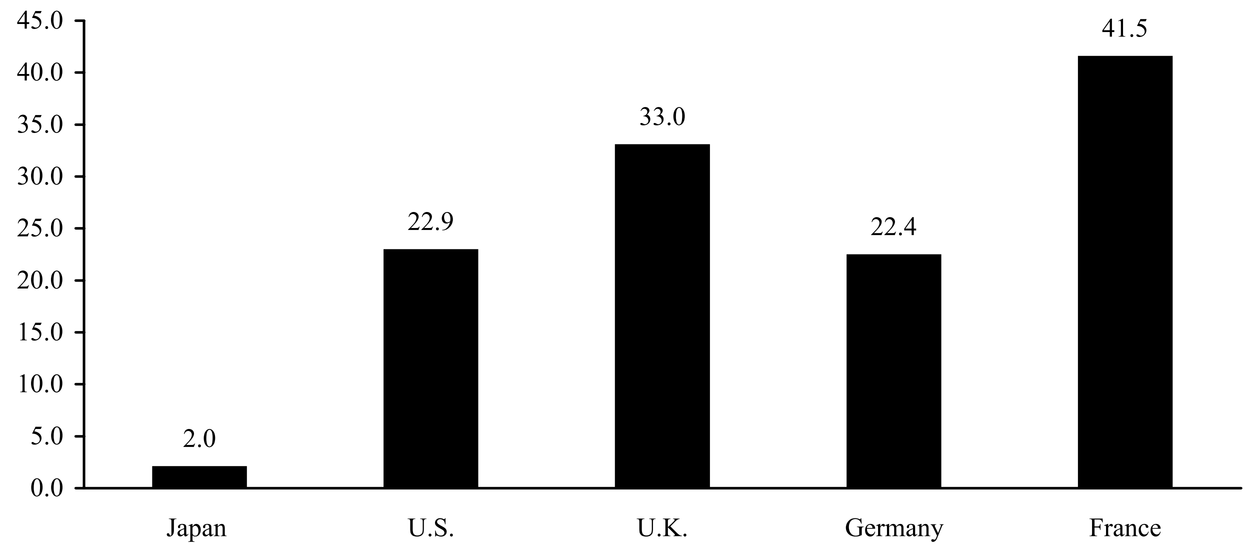
Table G

FOREIGN DIRECT INVESTMENT IN JAPAN

Cumulative Stock of Foreign Direct Investment in Japan (Trillion yen)



Inward Foreign Direct Investment Levels in Major Countries
(Stock Basis, as of December 31, 2005, Percent of Nominal GDP)



Sources: IMF International Financial Statistics and Ministry of Finance/Bank of Japan.

Note: At the end of 2005 the number of cumulative stock of foreign direct investment in Japan includes capital reserves, which were not included in previous years.