

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: WHY WE CONSIDER JAPANESE EQUITIES OVERVALUED

July 2002

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Why We Consider Japanese Equities Overvalued

After a promising start to 2002, when Japanese equities posted positive returns for four consecutive months, their secular slide seems to have resumed. In June, MSCI Japan reported a -8.5% return, bringing its year-to-date return to -1.1%, and its trailing 12-month return to -20.0%. Since the onset of the U.S. bear market in March 2000, MSCI Japan has actually underperformed MSCI U.S., with returns of -35.8% and -29.1%, respectively (all returns are in local currency unless stated otherwise).

The Scent of Opportunity

With market sentiment on Japan exceptionally negative and equity prices at 18-year lows, contrarians are salivating at potential opportunities. Although there is definitely merit to the contrarian case, we continue to caution investors against overweighting Japanese equities at this time. While several valuation metrics indicate they are fairly valued, the economy remains hopelessly muddled, and we are skeptical that earnings growth will meet the market's aggressive expectations.

The Problem of Earnings

Valuing Japanese equities is challenging for several reasons. First, Japan's accounting practices distort reported earnings compared to the results of accounting practices in other developed markets. Second, aggregate corporate earnings are negative, which means that we cannot use a dividend discount model to determine valuations, because negative earnings skew the earnings growth input in the model, making it difficult to determine the market's fair value. With these caveats, we analyze the valuations of MSCI Japan by looking at four metrics: price-to-earnings (P/E), price-to-cash earnings (P/CE), price-to-book (P/B), and dividend yield (DY) (see Tables A-C). We compare Japan's current valuations with its own historical valuations, as well as with those of other developed markets equities.

Relative to its own historical valuations, several metrics indicate that MSCI Japan is roughly fairly valued. For example, the P/B ratio suggests that equities are quite inexpensive (1.0 standard deviation below its post-1980 level), though they are fairly valued according to the P/CE and DY measures. Although on balance these measures imply that equities are moderately inexpensive, they are not cheap enough to counteract the effect of an astronomical P/E. In fact, one cannot calculate a meaningful P/E based on trailing earnings, because they are still negative. Consequently, any attempt to compute a meaningful P/E must rely on projected earnings growth, expectations for which have been at heroic levels in recent months, despite persistent systemic problems in the Japanese economy.

Similarly, those bullish on Japanese equities argue that they are cheap relative to those of other developed markets on the basis of relative P/B, P/CE, and DY, each of which is one standard deviation below its 20-year average. Skeptics point out that the U.S. market is still expensive when measured by these metrics, which results in Japan looking cheaper than it really is. However, this argument is undermined by the fact that Japan also looks cheap relative to EAFE ex Japan, where current valuations are not as high as in the United States. Nevertheless, the bullish case for Japan still runs aground on the pervasive inability of all but a few Japanese companies to realize meaningful profits. Although there is scattered evidence that some Japanese companies are now focusing on creating shareholder value, there is as yet no indication of a systematic reformation of Japan Inc. along these lines, which means that bulls must simply rely on blind faith that earnings growth will occur someday, somehow, sometime soon.

Will Forward Earnings Expectations Be Met?

In fact, Japanese firms are unlikely to meet the extraordinary earnings expectations already discounted by current equity prices. Many Japanese company officials and equity analysts expect a V-shaped profits recovery over the next 12 months, and forecasts by both have been notoriously overly optimistic in the past. According to I/B/E/S, analysts expect earnings to grow 1,483% over the next 12 months, compared to a forecast of 25.8% for the fiscal year ending 2004. While it may not be impossible for companies to grow at quadruple-digit rates coming off a low base, the downside risks to equity prices seem more prominent than the potential to surprise on the upside. Earnings estimates have already been revised downward so far this year, and it would not be surprising to see this pattern continue.

In addition, bank stocks continue to underperform the overall Tokyo Stock Exchange, most recently falling to lows not seen since 1983 (when these data begin)—and bank shares continue to fall sharply (see Table D). The market will probably not have bottomed until the banking sector, the linchpin of the economy, begins to show some strength relative to the overall market and this is unlikely to occur until some crisis or catalyst forces Japan to undertake meaningful, widespread, and lasting structural reform.

Despite Overvaluation, Still Some Opportunities

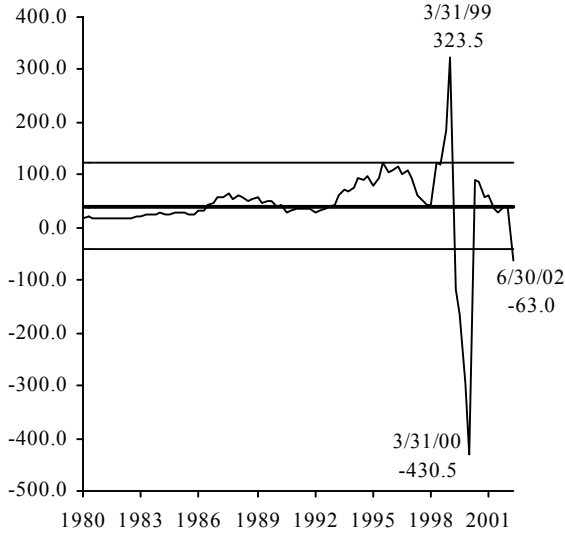
In short, we remain leery of Japanese equities because prices hinge on their meeting forward earnings growth expectations that seem extremely optimistic in light of the economy's continued stagnation. However, for some time we have also stressed that in what is essentially a dysfunctional economy there appear to be many attractive individual opportunities, and would continue to encourage investors to seek out managers oriented towards bottom-up stock selection, while avoiding those whose portfolios reflect the composition of the index.

Table A

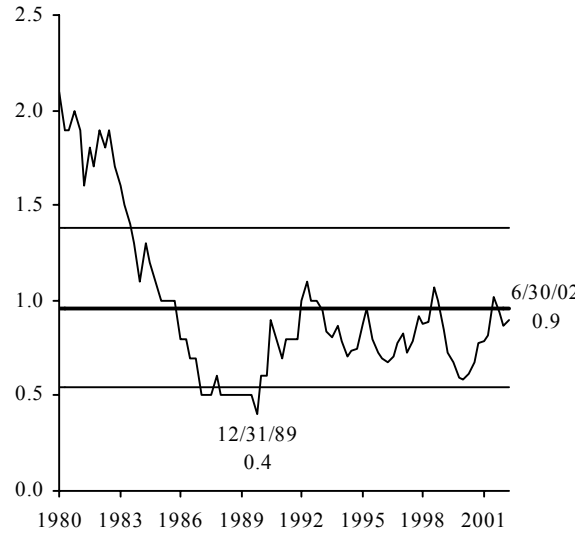
MSCI JAPAN VALUATIONS

March 31, 1980 - June 30, 2002

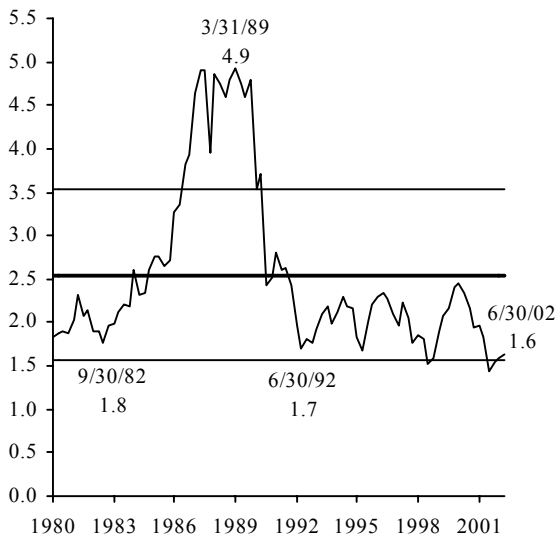
Price-to-Earnings



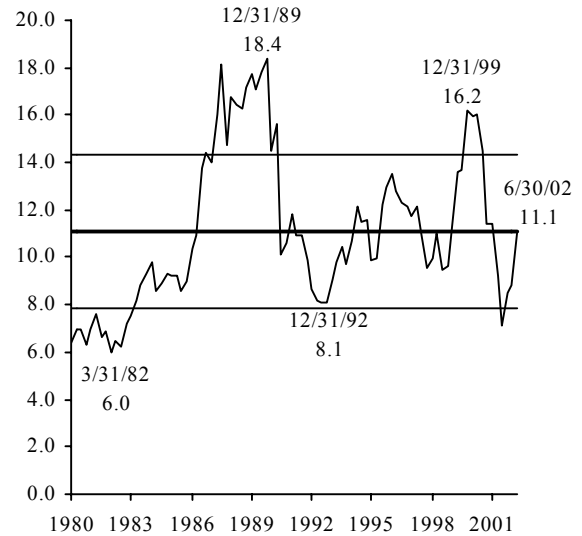
Dividend Yield (%)



Price-to-Book Value



Price-to-Cash Earnings



—	Mean
- - -	One Standard Deviation

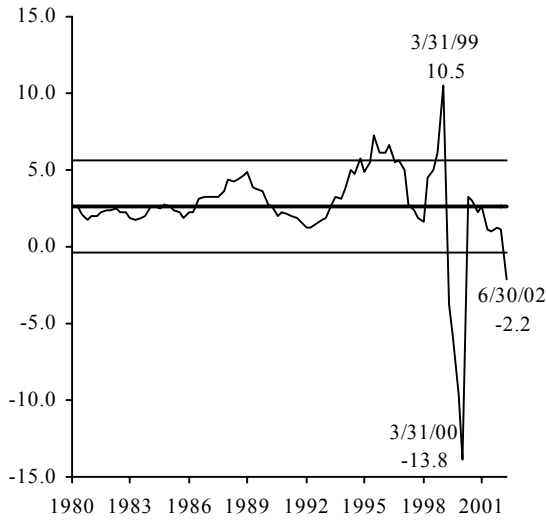
Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Table B

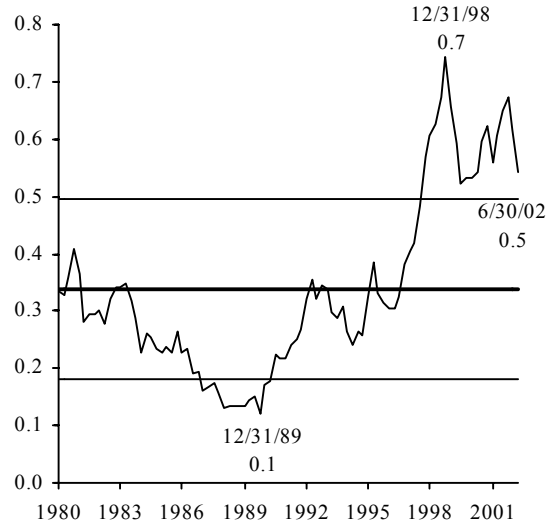
MSCI JAPAN VALUATIONS RELATIVE TO MSCI U.S.

March 31, 1980 - June 30, 2002

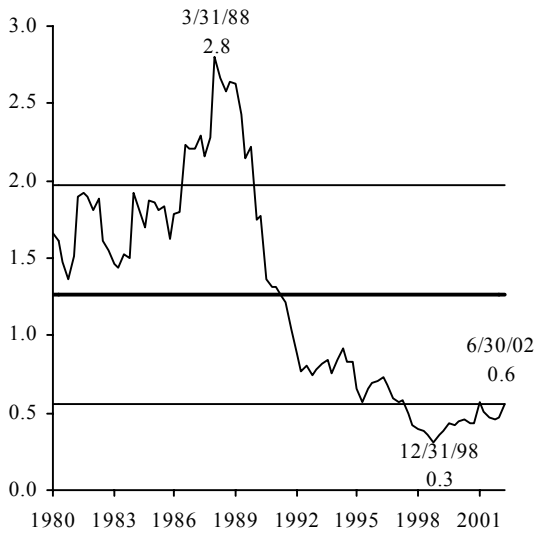
Price-to-Earnings



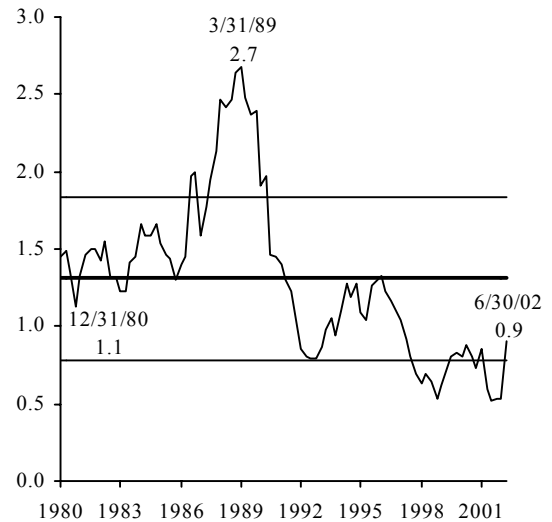
Dividend Yield (%)



Price-to-Book Value



Price-to-Cash Earnings



—	Mean
—	One Standard Deviation

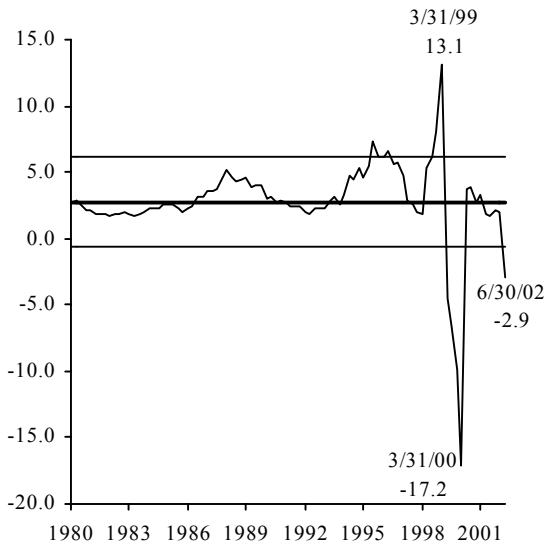
Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Table C

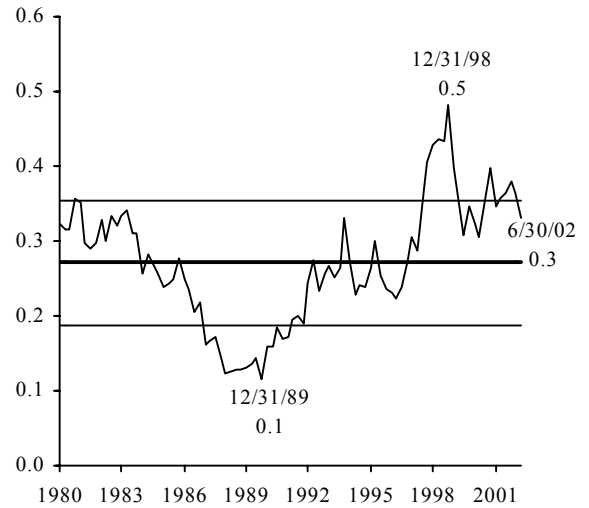
MSCI JAPAN VALUATIONS RELATIVE TO MSCI EAFE EX JAPAN

March 31, 1980 - June 30, 2002

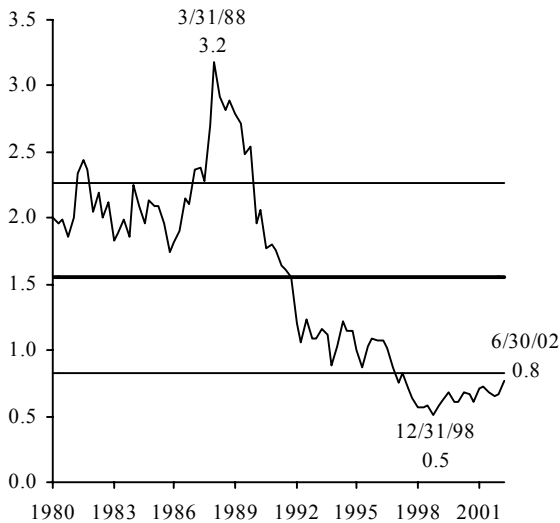
Price-to-Earnings



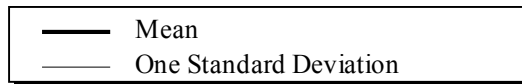
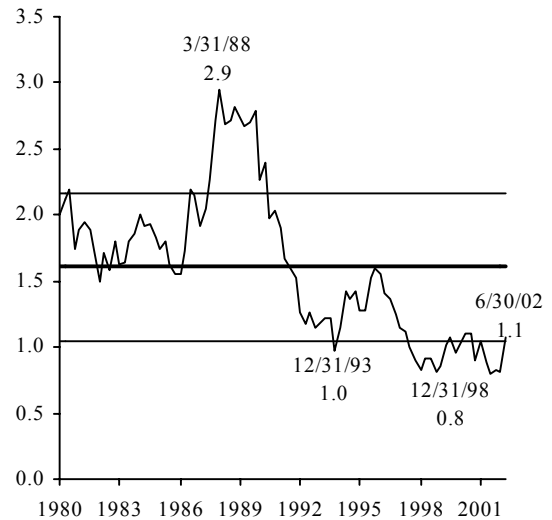
Dividend Yield (%)



Price-to-Book Value



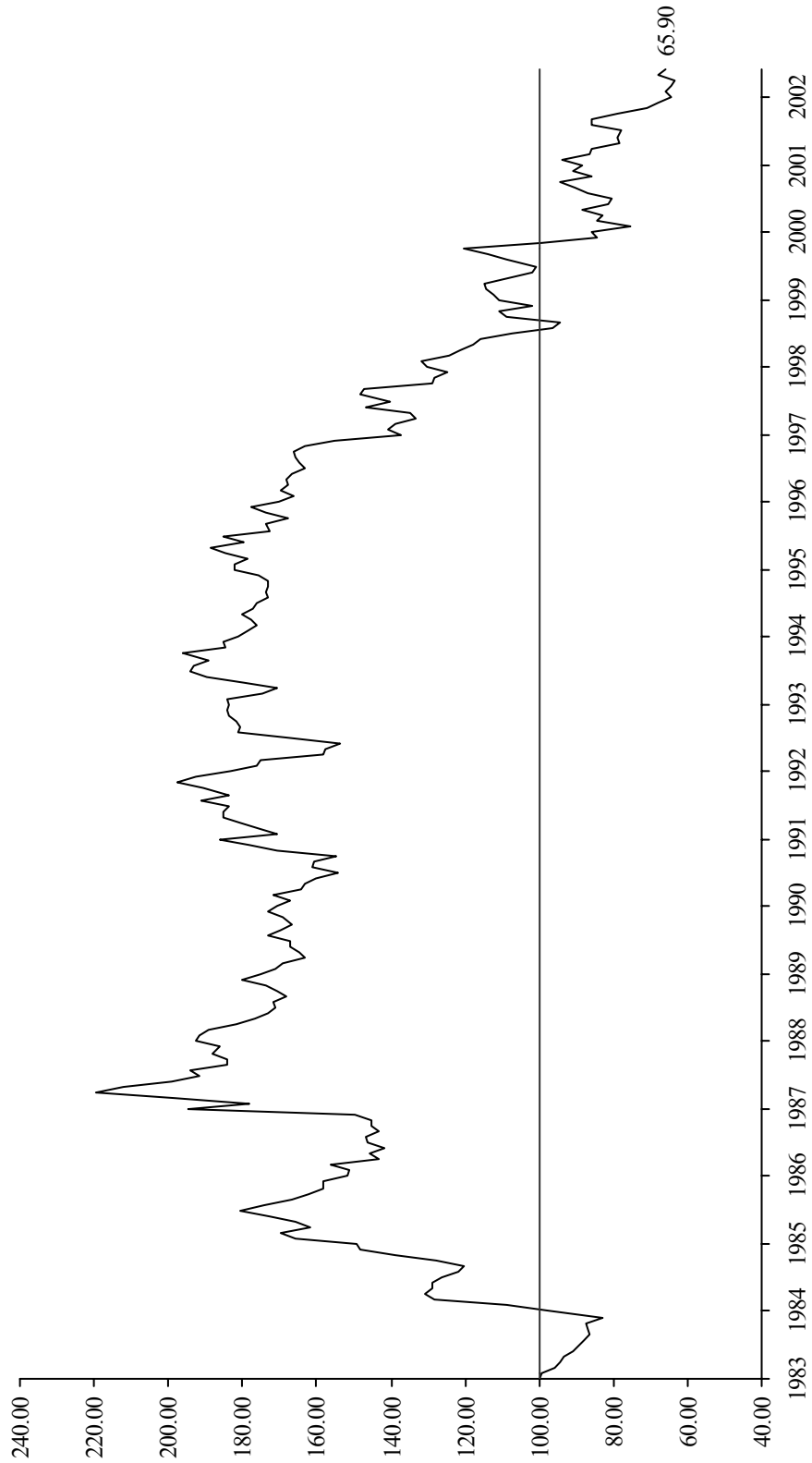
Price-to-Cash Earnings



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

Table D
JAPANESE BANKING SECTOR RELATIVE TO THE TOKYO STOCK EXCHANGE

February 1, 1983 - June 30, 2002



Source: Thomson Financial Datastream.
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