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STERLING'S WORLD REPORT

What's Next For Japan?

Japan has had one of the most dismal stock markets in the world for the past 12 years in response to persistent economic stagnation (see Charts 1 and 2). In recent days, however, both the Japanese stock market and the yen have moved up sharply despite rather tepid reviews of the government's latest economic measures.

One trigger for the market's gains was good old-fashioned government manipulation, also known in Japan as PKO or "price-keeping operation." In an effort to reverse negative market sentiment, the government put some new curbs on short selling and also allocated some new government funds towards the purchase of stocks.

Another trigger for the market rally was a rapid change in perceptions about whether Japan was facing an imminent financial crisis. Until quite recently, some market strategists had been warning of a major financial crisis in Japan following the government's planned April 1 cancellation of deposit insurance on bank accounts in excess of about \$75,000 US. Many Japanese banks are believed to be insolvent, and the fear was that money would flee not only the banks, but also flee Japan and yen assets entirely.

Even though no sane government would let a run on its banks turn into a rout, the fear was that Japan's government had boxed itself into a pretty tight corner. Because of past decisions, it is technically not able to come up with new money to bail out its banks until it has declared a state of financial crisis. To provide political cover, it needs at least a little bit of crisis to develop before

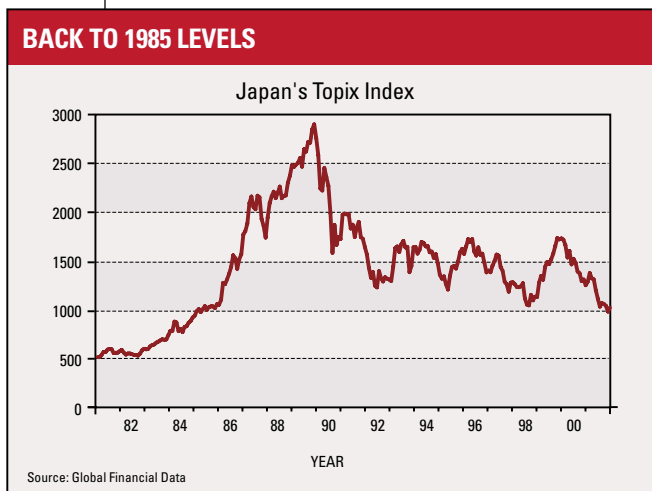


Chart 1. After several strong rallies in the 1990s, the Japanese stock market recently revisited levels not seen since 1985.



What's Next For Japan? (cont'd)

it can act forcefully. Hence the fear in the market place that some type of crisis was on its way.

Ironically, a slide in Prime Minister Koizumi's standing in the polls in recent weeks has helped ease fears of an imminent financial crisis. That is because many market participants believe that Koizumi's loss of popularity will increase the power of the old guard in Japan who are against his reform-oriented policies. The view is that they will find some stop-gap measures to keep the banks afloat and "muddle through" while blocking more fundamental reforms.

In any case, as the likelihood of a near-term financial crisis diminished, a "short squeeze" seems to have developed, forcing those who were betting on a weaker market and a weaker yen to

reverse their positions rapidly. That said, recent events generate little confidence that Japan's politicians will ever get around to making fundamental reforms to its dysfunctional economic system. That would require politicians and bureaucrats to bite the hands that feed them by pulling the plug on bank loans to inefficient retailers and construction companies – companies that are major contributors to the ruling party.

Long-term Problems Remain ...

In any case, fears of bank runs have been overdone because 90% of bank deposits are small enough to continue to be covered by deposit insurance, and any larger accounts can easily be split into smaller accounts. Japan's huge base of savings and large current account surpluses also provide major cushions against any immediate crisis.

Ironically, Japan's wealth is part of the problem because there is little broad-based support for economic reform by a generally complacent populace. Koizumi, who rode in on a wave of pro-reform sentiment last year, has been thoroughly stymied by his own party. According to a Japanese saying, "the nail that stands up gets hammered down," and that currently describes Mr. Koizumi's experience. Even charitable critics of Mr. Koizumi are now depicting him as

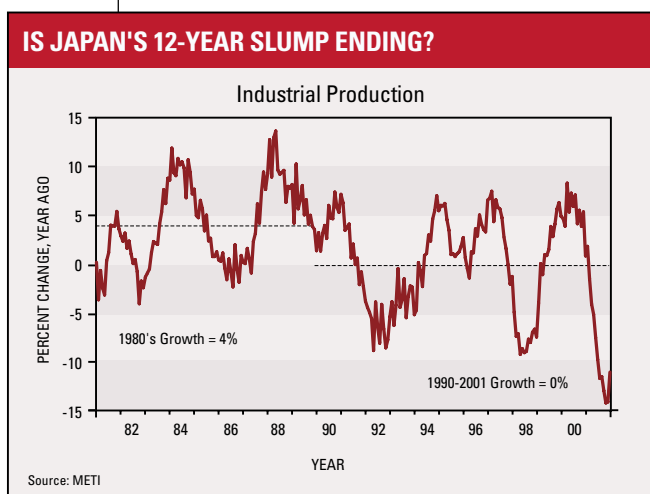


Chart 2. Growth in Japanese industrial activity has averaged zero since 1990, despite several business cycle upswings.



What's Next For Japan? (cont'd)

a Gorbachev-type figure – someone who may initiate the dismantling of a dysfunctional system, but not someone who will lead the creation of a new system.

As veteran Japan watcher Richard Katz has argued: “So deep-seated are Japan’s dysfunctions that, even if it did everything right today, it would take another five years to get back to truly vibrant growth. And Japan will not do everything right today. The government’s latest anti-deflation package ... is mostly just a new label on old measures. Opposition to reform remains deep-seated, with a myriad of vested interests and millions of jobs at stake.”

Don't Rule Out a Cyclical Recovery

Despite ample reason for caution about Japan’s long-term prospects, it would not be surprising

over the next year to see Japan develop one of the major rallies that it has experienced every few years since entering its zero-growth mode in the 1990s. Here are some reasons why:

1. **The business cycle.** Much of the discussion about Japan’s long-term problems focuses on structural issues, but Japan is still capable of generating strong business cycle dynamics in the short run. If the global economy recovers in 2002 thanks to global easing, lower oil prices and an abatement of the “tech wreck” problems, Japan’s exports should pick up. That should initiate a process of vigorous inventory rebuilding, much like what is expected in the United States. Indeed, Japan’s index of leading economic indicators looks like it has bottomed and many analysts are expecting the indicator for January of this year to be back above the 50% “boom or bust” line (Chart 3).

2. **Monetary refutation.** The Bank of Japan has been increasing the pace of monetary creation and has let Japan’s monetary base (bank notes and short-term bank reserves) grow by more than 20% over the past year. Despite banking system problems, other broad money aggregates have also been growing more rapidly in recent months (Chart 4). With Japan’s banking woes, there is no guarantee that such measures will rekindle growth any

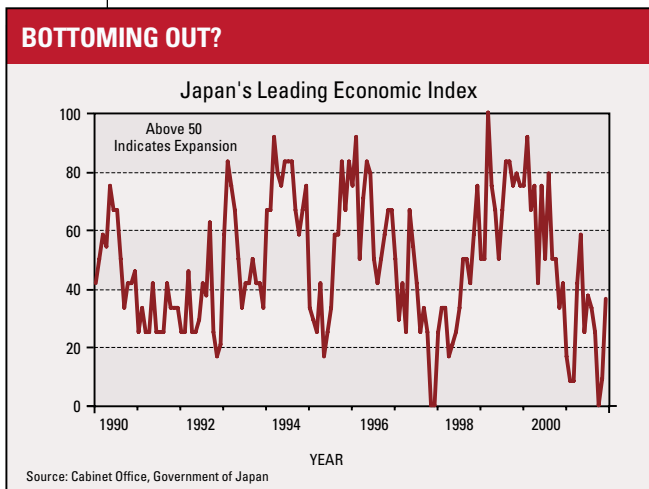


Chart 3. Japan's index of leading economic indicators appears to have bottomed in October, at about the same time the U.S. economy bottomed.



What's Next For Japan? (cont'd)

time soon. However, despite the widespread criticism of the Bank of Japan, these measures look pretty aggressive.

- 3. Relative valuations.** Japan's market is not cheap by most conventional measures. For example, the Tokyo market's price-earnings ratio is currently about 39 times trailing earnings and its dividend yield is about 0.9%. However, those measures need to be viewed in the context of cyclically depressed earnings and short-term interest rates of close to zero. By other measures such as price-to-cash-earnings or price-to-book-value ratios, the Japanese market is 46% or 53% cheaper, respectively, than the U.S. market.
- 4. Relative sentiment.** Know many bulls on Japan? We rest our case.

These are reasons we maintain a modest weight in Japan in our global equity portfolios. Richard Katz is probably right – Japan still has a long and difficult road ahead of it. But expectations toward Japan have been so depressed that even modest improvements may be viewed as positive surprises by the financial markets.

Conversely, market expectations in the United States are now for growth in corporate profits of nearly 40% for the fourth quarter of 2002 over the fourth quarter of 2001. That would not be unusual during the first year of economic recovery. But what if U.S. profits undershoot those optimistic expectations, or are restated downward by newly zealous accountants?

If anything, the recent Enron fiasco has reminded investors everywhere of the importance of diversification and how quickly market opinions can change about who's on top – or who's not. Japan's major companies may not be on Fortune magazine's "most admired" list any time soon, but they may well have an easier time beating expectations than many of their U.S. counterparts.

WILL MONETARY REFLATION WORK?

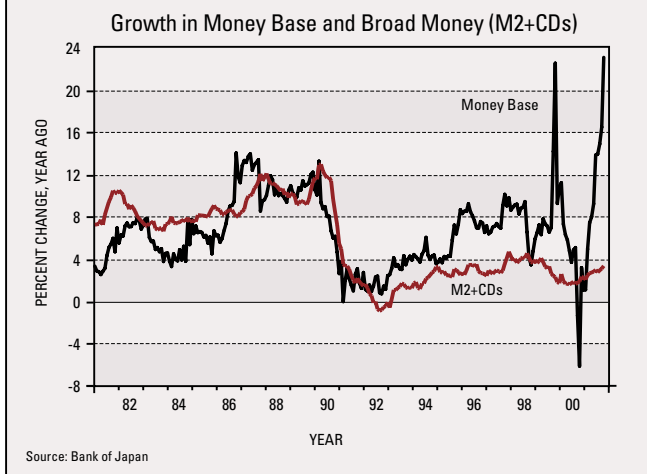


Chart 4. The Bank of Japan has been fighting deflation with increasingly aggressive money growth. Expect more of the same.

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