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STERLING'S WORLD REPORT

Has Japan Got Its Mojo Back?

After many years of stagnation and a series of false dawns, Japan's economy finally seems to be back on track. It may be an exaggeration to say that Japan is booming, but profits are up by an impressive 30% from a year ago and some economists believe that the nation is headed for real GDP growth of 5% or better this year.

The key question for investors is whether Japan's recovery is sustainable. If so, the Japanese stock market could finally be an interesting place for investors after years of providing little but disappointment. As shown in Chart 1, relative performance against the MSCI World Index has been dismal since the late 1980s. We recall back then that many political commentators were afraid that Japan was going to dominate the world in every industry. Oops, bad call.

At one point in the late 1980s, the Japanese stock market accounted for nearly 60% of the market capitalization of the major non-U.S. equity markets combined, as measured by its weight in the MSCI EAFE Index (which stands for Europe, Australia and the Far East). Because of its poor performance, Japan now represents only 23% of the EAFE index.

Against this backdrop, it is easy to understand why non-U.S.

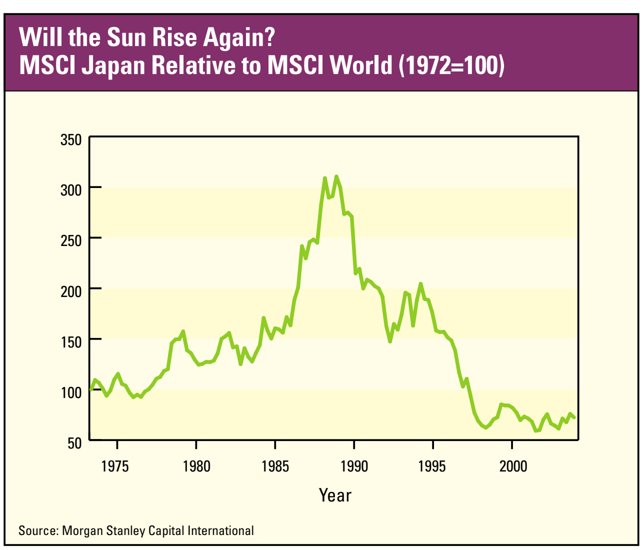


Chart 1: Japan's stock market outpaced the MSCI World Index dramatically in the 1970s and 1980s, but gave up all of its relative gains in the 1990s.

equity markets have had so little appeal to both U.S. and Canadian investors in recent years. For a long time, the EAFE index was dominated by one market, namely Japan, which posted dismal performance year after year.

If Japan's economy has now entered a period of sustainable economic growth, attitudes about the Japanese stock market could be poised to change fairly dramatically among both foreign and Japanese investors alike. And we can think of eight trillion reasons why it will matter if Japanese investors start to reassess prospects for their own economy. That's because Japanese households have stashed close to $8 trillion US into liquid currency and bank deposits that earn virtually no interest. That represents an astounding 55% of their total financial assets. In contrast, Japan's households currently have less than 5% of their total financial assets in stocks.

So the potential for a fairly significant shift in funds away from cash and toward stocks is clear. All that is needed is for investors to regain some confidence in the overall economy and in the determination of Japanese companies to generate reasonable returns.

Capitalism with Warts?

We think Japan's economy has turned the corner and, more importantly, that growth is sustainable. That does not mean that the problems that have plagued the Japanese economy in past years have been completely eliminated. Like many other countries, Japan can be considered a case of "capitalism with warts," meaning that there are still a lot of inefficiencies in the economy associated with the heavy hand of government regulations and bureaucratic inertia.

However, that represents a tremendous improvement from the Japan of yesteryear! In 1991, Brian Reading, author of a book called *Japan, the Coming Collapse*, characterized Japan not as

a case of capitalism with warts, but one of "communism with beauty spots." He meant that Japan, Inc. was a top-down, collectivist system ruled by bureaucrats and corporate technocrats who pursued market share rather than profitability or shareholder value. It worked well in the immediate postwar years when Japan's primary mission was rebuilding from the war and catching up with the West. It did not work as well when Japan faced rapidly changing markets and increasingly sophisticated and low-cost international competition in both service and manufacturing industries. Japan's banks, which stood at the centre of the system, misallocated capital to heavy industry and real estate and have been struggling with bad loans for nearly 15 years.

It would be a mistake to argue that all has now changed in Japan. Many elements of the old system remain in place, even though many important elements have been radically reformed or even dismantled. Corporations slashed unproductive capital expenditure throughout the 1990s, but continued to maintain key elements of the paternalistic lifetime employment system. Profits slumped accordingly. Government officials tried to prop up the economy with increasingly large and frequently wasteful pork-barrel spending projects, which resulted in massive government budget deficits and a staggering government debt-to-GDP ratio of 140% – up from less than 50% in 1984.

In recent years, corporate restructuring has proceeded in earnest as private business executives came to realize that there would be few further rescues from Japan, Inc. Japan's corporations have increasingly shifted their focus from maximizing sales to boosting profits and shareholder value. Shareholder activism is on the rise, reminiscent of developments in the U.S. in the early 1980s. The paternalistic lifetime employment system has faded as companies have focused on stringent cost controls. The government has also tightened its belt and public spending is now down from the late 1990s peak by 40% in real terms and is still declining.

The banking system has become much healthier, as reflected by a sharp rise in the price of bank stocks over the last year. Banks have more capital and they are now battling for supremacy, as shown by the recent takeover battle between Mitsubishi Tokyo Financial Group and Sumitomo Mitsui for the assets of UFJ Holdings. In the past, this type of transaction would have been completely orchestrated and financed by the government. In contrast, this transaction will be privately financed. The fact that Japanese banks are now making competitive bids to acquire assets is a strong sign that there is now a new era in Japan's capital markets.

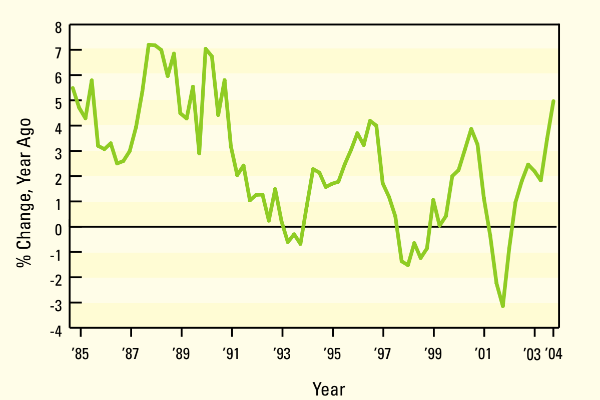
Japan has also opened up its economy to trade in recent years, which has dramatically changed the pattern of trade. Several decades ago, the pattern of trade was very simple: Japan imported energy, raw materials and some food and exported manufactured goods. Currently, nearly two-thirds of imports are manufactured goods, of which nearly one-third comes from China. International competition has put pressure on Japanese firms to shift resources toward higher value-added products and has contributed to stronger growth in productivity. Maintaining stronger productivity growth will be key to Japan's longer-term economic prospects because overall population growth is relatively stagnant.

That said, Japan's demographics are not entirely gloomy from either a growth or a stock market perspective. Although Japan's population is aging rapidly, the working age population is not expected to decline until 2014. In the meantime, the nation appears to be experiencing a generational change from a post-Second World War thrift culture to a consumer-driven culture. Japan's national savings rate, which many economists have argued has been too high, has started to decline as people spend more freely to enhance their standard of living.

With large numbers of people moving into their retirement years, the savings rate is expected to continue to decline as retirees spend capital they have saved during their lifetimes along with their often substantial retirement bonuses. In addition, the fastest-growing segment of the population is currently those in their mid-30s to mid-40s who tend to have the highest propensity to consume. Since consumer spending is the largest contributor to the overall economy, the rise of a consumer culture in Japan augurs well for the sustainability of the recovery.

The recovery that is currently under way certainly has impressive momentum. As shown in Charts 2 and 3, real GDP was up 5% from a year earlier in the first quarter of this

Best Growth in More Than a Decade
Japan: Real GDP Growth



Source: Bank of Japan

Chart 2: Japan's real GDP growth has recently reached 5% and strong momentum is likely to persist into 2005. With plenty of slack in the economy, this expansion should be long lived.

year and has been accompanied by a major acceleration in broad money growth for the first time in years. Improved money growth is a reflection of government measures to clean up the nation's banking problems and a commitment on the part of the Bank of Japan to keep monetary policy accommodative until deflation has been eliminated. Since the overall national price level, as measured by the GDP deflator, was down from a year ago by more than 2% in the first quarter, the Bank of Japan is in no hurry to tighten monetary policy any time soon. That said, if robust growth continues into 2005, the bank may finally begin to consider ending the zero interest rate policy that has been in place for many years.

Surprising Valuations

All of the good news about the economy would be of little interest to investors if Japan's stock market were still as overvalued as it was in the late 1980s. However, years of poor price performance coupled with significantly improved corporate profits have brought the market to far more attractive valuations by many (but not all) measures. In terms of its price-earnings ratio, the Japanese market trades at about 20 times expected earnings over the next 12 months.

That does not sound particularly cheap, but it is important to keep in mind that Japanese accounting practices permit Japanese companies to take far more aggressive depreciation charges against their revenues. That not only understates their profitability relative to international competitors, but also minimizes what they have to pay to the tax authorities.

Looking through the depreciation smokescreen at actual cash earnings, the picture is much rosier. On a price-to-cash earnings basis, the Japanese market trades at a multiple of 8.6 times, compared with 13.1 times for the U.S. market. Inverting those ratios, Japanese companies are currently providing a cash flow yield of nearly 12%, compared with 7.6% for U.S. companies. Keep in mind that 10-year Japanese government bonds offer a current yield of only 1.8%, while bank deposits offer essentially zero interest. Even accounting for debt repayment by Japanese companies, the estimated free cash flow yield is about 5.5%, which should be far more attractive to long-term savers in Japan than government bonds or bank deposits.

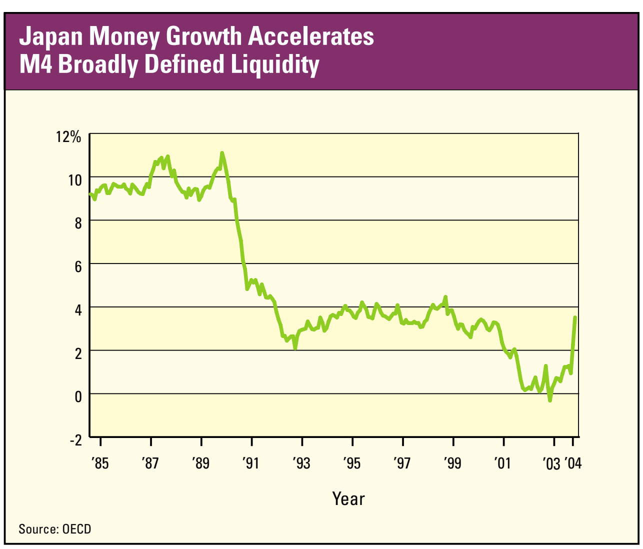


Chart 3: Money growth in Japan has finally accelerated, reflecting aggressive monetary expansion by the Bank of Japan and recent measures to deal with banking system problems.

To be sure, there are still important risks to investing in Japan. Even with improving domestic fundamentals, Japan would not be immune to global market volatility associated with rising U.S. interest rates or a major slowdown in China. And while we think the risks of a policy mistake in Japan – such as a premature monetary tightening or major tax hike – are low, these things have happened before.

At the same time, it is important to remember that the Japanese stock market is not simply a play on exports to the U.S. or China. Like other major economies, nearly 90% of the economy is domestically focused. Japan's market historically has been one of the least correlated markets with other major markets, because its domestic economy has tended to move to its own drumbeat. External influences aside, if the Japanese domestic economy begins to improve, it should eventually be good news for investors in Japan.

At the very least, we think the long period of underperformance of Japan's market relative to the rest of the world has ended. As shown in Chart 1, the period of dramatic underperformance of Japan's market lasted from 1989 to 1999. Since then, Japan has traded more or less in line with other markets, with some relatively minor zigs and zags.

Our bottom line: With the dollar likely to remain weak, with Japan's companies having restructured and refocused on profitability, and with Japanese valuations at attractive levels, Japan should definitely be back on investors' radar screens. In particular, investors who have avoided international equity funds (which invest outside North America) because they did not want any exposure to Japan should think again.

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