



## Has Japan Become a “Normal” Country for Global Investors?

In mid-June, the Financial Times carried an article that argued, “to treat Japan as an economic curiosity looks ever more odd.” The author, Chris Giles, noted that the world’s second-largest economy is widely considered to be an economic and

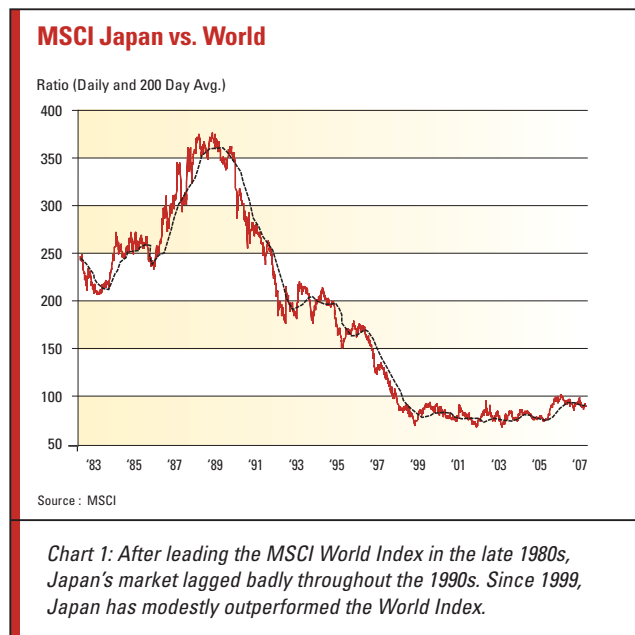
financial anomaly, whose economic performance is destined to lag the rest of the world. He pointed to the perception that Japan’s “culture is so weird and the concerns of its population so unique that the latest global reform ideas are inapplicable.”

To be sure, during the bubble period when Japan’s stock market traded at 100 times earnings or more, it made sense to consider Japan to be an exceptionally unattractive market. Furthermore, as shown in Chart 1, the Japanese market lagged global markets badly throughout the 1990s as the economy suffered and valuations came down during the post-bubble era. However, since 1999, the MSCI Japan Index has modestly outperformed the MSCI World Index in U.S. dollar terms – suggesting that Japan should once more be considered a “normal” country for global investors.

This view is supported by the fact that Japan has enjoyed a steady economic expansion over the past five years with annual growth rates in real gross domestic product ranging from 1.5% to 2.5%. That puts it in the middle of the G7 pack and suggests that the dramatic economic underperformance of the 1990s is a thing of the past. The recovery has come in tandem with the stabilization of Japan’s banking system, which was reflected in a very recent decision by Standard & Poor’s to upgrade the credit ratings of eight major Japanese banks.

The Financial Times article also points out that Japan has been quite normal from several other points of view. First,

it has had a similar experience in recent years to other rich countries such as the U.S. in its trade integration with developing economies, particularly with China. Second, it has experienced a huge surge in corporate profits relative to wages, just as in every other G7 country. Third, it has experienced a significant drop in its household savings rate as its consumers have responded to lower interest rates and the expectation of continued steady growth. Finally, its public policy debates have been broadly similar to those of other rich developed nations, with a focus on dealing with rising income and regional inequalities and in reforming its pension system to deal with its aging population.





### After a Lost Decade, Wealth Creation is Back

A look at the distribution of individual stock price movements in Japan compared with those in world markets outside of Japan also shows that the Japanese market has offered investors a fairly normal range of opportunities in wealth creation – and wealth destruction – in recent years. As shown in Table 1, the distribution of stock price returns in the MSCI Japan stock universe from June 2002 to June 2007 overlap largely with the distribution of stock returns in the MSCI World excluding Japan universe. Although the average return of the Japanese market in U.S. dollar terms lagged the rest of the world (due in part to a weaker yen), there were many opportunities at the individual stock level to make stellar gains in Japan during that period, with the cutoff for the 75th percentile being a gain of 156%, while the cutoff for the 95th percentile was a gain of 556%.

This was in sharp contrast to the experience over much of the previous decade when, over many periods, a top-quartile stock picker in Japan would have been lucky to have posted bottom-quartile results compared with most other international markets.

<b>Distribution of Five-Year Stock Price Returns</b> (U.S. Dollar Basis, %)		
Percentile	Japan	World excl. Japan
99%	1118.3%	1436.4%
95%	556.4%	579.8%
75%	156.7%	211.1%
50%	80.5%	112.1%
25%	39.0%	42.3%
5%	-14.0%	-10.3%
1%	-41.7%	-47.9%
<b>Geometric Mean</b>	95.1%	120.9%

Source : MSCI

*Table 1: The distribution of stock price returns in the MSCI Japan universe from June 2002 to June 2007 is similar to that of the MSCI World excluding Japan. This shows there were many opportunities to make exceptional returns on individual Japanese stocks during the period.*

A look at the top-performing and worst-performing stocks over the last five years also illustrates the process of “creative destruction” and intense structural change in Japan as its economy becomes more integrated with those of its Asian neighbours. The 10 leading stocks included steel, basic materials and construction companies, all beneficiaries of the global commodity and infrastructure boom. The bottom 10 stocks were dominated by mid-tier Japanese manufacturing companies that have had to deal with intense competition from low-cost competitors in China and other emerging markets. Essentially, the winners have been those selling to China and other emerging markets while the losers have been those competing with their growing manufacturing prowess. In view of the strong political clout of the major manufacturers, it is no wonder that Japanese policymakers have opted for a weak yen to help cope with the challenge from China.

### Persistent Peculiarities

With Japan’s economy no longer in a deflationary trap and with Japan’s stock market having delivered reasonably healthy performance in recent years, the argument for no longer treating Japan as an economic curiosity seems sensible enough. That said, there are still any number of persistent peculiarities that make analyzing potential investment opportunities in Japan somewhat challenging. These have to do with the abnormally low Japanese interest rates, higher-than-average equity valuations, and various impediments to mergers and acquisitions and foreign direct investment.

Japan’s interest rates remain unusually low by international standards, with three-month money market rates of about 0.75%, while 10-year government bonds yield only 1.8%. The low rates reflect persistently low inflation and slow rates of credit growth. Despite strenuous deflation-fighting efforts by the Bank of Japan in recent years, bank lending growth has essentially stalled while consumer price inflation

remains non-existent. Furthermore, in spite of the recent downward trend in household savings, growth in corporate savings and retained earnings has been so robust that Japan still has massive excess savings relative to its domestic investment needs. That contributes to extremely low real interest rates and is reflected in a current account surplus in excess of 5% of GDP.

Against a backdrop of low inflation and low interest rates, Japan's equity valuations remain higher than in many other nations. As can be seen in Table 2, Japanese stocks currently trade at around 18 times expected earnings over the next 12 months, compared to a global average of about 14.5 times expected earnings. Accordingly, Japanese stocks still look unattractive in a global context by that particular measure.

Relative to Japanese bond yields, however, Japanese stocks look exceptionally cheap. With Japanese stocks providing an earnings yield of 5.6% (the inverse of the P/E ratio of 18), while 10-year bonds yield only 1.8%, Japanese stocks appear to be nearly 70% undervalued compared to bonds. The calculation is even more extreme if the yield on Japanese stocks is compared to the yield on inflation-linked 10-year government bonds, which currently stand at only 1.3%. That comparison implies that Japanese stocks are 76% undervalued versus government bonds.

The fact that Japan's domestic investors are still shunning stocks is also seen in survey evidence showing that only 12% of individual financial assets in Japan are held in the form of equities, while more than 50% are still held in cash equivalents earning next to nothing. In contrast, individuals

### Valuation Comparison: International Stocks vs. Bonds

Data as of June 29, 2007

Market	12 - Month Forward P/E Ratio	Earnings Yield	10 - Year Nominal Bond Yield	Relative Valuation Stocks vs. Bonds
Canada	17.1	5.8%	4.6%	-22%
U.S.	15.3	6.5%	5.0%	-23%
Europe ex. U.K.	13.4	7.5%	4.6%	-39%
U.K.	12.8	7.8%	5.5%	-30%
Japan	18.0	5.6%	1.9%	-66%
Pacific ex. Japan	16.1	6.2%	5.6%	-10%
World	14.7	6.8%	4.6%	-32%

Source: Lehman Brothers, Bloomberg and Trilogy Global Advisors

*Table 2: With a P/E ratio of 18, Japanese stocks appear expensive relative to the rest of the world. However, when compared to yields on Japanese bonds, Japanese stocks look very cheap - 66% undervalued versus bonds.*

in the U.S. keep about 13% of their financial assets in cash equivalents and 33% in equities. Presumably, the hyper-conservative asset allocation of Japanese households reflects their dismal experience with equity markets during the post-bubble, deflationary decade of the 1990s which was followed by the global bear market in the early part of this decade.

Another reason that Japanese equities remain quite cheap relative to bonds is most likely due to the fact that Japanese society still discourages free-wheeling merger and acquisition activity that puts pressure on corporate managers to adopt shareholder-friendly practices. Although there have been a few isolated cases of unfriendly takeovers in Japan in recent years, there are still many institutional hurdles facing potential acquirers of Japanese companies. As a result, the cumulative total of foreign direct investment in Japan stands at only 3% of GDP – compared with 22% in the U.S. and 37% in the U.K. Obviously, if the environment for takeovers were to change significantly, the Japanese market could become very interesting indeed.



### **Will Domestically Oriented Growth Make a Comeback?**

Although much of Japan's economic expansion in recent years can be attributed to strong capital goods exports to the emerging markets, a case can be made that the economy is getting ready to shift gears toward more domestically led growth. Japan's unemployment rate has been falling steadily over the past few years, reaching 3.8% in May and June – the first time in nine years it has been below 4%. This reflects stepped-up hiring by Japan's major corporations and should lead to better wages and improved consumer spending. To benefit from this trend, we hold positions in a number of leading retailers in Japan, including Nitori, Komeri, Yamada Denki, and Don Quijote.

The rise in employment also could have an impact on the extraordinarily low Japanese interest rates and the yen. As consumer spending picks up, pricing power is also likely to improve for Japanese corporations. And while core inflation remains slightly negative in Japan, it is likely to begin to advance over the next six to 12 months, which would allow the Bank of Japan to continue to raise interest rates and help stabilize the yen.

Unlike other nations, where rising rates would hurt financial stocks, Japanese financial stocks are likely to benefit from rising rates for two reasons. One is that higher rates will be a signal that Japan has definitely exited from the deflationary era that created such massive asset quality and credit problems for the banks. The other reason is that higher interest rates will permit banks and other lenders to improve their net interest margins, which were squeezed brutally during the period of super-low interest rates. Accordingly, we maintain positions in premier financial institutions like Mizuho Financial Group, Sumitomo Mitsui Financial and Credit Saison.

Despite the persistence of some peculiar features to the investment environment in Japan, we believe firmly that Japan once again offers interesting growth opportunities. As Japanese domestic investors take note that their equity returns have trounced their returns from fixed income for a number of years, the stage should be set for a resurgence in domestic demand for Japanese equities. That, combined with the strong vested interest for Japan's aging population to earn a decent rate of return on their retirement assets, could also bring pressure to bear on Japan's corporate managers to adopt more shareholder-friendly policies and to be open to takeover bids as well.

In short, even for those who are not convinced that the sun will rise again, the outlook is at least partly sunny for investors in Japanese stocks.

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