

The Japanese equity market provides a safer haven for investors

Japanese companies offer compelling opportunities

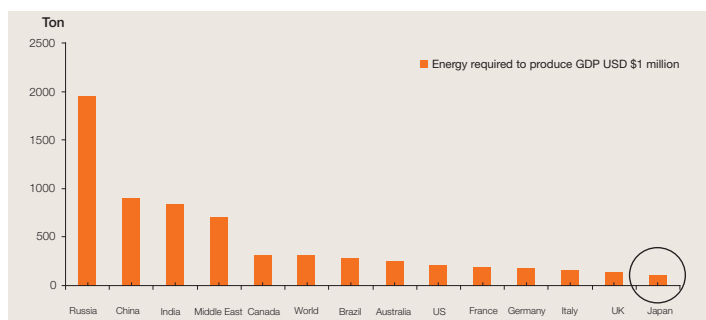
Japan was an underperformer in 2007, and has outperformed in the first half of 2008

In 2007, the Japanese equity market underperformed, giving back the entire premium it had built since its last rally in 2005. Japan was hit more than other markets by the impact of the global credit crunch, despite the fact that Japanese companies had negligible exposure to the US subprime market. However, the Japanese equity market has started to once again outperform other global equity markets in 2008. A particular catalyst came from the rescue of Bear Stearns in March, which appeared to draw a line under concerns about the global financial system. Investors are becoming increasingly aware of the risk of not having Japanese equity exposure.

Several factors have given the Japanese equity market an edge, making it potentially a safer haven in these uncertain times where rising inflation and energy price increases are causing concerns. First of all, on both an historical basis and in comparison with regional peers, the valuation of Japanese equities is now compelling. In addition, Japanese inflation is well contained compared to other regions, while Japan has a much higher threshold for inflation before interest rates need to be increased. Japan also benefits from superior energy efficiency compared to other major economies.



Source: Morgan Stanley Research. Information as at 11.06.08.



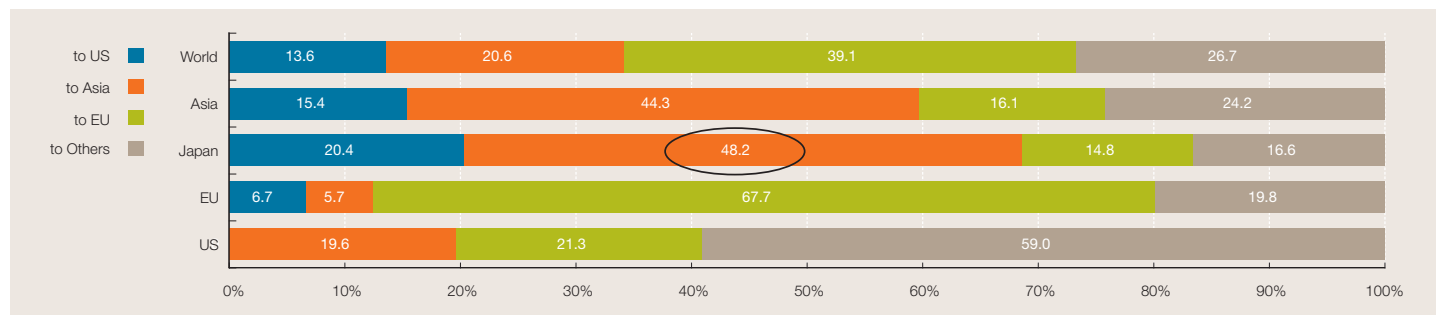
Source: Nomura Research. Information as at 23.06.08.

Further downside risk to Japanese Corporate Earnings is limited, in contrast to other regions

Japanese corporate earnings are expected to hold up well, in contrast to Europe and the US, where the worsening macroeconomic environment is likely to trigger downward revisions to corporate forecasts. The key point, however, is that the market has already factored slowing economic growth, rising costs and stronger yen levels into its earnings guidance for the 2008 fiscal year. Foreign exchange assumptions by Japanese companies are already very conservative due to the yen's appreciation against the US dollar in the first quarter of 2008. Since then, however, the yen has weakened slightly and has now stabilised. We also maintain the view that Japan is a primary beneficiary of emerging market demand, especially from Asia. Strong demand from emerging markets should support earnings from Japanese manufacturers, whose market cap comprises 60% of the Japanese equity market.

The main risks include any sudden appreciation of the JPY against the USD, and any significant deterioration in emerging market economic growth. If the current uncertainty in the global financial system persists, and US interest rate expectations should fall again, the USD would be expected to weaken, which would be damaging for Japan. Although historically foreign exchange rates have not been the most important factor for long term earnings, in the short term, the exchange rate may penalise Japanese exporters. However, this risk of a negative impact from JPY appreciation should be to some extent offset for overseas investors who are holding unhedged Japanese equity investments in JPY. Meanwhile, any significant slowdown in emerging market growth, especially in China, would be negative for Japan. However, we currently maintain the view that the current economic uncertainty will eventually recede, while strong internal demand from emerging countries will help support the overall global economy.

Regional breakdown of exports – 2007



Source: IMF, Nomura Securities.

The Japanese equity market provides a safer haven for investors

Japan's healthy financial system

What a difference a decade makes. Unlike the situation around 10 years ago, when the Japanese banking system was crippled by bad loans, now the Japanese banks have plenty of capital. Japanese banks have much healthier balance sheets than their US and European counterparts. Lending by Japanese banks was up by 2.0% in June 2008 from a year earlier, data from the Bank of Japan showed in July. The June increase follows a 1.6% gain in May and marks the 29th straight month of expansion.

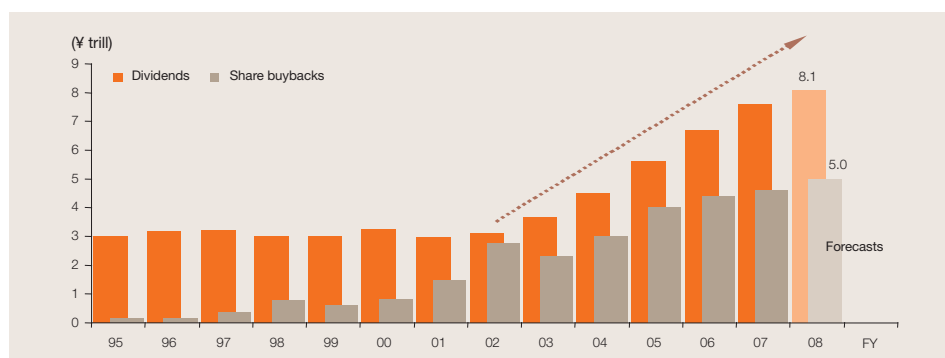
Japanese banks have also seen ongoing growth in overseas lending as their US and European counterparts reduce their risk tolerance. With a large number of global financial players reeling from the subprime crisis, Japanese banks have a unique opportunity to leverage their relative strength and improve their international standings. There are already signs that Japanese banks are playing a growing role in the international market for syndicated loans. According to data compiled by US research firm, Dealogic Ltd, Japan's provision of syndicated loans jumped 56% year on year in the first six months of 2008. In contrast, US loan provision dropped 50%. Japan's top three banks also climbed in the rankings of lenders.

Cash rich Japanese companies are focusing on shareholder returns

Japanese companies have very healthy balance sheets. Publicly traded companies have continued to improve their financial health – approximately 40% of listed companies are now virtually debt-free. Because of their healthy balance sheets, Japanese companies are well positioned to withstand rising interest rates and other changes in the financial environment.

There is also clear evidence that corporate governance is improving and that shareholder returns are on the rise against the backdrop of increasing pressures from foreign investors, as well as domestic institutional investors. The Japanese Pension Fund Association last year adopted a policy of opposing director reappointments at firms whose return on equity has remained below 8% for three consecutive years, unless they provide sufficient explanations and make satisfactory proposals. It voted against 39% of the director reappointment proposals at general shareholder meetings last June. Aside from pension funds, asset managers have also been focusing on ROEs in assessing the competence of corporate directors. Facing increasingly vocal shareholders, firms have begun making efforts to improve capital efficiency. Furthermore, higher dividends and increased share buybacks have been an important feature of the Japanese market for a number of years and these positive trends will underpin valuations going forward. This positive development has not yet been fully appreciated by overseas investors, but may eventually become a catalyst for foreign buying. Dividends paid by Japanese companies increased by 14% for fiscal year 2007 compared to the year before, while shareholder returns including both dividends and share buybacks reached historical highs.

Expansion of Japanese Corporate Shareholder Returns



Note: Universe = All listed companies.

Source: Toyo Keizai; compiled by DIR.

Summary: Japanese companies offer compelling opportunities

- Attractive valuations, well contained inflation
- Lower downside risk to corporate earnings
- Among the largest beneficiaries of emerging markets growth
- Stable currency
- High energy efficiency
- Healthy financial system, strong balance sheets
- Increasing shareholder focus

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