

JAPAN INTRODUCES CATALYSTS TO PROMOTE GROWTH AND REFORM INDICATORS POINT TO CONTINUING EXPANSION AND PROGRESS

MARCH 2006

The Japanese economy is growing. Corporate profits are robust and a growing number of firms investing. Prices are rising and office vacancies declining. Job opportunities are increasing, wages are rising, and bonuses have risen significantly, leading to strong consumer and business spending. The Bank of Japan is moving forward and ending the quantitative easing policy that it has enforced since 2001. Investor and business interest in Japan remain strong, backed by solid macro, industry, and firm level data.

Recognizing that additional progress is dependent upon making Japan a more market-friendly and competitive business environment, the Japanese government is now introducing a number of important new programs. These include efforts to invigorate the media and telecommunication sectors through regulatory and legal reforms as well as measures to enhance the regulation of corporate finance and Japanese capital markets through enhanced disclosure requirements. The government is also moving to strengthen bank governance, bolster the utilization of IT in banking, and improve the financing of Small and Medium Sized Enterprises (SME's).

With continuing corporate and government efforts to introduce additional catalysts that can build on Japan's recent achievements, the country will remain an increasingly attractive and important market for any corporate and portfolio investor that is seeking to expand their international presence.

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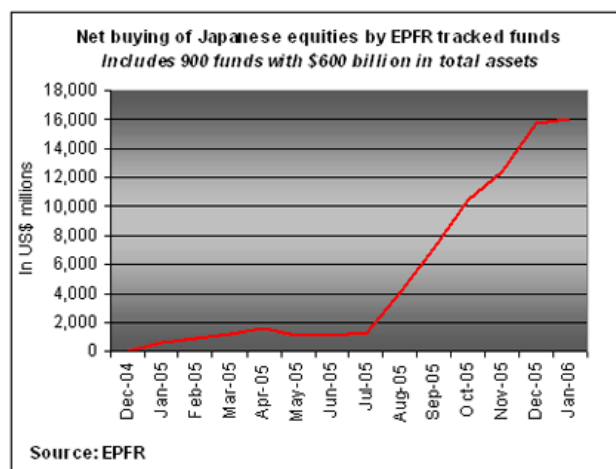
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Analysts Identify Catalysts that can Sustain Japan's Recent Advance

Strong Japanese stock market performance in 2005, record corporate earnings and evolving monetary policy have caused some analysts to question whether there are additional upward gains to be achieved in Japan. This has led strategists such as JP Morgan's Hajime Kitano to suggest investor's lock in their profits. Others, such as Goldman Sachs Kathy Matsui, are more optimistic, believing there is opportunity for future gains on the back of strong domestic demand and more active involvement by domestic investors. Takashi Kamiya, chief strategist at T&D Asset Management in Tokyo echoes these sentiments, saying in light of the end of deflation, "If you are looking at the next three to five years, you have to be bullish on Japan."

The search for new catalysts to drive future performance has created some investor anxiety. The Tokyo Stock Exchange reported that foreign investors were net sellers of Japanese equities during the week ending March 16. On the other hand, the Nikkei 225 index rose 285 points the following Monday, indicates along with other data that this may be only a sign of indecision and a temporary phenomenon. Emergingportfolio.com, for example, while reporting a moderated appetite for Japanese funds by foreign investors during the week ending March 8, 2006, noting that allocations "were well off the pace set during the 2005" only one week later stated "Investors demand for Japan Equity Funds returned to its strongest in five weeks as these funds have taken in nearly \$3 billion in new money this year."

Regardless of the direction of the Japanese stock market over the near term, it is fair to recognize that future performance will be dictated by Japan's ability to introduce new catalysts and continuing progress toward its goal of building a more competitive and efficient economy. Otherwise the gains that have been achieved are likely to prove more cyclical than structural in nature and will erode over time.



Japan Offers Positive Economic Data on Many Fronts

Macroeconomic Reports Yield Good News

In 2005 Q4 Japan's economy grew 1.4% (5.4% annualized), a rate far greater than the 0.3% experienced in the U.S. and 0.4% experienced in the European Union. Japan's 2005 Q4 performance derived largely from domestic sources such as consumer spending and business investment. In remarks given to the BBC Koji Fukaya, an analyst at the Bank of Tokyo-Mitsubishi UFJ, observed the data "proves a well-balanced expansion in the economy is continuing." Along similar lines, Jesper Koll, economist at Merrill Lynch in Tokyo stated "Japan's economy has snapped out of its deflationary doldrums...This is not a 'one-quarter wonder.'" Other signs of Japan's strong economy include the lowest office vacancies in Tokyo since October 2001 and the increase in Japan's leading economic index, which includes consumer confidence.

Business Continues to Play a Vital Role in Japan's Economic Growth

The rebuilding of business inventories depleted in the third quarter nonetheless added to Japan's continuing economic rebound, and business investment during 2005 increased by 8.4%. Data for January 2006 indicates Japanese businesses remain upbeat with industrial output increasing by 0.3% over the previous month -- the sixth month in a row production had increased. Importantly, this recovery is broad based and not just concentrated in the IT sector. For example, in February 2006, the Japan Machine Tool Builders' Association reported that machine tool orders surged 5.3% year-over-year (YOY), the 41st straight month of expansion. A Tankan survey released in the same month revealed that Japanese manufacturers, on the whole, are becoming increasingly confident.

Positive Trends in the Business Sector are leading to Strong Corporate Profits

In the 4th quarter of 2005, Japanese corporations recorded a stellar 17.7% increase in profits over the previous quarter (the 14th consecutive quarter of high growth), with profit growth especially noteworthy among major Japanese corporations. While profits among SME's has not been as strong, this can be seen as a sign of increased competitiveness and efficiency -- as Japan continues to deregulate and open its economy there is shift toward industrial consolidation.

The strong performance of the corporate sector is also leading to a resurgence of Japanese banks. Mitsubishi UFJ, the world's largest bank by assets, recently reported record annual profits of ¥1,170 billion (\$10 billion), allowing the bank to increase its dividend while paying back government loans. The improved economy is also encouraging Japanese banks to lend more freely, as evidenced in Bank of Japan (BoJ) statistics for February which show the average daily balance of bank lending growing for the first time in more than eight years. Furthermore, after adjustments for special factors such as loan-loss reserves, bank lending expanded to ¥388.20 in February YOY, the seventh straight monthly rise.

Stronger Consumer Spending Led to the First Rise in Annual Retail Sales in Nine Years

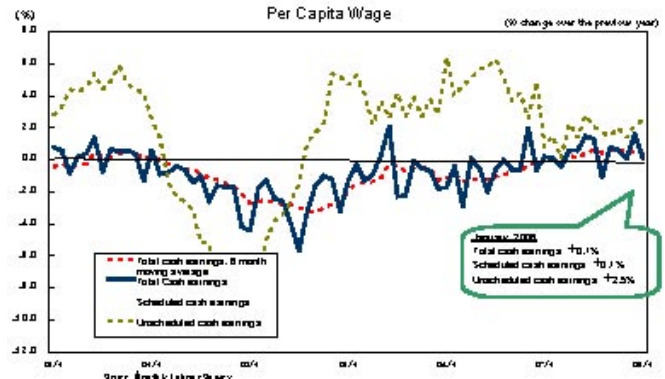
The impact of stronger consumer spending in Japan can be seen in rising retail sales. In 2005, retail sales rose 1.1% YOY, constituting the first rise in annual retail sales in nine years. This prompted the Japanese Cabinet Office to note in its March report that private consumption has been "increasing moderately" as a result of favorable consumer sentiment (which has been rising for almost 9 months) and an improving employment situation. In the view of Ryota Sakagami, an economist at Nomura Securities, this should enable consumers, "who already have been a key player in growth" to "play a more pronounced role in the economy" in 2006.

It is not surprising that Japanese consumers have been spending given the improving employment situation. In January the number of individuals holding jobs increased by 80,000, representing a dramatic improvement over the 5.5% high registered in January 2003. Evaluating this data, Tatsuya Torikoshi, senior economist at the Daiwa Institute of Research states "the improvement in the unemployment rate confirmed that the Japanese economy is headed towards steady recovery." Significantly the jobs-to-applicants ratio rose to 1.03 from 1.00 in December and .99 in November. For the first time in 13 years, there were more job openings than applicants.



Source: "Financial Statements Statistics of Corporations," Ministry of Finance, Japan

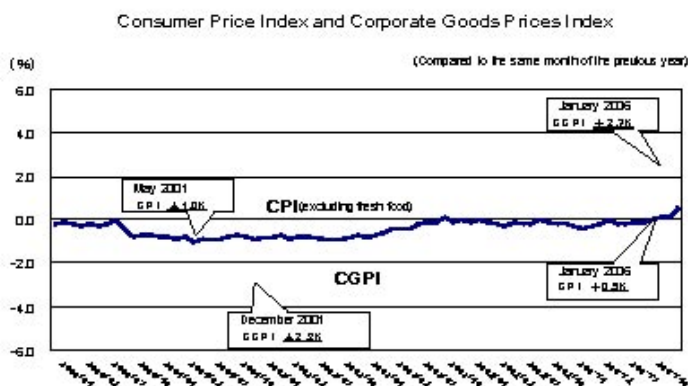
Although not all jobs are permanent full-time positions, developments in the work environment are increasing wages, producing sizable bonuses, and resulting in higher disposable income. For example production workers at leading automobile and electronic companies such as Toyota and Fujitsu won gains in monthly pay for the first time in five years. These gains are encouraging consumer spending which, in a virtuous cycle, is fueling greater business investment and increased economic activity and subsequently more job opportunities, wage growth, and consumer spending.



Source: "Labour Force Survey," Ministry of Internal Affairs & Communication, Japan

Price Data is also Lending Encouragement

In January Japan's rate of underlying inflation, excluding fresh food, rose 0.5% YOY. This was the third straight monthly increase in the core CPI and represented an eight-year high. It followed Japan's first back-to-back rise—in November and December—in the CPI since April 1988. This data led Takuji Aida, chief economist at Barclays Capital, to remark in late January, "Japan is finally shaking off a long bout of deflation."



Source: "Monthly Labour Survey" Ministry of Health, Labour & Welfare, Japan

Two months later, Japanese Prime Minister Junichiro Koizumi said before a parliamentary committee "We are seeing signs of getting out of deflation." For Christopher Wood, an analyst with CLSA Brokerage in Hong Kong, progress on deflation was welcome news, suggesting an increasing demand for loans and rising asset values.

End of Quantitative Easing in Japan and its Implications

BoJ Changes Tact

In response to the positive news regarding the end of deflation as well as Japan's solid economic performance, the BoJ moved on March 9th to end its quantitative easing (QE) policy, initiated in March 2001 to support a troubled financial system, combat deflation, and facilitate government and corporate borrowing. In the course of ending QE the BoJ will remove over time roughly around ¥24-29 billion of excess liquidity, while seeking to keep overnight call rates around zero. In tandem, the BoJ confirmed its willingness to purchase significant quantities of Japanese government debt. The BoJ also affirmed that it will sustain the inter-banks overnight call rate near zero (so called the zero-interest rate policy (ZIRP)) for a considerable period, and made public the "understanding of Long to Medium term Price Stability" by members of its Policy Board which regards a 0-2% rise in CPI as an appropriate level of inflation.

Concerns about the End of QE May be Overdone

Some analysts have asked whether the end of QE will lead to de facto higher interest rates and a formal end to ZIRP, with various ramifications for the "carry trade" that has allowed investors to borrow in lower-yielding currencies such as the yen and invest in higher yielding currencies and assets. Others recall 2000 when the BoJ ended ZIRP prematurely and magnified the difficulties Japan was experiencing in the aftermath of the Asian financial crisis and the bursting of the dot-com bubble in the United States. While these concerns are understandable, it is unlikely the BoJ will rapidly or steeply raise interest rates. For example, BoJ Governor Toshihiko Fukui, attending a Group of 10 Central Bankers meeting in Basel, Switzerland, stated, "it's too early to speak about rate hikes. We have to carefully watch the future course of the economy and prices." Similarly, Eisuke Sakakibara, Japan's former vice-minister of Finance for International Affairs, recently stated that any interest rate increase was likely to be small and "not something to worry about."

Even if rates do rise over the longer term in accordance with Japan's continuing economic progress it is not clear they will have a serious impact, as Japanese companies have significantly de-leveraged themselves and are far more competitive in how they utilize capital.

Takehiro Sato, an economist with Morgan Stanley, writes that any resultant yen appreciation is unlikely to affect Japanese companies because the effective real yen rate is quite low. BCA Research adds that growing bank lending means that the money supply will grow even as rates rise.

The End of QE Has Benefits

Rising interest rates can have positive consequences such as allowing banks to charge more for loans. Brett Hemsley, associate director of financial institutions at Fitch Ratings, stated the end of QE was “a very positive move for the financial system as a whole and particularly for the mega-banks.” As well, the Japanese people, who are huge net savers, will gain. Goldman Sachs estimates a 1% rise in deposit rates could increase household balance by ¥7,800bn and feels new interest income could lead to new levels of spending on goods and services. In a piece in the Wall Street Journal, David Malpass of Bear Stearns forecast that rising rates would limit cash hoarding, thereby leading to an increase in the velocity of money and productive investment. This is likely to induce greater demand for Japanese as well as foreign equities and other financial products and services. Coupled with these benefits, interest rate shifts could help to rebuild money and strengthen capital markets, adjust global imbalances, and facilitate a rationalization of investment activity as well as that of the corporate sector.

Corporate Change and Restructuring Continues

Even before the BoJ moved to end QE, many Japanese corporations had begun to take steps to rationalize their operations, enhance their domestic and international competitiveness, and increase their returns to shareholders. Recently Sony Corporation took steps to rid itself of non-core operations by announcing it would sell a 51% stake in five retail-related businesses to Nikko Principal Investments, a private equity firm. Over time, Sony plans to further reduce its stake in these businesses. Nikko Asset Management, with which Nikko Principal is affiliated, implemented new incentive structures, streamlined its organizational chart, and transformed reporting and promotion practices. In the process, the firm dramatically grew its assets and the performance of its funds.

Japanese banks are also some of the main players in corporate rationalization. According to CLSA, the Asian brokerage, Japanese banks have dramatically shed their bad loans from 8.4% of total loans to 2.4% over the period from 2002 to 2005. Moreover by the end of 2005 Japanese bank capital-adequacy ratios were 3 full percentage points higher than international requirements.

On the investment front Canon, which since the mid-1990s has been rationalizing its business by eliminating money-losing businesses, restructuring manufacturing, and dramatically reducing debt, is seeking almost to double its R&D budget, while investing billions of yen in new flat-screen technologies. Elsewhere news reports reveal Japanese firms continue to invest to maintain their ability to manufacture high-quality goods efficiently. For instance, Honda Motor announced it would build a ¥30 billion (\$252 million) plant in Yorii, north of Tokyo, to produce power trains or assemble cars.

Japanese Government Moves to Improve the Business Environment

The Japanese government continues to adopt and implement policies designed to improve the environment for foreign and domestic business. Heizo Takenaka, Minister for Internal Affairs and Communications, revealed in a Financial Times interview that he had convened a special taskforce to investigate how Japan might reform business practices and regulation in the telecommunications and media sectors to double or even quintuple revenues. In particular Takenaka is developing policies that would allow companies to utilize the Internet as a medium for distributing television and other content.

In addition, Japan's Ministry of Economy, Trade, and Industry (METI) has been implementing a strategy supporting strategic sectors such as fuel cells, environmental services, and robotics. This strategy provides assistance to firms involved in advanced components and materials and contains measures to strengthen the protection of intellectual property rights and trade secrets, offering support—e.g., tax incentives and aid to graduate programs—for investment in training, R&D, and IT.

Japan Further Develops Its Capital Markets and Security Regulation Infrastructure

Traditionally, Japanese businesses have relied on the banking system to meet the vast majority of their financing needs. Akira Kojima, Chairman of the Japanese Center for Economic Research and a Special Editorial Advisor to the *Nihon Keizai Shimbun*, wrote in *Japan Economic Currents* that Japan needs to further develop its capital markets to ensure funds were available for risk takers and firms with an entrepreneurial spirit. In particular there is a need to develop the complex infrastructure necessary to promote and support liquid, transparent, and stable capital markets as well as discourage unlawful actions such as that witnessed in the case of Livedoor, an internet portal. David Sneider, a partner at Simpson Thatcher and Bartlett in Tokyo, put it simply: "Japan needs a greater disclosure enforcement regime."

In June 2005 the Japanese Diet passed legislation to build the needed infrastructure by revising the Securities and Exchange Law. This has resulted in increased disclosure requirements. For their part, the Financial System and Business Accounting Councils of Japan's Financial Services Agency (FSA) proposed, around the same time, standards for audits, internal controls over financial reports, and quarterly reporting.

More recently, the FSA has begun to work on a law that would establish a comprehensive and cross-sectional body of rules to eliminate loopholes and the inconsistent treatment of similar financial instruments. In addition to standardization, the law is also designed to create new financial instruments and relationships. Consequently this legislation would allow for different rules depending upon differences in financial instruments, the knowledge or experience of investors, and so on. One interesting facet is its desire to regulate activities—e.g., advertising, fee disclosures, and marketing—of businesses offering investment services. This law would also introduce a statutory quarterly reporting system and mandatory certification of annual reports by management. Finally, this initiative seeks to synchronize Japanese and international rules, strengthen enforcement mechanisms, and improve the civil liability system for customers.

Japan Continues to Present Strong Opportunities for Investors

Analysts such as Robin Griffiths at Rathbones Investment Management continue to see opportunities in Japan for lucrative gains, both in respect to the market as a whole and especially in sectors such as retail, mining, property, and financial services. CLSA notes that the Japanese market, despite the gains of the past few years, is still substantially below its 1990 peak. Furthermore, in the view of CLSA analyst Christopher Wood, rising Japanese interest rates are likely to push Japanese domestic institutions, who have been net sellers of ¥16 trillion of equities since 2003, out of bonds into equities. Lastly, Japanese households only hold 9.8% of their financial assets in equities, far lower than other developed countries such as the U.S. Related to this, CLSA found, through a survey, that one in four Japanese baby boomers, who hold almost two hundred trillion yen in assets, plans to increase their stake in Japanese equities.

Continuing progress in Japan and greater involvement by both foreign and domestic investors is ultimately dependent upon the ability of Japan and its corporations to build on recent achievements and to introduce new catalysts that will introduce additional advances in efficiency, profitability and a more open, transparent and competitive business environment. Fortunately, recent indicators seem pointed in the right direction.

In addition to growing business investment, increasing R&D spending, and rising bank lending, the Japanese government is dedicated to ensuring these trends continue and has introduced a number of policies including the industrial promotion and securities regulations measures highlighted above. In addition, there are many other advances and initiatives that are now underway, not least of which are plans to privatize Japan's \$3 trillion+ Postal Savings System.

Interim volatility and consolidation remain a healthy feature of any rising market, including Japan. That said, there is every reason to believe the underlying trend remains positive and that Japanese corporate and government entities will continue to introduce the strategies, catalysts and improved operating environment that will help to sustain the Japanese economic recovery for many years to come.

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