

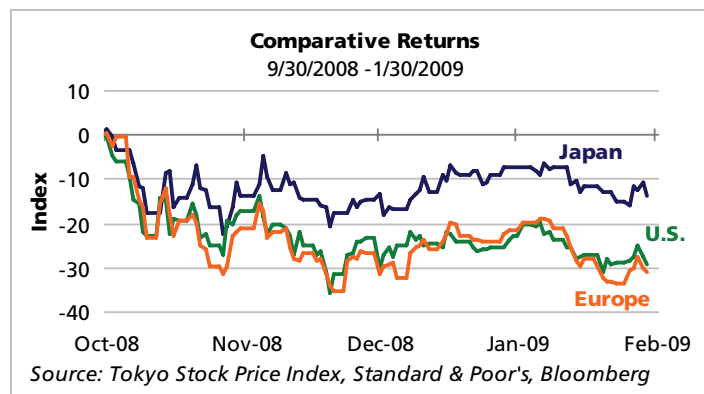
## Japan: Will The Sun Ever Rise?

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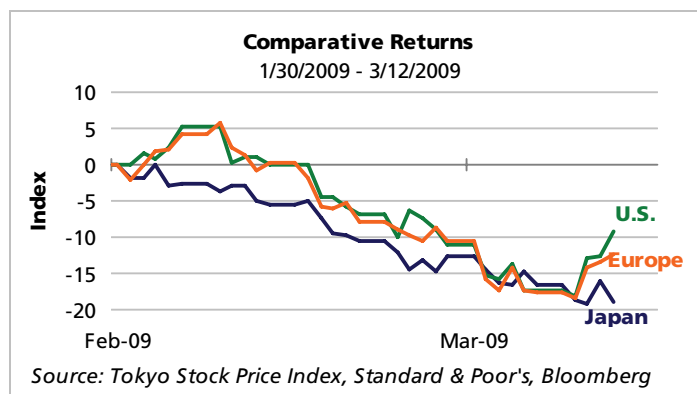
Japan's moniker – "the land of the rising sun" – has been somewhat inapt for almost twenty years now. Both the Japanese economy and stock market, barring a few interludes, have persistently underperformed their developed peers ever since the Japanese bubble burst in 1990. Sluggish growth, a series of banking crises, and a lack of decisive leadership to deregulate and effectively stimulate a moribund economy were woefully inadequate to address the underlying deflationary pressure and sub-par profitability.

Since 2002, the picture was a little brighter; a strong world economy played into its one major strength, namely its world class consumer and capital goods exporters. A strong export performance more than masked its dead-in-the-water domestic economy. Its geographic proximity to the motoring Asian economies and higher penetration of the North American and European markets were reflected in strong trade surpluses. Japan though, with its zero interest rate policy and stagnant domestic economy, was a structural exporter of capital and facilitated the financing every imaginable carry trade. These outflows largely neutralized the strong trade surpluses, resulting in time in an undervalued Yen and which helped underpin the profitability of its vital export engine.

From an investment perspective, the Japanese equity market as a whole remained unattractive, and it proved to be the "low beta play" in the 2003-2007 global bull market. Hope flickered briefly under the reformist premier Koizumi in 2005, but was swiftly snuffed due to the ingrained political inertia. Paradoxically, though, the Japanese market proved to be relatively defensive in 2008 when global deleveraging and derisking (a much used term in this bear market) and the associated unwinding of the multitude of carry trades was reflected in a much stronger Yen. As Chart 1 below illustrates, for the four months through January this year the Japanese Topix Index outperformed the S&P 500 Index by almost 1500 bps and the European Bloomberg 500 Index by nearly 1700 bps, substantially as a result of the appreciating Yen.



Late in January, however, this trend reversed and the Japanese market has been much weaker than its developed peers since then (Chart 2).



It would seem that the relatively poor fundamentals for Japan in a globally contracting economy are now a key driver. The trade balance has collapsed from a robust 2-3% of GDP and is heading for a 2% deficit. The fiscal deficit, estimated at more than 5% of GDP for 2009 and heading higher, implies that any fiscal stimulation is commencing from a weak structural position. With the consensus now expecting a contraction of more than 5% for the economy in 2009, Japan will be by far the weakest performer of all the major economies. The exporters are gaining some relief from a Yen that has depreciated by 12% against the U.S. dollar since its recent peak, but this is scant solace in a world where the demand for its high-end goods will be under pressure for quite some time.

The world's second largest economy has few domestic levers it can pull to stabilize its export-dependent economy, certainly over the short-term. The impact of a demand stimulus on a demographically old and risk-averse populace will at best be muted. This renders the Japanese economy even more dependent on a resumption of global demand growth than even a sclerotic Europe and most certainly the United States. This is not in any practical sense a locomotive the world economy can rely on to help get it out of the current mess.

The implication is that the Japanese market and the export contingent in particular, are now highly geared to the world economy. The low beta play of the past few years has been transformed into a higher beta one. This market consequently remains highly vulnerable to continued global weakness, but has the capacity to do well once the global economy and trade flows stabilize. So at the upcoming G-20 meeting it will be particularly dependent on the group agreeing on a coordinated and aggressive plan to help jump-start their economies, while it essentially stands by wringing its hands. Such an outcome would depend vitally on an about-turn of the cacophonous European participants, where major economies such as Germany have yet to grasp the necessity for such aggressive moves. An imminent rising of the Japanese sun, even in a relative sense, is in this context not something to count on. ■

### INVESTMENT MANAGEMENT

