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## Ganbatte Japan

### Executive Summary

- No Imminent Risk To Japanese Economy – There are signs that the Japanese economy is recovering at a faster-than-expected pace from the trio of disasters.
- Japanese Equities are Still A Bargain – Valuations remain supportive as corporate earnings may continue to rebound, fuelled by reconstruction demand and exports.
- The End of Deleveraging – The reconstruction demand and government stimulus, will provide the extra catalyst to pull Japan out of its deflationary cycle.

### Making a Comeback

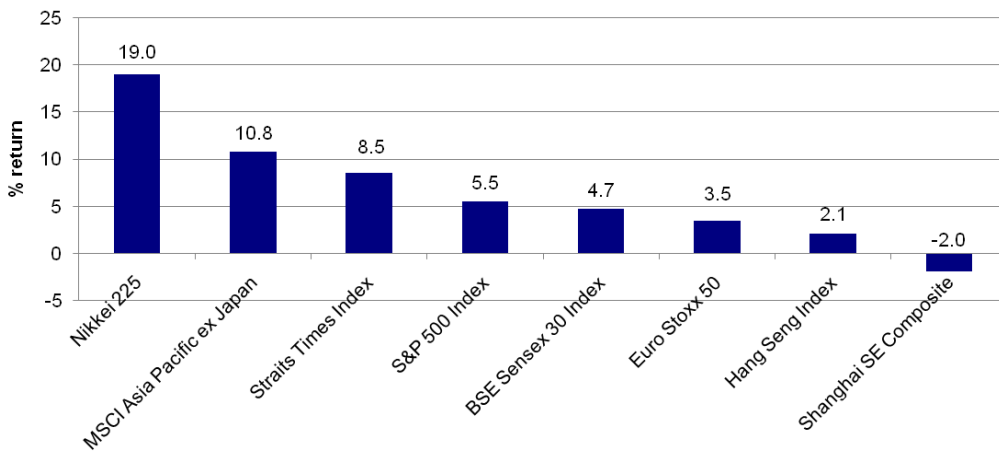
Japanese stocks completed its longest winning streak since July 2009. The Nikkei 225 Index gained for seven straight days, closing at 10,082.50 on Jul. 6. It was the highest level since Mar. 11, the day an earthquake and tsunami devastated Japan's northeast coast.

The initial earthquake, tsunami and ongoing nuclear crisis created great uncertainty for the Japanese economy and stock market. However, the initial sell-off proved to be an overreaction as Japanese equities rebounded and outperformed the regional equities strongly. From their respective Mar. 15 lows, the MSCI Asia Pacific ex Japan Index was up 10.8 percent while the Nikkei 225 Index gained more than 19 percent as of Jul. 8. (See Chart 1 below)

Also, the market value of stock in 7 of the 20 largest Japanese firms are back above the pre-earthquake crisis levels. Despite the domestic disasters, these large Japanese firms remain strong global players, deriving substantial revenue from the overseas markets.

**Chart 1: Outperformance of Japanese Equities Since Its Mar. 15 Sell-Off**

#### Performance of Equity Markets since Mar. 15



*Japanese equities are enjoying a fine run, up 19 percent since Mar. 15. Asia Pacific ex Japan equities were up 10.8 percent.*

Source: Bloomberg, as of 08 Jul 2011



**Japanese Economy – No Imminent Risk In Sight**

There are already signs that the Japan's economy is recovering at a faster-than-expected pace from the earlier mentioned trio of disasters. According to a recent Bank of Japan (BOJ) quarterly report, 7 of 9 regions in Japan are upgrading their assessments of their local economies.

The pickup in the regions' economic activities is largely a result of massive reconstruction efforts in damaged infrastructure and production facilities. As such, this underscored our earlier view that the nation's economy will experience a V-shaped recovery as it emerges from supply-side pressure and production recovers momentum.

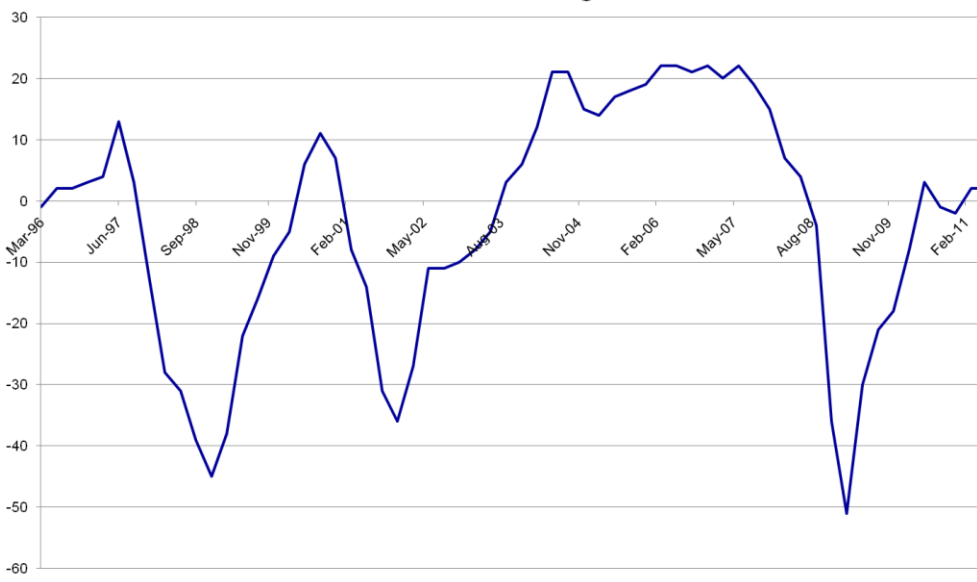
Also, the household and business sentiments are improving. The BOJ's quarterly tankan survey showed that Japanese large manufacturers expect business sentiments to improve considerably by this September. The survey also suggested that the Japanese corporations are more optimistic and plan to increase investment in plant and equipment at almost twice the estimated rate this year.

Despite the improvements in economic outlook, strong political pressure still persist on the BOJ to maintain its ultra-easy monetary policy at its next board meeting on Jul. 11 and 12. This is due to possible bottlenecks from power shortages and capacity constraints while the overall inflationary pressure is still minimal.

Moving forward, we feel that the rebound in economic activities, improvement in business sentiments and ongoing loose monetary policy will make Japanese companies attractive investments. There are further rooms for production levels to be fully restored and the labour market is expected to be tightened. External factors such as higher auto export to the U.S. and ongoing infrastructure projects from China are potential positive drivers for Japan's manufacturing sector as well.

**Chart 2: Japanese Large Manufacturers Forecast Better Business Sentiments**

**Japan Tankan Business Conditions Forecast Large Enterprises Manufacturing**



Source: Bloomberg, as of 08 Jul 2011

*Japanese large manufacturers expect business sentiments to improve considerably by this September.*



**Japanese Equities – Still A Bargain**

Buying from overseas investors is boosting the Japanese equities. According to the Finance Ministry, Asian and European investors were net buyers of Japanese equities for the week ending Jul. 2. Foreign investors bought a total of 3.6 trillion yen of Japanese stocks while selling 3.4 trillion yen worth of Japanese stocks, making a net purchase of 186.4 billion yen.

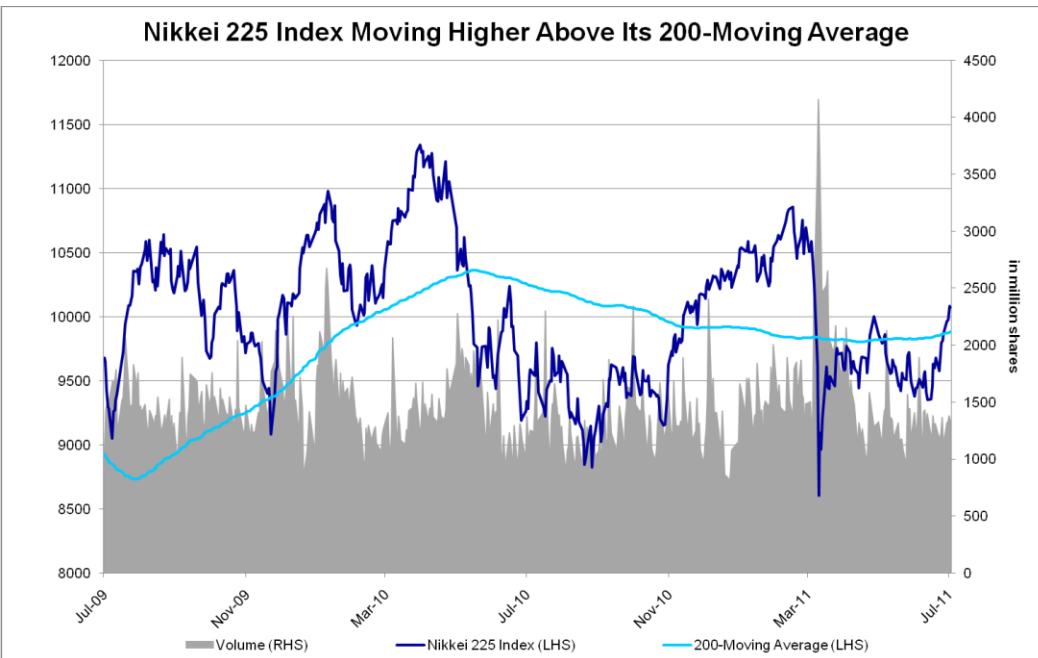
Technically, we feel that recent price actions had pushed Nikkei 225 Index out of its 9,400-9,800 consolidation range over the past 3-4 months. The index has moved higher above its daily 200-Moving Average resistance and is eyeing the 10,250 mark before testing its previous high at 10,850.

Since the flash crash on Mar. 15, the Energy sector and Material sector have been leading the gains among the Japanese equities. Valuations remain supportive as corporate earnings may continue to rebound, fuelled by reconstruction demand and exports. In particular, we favor the financials sector which exhibit both attractive forward price earnings and high free cash flow yields. (See Table 1 on the next page)

Japan’s recent disasters may potentially trigger a surge in loan demand as Japanese companies seek reconstruction capital. The yield spreads in Japan may increase on the back of an increasing domestic loan growth. Higher yield spreads are generally a positive case for bank lenders’ profitability. We expect the 10-year Japanese government bond yield to climb up from its current low level, at 1.2 percent.

Lastly, there is no imminent sovereign risk in Japan itself. Given its surplus in current account balance together with rising domestic savings, we believe that the government debt will continue to be financed domestically. Its 5-year CDS has been declining steadily since peaking on Mar. 15. (See Chart 4 on the next page)

**Chart 3: Nikkei 225 Moving Higher Above Its 200-Moving Average**



*Nikkei 225 Index moved out of its consolidation range over the past 3-4 months, surging past its daily 200-Moving Average.*

Source: Bloomberg, as of 08 Jul 2011



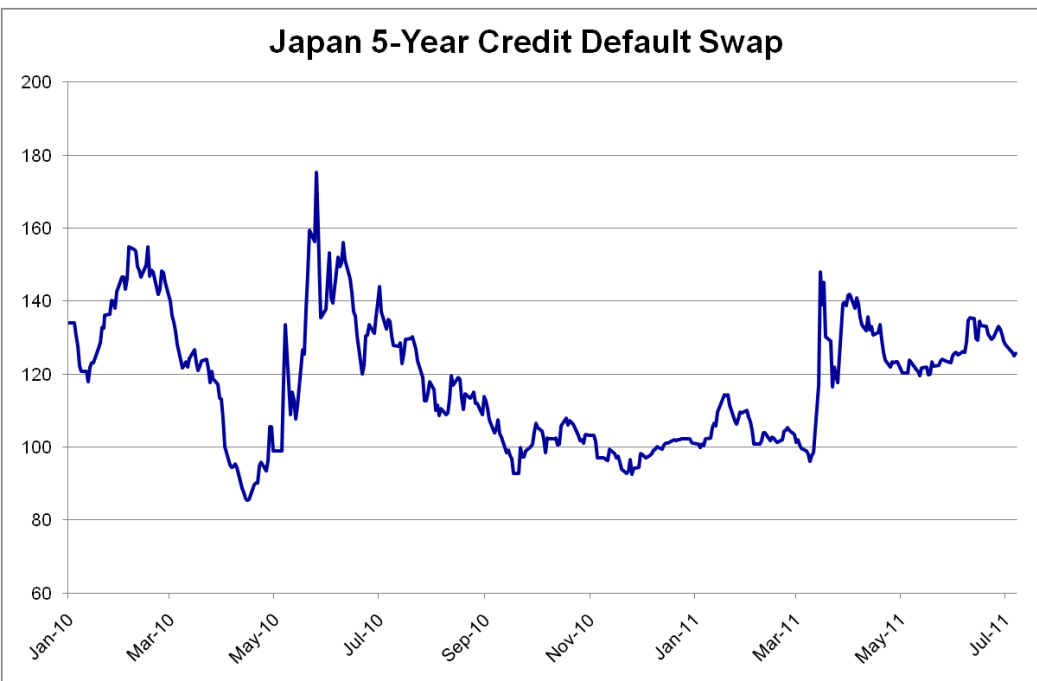
**Table 1: Aggregate Valuation Metrics for MSCI Japan and Sectors**

	Valuation Metrics				Return %	
	Price-to-Book	Forward Price-to-Earnings	Dividend Yield	Free Cash Flow Yield	Since March 15	Year-to-Date
Energy	0.93	8.32	2.12	5.25	22.01	11.18
Material	1.09	14.82	1.82	9.54	21.64	-0.70
Consumer Staples	1.34	19.48	2.23	9.09	18.18	2.66
Industrial	1.26	13.03	1.96	5.23	16.71	2.12
Consumer Discretionary	1.15	23.08	1.43	8.41	14.79	0.73
Telecom Services	1.29	11.06	2.16	18.64	14.21	10.20
MSCI Japan	1.11	16.54	2.11	9.75	13.26	-2.78
Health Care	1.43	16.35	3.33	7.05	12.79	-0.43
Information Technology	1.38	16.65	1.78	8.47	12.43	-7.60
Finance	0.83	12.62	2.59	16.13	11.57	-5.72
Utility	0.73	---	3.91	14.40	-19.44	-35.65

Source: Bloomberg, as of 08 Jul 2011

*Valuation on various sectors remains attractive, supported by low Price-to-Book ratio and high Free Cash Flow yield.*

**Chart 4: Japan 5-Year Credit Default Swap Indicates Declining Sovereign Risk**



Source: Bloomberg, as of 08 Jul 2011

*There is no immediate concern on Japan's sovereign risk. Japan's 5-year CDS trends lower.*

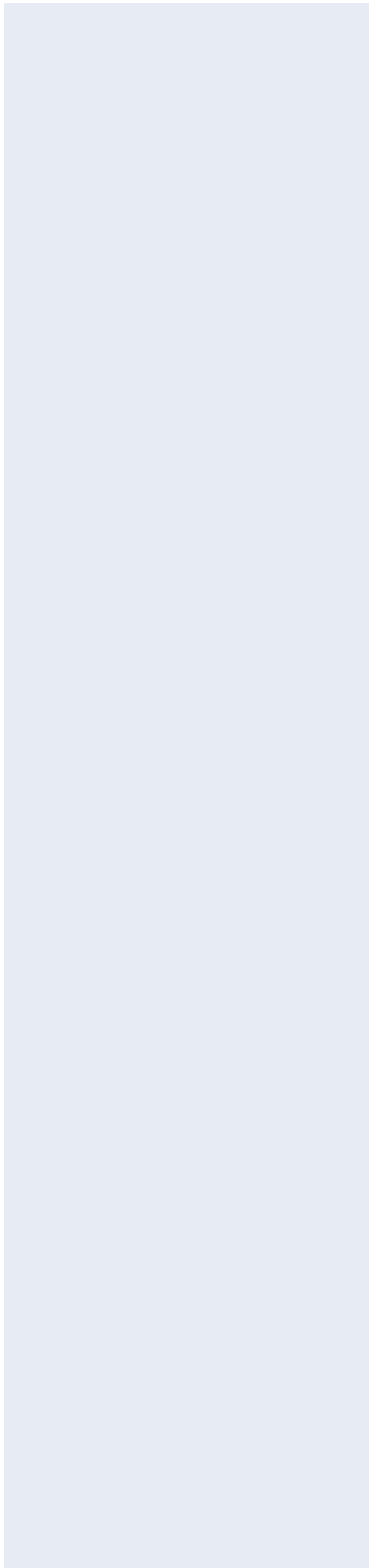


### Japan In 2011: The End of Deleveraging?

Clearly, the recent economic figures are signaling that the down leg in the “V” recovery may be near its end. Tapping on the reconstruction demand and government stimulus, the trio of disasters may provide the extra catalyst to pull Japan out of its deflationary cycle. Importantly, we feel that the earthquake had done little in changing the sound fundamentals of Japanese companies. Although the recent equity run-up had been more than impressive, valuations remain supportive.

Nevertheless, there are still inherent risks too big to ignore. A subdued growth outlook for the U.S. and Europe may cause a setback in Japan’s export recovery. A China slowdown can have an even more profound effect given the two countries’ proximity. In terms of numbers, China, US and Europe make up close to 35 percent of Japan’s export. Together with the persistent yen strength, Japanese exporters are feeling the heat to stay competitive in the global landscape. Domestically, electricity shortages and disruptions are still a problem for production plants.

Though many external and internal risks exist, we feel that the above-mentioned risks are still premature to pose any significant damage to Japan’s recovery. Investors should consider looking for investment opportunities to ride on Japan’s next leg up in its “V” recovery. It may well be the time for Japan to put its two “lost decades” behind it.





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