

## **Pictet Asset Management**

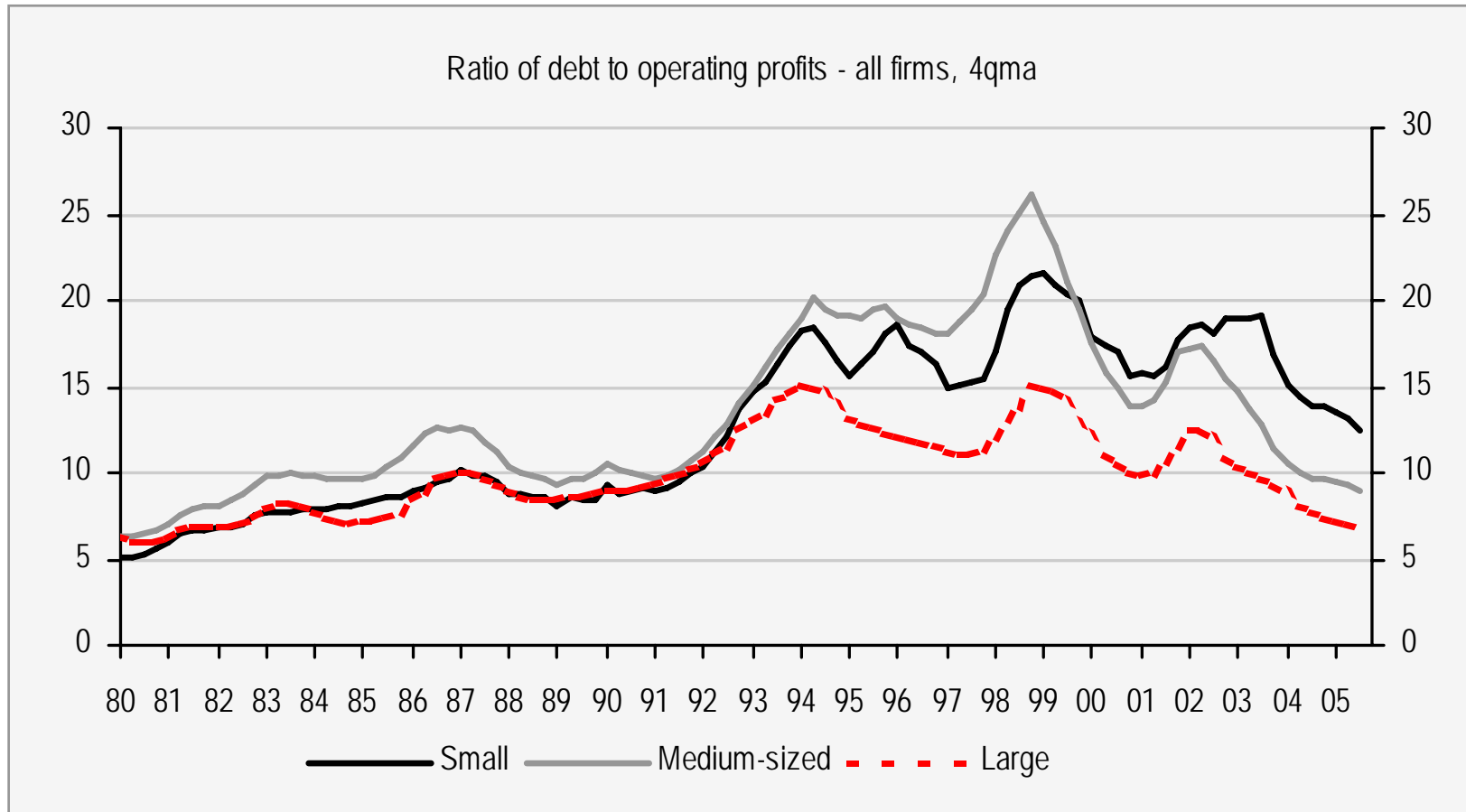
**Japan - Is there more to go for?**



Richard Heelis  
March 2006 | Santiago de Chile

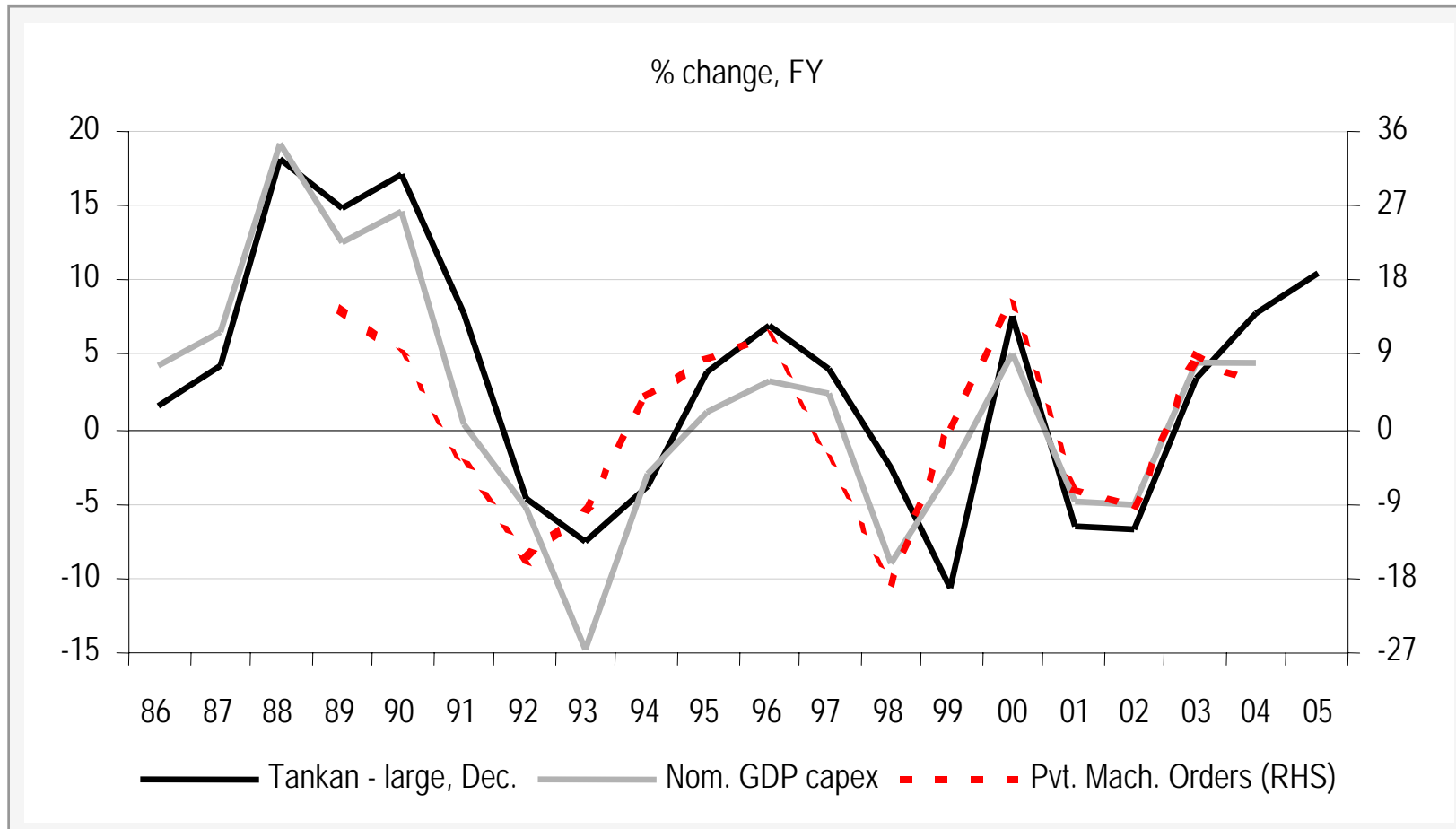
- Is Japan's recovery the real thing?
- Will policy mistakes of the past be repeated?
- Who believes it?
- How much is the equity market already discounting?
- What are the risks?

# Corporate restructuring has laid the foundations for a rebound in domestic activity .....



Source: MoF, HSBC

# .... and there is now a clear intention to increase capital spending

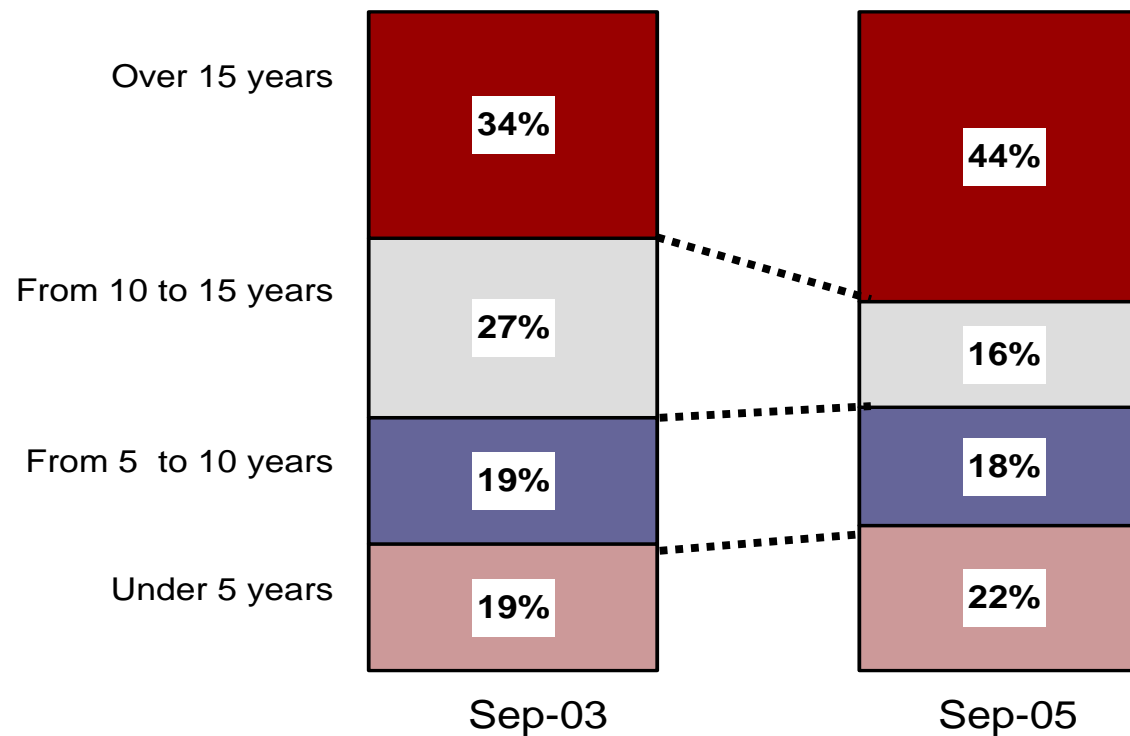


Sources: BoJ and Cabinet Office

# It is not just cyclical demand, there is also a need to replace old equipment



Average age of machinery used by major Japanese machine tool companies' clients

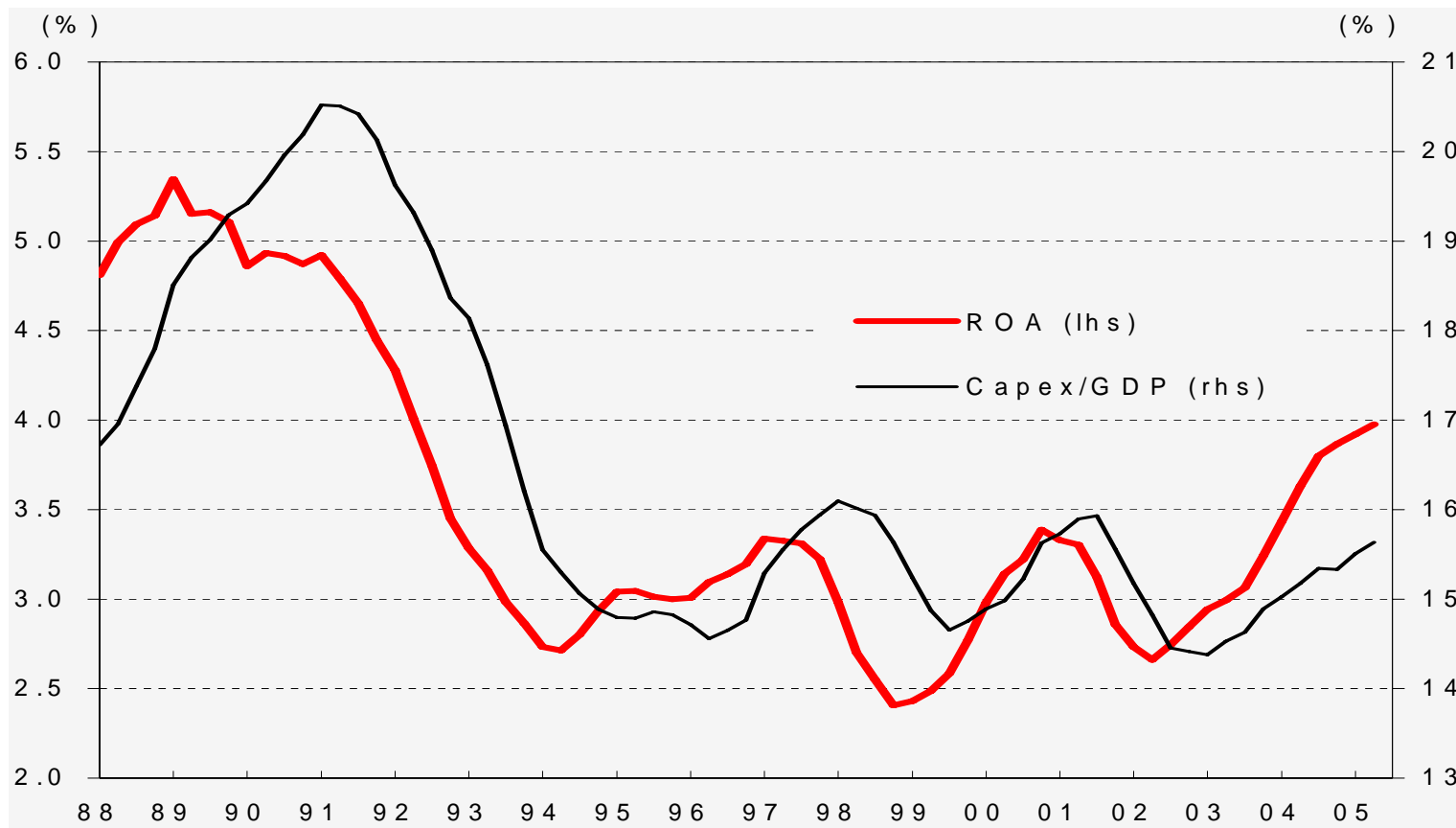


Source: Nomura

# Importantly, capital is being used more efficiently



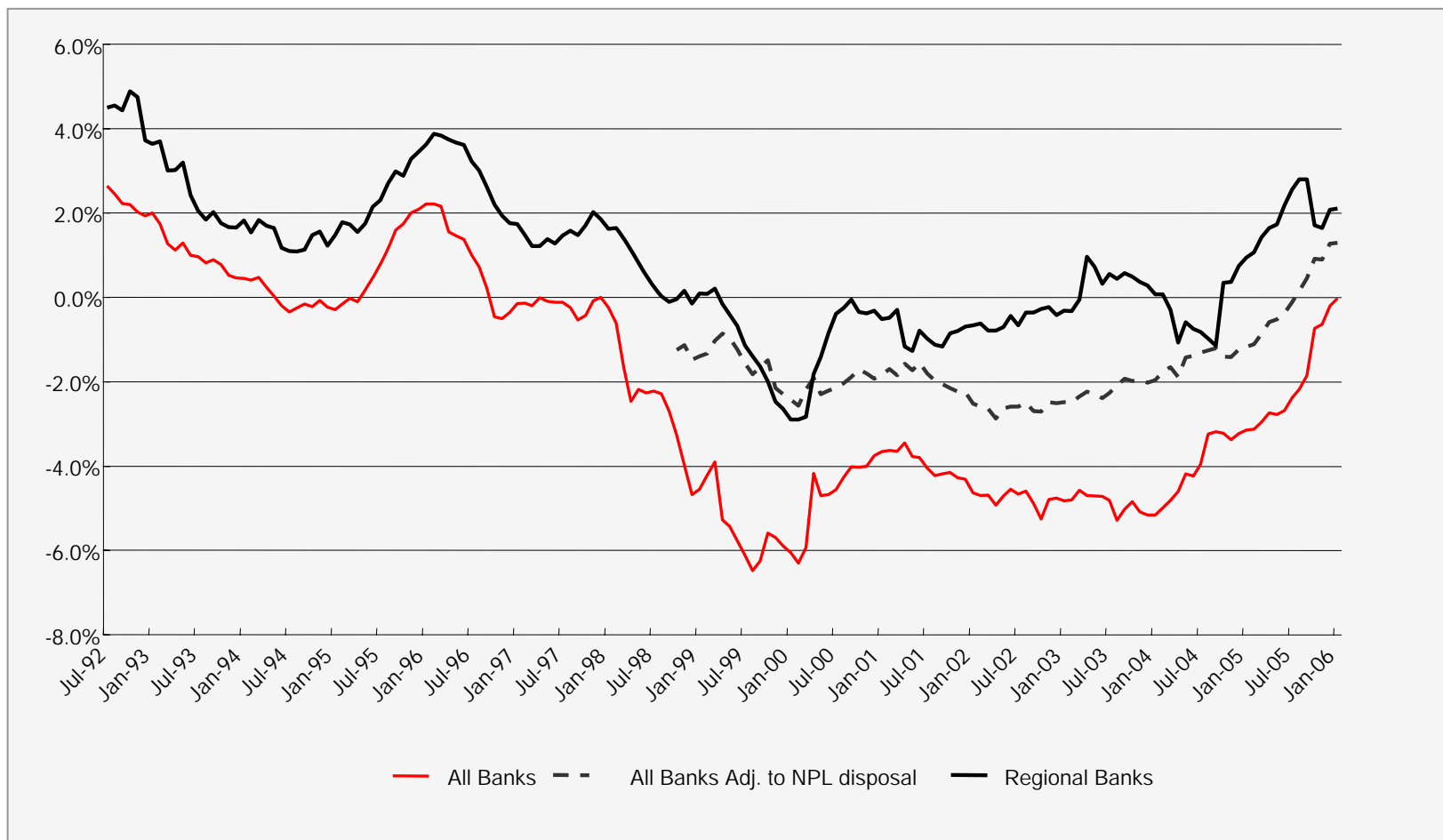
ROA and capex-to-GDP ratio



Note: Both series are 4-quarter moving average

Source: Nomura based on Cabinet Office and MOF data

# Bank lending provides further evidence of an emerging “growth” mentality

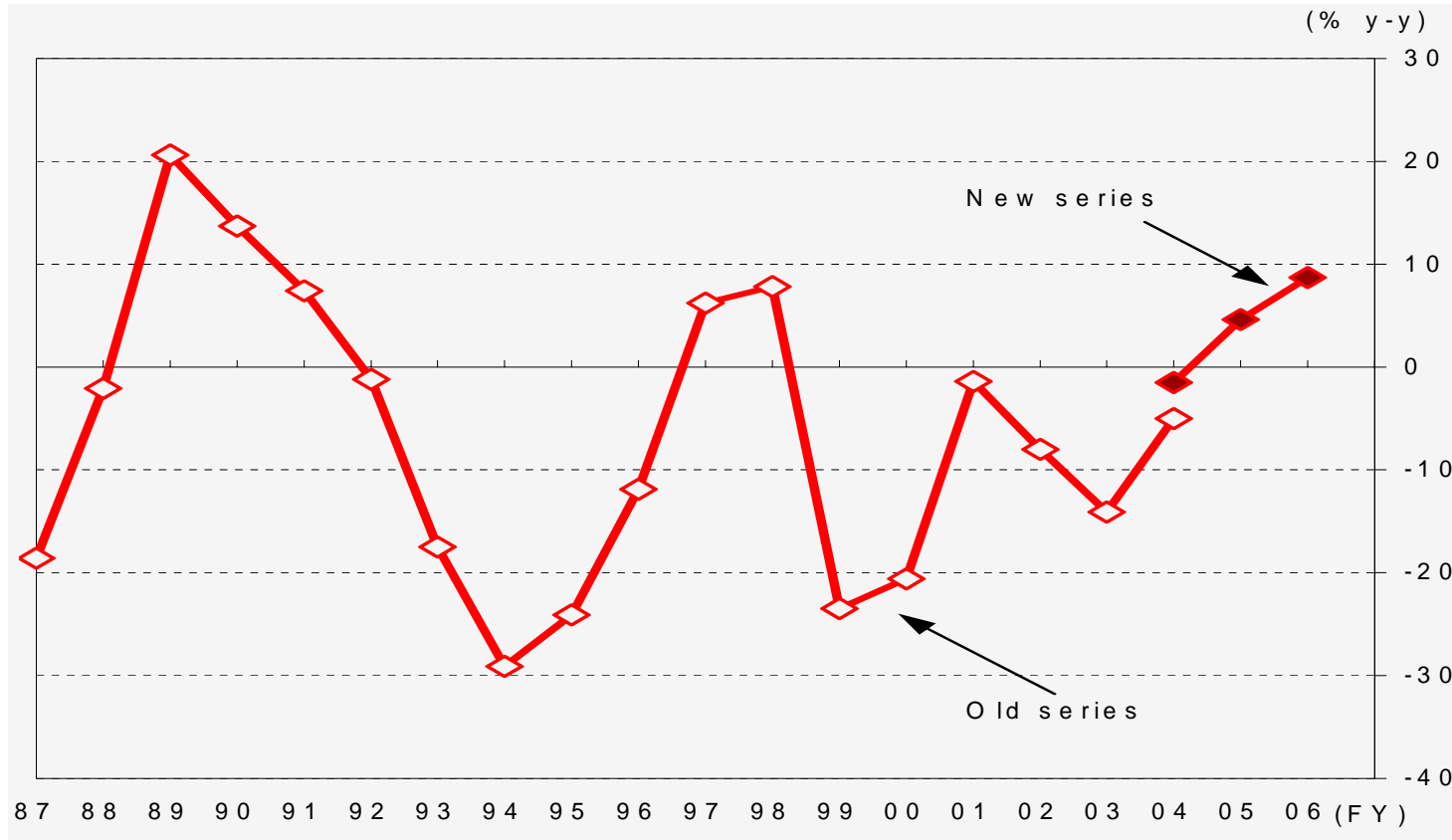


Source: Mizuho Securities Equity Research, BoJ

# It is not just plant and machinery that is required, the labour market is tightening ...



Companies' plan to hire new graduates



Note: Pre-year survey as of December

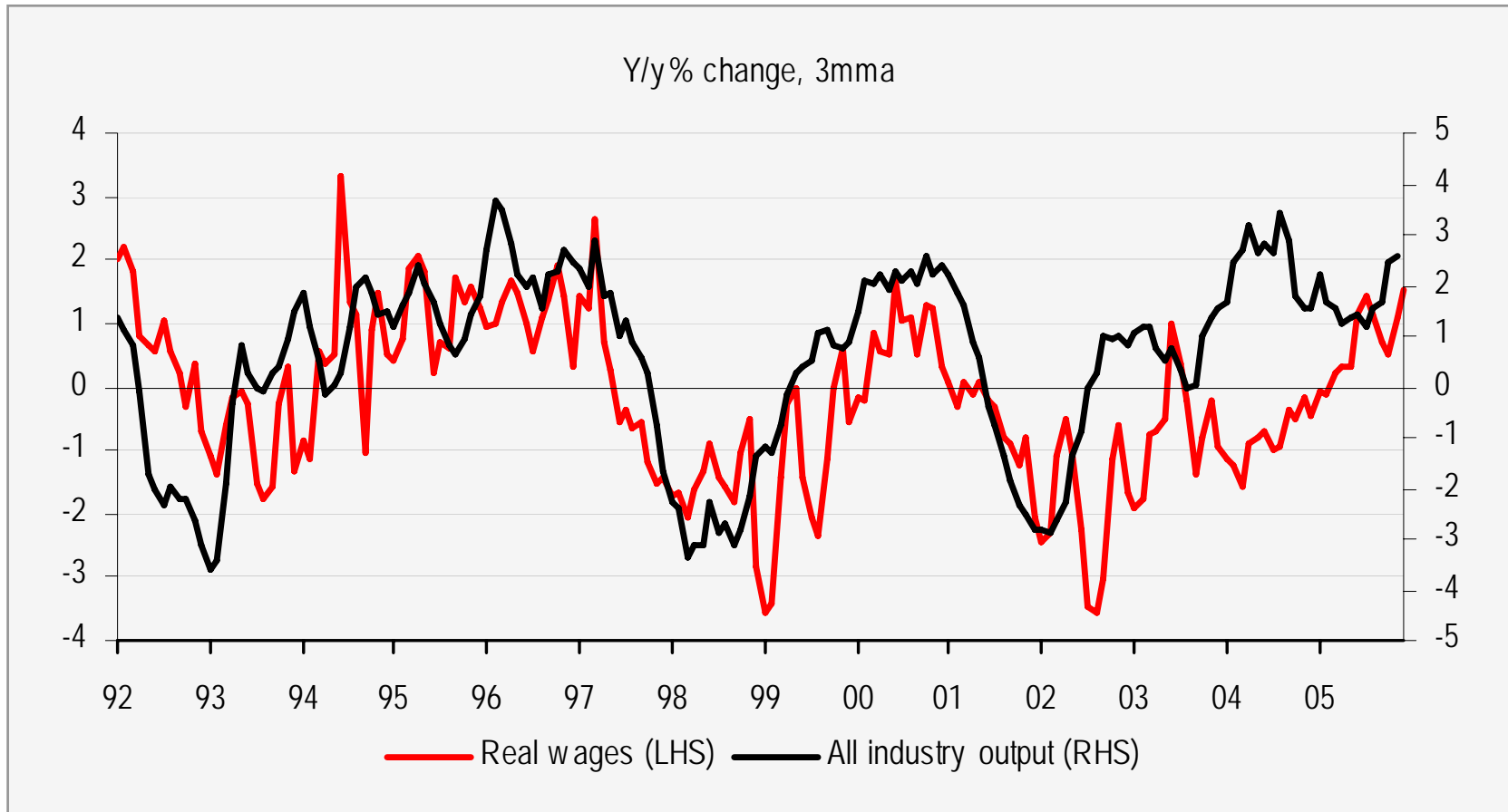
Source: BOJ Tankan

.... and we are seeing a shift to full-time employees (first since 1997)



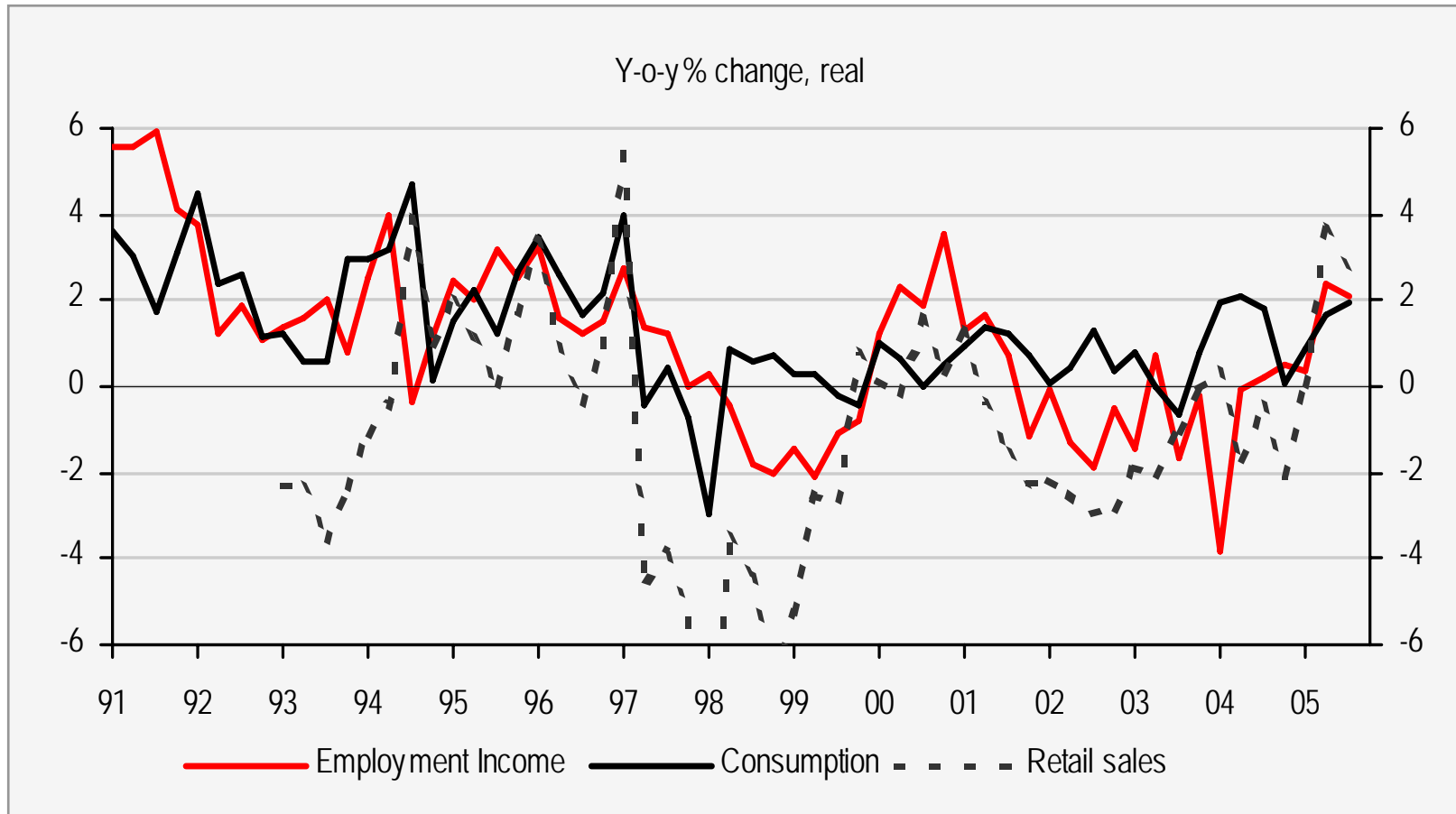
Source: MHLW and MIC

# The “social contract” kept wages depressed, but they are now catching-up



Sources: MHLW and METI

# Income growth is supporting consumption growth



Sources: Cabinet Office, METI, MIC

## Macro policy: some tightening is to be expected, but it will be modest



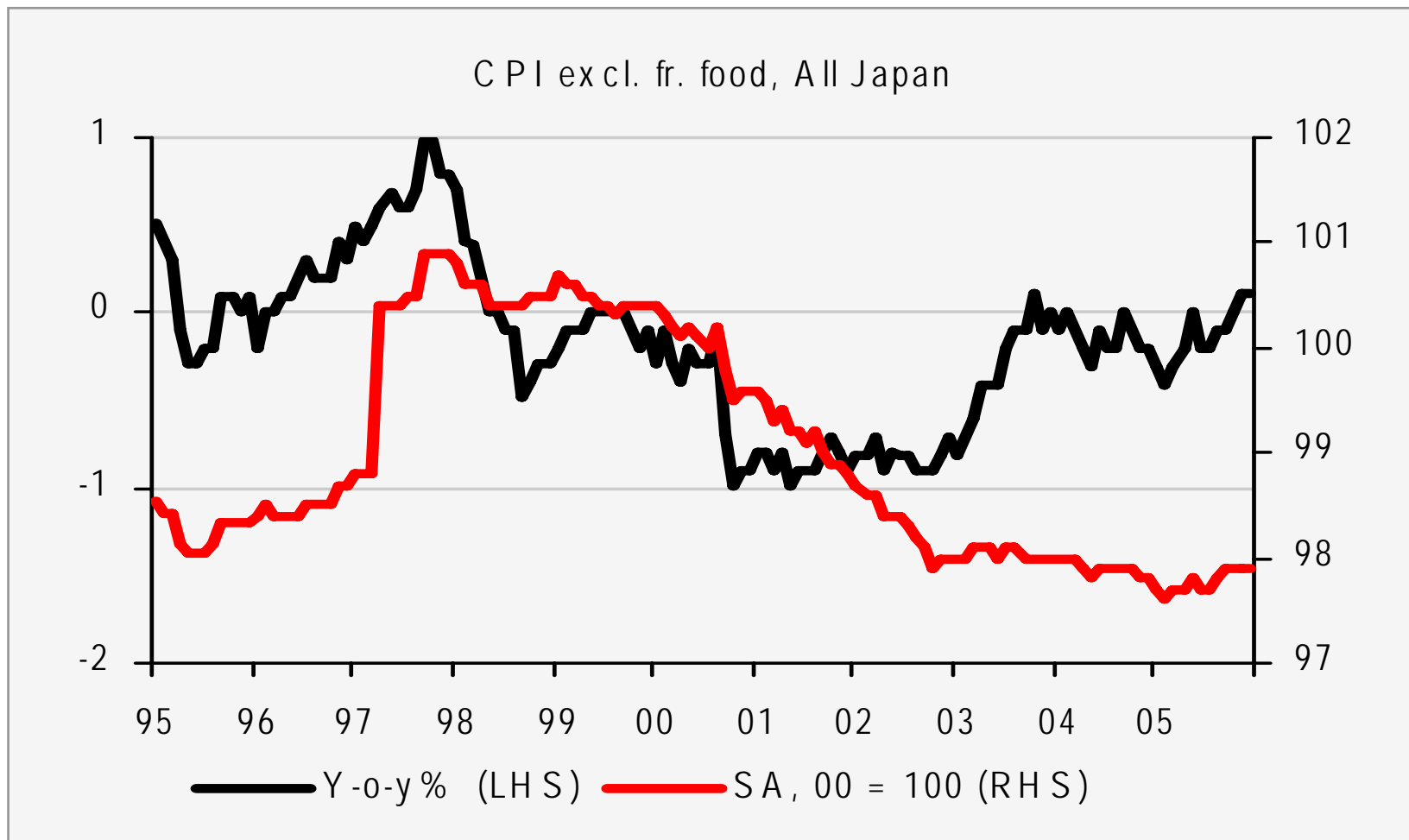
### Monetary Policy:

- An end to Quantitative Easing – expected to end in April 2006
- An end to Zero Interest Rate Policy – a confirmed end to deflation is required. Expected to end in Q1 2007
- “Normal” interest rate policy – likely trigger is inflation above 1%

### Fiscal Policy – some tax hikes are in store:

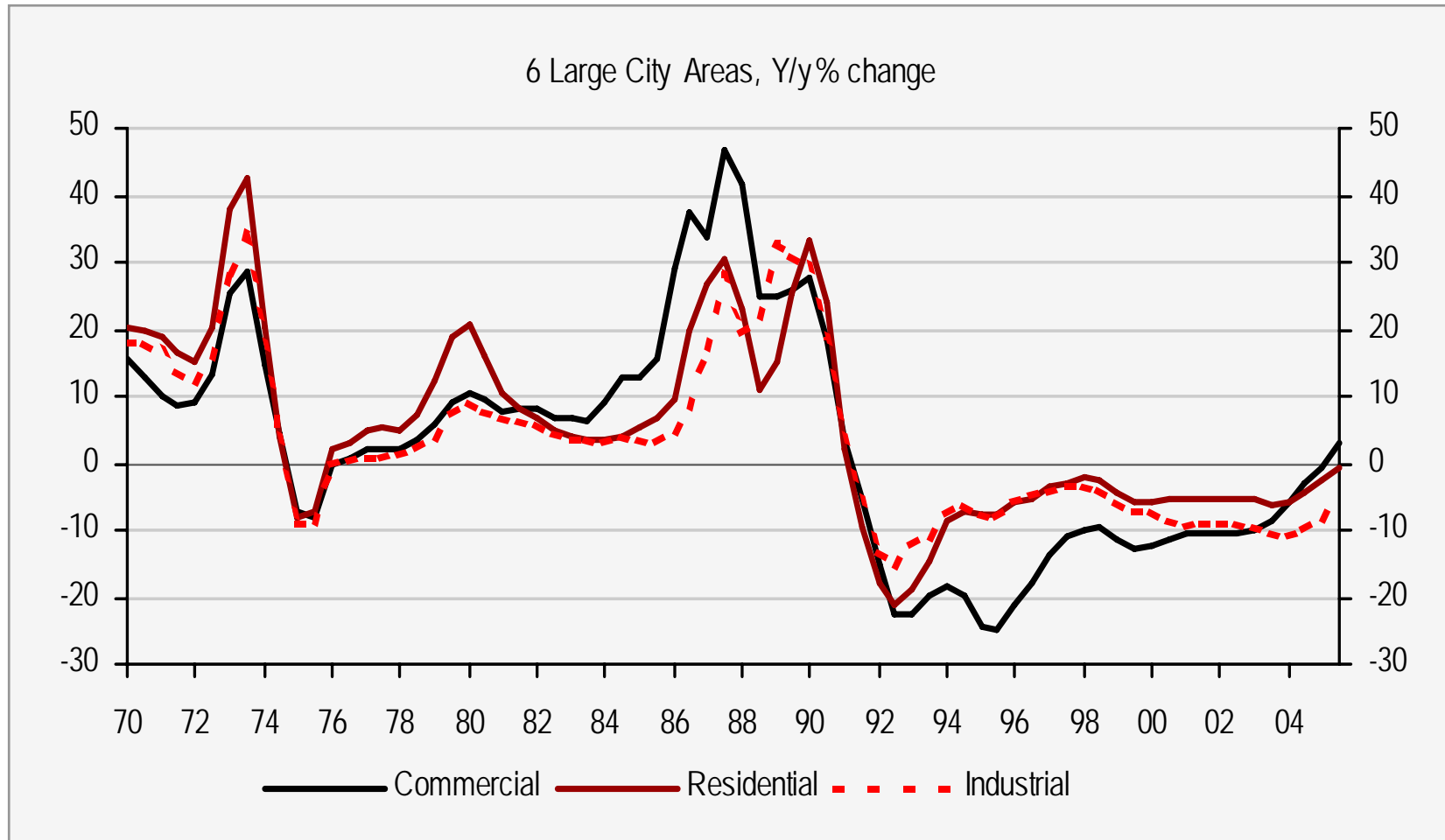
- 2006 and 2007: increased social security contributions and two-step reversal of earlier income tax cuts. GDP impact: -0.5% p.a.
- 2008: Consumption tax hike (5% to 7%)?

## Core inflation turned positive in November



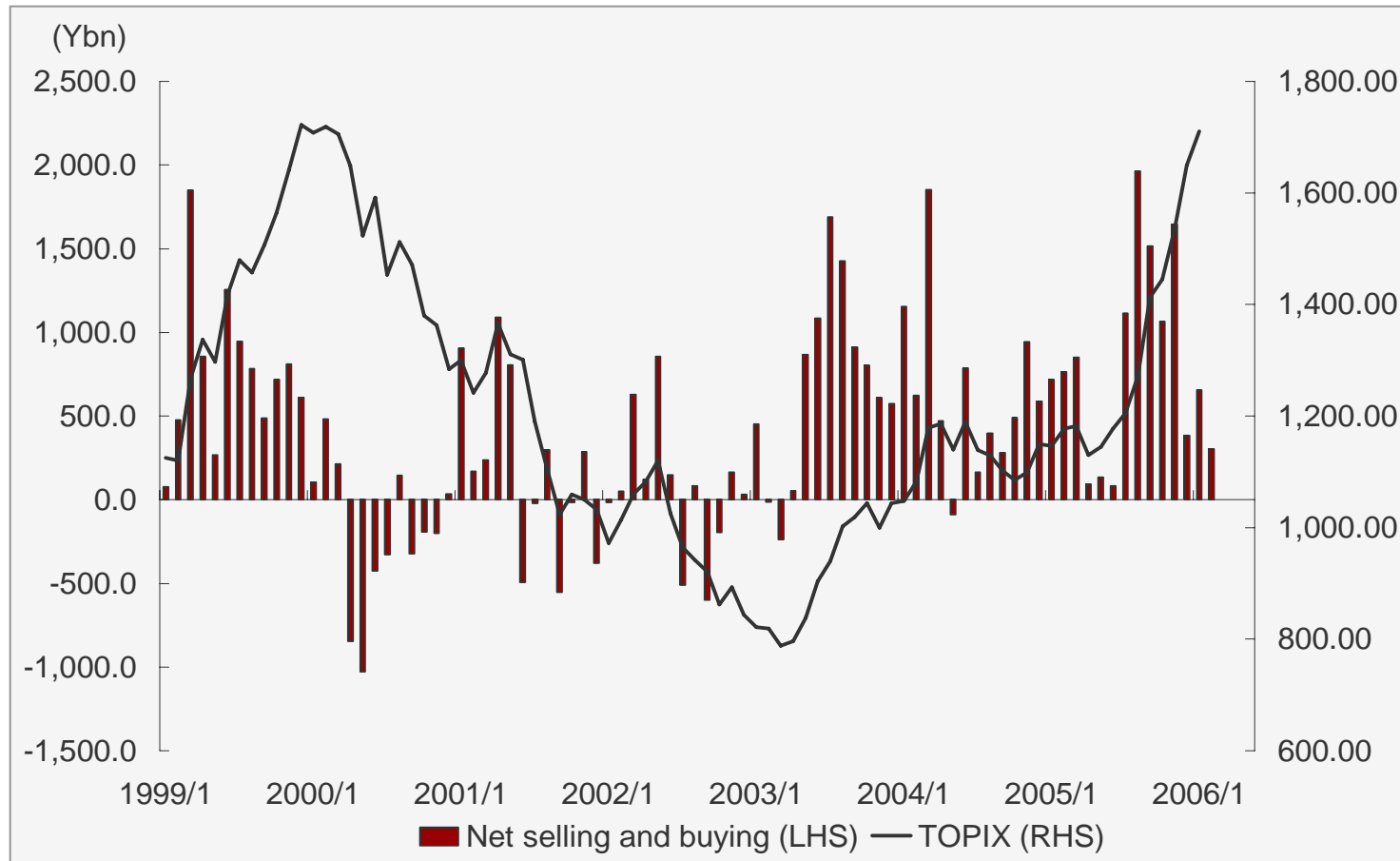
Sources: MIC and HSBC

# It is not just consumer prices that are stabilising, asset prices (Real Estate) are also increasing



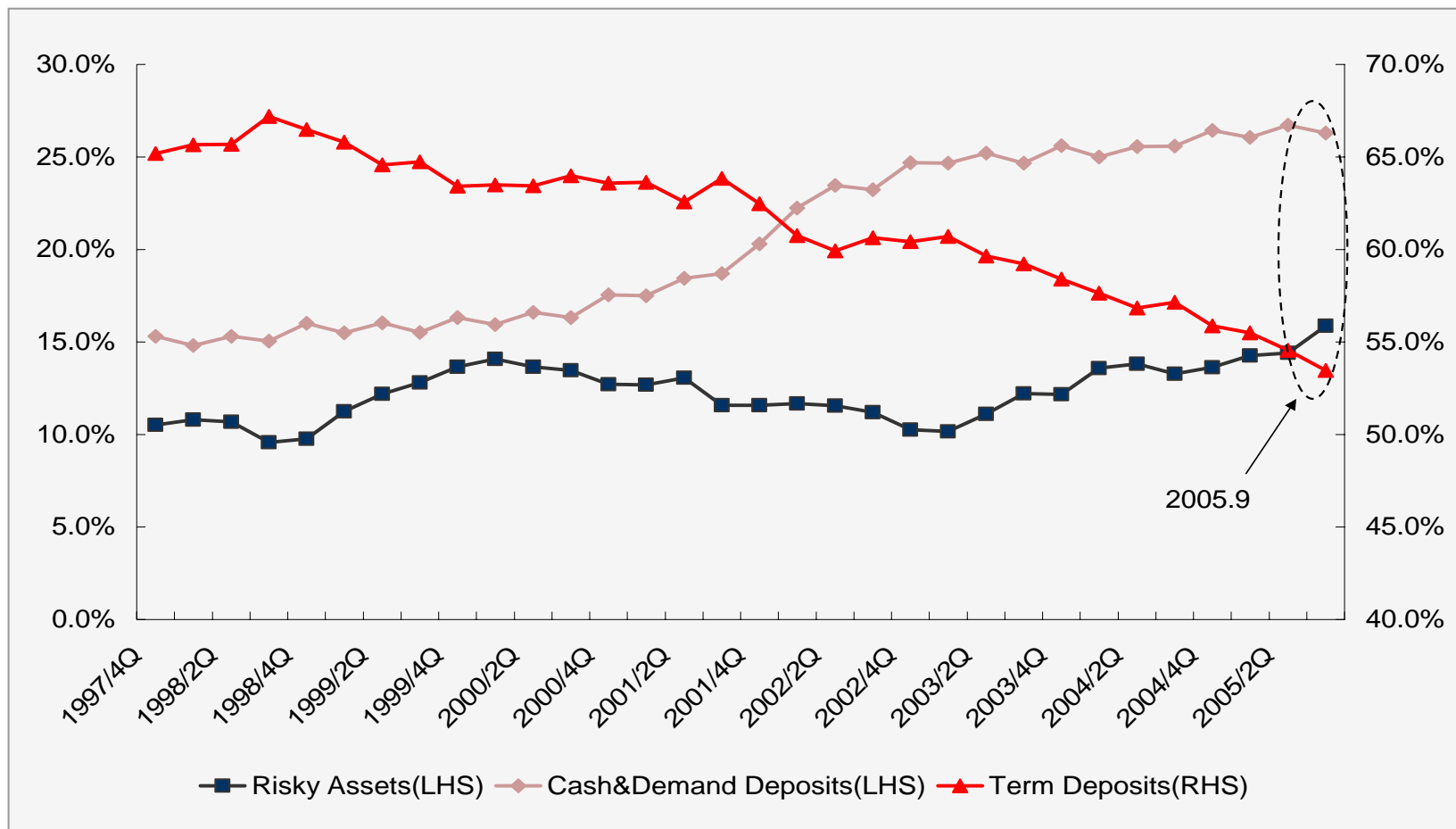
Source: Japan Real Estate Institute

# Foreign investors believe in Japan's improving prospects



Source: Mizuho Securities Equity Research, based on TSE and Bloomberg data

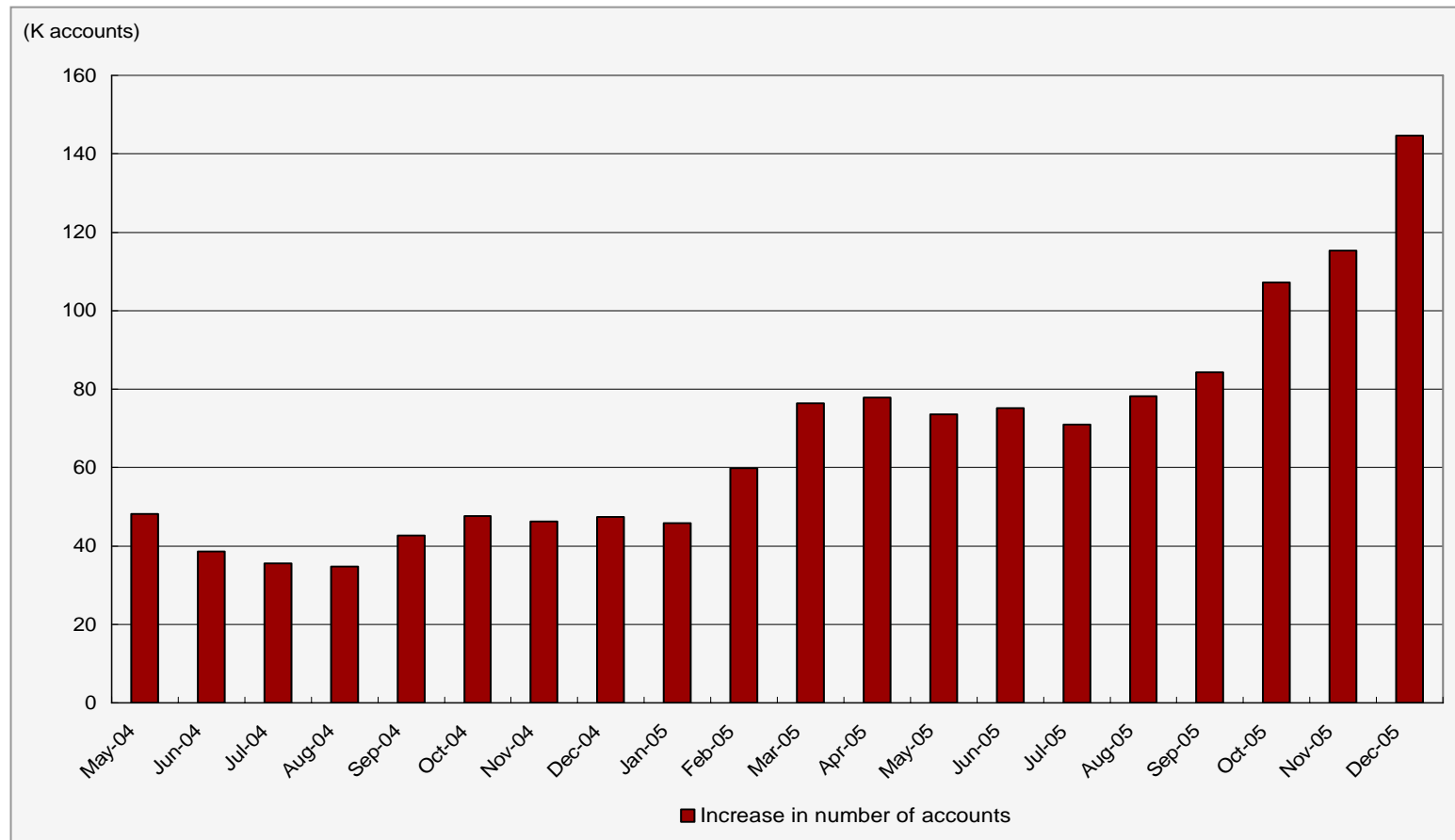
# Individuals have been more cautious, but they are gradually increasing their exposure to riskier assets



Note: Risky assets include equities, mutual funds, and non-JPY assets

Source: Mizuho Securities Equity Research, based on BoJ data

This is also apparent from the number of new accounts being opened at online brokerages

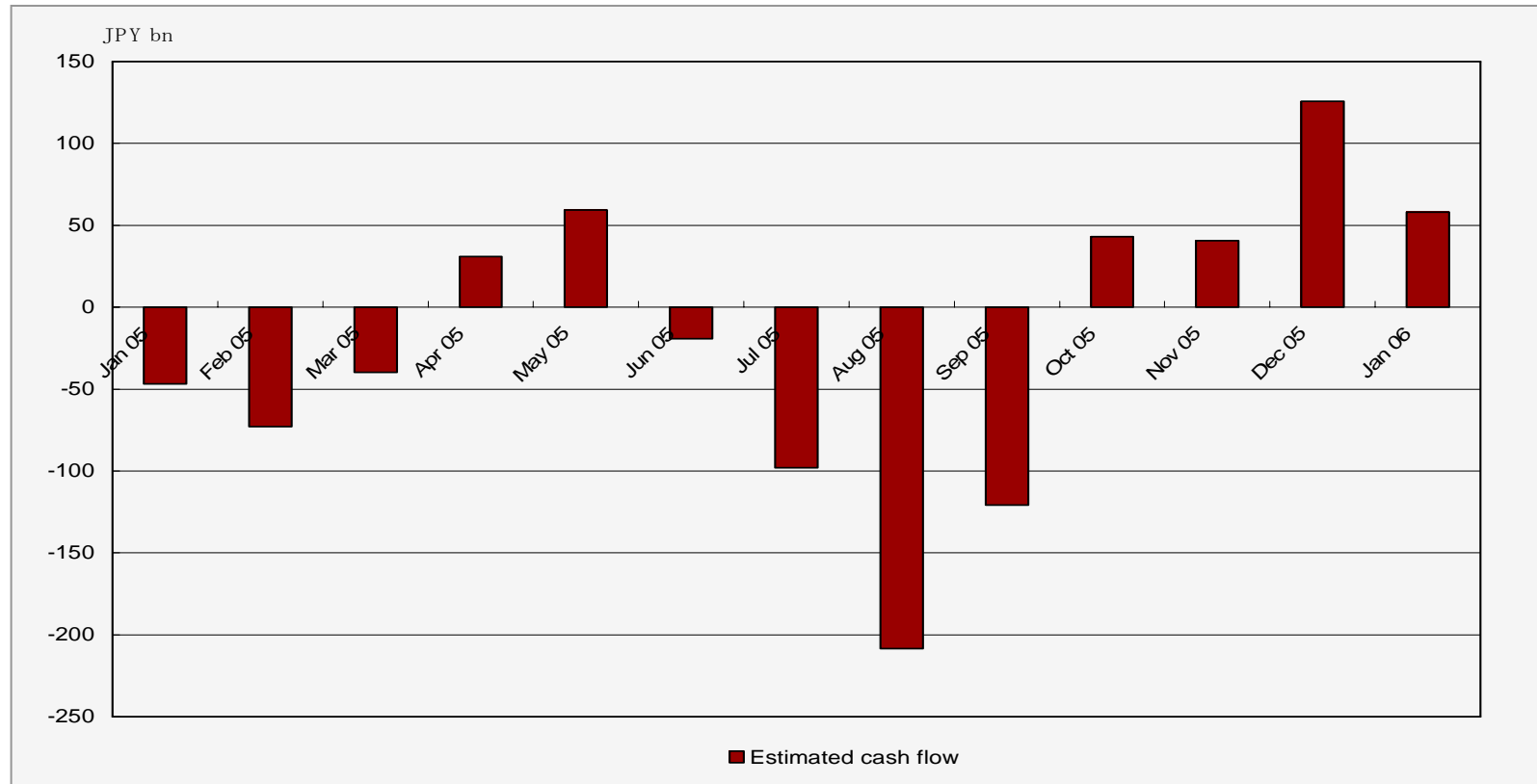


Source: Mizuho Securities Equity Research, based on Net Securities Association data

# Cash flow into existing domestic equity funds has turned positive



Estimated cash flow into domestic equity funds with JPY 50b or more\*  
at the end of December 2005



\*34 funds with data available on Bloomberg

Source: Mizuho Securities Equity Research, based on  
Bloomberg data

# Household assets are managed conservatively



Breakdown of Household Financial Assets in Japan

As of Mar 2005	trillion yen	
Total Financial Assets	1416.1	(100.0%)
Currency and deposits	776.3	(54.8%)
Currency	42.4	(3.0%)
Transferable deposits	203.7	(14.4%)
Time and savings deposits	524.3	(37.0%)
(of which: Postal savings)	214.1	(15.1%)
Securities other than shares	77.3	(5.5%)
JGB and FILP bonds	21.4	(1.5%)
○ Investment trust beneficiary certificates	38.0	(2.7%)
Trust beneficiary rights	10.2	(0.7%)
Shares and ownership	121.2	(8.6%)
◎ Shares	81.9	(5.8%)
Insurance and pension reserves	374.7	(26.5%)
(of which: Postal life insurance "Kampo")	118.7	(8.4%)
◎ Shares directly held	81.9	(5.8%)
○ Shares indirectly held	11.4	(0.8%)
Total shares held	93.3	(6.6%)
Postal savings + Postal life insurance	332.8	(23.5%)

Note: Indirec share holding is estimate

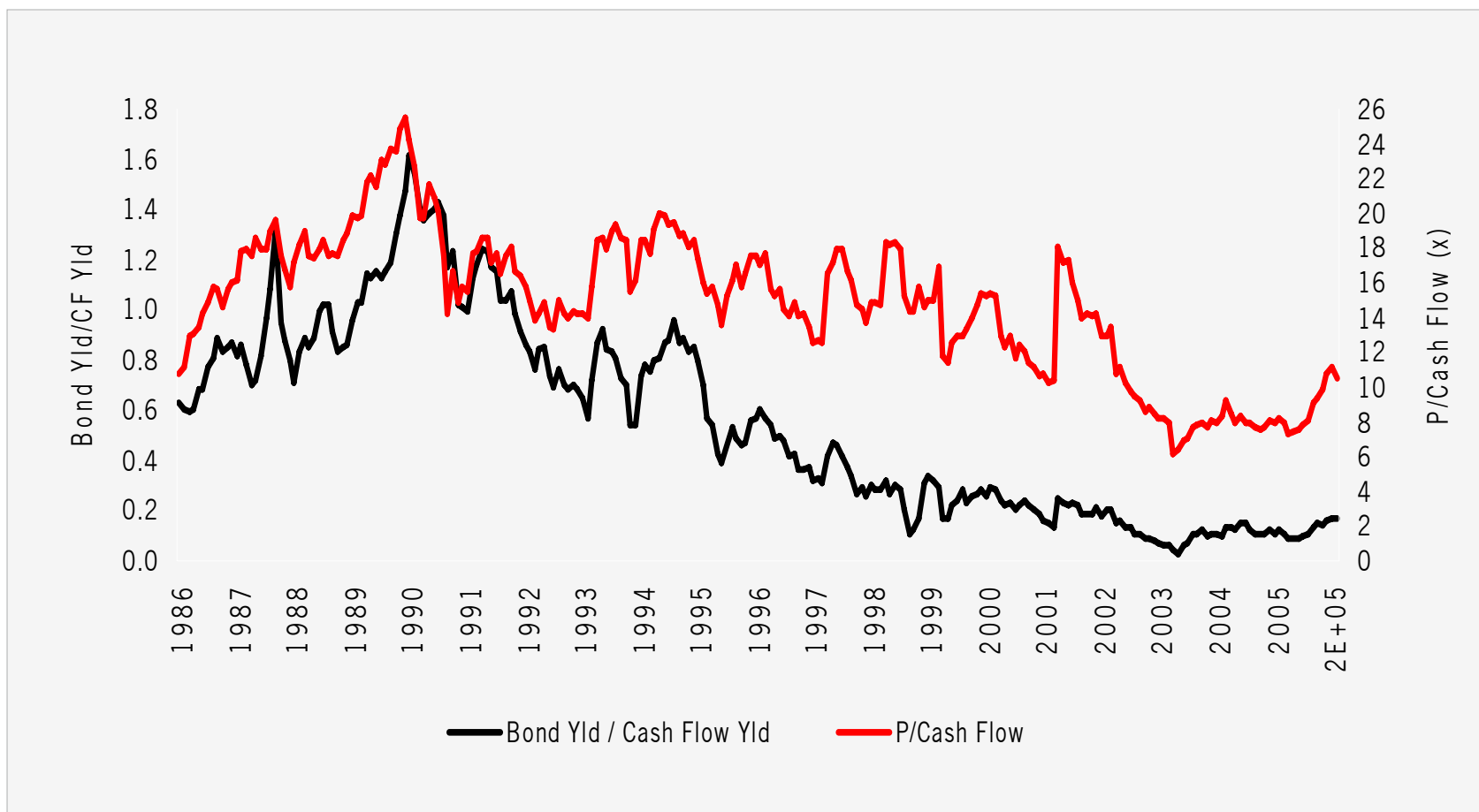
Source: BOJ, Nomura

Breakdown of Household Financial Assets in US

As of Dec 2004	billion dollars	
Total Financial Assets	36,620	(100.0%)
Deposits	5,558	(15.2%)
Foreign deposits	101	(0.3%)
Checkable deposits and currency	319	(0.9%)
Time and saving deposits	4,233	(11.6%)
MMF	904	(2.5%)
Bonds and other credits	2,172	(5.9%)
Treasury securities	518	(1.4%)
Agency/GSE-backed securities	479	(1.3%)
Municipal securities	666	(1.8%)
◎ Corporate equities	6,576	(18.0%)
○ Mutual fund shares	3,558	(9.7%)
○ Life insurance reserves	1,099	(3.0%)
○ Pension fund reserves	9,613	(26.3%)
◎ Shares directly held	6,576	(18.0%)
○ Shares indirectly held	7,772	(21.2%)
Total shares held	14,347	(39.2%)

Source: FRB

# Equity valuations remain attractive, especially when compared to bonds



Source: MSCI / IBES

## Some of the risks



SUMMARY IMPACT MULTIPLIER TABLE				
% change from base case	10% rise in Yen/\$ rate	1% drop in US GDP	1% drop in China GDP	10\$/bbl oil price rise
CPI	-0.3	0.0	0.0	0.3
Real exports	-0.6	-2.6	-1.3	0.0
Real imports	3.6	-0.7	-0.4	-0.2
Real consumption	-0.1	-0.1	0.0	0.0
Real private capital investment	0.0	-1.1	-0.6	-1.8
Real GDP	-0.5	-0.4	-0.2	-0.3
Industrial production	-0.2	-1.1	-0.5	-0.3
Recurring profits	0.2	-4.3	-2.2	-2.6

Source: HSBC

## Conclusion



- Restructuring (debt, capacity and employment adjustments) has been completed and has laid the foundations for a self-sustaining domestic recovery
- A more confident and ambitious Japan has started to emerge
- Any tightening of monetary and fiscal policy is likely to be moderate
- Valuations remain attractive, particularly relative to other asset classes
- The demand/supply balance for equities is likely to improve