

Japanese Market Outlook

Laura Palomino de Forbes of DIAM International reflects on 2005 and sees more positives for 2006

DIAM began 2004 bullish both near term and long term due to inexpensive valuations, solid earnings results and a possible increase in bank lending. As we moved into Q2 2004, we did become slightly uncertain in the near term, believing that the Japanese stock market could consolidate on the back of investor concerns over the slowdown in growth of the US and China. Our long-term view, however, remained positive, especially in light of our view that concerns over US and China were overdone.

DIAM maintained a long-term view into Q4 2004 whilst anxiety over rising oil prices continued to put a lid on Japanese equities in the short run. By December 2004, DIAM believed that we would see the bottom of market sentiment in Japan within the first half of 2005. Into the second half of the year we believed we would see a return to the recovery trend. The key driver being a recovery in personal consumption due to a positive corporate sector, increase in wages and contribution from more female workers.

We began 2005 expecting the increase in exports to continue as overseas economies gradually recovered. As such, production in January to March was expected to rise for the first time in three quarters. The inventory adjustments that started in 2004 (particularly in the electronics sector) were coming to an end. DIAM also saw personal consumption and consumer spending increase as employment conditions and incomes improved. As such, DIAM expected corporate earnings to improve as we moved into Q2 2005. This also led us to expect higher levels of cap-ex activity. DIAM recognises that companies now face a shortage of capacity, not excess.

In May 2005, rises in oil prices and the commodities markets began to have a

negative effect on corporate profits. Although we expected improved personal consumption to counter balance this effect. However, sluggish exports to the US and China meant inventory level adjustments did slow and as a result industrial production fell back. Our main view centred on a domestic demand-related recovery with personal consumption and cap-ex forming the basis of this.

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fall due to improvements in the labour market and retail shares looked promising on the assumption that personal consumption remained on a strong footing. Since the end of WW2, the average duration period of economic expansion has been 33 months. June 2005 marked the 40 month of recovery for Japan since the economy bottomed out in January 2002, so even the sceptics amongst us cannot deny that economic conditions are reaching favourable maturity.

Moving through to the latter half of 2005, positive macroeconomics indicators supported our belief that deflation is largely over and that the economy is on track for recovery. DIAM has seen money flowing into large caps from small and mid

caps as aggressive purchasing by non-Japanese investors reached record levels. This can partly be attributed to the spectacular election victory of the Liberal Democrats and the belief that Prime Minister Junichiro Koizumi can set the wheels in motion for economic reform that will have lasting benefits. With strong export demand from China and the US, DIAM has seen a resurgence of global investors turning their attentions to Japan's market and enhancing their exposure in order to reap the benefits of what the financial press have claimed to be Japan's "new dawn".

As 2005 draws to a close, the economy is continuing to recover and there is an expected end to deflationary pressure. Companies are regaining enthusiasm to recruit new staff and are keen to invest more money, personal consumption is on the up and real exports were up for the eighth month in succession. It has been reported that the Japanese market has risen by 32% over the course of the year, which helps to confirm DIAM's bull market psychology. We aim to maintain this stance which has served us well so far, as we enter the new year and are confident in our outlook that along with foreign investors, Japanese investors will return to "the most attractive market for 2006".



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