OCTOBER 2003

Commentary

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Japan: Land of Rising Expectations

Fresh from a September re-election victory, Prime Minister Junichiro Koizumi leads his Liberal Democratic party into a second term that offers exciting potential for Japan. The latest GDP numbers show a 3.9% annual growth rate. The Nikkei 225 stock index has surged 45% from a low of 7608 in April to above 11,000.

Is Japan's long period of recession finally over? Have the deflationary forces that have for so long dominated the Japanese economic landscape begun to recede? Is the apparent emerging economic revival likely to take hold and give Japan a stronger sustainable position in both domestic and global markets? These are some of the questions now being asked as evidence unfolds of rising expectations for the future of Japan's economy.

A government bailout of Japan's fifth largest bank, Resona, has brought a renewed sense of hope and confidence to the nation's banking industry. Investment in information technology is increasing. Spending for consumer electronics is trending upward. Mergers and restructuring in basic industries have produced efficiencies and reduced excess capacity.

The Bank of Japan, acting on behalf of the Ministry of Finance, has adopted an intervention policy in the foreign exchange market. The Japanese government's policy is to bring the economy out of the long recession by maintaining the yen at a level that will boost exports. The currency intervention policy had successfully defended the yen at the rate of 115 to the US dollar. Without the intervention policy, the yen would most likely have risen to the 100-105 range against the US dollar. If this had happened, there would have been an abrupt end to the export-led economic recovery. But, following the issuance of a communiqué from the September G-7 meeting of Finance Ministers in Dubai concerning flexible exchange rates, the Japanese intervention policy will probably be modified with a target level of 110 yen to the dollar, reflecting the market reaction to the communiqué that produced a significant sell-off for the US dollar.

The surge in the Japanese equity market has been fueled mainly by foreign buyers. Recently, foreign investors have typically under-weighted Japan in their portfolios. But, as these investors quickly move toward a policy of full weighting or even overweighting for Japan, the investment inflows have produced the longest sustained period of buying since the nineteen-sixties. Japanese equities are currently trading at moderate price levels in relation to historical ranges for price/earnings ratios and they appear reasonably priced compared to equities in US and European markets.

Nevertheless, skepticism remains regarding the sustainability of the Japanese stock market rally and the long-term prospects for the economy. Domestic buying of equities has been far less pronounced than foreign buying. Banks have been selling their cross-holdings of shares under a mandate from the Japanese government and some pension funds have been net sellers of equities

Japanese Government Bonds (JGBs) constitute the world's largest government bond market, a market that is dominated by Japan's domestic investors. As the equity market revives, rising expectations begin to change the relative attractiveness of equities compared to bonds. The Bank of Japan adopted a zero interest rate policy two years ago and the yield on the 10-year JGB was around 0.40% at mid-year. Over the third quarter, as selling pressure has driven up bond yields, the 10-year JGB yield has almost quadrupled. These recent dramatic shifts in the bond and equity markets present some real challenges for the active management of pension fund assets and liabilities.

Japanese government statistics indicate that the birth rate has fallen to a record low while the percentage of the population aged 65 and over has risen to a record high level. Japan's demographic situation portends a real crisis for the country's public pension system. Recently Japan's Economic and Fiscal Policy Council stated the situation succinctly: "The fiscal and social security systems will be unable to cope with the sharp decrease in birth rate and increase in longevity of the Japanese population, and therefore citizens are not able to feel secure about their future." In order to maintain a sustainable public pension system, there are a number of proposals being debated, including an immediate pension reduction of 10 percent and increases in contributions from the existing level of 13.58 percent of salary up to as much as 20 percent.

The Japanese experience with demographic trends, recession, deflation, stock market collapse and zero interest rates may provide some insights into future prospects for the United States and Europe. Cultural and social changes have emerged in Japan since the days of super economic growth and a 38,000 Nikkei a decade ago. The Japanese population has adapted to changing conditions and attained a state of passive acceptance of the limits to economic growth and a more philosophic focus on social values and non-economic priorities.

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