

Commentary

BUFFIN PARTNERS INC.

ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

Japan Arising

In our October 2003 *Commentary* titled *Japan: Land of Rising Expectations* we wrote about an outlook “that offers exciting potential for Japan.” We posed a number of key questions that we felt at that time would signal improving prospects for the Japanese economy: “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?” Although we were confident of our forecast of “rising expectations for Japan and its economy” we noted at the time that “nevertheless, skepticism remains regarding the sustainability of the Japanese stock market rally and the long-term prospects for the economy” reflecting the views of many of our fellow researchers in the international equity markets.

As the year 2005 comes to a close with the Japanese equity market, as measured by the Nikkei 225, up over 40 percent for the year, it is time to revisit Japan to consider its recent economic experience and to assess its future outlook. Japanese macroeconomic, business, corporate and political developments all indicate that the Japanese economic recovery has taken hold and is indeed sustainable. Business investment is surging; employment is growing and consumer spending is in an upward trend. These factors auger well for the Japanese economy as it becomes less reliant on its exporting industries and on government spending. In 2004 and 2005, Japan experienced substantial capital and direct investment inflows.

Many economists forecast a weakening of the US economy in 2006 as the Federal Reserve’s policy of raising interest rates impacts the economy with a deflation of the US housing market and a moderation of consumer spending. As

a result, Asian and other emerging markets will likely represent the primary source of incremental growth in business, industrial and commodity markets. Japan is regaining some of its lost competitiveness in its traditionally strong industries such as automobiles, steel, chemicals and ceramics. Capital spending is on the increase as major corporations announce new projects: Toshiba and Canon have announced a 20 billion yen project for a research center for flat panel display technology; Komatsu recently announced a 30 billion yen project to construct a plant for mining and large pressing machinery. The Japanese banking industry has re-emerged from a long period of about seven years, where it was essentially moribund, to witness an increasing trend in bank lending in the second half of 2005. The Bank of Japan is forecasting an end to deflation and it is likely that the Japanese Central Bank will soon terminate its zero interest rate policy.

The Japanese Government, with the Bank of Japan, announced in December a commitment to a policy of acceleration and expansion of structural reforms based on “policies for economic and fiscal management and structural reform” as agreed in a cabinet decision for “Basic Principles of Fiscal Year 2006 Budget Formulation.” Also, the Ministry of Foreign Affairs of Japan has launched an “Invest Japan” campaign to promote increasing foreign direct investment in Japan as a means of introducing more advanced business models, technology, knowledge, products and services from overseas and further accelerate the structural reform and revitalization of the Japanese economy. Under the direction of the Japan Investment Council, the program will be based on five core measures to improve the investment environment, namely: dissemination of information to communicate Japan’s appeal and welcoming foreign

investment; improvements in the Japanese corporate business environment to facilitate foreign participation and activity; clarification and simplification of administrative procedures to facilitate foreign investment and access to Japanese markets; creation of favorable employment and living conditions for foreign nationals; and improvement of local and national systems and structures, particularly at the regional level to facilitate foreign direct investment.

Following a rise of 40.2% in 2005, the Nikkei 225 index closed the year at 16,111 representing a 112 percent increase since hitting a low of 7608 in 2003. The outlook for the Japanese stock market remains positive for 2006 with many research analysts predicting that the Nikkei 225 will reach 18,000 or even 20,000. Apart from fundamental economic considerations, an important factor that will contribute to continuing strength in the Japanese equity market is that many international investment institutions have been underweighting Japan in their equity portfolios. They are now moving to re-establish a market-weighted allocation to Japan, or in some cases have implemented an overweight strategy. The demand-push effect of this strategy will be very positive for Japanese equity prices as the Nikkei 225, already at a five-year high, continues on the road to recovery to the long-forgotten level of 38,916 achieved in 1989.

***Note: Past issues of *Commentary* are available at <http://www.buffinpartners.com/archives.htm>**

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