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Japan Strategy

The Relevance of Japan: Everything to Play for….

Investment conclusion: Our position is that 2009 will in retrospect prove to have been a good, possibly great, time to have bought Japanese stocks.

Japan no longer appears structurally overvalued: At the end of a 19-year bear market, any renewed revulsion against equities should be construed as an opportunity to deploy more cash, not as a reason to embrace extreme pessimism.

Policy is loosening: A directional change in macro-economic policy settings seems likely to be accomplished. Such a decisive shift in macro-economic policy settings will eventually deliver a recovery from deflation.

Japan's relative ROE has probably bottomed: Low ROE in Japan is a consequence of too tight macro economic policies causing and then prolonging deflation. Under looser policy, ROE can normalize to as much as double its recent level.

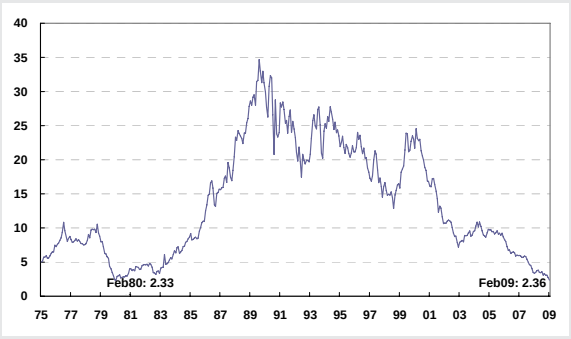
Where we differ: We are more encouraged by the technical and sentiment position from which we start, and more convinced of Japan's undervaluation. We are less concerned about putative "structural problems" allegedly peculiar to Japan.

What's next: Confirmation that the Japanese production cycle is picking up – or evidence to the contrary.

The risks: We pay especially close attention to auto production as a leading indicator of overall production. We watch US credit spreads carefully. Deterioration in either of these indicators would cause us to reconsider our optimism on a tactical basis.

If the monetary policy reverts to over-tight settings, we would temper our optimism on a strategic basis.

TSE Simple Average Share Price Relative to Gold Priced in Yen: A Secular Low?



Note: Chart shows price of 1,000 shares of the simple average divided by yen price of an ounce of gold
Source: Bloomberg, Morgan Stanley Research

Contents

Note:

This report deals with macro factors operating mainly on the whole market, on the broader averages. We will return to questions of stocks and sectors, and of the implementation of the strategic conclusions we have reached, in further publications.

Key Conclusions

Below we summarize the issues we consider central to investment decisions concerning Japan.

1. ***The market appears cheap relative to its own history and relative to the rest of the world***
   Our Composite Valuation Indicator stands at extremely depressed levels; the market appears to be assigning a negative implicit valuation to future earnings; Japan is the cheapest major market on Price-to-Book; smaller stocks are cheap on a "Shiller" P/E multiple.
2. ***We believe the market is also cheap in absolute terms***
   Analysis of probable levels of ROE reveals that Japan's ROE in recent years has been far below the long run average. Valuations do not take into account the normal ROE, but continue to discount an unchanged, depressed ROE.
3. ***A common misperception stands behind such low valuation***
   It is widely believed that there is something peculiar to Japanese politics and corporate organization which prevents higher levels of ROE. Our analysis suggests that, on the contrary, Japan's ROE fell below earlier norms only with the onset of deflation. Low ROE is, at root, driven by macro-economic conditions, not by management orientation or more general social factors.
4. ***Normalization of deflation will follow from a change in macro-economic policy biases***
   The origins of deflation in Japan lie in over-tight policy settings. In recent weeks, both fiscal and monetary policy have turned looser. If a loose policy bias is sustained, deflation will end. A sustained loose policy stance is a very rare event in Japan.
5. ***Normalization in ROE would drive a repricing of Japanese equities***
   Current valuations discount no improvement in long-run ROE. A normalization in ROE would put the market on 10x long-run average earnings, and imply a 4-6 fold expansion in actual EPS.
6. ***Sentiment appears washed out, and participation in the market low***
   The scale of global difficulties has crushed sentiment and driven investors away from stocks. Contrarian measures which have proved useful in the past suggest the scope for large gains.
7. ***Our 12-month Topix target is 1100.***

Valuation – Japan Looks Cheap at Last

1. Is Japan cheap?

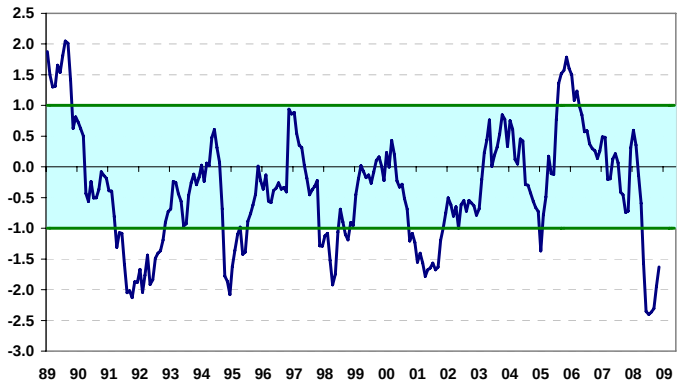
Market's view: "Japan may be cheap, but deserves to be."

Our view: Japan is cheap. Whether it deserves to be is not immediately relevant to one's posture towards the market on a tactical basis. Valuation is mean reverting.

J-CVI: Our proprietary valuation indicator suggests the market is 50% cheaper than a neutral level of valuation would require.

Where we could be wrong: This indicator will trend higher as earnings fall in the near term.

J-CVI: At bottom of historical range



Source: Factset, Datastream, MSCI, Morgan Stanley Research (based on model developed by the European Strategy team).

2. Don't earnings declines make valuation meaningless?

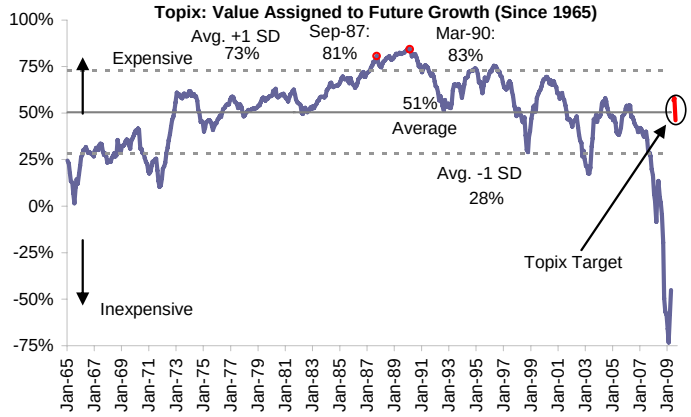
Market's view: "Earnings in FY09 may be down 75% from peak – the market must be expensive."

Our view: The market has already written off and discounted nearer term earnings prospects.

Value assigned to Future Growth: This simple model suggests investors have already given up on earnings power. Would the confirmation of their implicit expectations really be an additional negative for stocks?

Where we could be wrong: Perhaps it is not earnings but a rise in the required risk premium that is driving valuation.

Market has written off the future



Source: MoF, Morgan Stanley Research.

3. Is Japan cheap relative to the rest of the world?

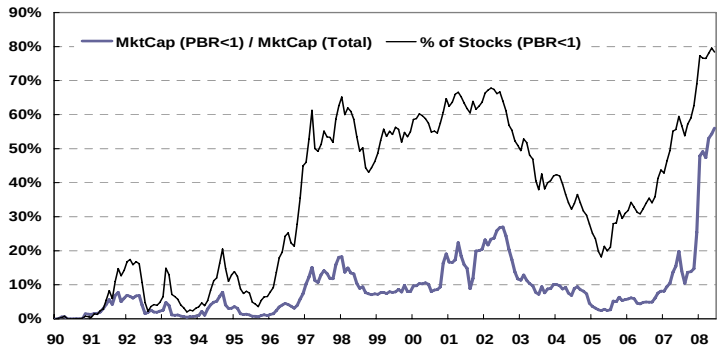
Market's view: "Who cares?"

Our view: Japan is cheap – cheap on an absolute basis not just relative.

Price-to-Book: Japan is the cheapest developed country. (Price-to-Book = 1x; US= 1.8x, EU = 1.2x, World = 1.4x). A majority of market capitalization trades below book. Book appears safe.

Where we could be wrong: Book could be unsafe in the light of the weight of land in balance sheets.

Most of market cap still below book



Source: MSCI, Toyo Keizai, Morgan Stanley Research

Why Should Japan Perform?

1. Where is sentiment towards Japan?

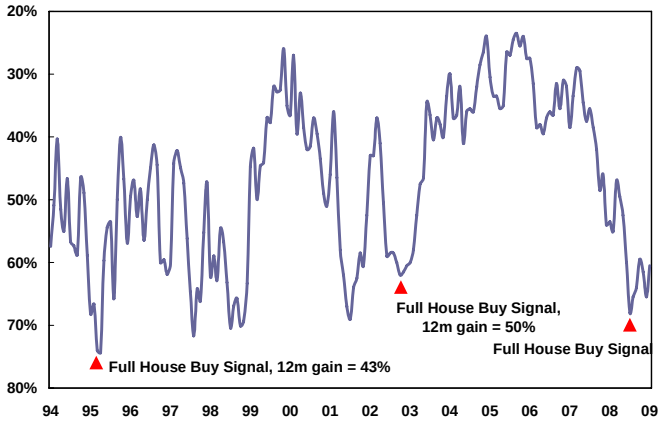
Market's view: "It's been safe to underweight Japan for years, trading it once in a while as a cyclical stock."

Our view: Japan is unloved, misunderstood and wildly under-owned.

Investor Sentiment: Our analysis shows a "Full House Buy" signal in October 2008. To equal past performance, Topix would need to hit 1250 by September.

Where we could be wrong: We are placing excessive weight on two precedents.

Quick Sentiment Survey: Majority Underweight



Source: Quick Sentiment Survey, Morgan Stanley Research.

2. Why should ROE rise?

Market's view: "Japanese management style means ROE will only ever be 5%."

Our view: The normal level of ROE in Japan is 10%. Its decline is a macro-economic phenomenon, a consequence of deflation not an issue of management orientation.

DuPont Analysis: Half a turn of leverage plus rising Asset Turnover – a natural consequence of a real end to deflation – will deliver close to normal ROE over the longer term.

Where we could be wrong: We are premature as policy fall back to anti-growth settings and deflation remains embedded.

DuPont decomposition of ROE by decade

	1960s Average	1970s Average	1980s Average	1990s Average	2000s Average
ROE (%)	10.25	11.47	10.98	5.72	6.35
Net Margin (%)	2.3	1.6	1.9	1.6	2.5
Asset Turnover	111	120	129	97	90
Leverage Ratio	4.2	5.1	4.7	3.6	2.8

Source: MoF, Morgan Stanley Research.

3. Why should deflation/sub-par economic performance end?

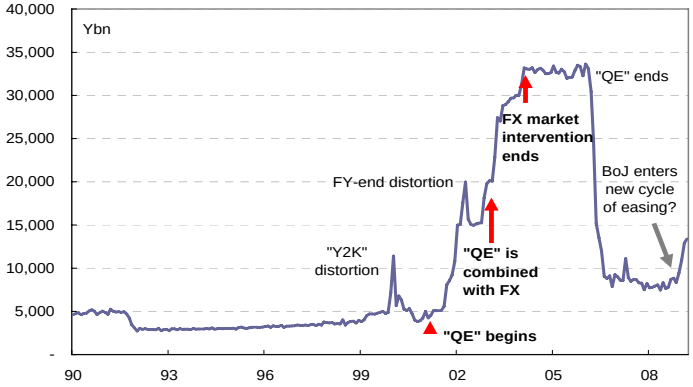
Market's view: "There's no "reform" – nothing's changed."

Our view: Macro-economic policy drives deflation/economic performance.

Policy has already shifted: The "¥15 trillion" package renders fiscal policy loose for the first time since 1998. Monetary policy looks to be loosening for the first time in 5 years.

Where we could be wrong: Is it just a "head fake"?

BoJ Current Account Balances rising again



Source: BoJ, Morgan Stanley Research

Summary of our views

OUR VIEW	IN CONCRETE TERMS	OUR RATIONALE
Japanese Market Outlook		
We are optimistic that Japanese stocks can bounce further and hard	**12m Topix Target:** **Base: 1100 (30% upside)**	**Base case 'It's not the Thirties; time to take Japan seriously again':** At Topix 1100, 50% of the market's value lies in future growth potential – in line with the post-1965 average. Our J-CVI recovers to between -1 and -0.5 (vs. -1.5 now). Price-to-Book reaches 1.25.
	Bull: 1250 (50% upside)	*Bull case 'Straight back to euphoria':* Valuations above average as market reaches blow-off top; J-CVI clears 0.
	Bear: 800 (6% downside)	*Bear case 'It may be the Thirties after all':* Global credit problems resurgent, earnings collapse intensifies, no additional easing; J-CVI falls back to bottom of range.
Implementation		
We prefer aggressive sectors, a category which includes banks and financials	**Preferred Sectors**: Financials Production-cycle sensitives (Materials etc) Machinery, Rubber, Precision	In a production recovery, economic pace sensitive sectors lead. Autos, Precisions, and Electric Machinery, have the best 3-6m record out of troughs in the ISM PMI. Market level dependent sectors such as Securities also do well in the near term. We find it difficult to believe that Banks will not follow. The quality of the banks' lending books in aggregate depends on economic pace. We look for a rally in bank stocks. Standard economic pace sensitive sectors such as Steels, Chemicals, Machinery, Rubber and Precision, should also benefit.
	Least preferred Defensives	
Longer-term focus on low valuation ("Greenblatt", low Price-to-Book) and stable financing (Piotroski)		Over the longer run, recovery potential is less decisive a factor than low valuation.

The Relevance of Japan

Change at the margin and non-consensus ideas
It was my good fortune to have two great mentors at Morgan Stanley, Barton Biggs and Byron Wien. Barton was always, and closely, identified with the view that change at the margin is what drives markets[1]. Byron was convinced that the aim of a strategist (and indeed of an investor) is "to take non-consensus positions which turn out to be right". With gratitude for the guidance so kindly offered in the past by both these gentlemen, guidance which I hope to keep in front of me as I write, I offer the thoughts which follow.

First, three observations:

1. It is not necessary for things to get better for stocks to rise' just that they stop getting worse.

2. For the first time since the 1970s, the Japanese market does not appear structurally overvalued relative to probable levels of long-term earnings power.

3. Japan sports the most conservatively financed and robust household sector amongst the major economies. Not only is the Japanese household sector not "bust", it is effectively unlevered too, and underinvested in risk assets in addition.

The household sector is worth taking seriously. Its investment judgments have tended – when seen at the level not of personal but of aggregate behaviour – to be correct. With the global outlook so changed, and explicitly inflationary polices coming into vogue throughout the developed world, the Japanese household sector has the most to lose if inflation does rise. Accordingly, it might be unwise to assume that the investment biases which have characterized the household sector in the past twenty years will be those that persist over the next ten. We note that – as shown in the cover of this note – relative to gold priced in yen, domestic equities are cheaper than at any point since 1980.

While we propose to return to this particular question, to study it in greater detail, in the future, the more general theme which underlies the conclusions of this note is also that the last twenty years may not be a good guide to the Japanese market we are likely to encounter over the next twenty.

[1] 'Wealth, War and Wisdom', Barton Biggs, Wiley, 2008, ISBN 0470223073

We would add that the unusually deflation-resistant structure of household sector finances was the reason Japan could "choose" deflation in the aftermath of its Bubble. For countries with differently structured household sector balance sheets, that "choice" does not exist as a plausible option. In the same way that Japan found deflation the path of last resistance, so other countries may find the path of least resistance leading in the opposite direction.

Thinking the unthinkable about the allegedly unimprovable level of Japanese ROE
In addition to this potential for a change at the margin in the perspective and behaviour of the most important Japanese investor, we are inclined to argue that early intimations of a normalization in Japanese ROE can be discerned in the performance of companies over recent years.

In contrast to other parts of the developed markets investment universe, normalization in the Japanese context implies a rise in potential ROE relative to recently delivered ROE. We take the pre-1980s Bubble as the norm upon which ROE should converge as it comes out of the slump created by the anomalies of the deflationary 1990s and 2000s. Such a normalization would suggest long-term earnings power in the range of a 7.5% to 10% ROE, as opposed to the 5-6% average which prevailed in the 1990-2009 period.

The potential for Japan's normal ROE to be higher than the average of recent years sets Japan apart from both the US and Europe, where it seems more probable that recently achieved ROEs were above the range a prudent investor would pencil in for the next ten years. In Europe, for instance, the last three years' average ROE was 16%, versus a 26-year average of just under 11%.

This is not to suggest that some "reform" has occurred in Japan. On the contrary, "reform" as it has existed in Japan in the period following the resignation of the Hosokawa Cabinet in 1993, has existed largely in the media rather than in reality, and helped to reduce the political contestability of tight monetary and fiscal policy.

Nor is it to suggest that there is some imminent possibility of "reform" or "structural change" in Japan. It is our view that, while, from the perspective of equity investors, there are, as in every country, numerous micro-economic adjustments that could prove positive for both earnings power and equity valuations, all such micro-economic concerns pale into

insignificance when set against the potential impact of a shift away from over-tight monetary and fiscal policy, a move to a pro-growth from anti-growth policy stance.

The decisive "structural change" that would allow ROE to return to its historical norms is related to macro-economic policy settings, not to factors which are social or political in nature and which, in any other developed country, would not figure in a discussion of the stock market.

Under this analysis, the Japan of 10% ROE in the 1960s, 70s and 80s, was degraded to a Japan of 5% ROE not as a result of a bureaucratic style of management's lack of attention to economic efficiency but as a result of a persistently tight policy stance and the deflationary conditions that this policy bias first produced and then prolonged.

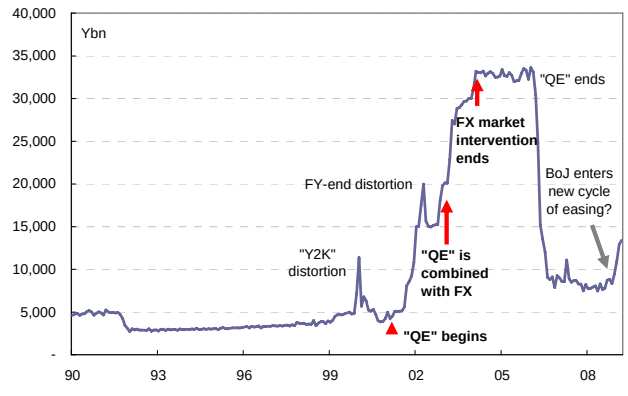
From anti-growth towards pro-growth policy

Fiscal policy – with the Aso administration's latest economic "package" – has already made the directional shift from tight to loose. It remains to be seen how able the administration will be to continue expanding the fiscal deficit after early 2010, and how willing the BoJ will be to run a consistently expansionary policy.

But there are already early indications that monetary policy has turned looser. It seems as though – at least to some degree – the BoJ has hopped aboard the global "QE" bandwagon. Exhibit 1 shows the evolution of current account balances held by the private banks at the BoJ. Under QE between 2001-2006 this was the variable targeted by the central bank. This is the first hint of proper loosening by the BoJ since 2004.

Exhibit 1

BoJ starts to loosen for first time in five years (Current Account Balance)



Source: BoJ, Morgan Stanley Research

The possibility of a break with the policy dispensation of the 1990s and 2000s presents itself not because policy-makers have internally and spontaneously switch to attaching importance to the pursuit of growth but because the line taken by policy-makers elsewhere in response to the global downturn – an explicitly inflationary line, in my opinion – precludes the continuation of anti-growth policies in Japan.

Should Japan attempt a policy of austerity in one country, the risk is open-ended yen appreciation. It seems to us unlikely that policy-makers would be willing to run such risks.

Far easier to allow oneself to be drawn towards the combination which always worked before – domestic fiscal stimulus, with the central bank cooperating to offer some monetary accommodation as well – a combination that might be seen as the diplomatic price to be paid for foreign acquiescence in a lower-than-otherwise external value for the currency. This is exactly the combination that now appears to be developing.

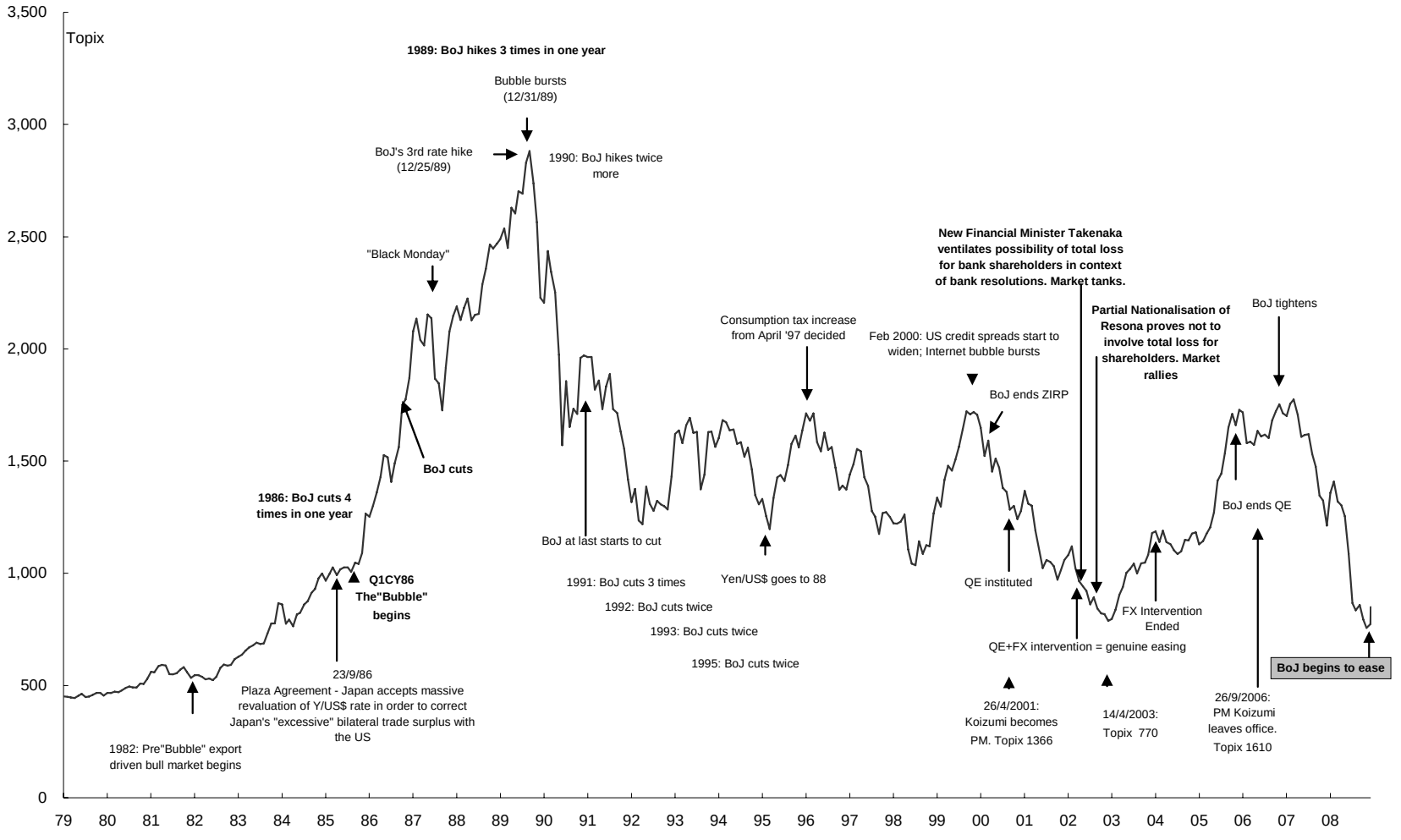
In addition, the scale of the damage done to the stock market by the global meltdown has provoked renewed interest in the question of banks' balance sheet exposure to equities. In 2003, financial pressures resulted in one bank having publicly-quoted equities stripped entirely from its balance sheet; all the banks found new limits placed on their equity exposure.

This theme has returned, with both the BoJ and the Bank Shareholding Purchasing Corporation authorized to buy bank held equities. The total value of their budgetary authorization is ¥21 trillion – over 10% of market capitalization and more than the aggregate holdings of the banking sector.

While we emphasise the primacy of macro factors, we can conceive of no individual improvement to Japan's financial sector of greater importance to the character and valuation of the stock market than to eliminate banks' exposure to equities. By 2014 bank ownership of public equities will in any case become effectively impossible if changes to BIS regulations are enacted as currently proposed. Reduction in the banks' arguably excessive exposure to risky equities, and the excess volatility this engenders in the credit cycle, could allow for a fall in the risk premium attached to the whole market. That this discussion has surfaced now is, perhaps, an unlooked for positive arising out of global events.

To the extent that "Japan" "changes", therefore, it will change because the external environment has changed and not because of any internal decision to change. In other words, when the facts change, Japan changes too – just like any other country.

Exhibit 2
"Don't fight the Fed" - a maxim which works



Source: Bloomberg, Morgan Stanley Research

And just as in other countries, investors in Japan are well advised "not to fight the Fed". As Exhibit 2 underscores, the really important "stop" and "go" signals for stocks over the past three decades have all been macro in nature, all relating to directional shifts in fiscal and monetary policy.

We wish in particular to emphasise how rare and unusual is the conjunction of genuinely loose monetary and fiscal policy in Japan. There are no prolonged periods of such pro-growth policy orientation in the 1990s and 2000s, merely episodes in the 1992-1995 and 1997-1999 periods.

Our expectation that Japan will be drawn into a multi-year reflation that is global in character is a longer-term forecast.

Over the nearer term, the greatest risk to our benign interpretation of longer-run prospects is, of course, that a global tide which rises more rapidly and completely than expected allows the central bank in particular to return to inactivity. Conversely, a falling global tide would, we suspect, only provoke a still more aggressive policy response.

The stronger the global uptick, the weaker are the incentives operating on the BoJ to play its part in continuing to support growth. On the other hand, while economic outcomes unless extreme appear only weakly to influence the central bank, market variables may do. More aggressive use of policy measures which have quasi-monetary policy-like consequences (removal of the cap on BoJ purchases of JGBs, for instance) could arise either out of a sharp move upwards in the currency or a sharp move downwards in the JGB market.

The stronger the economic recovery, the stronger the argument for a fall in bond prices; the weaker Japan's monetary policy response relative to other countries, the more pressure for an upwards movement in the yen. The balance is perhaps more delicate than a simple reading might suggest.

Ours is not a Panglossian optimism. Given the experience of the period since the Bubble, we do not underestimate the capacity for the policy to turn suddenly and unpredictably in a direction unfriendly to equities. After all, it has done so on each occasion the economy has rallied since 1989. Yet we remain hopeful that this time changed global circumstances – a new "orthodoxy" amongst central bankers rather than a spontaneous change in Japan – will obviate the tightening bias which characterized the 1990s and 2000s.

Japan is now 24% of the MSCI EAFE index, up from 20% at the end of 2007. We doubt that it occupies a quarter of the attention of more than a minority of international managers.

After all, seen in purely practical terms, it has been quite possible to run a successful portfolio without reference to Japan for more than a decade.

But with the changed global environment beginning to change Japan, perhaps, after ten years as little more than a laboratory experiment in deflation, it is time to take Japan seriously again – in all senses of the word.

Tactical considerations

While the backdrop in Japan is much like (though not exactly the same as) the position which attended stocks in the US at the end of the '70s and in the early '80s, the realization that a benign evolution of conditions is beginning (or has begun) is not the same as wishing to buy stocks indiscriminately today.

Clear sources of concern remain. Though my colleague Gerard Minack is tactically bullish, our US economists led by Richard Berner have laid out the case for a painfully sub-par medium term economic outlook there. My colleague Teun Draaisma, our European Strategist, has turned bearish on European stocks. Jason Todd, in our US strategy team, continues to urge caution following a similar logic.

Meanwhile Jonathan Garner, our EM strategist, continues to play the rally in EM markets and looks to the Chinese consumer – in the absence of the strong lead to which we have become accustomed from the US consumer – to prod EM towards higher ground.

Our views towards Japan therefore stand at the more optimistic end of the regional spectrum even as we acknowledge the probability that the near future will be characterized as much by choppiness as by a visible uptrend.

But our position is that the lows are in for Japan for this cycle and that the period up to late 2009 3Q will see news flow turn – at the margin! – better rather than worse.

Our very simple simulations of the effect of a stabilization and recovery in automobile production on the overall level of Japanese industrial production suggest that 3Q production for the economy overall will be approximately 10-15% higher than the level in 2Q. Our economists now see upside risks to their GDP and production forecasts, especially in 2009 3Q and 4Q. In the nearer term, the evolution of the production cycle seems likely to be the key variable for the market. That cycle seems unlikely to deliver disappointment until 2010.

We outline our analysis of what drives Japan – more precisely, what has driven Japan – over the medium to long term, on page 30

and following ("What makes Japan perform: Concepts and Triggers").

While at this point our judgment is that enough factors have developed favourably to allow Japan to do well, we would turn tactically bearish if two or more of the following developments occurred:

1. If automobile production in Japan fails to rise.

2. If the US Baa credit spread widens once more.

3. If the ISM PMI, the DI of the country components of the OECD LEI and the DI of the sector components of the Japanese IIP, all show renewed deterioration irrespective of the path of the Japanese production cycle.

We also monitor the level of unsold homes in the US. This gives, in our view (which we share with our European strategy team colleagues), a clear signal as to the waxing and waning of the pressures weighing on private consumption in the US.

By contrast, further improvement in these indicators would allow us to overlay additional tactical bullishness on our strategic optimism.

Tactics and Timing

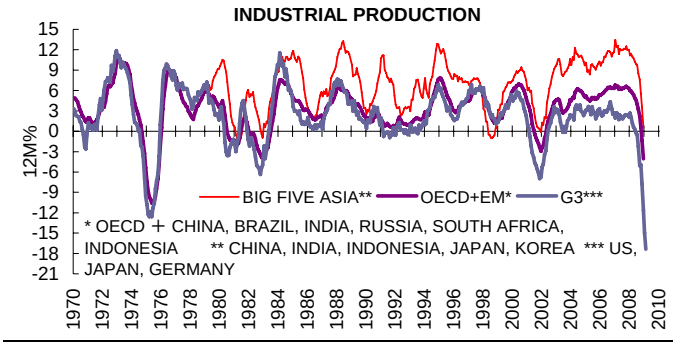
A sharp production bounce-back

The route by which the global economy found its way into its current mess is unusual when examined in a long run context. While abnormal in a number of respects, the principal divergence between the current period and most 20th century experience is that for the first time since the 1930s US policymakers were willing to allow (or perhaps had no choice other than to allow) the failure of a financial institution without making whole overseas investors in that institution.

This cross-border failure occasioned and/or exacerbated a disruption in global trade finance to which producers could only react by cutting production far more sharply than they would (and indeed, ever had) in the face of a 'standard' downturn (as shown in Exhibit 3) While economic historians of a particular bent have always been interested in trade finance effects in the context of the 1920s-30s collapse, we have no recent incidences against which to judge the scope for a bounce-back, or, indeed, the probability of a further, open-ended decline.

Exhibit 3

Global Industrial Production: Trade Finance Disruption in Evidence



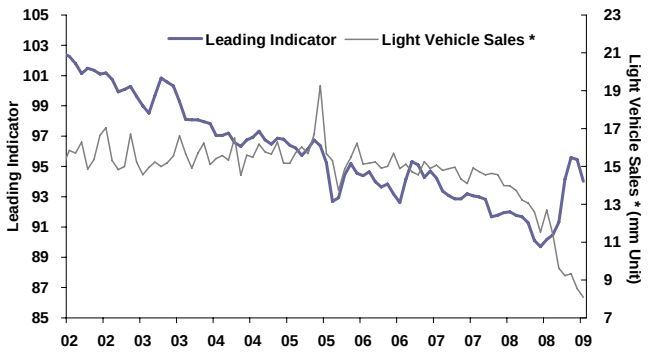
Source: Datastream, Morgan Stanley Research

Numerical evidence on trade credit is hard to find, but anecdotal information (for instance, conversations with national and international monetary institutions) suggests that, after an almost complete shutdown in the availability of such funding in 2008 4Q, credit is beginning again to flow more or less normally.

Exhibit 4 shows how far sales have fallen below our leading indicator of US light vehicle demand. This sector specific divergence appears unsustainable over a 6-9 month time frame even in the light of the renewed fall in the leading indicator. (We are not committed, by taking this view, to any position in respect of auto demand over any longer time-frame.)

Exhibit 4

Morgan Stanley US Auto Sales Leading Indicator and Actual Light Vehicle Sales, 2002-date



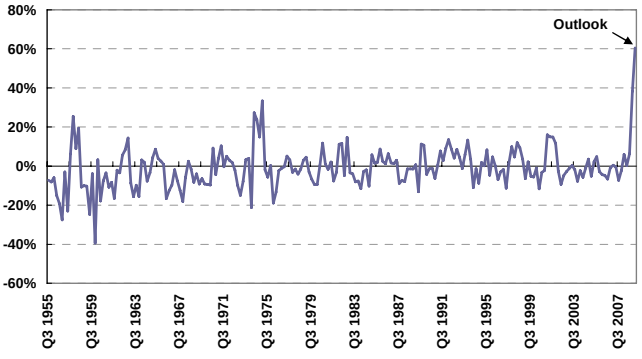
*: Excluding imports
Source: Global Insight, Bureau of Labor Statistics, Federal Reserve Board, Morgan Stanley Research

More generally, the divergence between production and consumption in the recent past has been more extreme than at any point since the 1970s.

Exhibit 5 shows, on a quarterly basis, the divergence between the annualised growth rate of private consumption and the annualized growth rate of production across all sectors.

Exhibit 5

Divergence between Growth in Private Consumption and Growth in Industrial production, Annualised on a Quarterly Basis



Source: Datastream, Morgan Stanley Research

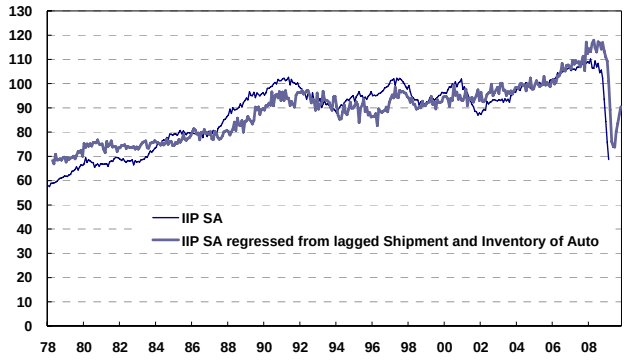
Currently private consumption is falling (our economics team's estimate for 2009 1Q is at the rate of -4.7% on an annualised basis) but we estimate that production has declined much faster (-65% during the same quarter at an annualised rate).

Clearly, given the starting point, a sharp bounce-back in industrial production could occur even in the context of a longer-run erosion of consumption. Production has fallen far more sharply than final demand, largely, we believe, because of the unusual interruption of trade finance late in 2008. We are now going to have to deal with the backwash from the end of that disruption.

Already some evidence appears to be developing that an inflexion point has been reached. The ISM PMI seems to have bottomed. The Japan Economy Watchers index is clearly rising.

Exhibit 6 is a production proxy (estimated from a simple regression analysis of actual shipments by and inventories in the Auto sector) pushed forward three months and the overall Index of Industrial Production. The implication is that an increase in automobile production will lead to a firming in industrial production overall. A rough estimate of the magnitude of the bounce would be that the average level of industrial production in 2009 3Q will be around 10%-15% higher than the average level in 2Q.

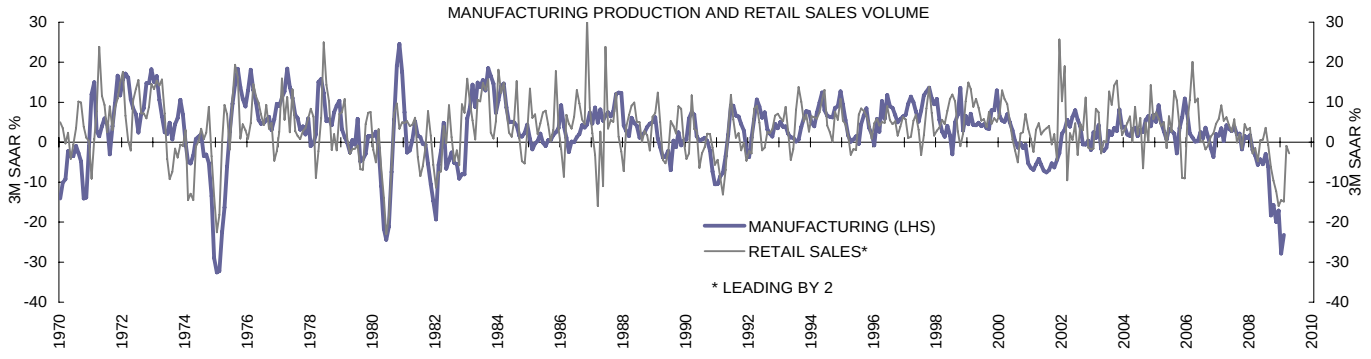
Exhibit 6
IIP Regression – Autos lead overall Production



Source: METI, Morgan Stanley Research

A broader perspective is given in Exhibit 7 for which I am indebted to my Sydney-based strategy team colleague, Gerard Minack. The mismatch between falling consumption and even sharper falls in production is visible in the US too. Our US economist, Richard Berner, cautions that on wider measures of activity – for instance, business spending as opposed to retail sales – the scope for a bounce-back in production appears rather more muted.

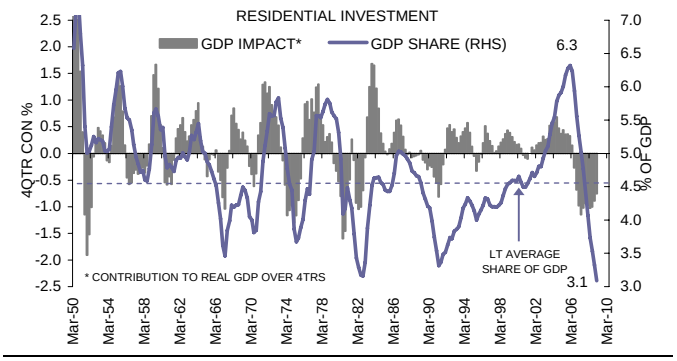
Exhibit 7
Manufacturing Production and Retail Sales in the US: Consumption down; Production down by more



*: Leading by 2 months
Source: Datastream, Morgan Stanley Research

Exhibit 8

US Residential Investment: Record Lows relative to GDP



Source: Datastream, Morgan Stanley Research

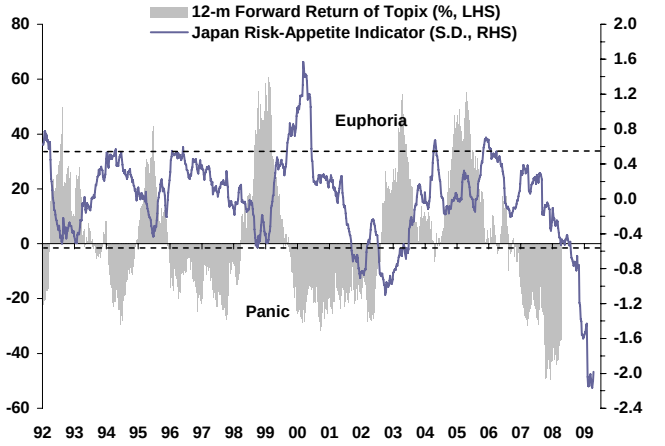
Furthermore, as Exhibit 8 shows, residential investment in the US has fallen to the bottom of its historical range relative to GDP. One of the initial driving forces behind the slowdown in the US may, at last, be falling out of the picture.

All this is occurring against the backdrop of a market that is deeply oversold. Indeed, even after its stellar recovery, it remains more heavily oversold on most of the technical measures we use than at any time since the bursting of the 1980s Bubble. (Please see p.29ff for a closer analysis of the technical position).

Despite the recovery, sentiment remains deeply depressed. Our Risk-Appetite Indicator has barely rallied (as can be seen from Exhibit 9), despite the extraordinarily low levels to which it had declined.

Exhibit 9

Japan Risk-Appetite Indicator



Source: Factset, Datastream, Quick, Bloomberg, TSE, Morgan Stanley Research

This absence of recovery may, nonetheless, be a suggestion of a deeper problem. While equities rally, lower-rated credit has not led it upwards. A conventional understanding would demand that any rally in equity unconfirmed by a rally in credit be distrusted as weakly founded and liable to quick reversal.

We examine *inter alia* valuation relative to credit in a little more depth in the next section of this note.

Japan's Valuation Conundrum: Part 1: Historical and Relative Context

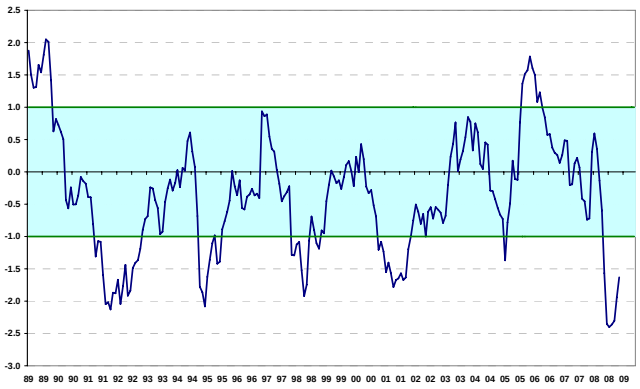
Genuinely Cheap

We remain impressed that our Composite Valuation Indicator (J-CVI), shown in Exhibit 10, still stands at very depressed levels (-1.5).

This indicator is modeled upon a similar indicator (CVI) developed by our colleagues in Morgan Stanley's European Strategy team which has proved a useful analytical tool in their markets. The model incorporates seven different measures of interest rates, earnings and dividends. The market – despite the rally – is still as inexpensive as at the lows in 1992, 1995, 1998 and 2003.

Exhibit 10

Composite Valuation Indicator



Source: MSCI, Factset, Datastream, Morgan Stanley Research based on model developed by the European Strategy team

Our 12m Topix target of 1100 is based on a target range for the J-CVI of -0.5 to -1.0. This would still be below average, but not at levels consistent with a depression.

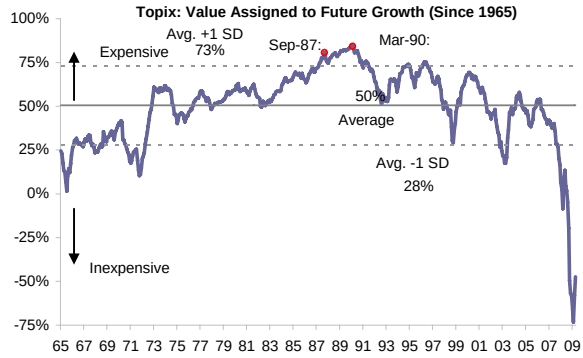
Given the views of our colleagues overseas, we remain alert to intimations that the "second derivative rally" is ending, and have looked for yardsticks which might help us make the judgment that the positive developments we identify have been fully priced in. Given our *mise-en-scene*, we expect to be provided with one indication that the scope for further gains is gone when the proportion of current market value attributed to future growth has risen back towards zero. Should this occur, we will reconsider our optimism.

Put differently, only when the market has first retreated from the perception that "the 1930s all over again" should it be time for contrarian investors to revisit the more extreme scenarios which have come into view in the past year.

As Exhibit 11 shows, in common with other major markets, current valuations imply that the future will not represent an addition to the value of the index, but rather a deduction. Clearly, in times of rapidly shifting earnings, models of this kind require careful calibration and interpretation, but it does appear as though markets are overlooking the possibility that, while current operating conditions and the outlook for earnings in the near future remain bleak, the far distant future might not be so ghastly[2] .

Exhibit 11

Topix: Proportion of Index Value Assigned to Future Growth



Source: Datastream, TSE, Bloomberg, Morgan Stanley Research

When, once again, expectations towards the far distant future have come back towards more normal levels, we would expect to see this chart revert to its normal 25-75% range. Our Topix 1100 target would imply that 50% of the value of the market would lie in future growth, in line with the post-1965 average.

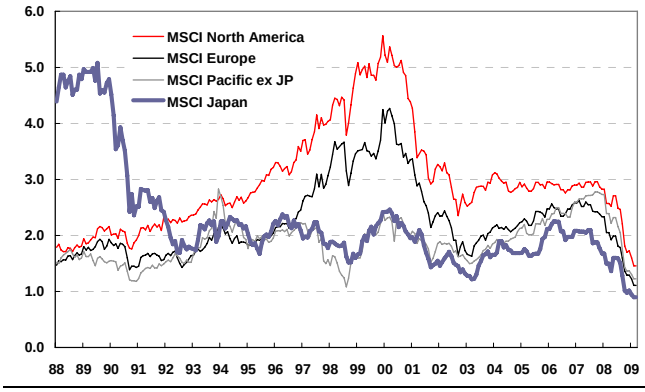
In an international context, Japan appears expensive on P/E, but is the cheapest major market on Price-to-Book. We address the question of earnings over the longer term in the following section of this note.

In the nearer term, it is clear that earnings in Japan are unlikely to recover by sufficient to render the market undervalued relative to others on a P/E basis. Nonetheless, the fact that the market is already trading at a low valuation of book seems to us

[2] Recent academic work tends towards the position that, while refined measures of equity duration carry more explanatory power than cruder measures of valuation, crude measures such as Price-to-Book work partly because they embody and express duration. e.g. Dechow, Sloan and Soliman, 'Implied Equity Duration: A New Measure', Review of Accounting Studies, June 2004.

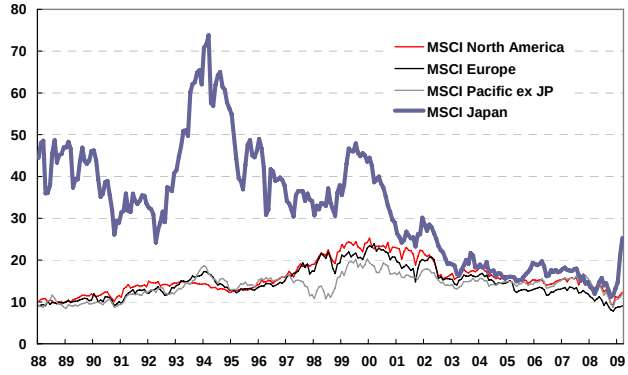
to indicate – in confirmation of the model offered above – that both long-term and short-term earnings power are likely to have been comprehensively "written off" already.

Exhibit 12
MSCI Price-to-Book by market



Source: MSCI, Factset, Morgan Stanley Research

Exhibit 13
MSCI P/E by market

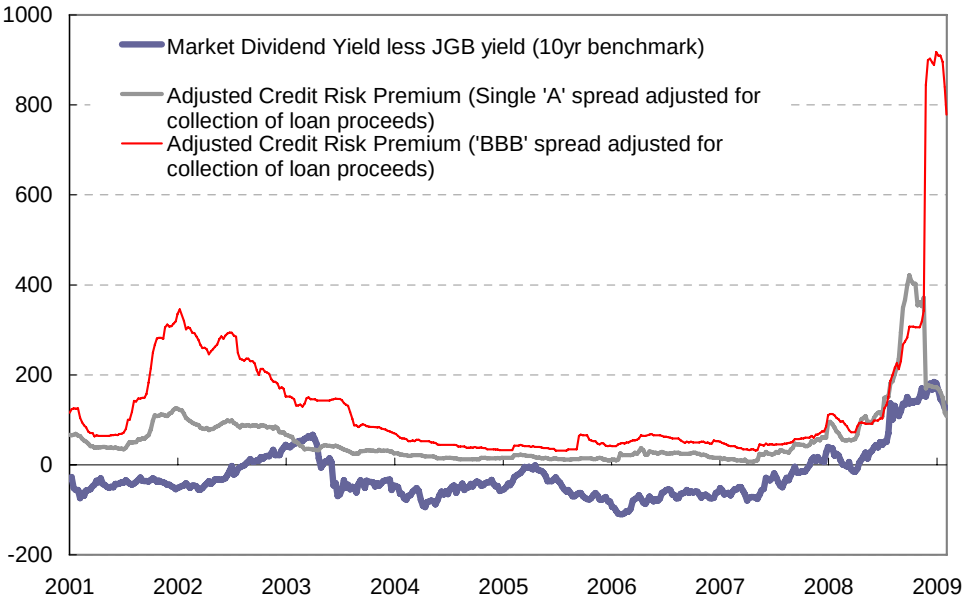


Source: MSCI, Factset, Morgan Stanley Research

We also view equities as an asset class competing with credit.

In this relative context, we focus on the key difference between equities and credit of a defined maturity – a great part of the value of equities is constituted out of the present value of far-distant income streams. This quality may allow the equity rally to elongate and outperform credit.

Exhibit 14
Equity Index Pricing Following Highly Rated Credit



Note: Note: ACRP = Plain spread/(1-estimated credit recovery rate) = plain spread adjusted to reflect the lower value at risk of the credit. In almost all circumstances the credit investor gets something back so has less VAR when compared to the equity holder, who we assume, loses everything in a serious credit event. We assume a 30% recovery rate for the purposes of this analysis.
Source: Datastream, Bloomberg, Morgan Stanley Research

Recent market action has been, to some degree, puzzling in that equity has performed better than lower rated credit. As shown in Exhibit 14, 'BBB' spreads have come in but not to the degree either that lower rated equities or higher rated credit have rallied.

Exhibit 14 rather crudely attempts to set credit and equity valuations in a comparable framework. Drawing on work by Andrew Sheets (our head of European Credit Research), we adjust credit spreads to reflect the lower value at risk (relative to equities) that arises out of the probability that the credit investor would see something recovered in the event of the borrower's failure, while the equity holder would recover nothing. For the purposes of simplicity we set the recovery rate at 30%, and then relate the adjusted spread to the equity market's dividend yield less the prevailing risk free rate (in this case, as usual, the yield on the benchmark 10-year JGB).

The most recent period in which credit and equity pricing displayed some similarity with the current position was in mid-2003. Then the equity (dividend) yield spread traded above the adjusted credit risk premium derived from the single 'A' credit spread. This was a great time – in retrospect – to have bought stocks.

The equity market's dividend yield spread is once again, though only fractionally, above the single 'A'-derived adjusted credit risk premium.

One interpretation of the 2003 and current positions is that the equity market has so far moved up only because higher rated credits have performed. There has been, in reality, little change in the market's perception that the option value attaching to the potential for future growth is zero – the equity dividend stream has only annuity value. This approach underscores the verdict of Exhibit 11.

Our position therefore is that the bulk of the fluctuation in the valuation attached to equities over the coming year or so is unlikely to be in any serious sense related to current and next period earnings. On the contrary, equities will be highly sensitive to changes in the valuation attached to potential earnings to be delivered in the far-distant future. Perhaps a re-pricing of such a kind could best be interpreted as the equity market's moving away from the assumption that "it's the Thirties all over again". We would caution that investors will probably be as surprised by the scale of re-pricing this implies as they were unfavourably impressed by the magnitude of the earlier decline.

Perceptions of the far-distant future will depend largely on the news flow in the present. For as long as sequential data relating to the production cycle is more positive than negative the market should continue to move away from the idea of a replay of the Thirties.

I believe that this way of looking at the mechanisms behind a segment of equity valuation naturally prone to wide fluctuation helps explain why the equity market will be prone to move more than the consensus thinks it can, and arguably more than it "should".

Japan's Valuation Conundrum: Part 2: Absolute Value

Normalised P/Es and Price-to-Book

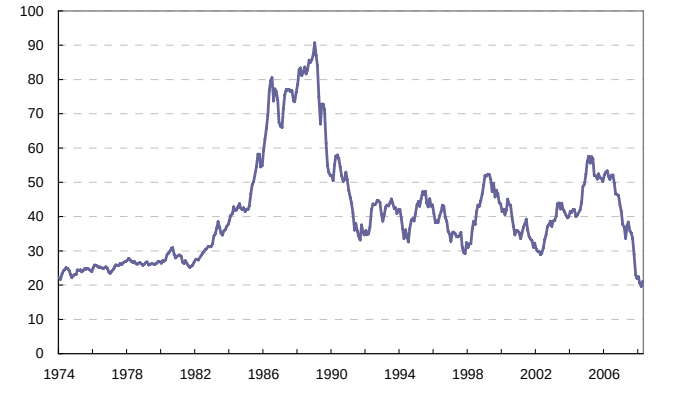
As Exhibit 15 shows, the long-term "Shiller" multiple (a P/E ratio based on the average of 10-years' reported earnings[3]) remains at 20 times. By contrast, the market multiple calculated on this basis in Europe is 10 times and in the US it is 13 times. Trough valuations (of the depression era) were 7 times for the US.

It is our position that while conditions will remain severe for some time, it is not the "Great Depression all over again". As a result valuations perhaps need not decline quite to the same extent as they did then (for the reasons advanced earlier).

Viewed superficially, it would appear that Japan has to endure further declines in valuation to bring it into line with global norms.

Exhibit 15

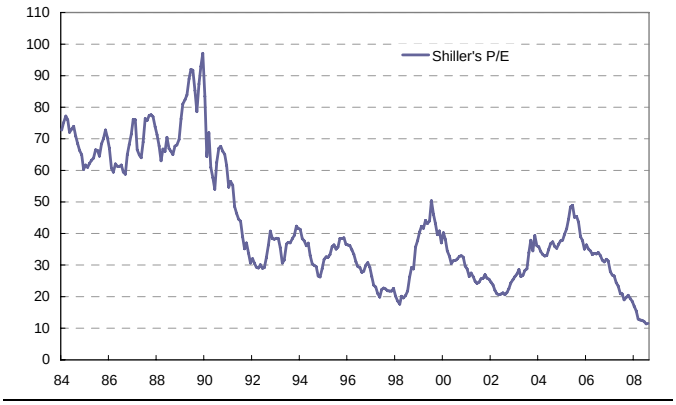
Topix: "Shiller P/E", 1974-2009



Source: Datastream, Bloomberg, Morgan Stanley Research

Exhibit 16

TSE2: "Shiller P/E", 1980-2009



Source: Datastream, Morgan Stanley Research

[3] We employ the approach popularized by the economist Robert Shiller.

Exhibit 16 shows the same long-term P/E for the TSE Second Section. It is already at 10 times, suggesting that in the small cap arena valuation compression has proceeded much further than amongst large caps. This is the pool of truly undervalued opportunities in Japan.

As noted above, while a focus on P/E does not reveal a clear-cut value case for larger-capitalisation stocks in Japan, on Price-to-Book Japan is the cheapest of the major markets (at 1 times as of the end of March 2009).

Taking an absolute rather than a relative view, what is striking is that not only a lot of stocks, but also a very high proportion of market capitalization trades below book, as shown in Exhibit 17.

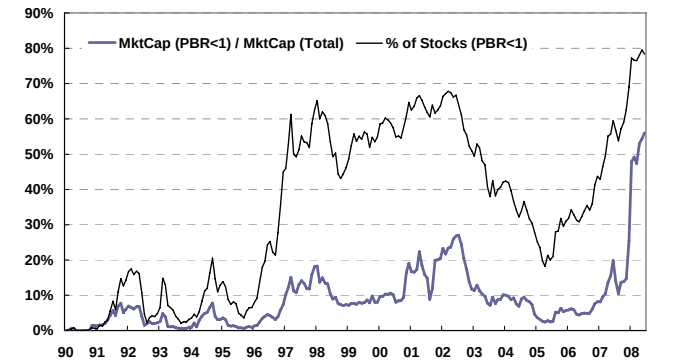
This implies either that the market believes that book is overstated relative to its economic substance, or that book will fall dramatically owing to the scale of future losses to be booked by companies.

While we assume that market earnings in the near term will be negligible in aggregate (perhaps as low as 20% of peak), we would argue that the low absolute level of Price-to-Book and the vast number of stocks below book, indicate that the market has already discounted the near term earnings disaster that the global economic slowdown has engendered.

It is a truism that valuation measures such as Price-to-Book "do not work in the short run". Instead of focusing on the short run, we suggest that the most effective way of judging absolute and long-term valuation is to consider whether current valuations are consistent with probable (though uncertain because far-distant) levels of earnings power in the future.

Exhibit 17

Stocks below Book – Number of Stocks and Proportion of Market Capitalisation



Source: Toyo Keizai, Morgan Stanley Research

Exhibit 18

Residual Income Analysis: Even under the assumption of a near term earnings disaster, the market ascribes trivial value to the long run

TSE 33 Sector

Code	Sector	Curr. Mcap	Book Value (Estimates are adjusted to Top-down forcast)			PV of Residual Income			Forecast Value	Terminal Value implied by Mcap	TV/Mcap
			FY0	FY1	FY2	FY1	FY2	FY3		Mcap - Fv	
50	Fishery, Agriculture & Forestry	290,456	312,054	311,699	307,916	(7,994)	(10,282)	(9,943)	283,835	6,621	2.28%
1050	Mining	2,006,835	1,738,524	1,887,971	1,968,866	74,371	1,426	2,101	1,816,423	190,412	9.49%
2050	Construction	6,274,636	7,999,886	8,059,039	8,038,624	(211,384)	(288,098)	(281,652)	7,218,752	(944,116)	-15.05%
3050	Foods	9,383,092	8,742,292	8,807,458	8,774,354	(151,289)	(244,881)	(236,636)	8,109,485	1,273,607	13.57%
3100	Textiles & Apparels	2,303,767	3,152,172	3,182,263	3,187,668	(75,851)	(108,306)	(106,309)	2,861,705	(557,938)	-24.22%
3150	Pulp & Paper	1,297,801	1,629,114	1,628,262	1,616,739	(45,217)	(55,970)	(54,652)	1,473,274	(175,474)	-13.52%
3200	Chemicals	14,542,311	15,780,954	15,984,571	16,004,127	(261,238)	(479,382)	(465,092)	14,575,241	(32,930)	-0.23%
3250	Pharmaceutical	12,604,977	8,941,549	8,864,418	8,624,939	(59,238)	(186,806)	(166,642)	8,528,863	4,076,114	32.34%
3300	Oil & Coal Products	2,699,580	3,703,332	3,790,353	3,806,481	(15,071)	(87,906)	(83,753)	3,516,601	(817,021)	-30.26%
3350	Rubber Products	1,755,918	1,809,224	1,823,437	1,822,501	(50,211)	(66,593)	(65,388)	1,627,032	128,886	7.34%
3400	Glass & Ceramics Products	2,926,914	3,478,480	3,544,078	3,569,385	(67,529)	(116,935)	(114,886)	3,179,131	(252,217)	-8.62%
3450	Iron & Steel	7,321,254	7,594,517	7,878,295	8,041,287	22,246	(172,074)	(167,962)	7,276,727	44,528	0.61%
3500	Nonferrous Metals	2,929,600	3,689,411	3,830,370	3,911,382	(23,975)	(104,299)	(103,435)	3,457,702	(528,101)	-18.03%
3550	Metal Products	2,048,025	2,935,656	2,945,477	2,943,534	(99,248)	(119,181)	(117,687)	2,599,540	(551,514)	-26.93%
3600	Machinery	11,264,838	11,964,614	12,169,132	12,266,799	(202,571)	(389,217)	(381,917)	10,990,910	273,928	2.43%
3650	Electric Appliances	32,485,930	35,402,403	36,003,393	36,251,797	(692,524)	(1,183,546)	(1,162,256)	32,364,077	121,853	0.38%
3700	Transportation Equipment	30,048,573	31,526,850	32,395,823	32,916,664	(281,814)	(886,032)	(872,021)	29,486,982	561,591	1.87%
3750	Precision Instruments	3,360,151	2,486,046	2,537,274	2,554,123	(12,916)	(60,221)	(57,812)	2,355,097	1,005,054	29.91%
3800	Other Products	6,987,111	5,616,440	5,555,400	5,432,233	(71,258)	(144,949)	(133,321)	5,266,912	1,720,199	24.62%
4050	Electric Power & Gas	13,599,896	12,483,179	12,313,399	12,065,068	(360,210)	(423,836)	(407,822)	11,291,311	2,308,586	16.98%
5050	Land Transportation	10,356,512	7,758,754	7,927,026	7,964,581	(23,210)	(157,690)	(149,803)	7,428,051	2,928,461	28.28%
5100	Marine Transportation	1,775,930	1,867,046	1,964,685	2,030,459	54,667	(13,877)	(12,815)	1,895,021	(119,092)	-6.71%
5150	Air Transportation	1,284,299	794,719	821,935	837,733	(5,663)	(18,281)	(18,104)	752,671	531,628	41.39%
5200	Warehousing & Harbor Transportation Services	766,069	1,026,787	1,038,599	1,040,395	(22,261)	(33,116)	(32,426)	938,984	(172,915)	-22.57%
5250	Information & Communication	23,739,960	19,709,113	20,019,391	19,957,137	(36,664)	(383,859)	(356,525)	18,932,065	4,807,894	20.25%
6050	Wholesale Trade	12,006,741	14,306,175	14,600,720	14,738,763	(135,382)	(402,141)	(391,322)	13,377,330	(1,370,589)	-11.42%
6100	Retail Trade	10,877,641	10,445,894	10,588,183	10,598,023	(115,768)	(270,055)	(259,550)	9,800,520	1,077,121	9.90%
7050	Banks	-	-	-	-	-	-	-	-	-	NA
7100	Securities & Commodity Futures	-	-	-	-	-	-	-	-	-	NA
7150	Insurance	-	-	-	-	-	-	-	-	-	NA
7200	Other Financing Business	-	-	-	-	-	-	-	-	-	NA
8050	Real Estate	5,682,981	5,267,860	5,405,261	5,448,229	(67,222)	(166,018)	(161,761)	4,872,860	810,121	14.26%
9050	Services	5,112,268	4,260,892	4,246,249	4,229,556	(52,375)	(106,882)	(101,994)	3,999,641	1,112,626	21.76%
NA	Other (NA)	-	-	-	-	-	-	-	-	-	NA
	All Sectors (excl. Financial)	237,734,065	236,423,936	240,124,160	240,949,363	(2,996,800)	(6,679,008)	(6,471,386)	220,276,743	17,457,323	7.34%

TMT

Manufacturing	143,959,843	148,453,054	150,940,004	151,724,013	(2,087,705)	(4,406,299)	(4,289,773)	137,669,279	6,290,564	4.37%
Non-Manufacturing	81,767,481	73,664,707	74,583,437	74,486,587	(773,713)	(1,870,568)	(1,790,292)	69,230,134	12,537,347	15.33%
Trade	12,006,741	14,306,175	14,600,720	14,738,763	(135,382)	(402,141)	(391,322)	13,377,330	(1,370,589)	-11.42%
All Non-Financials	237,734,065	236,423,936	240,124,160	240,949,363	(2,996,800)	(6,679,008)	(6,471,386)	220,276,743	17,457,323	7.34%

Source: Company data, ModelWare, Morgan Stanley Research

In Exhibit 18 we use a Morgan Stanley ModelWare model to adjust current accounting based value to reflect more accurately the economic value (or the destruction of economic value) represented by earnings in the more visible, nearer future. The analysis is based on the First Section and includes the majority of companies, aggregated according to Topix sector classifications.

Our top-down corporate profits estimates for the next three accounting periods are incorporated in this analysis. For reference, we expect FY08 to have seen a decline of 60% and FY09 to see a further decline of 40% before a 5% recovery in FY10.

This rather mechanical approach yields a “forecast value” based on book value increased or reduced by an estimate of the economic value of near-term earnings.

The small differential between market capitalization, book value and the value implied by this analysis (forecast value is 7% lower than current stated book) underscores our perception that the market is already taking the most severe view of valuation and current earnings power. This model includes no element of future growth towards a normalized earnings level.

At the moment, the dominant view amongst market participants is that, while it is an intellectually interesting observation to note that for instance Japan’s Price-to-Book is low, it has no practical consequences because low ROE condemns Japan to a perpetuity of low Price-to-Book.

Is Japan cheap or expensive? It entirely depends on what level of medium-term ROE one thinks is normal.

We believe normal ROE is potentially double recent levels. It is this long-term optimism which underpins our perspective that valuations are depressed and liable to rise over time.

Japan's Valuation Conundrum: Part 3: But why should valuations rise?

What ROE is "Normal" in Japan?
Two broad schools of thought exist in relation to this question.

First, pessimists argue that entrenched management is not interested in returns, and so creates none.

Second, optimists argue that Japanese management practices and orientation have changed or are changing so radically that the past is no guide to the future.

It is unusually difficult to disentangle these factors. Large, bureaucratic, companies[4] change only at a slow pace. They are, by design, uninterested in return on capital; but they are, of necessity, forced to consider access to capital, which implies an emerging, though incomplete, focus on efficiency. This tension between basic outlook and the demands of the market is not one that can be resolved in the short term.

But, in any case, can this question of management orientation really explain the difference in performance between Japanese companies in the pre-1990 and post-1990 periods? Averages for different periods are shown in Exhibit 19. Clearly 1990 was a turning point.

Perhaps the focus on management orientation is already misleading – an artifact of the bear market. It may be that the financial performance of large, bureaucratic companies in the relatively recent past has been unusual and inferior not so much because of the orientation of management but because of the overall macro-economic settings of the country.

At the very least, a focus on management orientation fails adequately to address the question of why, with the same style of management across all periods, ROE in the pre-1990 period was double that in the post-1990 period, on average.

Comparison with Europe
In Europe, average ROE has been stable, at just above the 10% level. Comparison with Exhibit 20 shows higher net margins than in Japan, and a trend towards expansion in profitability, together with a stable and now higher than in Japan level of leverage.

The decade average for the 2000s obscures, however, the fact that in 2005, 2006 and 2007, the average of European companies' ROE was 16%. Perhaps in contrast to Japan, the near term outlook in Europe is for ROE to decline towards its long-run average.

The major difference between Japan's ROE and Europe's is that Japanese net margins are much lower. They have been much lower throughout the period for which we have history.

Low ROE in Japan a consequence of economic conditions, not management style
It seems, in retrospect, unlikely that any form of corporate organization could, in the "high period" of Japanese deflation (1997-2007), have delivered superior financial returns.

Usually tight and only fleetingly loose monetary and fiscal policy were, arguably, far more damaging to the interests of risk capital providers than managerial inattention to return maximization.

Nonetheless, the performance of management – at the aggregate level – should not be underestimated. Exhibit 21 shows market earnings, expressed as EPS of a share of Topix and adjusted for inflation (based on the CPI).

It is immediately obvious that the range occupied by real EPS in the 1970-2005 period was decisively broken by the profits expansion of the most recent cycle. Our conclusion is that the most bearish of views – that an unchanging, bureaucratic, style of management will only ever deliver 5% ROEs – should be rejected.

Of course, it is also clear that this profits expansion coincides with an extreme export boom. Given the global environment now developing, it might be unwise to assume any easy reconstruction of such favourable external conditions. But our thesis rests more on a long-run shift in internal conditions as a result of consistently looser macro-economic policy-settings than it does on a benign development of the global economy.

A simplistic reading of Exhibit 21 would suggest that there is scope for inflation-adjusted earnings in future to be higher than the ¥22-50 range in which they were confined from 1970 to 2007. It looks, superficially, as though a pattern of higher cyclical highs has reestablished itself after a trendless thirty years.

[4] This category of companies is often called "*salariman*" after their employees. We argue that features of this style of management, one adopted by most larger listed companies, include in particular, pay scales largely unrelated to work product, bureaucratic decision-making structures, and mandatory retirement. Every country has some version of this system in some part of the corporate sector. These companies represent approximately 30% of the Japanese male labour force.

The market currently has an equity base (book value) of ¥880 per share of Topix. If we assume a return to an average pre-Bubble ROE of 10%, market earnings would have to rise to an average – not a peak – of about ¥85-90. That would exceed the most recent peak of cycle level of ¥67.

If we assume that EPS at the bottom of this cycle will be similar to that at the trough of prior cycles, in the low ¥20s per share, we could foresee a four-fold rise in earnings to reach a normalized level.

At an average ROE of 10% sustained for 10 years, the forward looking "Shiller" multiple would be 10 times – exactly where Europe's is today on a backward-looking basis, and exactly the level already reached by the TSE Second Section.

The fundamental question, then, is whether 1965-1989 was normal, or whether 1990-2009 was normal (to the extent, of course, that describing anything as normal carries meaning).

Our position is:

1. that 1965-1989 was normal;
2. that normality will be approached again over the longer term as a result of a macro-economic normalization, not a putative "restructuring";
3. that macro-economic stabilization and in particular a decisive exit from deflation, will be the long-term result of a directional change in fiscal and monetary policy, from "tight" towards "loose".

A simplistic DuPont decomposition is presented in Exhibit 22. In the interests of having numbers which are more comparable over time we have used the MoF corporate survey for this. We have taken only the large companies segment of the survey, which, while it includes unlisted companies, is a good proxy for listed company data. The main reasons for not using disclosed listed company data are a) the poor quality of the older data and b) the discontinuity arising out of the switch from parent to consolidated accounting in the last decade. In order to verify the comparability of the data, however, we refer to listed company numbers in Exhibit 22.

The roots of the post-1990 decline in ROE now become clear. Net margins have, in fact, trended higher in recent years – little sign of any management inadequacy here, though it must also be noted that net margins remain not much more than half the level in Europe. Conversely, both leverage and asset turnover have been much lower in the recent past than in the 1960-1990 period, and are much lower than in Europe.

Declining leverage and asset turnover are natural developments under deflation. No corporate sector would wish to increase indebtedness when deflation is increasing the real burden of the debt. Moreover, sales booked in deflated terms will appear smaller relative to book value still held at historical cost, thus automatically reducing measured asset turnover.

Exhibit 19

TSE First Section ROE: The Bubble as Turning Point

ROE Average - pre-Bubble			
1965-2009	**7.7%**	**1965-1985**	**10.1%**
1965-1980	**10.4%**	**1965-1989**	**9.8%**
ROE Average - post-Bubble			
1990-2009	**5.0%**	**1990-2005**	**4.8%**
1990-2000	**4.9%**	**2004-2009**	**6.0%**

Source: Bloomberg Factset, Datastream, Morgan Stanley Research

Exhibit 20

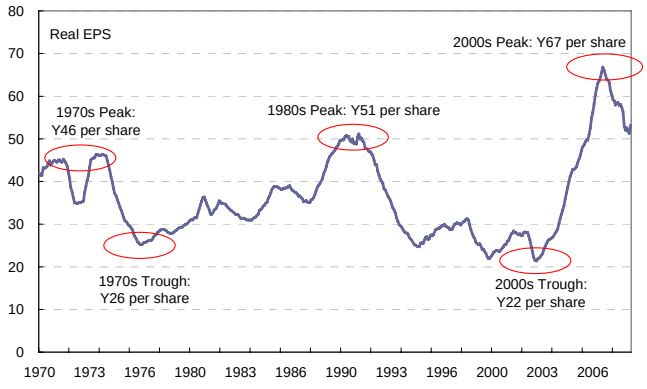
MSCI Europe ROE Decomposition, by decade

	1980s	1990s	2000s
Net Income Margin %	3.2	4.0	4.5
Asset Turnover	1.1	0.9	0.8
Leverage Ratio	3.2	3.1	3.1
Return on Equity %	10.6	10.9	10.7

Note: 1980s average is 1982-1989; 2000s average is 2000-2007
Source: MSCI, Morgan Stanley Research

Exhibit 21

Topix Real EPS (adjusted by the CPI), 1965-2009



Source: Bloomberg, Datastream, ESRI, Morgan Stanley Research

Exhibit 22
Japan ROE Decomposition, by decade

	1960s Average	1970s Average	1980s Average	1990s Average	2000s Average
ROE (%)	10.25	11.47	10.98	5.72	6.35
Net Margin (%)	2.3	1.6	1.9	1.6	2.53
Asset Turnover	111	120	129	97	90
Leverage Ratio	4.2	5.1	4.7	3.6	2.8

Note: Analysis based on MoF Corporate Survey data for ease of long-run comparison. The data does, however, unavoidably include some unlisted companies. The effective corporate tax rate is normalized to current levels over all periods.
Source: MoF Corporate Survey, Morgan Stanley Research

Exhibit 23
Plausible Future ROE Levels

Scenario Analysis	Assume						
	Net Margin	2.50%					
	Norm ROE						
Asset Turnover	**90%**	**95%**	**100%**	**105%**	**110%**	**115%**	**120%**
Leverage (x)							
2.75	6.19%	6.53%	6.88%	7.22%	7.56%	7.91%	8.25%
3.00	6.75%	7.13%	7.50%	7.88%	8.25%	8.63%	9.00%
3.25	7.31%	7.72%	8.13%	8.53%	8.94%	9.34%	9.75%
3.50	7.88%	8.31%	8.75%	9.19%	9.63%	10.06%	10.50%
3.75	8.44%	8.91%	9.38%	9.84%	10.31%	10.78%	11.25%
4.00	9.00%	9.50%	10.00%	10.50%	11.00%	11.50%	12.00%
4.25	9.56%	10.09%	10.63%	11.16%	11.69%	12.22%	12.75%

Source: Nikkei, Morgan Stanley Research

Clearly an argument might be made that the move from 10% average ROE to average 5% ROE is the result of less effective style management that has become more entrenched in the last twenty years[5]. But is it not much simpler to believe that the style of management which worked well amidst generally rising inflation in the 1960s and 1970s, and continued to function to some degree, though with declining efficiency, in the less inflationary 1980s, failed utterly amidst the deflation of the 1990s to 2000s?

Put differently, while a reasonable person might be initially receptive to the argument that double digit ROEs, as were delivered in the '60s, '70s and '80s, became harder to achieve as a consequence of diminishing focus on returns beginning in the 1990s, the bulk of the difference between a 10% average ROE and a 5% ROE lies not in management practices but in the presence or absence of deflation.

Given the scale of monetary accommodation already in the global pipeline, and the intimations of a decisive loosening in Japan too, together with the near certainty that there will be, if this batch 'does not work', even more aggressive accommodation still in future, it seems reasonable to assume that the median inflation rate in 2005 to 2025 will be similar to the median inflation rate in 1980 to 2000. In Japan's case that was 1.8%. That is rather different to the recent past – which has been characterized by measured deflation.

In such an environment it seems probable that Japanese ROE would rise towards its pre-Bubble norm, settling somewhere between 7.5% and 10%. At 7.5% average earnings over the next ten years would be ¥65-70 – the same as at the most recent peak; at 10% they would be the highest ever at around ¥85-90, assuming unchanged book value.

[5] It may be those who discern such a shift are really noting not a change in the style of management *per se*, but the disappearance of that generation of managers which had enjoyed both a pre-War education and promotion to management control of major companies at an unusually early age (following the Occupation period purge of pre-War management) and which tended to run larger companies until the early 1980s.

Exhibit 23 shows the results of a scenario analysis based on possible levels of Asset Turnover and Leverage (expressed as Total Assets/Shareholders' Equity). As can be noted, quite modest degrees of additional leverage and asset turnover result in ROE approaching 10%. Net Margins are set, for the purposes of this analysis, at 2.5%, the rounded-down average for the 2000s so far.

Note that we are making no assumptions in respect of "restructuring". We are only assuming that once macro-economic stabilization is achieved, deflation passes out of the system taking the distortions it caused to ROE with it.

Such a rise in ROE would render the normalized multiple for Japan (on a forward-looking basis) exactly the same as that for Europe and America (on a backward looking basis).

We conclude that Japan is genuinely inexpensive, probably for the first time in any currently active professional money manager's career.

Naturally, we caution that this perspective on ROE is a long-term one, and not an estimate in respect of the near term.

Japan's Valuation Conundrum: Part 4: Business behaviour appears to corroborate our conclusions

Tobin's 'q' based arbitrage suggests businesses think that the stock market undervalues companies

The residual income analysis presented in Exhibit 18 suggests that book value is underpinned by economic value at around current levels, even without allowance for future recovery in ROE.

A relatively recent estimate[6] of Tobin's 'q' suggested that at the end of 2005, the 'q' ratio for Japan was precisely 1. This would imply a 'q' value of 1650 on Topix, or approximately double book value. This seems likely to represent a large overestimate of current 'q', given the methodology, but it does imply that there is some cushion protecting stated book.

Taking these two observations together we suspect that the market may be inexpensive versus the reconstruction cost of the corporate assets.

I am strongly convinced that Tobin's 'q', often derided as excessively academic, is in fact a powerful analytical framework within which to view the market. Tobin's 'q'-based insights can be applied broadly. They are not, however, a matter of "supply and demand" – a perspective on market activity which generally leads only to trivial conclusions.

Tobin's theory is – in outline – that if businesses find it cheaper to build new capacity than to buy it, they should build it. By contrast, when it is cheaper to buy capacity than to build it (via absorbing competitors, units of competitors, etc) they should buy it.

The basic theory implies however, not only that businesses should arbitrage the public and private market valuations of their assets, but that they actually do.

This leads to the difficult, but logical, conclusion that the surest evidence of the undervaluation of Japanese stocks would be a sharp fall in capex accompanied by a rise in corporate activity. Perhaps, indeed, just what appears to be happening now.

In a different framework, the arbitrage that Tobin identified between the acquisition of physical assets themselves and the acquisition of physical assets through the medium of financial claims on physical assets also illuminates the question of net issuance of equity (or indeed of financial claims in general[7]). When stocks are expensive relative to physical assets, businesses issue "over-priced" equity. When stocks are cheap relative to physical assets, net equity issuance turns negative as businesses avoid selling paper that costs them dear.

Of course, the immediate objection to this perspective is that, as a matter of observation, individual managements do not know what their companies are worth, not least because they spend little time thinking about the question. We can only emphasise that Tobin's 'q' based insights work mainly at the level of aggregate behaviour and the net results of that behaviour. Focusing on one side of the coin – for instance, gross issuance by a particular company or type of company – can be profoundly misleading.

Tobin's 'q' is most easily approached as a practical stock market matter in the sphere of listed real estate securities. Sophisticated market participants habitually look at real estate securities on the basis of the resale value of the portfolio of property they represent, net of debt. Why should the generality of companies be viewed in any different manner, given that all assets have some resale value?

For the whole market, it is the level of aggregate net issuance activity which indicates whether businesses genuinely, though perhaps unconsciously, believe that their stock market valuation is cheap or expensive relative to their fundamental value.

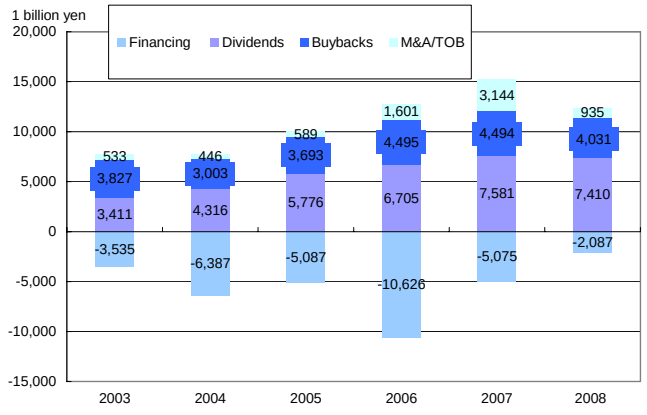
Exhibits 24 and 25 show gross and net financing activity by listed entities in Japan for the past five years. In Exhibit 24 we include dividends paid by companies. In Exhibit 25 we exclude dividends from consideration and look only at the net of new issuance less corporate actions and stock repurchases which reduce the volume of stock outstanding. Stock appears to be being retired from the market on a net basis at the rate of ¥2.75 trillion per year.

Whatever market participants may think about valuation, the implication of this level of "de-equitisation" is that businesses – in the aggregate – believe that their stock market valuations do not fully reflect the fundamental value that they see in their businesses.

[6] "Cash return on capital invested: ten years of investment analysis with the CROCI economic profit model", Pascal Costantini, Butterworth-Heinemann, 2006. ISBN 0750668547, 9780750668545

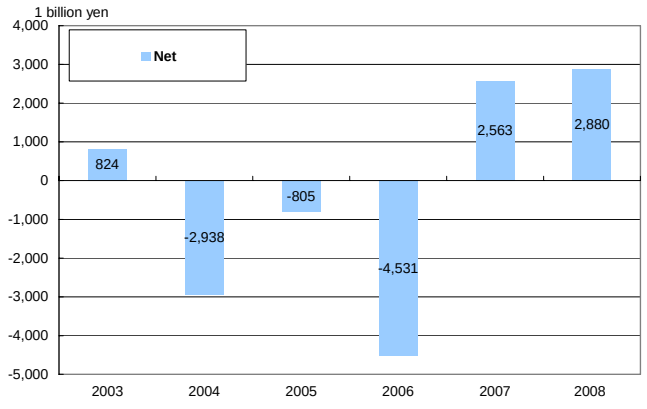
[7] See note 8 below for a discussion of relevant credit-pricing anomalies.

Exhibit 24
Gross Financing Activity by Listed Companies



Source: JSDA, TSE, Toyo Keizai, Recof, Morgan Stanley Research

Exhibit 25
Net Financing Activity: "De-Equitisation" at last



Source: JSDA, TSE, Toyo Keizai, Recof, Morgan Stanley Research

It seems quite clear that this state of affairs indicates that Japanese stocks are undervalued to an appreciable degree in an absolute and long-term sense by the constituency arguably best positioned to make judgments of fundamental value.

Naturally, this position does not commit us to the view that the market cannot, in the short run, go down. But it does force one towards the conclusion that, for investors with multi-year time frames, 2009 is likely to prove – in retrospect – a very good time to have been buying equities[8].

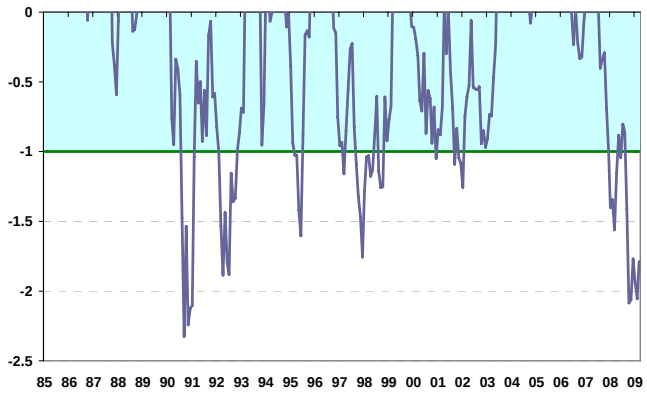
[8] I am aware that many market participants will be quick to object that "de-equitisation" in recent years in non-Japanese markets damages the credibility of 'q'-based analysis. It was indeed a signal of overvaluation rather than, as it always had been in the past, undervaluation. But the experience of recent years actually underlines the validity of Tobin's 'q'–based perspectives on market activity by clarifying the distinction between business and financial market perspectives on valuation. The central distortion that allowed "de-equitisation" (in the recent past, outside Japan) was the over-valuation of credit relative to public equity. Over-priced credit instruments could be issued to provide "cheap" funds to pay over-the-odds for equities. This distortion arose because buyers were disproportionately financial buyers who, though notionally operators of businesses, in reality did not so much have a business perspective, as a financial market perspective, on absolute and relative valuation. The critical insight contained in Tobin's 'q' based approaches is that businesses, through their aggregate behaviour, reveal what they really think, but cannot enunciate, about valuation, and that only businesses are in a position really to know what a business is worth. Japan escaped this distortion because publicly quoted equity did not for any useful period trade cheap relative to credit (cf. Exhibit 14)

Sentiment and Technicals

Still Oversold
Despite the rally, the market remains oversold.

Our most elaborate technical measure, the Capitulation Indicator (which we have modeled on a yardstick of the same name developed by our European Strategy Team), underscores this perception. The indicator is presented in Exhibit 26.

Exhibit 26
Topix: Capitulation Indicator



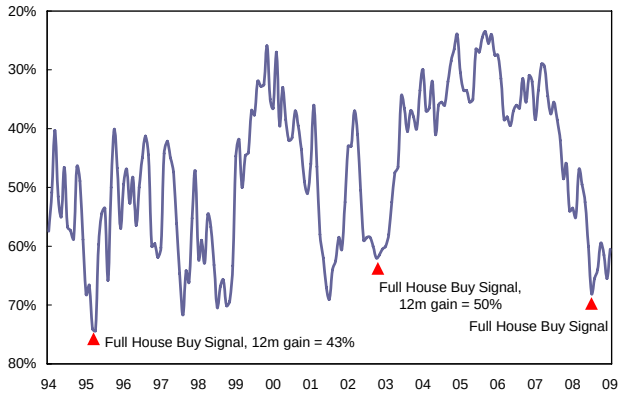
Source: MSCI, Morgan Stanley Research based on model developed by the European Strategy

A simple moving average deviation chart, such as Exhibit 28, shows that a 25% rally has taken the market from the most oversold in the post-War period to merely as badly oversold as in 1990-1 following the bursting of the 1980s Bubble.

As noted in Section II, our measure of general risk appetite (Exhibit 9) in Japan has barely moved after its plunge to new lows. The lack of any appreciable recovery in this indicator despite a 25% bounce in the major indices is something of a paradox, but one which we believe hints at a still skeptical consensus – the existence of such skepticism amidst a rising market being, for us, a positive, not a negative, factor.

Investor survey data – This rally has so far lagged past rallies starting from similarly depressed sentiment levels
Data from the Quick Sentiment Survey is useful as a contrarian indicator. The fact that there may be some divergence between actual positions held and responses made to a survey does not diminish the usefulness of survey data. The data tend to offer suggestive hints of a tired consensus at extremes.

Exhibit 27
Quick Sentiment Survey: Net "underweight"



Note: Scale is reversed to show a rising net underweight as a decline in the line
Source: Company data, Morgan Stanley Research

Quick asks two questions in respect of market direction; first about current positioning, and second about future intentions. Exhibit 27 shows the net proportion of survey respondents replying "currently underweight" (those responding "underweight" plus half those responding "neutral").

Certain patterns emerge from an analysis of the data since 1994 (when the survey began). "Full House Buy" signals have only been delivered three times in 15 years. The most recent occasion was October 2008. These occurrences are marked in Exhibit 27.

We define a "Full House Buy" as being when:

a) More than 60% of investors say they are net underweight (those responding "underweight" plus half those responding "neutral") in terms of their current positions

b) More investors say that they intend to reduce positions than to increase positions (future intentions)

c) The ratio of bulls to bears stands below 0.5 (in respect of current positions).

The previous "Full House Buy" signals were delivered in June 1995 and March 2003. On both occasions the market was up 6 and 12 months later, by an average of 31% and 46% respectively.

The recent "Full House Buy" has not delivered any performance. Topix was down 8% over three months and 2%

over six months. For stocks to approach the returns offered on the prior two occasions this measure bottomed out, Topix would have to rise to north of 1250 by September.

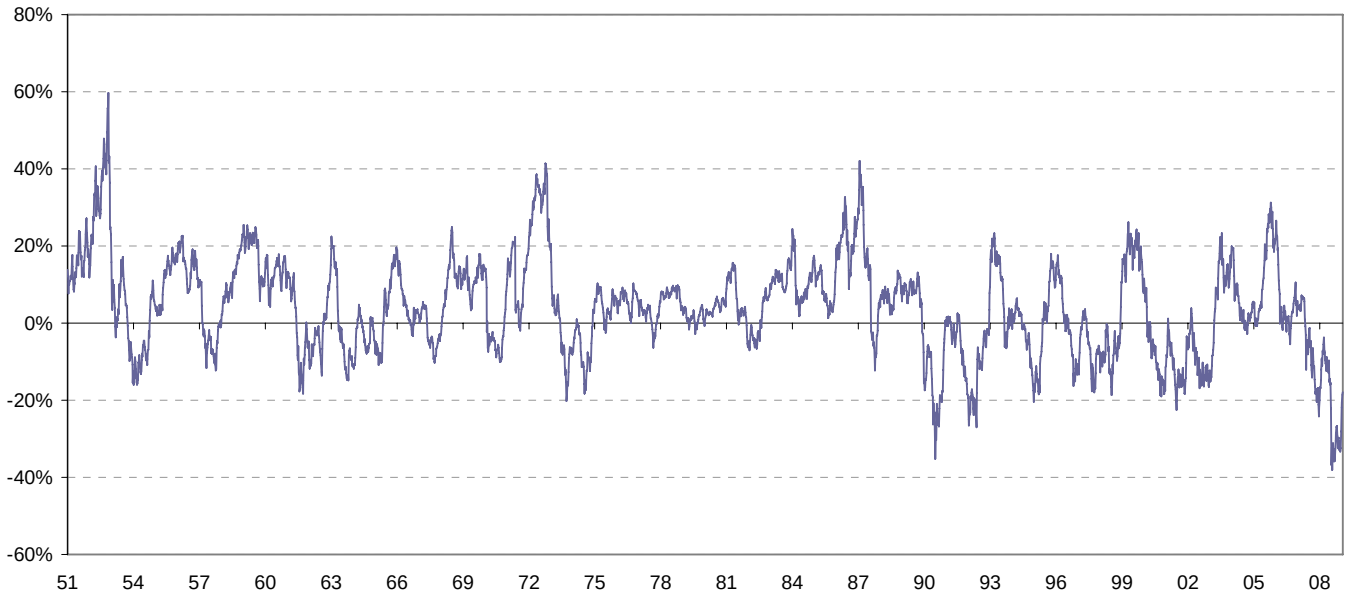
While this appears a distant prospect, the realisation that such would be no more (and no less) than what has occurred on previous occasions investor sentiment has started from a point as dejected as in 2008 4Q, helps set the rally from the March 2009 lows for the broader market averages in context.

While a lot has happened, little has happened.

A further aspect of the technical position which demands appropriate consideration is the comparatively good performance of the smaller capitalization indices even prior to the lows for the main averages. The relative performance of both the TSE Second Section and JASDAQ indices is shown in Exhibits 29 and 30.

Exhibit 28

Topix: Deviation from 52-week MA, 1951 to date



Source: Bloomberg, Morgan Stanley Research

Exhibit 29
TSE2 Relative to Topix, 1979 to date

Source: Bloomberg, Morgan Stanley Research

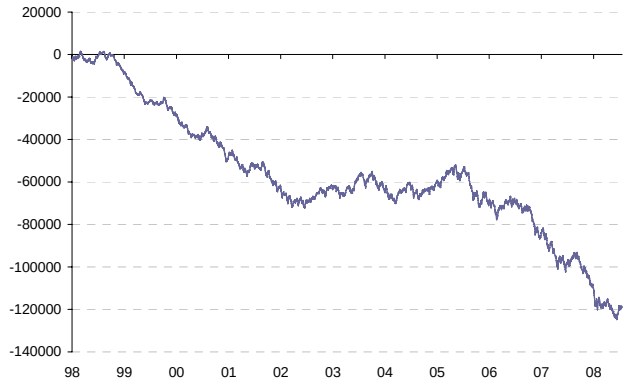
Exhibit 30
JASDAQ Relative to Topix, 1983 to date

Source: Bloomberg, Morgan Stanley Research

In the early 2000s, the smaller stock averages outperformed for long periods before the main indices hit their lows. The most recent period of outperformance by these smaller-capitalisation indices began in the late summer 2008. In the earlier period, however, this outperformance by small stocks was accompanied by a stabilization in the long term decline in the accumulated advance decline line.

As Exhibit 31 shows, it would be premature at this stage to deliver any verdict in respect of breadth.

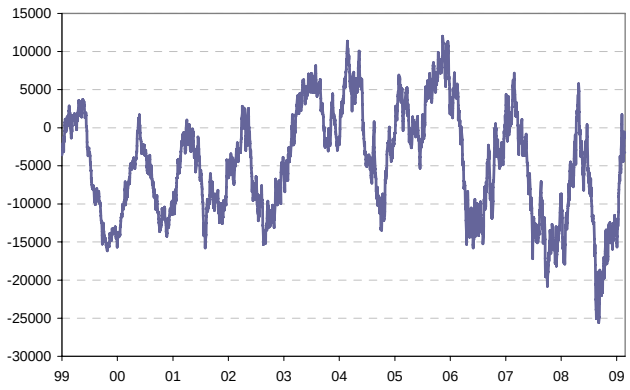
Exhibit 31
Bad Breadth – Accumulated Net Advances (daily), 1998 to date



Source: Bloomberg, Morgan Stanley Research

While tentative signs of a bottom's forming might be discerned by optimistic investors, as yet little that would satisfy those of a more cynical bent is visible. Certainly the relatively smooth bottoming process which pre-figured a general market stabilization in late 2002 is nowhere evident.

Exhibit 32
100-day Rolling Total of Net Advances, 1999 to date



Source: Bloomberg, Morgan Stanley Research

Exhibit 32 gives a shorter term perspective on breadth. A simplistic reading would suggest that the market should now narrow (more stocks down than up) and perhaps fall as a result of worsening breadth.

Exhibit 33, however, gives a somewhat different impression. One of our favoured measures of market timing, the evaluated loss on long margin, suggests that so far very little has happened. Margin investors suffered worse than at any time for which we have data history, and despite a sharp recovery in the market are still as badly hurt as at any time since the bursting of the 1980s Bubble.

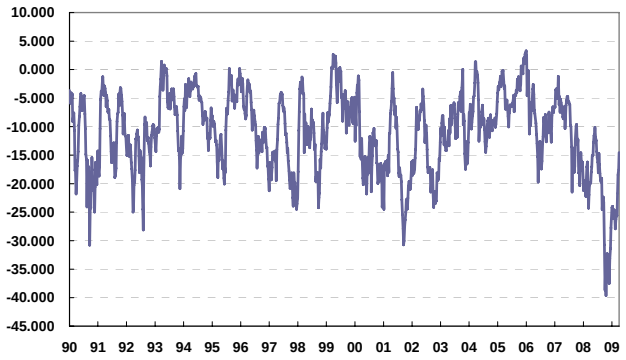
Exhibit 34 shows the aggregate of net long margin positions and net long arbitrage positions as a percentage of market capitalisation standing at close to record lows. This measure of professional, but speculative, demand tends to confirm the longer run conclusions we draw from sentiment surveys and technical analyses other than those based on market breadth.

We would reconcile the somewhat differing impressions given by our analysis of breadth – a metric which we do take seriously – and other indicators, by suggesting that so far a lot has happened, and simultaneously little has happened.

We may be only half way through a rally.

Exhibit 33

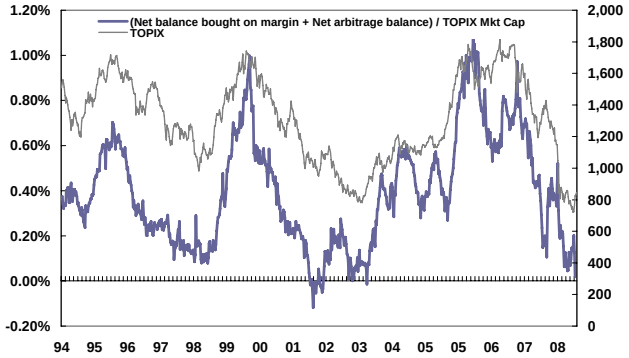
Evaluated Loss on Long Margin Positions, Jan 1990 to Date



Source: Bloomberg, Morgan Stanley Research

Exhibit 34

Speculative Demand for Shares Close to All-time Low



Source: Bloomberg, Datastream, Nikkei, Morgan Stanley Research

What makes Japan perform: Concepts and Triggers

A cyclical market
It is a truism that Japan is a "heavily cyclical market". This cyclical gearing arises for a number of reasons, principal amongst which we see as being:

1. the low percentage of domestic non-manufacturing industry and activity which is represented in market capitalization;

2. the large fraction of total market earnings derived from global economic pace sensitive companies;

3. the heightened cyclicality of market earnings during periods when achieved ROE is unusually low.

It is not necessarily the case that Japan must retain this largely cyclical character. Nonetheless, rather than take the truism for granted we have examined some factors which *a priori* might be expected to affect the market in order to quantify the potential returns available to simplistic strategies involving betting on the cycle.

What works and what doesn't
Exhibit 35 shows Topix performance from troughs in the IIP since 1990. On the basis that when a trough forms one does not know it has formed until several months later, we have looked at performance both immediately upon the trough ("at the time") and following differing lags from the trough.

The market clearly does take the production cycle seriously. Investors have one to two months from the actual trough in the IIP to confirm that it has in fact troughed, during which the strongest returns are available to those willing to "play the cycle".

Exhibit 37 looks at the progression of Topix sector returns following the lows for the ISM PMI. A clear cyclical bias in the early months gives way to a focus on export/technology/traditionally conservatively financed sectors as recovery matures.

Given that the trough for the ISM Manufacturing PMI appears to have been registered in December 2008, some transition from purely cyclical to more conservative but still economic pace sensitive sectors would now appear justified.

Of course, the Japanese production cycle does not exist in a vacuum. In Exhibit 36 we examine, in the same way, how the market tends to perform following troughs in the ISM Manufacturing PMI. Here, the data suggests, investors have to be earlier in seeing the trough before returns to playing the market from the bullish side diminish.

The complication is, of course, that Japan's IIP has not yet bottomed. As we noted in Exhibits 5 and 6, we would expect that trough to have formed in 2009 1Q. We would therefore argue for an upward bias to index activity with a cyclical bias to sector performance to persist in 2009 2Q as a consequence of the delayed formation of the low in the Japanese IIP relative to the ISM Manufacturing PMI.

Exhibit 35
TOPIX returns from troughs of IIP

	At the time			1m later			2m later			3m later		
	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m
Median return	3.3	1.2	-10.2	4.2	0.5	-17.4	8.7	0.9	-15.5	2.1	-1.2	-16.9
Minimum return	-3.5	-0.7	-15.5	2.7	-7.1	-19.2	-3.3	-13.1	-25.7	-10.8	-20.3	-26.4
Batting Ave.	60.0	80.0	40.0	100.0	60.0	40.0	80.0	60.0	40.0	60.0	40.0	40.0

Source: Datastream, Morgan Stanley Research

Exhibit 36
TOPIX returns from troughs in the US ISM Manufacturing PMI

	At the time			1m later			2m later			3m later		
	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m
Median return	14.8	8.7	-4.7	5.6	6.7	-10.9	3.8	-0.6	-16.1	9.7	-0.7	-14.7
Minimum return	-15.8	-19.9	-18.6	-21.3	-20.7	-21.2	-11.0	-18.4	-28.0	-7.5	-9.5	-32.9
Batting Ave.	71.4	71.4	42.9	71.4	57.1	42.9	71.4	42.9	42.9	57.1	42.9	42.9

Source: Datastream, Morgan Stanley Research

Exhibit 37
Sector ranking (returns from troughs in the US ISM PMI)

	next 3m			next 6m			next 12m		
	Sector	Median return	Batting Ave.	Sector	Median return	Batting Ave.	Sector	Median return	Batting Ave.
1	Precision Instruments	20.4	71.4	Electrical Machinery	25.8	71.4	Rubber Products	20.3	85.7
2	Wholesale	18.1	71.4	Precision Instruments	21.7	71.4	Transport Equipment	12.9	71.4
3	Securities	17.9	71.4	Transport Equipment	21.4	85.7	Precision Instruments	8.4	85.7
4	Electrical Machinery	17.8	85.7	Oil & Coal Products	16.4	71.4	-	-	-
5	Real Estate	17.4	85.7	Air Transport	15.0	85.7	-	-	-

Note: only those sectors with a >70% batting average are included
Source: Datastream, Morgan Stanley Research

Relationship with structure of US Rates
There is a clear link between both the domestic and international aspects of the production cycle.

A simple visual analysis of charts suggests that there is also a strong link between the level and direction of US interest rates, and in particular the shape of the yield curve, and the performance of Topix.

Exhibits 38 and 39 set out the results of a closer analysis. As can be noted, whether one takes the FF to 30yr spread, the 2yr to 30yr spread or the 10yr to 30yr spread, the highest batting averages and highest returns are associated with the curve at its steepest.

Clearly, however, this does not imply that the shape of the US yield curve, or the level of US interest rates, is always the dominant determinant of returns. We would frame our conclusions as: “The shape of the US yield curve is critical to Japanese equity returns once it reaches maximum steepness”. In other periods the relationship is more conceptual than practical.

We append a further analysis, based on visual identification of the final rate cut in a cycle of easing by the Fed, as measured by the final cut in the FF rate. As can be noted, the twelve month record, both in respect of index returns and batting average, is excellent.

Our conclusion is that in order to change the linkage with the US rate structure from concept into practical trigger, two factors are required: an extremely steep yield curve, and an end to Fed easing. On an absolute basis, a strategy of buying on the last FF rate cut has offered a median 12-month return of 20%, with a high batting average. It also has a record of delivering outperformance in relative terms.

Perhaps we are rather close to such a position now. The US yield curve is steep, and the Fed may be “done”. It is almost certainly “done” with conventional easing.

Exhibit 38

TOPIX returns vs. US spreads

vs 30y-FF

Spread range	Median returns in next 3m	next 6m	next 12m	Minimum return (Max loss) next 3m	next 6m	next 12m	Batting averages in next 3m	next 6m	next 12m	No. of data pts
Spread<-1.0	3.3	2.2	5.4	-11.2	-5.9	-25.5	67.7	64.5	67.7	31
-1.0<=Spread<0	0.3	-2.6	-15.0	-13.9	-23.5	-43.7	55.6	42.2	35.6	45
0<=Spread<1.0	3.2	5.6	6.3	-35.1	-31.1	-47.0	63.3	55.7	64.6	79
1.0<=Spread<2.0	3.2	8.6	10.7	-18.6	-25.2	-41.8	60.3	66.7	60.3	78
2.0<=Spread<3.0	0.6	1.4	14.0	-19.8	-30.2	-34.8	51.8	55.4	71.4	56
3.0<=Spread<4.0	2.1	0.7	6.9	-20.7	-26.6	-28.1	62.1	53.0	63.6	66
4.0<=Spread	0.4	9.6	10.6	-8.1	-14.2	-25.1	55.6	61.1	83.3	18

vs 30y-2y

Spread range	Median returns in next 3m	next 6m	next 12m	Minimum return (Max loss) next 3m	next 6m	next 12m	Batting averages in next 3m	next 6m	next 12m	No. of data pts
Spread<-1.0	3.4	2.1	9.0	-7.4	-5.9	-9.8	66.7	60.0	66.7	15
-1.0<=Spread<0	0.1	1.6	1.9	-13.9	-23.3	-29.8	52.0	54.0	62.0	50
0<=Spread<1.0	3.5	7.2	9.0	-35.1	-31.1	-43.7	63.6	60.4	60.4	154
1.0<=Spread<2.0	2.1	2.5	12.0	-18.6	-25.2	-47.0	64.0	57.0	65.1	86
2.0<=Spread<3.0	-2.7	-3.6	-2.1	-20.7	-30.2	-41.8	38.6	31.8	43.2	44
3.0<=Spread	2.9	11.7	21.9	-9.6	-12.6	-1.7	70.8	83.3	95.8	24

vs 30y-10y

Spread range	Median returns in next 3m	next 6m	next 12m	Minimum return (Max loss) next 3m	next 6m	next 12m	Batting averages in next 3m	next 6m	next 12m	No. of data pts
Spread<-0.25	0.2	0.1	8.2	-12.7	-16.3	-23.5	57.1	50.0	71.4	28
-0.25<=Spread<0	3.0	4.2	5.2	-19.8	-31.1	-43.7	71.2	65.4	69.2	52
0<=Spread<0.25	2.4	4.6	6.6	-35.1	-26.2	-40.7	61.8	58.8	61.0	136
0.25<=Spread<0.5	2.1	0.5	3.0	-18.6	-26.5	-47.0	57.9	54.7	54.7	95
0.5<=Spread<0.75	-2.7	-3.2	-2.2	-20.7	-30.2	-41.8	34.6	34.6	46.2	26
0.75<=Spread	2.2	4.8	11.5	-12.2	-18.0	-41.8	61.1	63.9	80.6	36

vs FF

	Median returns in next 3m	next 6m	next 12m	Minimum return (Max loss) next 3m	next 6m	next 12m	Batting averages in next 3m	next 6m	next 12m	No. of data pts
Start of a bottom	3.0	7.7	20.2	-6.1	-5.9	-15.8	71.4	78.6	92.9	14

Source: Datastream, Morgan Stanley Research

Exhibit 39

Datastream Japan Index ($) relative to Datastream World Index vs. US spreads

vs 30y-FF

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
Spread range	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	data pts
Spread<-1.0	0.3	0.1	-0.2	-10.6	-12.6	-19.9	51.6	51.6	48.4	31
-1.0<=Spread<0	-3.7	-8.5	-14.8	-11.8	-21.4	-25.8	24.4	6.7	6.7	45
0<=Spread<1.0	-1.5	-1.4	-8.0	-21.1	-25.0	-30.6	39.2	43.0	38.0	79
1.0<=Spread<2.0	0.6	1.3	-2.8	-19.7	-28.7	-39.8	51.3	52.6	46.2	78
2.0<=Spread<3.0	-1.4	-1.9	5.1	-19.0	-25.7	-27.6	39.3	46.4	60.7	56
3.0<=Spread<4.0	0.5	0.8	2.5	-17.4	-20.4	-20.4	57.6	54.5	57.6	66
4.0<=Spread	-0.9	5.9	8.5	-9.6	-9.8	-14.0	44.4	72.2	66.7	18

vs 30y-2y

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
Spread range	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	data pts
Spread<-1.0	3.1	4.9	2.6	-5.6	-5.0	-12.3	73.3	73.3	66.7	15
-1.0<=Spread<0	-3.9	-8.3	-11.7	-12.6	-18.3	-25.8	20.0	14.0	10.0	50
0<=Spread<1.0	-1.3	-1.5	-6.8	-21.1	-28.7	-39.8	44.2	42.2	36.4	154
1.0<=Spread<2.0	1.0	2.1	10.9	-11.2	-18.6	-30.6	58.1	60.5	70.9	86
2.0<=Spread<3.0	-2.0	-4.8	-1.3	-19.0	-25.7	-21.3	36.4	38.6	45.5	44
3.0<=Spread	-0.8	5.6	5.5	-11.4	-10.1	-12.0	45.8	70.8	66.7	24

vs 30y-10y

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
Spread range	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	data pts
Spread<-0.25	0.5	-0.7	-1.2	-14.9	-18.3	-22.0	53.6	42.9	42.9	28
-0.25<=Spread<0	-2.3	-4.3	-7.8	-10.6	-21.4	-25.8	34.6	42.3	38.5	52
0<=Spread<0.25	-0.7	-1.0	-5.3	-21.1	-28.7	-34.2	47.1	44.9	41.2	136
0.25<=Spread<0.5	-0.5	-0.5	-3.7	-19.7	-27.9	-39.8	45.3	47.4	47.4	95
0.5<=Spread<0.75	-1.2	-1.9	1.2	-17.4	-25.7	-21.3	34.6	46.2	53.8	26
0.75<=Spread	-0.2	-1.0	2.7	-17.8	-18.3	-14.0	47.2	47.2	58.3	36

vs FF

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	next 3m	next 6m	next 12m	data pts
Start of a bottom	0.2	6.8	14.4	-8.3	-7.5	-30.6	50.0	64.3	85.7	14

Source: Datastream, Morgan Stanley Research

Exhibit 40

MSCI Japan Index returns

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
PCFR range	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	data pts
PCFR<4	29.1	105.5	107.1	9.7	52.1	47.5	100.0	100.0	100.0	16
4<=PCFR<6	18.5	25.2	33.1	-13.7	3.4	3.9	77.4	100.0	100.0	31
6<=PCFR<8	9.0	21.1	33.3	-28.5	-27.2	-18.5	83.3	87.3	91.3	126
8<=PCFR<10	16.0	32.7	50.9	-29.7	-35.9	-44.8	78.0	88.1	76.1	109
10<=PCFR<12	-4.7	-4.2	-5.5	-33.1	-43.7	-54.3	33.3	33.3	33.3	63
12<=PCFR<14	-8.7	-16.6	-16.6	-26.8	-37.8	-46.5	34.3	20.0	22.9	35
14<=PCFR	-6.4	-29.3	-30.3	-43.8	-45.3	-54.3	44.4	31.5	13.0	54

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
Div. Yld range	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	data pts
3<=Div. Yld	30.0	86.1	92.8	-15.6	9.6	33.1	86.2	100.0	100.0	29
2.5<=Div. Yld<3	7.2	16.5	27.6	-13.7	-2.9	2.2	85.3	97.1	100.0	34
2<=Div. Yld<2.5	8.6	19.1	29.9	-28.5	-22.5	-11.6	86.7	83.3	85.0	60
1.5<=Div. Yld<2	16.4	24.4	57.1	-27.4	-35.9	-24.1	65.0	85.0	85.0	40
1<=Div. Yld<1.5	28.2	47.9	85.6	-16.9	-2.4	-44.8	97.4	98.7	89.5	76
Div. Yld<1	-4.6	-5.8	-8.3	-43.8	-45.3	-54.3	41.3	39.8	33.7	196

	Median returns in			Minimum return (Max loss)			Batting averages in			No. of
PBV range	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	next 12m	next 24m	next 36m	data pts
1.2<=PBV<1.4	28.4	36.2	97.8	9.7	20.1	63.1	100.0	100.0	100.0	8
1.4<=PBV<1.6	-4.8	15.3	11.3	-27.8	-12.6	-5.3	47.1	70.6	82.4	17
1.6<=PBV<1.8	20.4	31.8	29.5	-29.7	-24.1	-15.3	90.6	96.2	84.9	53
1.8<=PBV<2.0	9.3	19.5	27.9	-24.8	-40.6	-38.1	85.7	88.4	83.9	112
2.0<=PBV	-1.0	-2.7	-6.3	-43.8	-45.3	-54.3	48.1	46.5	41.1	185

Source: MSCI, Factset, Morgan Stanley Research

Relationship between market returns and valuation

The observation that the character of the market is largely cyclical should not obscure the additional, parallel, reality, that medium- to longer-term index returns are related to valuation.

Exhibit 40 shows three measures of valuation, perhaps all more employed by value investors than growth investors, with index returns measured from the valuation starting point. For this analysis the shortest period we use is 12 months.

While the number of low valuation observations is rather smaller than the number of high valuation starting points, it is nonetheless clear that in each case a low valuation starting point significantly raises the possibility of making money.

The current position is that at a Price-Cashflow of 5.3 times and a Dividend Yield of 3% and a Price-to-Book of 1 times, the market occupies valuation bands on each parameter with very high batting averages and high returns.

Valuation would imply that the chances of the index rising are significant. The observation that one has tended to make money from the index from this sort of valuation departure point – an observation good only over the medium term – combined with our earlier thoughts on the cyclical gearing of the market in both relative and absolute terms in the nearer terms, underscore our constructive view of market prospects.

With the market cheap and the production cycle turning up (even if only temporarily), only technical, timing-related factors temper our optimism.

A Secular Change that Should Not Be Underestimated

Bank exposure to stocks
Just as the global meltdown caused a reconsideration of fiscal and monetary policy, so the scale of the damage done to the stock market has provoked renewed interest in the question of banks' balance sheet exposure to equities. In 2003 an earlier episode of heightened financial pressures resulted in one bank having publicly-quoted equities stripped entirely from its balance sheet; all the banks found new limits placed on their equity exposure.

In 2009, various strands of opinion have begun again to discuss reducing or removing banks' equity holdings.

The background – BIS regulations and bank capital determination
The central peculiarity of the Japanese financial system is not some matter of "culture" but rather more prosaically the involvement of the equity market in the determination of bank capital for regulatory purposes. Other countries also have lending institutions with exposure to the stock market, but no developed nation involves the equity market in matters of regulatory capital to the same degree as Japan.

The involvement of the equity market in the determination of bank capital for regulatory purposes has, in contrast to many other policy choices, tended to elude explanation. Recent remarks by the Prime Minister[9] confirm that there remains an influential area of opinion that mistrusts the stock market.

That such a lack of confidence in the proper working of the equity market mechanism existed (and exists) renders the 1989 decision to involve the equity market in the determination of bank capital less explicable.

Of course, in terms of economic reality such a relationship has existed throughout the post-War period; indeed its effects on the credit cycle were first quantified and described in a research paper of the San Francisco Fed in 1987.

Yet to formalize the dependency of the banks on the level of the equity market in response to the introduction of BIS capital adequacy regulations in the late 1980s still appears to have represented a high-risk policy which has, in retrospect, complicated and exacerbated credit-cycle fluctuations and credit-related problems in the post-Bubble period.

Signs of new thinking
The consciousness that balance sheet stability is reduced where a bank owns equities in a large volume has a long history.

One subtext of old Glass-Steagall Act in the US, which separated stock-broking and commercial banking, was to exclude the possibility that deposit-taking institutions achieve indirect exposure to or influence over the stock market.

In Japan, when public money was used to resolve Resona's non-performing debt problems in 2003, the public sector assumed the bank's stock holdings.

Beginning in late 2002 the Bank of Japan and thereafter a special purpose agency of the government, the Bank Shareholding Purchasing Corporation (the BSPC), both deployed public money to purchase equities from banks.

More recently, the government has acquired budgetary authorization to purchase up to ¥20 trillion of equity from the banks again via the BSPC. This is greater than the total exposure of the banks to the equity market.

At last the possibility of severing the link between the economic reality of bank balance sheets and the level of the stock market has presented itself again.

Scheme mechanics
In addition to the BSPC, the BoJ has also been granted the authority to purchase up to ¥1 trillion of bank-owned equities.

The BSPC's authority began in mid March and runs until September. Its purchases are to be only from the banks. There is, as yet, no evidence of any purchases. Market purchases by the BSPC would require additional legislation.

The government has guaranteed up to ¥20 trillion of BSPC liabilities. In mechanical terms the BSPC funds itself via bank borrowing and the issuance of bonds. This implies that ¥20 trillion is the potential maximum aggregate amount of any purchases the BSPC might make, not an actual buying target or commitment to any other particular level of activity.

Critically, actual buying by the BSPC is dependent upon the banks' stance. If banks are unwilling to sell, the BSPC cannot buy.

[9] Remarks to a meeting of "influential figures" as reported by 47 News. http://www.47news.jp/CN/200903/CN2009032101000756.html

It remains provocative that the government guarantee cap this time is ¥20 trillion, when in 2002 the BSPC was only funded to the tune of ¥2 trillion. Yet, unless the market rises sharply, or there is an expansion of the BSPC's remit, ¥20 trillion cannot be fully digested, as the sum exceeds the total of the banks' shareholdings.

The BoJ has enjoyed the authority to buy equity out of the banks from February 23. Actual purchases only require the approval of the Minster of Finance. Its ¥1 trillion allocation is best seen as a temporary measure designed to bridge the apparent gap until the BSPC could resume buying from mid-March and again is neither a commitment nor a target.

The difference is that the BoJ itself is the funding source for any such purchases, which makes purchases the effective equivalent of printing money. The BoJ is also committed to holding any shares purchased in this way until at least April 2012.

So far, the only bank which has shown an interest in the BSPC scheme is Mizuho Financial Group, which has ventilated the possibility of its selling roughly ¥900bn of its ¥2.9 trillion total equity exposure.

In 2014, a further evolution of BIS rules is scheduled, which will render it effectively impossible for Japanese banks to continue to hold equities. The question would therefore appear to be when and not if banks' exposure to the equity market is eliminated.

Why has this question surfaced again?
The decline in the market (by just over 20% since September book closing) has eradicated the contribution of unrealized gains to regulatory capital. It has not, however, reduced the proportion of regulatory capital that is represented by equity exposure. This proportion remains nearly 40%.

But it is because, for the first time since 1990, the banks are not benefitting from unrealised gains, that it is an opportune moment to revisit the question of why they require such equity exposure in the first place[10].

[10] Banks benefit from stock holdings because the combination of equity ownership and debt provision under bank monitoring puts them in the same effective position as if they held a preferred equity position in the firm. Firms have ambivalent views as this structure solidifies bank control even as it implicitly guarantees bank support.

Implications
It can never be emphasized too much how far the unusually close link between the equity market and effective bank capital complicates and exacerbates the credit cycle in Japan. One silver lining in the global downturn is that it has refocused official attention on this question.

While it is clearly premature to argue that the question is in any sense "solved", it seems likely that the eventual result of the combination of a market downturn, a severe recession and the end of the securitization model, will be that banks are separated, perhaps fully, but at least to a great degree, from their shareholdings.

This would represent the single largest potential improvement in the quality of effective bank capital in Japan, a reason for buying Japanese banks and Japanese stocks more generally.

Rather than merely notional reforms of a political or social character, the one micro-economic change of genuine consequence to the character and the level of the stock market is to substantially reduce or actually end banks' direct ownership of public equities.

While in the area of corporate governance and in respect of bank credit pricing, such a change would offer the potential both to promote industrial reorganization and to increase loan spreads, its major impact would be to dampen credit-cycle volatility. By loosening the feedback mechanisms working between banks' share prices, the level of the stock market generally, the volume of regulatory capital and the credit cycle, a smoother credit cycle could develop.

This would in turn, we argue, have important and positive implications for the equilibrium valuation that investors would be comfortable in attaching to the whole market – that is, the required equity risk premium could reasonably be expected to decline against the backdrop of reduced credit-cycle induced volatility.

As a practical matter, we suppose that any major policy initiative in this area would afford banks adequate opportunities – in the context of a phased and carefully calibrated withdrawal from direct ownership of the equity market – both to manage relationships and to express their views of market prospects in actual portfolio activity.

We will be monitoring developments in this connection most closely.

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