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JAPAN REVIEW AND OUTLOOK

FOR PROFESSIONAL INVESTORS ONLY

At 30 June 2008

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1. THE MACRO BACKGROUND

Overview

The Japanese market continued its recent run of outperformance in the second quarter. The Topix rose 8.9% in yen terms and 2.3% in US dollar terms. This compares favourably with most global markets, apart from the resource-rich Canadian market, which ended the quarter up 8.8% in US dollar terms. So far this year, the Japanese market (as measured by the Topix) is down 4.8% in dollar terms. This compares with a 20% fall in the Hang Seng, a 44% fall in Shanghai, a 12% fall in the FTSE100 and a fall of 12% or so in the S&P500. The reasons for this outperformance are Japan's relatively cheap valuations, the strength of its corporate balance sheets, improved corporate governance and under-ownership by the global investment community. Many of these attractions remain in place, and so the outperformance that we have seen so far in 2008 could continue for some time. We will be scrutinising the first-quarter results season to determine whether the market's forward valuations remain compelling.

The domestic economy - the June Tankan

June's Tankan report showed surprising resilience in corporate Japan. This strengthens our conviction that the economy is not in as bad a state as many economists would have us believe. The diffusion indices were better than consensus expectations across the board. Large companies maintained their positive view, although the diffusion index fell from +11 to +5. Nevertheless, the report shows that momentum in business conditions is slowing, and is a good lead indicator of economic activity.

From the upward revisions to capital investment plans at manufacturing companies in particular, it's clear that the impact of the global slowdown is yet to be felt. Profit expectations have been revised down quite sharply, however. This appears to be based on the much stronger yen levels since March's Tankan results, as well as higher cost of raw materials, rather than on any slowdown in top-line demand. Revenue expectations remain quite upbeat in terms of volume, with total sales expected to rise by 2.4% in the current fiscal year.

The global economy - recession worries increase

We view leading indicators at OECD countries as a key measure when assessing the outlook for global demand, and thus for Japanese exports and transplant products. As over 60% of corporate Japan's earnings come from exports or overseas earnings, this is important. Japan tends to enjoy robust earnings when global demand is high, while earnings struggle in a global downturn. This was especially true in the period from 1989 to 2003, when the domestic economy was in a deep depression. Now, the impact of global demand on earnings is more muted than before, because of higher levels of domestic demand, which allow domestically focused enterprises to generate better returns. But global demand remains key.

We are also worried about the medium-term outlook for demand from emerging economies. The Middle East and other resources-rich countries should continue to show robust demand, but recent monetary tightening in the BRIC nations and cuts in oil subsidies by various countries increase our concern over the outlook for demand. Up until this year, demand from these 'new markets' has more than compensated for weaker demand from the US and Europe. Given the current environment, there are real concerns over how long this will last.

2. THE MARKET

The broad-based Topix rose 8.9% over the quarter, bringing year-to-date returns in yen to -9.6%. The rally was particularly strong in April, when the index rose 12%. The commodity complex led the market, with mining and oil & coal delivering double-digit returns over the period. Air transportation, which was the only sector to show a positive return in the first quarter, suffered a reversal of fortune. The tendency towards mean reversion in the Japanese market was also evidenced by oil & coal, which was the weakest sector in the first quarter.

Over the quarter, returns varied considerably by market cap. Large-caps again led the market, with the Core 30 and Topix 100 indices rising by 12.4% and 11.2% respectively. In another example of mean reversion, the smaller-cap indices lagged the broader market, having been a relatively safe haven in the first quarter. The Topix small-cap index rose by 6.6%, while the mid-cap index rose by only 4.6% in yen terms. Following a terrible June, the Mothers index ended the quarter down 13.0%.

Topix Sector Performance

Fisheries & Farms	+25.4%
Mining	+19.4%
Oil & Coal	+18.4%
Paper & Pulp	+18.0%
Iron & Steel	+15.3%
Warehousing	+0.8%
Rubber Products	-0.8%
Textile & Apparel	-2.6%
Foods	-2.6%
Air Transportation	-11.5%

Source: Martin Currie. Figures as at 30 June 2008

Supply & demand

One notable development during the quarter was a pick-up in buying by overseas investors. Since the statistical arbitrage collapse in August, non-domestic investors have avoided Japan, viewing the market as a kind of black hole in terms of corporate governance and growth potential. Because foreign investors are the marginal traders in Japanese equities, this led to a fall in the market as well as significant underweight positions in Japan in many global funds. Since the beginning of the year, Japan, due to its defensive valuations and lack of exposure to global credit problems, has outperformed the rest of the world by a significant amount.

Another interesting point is that companies have been aggressively buying back their own shares since the turmoil of August 2007. As many companies implement trades to meet obligations undertaken at the recent spate of AGMs, this will accelerate in July. In June, there has been a substantial pick-up in interest from individual investors, who have been playing themes such as the electric car and nuclear power. The impact of such speculators can be substantial on individual stocks.

3. THE OUTLOOK

The earnings outlook for many Japanese companies remains tough, particularly in the manufacturing sector. Demand is weakening in North America and Europe, though not yet to a meaningful extent in Asia and emerging markets. On the cost side, the high costs of raw materials remain a severe problem, while rising depreciation expenses are also putting pressure on margins. For exporters, the yen is stronger against the dollar than it was this time last year, although this is offset to some extent by the continued weakness against the euro.

The official company forecasts for March 2009 confirm this harsh environment. Figures from Macquarie Securities show operating profit falling 5% and recurring (pre-tax) profit falling 4% on a 1% increase in sales. Many of these forecasts were based on ¥100/$, so the weakening of the yen against the dollar will have helped. The oil price has continued to rise, however. This has been a double negative, as it has pushed raw material costs up on the one hand, and depressed demand on the other. The auto sector is the best example of the latter effect.

We are about to go into the first-quarter reporting season, and we expect that share prices will be highly sensitive to any disappointments. The trend of analysts' earnings revisions is solidly to the downside, with the exceptions being stocks that are benefiting from higher selling prices (commodities, foods and certain retailers). Among downstream companies, we continue to favour those with a reasonable degree of control over selling prices, and hence relatively less risk of a big cost squeeze on margins. Elsewhere, we still have a high exposure to names with good earnings visibility.

The other area of interest for us is in companies where there is a material change in the attitude of the management. In a more challenging macroeconomic environment, companies with the ability to improve returns through restructuring offer some counter-cyclical attractions. We have seen a number of encouraging recent examples, such as the large price hikes pushed through by the glass companies, breaking the long-term trend of flat prices. The return of a crisis mindset is leading management increasingly to think of bigger corrective responses.

As always, the trend in earnings will set the level of the market. The demand for Japanese equities has waxed and waned; buying has pushed the market valuations up and selling has brought them back down again. Given the current state of the global economy and the earnings headwinds described above, we feel that it is right to favour a reasonably defensive positioning.

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