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HOW THE SUN ROSE OVER JAPAN

May 3, 2003

Since our last report, the Nikkei touched down at the 7600 level and, consistent with the New York forecast here, feels to me to have now put in its secular low, notwithstanding the fact that the Nikkei is to be shunned, given the alternatives. The macro view and how to benefit with the least risk and greatest potential, more specifically, is reviewed and summarized below, due to this historic point in investment history (New York, gold and Dollar commentary follows thereafter):

JAPAN:

In January 1990, the forecast for economic and stock market deflation was based on the over-leverage in the system, which had tied corporate earnings performance to future stock gains. Today, 13 years later, leverage is to the upside as write-offs have been taken that discount lower asset prices, the non-realization of which creates upside surprises.

Similarly, many companies possess clean balance sheets that are making them prime candidates for those seeking safe haven investments. For this reason, many stocks bottomed in the year 2000, precisely when so many indices and equities peaked around the world. Still other Japanese equities bottomed in 1998 when Big Bang was introduced.

Since Japan's cyclical peak in 2000, the Nikkei has drifted to under 8000, a level last seen when the world's secular bull market accelerated in 1982. In 2000, that index had 30 new names added that were from the peaking technology sector. Coupled with the statistical influence of the bear market in the banking sector, the Nikkei is masking 3-5 year old lows and the fact that countless stocks are already in bull markets, themselves precursor to Japan's unfolding broad bull market.

Many such equities will have turned in triple-digit gains against very low risk profiles. Even with the Nikkei languishing, there are those that have already done so.

<u>Taxation</u>:

Experiencing overwhelming changes, gift and inheritance taxes will allow people to pass on capital to children and grandchildren while still alive at very low tax rates, as long as the gift giver is 65+ and the recipient is 20+. Gift tax rates were so outrageously high (70% and now proposed to decline to 20%!) that children who themselves had children over 30 were still not receiving monies that would only become available to them until their own parents' deaths.

Particularly for new housing and quality financial assets, a great deal of Japan's $11.7 trillion US (no misprint) in 0% or near-0% savings would now be liberated. This will drive up the Yen further, against a backdrop of an improving economy and higher asset prices.

$5 trillion US is in the hands of the highest tax bracket Japanese.

If even 5% of the $5 trillion US were liberated into the economy and investment world, **$250 billion would pour into the economy and financial markets.**

<u>Banking:</u>

<u>Bank of Japan share repurchases</u>

Banks will have raised a great deal of capital, giving the market the impression that public capital injections are less probable. In fact, concerns about public purchase of convertible securities that would "nationalize" banks have been overdone but BoJ share purchase programmes are what are important. These are far more valuable than "capital injections" anyway, as bank share over ownership represents a problem as great as non-performing loans on the banks' books. The excessive shareholdings stem from banks taking possession of troubled companies' crossholdings (shares held by companies in one another) and the legislation that removes shareholdings in excess of Tier 1 capital by September 2004. Such over ownership hit 7 trillion Yen. The BoJ has already promised to repurchase 3 trillion Yen worth of shares. Bank selling of crossholdings has depressed equity prices of even those companies whose operating results have reversed. I believe that their purchase programme will continue until no share overhang or crossholdings remain.

<u>Debt Crash</u>

Japan's overwhelming inclination to pay down debt is evident across the board! Keeping interest rates low, Japan holds about 40% of the planet's savings and doesn't need to borrow. Financial companies reduced liabilities last year by around 14 trillion Yen, while recording a net surplus of around 15 trillion Yen.

Even when examining numbers that exclude the financial sector, the statistics are mind boggling, as Japan's national will is applied to debt resolution. Total public debt increased by around 40 trillion Yen, while non-financial debt crashed a record amount, a bit over 30 trillion Yen! The economy's net debt increase was 7-8 trillion Yen, which, as a percent of GDP, was the least in about **35** years.

Liquidity:

The issuance of bank shares to bolster capital has been a negative for liquidity in the short run. The BoJ share repurchase programme, if taken to the limit, could remove as much as 7% of the market's float, however. BoJ bank shareholdings purchases may not be sold back onto the market before Sep. 2008 but the holding period is expected to be even longer. Foreign fund inflows to Japan since September, that are in search of value and safe haven, have been another positive, as well as a full year of positive stock fund inflow. Corporate share buybacks this fiscal year will have more than doubled from the previous year, a constructive sign of a bottom (which is when corporations like to buy their own shares), as well as yet another liquidity positive.

Yen:

Bottom to top, from its 2002 low, the Yen rallied 14% versus the US Dollar, dramatically under-performing the Euro and Swiss Franc. As money moves out of 0% interest rate deposits and the economy recovers, interest levels will increase and push the Yen still higher. Since the recovery will benefit domestic demand stocks as here defined, the higher rates or Yen level will not be an overriding negative as Japan experiences the mirror image of the 1990's when Yen weakness was coupled with a falling stock market but with exporters trading at all-time highs (note Sony's recent crash).

Demographics:

SKDF used to argue that the demographics of Japan were actually bullish in that a great deal of money would be put into the hands of few, due to the low birth rate, spurring luxury item purchases and quality investment. This is unfolding, notwithstanding the profoundly bullish demographics of Asia upon which Japan's future is also tied (see TAXATION).

Psychology and Leverage:

90% of respondents to a recent survey felt that hardly anything constructive has been done about the banking crisis. This extreme number reflects the extreme low in the stock market as there is no one left to sell, the profound potential for investment once that psychology even begins to reverse and why <u>those immune to crossholdings and foreign ownership have done so well</u>.

<u>Valuation</u>:

Price-to-operating-earnings is at a 20 year low, price-to-cash flow is at a historical low and very cheap compared to the US, though in line with Europe. Price-to-book ratios are also at their lowest levels in 20 years. Capital expenditures are generally being maintained by operating free cash flow. The valuations of those defined here as value stocks, are particularly impressive.

<u>Economy, Restructuring</u>:

Going forward, employers will be saddled with higher social security costs, while enjoying greater R&D tax deductions. On balance, the 2 measures may result in a net revenue increase for the government. The R&D treatment change is also sensible. Such changes and others, such as the proposed extension of the loss carry-forward period, underscore the recognition for the need for restructuring, to which such tax considerations relate.

Meanwhile, Japan has achieved “net positive deflation”, that point at which costs fall more than revenues. Such restructuring profits tend to precede the recovery in sales, which in turn supports the exit from deflation, indicators with respect to which are in positive trends. The leading economic indicators were positive 9 of the first 11 months last year, yet the unrepresentative Nikkei fell to discount the completion of the banking crisis. With the economy not having enjoyed a simultaneous bull market in stocks, a temporary dip into recession this year will have had a limited effect on the index, as much of what could ever go wrong has all but been discounted by today’s price level.

<u>The Opportunity</u>:

Stocks that bottomed years ago have been enjoying strength, particularly since the latter part of last year. Similarly, Japanese stocks started to fall apart well ahead of the 1990 peak.

The mighty are those that apply according to particular valuation measurements, often trading for less than shareholder equity or with the capacity to repay total debt, while enjoying an Asian business emphasis (as opposed to the West). Many such equities fell as much as 90% through the ‘90’s. No less important, the stocks of such companies are unencumbered by crossholdings or foreign ownership, thereby immune to either of the 2 principal selling pressures that have acted upon Japanese shares.

<u>Bottom Line</u>:

Japan represents the majority of Asia's market capitalization and GDP. The preferred domestic (Asia) value theme has proven to be both the most sophisticated way of investing in Asia since 2000, while also providing the most risk averse approach to capital preservation. Still, these stocks have already exhibited their potential for triple-digit percent gains, once Japanese markets are so much as quiet, due to their extreme under valuation after all these years. Therefore, it is difficult to assess how strong may be the potential once the bull market recovery gets fully underway in even the Nikkei. If one assumes that that recovery can only help, those seeking safer havens will have stumbled over the most excitingly profitable investment theme in the investment world today.

With respect to the big picture, I believe that we are on the cusp of the death of deflation in Japan and the full-fledged commencement of a massive secular bull market that will skyrocket prices and sustain them for decades to come.

Sid Klein