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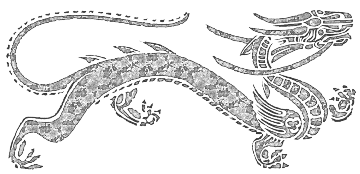

Japan's Recovery - What Japan Is and Is Not

The world is starting to notice that Japan's economy is in its fourth year of recovery. After a brief hiatus last fall, the economy has regained momentum in 2005. The basic recovery scenario is impressive. Japanese companies have been working on improving bottom-line profitability for years. Helped significantly by continued strong exports (especially to China), companies have been increasing hiring and raising wages. All of this has had a slow but very real effect on the Japanese consumer, who appears to be coming out of a long hibernation. Just as critically, Japan's seven years of deflation is widely expected to end in 2006. This is best seen in the rising property prices in the Tokyo region following 14 straight years of decline. A relatively healthy domestic economy in Japan is something the world has not seen for a long time.

Confidence in this domestic recovery has been enhanced by fresh hope for significant government reform following the Prime Minister Koizumi's electoral victory regarding postal reform. Postal reform in Japan means a lot more than efficient mail service, given that the postal system controls over $3 trillion of private savings (approximately 25% of the nation's household assets) in a somewhat feudal and highly politicized manner. This system has certainly been a prime contributor to the runaway pork-barrel government spending that has led to a very large government deficit.

With the stock market in its third winning year, confidence in the financial system and market has made significant strides. The infamous Japanese "overhang" of cross-held shares has dropped to levels not far from international norms. Hardly remembered are the widespread expectations of the collapse and nationalization of the banking system in March 2003. Japanese banks are not yet globally competitive, but they are working hard to serve the domestic consumer in a way they never had before. There has been a massive consolidation of the major banks and a major system failure seems unlikely.

The economy now seems on track to grow a little less than 2% in 2005, hardly impressive by Asian standards, but significant compared to the last 15 years. Japan's growth has never been likely to maintain the very strong 3% to 5% seen in the first half of this year. The government is struggling to reduce its fiscal deficit. The population is aging rapidly and will start shrinking in absolute terms in the next couple years. Japan's domestic economy still wrestles with many barriers to growth and competitiveness.

Investors in Japan should remember that the vast majority of Japanese companies and government bureaucracies are still managed by the same people who delivered 15 years of poor economic performance. Japan's bureaucrats have fought reform tooth and nail. The Bank of Japan killed a couple economic recoveries in its misplaced concern over inflation. Japanese companies largely abandoned investing in China during the late '90s with a true head-in-sand vision of the future. Japan's paranoia of foreigners impedes the transfusion of youth and talent it so badly needs. So let us not forget that Japan is unlikely to become a high growth environment. This is not to say that the recent rally is not justified or that the future is at all bleak.

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Japan is a massive restructuring play. Change is occurring from the top and the bottom. While the Liberal Democratic Party's dominance of Japanese politics since World War II has certainly reinforced many of Japan's worst problems, Koizumi's efforts to reform both the party and the government are clearly more than show. Such reform will be a long and often frustrating battle. The clash between vested interests in the old system, including the very old populations in rural Japan, and the more market driven companies and younger urban populations will take years to play out. But the winner would seem obvious as markets and youth eventually win out over feudalism and old age.

On the corporate front, competitive pressures build every day on companies that are failing to strive for greater operating efficiency and higher profitability. The market is rewarding successful companies and the allocation of capital is increasingly driven by merit rather than cronyism. Japan's vast inefficiencies in the domestic economy should be slowly ground out. Japan's powerful export engine should gain efficiency from such a process, although this sector has long embraced global business standards.

Japan's opportunities around the region would appear significant after many years of neglect. The relationship with China is a real opportunity for Japan. China's basic manufacturing strength combined with a growing demand for branded products offers a prefect production base and an ideal long-term market. China will also be in need of capital for many years to come as its economy is built, giving Japanese investors a much needed opportunity to diversify out of both Japanese and U.S. government debt. Of course, political tensions and social friction remain high, and Japan has managed to seriously damage the progress of recent years with both China and Korea. We still believe mutual benefits will outweigh old grievances over the long run. That Japan continues to run a significant trade surplus with China is a tribute to the still insulated nature of its domestic economy. That its currency has weakened by over 15% against the dollar in this year is, to some extent, a legacy of its export mentality.

Japan has the opportunity to regain its ability to be a growth economy, albeit on a much more modest level than seen in earlier decades. The growing enthusiasm for Japan is justified as long as it is tempered with the knowledge that a great deal remains to be accomplished to bring the world's second largest economy back to its full potential.

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China
China's gross domestic product (GDP) expanded 9.4% year-on-year in the third quarter. The strong economic growth continued to be underpinned by robust fixed assets investment (FAI) and exports, which grew 28.5% and 28.7% respectively. The country's trade surplus grew by 143%, reaching US$28 billion. Foreign reserves also rose, partly due to the increase in trade surplus, to US$769 billion from US$753.2 billion in the second quarter. Total retail sales grew 12.7%, supported by rising per capita disposable income in both rural and urban areas. To help further boost citizens' disposable income, the government announcement that effective January 1, 2006, China's monthly personal income tax exemption threshold will increase from Rmb800 (US$100) to Rmb1,600 (US$200). In the 11th Five Year Plan, in which the Chinese Communist Party set the framework for China's macroeconomic development in 2006 to 2010, policymakers also placed emphasis in balancing the country's investment-driven economy with a more consumption-led one.

Hong Kong
The labor market continued to improve in September as the unemployment rate fell to a four-year low of 5.5%, partly due to the newly opened Disneyland theme park and strong demand for workers in finance, services, and trade-related sectors. Total exports (comprised of re-exports and domestic exports) were strong in September, growing by 17% year-on-year. The government's spokesperson pointed out that the near-term outlook for Hong Kong's external trade would remain fairly favorable, mainly driven by the growth in the mainland's trade flows. Additionally, the government noted that domestic exports of clothing grew visibly faster in recent months due to manufacturers who have enlarged their clothing production in Hong Kong, in light of safeguard measures imposed by the U.S. and E.U. on certain clothing items from the mainland.

India
Last month witnessed some structural changes in the banking sector initiated by the Reserve Bank of India (RBI). In the mid-term review of the monetary policy, the RBI increased the general provisions that banks have to make on standard loans from 25 basis points to 40 basis points, but the timeframe to achieve the requirement is unclear. The change in provisioning norms is aimed at capturing risk more appropriately in an environment of accelerated credit growth, although it may negatively impact near-term profitability of banks. The Reserve Bank has also raised the limit for direct capital market exposure for banks from 5% to 20% of a bank's consolidated net worth, which is likely to provide additional liquidity for the stock markets. The inflation rate continues to inch up in recent weeks to 4.5%, up from August lows of 3.0%, prompting the RBI to raise the key short-term rate by 25 basis points to 5.25%. Separately, the RBI has raised its forecast for GDP growth in 2005-06 from 7.0% to a range of 7.0-7.5% following the strength seen in various sectors.

Indonesia
The Indonesian government cut fuel subsidies in the beginning of October, after the previous subsidy regime proved too much of a strain on the fiscal budget. As a result, petroleum prices rose 88%, while the price of kerosene, which is widely used for cooking, almost tripled. The spike in fuel prices became evident in October when year-on-year inflation jumped to 17.9%, an increase from the 9.06% posted in September. The Bank of Indonesia (BOI) increased its full year inflation-estimate to 14% from 12% previously. BOI also raised its benchmark interest rate to 12.25%, the highest among major central banks in Asia, in an effort to both curb inflationary pressures and to support the Indonesian rupiah, which had depreciated more than 7% since the beginning of the year. During the month, Indonesia confirmed its fourth fatal case of bird flu. The containment of the virus has proven particularly challenging for the government, since many people continue to live in close daily contact with poultry and other livestock.

Japan
The government survey released in early November showed that Japanese households slightly increased exposure to riskier assets than the previous year. According to the survey, the average household's financial assets was 10.9 million yen (approximately $94,300) this year, a 6.2% increase from 2004. On the other hand, the percentage of households having no financial assets was 23.8%, a 0.9% increase year-on-year, implying a widening disparity between households. Securities (bonds, stocks and investment trusts) were 12.4% of households' total assets, up by 2.9% from the previous year. In particular, stocks comprised 7.9%, up by 1.2% from 2004, showing a steady increase from 6.3% in 2001. Savings and deposits were 58.1%, down by 2% from the preous survey. 48.3% of the households indicated security was the most important consideration in asset allocation, while 14.7% of the surveyed, returns mattered the most.

Korea

During the third quarter, Korea's GDP expanded 4.4% compared to a year earlier, mainly due to increased economic activity in the manufacturing and services sectors. The economy grew at a faster rate than the previous quarter, when GDP expanded 3.3% year-on-year. The Bank of Korea (BOK) raised the benchmark overnight call rate by 25 basis points to 3.50% at its meeting in October. This was the first interest rate tightening in more than three years. The BOK had previously indicated that it would raise the interest rate from its historical low once it viewed the economy to be on firm footing. Inflationary pressures eased in October compared to the previous month, with the consumer price index increasing 2.5% from a year earlier. Unemployment rose to 4% in September, its highest level since April of 2001, as the number of new people looking for work outpaced the number of jobs during the month. The manufacturing and construction sectors both cut jobs compared to a year earlier, while the number of jobs within the services industry rose by 5.4%.