JAPAN CONSOLIDATES ITS GAINS AND ACHIEVEMENTS

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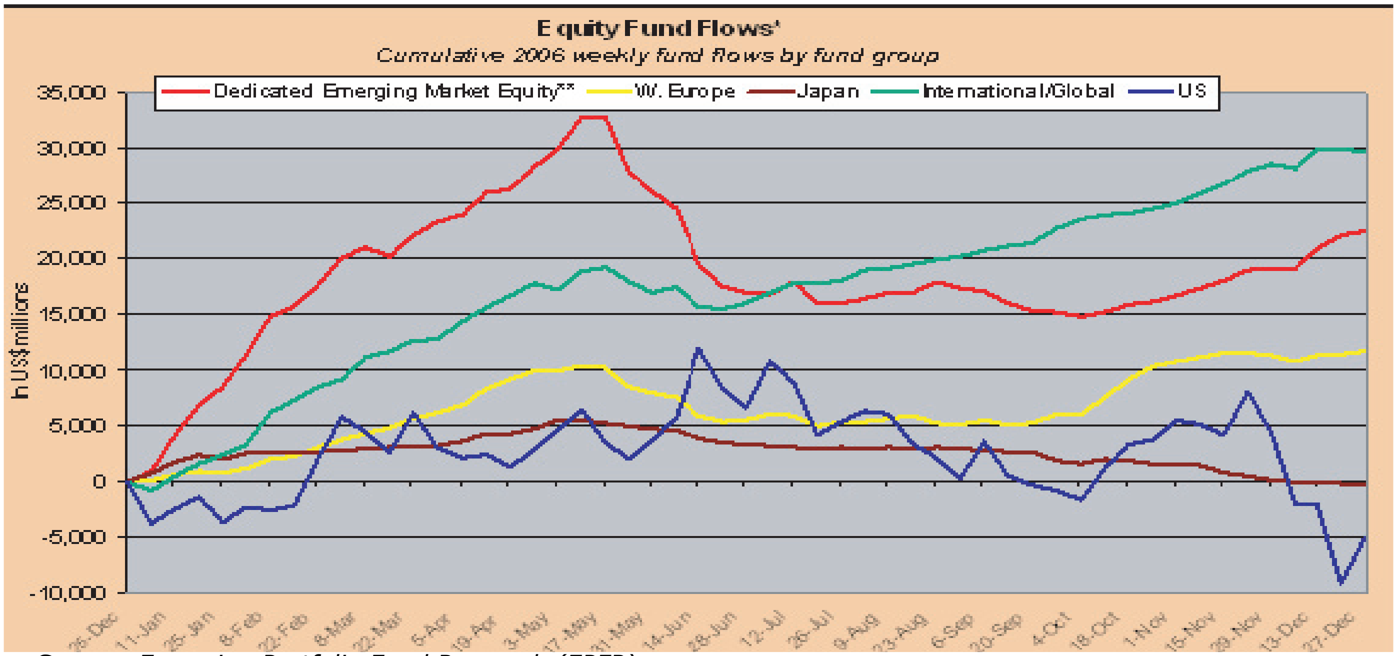
As investors recognized the extent of Japan's economy recovery in 2005, its primary Nikkei 225 index rose by an extremely strong 40%+. This performance exceeded all other major markets. The index appreciated an additional 6.9% in 2006 -- its fourth consecutive annual increase. In comparison, the US Dow Jones Industrial Average closed about even during 2005 and rose 16% last year.

This change in relative performance, whereby Japan followed a dramatic 2005 rise with a less vigorous advance in 2006 -- combined with less media attention, the inauguration of a new government -- has led many analysts to question whether progress in Japan has stalled, and to ask what the country has been doing to maintain positive momentum.

To maintain sustainability, however, every economic advance must be followed by a period of consolidation. This is a time when gains are absorbed, adjustments made, and a foundation laid for further progress. In Japan's case, this has meant preserving a social consensus behind necessary economic adjustments, bolstering Japan's capacity to promote innovation, and developing value-added industries and services. Furthermore, it has involved efforts to broaden the reform agenda first adopted in 1996 and other subsequent policy measures, and to further advance the economic integration and dynamism of East Asia.

Japan Maintains Investor Confidence Despite Movement Toward More Risky Assets

While most US market indices outperformed Japan in 2006, it is interesting to note many investors pulled back on their US investments while maintaining their enthusiasm for Japan. This can be seen in funds flow data in equity funds tracked by emergingportfolio.com, which indicates that Japan-related funds remained relatively level while US Equity Funds registered outflows of more than $10 billion over the past year. The ability of Japan to maintain investor confidence after their large 2005 advance, however, and to not only hold onto these gains but to advance further, is a very positive sign, despite the slower advance seen over the past year.



Source: Emerging Portfolio Fund Research (EPFR)

One can ask why investors have maintained their holdings, particularly given the gains and momentum seen in emerging markets and other markets that achieved higher gains. Partly this is a matter of their having been far underweight Japan for almost a decade. It is also recognition of the progress that Japan has achieved in addressing the diverse range of economic and social issues that had been constraining its economic performance.

Although Japan adopted a variety of policy initiatives after the economic bubble burst in 1990, Japan's recovery began in earnest in 2001 after Prime Minister Junichiro Koizumi assumed office. Prime Minister Koizumi proved willing to challenge established interests and political, social and economic conventions, while moving to push through the reforms necessary to reinvigorate the country. This included transformation of the old development model into a new structure that would enhance Japan's productivity, competitiveness, and overall ability to meet the challenges of the 21st century. His administration cleaned up the banking sector, and introduced measures to enhance corporate governance, and privatize Japan's $3 trillion Postal Savings System (PSS). His administration also began to privatize some government services, cut public works spending, and create a regulatory and financial environment more supportive of R&D.

For their part, Japanese businesses reduced debt, eliminated unprofitable divisions, unwound cross-shareholdings, introduced stricter management controls, and moved to devote greater attention to profitability and shareholder value as opposed to market share. They also began to invest abroad--not only to tap into sales opportunities -- but also to lower production costs. Noteworthy, too, was a rise in business investment and R&D expenditures. This, along with a rationalization of the work force, helped to increase productivity. In total, these changes enabled major Japanese firms like Mitsubishi, Matsushita and Toyota to bolster profits, returns on equity, and dividend payouts.

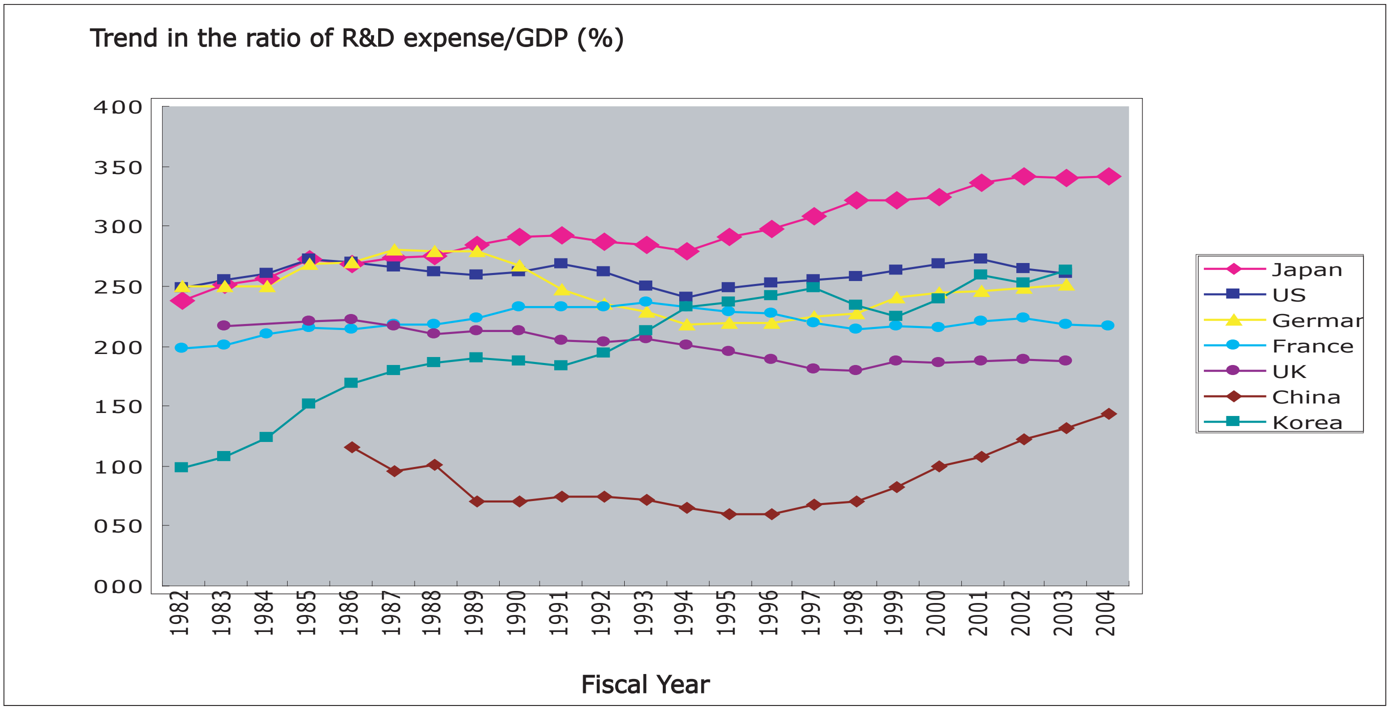
These much needed changes helped to introduce market-based incentives, spur economic growth, elevate corporate profits, and reduce unemployment. Concurrently, however, they induced a variety of dislocations such dramatic changes in corporate values and an increasing reliance on part-time, rather than traditional full-time employees. Given this, and the rapidity of the changes which transpired before assuming office, it is not surprising, and not entirely undesirable that the Abe administration is taking extra care to build the bureaucratic, legislative, and social base required to maintain social consensus. This is necessary to maximize the gains achieved from past initiatives as it moves to lay the foundation for the next stage of advances.

Japan Enhances Innovation, Education and Development of Value-Added Industries and Services

Until the late 1980s Japan was able to compete based on its ability to manufacture products more efficiently -- not only more efficiently than competitors in the US and Western Europe but also emerging economies -- who had not yet achieved the same level of technical proficiency.

Over the last two decades, however, a host of other economies, including, but not limited to South Korea, Taiwan and the Peoples Republic of China have absorbed Japanese techniques and methods. When combined with demographic trends and rising labor costs/living standards, Japan, has been required to make a concerted effort to maintain its competitive position by supporting innovation. This includes expanding value-added industries and services, and developing its own intellectual property. It has become important to reform the Japanese education system as well.

The chart below reveals that Japan has historically compared well with other major economic players on an R & D expenses to GDP basis.



Source: METI (calculated from Science & Technology Summary published by MEXT)

Even so, the government recognizes the need to facilitate innovation in Japan. For this reason, it has developed an Innovation Super Highway program, which is working to facilitate interactions between knowledge workers, domestic and foreign, businesses and academia. This will help to catalyze technological advances and the creation of intellectual property. Additionally, the government is subsidizing "intellectual cafes" or communities where individuals can gather both physically and virtually to exchange ideas.

As for higher value-added industries and services, the government is offering financial support in areas such as nanotechnology, industrial robotics, and new generation batteries for automobiles. It is also considering the modification of Japan's Copyright Law to allow for search-engine servers to be located in Japan, to facilitate advances on next-generation technologies.

Such policies would build upon programs launched between 2005 and the beginning of 2007. These are designed to create the world's fastest patent examination system, to increase punishments for patent infringement, trademark rights, and trade secrets, and to create programs on intellectual property at law and graduate schools. Joined with measures to reduce patent fees and support local government intellectual property strategies, these actions will facilitate Japan's acquisition of its own intellectual property.

Particularly encouraging for Japan's future growth prospects is the fact that research outlays by companies, universities, and government-supported research institutes hit a record 17.85 billion yen in fiscal 2005. This was an increase of 5.4 percent over fiscal 2004 and the 6th straight fiscal year of increase.

With respect to educational reform, Prime Minister Shinzo Abe recently shepherded an amendment of the Fundamental Law of Education through the Japanese Diet. This was done, in the Prime Minister's words, partly to promote "a spirit of public-mindedness and self-discipline, moral values and attachment to and affection for one's own community and the nation." Also important, however, is a desire to improve the skills of Japanese youth. This is essential to ensure the availability of the skilled workforce necessary to support higher value-added production activities. Related to this, a government panel on education reform is expected to propose, in coming months, a more stringent curriculum, teacher licensing system, and national achievement test.

Japan is Maintaining its Commitment to Reform and Rationalization

Many commentators have remarked that Prime Minister Koizumi's greatest achievement was to use his personal charisma to overcome traditional Japanese "conservativeness", established political coalitions, and a general aversion to radical change. This helped to push forward an agenda that emphasized the need for reform and the dramatic adjustments necessary to overcome the structural inefficiencies that had been constraining Japan's economic performance.

Newly elected Prime Minister Abe seems to have a very different style than his predecessor. It would be a mistake, however, to believe Japan has reversed course and is no longer dedicated to the course embarked upon with the adoption of the Action Plan for Economic and Structural Reform in 1996. Indeed, the Abe administation is moving on a variety of fronts to address remaining political, budgetary, and social issues.

For example, to bolster its political integrity, the Liberal Democratic Party (LDP) readmitted 11 of its 12 former members, who were ousted for opposing the Postal Savings System privatization, only after they signed a pledge accepting the privatization. To enhance the public's trust -- which is vital for new reform initiatives -- the LDP-led Diet passed legislation in early December which imposes tougher penalties on bureaucrats involved in bid-rigging and criminalizes the act of abetting the practice. Later in the same month, Prime Minister Abe appointed Yoshimi Watanabe, who has strong reformist credentials, as his Minister of State for Regulatory Reform. Watanabe's appointment is said to be a signal of Abe's commitment to reduce government debt and to deregulate and decentralize.

On the budgetary front, the Abe administration has drafted a budget which, as a result of an improved revenue situation, includes a record 4.5 trillion reduction in new bond issuances from the current year to 25.4 trillion yen in 2007. This will result in the ratio of new government bond issuance to expenditures falling from 37.6% in fiscal 2006 to 30.7% in 2007. In the words of Finance Minster Koji Omi, the draft budget shows that "the fiscal reform drive will carry on." Naoko Nemoto, a manager director of Standard &

Poor's Tokyo branch, observed that the improved revenue might allow the government to accelerate its goal of bringing the country's primary balance back into the black by one or two years. Continuing a trend begun in fiscal 2002, the government's draft budget reduces public works spending to its lowest level in 20 years. It also cuts the fiscal investment and loan program to its lowest level in 30 years. Beyond this, Prime Minister Abe has made additional progress in addressing Japan's budgetary situation by getting authority from the LDP to shift surplus road-tax revenues to the general fund. The agreement he negotiated still represented the first change in the allocation of road-tax revenues since 1954.

Regarding the social front, the Abe administration has taken concrete as well as rhetorical measures to support increased child care opportunities, a better work-life balance, and maternity leave, to improve Japan's declining birthrate. Its draft fiscal 2007 budget also allocates funds for job training, aid to small firms, assistance to regional economies, and an expansion of expenditures on pensions and health insurance.

Japan is Moving to Enhance the Economic Integration of East Asia

Global growth over much of the postwar era has been driven by consumption in the US and Western Europe, while emerging nations in Asia and other markets have sought to achieve economic development largely through development of an export capacity to sell into these more mature and affluent economies.

As the BRIC economies, Brazil, Russia, India and China, and other emerging markets continue their advance, however, billions of new people are entering the workforce. This is rapidly giving rise to new sources of demand. Compounded with lower growth and a maturation of demand in the US and Western Europe, the old dynamic is rapidly changing. Markets such as East Asia now constitute some of the largest and most vibrant markets in the world. One analyst quoted by Bloomberg recently noted the market for luxury products in China alone is forecast to grow larger than that in the US within the next decade.

In diverse ways, Japan is moving to take advantage of these opportunities while allowing investors the stability offered by allocating funds to a more stable and established economy.

This will allow it to reduce its reliance on the U.S. and European markets. An increased focus on East Asia also allows Japan to tap into new production venues and to develop ties with consumers. Osamu Watanabe, Chairman and CEO of JETRO, reports that the efforts of Japanese businesses to build production and procurement networks in East Asia, following the region's move towards increased integration after 2000, has paid off in the form of increased profits (For full text of Chairman Watanabe's speech, please visit: http://www.jetro.go.jp/en/jetro/profile/speeches/). Suzanne Berger, a political science professor at the Massachusetts Institute of Technology, notes that the presence of Japanese companies in markets such as China has enabled Japanese firms to develop knowledge about consumer preferences that is lacking in many competitor firms.

On an official level, Japan has done much to enhance integration in the region. First, Prime Minister Abe moved to improve ties with China and South Korea shortly after taking office. Second, Japan has proposed measures such as the establishment of an Economic Research Institute for ASEAN and East Asia. Third, Japan has struck a number of deals with countries in the region. To illustrate, in late November, Japan and Indonesia signed a Free Trade Agreement (FTA), which reduces tariffs and opens borders to service workers and follows in the wake of the FTAs Japan has concluded with Malaysia, the Philippines and Singapore.

Some Economic Indicators Show Strength While Others Show Signs of Moderation

In early December, the Japanese government announced that the economy had posted a 0.8% growth rate in the third quarter (July-September) as a result of slowing capital expenditures and more tepid consumer spending. This led the Bank of Japan (BOJ) to refrain from increasing interest rates. Nevertheless, the government expressed the view that "the basic trend of economic recovery remains unchanged" while the BOJ took the stance that the economy would continue to expand. These positive outlooks received validation when the government released industrial production figures for November. In November, industrial production grew a seasonally adjusted 0.7 percent over the previous month, hitting a new high as a result of strength in automobile and mobile phone part production.

Positive news could also be found on the inflation front. November wholesale prices surged 2.7 percent in November year over year (YOY), while consumer prices moved up 0.2 percent YOY. The former represented the 33rd consecutive monthly increase, while the latter represented the 6th consecutive month of CPI gains. There was good news, too, on the job front with the headline unemployment rate falling to 4.0 in November from 4.1% in October, though the jobs-per-applicant ratio remained flat.

Retail sales were somewhat sluggish in November, registering a 0.1% decline YOY. However, there was room for optimism as consumer confidence rose in November, both over the previous month and YOY. Increasing the prospects for continued improvement in consumer confidence was the fact that almost 80% of firms surveyed by the government, intend to, or have, raised average employee pay. The 80% figure represents the highest ratio since comparable data began to be collected eight years ago. Since consumer spending represents around 57% of Japan's GDP, higher wages have the potential to significantly catalyze increases in economic growth.

In November, the Japanese economy also continued to receive support from exports, with Japan recording a 54.1% explosion in its trade surplus YOY. Exports of cars, steel, and electronics fared particularly well. Yasuo Yamamoto, a senior economist at Mizuho Research Institute, said, "the trade surplus was bigger than expected as exports were stronger than we thought." Furthermore, "as crude oil prices continue to decline, this trend may be here to stay for a while."

The BOJ Tankan Survey revealed solid business confidence at large, midsize, and small companies, with the business sentiment for large manufacturers rising from 24 in September to 25 by December and business sentiment for midsized manufacturers rising from 6 to 10. Favorable business sentiment filtered into corporate capital spending, which expanded 12.0% from July-September YOY for the 14th straight quarterly increase. It also is demonstrated by National Tax Agency reports on entertainment expenses, which grew by 2.7% YOY, the first increase in nine years.

There is Optimism over the Prospects for the Japanese Economy in 2007

The reforms and economic data noted above as well as continued improvement in the conditions and profitability of Japanese firms have made a number of analysts and investors optimistic about the prospects for the Japanese economy and stock market in 2007. For example, Tsuyeoshi Segawa, equity strategist at Shinko Securities, contends that strong business earnings growth in the years ending March 2007 and March 2008 should boost stocks. Hiroaki Kuramochi, head of equity sales at Bear Stearns (Japan) Ltd., believes that foreign investors will increase their acquisition of Japanese stocks to profit from the continuing undervaluation of Japanese equities. Furthermore, there are some who conclude that a shift of domestic savings into the stock market will drive Japan's economic recovery.

For investors, there seem to be two main concerns. One is Japan's ability to maintain economic growth. In this regard, there is encouraging news from the World Bank which forecasts 2.4% GDP growth in 2007 and 2.5% growth in 2008 based on expectations of "vigorous growth in developing East Asia, renewed consumer and business confidence [detailed above], and reduced drag from consolidation" as well as the return of positive inflation. Another concern is whether or not reform will continue. As this Focus newsletter has shown, reform is indeed underway and there are a number of new initiatives on the horizon as well. In the words of Robert Feldman, chief economic and a managing director with Morgan Stanley (Japan), Prime Minister Abe has "the philosophy and fortitude to persist" with reform, the Japanese public wants reform, and reform "implies that equity prices…should be strong."

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