

Evolving Markets

focus

PREVIEWING THE GLOBAL INVESTMENT HORIZON FOR PROFESSIONAL INVESTORS
MARCH 3, 2010

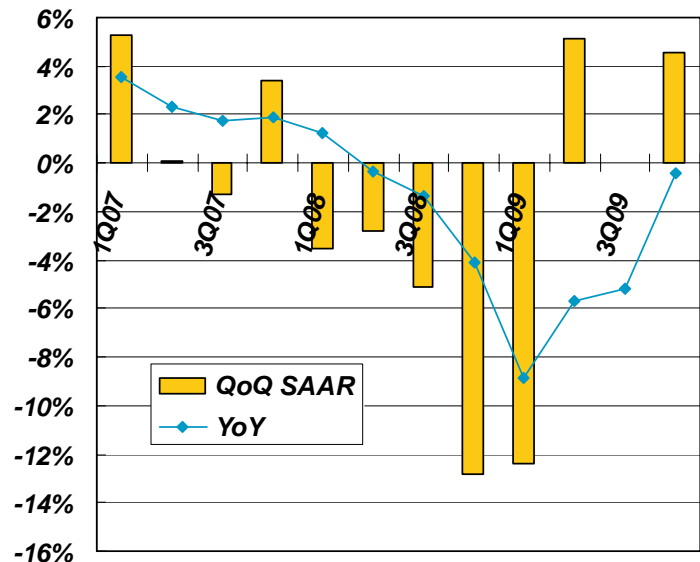
Japanese and Global Economic Updates

Japan's GDP data was heavily revised recently and 4Q09 data was therefore stronger on a sequential basis than we expected. This is due to the fact that the initially reported 3Q09 GDP surge was revised down to flat QoQ. Regardless, the 4Q09 did show some very positive traits, with personal consumption remaining firm. Most of the growth, however, came from net exports, which we detail in this report.

Meanwhile, economic macro data is improving globally and we update the comparisons of the G-3 countries. We also provide an analysis of US CPI trends, which continue to be "schizophrenic," with domestic factors being deflationary but globally sourced factors being quite inflationary.

Our Global Investment Committee (GIC) will meet soon to update our house view, but our overall view of slow to moderate G-3 recovery, with surging Chinese growth, still seems relatively well on target. Key to our view will be our supply and demand forecast for G-3 sovereign bonds and our view on Greece, the other PIIGS and selected emerging markets.

Japanese GDP

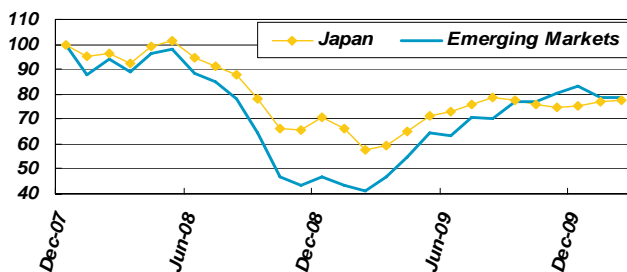


Source: Datastream

MARKET WATCH

Many investors were surprised to note in our November issue that Japan had performed right along with global emerging markets since Dec07, so we updated the numbers and found that Japan is still competing well. In USD terms, MSCI Japan had a total return of -22% while MSCI Emerging Markets had -21% through the end of Feb10. Given the state of investor sentiment, one would have thought Japan had terribly lagged over this cycle. However, quite logically, Japan underperformed them during the upswing, but was much more resilient during the crisis. More surprisingly, it has performed in line since Oct09. Similarly, Japan performed much better than the US in the crisis period and has underperformed on the upside, with Japan now only slightly underperforming the US over the entire period. Thus, investing in Japanese equities has proven much less volatile while providing very similar returns, which is a very positive investment trait.

Indexed MSCI total return in USD Dec07- Feb10



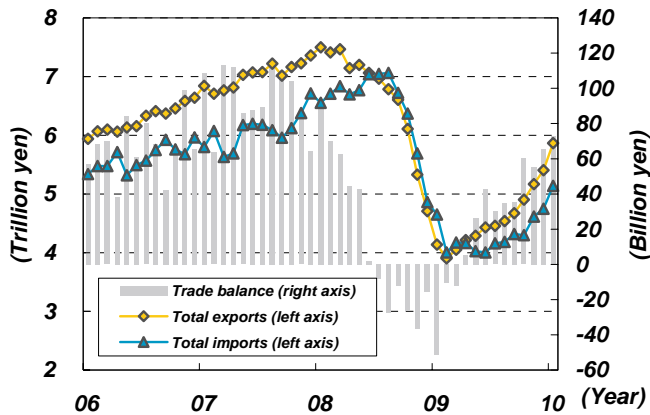
Source: Bloomberg

Exports Supporting Japanese Economic Recovery

Recovering Foreign Exports

Japan's trade statistics for January 2010 (provisional) were announced and showed its exports totalled 4.90 trillion yen, up 40.9% year-on-year, which is more than the projected increase (a survey by Bloomberg) of 39.5%. Japan's exports continue to recover after hitting bottom at 3.96 trillion yen in February 2009. Japan's exports experienced a year-on-year increase for the second consecutive month after previously declining for 15 months. The total value of Japan's imports was 4.81 trillion yen and they rose for the first time in 15 months, up 8.6% year-on-year, although they were below the projected increase of 12.1%. Japan's imports bottomed out at 4.03 trillion yen in June 2009, lagging four months behind exports, and have continued to increase since then. Japan's trade balance was 85.2 billion yen, recording a surplus for twelve consecutive months. By item, automobiles, electronic components including semiconductors and automotive parts contributed to the increase in exports and crude and raw oil, petroleum products and electronic components including semiconductors helped to boost imports.

Exports, Imports and Trade Balance (seasonally-adjusted)



(Source) Bloomberg

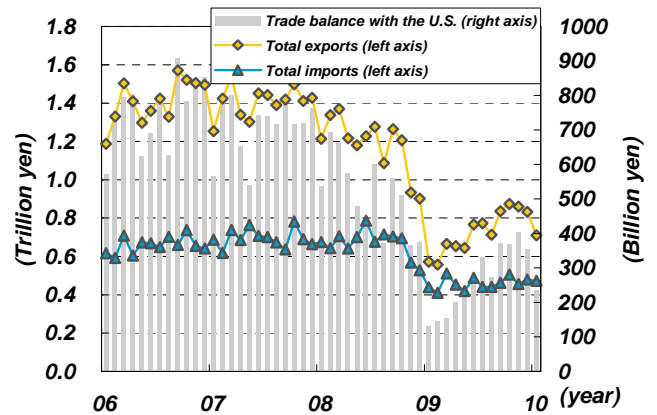
Recovery with Regional Gaps

Although the recovery in Japan's exports and imports can be confirmed with provisional trade statistics for January, a look at the previously announced trade statistics in chronological order more clearly shows the importance of the recovery in its exports in the recovery phase from the economic slowdown triggered by the recent financial crisis. The statistics reveal that the economies in many countries and regions in the world, including Japan, have hit the bottom, despite some differences in timing, from the first half to the middle of the previous year. This could largely be attributed to governmental economic stimulus measures, such as public fund injections and tax cuts. Exports from Japan increased with the higher demand overseas, but there is a difference in the pace of recovery depending on region and country.

The graphs below show the trends in exports from Japan, exports to Japan and the trade balance with the U.S., EU and Asia. The graph of the trend in trade with the U.S. shows a recovery in Japan's exports to the U.S. This fact can also be confirmed when looking at a business index in the U.S. The American Industrial Production Index hit the bottom in June 2009 and has continued to increase, though slightly, since January 2010. So, it can be said that the rise in demand has accelerated American imports from Japan.

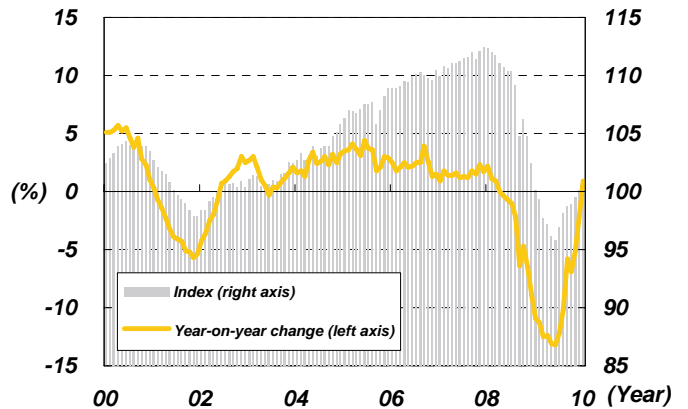
On the other hand, Japan's imports from the U.S. are still flat due to a delayed recovery in the Japanese economy and Japan's trade surplus with the U.S. is therefore expanding.

Trend in Trade with the U.S.



(Source) Bloomberg

American Industrial Production Index

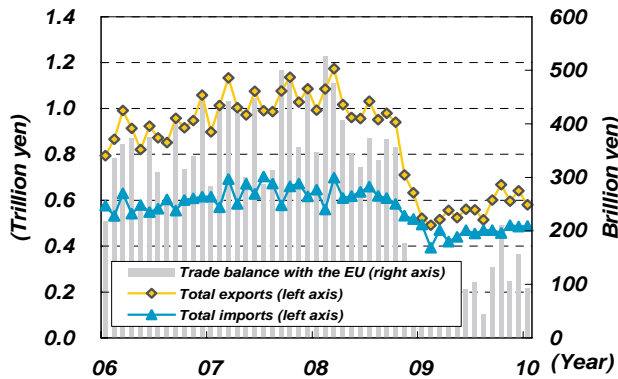


(Source) Bloomberg

Exports Supporting Japanese Economic Recovery

Japan faces a different situation in trade with the EU. Japan's exports to the EU registered a year-on-year increase for the first time in 17 months in January 2010, but as can be noted from the graph, their recovery was milder than that in Japan's exports to the U.S. Thus, gaps between Europe and the U.S. in terms of economic recovery can be confirmed by the data of exports from Japan. In addition, the EU's exports to Japan bottomed out in February 2009 and remained flat thereafter. Under these circumstances, Japan has recorded a slight trade surplus with the EU.

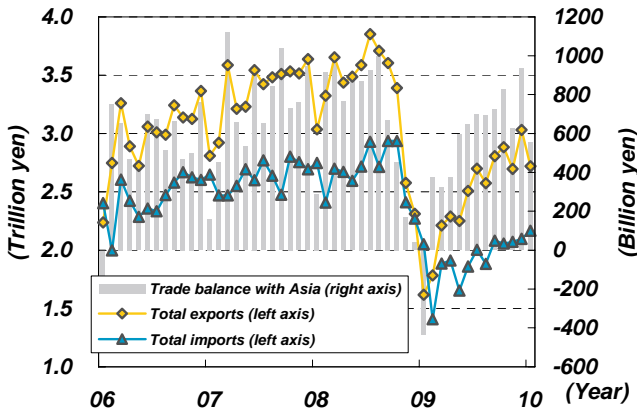
Trend in Trade with the EU



(Source) Bloomberg

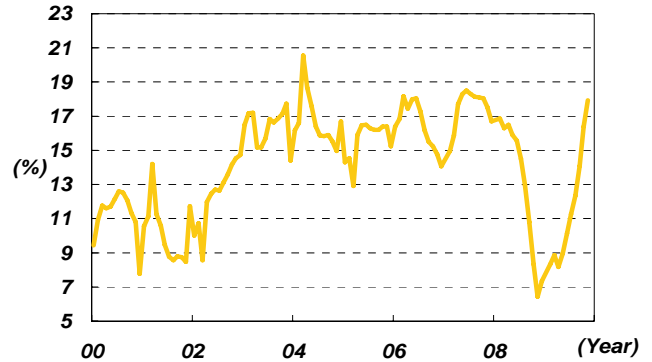
Compared with the U.S. and EU, the economy in Asia is showing a clearer recovery trend. Japan's exports to Asia hit the bottom at roughly the same time as its exports to the U.S. and EU, in the first quarter of 2009. However, they showed an overwhelming recovery after that. This could largely be attributed to Japan's exports to China, which constitute about one-third of its total exports to Asia. Like other countries, China experienced a rapid deterioration in its economy in the latter half of 2008, but owing to its government's fast economic stimulus measures and its goal of a high economic growth rate, it achieved a strong recovery thereafter and has sustained high rates of growth. Under these circumstances, Japan's exports to China show a stronger recovery than in any other region.

Trend in Trade with Asia



(Source) Bloomberg

China's Industrial Production Index (year-on-year change)

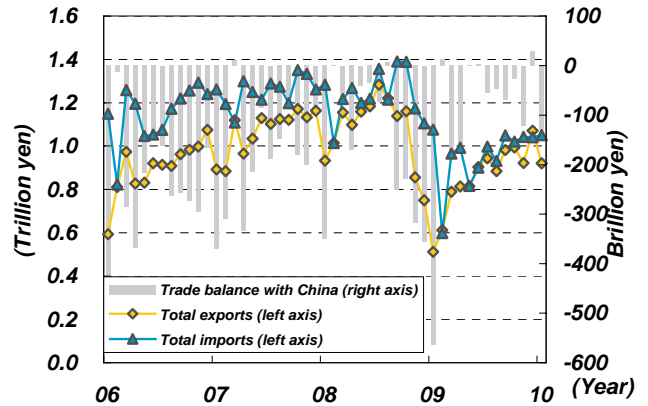


(Source) Bloomberg

Although Asia was affected by the financial crisis, the effect was not as direct as in the U.S. and Europe, and this also was a contributory factor in the early recovery of the Chinese economy. In the U.S., households taking out subprime loans were directly affected by the financial crisis, but that is not the case with Asia. In addition, in some European countries, people had formerly borrowed funds in foreign currencies at low costs for use in investment and consumption but a rapid rise in borrowing costs triggered by the financial crisis caused great damage to the economy. This phenomenon was also not seen in Asia.

Because of these factors, the Asian economy is recovering faster than any other region and Japan's exports to Asia continue to increase. By item, electronic components including semiconductors, plastic products and organic compounds contributed significantly to the higher exports. On the other hand, Japan's imports from Asia experienced a year-on-year increase for the first time in 15 months, though they are recovering more slowly than its exports to Asia. Under these circumstances, Japan's trade surplus with Asia is expanding.

Trend in Trade with China



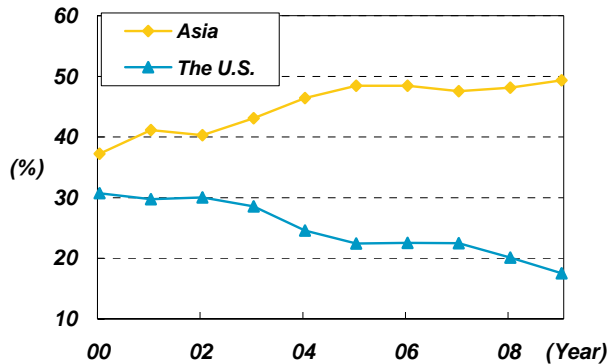
(Source) Bloomberg

Exports Supporting Japanese Economic Recovery

Exports Supporting the Recovery of the Japanese Economy

As discussed earlier, the ongoing economic recovery in Asia and the U.S. has provided a major boost to Japanese exports, with rising exports to Asia especially having an effect. While there was no meaningful gap between exports to Asia and those to the U.S. in terms of the contribution to the overall value of Japanese exports 10 years ago, the situation has changed dramatically since then. In 2009, Asia-bound exports accounted for more than half of Japan's total exports, while the percentage of exports to the U.S. was down to below 20%. The U.S. and European economies have been stably growing for quite some time. Meanwhile, although not entirely immune to some fluctuations caused by economic cycles, emerging economies have been thriving on growing consumer spending, helped by significant capital spending and rising income levels that accompany a phase of rapid economic growth, which is expected to lead to a further expansion in domestic demand. A rising proportion of exports to Asia in overall Japanese exports, assisted by Japan's contribution to the growth of Asian economies, should serve as a major pillar to support the country's economy going forward.

Proportion of Asia and the U.S. in overall Japanese exports (value)



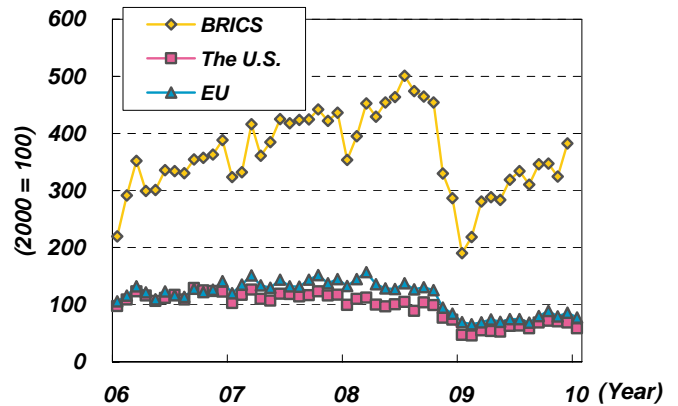
(Source) Bloomberg

Although exports, the key driver of the economic recovery, are expected to grow further, there are some concerns in the short term, including a potential demand slowdown in China, the country that has the ability to greatly affect the entire Asian economy as earlier mentioned, brought on by the Chinese government changing its policy. After implementing an aggressive economic stimulus package, the Chinese government shifted to a monetary tightening policy at the end of 2009, causing some worries about a potential dip in the Chinese economy. Against this background, there are growing concerns over a possible downshift in Japanese exports to China after years of solid expansion. Yet high economic growth is top of the agenda for Chinese policy makers, who did not resort to the tightening to cool the economy, leading us to believe such concerns will eventually subside.

Meanwhile, the Greek budget crisis is seen as another uncertainty. Some eco-watchers have expressed worries about a potential impact on the overall eurozone economy due to anticipated knock-on effects in the region. Yet any direct impact on Japan should be minimal as the European economy represents a small portion of Japanese exports compared with Asia and the U.S.

On the other hand, it should be noted that the recovery in Japanese exports is supported disproportionately by automobiles. Toyota's recall issue in the U.S. is likely to result in reduced Japanese auto sales in the world's largest economy at least in the short term, curbing the growth in exports. While we currently believe the recall effects will be short-lived, it seems necessary to keep a close watch on the developments.

Exports to BRICS (value)



(Source) Bloomberg

Summary

With the Japanese GDP growing for the third quarter in a row, its domestic economy remains on a modest recovery path after weathering the worst phase. The economy, however, still suffers from high unemployment and deteriorating household income, pointing to a prolonged slump in consumer spending, which has left businesses unwilling to spend money on new equipment. Recent developments indicate the Japanese economy remains fragile in the absence of any visible driver, suggesting that its recovery will be supported mainly by the rising exports helped by expanding overseas demand for the near-term future. Yet export growth will eventually lead to a pickup in capital spending by Japanese companies as well as an improved job market, which should represent a self-supported cyclical recovery of the Japanese economy.

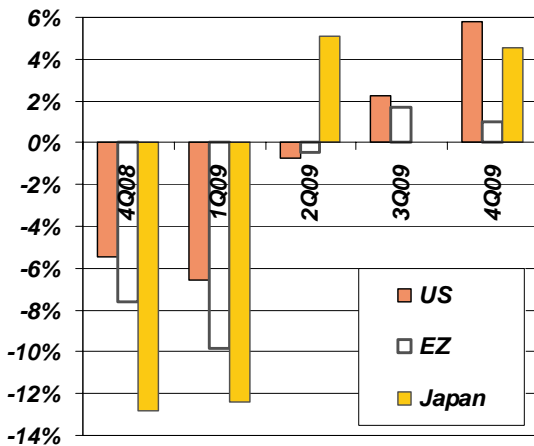
The Shape of Global Economic Recovery

G-3 GDP overview

Of course, we expect many revisions in the data in the quarters and years ahead, but the general path of G-3 GDP recovery is quite clearly a moderate one, especially compared to previous recoveries. Notably, the US utilizes many more statistical methods to boost its GDP reported numbers than does the Eurozone or Japan, so this likely represents 0.5%-0.7% per annum of the growth differentials.

As mentioned on p.1, Japan's GDP numbers were recently greatly revised, with the initially reported surge in 3Q09 GDP now revised down to flat growth. This boosted 4Q09 sequential growth, with consumer spending and net trade leading the way, while private capex, both residential and non-residential, lagged badly. The Eurozone's 4Q09 GDP is not confirmed yet, but we expect a 1.0% QoQ annualized rate, mostly due to the retrenchment in consumer demand after government stimulus incentives were removed. The US's 4Q grew only 1.9% excluding the inventory factor, with personal consumption growing only mildly after the auto stimulus disappeared, while private capex soared.

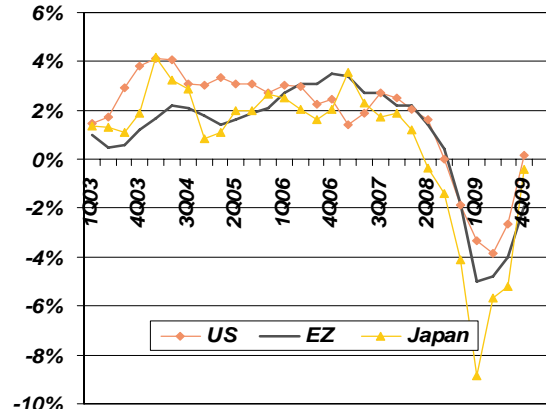
G-3 GDP Growth: QoQ Seasonally Adjusted Annual Rate



Source: Bloomberg, 4Q Eurozone estimate by Nikko AM

An additional GDP comparison, which eliminates some of this quarterly volatility, is the 2H09 annualized growth rate vs. the 1H09. For Japan, the US and the Eurozone, such rose 2.5%, 2.4% and 1.0%, respectively, confirming our expectation early in 2009 that Japan would have the strongest 2H within the G-3. As for YoY terms, Japan and the US were virtually flat in the 4Q09. Europe continues to lag behind, at about -2% YoY, although it also fell less during the crisis.

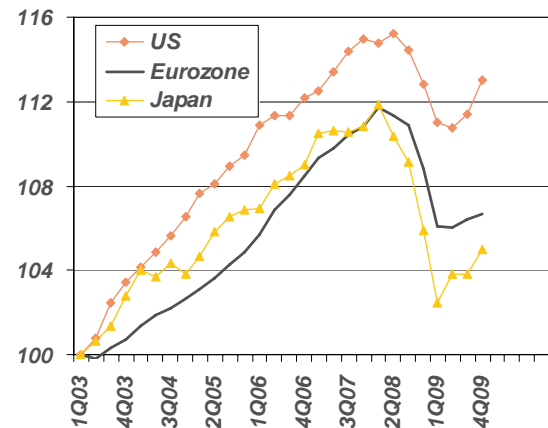
G-3 GDP YoY Growth



Source: Bloomberg, 4Q Eurozone estimate by Nikko AM

Rebasing to 1Q03 levels, as per the chart below, we see that Japan lags the US and Eurozone. Japan had been tracking the Eurozone quite closely until the crisis began in the 4Q7, but since then, has performed considerably worse.

G-3 GDP Rebased Growth



Source: Bloomberg, 4Q Eurozone estimate by Nikko AM

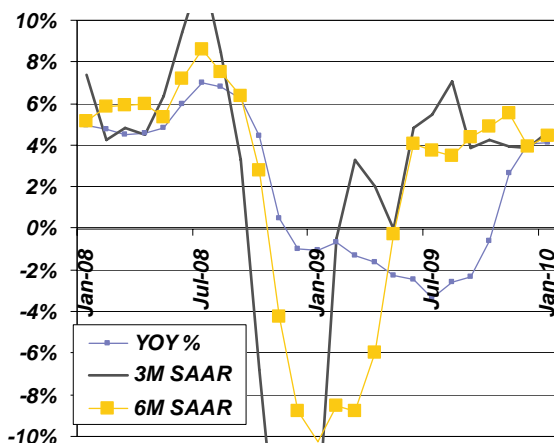
Conclusion

It is important to note that the divergence in inventory patterns remains extremely wide, with the US now needing to build up its inventories, while Japan still likely needing to shrink inventories. If it were not for this factor, we would be optimistic that Japan's GDP growth would exceed that of the G-3 in 2010, but given this and other factors, we currently expect it to slightly lag the rest of the G-3. However, we expect private capex to be a new major factor in Japan's 2010 GDP growth, with net exports continuing to support growth along with mild increases in consumer spending. Excluding the inventory effect, these underlying GDP growth factors should encourage equity investor sentiment, while providing caution to the deflationary bond market bulls.

The Schizophrenic US CPI

The US CPI is a mixture of many trends, but the most striking to us is the divergence between the shelter component, which includes housing, and the rest of the index (Ex-shelter. CPI). Not only is the Ex-Shelter CPI rising 4% YoY, which is partly due to the low commodity prices a year ago, it is also rising at this same high level on a 3-month and 6-month seasonally adjusted annualized rate (SAAR). Thus, there are ongoing sources of US inflation. These are greatly driven by global demand for crude oil and foodstuffs. However, it is not just global growth factors pushing up US prices; rather, medical, education and other goods hit by higher consumer taxes (particularly cigarettes) are also domestic inflationary factors, with YoY rates rising 3.5%, 4.6% and 7.8%, respectively.

US Ex-Shelter CPI (cropped)

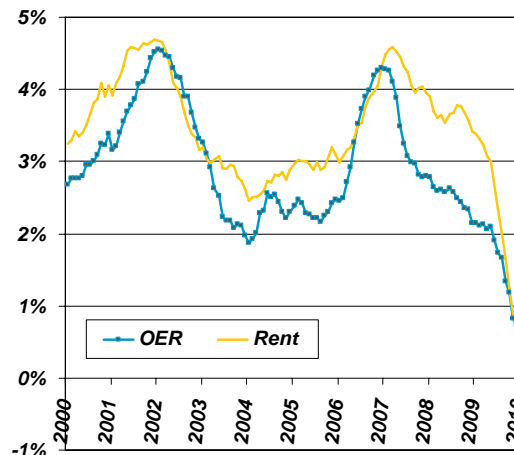


Source: Bloomberg

The shelter component has been relatively flat since Nov08 and turned negative YoY for the first time ever in Jan10, when the MoM decline was very large, at -1.2%. A conspicuous oddity about the number was that it was driven mostly by a MoM plunge in "lodging away from home" costs (hotel charges) which fell by 2.1% MoM, a decline **only exceeded twice in this component's history** (Sep01 and Sep05). We cannot find the fundamental reason for this large decline, which is important as shelter comprises 32% and 42% of the CPI and Core CPI, respectively, and this played a significant role in the surprisingly low -0.1% MoM move in the Core CPI in January vs. a consensus estimate of +0.1%.

The two largest components of the shelter are Owner's Equivalent Rent (OER, which is the amount an owner would theoretically rent his house for) and Rent (which is based on a survey of rented homes that often has a very small sample size). These two components are not declining YoY yet, so it is hotel charges, at -5.8% YoY, that is forcing the shelter index into negative territory. The current explanation in the market for this is that despite the surge of foreclosed families being forced into becoming renters, the supply of foreclosed homes is large enough (and some former owners are doubling up with friends or family) that rents are now weak. Obviously, hotels have been suffering during the crisis, but industry reports have been showing increases in their business activity rather than the sharp deterioration implied by these numbers.

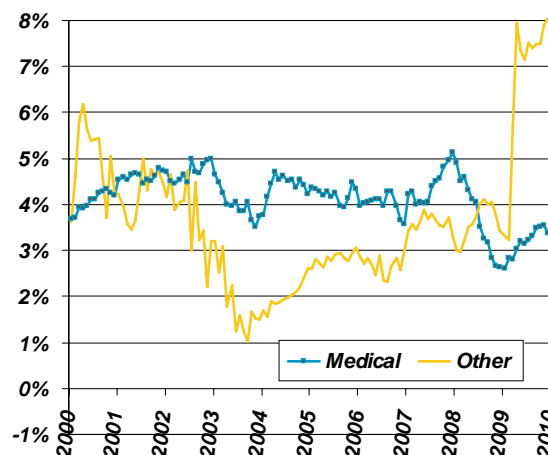
US Ex-Shelter CPI



Source: Bloomberg

The US CPI is very rarely revised, so if this hotel component is not accurate, then we will likely see a large MoM gain in February, which would likely lead to the Core CPI rising more than expected. However, if this component stays low, it indicates that the Core CPI will be suppressed.


Rising Domestically Driven CPI Components



Source: Bloomberg,

Conclusion

Many investors will likely be surprised to know how much inflation is rising in the US when stripping out shelter costs. Not only are globally driven costs, especially energy and foodstuffs, rising but some domestically driven costs are rising too. Thus, while core inflation may look low, this is not necessarily indicative of low global inflation trends. As regards the question of rising sales taxes, this will very likely be a significant factor for CPI increases in the G-3's future. Whether or not this is considered true inflation by economists will not likely matter to actual consumers, who may push for higher wages to compensate for such. Thus, it is a trend that investors should watch very closely.



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