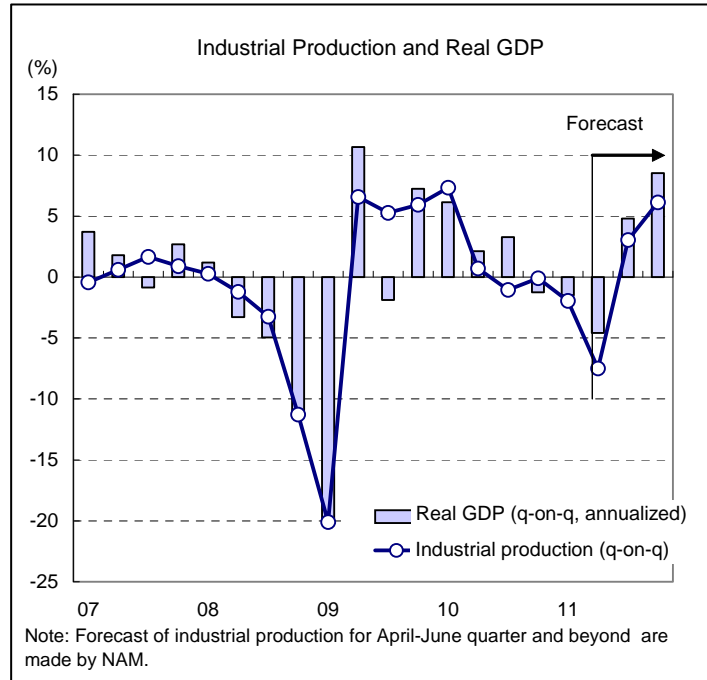


June 2011

I. (1) Economic Impact of the Tohoku Earthquake and Prospects for the Recovery

- Nomura Asset Management's (NAM) forecast for Japan's calendar year (CY) 2012 real gross domestic product (GDP) growth is 3.2%, up from an expected rate for CY2011 real GDP growth of just 0.1%.
- Although there has been a temporary deterioration in Japanese economic indicators due to supply side constraints, such as capital stock damage, supply chain disruption, and electricity generating capacity shortfalls, we have already started to witness signs that these constraints are easing. We expect the supply chain to return to normal this autumn, as production bases in the disaster-affected areas are restored or the users quickly switch to substitute components.
- As for power supply during the summer peak demand, Tokyo Electric Power Company (TEPCO) has revised its output capacity estimate upward to 55 million kilowatts, which meets average peak demand during the summer. NAM believes that the risk of severe supply shortages is substantially reduced.
- NAM forecasts a V-shaped turnaround during the 3rd quarter of 2011 (July to September), when the supply chain is expected to be restored. We have started to see financial support for the reconstruction, and a recovery in private sector capital spending and rebuilding of inventories. This view has been widespread recently in the market.
- As for the Corporate sector, recurring profits (ex financials and utilities) are expected to be flat or to decrease slightly this fiscal year (yoy), while recurring profits for fiscal year 2012 are expected to rebound to a growth rate of 15-20%, helped by the economic recovery.



(Annualized growth rate year-over-year (yoy) Apr-Jun :
-4.3%; forecast for Jul-Sep: +4.9%)

Source: Nomura Asset Management Co., Ltd.

I. (2) Policy and Corporate Action Required to Sustain a Recovery.

- Concerning fiscal policy, we hope the government and the main opposition parties can quickly come to an agreement and pass the second supplementary budget soon.
- Government debt is likely to become an even more serious concern following the earthquake. Maintaining public debt at a long-term sustainable level is a very important issue, but the timing of any fiscal contraction or tax increases needs to be considered with caution given the risk of a further decline in economic activity. Unless the timing is right, economic activity could shrink and lead to a further drop in tax revenue. The authorities must carefully balance the interrelationship between economic activity and fiscal conditions while outlining a clear timetable. Fiscal reform must be based on a credible long-term plan, balancing issues such as social security and the impact on the real economy.
- The Bank of Japan (BOJ) has maintained its “comprehensive” monetary easing policy over the past year, and this has been effective in preventing a rise in the risk premium of risk assets. What’s more, the BOJ has proceeded smoothly in meeting emergency funding demands. We believe the BOJ needs to expand its lending program aimed at spurring growth in industries with strong growth potential, while also supporting credit creation.
- Meanwhile, the BOJ’s balance sheet has not expanded since the major fund supply operation right after the March 11 earthquake. This fund injection was not considered sufficient, so in order to secure an economic recovery and to achieve the target inflation rate, more aggressive monetary easing is expected.
- In particular, we are focusing on the difference between the BOJ’s actions and the speed at which central banks of other developed countries are expanding their balance sheets. If the expansion of the balance sheet is not speedy enough, there is a risk that the yen’s appreciation will advance further. Therefore, we expect an aggressive attitude from the BOJ, with greater sensitivity to changes in market and economic conditions.
- Disruption following the Tohoku earthquake revealed that supply chain management systems that minimize inventories, typified by Toyota’s “just in time” inventory management system, has become established across a wide range of industries, not just the automobile industry.
- We believe there are likely to be three major changes in terms of company management: 1) shifting some functions overseas for the purpose of diversifying suppliers and production base, 2) modifying component supplies to allow more versatility in order to enable the use of substitutes; and 3) adopting cloud computing to ensure that administrative systems and the flow of information continue to operate regardless of location.
- However, concerns over the hollowing out of industry in Japan are likely to intensify, and its negative

impact on the macro economy would be significant. Therefore, the government needs to establish new policies that encourage companies to engage in domestic investment and support workers to help them develop new skills to adapt to new working methods.

- Moreover, the government needs to identify job creation methods to compensate for job losses within the Manufacturing sectors, and also needs to devise a new energy policy. In particular, investments in alternative energy sources, an initiative taken by politicians, could be a focal issue. Becoming a pioneer within the alternative Energy sector is an attractive proposition. If it is possible to shift labor simultaneously as these new industries develop, then the employment pinch caused by the March 11 disaster could become an opportunity if viewed from another angle.

I. (3) NAM's Evaluation of Support Scheme for TEPCO and Impact on the Financial Market.

- Although we can only hope that the nuclear power plant problem can be brought completely under control, we think it will take much longer than is specified in TEPCO's road map to restore stability to the damaged Fukushima Daiichi nuclear plant.
- Under Japanese law, the operator of a nuclear facility can be granted an exemption from damages caused by a reactor if the accident was deemed to have been triggered by "a grave natural disaster of an exceptional character". Strictly speaking, the widespread damage to TEPCO's nuclear plant was caused originally by an unprecedented natural disaster. Therefore, there are some basic doubts about whether TEPCO should be exempt from damages claims this time, although such action would probably be met with great public disapproval.
- Because the point of the government's announced bailout scheme for TEPCO's compensation is how and by whom the damages resulting from the nuclear accident are paid, there are conflicts of interest between stakeholders and there are arguments both for and against these measures. Nevertheless, the shared objective is to avoid a corporate collapse and its potential costs, and to ultimately minimize the national burden. TEPCO needs to secure smooth and reliable funding sources to sustain the electric power supply. This needs to be addressed quickly, and we hope the government and opposition parties can arrive at an agreed framework as a matter of priority.
- Japan needs to establish a scheme to accomplish 3 pressing issues: smooth compensation, stable power supply, and measures to prevent turmoil in the financial system. Yet there are many issues of deep concern that could lie in the way of passing the required legislation. A wrong turn could result in even greater compensation costs and a larger government debt burden. In 2008, the U.S. government took public

sentiment into consideration when it chose not to save Lehman Brothers; and the end result was higher unemployment, lower tax revenues, and a swelling budget deficit. If the United States had allowed the Freddie Mac and Fannie Mae housing loan agencies to go bust, the U.S. real estate market could have suffered a devastating blow, which might have further inflated the deficit. In Japan, the measures that need to be taken immediately will require massive budget spending – compensation payments for victims of the nuclear crisis, stabilizing the crippled Fukushima Daiichi nuclear power plant, power supply restoration, and a recovery budget. It is important to press ahead with securing the budget financing, or at least if there are further delays, we believe the government should at least secure the immediate short-term liquidity.

- Haphazard policy making will only increase the uncertainty over the economic outlook. It will also diminish the risk appetite of management, investors, and consumers. In the short-term, we expect the government to pass the essential bills, such as a bailout scheme to cover TEPCO's compensation, a second supplemental budget, and a bill to permit deficit bond issuance. Afterwards, we will need to face up to the long-term issues and some careful policy choices will be necessary. Eventually, the conditions will be established to permit a recovery in the Japanese equity market.

II. (1) Outlook for the Japanese Equity Market and USD/JPY Exchange Rate.

- Corporate earnings are expected to decline during the first half of the fiscal year, followed by a rapid recovery. Valuations still look cheap, while low interest rates will also support economic activity. Free cash flow from the Corporate sector remains abundant, so once managers regain confidence in the economic outlook, the environment is there for managers to encourage investment.
- NAM has continued to attract new asset inflows from foreign investors and this has been increasing since the Tohoku earthquake for the Japanese stock market in general too.
- We analyzed the reasons for this and arrived at the following conclusions: The Japanese market seems to have significantly lagged behind the global equity market and remains attractive. We think it is an opportune time for investors who have been underweight the Japan equity market to raise their exposure to Japan. By overcoming the handicap of operating in a low growth country, we think Japanese companies are capable of generating higher profits than their market prices and low valuations indicate. As long as this outlook prevails, the trend of foreign investors remaining net buyers of Japanese stocks could continue for a while.
- For the currency market, NAM has forecast a dollar-yen rate of around 80 yen for the end of fiscal year 2011, ending March 2012.
- The risk of a further rise in value of the yen against the dollar appears to have eased temporarily.

- In terms of the real effective exchange rate, the yen has been appreciating since 2007, and this seems to have been a correction from its earlier weakness. The yen exchange rate is already strong and is now less likely to appreciate further. An even stronger yen than the current level would make Japanese companies less competitive and lead to unfavorable equity market conditions. Meanwhile, pressure for a stronger yen/weaker dollar remains from a financial perspective. The U.S. seems to have little room for further flexibility in either its fiscal or monetary policy. The dollar will not start to appreciate until the Federal Reserve Bank raises the interest rate several times, in other words, pressure for the yen to appreciate will remain in place for a while longer. Market expectations for the yen's depreciation/dollar appreciation are spreading, based on a pessimistic view of the Japanese market, but our view is different.

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