

## **Outlook for Japanese Market and background of simultaneous decline of global stock markets**

Global equity markets have become increasingly unstable and volatile since the beginning of August. The S&P500 Index posted a weekly loss of -7.2% for the week ending August 5<sup>th</sup>, which is the single biggest weekly decline since November 2008. Moreover, the ongoing sovereign debt crisis in the European Union (EU) has resulted in double-digit losses for market indices in Italy and Germany. In Japan, the TOPIX Index also declined, posting a loss of -4.8% from the week before.

### **Change of Fiscal and Monetary policy in Europe and the U.S.**

Sovereign debt problems in Europe and the U.S. have been the main cause behind the current worldwide decline in stock markets, while the worsening economic conditions in the U.S. have also weighed on stock prices. Although the employment statistics for July were positive, other economic indicators continue to highlight subdued economic conditions, while there are growing concerns that the stagnant economic situation might be prolonged.

We understand that such changes in monetary policy, both in Europe and the U.S., are the underlying causes of the volatile financial markets and weak economic conditions. The European Central Bank raised interest rates in April of this year for the first time since July 2008, and followed with another interest rate hike again in July. This situation now reminds investors of the Lehman shock, which occurred soon after the European Central Bank (ECB) raised interest rates in July 2008. In the U.S., the so-called quantitative easing (QE2) policy, which includes balance sheet expansion by the Federal Reserve through purchases of Treasury bonds, finished at the end June this year. Such changes in monetary policy, both in Europe and the U.S., are believed to be among the catalysts for the current volatility in the financial markets.

Currently, there are not many policy options left available. Even if western governments wanted to introduce fiscal stimulus policies, the current level of public debt is so high that it would be difficult for the governments to increase their budget deficits further to fund additional fiscal spending. Moreover, increasing public spending does not seem to be a popular policy option in many developed countries.

Loose monetary policy also has some inherent risks, as QE2 is perceived to have been one of the main causes of the surge in commodity prices. Higher gasoline prices during the first half of this year had the effect of depressing personal consumption even further. The QE2 policy was successful in preventing deflation but the probability of higher prices before any improvement is seen in the employment situation is considered a negative outcome.

Last week's downturn in the global financial markets was close to panic. The probability is high that current prices in both the stock markets and bond markets may have already discounted a future slowdown in the global economy.

## Outlook of Global Equity Market

Global capital and equity markets reacted with panic last week to the extent that current equity and bond prices now appear to have reached price levels where they already reflect the risk of a global economic recession. Last week, we also witnessed growing concerns about the stability of the financial system in the EU and questions over the capital raising abilities of European banks on the back of the ongoing sovereign debt crisis. With these negative events dampening investor sentiment, trading in the equity markets subsided as investors became more risk averse. In essence, this reflects how investors and financial institutions alike, after the collapse of Lehman Brothers in 2008, became more self-conscious about protecting their investment capital by taking risk averse positions. However, the markets have become prone to violent fluctuations when this risk aversion becomes universal; and this is exactly what occurred in the markets last week, when investors “herded” towards the same behavior.

Our in-house outlook suggests that governments and the central banks of the leading economies will not overlook the unfolding situation, which has the potential to cripple the global financial system. The G7 (members are Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) convened an emergency meeting for August 8th to declare their commitment to take any means necessary in order to stabilize the financial markets and provide them with ample liquidity. Lessons that were learnt from the collapse of Lehman Brothers are indispensable and we can expect to see an ample supply of liquidity to be injected into the markets to maintain the integrity of the financial system. In addition to the actual market prospects, we can expect the course of fiscal and monetary policies in certain countries and regions to undergo some changes. For example, the Federal Reserve Board will consider the possibility of additional monetary policies centered on creating more jobs and also aimed at stabilizing the housing market as well as the financial markets. As for the ECB, it decided to revive its bond-buying program last week. Over the weekend, it was announced that Italy’s BTPs (Italian Government Bonds) and Spain’s SPGBs (Spanish Government Bonds) were to be included on the list as a part of this asset purchasing scheme. We expect the ECB to maintain its stance on tightening fiscal policies, but with a new situation surfacing, it is likely to become vigilant in assessing the timing of any interest rate increases. Additionally, with the expansion of the European Financial Stability Facility (EFSF), the EU will look to make further commitments in sustaining fiscal conditions and implementing structural reforms of its member countries.

Turning our attention to the financial conditions of developed country governments, the sheer size of their fiscal deficits seems ominous for the investment outlook. However, the landscape is significantly different for the private sector in these countries. Wage growth pressure remains subdued and corporations have made a huge effort to cut costs. Therefore, their current profit to revenue ratios are very high. Despite the moderate growth of the global economy, corporate profits have been consistently trending upwards since the Lehman Shock. Going forward, we expect this trend to decelerate to some extent, but companies will start to resume investments to expand production capabilities, which they have foregone for some time. We

expect these investments to facilitate further economic growth. If capital is utilized in other ways such as to buy back shares or pay out dividends, this may also be of benefit to stockholders. Either way, it could have a positive effect on stock prices.

Inflationary pressures have forced most developing countries to tighten their monetary policy, which has been one of the main factors behind the deceleration in economic growth and the lackluster performance of domestic stock prices. As the slowdown in the global economy becomes more tangible, commodity prices will begin to decline and will cause inflationary pressures to subside naturally, which will allow governments to implement measures to revive their lackluster economies. Emerging countries with large populations and high levels of domestic demand will suffer less impact from the economic doldrums of the Western countries. Considering this, we can expect the economic growth of the emerging countries to help lift the global economy going forward.

### **Outlook of Japanese Equity Market**

Although it is disturbing to see a global economic slowdown and a market slump so soon after witnessing such a rapid recovery from the Japan's post-disaster supply chain disruption, we still have a broadly positive view of the Japanese equity market.

One factor behind our confidence in a Japanese market recovery was the Bank of Japan's (BOJ) decision to provide additional monetary policy stimulus to expand its special fund for asset purchases. Given the saturation of the U.S. and EU central bank's monetary policies, we think the BOJ's actions will be evaluated positively. As part of the 10 trillion yen expansion, the BOJ plans to buy additional assets so the pricing of risk assets such as equities will be supported by the BOJ's actions. However, if the central banks of the EU and U.S. offer further monetary easing, it is also possible that we will see pressure for the value of the JPY to appreciate, such that further expansion of Japan's domestic monetary policy may be necessary.

Another reason is the progress we are seeing in managerial attitudes of Japanese companies. News of a planned merger between Nippon Steel Corp. and Sumitomo Metal Industries is still fresh in our memory. Also, according to news released last week, the two major infrastructure companies might have begun hashing out business integration plans, a move that could spawn the world's largest infrastructure firm. The news was not officially verified, but there is a movement even among the smokestack industries that companies should end their war of attrition through price competition in the Japanese market and instead concentrate on enhancing their global competitiveness. A sense of impending crisis is becoming more widespread among Japanese management. Many managers of Japanese companies are working on reorganization and restructuring and are struggling for survival; so by putting the chaotic political situation and the uncertain economic outlook aside, they may be able to create shareholder value. This movement is likely to become more established among larger companies and should encourage shareholders.

Major Japanese companies are generating strong free cash flow and are likely to start making strategic investments globally. Although corporate earnings in Japan are expected to increase this fiscal year (FY), the Japanese stock market has declined due to concerns over the U.S. and European economies. The estimated TOPIX forward P/E ratio (Price-to-Earnings) for FY 2011 is 14.8, the actual P/B ratio (Price-to-Book) for the past 12 months is 0.95, and the dividend yield<sup>1</sup> is around 2.3% (as of August 5<sup>th</sup>, Bloomberg data). This dividend yield is twice as high as the yield on 10-year government bonds.

Therefore, we believe the market is currently undervalued, and instead of using a historical risk return profile, it is more informative to focus on the value of Japanese equities given the current price level. After the devastating earthquake in March, we saw the number of international investors increase their investments in Japanese equities. With concerns growing in the U.S. and European economies, there seems to be a growing preference for Japanese equities among international investors.

Investors can afford to be less nervous in a market that has already declined significantly. Rather, we would recommend that investors should recognize the ability of these companies to generate earnings as well as their ability to sustain their dividends payments. Governments of all major developed and emerging countries have to deal with deteriorating economic forecasts, so until investor psychology calms down, patience may be needed. At Nomura Asset Management, we will continue to monitor the changing investment environment and identify stocks that offer worthwhile investment opportunities.

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<sup>1</sup> Dividend yield does not represent any Nomura Partners Fund's yield.

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