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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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# Downunder Daily

## The Big Disappointment

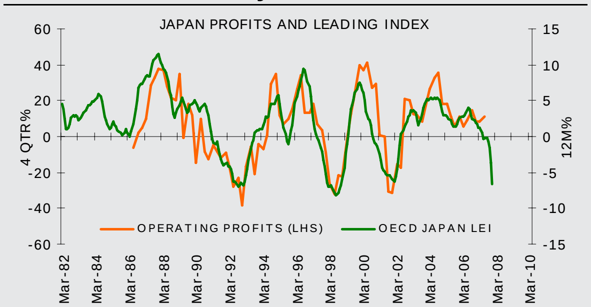
**Japan gets my vote for the stand-out disappointment of 2007.** It has the world's worst performing major equity market (down 10% year-to-date, and the only market down even in US$ terms), and the economy has slowed despite signs last year that it was shrugging off the structural problems that dogged it through the 1990s. More worrying, some leading indicators are pointing to worse to come.

In fact, some indicators are pointing to much worse to come: The OECD's leading indicator for Japan now points to a recession-type fall in operating profits (Exhibit 1). The leading indicator has an excellent track record, so this warning should be taken seriously.

These concerns exist even though Japan arguably has the world's cheapest major currency and sits amidst the globe's hottest economic region. It is true that net exports are adding a substantial amount to growth (1.0 percentage point over the four quarters to September, out of total GDP growth of 2.2%). Exhibit 2 shows the link between the net export contribution to GDP and the real yen trade-weighted index (inverted in the chart, so the line goes up when the yen goes down).

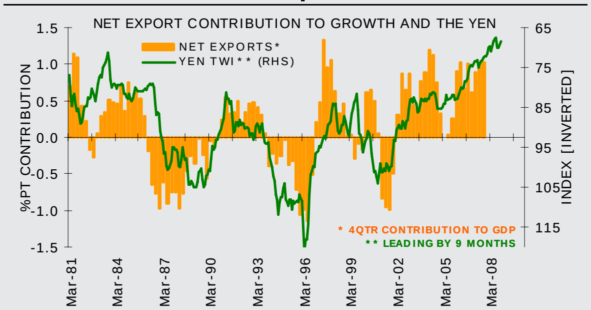
But even here Japan has disappointed. Export growth has slowed over the past three years. The net export contribution has remained high because import growth has slowed by more than exports. Exhibit 3 shows that Japan has not increased its market share amongst its trading partners, despite currency decline. (Yet again underscoring the relative unimportance of currency movements in explaining export performance – a point likewise reflected in America's relatively lackluster trade response to sustained dollar declines.)

Exhibit 1
**Is the Outlook Really This Bleak?**




Source: OECD, Cabinet Office; Morgan Stanley Research

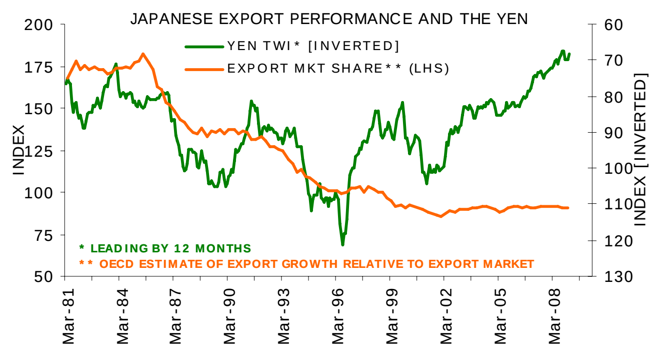
Exhibit 2
**The Boost from a Cheap Yen**




Source: Cabinet Office, JP Morgan; Morgan Stanley Research

Domestic indicators look tepid, at best. Business investment spending has stalled (Exhibit 4). The slowdown in investment is despite the reported ongoing willingness of bankers to lend.

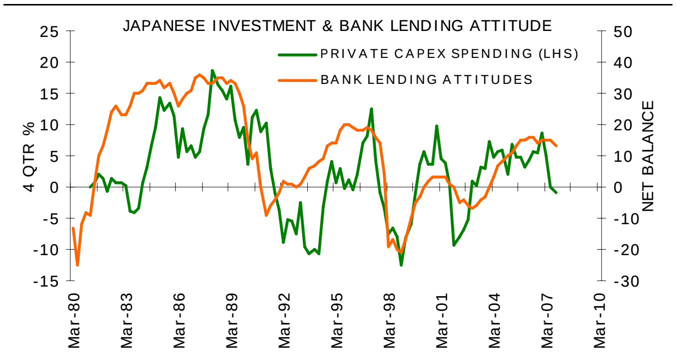
Exhibit 3
### No Gain in Export Market Share




Source: OECD, JP Morgan; Morgan Stanley

Consumer spending has been supportive, but headwinds are starting to appear. Consumer confidence measures have fallen sharply over the past half-year. Historically, consumer confidence has correlated with spending, although admittedly this link has loosened in the past three years (Exhibit 5).

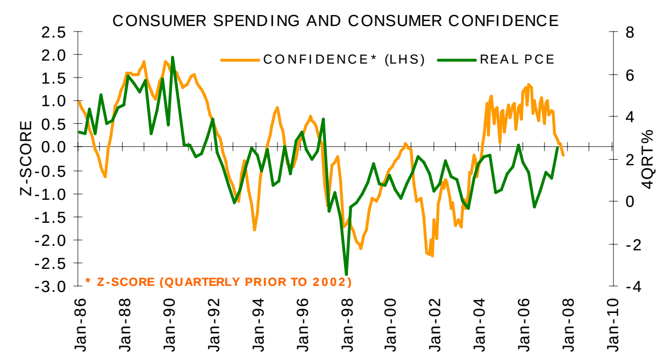
Exhibit 4
### Capex Stalls – Profits to Follow?




Source: Cabinet Office, Bank of Japan; Morgan Stanley Research

More importantly, the labour market appears to have weakened. Employment has fallen in each of the past five months, and is now 0.1% below year-ago levels. Real labour income is up only 0.5% on year-ago levels, the weakest growth since March 2004.

Exhibit 5
### Consumer Confidence Falls




Source: Cabinet Office; Morgan Stanley Research

It's remarkable that Japan's outlook is, at best, mixed, given an exceptionally low currency, still-low interest rates, and the benefits of a booming Asia on the doorstep. Indeed, the risks now seem slanted to further deceleration heading into 2008.

Although investors have become used to soggy growth in Japan, it remains one of the world's three largest economies (at market prices), and it has contributed to the strong tone in global activity over the past four years. Consequently, the deteriorating outlook adds to the picture of downside risk to global growth for 2008. It also suggests that, aside from being denominated in a cheap currency, Japanese equities don't offer a lot of macro attraction.

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|---|---|---|---|---|---|
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