Japan

This Time For The Money

Grant's Interest Rate Observer 2013 Spring Conference
2013 is a Tokowaka Year in Japan, Time For Real Change

“Tokowaka” – continual renewal

The Ise Grand Shrine

Source(s): Taiyo Pacific Partners, Tokowaka – Continuous Renewal – Shrine being torn down and reconstructed for 61st time since 678.
JG: Negative Real Returns in Traditional Assets Till 2020

GMO 7-Year Asset Class Return Forecasts*  
Alpha

As of February 28, 2013

<table>
<thead>
<tr>
<th>Stocks</th>
<th>Bonds</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.6%</td>
<td>4.1%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

6.5% Long-term Historical US Equity Return

*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

Source(s): Grantham, Mayo, Otterloo ("GMO").
Japan: A Developed Market With Solid Forecast Returns

Components of annual return of Japan stocks, with regression over 7 years

<table>
<thead>
<tr>
<th></th>
<th>P/E</th>
<th>Profit Margin</th>
<th>Real Sales per Share Growth</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting Levels</td>
<td>12.3</td>
<td>3.4%</td>
<td>0.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Assumption for Next 7 Years</td>
<td>15.0 (Terminal Value)</td>
<td>3.1% (Terminal Value)</td>
<td>2.5%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

Gain from P/E - Loss from Margin Decrease + Gain from Sales Growth + Dividend Yield = Total Return

Gain from P/E: 2.8%
Loss from Margin Decrease: -1.7%
Gain from Sales Growth: 2.5%
Dividend Yield: 2.9%
Total Return: 6.6%

Source(s): GMO.
Japanese Equities are Cheap vs. ROW and to Own History

Source(s): Taiyo Pacific Partners, Tradingeconomics.com.
Bonus: Depreciation Overstated, Book Value Understated

Accounting Differences Result in Significantly More Free Cash Flow in Japanese Corporations

Source: Sloane Robinson.

Source: Goldman Sachs. As at January 2013
Buffet’s Favorite Valuation Indicator Not Stretched Here

Source(s) Tradingeconomics.com.
Current Rally is Just Getting Started, Lots of Headroom

 THE JAPANESE EQUITY RALLY IN CONTEXT

Japan Nikkei Rallies Since 1989

12% ROE, P/B 1.5, Plus Overshoot

The rally in Japanese equities still looks more typical, than atypical.

12% ROE, P/B 1.5

Current Rally

Source(s): Strategas Research Partners, Sloane Robinson estimates.
“Abenomics” is the Plan to Create the Tokowaka Renewal

Abe government’s "Print & Spend" economic policy framework is the most aggressive attempt by a Japanese government in recent history to tackle the country’s two-decade long deflation once and for all.

- Aggressive monetary easing to overturn the Yen’s appreciation
- Flexible fiscal expansion to support domestic demand
- Long term strategy to revive domestic investment

Source(s): Japantimes.co.jp, Instinct Capital.
Japanese Corporations Fighting Yen for Past Twenty Years

Nikkei—23-Year Downtrend Is Broken

Japan Nikkei 225 Index

12 Rallies:
+47% Average

USDJPY: Price of 1 USD in JPY

Source(s): Strategas Research Partners.
By Relentlessly Slashing Costs, Maintained Profit Margins

Source(s): Sloane Robinson, Nezu Asia.
Difficult Growth Environment, GDP Nearly Flat Since ‘96
Japan Mired in “Noflation” for 20 Years, New BOJ Target 2%

Could Take Two Years, But Commitment Seems Real

Source(s): Tradingeconomics.com.
BOJ Been on Sidelines Since Crisis, Let The War Begin…

The BOJ has a lot of catching up to do.

Source(s): Strategas Research Partners, JP Morgan.
We Have Seen This Movie Before…

Source(s): Japantimes.co.jp.
Abe I Challenged Hawkishness of Koizumi, Topix Doubled

Source(s): Nezu Asia.
Within Broad Bull Market, Some Really Huge Winners

<table>
<thead>
<tr>
<th>Top 10 sectors in 2005</th>
<th>CY2005 performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 MINING</td>
<td>104.9%</td>
</tr>
<tr>
<td>2 REAL ESTATE</td>
<td>100.6%</td>
</tr>
<tr>
<td>3 NONFER METAL</td>
<td>86.6%</td>
</tr>
<tr>
<td>4 IRON &amp; STEEL</td>
<td>84.1%</td>
</tr>
<tr>
<td>5 WHOLESALE TRD IND</td>
<td>82.3%</td>
</tr>
<tr>
<td>6 TXTL &amp; APPRL</td>
<td>74.7%</td>
</tr>
<tr>
<td>7 MACHINERY</td>
<td>70.2%</td>
</tr>
<tr>
<td>8 WARE&amp;HARB TRNS</td>
<td>68.1%</td>
</tr>
<tr>
<td>9 RETAIL TRADE</td>
<td>61.1%</td>
</tr>
<tr>
<td>10 SEC&amp;CMDTY FUTR</td>
<td>59.9%</td>
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</tbody>
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<table>
<thead>
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<th>Top 10 sectors 2003-2005</th>
<th>03-05 performance</th>
</tr>
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<tbody>
<tr>
<td>1 IRON &amp; STEEL</td>
<td>295.5%</td>
</tr>
<tr>
<td>2 REAL ESTATE</td>
<td>258.2%</td>
</tr>
<tr>
<td>3 WHOLESALE TRD IND</td>
<td>226.3%</td>
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<tr>
<td>4 NONFER METAL</td>
<td>211.7%</td>
</tr>
<tr>
<td>5 MARITIME TRAN</td>
<td>210.7%</td>
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<tr>
<td>6 BANKS</td>
<td>197.2%</td>
</tr>
<tr>
<td>7 OTHER FINC BUS</td>
<td>176.0%</td>
</tr>
<tr>
<td>8 TXTL &amp; APPRL</td>
<td>175.7%</td>
</tr>
<tr>
<td>9 MINING</td>
<td>174.0%</td>
</tr>
<tr>
<td>10 GLSS &amp; CRM C PRD</td>
<td>166.4%</td>
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<table>
<thead>
<tr>
<th>Worst 10 sectors in 2005</th>
<th>CY2005 performance</th>
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<tr>
<td>1 PULP &amp; PAPER</td>
<td>17.5%</td>
</tr>
<tr>
<td>2 INFO &amp; COMM</td>
<td>17.5%</td>
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<tr>
<td>3 PHARMACEUTICAL INDI</td>
<td>20.9%</td>
</tr>
<tr>
<td>4 ELEC POWR &amp; GAS</td>
<td>21.0%</td>
</tr>
<tr>
<td>5 AIR TRANSPORT</td>
<td>22.1%</td>
</tr>
<tr>
<td>6 FOODS</td>
<td>24.3%</td>
</tr>
<tr>
<td>7 OTHER PRODUCTS</td>
<td>26.2%</td>
</tr>
<tr>
<td>8 METAL PRODUCTS</td>
<td>26.7%</td>
</tr>
<tr>
<td>9 ELECTRIC APPL</td>
<td>27.9%</td>
</tr>
<tr>
<td>10 RUBBER PRODUCTS</td>
<td>31.9%</td>
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<td>1 PULP &amp; PAPER</td>
<td>25.2%</td>
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<td>2 INFO &amp; COMM</td>
<td>32.1%</td>
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<tr>
<td>3 ELEC POWR &amp; GAS</td>
<td>37.5%</td>
</tr>
<tr>
<td>4 PHARMACEUTICAL INDI</td>
<td>43.4%</td>
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<tr>
<td>5 LAND TRANSPRT</td>
<td>47.9%</td>
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<tr>
<td>6 OTHER PRODUCTS</td>
<td>56.3%</td>
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<tr>
<td>7 ELECTRIC APPL</td>
<td>58.3%</td>
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<tr>
<td>8 AIR TRANSPORT</td>
<td>62.9%</td>
</tr>
<tr>
<td>9 SERVICES</td>
<td>63.7%</td>
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<tr>
<td>10 FOODS</td>
<td>66.1%</td>
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Source(s): Nezu Asia.
Abe II Stimulus Will Sharply Increase Corporate ROE

Projected ROE to reach a post bubble high

Note: Based on TSE1-listed firms with consolidated data available from 2006. GS Global ECS Research estimates for FY3/13, FY3/14 and FY3.15.
Source: Goldman Sachs. As at January 2013 Sloane Robinson LLP estimate.

Source(s): Sloane Robinson.
Corporate Japan Could Experience Explosive EPS Growth

The result of this potent mix of Japanese renewal and political will is an MSCI consensus estimate calling for 25% EPS growth in 2013 and 24% in 2014 for Japanese equities... more than double any other MSCI region.¹

TOPIX EPS

Source(s): Taiyo Pacific Partners, Daiwa Asset Management.
Like Abe I, There Will Be Winners and Losers This Time

Source(s): Japantimes.co.jp.
With Yen at 2007 Level of 110, Toyota’s Profits Rise 70%

Same Price as 2007 with Materially Higher Profits

Source(s): Bigcharts.com.
Trading Companies Have Gotten Religion on ROE, Profits

Source(s): Bigcharts.com.
LDP Wants Financials Market Cap to Double, Big Tailwind

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LDP Wants Financials Market Cap to Double, Big Tailwind

Source(s): Bigcharts.com.
New Zombies: The Recent Short Squeeze Might Be Over

Source(s): Bigcharts.com.
New Zombies: Signs of Life or Dead Cat Bounce? UHDTV

Source(s): Bigcharts.com
Airlines & Foods Struggled Last Reflation, TPP Change?

Source(s): Bigcharts.com.
Diapers & Gen Y Clothes are En Fuego, Input Costs Rise?

Source(s): Bigcharts.com.
Be Careful What You Ask For, You Just Might Get It…

Sayonara, Shirakawa-san, Konnichiwa, Kuroda-san, Ganbaru!

Source(s): Japantimes.co.jp.
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S&P 500 Index -- this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index – each stock’s weight in the index is proportionate to its market value. Definition is from Standard and Poor’s.

MSCI EAFE Index -- this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index -- this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

Nikkei-225 Index -- This is an index consisting of the price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. The Nikkei Stock Average was first published on May 16, 1949, where the average price was Yen176.21 with a divisor of 225.

Japan Topix - Also known as the Tokyo Stock Price Index, is a capitalization weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The index is supplemented by the sub-indices of the 33 industry sectors. The index calculation excludes temporary issues and preferred stocks, and has a base value of 100 as of January 4, 1968.

Citi JGB Index – this index is intended to measure the performance of a long position in 10-year JGB (Japanese Government Bonds) Futures. The underlying assets of 10-year JGB Futures are Japan-government issued debt securities (JGBs) with a remaining term to maturity of not less than 7 years and not more than 11 years as of their issue date and the futures contract delivery date.

MSCI Japan Index -- this is a free-float adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The index has a base date of December 31, 1987. Definition is from MSCI.

JGB – refers to Japanese Government Bonds.

BOJ– refers to Bank of Japan.
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