

JAPANESE EQUITY / OCTOBER 2009

## From a “V” to a “U?”

With the general election out of the way, Japan welcomed its new prime minister to the leadership of the world’s second-largest economy. The Democratic Party of Japan (DPJ) has come to office with a manifesto designed to please everyone, save the vested interests that kept the Liberal Democratic Party (LDP) in power these last 50 years. How they will actually govern, which parts of the manifesto can legitimately be pursued, and which parts were electioneering fluff will go some way toward defining the future of what role Japan will play on the world stage. However, it is unclear whether the DPJ or their current policy focus is sufficiently differentiated from the construct of the party, which includes the former Socialist Party of Japan and disenfranchised LDP members, to be called a vision of the future. We think that it is more likely that this election marked the start of a multi-year process, which may lead to a more profound political realignment along isolationist and internationalist lines.

Meanwhile, the market has begun to look beyond the first-half production recovery. End-demand in those sectors that do not have the financial backing of a government incentive, be they Chinese intermediate goods production or American private consumption, looks to be anemic at best. Auto sales after the expiration of the American cash-for-clunkers program fell right back to the levels seen earlier this year. More worrisome for the Japanese auto companies is the phenomenal success of Korea. Hyundai is now the second-largest seller of small autos in the United States with a 19% share, double the level of one year ago. Time and again, American consumers have shown that they lack brand loyalty when a product of similar quality can be found for lower prices. Hence, Wal-Mart now advertises flat panel television sales, with Samsung and Vizio among the top three brands available. If Korea is the new “in,” this is decidedly bad news for the domestic Japanese production base. Japan still produces 10 million automobiles domestically and only consumes four million. Exports have to go somewhere, and without the U.S. market, it is unclear where they will go.

In a sense, the reality of excess domestic production capacity is the last facet of the “Japan, Inc.” model left to unwind. The financial structure that supported the funneling of low-cost capital to exporters was badly undermined by Japan’s real estate bubble and subsequent collapse. However, the exporters were given a reprieve from a painful restructuring of their domestic excess production model by the boom in consumption in America. This, in turn, was fueled by America’s own real estate bubble. The collapse in U.S. asset prices, and consequently private consumption, has now laid bare the foundation that underpinned Japan’s export success. The export sector and, most specifically, the auto companies now face a multi-year period of production cutbacks and plant closures before any form of normality can be restored to profits. As there have been no domestic auto plant closures in Japan’s history, this is not likely to be a well-received development.

As for the second half, earnings are likely to disappoint. Most companies profiled a relatively conservative first-half forecast, which they beat, followed by a significant “V”-shaped second-half recovery. Without fiscal-stimulus-supported consumption, demand is likely to return to trend line, and the “V” will look more like a “U,” or even an “L.” This has yet to be priced into expectations. In addition, domestic consumption remains focused on low-priced goods with the likes of discounters Shimamura and Fast Retailing enjoying robust sales at the expense of pretty much everyone else. We believe the DPJ needs to act fairly swiftly to forestall a renewed downturn; while their comments are supportive, the reality of the time it will take to execute makes the probability they can stop the slowdown soon remote.

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