

Japan's Economic Revival: A Fresh Ascent

February, 2010

This month's topic: The Japanese Economy Recovery Cycle is Progressing Steadily

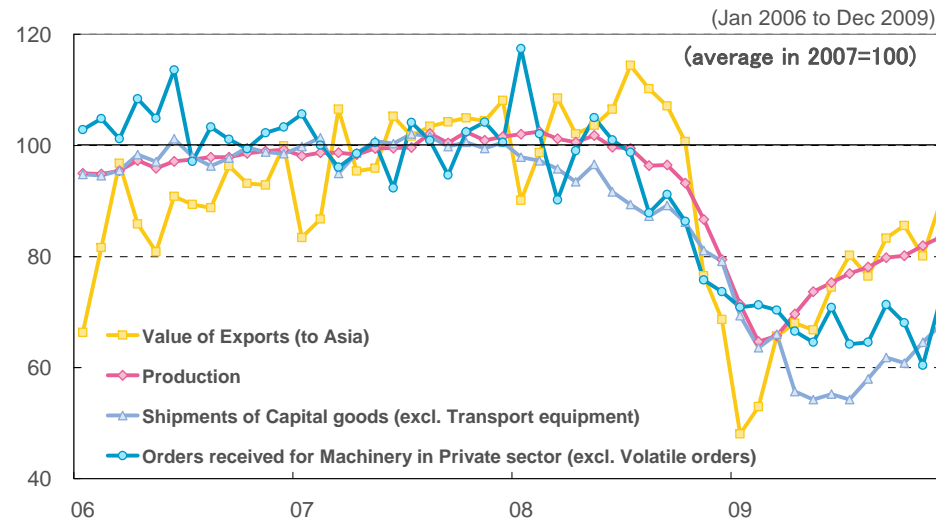
Nikko Asset Management Co., Ltd

This Month's Topic: The Japanese Economy Recovery Cycle is Progressing Steadily

The export-driven Japanese economy follows a four-stage recovery cycle; starting with a “cyclical bottom”, next comes “early stage recovery” (production improvements following export recovery), “middle stage of recovery” (improving capital investment) and finally, “self-sustaining recovery” (improving domestic consumption). Current economic indicators suggest that Japan is entering middle stage of recovery.

The Japanese economy dropped off sharply from the end of 2008 to the beginning of 2009. One year later, however, multiple economic indicators show significant improvements on a year-on-year basis. In order to see more easily how much these indicators have improved, we compared levels both at the cyclical bottom and in recent months, by setting average pre-recession indicators in 2007 to 100. Looking at export and production-related indicators, which tend to improve at an early stage of recovery, exports to Asia (accounting for more than 50% of total exports) are exhibiting improvement patterns, fluctuating from 100 in 2007, to 48 in Jan 09 and finally back up to 90 in Dec 09. Similarly, the Industrial Production Index fell from 100 to 65 in Feb 09, before climbing up to 83 in Dec 09. As these figures reveal, even though these indicators took a year to improve, they have recovered 80% to 90% of 2007 levels in recent months. As for capital investment-related indicators, which improve in the middle stage of recovery, shipments of capital goods fell from 100 to 54 in Jul 09, creeping back up to 68 in Dec 09, whilst machinery orders have fluctuated from 100 to 60 in Nov 09 and then to 73 in Dec 09. This suggests that capital investment is likely to improve in the future. In addition, the Business Watch Survey carried out in January 2010 shows that favourable increases in exports are also extending to domestic demand-related companies. In light of these positive factors, we believe Japan's economy to be on a path of solid recovery.

Changes in Values of Exports, Production and Investment-related Indicators



Source: Ministry of Finance, Ministry of Economy, Trade and Industry, and Cabinet Office. The data above represent past figures and are not a guarantee of future investment returns.

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Summary: The Japanese economy escaped the worst of the downturn and is on a recovery track driven by foreign demand

Current economic conditions	Supported by both domestic and overseas financial and economic policies, Japan's GDP growth rate turned positive in April to June 2009 for the first time in five quarters, escaping the worst of the downturn. This positive growth has also been sustained for the three consecutive quarters to December 2009.
Recovering exports	After the autumn of 2008, Japan's exports continued to see a yoy declines, but turned positive in December 2009 for the first time in 15 months. In response to recovering Asian economies (especially China), improvements in Japan's exports have become noticeable. Exports to other regions are also improving and these favourable factors offer brighter prospects for Japanese exports going forwards.
Bright signs in production and capital investment	Following the global decline in demand, Japanese companies appear to be taking a cautious stance by reducing production and capital investment. However, production activity has continued to improve, supported by export recovery and completed inventory adjustments. Capital investment is also showing signs of bottoming out.
Corporate structural changes	Due to the sharply declining corporate earnings after 2008, many Japanese companies are pursuing measures such as withdrawing from underperforming business areas and pushing down (improving) break-even points by reducing fixed costs, with a view to maintaining resilience. Corporate earnings turned upwards in the second half of F/Y2009 and are expected to increase significantly in F/Y2010.
Severe situation continues in consumption	Although the employment and income environment remain harsh, consumer sentiment has continued to improve in recent months, with positive effects from government policy measures.

- **Japan's economy escaped the worst of the downturn and exports and production continue to improve. In addition, capital investment shows signs of bottoming out. Corporate and consumers' business sentiment has also improved, with the positive effects of economic stimulus packages.**
- **Whilst the effects of the monetary policy easing adopted by central banks in major countries and government economic stimulus packages are expected to continue shoring up the global economy, self-sustaining recovery is being observed, particularly in Asia. Based on these positive factors, the Japanese economy, which turned into positive growth in the April to June 2009 quarter, is expected to sustain moderate growth.**

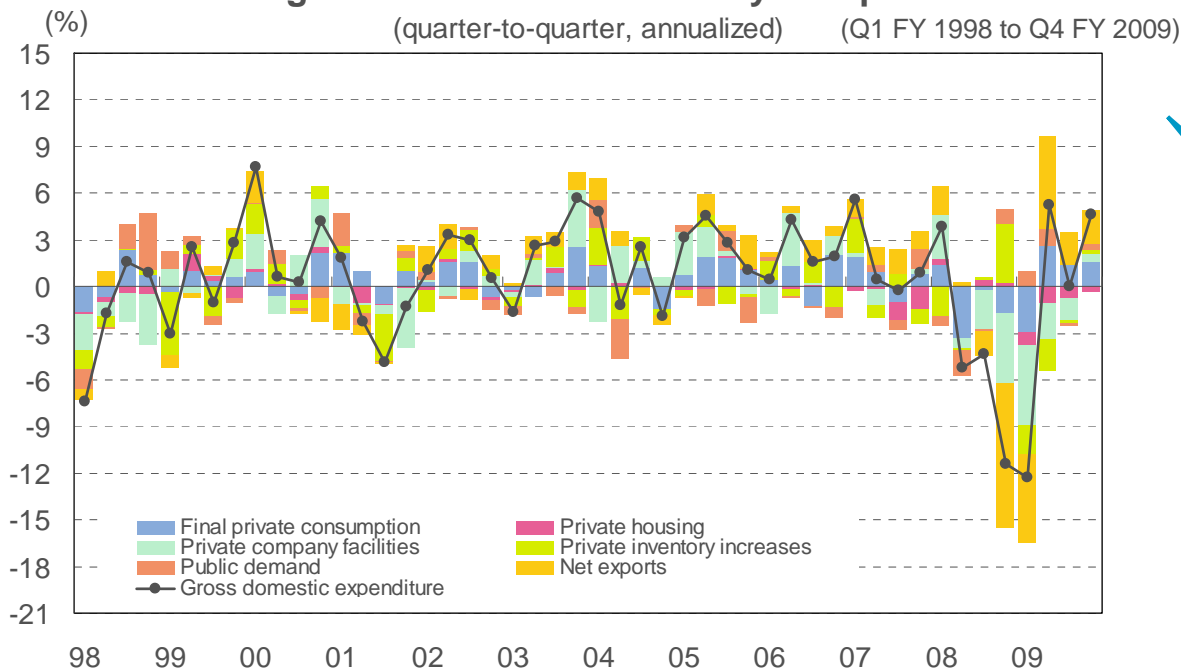


Japanese equities are relatively attractive in the long and medium term	Whilst the outlook for the domestic economy and corporate earnings is uncertain for the time being, from a medium- to long-term perspective, we believe that companies' stance of emphasising shareholder interests, as seen in the increase in dividends and share buy-backs, will provide support for the market.
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GDP posted positive growth for three straight quarters

- For the first time in five quarters, GDP turned into positive growth during April to June 2009, supported by improving exports following Asian economic recovery and government economic policies. Positive GDP growth was sustained for three straight quarters to December 2009.
- Exports and private-sector final consumption expenditure increased for three consecutive quarters, supported by strong foreign demand and policy effects of economic measures, such as the Eco-point system for energy-saving home appliances, tax cuts and subsidies related to the purchase of environmentally responsible “Eco-cars”. On top of this, capital investment turned positive for the first time in seven quarters and overall domestic demand saw positive growth. This indicates that economic recovery is spreading from foreign demand to domestic demand.

Changes in GDP contribution by component



During the quarter to December 2009, net exports, private sector final consumption expenditure and capital investment all turned positive.

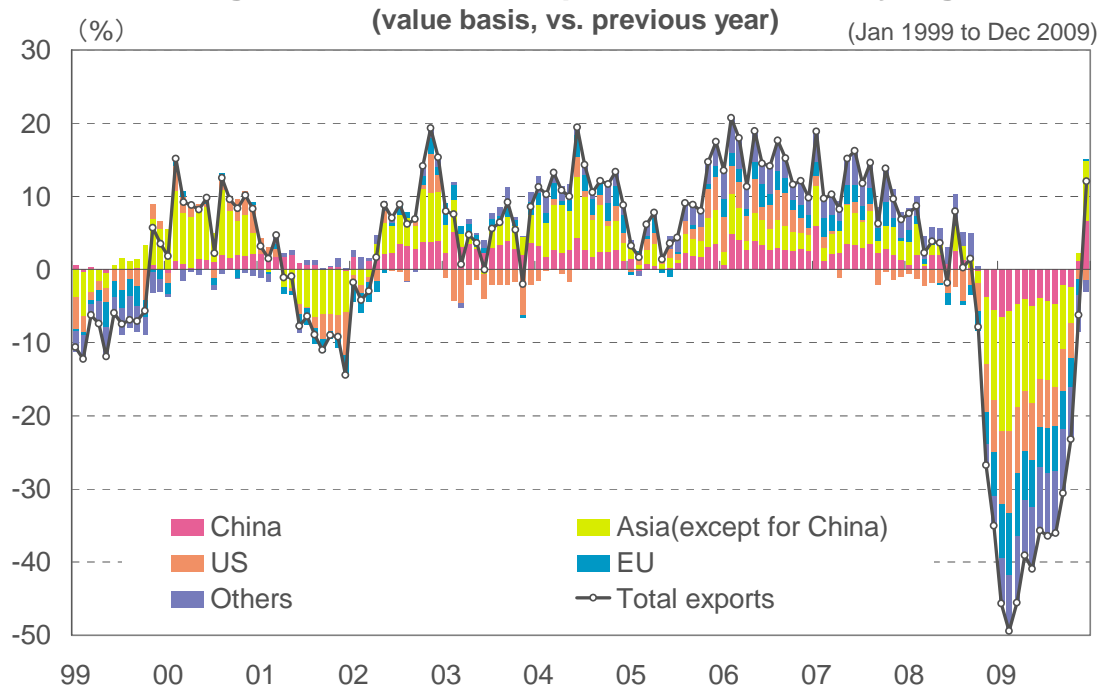
Source: The Cabinet Office, Japan and “National Economic Accounting”. The data above represent past figures and are not a guarantee of future investment returns.

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Exports turned positive (yoy) for the first time in 15 months

- After the autumn of 2008 when, the largest US securities firm fell into bankruptcy, Japanese exports continued to see negative growth on a yoy basis. However, this turned into positive growth in December 2009, for the first time in 15 months. In particular, exports to Asia (especially China) increased for two consecutive months. On top of this, exports to the EU, Central/South America and Oceania also increased.
- Asian economies, which account for more than 50% of total exports, show remarkable recovery and the US ISM Manufacturing Index, (a leading index for Japanese exports), is at its highest level since 2004. Business sentiment in export partners is also on an improvement trend and, Japanese exports are expected to continue growth momentum going forward.

Changes in the level of export contribution, by region



After bottoming out in February 2009, exports continued to improve and finally turned positive (yoy) for the first time in 15 months in December 2009.

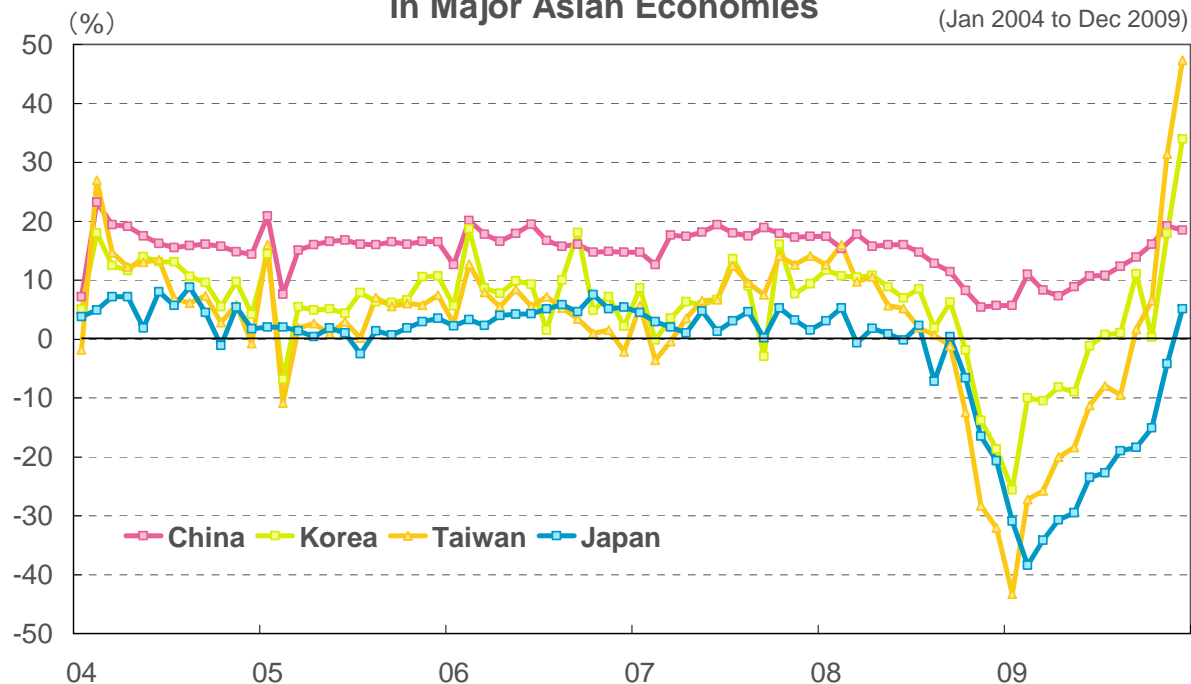
Source: Ministry of Finance, Customs, Trade Statistics. The data above represent past figures and are not a guarantee of future investment returns.

Yoy export growth data of EU is based on 15 EU countries up to April 2004 and 25 countries from then onwards.

Asian economies (especially China) are improving

- Asian economies, especially China, are on a recovery trend. Industrial production in China has continued double digit growth (yoy) since June 2009, whilst other Asian regions (including Taiwan and Korea) have shown sharp improvements in recent months. In export-driven economies, such as Taiwan, Korea and Japan, strong demand is supporting production improvements. In particular, Taiwan is expected to see rigorous demand for capital investment in core industries, such as semiconductors and electric parts.
- It is assumed that Asian economies have entered into a sustainable recovery phase. This provides support to Japanese production activity through export improvements to these regions.

Changes in the index of mining and industrial output in Major Asian Economies



Improvements in production activity spread from China to other Asian regions including Korea, Taiwan and Japan.

Source: Japanese Ministry of Economy, Trade and Industry. National Bureau of Statistics of China. Korean Statistics Bureau. Ministry of Economic Affairs of Taiwan

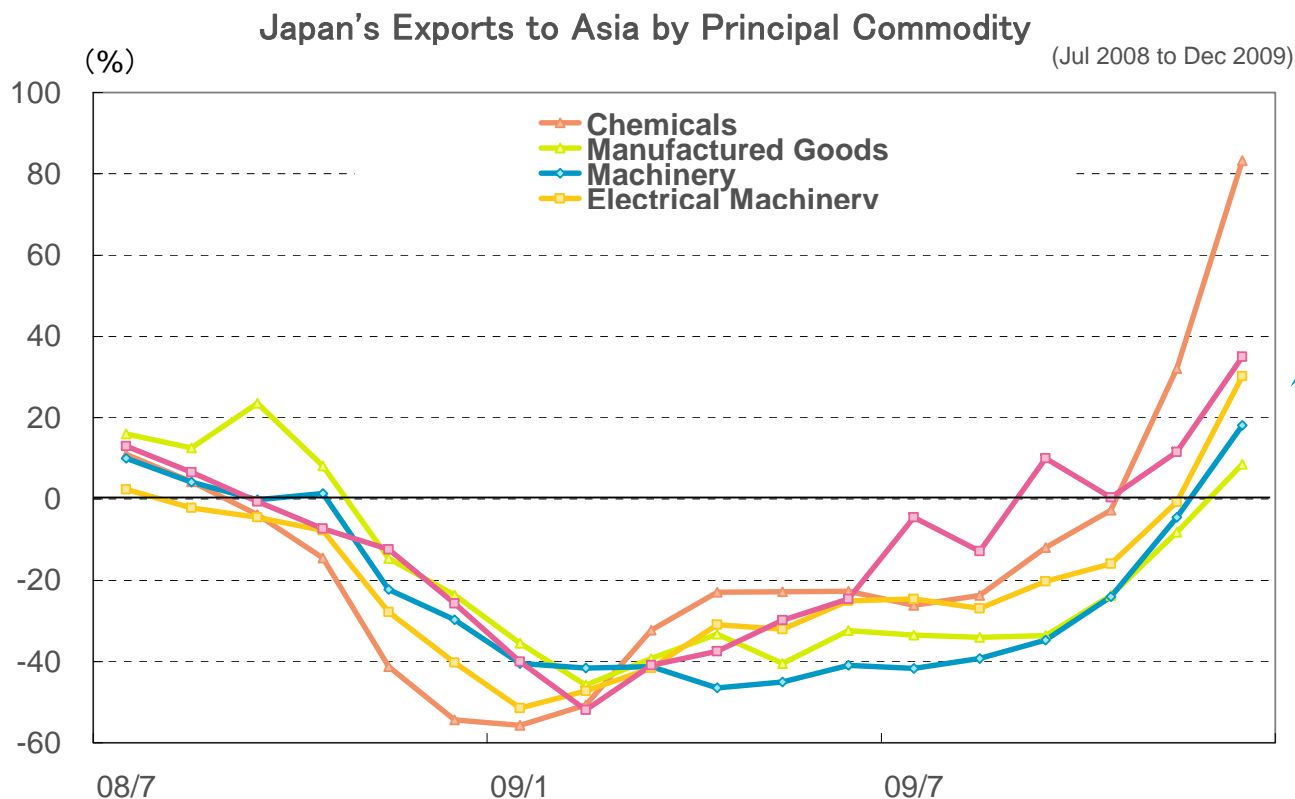
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Asian economies (especially China) are improving

- Japanese exports to Asia, which account for more than 50% of total exports, are improving. This is seen in items ranging from consumer goods (such as transport and electric equipment), chemical goods and intermediate commodities, to capital goods such as machinery.
- In particular, improvements in capital goods exports to Asian regions indicates that demand for capital investment in these countries is improving and that economies are entering into self-sustaining growth. This also provides brighter prospects for future Japanese exports.



Improvements capital goods exports to Asian regions indicates that the economies of these countries are entering into self-sustaining growth.

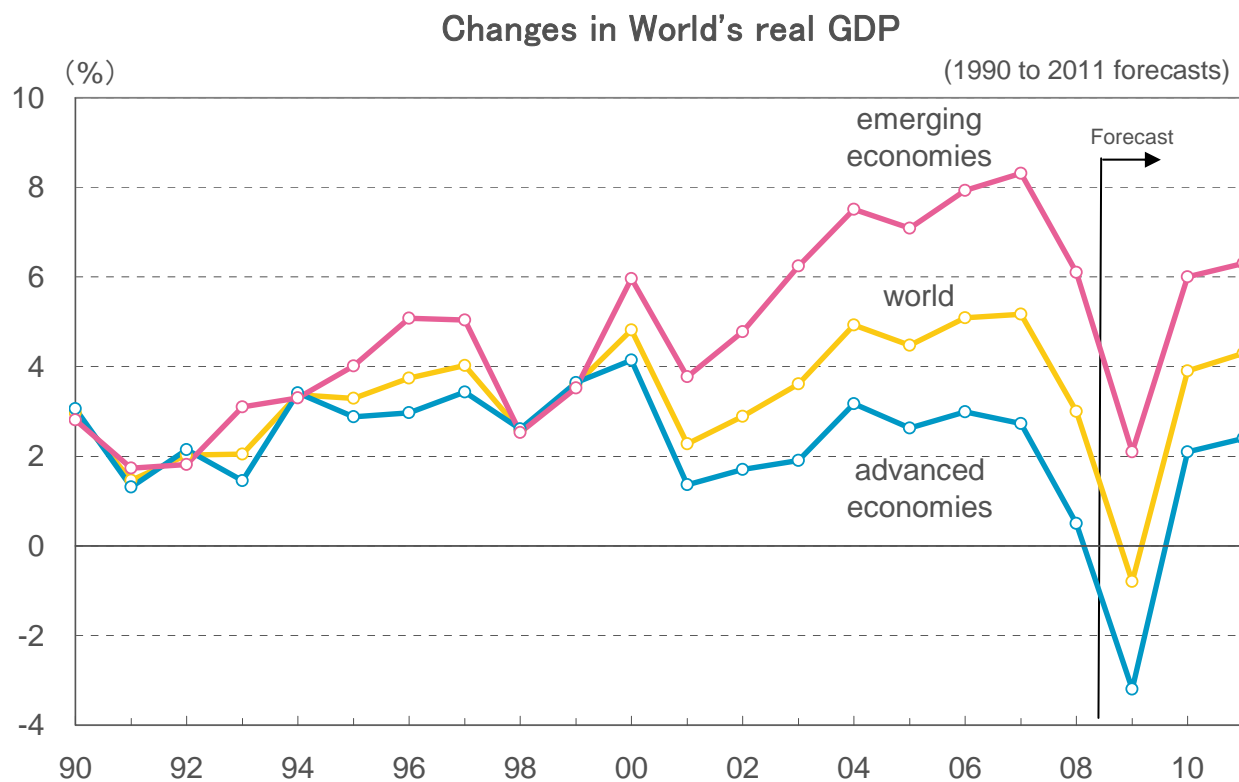
Source: Finance Ministry, Foreign Trade Statistics. The data above represent past figures and are not a guarantee of future investment returns.

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Emerging countries' economic growth drives global economy

- Global economic growth is expected to slow down sharply in 2009, in response to a US-led economic downturn in developed countries. Although it is unavoidable that emerging country economies will decelerate in response, economic growth of emerging countries should continue to greatly exceed that of developed countries.
- Expectations that economic growth of emerging countries will continuously drive the global economy after 2010 has a favourable impact on Japanese exports.



Emerging country economies slowed down in 2009, in response to the economic downturn in developed countries. However, GDP growth of emerging countries is expected to pick up in 2010.

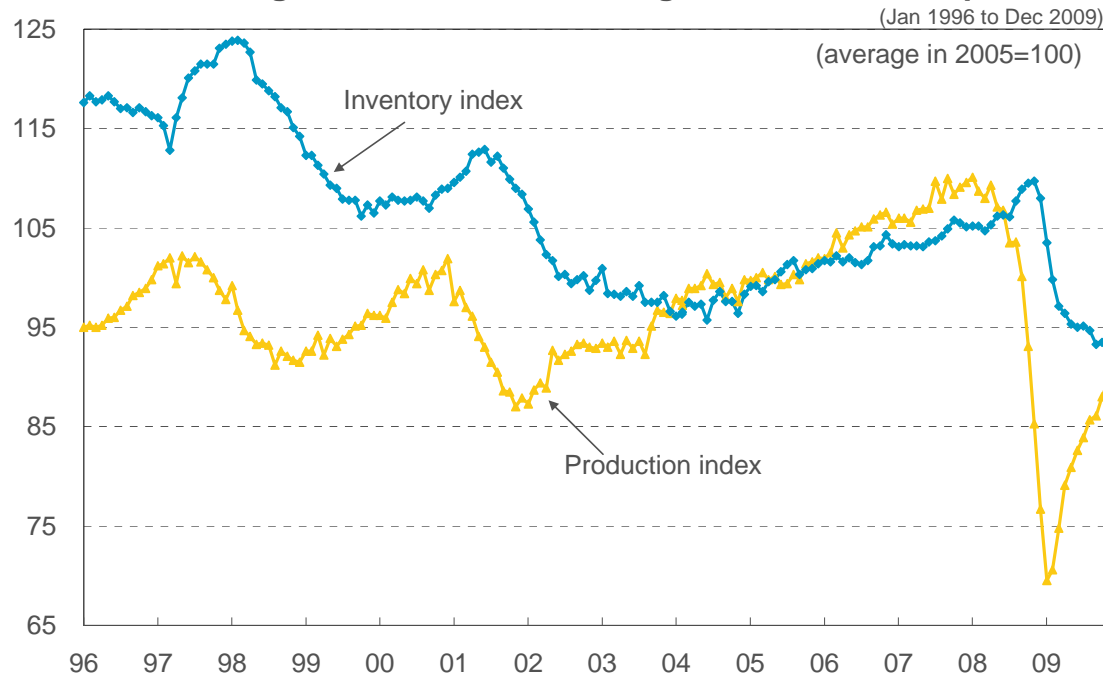
Source: IMF "World Economic Outlook, January 2010". The data above represent past figures and are not a guarantee of future investment returns.

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Production continuing to recover

- As a result of the global recession, the Industrial Production Index had declined significantly up until February 2009. However, production continued to recover for ten straight months until December, thanks to improving exports, progressing inventory adjustments and positive effects from the government's economic policies.
- Although caution is still required for complete inventory adjustments and the gradually deteriorating effect of economic stimulus packages, a production forecast survey shows production is expected to increase both in January and February 2010 and will continue upward momentum.

Changes in the index of mining and industrial output

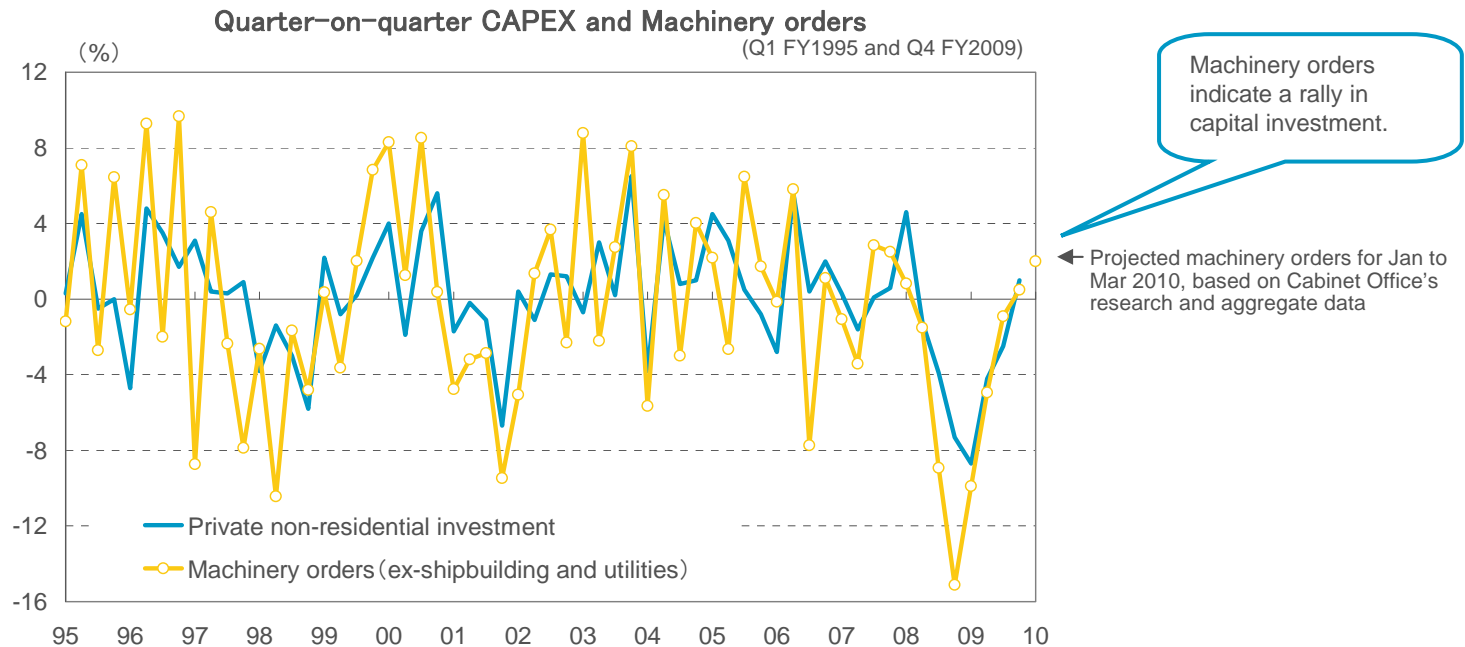


The Inventory Index has moved from decline (improvement) to flat growth.

Source: Ministry of Economy, Trade and Industry, "Industrial Index". The data above represent past figures and are not a guarantee of future investment returns.

Capital investment showing signs of bottoming out of decline

- The motivation of Japanese companies to undertake capital investments has been on a declining trend (due to equipment surpluses and low production levels), for the six consecutive quarters to September 2009. However, the extent of the decline in capital investments after the April to June 2009 quarter became smaller, thanks to improvements in exports and production, as well as the projected bottoming out in corporate earnings. As a result, capital investments turned positive in the quarter ending December 2009 for the first time in seven quarters.
- Machinery order statistics (for private demand excluding shipping and electricity), a leading indicator for capital investment, declined for six straight quarters up to September 2009. However, after bottoming out in the last quarter of 2008, the index was on an improvement trend and finally turned into positive growth during the last quarter of 2009. The index is expected to continue rising in the first quarter of 2010.

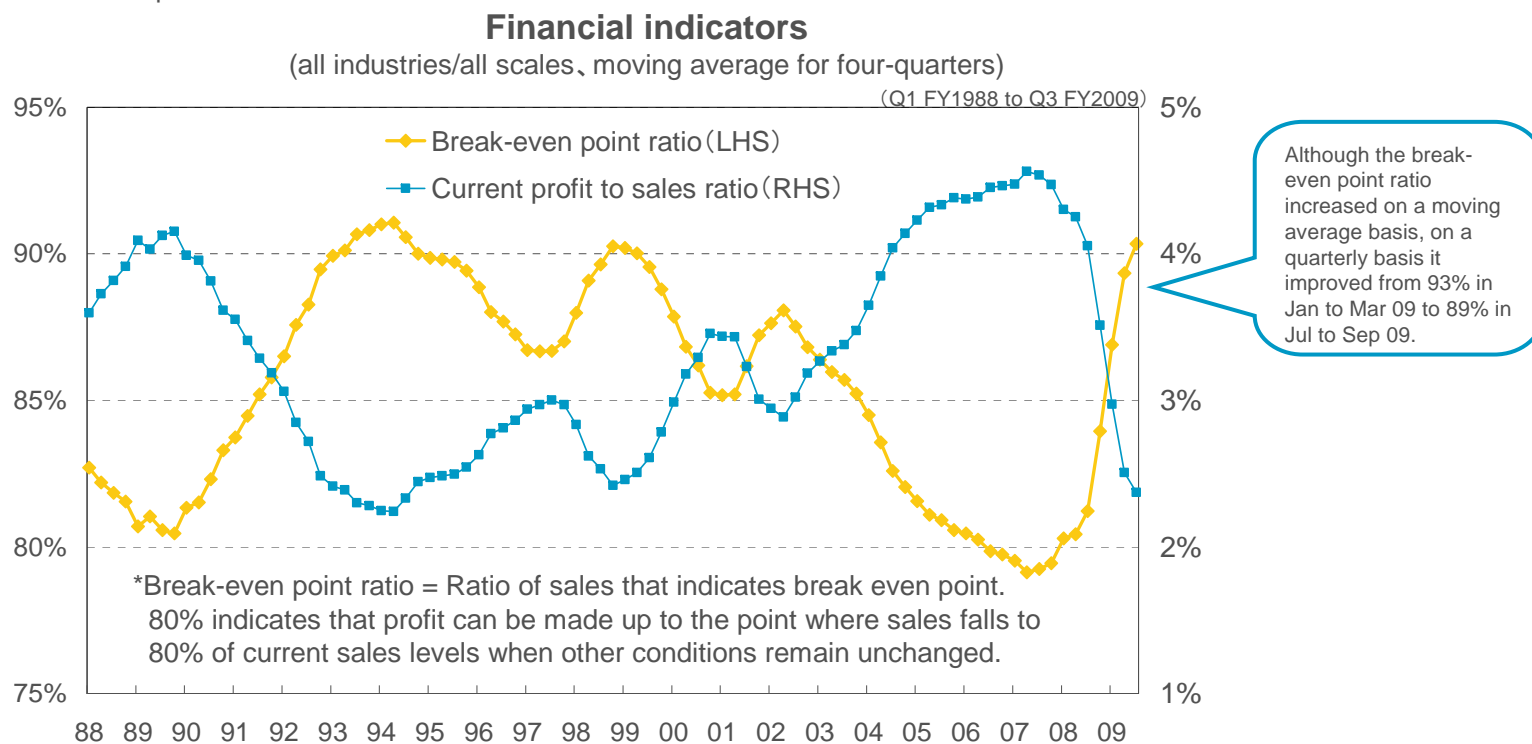


Source: The Cabinet Office, Japan, "National Economic Accounting" and "Machinery Order Statistics". The data above represent past figures and are not a guarantee of future investment returns.

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Corporations aiming for robust structure

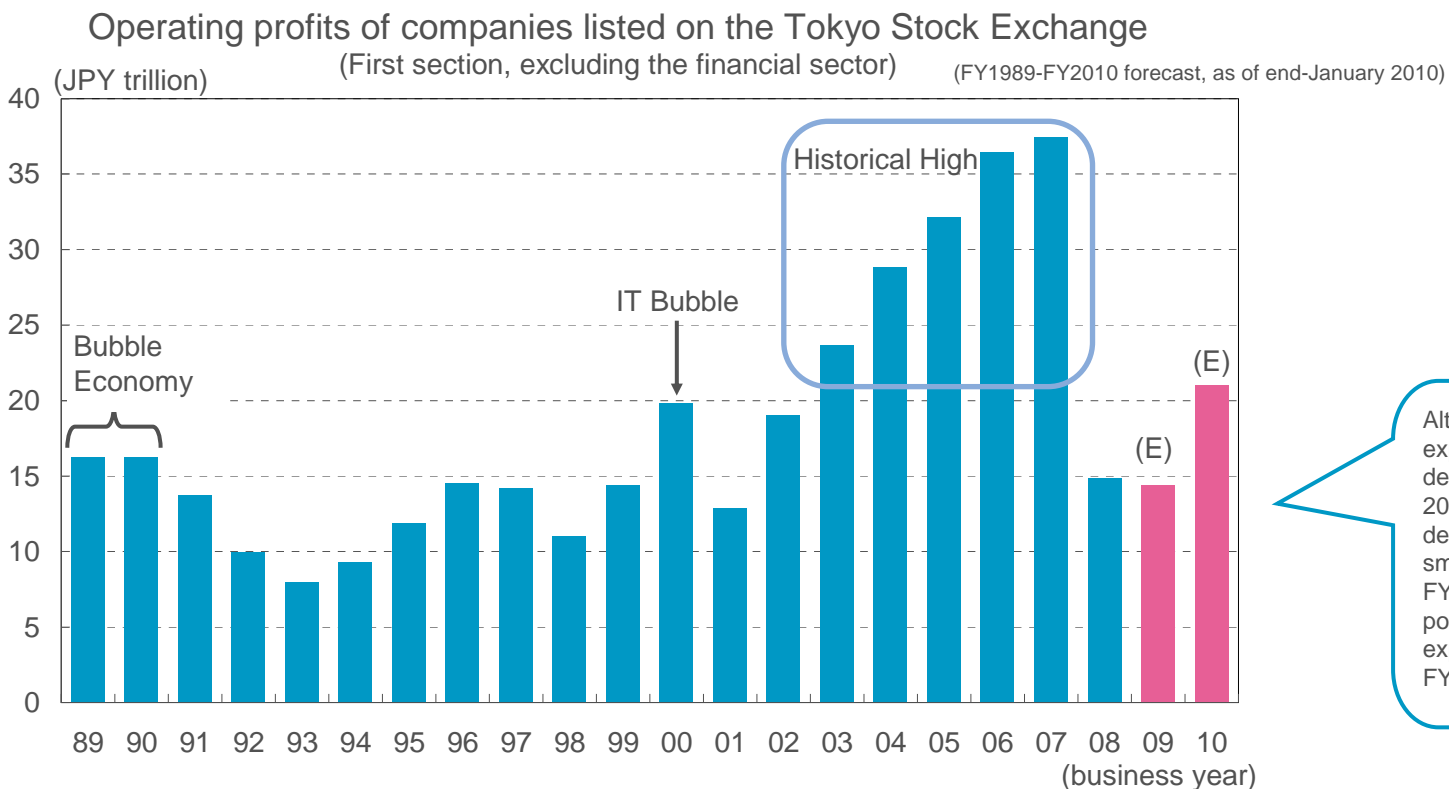
- According to corporate statistics for the July to September 2009 quarter, corporations have faced declines in both sales (down by 15.7% yoy) and current profits (down by 32.4% yoy) for seven straight quarters. However, the extent of the declines have become smaller compared to the previous quarter.
- Break-even point ratios* continue to increase (worsen), however most Japanese companies are pursuing measures such as withdrawing from underperforming business areas and reducing fixed costs, to push (improve) them down. Based on this, there are signs of improvements in break-even points.



Source: Treasury Department "Corporate Statistics". The data above represent past figures and are not a guarantee of future investment returns.

Corporate earnings are expected to increase for first time in 3 years in FY2010

- Following the significant decline in corporate earnings in FY2008 (as a result of the sharply decelerating global economy), Japanese companies continued to face a harsh earnings environment in FY2009. However, the effect of corporate efforts to adjust inventories and cut fixed costs, as well as global economic stimulus packages, provided support for recovering corporate earnings in the second half of 2009.
- Corporate earnings are expected to continue improving in FY2010 and significant increases in company earnings are anticipated.



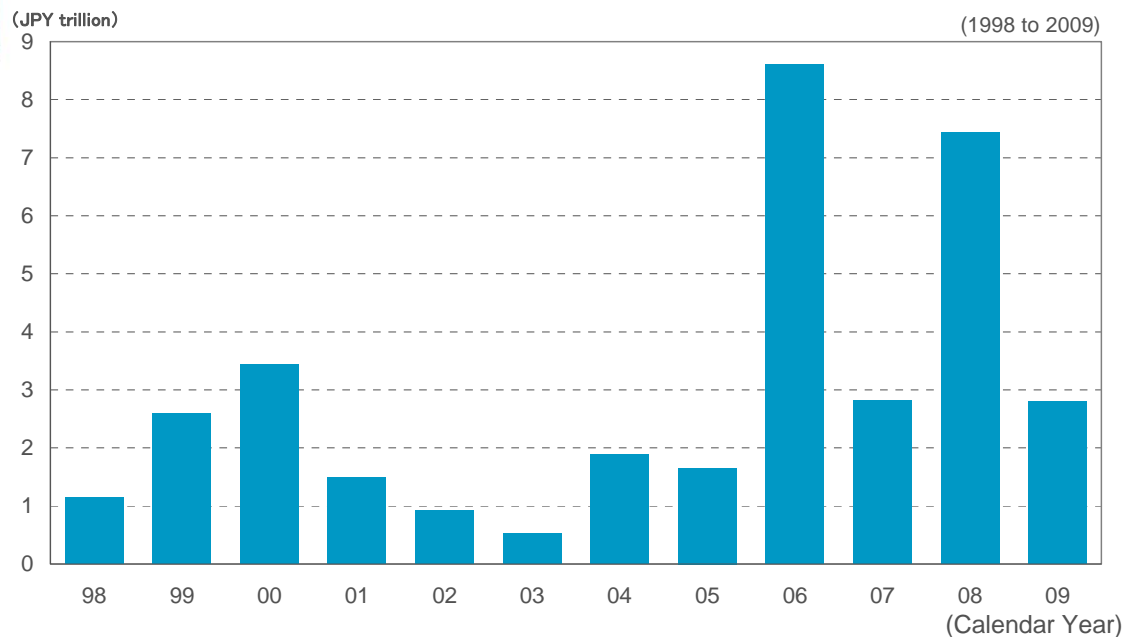
Although profits are expected to decrease in FY 2009, the extent of decline will be smaller than in FY2008 and positive growth is expected in FY2010.

Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

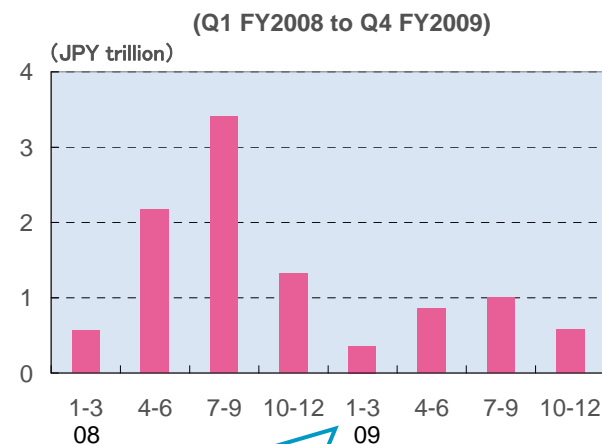
Japanese Firms' Growing Overseas M&A Activity

- Whilst global M&A activity falls due to financing difficulties (as a result of the global financial crisis), overseas acquisitions by Japanese companies increased in 2008, as they began to employ comparatively abundant cash reserves. We believe there are strategic objectives behind this, which will enable companies to enter new growing markets and enhance competitive advantages.
- After the autumn of 2008, when the financial crisis became serious, M&A activity by Japanese firms also decreased sharply. However, as the financial market conditions get more stable, Japan's M&A activity is expected to increase again. In particular, domestic demand companies such as foods and pharmaceuticals will be highly willing to acquire overseas companies. Currently, the movement of industry restructuring is observed domestically.

Changes in M&A Cost of Overseas Firms by Japanese Firms



Changes in M&A Cost of Overseas Firms by Japanese Firms On a Quarterly Basis

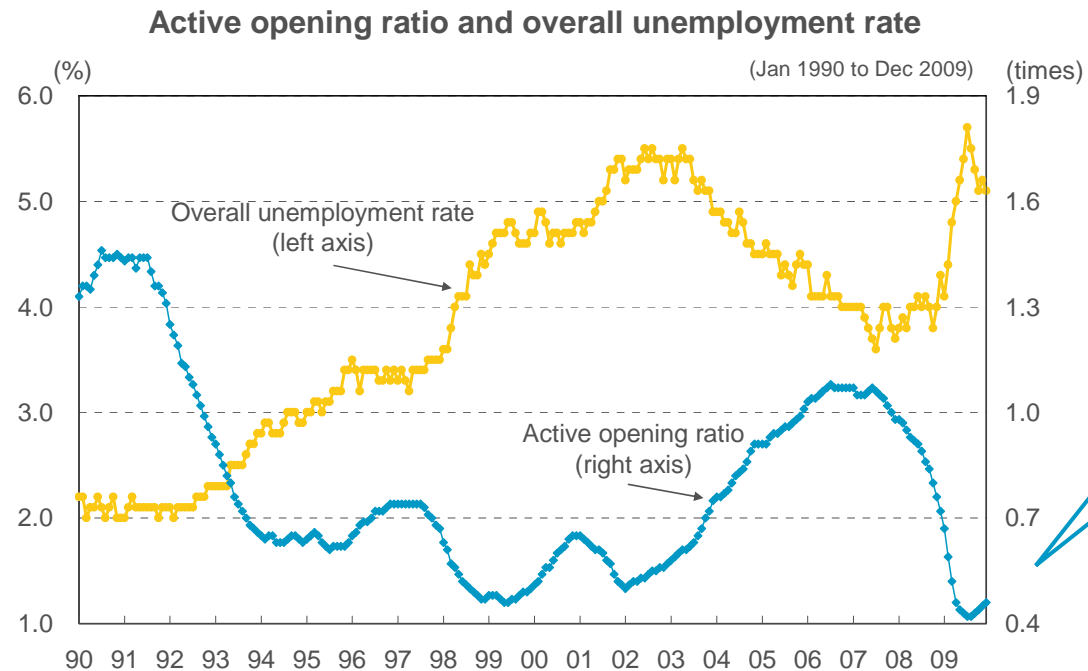


After bottoming out in the Jan to Mar 2009 quarter, M&A activity of Japanese firms exhibits gradual recovery .

Source: Monthly M&A magazine, "MARR", published by RECOF DATA Corporation. The data above represent past figures and are not a guarantee of future investment returns.

Harsh employment situation

- The domestic employment situation remains harsh, as evidenced by the unemployment rate hitting a record high in July 2009 and the job availability rate hitting a record low in August 2009. However, both indicators are currently improving, indicating a halt to further declines in the employment environment.
- Although the number of workers in some industries have started to increase on the back of production improvements, there are still approximately 2 million workers who are entitled to receive government subsidies for employment adjustments (the government subsidises leave allowances for workers who are forced to downsize their businesses for economic reasons). This does not show a brighter outlook for future employment conditions.

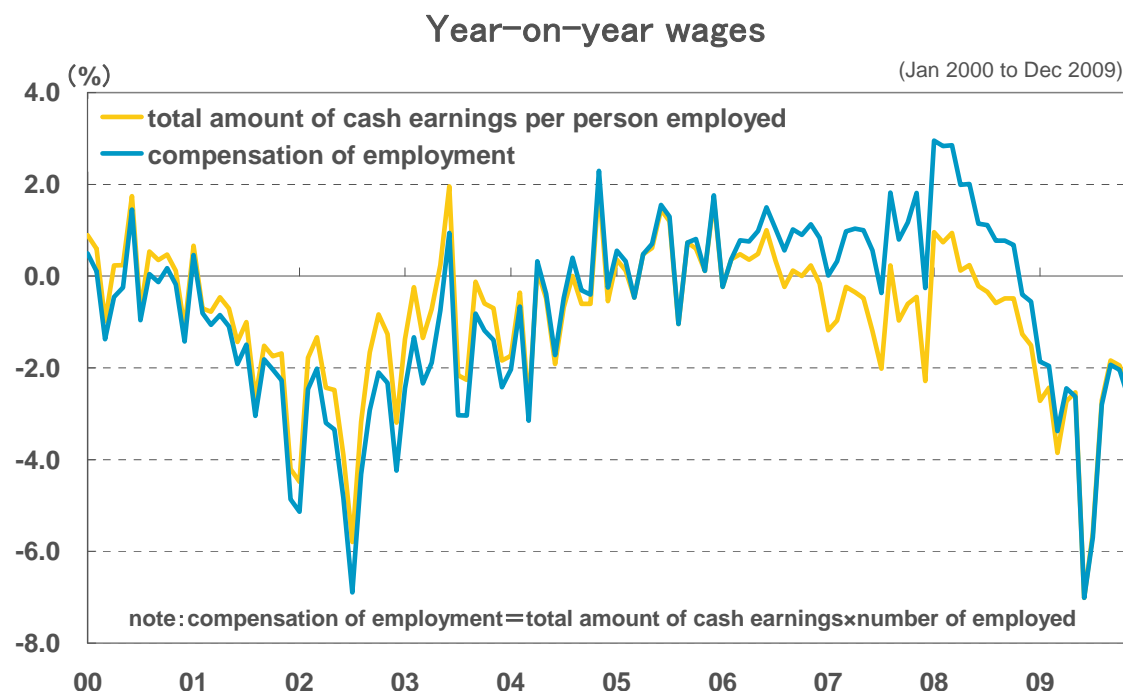


Taking the current job availability rate in account, unemployment is open to a potential upturn.

Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

Severe income environment continues

- Total cash earnings per person employed fell (yoy) for 19 consecutive months up to December 2009. In particular, annual summer bonuses paid in June and July, as well as winter bonuses paid in December, saw significant declines and this pushed the total cash earnings per person employed down even further.
- Time will be required to dispel the sense of employment surplus and it will be difficult to see significant improvements in the income environment in 2010. Households are expected to continue taking a cautious stance on consumption and there are concerns that the speed of economic recovery will be slow.

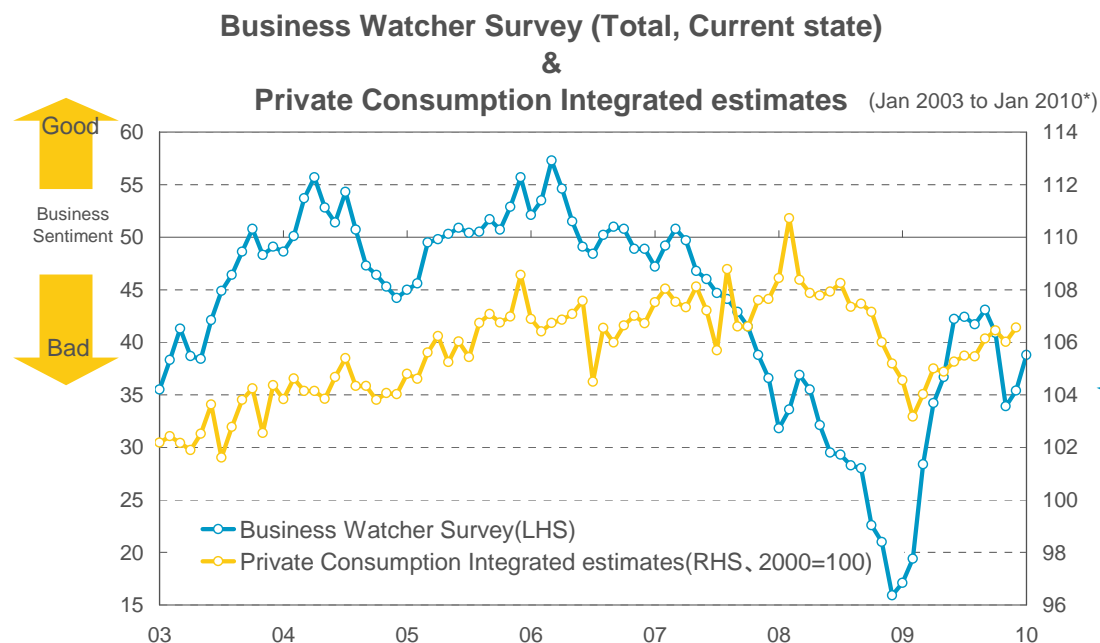


The employment environment remains harsh and total compensation has considerably declined, impacted by significant falls in annual bonuses.

Source: Ministry of Health, Labour and Welfare, "Monthly Labor Survey". The data above represent past figures and are not a guarantee of future investment returns.

Improvements in 'street level' business conditions and consumer spending

- According to the Business Watchers Survey (a survey targeted at economically sensitive people such as taxi drivers and supermarket owners), "street level" business sentiment improved for the two months to January 2010. Improvements were seen across all constituents (relating to household/corporate trends and employment) of the survey. The Future Business Sentiment Index also improved for two consecutive months.
- Consumer sentiment has also improved in recent months, with positive effects from additional economic measures, such as the Eco-point system for energy-saving home appliances and houses, as well as an extended period of tax cuts relating to the purchase of environmentally responsible "Eco-cars". Favourable export growth has also helped support consumer sentiment. It is worth watching the momentum of economic recovery going forward.



* The most recent figure for the private consumption index is as at December 2009

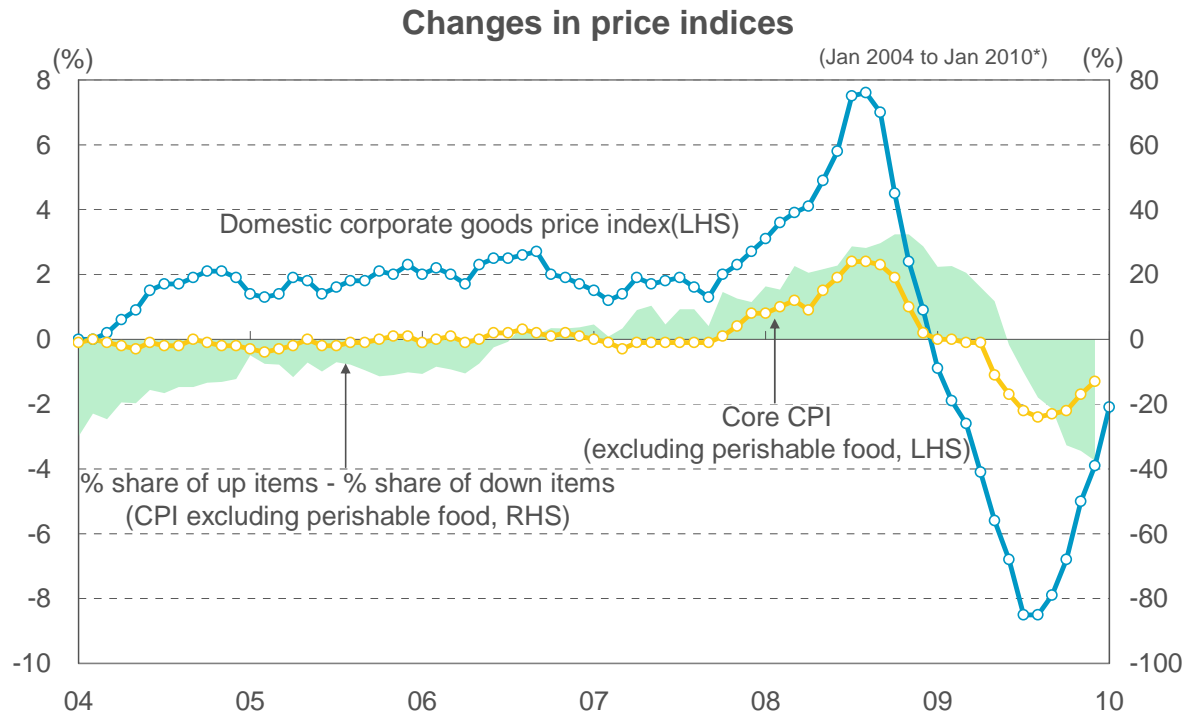
The Business Watcher Survey (Diffusion Index for Jan 2010) improved for two straight months, whilst Private Consumption Integrated Estimates showed an uptick in December 2009.

Source: The Cabinet Office, Japan. The data above represent past figures and are not a guarantee of future investment returns.

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Increasing downward pressure on goods prices

- Declining domestic and international demand as a result of the recession, is one of the factors placing downward pressure on goods prices. Impacted by soaring oil prices, the domestic corporate goods price index for July and August 2009 declined by 8.5% yoy; the largest decline for two straight months since records began in 1960 .
- Core CPI (excluding fresh food) did not decline as much, as it is largely affected by service businesses with the highest proportion of personnel expenses. However, Core CPI has continued to decline on a year-on-year basis for ten consecutive months up until December 2009. Also, the proportion of low priced products exceeds that of high priced products and this indicates that price decreases have expanded.



* The most recent figure for the private consumption index is as at December 2009

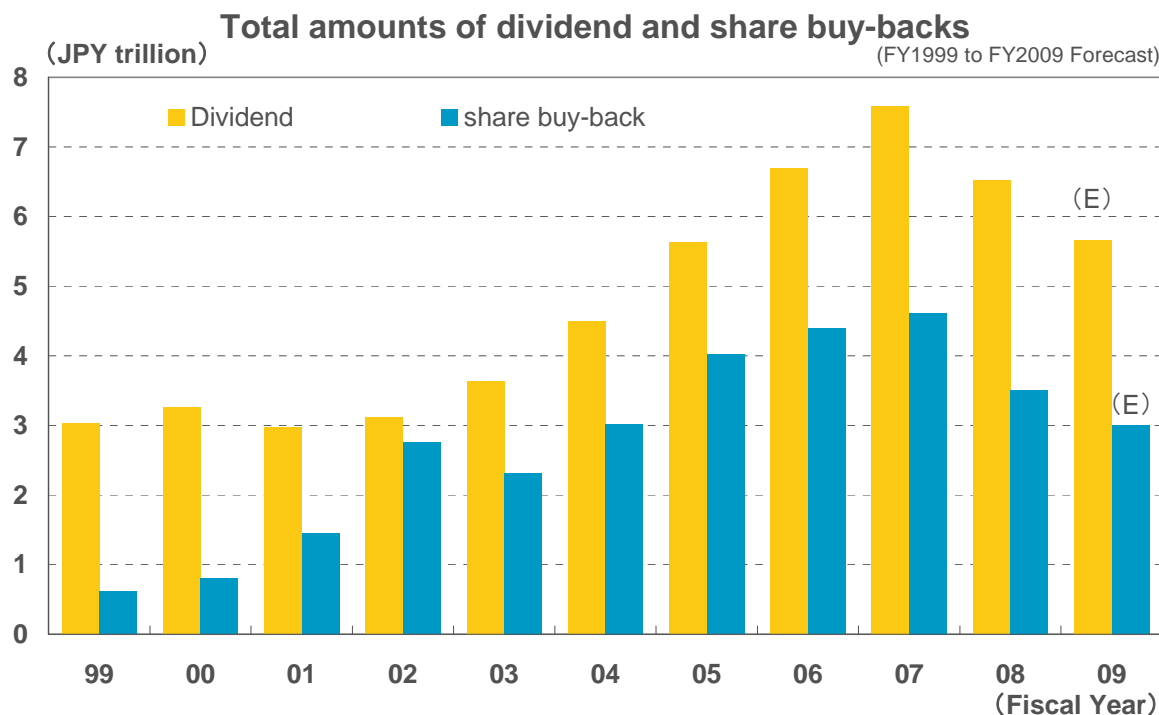
The increasing market share of low price products, as a result of declining goods prices, is supporting household purchasing power. However, this will serve as a negative factor to corporate profits.

Source: Ministry of Internal Affairs and Communications, Bank of Japan. The data above represent past figures and are not a guarantee of future investment returns.

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Returns to shareholders during the temporary lull

- Japanese firms have been proactively enhancing shareholder value via rises in dividends and share buy-backs, thanks to the increasing number of activist shareholders and M&A activity (corporate mergers and buyouts).
- With the rapid deterioration of corporate performance during the second half of the year, shareholder returns in FY 2008 will level off and the environment is likely to remain harsh in FY 2009. However, corporate awareness of the importance of shareholder returns remain strong and companies are expected to proactively resume shareholder returns, as the sense of uncertainty over the future the business environment dissipates.



Implementing share buy-backs as a way of shareholder returns and high awareness of capital efficiency is taking root in Japanese companies

Reference: Dividend payout ratios in major markets
Eurozone: approx. 44%
U.S.: approx. 32%
Japan: approx. 32%
(based on the MSCI Index for the respective countries, as of end-January 2010)

Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

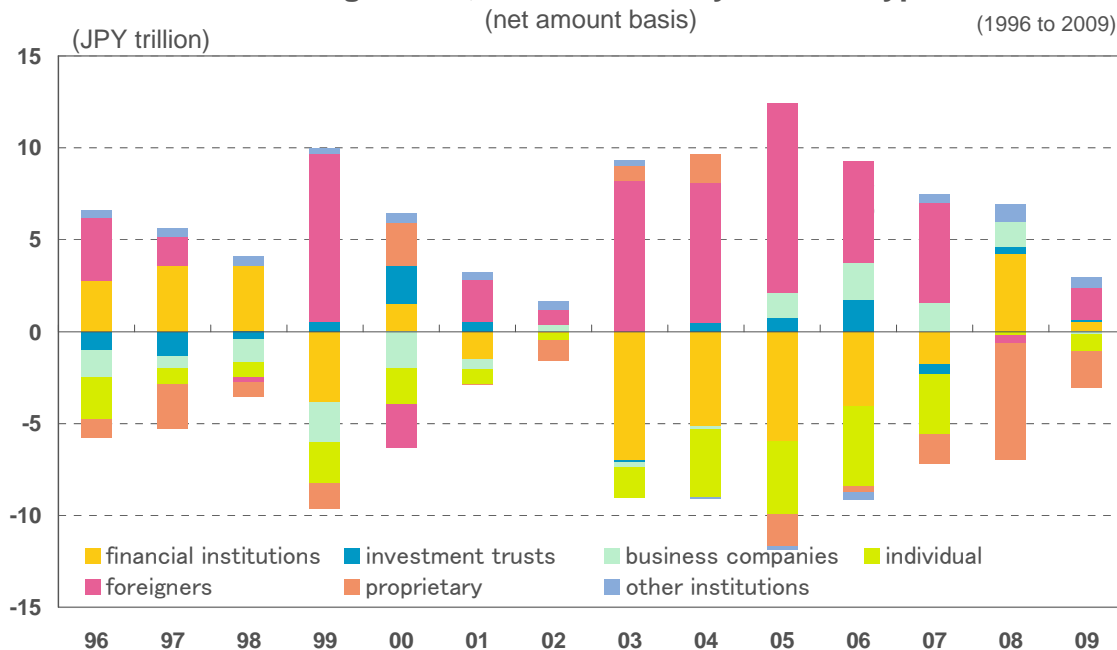
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Trading trends by investors

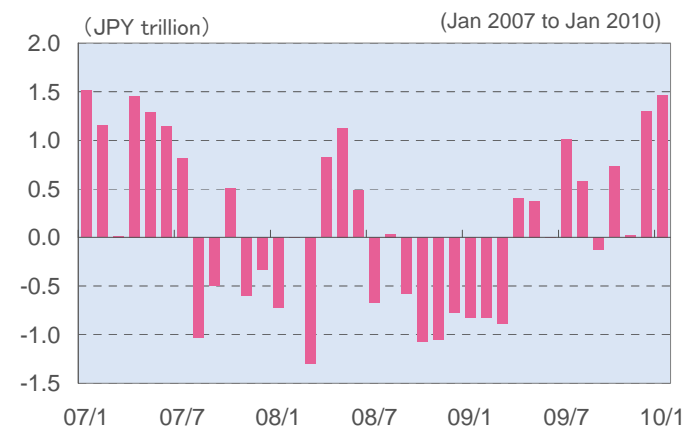
- Whilst overseas stock markets remained strong, there were inflows into Japanese equities. Trading trends for CY 2009 showed that purchases by foreign investors amounted to approximately 1.8 trillion yen for the first time in two years. Trust banks also provided support, with purchases of approximately 1.4 trillion yen.
- Meanwhile, sales of Japanese equities by retail investors totalled 866.6 billion yen. After becoming buyers in 2008 (for the first time in 18 years), they sold out to take profits in 2009. Banks and insurance companies also became sellers.

Foreign investors have continue to buy Japanese equities since April 2009.

Trading trends, broken down by investor type



Foreign investors' trading trend (net amount basis)

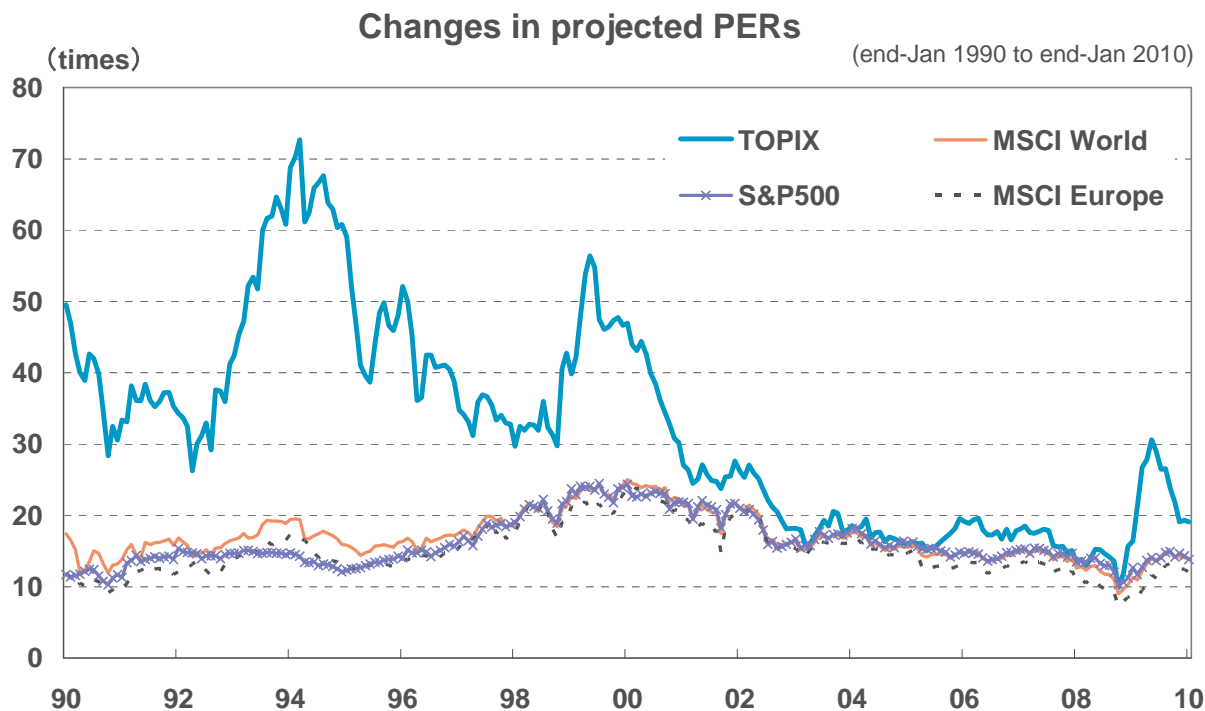


Source: Tokyo Stock Exchange. The data above represent past figures and are not a guarantee of future investment returns.

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Japanese equities valuation (1)

- Looking at price-to-earnings ratios (PER), an yardstick used to determine stock price levels compared to corporate earnings, Japanese equity PER had seen an uptrend since the autumn of 2008, despite share price declines, due to the deterioration of corporate earnings. However, after the spring of 2009, Japanese equity PER have begun to decline (improve), as corporate earnings are expected to bottom out.
- Estimated PER as at end January 2010 (based on estimated earnings for the full year) are approximately 19X for Japan (TOPIX) and 14X for the US (S&P500).

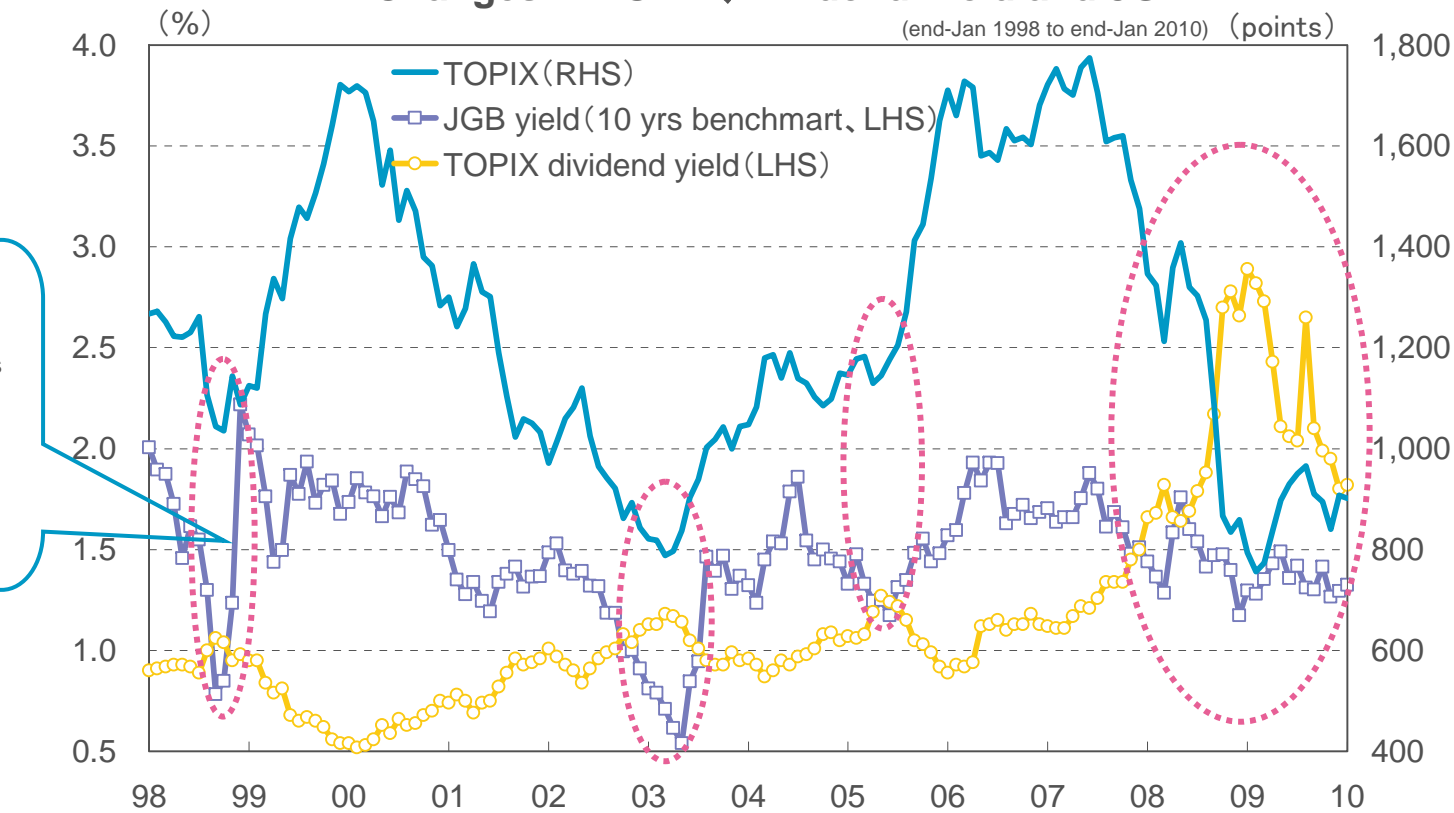


Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

Japanese equities valuation (2)

- Dividend yields on the TOPIX currently exceed yields for 10yr Japanese government bonds.
- Judging from the past, this is a likely indicator of good investment opportunities to come

Changes in TOPIX, Dividend Yield and JGB



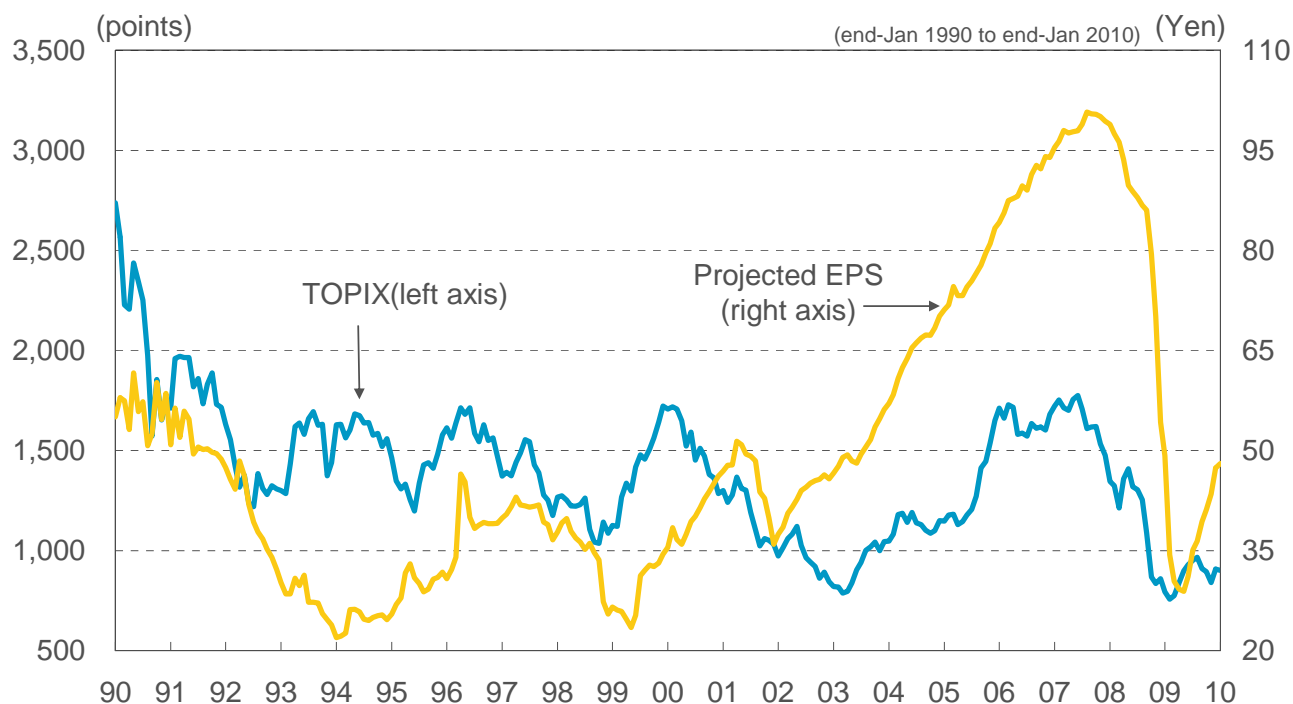
Past data shows Japanese equities rebound following periods when the TOPIX dividend yield exceeds 10 yr JGB yields

Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

Corporate earnings and stock prices

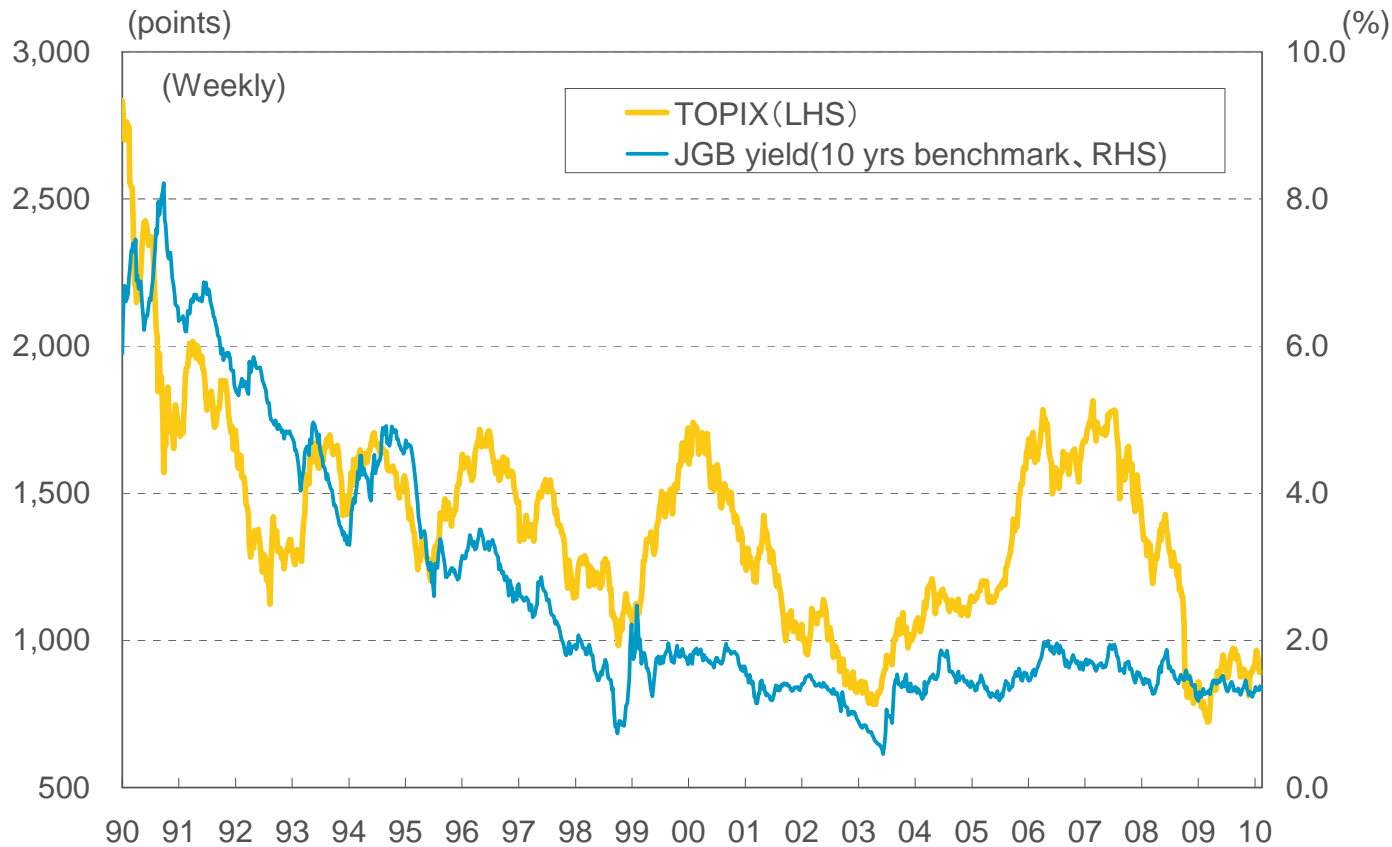
- Whilst the outlook for the domestic economy and corporate earnings is currently uncertain, the Japanese stock market is expected to rise ahead of corporate performance improvements, along with economic recovery.
- From a medium- to long-term perspective, we believe that companies' stance of emphasising shareholder interests (as seen in the increase in dividends and stock buy-backs) will provide support for the market.

Changes in the TOPIX and in projected EPS of TSE 1st section shares



Source: Nikko Asset Management. The data above represent past figures and are not a guarantee of future investment returns.

TOPIX & JGB Yield Movements Since 1990



	2/19/10	High (date)	Low (date)
TOPIX	889.08	2,867.70 (1/04/90)	700.93 (3/12/09)
10 yr JGB	1.338	8.230 (9/27/90)	0.448 (6/12/03)

Source: Bloomberg

The net asset value (NAV) of investment trusts may fluctuate due to investments in assets with variable prices (foreign-currency assets also contain exchange rate fluctuation risks) and therefore the principal investment is not guaranteed. Investors may be charged transaction fees for purchase, holding, and redemption of investment trusts. Please read an explanatory leaflet of investment trusts (Prospectus) for further information. This document is produced by Nikko Asset Management with the purpose of providing information on "A Fresh Ascent: Economic Revival in Japan," and is not a material for solicitation to a specific fund. Moreover, the content mentioned in this document will have no impact on the investment management of the Company's funds.

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