Kimura Dreamvisor Newsletter Summary 13th October 2006

Capital quietly shifting toward Equities.

Even if economy is slowing earnings will continue improving.

Japanese stock market is showing remarkable polarization pattern. From one side large international blue chips companies like (4063) Shin-Etsu Chemical, (7203) Toyota, (7751) Canon are recording regular new highs, meanwhile New Growth Markets, second sections and first section listed small caps show poor performance. MOTHERS and HERAKLES indexes halved during the past six months. In short stocks bought by Institutional investors and mutual funds are showing strong resilience meanwhile rainy season continues to weight on individual's favourite stocks and market since Livedoor shock. Livedoor shock inflicted heavy wounds to individuals, margin selling days become like downpour. This time the April peak linked margin settlements cumulated with North Korean nuclear test and led to heavy selling by market participants.
As previously mentioned a substantial number of foreign investors consider Japan as a one way cyclical play. Mid small caps are considered as having even higher correlation with business sensitivity therefore they keep distance with this universe if they forecast a slowdown. For now foreign as much as domestic investors have a negative perception toward small capitalizations. In addition IPOs and capital increase are piling up one after another, as numerous individuals are selling their holdings to subscribe cash realization on mid small caps occurs on repeat basis.

On one side large foreign institutional investors receive fresh capital flows on a regular basis and have to invest the money. Originally stocks are sold when economy suddenly worsen however consensus is now pointing at US soft landing scenario and corporate profits should keep growing. Equities profitability is higher than fixed income yields, for long term investors like pension funds the obvious choice are equities relative to fixed income. By elimination such investors select large capitalization blue chips. Japanese global blue chips rise comes in the wake of the US Dow renewed highs.
Japanese individual investors backward stance is a fact. As trading volume decreased on line brokers account openings has weakened. However taking too pessimistic a view would be mistaken. TSE first section recent trading volume keeps a daily 2 trillion 200 billion Yen and the whole market maintains enough energy. Current fiscal year forecasted Per is 19x, earnings yield is 5.5 % and the gap with ordinary savings yield is extremely large. As a result mutual funds are buying on a large scale, companies also substantially increase shares buy backs. Even though there are numerous sluggish stocks the whole market is far from inactive.

<u>Although limited for now small caps and new growth markets rebound is closing by</u>

There is something called the 'dam theory'. If a dam contains companies' earnings taken as water flow, at one point it will overflow and flow back to households and as a consequence consumption recovers. Applying the same reasoning to the market if money flows continuously feed main large caps allowing them to reach the maximum high price then money realized on this universe will shift to undervalued equities universe.
Foreigners net cumulated buying for January September amounted to 2.8 trillion Yen. For October December past figures show roughly 2 trillion Yen for years 2003 and 2004, 2005

stands out with 3 trillion Yen. Although Japanese equities average PER looks a bit high I believe foreign investors will buy at least 1.5 trillion Yen and probably the regular 2 trillion Yen.
The price gap opened within small capitalization's universe may well correct itself soon.
We are now entering the mid term earnings publication season and I expect at 60 % probability that companies will revise upward (or include future's upward revisions). In addition next fiscal year's estimates start to come in line and this should give positive impression to investors. Further as companies want to increase their financing prospects they will show how they intend to use excess liquidity (whether for dividend increase purpose or shares buyback).

There are numerous factors to be optimistic for supply demand situation. For January September period Investment trusts increased their net buying to cumulated 1.6 trillion Yen, industrial corporations to 1.5 trillion Yen. Considering next year's end to M&A restraints by share swap agreement plus retiree generation huge wave it is quasi sure that demand from investment trusts and shares buyback will increase.

Long margin settlement balance was 13 trillion 500 billion Yen by the 13th of October. Balance has gone down 40 % since February 6 trillion Yen peak, on the reverse short margin balance increased to 1 trillion 700 billion Yen bypassing 2005 September peak and this figure is the highest since 1989. Short/long multiple ratio is close to 2x.

What I am worried about is the long arbitrage balance still at high level: 4.3 trillion Yen. Since June this figure rose 1.5 trillion Yen however this is mostly due to Nikkei 225 futures (the percentage of high priced shares and highly capitalized equities is important).
The Nikkei 225/TOPIX multiple (NT multiple) increased from 9.70x to 10.14x but as there are a lot of TOPIX led arbitrage buying this ratio should not change much. It may look odds but when unexpected factors dash out as arbitrage balance goes up alongside market high price shares become the main engine.
The North Korea nuclear incident was quickly closed and in addition to having very limited impact on economy or stock prices I believe it became Abe cabinet first success. It is understood that the surprise visit to China was engineered by China herself rather than Japan and this allowed clearing former Prime Minister Koizumi Asian Diplomatic relations 'homework'. Abe cabinet is now enjoying high support; this also cleared the fears regarding post Koizumi sell off.