Kimura Dreamvisor Newsletter Summary 2cd October 2006

Interim earnings upward revisions likelihood is increasing.

BOJ Tankan was announced just before market close and earnings diffusion index was above market expectations. Economic expansion is confirmed, there was a slight increase in industries forecasting a worsening environment. The market has already largely discounted concerns for the foreseeable future , market rise is understandable, as current earnings already led to stock upside potential.

Within 'Tankan' report I personally focus on large companies' current earnings and current profitability (current earnings/sales). This is an advance indicator for listed companies' profitability trend, both upside and downside revisions are important therefore it is important to mark it out. The 'Tankan' survey also shows that quite a number of companies stay very careful. Those companies have not changed their full year earnings estimate despite first half earnings were above forecasts. Consequently I feel second half figures are somewhat artificial. Overall profit level is increasing and I feel something is missing regarding the variation rate. Real mid term earnings announcements will start from the second half of October; when real earnings become definitive it will be difficult to give some evasive answers. Will companies finally be forced to revise upward current forecast? I believe numerous companies will do so. Time to time it is enjoyable to see stocks holdings shooting up when earnings are revised upward! You can become more aggressive by taking reasonable profit and switch with stocks left behind as some companies have not yet revised up full year earnings.

At this crossroad nerve yourself to make swift decisions! I strongly advise to regularly look over the earnings headlines of Nikkei or Companies handbook.

'Tankan' shows that large companies expected sales have been revised +1.1% for industry, +0.7 % for services. Current earnings are forecasted to increase +1.7 % for industry and -0.1 % for services. Industry shows -3.2 % forecast for *second half* against +8.0% for *first half* which looks pretty conservative to me.

This is probably due to the large number of companies keeping the same full year forecasts. However current fiscal year exchange rate is assumed at 111 yen against 1 US $ which leaves ample margin for later upside revision. Services forecasts are -2.3 % for *second half* against +2.1 % for *first half*, again this looks pretty severe. Companies in the service sector suffered from high transport and fuel costs.

For other industrial sectors earnings diffusion index is far above previous forecasts but still, I believe upside revision potential remain important. It is clear enough for sectors such as steels, real estate, non ferrous metals, machinery and other industrial services. Even Utilities (gas, electric power) previously forecasting earnings downgrade registered an improvement. Underperforming sectors are chemicals and services for individuals. High raw materials costs plus lack of personnel are the main culprit. The only negative diffusion index was for steel products (bridge construction work).Shipbuilding and paper DI was flat.

Equipments and staff shortage will further deteriorate.

Looking at current Tankan domestic economy is progressing smoothly. There is another indicator called productive equipment investment DI which became slightly negative for large companies as well as small companies, this advanced indicator means there is a shortage of equipment investments. Such a phenomenon is very rare, it has not happened since the bubble period in 1988-1991. Despite current economic expansion being one of the longest excess investments does not show up like during the bubble period. If all industry participants compete with each other any excess will self destruct itself.

In addition the employment diffusion index also felt into the -11 ranging from large companies to small companies alike. Staff shortage is progressively becoming apparent but personnel costs are still sidelined to slightly up therefore company are able to stay profitable. Next step is for personnel costs to increase which certainly makes it uneasy to buy stocks but we still have quite some time before this fully materialize.

As employment situation eases, propensity to save for potential joblessness gradually disappears. In addition by the end of current calendar year baby boomers generation retirement rush will start. Labor supply demand situation should therefore remain somewhat tight for a while. For potential pensioners the desire to continue working is still high consequently people will continue working (despite having reached age limit) by adjusting their consumption habits to income level. As the gross number of active people will not decrease the economic activity level will remain high.

Based on such a scenario and putting aside unforeseen elements like a US severe slowdown or the US $ crash I do not believe Japanese economy will slow in the foreseeable future. As previously mentioned US housing starts fall scope is decreasing and no one expect US Japan rate differential to decrease , US $ will not go down substantially.

Prime Minister Shinzo Abe questioning session took place at the national assembly;

1. I personally doubt that a growth oriented policy with a nominal growth target can ever be met.
2. Regarding his concept of a society meeting new challenges: obviously some people fail and make a comeback but the overwhelming majority join the losers ranks therefore without a new set of measures it looks difficult for a society to change that radically.
3. Consumption tax debate was yet again put forward. I believe Shinzo Abe just cannot debate on the welfare financing and pension money problem.

To speak clearly I feel Abe was not willing to answer the questions even if such questions were not from the political opposition. I have the strong impression that he desperately avoided to answer. My feeling is that this is a very poor debut for a 'young' promising leader. Negotiations have started for Abe to visit China as soon as next week but should that fail he will be severely rated by outside observers.