

**There is wide scope to purchase Japanese mid small caps at that stage**

Supply demand situation is changing, 'behind the scene' factors on the move.

It looks like onshore (and offshore) funds are finally the move; fund managers plus analysts are currently piling up Japanese companies visits showing increased confidence. Supply demand situation for mid caps is slowly improving. Meanwhile the Dow broke historic highs Nikkei 225 or TOPIX look top heavy , but you should look out for the trees in the forest. The downtrend for mid to small caps has been near continuous up to the 13th of October. Large institutional investors see the mid caps recovery as extremely important and factors supporting the recovery are pointing their nose.

TSE second section, Jasdag, MOTHERS march 2007 forecasted Per is currently at **17,1x**. Surprise this figure is slightly lower than TOPIX current forecasted Per **17,2x**. Such a reverse Per phenomenon last occurred in February 2004 something not seen for 2 years and eight months precisely. Broker strategists are pointing to the fact that the logic beneath mid caps relative higher valuation compared to the core market has all but disappeared. The Nikkei Financial daily 18th of October edition mention equities like for example mini shovels manufacturer: [\(6432\) Takeouchi mfg](#) revised up its mid term interim earnings + 94 % and the stock now trades at 15 times current full year earnings, this attracted buying and the stock rose 8 % after the announcement. The daily quotes again real estate developer [\(8890\) Recm reserach](#) who revised its august interim current profit + 70 % two weeks ago, the stock rose +17 % as a result, the stock trades now at 10 times current fiscal year's earnings.

Of course small caps liquidity remain a problem. Jasdag (which I recall is the Japanese counterpart of Nasdaq , negotiations have been opened between both for a potential tie-up) long margin buying is at one year low at cumulated 220 billion Yen. Long margin settlements will take place in November second half and selling interest has been steadily going down. US and Japanese small caps correlation remain strong but obviously Nasdaq is much more highly priced and risk money has flown to BRICs stock markets and foreign small caps. Japanese mid to small caps universe has been left behind, under valuation is now patent on a worldwide basis.

This said market participants still are hesitant, they doubt growth prospects earnings for this universe. But moment of truth is nearing as we have entered the earnings forecasts season for new growth markets. The belief that global Japanese high tech stocks remain the core engine of the market is still strong and most domestic related mid caps remain out of the agendas of large fund managers. Some believe that recent small caps outperformance is due to excess selling self correction although personally it has been a while I feel that substantial value lies at your hands .

As the Dow reached 12,000 tax matters may also explain the fact that Japanese indexes upside gain is capped. Japanese brokerage industry is currently lobbying for Japanese taxation system to be revamped. This is specially aimed at 401K Japanese version (defined pension scheme). It has been already 5 years since the Japanese 401K system has been implemented but outstanding balance is still limited to a few billion Yen. Limited tax-free amount is the basis reason. The Nikkei Financial daily 19th of October points at the fact that even though the tax free ceiling was raised in 2004 it is still limited to 550,000 Yen per year for companies. In the United States original version free taxation pension money ceiling has been consistently increased over the years. By the end of calendar year 2005 US defined pension scheme balance was 2 trillion 900 billion US \$ (340 trillion Yen). Japan's 401k version (2 trillion 500 billion Yen balance ) is one tenth of that and just cannot stand the comparison. For reference Japanese largest onshore mutual fund balance (Kokusai asset global sovereign) balance is 5 trillion 600 billion Yen. However this may change, current government tax consultative committee head will soon retire and Abe new cabinet is keen to prioritise growth over taxation. Should the new Abe cabinet 'catchphrases' such as growth and dynamism weight on the government new tax panel members it would certainly become additional support for the stock market.

**Now what to buy?**

A quick technical insight regarding analysts well covered [\(6753\) Sharp](#) . It is highly technical but interesting, for the first time in 20 years Sharp issued earlier a huge Convertible Bond (200 billion Yen). Most Japanese large electronic giants that issued convertible bonds since year 2000 have their face value under conversion price. Hitachi, Toshiba, NEC, Fujitsu all have their current stock price under conversion and it looks that only (6502) Toshiba have used the financing for its strategic core business field (as you may know Toshiba recently revised up substantially reaping the rewards of its focused strategy). Back in April Hitachi lowered the conversion price of its convertible. For investors who bought the CB a stock price under conversion level means no capital gain , therefore company's management must aim at raising its share price to allow profit for investors. For example Sony's woes hit hard the stock price recently making it difficult to allow conversion. I mentioned Sharp on [seeking alpha Steven Town's blog](#). As the undisputed leader for large LCD flat panel TVs earnings are good but some analysts still doubt Sharp can easily increase its stock price above the conversion price. Sharp CB conversion is 2,530 yen compared to the 4th of October conversion price there is a 25 % gap. Analysts calculated Sharp forward Per at 20 times March 07 earnings , 180 billion yen current profit is needed for the stock to trade above conversion price . CB maturity date is 2013 but price war on LCD large flat screens is heating up in Japan setting doubt on the profitability of this sector. Sharp intends to use the money raised to invest in equipments for Kameyama plant number 2 and above. According to a worldwide survey for large flat screens TV market share Sharp was ranking in third position therefore everything depends on Sharp's worldwide strategy.

Earnings season at peak therefore let's focus on timely updates regarding

[\(8692\) Daiko clearing services](#) disappointed the market the 19th of October (largest fall on TSE 1 that very day) by revising down interim earnings. The interim consolidated current profit was revised down from 2 billion 350 million Yen to 1 billion 480 million Yen (- 44,3 %) and revising down full year dividend from 25 to 20 Yen. The downside revision background is namely online brokerages accounts opening slowdown plus new growth markets stalemate since beginning of this year. This is quite a disappointing figure although I bet on a recovery on this side and therefore keep an eye on the stock.

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