
Green Shoots of Japan's Economic Recovery

Shuhei Abe

Chairman and Representative Director of SPARX Asset Management Co., Ltd.

Introduction

The past six months have been an interesting time with the Japanese equities market hitting another low in March, and then experiencing a sharp rebound. The market's perception has turned from being extremely pessimistic to cautiously optimistic, yet economic data remains mixed. It is still hard to say that this once-in-a-hundred-year financial "Tsunami" has finally passed, but I believe that we won't experience a similar market collapse as last September's due to the world's quick action to inject substantial amounts of capital into the system.

Like most other nations, Japan has taken aggressive fiscal and monetary steps to prevent its economy from descending into the throes of a depression. At the same time, Japan's political system is also facing an important juncture as the country debates whether its post-World War II bureaucratic-led system is still relevant. On July 21st, Prime Minister Aso dissolved the Lower House and called for an election to be held on August 30th. The public polls currently suggest that the ruling Liberal Democratic Party or LDP's control over Japan's political system is coming to an end after more than 50 years.

People say that there are very few differences between the ruling LDP and the Democratic Party of Japan, however we should appreciate that it would be a historic

event if the Democratic Party were to defeat the LDP. In the short term, political stability will be achieved and decisions can be made given that the Upper and Lower Houses will be controlled by the Democratic Party. More importantly, Japan's final phase of its restructuring from a bureaucratic led system to a market oriented one will begin. Over the last six decades, the LDP has built up a powerful structure made up of entrenched interests that was not only supported but reinforced by the government's bureaucrats. I believe that a victory by the Democratic Party will break this cozy relationship causing a major power shift, and in the longer term, forces Japan's political system to re-align and transform itself to a "more dynamic, people driven system."

It may be naïve to believe that this transformation will be completed overnight, but the process will start, and most likely take place over the next two to three years. In my opinion, the market would view this change as a positive.

Japanese Market Review

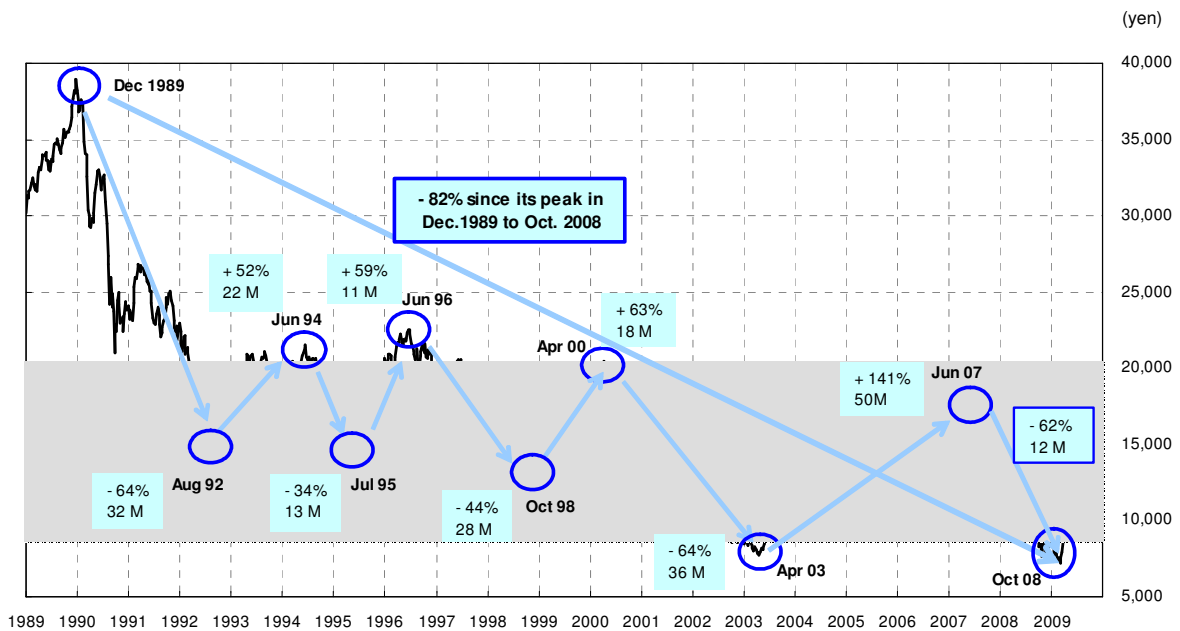
Japanese stocks peaked in December 1989 benefiting from a price bubble in both real estate and stocks. As you can see on the next page in Chart 1, stock prices collapsed as the Japanese economy spiraled into deflation for over a decade following the bursting of the bubble. It was only in April 2003 that the Japanese economy completed its de-leveraging process, and subsequently the market rebounded.

However, after the bankruptcy of Lehman Brothers in September 2008, the Nikkei 225 collapsed again. From its peak level in 1989, the Nikkei 225 sank about 80%. However, from mid March to mid June this year, the market rebounded more

than 40% before taking back some of its gains.

Many investors worry that this year’s rebound was a “bear market rally”. While there are no clear signs indicating a sustainable rally going forward, I believe there are some positive signs that should be considered by all investors.

Chart 1: Nikkei 225 Trend Since 1989

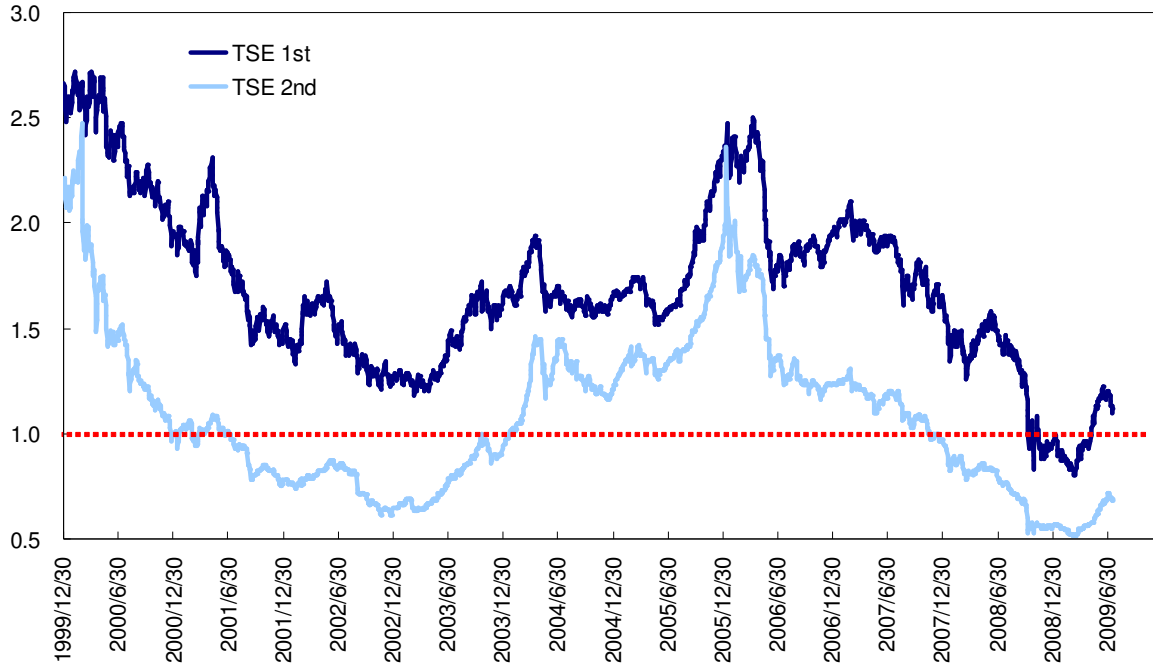


Source: Bloomberg, SPARX (January 6, 1989 - June 30, 2009)

On Chart 2 the historical price-to-book ratios for Japanese equities trading on the Tokyo Stock Exchange’s First and Second sections are provided. After the “Lehman Shock,” stocks were indiscriminately dumped creating an extremely over-sold situation especially for smaller companies. While the market has strongly rebounded from mid March, valuations for Japanese stocks remain at historical low levels.

Chart 2: Japan's Equities Market is Close to a Record Low Valuation Level

Price-to-Book Ratio Trend



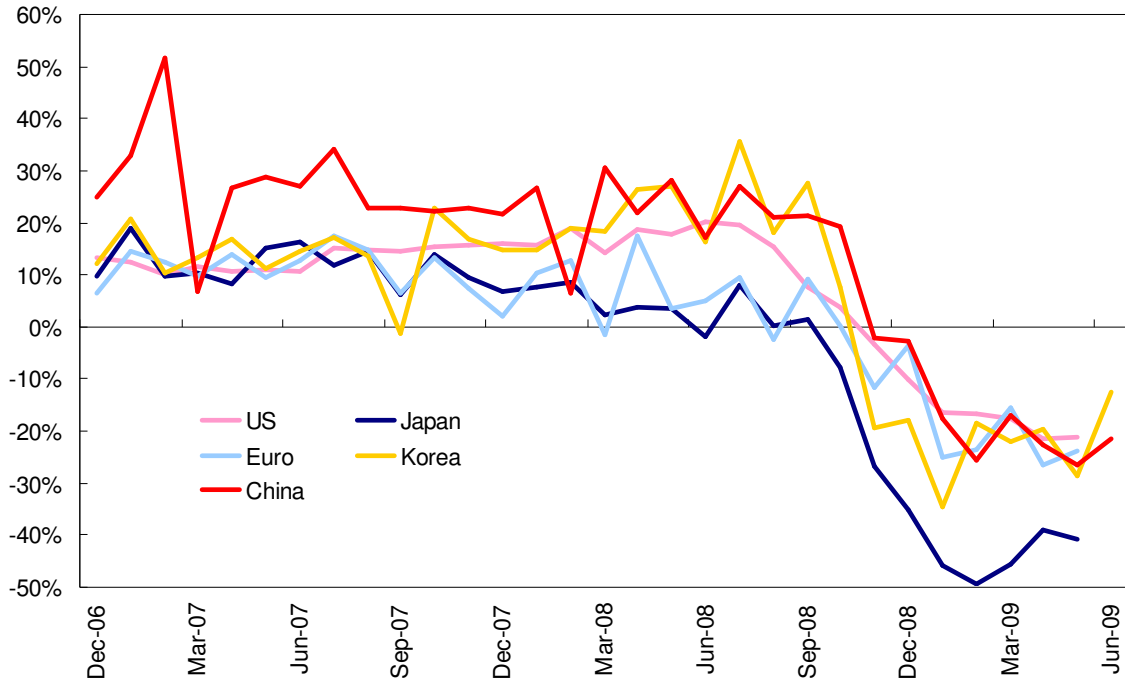
Source: Bloomberg (Tokyo Stock Exchange 1st and 2nd sections, December 30, 1999 – July 17, 2009)

Demand Contraction in the World

On Chart 3, which shows export growth since December 2006, real economies have deeply suffered with global demand undergoing a severe contraction. Global trade has suffered where exports of most countries have decreased about 30% year-on-year. Unfortunately, Japan was one of the hardest-hit countries experiencing a 50% year-on-year decline. This was not overly surprising given that Japan's economy continues to remain heavily dependent on trade, which I talked about in January.

Chart 3: Global Trade Continues to Be Stagnant

Exports Growth by Country/Area (year-on-year)



Note: Korea and China (Dec 2006 - June 2009), Others (Dec 2006 - May 2009)

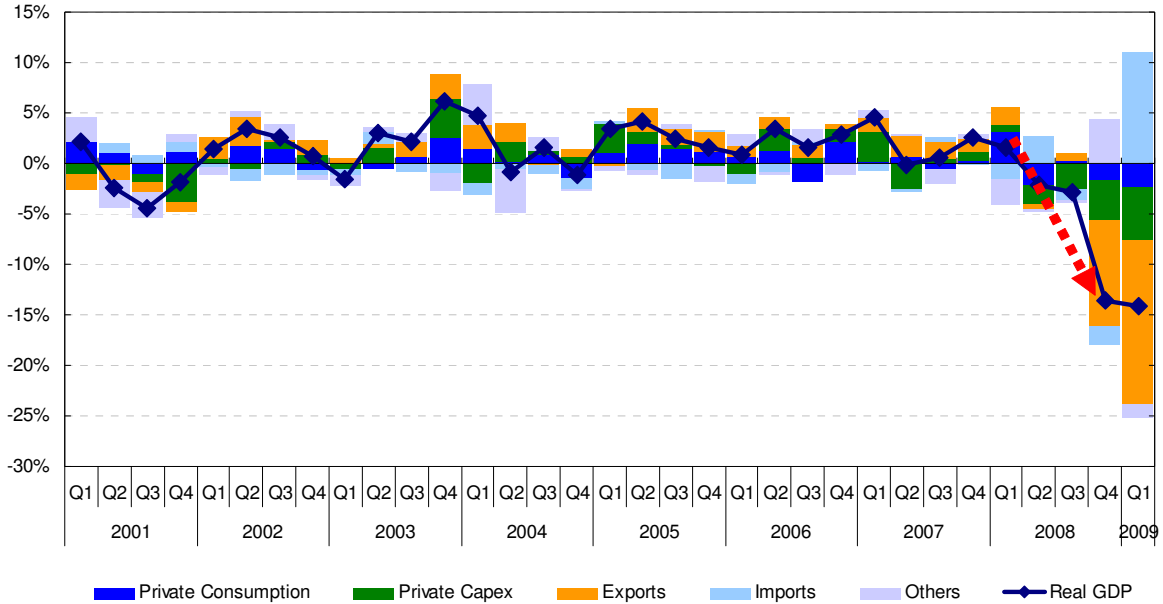
Source: Bloomberg (January 2007 - June 2009)

Focusing on Japan, the nation's real GDP growth rate was seriously impacted when exports slowed, and then this slowdown quickly spread to other parts of its economy, as Chart 4 illustrates on the next page.

The magnitude of this contraction was the worst that Japan had experienced since 1955, and it was also the first time that the country had two consecutive quarters where annualized growth was more than negative 10 %.

Chart 4: Slowing Exports and Capital Spending Continue to Hurt Japan

Contribution for Real GDP Growth (quarter-on-quarter, annualized)

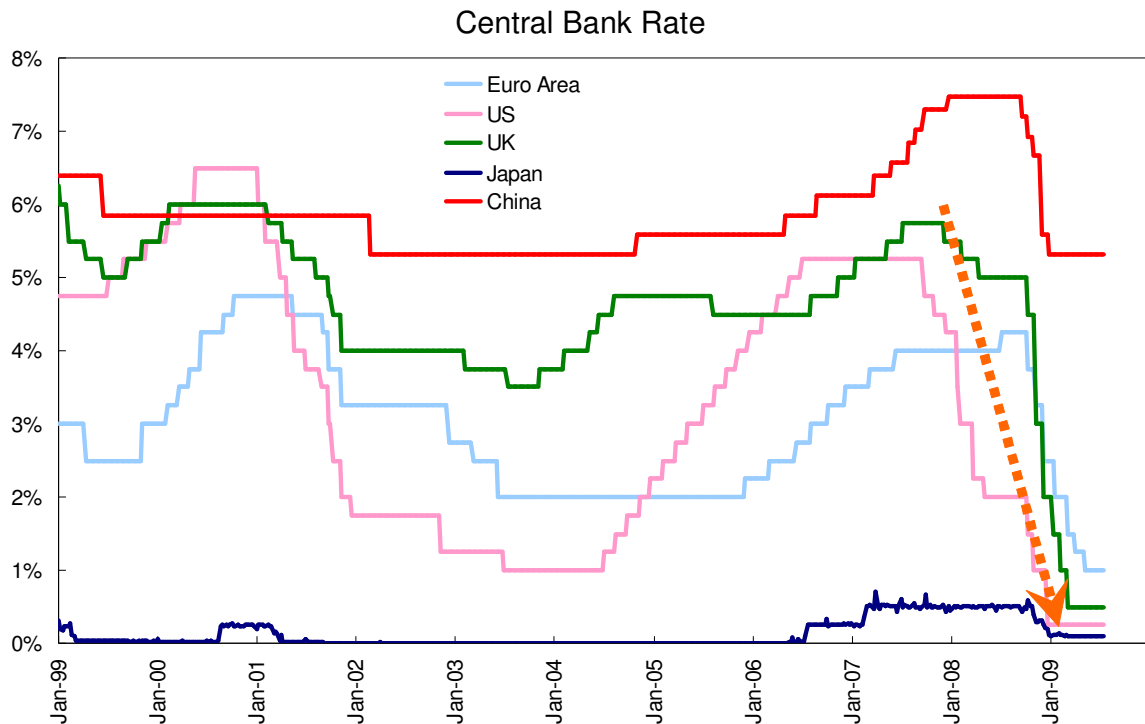


Source: Cabinet Office, as of June 11, 2009

Global Measures for Credit Crisis: Zero Interest Rate Policy

Facing a global credit crisis, the world’s major Central Banks took decisive and coordinated measures. Chart 5 shows that most of the developed world’s Central Banks lowered their policy interest rate down to nearly zero in a very short period of time. China, which represents the developing countries, lowered its policy rate to a historical low level. The world has adopted a “zero interest rate policy,” and this unprecedented action among others taken, is a reason why I think we’ll not experience a similar market collapse that we saw last September.

Chart 5: World's Central Banks Have Aggressively Taken Action



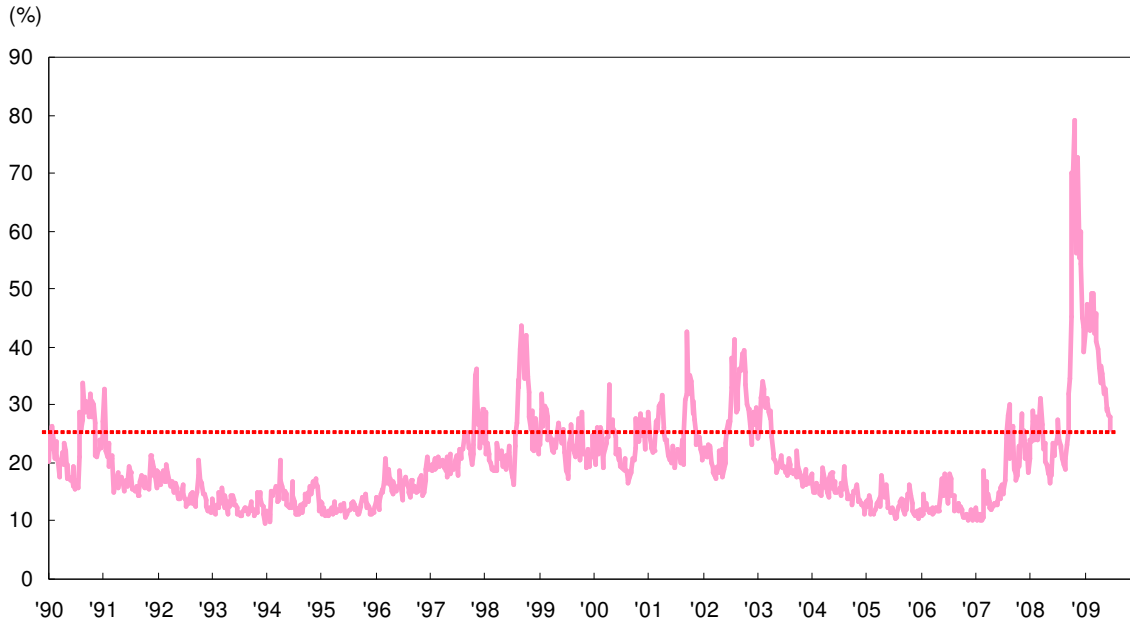
Source: Bloomberg (January 1, 1999 - July 17, 2009)

A Return to Normalcy?

Thanks to the measures taken by the world's major Central Banks, we are observing some signs that the financial panic caused by the "Lehman Shock" has passed and that the financial markets are starting to work again. First, we have a chart of the volatility index for the S&P 500, or VIX index. Before September 2008, this index peaked at about 45% during periods of crisis. For example, in 1998 we had the Russian financial crisis, then the bursting of the Internet bubble and 9-11. The significance of the "Lehman Shock" is illustrated by the fact that the index surged to 80%.

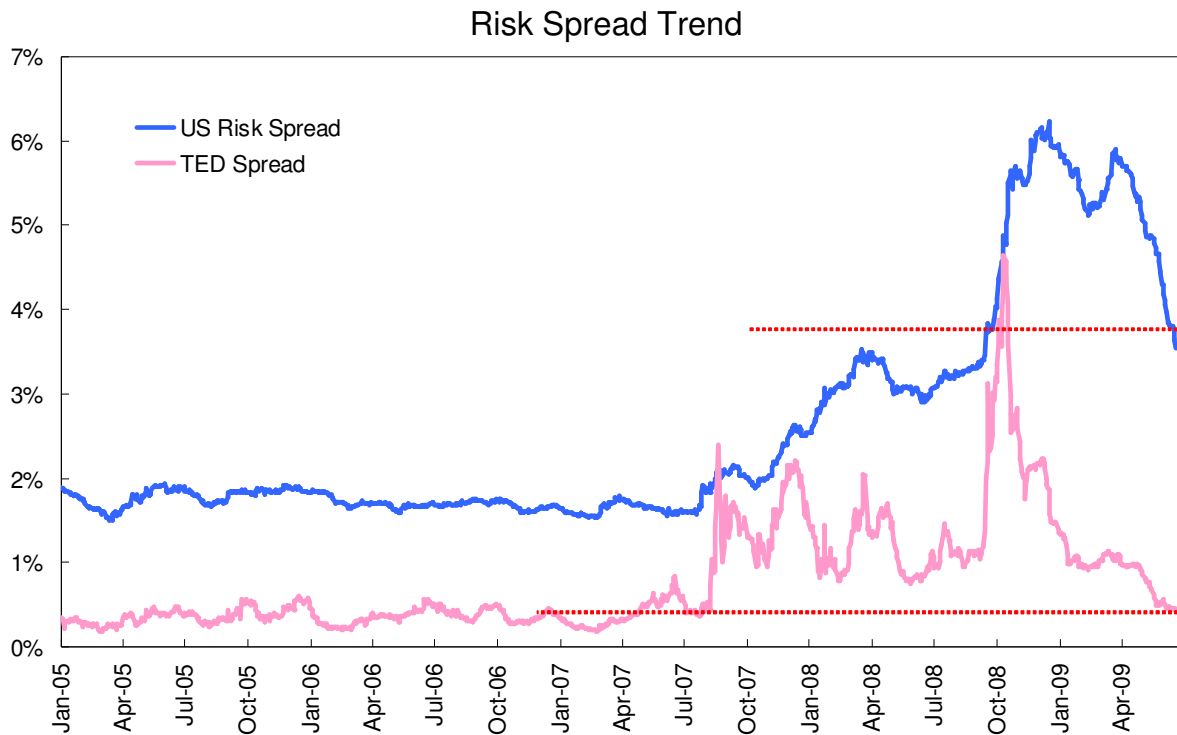
Chart 6: Back to Normal? Equity Market Returns to Pre-Crisis Days

CBOE S&P 500 Volatility Index



Source: Bloomberg (Chicago Board Options Exchange, January 5, 1990 – July 17, 2009)

Fortunately, the world has taken quick and unprecedented action causing the index to fall below 30%. It is still at a high level, implying that investors are still worried about downside risks; however, we are no longer at an extreme panic level. The next chart shows the TED spread and credit spread.

Chart 7: Back to Normal? Inter-Bank Lending Crisis is Over


Note: US risk spread = Moody's Baa CB Yield - 10yr Government Bond yield

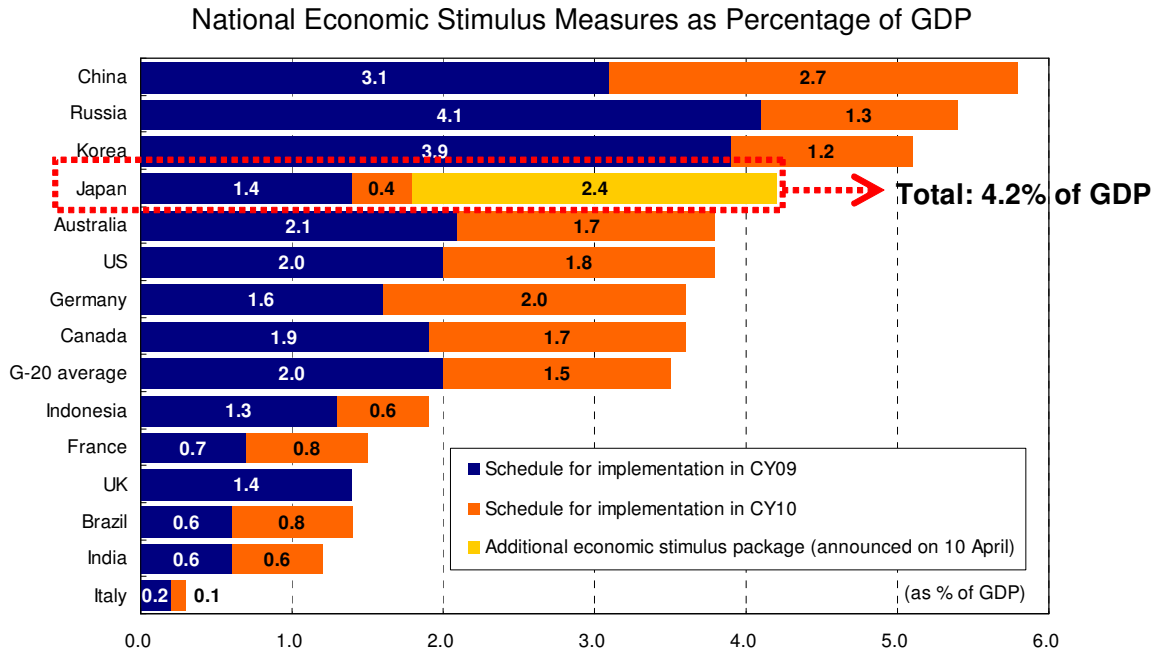
TED spread = LIBOR 3M yield - 3M US Treasury yield

Source: SPARX, Bloomberg (January 1, 2005 – July 17, 2009)

After the “Lehman Shock,” most financial institutions worried about the risk of default by their counter parties, and therefore were unwilling to lend money to one another. At one time, the TED spread rose to about 5%, but has fallen back to a “normal” level after Central Banks stepped in to “unfreeze” the banking system. On the other hand, the credit spread continues to remain high on a historical basis. As a result, it is still not easy to get a loan.

Global Coordination to Stimulate the Global Economy

Chart 8: Massive Economic Stimulus Packages Have Been Introduced Too



Note: 1. Excludes financial sector assistance measures and liquidity support measures for corporations, for all countries.

2. Shows values estimated by IMF, based on economic stimulus measures disclosed as of end-February 2009.

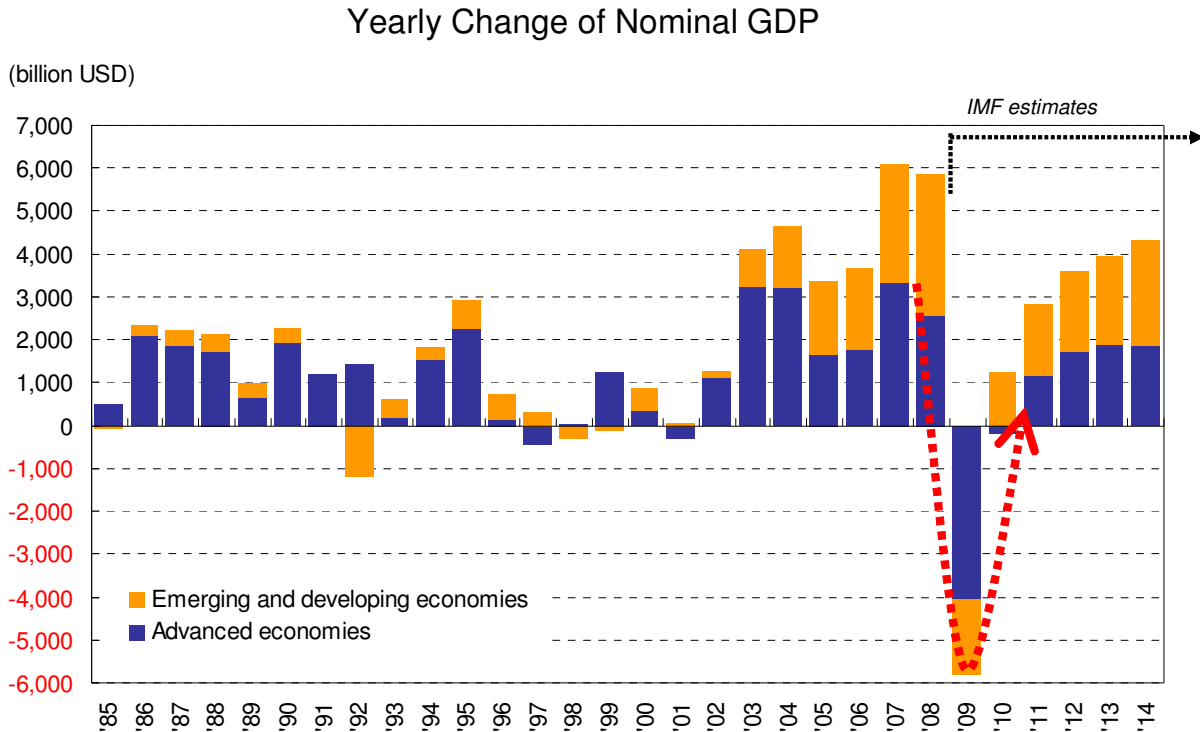
3. IMF estimates used for Japan

Source: Nomura research report dated May 26, 2009

With global demand contracting to levels not seen since “the Great Depression,” huge fiscal stimulus activities have been conducted on a global basis. Asian countries such as China and Japan have announced some of the largest programs as seen in Chart 8 on this page. As for Japan, its package is equal to about 4.2% of nominal GDP, which is the largest for the nation’s history. With no other options available to make up for the loss in global demand, we believe that these actions were necessary and will eventually lead to an increase in demand.

Expected V-shaped Recovery

Chart 9: Worst May Be Over: Expected V-Shaped Recovery for World GDP

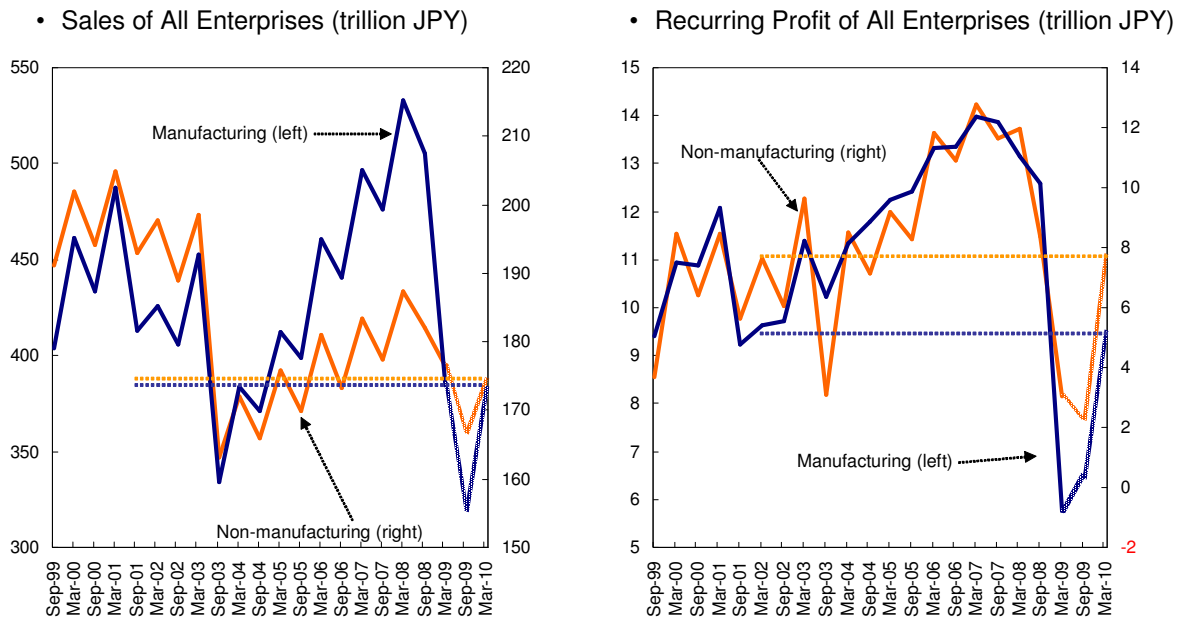


Source: IMF (World Economic Outlook Database, April 2009)

Above in Chart 9 you can see that about 6 trillion dollars of demand disappeared in 2009. This amount is larger than Japan’s nominal GDP, yet thanks to the various actions that we have discussed, a V-shaped recovery is anticipated. In fact, the IMF recently increased its 2010 forecast by 0.6 percentage points or to 2.5 percent.

On Chart 10 below, we see the Sales and Recurring Profit trends for Japanese companies from the Bank of Japan’s TANKAN survey. Both manufacturing and non-manufacturing companies experienced a sharp downturn in their business. Consistent with the IMF GDP growth forecast from the previous page, Japanese companies are also expected to experience a V-shaped recovery.

Chart 10: Japanese Companies Also Expect a V-Shaped Recovery



Note: Data from September 2009 through March 2010 are projections provided by the Bank of Japan

Source: Bank of Japan’s TANKAN Survey as of June 2009

Where Are We Now?

Where are we today? I believe that the worst is over and that there are positive signs emerging to indicate that the world economies will start to grow again. However, is today’s recovery real or not?

There are a number of positive factors where the world's massive fiscal stimulus programs are not fully in place, so their impact has not been fully realized. While growth in the developed world is not visible, Asia continues to grow. Additionally, the crisis has provided the world an opportunity to focus on the environment, which is creating a new source of demand. We are also slowly observing that liquidity is returning to the financial system, and lastly factories are beginning to operate again especially in the electronics related sector following a severe adjustment in their inventory levels.

▶ **Positive factors**

- ◆ Massive fiscal stimulus measures
- ◆ Asia's private consumption continues to decouple from the West
- ◆ Strong demand driven by Green New Deal
- ◆ Ample liquidity
- ◆ Surge in demand following inventory and production adjustment

▶ **Risk factors**

- ◆ Weakness in household consumption
- ◆ Overcapacity in certain manufacturing sectors
- ◆ Debt deflation
- ◆ Early "exit policy"
- ◆ Possibility of a hike in oil prices

On the other hand, private consumption in developed countries remains weak and unemployment continues to increase. The massive contraction in global demand has resulted in overcapacity leading to deflationary pressure, which we are beginning to observe in Japan. Also, the de-leveraging process is not completely over in the U.S. and Europe. Like a patient who underwent triple bypass heart surgery, the world has been moved from the ICU or Intensive Care Unit to the medical floor for observation

and monitoring. However, as Japan experienced in the late 1990s, there is a risk of reversing or exiting too early from our global reflational policy.

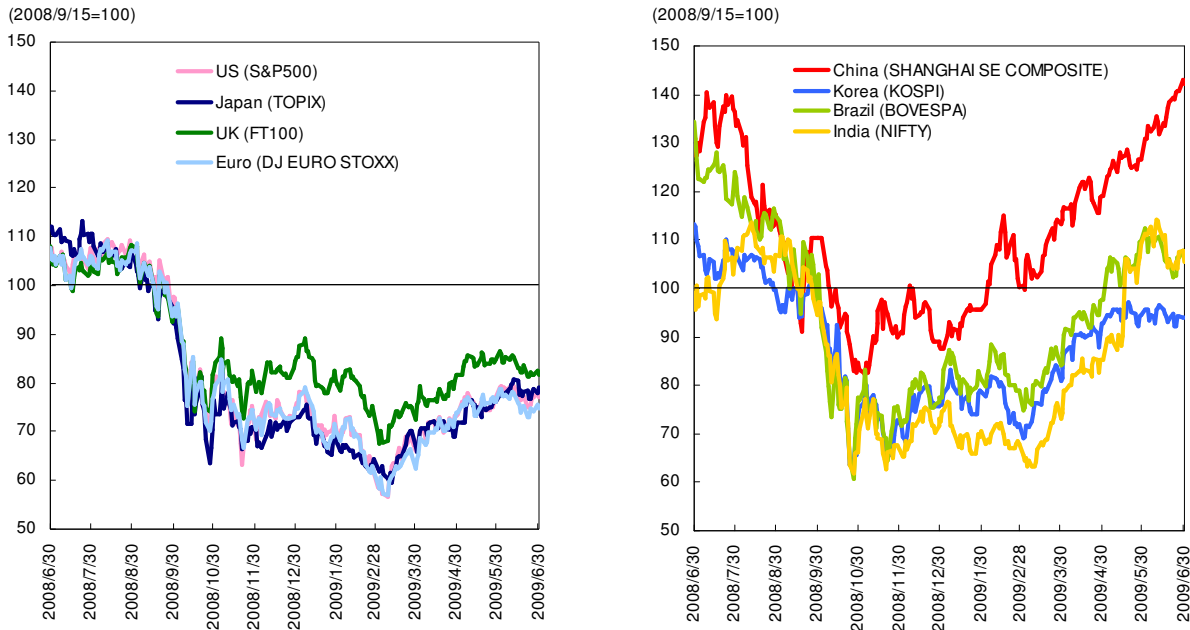
That said, markets will remain volatile in the short run, however two very important growth drivers continue to gain momentum. For the mid and long term, I believe Japanese companies will be able to capitalize on these opportunities, which I will explain in more detail in the following sections.

Growth Opportunities: Asia

Chart 12 on the following page shows the major equity indices of the developed and emerging markets since the “Lehman Shock.” All the indices have rebounded since March, but there is a clear difference in the magnitude of the recovery between the two. I think this performance disparity reflects the growth gap between developed countries and emerging countries.

Chart 12: Emerging Economies Have Led the Market Rebound This Year

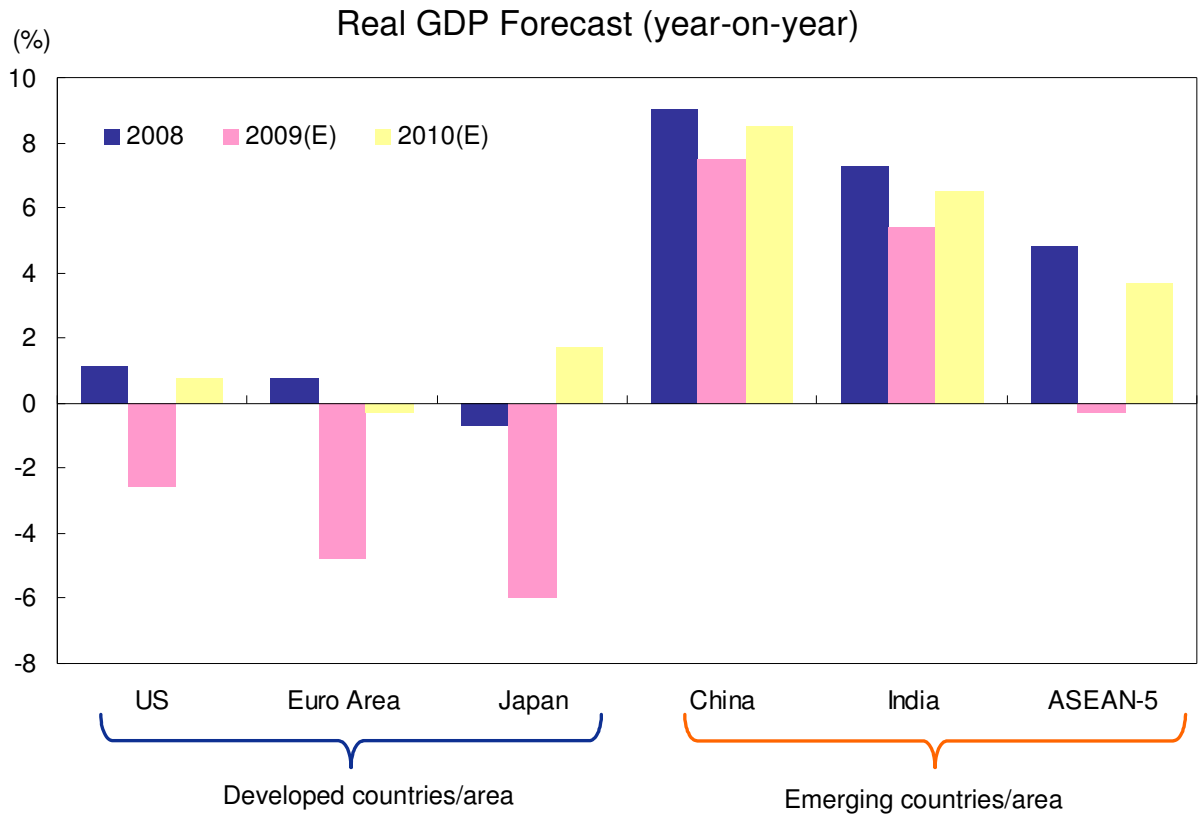
Representative Index Returns Since the Bankruptcy of Lehman Brothers



Source: Bloomberg (June 30, 2008 - June 30, 2009)

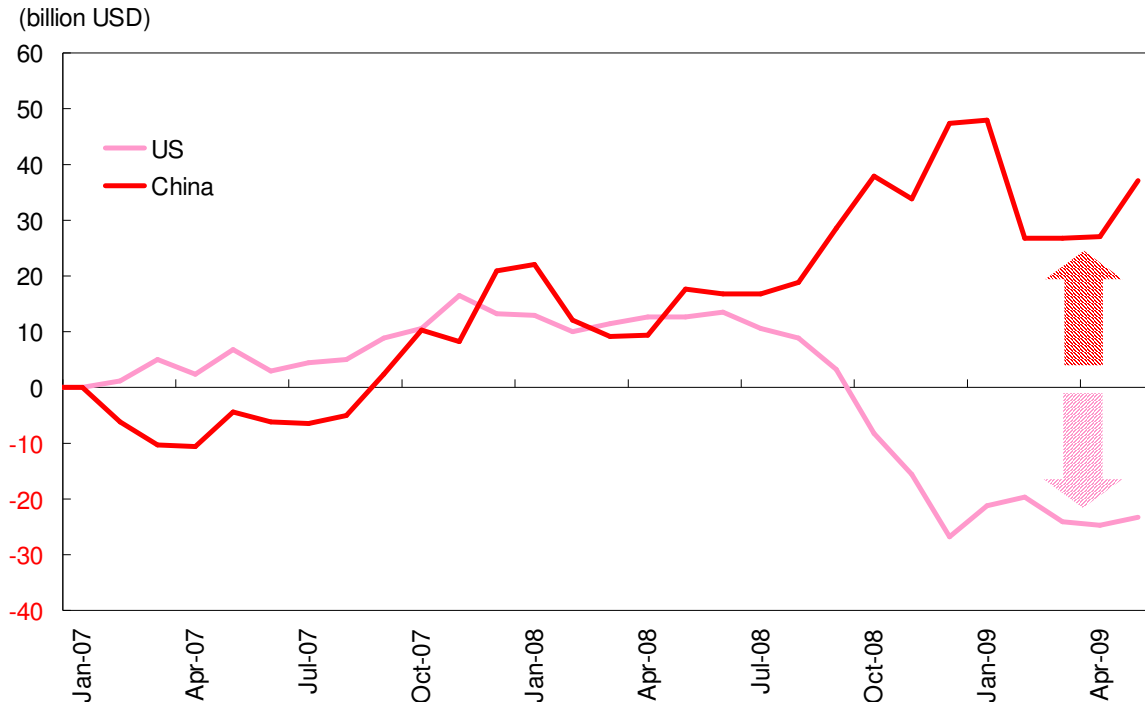
As chart 13 on the next page shows, there is a clear difference in growth rates where the emerging countries are growing at a much faster pace, and moreover, the growth gap is getting larger. While global demand will remain at a much lower level than the past due to the de-leveraging that has taken place in the U.S., emerging countries are expected to take up the slack.

Chart 13: Emerging Economies are Still Growing in Real Terms



Source: IMF (World Economic Outlook Update, July 2009)

This trend becomes more apparent when comparing the change in retail sales between that of the U.S. and China, which is shown on chart 14 on the following page. After the “Lehman Shock,” U.S. retail sales started to decline, but interestingly, retail sales in China have started to increase.

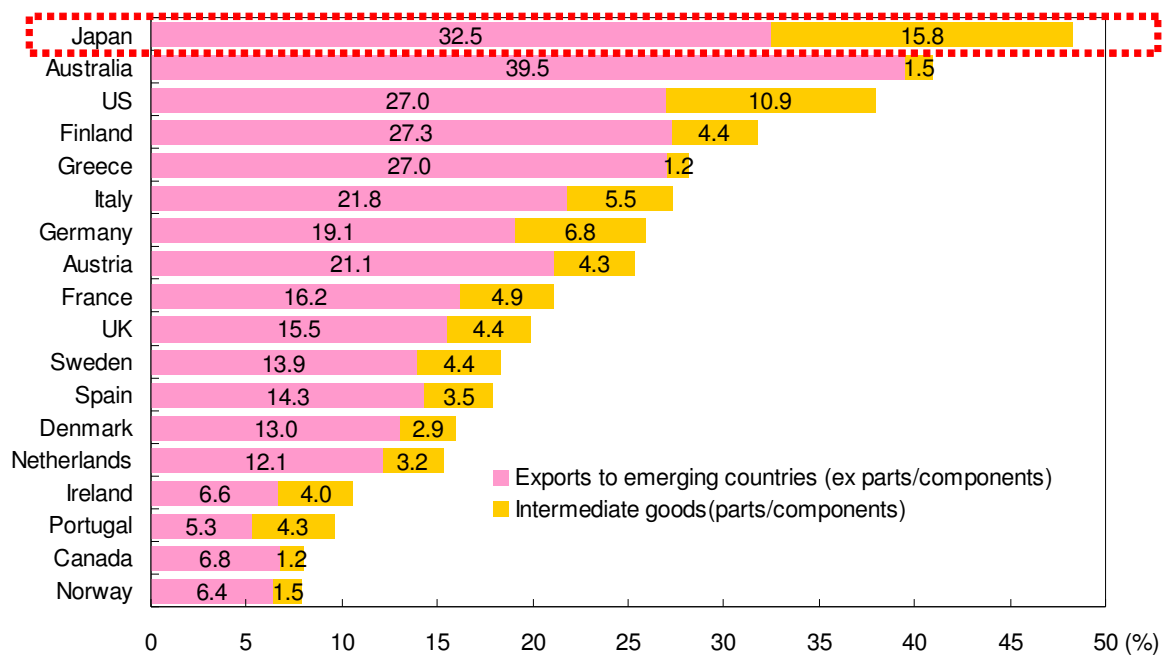
Chart 14: China's Household Spending Continues to Rise
Change in Retail Sales Since January 2007


Source: Bloomberg, SPARX (January 2007 - May 2009)

It may be a coincidence that the rate of change between the two countries is about the same, however I believe that this is a sign of “global rebalancing”. China is spending a vast sum of money to support its economy and transform itself from an external driven economy to a domestic driven one.

The data continues to support this trend, so I am interested in determining who will be a prime beneficiary. For several reasons, I believe that Japan would be the number one beneficiary. Based on exports to emerging countries as a percentage of total exports, Japan versus other nations has the largest exposure to emerging countries.

Chart 15: Japan Leads: No. 1 Beneficiary of Emerging Economies' Growth



Note 1: Commodity classification based on BEC code.

2: "Emerging countries" is originally defined by Nomura as follows. Emerging Asia : Bangladesh, China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Philippines, Korea, Singapore, Thailand, Vietnam, Emerging Europe: Bulgaria, Croatia, Czech, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia, Turkey, Oil producers: Algeria, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE, Venezuela, Others: Argentina, Brazil, Chile, Mexico, Egypt, Morocco, South Africa.

Source: Nomura based on UN data as of June 3, 2009

Today, Japanese companies are more focused than ever to leverage their geographic and cultural advantages for developing opportunities in Asia. A recent example is the beverage company Kirin who confirmed their merger discussions with privately held Suntory. Besides aiming to strengthen their business infrastructure, one other objective is to develop their overseas business.

Growth Opportunities: Green New Deal

On a longer term perspective, I believe that the emergence of “Green” related businesses will create huge investment opportunities. The table on chart 16 lists the “Green” related fiscal measures taken by the G-20 countries. About 400 billion US dollars is targeted for this new area. This is a globally coordinated initiative, and I believe it should create new demand and lead to structural changes in many areas.

Chart 16: World’s New Growth Driver: ‘Sustainable, Green Revolution’

Green Fiscal Measures by the G20 (billion USD)

	Total Fiscal Stimulus	Fiscal Stimulus As share of 2008 GDP (%)	Green Stimulus	Green Stimulus As Share of 2008 GDP (%)	Renewable Power	CCS/Other	Building EE	LO C Vehicles	Rail	Grid	Water /Waste	Period (Years)
Argentina	3.7	1.1	0.0	0.0	-	-	-	-	-	-	-	2009
Australia	26.7	2.5	2.5	0.2	-	-	2.5	-	-	-	-	2009-2012
Canada	31.8	2.0	2.6	0.2	-	1.1	0.2	-	0.4	0.8	0.1	2009-2013
China	586.1	13.9	200.8	4.8	-	-	-	1.5	98.7	70.0	30.7	2009-2010
France	33.7	1.1	7.1	0.2	0.9	-	0.8	-	1.3	4.1	-	2009-2010
Germany	104.8	2.7	13.8	0.4	-	-	10.4	0.7	2.8	-	-	2009-2010
India	13.7	1.1	0.0	0.0	-	-	-	-	-	-	-	2009
Indonesia	5.9	1.2	0.1	0.0	0.1	-	-	-	-	-	-	2009
Italy	103.5	4.3	1.3	0.1	-	-	-	-	1.3	-	-	2009 onwards
Japan	485.9	10.0	12.4	0.3	-	-	12.4	-	-	-	-	2009 onwards
Mexico	7.7	0.7	0.8	0.1	-	-	0.8	-	-	-	-	2009
Saudi Arabia	126.8	24.0	9.5	1.8	-	-	-	-	-	-	9.5	2009
South Korea	38.1	4.0	30.7	3.2	1.8	-	6.2	1.8	7.0	-	13.9	2009-2012
UK	30.4	1.1	2.1	0.1	-	-	0.3	1.4	0.4	-	-	2009-2012
US	972.0	6.8	112.2	0.8	32.8	6.6	30.7	4.8	9.9	11.9	15.6	10 Years
EU	38.8	0.2	22.8	0.1	0.6	12.5	1.9	1.9	-	4.9	-	2009-2010
G20 (excl. EU)	2,609.6	5.5	396.0	0.8	35.5	7.6	10.1	10.1	121.8	86.8	69.8	

Note 1: Data has been reported by all G20 members except Brazil, Russia, South Africa and Turkey

Note 2: CCS (Carbon Capture Storage), EE (Energy Costs and Efficiency), LOC (Low-carbon)

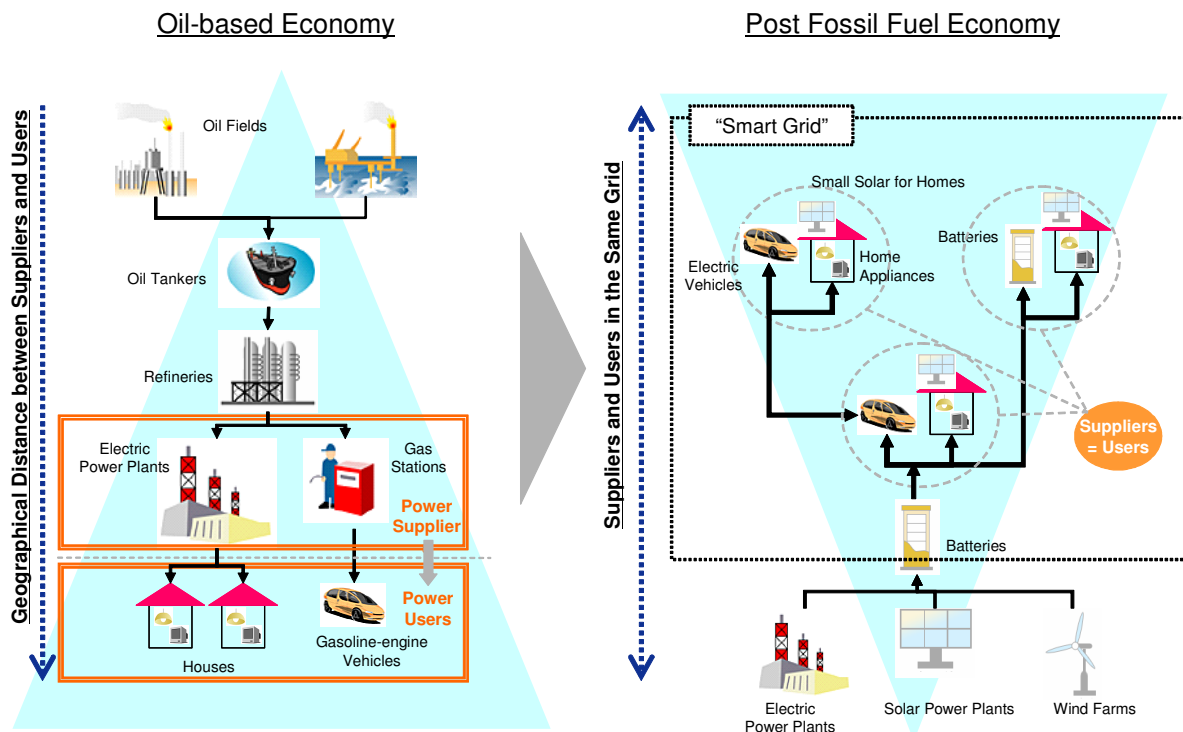
Source: Report for the G20 London Summit in April 2009

Japan's Advantage for Green Technology in Post Fossil Fuel Economy

On chart 17 on the following page, I have tried to illustrate the image of the structural change or transition from an oil based economy to a post fossil fuel economy.

In the oil based economy, the interactions between suppliers and users are one-way as shown in the chart on the bottom left. Suppliers and users are separated by geography and power generation is centralized. However, I believe we are in the early stages of a transition to a post fossil fuel economy where we will operate within a "Smart Grid". In this new system, electric power will be produced and used by individuals who are connected to one and another in the grid.

Chart 17: Structural Changes in Power Generation and Energy Use

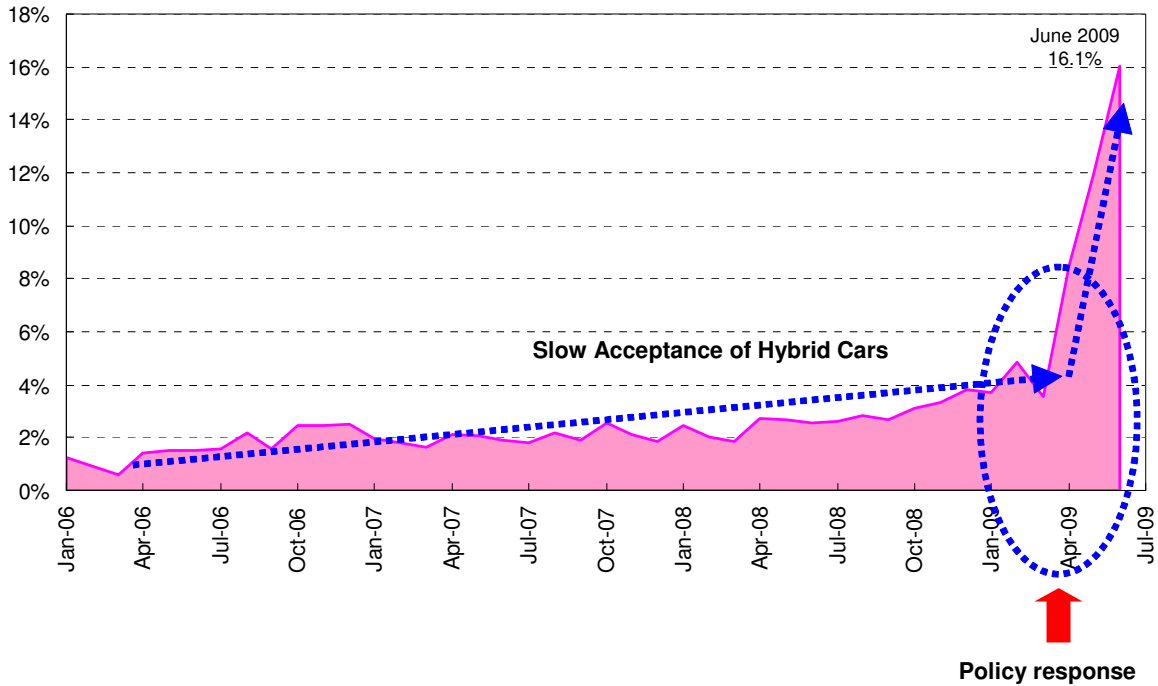


This new “Green Society” is not only limited to batteries or solar cells, our daily lives will be impacted too. Like the Internet, I believe that this eco-focused trend would be a similar transformational event for our society.

Governments and consumers are becoming more aware of the environment. As an example, the Japanese government announced a tax reduction for “Eco Cars” on March 30. Since then, the sales of hybrid cars have increased dramatically, which is shown on chart 18 on the next page.

Chart 18: Economic and Policy Measures Foster New Demand

Market Share of Hybrid Cars in Japan for New Passenger Car Sales



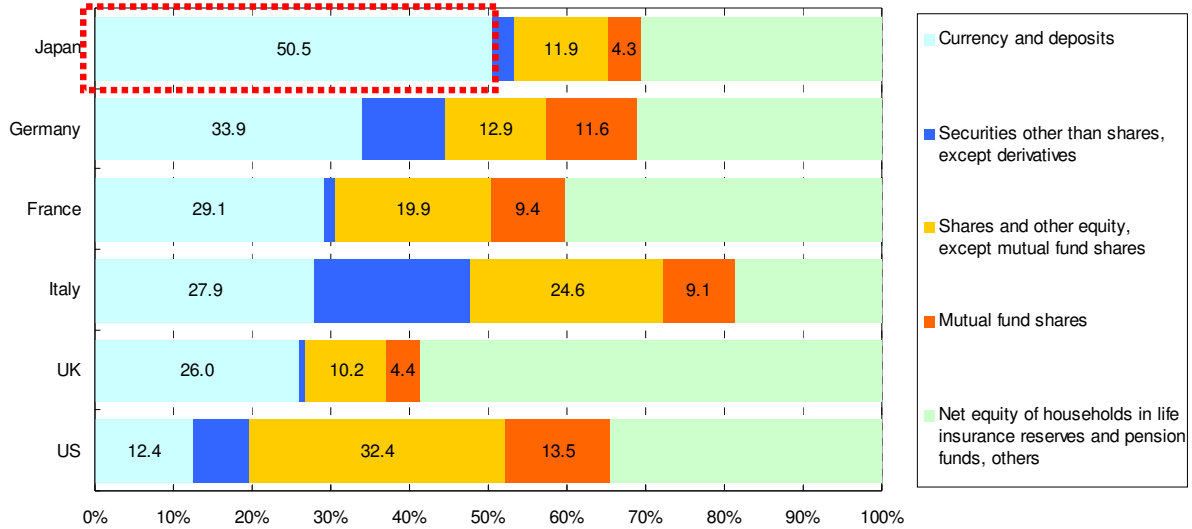
Note: Hybrid cars are defined as Toyota's Prius and Honda's Insight
 Source: JADA, JAMA, SPARX (January 2006 - June 2009)

A “Green Shoot”: Japanese Individuals’ Appetite for Japanese Equities

Lastly I would like to briefly talk about the possible change in the mindset of the Japanese retail investor. It is no secret that Japanese hold more than half of their assets in cash. It was often viewed as an opportunity but one that never materialized.

Chart 19: Pool of Wealth: Where is Japan’s Households’ Savings?

Composition of Japanese Households’ Financial Balance Sheet in 2006

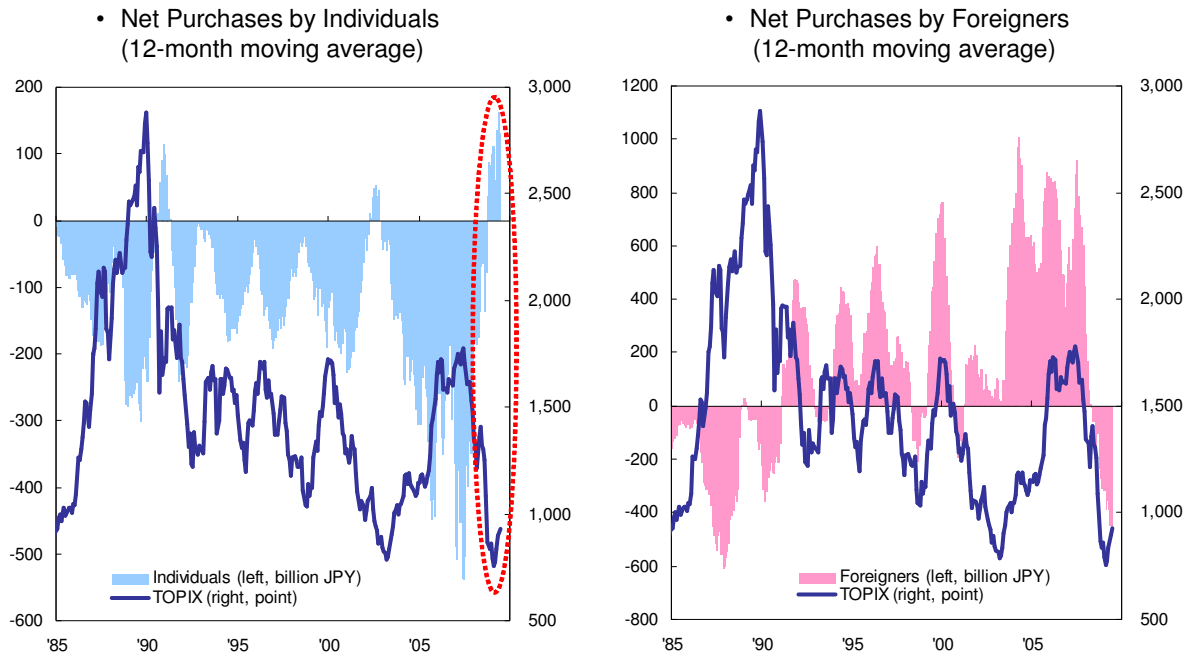


Source: OECD “Households’ Wealth Composition Across OECD countries and Financial Risks Borne by Households”, January 8, 2009
 Bank of Japan “Flow of Funds” as of March 23, 2007

However, due to their conservative approach, Japanese households are in a relatively better position today than others. Now, we are beginning to see signs that they are finally starting to invest in Japanese equities.

On Chart 20, we compare the net purchases of Japanese equities by individuals and foreigners. Since 1985, Japanese have been net sellers of Japanese equities. Since the “Lehman Shock,” there are signs that they are finally buying. It is still too early to make a conclusion, but it may be possible that Japanese have changed their decision to invest in Japanese equities instead of foreign currencies.

Chart 20: Japanese Individual Investors: Bottom Fisher vs. Trend Follower



Source: Tokyo Stock Exchange, Bloomberg, SPARX (January 1985 - June 2009)

Conclusion

This year’s market rally has been a major move, but I believe it was part of a normalizing process from over-sold conditions as global investors became less-negative. While the world’s efforts seem to have pulled us from the edge of a depression, the global economies remain weak and more time is required to heal. Therefore, in the short run, supply and demand will determine the direction of the market and this will lead to more volatile movement in share prices.

- ▶ **Short-term Outlook: Volatile Market**
 - ◆ The worst may be behind us thanks to the coordinated reflationary policy
 - ◆ Mixed bag of economic reports would paint an uncertain picture
 - ◆ Supply and demand is likely to influence the equity markets rather than economic fundamentals

- ▶ **Mid-to Long-term: Asia Growth & New Demand for Green Technology**
 - ◆ Rising demand in Asia would lead the way to a worldwide recovery
 - ◆ Among all developed nations, Japan would be the biggest beneficiary of growth in emerging economies
 - ◆ Global fiscal stimulus measures targeted toward “Green New Deal” would help create new demand
 - ◆ Corporate Japan possesses key technologies to address environmental needs

- ▶ **Changes in Japan**
 - ◆ Japan’s cash-rich individuals have turned net buyers of Japanese equities
 - ◆ Japanese call for a change of government

From a mid-term perspective, Asian driven growth will be the theme for the market. Asian domestic related demand will become a more important component of global demand, and Japan would be one of the biggest beneficiaries. I believe you should consider participating in Asia growth opportunities through Japanese companies.

Additionally, the Green New Deal will be one of the most interesting and biggest opportunities for Japanese companies. Today Japanese companies produce many of the key technologies for Green related products and services, and should benefit from this new source of demand.

Lastly, Japan’s households are showing signs of change as well. Finally they have started to make the slow transition from savers to investors, and now they are calling for a change in the political system.

It has been an interesting year so far, and I anticipate more twists and turns for the rest of the year. At the same time, I remain excited about Japan's future as its political system is set to be re-shaped and once-scarce growth opportunities for Japanese companies are becoming more tangible.

SPARX Asset Management Co., Ltd acts as the sub-advisor to the Hennessy Select SPARX Japan Fund and Hennessy Select SPARX Japan Smaller Companies Fund.

The Hennessy Funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by visiting www.hennessyfund.com or calling 1-800-966-4354. Please read it carefully before you invest or send money.

Past performance does not guarantee future results. Index performance is not illustrative of fund performance. You cannot invest directly in an index. Please visit www.hennessyfund.com for fund performance.

Small and medium-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies. Investments in foreign securities involve greater volatility and political, economic and currency risk and differences in accounting methods.

VIX is the ticker symbol for the Chicago Board Options Exchange Volatility Index, a popular measure of the implied volatility of S&P 500 index options. The S&P 500 is an unmanaged index commonly used to measure performance of U.S. stocks. The Nikkei 225 is a stock market index for the Tokyo Stock Exchange (TSE). The Tokyo Stock Price Index (TOPIX) is a market capitalization-weighted index of all companies listed on the First Section of the Tokyo Stock Exchange. The FT100 is the Financial Times Share Index and is made up of 100 largest (according to market capitalization) UK firms listed on the London stock exchange. The DJ Euro STOXX is a market capitalization-weighted index of 50 blue-chip stocks from the countries that participate in the European Monetary Union. The Shanghai SE Composite is an unmanaged index commonly used to measure performance of Chinese stocks. KOSPI is the Korea Composite Stock Price Index is the index of all common stocks traded on the Stock Market Division—previously, Korea Stock Exchange—of the Korea Exchange and is representative of the performance of stocks South Korea. BOVESPA, or Bolsa de Valores, Mercadorias & Futuros de São Paulo is a São Paulo-based stock exchange and is representative of the performance of stocks in Brazil. The NIFTY is Standard & Poor's CRISIL NSE Index 50 and is the leading index for large companies on the National Stock Exchange of India. The Nifty is a well diversified 50 stock index accounting for 21 sectors of the economy. One cannot invest directly in an index. The price-to-book ratio, or P/B ratio, is a financial ratio used to compare a company's book value to its current market price.

Opinions expressed are those of Shuhei Abe and are subject to change, are not guaranteed and should not be considered investment advice.

The Hennessy Funds are distributed by Quasar Distributors, LLC. 10/09

Disclaimer

This Report has been prepared by SPARX Asset Management Co., Ltd. (“SPARX”) for information purposes only to professional investors who are expected to make their own investment decisions without undue reliance on this report. The views and strategies described may not be suitable for all investors. Under no circumstances is it to be used or considered as investment advice, a recommendation to buy, an offer to sell, or a solicitation of an offer to buy or sell securities. We accept no liability whatsoever for any direct or consequential loss arising from any use of this report or its contents. The information is intended solely to report on investment strategies and opportunities identified by SPARX. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. SPARX and its affiliates do not warrant the accuracy or completeness of any of the information or data contained herein. References to specific securities and their issuers are for illustrative purpose only and are not intended to be, and should not be interpreted as investment advice or, a recommendation, offer or solicitation for the purpose or sale of any financial investment. This report does not constitute tax advice and as such investors should be advised to consult their own tax advisers regarding the tax consequences of their investment activities. Investment return and principal will fluctuate, so that a client’s initial investment may increase or decrease. Investing in securities markets involve risks like those arising from stock and bond markets, currency exchanges rate and interest rate volatility. No part of this material may, without SPARX prior written consent be copied, reproduced or published by any recipient for any purpose. Past performance is not indicative of future performance.

© 2009 SPARX Asset Management Co., Ltd.