NATCAN MARKER

January 16, 2009

ARE THE UNITED STATES OF AMERICA THE NEW JAPAN?

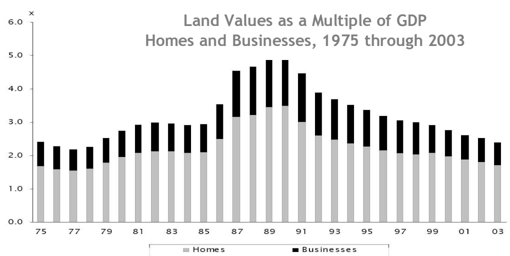
Following the extraordinary market developments of 2008, many investors question whether the U.S. is headed for their own version of Japan's "lost decade". The question is pertinent given the superficial similarities between the two countries: each experienced real estate bubbles and equity market crashes. In Japan's case, these were followed by a decade (November 1992 – November 2002) during which GDP grew at 0.2%[1]. In this edition of the Marker, we compare and contrast end-of-cycle contractions between the world's two largest economies in an effort to come to terms with possible paths for the world's largest economy.

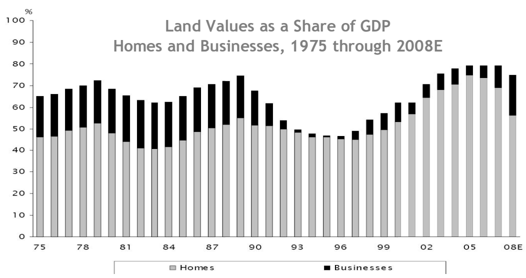
KEY SIMILARITIES

Michael Goldstein published an insightful, data-filled analysis on this question[2] from which we draw several key points. As so often is the case, hard facts grant us perspective. The greatest, in fact perhaps the only, commonality between Japan of 1989 and the U.S. of 2007-2008 will have been real estate and more specifically, land prices. Both had irrefutably appreciated strongly, and "new paradigm" thinking had taken hold of investor attitude.

MORE DIFFERENT THAN MEETS THE EYE

Closer examination of the hard facts surrounding this issue reveals how different the two situations truly are. First, the dimension of the real estate problem in each country takes on a deep contrast when measured relative to the size of each country's overall economy (land values are used as proxy in the charts below). The value of real estate in Japan went from three times GDP to five times - an astounding ratio - while it grew from 0.62 to 0.90 times in the U.S., albeit over a shorter horizon.





Source: Empirical Research Partners, December 2008

There are several other noteworthy differences between the two countries. The real estate value explosion in Japan was centered in the commercial sector while the key run up in values in the U.S. occurred mostly in the residential area. Consumers in the U.S. were far less exposed to overpriced land than their counterparts in Japan, but they had much greater leverage on this asset. This leads us to banks. While the two groups suffered greatly from bad real estate loans, U.S. banks were much faster at recognizing losses. The lack of desire by Japanese authorities to force loan loss recognition turned out to be a key contributor to the duration of the crisis in Japan. Another key difference between countries worth mentioning is the strength of their business sectors. In Japan, corporations exhibited low profitability and heavy-debt burdens were the order of the day. The priority was lifetime and full employment through export growth. The U.S. corporate sector has returns on capital and debt levels that compare very favourably with return on equity (ROE) levels more than double those of its Japanese counterpart.

NATCAN MARKER
Many investors fear the U.S. is heading into a lost decade, as was the case for Japan in the 1990's. A close look at the facts discredits this line of thinking. The challenges faced by the U.S. are massive and will play out over several months and years. Yet, the greatest difference may be cultural with the U.S. already demonstrating its low level of tolerance for economic pain, and a high degree of resourcefulness and resolve at addressing its problems. On the other hand, Japan took many years to implement policies that still appear tentative and ineffective to many observers.

Michael Quigley, CFA, CAIA
Senior vice president, Distribution

FINANCIAL MARKETS

RETURNS AS AT JANUARY 12, 2009 (%)	MTD	QTD	YTD
S&P/TSX	-2.06	-2.06	-2.06
S&P 500	-3.74	-3.74	-3.74
S&P/TSX Small Cap	-2.24	-2.24	-2.24
Russell 2000	-6.28	-6.28	-6.28
MSCI EAFE	-2.85	-2.85	-2.85
MSCI World	-4.29	-4.29	-4.29
DEX Universe Bond	0.25	0.25	0.25

	RATES AS AT JANUARY 12, 2009
CAD/USD	1.20
CAD/Euro	1.61
US Treasuries yield 10-yr/30-yr	2.31/2.99
GOC bond yield 10-yr/30-yr	2.76/3.60
Fed Fund Rate (target)	0.25

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

[1] Standard and Poors Research – 20 October 2008
[2] Empirical Research Partners – Portfolio Strategy December 2008

N A T C A N