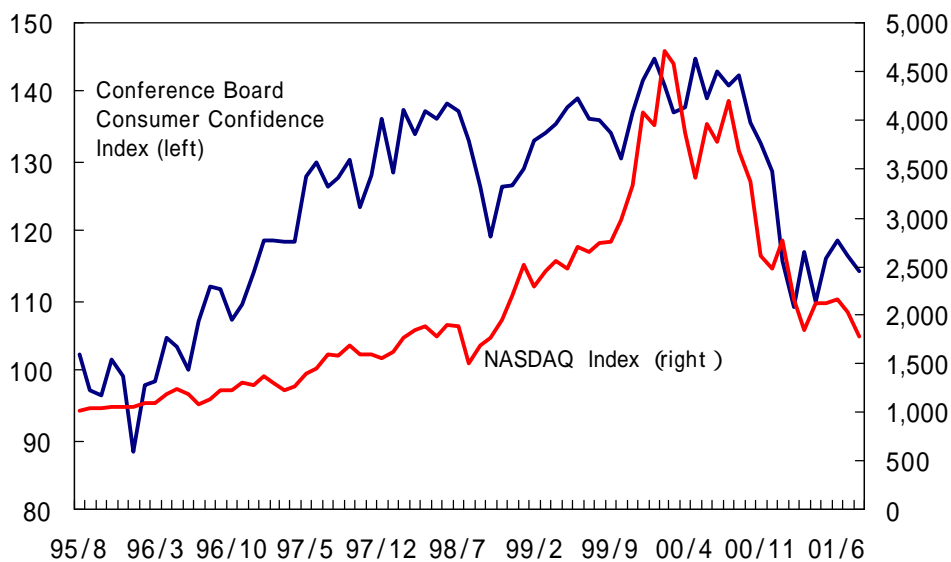

Monthly Strategy Report

Tug-of-War Between Expectations on Policy Initiatives and Global Deflation

Will the U.S. Stage an L-Shaped Recovery? Changes in the U.S. Consumer Confidence Index



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Synopsis





1. No signs of the recession bottoming out.
2. The U. S. economy is likely to see an L-shaped recovery.
3. Service industry in the doldrums – Unable to provide employment
4. Nikkei's drop below ¥10,000 level will bring policy initiatives.
5. Political agenda packed after September.
6. Expectations rise for initiatives on bad debt write-offs.
7. Liquidity-driven market recovery (not a rebound)?
8. Deterioration in fundamentals must be factored in again?

Index Range Forecast



Period	TOPIX	Nikkei
Sept. 2001	1,000 – 1,200	¥9,500 - ¥11,500
Oct.-Dec. 2001	1,050 ~ 1,350	¥10,000 ~ ¥13,500
Jan.-Mar. 2001	1,100 ~ 1,300	¥11,000 ~ ¥13,000

Overview of Investment Environment for Equities

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	Primary Scenario	Risk Scenario
Domestic Economy	The economic pullback is becoming increasingly pronounced. July industrial output was down for the fifth consecutive month, falling below the 1998 level. Inventories are beginning to fall, but declining exports and soft consumer spending are pushing final demand even lower. As the employment rate rises, the Koizumi Cabinet has approved additional spending, but this is aimed mainly at the employment picture and is likely to have little effect on the real economy. On the other hand, even if a large-scale spending package is implemented, it may have a negative impact due to the resulting rise in long-term interest rates.	Concerns about Japan's financial system flare up again as stock prices fall and the end of unlimited deposit insurance nears. Bankruptcies of companies large and small increase, causing the recession to deepen. On the positive side, consumer sentiment improves due to the Koizumi Cabinet's reforms. Economic activity grows as more new companies are formed.
Revision & 3-mth trend	The outlook remains unchanged. 	
Corporate earnings	In the critical electrical machinery sector, it appears that reductions in earnings estimates are largely over. However, we will probably see companies in many other industries reduce earnings projections as the September interim reporting period approaches. We will also see a large number of companies announcing restructuring programs that include layoffs. Nevertheless, investors need to remain cautious about whether or not these restructuring steps signal the beginning of a true shift in how companies do business.	The downturn in the U.S. economy deepens, leading to greater fears of a big drop in earnings in 2002. A positive surprise could come from an upturn in earnings in Japan in the first half of fiscal 2002 as the yen weakens and benefits of restructuring actions appear.
Revision & 3-mth trend	The current series of downward earnings revisions is factored into stock prices, but uncertainties about a recovery next year remain. Thus, corporate earnings remain a negative factor. 	
Domestic Interest Rates	For now, interest rates are likely to remain at the current level and be sensitive to concerns about a possible increase in government spending and the possibility of growing demands for adoption of an inflation target. However, there appears to be no change in the Koizumi Cabinet's policy regarding the restructuring of government finances, so interest rates will probably move downward over the medium term.	Rising pressure to increase the money supply leads the BOJ to purchase more bonds and to more government spending. This sparks a full-scale undesirable interest rate increase and rising worries about stagflation.
Revision & 3-mth trend	Outlook remains unchanged. 	
Overseas Economies	Private-sector capital spending in the U.S. is falling rapidly due to excess capacity in the IT sector. A deteriorating income picture is weakening consumer sentiment, sparking concerns about the outlook for consumer spending. With little room for additional interest rate cuts, worries will grow as the U.S. has access to fewer options to deal with the softening economy. European economies will probably deteriorate due to the downturn of the U.S. economy.	Balance sheets of U.S. financial institutions weaken and changes in money flows spark concerns about the U.S. dollar. A positive surprise could come from a sudden upturn in the U.S. economy that would support expansion on a global scale
Revision & 3-mth trend	Outlook remains unchanged. 	

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Foreign Exchange	At this time, attention is focused on the downturn in the U.S. economy. There are concerns that Japanese investors will sell and take their money home, and this may lead to a slight decline in the dollar's value. However, over the medium term, a gradual decline in the yen's value is foreseen. Pressure on the yen will be exerted by a falling trade surplus, expectations of more monetary easing by the BOJ and Japan's troubled financial system. The yen is also expected to weaken over the medium term against the euro.	A U.S. recession prompts the end of the strong-dollar policy, sparking a rapid increase in the yen's value. Or the effects of the Koizumi Cabinet's structural reforms cause the yen to plunge, an event that could trigger another Asian currency crisis
Revision & 3-mth trend	Outlook remains unchanged. 	
Supply-dem and dynamics	Sales of cross-holdings are accelerating. By the fourth week of August, net sales by Japan's city, long-term credit and regional banks already totaled ¥325.6 billion, far more than July's total of ¥122.6 billion. These sales will hold down stock prices until the middle of September. At this time, foreign investors have become net buyers of equities, but most of this buying appears to be repurchases of shares, mainly bank stocks, as the end of the interim fiscal period approaches. However, if no progress in the bad debt issue becomes apparent, foreign investors may become net sellers too. And if the turnover in lower-priced stocks, the primary target of individual investors, does not remain active, we could see an absence of buyers.	The debate regarding revisions to securities taxes is not going well. Prime Minister Koizumi's leadership may allow revisions to be approved in late September, but it appears that these reforms will no longer be able to serve as a stimulus for the stock market.
Revision & 3-mth trend	Outlook remains unchanged. 	

→ *Changes and trend for next three months*

(1) Current Economic Conditions

■ **Analysis of Investment Climate**

The deterioration in economic fundamentals continues. Inventory reductions that began in the electrical machinery sector have spread to other sectors as expected. Next, we foresee a more pronounced downturn in the non-manufacturing sector, which had been viewed as a source of jobs for people displaced by manufacturers.

Japan is now trying to decide whether the country is in the midst of Koizumi reforms or the Koizumi recession. First of all, we need to realize that we have already taken one step toward a global recession. This fact makes it difficult to make a prediction about Japan's fundamentals based solely on domestic policies and inventory trends. There are concerns that the U.S. economy will soften in concert with Japan's. Consequently, there are considerable risks associated with adopting an optimistic view of the investment climate at this time. Only a shift in government policies can alter the direction of the markets.

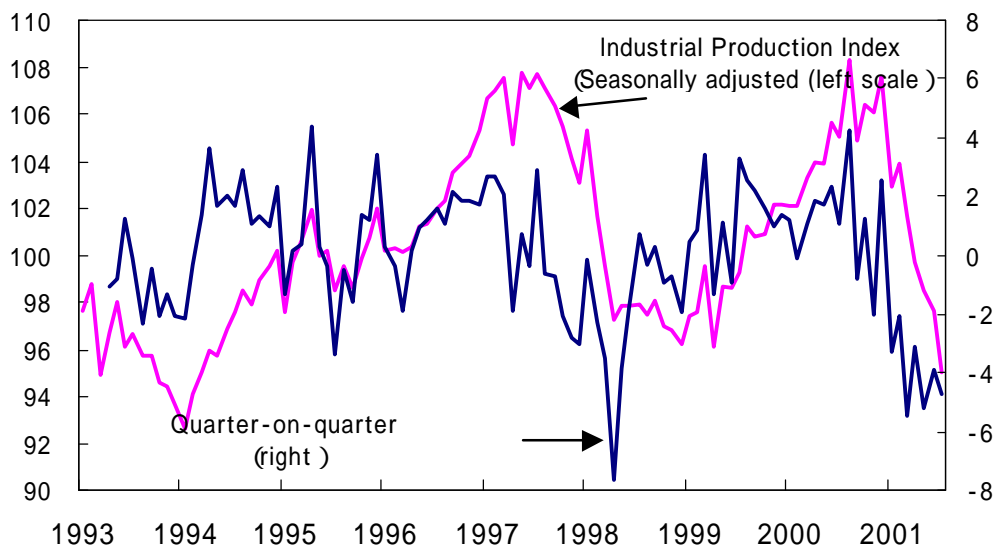
In this report, we have stated that the supply-demand gap in the high-tech sector has been the primary reason for the economic downturn. We further stated that the downturn would probably be prolonged as inventory reductions spread to many other sectors of the economy. In fact, the preliminary report on July industrial output showed inventory reductions in all sectors except metal products. Although inventories were slightly lower due to lower production levels in the electrical machinery sector, the drop in shipments was steep. The result was an increase in the inventory ratio.

Signs are appearing of an easing in the manufacturing output downturn. Table 1 shows changes in the monthly industrial output index in relation to three months earlier. As was clearly demonstrated in 1998, the decline in the 3-month comparison, an indicator of the momentum of the weakening in manufacturing, bottoms out prior to the actual bottom in output. Currently, the three-month comparison is hovering at about 5%.

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However, the gradual nature of the decline leads us to believe that considerable time will be needed until manufacturing output reaches its lowest point. Looking at actual production rates in relation to the estimated production index, companies are still revising production plans downward even though they began to reduce production levels a long time ago. This signifies that demand is even weaker than companies had been expecting. Investors should therefore adopt the view that inventory reductions will require more time than had been expected.

Figure 1 Three-Month Comparison of Industrial Output Index

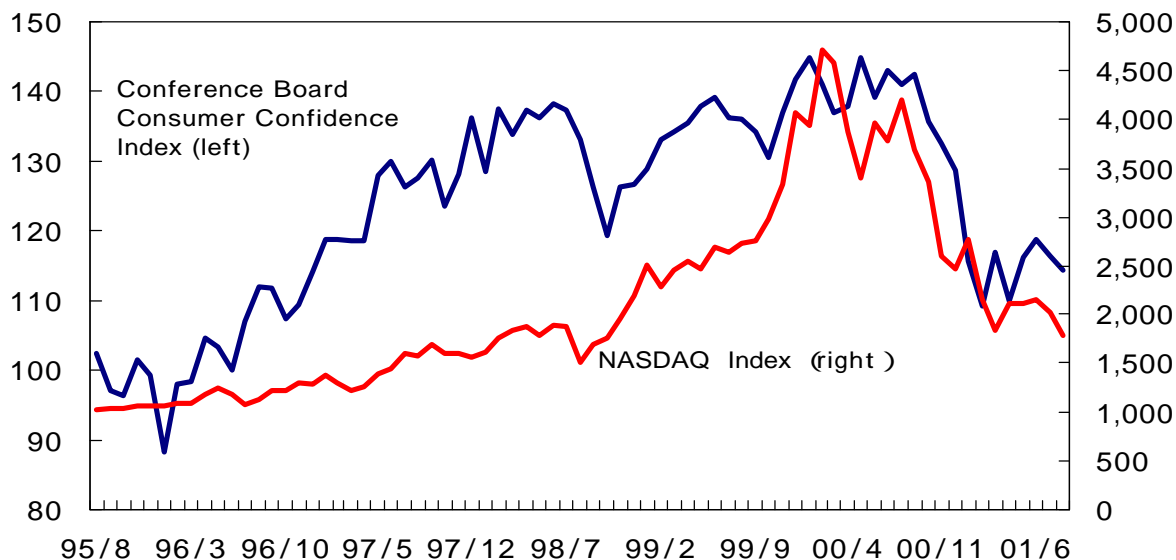


Softening demand is also rooted in Japan's weak consumer spending and declines in capital expenditures. But, as we have previously stated, the U.S. economy's downturn is having a major impact. Opinions differ as to whether the U.S. economy will stage a V, U or L-shaped recovery. Taking a serious view of the current downturn, which is linked to falling capital expenditures, we have projected an L-shaped recovery. In any case, the absence of signs of a recovery in July and August now preclude the possibility of a V-shaped recovery.

Now the question is whether or not the U.S. economy can stage a rebound in the second half of 2001, even a U-shaped recovery with a weak right side. Our conclusion is that a recovery is unlikely. Although the U.S. barely avoided a decline in consumer spending in the second quarter of 2001, any further improvement in consumer spending is highly unlikely. Layoffs are beginning to spread from dot-coms to many other industries. We are also starting to have concerns about a negative wealth-effect as stock prices drop (see table below comparing consumer confidence with the NASDAQ index). European economies are slowing too, pointing to the possibility of a global recession.

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Table 2: Conference Board Consumer Confidence Index vs. NASDAQ Index



Another cause for concern is growth in concerns about deterioration in the domestic non-manufacturing sector, an area that until now has experienced a comparatively mild downturn. Workers displaced by structural reforms were to have been absorbed by the service sector. Unfortunately, even in the retailing sector, small and medium-sized companies are now sensing that they have too many employees. Obviously, it will not be easy to find new jobs for displaced workers. A long time will be needed to bring about improvements in Japan's economic fundamentals.

(Excess – Shortage)

	March 2001 survey			June 2001 survey		
	Large firms	Medium-size firms	Small firms	Large firms	Medium-size firms	Small firms
Wholesale	1	15	6	15	13	10
Retail	12	5	2	11	4	7

In this difficult environment, attention will be centered on government policies. We would like to discuss this point within the context of the market outlook.

(2) Investment Strategy

■ Market Outlook

We believe that the market has fallen to a crisis level. If the Nikkei broke the ¥10,000 line, it would not only have major technical ramifications, but also serve as a powerful sign that Japan is becoming the source of a global recession. However, we do not expect to see the market fall at once because the Japanese government is likely to take a number of preventive actions. We therefore foresee a market in which investors look for a medium-term turning point while closely following government actions.

The Nikkei average has approached ¥10,500, the level that we have previously estimated would be the

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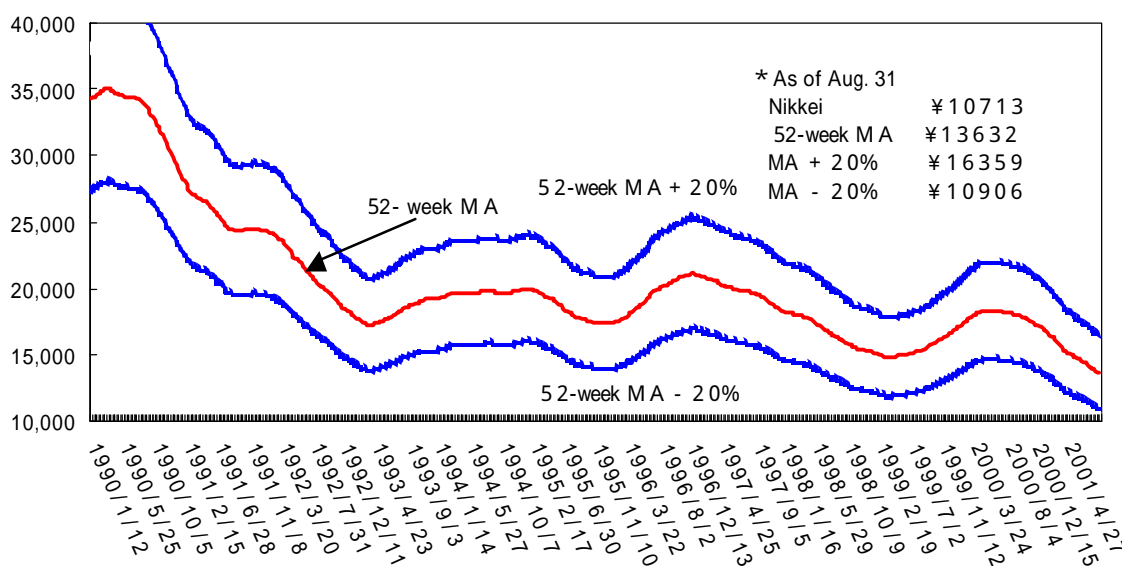
support line for the time being. We chose the ¥10,500 figure because of our belief that the government would take decisive steps before the average fell below ¥10,000, sparking a rebound from that point.

Irrespective of the technical importance of the ¥10,000 level, a significant fall below this figure would probably become a powerful symbol that Japan is becoming the source of a global recession. The world has already moved halfway toward a recession. Under such circumstances, the Japanese government is determined to avoid being identified as the primary instigator of a global recession.

As the table below illustrates, Japan's equity markets have often rebounded at the point where the Nikkei average falls 20% below its 52-week moving average. This was the case when stock prices turned upward in March of this year in the wake of monetary easing by the BOJ. This time too, the market has fallen to the point from which it could bounce back following the adoption of effective government policies. We believe that it is very likely that the government will reveal measures in late September or October to deal with bad debt, an issue of great interest among investors. Based on this outlook, we are retaining our scenario of a temporary upturn in stock prices, but are making only a small revision in our estimated price range.

However, we believe that the weakening U.S. economy will continue to make the global economy soft for the time being. In this environment, investors should not pin their hopes on a sustained, full-scale upturn in stock prices. We expect to see the market test a second bottom late in 2001 or during the first three months of 2002.

Table 3 Nikkei Average 52-Week Moving Average



There are two key points regarding government policies: dealing with bad debt and stimulating the economy through additional spending. With regard to bad debt, the Financial Services Agency sent stock prices plummeting in late August by announcing its intention of achieving a 50% reduction in bad debt over the next seven years. This market reaction clearly demonstrated the extreme sensitivity of investors to this issue.

Many events are on the docket following the return of Financial Services Minister Yanagisawa from his overseas trip on September 8. U.S. Treasury Secretary O'Neill comes to Japan on the 12th, a G7 meeting is scheduled for the 29th, bad debt experts from the U.S. are to visit Japan in late September, an

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extraordinary Diet session is scheduled to begin on the 27th, and President Bush is to visit Japan in mid-October. Although we remain cautious, it is possible that we may see some actions to deal with problem loans during this period. Particularly noteworthy is the upcoming visit by experts who helped clean up the U.S. S&L mess. This indicates that Japan may use public funds in some way through the Resolution and Collection Corp. (RCC).

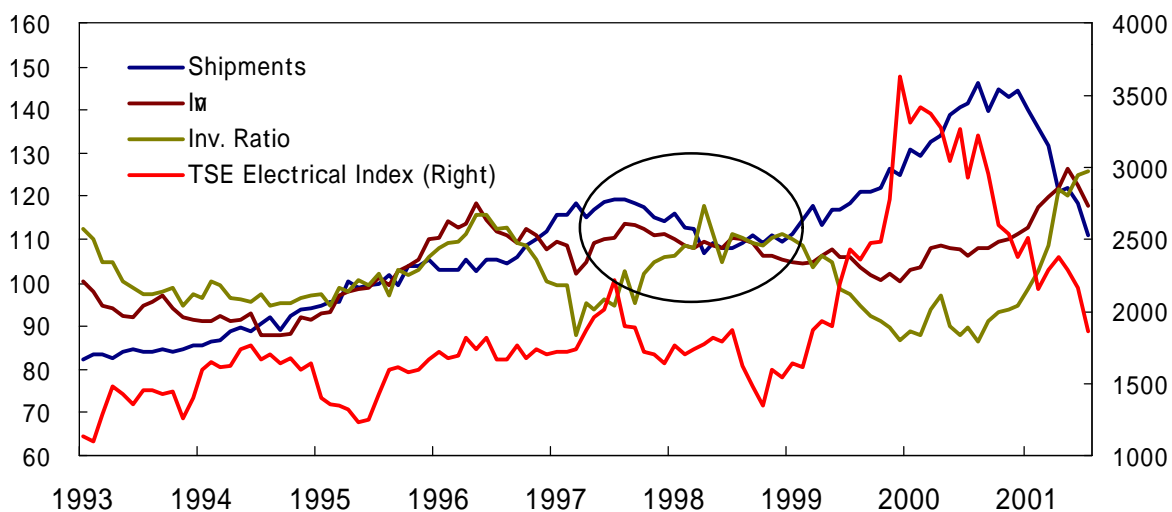
A BOJ policy meeting is scheduled for September 18 and 19. This may lead to an expansion of monetary easing to accommodate bad debt measures. But merely increasing the money supply will have only a minimal impact on the economy. Any increase must be accompanied by steps to improve Japan's financial functions. If both these actions are taken, we believe that expectations would rise, creating a base for a liquidity-driven market. These developments could lead to a market rebound.

On the other hand, calls for economic stimulus through a large spending package are rising. Many market participants regard such additional spending as an essential condition to halting the slide in stock prices. However, we believe that such one-time actions would have the opposite effect because they would erode the government's power base. Ultimately, there is no significant difference in the economic impact of a ¥2 trillion and ¥5 trillion spending package.

Investors must also understand the limits to the sustainability of a market supported by expectations of growth in liquidity. Upward movement will be held back by the inability of investors to see any reasons for a sustained economic rebound. As we discussed in the market environment section, any clear indications of an L-shaped rebound in the U.S. (although no rebound is likely at this time?) would cause Japanese stocks to seek a second bottom.

At this time, some investors are encouraged by the decline in inventories in the electrical machinery sector. Looking back to the 1998 data, though, a full-scale upturn in the electrical machinery index will not occur until the inventory ratio, which is one of the industrial output statistics, peaks and shipments bottom out. With the investment climate worsening in other industrial sectors as well, investors need to accept the fact that a broad-based rebound in stock prices is still some time away.

Table 4: Electrical Machinery Index, Shipments, Inventories and Inventory Rate



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