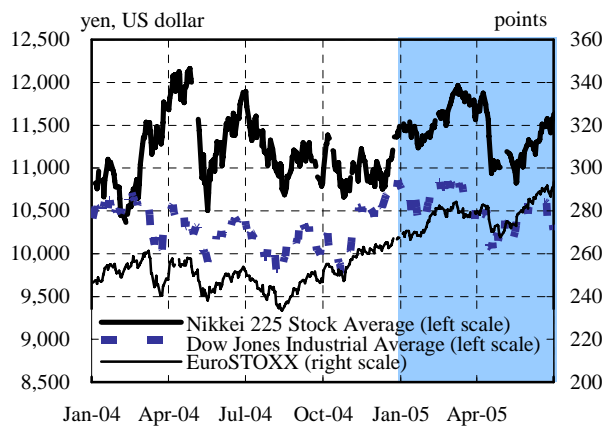


3. Equity markets

Stock prices rose toward early March, but similar to the JGB markets, reflecting a more cautious outlook on the pace of economic recovery, had limited upward strength thereafter. The Nikkei 225 Stock Average, following the developments in the latter half of last year, remained range-bound between 10,000 yen and 12,000 yen. As of end-June, the Nikkei was at the mid-11,000 yen range, basically the same as at the end of 2004.

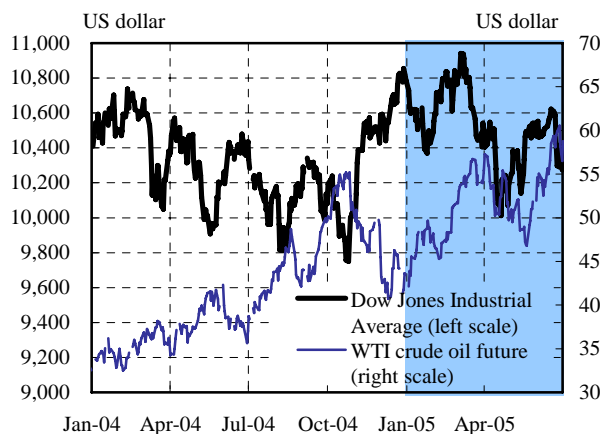
Looking more closely at developments during this period, with higher hopes for a domestic economic recovery, stock prices rose from the beginning of the year until early March, reaching a peak of 11,966 yen (March 9th), the highest level since April last year (12,163 yen) (Chart 16). However, overseas equity prices fell amid concerns that crude oil prices which broke record highs seen last fall could dampen global economic growth, particularly the US (Chart 17). Domestic stock prices also fell, dropping below the 11,000 yen-level for the first time since December last year. This was based on heightened concerns regarding the outlook for exports. The anti-Japanese demonstrations in China (April 16th) also dragged down the stock prices of the sectors linked relatively closely to developments in the Chinese economy (China-related sectors), which had previously driven the market (Chart 18). Although equity prices recovered in the US and Europe toward mid-June, the Japanese equity markets lacked in upward strength. Entering July, after the release of stronger than expected economic indicators, and the strength in the US and European markets, domestic stock prices have also edged up, but were still at levels below the highs recorded in March.

(Chart 16) Global equity prices



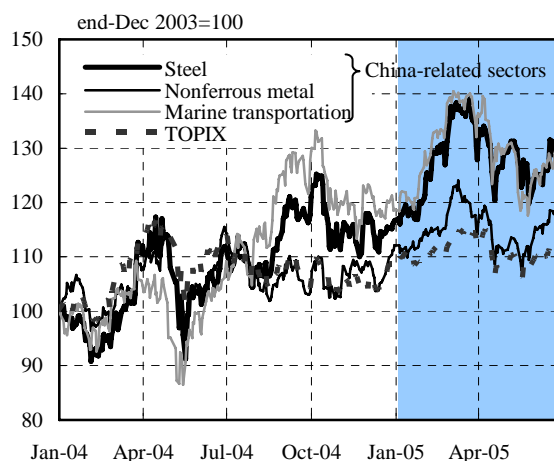
Source: Bloomberg

(Chart 17) US equity market and crude oil price



Source: Bloomberg

(Chart 18) Equity prices of China-related sectors

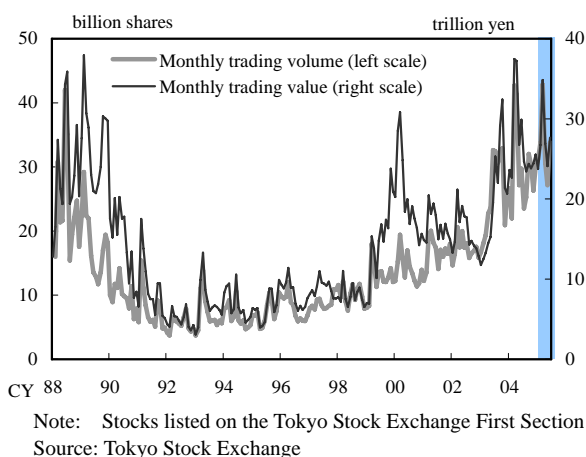


Source: QUICK

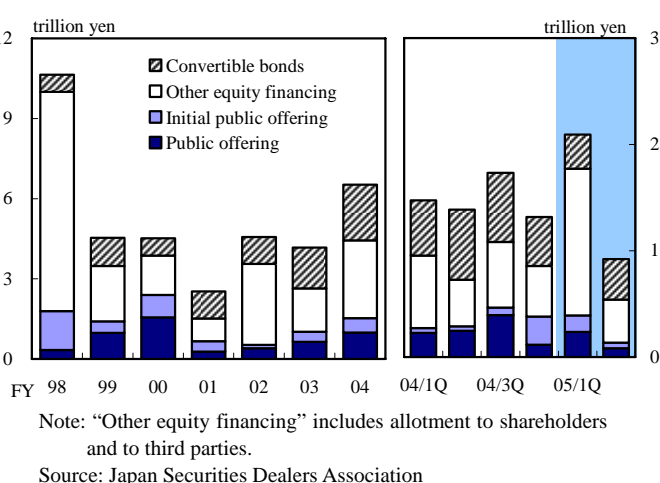
The limited upward momentum in the domestic stock markets can be explained by (1) conservative expectations on future corporate earnings in light of a more cautious view regarding the timing of acceleration in economic recovery, and (2) the slowdown in purchases of Japanese equities during the second quarter by foreign investors, who had been the most active buyers of stocks in recent years.

Meanwhile, both trading volume and trading value have been at relatively elevated levels (Chart 19). Equity financing increased during the first quarter as a number of firms raised large amounts of capital as part of a business revitalization plan. However, it dropped back down in the second quarter, as convertible bond issuance and public offerings were weak in an environment of soft equity prices and low volatility (Chart 20).

(Chart 19) Stock trading volume



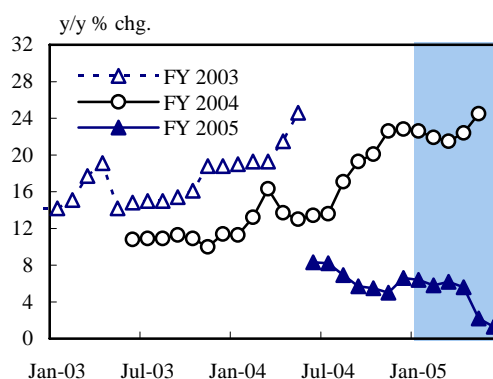
(Chart 20) Equity financing



(More cautious corporate earnings outlook)

Looking back at Japanese equity markets over a longer time period, after the market hit new lows for the post-bubble period in 2003, stock prices began to recover, reaching the 10,000 yen level in August 2003. Since then, the Nikkei has generally remained in the 10,000 – 12,000 yen range. During this two year period, corporate earnings have risen substantially and mid-term expectations for an economic recovery have generally been maintained. Notwithstanding such fundamentals, equity prices have lacked upward momentum. This can be observed in the fact that the price-earnings (P/E) ratio has gradually fallen during this period. P/E ratio itself has been, since 2003, at roughly the same level as in the US and European markets.

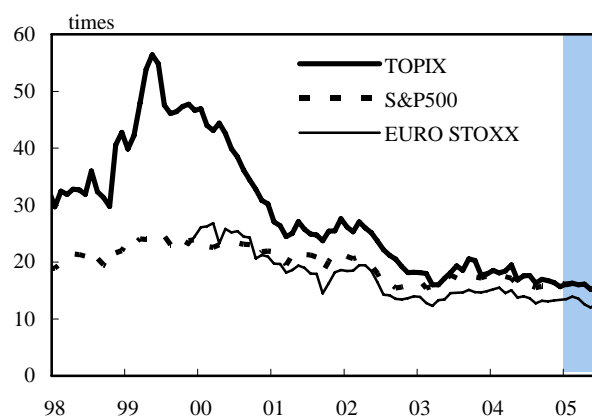
(Chart 21) Outlook on corporate earnings



Notes: 1. Forecast of operating income growth of companies listed on the Tokyo Stock Exchange First Section
2. Financial services sector is not included
3. Only companies which meet the following conditions: (1) books closing in March, (2) have not changed their fiscal year nor have merged since FY 2002, (3) do not have parent companies whose stocks are listed or offered in public.
Source: Daiwa Institute of Research based on data from Toyo Keizai Inc.

Since the beginning of this year, the outlook for corporate earnings growth has become more cautious (Chart 21) and this is one of the factors behind the limited upward momentum in the stock market. The continued gradual decline of P/E ratio may imply that equity prices may have been held back more than it can be explained by the earnings outlook (Chart 22). A breakdown of changes in P/E ratio into factors demonstrates that risk premium continues to be the largest contributor to the declining ratio (Chart 23). This risk premium also likely is a reflection of the persistent uncertainties in the market regarding the economic outlook.

(Chart 22) P/E ratio of major markets

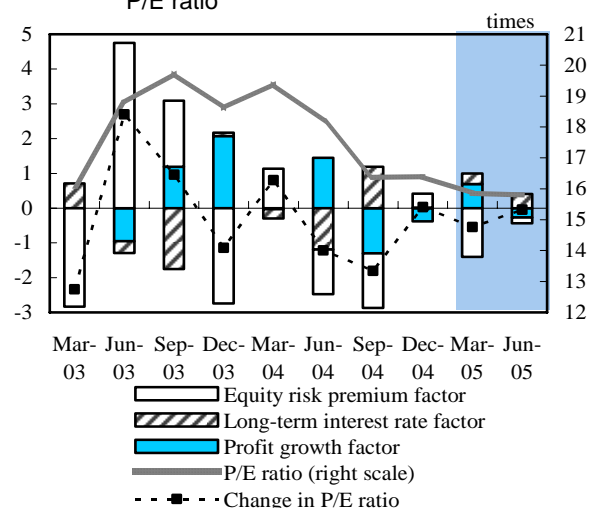


Note: 12-month forward EPS is used to calculate P/E ratio.
Source: I/B/E/S

(Activities of overseas investors)

In the Japanese equity markets, as a longer-term trend, domestic investors such as banks, life insurance companies and corporate pension funds have been reducing the size of their equity portfolios, while overseas investors have become the main buyers (Chart 24). As a result, the share of overseas investor equity holdings has increased. During the first half of 2005 (especially in the second quarter), overseas investors have slowed their purchases of Japanese equities, creating a pause in the trend observed thus far.

(Chart 23) Factor breakdown of changes in P/E ratio



Mar-03 Jun-03 Sep-03 Dec-03 Mar-04 Jun-04 Sep-04 Dec-04 Mar-05 Jun-05

Equity risk premium factor
Long-term interest rate factor
Profit growth factor
P/E ratio (right scale)
Change in P/E ratio

(Chart 24) Investment trends by investor category

	net purchases (-:net sales), billion yen				
	CY 2002	CY 2003	CY 2004	CY 2005	
				1Q	2Q
Insurance companies	-827	-1,107	-518	-286	-50
Banks	798	-5,804	-4,395	-1,521	45
Major and Regional	-1,295	-1,480	-1,022	-284	-116
Trust	2,093	-4,324	-3,373	-1,236	161
Investment trusts	-39	-142	464	-122	312
Corporates	412	-225	-175	-93	298
Foreigners	760	8,213	7,652	2,333	307
Individuals	-346	-1,652	-3,673	-376	-668

Note: The First and Second sections of Tokyo, Osaka, and Nagoya Stock Exchanges
Source: Tokyo Stock Exchange

Note: The equity risk premium is calculated based on the following dividend discount model. In the model, the stock price is expressed as the present value of future earnings stream.

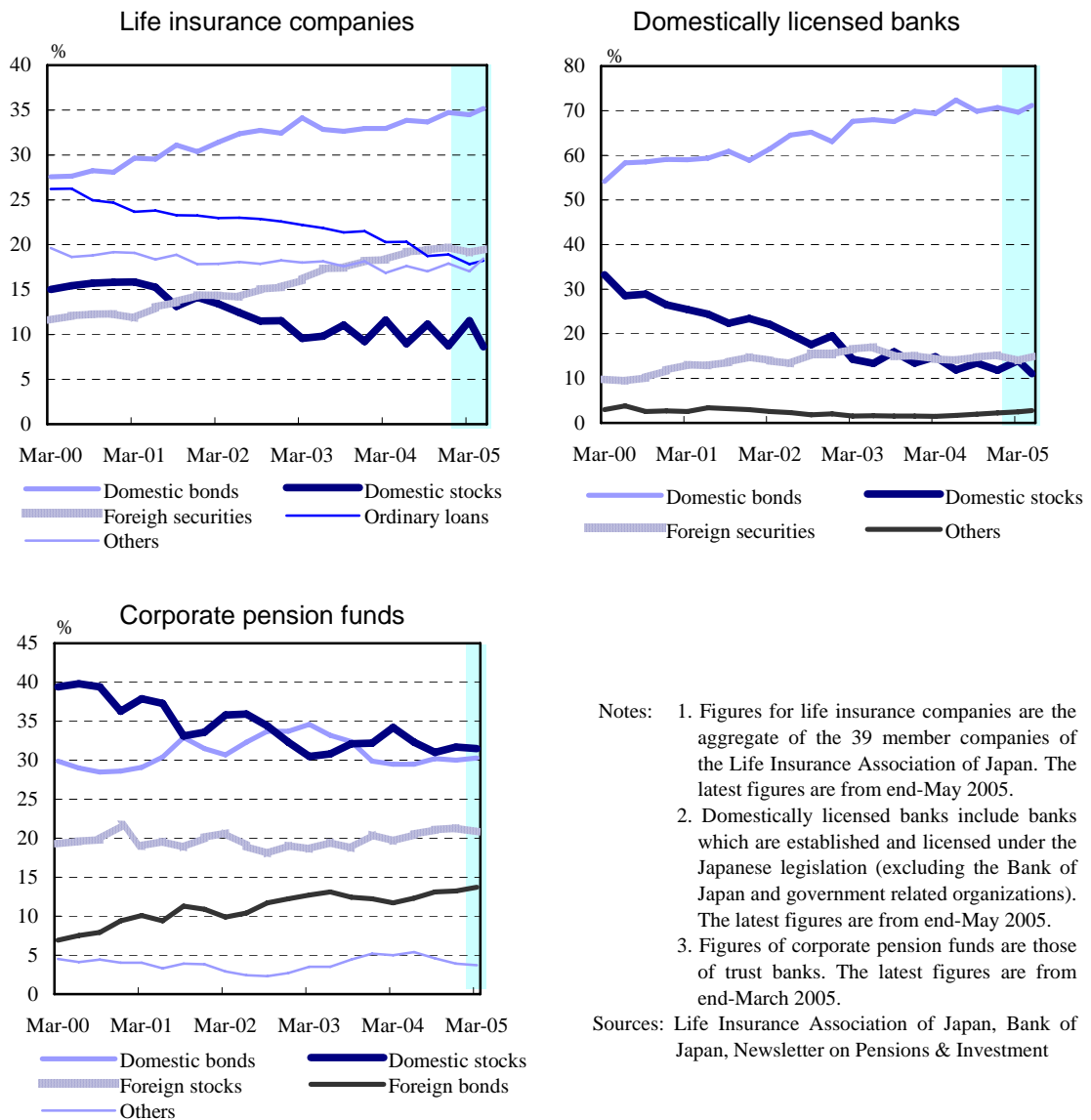
$$P = \frac{D}{1+R+\rho} + \frac{D(1+g)}{(1+R+\rho)^2} + \frac{D(1+g)^2}{(1+R+\rho)^3} + \dots = \frac{D}{R+\rho-g}$$

P: TOPIX
D: 12-month forward EPS
R: 10-year JGB rate
g: consensus forecast of long-term earnings growth

Sources: I/B/E/S, Bloomberg

The reduction in equity holdings by domestic investors reflects a more restrictive environment toward risk taking through, for example, regulation and credit ratings. Banks moved to reduce cross-shareholdings and to adhere to the “Shareholding Restriction Law”. Life insurance companies raised their solvency margin ratios, and more companies implemented investment strategies emphasizing asset liability duration matching. Corporate pension funds, reflecting rule changes, increased “Daiko Henjo” (i.e. to transfer back the substitutional portion of pension obligations and associated assets to the government) and reduced the assumed interest rate. This trend continued during the first six months of this year, but there have also been some signs during the months of April to June that domestic investors have slowed their reduction pace of equity holdings (Chart 25).

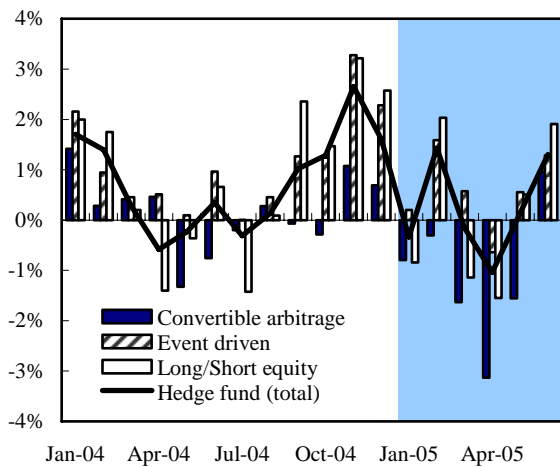
(Chart 25) Asset management trends of major domestic investors



Overseas investors' demand for Japanese equities was strong during the first quarter, but dropped to low levels during the three months from April to June. Hedge fund performance had fallen substantially (Chart 26) and the risk appetite of global investors had fallen due to the downgrading of GM and Ford. This may have also influenced their investment stance toward Japanese equities, dampening stock prices movements (Chart 27). Nonetheless, by June, the negative fallout from the GM, Ford downgrades seems to have diminished in the US and European markets, and foreign purchases of Japanese equities is gradually increasing once again in July. Attention is now focused on whether foreign investment in Japanese equities will regain the momentum experienced last year.

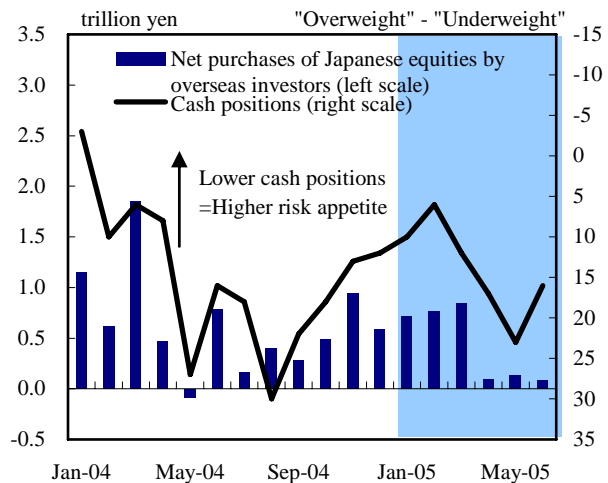
Meanwhile, individual investors overall have probably been net buyers by a slight margin when taking into account purchases in the primary markets, although they have been substantial sellers in the secondary market. Their presence is growing mainly in the newly developing stock markets (i.e. markets such as JASDAQ where relatively new high growth companies are traded) through, for example, the use of internet trading, and, after April, investments through equity funds have started to pick up. The investment behavior of individuals will, in the longer term, be an important factor affecting supply-demand conditions in the equity markets.

(Chart 26) Hedge fund performance



Note: Monthly returns
Source: CSFB/Tremont

(Chart 27) Purchases of Japanese equities by overseas investors



Note: "Cash positions" = "share of investors whose cash positions are overweight" - "share of investors whose cash positions are underweight"
It is assumed that lower cash positions mean a higher risk appetite
Sources: Tokyo Stock Exchange, Merrill Lynch "Global Fund Manager Survey"