



## Japan Rate Increase May Spur Rebound in Stocks (Update1)

By Michael Tsang

July 14 (Bloomberg) -- Japanese stocks, the biggest losers among the world's 10 largest equity markets this year, may get a lift from a decision by the Bank of Japan today to increase interest rates for the first time in almost six years.

The Nikkei 225 Stock Average has declined 7.9 percent on concern corporate profit growth will slow as central banks in the U.S. and Europe increased rates to quell inflation. Higher borrowing costs in Japan, by contrast, indicate that the world's second-biggest economy has emerged from a decade-long battle with deflation.

The rate increase highlights ``the fact that Japan is coming out of the intensive-care unit," said Quinn Riordan, who oversees about \$250 million in hedge-fund assets as principal of Singapore-based Elmwood Advisors Pte. ``Higher interest rates mean the economy is good and demand is strong," which is positive for equities in the long run.

The Bank of Japan Governor Toshihiko Fukui and his policy-board colleagues increased the key overnight rate between banks to 0.25 percent from almost zero, a move that was expected by all 16 economists surveyed by Bloomberg News. The U.S. Federal Reserve's benchmark stands at 5.25 percent after 17 increases in the past two years.

Right This Time?

The last time the Bank of Japan raised rates was in August 2000, when it also lifted borrowing costs from near zero. Seven months later, the bank had to reverse course after the bursting of the Internet-led technology bubble caused global growth to slow down.

This time around, evidence suggests that Japan's economy is strong enough to withstand higher borrowing costs and propel shares of banks and consumer-related companies higher.

Core consumer prices, which exclude fresh food costs, rose for a seventh month in May, breaking a cycle of deflation that made it hard for companies to repay loans. Lending in June grew at the fastest pace since March 1996, a central bank report showed this week. Mizuho Financial Group Inc., Japan's second-biggest bank by assets, said this week it will raise the rate it charges its most creditworthy customers to 2.65 percent.

Loan demand has been supported by Japanese companies borrowing money to help expand factories and boost production. Japan's largest companies said they plan to increase investment this year at the fastest pace since 1990, the Bank of Japan's Tankan survey of business confidence showed last week.

Sign Language

``Companies are getting more aggressive in spending, even the small and mid-sized ones," said Masanao Yoshitake, chief investment officer at the asset management division at Privee Zurich Turnaround Group Co. in Tokyo, which oversees about \$700 million. ``It's a real sign of strength in the economy."

He favors shares of Japan's biggest lenders.

Lending margins, a measure of profitability, at Japan's top eight banks will widen by 0.4 percentage point on average if the central bank increases its target rate to 1 percent in the year ending March 2007, Goldman, Sachs & Co. has said.

Investors should increase their ``exposure" to Japanese banks by buying shares of Mizuho, Mitsubishi UFJ Financial Group Inc., the world's largest bank by assets, and Sumitomo Trust & Banking Co., Japan's No. 5 lender,

Toyoki Sameshima, an analyst at Morgan Stanley's unit in Tokyo, wrote in a note this week.

Higher interest rates will also lead to higher returns on the 531.2 trillion yen (\$4.67 trillion) that Japanese hold in bank deposits, giving consumers more cash to spend and increasing sales at companies that rely on local sales.

#### Money for Nothing

A percentage point increase in rates would boost interest income from deposits by a net 6.2 trillion yen, the Nihon Keizai reported, citing a government report on the economy and fiscal policy due at the end of the month.

Consumers are also more willing to spend after the unemployment rate fell to an eight-year low of 4 percent and companies started increasing wages.

Takashimaya Co., Japan's largest department store operator, said sales at its 18 stores nationwide in June increased for a ninth straight month, on a year-on-year basis, driven by purchases of luxury items such as jewelry, artwork and kimonos.

``It's a lot of spending power coming into play," said Elmwood's Riordan, who has Daimaru Inc., Japan's No. 3 department store operator, among his top 10 shareholdings.

Soichiro Monji, who helps oversee \$47 billion as strategist at Daiwa SB Investments Ltd. in Tokyo, is less sanguine. He says that competition between the banks may squeeze lending margins, while loan demand may dry up as borrowing costs increase.

#### Glass Half-Empty?

``Whether banks can really benefit from higher rates is still a question mark for me," Monji said. He favors drugmakers and companies that sell staple foods on concern economic growth around the world may slow as borrowing costs rise.

Japanese stocks fell today after oil prices surged to a record on tensions between Israel and Lebanon, and downgrades of U.S. companies pointed to slowing growth in the nation's largest overseas market.

Larry Smith at Third Wave Global Investors LLC says the Bank of Japan's rate increase will ultimately extend the nation's economic growth cycle.

``Everything's in place for a robust equity market in Japan over the next year," said Smith, who oversees \$400 million as chief investment officer at Third Wave, a global hedge fund based in Greenwich, Connecticut.

Mitsubishi UFJ Financial Group Inc. (8306 JT)

Mizuho Financial Group Inc. (8411 JT)

Sumitomo Trust & Banking Co. (8403 JT)

Takashimaya Co. (8233 JT)

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