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Three Unprecedented Factors for Even Higher Prices of Japanese Stocks

- The second wave of the long-term bull market has started

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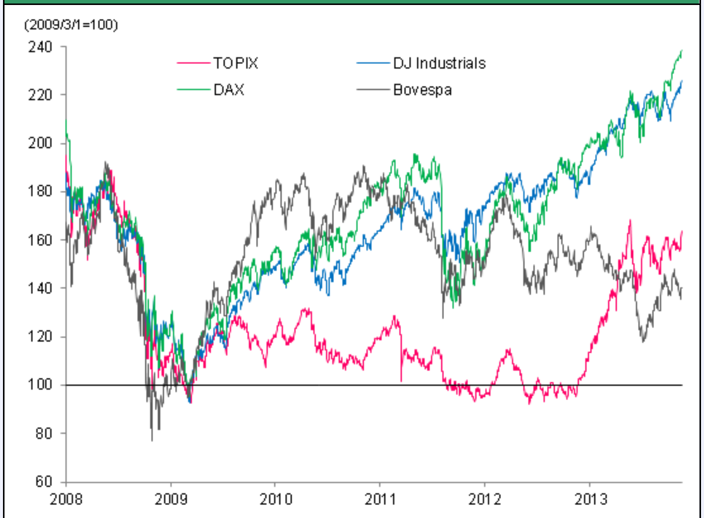
Stock indices in the United States and Germany are climbing to new highs day after day. In Japan as well, it appears that the long-term rally that started in November 2012 has advanced to the second wave. These events point to the possibility that the post-Lehman shock crisis phase has ended as the world begins a new era of prosperity backed by the United States, Germany, Japan and other industrialized countries. The central banks of these three countries are all implementing quantitative easing on a scale that far surpasses conventional standards. Two factors underpin these actions: rising productivity and strong growth in corporate earnings. Both are the result of the new industrial revolution and globalization. Record highs for U.S. stock prices after a prolonged period of sluggishness is an event that seldom occurs. When this happened in 1954 and 1982, high stock prices were followed by long-term economic prosperity. This may very well happen this time, too (see my March 6, 2013 Strategy Bulletin No. 94 “The historical significance of the DJIA’s new record high”).

Over the past six months, Japanese stocks have fallen well behind other stock markets. The cause is most likely a number of forces affecting the supply and demand for stocks in Japan. For example, investors are selling prior to next year’s capital gain tax hike (10% to 20%), investors are closing out margin positions established when a peak was reached in May 2013, and hedge funds are locking in profits before the end of the year. But the fact is that the virtuous cycle created by Abenomics is starting to improve economic fundamentals and corporate earnings. These positive developments will probably offset the negative effects of disappointment concerning some reforms and of the consumption tax increase.

Stock prices in Japan rose by 80% between late November 2012 and May 2013. Investors should now view the market today as the beginning of the second upturn. The end of the yen’s abnormal strength and prolonged deflation due to Abenomics will probably lift the Nikkei Average above ¥20,000 in 2014. Once inflation is

Figure 1： Stock performance in major countries



Source: Bloomberg, Musha Research

established and there is progress with reforms, the average is likely to continue to climb to a new all-time high of ¥40,000 by about 2020, when Tokyo will host the Summer Olympics.

There are two reasons for this outlook. First, record-high stock prices in the United States and Germany are indicators of a new phase of prosperity (that is backed by quantitative easing). Second, I expect to see a correction in the enormous lag in the performance of Japanese stocks due to the emergence of "three unprecedented factors for even higher prices."

1. QE – The new vector of financial policies in the US, Europe and Japan will produce global prosperity

The 21st century industrial revolution will fuel global economic growth

Once we abandon biased views, we can see that the world has entered an era of prosperity on a level that occurs only rarely. The 21st century industrial revolution has been triggered by globalization and the Internet as well as developments like cloud computing and smartphones. Companies are using this revolution to achieve dramatic productivity gains and cost reductions. Equally momentous changes are taking place in life styles and standards of living. One result is strong growth in corporate earnings and rising stock prices worldwide. Consequently, the current global stock market rally is not an asset bubble or money game. Higher prices are instead supported by remarkable strength in the corporate sector.

Growth in earnings is being driven by smaller investments in labor as productivity rises, which in turn has greatly reduced labor's share of income. However, this also causes unemployment to increase. As a result, economic growth is lackluster until new demand (more jobs) can be created. On the other hand, higher productivity allows companies to use less capital. The resulting steep drop in expenses for equipment has produced an unprecedented volume of surplus capital. This surplus has been responsible for the decline in long-term interest rates to historic lows. We have seen higher productivity lead to surplus labor that subsequently leads to surplus capital. This process has been the fundamental force controlling the United States since 2000, both before and after the collapse of Lehman Brothers.

QE (higher stock prices) is essential to the creation of demand

Figure 2 shows that the number of jobs in the US information and manufacturing sectors fell sharply along with the 21st century industrial revolution. Despite this drop (and despite the large amount of surplus capital as shown in Figure 3), surplus labor and capital were absorbed by the housing sector until the Lehman shock. A bubble was created and the surplus of people and money did not come to the surface. However, once the housing bubble burst, there was an eruption of surplus labor and capital that had been temporarily absorbed by the housing sector. The result was the deepest recession in the postwar era. The economy would have collapsed if nothing was done about this excess labor and capital (both the result of rising productivity). But economies would grow if these resources could be used to create demand (new value). It was a critical moment. The selection of government policies immediately after the Lehman shock would determine the future direction of the world. Fortunately, under the oversight of Fed chairman Ben Bernanke, the US implemented forceful and persistent measures to create demand. Taking these steps quickly returned markets to stability. Quantitative easing was the nucleus of these actions.

Figure 2: US Employment by sector

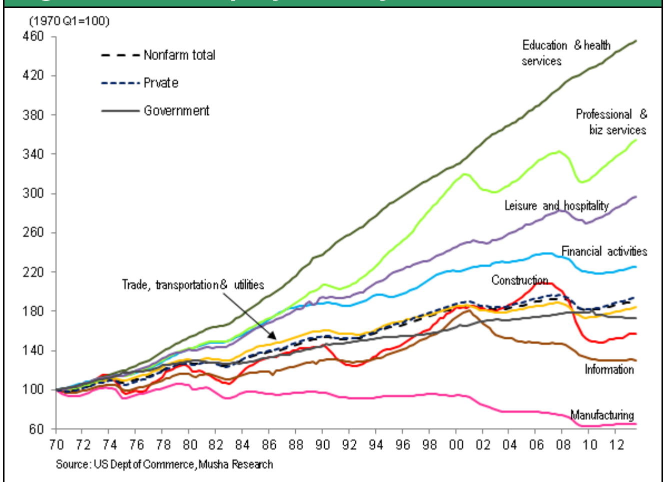
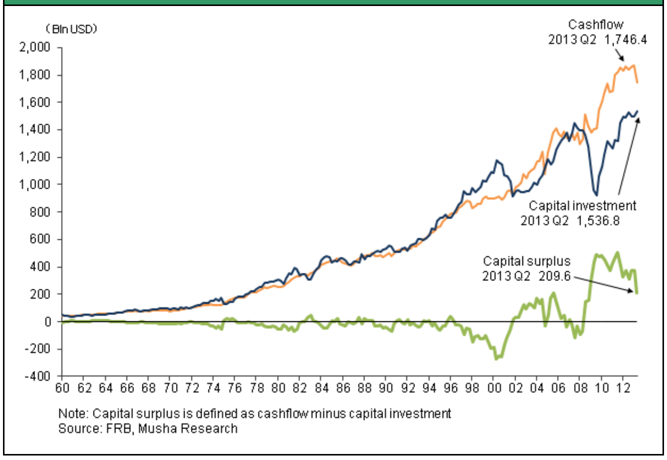


Figure 3: US non-financial corporates Trends of capital surplus



Janet Yellen, who is likely to be the next Fed chairman, has stated that she will continue the Bernanke stance of doing everything possible to create demand. In her testimony to Congress, she said that the current levels of economic activity and jobs are far below the potential of the US; there would be a high price for a quick end to monetary easing; she firmly promised to increase economic vitality; and monetary policies produce the greatest benefits when the people understand the goals of the Fed. In Europe, ECB president Mario Draghi's relentless interest rate cuts show his determination to stimulate demand and end deflation. In the United States and Europe, economies appear to be on a long-term path of growth as forceful monetary easing leads to a long-term stock market rally (decline in the risk premium) that produces new economic prosperity (broad-based economic growth and a return to full employment.

Record high stock prices in the United States and Germany may be a sign that stocks are starting to factor in this new prosperity. If this is true, then the low level of stock prices in Japan, which are still less than half the all-time high even after the recent rally, is inexplicable. Once the causes unique to Japan that are holding down stock prices can be resolved, we should see an upturn that propels stock indexes in Japan to all-time highs.

2. Three unprecedented factors for even higher prices that apply only to Japanese stocks

Using Abenomics to end Japan's position as the only loser following the Lehman shock

There are three powerful reasons for even higher prices that are applicable solely to Japanese stocks. First is using Abenomics to end the yen's abnormal strength and Japan's prolonged deflation. After the Lehman shock in 2008, stock markets worldwide plunged 60%, about the same as the drop during the Great Depression that started in 1929. But a subsequent V-shaped recovery brought stock prices back to their previous levels in just two years almost everywhere except Japan. From the post-Lehman shock bottom, US and German stocks are up 140%. In Japan, though, prices remained at the Lehman shock low for three years until November 2012. Even after the Abenomics rally, Japanese stocks are only 60% above the Lehman shock bottom, lagging far behind stock markets in other countries. The Lehman Brothers collapse as well as the euro crisis should have been distant events with little effect on Japan. So how can we explain Japan's position as the only loser in the global economy? The answer is that the Bank of Japan alone adopted a negative stance for financial policies under the leadership of its previous governor Masaaki Shirakawa. At the same time, the central banks of the United States and Europe were embarking on the new direction of quantitative easing. Due to these events, the yen was the world's only currency to become extremely strong. As the yen surged, Japanese companies quickly lost their competitive edge. The Korean won fell by half in relation to the yen. Obviously, this cut expenses for Samsung and other Korean companies by half in relation to expenses at Japanese companies like Sony and Panasonic. This was a catastrophic blow to Japan's export-dependent industries, particularly electronics.

Figure 4: Central banks' total assets (%of GDP) in major countries

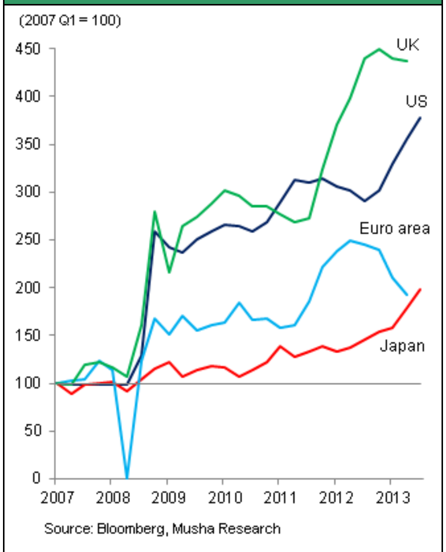


Figure 5: Major currencies' exchange rates against JPY after the Lehman Shock

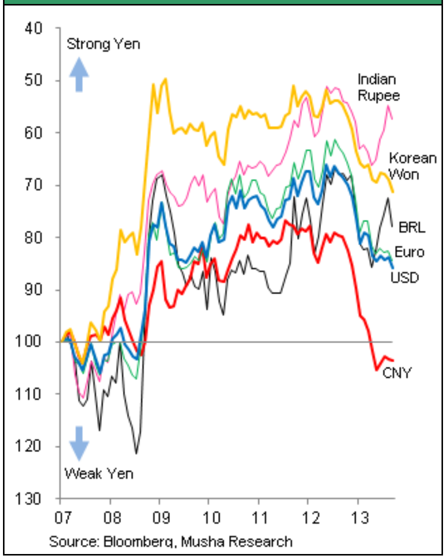
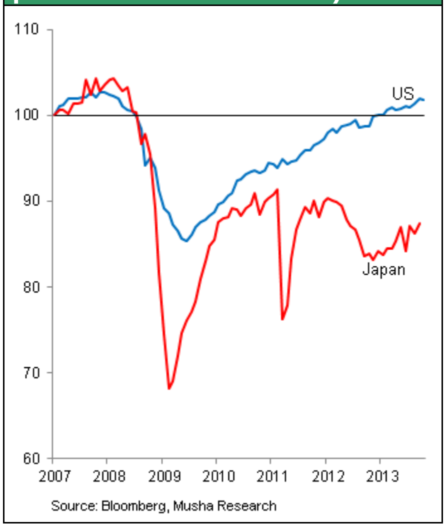


Figure 6: Japanese economy - Fallen well behind alone (Japan/US industrial production index trends)



The yen's extreme strength was also a cause of Japan's deflation. Only Japan among the world's major countries is still mired in deflation five years after the Lehman shock. Since the yen's value doubled in relation to the won, Japanese companies would have to cut wages in half in order to compete. Naturally, wages cannot be slashed immediately. So Japanese companies were forced to cut bonuses, reduce overtime and replace full-time workers with temporary workers. This explains why deflation exists only in Japan. Deflation's impact has been especially severe in the service sector, which relies on domestic demand. The reason is that there is little room for cost cutting since most services cannot be moved overseas or automated. Negative policies of the Bank of Japan produced an abnormally strong yen and, as a result, long-term deflation. This weakened Japan's industries, which caused Japan to become the world's only economic loser. To use a soccer expression, this was the Bank of Japan's "own goal."

Abenomics is currently correcting these problems. The yen is approaching a suitable level. According to the OECD, the yen should be ¥104 to the US dollar based on purchasing power parity. Furthermore, events like steady inflation in Japan and a tapering of US quantitative easing due to sustained US economic growth of more than 3% could bring the yen down to about ¥120 to the dollar two years from now. A growth strategy, the third arrow of Abenomics, has not yet been initiated. But ending the yen's abnormal strength and long-term deflation are the structural reforms that are in fact the most important growth strategies.

Correcting a negative stock market bubble of an unprecedented magnitude

The second factor for even higher stock prices is the remarkable degree to which Japanese stocks are undervalued. This undervaluation has never been seen before anywhere in the world. Eliminating this negative bubble would push prices even higher. The income return on Japanese stocks is currently 7%. That means there is ¥7 of income for every ¥100 of stock (of which ¥1.5 represents dividends). By comparison, the return on ¥100 invested in a bond is 0.8%, or ¥0.8. The difference is about 8 times. Of course, the return on bank savings accounts is zero. Despite this gap, money did not flow into Japan's stock markets. We are now witnessing the beginning of an enormous wave that will end this undervaluation. The current environment for equity investment in Japan is excellent. An investor with a 50X leveraged investment in Japanese stocks can expect to recover 100% of the invested capital with just one-year's dividend income, assuming a dividend yield of 2% and no financing cost. To begin with, we expect hedge funds to dramatically raise their positions in Japanese equities.

Figure 7: Pendulum of the bubble in Japan

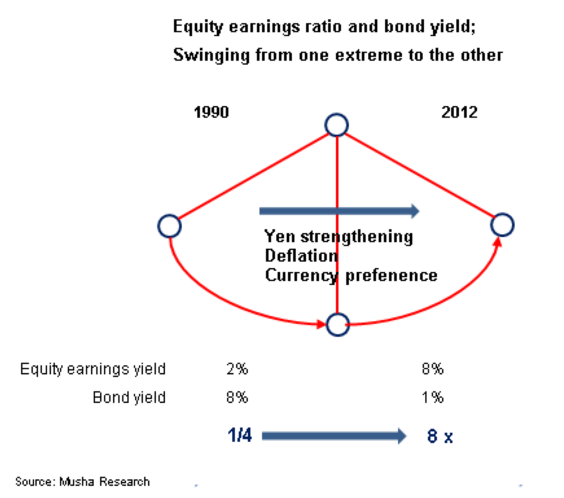


Figure 8: Japan/US long-term earnings yield of equity and corporate bond

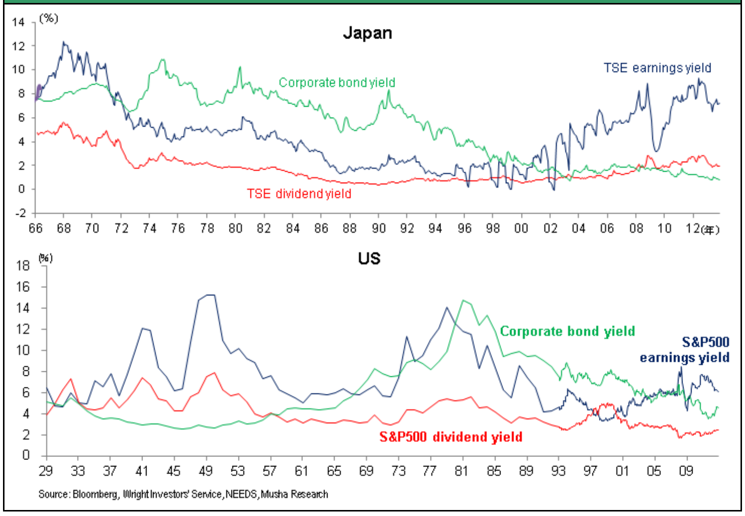
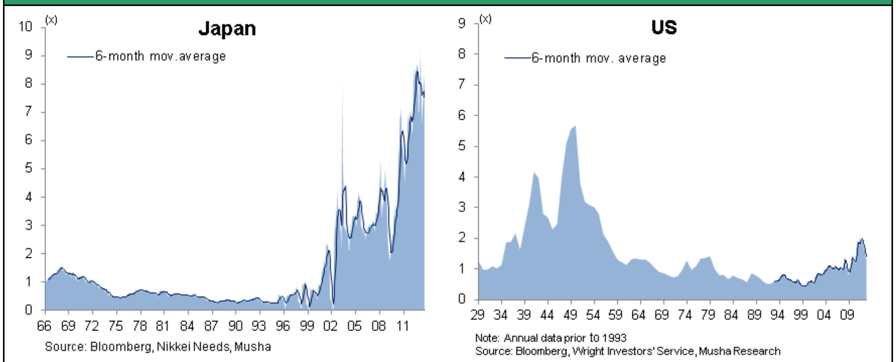


Figure 9 : Comparison of equity earnings yield/corporate bond earnings yield of Japan and US



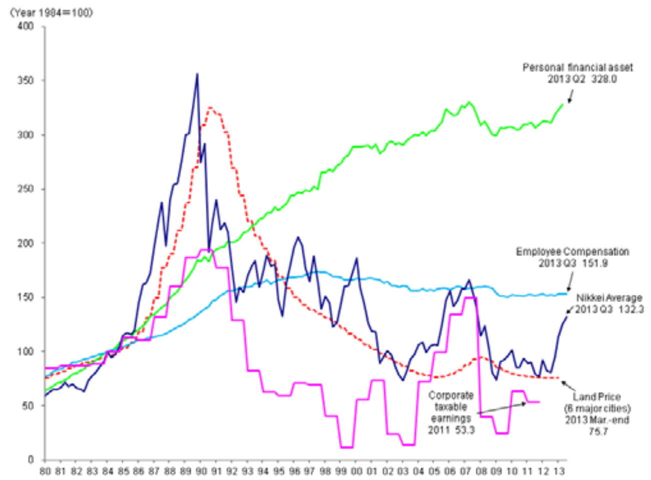
Strengthening rather than bashing Japan's economy is now in the best interest of the United States

The third factor for even higher prices is geopolitical. Japan's economy has been stagnant for 23 years following the bursting of the asset bubble. The basic cause was the US stance of "containing Japan." Up to 1990, Japan enjoyed prosperity and increasingly competitive industries in automobiles, electronics and other sectors. Making this possible was the use and improvement of US technologies and a significant increase in Japan's share of US markets. But Japan's excessive strength posed a threat to the industrial base of the United States as the world's superpower and was detrimental to national interests. The result was the start of Japan bashing that produced trade friction, an extremely strong yen and other events. But now this situation is reversing.

The reason is that revitalizing Japan's economy has become critical with respect to the national interests of the United States. Allowing Japan to become even weaker would allow Asia to fall under the control of China. Only a strong Japanese economy can contain China and preserve the US presence in Asia. In other words, geopolitical forces for Japan have shifted from a headwind to a tailwind.

As I have explained, we are finally advancing to a stage where Japan's position as the world's only economic loser ends at the same time that the global economy is healthy. All the pieces are in place for a powerful stock market rally in Japan. I believe that drastic change on a scale seen only once in a century is about to happen.

Figure 10: Japanese economic trends in/after 1980 seen in stock and land prices, corporate earnings, employee compensation, etc.



Note: Due to change in personal financial asset statistics in 1997 Q4, data is not consecutive.
Source: BoJ, Japan Real Estate Institute, National Tax Agency, Bloomberg, Musha Research

Figure 11: Japan's rise and fall and corresponding geopolitical regimes

1870⇒1930	Remarkable growth	····	Meiji Restoration	
1930⇒1940	Collapse	····	Defeat in World War II	
1950⇒1990	Miraculous recovery and growth	····	Japan-US security agreement	(1) Fortress against communism
1990⇒2010	Long-term stagnation	····	Japan-US security agreement	(2) Cap in the bottle of Japanese militarism
2010's		····	Rebuilt Japan-US alliance	(3) Containment of China

⇒ Using an abnormally strong yen to contain Japan was the primary cause of Japan's prolonged economic stagnation.