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Is the Early 2014 Technical Correction Over?

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The exciting Olympic games of Sochi have ended. Furthermore, Japan has returned to normal after a two-week period of unprecedented snowfall nationwide. Financial markets as well have finally quieted down.

Falling stock prices in January and February fueled the pessimistic view that the effectiveness of Abenomics has come to an end. Stock prices in Japan plunged 14% in only one month. People were naturally frightened by this drop. But a closer look reveals that this downturn was almost entirely a technical event. Now that investors have mostly finished making technical adjustments to their holdings, the market is very likely to stage a sharp rebound for the same technical reasons. Looking at fundamentals, there is no change in the strong growth in corporate earnings and the yen's weakness. These are the two vital conditions for creating an even more favorable economic environment. One negative outlook is for widespread excessive pessimism caused by the belief that this technical correction signals the failure of Abenomics. But even if people embrace this view, the result could be even more technical pressure on the upside. By the end of March, we could even see Japanese stocks climb to a level that is higher than the peak reached at the end of 2013.

(1) Technical factors caused Japanese stocks to plunge as 2014 started

The attack on the technical weakness of the early 2014 market

Volatility increased in stock markets worldwide as 2014 started. US and other major stock indices were down 7% in just one month. One possible cause is the decision of investors to pull money out of emerging countries in response to rumors of an impending reduction in US quantitative easing. But even if this is true, taking out these funds could not have a severe impact on emerging countries because of the size of their markets and economies. After all, shifts in the supply and demand for capital and the changes in markets associated with the movements of capital are nothing more than a zero-sum game. When the financial assets and currencies of emerging countries are sold off, buyers turn their attention to other assets. In fact, there was a brief period when investors dumped emerging country currencies and risk assets because they wanted to avoid risk. During this period, money flowed to the bonds of industrialized countries. The result was a decline in US Treasury interest rates that in turn made risk assets more attractive in terms of relative valuations.

The recent global downturn in stock markets reflects the belief at the end of 2013 that "the only reason to worry is that there is absolutely no reason to worry." Prices dropped suddenly precisely because everyone had an optimistic view. The pathway for sustained US economic growth was finally in sight. The Fed's tapering of quantitative easing, long a source of concern, started in an orderly fashion. The IMF raised its outlook for the global economy in 2014. US stock prices were climbing to all-time highs. Amid all these positive signs, the very rapid sell-off of the extremely long positions of hedge funds is apparently what triggered the turnaround in the market's mood. But these sales were also viewed as a devious move to temporarily lower stock prices intentionally. Companies in industrialized countries worldwide have been reporting strong earnings that are backed by rising productivity resulting from the new industrial revolution. An unprecedented volume of surplus cash has accumulated at these companies as a result. When demand stopped growing after the Lehman shock, there was nowhere to invest these surplus funds anywhere in the world. If we believe that strong earnings and excess cash will continue, then there is no reason to expect the global stock rally to end. In fact, by the end of last week the S&P 500 had recovered almost all of its recent downturn and was less than 1% below its all-time high. The rebound in New York occurred even though there have been no changes to the excuses used to explain the January downturn: concerns about a US economic slowdown; financial worries about emerging countries; and the reduction in quantitative easing, including the tapering of bond purchases. Consequently, technical factors were probably almost entirely responsible for the January sell-off.

The absence of Japanese investors has made volatility in Japan extremely high
Early in January, many investors became increasingly optimistic even as they realized that "the risks you can't see are the biggest risks of all." There was a technical weakness because investors established substantial long positions in many types of risk assets. As a result, the greatest risk in January was that all the conditions were in place to make it easy for a technical sell-off to occur. When the global stock market drops and a shift to risk-off positions happens, investors sell the dollar and buy the yen. This explains why the yen strengthened by about 5% while Japanese stocks fell twice as much as US stocks. Since the start of 2014, the Nikkei Average fell 14% and TOPIX fell 13%. In comparison, the S&P 500 decreased only 6% and the DJIA only 7%. Foreigners are the main players in Japan's stock markets. Japanese stocks moved down while the yen moved up because foreigners had been buying stocks while shorting the yen. So Japanese stocks were impacted in two ways.

This is why there are good prospects for a large technical upturn in stock prices once this excessive technical sell-off comes to an end. That means Japanese stocks may go even higher than before for technical reasons. The reason is evident in the recent extreme volatility in Tokyo. Japan's GDP growth in the fourth quarter of 2013 was a disappointing 1%. Following this announcement, the Nikkei Average fell sharply for a short time. But the selling quickly ended and the average ended higher for that day. Next, the Nikkei Average surged almost 3% in response to the Bank of Japan's decision to double the amount of funds provided to support economic growth. But was this news really enough to spark a rally of this magnitude? Most market observers believe it was not. In other words, stocks were sold for technical reasons and then bought for technical reasons. Now people are doing nothing more than looking for a variety of other reasons to explain this rebound.

(2) The two main reasons for high stock prices: strong earnings and a weak yen

Never before have there been more reasons for the yen to fall
From a long-term perspective, fundamentals are what determine the direction of stock markets. Today, there are two decisive conditions in place that are pushing up Japanese stocks. First is that five factors for a weaker yen have come together in a type of "perfect storm": 1) the Bank of Japan is the biggest dove among the world's central banks; 2) Japan's real long-term interest rate is negative for the first time ever and is the lowest in the world; 3) a record trade deficit (¥11 trillion in 2013) is creating massive real demand for the dollar; 4) Japanese investors are expected to generate enormous outflows of funds (due to purchases of overseas financial assets by individuals, pension funds, insurers and mutual funds and to overseas M&A activity by Japanese companies); and 5) geopolitical factors such as the US stance of allowing the yen to weaken (for more information, see Strategy Bulletin Vol. 112 of January 23, 2014). Economic fundamentals are obviously pushing the yen downward. This is why the yen-dollar rate moved only from ¥105 to ¥101, a correction of less than ¥5, even in the midst of January's strong risk-off environment. Furthermore, a weaker yen will probably become an extremely powerful reason for buying Japanese stocks.

Stocks will benefit from record earnings and the lower sales break-even point
The second decisive condition is the very strong earnings at Japanese companies. Companies will probably report record earnings for the fiscal year ending in March 2014. Based on these earnings, there has been no correction at all in the extreme undervaluation of Japanese stocks. According to the Nikkei Shimbun, the outlook for about 1,500 Japanese companies ending their fiscal years in March 2014 is for a 65% increase in pretax earnings. This will raise earnings to approximately the highest level ever and more growth is foreseen in the next fiscal year. No other country in the world is increasing earnings at this pace. But there has been almost no correction in the undervaluation of Japanese stocks. The income return on Japanese stocks was 8% one year ago immediately before the start of Abenomics. Today, the return has declined only slightly to 7% even though stock prices are 60% higher. Furthermore, the yield on corporate bonds is even lower at 0.8%. So the multiple for these two yields (income yield/bond yield) is eight times, which is the same as in 2012. This multiple is the best indicator of underpriced stocks and it has not changed at all since 2012. Therefore, during the past year, there was no correction in the undervaluation of Japanese stocks regardless of how far stock prices climbed.

Why have stocks remained undervalued? The reason is that Japanese investors, who should be the main players in Japan's stock markets, continued to refuse to buy these attractively priced stocks. But now a major shift is about to take place in the negative stance of these investors. Consequently, Japanese stocks will probably continue to climb for two reasons: the correction in the extreme undervaluation of stocks and the steady growth of earnings at Japanese companies. Most people think that last year's 57% stock market rally in Japan will stop because this is an abnormally high annual increase. However, the truth is that stocks can still continue to climb at this pace.

(3) Pessimists have no ground to stand on

There is no reason for the pessimism that emerged when stocks fell

1) No similarities at all with the 1994 tequila crisis

The Mexican economic crisis of 1994 showed how tightening by the Fed can lead to global financial turmoil. At that time, the Fed ended low interest rates that had prevailed for many years and raised the federal funds rate from 3% to 6% in just one year. The 10-year Treasury note increased in tandem, rising from 5% to 8% during the same period. The rapid rise in interest rates prompted many investors to pull out of risk assets. One result was a plunge in the Mexican peso, one of the weakest currencies. In the US, Orange County in California defaulted. But this time, the return of money from emerging countries pushed down US long-term interest rates. Inflows will contribute to purchases of risk assets, so the situation today is the exact opposite of what happened during the tequila crisis. Furthermore, the current instability of emerging country currencies is not similar in any way to what happened during the 1997 Asian currency crisis and the 1998 Russian ruble crisis. Both of these crises started when there was no shift at all in Fed policies. Consequently, there is absolutely no relationship between the reduction of quantitative easing by the Fed and the instability of emerging country currencies and associated drop in prices of risk assets in industrialized countries. Moreover, other than China, there is no danger of emerging countries threatening global economic stability. In Brazil, India, Indonesia, Turkey and South Africa, currencies and finances are unstable because of large current account deficits. But there has been no shock due to the open movement of capital in these countries.

2) The effectiveness of Abenomics has not expired

There is no basis for saying that Abenomics has expired and will not produce benefits. Criticism of Abenomics using only selected facts is not at all persuasive.

a) Critics are worried that inflation will lower real wages. However, prices are rising as the weaker yen makes imports more expensive. Deflation has ended. January prices were up 1.6% from one year earlier (and up 0.7% for core consumer inflation, which excludes food and energy). Real wages are down at this time because wage increases lag behind inflation. But this is nothing more than an unavoidable temporary phenomenon that occurs during a transitional period. Wages will recover once real growth increases and wage climb. The belief that real wages will continue to fall is a criticism that is based on the conclusion that Abenomics will fail.

b) Critics think the weaker yen is having a negative impact because exports are not growing. In fact, the delay in the recovery of exports is caused by the time needed for companies to rebuild the international component of their business processes. A number of long-term events are taking place. Major examples include 1) the widespread movement of production to other countries by Japanese countries, 2) the time needed for a revival of products that can no longer be made in Japan, and 3) no decrease in imports because Japan's internal demand is increasing faster than external demand. But corporate earnings are clearly reflecting the benefits of the weaker yen. Now that Japanese companies are convinced the yen will not strengthen again, they will slowly reallocate the global division of business processes. This reallocation will eventually raise the volume of exports from Japan. The J-curve effect will emerge, but the upturn will not begin soon.

c) Critics think that higher earnings from the weaker yen will not last long. Big increases in earnings do appear to be a one-time event. In fact, higher earnings are the result of the world's biggest cost-cutting initiatives by Japanese companies while the yen was strong for many years. Cutting costs has given Japanese companies the lowest unit labor cost in the world. Now that the yen has retreated, the benefits of the leaner cost structures are coming to the surface. Nevertheless, the success of Abenomics has not yet produced significant growth in sales volumes. Companies have greatly lowered sales break-even points. Once sales volumes start to climb, companies should be able to use the resulting leverage to maintain strong earnings growth.

d) Critics think the third arrow of Abenomics will fail. Many people view the growth strategy, which is the third arrow of Abenomics, as being an ineffective measure that is certain to result in disappointment. But the growth strategy, structural reforms and deregulation are all long-term measures. Benefits will also appear slowly over many years. The third arrow is not something to be used as an explanation for short-term movements in stock prices and the economy. This is an excuse used by people who think that monetary easing, the first arrow of Abenomics, will also fail. If you look at a period of many years, Japan has been making steady progress with respect to employment formats, corporate income taxes, reforms involving agriculture and in many other areas.

e) The negative impact of higher taxes is the only legitimate worry of critics of Abenomics. Although there is no doubt that there will be a negative impact, this effect can be offset by the government's ¥5 trillion spending program and the benefits of the weaker yen.

Nothing can block the benefits of the weaker yen and higher earnings

We need to look at the big picture rather than merely small pieces. From this standpoint, nothing is more important than the sustainability of the weaker yen and strong corporate earnings. Keeping the yen weak will be vital to ending deflation and maintaining strong earnings. Furthermore, earnings are the starting point for changes involving jobs, wages (and thus consumption), investments by companies and stock prices. No one should underestimate the importance of the solid positive conditions now in place in Japan: a weaker yen and robust earnings. To preserve these conditions, the Bank of Japan obviously needs to continue its qualitative and quantitative easing. And there is no need for any worries about this point either.