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Japanese stocks are at a key turning point
A message to pessimists: Enough is enough!

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Buy stocks in May and June – The year's second half will be an Abenomics rally
Japan will probably finally see the start of another stock market rally now that one year has gone by since the stock market plunge of May 23, 2013. Expectations for an Abenomics market sparked the 80% surge in Japanese stock prices between November 2012 and May 2013. But the next market upturn will be propelled by the actual emergence of Abenomics benefits. I think that the Nikkei Average may climb to the range of ¥18,000 to ¥20,000 by the end of 2014 as stock prices factor in the improvement in Japan's fundamentals resulting from Abenomics. Thus far in 2014, Japanese stocks have dropped 14%, the worst performance among major countries of the world. In the United States, stock indices are at record highs. Stocks prices are higher in Turkey, Brazil and other emerging countries as well despite worries about the outlook. Japan is the only loser. But no other country has enacted more aggressive financial measures. Furthermore, Japan ranks first in the momentum of the shift in fundamentals (from deflation to inflation) and in corporate earnings growth with a 70% increase. This is why Japan's stock market slump in the midst of the world's best investment environment was completely unexpected.

Furthermore, every imaginable negative influence on the stock market is disappearing. In fact, a correction involving the biggest worries will probably occur.

(1) Overseas economies: There are many sources of concern about the overseas economic outlook. Examples include financial instability in emerging countries, geopolitical instability in Ukraine and other countries, the possibility of sales of risk assets as U.S. economic growth slows and monetary easing is reduced, and slowing economic growth in China. But the strength of overseas stock prices shows that these worries are overblown. Some people think that falling long-term U.S. interest rates are a sign that people are running away from risk. But this is wrong. Falling interest rates are instead caused by excessively pessimistic bond bears closing out their U.S. Treasury short positions. Long-term interest rates will probably start climbing slowly once these bears have eliminated their short positions. The reason for consistently low long-term U.S. interest rates is the mismatch between the steady recovery in the economy and jobs, and the lackluster growth in demand for capital. Consequently, I believe that low interest rates are a positive sign showing that capital productivity is increasing.

(2) Supply and demand: In Japan, foreign investors were net buyers of ¥15 trillion of stocks during 2013. But since the start of 2014, these investors have been selling Japanese stocks. The result was a dramatic deterioration in supply and demand dynamics due to the lack of buying by Japanese investors. But foreign investors have completed their portfolio adjustments. Furthermore, Japanese long-term investors have started buying stocks. Japan will enact reforms to the Government Pension Investment Fund (GPIF) in June as part of strategies for growth. This will probably cause pension funds, insurance companies and many other institutions to adopt a similar investment stance. The result is likely to be an enormous volume of investments in Japanese stocks. Banks have already started to alter their portfolios. Japanese government bond holdings at the country's three megabanks were ¥80 trillion in March 2014, down ¥28 trillion (26%) from March 2013. Funds created by this decline are currently sitting idle in short-term deposits and similar financial instruments. But at some point, banks will probably start using this money to invest in stocks and other risk assets and to extend loans. Foreigners as well are likely to come under pressure to once again raise their holdings of Japanese stocks.

(3) Doubts about Abenomics and worries about the consumption tax: Worries about Japan's fundamentals will soon be eliminated. The negative impact of the consumption tax hike was smaller than expected. Moreover, very few people foresee a return to deflation. As a result, buy-side economists will most likely be forced to make a big change in their outlooks.

(4) Criticism of Abe's Yasukuni Shrine visit, U.S.-Japan friction: Criticism of Prime Minister Abe within Japan and from overseas has declined significantly. The reason is actions by China and Russia to expand their borders and to use force to achieve desired changes. Reasons for concern about Prime Minister Abe's nationalistic positions have become weaker, in part because President Obama's recent trip to Asia brought about a small revision in the prime minister's stance.

With these worries eliminated, the only factors that remain are record-high earnings at Japanese companies and the unprecedented undervaluation of Japanese stocks. This is why I believe that a big upward correction in stock prices in Japan is about to begin.

An unprecedented combination of vectors pointing to a weaker yen: ¥105-¥110 by the end of 2014 and ¥115-¥120 by the end of 2015

A stock market rally will probably be accompanied by a steady decline in the yen's value. As I explained in a previous report, all three of the following key vectors that determine exchange rates are pointing to a weaker yen. This has never happened before. Furthermore, there has been a shift from upward to downward pressure on the yen from geopolitical factors (the national interests of the United States, the world's superpower). These factors had been a force behind the yen's appreciation that was unique to the yen. The result is an environment conducive to the steady, long-term weakening of the yen.

(1) Money printing competition among central banks
- ➢ 50% growth in Bank of Japan base money, the fastest in the world

(2) Trade balance, which determines supply and demand
- ➢ Shift from the world's biggest trade surplus to record-high trade deficits

(3) Real long-term interest rates, which determine the level long and short positions
- ➢ The yen has the world's lowest interest rates, with negative real interest rates

+ Geopolitical factors (U.S. national interests)
- ➢ Revitalizing the Japanese economy will be good for U.S. national interests

Early in 2014, the yen strengthened somewhat even in the current climate of long-term depreciation created by excessive concerns about the U.S. economy and unemployment and the decline in U.S. long-term interest rates. Economic fundamentals were not the main reason for the yen's upturn. Ending the substantial volume of short positions was what pushed the yen up. But investors appear to have largely finished eliminating these short positions. A steady, long-term depreciation of the yen is likely to create an excellent foundation for ending deflation and driving a virtuous cycle for the Japanese economy.

Record-high earnings will fuel a virtuous cycle

Corporate earnings are the decisive factor for economic analysis and forecasts. The reason is that the creation of value by companies is what determines the levels of jobs, wages, spending, investments and stock prices. Japanese companies reported record-high earnings in the fiscal year that ended in March 2014. At all listed companies, ordinary income was up 36% and net income was up 73%. Strong earnings will almost certainly spark a virtuous cycle in Japan. One view is that these earnings are only temporary because the cause was the yen's decline. But this is an extremely one-sided position. In fact, there are three reasons that earnings reached an all-time high.

(1) Japanese companies implemented the largest restructuring and streamlining initiatives in the world. (Big gearing effect for earnings due to the big reduction in the break-even point along with growth in sales resulting from Abenomics)

(2) Japanese companies established a new business model (a global base of operations).

(3) Japanese companies achieved a technological edge by making constant investments to develop new technologies.

These are not one-time factors. Therefore, all three should create a sound foundation for long-term earnings growth.

The period during which Japan struggled with strong-yen deflation is usually called the “lost 20 years.” But I think this should be called “the 20 years when Japan built a foundation for the future.” Two decades ago, Japanese companies could no longer rely on a business model centered on lower costs and a competitive edge in export markets. Companies subsequently accomplished a remarkable transition to a business model centered on superior technology and quality along with a global manufacturing infrastructure. Funds for the switch to this model came from surplus earnings and capital obtained by forcing workers to accept a greater financial burden, such as through a decline in labor’s share of income. However, the end of deflation and an increase in labor’s share of income mean that it is now the turn of workers and domestic-demand services to reap the benefits of strong corporate earnings.

I believe that it is quite possible that the Nikkei Average will reach ¥40,000 by 2020.