MR Musha Research

7 August 2015

Musha Research Commentary

Strategy Bulletin Vol.144

The hunger for risk in global financial markets will push Japanese stocks higher

Musha Research Co., Ltd.
President
Ryoji Musha
Direct ＋81-3-5408-6821
musha@musha.co.jp
http://www.musha.co.jp

901 Renai Partire Shiodome
2-18-3 Hiagshishinbashi,
Minato-ku, 105-0021 Tokyo

(1) Potential risks are factored in – Greece, China, US interest rate hike, falling resource prices

Greece – A July crisis in Greece has been avoided. But Greece faces a series of debt repayment deadlines, so people are still worried about the possibility of a default. But the Greek economy will probably not collapse for the time being. The country will continue to need financial aid and debt restructuring to deal with its economic problems. However, at this point, Germany no longer has the option of pushing Greece over the cliff. France, Italy and other southern European countries are critical of Germany's tough stance and the US and IMF oppose this position, too. Other countries have pointed out that Germany is the biggest beneficiary of debt restructuring because of actions that followed the two world wars. Furthermore, Germany is the biggest beneficiary of the euro, which is a cheap currency that is disproportionate to Germany's competitive edge in global markets. Consequently, it is in Germany's interests to support Greece and preserve the euro. Financial markets of Germany also back up this position (maintenance of the euro and support for Greece is good news for German stocks).

China – The problem of plummeting stock prices and slowing economic growth will most likely quiet down. The normally calm Premier Li Keqiang was pounding his desk and ordering measures to stop the drop in stock prices (Wall Street Journal). China has set in motion its ultimate contingency policy. Stock prices have stopped falling. Furthermore, China has a sufficient capability to use monetary easing and increase spending. In fact, public-works expenditures and real estate investments have started to increase due to policies enacted by the Chinese government. Signs of upturns in manufacturing, real estate investment and imports and exports are appearing, too. As a result, investors can put aside fears about a Chinese financial crisis and economic slowdown for a while.

The first US interest rate hike – The likelihood of a September interest rate hike has increased. But this hike will probably be nothing more than letting the air out of the balloon filled with excessive worries. Now that the Fed dialogue about this subject has gone on for so long, only a well-entrenched cynic could believe that an interest rate hike would negatively impact the animal spirit of the US economy and financial markets. If market participants still regarded an interest rate hike as a negative event, there would soon be a big positive surprise. Looking back, the first interest rate hike has never had a negative impact on the economy or stock prices.

Cheap crude oil – The falling price of crude oil simply means that purchasing power has shifted from oil-producing countries to oil-consuming countries. But there is a time lag. Cheap crude oil has the immediate effect of cutting revenue and demand at oil-producing countries (and oil companies) while at the same time boosting income in oil-consuming countries (and oil-consuming countries). On the other hand, time will be needed for higher income to lead to growth in demand in oil-consuming countries. The world has currently reached this time lag phase. For example, earnings at US oil companies are plunging but there is no immediate upturn in demand and earnings at consumer product companies. However, growth in demand on the oil demand side is only a matter of time. Developed countries, including the US, Japan and European countries, are probably in the midst of accumulating the benefits of an “oil tax cut” of an unprecedented magnitude. Negative effects of crude oil’s drop are already evident. Now we can expect to see the positive effects slowly emerge. Once these effects appear, they are likely to spark a global stock market rally.

See Strategy Bulletin No. 141 “Greece says ‘no’ – Creditors and Germany will have to compromise” (July 6, 2015) and No. 142 “Do China’s repeated extreme stopgap measures signal the start of a contingency plan? – The other side of China’s growing global presence” (July 21, 2015).

(2) No reason to worry about any major country from the standpoint of economic cycles

A number of temporary events caused economic growth to slow in the US and Japan in the first half of 2015. Many people expect the growth rates of these countries to recover in the second half. In the eurozone, pressure will increase for a cyclical economic recovery now that a crisis in Greece has been prevented. In China, the government is doing whatever is needed in response to plunging stock prices and slowing economic growth. These actions should produce a slow economic recovery. Based on this outlook, prospects are excellent for faster global economic growth later this year.

See Strategy Bulletin No. 140 “Global economic growth fueled by Japan, the US and Europe while the BRCS (exc. I) economies weaken – A strong dollar and rising stock prices in Japan and Europe will characterize the summer rally” (June 8, 2015).

(3) A rapid increase in Japanese inflation and higher US interest rates will probably make the yen even weaker

The end of deflation in Japan started with higher prices of exported goods. Next came the cost of construction, real estate, imported goods, restaurant and hotel rates and other items as inflation continues to spread. This should lead to higher real wages and a steady rise in prices of services. Japan’s CPI growth fell to about 0% in the middle of 2015 because of the falling price of crude oil and the end of price increases to pass on the April 2014 consumption tax hike. According to the ESP Forecast Survey (the consensus of 41 economists in Japan), the outlook is for inflation to rise to 1.3% by the end of 2016. The Bank of Japan’s 2% inflation target in the first half of fiscal 2016 appears to be out of reach. But inflation is expected to climb to a reasonable level as deflation ends and domestic demand grows.

Consequently, in the final months of 2015, we will probably see a faster increase in Japan’s CPI along with a stronger dollar and weaker yen following the US interest rate hike.

(4) In addition, supply-demand dynamics are strong for Japanese stocks

1) Overseas investors will probably start buying even more Japanese stocks. A worldwide shortage of attractive investments is the main reason. Today there are very few investments with good prospects. Concerns about global deflation are not the reason that long-term interest rates are so low around the world. The real cause is the surplus of savings and lack of places to make investments. But the appeal of Japanese stocks is rising. Net purchases of Japanese stocks by foreigners were ¥15,000 billion in 2013 but only ¥800 billion in 2014. During the first seven months of this year, net purchases are already more than ¥2,100 billion. Clearly, Japanese stocks are still underweighted in the portfolios of foreign investors.

2) Higher weighting of Japanese equities by public-sector funds in Japan, the Bank of Japan, GPIF, Japan Post Bank, Japan Post Insurance, pension funds, insurance companies and other institutions

3) Individual investors have been big net sellers of Japanese stocks. Once stock prices rose to the level where they could finally make a profit, individuals were net sellers in the amounts of ¥12,000 billion in 2013, ¥5,000 billion in 2014 and ¥5,200 billion during the first seven months of 2015. These sales have given individuals an enormous volume of funds waiting to be invested.

These developments indicate that all investor categories in Japan and overseas have an unprecedented volume of money available to buy Japanese stocks.

See Strategy Bulletin No. 140.

(5) No change in the underlying attractive valuations of Japanese equities

Japanese stocks are extremely undervalued for several reasons. One is the outlook for Japanese stocks to post the highest earnings growth rate among all major countries. In addition, Japanese stocks have the world's lowest valuations in terms of PBR and other metrics. Stock prices are up 140% since the Abenomics rally started. But they are still undervalued because of the big increase in earnings that accompanied this rally. Furthermore, investors have a very strong desire to buy income-producing securities. For proof, we need only look at the size of the demand for Toyota's new class AA stock with guarantees for the dividend and principal. The IPOs of Japan Post Bank and Japan Post Insurance, which are expected to give shareholders a high dividend yield, may trigger an investment boom that entices individuals to shift their savings to the stock market.

(6) A new upswing in the stock market may push the Nikkei Average to ¥25,000 by the end of 2015 to the end of fiscal 2015

Hopes for a summer rally are gone. But isn't this precisely the time to buy stocks? The market appears to be poised for a rally that propels the Nikkei Average to ¥22,000 by the end of September and about ¥25,000 by the end of 2015 to the end of fiscal 2015. If anyone objects to this optimistic view, the only reason would be the inability to understand that we are in middle of a historic bull market.

See Strategy Bulletin No. 131 "A fabulous year – Japan's full-scale resurgence is certain to occur in 2015" (December 15, 2014).