Musha Research

29 September 2015

Musha Research Commentary

Strategy Bulletin Vol.148

Is the long-term outlook for the Nikkei Average to move higher still viable?

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Miller[*]: Today's topic is whether or not investors can still believe in the long-term scenario for the Nikkei Average to move higher. What is your view of the world amid all of today's uncertainty?

Three clear mega-trends affecting the long-term outlook

Musha: Investors need to be cautious about upcoming events in China. The outlook for China is extremely uncertain and unclear. At a time like this, it is critical that we understand that we don't know what we don't know but we do know other things without any doubt. Obviously, there are many things that we don't know. But I believe that virtually unmistakable mega-trends are emerging. Thinking about various points against the backdrop of these mega-trends allows us to gain insights into the future.

The first mega-trend is the robust US economic recovery and outlook for long-term economic vitality. No change has occurred in this trend. Although many people are skeptical about this outlook, I think that the United States will very soon regain the strength to once again be the world's superpower. I believe the likelihood of this happening is almost 100%. The United States is the world's liberal democracy leader, the center of global finances, and the leader of the Internet and information revolution. The United States has a bright future.

The second mega-trend is Japan's resurgence. During Japan's lost 20 years, there were countries where nominal GDP increased by three times and four times. Japan was the world's only country where nominal GDP was flat during this period at about ¥500 trillion. It was almost as if Japan had become temporarily paralyzed. As other countries recorded strong growth, the era of Japanese economic power appeared to have come to an end. But now Japan has overcome this 20-year period of obscurity and is on the verge of a powerful comeback. This is another trend that I believe can be viewed with absolute certainty.

In the past, global economic growth was fueled by the growth of physical goods that was led by China (due to developmental dictatorship). But a shift is occurring in the growth model. The focus of growth is now on creating demand and improving the quality of life in countries with democracies. This is a pattern of progress involving forms of infinite value that are placed on technology, quality, safety and comfort. During Japan's 20 years of obscurity, the country broke away from the old model. With this model, growth was achieved by using the developmental dictatorship method beginning with adoption, imitative technologies and price-based competition. Now Japan has advanced to a new age in which goods and services supplied by using a newly created model significantly increase value. In this new model, there is a strong commitment to quality, superior technologies and customer satisfaction.

Also from a geopolitical perspective, which I will discuss another time, the end of the age of China can be viewed as the beginning of an age when Japan's global influence increases.

The third mega-trend is the decline of China along with the country being significantly overtaken by other emerging countries. The dramatic growth of China's power was the biggest surprise of the past decade regarding the global economy. Now, this economic growth is finally coming to an end. As China declines, the world will be seeking replacements to fill in this power vacuum and create a new structure for the international division of labor. China's decline does not signal the demise of the world. Instead, we will see the appearance of new players that will replace China.

Miller: While some countries will be affected by this turmoil in China, won't these events have only a small impact on Japan and the United States?

Musha: I think that turmoil in China will have positive and negative effects on other countries. First, there will be damage to countries that had been benefiting from China's economic strength. This damage will be the most severe in resource-producing countries like Brazil and Australia and in many oil-rich countries. China's problems may even cause recessions in countries that had supplied China with natural resources. According to the Sankei Shimbun, the reliance on China for exports is high in Africa (44.5% in Angola, 53.8% in the Republic of the Congo, 31.5% in Sudan, 43.7% in the Democratic Republic of the Congo, and 32.0% in South Africa), the Middle East (13.9% in Saudi Arabia, 19.7% in Iraq, 26.8% in Iran, 38.2% in Oman and 29.4% in Yemen), Central Asia (22.7% in Kazakhstan and 90.0% in Mongolia), Latin America (19.0% in Brazil, 17.8% in Peru, 24.9% in Chile, 21.9% in Uruguay and 15.2% in Cuba) and Oceania (36.1% in Australia and 20.8% in New Zealand).

We will also see damage to countries that are highly dependent on products exported to China. For example, China accounts for 26.1% of South Korea's exports and large percentages of Singapore and Hong Kong's exports. These percentages are also high in Taiwan (27.1%) and Malaysia (14.2%). Basically, damage will occur in countries where overseas Chinese capital has a significant influence. These countries have prospered by using tie-ups with China. As a result, the economies of these countries may sink with China's economy or there may be growth in non-performing loans to China as loans are not repaid.

On the other hand, some countries will become stronger as China declines. India will probably be the biggest beneficiary. India relies on imports from China for a very high percentage of a variety of consumer products like apparel, toys and sporting goods. Manufacturing a broad array of products internally is normally vital for an emerging country to sustain economic growth. But in India, the service sector and software industry were responsible for the initial phase of economic growth. The country has not made significant progress with its manufacturing infrastructure. Rising demand for goods in India has been met with imports from China. But now India will probably have to switch to internal suppliers. If this happens, China's troubles will enable India to enlarge many industries. Similar growth is about to occur in Vietnam, too.

One more key point is that China has been soaking up most of the world's capital for economic growth. Instead of being concentrated in China, this capital can now be directed to other countries. The most likely destinations for these funds are the United States, Japan and Europe. If these funds are redirected in this manner, domestic demand in developed countries will replace China as the driver of global economic growth. In other words, China's investments in plants and equipment contributed to the creation of global demand. Now demand creation in developed countries must replace this contribution.

The next question is where these funds for growth will be invested. Unlike in China, investments in developed countries will not be used to buy more plants and equipment. Instead, most of the funds will be used for growth of services. Investing to upgrade services will lead to a new domain of growth that enables people to lead more fulfilling lives. Service sector growth and a further increase in living standards in the United States, Japan and Europe may drive global economic growth. The result would be the creation of a new growth domain by the developed countries. Moreover, this service sector growth will obviously include dramatic technological progress in fields like the Internet and artificial intelligence. These advances will produce new life styles and innovative industries.

As you can see, China's economic downturn may cause some countries to sink and others to achieve significant growth. For the time being, investors should be wary of countries that are vulnerable to negative effects of China's decline. In countries that will benefit, investors should view temporary periods of market volatility as excellent opportunities to earn good returns. Japan should be at the top of the list of these countries. There are three main reasons. First, although Japan relies on China (including Hong Kong) for 22% of its exports, imports from China are an even higher 24% of all of Japan's imports. As a result, Japan has an annual trade deficit of ¥2 trillion with China. That means a decline in trade with China is very likely to cause manufacturing output within Japan to grow. Second, most of Japan's exports to China are capital goods and intermediate goods. Although finished products are made in China, most are eventually sold in Europe and North America. Consequently, falling demand in China will have no effect on these exports (and the damage will be small even if the yuan is devalued). Third, Japan's exports to China peaked in 2005 and have been declining very slowly during the past decade. So Japan has been reducing its reliance on China for some time now.

Prospects are still good for the Nikkei Average to keep climbing over the long term

Miller: What is your short-term view of the market?

Musha: I do not expect current turmoil in China to create a spiraling financial crisis as we saw after the collapse of Lehman Brothers and the Asian currency crisis. China will probably be unable to avoid problems like the collapse of its asset bubble or a sharp drop of the yuan. However, even if this happens, I think the resulting problems will be limited. A few overseas Chinese investors are responsible for most loans and investments in China. Problems in China will have only a minimal impact on financial institutions in the United States, Japan and Europe. These institutions have already established firewalls to protect themselves.

One fear is that a further weakening of the Chinese economy could spark a major global recession. But even if the global economic growth slows temporarily, economies are likely to remain strong in the United States, Japan and other countries. Furthermore, economies of emerging countries may strengthen as they replace China. These events would prevent a global recession from occurring. In addition, risk involving China has already been reflected in financial markets by the decline of emerging country currencies and worldwide drop in stock prices. That means financial markets will be resilient to any more bad news. Consequently, there is good reason to believe that the scenario for the long-term growth of the global economy is intact, even if there are disruptive events. If this is true, then a big rebound in today’s very low prices of stocks and other assets is quite possible.

From a short-term standpoint, major countries of the world will probably jointly implement economic stimulus measures in response to the problems in China. The United States pushed back an interest rate hike and may enact the second and third phases of quantitative easing if necessary. We could also see financial measures aimed at creating demand along with other initiatives. But China has responded to the frantic shift of investments out of the country with iron-fisted economic measures along with measures intended to guide and manipulate financial markets. Due to these actions, stock prices have stopped falling and a further decline of the yuan is unlikely. At the same time, China is using massive spending and other actions to prop up the economy. As a result, there may be a big rebound in global stock prices because the dark clouds hanging over markets have briefly gone away. The recent fall of stock prices has probably established a solid downside support level. Therefore, once investors are no longer worried about the economic climate, we could see a surge in stock prices. This rebound may not be an explosive rise to new highs, but it is very likely to be almost as dramatic.

How long will this rebound be? I think a second crisis in China will happen at some time. The current quiet period in China may come to an end for a number of reasons. For example, there may be a further drop in China’s exports or manufacturing output, another plunge in real estate prices as China’s monetary easing measures fail to have the desired effect, or an unavoidable devaluation of the yuan caused by a steady decline in foreign currency reserves. So there is still a possibility of one more shock from China. If this happens, subsequent events will depend on whether other countries can reach the point where the effects of China’s problems would be minimal. One possibility is a continuation of economic growth with no big breakthrough on the downside. The other possibility is a downturn in prices as markets look for a new bottom.

For these reasons, my short-term outlook is for an extremely bumpy ride for investors. It will be very dangerous to place bets on a steady downturn or upturn in prices. This environment is an extremely attractive opportunity for trading. However, long-term investors should buy stocks because the sell-off has created an excellent buying opportunity. The short-term scenario of a steady increase of the Nikkei Average must be revised. But I believe that six months or a year from now, once today’s problems have been resolved, financial markets may begin a long-term upward trajectory.

Miller/ Musha: Thank you.

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