Musha Research Commentary

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Japanese stocks alone drop as April begins – What does this mean?

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(1) Fears of a global crisis have receded and investors are seeking risk again

Niizeki: Today we are talking with Ryoji Musha about how investors should interpret the fact that Japan had the only major stock market downturn in the beginning of April. Stock markets in the United States and other countries are currently approaching new highs for 2016. And apparently there is no longer a risk of a global financial crisis sparked by China's troubles. What are your thoughts about these points?

Musha: Stock prices plunged worldwide in January and February. George Soros and others stated that China may trigger a global financial crisis. The belief that a hard landing in China was inevitable led to a speculative sell-off of the Chinese yuan and Hong Kong dollar. Fears about a crisis originating in China surged. However, this crisis mindset declined rapidly starting in the middle of February and the world's stock markets bounced back to their highest levels of the year. In the United States, stock prices fell more than 10% but are now at the highest level of the year. Furthermore, big downturns in emerging country stocks and currencies (Brazil real and Australia dollar) have been followed by powerful rebounds.
The crisis mentality in the world's financial markets has settled down for the time being. The global economy is now more likely to enter a desirable steady growth phase in 2016. This improvement is primarily the result of the strength of the US economy, the key component of the global economy. Consumption in the United States is driving global economic growth. In Japan and Europe as well we are seeing slow improvements in consumer spending and jobs. Stock prices are also benefiting from the belief that a variety of actions will succeed at containing the crisis in China. For these reasons, I think that there is a favorable environment for risk taking on a global scale.

(2) Japanese stocks alone move down while the yen strengthens

Niizeki: Despite this favorable environment, stock prices in Japan have declined as stock markets rallied in other countries. It appears that Japan has replaced China as the selling target of global speculators. What are your views about these events?

Musha: In China, the SSE Composite Index has bounced back 14% from a low of 2,655 points at the end of January to 3,049. This rally has covered two-thirds of the drop that took place in early January. Only stocks in Japan have been falling during the past few weeks. The Nikkei Average started 2016 at ¥18,800 and hit bottom at ¥14,900 on February 11, a drop of 20%. Although stock prices staged a small comeback, prices dropped sharply again in April. The Nikkei Average is now down 17% since the beginning of 2016. Moreover, the yen has appreciated rapidly as stock prices fell.

No news is worse for Japanese stocks than a stronger yen. When the Bank of Japan introduced a negative interest rate at the end of January, the US dollar exchange rate was about ¥120. Since then, the yen quickly appreciated and is now ¥108 to ¥109 level . A strong yen is a perfect excuse to sell Japanese stocks because investors think the yen's rapid upturn will severely impact earnings. In the Bank of Japan Tankan that was released on April 1, the fiscal 2016 (year ending March 2017) outlook for ordinary income at large manufacturers is for a decline of 1.9%. This outlook assumes that the average US dollar exchange rate will be ¥117 during the fiscal year. But current exchange rate is below ¥110.Consequently, the Bank of Japan is predicting lower earnings even on the premise that the yen will depreciate significantly. Investors are selling stocks faster because of expectations of a big decrease in earnings if the yen continues to appreciate. This appears to be a vicious spiral where stock prices fall and the yen rises. I think Japan has reached an extremely dangerous point that could block the success of Abenomics. There are many possible reasons for the yen's sudden strength.

One reason is the desire of participants at the February 2016 G20 Conference in Shanghai to stabilize exchange rates. That means restricting actions by countries to obtain economic benefits by weakening their currencies. The yuan was the primary target. But there were also comments that indirectly implied that Japan was about to take actions aimed at reducing the value of the yen and should be another target. I think that this reinforced expectations for a stronger yen. However, in the global financial environment, the need for a weaker dollar and stronger yen should be coming to an end. Nevertheless, the yen alone among major currencies continues to appreciate. This explains why a vicious cycle of stock selling has become entrenched during the past few weeks.

(3) The logic for selling Japan and buying the yen

Niizeki: Why is the yen becoming stronger as stock prices fall?

Musha: I think we could be seeing the start of investors selling Japan. Using this expressing may be going too far. But it is also possible that investors who want to sell Japan have started a trial-and-error process. Buying the yen is symbolic of selling Japan. If Japan's reforms fail to end deflation, there will be a negative cycle in which stock prices fall as the yen continues to appreciate. Buying the yen and expecting more strength is the typical stance of investors who want to sell Japan. Until not long ago, many people thought that the yen rose as the dollar declined because a weaker dollar was needed for global financial stability. But what is happening now is not simply a matter of the dollar weakening. The yen alone among major currencies is strengthening due to speculative yen buying for the purpose of selling Japan. And investors are selling Japanese stocks because of the yen's strength. Why is this happening? I think the cause is the distinctive structure of Japan's equity markets. Foreigners own about 30% of all publicly traded Japanese stocks but account for 60% to 70% of trading volume. As a result, from the standpoint of investors, Japanese stocks are the best in the world in terms of liquidity and the ability to use quick purchases and sales to earn profits. Hedge funds are constantly paying close attention to Japan's stock markets as a source of enormous profits.

When Abenomics started, foreigners bought Japanese stocks because they expected the prices to climb. But even if stock prices go up, capital gains could evaporate due to exchange losses caused by a weaker yen. This is why short-term investors buy stocks and simultaneously establish a hedge by selling the yen. Using hedges allows investors to keep the entire capital gain. Speculators responded to Abenomics by selling the yen and buying Japanese stocks. The result was a positive cycle in which the yen moved down and stock prices moved up. If investors begin to think that Abenomics may end in failure, investors will shift their stance to selling Japanese stocks and closing out yen short positions. The reverse is also possible. Investors may decide to sell Japanese stocks while buying the yen. Investors who want to earn profits from declining stock prices would see their profits decline if the yen weakened. To prevent this, they would buy the yen in advance to lock in a profit from lower stock prices. For these reasons, selling Japanese stocks and buying the yen are most likely actions that are closely linked.

Foreigners have been net sellers of Japanese stocks for 13 consecutive weeks since the beginning of 2016. Net sales during this period of only three months total more than ¥5 trillion. Net buying by foreigners was ¥15 trillion for all of 2013, which was the peak of Abenomics. Obviously, foreigners have been dumping Japanese stocks at a feverish pace this year. But there has been massive buying of the yen at the same time. Mr. Onishi, manager of the foreign exchange department of Deutsche Securities in Japan has the following explanation. "Foreigners held Japanese stocks worth ¥185 trillion at the end of 2015. I estimate that investments with foreign exchange hedges accounted for about 20% of this figure. In other words, foreigners had short yen positions totaling ¥37 trillion in conjunction with investments in Japanese stocks. But the principal of these foreigners fell 20% because stock prices dropped by the same amount. So foreigners had to cut their short yen positions by 20% too. I think that terminating these hedges probably generated ¥7 trillion of yen purchases."

Stock prices tend to move in tandem with changes in the yen's value because foreigners view Japanese stocks as hedged investments. This is the cause of the current negative cycle driven by sales of Japanese stocks and a stronger yen. Therefore, investors who want to sell Japan are buying the yen and selling Japanese stocks. Now concerns have emerged about this situation becoming even worse in a self-fulfilling manner. Only a short time ago people were worried about events in China sparking a financial crisis. But we are currently seeing growth in short positions involving Japan, which implies that the seeds of a financial crisis exist in Japan.

(4) The healthy US economy will stop the dollar's decline

Niizeki: How much farther do you think the dollar will weaken in relation to the yen?

Musha: Will the Japanese economy disintegrate if sales of Japanese stocks continue and the yen also continues to appreciate? China has intrinsic characteristics that are leading to a crisis, but these characteristics clearly do not exist in Japan. As a result, I think that sales of Japanese stocks and the yen's appreciation can go on only to a certain point. Limiting this trend most of all are the strength of the dollar and the US economy. A strong dollar means that there is no basis from the standpoint of fundamentals to expect the yen's upturn to continue for a long time. The US economy is much sounder than the Japanese economy. In fact, current trends indicate that the US economy will continue to gain strength for a while. The unemployment rate has dropped to 5.0%, which is near full employment. Job creation is remaining steady at more than 200,000 jobs every month. Moreover, wage growth has increased to an annual rate of more than 2%. Overall, there is no doubt that the environment for US workers is improving at a consistent pace.

Business confidence in the US manufacturing sector, which has been a source of concern, is showing signs of a rapid recovery. As the dollar appreciated and China's economy became weaker, business confidence in the United States became worse only in the manufacturing sector. Just a short time ago, the ISM Manufacturing Purchasing Managers Index was below the borderline of 50 for a solid market conditions. But the index subsequently rebounded to more than 50. Increasing strength of the US economy demonstrates that the United States has the fundamentals to justify a stronger dollar.

As 2016 began, most people expected four interest rate hikes from the Fed by the end of the year. Now, the outlook is for only two. The slower pace of interest rate hikes is widely viewed as the result of overseas factors rather than problems within the United States. Although the speed will be slower, there is no change in the Fed's intention to raise interest rates. But the Bank of Japan is almost certain to implement more monetary easing measures. As long as the US economy is healthy and continues to improve, there will be a natural limit on how far the dollar can weaken in relation to the yen. The exchange rate may overshoot the ¥110 level for a while but the yen is then very likely to retreat to more than ¥110. This is the most obvious and unmistakable reason that the present vicious cycle of falling stock prices accompanied by a stronger yen cannot go on forever.

(5) Why foreigners will start buying Japanese stocks again

Niizeki: What will have to happen for foreigners to start buying Japanese stocks again?

Musha: As I have just explained, foreigners are currently selling Japanese stocks and buying the yen at the same time. Once foreigners become buyers of Japanese stocks, the yen will stop appreciating and begin to decline. I think the key point is when and why foreigners start buying Japanese stocks again. Japan will have to establish an economic and market environment that is attractive to overseas investors. Accomplishing this will require a steady improvement of the Japanese economy. Most important of all are positive economic indicators like growth in earnings and more signs of the end of deflation. Whether or not economic indicators improve very short term, I believe that Japan will slowly create an attractive economic and market environment for the following reasons.

The first reason involves the negative psychological impact of the stronger yen and weaker stock prices. The planned consumption tax hike in 2017 has been holding down the sentiment of investors. A higher tax rate makes the outlook bleak. However, there will be a dramatic improvement in sentiment if Japan decides to shelve this consumption tax hike.

Another reason is the much lower cost of crude oil. Many people regard lower prices of goods as bad news. But cheaper crude oil is boosting the real purchasing power of households, which should support consumer spending. Furthermore, if wages continue to climb in Japan, even at the current slow pace, consumer spending will undoubtedly benefit from the resulting increase in real purchasing power. There is almost no chance of a steep economic downturn in Japan. However, there is room for a possibility of a return to deflation as the effectiveness of Abenomics expires. The result would be skepticism among investors that fuels the conviction that they should continue to sell Japanese stocks. If this happens, I think there would be strident demands for government initiatives to halt sales of Japanese stocks by speculators attempting to take advantage of these events.

(6) The government should use the stock market for translating corporate earnings into new demand

Niizeki: What actions should the government take?

Musha: Many actions will be needed, but I think two initiatives will be critical. First, the Japanese government must implement reforms that span many years. Japan needs to change how people live and work in order to foster an environment in which people have the confidence to spend more. Examples of necessary reforms are more flexible working conditions, measures to encourage women to remain in the labor force and programs to help parents raise children.

Another critical action is policies aimed at creating demand. In the past, Japan was unable to do anything because companies were no longer profitable. But today Japanese companies are generating substantial earnings. Companies have large incomes and unused purchasing power. Japan must devise a way to put this idle income and purchasing power to work. There are several possible methods.

Fiscal measures are the most important and fastest method. Japan’s 10-year government bond now has a negative yield. The Japanese government can create an enormous amount of demand by using proceeds from this negative yield to fund loans. Just as in the United States, Japan has a large volume of aging infrastructure. After Japan’s asset bubble burst in the early 1990s, there were many public-works projects for the construction of buildings, highways and other facilities that were often regarded as unnecessary. In 2016, two decades after the end of the bubble, public-works expenditures are less than half of the fiscal 1998 peak. But aging infrastructure facilities of all types need to be replaced. Public-works expenditures must be raised significantly, although not necessarily back to the peak, in order to rebuild outdated facilities. Government spending is one of the pillars of Abenomics and it should be used. Furthermore, low interest rates create an excellent opportunity for increasing this spending. I think that we can expect the Abe administration to announce a major government spending program before the Ise-Shima G-7 Summit in May and the July election.

Fully opening a channel for the effective use of idle purchasing power at companies is the second critically important government initiative. Wage increases are one way to use this money. If companies give employees higher wages, household spending will increase. Progress is being made with wage increases, although more is needed. The government also needs to build a framework that allows company profits to boost household income. In the United States, wages typically account for three-fourths of disposable income with interest, dividends and other income from assets accounting for the remainder. But household interest and dividend income in Japan is almost nothing because of negative interest rates and the very small holdings of stocks by individuals. Consumers rely on wages for almost all of their income. Since workers in the United States have two sources of income, they benefit from wage increases as well as from higher stock prices and dividends. But in Japan, higher wages are the only way to raise household income, and thus consumer spending. Of course, Japanese companies distribute part of their earnings as dividends. That means it is possible for the government to expand the channel for using the earnings of Japanese companies in order to supplement household income.

I think the best ways to accomplish this goal are a sustained upturn in stock prices and a shift in the financial assets of individuals to stocks. At the end of 2015, individuals in Japan had ¥1,741 trillion of financial assets. Since ¥510 trillion is the value of annuity policies, individuals have ¥1,231 trillion that can be invested. Currently, 75% (¥920 trillion) of these assets available for investments is sitting idle in safe assets like cash, bank deposits and Japanese government bonds that have virtually no return. At ¥169 trillion, stocks are only 14% of investable assets. Therefore, people in Japan have substantial savings but almost no income from that money.

If part of these zero-return assets is shifted to stocks, the money would earn a 2% return. This would produce a dramatic change in the composition of household income. And this change in income composition can be accomplished by altering the structure of the public's financial assets. In the United States, the average household has half of investable assets in safe holdings like cash, bank deposits and government bonds and the remainder in the stock market. If households in Japan allocated their savings in the same way, ¥300 trillion would be withdrawn from the ¥920 trillion of safe assets. This enormous amount of funds for new stock purchases would push up stock prices.

Persuading people to move their funds into the stock market is another channel for the effective use of idle money. To encourage people to buy stocks, I think the Japanese government should use both monetary measures and new programs. In 2015, there was a major policy shift that resulted in the Government Pension Investment Fund (GPIF) reducing its extreme overweighting of safe assets by purchasing stocks and other assets with risk. In 2016, a new GPIF president was named. I think the time has come for measures that encourage institutions like the GPIF, Japan Post Insurance, Japan Post Bank and others that have vast holdings of Japanese government bonds as well as individuals to transfer their money to stocks. Shifting this money would give individuals a second source of income, thereby enabling the use of idle purchasing power at companies to fuel economic growth.

To make this shift happen, the government must take actions that are clearly aimed at moving funds to the stock market. Government bond purchases by the Bank of Japan alone are not enough. The Bank of Japan should directly purchase large volumes of stock and perhaps even ask private-sector financial institutions to create ETFs that are easier for the Bank of Japan to buy. If these purchases total ¥10 trillion or ¥20 trillion, the stock market will no longer be at the mercy of stock sales of ¥5 trillion by foreigners. My main point here is that the extremely distorted structure of ownership of stock, which should be the most important financial asset for the people of Japan, is the primary cause of the current Japanese stock selling by foreigners. Correcting this distortion will be vital to the success of Abenomics.

Musha/ Niizeki: Thank you.