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Time to buy Japanese stocks and the dollar

– No way for the Trump administration to stop the yen's depreciation

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 Higashishinbashi,
Minato-ku, 105-0021 Tokyo

(1) Markets cannot ignore the economy's health, strong earnings, large volume of savings and low interest rates

Niizeki: Musha Research believes that the second stage of the Abenomics rally has started. What is your outlook for the magnitude of this rally?

Musha: I think the Nikkei Average can climb to about ¥25,000 by the end of this year and about ¥30,000 by the end of 2018. Also, I expect the yen to decline to between ¥125 and ¥130 to the dollar by the end of this year and ¥130 to ¥135 by the end of 2018. There is a strong link between the dollar-yen rate and stock prices in Japan. Therefore, the current environment for a big upturn of the dollar is the biggest reason for a positive outlook for stock prices. Furthermore, as I will explain later, I think there is no way that the Trump administration can stop the dollar from climbing and the yen from falling.

Niizeki: Why are you so confident about the outlook for the stock market?

Musha: The primary reason is the existence of three positive fundamentals on a global scale. First is healthy economies accompanied by strong earnings. Second is the continuation of low interest rates, which equates to a large volume of savings. Third is the continuation of easy-money policies by countries worldwide because of the low risk of inflation. Stock markets, where prices continue to move up, will be the only place for investors to put money that has nowhere to go. Most well-known hedge fund managers (such as Paul Tudor, George Soros, Jim Rogers and Bill Gross) are now very cautious. This stance demonstrates that people are very reticent about risk-taking. It is almost as if investors are searching for an excuse not to buy stocks because they refuse to believe the three positive fundamentals I just listed.

Geopolitical risk is viewed as a good excuse. However, Brexit and Donald Trump's election victory, which investors initially feared, turned out to be excellent buying opportunities. Whenever the voters of a country choose populism, the new administration is subsequently forced to revise its policies. Prime Minister Tsipras in Greece and President Trump are two examples of leaders who had to alter their populist policies. Any candidate who wins an election will be unable to take any actions that would be harmful to the current environment that encourages risk-taking. Illustrating this point is the switch in President Trump's stance from criticizing the Fed to asking for continuation of low interest rates. And now that Emmanuel Macron will be France's next president and the possibility of an armed conflict in North Korea has declined, investors have no choice other than to turn their attention to fundamentals: (1) Healthy economies and strong earnings, (2) Low interest rates and a large volume of savings, and (3) Market-friendly monetary policies.

Niizeki: It looks like pessimists, who are the majority among hedge funds managers, are ignoring these positive fundamentals at their own risk.

Musha: That's right. Signs of a worldwide economic upturn are becoming increasingly obvious. Now is the time for investors to discard outdated beliefs and place their faith in fundamentals. The sustainability of US economic growth is the most critical point. As even the Fed itself has said, the decline in March economic indicators was only a temporary slowdown. First, there were indications of upcoming economic weakness. For example, job growth slowed in March and retail sales, the industrial production index and housing starts were all down from February. Second, the first quarter GDP growth rate decreased to 0.7% because of the nature of statistical seasonal adjustments. Third, the growth rate of imputed rent decreased and the increase in the CPI slowed in March. Core CPI was up 2.0% over the past 12 months compared with 2.2% over the prior 12-month period mostly because of communication and apparel prices. The consensus among economists is that all these figures are merely noise rather than a sign of a change of direction in the economy. The US economy will probably bounce back very quickly. This is why the rapid drop in the US long-term rate from 2.6% to 2.1% will probably not last very long. Investors can expect to see a resumption of the Trump rally that started last November and raised stock prices, interest rates and the dollar. A restoration of the Trump trade, which has come to an end for the time being, is also likely to occur.

Niizeki: There is no doubt that optimism is growing. For instance, the IMF raised its forecast for the global economy. Does that mean there are no reasons at all for concerns about the outlook?

Musha: In China, monetary indicators are weakening amid monetary tightening (declining share prices, rising rate for corporate bonds as well as overnight rate, increase of defaulting firms). In addition, prices of commodities are falling. But these events will probably not become serious because they are most likely simply letting some air out of the Chinese economy prior to the 2017 National Congress of Communist Party this fall. In the United States, bank loan growth are falling fast. Some people think this demonstrates a lack of interest in making investments. But I think this downturn in loans should instead be viewed as the result of the shift in corporate fund procurement from loans to bonds. There is no need to worry about this downturn because companies are issuing bonds in response to rising interest rates. Companies want to use bonds to lock in low-cost debt while interest rates are still low.

(2) The fate of Japanese stocks depends on the dollar-yen rate

Niizeki: Since the end of April, stocks worldwide have started rebounding and Japanese stocks which had been the biggest target for sellers have been performing very well. What is the reason for this shift, and is this rally sustainable?

Musha: No major stock market in the world is more volatile than Japan's stock markets. During the recent correction, stock prices in Japan fell more than in any other major stock market. The reason is the link between stock prices and the big swings in the dollar-yen exchange rate. In a risk-off environment, US stock prices move down and the yen appreciates. The result is increased selling of Japanese stocks. In a risk-on environment, US stock prices move up and the yen depreciates. This produces a powerful rally in Japanese stocks. These characteristics make the Japanese stock market an ideal place for speculators.

There are three primary reasons.

1) Foreign speculators account for a large share of stock market trading in Japan. Foreigners hold 30% of stocks but generate 60% to 70% of trading volume, about 90% of which is estimated to be speculative.

2) Foreigners are probably using forex hedges for about 20% of their investments. When stock prices are climbing, investors sell the yen for these hedges. When stock prices are falling, investors buy the yen to close out their hedges. This buying and selling increases the volatility of the yen-dollar exchange rate. Japanese stock market capitalization is ¥580 trillion and foreign ownership is 30%. Multiplying foreign ownership by a 20% forex hedging rate results in a hedge position of ¥35 trillion. Therefore, a 5% drop in stock prices in Japan produces ¥1.7 trillion of demand for buying the yen, which reinforces the link between forex and stock prices.

3) Japan has net foreign assets of $2.9 trillion and net foreign securities holdings (overseas securities investments – net foreign investments in Japan) of $890 billion. Both are the largest in the world. Due to the massive amount of foreign securities held by Japanese investors, foreign exchange rate volatility increases when market sentiment shifts between risk-on and risk-off.

Linkage between forex and stock prices is likely to continue for some time. That means the outlook for the dollar-yen exchange rate is critical to determining an outlook for Japanese stocks. Three major factors influence stock prices in Japan. First is US stock prices, which are an indicator of the global appetite for risk. Second is Japan's economic fundamentals. Third is the dollar-yen exchange rate. For these reasons, if a global risk-on environment emerges and US stock prices climb, prices of Japanese stocks are very likely to move up even more as the yen depreciates.

(3) Why the Trump administration's efforts for a stronger yen and weaker dollar will fail

Niizeki: The exchange rate outlook is clearly a key factor for determining a stance about Japanese stocks. What is the most important point that investors should watch concerning upcoming exchange rate movements?

Musha: The key point regarding the dollar-yen rate is the imminent and almost complete failure of the Trump administration's goal of weakening the dollar, which is the sole potential reason for the dollar to depreciate. If the Trump administration wants to boast about the soundness of US fundamentals, then the dollar should logically be strong, too. Furthermore, if the Trump administration wants to use political actions like taxes and non-tariff trade measures to reduce the trade deficit, then these actions should make the dollar even stronger. The Trump administration is using its own one-sided reasons for its goal of a weaker dollar. But the dollar-yen rate is a floating rate in every way. As a result, the Trump administration has no means of exerting pressure for the yen's appreciation and the dollar's depreciation. This is the essence of this issue. Once the market starts to incorporate these points, we could see an unexpectedly large decline in the yen's value.

Niizeki: First, please explain the main reasons with regard to fundamentals that Musha Research is confident the dollar will appreciate.

Musha: The dollar is backed by a faster economic growth rate and rising interest rates while Japan continues to implement extreme monetary easing. The dollar should obviously be stronger. From the standpoint of US fundamentals, there is no reason for long-term interest rates to go any lower. Interest rates have probably hit bottom at the recent 2.1% and are about to climb for many years. In addition, the US CPI is expected to increase at a rate of more than 2%. Consequently, I think that the real US interest rate, which was recently close to zero, will increase to about 1%.

Prices in Japan have been held down by the drop in the price of crude oil and the yen's appreciation. But these effects are coming to an end. Prices are starting to climb as wages in Japan rise. According to the ESP forecast survey of the Japan Center for Economic Research, the average outlook of economists is for core inflation (which excludes fresh food) of -0.24% in fiscal 2016, which ended in March 2017, and +0.83% in fiscal 2017. This is a difference of more than one percentage point. But the Bank of Japan is holding the long-term interest rate steady at 0%. As a result, Japan's real interest rate is likely to move from the positive territory of last year all the way to more than -1%. For these reasons, the outlook is for a big increase in the gap between Japanese and US real and nominal interest rates.

Niizeki: Financial markets are very worried about pressure from the Trump administration for a stronger yen. Are these worries justified?

Musha: There is basically no need for concern. When the March US trade deficit was announced on May 4, Secretary of Commerce Wilbur Ross said that the trade deficits with Mexico and Japan were growing at an unsustainable pace. He also said the United States can no longer sustain inflated trade deficits. Mr. Ross held back on criticism of China, which has the largest trade deficit with the United States, due to the need for China's cooperation to deal with North Korea. This explains why he singled out Mexico and Japan.

The remarks by Mr. Ross were mostly for show. But foreign exchange market did not respond at all. The yen's depreciation rather gained momentum afterward. Statements by Mr. Ross were extremely arbitrary. For example, (1) he used monthly statistics, which have significant random fluctuations, as the basis for a problem; (2) he talked about only trade statistics for goods and left out the service sector, where the United States has a competitive edge; and (3) he said nothing about China, which has the largest trade deficit with the United States. Apparently, foreign exchange markets saw right through these statements as something of a threat aimed at giving the United States an advantage in any upcoming bilateral trade negotiations to reach a deal with Japan.

Global foreign exchange rate movements, especially for the dollar-yen rate, are probably already starting to move away from regulatory agencies and ignoring the wishes of the US and Japanese governments. The dollar-yen rate has been completely floating since the last market intervention more than six years ago. Market forces determine the rate. Governments have only three ways to influence an exchange rate: (1) Monetary policies, (2) Tax measures (tariffs, repatriation tax cut, etc.), and (3) non-tariff trade barriers. As I explained earlier, monetary policies are creating a strong environment for the dollar to appreciate. Using tax measures to weaken the dollar would require putting off any tariff and repatriation tax cuts. But this would be contradictory to the goals of the Trump administration. Finally, the use of non-tariff trade barriers to pressure Japan to lower its US trade surplus would cause the dollar to appreciate. These logical outcomes of the three possible measures demonstrate that all of the policies of the Trump administration will make the dollar move up and the yen go down. Market participants may just now be starting to comprehend this point.

Niizeki: Forex markets may be starting to ignore the illogical statements of US regulatory agencies as nothing more than noise. But if this is true, what will determine the dollar-yen rate?

Musha: The rate will depend on Mrs. Watanabe, in other words, ordinary consumers in Japan who make overseas investments. There is no doubt that the gaps between both nominal and real US and Japanese interest rates will continue to widen significantly. In the second half of 2016, the high cost of procuring dollars (the dollar premium for basis swaps) limited the amount of Japan's external investments. But this premium is now much smaller. Furthermore, savings are growing in Japan but there are no places (other than stocks and real estate) for people to earn a meaningful return. In this environment, Mrs. Watanabe is watching for an opportunity to invest her savings outside Japan. The time when household savings fuel growth in Japan's external investments is probably becoming closer with every day that goes by.

** Yuko Niizeki, Director, Musha Research*

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