Musha Research

6 March, 2019

Musha Research Commentary

Strategy Bulletin Vol. 221

Investors are shifting their attention to the Obama-Trump economic boom

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

The 2018 year-end plunge may have set the stage for a powerful rally

The big drop in stock prices that took place in the final quarter of 2018 was of the same magnitude as the downturn that happened following the collapse of Lehman Brothers. In December, the net outflow from US equity mutual funds and ETFs was $75.5 billion. This was a new monthly record and far higher than outflows triggered by the Lehman Brothers bankruptcy. AI trading has dramatically increased the speculative nature of the stock market. Volatility is beyond the level that can be explained by previous experience. In this highly turbulent environment, an abnormal space was created when buyers disappeared because investors had become temporarily paralyzed by fear. The PBR of the Nikkei Average was below one at the end of December 2018. Previously, a PBR this historically-low had occurred only when Lehman Brothers collapsed and immediately prior to the start of Abenomics.

The Dow Jones Industrial Average fell 19.4%, or 5,238 points, measured from the top to the bottom, in the last quarter of 2018. But this average subsequently needed only three weeks to rebound to the halfway point of this drop. During January and February, the DJIA recovered to a point that erased 86% of the initial downturn. This index is now only 3% below its all-time high. Even the Nikkei Average has staged a strong recovery despite the perception that Japanese stocks should be more vulnerable to a weaker Chinese economy. The Nikkei Average fell 22.5%, or 5,499 points, during the fourth quarter of 2018 but has already come back enough to cut this downturn almost in half.

Assuming that the world is not about to experience a recession on the scale of the Great Recession caused by the global financial crisis, the recent drop in stock prices was an extreme overreaction. This is why Musha Research has declared that this downturn is an unprecedented buying opportunity. The 20% surge in stock prices during the first two months of 2019 proved that this outlook was correct. However, investors are becoming increasingly cautious based on the belief that this powerful rebound means that a bear market is about to begin. This negative view is particularly widespread in Japan. At the end of January 2019, the total market value of “bear ETFs” or inverse ETFs, which produce profits when stock prices fall, was about ¥100 billion. Now, this figure has doubled to reach a record-high. On the other hand, the existence of such strong negative sentiment and caution may very well be a sign that stock prices are likely to continue climbing without any significant downside correction.

The rally will gain momentum when the Chinese economy stops weakening

Although investors have been worried about the US and Chinese economies, the outlook for these economies is becoming increasingly positive. As a result, there will probably be a large number of positive surprises involving the global economy in the second half of 2019. In China, the growth rate of yuan-denominated bank loans increased in January due to monetary easing. Furthermore, the growth rate of total social financing (bank loans + shadow banking), which had dropped sharply, has started to increase again. This growth rate was 12% in the first half of 2018, then 9.7% in December, but 10.4% in January. Another positive sign is the start of a recovery in the growth rate of China’s infrastructure investments, which were one cause of the slower growth rate of economy in 2018. But most important of all is the agreement between President Trump and President Xi Jinping that prompted the resumption of investments that had been postponed because of uncertainty about the outcome of the US-China trade war. Ending this uncertainty will probably unleash pent-up demand that will make a big contribution to improving economic sentiment. Anticipating this upturn, global investors have already increased investments in Chinese stocks significantly. The Shanghai Composite Index reached a major low on January 4 but has subsequently staged an impressive rally that raised this index by 22%. The index is now at thelevel where it was when the dramatic downturn in stock prices in China started in the spring of 2018. Moreover, fueled by a recovery in demand and insufficient inventories in China, prices of copper and other metals have made a big comeback from recent lows.

Attention is shifting to the record-long Obama-Trump economic boom

In the United States, the stock market downturn late in 2018 had absolutely no negative impact on the strong labor market. The consumer confidence index is continuing to climb. Many economists are worried about a series of superfluous tax cuts enacted by the Trump administration. Economists thought lower taxes would increase the risk of a tight supply-demand balance, accelerating inflation and the end of this phase of economic expansion. But these expectations have been proven to be wrong. In fact, inflation has decreased. One explanation is that tight supply and demand has been avoided because increasing investments have raised the growth rate of productivity.

In June 2019, the current U.S. economic expansion will set a new longevity record of 120 months. When this happens, President Trump will probably praise himself and the media will rush to applaud and analyze the renewed vigor of the US economy. Pessimism ruled financial markets late in 2018 when stock prices plunged. But sentiment is likely to switch to optimism as people examine the reasons for this record-long economic expansion and think about its sustainability. In an op-ed in the February 26 Wall Street Journal, former Fed vice chairman Alan Blinder, now a professor at Princeton University, said this record economic boom is likely to continue for the foreseeable future. “The key point is that expansions don’t die of old age; something kills them,” he wrote. “If not old age, then what ends expansions? A common answer in the modern era is that the Federal Reserve clamps down to fight inflation. But today inflation remains quiescent despite extremely low unemployment.” Dr. Blinder also notes that a spike in the price of oil often kills an expansion, but a jump to $90 or $100 a barrel doesn’t look likely any time soon. Regarding US-China trade friction, he points out that exports to China are only about 1% of US gross domestic product. Even if they fell by half, it would probably not trigger a U.S. recession. Furthermore, Dr. Blinder believes that the probability of a US-China trade agreement is increasing. He also noted that stock market crashes alone do not lead to recessions and that in fact last year’s stock market crash did not inflict serious damage on the economy.

Japanese stocks may climb faster once the era of the new emperor begins

There is no longer possibility at all of a recession in the United States or China in 2019. Now that a recession is off the table, investors can stop worrying about an economic slowdown this year. Instead, investors can turn their attention to global risk-taking due to the outlook for economic growth to start speeding up again in the second half of 2019. The recent upturn of the dollar against the yen is a clear signal that investors’ appetite for risk-taking has come back. The Fed has reinforced its monetary easing posture and the FOMC made a decisive shift to a dovish stance on January 30. A rapid switch to risk-on sentiment in global financial markets in the wake of this FOMC meeting is the only conceivable reason for the yen’s rapid depreciation in February.

The improvement in the global environment for investments will almost certainly have a favorable effect on the Japanese economy. Within the international division of labor, companies in Japan are specializing in capital goods and producer goods. These are categories with big fluctuations in demand. For example, investment demand in China vanished late in 2018 because of the pessimistic outlook regarding the US-China trade war. Orders received by many Japanese companies briefly plummeted as a result. But Japanese companies are also likely to experience the world’s biggest rebound in demand following this downturn. Furthermore, demand within Japan is expected to increase as the country looks ahead to the transition to a new emperor in May.

Markets started 2019 in extreme turbulence. But investors’ growing confidence about the economy is very likely to make it a year when stocks post very strong returns.