Musha Research Commentary

MR Musha Research

16 August, 2019

Strategy Bulletin Vol. 230

A Midsummer Night's Nightmare

Is this the end of the multi-year upturn or the bottom of a mini-cycle?

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

A midsummer night's nightmare – Turmoil in financial markets
Financial markets have suddenly become volatile right in the middle of summer vacation, triggering a dramatic shift in investor sentiment. Falling prices and turmoil were sparked by a sudden tweet by U.S. President Donald Trump on August 1, announcing a 10% tariff on imports from China worth $300 billion. People were expecting an agreement to end the trade war, but now a resolution is no longer in sight. Is this a midsummer night's nightmare? Volatility has been buffeting stocks, exchange rates, interest rates, gold and a broad range of financial instruments. The Chinese yuan fell below the key 7 CNY/$ level, the yen was the sole currency to appreciate, and US long-term interest rates plunged along with stock prices. With many investors on vacation in August, speculation about upcoming events made financial markets extremely volatile. Is this the beginning of a full-scale crisis or merely a short-term event?

If this turmoil will end soon, then now is a time for investors to place bets on higher stock prices, a weaker yen and lower bond prices. The price of gold has moved up mainly because of geopolitical forces. Gold may be held partly as a substitute when dollar-denominated assets are frozen. And the higher price of gold is not linked to selling the dollar. Big upswings in the price of gold in 1980, 2011 and other times coincided with the end of an extended depreciation of the dollar. But this time is different.

The bottom of this mini-cycle is near
The decision of how to view the current volatility depends entirely on whether this is the end of the long-term economic expansion or simply the bottom of a mini-cycle. Fundamentals tell us that the risk of an end to the multi-year period of economic growth is small. The negative impact of the US-China tariff war alone is limited. US economic expansion that began in 2009 has continued for 10 years and become the longest ever period of growth. No indications of the end are evident. In China, a loss of economic momentum has been prevented through government measures to promote investments in infrastructure and real estate.

However, mini-cycles occur even during prolonged periods of economic growth. Global trade and investments move up and down with these cycles. In recent years, there were mini-cycles with a 2015 spring peak and 2016 spring bottom and a 2018 spring peak and 2019 spring bottom. The mini-downturn that started in the middle of 2018 happened because many investments were postponed in response to an uncertain outlook. The cause was the outbreak of the US-China trade war at the same time that the cycle of replacing smartphones and automobiles almost peaked. Today, the replacement cycle is almost over and uncertainty about the US-China trade war is decreasing. Although the trade war has not ended, a full-scale confrontation has been avoided. The big picture of the outcome is coming into view. For instance, companies will probably have to move some of their factories out of China. Prospects are good for this mini cycle to start reversing direction towards the end of the year.

In addition, it will be possible to avoid deep economic downturns in the United States and China. There is steady progress with revisions to supply chains. One result is the accelerating pace of positive effects on the ASEAN region, Taiwan and Mexico as companies move production activities out of China. In Europe, the German economy is weakening, but there is considerable room for countermeasures, including more

monetary easing by the ECB or more public-sector spending.

No significant risk of the start of a negative financial cycle

Financial markets are the greatest risk. If the current turmoil does not wind down, the resulting chain reaction of risk avoidance efforts could possibly increase the negative impact. We could see a detrimental chain reaction as investors establish risk exposure profiles that use low interest rates for leveraged investments and have a higher weighting of high-yield assets.

Two factors are particularly significant with respect to this point. First is the reversal of US long and short-term interest rates, which is normally viewed as the sign of an impending recession. However, yield curve inversions in 1986 and 1998 ended after a short time and there was no recession. In both 1986 and 1998, long and short rates became upside-down briefly due to the different speeds at which these two rates moved during periods of declining interest rates. Other yield curve inversions that led to a recession happened because of rate hikes that raised short-term interest rates above long-term rates. All were the result of intentional monetary tightening.

This time, the reversal of long and short-term interest rates is obviously the result of different speeds of rate movements. Consequently, there is little need to worry about a recession. Furthermore, a recession following a yield curve inversion always starts at least one year after the inversion begins. Also, stock prices tend to gain upward momentum during the initial phase of yield curve inversions. For these reasons, investors should not be overly concerned about stock prices for the time being. In a situation like this, the Fed's only course of action is to cut interest rates at least by about half a percentage point in order to end upside-down interest rates quickly.

The second significant factor is the unusually high level of uncertainty in the world's affluent countries. There is no consensus at all about whether long-term interest rates will go up or down as well as whether the trade war will end. Some people think that long-term rates will rebound after the Fed lowers the interest rate, an action that is regarded as certain to happen. Others believe that long-term rates will continue to decline. But irrespective of the direction of long-term rates over the next few years, cuts in short-term rates will be good for the economy and encourage risk-taking. There is no doubt that the Fed will retain an accommodative posture as long as inflation and an asset bubble are not likely to occur. This is why investors have good reason to expect to see the bottom of this mini-cycle and an upturn in long-term interest rates fairly soon. If this does happen, the end of the yen's appreciation is not far away.

Policy initiatives are the key to the outlook, US, UK, EU and Japan are interesting

Ultimately, stock price movements will be the critical factor. Here, the crucial point is whether or not government policies can prop up stock prices. When there is no inflation and companies are reporting strong earnings, monetary easing (ETF purchases, interest rate cuts, quantitative easing and other measures) and expansionary fiscal policy for boosting stock prices have very little risk. All countries are becoming increasingly dependent on such policies, no matter this is perceived to be a positive or a negative one. By raising productivity, the AI and internet revolution is increasing the supply of goods worldwide. One result is constant deflationary pressure. This leads to a surplus on the supply side that can also be viewed as a shortage on the demand side. Ending this situation requires policies that create demand in order to absorb the surplus of capital and supply. In other words, governments must use a combination of monetary easing and more spending. Governments worldwide are embracing the modern monetary theory, the fiscal theory of the price level, quantitative easing, and other monetary and fiscal policies precisely because the current economic environment (excess supply and insufficient demand) requires these types of actions. US stocks have the best performance in the world because the Trump administration is doing almost exactly what is needed to create more demand.

In Japan, a consumption tax hike is planned for October and the Bank of Japan appears to have little room for any more monetary easing. Expectations for government actions are lower than anywhere else in the world. Investors worldwide should therefore be shunning Japan. Prime Minister Abe says that this will be the last consumption tax hike and taxes will not increase over the next decade. In fact, Mr. Abe was not prime minister when the 8% to 10% consumption tax hike was first proposed in 2012. At that time, this idea was nothing more than a homework

assignment based on an agreement of the three-party coalition led by the Democratic Party of Japan and including the Liberal Democratic Party and Komeito. Now, most people expect that reflationary initiatives backed by Prime Minister Abe will become the central economic issue of Japan's next general election. Before the next election, the prime minister will probably unveil a plan to use higher tax revenue to cut taxes while making expenditures to make Japan more resilient to natural disasters.

The global deflation crisis and falling interest rates are significantly increasing the Bank of Japan's freedom concerning its policies. In Europe, the ECB's deposit facility interest rate is negative 0.4% and more people are calling for the ECB to start buying ETFs. As a result, the Bank of Japan has much more flexibility regarding negative interest rates and more ETF purchases. Taking these actions would be a big surprise for financial markets, where there is currently a general mood of resignation. The result would trigger a synergistic effect consisting of an upturn in the global economic mini-cycle and expectations for still more beneficial policies. These events may produce a powerful upswing next year in the prices of Japanese stocks, which are now at an absolute bottom.

Britain is the focus of attention with the United States and Japan. Prime Minister Boris Johnson's policies are similar to those of President Trump. Once Britain is no longer subject to EU spending restrictions, there may be a tax cut and more government expenditures. In addition, once Brexit becomes a certainty, many companies are likely to resume capital expenditures that had been postponed. A British stock market rally like the Trump rally in late 2016 could happen. If this happens, it would contribute to reflation on a global scale.

The possibility of a severe economic downturn

Many investors are terrified of the possibility of a severe economic downturn or the bursting of an asset bubble. The August 11 issue of Nikkei Veritas, a financial and investing newspaper, had an article about signs of the impending end of US and Chinese asset bubbles, contributed by Tadashi Nakamae. The August 12 issue of the Financial Times had an article titled "Braced for global downturn" and the Nikkei newspaper had a similar article two days later. The recent steep drop in stock prices has suddenly made bubble-bursting predictions by highly confident people much more persuasive. However, it is impossible to know in advance if or when an asset bubble will end. The bubble will grow and then burst at some point. But there is very little discussion in these predictions of a drastic economic downturn about whether or not this will happen now. Furthermore, there are no persuasive arguments for regarding today's asset prices as a bubble. Bond prices could be regarded as the biggest bubble right now. However, a bursting of this bubble would definitely push up stock prices.

Government policies are the decisive factor regarding the outlook and there are no significant worries about these policies. Falling long-term interest rates will cause the intrinsic value of assets to increase. As long as a recession can be avoided and companies can maintain their cash flows, there is no possibility of a plunge in asset prices.

© Copyright 2019 Musha Research Co., Ltd
Although the information contained herein is based on sources that Musha Research believe reliable, Musha Research do not make any representation or warranty, express or implied, with respect to the fairness, correctness, accuracy, reasonableness or completeness of the information and opinion herein. Musha Research is not responsible for any losses or damages incurred by your relying on such information and opinion. The analyses or opinions contained herein may be based on assumptions that if altered can change the analyses or opinion expressed. Nothing contained herein shall constitute any representation or warranty as to future performance of any financial product, credit, currency rate, interest rate or any other market or economic measure. Furthermore, past performance is not necessarily indicative of future results. Musha Research has no obligations to update, modify or amend this document or to notify a reader in the event that any matter stated herein changes or subsequently becomes inaccurate. When you analyze risks and issues on investment, finance, tax, law and/or accounting contained herein, you should take steps to ensure that you understand the transaction and have made an independent assessment of the appropriateness of the transaction and it is strongly recommended to seek advice from your own experts and/or advisors, in light of your own objectives and circumstances. This document shall not be construed as and does not form part of an offer, nor an invitation to offer, nor a solicitation or recommendation to enter into any transaction with DSI or any of its affiliates, nor is it an official or unofficial confirmation of terms. This document and any information contained herein are confidential and may not be reproduced or distributed in whole or in part without our prior written consent.