Musha Research

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DSI Vice Chairman Commentary

Key Strategy Issues (Vol. 282)

A recovery has started despite declines in employment and credit extensions.

Progress in corrections by U.S. companies points to greater likelihood of a V-shaped rebound.

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Remarkable progress in corrective measures by companies and strong earnings outlooks should be the focus of attention right now. Investors should not be distracted by rising unemployment, negative consumer sentiment and flat consumer spending or even the credit crunch. Rising unemployment and sluggish consumer spending are both nothing more than the product of past corporate behavior. This is history. So what about the future? A recovery will depend on the ability to companies to once again increase output and employment while raising wages.

Some people use rising unemployment and flat consumer spending as excuses to adopt a pessimistic view. However, this stance is tautological that is saying the same thing twice: People believe the outlook is negative simply because the economy has been weak until now. But we must not forget that every economic recovery has been accompanied by an increase in unemployment and decrease in loans, as I will explain later.

The speed of responses by U.S. companies to the economic downturn has been impressive. Furthermore, we are seeing a sharp recovery in orders at U.S. manufacturers. Corrective measures by these companies have lowered the breakeven point. And now we are seeing the beginning of a recovery in production volumes. More jobs and higher wages are certain to follow, which will in turn fuel an upturn in household spending. This is why I am convinced that the probability of a V-shaped recovery is increasing.

Two risk factors should be kept in mind. The first is the possibility of changes caused by monetary adjustments in China, which is responsible for much of the demand in the world today. The second involves the broad-based U.S. economic recovery that will probably follow a recovery in employment levels. Investors should watch for any interruption in the pace of this recovery. Either factor could cause a short-term downturn in stock prices, but this is very unlikely to happen.

Musha to appear on NHK
Musha will participate as a panelist in a debate concerning whether U.S. economy is going to weaken or recover. The program will be broadcast from 22:10 to 23:00 on August 23 on the NHK BS channel. The other panelists are Noriko Hama, Kazuyo Katsuma and Hidehiko Fujii.

(1) The recovery begins even as employment and loans decline

The "jobless" and "creditless" recovery

Unemployment is still rising, although more slowly than before. Furthermore, financial institutions are still cutting their business loans because of damage inflicted by the financial crisis. The vast majority of economists and other market observers agreed until only recently that persistent employment and credit problems would block any economic recovery. Embracing this belief led to predictions of a double-dip recovery or L-shaped recovery. But the chart below shows this is wrong. During the first year of any economic recovery, there are always job losses and declines in bank loans to companies. In each case, the recovery has continued even as unemployment rose and credit extensions fell.

These two characteristics of a recovery are obvious. Unemployment rises because companies inevitably have too many workers when a recovery begins. A "jobless" recovery takes place because companies make greater use of their excess labor. This explains why a production recovery always takes place at the beginning of an economic upturn. Right now, this is precisely what is taking place at a rapid pace in the United States.

Credit extensions fall as a recovery starts because companies have too much money. Substantial free cash flows (operating cash flows less capital expenditures) are the primary cause. Holding excess funds prompts companies to start investing, which triggers a recovery. This explains how a recovery can take place even as bank loans to companies decline.

For these reasons, no one should be surprised to see an economic recovery accompanied by rising unemployment and declining loans. Anyone who uses unemployment and credit statistics to prove that the recovery cannot last is merely being tautological.

Figure 1 : US Employment Situation and Recession
– Employment continues to fall when a recovery begins

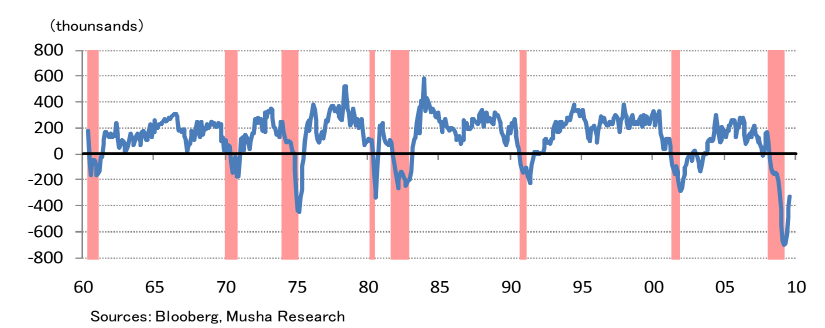


Figure 2 : US Bank Commercial Loans and Recession
– Loans decline when a recovery begins

(2) The speed of corrective measures at companies is the most critical factor now.

U.S. companies are far ahead

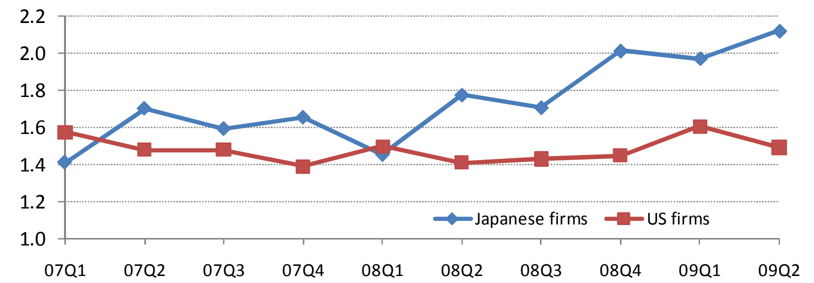
What should investors watch closely at this stage of the recovery? I believe the most critical point is the speed at which companies are streamlining their operations. Do companies still have too many employees or too much inventory, capital equipment and debt? In all respects, U.S. companies are far ahead of companies in other countries. The figures below show that U.S. companies are producing massive free cash flows because they have (a) finished cutting inventories, (b) rapidly reduced their workforces and (c) reduced capital expenditures. Furthermore, the (d) low percentage of labor expenses to total expenses allows companies to hold down expenses and remain profitable.

A V-shaped rebound in U.S. earnings has started

As I just explained, U.S. companies have moved much faster than other companies to streamline their operations. This is especially true of workforce reductions. As the table below shows, the United States is expected to have the smallest decline in GDP but the largest increase in unemployment in 2009. What this means is that U.S. companies have maintained labor productivity while cutting expenses. Naturally, this makes it easier to earn profits. In fact, operating income at U.S. manufacturers posted a sharp recovery in the second quarter of 2009 even as their sales continued to fall and the GDP shrank again. But the drop in U.S. employment is finally reaching the end. For instance, the July decrease in U.S. nonfarm payroll employment was 247,000, only about one-third of the 740,000 decrease in January.

	U.S.	Japan	EU
2009 GDP Forecasts (IMF)	-2.6%	-6.0%	-4.8
Unemployment rate (2008 2Q = 2009 2Q)	5.3%⇒9.3%	4.0%⇒5.2%	7.4%⇒9.3%

Figure 3 : Inventory Ratio (Defined as commodity stocks divided by monthly sales)
– U.S. companies are lowering inventories faster



Sources: Blooberg, Musha Research

Figure 4 : Operating Income at U.S. and Japanese Companies
– U.S. companies are now staging a strong earnings recovery

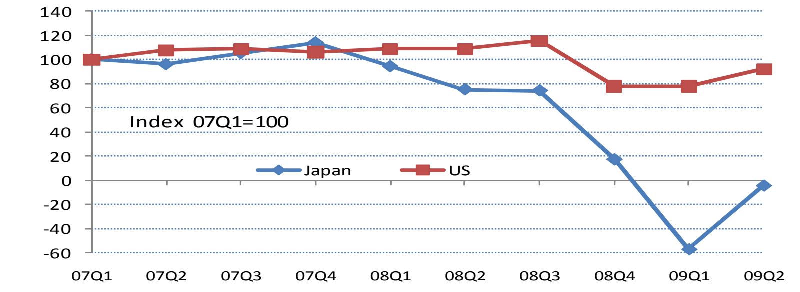
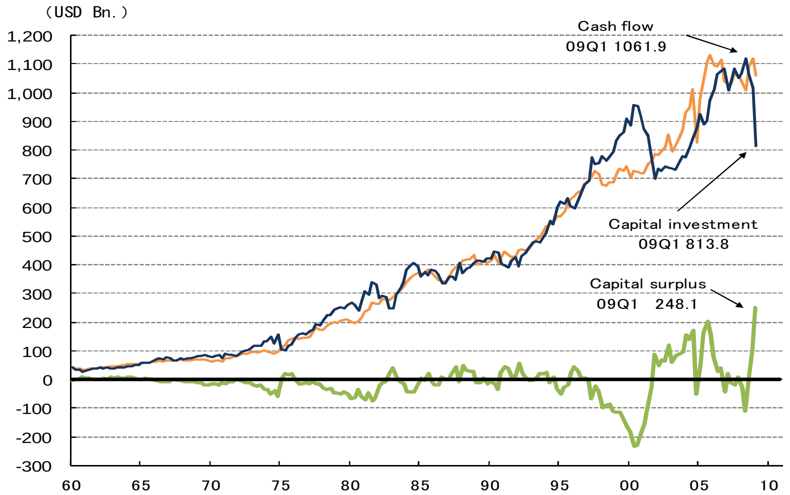
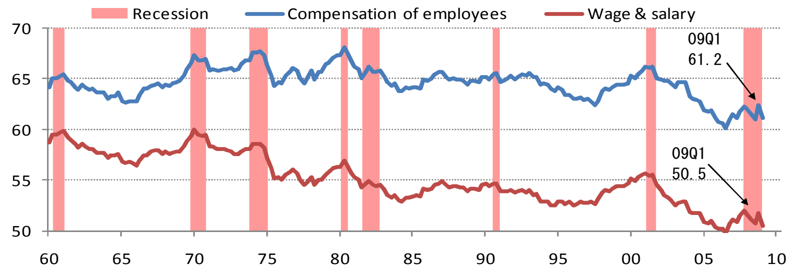


Figure 5 : US Corporate Sector: Cash flow, Capital Investment, and Surplus(free cash flow)
– Net savings at U.S. companies are at an all-time high



Sources: Flow of Funds, Musha Research
Note: Capital surplus is defined as cash flow minus capital investment.

Figure 6 : U.S. Labor Expense Distribution Ratio and Recessions
– This ratio is extremely low during recessions



Sources: U.S. Bureau of Economic Analysis (BEA), Musha Research

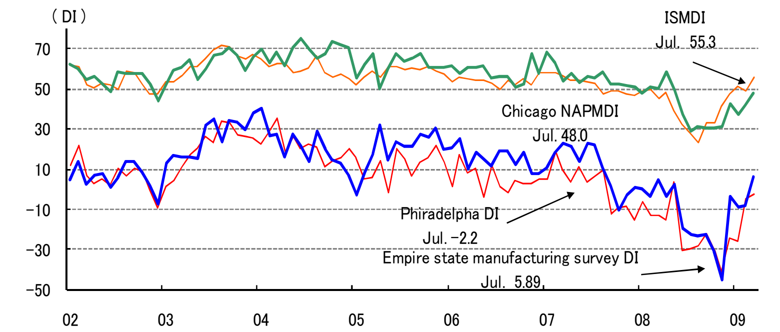
(3) The rapid recovery in new orders at U.S. manufacturers

Production volumes recover as breakeven points fall

Progress in streamlining operations allows companies to respond quickly to the emergence of additional demand. When demand climbs, companies can once again raise output, hire workers and make capital expenditures in order to increase inventories.

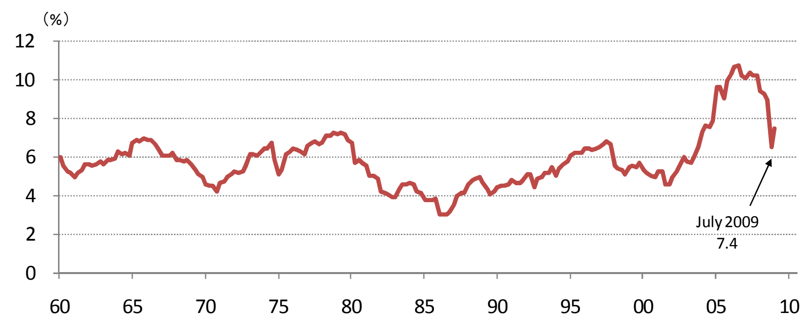
U.S. manufacturers have completed most of their actions to streamline operations, giving them a much lower breakeven point. Having finished this process, these manufacturers are now seeing a strong upturn in new orders. There are several causes. Most significant are (a) higher demand and growth in net exports in China and other emerging economies; (b) the completion of inventory reductions; and (c) the end of the downturn in final domestic demand, including automobile and home sales and household spending. These developments are setting the stage for a powerful surge in production volumes and earnings in the United States.

Figure 7 : US New Order DI
– A big increase in production volumes is certain to start in the fall



Sources: Bloomberg, Musha Research

Figure 8 : Earnings Remain High at U.S. Companies (relative to GDP)

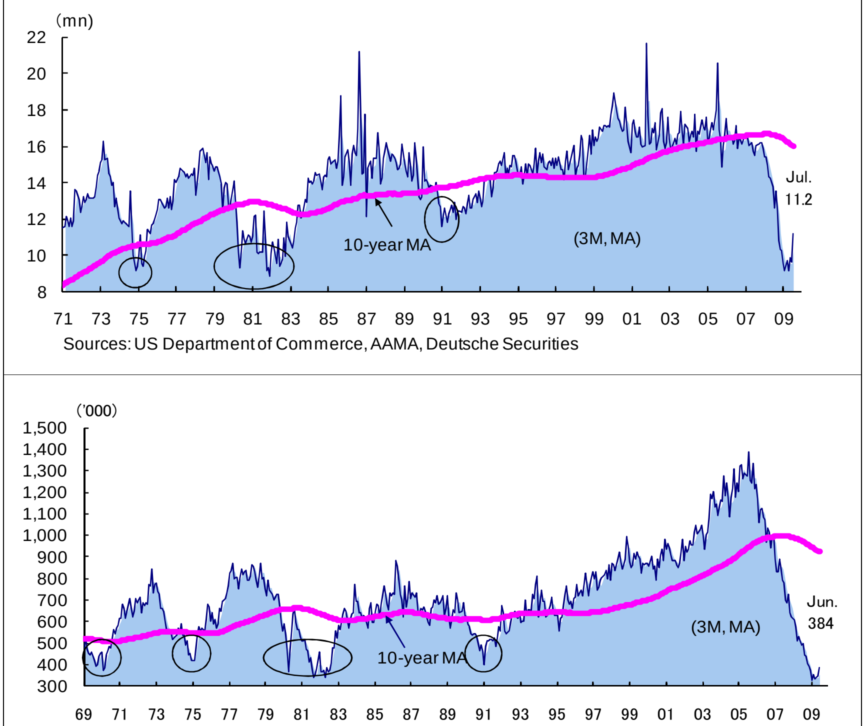


Sources: Blooberg, Musha Research

The correction to eliminate excessive U.S. consumption has ended

My next subject is U.S. consumer spending, which is the nucleus of the U.S. economy. As I have noted in past reports, corrections in excessive spending on houses, automobiles and other products have become excessive themselves. Automobile sales fell by about half from the peak. Sales of houses bell to only one-fourth of the peak. But we are finally seeing upturns. Moreover, the household saving rate has increased from 1.8% in 2008 to 4.3% in the first quarter of 2009, 4.7% in April and 6.2% in May. But this figure retreated to 4.6% in June, indicating that May was probably the peak. Many positive factors are emerging: housing prices have reached the bottom; the saving rate has peaked; corporate earnings are climbing; consumers are feeling more affluent as prices of stocks and other assets rise; governments are enacting stimulus packages; and the clear end of the decline in jobs is further improving consumer sentiment. All these events point to the possibility of an extremely strong economic rebound. Many economists are already significantly raising their growth forecasts for the second half of 2009 and afterward. This further underscores the increasing likelihood of a V-shaped U.S. recovery. For more than one year, I have been repeatedly saying that the biggest surprise of 2009 will be the remarkable strength of the U.S. economy. Current events appear to be showing that I was not wrong.

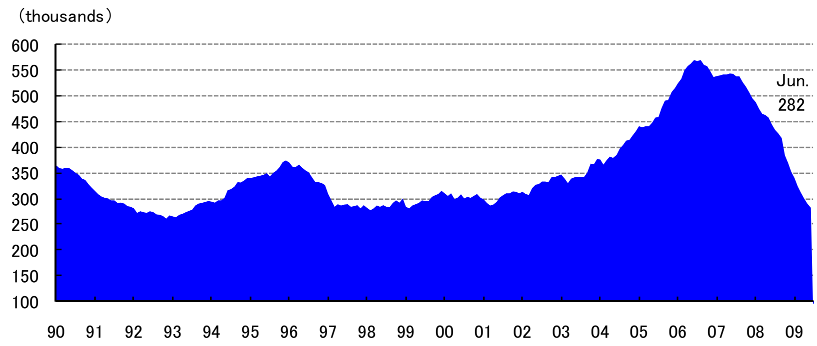
Figure 9 : US new passenger car and light truck sales & US sales of new single-family houses – A recovery has started after hitting rock bottom



Sources: US Department of Commerce, AAMA, Deutsche Securities

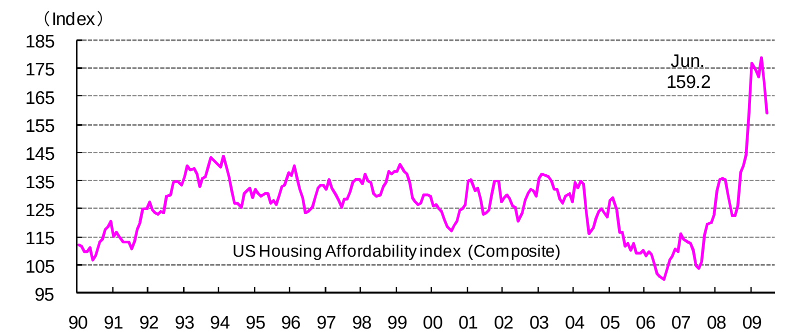
Sources: US Department of Commerce, Deutsche Securities

Figure 10 : Inventory of new homes for sale coming down from its peak – The correction is over following a dramatic decline



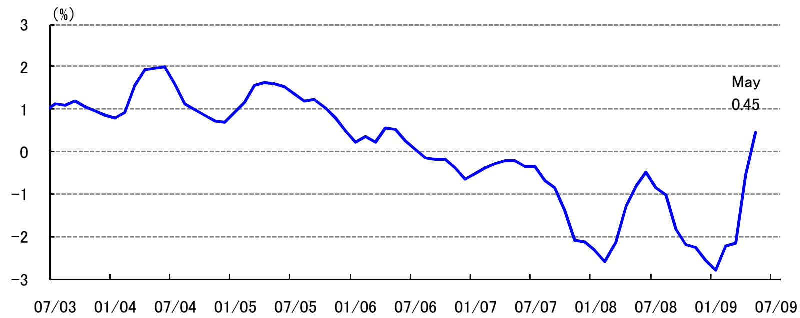
Sources: Bloomberg, Musha Research

Figure 11：US Housing Affordability index
– The affordability of housing is at an unprecedented high



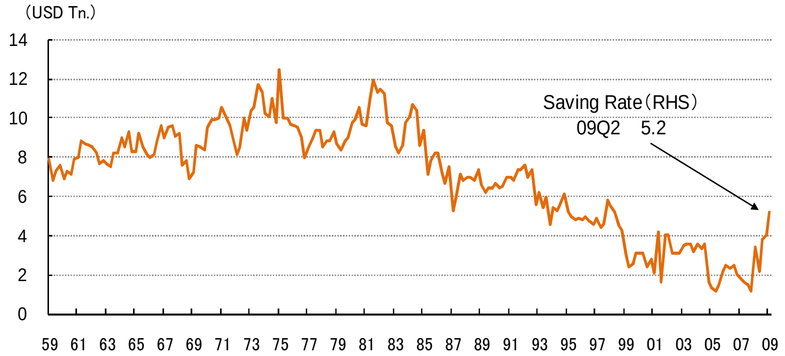
Sources: Bloomberg, Musha Research

Figure 12： Case-Shiller national index（MOM）
-Housing Prices Have Bottomed Out After a Two-year Decline



Sources: Bloomberg, Musha Research

Figure 13： U.S. Household Savings
–In the Rapid Increase, the saving rate is currently too high



Sources：Bloomberg, Musha Research

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