MR Musha Research

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DSI Vice Chairman Commentary

Key Strategy Issues (Vol. 285)

2010 outlook depends on the U.S. economy
A dramatic recovery is quite possible

～2010 may be a year of economic recovery, even higher stock prices and a rebound in the dollar～

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The direction of the U.S. economy is the key to determining the outlook for 2010. Even now, people remain mired in a pessimistic mindset. Even the most optimistic observers expect U.S. economic growth of only about 4% in 2010. Due to the magnitude of the recent economic downturn, we would normally expect to see a recovery ratio of 9%. But the 2010 forecast is less than half of this percentage. Enormous progress has taken place in the real economy. We have seen unprecedented progress by companies in streamlining operations and households in cutting expenditures. Furthermore, housing prices have dropped to an unprecedented low. All of these events are the result of an extreme contraction fueled by panic. The downward correction in the real U.S. economy has gone far enough. Furthermore, the rebound from these extremes back to normal may very well have an impact that is greater than anyone expects. This is why I believe that stock prices will be supported by both rising earnings and improving supply-demand dynamics.

Prospects are excellent for a continuation in the U.S.-led global rally in stock prices. But one source of concern is selling pressure as investors lock in profits following the remarkable 50% to 70% rally over the past six months. For the time being, I think stock prices will remain flat during the transition from a market driven by low interest rates to a market fueled by higher earnings. In foreign exchange markets, I expect to see a big reversal in the dollar once people realize how strong the U.S. economy is. Speculators are mainly responsible for the current decline in the dollar’s value. Weakness has little relationships to the current state of the U.S. economy. But the dollar’s weakness will probably end once investors see that the U.S. economy is recovering faster than the economies of other countries.

Japanese stocks have fallen to a level that presents an excellent buying opportunity. Despite these low prices, Japanese stocks will probably lag behind the stocks in other countries. Nevertheless, I expect to see a major rally in Japanese stocks starting early in 2010 for two reasons. First is the strength of the U.S. economic recovery. Second is the end of the dollar’s decline as the yen reaches its peak. However, due to worries about Japan’s structural problems and concerns involving the government and its policies, I think that some industrial sectors will perform better than others.

(1) A pessimistic bias still controls the actions of many investors

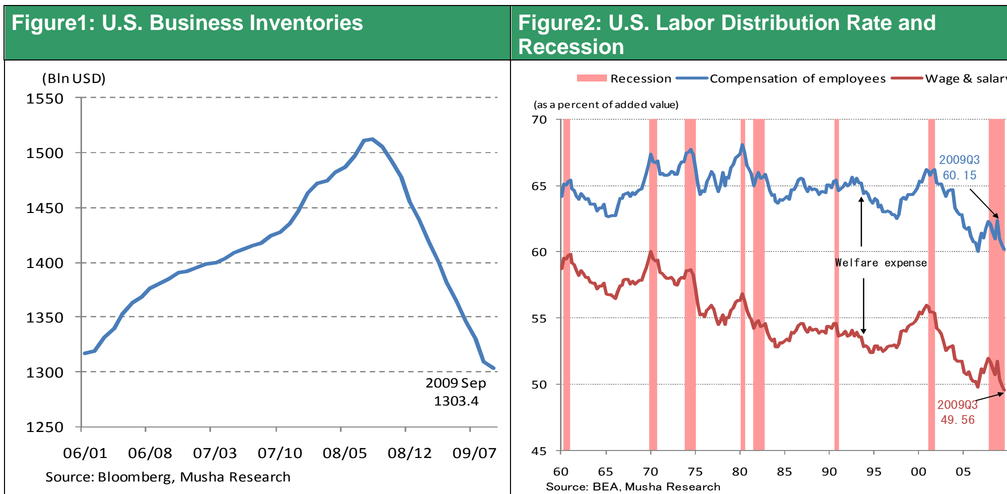
The many causes of negative sentiment

Many statistics, including the improvement in November employment figures, are pointing to the start of a dramatic turnaround of the U.S. economy. But no one is accepting these numbers at face value. Many factors are making people cautious. First, pessimists are convinced that the recent financial panic signals the end of the age when prosperity was fed by excessive debt and consumer spending. They have already decided on their outlook and will not change until they see irrefutable data showing an economic recovery. Second, pessimists are retaining a cautious stance because they believe central banks and other government agencies will not permit another financial panic like the one we saw late in 2008. Third, economic and market analysts are reluctant to become optimistic because adopting this stance may end up damaging their reputations. With pessimism about the outlook still widespread, people are afraid to appear simplistic by switching to optimism based simply on what may be trivial economic data. Others feel they must cling to a cautious stance based on the conviction that there must still be hidden risks somewhere because the magnitude of the financial panic was so great. That means almost everyone is still a prisoner of pessimism. If this is true, shouldn't we view this as an attractive buying opportunity? Investors don't need ideology now. All you need to do is look at the actual economic data.

(2) Progress in the U.S. microeconomic correction is undermining the pessimists' beliefs

The remarkable speed of corrective measures by companies

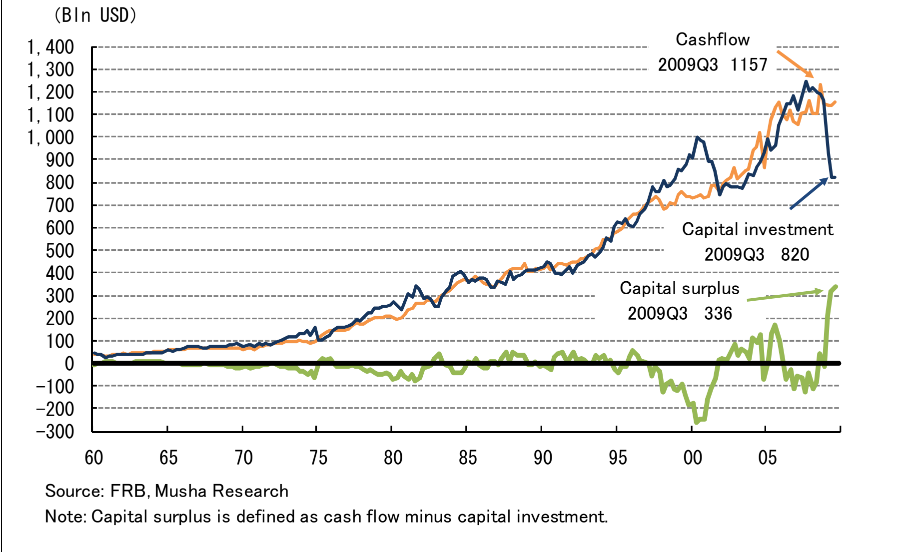
The speed of actions taken by companies in response to this crisis holds the key to an economic rebound. After all, employment, wages and investments all depend on the decisions of corporate executives. Data showing the performance of U.S. companies show that companies are improving their operations and financial soundness at a remarkable pace. Inventory reductions were completed by the end of June 2009. Moreover, U.S. companies cut their workforces much faster than other countries did. In fact, job cuts are largely over in the U.S. private sector. According to the IMF, there will be GDP contractions of 2.7% in the U.S., 5.4% in Japan and 4.2% in the EU in 2009. Even though the U.S. has the smallest decline, it has the largest increase in unemployment. Between the second quarters of 2008 and 2009, the U.S. unemployment rate was up by 4 percentage points (5.3% to 9.3%). During the same period, this rate increased only 1.2 point in Japan (4.0% to 5.2%) and 1.9 point in the EU (7.4% to 9.3%). Only the U.S. cut jobs by more than the drop in production. That means labor productivity in the U.S. has increased even during a severe recession. As a result, labor expenses as a share of total expenses at companies fell to an all-time low in the third quarter of 2009. Normally, the ratio of labor expenses increases during a recession as employees perform less work. But this did not happen at all this time in the U.S. as companies were surprisingly successful at holding down costs.



Liquidity at companies has never been higher

We have also seen remarkable progress in reducing capital goods and improving cash flows. During a recession, economic growth is dragged down by plunging capital expenditures in response to a sharp drop in the utilization rates of machinery. However, even as the economy contracted, cash flows at U.S. companies remained generally flat and free cash flows climbed to record levels. By taking these corrective actions, companies were able to remain profitable even as newspaper headlines told us about the worst recession in the postwar era. This strength was a defining characteristic of the recession.

Figure 3: U.S. Nonfinancial Corporate Business Cashflow, Capital Investment and Surplus



Source: FRB, Musha Research
Note: Capital surplus is defined as cash flow minus capital investment.

The savings rate has stopped climbing

Consumer spending and housing are the nucleus of the U.S. economy. But the corrections in both sectors have reached an excessive level. Automobile sales fell to about 50% of the most recent peak. Demand for homes was down by 75% at one point. Now, sales of automobiles and houses are starting to bounce back. We are also seeing an improvement in the household savings rate, which is a barometer of pessimistic consumer sentiment. This savings rate increased from 1.2% in the first quarter of 2008 to 3.7% in the first quarter of 2009. After climbing to 4.9% in April and 6.4% in May, the savings rate retreated to 4.9% in June, 4.8% in July and 3.9% in August. The rate was 4.6% in September and 4.4% in October. As a result, the household savings rate most likely reached its peak last May.

The savings rate is a key indicator of the upcoming direction of consumer spending. This statistic is greatly influenced by two items: the number of jobs and the price of assets (the asset effect). With regard to employment, the loss of jobs in the U.S. is largely over. The number of jobs lost peaked at 740,000 last January and fell to only 10,000 in November. With regard to assets, households are benefiting from the surge in stock prices and the end of the decline in home prices. A steady improvement in consumer sentiment is almost certain to occur. Net assets of U.S. households peaked at $65 trillion in 2007. This figure fell all the way to $48.5 trillion in the first quarter of 2009 but rebounded to $53.4 trillion in the third quarter, an increase of $5 trillion in only six months. Another $3 trillion will probably be added by the end of the fourth quarter. Overall, household wealth will probably grow by $7 trillion in 2009, which is 50% of the GDP. An increase of this size is almost certain to raise household spending.

Figure 4: U.S. Light Vehilce Sales

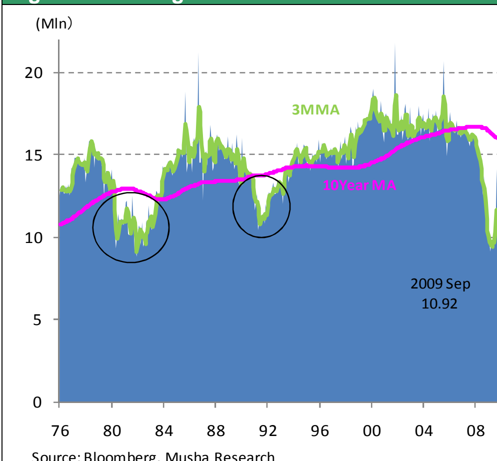


Figure 5: U.S. New Single-family Home Sales

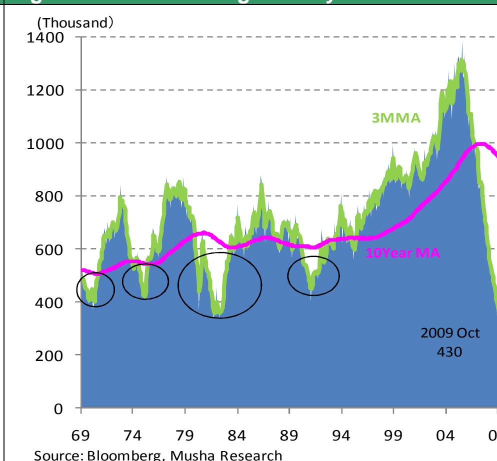


Figure 6: U.S. Household Saving Rate

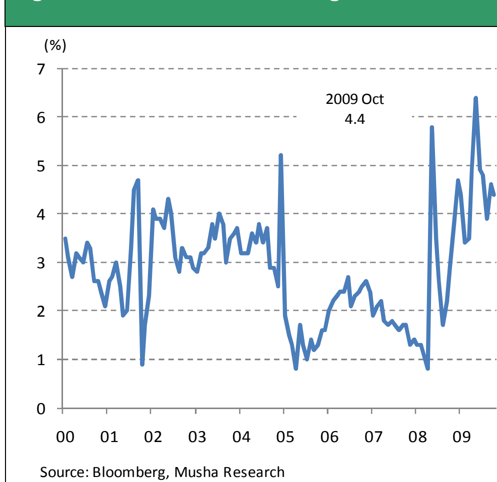
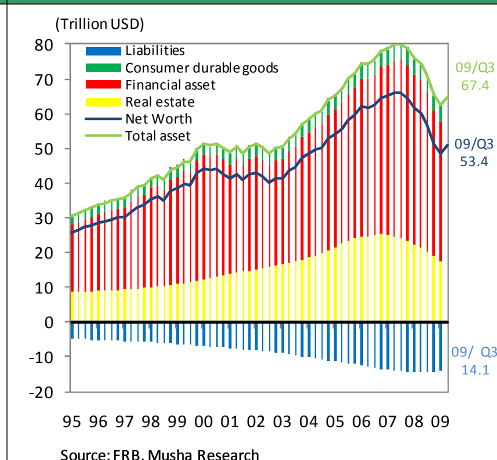


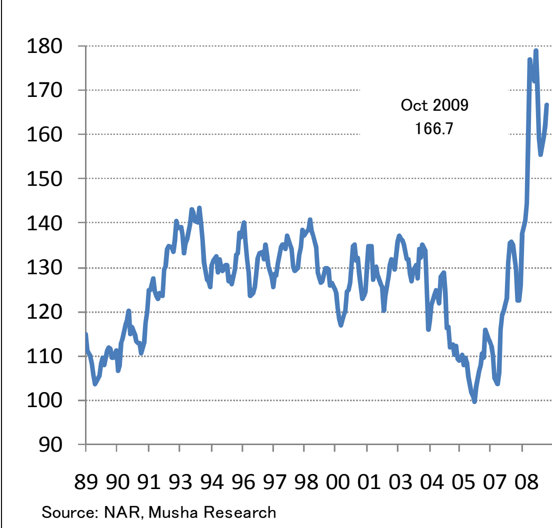
Figure 7: U.S. Household Asset, Liabilities and Net Worth



Bargain hunters are starting to buy houses

A recovery from severe downturns has started in the markets for existing homes, newly constructed homes and housing starts. Companies have mostly finished cutting the number of housing construction workers. The U.S. housing affordability index has reached a record high. Never before have houses in the U.S. been easier to buy or more attractively priced. We are already seeing the first signs of a boom in the existing home market. Pending sales of existing homes are surging because of low interest rates and government incentives for homebuyers. This upturn will probably translate into a big increase in sales of existing homes within a few months. Furthermore, prices are no longer falling. The enormous volume of unsold new homes was the greatest source of pressure on home prices. But new home inventories have dropped from a peak of 570,000 in October 2008 to only 250,000, the lowest level in the past 20 years. This virtually eliminates a major source of downward pressure on prices. In fact, we are seeing unmistakable signs that home prices have hit bottom. Most significantly, the Case-Schiller home price index posted the first month-to-month increase in two years. As home prices recover, we can expect to see a virtuous cycle as the asset effect enables households to increase their spending.

Figure 8: U.S. Housing Affordability Index

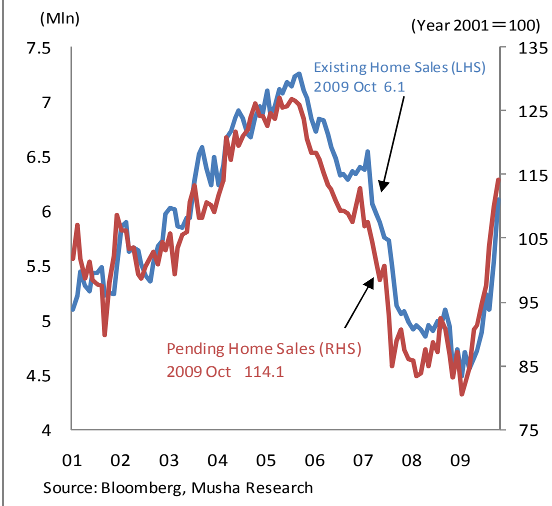


Source: NAR, Musha Research

Figure9: U.S. Inventory of New Home Sales

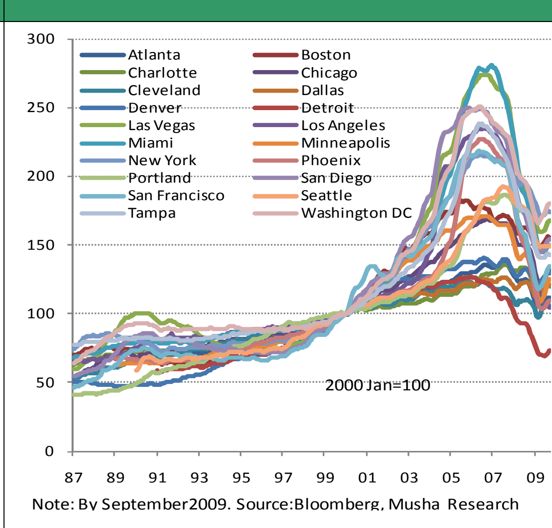
Source: BEA, Musha Research

Figure 10: U.S. Existing Home Sales and Pending Home Sales



Source: Bloomberg, Musha Research

Figure 11: Case-Shiller Index by Cities



Note: By September2009. Source:Bloomberg, Musha Research

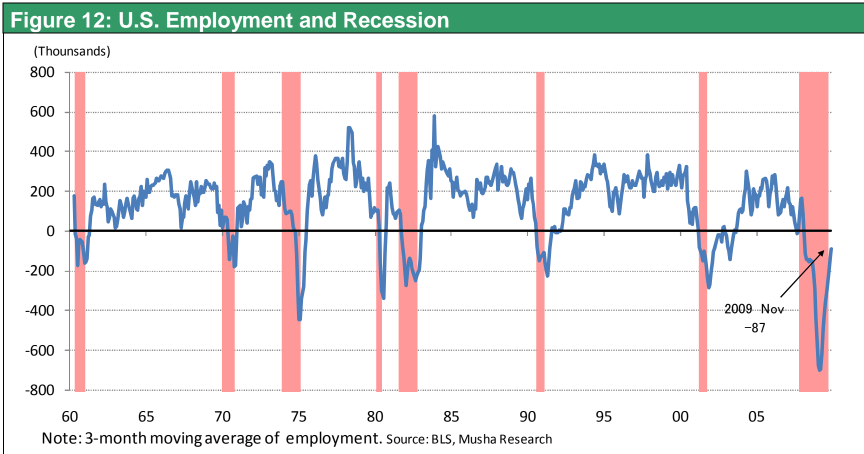
(3) Potential Barriers to a Recovery Can Be Ignored

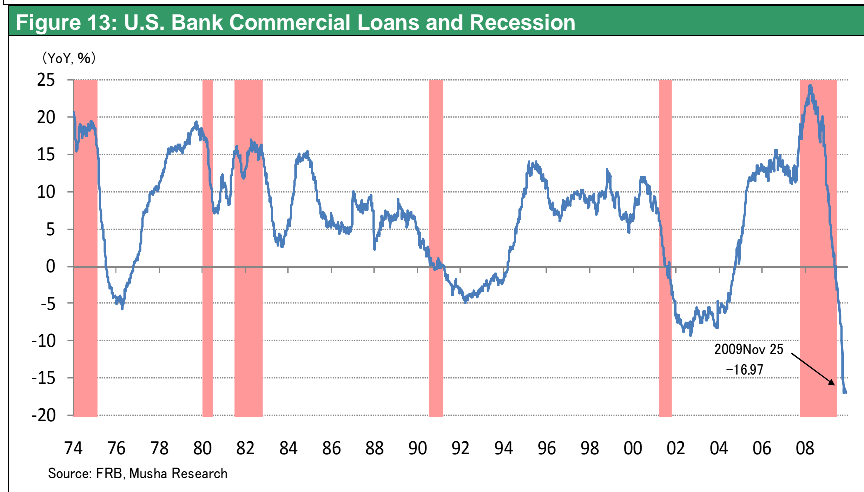
Potential barriers to a V-shaped recovery – Employment and credit are both lagging indicators

Everyone can see that U.S. companies improved their performance at the expense of workers. We can conclude that the drop in jobs blocked a recovery in consumer spending. Making matters worse, actions taken by banks to restore soundness caused a drop in business loans. Until only recently, the vast majority of economists believed that the steady drop in the number of jobs and availability of loans was holding back a recovery. This stance caused many people to predict a double-dip recovery and even an L-shaped recovery. However, as the figure shows, employment and bank business loans have always decreased during the first year or two of an economic recovery. Contrary to what many people believe, declines in jobs and business loans do not stand in the way of a recovery.

The recovery in commercial real estate is lagging, too

Commercial real estate is another category that is lagging behind the macroeconomic recovery. This should come as no surprise since commercial real estate is typically the most leveraged and the most sensitive to changes in the loan market. Due to these factors, the commercial real estate market continues to decline for a while even after a recession ends. At present, there are $700 billion of commercial mortgage-backed securities (CMBS) outstanding. Approximately $100 billion have become non-performing loans because of falling prices the refusal of banks to extend loans. Some observers (Deutsche Bank) think that commercial loans may cause a number of regional U.S. banks to fail. Of course, commercial real estate could trigger the next crisis if the current macroeconomic rebound cannot be sustained. But unlike the days before the Lehman Shock, the Fed and FDIC both have powerful supervisory and crisis response systems in place. The failure of a few banks is thus very unlikely to grow into a full-blown crisis the envelopes the entire financial sector.





Monetary support will probably end within one year

Pessimists have another reason for predicting that the recovery will not last. They believe that we will soon see the negative effects of the monetary and financial support that has been propping up the recovery. First of all, I admit that the recovery may briefly lose momentum when monetary stimulus measures wind down at the end of 2010. These measures are adding about 2% to the economic growth rate. But this recession is the result of an unprecedented drop in cyclical economic components like capital expenditures, purchases of durable goods, housing investments and inventory investments. We can expect to see these cyclical components come back faster during this recovery than for a recovery that follows a less severe recession. I believe this faster recovery will be sufficient to offset the upcoming end of economic stimulus measures. My second point concerns fears about the U.S. budget deficit. The U.S. Office of Management and Budget predicts that the national government's debt will rise to 76.5% of GDP by 2019. Massive debt is sparking fears of higher interest rates and inflation. However, this will probably not become a problem for at least a few more years, so there is no need to be concerned at this time.

(4) Earnings and supply-demand are both pushing up stock prices

U.S. companies have right-sized their workforces, held down costs and accumulated large amounts of liquidity. That means companies are well positioned to jump-start the economy once executives regain their confidence about the economy. Companies have the resources to hire workers and make other positive investments (capital expenditures, acquisitions, stock repurchases and dividend hikes). Break-even points are much lower now that companies have finished responding to the recession. At the same time, U.S. manufacturers are benefiting from a rapid recovery in orders. Rising orders means that we should see a big upturn in production and earnings starting in the first half of 2010. As a result, we will probably see positive surprises when companies report their earnings. At the same time, I expect to see companies channel their massive liquidity into the stock market in the form of acquisitions, stock repurchases and dividend increases. For these reasons, I believe that a favorable environment for stocks in terms of both earnings and demand is now firmly in place.

In the past, a deeper recession has typically been followed by an even more vigorous recovery. We have just endured the worst downturn in the postwar era. Naturally, we should expect to see a powerful rebound. Based on past recoveries and the depth of this recession, the economic growth rate in 2010 should be 9%. But even the most optimistic economists are predicting growth of only about 4%. And that's not all. The average prediction is for growth of between 2% and 3% and many pessimists call for a second downturn and even negative growth in 2010. Is it possible that all these economists are mesmerized by the pessimistic bias that I discussed earlier? In any case, what do you think will happen if the dramatic recovery that no one expects becomes a reality?

(5) The Isolation of Japanese Stocks Will End

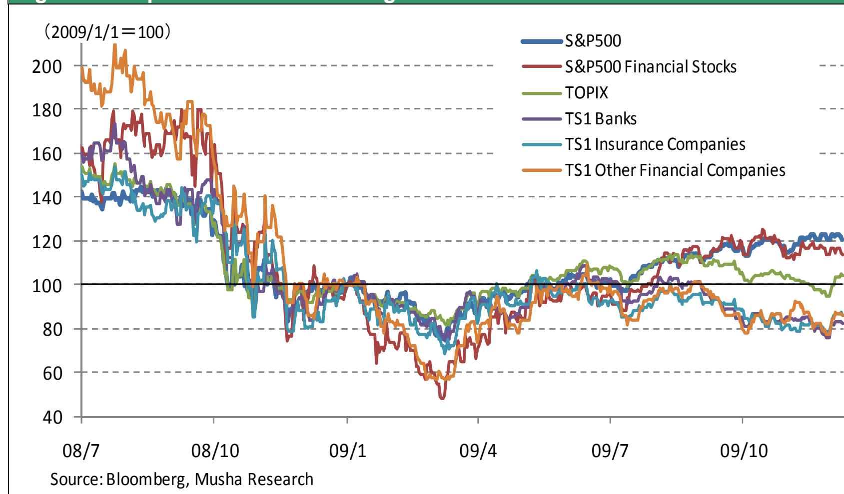
We must not link the poor performance of Japanese stocks with concerns about the global economy, negative views of the U.S. and other pessimistic beliefs. Japan's stock markets have fallen far behind overseas markets because of the following two factors that are unique to Japan.

1) Japanese stocks prices are the most sensitive in the world to changes in the global economy. This is because economically sensitive products like high-end goods, high-tech materials and capital goods account for a large share of sales by Japanese manufacturers. Since the current global stock market rally is fueled in large part by low interest rates rather than an economic recovery, Japan has been left behind. Once a full-scale economic recovery begins, Japanese stocks should react swiftly.

2) Structural problems unique to Japan are also exerting pressure on stock prices. Examples include deflation, a delay in stimulating internal demand due to the failure of structural reforms, the lack of a culture of independent-minded thinking in Japan, and the desire of Japanese investors to avoid risk.

Japanese stocks are remaining weak because the Democratic Party of Japan has not yet established a clear set of policies. But this problem will most likely once an economic recovery begins, as I explained in item 1 above.

Figure 14: Japanese Stocks are being Left Behind the Global Trend



Source: Bloomberg, Musha Research

(6) The Dollar Will Stage a Big Rally in 2010

A weak dollar gives the U.S. a competitive edge

Pure speculation is probably responsible for the decline in the dollar's value. This is not a reflection of concerns about the U.S. economy. I do not believe that the weak dollar will lead to another financial crisis or stand in the way of an economic recovery. Normally, a weaker dollar is linked to an outflow of capital. But this outflow is the result of increasing overseas investments by U.S. investors and growth in dollar-denominated debt held by foreigners. Growth in both investments and debt shows that investors are willing to enlarge their balance sheets in order to take on more risk. The fact that the dollar weakened as U.S. stocks rallied proves this point. Some people think that the current decline in the dollar is linked to a drop in confidence in the U.S. and the outlook for an economic recovery. But this belief does not make sense. I expect that this recovery will produce increasingly concrete benefits in 2010. Demand for investments in goods rather than financial instruments will grow. Once investors become convinced that the rebound will lead to higher interest rates, the dollar will probably start to rebound. Obviously, a decline in the dollar's value will put the U.S. economic recovery even farther ahead of other countries. This is why I expect to see the dollar stage an upward correction in 2010.

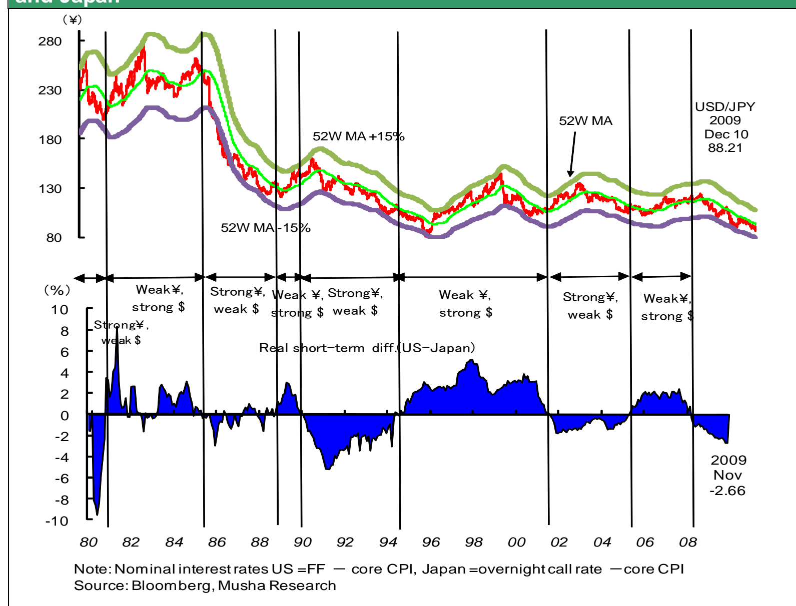
The yen's strength puts Japan at a disadvantage

There is a strong possibility that the yen's strength is influenced by the tendency of Japanese investors to shun overseas investments and avoid risk even more than by the dollar's decline. Money is sitting idle in Japan because of the reluctance to make new investments. Furthermore, the inferiority of Japan's economy is becoming increasingly evident as the value of the yen climbs. Consequently, we are very likely to see a major shift in 2010 to a weaker yen due to shifts in Japan's economy and the adoption of government policies aimed at bringing down the yen's value.

Is Japan prepared to do what is needed?

As the figure below shows, the dollar-yen exchange rate has basically moved in tandem with the gap between real short-term interest rates in Japan and the U.S. Currently, short-term interest rates are zero in both countries. But there is a large and growing gap between real short-term interest rates because of deflation in Japan and inflation in the U.S. In October 2009, this gap widened to 2.55 percentage points, which is the largest in the past decade. Japan therefore faces the danger of having a much stronger currency that is backed by the continuing increase in real interest rates. If this happens, the Japanese economy will be impacted by both high interest rates and a strong yen. The result could be a steep downturn. I do not think the Bank of Japan and Ministry of Finance could prevent this type of recession. The Bank of Japan would be forced to use radical measures to end deflation. At the same time, the Ministry of Finance would have to intervene in currency markets to lower the yen's value. These actions would lead to a correction in the unusual strength of the yen that has no relationship at all to the state of the Japanese economy.

Figure 15: USD-JPY Rate and Short-term Interest Rate Difference between U.S. and Japan



Note: Nominal interest rates US = FF — core CPI, Japan = overnight call rate — core CPI
Source: Bloomberg, Musha Research

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