Musha Research

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Discussions with Overseas Investors

Everyone agrees that the outlook is positive

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Impressions from my visits with overseas investors

Last week, I visited a number of overseas investors. Our outlook consists primarily of the following four positions. (1) The U.S. economy has started a powerful self-sustained recovery and the United States will probably start to change its monetary policy in 2012. (2) The negative impact of the earthquake on the Japanese economy will end by the middle of 2011 and the economy will start gaining strength in the second half of the year. (3) The G7 intervention has ended the yen's upturn and will probably result in dollar exchange rates of ¥90 by the end of 2011 and ¥100 one year from now. (4) Deflation in Japan will end this year and the Nikkei Average will climb to ¥20,000 in 2013. This **equates to an annual increase of 30% over the three-year period ending in 2013.**

The remarkably strong consensus outlook for Japanese stocks

Above all, I was surprised that all overseas investors I met have almost the same outlook for the economy. Investors told me that (1) Japanese stocks are very undervalued, (2) Japanese companies (particularly multinational companies) are competitive and will stage a strong recovery in earnings, (3) they are confident that the U.S. economy will continue to recover, (4) they are convinced that the yen will weaken, and (5) Japanese stock prices will rise from a medium and long-term perspective (of course, there is the widely held conservative view that we need to keep an eye on the impact of the recent earthquake disaster on immediate stock price trends). These views are identical to the outlook of Musha Research. As a result, little effort was necessary to persuade them. Furthermore, overseas investors were very impressed with the solidarity and social order in Japan following the earthquake. These investors were deeply touched by the suffering in Japan. Almost all investors extended their condolences and wishes for a speedy recovery. Only a short time ago we frequently heard the phrase "Japan bashing, Japan passing, Japan nothing." But there is absolutely no negative sentiment about Japan now. No one is jealous of Japan's strength today. Instead, we are seeing a big increase in the world's respect for Japan with regard to the country's high-quality products, advanced technologies and global citizenship.

I believe that a consensus outlook backed by this degree of agreement indicates that we will soon see the start of a powerful stock market rally. Moreover, we are starting to see many articles in the Financial Times and Wall Street Journal and other publications about how much stocks in Japan are undervalued.

Every reason to worry about Japan is a stereotype

My discussions with overseas investors showed that everyone also agrees on reasons to worry about Japan: (1) government budget deficits may cause long-term interest rates to spike, resulting in a sharp economic downturn; (2) Japan's declining and aging population; (3) lack of political leadership; (4) corporate governance at some Japanese companies that ignores the interests of shareholders; and (5) the pessimism of many investors in Japan. I responded by explaining that all of these fears are abstract concerns that have become stereotypes. Furthermore, stock prices already reflect these risk factors.

The Musha Research view of each risk factor

(1) Budget deficits

Reforms are definitely needed, but there is no need for urgency and deficits will not destroy the Japanese economy. Viewing a budget deficit as a means of pushing expenses into the future is a mistake. The public is paying the cost of the budget deficit every day by enduring zero interest rates on their savings. The people of Japan are financing about 95% of the Japanese government's deficit. Obviously, higher interest rates in the future will increase the fiscal burden. However, the resulting higher expenditures will directly contribute to growth in household interest income. As a result, there would not be a positive or negative effect on the Japanese economy. Higher interest rates would force the public sector to enact reforms while at the same time stimulating the private-sector. This would be good news for the stock market. The biggest cause of Japan's red ink is falling tax revenues because of deflation and inflexible expenditures (pensions, health insurance benefits and salaries of government workers do not fall even during deflation). Ending deflation is therefore the most important requirement for lowering Japan's budget deficit.

(2) Declining and aging population

Japan's declining population is creating two main problems: a falling number of workers and shrinking markets. Economic globalization can solve both of these problems. Over the past two decades, Japanese companies have demonstrated their ability to utilize overseas workers. In addition, Asia is a prime target for Japanese companies, which have powerful brands and a reputation for making high-quality products. Asian markets are very attractive because personal income is increasing rapidly in many countries in this region. Japanese companies should be able to preserve their competitive edge by leveraging their superiority with respect to technology, quality and brands.

(3) Lack of political leadership

A further deterioration in Japan's political situation is difficult to imagine. In fact, any improvement would most likely be a significant positive surprise. From 1955 until 2009, Japan was ruled by an unproductive two-party system. In very basic terms, this was a period of competition between two groups. One was the Liberal Democratic Party. This party used good policies (support for democracy and a market economy, the Japan-U.S. alliance, and support for business) for a bad objective (the pursuit of own interest). The other group was the opposition parties (Socialist Party and Democratic Party). The opposition promoted poor policies (inadequate emphasis on markets, excessive emphasizes on weak aid programs despite their heavy cost, criticism of Japanese big companies, and much less support for the Japan-U.S. alliance) for a good objective (no pursuit of their own interest). Clearly, the stances of these two groups were completely incompatible and they were talking past each other in the Diet. But everything changed when the Democratic Party became the ruling party. The LDP's pursuit of self interest came to an end. At the same time, it soon became clear that a lot of policies of the Democratic Party were failing. In response, the Democratic Party was forced to make sweeping revisions to its manifest. After enacting these revisions, the Democratic Party found itself going along with almost every policy of the LDP. Japan finally reached the point where the government is pursuing the right policies for the right reasons. Formation of a major coalition or the realignment of political parties that is likely to occur in the near future will therefore be very beneficial for Japan.

(4) Corporate governance that ignores shareholders

All overseas investors agree that significant improvements have been made in governance at Japanese manufacturers as they became stronger by overcoming challenges posed by a strong yen and trade friction. Furthermore, the remaining Japanese companies are very likely to achieve big improvements of their own in corporate governance. These companies accumulate cash on their balance sheets while paying meager dividends because they are concerned about the uncertainties facing the Japanese economy. Once deflation ends and companies have a better grasp of the economic outlook, we will probably see large dividend hikes. Fujifilm Holdings Corp. was the symbol of criticism by foreign investors of Japanese companies that held excessive amounts of cash. When the market for photography film, which was the company's core product, disappeared, Fujifilm used its considerable liquidity to establish new sources of earnings. The company maintained its profitability as a result. Consequently, a balance sheet with lots of cash indicates that a company has the potential to achieve a major transformation by using the money for acquisitions, R&D and other activities.

(5) Pessimism of Japanese investors about Japanese stocks

Investors in Japan lost their "animal spirit" for risk-taking because the bear market of the past two decades destroyed their will to take risk. Furthermore, these investors were unable to act quickly because of regulatory restrictions and a system in which investment decisions were made by groups rather than individuals. Japanese investors were inevitably late-comers to the market because of these problems, often buying high and selling low. If we assume that these problems still exist, Japanese investors too are likely to be active stock market participants as stock prices continue to rise in the new fiscal year in Japan that started on April 1.