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Economic and Market Outlook for 2013

- Prospects are Excellent for a Powerful Revival of Japanese Stocks -

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(This vol. 84 covers text only. Figures 1-18 mentioned below will be included in vol. 85.)

Conclusions

- A full-scale upturn in Japanese stocks is likely to occur. Reasons include (1) the likelihood that a new administration in Japan will enact policies to stimulate economic growth and end deflation fueled by a strong yen as well as have the Bank of Japan implement more monetary easing; (2) a steady increase in the U.S. dollar's value along with the rejuvenation of the U.S. economy; and (3) the inability of investors in Japan and overseas to ignore any longer the unprecedented undervaluation of Japanese stocks and favorable supply-demand dynamics. Consequently, the primary scenario is for a change of direction in Japan that will lift the Nikkei Average to ¥15,000-¥18,000, the yen/dollar exchange rate to ¥100-¥110 and the long-term interest rate to about 1.5%-2.0% over the next two years.

- The global economy is recovering from the Lehman shock, euro crisis and a downturn that brought the world to the brink of a depression. Progress continues with measures to deal with negative after-effects such as insufficient capital at financial institutions and burgeoning debt. Countries are switching to a focus on policies to spur economic growth and encourage risk-taking. As a result, we will probably see a favorable investment climate in 2013 with (1) steady global economic growth backed by the U.S. economic recovery, (2) aggressive monetary easing measures and ample funds for investments, and (3) downward pressure on inflation from the shale gas revolution and deflation exported from China. In this environment, risk-taking will probably increase worldwide and stock market rallies will gain momentum.

- Risk factors are slowing economic growth in China on a global scale and in Europe another euro crisis sparked by a downturn of the French economy. But the probability of these events occurring in 2013 is small. In Japan, there are fears about the possibility of a new administration failing to adopt a sufficiently aggressive stance for monetary easing. The primary reason for Japan's strong-yen deflation since 2007 has been the gap between the easy-money policies of the Bank of Japan and overseas central banks. Consequently, we may see a significant correction in the yen's strength due to a switch in the Bank of Japan's posture. However, if the new administration in Japan fails to demand adequate easing measures due to pressure from conservative public opinion, this correction may not take place.

(1) 2012 was a year of global healing except in Japan, which fell behind in enacting reflationary policies

Even amid intense pessimism, 2012 was a year or progress with global healing. Pent-up demand that accumulated over a long time began to emerge (for example, demand for automobiles and housing in the U.S.). Governments switched from austerity to growth policies. Financial markets slowly moved to more aggressive risk-taking as stock prices continued to climb. Long-term interest rates hit bottom as did the declines in exchange rates for the U.S. dollar and euro. In this environment, the trauma (excessive pessimism) created by the Lehman shock slowly dissipated. Today, there is almost no possibility of a crisis of the same magnitude as the Lehman shock. Most people believe that the global economy will slowly return to normal.

The biggest reversal of market sentiment was sparked by the announcements by the ECB and Fed of a new initiative: unlimited quantitative easing. ECB President Mario Draghi announced that the ECB will use outright monetary transactions (OMT) for unlimited market interventions until sharp increases in southern Europe government bond interest rates (the premium for the possible demise of the euro) that threaten the euro's existence are eliminated. In addition, Fed Chairman Ben Bernanke is enacting QE3: unlimited purchases of mortgage-backed securities until employment in the U.S. recovers. In other words, these two central banks have stated that they will extend support for risk-taking. Next, at the IMF-World Bank Annual Meetings in October, there were signs of a shift in emphasis to measures for increasing demand. Emerging countries as well started to embrace monetary easing. Rather than being a "beggar-thy-neighbor" initiative, U.S. monetary easing instead served as collaborative monetary easing that stimulated the creation of demand on a global scale. As a result, the world avoided a reoccurrence of the economic nightmare that took place in the 1930s.

Figure 1: Equity indices in major countries
Figure 2: Exchange rates of major currencies against US dollar after 2007
Figure 3: Central banks' total assets ratio to nominal GDP in Japan, US, Euro and UK after 2007

Japan clearly lagged behind as the rest of the world improved. Japan was the only loser. Japan alone saw its currency strengthen and continued to struggle with deflation. In February, the Bank of Japan created expectations of full-fledged quantitative easing with the announcement of a 1% inflation goal. Unfortunately, this was ineffective. Stocks continued to fall and the yen continued to climb. Japan's high-tech companies reported massive losses because they were no longer competitive, raising fears that Japan would lose its industrial base. Moreover, the Senkaku Islands dispute impacted exports as people in China shunned Japanese products. At the same time, the cost of fuel imports surged due to the suspension of nuclear power plant operations. This caused Japan's six-month trade deficit to surge to the unprecedented level of more than ¥3 trillion. Economic growth slowed and reached an annualized negative 3.4% in the third quarter of 2012. Another contraction appears to be inevitable in the fourth quarter. Many factors are exerting pressure on Japan's economy: the end of the eco-car tax reduction; the end of one-time demand associated with earthquake recovery activities; changes occurring in China; the boycott of Japanese products in China due to the Senkaku Islands dispute; and the rapid decline in the competitive edge of Japan's industrial base caused by the yen's strength. Moreover, many people in Japan follow the demon of poverty (anti-growth mentality), and this spirit has influenced public policies and contributed to the stock market's downturn. This anti-growth sentiment created an extreme reluctance to take on any risk and paralyzed Japan's economic mindset.

Figure 1 illustrates this problem. Japan suffered the worst decline in stock prices in the world after the Lehman shock even though these events should have had little impact on Japan. The country was not affected by the housing market bubble, euro crisis, or problem loans and inadequate capital at banks. Nevertheless, stock prices in Japan plummeted. The reason is the demon of poverty, which called anti-growth mentality. After stock prices hit bottom following the Lehman shock, they have doubled in the United States and in Germany. However, stock prices in Japan are up only 10%, far below the rallies in the United States and Europe where the problems originated.

Figure 4: Japan equity earnings ratio and bond yields - Swinging from one extreme to the other
Figure 5: Unprecedentedly high multiple of equity return/bond return in Japan
Figure 6: Multiple of equity return/bond return in US
Figure 7: Long term trends of equity and bond returns in Japan and US

As you can see in Figures 4, 5, 6 and 7, the stock yield/corporate bond yield multiple, an indicator of investors' willingness to accept risk, is now very high. This multiple was 0.25 at the peak of Japan's asset bubble in 1990 and 0.5 at the peak of the U.S. IT bubble in 1999. Today, the multiples in Japan and in the United States are 8 and 2, respectively. In the United States, the all-time high since the 1930s was 5 in 1949. This clearly demonstrates the extremely high level of risk aversion that currently exists in Japan.

Slowing economic growth in China and geopolitical risk are concerns that appeared in 2012. China's economy has relied too much on investments. Excessive investments led to an excess of equipment, erosion in profitability, and growth in problem real estate along with a drop in real estate prices. The economy has hit the wall as a result. The next year or two will be a period when China lays the economic groundwork for the beginning of the Xi Jinping regime. Although the Chinese government has continued to prop-up the economy, foreign currency reserves, the source of investments, are no longer increasing. Even the possibility of a slowdown in the economy in the near future cannot be ruled out. In addition, regarding the euro, there are concerns about the weakness of the French economy. Unemployment in France is rising even as Germany continues to add jobs. France's current account deficit continues to increase, too. Consequently, one cannot completely reject the possibility of France joining the southern European eurozone countries that need to be rescued. Although this is very unlikely to happen, the need to rescue France could create a situation in which Germany would no longer be capable of supporting the euro on its own.

Figure 8: China's foreign reserve ratio to GDP
Figure 9: Unemployment ratio and current account balance ratio to GDP in Germany and France

(2) 2013 – A year of accelerating risk-taking and the defeat of pessimism

The direction of the U.S. economy is the most crucial factor concerning the outlook for the 2013 investment climate. With U.S. fundamentals improving steadily, worries about an economic slowdown will soon be pointless. Concerns exist about the fiscal cliff, but the U.S. will eventually overcome this problem. Ending the Bush tax cuts and payroll tax reduction and implementing the uniform fiscal cliff budget cuts would lower U.S. economic growth in 2013 by 4%. However, there is no doubt that the tax cuts will be extended (entirely or partially) and that the uniform budget cuts will be reduced. Although these events will temporarily have a negative effect, they will not hold back economic growth in the second quarter of 2013 and afterward. Once the fiscal cliff issue has been overcome, the outlook for the U.S. economy will be positive. The economy will benefit from (1) an improvement in housing demand that pushes prices up, (2) the wealth effect from rising stock and housing prices, and (3) growth in the number of jobs (particularly in the service sector). A rebound in the price of houses will have an especially big impact. After the Lehman shock, the U.S. housing investment/GDP ratio plunged from 6% to 2%. As a result, 50% (2.2 million) of the 4.4 million jobs lost from the end of 2007 up to September 2012 were in the housing and construction sectors. If only the housing sector returns to normal, about 2% would be added to the GDP growth rate. Against a backdrop of progress with the new industry revolution and globalization, productivity will climb as companies continue to report record earnings. Downward pressure on inflation from the shale gas revolution and expectations for a smaller trade deficit are more good news for the U.S. economy. This raises the possibility of annualized GDP growth increasing to the 5% to 6% range in the second half of 2013.

Figure 10: US residential investment ratio to GDP
Figure 11: US employment trends by sector

A slow improvement will probably occur in the eurozone, too. Pressure on demand in southern European countries from budget cuts and extremely high interest rates peaked in 2012. We will probably see a gradual improvement in 2013. There are concerns about the possibility of the Chinese economy spreading deflationary pressure around the world. But China has apparently hit bottom for the time being due to a series of monetary easing measures and an end to the drop in public-works expenditures. Furthermore, this is a crucial period as the beginning of the Xi Jinping regime. As a result, the Chinese economy will probably remain subdued in 2013.

In 2013, there will probably be even more risk-taking that fuels a worldwide stock market rally. Three factors may create an ideal environment for investments: (1) steady economic growth, (2) unprecedented monetary easing accompanied by powerful Fed and ECB support for risk-taking, and (3) a decline in inflationary pressure (due to the shale gas revolution and deflation exported from China). Many people have an excessive risk-avoidance mentality based on the belief that the once-in-a-century crisis that followed the Lehman shock will happen every year. Correcting this mentality will probably trigger an enormous global surge in risk-taking. Furthermore, this risk-taking will not lead to a "harmful interest rate upturn" because inflation is under control and companies continue to report strong earnings as productivity rises. In this environment, there will probably be only a moderate increase in long-term interest rates in the United States, Germany and Japan.

Increasing prices of assets, particularly in the U.S. housing market, will rapidly improve household balance sheets by eliminating negative home equity (mortgages that exceed a home's value). This may accelerate the pace of risk-taking. If this happens, bank loans will start to climb and there will be an increase in credit creation, such as through growth in bond issues in the U.S. real estate sector.

Figure 12: US home price trends - S&P Case/Schiller Composite
Figure 13: US trends of bank commercial loans
Figure 14: US commercial property price index

(3) A positive surprise in Japan from the government's policy reversal

Countries around the world are shifting the focus of economic policies from austerity and liquidation to reflationary measures. Japan has not been keeping up with this trend. But Japan is likely to join the ranks of reflationary countries if a new administration takes over at the end of 2012. Immediately after Japan dissolved the parliament on November 14 and set an election for December 16, the yen/dollar exchange rate jumped by ¥2 and Japanese stocks rallied on November 15 as stock markets worldwide retreated. The reason is expectations for a defeat of the Democratic Party of Japan, making the next prime minister Liberal Democratic Party president Shinzo Abe, who is committed to waging a "war against deflation." These exchange rate and stock market movements demonstrate the magnitude of the premium on the yen and the discount on Japanese stocks created by the Bank of Japan's stance of permitting deflation. If the next government decides to fundamentally alter the Bank of Japan's policy of permitting deflation, we will probably see a dramatic reversal of the yen and Japanese stocks. In fact, we could see a stock market rally on a scale greater than the upturn that followed the parliament dissolution in 2005 over proposed reforms of Japan's postal system. The rally may even surpass the more than twofold rise in stock prices that occurred in Japan in 1932 when the reflationary policies of Korekiyo Takahashi ended the Showa Depression.

Shinzo Abe is prioritizing policies aimed at ending the yen's strength and deflation. He has proclaimed an inflation target of 2% to 3% and plans to use unlimited monetary easing by the Bank of Japan until deflation comes to an end. Revisions to the Bank of Japan Law are also planned. This stance is almost identical to the goals of the Japan Restoration Party, Your Party and other political parties that are expected to be successful in the upcoming general election. With Japan poised for another recession, economic stimulus measures are imminent. Pressure on the Bank of Japan is mounting, which is creating the conditions needed for a prolonged downturn of the yen and upturn in stock prices. The Noda Cabinet had reached a general consensus regarding proposals like tax hikes and pension cuts that would have a negative impact on the economy. However, Japan is on the verge of another recession after the GDP contracted at an annualized 3.4% in the third quarter of 2012. In this environment, there are growing calls for immediate measures to stimulate the economy.

Figure 15: Trade balnce of Japan
Figure 16: Labor compensation in Japan, US, Germany and UK

Shifting from austerity to growth policies is very likely to create a favorable environment for the Japanese economy. The biggest engines of growth will be the wealth effect from rising asset prices and higher wages as Japan enacts measures to weaken the yen. Japan will tap the growth potential that has accumulated over the country's lost two decades. Wages and returns on capital will probably create positive surprises as (1) companies streamline operations, (2) the cost of wages in Japan falls, and (3) Japanese workers make modest demands for wages and Japanese investors make modest demands for capital return. Japan can play a central role in global demand creation. Several conditions for growth are in place: (1) a massive volume of idle capital; (2) a huge amount of invisible unemployment (young people as well as women, older people and others); and (3) the many unfilled demands among consumers (living standards are still low). Furthermore, since assets in Japan have become extremely undervalued, a correction in asset prices would generate huge capital gains. If the PBR of Japanese stocks simply increases from the current 0.9 to the world average of 1.7, stock prices would double. This would raise Japan's stock market capitalization by more than ¥200 trillion. There is substantial room on the upside for real estate prices, too.

The global economy continues to expand at only a moderate pace. In a worldwide environment of extreme easy-money policies, there will be no end to investors' pursuit of assets with risk. As investors around the world continue to seek untapped places to invest, they will undoubtedly stop when they reach the virgin territory of Japan, which has one of the most attractive economies and markets in the world. One risk factor is the possibility of Japan's new government failing to be sufficiently aggressive about monetary easing. The gap between the easy-money stances of the Bank of Japan and other central banks is the primary reason for the strong-yen deflation that has persisted since 2007. Consequently, a shift in the Bank of Japan's stance could produce a major correction in the yen's strength. However, there is a risk that this correction will not take place if conservative public opinion forces Japan's new government to weaken its demands for monetary easing.

Figure 17: Home price in Japan - Well below its fair value
Figure 18: Property and equity price trends in Japan

(4) What is happening now? The urgent need to switch from "saving to demand creation" and "consumption to virtue"

The world today is similar in many ways to when a global depression occurred in the 1930s. But there is one crucial difference: advances in government policies based on lessons learned from this depression. Government initiatives saved the global economy from a catastrophe and the economy is now returning to a path of sustained growth.

The current global economy has the following major characteristics (the first and second are the same as during the global depression):

(1) A surplus of workers and capital created by increasing productivity worldwide (fueled by technological progress and globalization) and a surplus of some equipment in China;
(2) The trauma of excessive risk avoidance following the sudden occurrence of a financial crisis following the end of an asset bubble;
(3) Widespread shadow banking and a shift in financial policies;
(4) The emergence of state capitalism and resulting threat to market-based economies;
(5) Changes in energy resource prices caused by the shale gas revolution, nuclear power plant accident, bursting of the solar power bubble and other events.

The proper responses to these characteristics are:

(1) Shift course so that saving is no longer a virtue, making demand creation and consumption priorities;
Monetary easing, fiscal measures, deregulation and creating new life styles (encouraging extravagance), support for service price inflation, new energy and other policies to create demand;
(2) Policies for internal demand rather than for "hunger exports", fair competition;
(3) Creative financial measures, avoidance of financial market paralysis, preservation of the distribution of capital.

Countries are competing to determine the best policies. Wise countries can secure advantageous positions for their economies and markets. In the 1930s, Takahashi reflation (ending the gold standard and adopting a managed currency system, guiding the yen downward, using the Bank of Japan to underwrite government bonds) made Japan the first country to abandon "liquidationism" and shift to policies that target demand. Taking these actions enabled the Japanese economy and stock market to recover ahead of other countries. Takahashi reflation was a Keynesian initiative prior to the birth of Keynesian economics. In the United States, there was a delay in the shift from the Hoover administration's liquidationism to the demand-linked policies of the Roosevelt administration. As a result, the United States suffered more than any other country from the global depression.

This time, the United States was first to shift its policies rather than last as in the 1930s. Japan, which was first in the 1930s, has been the greatest laggard in altering its economic policies. The reflationary policies of Shinzo Abe are reminiscent of the Takahashi reflationary measures in Japan's prewar days. Today, Japan has reached a critical point in determining whether or not these policies will be enacted.