MR Musha Research

26 April 2013

Musha Research Commentary

Strategy Bulletin Vol. 98

A once-in-a-century stock market rally has started in Japan

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 Hiagshishinbashi,
Minato-ku, 105-0021 Tokyo

My new book titled *A Once-In-a-Century Japanese Stock Market Rally Is Here!* (Chukei Publishing) will be published on April 30. The primary messages of this book's introduction and conclusion are as follows.

Introduction

"The Nikkei Average will exceed ¥20,000 within two years." The powerful surge in Japanese stocks since November 2012 has finally brought us to the point where this forecast "does not feel at all strange." Even some economists who specialize in Japanese equities have a positive outlook calling for the Nikkei Average to climb to the ¥15,000 level. Overall, there is now widespread belief that the Nikkei Average is likely to increase.

However, I believe that this rally is an extension of the "Japanese stock resurgence" that I have talked about constantly for the past four years. Furthermore, I think the current rally is merely the beginning. The ongoing upswing in stock prices is not the currently forecast "to a certain degree" rally. Instead, this rally is very likely to be nothing more than the first step that leads to a full-scale upturn that may propel the Nikkei Average to ¥40,000. We could be seeing a rally that will create investment opportunities on a scale that occurs only once in a century.

Japan had fallen under the spell of pessimism

Readers of this bulletin are probably unable to image a world in which the Nikkei Average is ¥40,000 and the Dow Jones Industrial Average is $100,000. Many people would undoubtedly reject this view as "absurd optimism" and "absolutely impossible." However, from my perspective, these rejections are proof that people have been trapped by the curse of extreme pessimism. The reason is that looking at the flow of history from this standpoint shows that the world is poised for an unprecedented period of economic prosperity.

An industrial revolution of an unprecedented magnitude is under way. Globalization, technological progress and rising productivity are cutting costs rapidly while fueling dramatic transformations and progress with business models. Only a decade ago, no one could have foreseen what IT has made possible today. Smartphones and cloud computing are two prime examples. In the near future as well, we will probably see more changes in fields like new energy and biotechnology that turn yesterday's "common sense" upside-down. Technological advances like these will greatly alter business models and how we lead our lives. This will propel both technological innovation and improvements in productivity, which are key drivers of economic growth.

This is an historic opportunity that mankind has never experienced. In the United States, the Dow Jones Industrial Average and S&P 500 set new all-time highs in March 2013. This is unquestionable evidence that we are in an age of prosperity.

Despite this good news, Japan has been ruled by an abnormal degree of pessimism. People have overstated problems like the government deficit, non-performing loans, the widening gap between rich and poor, a declining population, regulations, and vested interests. The media and opinion leaders alike have been supporting these pessimistic views. As a result, many people have been distracted from the true significance of history. Government deficits and the financial crisis are like only a "pimple" on one part of the body. Pessimists are focusing their attention on the pimple and overlooking the truly significant events: the technological progress and rising productivity. This is clearly a very unbalanced view.

I think that Japan today is in a state of fear after taking every bush for a bugbear. In this type of environment, once people realize that this is actually a bugbear, stock prices can climb at a remarkable pace. The greater the degree of pessimism, the more room there is for stocks to rebound. The people of Japan have been controlled on an unprecedented scale by pessimism with a paper-thin backing. The enormous magnitude of this pessimism means there is a possibility of an equally massive stock market rally.

Why will Japanese stocks move higher?

The Nikkei Average has been climbing steadily, closing at ¥12,833 on April 5, 2013. This is an amazing 48.89% increase from ¥8,619 on November 14, 2012, the day before Japan's parliament was dissolved for a general election. Expectations created by economic measures of the administration of Prime Minister Shinzo Abe (Abenomics) have been fueling this rally. But now actual initiatives enacted by the government will start to influence financial markets and the economy.

The nucleus of these measures is the "new dimension of monetary easing" announced on April 4 by Haruhiko Kuroda, the new Bank of Japan governor. The BOJ's goal is inflation of 2% within two years. The bank has shifted its policy target from interest rates to the money supply. Over the next two years, the BOJ plans to double its monetary base, an indicator of the amount of money supplied to markets. In addition to buying Japanese government bonds, the bank has decided to purchase assets with risk exposure like exchange-traded funds. On the surface, a doubling of the money supply (with no subsequent change in the markets) should lead to a doubling of stock and land prices and a 50% drop in the value of the yen (if there is no change in the money supplies of counterparty countries). Enacting this new policy is almost like shooting a bazooka into financial markets. Consequently, these actions are certain to have significant and constant effects in asset and foreign exchange markets. Furthermore, investors will probably start buying Japanese stocks and other risk assets.

After the Lehman shock, I have consistently stated my position that Japanese stocks will stage a comeback. Simply put, my position was that "stock prices are mistaken" rather than "stock prices will increase." In other words, my position was that stocks were too cheap. At a time that most people adhered to the pessimistic view that Japan's economy was going to collapse, I was one of very few optimists. Looking at the stock market today, I can say that my consistent expectation for Japanese stocks to come back to life will apparently finally come true after four years.

One reason is Abenomics, including the new stance of the Bank of Japan. This rally is also backed by the correction of the yen's prolonged strength and the drop in asset (stocks and real estate) prices, two causes of Japan's "lost 20 years" following the end of the asset bubble in the 1990s. People can now see a pathway that takes Japan away from long-term deflation. Consequently, Japan has started a full-scale move toward an economic revival.

The resurgence of Japanese stocks is finally happening

I have been watching financial markets for 30 years as an analyst. My forecasts have been right on the mark more times than I can remember. I predicted the long-term U.S. resurgence and prosperity starting in the early 1990s. I foresaw the collapse of Japan's financial markets and economic stagnation in the 1990s after the bubble burst. In 2000, I said the IT bubble was going to collapse. Many times I was alone in announcing forecasts that went against the accepted thinking espoused by the vast majority of market observers and economists. And I was the one who was right. My outlook was far off target only when stock prices fell sharply between 2007 and the collapse of Lehman Brothers. But the optimist position that I backed at that time is now coming true at last.

We are about to witness an investment opportunity on a scale that occurs only once in a century. I base my outlook for a resurgence of Japanese stocks on the following five factors.

(1) In the first place, Japanese stocks have been undervalued since the Lehman shock.

(2) Abenomics (monetary easing) will end long-term strong-yen deflation called the Japan disease.

(3) The U.S. policy of containing Japan with an ultra-strong yen is ending due to a shift to a strategy of containing China. Furthermore, the U.S. will support a weaker yen to trigger an economic recovery in Japan, which is an ally for holding back China.

(4) The steady global economic recovery will continue. With the support of the broad-based expansion of the U.S. economy, which is becoming increasingly powerful, the European debt crisis and slowing Chinese economic growth will not become serious problems.

(5) Japan's "lost 20 years" have given the country competitive advantages in terms of quality and cost. Furthermore, the end of deflation will revive the pricing mechanism, by which supply-demand imbalances are automatically corrected by changes in prices. As a result, the pace of structural change in Japan will increase and domestic demand will grow.

I think the resurgence of Japanese stocks will take place in two stages. In the first stage, Abenomics will bring an end to prolonged deflation and the ultra-strong yen. This will bring the revival of the Japanese economy to the starting line. In the second stage, reforms will once again make Japan one of the world's major economic powers. People are criticizing Abenomics in many ways. "Japan needs structural reforms, not monetary measures." "The side effects of Abenomics are too big." "Inflation is more frightening than deflation." "The Japanese government bond market will plummet." I believe these views are off the mark and show that people are engaged in fault finding.

I have no doubt that Abenomics will lift the Nikkei Average to ¥20,000. If this process advances to the second stage, the stage will be set for an upswing to ¥40,000. This is why I believe that a major resurgence of Japanese stocks is about to take place.

Conclusion

So exactly why did the people of Japan become so pessimistic? And why is the criticism of Abenomics so intense? The decisive blow from Abenomics critics is "doesn't this story sound too good?" "Will the economy improve simply by printing money at full speed? Can this really be true?" Also, "won't easy money that is received without working not last long and eventually lead to failure?" The people of Japan have strangely been persuaded to believe in these explanations, which they have simply accepted at face value.

Why? The reason is that these explanations are ethical. These points resonate with the long-held Japanese spirit of virtue, ethics, fairness and integrity. From the standpoint of these values, "the easiest path of all" cannot possibility be the best course of action.

However, ethical beliefs themselves are an impediment to evaluating a situation properly. Economic analysis requires studying the relationship between cause and effect. Actions must produce results. Currency and credit are nothing more than a lubricant for economic activity. That means they can be utilized without restrictions in order to produce results. This raises the question of what kind of result is desirable.

What should the result be? Everything boils down to "putting idle people and capital to work in order to create wealth and demand." Today, there is an unprecedented volume of excess labor and capital because of rising productivity. This is the most serious "disease" that is afflicting Japan and other industrialized countries today. Unemployment has increased greatly and interest rates are at historic lows because of this disease.

If these surplus resources can be used to generate new demand, economies will grow and living standards will improve. Leaving these resources idle will lead to a deep economic recession with deflation, very low interest rates and severe unemployment. Money performs the role of a bridge between idle resources (people and money) and demand. Policies must be used for this purpose. Assessments of ultra-monetary easing as well must be made based on this single point. Critics say that ultra-monetary easing is unethical because it leads to asset income (income other than wages). But this is not the essence of easy-money policies.

The economist John Maynard Keynes described the obstacle to new ideas as follows. "Ordinarily, any type of economic practitioner is a slave of past economists." Bureaucrats and politicians make mistakes because they use ideas that are outdated and wrong. "Whether good or bad, the real danger is ideas rather than vested interests."

Abenomics is creating a once-in-a-century opportunity for Japanese stocks and the economy. Now is the time for the people of Japan to abandon their idealism and start making the country's economy and finances more pragmatic.