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GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

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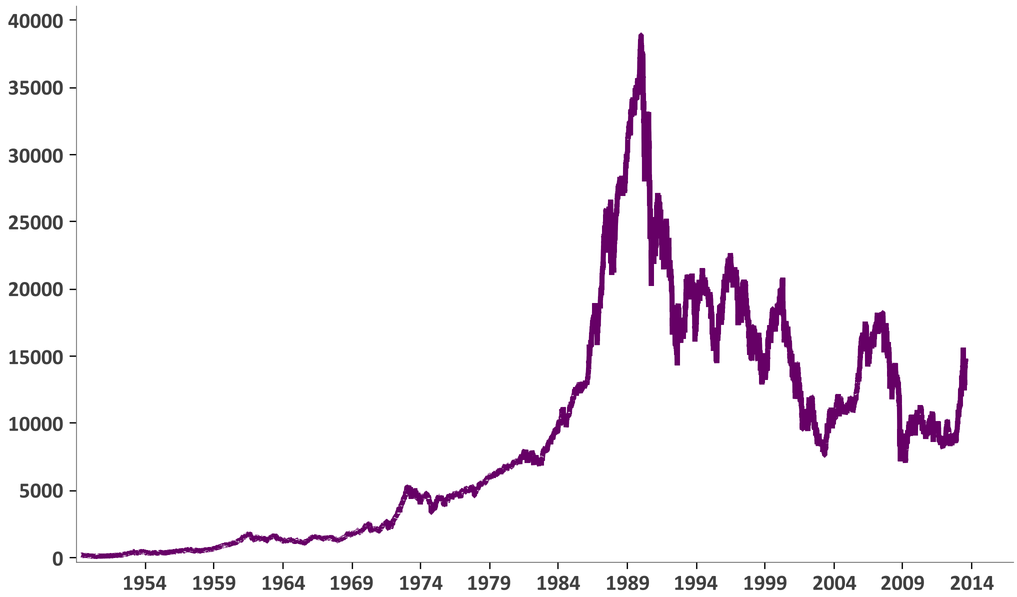
GLOBAL MACRO

Japan Bull Markets Die of Anemic Demand

While the current equity upturn has been more intense than previous post bubble bull markets- shares prices have jumped by more than 80% between November 2012 and March 2013, its sustainability rests on prospects of reviving internal demand. Don't hold your breath, when Abe will fire its *Third Arrow* -the Growth Strategy- odds to hit its target are low. The reason lies in a misguided objective: **Japanese economy suffers from a lack of internal demand, not from a low productivity growth.**

Japan, Equity Indices, Nikkei, 225 Index, Close, JPY



Sources : RichesFlores Research, Macrobond

Anatomy of a bull market

Over the last two decades the comparison between Japan and US (or world) equity markets has been highly unfavorable to the former. Since the Japan equity bubble bust at the end of 1989, the market has declined by 4.5% per annum on average versus 6.8% per annum for the US markets[i].

Even taking a less arbitrary starting point than the peak of Japanese shares, equity markets have disappointed:

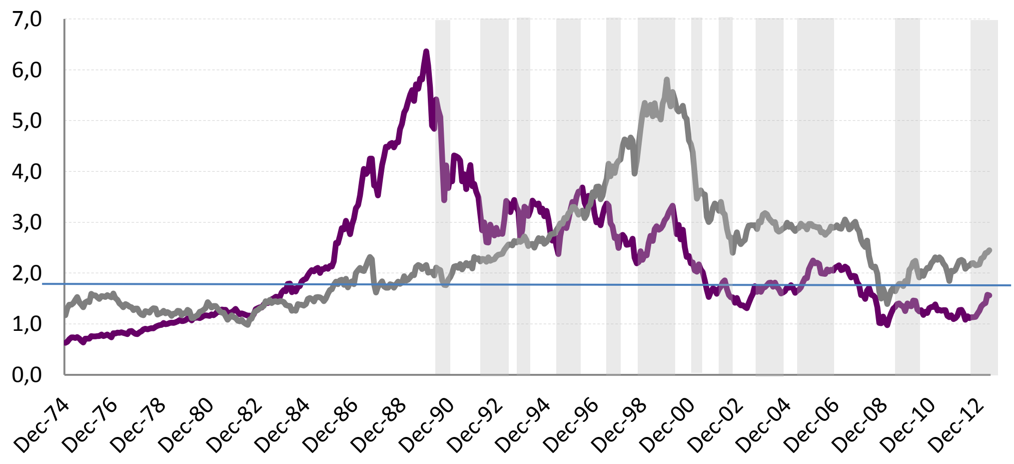
- In the 1990s, they fall by 6.9% per annum on average at a time that US equities were experiencing a massive bull market (+16.1% per annum).
- In the 2000s, the return gap shrank but remained significant, respectively -4.6% and -1.2% per annum on average.
- In the current decade, US equities continues to outperform in spite of the robust equity market upturn in Japan between November 2012 and May 2013 (Japan is up 8.4% as at 24 June versus 12.5% for the US).
- On a calendar basis, Japan equities have underperformed their US counterpart in nineteen years out of twenty three years since the bubble burst.[ii]

The extraordinarily high valuation of Japanese shares reached at the end of the 1980s has certainly been a reason for subsequent market rallies not being sustainable. Any pick-up in Japanese shares was doomed to be short-lived as long as equity valuations did not adapt to the new normal of lower growth.

As a matter of fact, the Japanese equity market remained, as measured by the price to book value, more expensively valued that the US market until mid-1995, in spite of the market more than halving during that period and US equities rising by more than 63%. In absolute terms, it has been consistently above 2 times until May 2001.

Arguably, it can be said that equity prices in Japan during the 1990s merely reflected an adjustment from a high to low growth environment.

Japan and US price to book value



Sources: Bloomberg, MSCI; Japan: Nikkei; US: MSCI US

Since the bubble burst there has been twelve bull markets[iii], of which six took place after 2001 at time when valuations were either fair (price to book value below 2x) or low (price to book below 1.5x). With the exception of the latest, each of these bull markets was followed by new historical lows as domestic demand failed to sustainably recover.

Japan bull markets since the bubble bust

Start Date	End Date	Number of days	Nikkei Return	S&P 500 Return	USD vs. JPY	PB at start	PB at end
10/1/1990	3/18/1991	168	**34.25%**	20.14%	0.91%	4.05	3.72
8/18/1992	6/10/1993	296	**43.22%**	8.27%	-15.95%	5.37	6.08
11/29/1993	6/13/1994	196	**34.05%**	0.91%	-5.81%	5.22	3.81
7/3/1995	6/26/1996	359	**57.47%**	24.29%	29.07%	3.49	2.78
4/10/1997	6/25/1997	76	**18.30%**	17.68%	-9.61%	2.68	3.31
10/9/1998	4/12/2000	551	**63.69%**	51.91%	-9.06%	2.52	3.44
3/13/2001	5/1/2001	49	**22.44%**	5.86%	1.67%	2.69	2.49
2/6/2002	5/1/2002	84	**23.09%**	0.59%	-4.76%	2.19	2.26
4/29/2003	4/26/2004	363	**61.32%**	25.84%	-9.65%	3.03	2.34
5/17/2005	10/3/2007	869	**62.57%**	37.10%	8.79%	1.68	1.73
3/3/2009	4/5/2010	398	**60.63%**	74.61%	-4.23%	1.90	2.05
11/13/2012	3/21/2013	290	**85.65%**	13.40%	19.53%	1.33	1.35

Source: Bloomberg, MSCI; returns are price returns

This Time is No Different

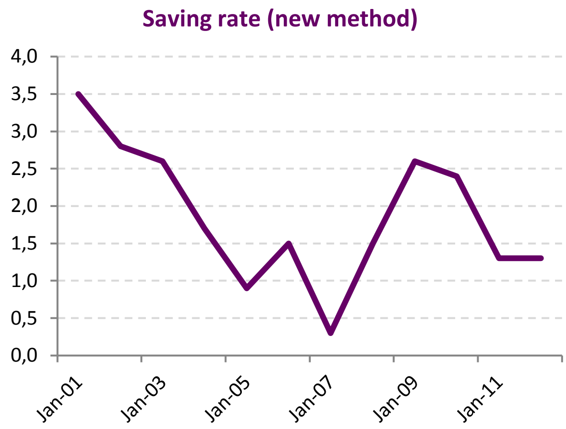
The latest bull market spanning from the period November 2012 to March 2013 is no different.

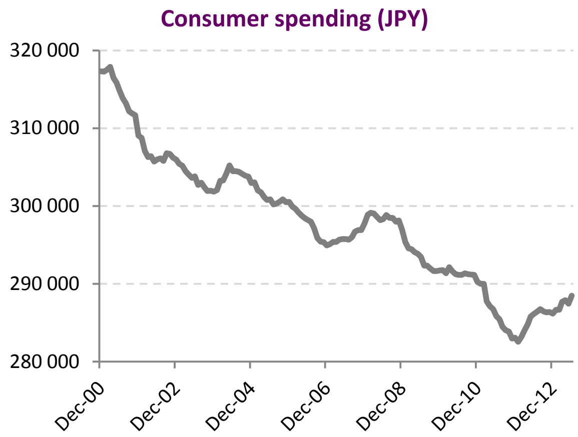
True, it has been more intense than any of its predecessors because of the monetary revolution currently taking place. Since deflation emerged fifteen years ago, the Bank of Japan and the Government have never tried very hard to fight deflation and markets have never been believers of them trying hard. On that aspect, and on that aspect only, this time is different.

The probability of the 2012/13 market upturn to experience the same outcome than its last decade predecessors -ending because of a lack of domestic demand- is however high.

- **The domestic consumption is capped.** There would be two ways that consumption could grow: either disposable income would rise or savings rate would decline. There is however no reason to think any of these two outcomes would materialize. The savings rate has been dramatically falling over the last twenty years, in line with demographics as population ageing is consistent with a decrease in the savings rate. Currently standing at 1.3% of household income, the potential for the savings rate to fall further is limited.

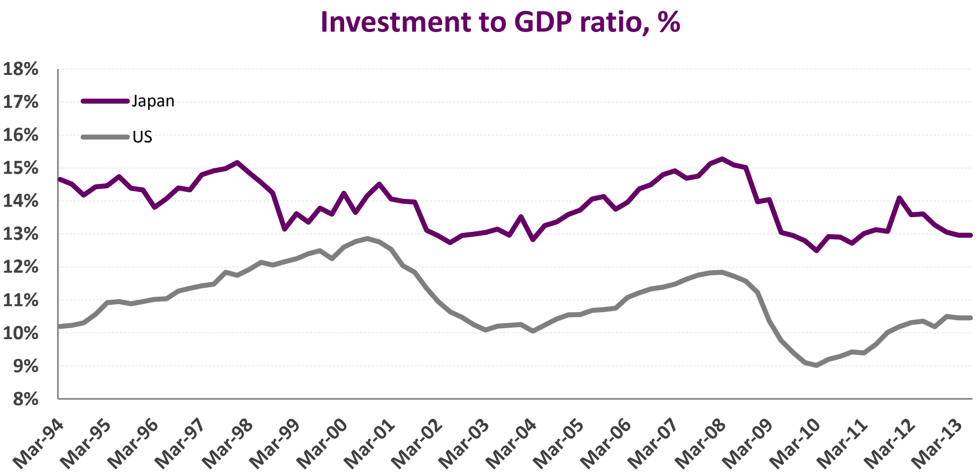
- The Abe Administration has been actively encouraging employers to raise wages. A sustainable increase would ultimately depend on corporate profit growth, which remains highly dependent on exports. Unlike previous economic recoveries, wage growth would need to be substantial enough to offset inflation.





Sources: Bloomberg; consumer spending: monthly nominal consumer spending, average household

- **Investment growth is capped.** Investment has little room to expand as it is already high when compared to output -investment to GDP is one of the highest in the OECD region. The excess in investment result in only mediocre return on capital. In other words investment opportunities are simply too scarce in a country where many industries are oversupplied.

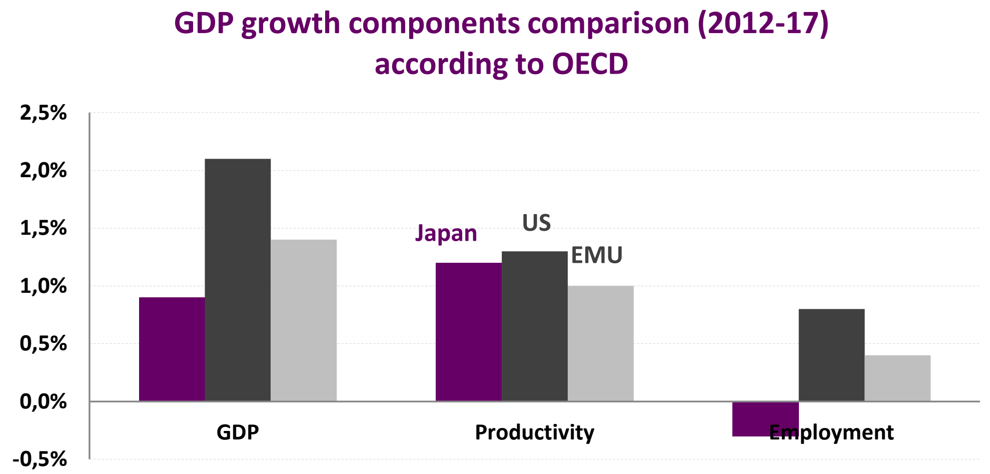


Source: Bloomberg

The Growth Strategy, the Third Arrow in the Abe arsenal, aims at raising GDP potential growth rate, currently standing at the bottom of OECD members. While markets have negatively reacted to preliminary announcements, details are expected after July 21 elections, when the governments will have secured a sustainable majority and get freer hands to implement its program.

Broadly speaking the Growth Strategy consists of supply-side measures whose objective is to increase productivity growth through deregulation. Among the initiatives that top the agenda some are related to trade- Abe has announced its intention to join the Trans Pacific Program (TPP), agriculture (turning it in a growth industry), or tourism. Notwithstanding the political and social difficulties in implementing some of those measures which are going to hurt well-established vested interests, there is no reason why they should significantly raise Japan prospective growth.

Japan low potential growth is not due to an especially weak productivity. The problem is labor growth as shown in the chart below, which compares Japan potential growth with that of the US and the Euro zone over the 2012-17 period.



Source: OECD

While productivity growth stands somewhere between the European and US levels, prospective employment growth is deeply depressed (only Russia would experience a worst decline according to the OECD) as a result of poor demographics, highly restrictive immigration policies and low female participation rate.

- The low fertility rate will not easily be reverted, and assuming it would, the impact on growth would not be immediately felt.
- Relaxing immigration laws is not on the agenda.
- The Abe Administration, as all its predecessors has talked of increasing female participation, currently standing at 68% (women aged 25-44) to 73% by 2020. The effects on female participation remain highly hypothetical given societal forces at play among Japanese firms and general attitude of the society for women working. The IMF estimates that if Japan were to raise its female labor participation ratio to the level of G7 countries excluding Italy and Germany (roughly the objective set by the Abe Administration), it would raise the potential growth by about 0.2% point. It could reach 0.4% point if it were raised to the level of Northern European countries.

Sell Equities

Martin Feldstein wrote in the Guardian that Japan may make the sacrifice of its huge advantage of low nominal rates for the hypothetical pursuit of raising the nominal growth rates. If it succeeds and the government successfully engineers a 2% inflation rate and 3% nominal growth rate, the Japan bull market has legs and will be supported by an expanding valuation and earnings growth. If it fails, the equity market decline will even not have the cushion of a re-appreciating currency.

At current equity valuation level, the risk is not worth the reward. If you hold Japanese equities, sell it. If you have resisted the sirens of booming markets during the first half of the year, continue to do so. Unlike preceding bull markets, yen strengthening to cushion the descent may be the grand absent.

Frank Benzimra
fbenzimra@gmail.com

[i] *Nikkei index for Japan and MSCI index for the US, in local currencies*

[ii] *In common currency, the amplitude of the US outperformance would diminish but however remain elevated (+12.3% percentage points in the 1990s, +2.4% in the 2000s and 5.8% in the current decade). US equities are measured by MSCI US total return and Japan equities by the Nikkei total return (although dividends reinvestments may not have been available in the yearly years)- Source: Bloomberg*

[iii] *A bull market is defined by an increase of more than 20% trough to peak, interrupted by a correction of more than 20% peak to trough.*