Here is the Daily Research note from Gavekal Dragonomics. The Japanese Value Trap â€“ by Anatole Kaletsky Equities around the world have enjoyed a modest rebound over the last week, with encouraging signs of buy-on-dips behavior and the leadership rotation that we believe was the main driving force behind early Aprilâ€™s sharp setback (see The New Rotation Into Value). But there is one major market that is a glaring exception to the generalized shift from growth to value: Japan. Japanese equities are the worldâ€™s most obvious value investment right now, with the Topix now trading at just 1.1 times book value according to Bloomberg. In contrast the S&P 500 is at 2.6x, while the Stoxx Europe 600 is at 1.9x. However Japan has been by far the worst performer among developed stock markets this year, and Tokyoâ€™s relative performance has failed to improve in recent weeks, even though the rotation from growth to value has gathered pace in the rest of the world. To be precise, the Topix is down -2.9% this month, extending its 2014 decline to -10.3%. To make matters worse both the Topix and Nikkei look set once again to test the lower boundaries of trading ranges that have held since last October, potentially opening up significantly bigger downside in a market where momentum has always played an important role. There are two possible responses to this depressing behaviour, as there always are when a â€œvalueâ€□ stock keeps going down. The hopeful reaction is to say the stock is merely suffering a time lag. Its intrinsic value and potential for improvement have not been properly recognized yet, but they will be soon. The pessimistic alternative is to dismiss what seems to be a great â€œvalue tradeâ€□ as a â€œvalue trapâ€□. What makes Japanâ€™s situation today so intriguingâ€”and so annoyingâ€”is that a strong case can be made for both points of view. Japan bulls can easily explain why investors have been so slow to recognize value in the Tokyo market. At some point since 1990 nearly everyone has lost money on the Japanese turnaround story, so it is hardly surprising that investors are now more wary of diving into value trades in Tokyo than on Wall Street, in Europe, or even in the emerging markets. Sadly, however, there are equally convincing reasons to dismiss Japan as a classic value trap; one that is now reverting to the dismal pattern which has tormented investors again and again since 1990â€”nine months of a powerful rally followed by five years of de-rating. Iâ€™ve been firmly of this camp ever since last autumnâ€™s decision to go ahead with this monthâ€™s fiscal tightening. As Gavekalâ€™s resident Japan bear, I presented these arguments in detail three weeks ago (see One Last Flicker Before The Japan Trade Goes Out). My case against Japanese equities consists of four observations. Firstly, this monthâ€™s sales tax hike, a fiscal tightening equal to more than -2% of gross domestic product, guarantees a slump in the Japanese economy unless it is offset by new expansionary measures. Secondly, none of the countervailing initiatives that Japan bulls had hoped for have materialized in time to prevent an economic contraction. To make matters worse, only one such offsetâ€”further monetary stimulusâ€”remains on the horizon, and it looks as if this will not be implemented until July. Thirdly, even if the Bank of Japan does ramp up its balance sheet expansion to well above the present rate of ï¿¥60-70 trillion a month, it is not clear that this will deliver stronger economic growth. The Bank of Japanâ€™s official target of 2% inflation will probably be achieved. But why should quantitative easing in Japan, no matter how aggressive, be any more effective at boosting economic activity in the teeth of fierce fiscal headwinds than it was in the United States or Britain? All of which leads to the fourth step in the bearish argument. Accelerating inflation, combined with a slump in the real economy, is an unlikely formula for an equity bull market, especially given Japanâ€™s longstanding reputation as a value trap. If the BoJ cranks up the printing press in this environment, the main result may not be stronger equities but simply a weaker yen. If we believe that the BoJ will â€œdo whatever it takesâ€□ to hit its 2% inflation targetâ€”which it probably willâ€”then shorting the yen will be a better way to bet on this ultra-expansionary monetary policy than buying Japanese equities.