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A PERSONAL VIEW FROM PETER BENNETT

MID-YEAR STRATEGY UPDATE PART 3

The One They Still Love To Hate – Japanese Equities (Nikkei Index 8500 or so)

Good value. And value is the main determinant of your likely long term, say 7 to 10 years, investment return. The data supporting the good value is shown below. Mostly it is common sense too. Generally, when an equity asset class (NOT an individual share) has fallen substantially – say 60 – 90 %, the rebound time is not far away – say up to 3 years. Based on studies you might expect a pre-expenses total return of somewhere in the, ok very wide, range of 50 to 300 %.

Japan is somewhat exceptional in this particular matter – having peaked at the end of 1989 (Nikkei index just under 39,000). The index, a generation later, is currently under 9,000 i.e. an 80 % fall at the very bottom. It has, in fact, already been down around current levels twice before, in 2003 and at Lehman time. (October 2010). From the 2003 "temporary bottom" there was about 100 % capital gain up to 2006. After a useful post-Lehman bounce, the market has backtracked to where it was roughly at that time. Statistically, matters are not quite as bad as they look. For most of the last generation Japan has seen deflation of 1 % plus. The index is, as one would expect, expressed in nominal terms. In "real" terms the decline, especially with income re-invested and deflation adjusted, would be a great deal less than raw index numbers.

Commentators are routinely scared by the deflation – and they endlessly chorus headline gross government debt – some 200 % of GDP.

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This incurious view needs more examination than just knee jerk reaction.

1) As a general reality, in the first instance the economic "lost generation" didn't actually happen. In real, deflation-adjusted terms GDP has shown annualised growth of 1% ±. A GDP figure alone is, as you know, meaningless, unless it is also population adjusted. Japan has had a declining population for some time (0.6% p.a.). Further, for what it is worth, just as I believe US inflation is understated I have seen it suggested that Japanese deflation is understated. Possibly by 1% or more. In reality, one could thus be looking at real GDP per head growth of nearer 3% per annum. Japanese GDP, real per head, exceeded that of the USA this century up until the tsunami. US GDP per head, adjusted for inflation, may well be negative over many years back. Certainly, if you believe, as many do, that the underlying statistics that make up the GDP figure need substantial negative adjustments (recent bulletins).

2) Japan has dealt extraordinarily well with the bursting of their triple bubble. Stock market, housing, and commercial real estate, including land. The extent of the bubble relative to GDP has been estimated at three times the size of the recent US debacle. Nevertheless, the economy appears to have been growing moderately over the years. And on average unemployment has been, by international comparison, relatively low since the bubble burst. Ok, understated as just about everywhere else. The banking system currently seems fully functional, having absorbed massive hits on money lent during the bubble. It is indeed the case that some went bust. As indeed they should have (and probably more too). Currently they have more money to lend than for which they can find good opportunities. One plus on the matter of the large gross government debt figure is that for the last ten years or so, off balance sheet lending undertaken by a government entity, FILP, Fiscal Investment Loan Programme has been reined in, such that the total of the two figures added together has in fact flat-lined over that period.

3) The government sector is not the whole economy. The Japanese personal sector has huge net savings (ditto Italy – which seems to be forgotten by many commentators). The US and the UK, in grim contrast, have Pelion upon Ossas of personal debt. The Japanese corporate sector was massively borrowed in 1990, but has been deleveraging ever since. Net interest bearing financial liabilities are currently around 37% of assets, versus 173% in 1990. The main reason for this leverage was excessive capital investment. The corporate sector also got caught up in the bubble speculation. Productivity has grown strongly nevertheless.

4) Other relevant data on government debt and Japanese finances are as follows:

   a) The debt is 93% owned by the Japanese. Regrettably, not so Italy, Spain and the USA for example. Thus you could say one Japanese pocket merely owes money to another. I do agree that rebalancing this may be tricky. But the overseas begging bowl should not be needed.

   b) GaveKal show household financial net worth to be twice the 200% of GDP gross government debt.

   c) The net government debt is in fact about 130% (the government owns assets).

   d) Indeed, as year after year the Japanese has run in credit to the world, massive net total savings have accrued.

   e) Whilst the huge annual personal savings rate has almost disappeared, as the population ages, the corporate sector has become flooded with cash flow, notably as excessive capital investment is cut back. With depreciation charges, therefore, shrinking fast, not only cash flow, but profits, have been boosted. Profits have soared this century. In the period 2005 to 2010 dividends rose faster than those of any developed market. (I do not have subsequent data).

f) Gross total annual national savings runs at around 4 times the 6 % per annum government deficit. As stated, the savings are these days concentrated in the corporate sector – where one invests.

g) First steps to address the government deficit have been announced. The (low) 5 % sales tax rises to 10 % by 2015. On its own this should fix about one third of the government annual deficit. Total economy tax take is around the bottom of the international developed economy league tables at some 33 % of GDP. There is thus scope for further increases in the tax take over time. The government's pension liabilities are fully funded.

h) Gross personal sector debt is less than the UK, USA. Indeed it has been shrinking for most of this century. US personal sector debt has been rising for most of a generation.

i) Household cash/deposits represent an extraordinary 170 % of GDP, as well as 130 % or so of household financial liabilities. The excoriated by outsiders deflation, in fact, is a small tax free return on this cash in real terms.

j) The economy is far from moribund. Despite an ageing population Japan is routinely around number one or two in R and D spending as a percentage of GDP and patent applications.

k) The endless balance of payments surplus underpins the currency – though the merchandise trade surplus, following the tsunami, turned into a deficit. This has measurably improved recently. Capital Economics show that the Yen, inflation/deflation, adjusted has stayed about static versus the US Dollar since the end of the 1980s. I do not understand the endless chorus "the Yen must fall". Surely, only if the payments surplus turns into a sustained deficit. But it hasn't.

In sum the overall financial strength of Japan is awe inspiring. They do not (mercifully) put pompom wavers (oops financial "analysts") on tout TV to advertise this, unlike you know, who makes Pollyanna seem like a suicidal depressive.

To be fair, politics is routinely gridlocked. If only the Fed had been this century. Prime Ministers push ever harder on the in-out revolving door. But it seems to work. Self discipline and hard work usually do. Ditto the Germans in this matter.

Equities

There should be a huge market technical improvement soon. In 1990 around 75 % of quoted equities were held in business cross-holdings. Since then these holdings have been sold down into the market and have provided a perpetual wet blanket on the market. For a generation. It is estimated that this selling is getting near its end. It may well be completely finished within a couple of years. This is the exact opposite to the USA where (often stock optioned) directors pump up prices by buying in company equities – instead of investing. Smithers & Co. indicate that, per official figures, the proportion of domestic corporate US cash flow devoted to capital investment is at record lows of about 57 % - compared with an average of 77 % over the past 60 years.

Valuation - a gimme

1) The Shiller (ten year historic average) PER (price to earnings ratio) is about 8. The lowest for decades. US is currently is over 20.

2) Price to book value is barely over 1 – a 40 % discount to MSCI World. 40 % of companies have net cash equal to market value.

3) Price to cash flow is well below price to earnings (at around 6) – also suggesting, perhaps, that large corporates may still low ball profits to avoid high corporate tax levels. In the USA, by contrast, corporate profits are routinely manipulated upward, albeit usually in a legal manner. Readers will

remember I have shown over a dozen such fiddles starting at the height of the tech boom. Analyst's profits estimates are typically massaged down so that, hey, 67% of quoted companies on average "beat" estimates. What a load of twaddle.

In any case it is cash flow that pays bills and dividends – not profits. I remember one or two fashionable growth stocks in my investment youth, in the UK, that all grew "reported profits" year after year. Except that they were bust!

4) Dividends: the nominal yield on the market is about 2.6%. After deflation that equals around 3.6% "real" to local investors. US barely over zilch real. UK: say, 1 % real. Europe: say, 2 to 2.5% real. The debtor nation investor in Japan gets the "real" bit of the yield from relative currency movements.

5) Price to sales is laughably cheap – about 0.6.

One reason for improved corporate health is the dropping of the (rather pleasant) culture of looking after the workforce as a priority. "Salaryman"/jobs for life – in return for loyalty. Thus the percentage of GDP taken by labour has collapsed to US levels – about 54%. Shareholders, the beneficiaries.

Conclusion

Valuation is the most important determinant of expected long term equity market return. It is, of course, not a short term timing indicator. The Japanese equity valuation case is clearly extremely strong.

Good Luck.

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