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STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

Strategy Update

Japanese Equities

Wow. Some shift – about 35 % in a couple of months or so.

Courtesy: David Fuller

We now wait to see how much talk translates into action. On current likelihoods Daiwa Securities estimate EBIT profits on the Topix Index companies to rise some 20 % in the year beginning March 2013 – using a ¥90 / $1 exchange rate. After Korea and Taiwan this figure is the highest of 16 markets that they list. (Ed – why can't analysts talk post-tax profits, which is what shareholders actually get?).

Market technicals are very favourable. Japanese equities are highly "under-owned". Institutions are well under-weight. Very little money has shifted in that direction so far in this move. What overseas buying there has been has been met by domestic, largely investment trust, selling.

If there is some success in reducing deflation, this could have a dramatic effect. Some 56 % of Japanese household assets are held in cash / deposits (USA 15 %) and 10 % in shares (USA 45 %). Japanese pension funds are 88/12 bonds/equities. I previously have pointed out that Mr and Mrs Takahashi have no problem with safe cash which earns almost no interest, but benefits tax-free from deflation. But with, say, 1 %-2 % inflation, this could well change. Topix yields 2 % and the new culture of rapidly jacking up dividends should continue. All this starts from the basis where price to cashflow and sales are still extraordinarily low (albeit 30 % + less so than when I wrote mid-year 2012 Strategy).

Furthermore, as you know, the end of a generation of bank and other selling of 'convoy' cross holdings – a ceaseless generational market incubus – is, I believe, in sight.

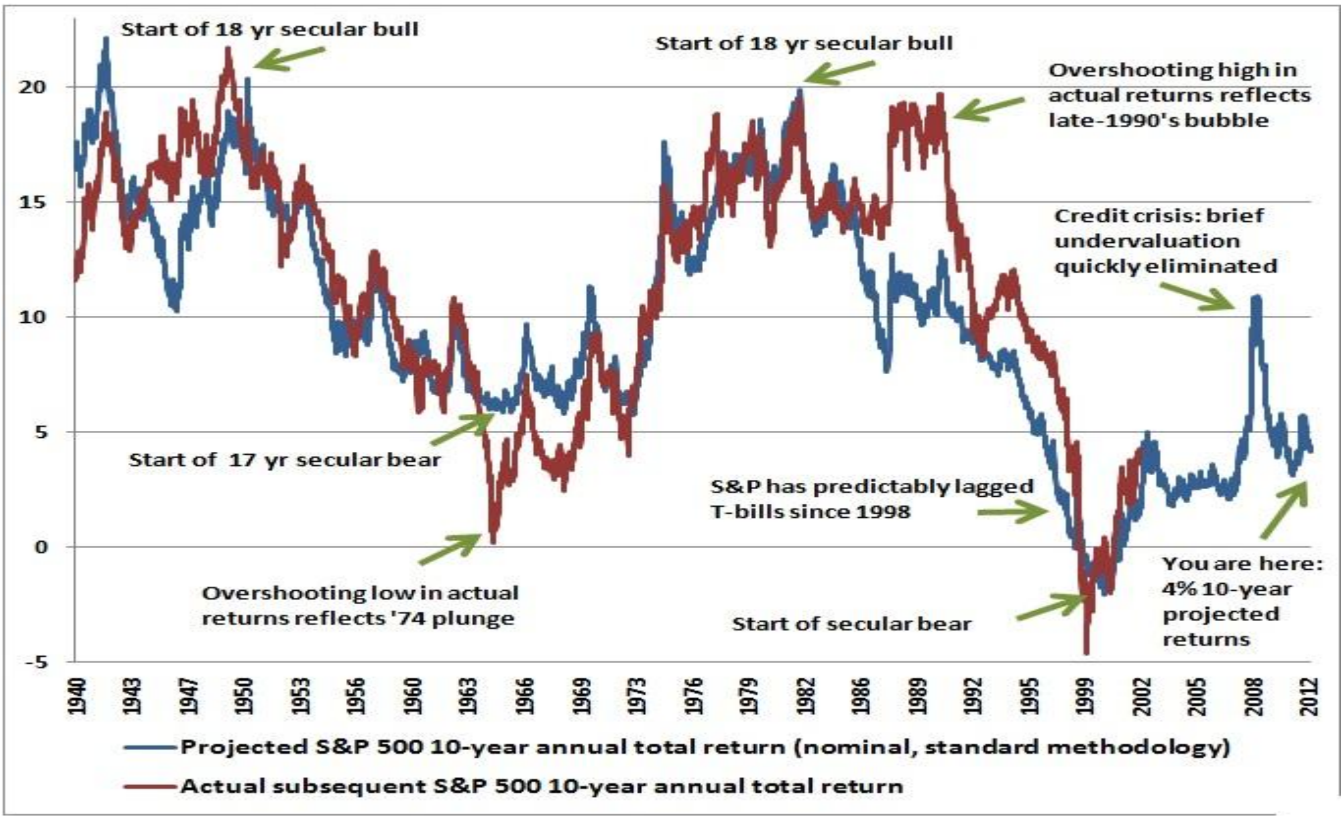
Trustee to Fund Manager:	I see we hold no Japanese equities?
Fund Manager:	Any idiot knows you never invest in Japan. All my colleagues say the same.
Trustee:	Why not?
Fund Manager:	Because it's been wrong for a generation.
Trustee:	So? Someone at the 19th Hole told me it was dirt cheap – almost alone amongst the main developed markets and representing a cohesive society.
Fund Manager:	But it's always wrong.
Trustee:	Do you always stay with markets that are wildly over-valued and have shot up? I see we're up to our necks in the USA.
Fund Manager:	Err, err ...

Well, you get the point.

Equities Generally: Leverage

This is indeed important in the world macro sense. Dr Richebacher, sadly now deceased, set me on the right track here, nearly a generation ago. (He was sometimes mocked, but was proved dead right in the end in his dire analysis.) Corporate revenue resulting from purchases made with borrowing are pretty much a freebie for companies. There is no (normal) wage / salary cost to deduct from the profitability of the sales. This is a macro., i.e. total economy, statement. Clearly this may not apply to an individual company. This may well be an explanation as to why corporate profits are so high in the USA and some other countries, despite very weak economies. Indeed, there has never been leverage like that which currently exists in the developed economies. Widespread talk of deleveraging is, frankly, just plain wrong. Peter Warburton, referenced in the FT 04.02.2013, points out that in 35 out of 39 countries he follows non-bank / financial debt is still increasing. Global debt is increasing at 5.2% pa in the private sector and 7.4% pa in the public sector. He is a respected analyst and I have no reason to doubt his figures. As regards the USA total non-financial debt stood at $34.5tn in December 2008. By the end of last September it exceeded $39tn. These figures exclude entitlements, which are truly mind-numbing in size, but which obviously will be largely welched upon.

So let's look forward to some deleveraging. What happens? Or even just a cessation of increased leveraging? For what it is worth, Jamil Baz, chief economist of Man Group, pointed out in the FT recently that G7 debt is at a record 410% of GDP. He takes the matter further. He suggests that this figure must fall to at least 310% before the position can become merely sustainable. As regards the US, leverage would be back to 1995 levels. The ratio of profit to GDP was then 45% lower. And arguably (I cannot be quite sure) somewhere near the middle of the long-term trend of profits growth. Readers know that profits currently (to the extent that you believe the figures tell you approximately the 'truth' – I am not sure that they do) stand at about record levels, as a percentage of GDP. US profits have mean reverted throughout history. To suggest that they might well mean revert to 1995 levels, very approximately, would seem a pretty sensible central case estimate. And market valuations also stand at record levels, bar 2000± and, just, 1929. As you know, Wall Street is about 50% overvalued (Andrew Smithers). The Shiller PER and q, the measurements best used for this long-term valuation, mean revert over history also.



Courtesy: John Hussman

The predictive correlation in the US between the Shiller PER and subsequent market returns is staggering. Do also read "Valuing Wall Street" by Smithers and Wright. It is possible to make a very dire central case long-term guestimate for the sort of level the Dow might reach when the Great Disconnect (as Gary Shilling calls it) between reality and QE-puffery (my words) ends. There is plenty of other 'puffery', but that is an eternal constant given vested interests. Mr Baz calculates that a level of perhaps one third of its current level could be reached by the Dow. I do not, as you know, 'forecast'. No-one can 'forecast', which does not prevent battalions of analysts(?)doing this all the time. As it happens, readers will remember that very many years ago when the then pretty obvious (to me) sooner-or-later-coming-disaster was building up, I wrote that I would not be surprised to see the Dow at 4000-6000. No, emphatically not a projection. Then nor now. But tell me why not?

Incidentally, purleeese, may we stop hearing about "the Great Rotation" (out of bonds into equities). It is mathematically a complete impossibility.

Good luck,

Peter Bennett, BA Cantab, MBA Wharton
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