WALKERCRIPS STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

QUARTERLY STRATEGY – PART I

Japan - Update

The market surge continues. Gold medal main market year-to-date (+20%). Nikkei: 12,560.

Recent figures indicate the strength of the Japanese corporate sector. Work by Andrew Smithers shows that business cashflow is running at a level almost identical to the endlessly paraded gross fiscal deficit: 7% of GDP, or so. In my last Japan note, I pointed to work by Daiwa Securities: TOPIX EBIT (earnings before interest and tax) to rise 20% in the fiscal year starting this month. That figure was suggested on the basis of a dollar : yen exchange rate of 90 (and euro equivalent). I rhetorically asked why analysts can't talk of earnings after tax, which, after all, is what interests shareholders. Using EBIT seems to imply the Tooth Fairy pays for interest and tax. You have my word, he (or she) doesn't. Most recently, a report by Daiwa in fact expects a 40% rise in **earnings** this year based on a 90 yen : 1 dollar exchange rate. More, the lower the yen goes. Currently the yen : dollar is 96. In their estimate the next three largest earnings increases in the current financial period will come from Taiwan – 28%, then Korea and France (Ed: ? France?), both around 20%. Steel and electrical, electronics emerge as mega-monster winners. The FT shows the existing TOPIX PER as 13 or so; so this change in profits would collapse that figure by about 40% - to about 8. Much more in line with the still incredibly low price to cash flow ratio of Japanese equities, ditto price to book and price to sales. (Funnily enough, in the UK and the USA business cash flow is also reported as being very similar to the monster Government deficits in both those nations. This further underlines, what I have said before, that a return to normality – and in this context meaning a reduction in Government deficits – is highly like to clobber corporate profits. More in my next Bulletin on inflation. I don't expect Japan to be totally immune from this either but it does start from such a deep base of value.)

Policy

There is a massive list of proposed policy initiatives (a near three hour read from Daiwa, merely for the outlines). The aim is to jerk the economy into a new trend of more growth plus modest inflation. The list is very long and so often do initiatives in Japan get bogged down in the bureaucracy, it would be a surprise if more than a few (taken from a list of some 8 – 10 main headlines) actually get put into effect. Reading the list, contrary to some comment, I believe a great deal of thought and preparation has gone into the exercise. Many of the proposals look inventive and sensible (don't worry, I'm not about to hit you with all the details. No doubt if you are frantic for them the Internet will oblige.).

As you know, Japan starts from a fortress-strength financial position. The endless old wives rot talked about in this matter never ceases to amaze me. Indeed, corporates, despite the near 40% tax rate and heavy depreciation (ok – a non-cash charge) are probably in the best shape of any business sector anywhere in the world. And, repeatedly, if anything, directors 'low ball' their numbers, completely unlike the blowhards you know where. Whilst Andrew Smithers suggests there is not enough data to calculate a Shiller PER nevertheless, just before the market took off, the FT (LEX section) indicated about 8. Add some 40% for the market surge since = say, 11+. Less than half the current S&P Shiller PER. Unlike across the Pacific, the personal sector is also in pretty good shape, as indeed is the banking sector which, having years ago got through its post-bubble traumas, now has excess lending ability coming out of its ears. Ok, the sector is stuffed with Government bonds which could ‘blow up’ (ditto everywhere else for that matter). The key to handling the matter is that the bonds are nearly all (over 90%) owned by the balance sheet of the strong private sector, notably including the banks. A slight worry for shareholders is that the corporate sector will almost definitely be called upon to spread some of its largesse to other sectors. Indeed, this is included in the list of proposed policies. If push comes to shove in this era of reckless and unconventional monetary policy, the Bank of Japan could, if it wanted to, just print money to buy the bonds on offer. Given Japan’s deflation plus general overall balance sheet strength that would seem an appropriate policy in an emergency – unlike, say, the UK and the USA, where it is actually going on already. Over 30% of US/UK government bonds are owned by the US/UK central banks. In Japan so far mainly short-term bills, and not many, have been bought.

The stated aim is to get rid of the fiscal deficit by 2020. Frankly this is unlikely but there are numerous proposals to attack it, despite the much-vaunted expected increases in infrastructure spending. Whilst the large corporate sector is heavily taxed, the personal sector is one of the lowest taxed of the main economies. It hardly pays any. Indeed, overall the Government only takes about 34% of GDP (dream on UK / Europe) so the mooted increase in the very low sales tax (5% - UK 20%) plus other measures might be instituted without upsetting the apple cart too much.

Conclusion

In sum, the ‘value’ is still there, despite the market surge. At the technical level, Japanese retail investors have just been shown also to have surged in their interest in the market. This makes a change. Underweight external investors must be getting very antsy. The ultimate irony in this Alice Through the Looking Glass financial environment is as follows: Now that Japanese policy is to generate inflation bond prices have actually **risen**. The lunatics really have taken over the world financial asylum. (Risen because of expected BoJ support.)

Good luck.

Peter Bennett, BA Cantab, MBA Wharton
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Finsbury Tower, 103-105 Bunhill Row, London EC1Y 8LZ
020 3100 8000 | client.services@wcgplc.co.uk | www.wcgplc.co.uk