From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Japan: Economic Change Brings Volatility and Opportunity

We are optimistic on the one-year outlook for Japanese stocks. We believe that Prime Minister Abe's goal of reinvigorating economic growth by ending two decades of deflation will continue to drive Japanese stocks higher. We have been pleasantly surprised by the speed and magnitude at which the markets have anticipated the success of his policies so far. The Nikkei 255 Japanese stock index almost doubled from its November low to its recent high, and the yen has depreciated by more than 25% versus the dollar. Abe's 'three arrow" strategy of (1) quantitative easing (to reverse deflation and weaken the yen); (2) fiscal stimulus (to promote investment and growth); and (3) structural reforms (to increase competitiveness and sustain corporate profit expansion) is one of the most aggressive experiments in policymaking by any major economy, and its outcomes can only be estimated. Just as we are optimists, there are plenty of skeptics.

Abe's 'three arrow" strategy of (1) quantitative easing (to reverse deflation and weaken the yen); (2) fiscal stimulus (to promote investment and growth); and (3) structural reforms (to increase competitiveness and sustain corporate profit expansion); is one of the most aggressive experiments in policymaking by any major economy.

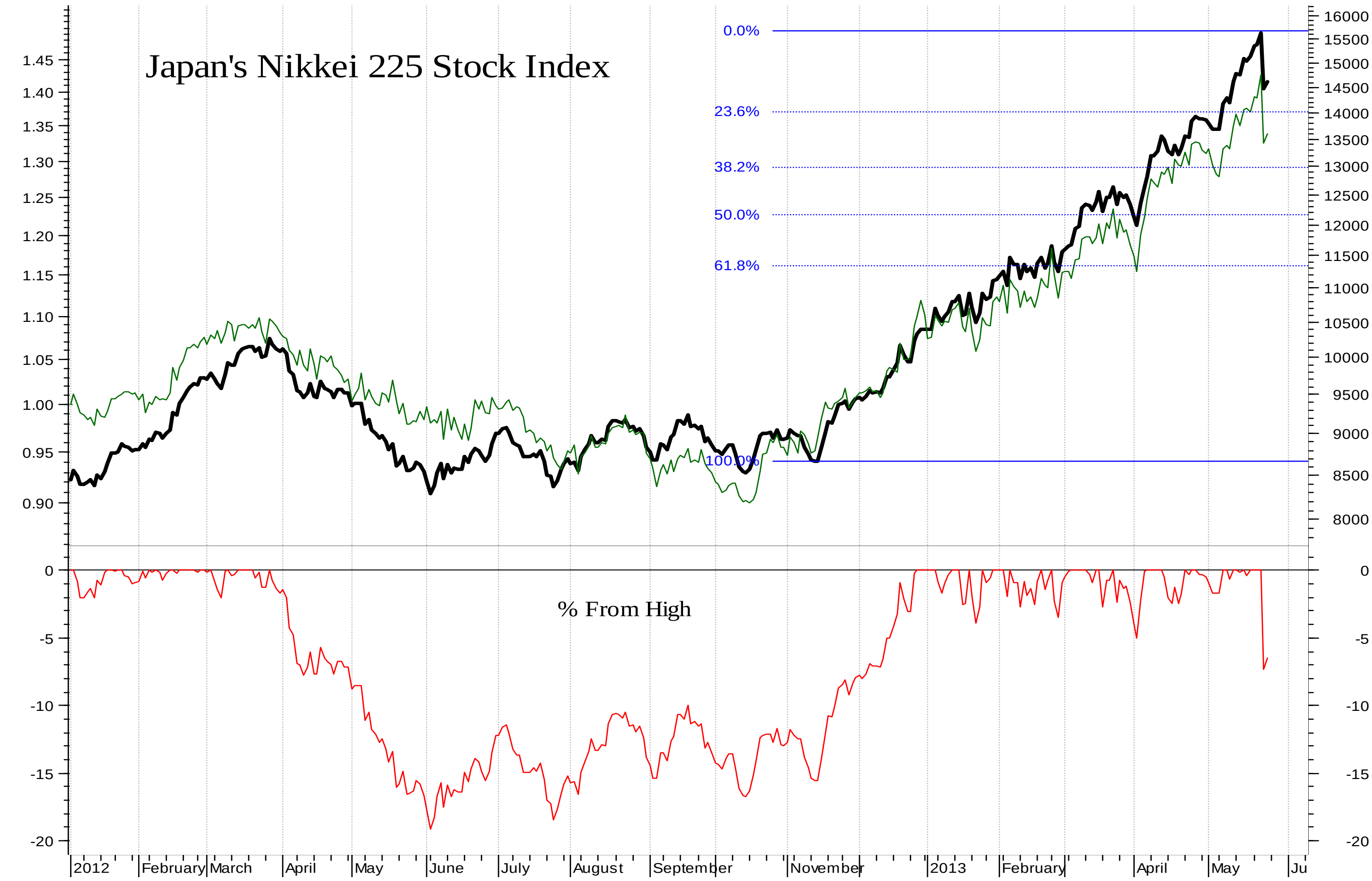
Thus, last Thursday's 7.3% decline in Japan's Nikkei 225 stock index is understandable when viewed in the context of significant variations in estimates for earnings, long-term interest rates, and economic activity. US and global markets had similar volatility and price swings following the sea change in economic expectations in 2008. During that time, as stocks were adjusting to significant downshifts in growth and earnings, there were several weeks that stocks rose 5–10%, even as the market remained in a severe downtrend. We think Japan is experiencing the opposite situation — an upgrade to earnings and growth expectations as 'Abenomics' increasingly appears to be working. We remain comfortable with our overweight position in the medium term.

We think Japan is experiencing an upgrade to earnings and growth expectations as 'Abenomics' increasingly appears to be working. We remain comfortable with our overweight position.

US stocks also fell last week, although by little more than 1%, reflecting a more stable economic and earnings environment, and much lower dispersion of estimates. We view the pause in US stocks' uptrend as healthy rather than as a cause for alarm. Markets reacted to Federal Reserve Chairman Ben Bernanke's comments on tapering asset purchases as an 'excuse' to sell off, although we saw nothing new in his statements. Crowd sentiment had become extremely optimistic following the S&P 500's string of all-time highs since early April. We think this optimism probably needs to recede before stocks resume rising.

The Fed has explicitly stated that it will begin to remove extraordinary policy accommodation as unemployment falls towards 6.5%. Unemployment is now 7.5% and could conceivably hit the Fed's target in about a year given the current slow but steady pace of job growth. Focus is turning to the timing of a reduction in Quantitative Easing (QE). Hawkish minority members of the Fed's policy committee have been vocal about stopping QE right away (i.e., selling assets and raising interest rates), but the data on inflation and inflation expectations do not support them at present. We regard comments from Vice Chairman Janet Yellen (who is a strong candidate to succeed Bernanke at the end of his term as Fed Chairman in January 2014) as a more influential guide regarding monetary policy. Yellen recently said, "I am likely to supplement the data on employment and unemployment with measures of gross job flows, such as job loss and hiring, which describe the underlying dynamics of the labor market... I would look for an increase in the rate of hiring. Similarly, a pick-up in the quit rate, which also remains at a low level, would signal that workers perceive that their chances to be rehired are good — in other words, that labor demand has strengthened." The hire rate has been flat at just over 3% and is still below prerecession levels. Yellen's comments suggest to us that sustained improvement towards 4% is necessary for the Fed to take its foot off the gas.

THE WEEKLY CHART: LAST WEEK'S PULLBACK IN CONTEXT



The Nikkei 225 fell 7.3% last Thursday, prompting fears that the rally from its November lows is ending. With the Nikkei up 80% from November to last week's peak, we think a pullback is normal. Based on typical retracements (shown in the top panel of the chart), last week's decline did not even reach the 23.6% retracement of the November through May rally, typically the shallowest retracement that is experienced during a powerful rally. The Nikkei has been volatile – the bottom panel shows its drawdowns from peaks since 2012; by June 2012 it was down 19% from its March high. An equivalent decline from last week's peak would take the Nikkei down to around 12,700, between the 38% and 50% retracements, which still would be consistent with a short-term pullback in the context of a longer-term uptrend. However, given the recent success of, and enthusiasm for Abe's 'three arrow' strategies, we expect the uptrend to resume and pullbacks to be 5–7% as that they have been since the November rally, as shown in the bottom panel of the chart. Furthermore, from a long-term perspective the Nikkei is 62% below its December 1989 all-time high and it made a record low relative to the S&P 500 last October (thin green line in the top panel, left scale). Since that low the Nikkei has outperformed the S&P 500 by about 48%. We expect Japanese stocks to outperform for the rest of the year and we remain overweight in our portfolios.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.