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Japan's Pre-emptive Strike

In Japan, reality is never what it seems to be.

Its stock market has soared this year and there's been a strong pick-up in economic growth, all attributed to a spectacular reform programme introduced by the new government of Shinzo Abe, dubbed Abenomics.

However, that programme is quite unconvincing. It's a mishmash of policies that have been tried repeatedly in the past and largely failed, and good intentions on which it will be very hard politically to deliver.

So why has it been so effective, at least for its first few months?

Because its real purpose has been one Abe cannot admit to, in fact he publicly denies it. It has been a pre-emptive strike -- a devastating broadside in the escalating international currency war, driving down the exchange rate of the yen.

Although it's been bouncing around a lot, at 98 to the dollar the yen is now about 20 per cent lower than it was just eight months ago.

That has given an adrenaline boost to the sluggish economy, and in particular to all those businesses in the export sector. Economic growth surged to a 4 per cent annual rate in the first quarter. Shipments to foreign markets are up 10 per cent.

Corporate profits have started to surge and equity investors clearly believe there's lots of good news to come. Companies have started to distribute some of the benefits to their employees, with the promise of higher summer bonuses.

By scaring the markets with the promise of a tidal wave of "printed" money, Abe has achieved in a few months most of the boost to economic growth implied by his entire stimulus programme. Seemingly it's also about to achieve his other objective -- securing a majority for his party in the upper house of parliament in the elections scheduled for next month.

After that, for a while the markets are likely to remain optimistic that Abe will have the political power to implement the structural reforms needed by Japan's sluggish economy… and to drive through mega-doses of old failed policies.

However, my own expectation is that disillusionment will set in within 12 months.

Why? Let's take a quick look at the three constituents of Abe's growth-stimulation plan:

► "Print" money on a scale that makes the Fed look like a model of caution. The central bank has been ordered to double the size of the monetary base over just two years to 54 per cent of GDP (latest comparative figure for the US is 19 per cent).

Trouble is, Japan has implemented bouts of what is now called "quantitative easing" eight times over the past two decades. The new round of money-creation will be the ninth. Why should it be any more effective than previous ones?

It is true that those bouts of money creation underpinned the economy by preventing financial collapse. But they failed to stimulate growth.

The reasons are well-known to economists, and commonly described as trying to push on a piece of string. Abundant nearly-free central bank credit only works if there are lots of potential borrowers available confident enough about the future to want to borrow cheaply and risk investing in business expansion. That's what is missing in Japan and other mature economies.

Japanese corporations don't need to borrow. They're sitting on the equivalent of $2.4 trillion of cash and near-cash deposits that they're not confident enough to invest. Despite an economy only a third the size of America's, that's one-third more than US firms are holding.

In the short run, money printing is like pumping out analgesic to suppress pain. Over the long run, it's likely to be poisonous. Businessmen are not foolish. They know that, so they remain cautious. Bad policies don't start working just because you double the dose.

► Spend heavily on infrastructure.

Trouble is, that's another policy Japan pursued aggressively in the past. It produced railways to rural areas which made no sense because there would never be enough traffic to make them viable, and covered much of the country with unnecessary and disfiguring concrete walls, river banks and similar structures.

Some other countries, such as the US and India, do clearly need to renew or expand their physical infrastructures. Not Japan. Its infrastructure is generally excellent, and sufficient. In pursuing this path, it will clearly be wasting resources on a massive scale… while creating fat profits for construction companies.

Japan is already fiscally incontinent, with borrowed money financing about half annual government spending, so borrowing even more to spend wastefully on infrastructure is foolish. And with net government debt a sky-high 170 per cent of GDP, it's a financially risky strategy should investors in bonds grow nervous about the security of their savings.

Don't scare the horses with specifics

► Push through structural reforms to modernize the economy.

Abe has offered a list of no fewer than 170 good ideas including entry into a ten-nation Asia-Pacific free-trade club, regulation-light economic zones, relaxation of rigid employment laws, easier immigration, public/private partnerships to build and operate public works, tax incentives for business investment, increased participation by women in the work-force, and schemes to promote clean energy, energy-saving housing, tourism, traditional food.

He has avoided revealing any specifics of those proposed reforms. That is understandable, as he doesn't want to scare the horses ahead of an important election. After that, he faces the hard task of turning good intentions into reality.

Powerful vested interests will fight hard to block major reforms, or at least to attenuate them. For example, the mooted entry into the Pacific free trade bloc would require scrapping much of the protection given to Japanese farmers, which would be fought not only by their politically powerful representative bodies, but also by conservatives defending domestic food supplies for security reasons.

Some of the biggest potential reforms, such as liberalizing immigration to deal with problems such as an aging and contracting work-force and, more specifically, providing labour to service the personal and healthcare needs of a ballooning population of the elderly, may continue to be impossible because of (understandable) fears about the social consequences of permitting, even promoting, multi-culturalism.

There are broader issues relating to the consequences, especially the political ones, of implementing Abenomics, as they are claimed to be.

► A key objective is to achieve inflation, because policymakers see that as a way to stimulate economic growth through stimulating consumer demand. But Japan has a huge and growing population of retirees who cannot afford inflation because negligible interest rates have squeezed their incomes.

Many of the middle class have also suffered too much from two decades of negligible economic growth to be in a frame of mind to boost their personal spending. As for borrowing to spend, the American way… not in this land where thrift is so embedded in the culture of the people.

► With national debt so high, investment markets could be seriously destabilized by fears that seriously irresponsible money creation and state borrowing will lead eventually to rising taxes (encouraging consumers to save rather than spend), and to higher interest rates (devastating the capital value of existing longer-term bonds).

► Although Japan has largely escaped international criticism for its stunning pre-emptive strike in the currency war, it cannot do so for much longer as its competitors experience the adverse consequences. They can counter-attack by driving down their own currencies, threaten and introduce trade sanctions, and pursue other nasties like those populist consumer boycotts in China.

No more easy victories in the currency war

However, Japanese policymakers are well aware of the competitive power of a cheap currency if you both control its creation and have no dependence on foreign capital inflows. One of the oft-forgotten lessons of the past is the boost China got from devaluing the dollar exchange rate of its yuan currency by a massive 32 per cent in a single year (1994).

Although Japan may achieve no more easy victories in the currency war, it's likely to consolidate its position, keeping the yen's exchange rate at around a hundred to the dollar, and perhaps to make it even weaker.

However, longer-term, there are two developments probably coming down the track that could give significant underpinning to the Japanese economy:

► The government is almost certainly going to re-start more of the nuclear power stations that were shut following the Fukushima disaster.

Because of its lack of fossil fuels, Japan has heavy dependence on imported energy resources, particularly liquefied natural gas. That dependence has been much worsened by the nuclear shutdown, which is why this famously powerful exporting power is now actually running foreign trade deficits. Households are experiencing hikes of 9 to 12 per cent in their electricity bills (that's in a no-flation economy), and face the prospect of even more to come.

The rising costs of keeping the reactors switched off are eroding public and political opposition to nuclear power, although major obstacles remain -- the anti-nuclear culture of the only people to be victims of atomic bombing, the death-toll and broader consequences of the Fukushima disaster, and the dangerous siting of some reactors on earthquake fault lines.

In time those problems will probably be addressed through greater understanding of how safe are modern designs of nuclear power stations, permanent closure of existing badly-sited reactors, and construction of new generators high up, far from the risk of earthquakes and tsunamis.

► It seems certain that there will be a major rearmament programme.

Dangers to Japan are rising. North Korea is building its stockpile and nuclear weaponry and is ruled by a bunch of crazies. China is well on its way to becoming a military superpower, has a deeprooted ethnic hostility to the Japanese, and is increasingly pursuing foreign policy issues that could develop into confrontations, such as the dispute over sovereignty of the Senkak/Diaoyu islands. Its defence spending has multiplied five-fold over the past dozen years and is now four times Japan's.

There is slowly mounting pressure to revise the pacifist constitution imposed on Japan after the Second World War, clearing the way for boosting military capacity and recognition of that potential – including Japan's participation in United Nations' peacekeeping operations, currently prohibited by the constitution – and for closer military ties with the US.

Although some of the increase in defence spending would go to America for its most advanced weaponry such as F35 stealth fighters, substantial benefits would flow to Japan's own very advanced defence industries.

After bad experiences, companies are reluctant to invest

Japanese businessmen are much less confident about the transformative power of Abenomics than investors. They have seen such grand planning fade into failure many times before, given the lack of centralized power in the Japanese political system, the strength of vested interests and bureaucratic resistance… leaving their companies to suffer the consequences after having invested in what turned out to be empty promises.

Osamu Suzuki, a respected car industry leader, made this interesting comment: "We've been investing in India, Thailand and Indonesia… We won't suddenly bring production back to Japan just because the yen is cheaper."

Despite pressure from the government, the corporate sector is refusing to follow through on its currency-driven profits bonanza by investing in expansions within Japan. It still has plenty of unused capacity, is more confident about longer-term market growth prospects elsewhere in Asia (where it's continuing to focus its investment), and doesn't trust the politicians to deliver.

It is investment professionals, largely outside the country, who regard Japan as the last great prospect for equity profits. The respected London-based analyst David Fuller, for example, says Japan is "the most interesting major market opportunity that I have seen for a long time."

If you think the optimists may be right, as a personal investor you would probably be wise to take your stake in Japan through an exchange traded fund, investment trust or mutual fund. There are many available, in various currencies.

Although I know much about Japan, I have always struggled to find individual shares in which I felt confident to invest, because of unattractive track records, fundamentals and/or charts.

Five stocks to consider

However, here are a few suggestions of Tokyo-listed companies, all but one of them small-caps, that you may think worth investigating further…

Heiwa Corp. [ticker 6412] is in the casino equipment industry, specifically in developing and making machines for that uniquely Japanese arcade game Pachinko. Despite years of strong earnings growth, it's still trading on a PE ratio of 7x and a dividend yield of 3.2 per cent, more than four times covered.

Kaken Pharmaceutical [4521] is that great rarity – a Japanese company that is a Standard & Poor's Dividend Aristocrat (consistently paying and increasing its dividend for the past ten years), underpinned by strong earnings growth. Long-established, it develops and markets prescription and quasi-drugs for humans and animals, crop protection chemicals, food additives and medical equipment. It currently trades on a PE below 14x, with a div. yield of 2.8 per cent, 2½ times covered.

Toshiba Plant Systems [1983] is one of the handful of global companies with the engineering facilities and expertise to build nuclear power plants. It also designs, manufactures and services other very large machines such as thermal power generators. It's an interesting play on the prospect of a nuclear power comeback, trading on a PE of 14x, but with a very low dividend yield, below 1 per cent.

Unicharm [8113] is a midsized company engaged in manufacture and sale of products for the baby, feminine and pet care markets such as diapers, sanitary goods and pet food. It has an impressive earnings growth track record, but isn't cheap, trading on a PE of nearly 27x. The div. yield is only 1.4 per cent, but it's nearly six times covered.

Welcia [3141] operates 764 stores (at last count) selling pharmaceuticals, cosmetics, health foods, sanitary and baby care goods, as well as the design and construction of such stores, and is expanding into China. It trades on a PE of less than 12x, with a dividend of 1.8 per cent, but that's eight times covered.

If, as seems likely, recent weakness on the Tokyo market is a correction in a new bull trend rather than the culmination of a brief bubble, now and the next few weeks would seem to be a good time to buy.

Black Swan Risks and Your Defences

Much of the analysis of risk in investments is based on the theory of Normal Distribution – that if you chart a series of data, such as share prices, over time, the resulting shape will look like a bell. With increasing amplitude as the figures move away from zero, there is a sharply decline in frequency. There will be far fewer occasions when the market falls or rises, say, 10 per cent, than when it does so by 5 per cent.

That mathematic model is used to calculate risk – the declining probability of major moves – and put prices on it.

It is a model based on the Bell Curve attributed to the German mathematician Carl Friedrich Gauss. It does seem to work for forecasting occurrence probability in physics, engineering, even gambling.

Trouble is, it doesn't work in investment, despite its widespread use.

Nassim Nicholas Talib, the New York professor of risk engineering who famously dubbed as "Black Swans" those totally unexpected events with massive consequences, calls this the Ludic Fallacy – applying studies of chance from the world of dice and similar games to assessing uncertainty in other fields.

A simple example…

A Bell Curve based on the historical evidence enables you to project the probability that the US stock market, as measured by the Dow Jones Industrial Average index, will fall by, say, 10 per cent or more over the next 12 months.

What it will not do is tell you risk of that happening in a single day. The possibility is so extreme that it won't appear on the chart. Yet that is exactly what has happened, four times since 1896.

In other words a Bell Curve will tell you a lot about minor risks – but absolutely nothing about the really big ones, the ones that could cause you enormous losses, the ones that are most important that you protect yourself against them. If you can.

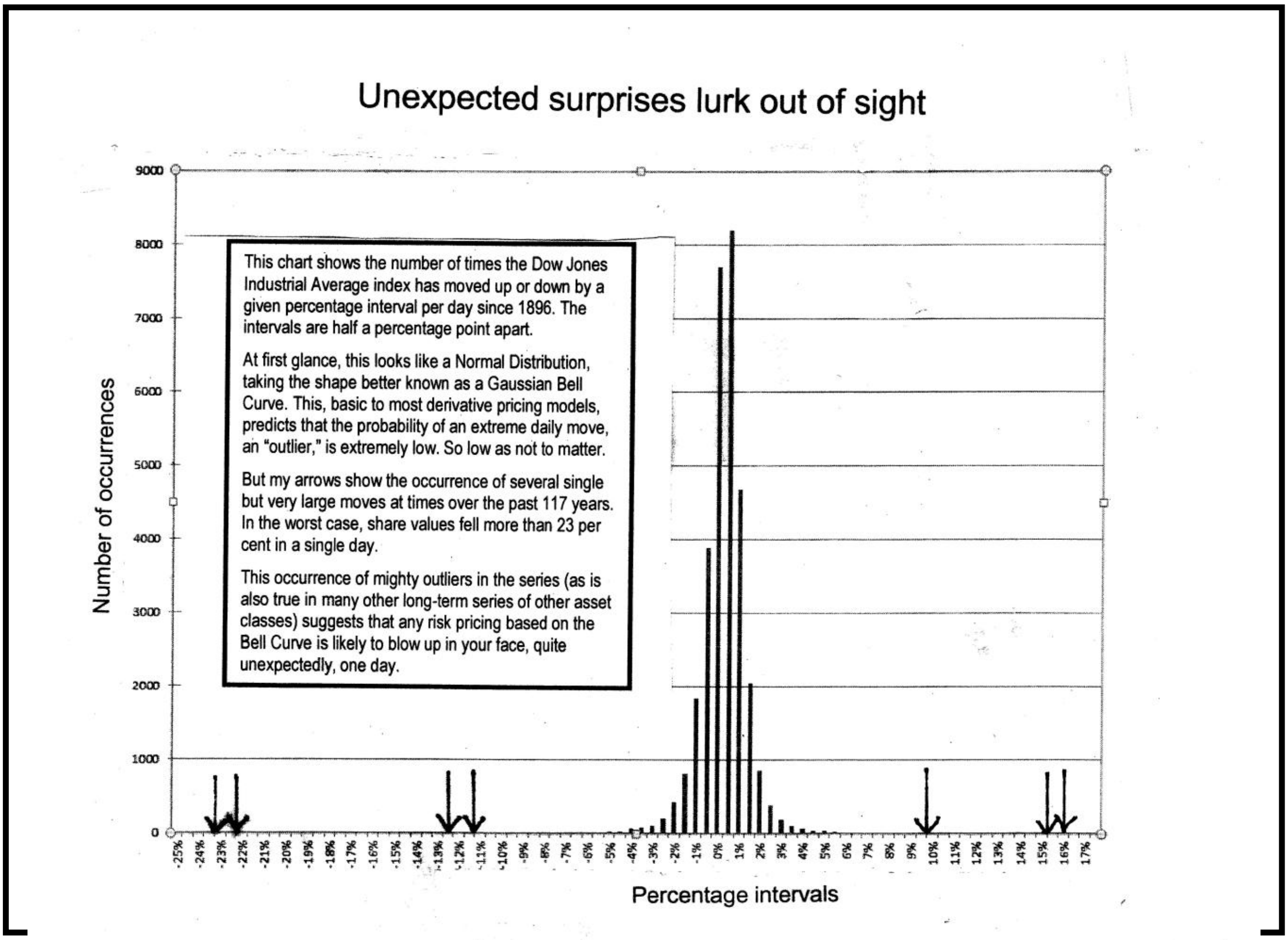
Standard mathematical thinking is unable to cope with, to analyze the risk in, extreme events, the Black Swans. Their probability is so unlikely as to seem not worth worrying about. The Gaussian model suggested that only once in several billion years could US stock markets lose more than a fifth of their value in a single day. But that did happen on October 19, 1987.

Such extreme events are more common than you might expect in long-term time series not only of shares, but also bonds, commodities and currencies.

It gets worse…

Much of the market-influencing valuation of complex investment products such as options and other derivatives is based on this Ludic Fallacy, taught to many thousands of investment professionals at business schools every year.

My friend Michael Zuber, who has been most helpful in researching this for me, says: "The premise of the $700 trillion-plus derivatives universe, the Black-Scholes pricing model, is plain nonsense."



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government securities. Cypriots discovered painfully only recently that there was risk even in the largest, "safest" banks. And Americans experienced the unthinkable in 1932 when their government seized their private gold holdings.

Can ordinary folk, who are not part of privileged elites, trust any government to stand by them in a financial crisis? Trust them not to seize personal assets, change the rules overnight?

A more important objection to what Taleb calls his Barbell Strategy is this: Who has the expertise and the courage to identify, as well as the connections to be able to in, high-risk opportunities with massive upside potential? Very few of us.

However, it seems to me there are some basic strategies you can use to limit your exposure to Grey Swans – events that are extremely unlikely, but are conceivable:

► You can shield your wealth by having a portfolio containing a diversity of asset classes (equities, bonds, property, gold and cash); with geographical diversification of ownership registration and business operation (the US, Europe, Asia, South Africa/Australia); and of currencies.

► You can take insurance comparatively cheaply against rare but potentially extreme events such as earthquakes, terrorism or kidnapping.

► You can insure against political or economic catastrophe in the country where you live by obtaining or sustaining residence rights elsewhere, if you can. My own family is fortunate enough to be able to do so in three continents and both hemispheres.

► You can strengthen your family's resilience through long-term planning of diversity in careers (own business, profession, skilled crafts, secure employment); education; language skills; and global spread of residence.

You don't need to be able to quantify risks to apply commonsense to reducing some of the most obvious ones – especially those that have the potential to be the nastiest.

Contrarian View on the US, Emerging Markets

Worldwide, the average investment manager is extremely underweight in the energy, commodities and emerging-market sectors, according to the latest Merrill Lynch survey.

This suggests most fund managers "believe the low inflation/deflationary pressures of the last two years will likely continue," says the Irish strategist Marc Tenwick.

But he has found this survey to be "an excellent contrarian tool. Investment managers as a group have historically suffered from the same herd-like mentality as retail investors – they are overly bullish and overly bearish towards an asset at the wrong time."

They were very bearish on commodities and emerging economies in December 2008 (wrong). And overweight in both sectors in April 2011, "just as these assets were peaking."

Tenwick believes they're once again wrong in their negative view and will probably be "caught flat-footed as inflation starts to accelerate."

The most successful investors are contrarians, who bet against the consensus view. "Today the most unloved assets… are inflation hedges such as commodities and emerging-market stocks."

Some other points he makes…

► **American stocks:** They're looking dangerously overbought. "Investors have poured every cent they have into stocks." This is "an ominous sign" as current cash levels they have available at Wall Street firms are similar to those prior to the 2000 and 2008 stock-market crashes.

Investors "are so optimistic about the outlook for stocks that they have even borrowed money to buy." Margin debt on the New York market has also reached peaks like those that preceded the 2000 and 2008 plunges.

On the other hand the shrewdest big investors now prefer cash to shares. Warren Buffett has accumulated a cash pile of $49 billion – as much as he raised prior to the 2008 crash.

► **The dollar:** Current sentiment is very bullish. In the past, that has often signaled peaks. And the second half of the year is typically a weak period for the greenback.

Should the Federal Reserve surprise the currency market by maintaining the quantitative easing programme at current levels or increasing it, that would probably lead traders to sell the dollar, "which would be a bullish development for commodities and emerging-market stocks."

► **Japan:** "There is a high probability that the recent rally in Japanese stocks is not the start of a new long-term bull market and was merely a powerful short-term rally."

► **China:** Despite well-known negatives, "when compared to the highly-indebted, low-growth economies in Europe and the US… appears to be a far more compelling alternative," with economic performance that is still impressive – latest numbers "are not the signs of an economy that is facing a hard landing."

Tenwick says (and this is also my view)…

"The Federal Reserve is in a conundrum." Its "ongoing money printing has created a monster of a stock-market bubble that is not supported by economic fundamentals.

"If they remove or reduce their QE programme, they are likely to burst the bubble, which could lead to a severe recession and even a renewed banking crisis." But "if they continue with their monthly QE programme, they risk destroying the US dollar and creating an inflation surge…

"Politicians greatly influence the actions of central bank governors… The path of least resistance is to do more of the same – that is, keep printing money."

Tax Avoidance: Who's Guilty?

The current brouhaha over highly successful tax planning by multinationals such as Apple is simply ridiculous.

Those companies are simply pursuing their shareholders' interests, as they are required to do, by acting within the law to minimize the tax they pay. The politicians who are making all the fuss created the international tax framework within which they expect firms to operate, and it is within their power – not the companies' – to change that framework. They prefer verbal diarrhoea to action.

It is especially disgusting that leaders like Barack Obama and David Cameron should attack corporate tax planning, and seek to persecute small jurisdictions for doing business as tax havens, when it's well known that their own countries (the US and the UK) provide some of the most egregious opportunities for tax saving, and have done nothing to change that.

The *FT* reports that the US, for example: "Tops the list of countries for the registration of anonymous shell companies, [and] does not require banks or corporate service providers to delve into beneficial ownership."

Of course, the only kind of political action I would like to see is a globally co-ordinated effort to reduce taxes, especially on entrepreneurship, raising business efficiency and creation. And to reform a system that discriminates against smaller companies by favouring high-cost avoidance strategies that only the big boys can afford.

Asia's Reluctant Partners

China's telecoms equipment giant Huawei this month announced it is increasing the share of Japanese parts in its smartphones from 50 to 70 per cent to boost its competitiveness against Samsung and Apple.

This highlights the fact, not well known, that despite the recent deterioration in the always-uncomfortable political relationship between China and Japan, there is increasing, and major, interdependence between the two nations. Especially as China's move into exports of high-tech products increases its dependence on imported parts.

Richard Katz reports in the *WSJ* that many Chinese do not realize how much their economy depends on Japan's.

"For years, Japan has been China's single largest source of imports – and around 60-70 per cent of these are the machinery and parts needed to make China's own products.

"A 2012 International Monetary Fund report calculated that for every percentage point of growth in China's global exports, its imports from Japan rise by 1.2 percentage points.

"Take away those imports, and China's exports collapse."

Strange Priorities Down South

The South African government has committed itself to yet another huge handout to state-owned South African Airways.

Subsidies for the perennial loss-making airline have already cost taxpayers at least R12 billion (that's equivalent to about $1.2 billion at current exchange rates) over the past decade, says the Free Market Foundation's Jasson Urbach. That money "could have been used instead to build approximately 218,000 houses, which would have considerably improved the lives of hundreds of thousands of poor South Africans who still have no adequate shelter."

He suggests SAA should be auctioned off to the private sector. That would end the subsidies, immediately provide the government with some funds, and create a vast new source of revenue.

It would, of course, also lead to much improved service to the travelling public, including the more than 8 million foreign tourists who visit South Africa every year.

Tailpieces

Global warming: Canadian scientists have published research proving that CFCs, not carbon dioxide emissions, are the key driver of climate change. CFCs are gases that were widely used in refrigerators and aerosols, but whose use is being phased out because they damage the ozone layer.

This explains why the earth has actually been cooling since 2002, matching the fall in CFCs in the atmosphere.

Data recorded from 1850 to 1970, when there were no significant CFC emissions, show that although carbon dioxide levels increased significantly because of industrialization, when solar-cycle effects are excluded, global temperatures were nearly constant – they only started to rise with the arrival of the CFCs. Now both are falling.

“The cooling trend is set to continue for the next 50 to 70 years as the amount of CFCs in the atmosphere continued to decline,” says Qing-Bin Lu, professor at the Waterloo University’s Faculty of Science.

A growth conundrum: I wrote in April about the strange fact that “investors do worst in countries whose economies are best delivering national wealth creation.” But Asia-Pacific strategist Christopher Wood rightly points out this is not always true.

“Sometimes faster growth is plain bullish for equities, most particularly if it is an acceleration after years in the comparative doldrums.

“The Philippines is a case in point, with the latest quarterly GDP data… showing the country to be the fastest-growing economy in Asia,” with real GDP up nearly 8 per cent over 12 months. The stock market? It’s been “the region’s best performer so far this year,” as it was in 2012, when it rose 44 per cent.

Biting the bullet: Policies that avoid tough action so as to protect the old and “connected” groups such as ruling classes and state employees, stretch out the pain of economic adjustment “to the horizon” and “are much more demoralizing than shorter, sharper depressions” of the kind embraced by the three Baltic countries, argues the *FT*’s erudite commentator John Dizard.

Since the leading Leftist economist Paul Krugman pronounced 2010 that austerity would be a failure, the Baltic states applying it have delivered the highest growth rates in Europe.

Investors who thought Krugman was a fool and acted accordingly would have done really well. In Estonia, share prices have risen about 60 per cent.

Central bankers: Judging by results, they are either fools, or dishonest in public statements about what they really believe, or both.

Here's an example – the track record of the Bank of England for forecasting the UK's economic growth…

Even allowing for the special circumstances of 2007-8, when growth went negative by 6 per cent, the Bank has been consistently and seriously wrong ever since. In May, and for four successive years since then, it predicted annual growth averaging 2.85 per cent. Actual growth averaged just 0.90 per cent.

Ticking time-bomb? As the economy of Cyprus plunges deeper into recession driven by its financial crisis, President Nicos Anastasiades, reveals that the situation at the mini-nation's largest bank is finding it nearly impossible to raise the cash it needs for day-to-day operations. He has asked the European Union to terminate the tough restructuring of Cyprus's banking sector it has imposed as the price of €10 billion in rescue loans.

Is it becoming more possible that the "unthinkable" is going to happen – a messy exit from the Euro zone?

Commodities: Their performance since the financial crisis has been the weakest during any global economic recovery of the past 40 years, Barclays reports.

Investors seem wary about bidding up prices of resources and companies that produce them in the face of slowing economic growth in China and rising production of iron ore, oil and wheat in response to years of high prices.

However, commentator Jack Farchy argues – China is still a fast-growing big economy and producers are cutting back on expansion. "Either the resources sector is undervalued, or it is signalling that we should be very worried about the outlook for [economic] growth."

Tattoo-proof: Warren Buffett at Berkshire Hathaway's annual meeting on the decision – that's turned out to be highly profitable – to put money into Harley Davidson senior unsecured notes offering a 15 per cent yield in the 2008/9 crisis: "We did not think that Harley Davidson would go broke. Any business that has its customers tattooing the logo on to their body parts can't be all that bad."

Wise words: *Government is like a baby – an alimentary canal with a big appetite at one end and no responsibility at the other.* Ronald Reagan.

Martin

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