TAM INTERNATIONAL INVESTMENT NOTE

JAPAN - Beware of bull

TAM clients may have noticed the successful investment into Japanese equities bought earlier in the Spring. At the time, we believed that the market had fallen unjustly out of favour and trading at levels we considered cheap relative to its western peers. With the Nikkei 225 Index up around 13% from the lows, we ask if this is still the case and what we can expect for the rest of the year and beyond.

Leaving aside the bull case for now, let's deal with the bad news that seems to have an unusually large following.

It is true that deflation, once it gets a hold of you, is hard to deal with. After all, Japan has been throwing money at the problem for 20 years. Japan's "misery index" has reached its highest level since 1981 with the population having to deal with rising food prices, a recent consumption tax hike and workers experiencing falling wages; a statistic made more remarkable by the fact that the workforce, as a percentage of the total population, has fallen consistently for 25 years and where the number of young males aged 15 to 34 has fallen by 25% since 2000. Only now are there tentative signs of businesses having to pay up for new joiners. Furthermore, in spite of a program of quantitative easing and balance sheet expansion that dwarfed the Federal Reserve for years, well before the Lehman crisis, tax revenues only really turned the corner 4 years ago. This has left Japan with a GDP to debt ratio at around 245% of GDP, which many consider dangerous and unprecedented.

However, it appears to have levelled off and, in the context of a recovery from a debt crisis (in Japan's case a property bubble) that has gone on for 25 years, one has to ask who really would sell Japan here? Apparently, it's not the government who, under Prime Minister Shinzo Abe are seriously considering unleashing the $1.3trillion sitting in the Government Pension Investment Fund (GPIF), the largest retirement fund in the world. This fund has historically been a huge holder of Japan's bond issuance which still yields a mere 0.5%. Equities now yield 2% and do look historically cheap relative to bonds, having only been cheaper on this measure immediately before the Japanese rally and during the Lehman crisis itself.

Enter Yasuhisa Shiozaki, who Prime Minister Abe appointed as Health Minister last week into a role that will oversee the GPIF. Mr. Shiozaki is an outspoken reformist and determined to overhaul the GPIF retirement fund and give it the freedom to seek the higher yields, and hopefully higher capital returns, available from equities. According to one official, this enormous fund could be looking to raise its allocation to equities from 12% to around 20%. Interestingly, Japan Post, a similar savings institution, has been reported as looking to make a similar shift with its own not insubstantial funds totalling $850 billion.

It's difficult to know when this might happen but a bout of inflation that knocks bonds off their perch would help. Happily, Bank of Japan Governor, Kuroda, reiterated his intention to bring about such a thing at the recent Jackson Hole meeting of central bank governors. He said he believed that the economic recovery of Japan would broaden out and that monetary policy would raise inflationary expectations. He also commented on stagnating wage growth which he believes will take time to react to actual inflation. Temporary workers may of course be distorting the real picture here, much as it appears to be doing in the UK. If this is the case then one might reasonably infer that the winners may well be corporations and, therefore, shareholders as costs can be contained even in an economy enjoying a healthy revival.

A lot has been written about Abe's "three arrows" of fiscal stimulus, monetary easing and structural reforms. If you're a capable central banker, the first two are relatively easy to implement. The third is a different kettle of fish and has been discussed for the best part of 25 years. It's a bigger problem than just saying it really means. One has to understand that we are talking about an economy that is the third largest in the world (and was the second).

Imagine for a moment going to Japan to visit some companies. As you gaze out of your modest hotel room on the 35th floor, you see hundreds of tower blocks right across Tokyo. If you dropped one of ours from Docklands in there, you wouldn't even see it, and you wonder what, or who, is filling up all this real estate when little old London seems to do a fair job as a global financial centre. What's filling them up is partly some of the 2,300 listed companies listed on the Tokyo Stock Exchange. That's a lot of reform to implement and Prime Minister Abe has a lot on his plate.

One interesting recent statistic showed that Japan had the lowest number of female board directors out of 20 leading nations. Norway was highest at 36% with other Nordic countries not far behind. USA and UK have around 13-14%. Japan has 1.1%. Perhaps this was in the back of Abe's mind when he appointed 5 new female cabinet ministers in the reformist reshuffle of which Mr. Shiozaki was a beneficiary. Whatever other challenges a reformist agenda faces, this had the immediate effect of boosting Abe's public poll rating support from 48% to 60%. Who knows? If Mr. Shiozaki's gets his way, the impact to Japan's stock market could be equally beneficial.

Considering both long and short term factors, present valuations and the possibility of ongoing structural reform we believe we are right to be invested in Japanese equities and are adding to positions where appropriate.

The recent weakening of the Yen against the strengthening US dollar may further stoke renewed investor interest in the major exporters that form a significant part of Japan's industrial base. A weak Yen can often acts as a rising tide that lifts all boats as far as Japan is concerned but we are also positioned for the reflation trade which means that we are inclined to have investments in a fund exposed to Japanese financials and real estate because this is at the heart of what a multi decade recovery is all about.

TAM INTERNATIONAL LIMITED
7th Floor, Wing B, Cyber Tower, Ebene, Mauritius

+230 454 6400 +230 454 5413 www.tamint.com