Prospects for growth in Japan - a new dawn in the Land of the Rising Sun?

"The government and the Bank of Japan will work as one to defeat deflation, and we hope the BOJ will keep taking effective monetary policy and earn the markets' trust." - **Shinzo Abe, Japanese Prime Minister 2012**

This month we focus on Japan, an equity market which finally seems to be turning the corner after almost 20 years of malaise. We explore **what caused Japan's "lost decade"** in the first place and ask, after a strong run since the latest election**, "Has the recent rally run its course or is this a new dawn for Japanese equity markets?"**

The 1990s was widely regarded as a broad ranging "bull market" for equities as, post 1994, a stronger global economy along with cheap and easily available credit fuelled a housing boom on both sides of the Atlantic. From 1990 to today (ignoring the impact of currencies or dividends re-invested), an investment of £1,000 in the **FTSE 100** would be worth **£2,640**, the same investment in the **US S&P 500** would be worth more than **£4,460**. However, an investment into Japanese equities (**Nikkei 225 Index**) would be worth only **£309.**

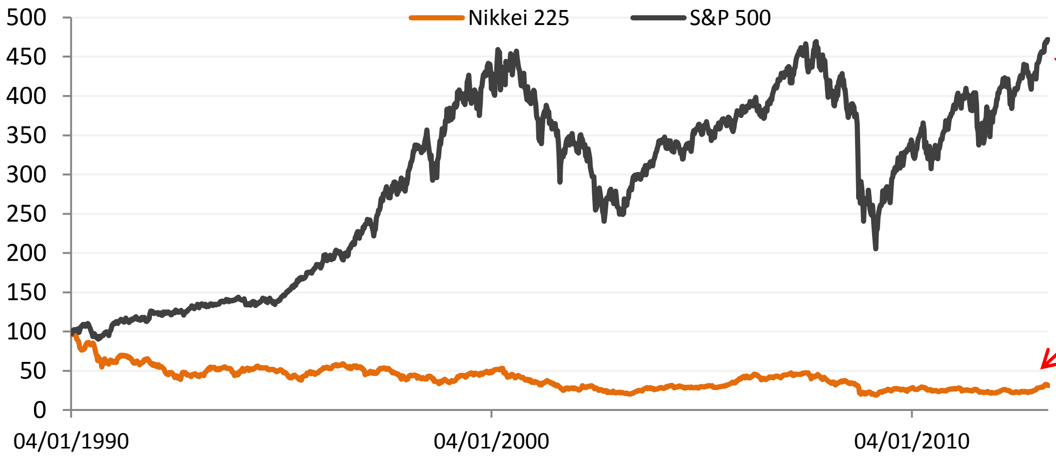
So firstly, we reflect on what led to Japan's meteoric rise and even greater fall. In 1985, **the Plaza Accord** (an agreement between the governments of France, West Germany, Japan, the United States, and the United Kingdom to depreciate the U.S. dollar in relation to the Yen and German Deutsche Mark) **signaled the emergence of Japan as a global market leader**. As a result, a much stronger Yen reduced export-led growth and prompted the Japanese Central Bank to start to print more money and drop interest rates to boost the economy, resulting in **much easier and cheaper borrowing conditions** and leading to a huge increase in asset prices from property to equities (sound familiar?). **Equities soared and a sense of "irrational exuberance" took over.** In addition, much of the growth was fuelled by financial institutions that owned large chunks of each other, creating a virtuous circle that would ultimately turn into a vicious spiral.

The Bank of Japan became naturally very concerned about soaring property prices. Prime commercial property in Tokyo's shopping district was changing hands for over $20,000 per square foot in 1989 and the Imperial Palace was estimated to be worth a little less than the total of all of the real estate in California. As a result they had to start increasing interest rates which in turn put massive pressure on borrowers and destroyed

economic growth. At first investors were relieved that the brakes were being applied to a rapidly overheating economy. **However, slamming on the breaks while approaching a brick wall often leads to disaster**. By 1992, both equities and property values were in steep decline and rapid rate cuts were too little too late as **bad loans piled up and bank equity values tumbled**.

Whilst western markets flourished, during the 1990s **Japan stumbled from recession to recession**, suffering a banking crisis years before our own and with corporate default rates much higher than elsewhere in developed markets. Such was the malaise that whilst **the Japanese equity market peaked in 1989 at a little under 40,000, today it stands at just over 12,000, a fall of 70%** and by 2004, prime property prices had slumped to less than 1% of their value at the peak.

After such dramatic market falls, some, if not all Japanese equities must now surely look incredibly cheap. In principle this is true, however consider that Japanese markets have stayed "cheap" for the last 15 years. In addition, investors have found it very difficult to obtain accurate corporate information about some Japanese companies' balance sheets (take the fraud at Olympus for example) and **opaque/misleading financial information often leads to an inaccurate assessment of a company's real value.** To this end "cheap" doesn't always mean "cheap".



With all of this in mind, **we have largely avoided investing in Japan over the last 10 years**, preferring more transparent and frankly better performing stock markets. So why spend so much time analysing a market that we haven't invested in**? Because we are now considering investing into Japanese equities for the first time in years.**

Last August, Japan's opposition party completely dominated the Liberal Democratic Party in a landslide election victory. **The significance of this victory cannot be overstated**. Shinzo Abe's new government will introduce massive quantitative easing by buying **an extraordinary $140bn bonds per month** (5 times as large as in the US), cut taxes, slash public spending, introduce a 2% annual inflation target and set negative interest rates. These revolutionary measures are aimed at dragging Japan out of its deflationary spiral and back into growth, ending more than 20 years of economic stagnation. Such has been the excitement about these controversial measures that **this policy has been given its own name - "Abenomics".**

It could be the turning point for the Japanese markets as fiscal and monetary stimulus is injected into the economy, devaluing the Yen and boosting asset prices once more. But you might then ask **"Is history about to repeat itself?"** Is this not a repeat of 1985 (see paragraph 3)? Perhaps, but we are starting from such a low base that we feel there is a **considerable opportunity to invest into Japanese equity based on current market valuations**.

Some "aggressive" investors (hedge funds in particular) speculated on the outcome of the election last year and were rewarded with **42% growth since July 2012 as a result.** Given such strong gains and as the market has recently paused for breath, it is fair to ask whether or not this rally is sustainable.

We believe that it is. With the introduction of "Abenomics", we have seen such a meteoric shift in policy by the central bank of the 3rd largest economy in the world that **we believe that this could prove to be the first leg of a more marked equity rally.** Indeed when institutional money managers return to Japan in a serious way (many global fund managers have performed well by simply underweighting Japan over the last 20 years), **momentum alone could drive the index forward in the short term**.

There will always be pitfalls. Short-term political change, which is so often a feature of recent Japanese politics, could result in a change of policy away from "Abenomics". This is a risk. In addition it would be foolish to dismiss the build-up of hostilities between China and Japan over the disputed sovereignty of the Senkaku Islands. However given what we know now, it is fair to say that we are as positive about Japanese equities as we have been for years.

How best then to participate in this market? We believe that "buying the index" through a passive tracker fund is not the right way forward when investing in Japan. We feel that **"knowing your stocks" is so much more important in this market** than in the UK or US and we prefer to access Japan via an established, well regarded, top performing managed fund. We also believe that **investors should buy "sterling hedged" share classes**, so that an investment is protected against further falls in the Yen (aggressive money printing should weaken the Yen further).

With this strategy in mind, **we will be looking to buy some exposure in most clients' portfolios over the weeks ahead and hope that this is the dawning of a new era for investors in Japan.**

Market "Stance" - the chart below illustrates our current general "market stance". Each of the dots on this chart represents a change in this market stance over time. Our current stance is still: **NEUTRAL.** Equities still look reasonable value at these levels as corporate earnings expectations remain positive and strong momentum (as investors rotate out of bonds) should continue to be supportive.