Up until February 2013, we had not held significant investment in Japanese equities for over a decade. Shinzo Abe's massive Quantitative Easing programme changed that, as we realised that Abenomics (the three pronged economic programme referenced in our April 2013 overview) was starting to have a major positive impact on the outlook for the economy after 20 years of deflation. We'd seen QE work in the UK and the US and felt that a similar approach in Japan would have the same effect - inflated asset prices and a declining currency. So far so good but can the same theory be applied to the Europe?

At long last the ECB has finally capitulated and has now embarked on its own money printing campaign. We were sceptical that this might not have the same direct impact as QE in the US, UK and Japan. Also the delicate situation in Greece cannot be underestimated. However there are reassuring signs that what worked for the US, UK and Japan could now work for Europe too. In this overview we compare the similarities between Europe and Japan and consider whether or not a recovery in European equities is as sustainable as the rally that we have seen in Japan.

One of the major causes of the problems in both Japan and the Eurozone lies in excessively high levels of debt. Typically when governments cut spending it is hoped that household and corporate sectors can run down savings to offset the impact. However excessive borrowing both from a personal and a corporate perspective created an even greater recessionary impact in the Eurozone than that felt in the UK and the US in the aftermath of the financial crisis – akin to that in Japan through the 1990's.

Japan through the 1980's enjoyed a period of rapid growth in financial assets and real estate prices as a result of low interest rates, a strong Yen, very significant export-led growth and aggressive lending by financial institutions. Sounds familiar? Consider the peripheral economies in Europe through to 2008. It is difficult to believe now but between 2004 and 2007 Greece was borrowing at lower interest rates than the US and house prices in Dublin increased over five fold in the twelve years through to 2007. There are currently more Porsche Cayennes in Greece than higher rate tax payers.

Like with the Eurozone in 2008, the debt financed bubble in Japan spectacularly burst in 1990, with the benchmark Nikkei 225 losing over 40 % in twelve months and land prices falling by nearly 80 % over the next decade. Whilst not widespread, similar declines were experienced in parts of Europe through 2008/09, with equity markets in Italy and Spain falling over 60% and residential property values in the peripheries declining by over 50% in the past six years.

In Japan the resultant period of deleveraging and low/negative GDP growth (averaging 0.49% between 1980-2015) became known as their lost two decades, characterised by 20 years of sustained deflation (the consumer price index in December 2012 was slightly lower than it was 20 years earlier). In the past twelve months we have seen the emergence of deflation in the Eurozone and but for the strength of the German economy post the financial crisis this would have occurred far sooner.

Along with deflation the Eurozone also shares with Japan the problem of a heavily ageing population. In Germany the average number of births per 1000 population dropped to 8.2 in the five years to 2013 which compared to 8.4 in Japan and 12.5 in Britain.

So there are some structural similarities between the two. However, the consensus is that Abenomics will help to resolve some of these structural issues, in particular the spectre of deflation, and we are hoping that the introduction of QE will bring about similar change for Europe.

Does the ECB understand the full implications of QE?

In April the Euro Area inflation did stabilise and whilst this may only be a temporary reprieve if the oil price drops back again, it is hoped that the European Central Bank (ECB) has learnt from the mistakes that the Japanese made in the 1990's, most notably raising rates and increasing taxes too early. This was acknowledged by Mario Draghi is his speech accompanying the launch of QE when he stipulated that the Quantitative Easing program they were launching would remain in place "until we see a sustained adjustment in the path of inflation".

Comparing Quantitative Easing Programs

	U.K.*	JAPAN	U.S.	EUROZONE
Amount	£375 billion	¥125 trillion	$2 trillion ($4 trillion)**	€836 billion (€1140 billion)***
Percent of GDP	21%	26%	12% (25%)	9% (12%)
Percent of bond market	27%	16%	18%	14%
Percent of annual Gross issuance	91%	69%	26%	54%
Percent of annual net issuance	107%	347%	85%	262%

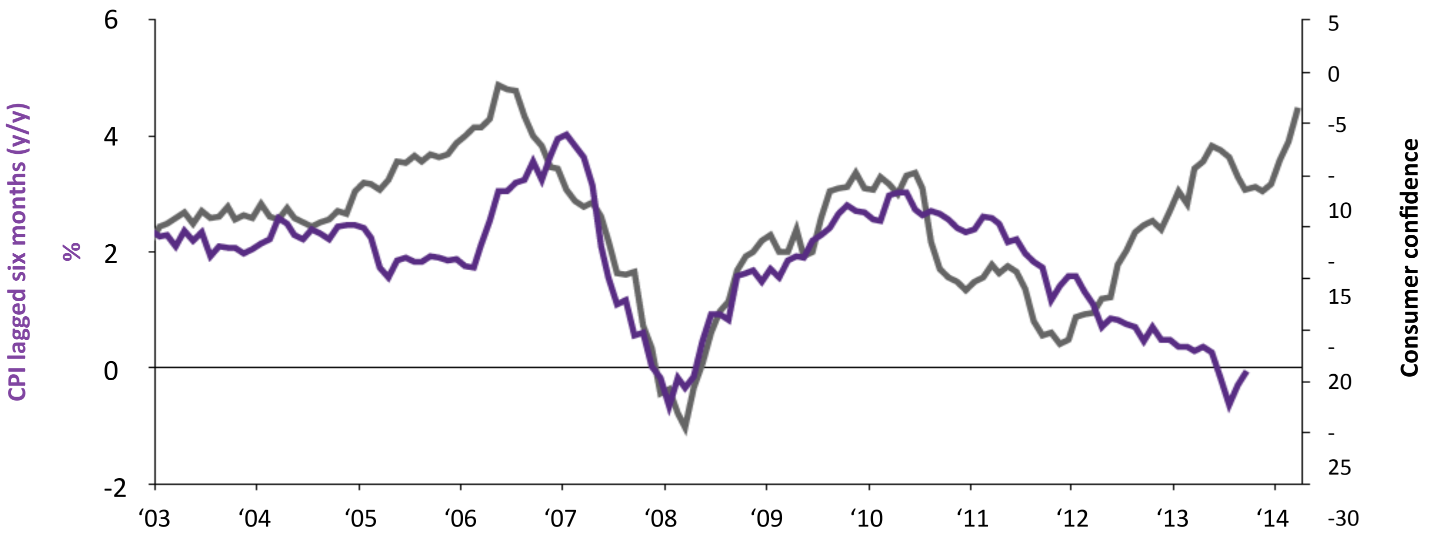
*Amount refers to market value rather than nominal value of bonds bought. ** Including MBS securities purchases. *** Including Covered Bonds, asset-backed securities, and European Institution Debt. Amount refers to market value rather than nominal value of bonds bought.

Although not explicitly admitted, as central banks are keen not to be seen to be actively engaged in a competitive devaluation, one of the primary aims of the European QE programme is to try to increase the competiveness of Eurozone exports through weakening the Euro. In a relatively short space of time, the ECB QE programme has achieved far greater success in weakening the currency than the Japanese central bank policies achieved in the 1990's.

Whilst the ECB has been slower than its UK and US counterparts to react to the threat of low inflation and low growth, mainly due to Germany's historic reluctance to embark on any form of money printing, the fact that they have now taken action has led to a shift in sentiment towards asset allocating in the region. We have already started to see the economic benefits in the form of a weakening currency, improved inflationary data and a raft of more positive surveys, reflected in the consumer confidence data shown below – and this led us to consider investing into European equities for the first time.

Like in Japan, we have chosen to invest into a fund that hedges exposure to the currency, as we believe that further QE can only apply further pressure on the Euro, particularly when the UK and US economies are preparing for interest rate hikes due to a stronger economic outlook. Secondly given our nervousness about Greece we have elected to focus on large companies with an emphasis on exposure to German stocks that export. The weaker Euro will help these companies as exports become cheaper abroad and an emphasis on larger companies helps us to de-risk the impact of more uncertainty in Greece.

We've seen the German stock market fall 14% from its highs and we feel that this is now a good entry point since these companies now look much better value. Our exposure to European equities is a longer-term play for us and whilst we believe that the position will improve there will certainly be turbulence along the way. Our first foray into European markets is therefore a tentative one.



Source: Eurostat, Factset, J.P. Morgan Asset Management.

What has held us back from building a significant weighting to Europe in contrast to Japan where we now hold a significant overweight position? Mainly the environment created by the political situation and the fiscal constraints imposed within the European Union. Shinzo Abe was given a clear mandate to implement his economic reforms in Japan when re-elected in 2014 whereas within the Eurozone there has been an ongoing battle between sovereign states and their largely German paymasters. You only have to look at the current Greek crisis to understand the political pressures that are exerted on such nations at home to ease austerity, whilst at the same time their creditors and neighbours are clamouring for further belt tightening. The situation in Greece makes us nervous in the short term but we feel that the magnitude and power of QE will continue to lead to a re-rating of European company valuations.