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JAPAN 2009: DARKEST BEFORE THE DAWN?

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Japan 2009: Darkest Before the Dawn?

Heading into 2008, we thought Japanese equities would be spared significant losses (although by no means immune to them) and prove somewhat defensive. Our view was based on Japanese equities' sharp underperformance over 2006–07 and their relatively cheap valuations, combined with Japanese banks' lower exposure to "toxic" assets and the generally unlevered and conservative balance sheets of both Japanese corporations and households. The market, however, did not agree. Japanese shares were pounded mercilessly in 2008—the MSCI Japan Index was down nearly 60% from its 2007 peak at one point in October, and the blue-chip Nikkei Index fell to its lowest level since 1982, effectively wiping out a generation of price appreciation.

So were Japanese equities a total bust in 2008? Not necessarily. Given their massively oversold state and depressed valuations, Japanese equities rallied strongly at the end of the year to back above their 2003 lows. They finished the year with a -43% total return—still painful, but roughly the same return as Europe ex U.K. equities, not much worse than U.S. equities (-38%), and better than Asia ex Japan's return of -48%. Nor was Japan's 60% decline since 2007 idiosyncratic; Asia ex Japan equities suffered a slightly greater peak-to-trough loss, reflecting that Asia as a whole is highly vulnerable to a global recession.[1] (See Table A.)

Yet in the end, 2008 will go down as the worst year in post–World War II history for Japanese equities. The market was hit harder than in 1990, when the market returned -40% following the burst of the "bubble economy" of the 1980s. Unlike 1990, however, cyclical shares—not financials—bore the brunt of the current fall, with consumer discretionary (which includes big name exporters such as Toyota and Sony) the worst-performing sector and largest negative contributor to market returns in 2008, returning -53% and accounting for 10.5 percentage points of index losses. Like most other equity markets, traditionally defensive sectors such as health care, consumer staples, telecommunications, and utilities outperformed. (See Table B.)

The real surprise for investors, however, may be the strength of the Japanese yen. The yen rose 31% in trade-weighted terms and 23% versus the US$ (the yen's largest annual gain versus the dollar since 1987), as turmoil in the financial markets forced an abrupt unwinding of the "yen carry trade" whereby hedge funds and retail investors alike repatriated borrowed yen from riskier, higher-yielding currencies and assets (Table C). Measured in any currency other than the yen, Japan was the *best-performing market in 2008*, returning -29% in US$ terms.[2] Japanese small caps (arguably the most out-of-favor asset class over the past few years) proved an even greater relative safe haven, down only 14% for the year in US$. While investors may expect horrible returns given the headlines surrounding Japan's local currency performance, unhedged investors may be surprised to see that their Japanese equity allocations have done relatively well and have likely increased as a share of the portfolio!

[1] The key difference, however, is that Japanese equities have been lagging global markets since 2006, thus making the recent losses that much more painful.
[2] Performance was even better in sterling and euro terms, at -2% and -26%, respectively.

Currency impacts aside, what went wrong for Japan in 2008? Japan's financial system was somewhat insulated from the credit excesses of Wall Street, but weak domestic demand and heavy reliance on exports left the Japanese economy vulnerable to a sharp slowdown in global growth, not to mention a soaring yen. Bridgewater Associates calculates that exports have accounted for over two-thirds of Japanese GDP growth over the past three years, with much of this growth geared to a booming Asia. According to Goldman Sachs, China and the rest of Asia account for 53% of Japanese exports, with China alone accounting for 17%, compared to 15% for the United States and 14% for Europe. Thus once the specter of a global, not just a U.S., recession appeared in October, Japanese equities were crushed on fears of plummeting external demand, fears that seem to be coming to fruition; November saw the largest month-to-month decline in Japanese exports on record.

Meanwhile, continued political musical chairs (Japan has gone through its third prime minister in two years) and backsliding on economic/corporate reform added to the negative sentiment already rampant among foreign investors who dumped Japanese shares wholesale in 2008. Table D shows the massive reversal in foreign buying in 2008, with foreign investors selling ¥3.7 trillion (roughly US$37 billion) over the 12 months to December, the largest net selling since 1990. The impact of foreign investors "giving up" on Japan is significant, since foreign purchases have largely driven the market in recent years as Japanese investors have been persistent net sellers since 2003. As a result, despite owning only 28% of outstanding market capitalization, foreign investors accounted for over 65% of trading by value on the first section of the Tokyo Stock Exchange (TSE) in 2008, up from 41% in 1999 and only 10% in 1988.[3]

If that was 2008, what is the forecast for 2009? Sadly, the macro outlook for Japan is not encouraging. The same structural issues of weak domestic demand and overreliance on exports continue, implying the economy will come under increasing cyclical pressure as global growth slows, corporate profits fall, unemployment rises, and consumers remain justifiably timid. While a host of fiscal initiatives have been announced (notably a ¥2 trillion tax rebate to households and credit guarantees to smaller businesses), these will at best help mitigate the damage, but not halt the slide into recession. Consensus GDP growth expectations for 2009 are rather weak for Japan at around -1.0%, while some forecasters see much weaker growth next year.

Given Japan's economic fundamentals, it will take a rebound or at least stabilization in global growth to turn the economy around in the near term. Yet the issues surrounding the Japanese economy are well known and arguably already in the price, especially after the mass exodus of foreign investors. By late October the return on equity (ROE)–adjusted price-earnings (P/E) ratio, our preferred valuation metric for Japan, had fallen to 9.2, its lowest level since our data begin in 1974 and 1.5 standard deviations below average (over 2.5 deviations below average if the bubble years of the late 1980s are excluded). October's carnage also saw the Japanese market fall to *below* book value for the first time since our data begin in 1974, reaching 0.87, implying corporate Japan was more valuable liquidated than as a going concern. Even after the recent bounce, Japan ended December at an ROE-adjusted P/E ratio of 10.7 and at 1.0 times book value,

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[3] Foreign ownership data are as of March 31, 2007, while trading figures are based on the 12 months to November 2008. Propriety trading of TSE members is excluded to eliminate double counting.

making Japan among the cheapest of the major markets tracked by MSCI on a price-to-book basis. (See Tables E and F.)

Built into these low valuations is a very negative outlook for corporate profits. Based on MSCI earnings data, earning per share (EPS) have fallen some 19% since June 2007, while the MSCI Japan Index has fallen roughly 53% over the same period, implying that the market is braced for an additional 34% tumble in earnings, for a peak-to-trough decline of over 45%. Such a decline would send earnings below their long-term trend level, thus leaving room for cyclical reversion to the mean (Table G). Furthermore, unlike other equity markets, analysts are decidedly bearish on Japanese earnings, with consensus expectations of a 36% decline next fiscal year, by far the lowest earnings growth expectations for any major developed market. Hong Kong and Singapore, for example, are both economies highly reliant on trade and a growing China and have the second lowest earnings forecasts for 2009, with EPS growth of -11% and -10%, respectively. In contrast, U.S. equities are expected to post 3% EPS growth in 2009.

In other words, the bar is set extremely low for Japanese equities next year, and valuations seem compelling despite the economic backdrop. From a long-term standpoint, buying at 1 times book value, even if that book value falls in the short run, has been a winning proposition. Yet the valuation case for Japanese has been made before, only to disappoint. So what are the key issues for Japanese equities in 2009?

- **Global Bust.** Being highly geared to the global economy, a hard landing in China and a deeper, prolonged global recession clearly have the potential to hit Japanese earnings even harder and send valuations even lower. Yet this is the major risk facing all equity markets next year and Japan seems the market most closely (although not fully) priced for this outcome.

- **Foreign Selling.** If a deep global recession forces foreign investors to continue selling Japanese equities, valuations may not find a floor. However, much of the immediate selling pressure may have abated; Goldman Sachs estimates that at the end of October most EAFE managers were already underweight Japan by an average of 9 percentage points relative to benchmark. Perhaps one of the most bullish developments has been the resurgence of domestic buyers, especially individual investors, who bought a net ¥1 trillion worth of equities in the 12 months to December, the largest amount since 1991 (Table D). With overseas assets flowing back home amid the unwinding of the carry trade, some of this money may find its way into the stock market, especially given that the 2.75% dividend yield (DY) on the MSCI Japan Index is twice the yield offered by ten-year Japanese government bonds. As Table H shows, Japanese equities have historically staged a sharp rally whenever DYs have risen above government bond yields. Regardless, the scope for renewed domestic buying of equities could potentially offset further foreign selling.

- **The Yen.** Continued yen strength is clearly a headwind for Japanese equities and has even alarmed global policymakers, with the G-7 granting Japan its blessing to intervene in the currency markets if need be. While similar interventions in the past have proved somewhat fruitless, any signs of a weakening yen should prove supportive to Japanese equities, although this may be a double-edged sword for unhedged foreign investors. Still, in a world of low growth and near zero policy rates in

the United States and possibly Europe, the yen may remain relatively strong until risk aversion subsides (Table C).

- **Political Reform.** Politics could potentially be a large catalyst in 2009, as arguably what Japan needs most is decisive reform from the top. Lower House parliamentary elections are scheduled to be held by September 2009, and should a party pushing a coherent reform agenda receive a mandate from the electorate, the stock market could soar. Such was the case following the September 2005 snap-election, which was in essence a referendum on the economic reform policies of then–Prime Minister Koizumi. Indeed, one could argue that Japan's sharp relative underperformance began after Koizumi's departure from office in 2006 as the subsequent Abe administration showed less reformist zeal. While Japanese politics are messy and Byzantine, we argued last year that a sharp recession may be needed to forge a strong reform consensus; the environment in 2009 may provide just such a crucible. The potentially most bullish outcome would be if the "reform wings" of the two major political parties could break rank and form a new party to end the political stalemate, although perhaps that may be wishful thinking. Continued political ineffectiveness is a risk, but we think this is already built into current valuations.

- **Corporate Consolidation.** A wave of corporate mergers & acquistions in Japan would be a positive catalyst for unlocking value in the market, as it is estimated that 80% of the firms listed on the first section of the TSE trade below book value. Despite the cultural rationales given for the lack of takeover activity in Japan, an ongoing recession may force companies to seek synergies—witness the announced merger of three Japanese insurance companies in early December. At some point strong balance sheets will be put to use, either domestically, or on overseas acquisitions.

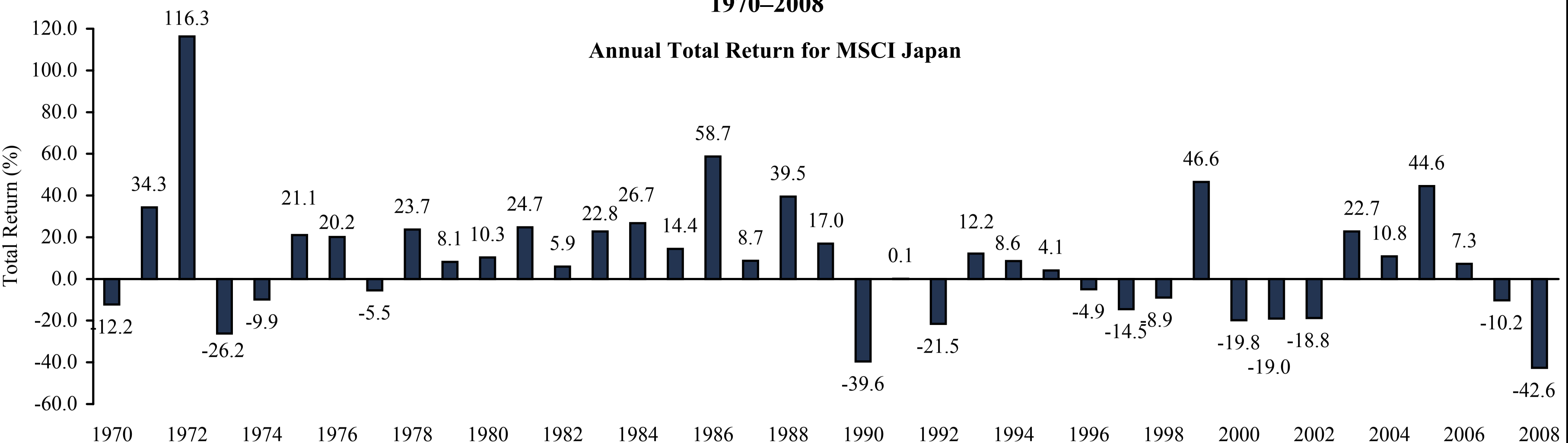
Conclusion

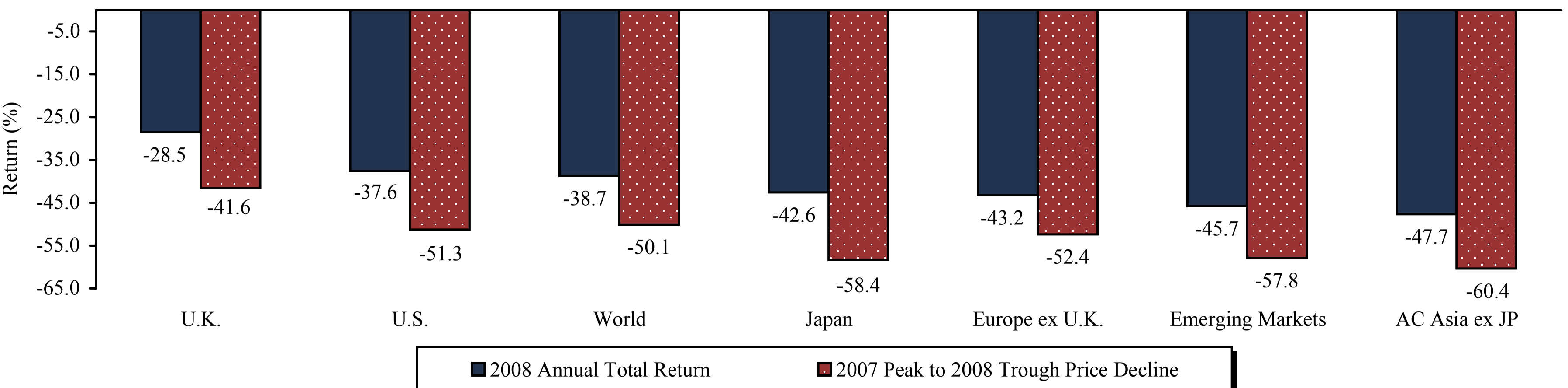
Although we underestimated the extent to which investors would dump Japanese equities (rightly or wrongly) in 2008, those investors that "stayed the course" in Japan last year outperformed the rest of Asia, and those that invested on an unhedged basis benefited tremendously from the yen's rise. While it is hard to be excited about the prospects for the Japanese economy, in our view Japan does not suffer from the same disease now afflicting the Anglo-Saxon world, which at some point should be seen as a virtue, not a vice. There are clear cyclical headwinds, but Japan has already gone through a painful and drawn-out deleveraging and we judge that the risks of a systemic collapse similar to what occurred in 2002–03 are low, given the relative health of the banking system and households unburdened by excessive debt (Table I). Encouragingly, Japanese equities did not break to new lows in November like most developed markets, implying valuations may have reached some sort of floor after overshooting to the downside. The key to unlocking the deep value in Japanese equities remains economic and corporate reform; however, given Japan's low valuations, it may not take much to spark a sharp rally, especially should the global economy begin to stabilize. In short, investors need to stay long Japanese equities, as the risk-reward trade-off is more compelling than ever.

Table A

JAPANESE EQUITY PERFORMANCE

1970–2008





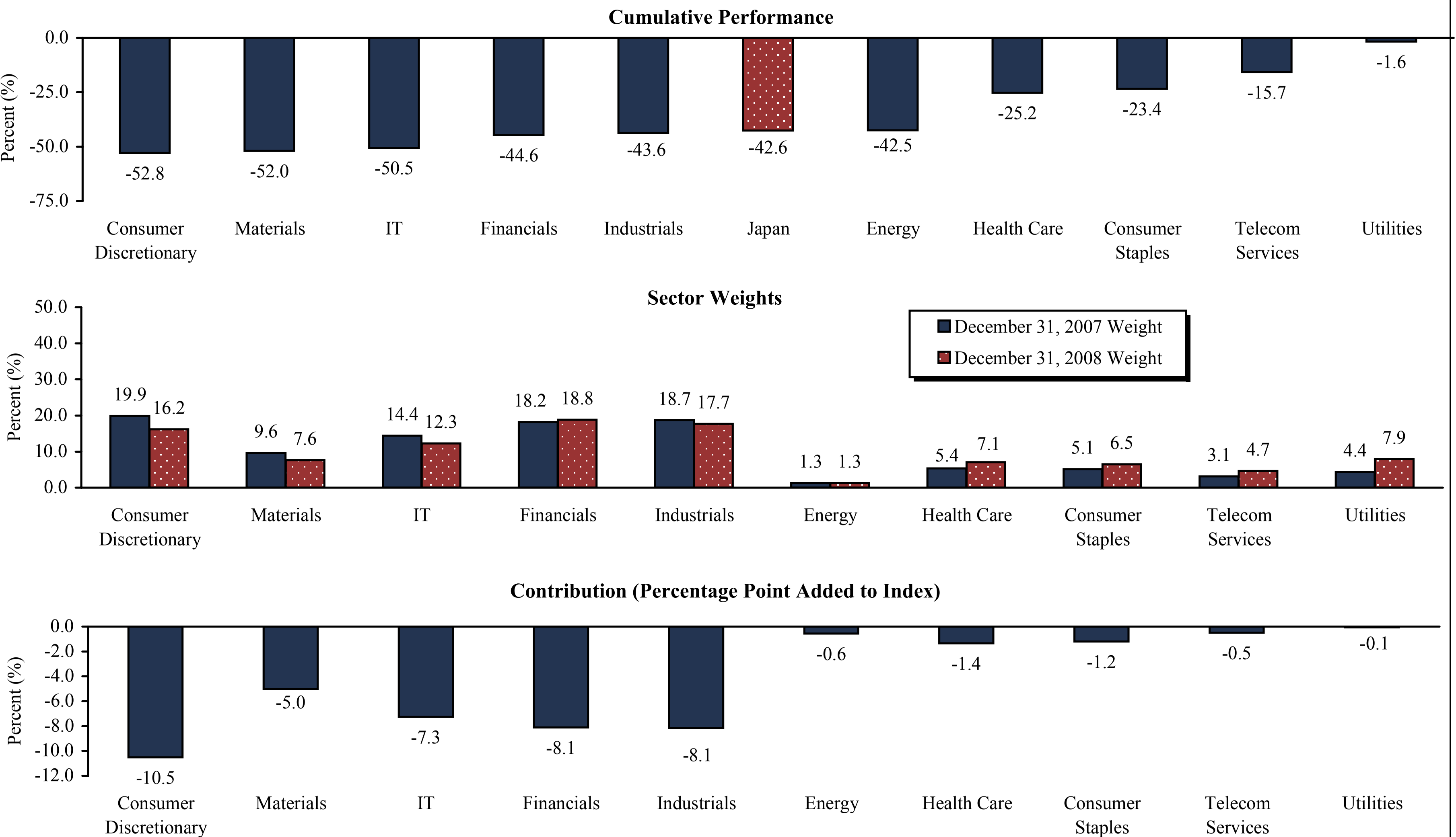
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: All returns based on local currency performance. Regional performance graph sorted by 2008 annual total return.

Table B

PERFORMANCE ATTRIBUTION FOR MSCI JAPAN INDEX

January 1, 2008 – December 31, 2008



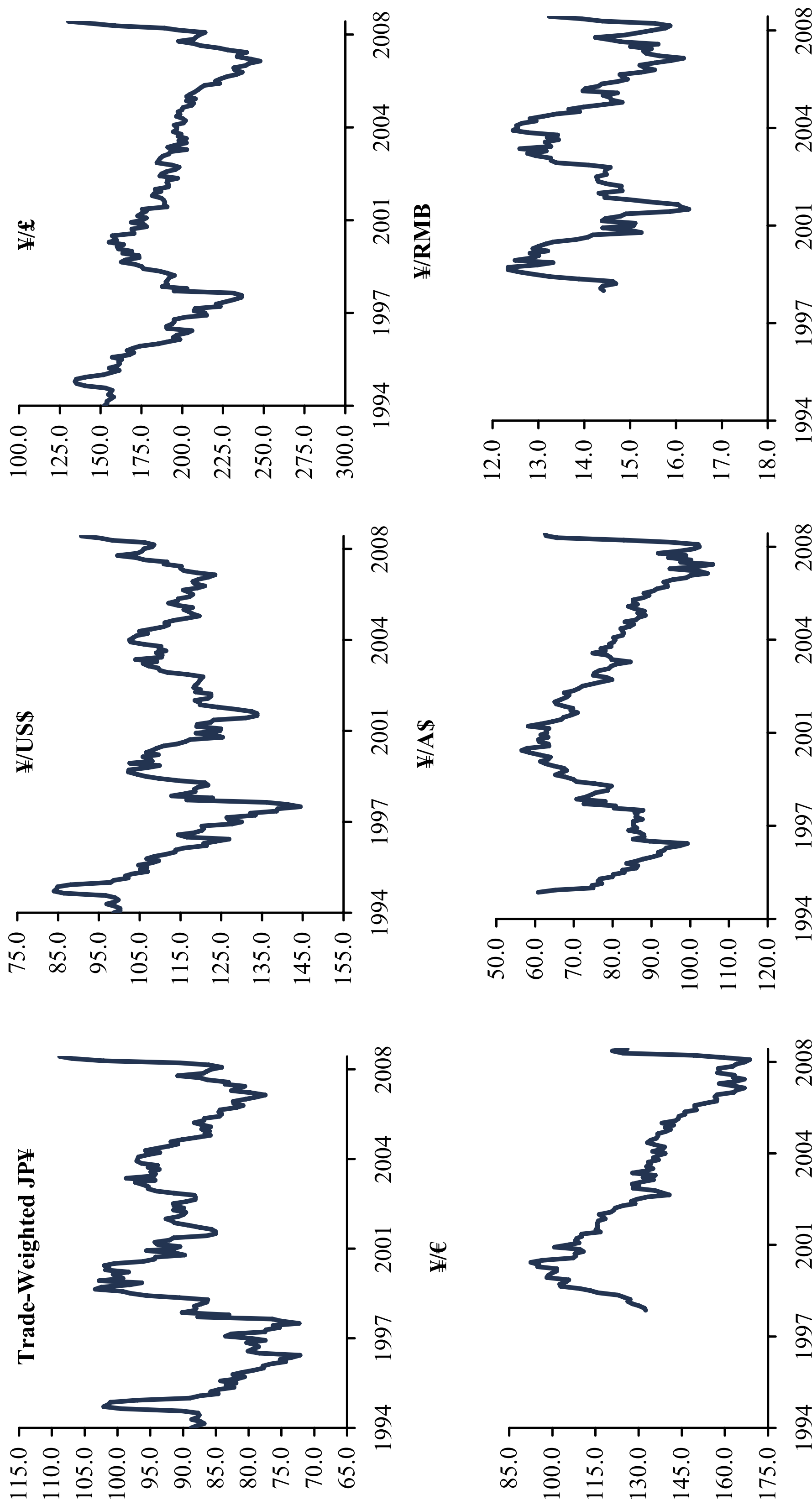
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Contribution represents the sector's percentage point addition to the MSCI Japan Index return of -42.6. Sector contributions are calculated by multiplying the sector's December 31, 2007 weight by its cumulative local currency return from January 1, 2008, to December 31, 2008. Percentages may not total due to rounding. Performance is measured by net total returns in local currency.

Table C

JAPANESE EXCHANGE RATE MOVEMENTS

June 30, 1994 – December 31, 2008



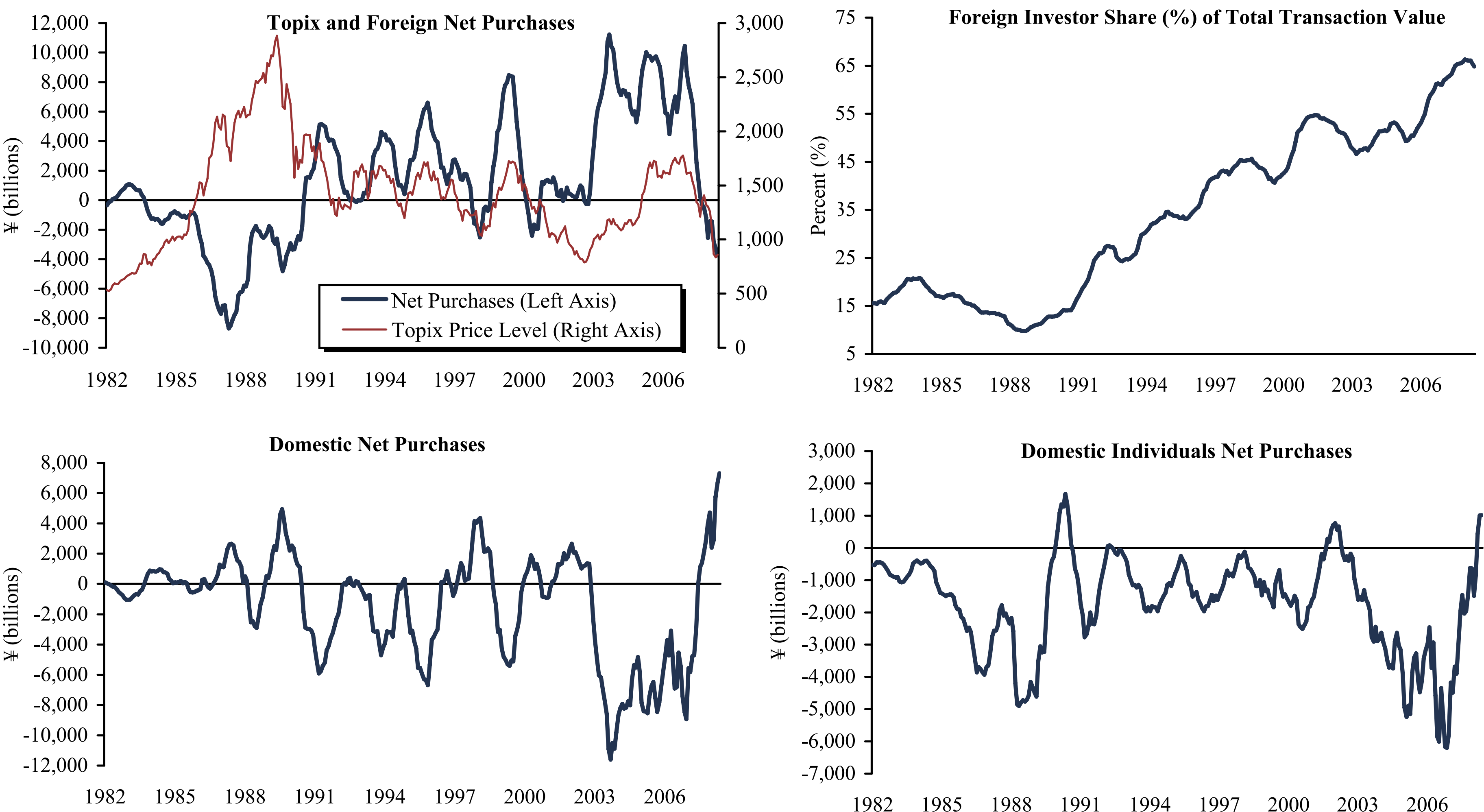
Source: Thomson Datastream.

Notes: Graphs based on monthly data. Scales inverted for every currency graph except the trade-weighted JP¥ to show yen strength/weakness.

Table D

NET PURCHASES OF JAPANESE EQUITIES BY INVESTOR TYPE

August 31, 1982 – December 31, 2008



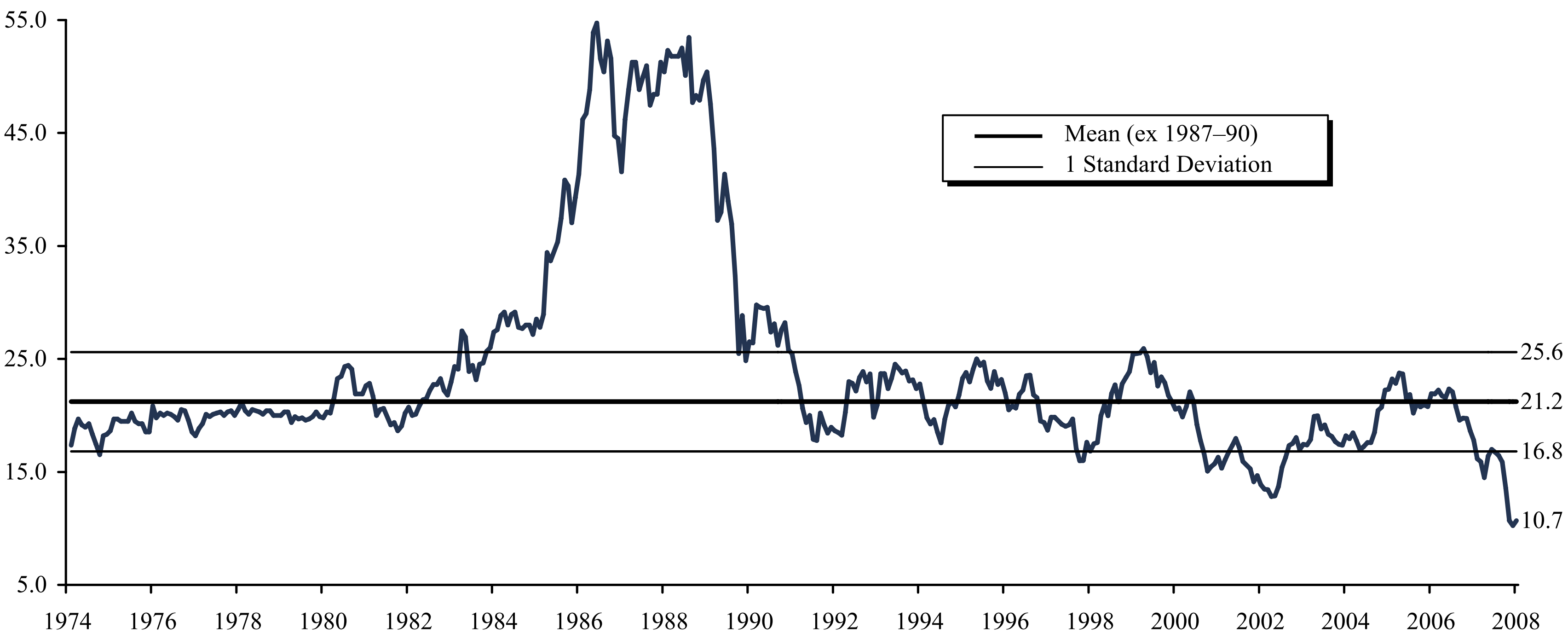
Source: Thomson Datastream.

Notes: Transaction values are for the first section of the Tokyo Stock Exchange and exclude proprietary trading. Net purchases are calculated on a rolling 12-month basis.

Table E

MSCI JAPAN RETURN ON EQUITY–ADJUSTED PRICE-EARNINGS RATIOS

December 31, 1974 – December 31, 2008



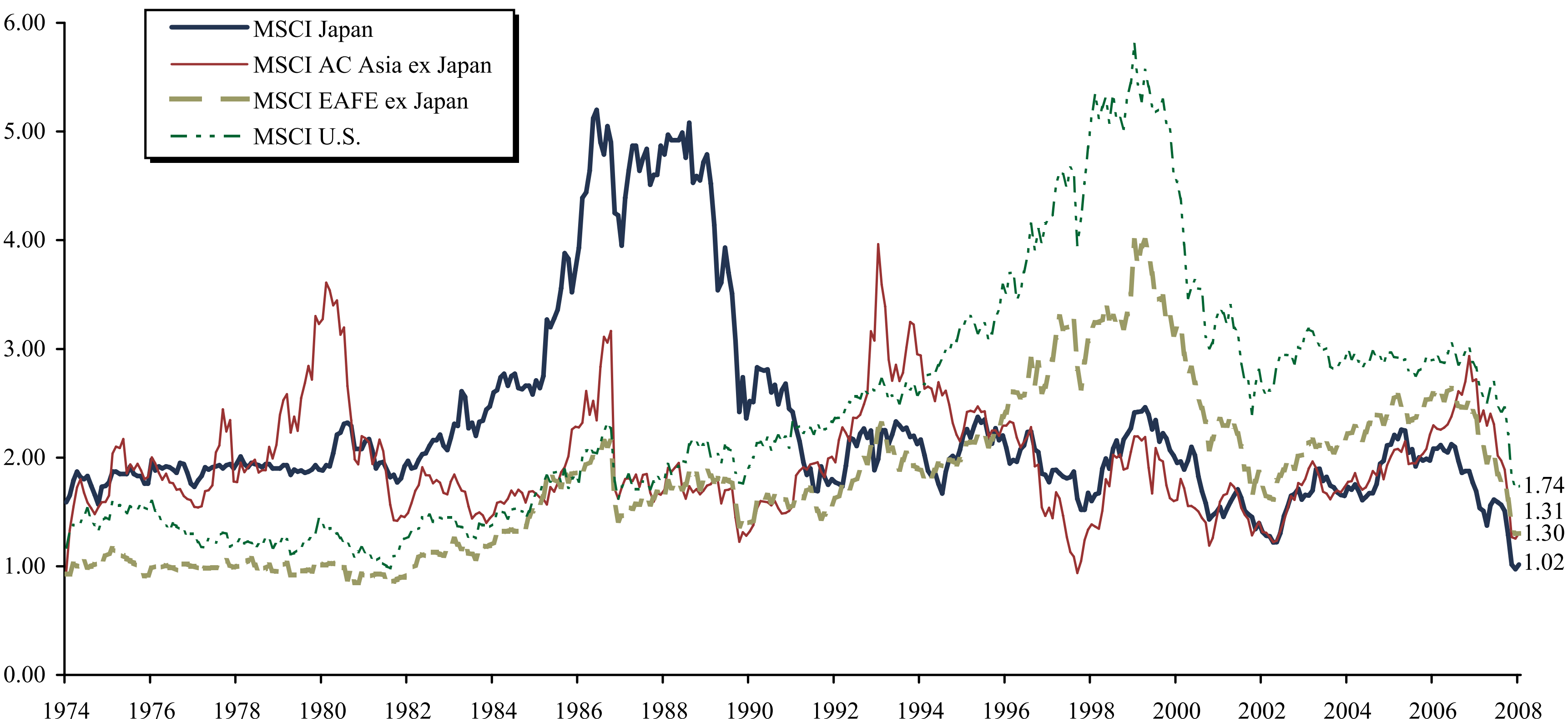
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The return on equity (ROE)–adjusted price-earnings (P/E) ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its normative average ROE of 9.5% (average ROE from 1974–91). To minimize the impact of the late 1980s bubble period on valuations, we have excluded the years 1987–90 from our historical average and standard deviation calculations.

Table F

PRICE-TO-BOOK RATIOS FOR MSCI INDICES

December 31, 1974 – December 31, 2008



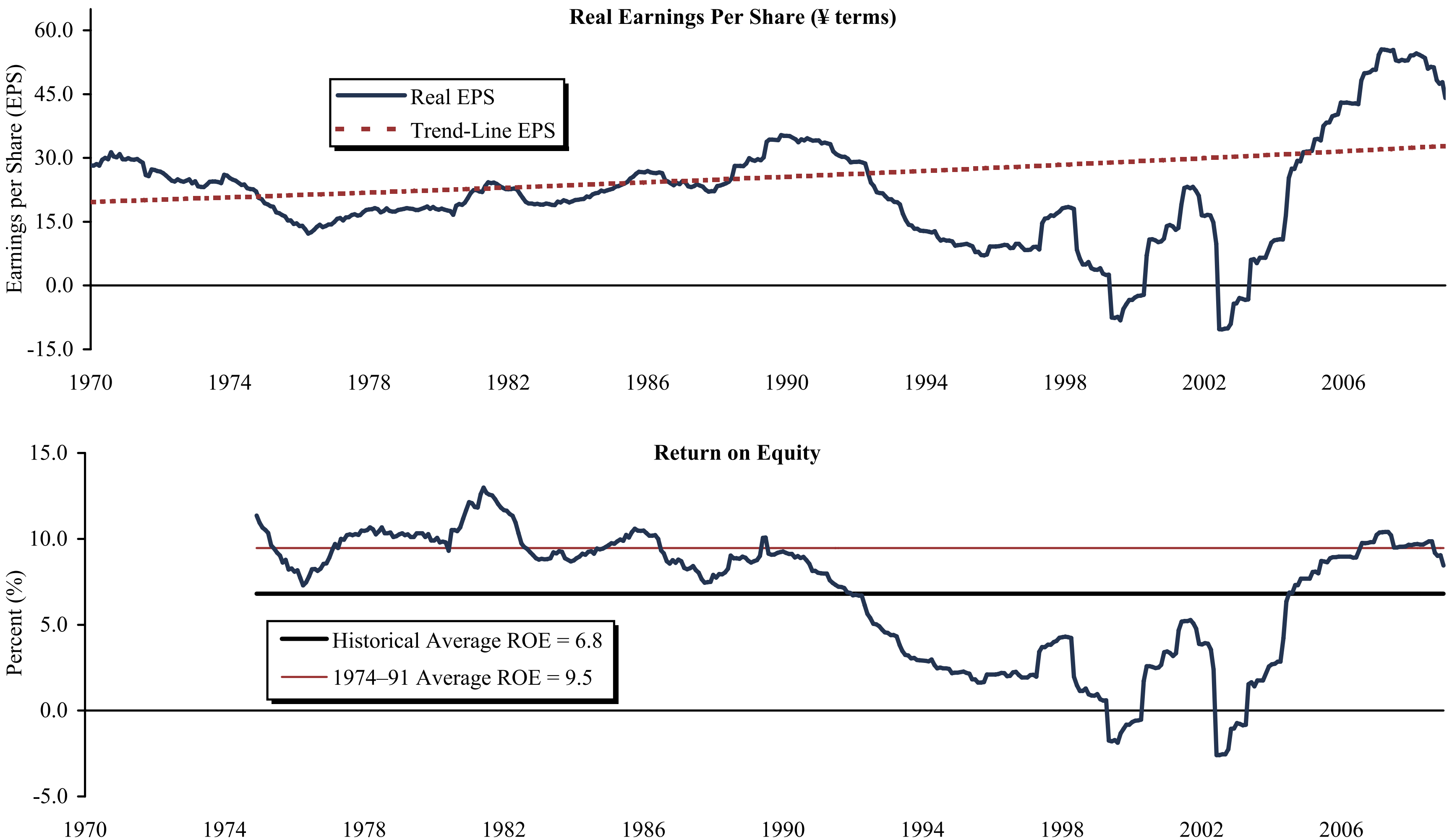
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Valuation history for the MSCI AC Asia ex Japan Index is re-created for the pre–November 1995 period by taking the market cap–weighted average of country level price-to-book (P/B) ratios. From 1974 to 1991, the index includes only Hong Kong and Singapore. Starting in 1992, Indonesia, Malaysia, the Philippines, and Thailand are added; in 1994, India; and in 1995, China, Korea, and Taiwan. Starting in November 1995 the official MSCI Index P/B value is used.

Table G

JAPANESE REAL EARNINGS AND RETURN ON EQUITY

January 31, 1970 – December 31, 2008



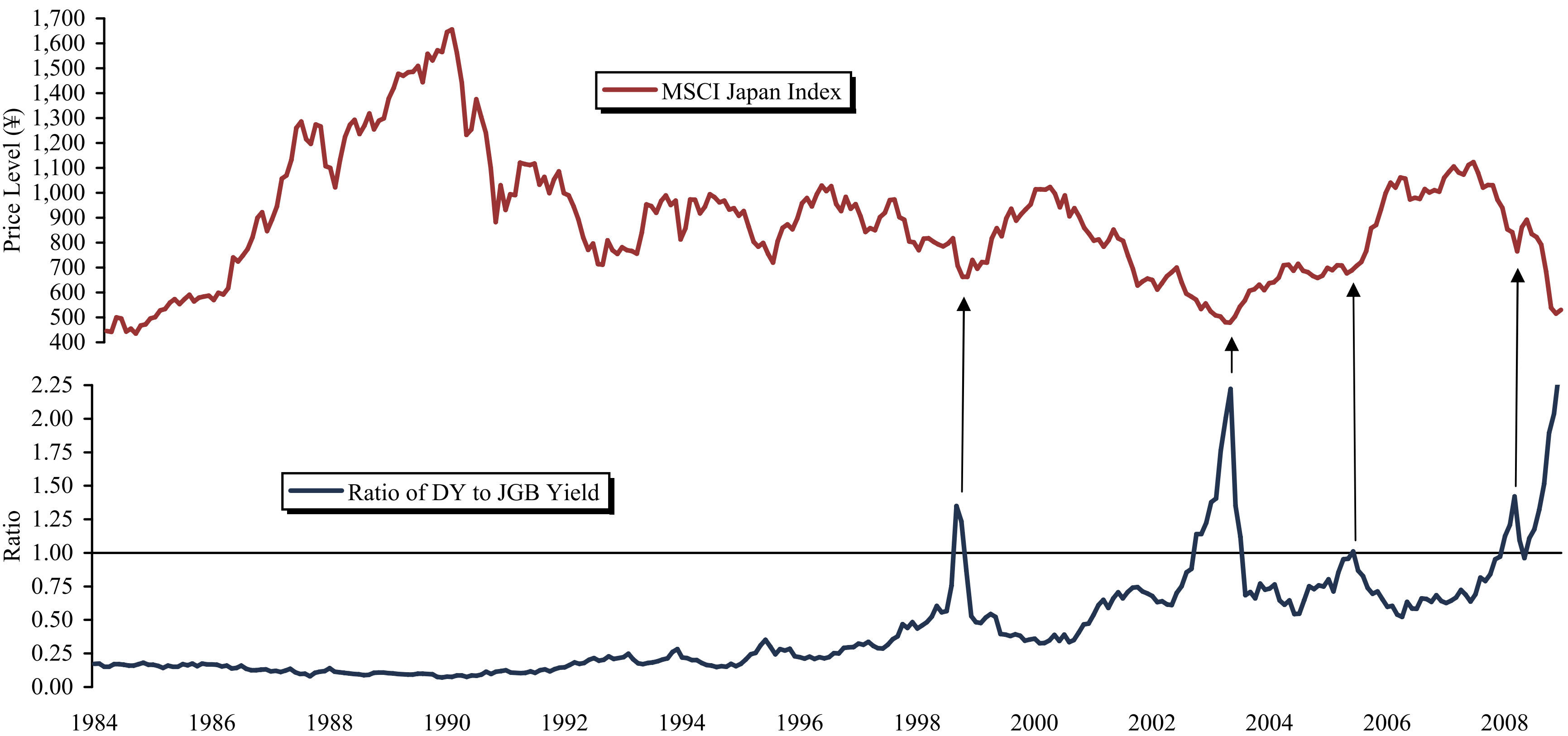
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranites.

Notes: Japanese earnings per share are deflated by CPI-Japan. Trend-line earnings based on simple linear regression.

Table H

JAPANESE DIVIDEND YIELDS RELATIVE TO GOVERNMENT BOND YIELDS

January 31, 1984 – December 31, 2008



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

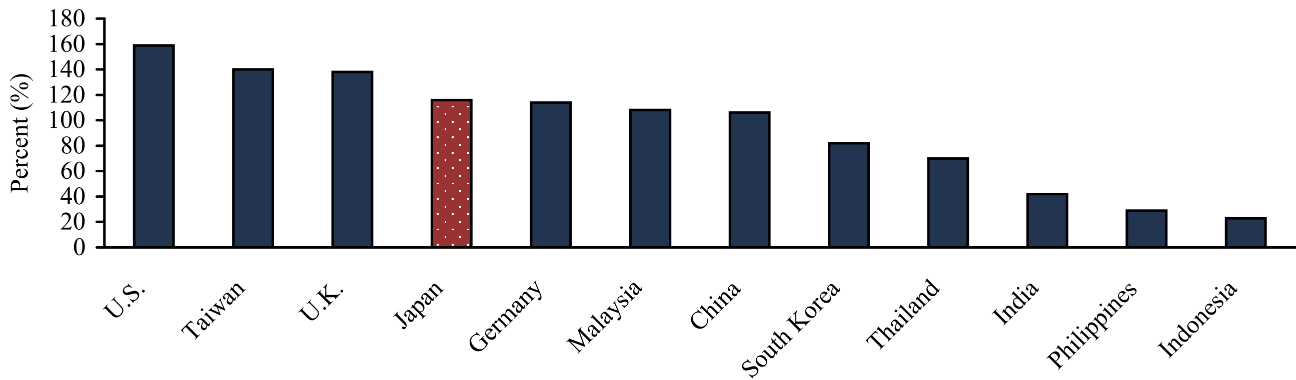
Notes: Chart shows the ratio of the dividend yield (DY) on the MSCI Japan Index relative to the yield on the benchmark ten-year Japanese government bond. A ratio greater than one signals equity DYs are higher than government bond yields.

Table I

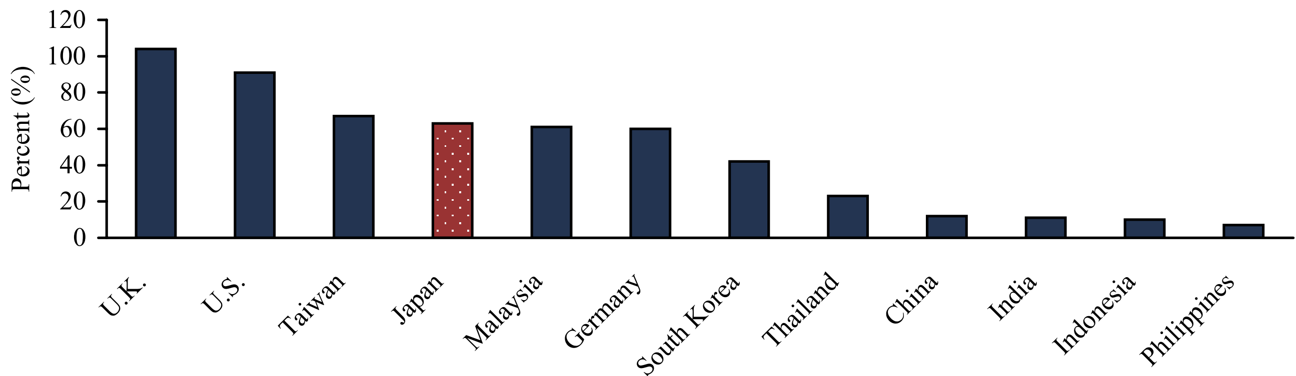
CREDIT AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT

2006

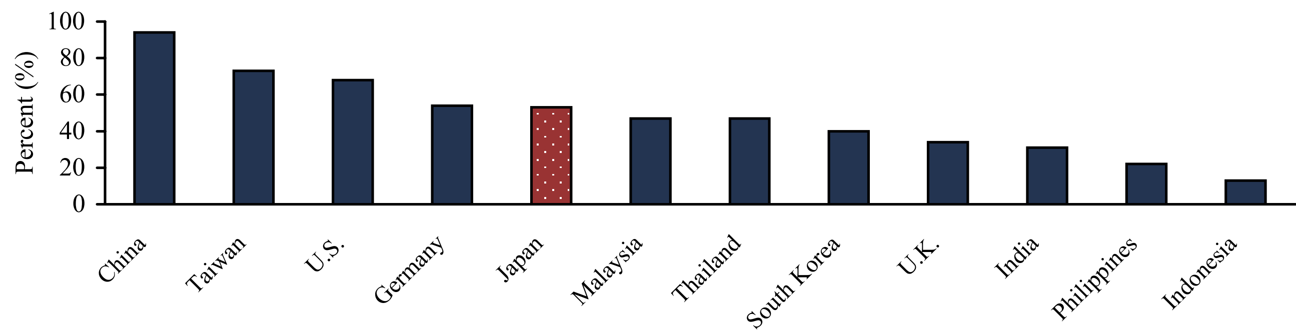
Total Debt as a % of GDP



Household Debt as a % of GDP



Nonfinancial Corporate Debt as a % of GDP



Sources: International Monetary Fund and Morgan Stanley Research.

Note: Total debt does not include government or financial sector debt.