March 2011

What about Japan?

The recent decline in global equity markets shouldn't come as a surprise. Investors became extremely comfortable, arguably complacent, with the equity markets as they have ascended steadily since July 1, 2010. Declines are a healthy cleansing of market optimism.

The horrific situation in Japan appears to be the catalyst for the declines of the past few weeks, but world markets were overdue for a correction. Historically, all disasters are eventually overcome. It won't seem like this nightmare will end for some of the Japanese citizens, but there is a bright day ahead.

You may have noticed recent purchases of Japanese equities in your account. We have written often about the importance of buying good assets at cheap prices. Even better is the situation where the investor community in general dislikes such assets. The Japanese stock market is cheap and disliked.

The Japanese stock market was the cheapest of the developed countries prior to the earthquake. From its high in December 1989 through the beginning of 2011, the Nikkei stock market was down 73.3%. After the recent earthquakes and tsunami, the Nikkei crashed approximately 17.5% in 3 trading days. We believe that the Japanese stock market offers compelling value. At the lows last Tuesday, Japanese stock valuations in terms of price-to-book value (price divided by the intrinsic value) were at a 47% discount to global markets – an all-time low. Japanese large company price-to-book ratios of approximately 1.0 were less than half that of their US counterparts (2.3). Japanese small company price-to-book ratios (0.63) are approximately one third that of the US Russell 2000 small cap index (2.1). Japanese corporations currently hold cash that is equivalent to 32% of their market capitalization. There are 200 small cap stocks trading in Japan for less than the cash they have in the bank!

Japan as an investment theme has been "unloved" by investors for years. Assets in US-based Japanese stock funds have plummeted over the past five years, down 70% since 2006. The top 15 international mutual fund weightings to Japan average 12.5%. This is in contrast to their international index benchmark which has a 22% weighting to Japan. The implication is that international mutual funds could be a significant catalyst for pushing Japanese stocks higher.

In addition to being cheap and unloved, the Japanese stock market is being restrained by the high value of the Yen relative to other currencies. This hurts exports because a high Yen makes Japanese products more expensive to other countries. The Yen has recently traded at a record high against the US dollar. Interestingly, the Yen has rallied during the recent crisis. The main reason for this rally seems to be the purchase of Yen by Japanese as they sell foreign holdings to bring money home to help rebuild. We don't believe that the Yen strength is sustainable. The Japanese public debt is the highest in the world at more than 200% of GDP. The Japanese federal funds rate is less than 0.1%. Japan Government Bonds (JGB's) have recently been downgraded by the various rating services. In the aftermath of the earthquakes, the Japanese government announced their latest round of quantitative easing. Japanese citizens, long among the world's best savers, are entering retirement in droves and will need to sell government bonds to help fund their retirements. These are all negatives to a sustained, highly priced Yen. We believe that the Yen is most likely to experience significant weakness, sometime in the near future.

As we have seen in the US markets, when the government "prints money" and keeps rates low, risk assets such as stocks benefit. Remember, from the moment US QE2 was announced last August, the US stock market rallied 28% in less than 6 months and the USD has fallen 9%.

The primary beneficiary of a devalued Yen is Japanese stocks. Japan is a huge exporter of goods and services to the rest of the world. As the Yen becomes cheaper, Japanese-made goods like cars, semi-conductors, heavy equipment and electronics become cheaper and more attractive to foreign buyers. The more goods Japanese companies sell, the more money they make – and the more they are worth.

We bought Japanese stocks near the lows last week. We don't expect an investment in Japanese stocks to be a straight ride up. There will possibly be follow-on earthquakes (normal following an 8.9 magnitude like the recent one). The nuclear issue is not yet resolved. The Yen may stay strong longer than we anticipate, especially if there is continued deflation in Japan.

All investments involve a degree of risk. Given the extremely cheap stock valuations in Japan, the very low level of investor interest in Japanese stocks and the prospects for the Yen/stock relationship, we believe that an investment in Japanese stocks is prudent at this point in time.