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Outlook on **Japan**

Back in 1989, Japan was feasting on one of the world's largest-ever financial booms; a postage-stamp-sized piece of real estate in central Tokyo was more richly valued than the entire state of California; the "Japan Inc." business model was considered unassailable; and the consensus among the local political and business elite was that these upward trends would last indefinitely. With zero perception of risk, and a central bank willing to be unceasingly supportive of asset-price inflation, at that time, being leveraged and long seemed to be the only intelligent investment option on the table. Cash yields on property were 0.5%; dividend yields, even lower.[1]

Oddly, as this financial bubble was building to a fever pitch, one investor group was somewhat more circumspect. Domestic individual investor holdings of Japanese equities hit a record low in 1989, just as vast numbers of corporations were abandoning any pretense of financial prudence and piling into stocks and property through various "tax-advantaged" investment schemes collectively known as Zaitech, a euphemism for financial engineering through a new-world combination of finance and technology. At the time, did individual investors have any premonition that the Bank of Japan (BOJ), under the aegis of its newly appointed governor Yasushi Mieno, was about to take away the punchbowl on a semi-permanent basis? As he stood in defiance of the political elite, the head of the newly independent agency squeezed monetary policy ruthlessly from mid-1989 onward; and ripped the underpinnings of the financial bubble to pieces.

For the next 20 years, the anti-bubble policymakers in the BOJ were in the ascendancy. Individual investors kept the vast majority of their savings in demand deposits, effectively earning real returns on their investments, with the help of general price deflation. Meanwhile, corporate Japan staggered towards insolvency, as massive leverage and unfunded pension liabilities overwhelmed their ability to generate sufficient cash flow to sustain operations.

These two decades of history have now been singed into the collective psyche of business managers. Today's Japanese corporate sector is generally cash-rich, with cash on hand as a percentage of balance sheets at all-time highs. Pension-return assumptions have been slashed to 3%, and over 70% of investments are held in what are considered safe fixed-income investments, mostly of the domestic variety.[2] Managing for survival is now the mantra among the corporate elite—as apparently it is among the political elite, given the turnover in prime ministers. Zaitech is a long-forgotten term, a relic of a bygone era.

Once again, there is one investor group that appears to be bucking the trend, abandoning the deleveraging frugality that is currently all the rage. Domestic private consumption of large-ticket items, especially houses, has picked up meaningfully in this past year. Developers are struggling to keep up with demand; inventories of new apartments are suddenly at 20-year lows; and prices are rising. Meanwhile, the pressure is ratcheting up on the BOJ to become more forceful in battling deflation, or risk losing its independence; in response, the inflationist camp within the BOJ appears to be gaining strength. It appears that private individuals may have, once again, anticipated a secular shift in policy.

Here we are, two decades after one of the most astounding manias in financial history, looking at anecdotal evidence that the same conditions, in reverse, may be beginning to play out in Japan. The corporate sector—typically a poor indicator of where to put your money—is cash-rich and investing in bonds. Meanwhile, dividend yields are over 2% and cash yields on property are 5%.[2] The private individual—typically a good indicator of where to invest—is leveraging up, presumably in anticipation that inflation is on its way to undermine the value of debt and hurt debt holders, just as 20 years of deflation had previously hurt holders of risk assets.

In Lewis Carroll's book, *Through the Looking Glass*, normal values are reversed and conventional points of view turned upside down. The view on Japan today, espoused by the mass media and most investors, is decidedly downbeat, reflecting years of a deflationary, recessionary, and low-return era that has been viewed as the norm. Yet it appears a few brave souls—domestic private citizens—have begun to step through the mirror to see something entirely different. Historically, this group has been a predictive indicator of the future. For Japan, we believe that future may well be up, not down.

Notes

1 Source: Bloomberg, as of December 1989

2 Pension Joho, as of Q3 2010

Important Information

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