JAPANESE EQUITY

Crunch Time

The bear market that has gripped the world has generated a number of superlatives for investors, most linked to the Great Depression. Hence, media publications are full of comments on "the biggest decline since…"-type hyperbole, which sharpens the debate and contributes to political popular bashing of the rich and attempts to bail out those who suffered the most. In the midst of this, markets appear to have hit a cathartic bottom, from which they have risen—pardon the superlative—at the fastest three-week pace since 1937 during the Great Depression. In Japan, which has largely followed global trends, one of the most noteworthy developments has been the outstanding performance of the auto sector, Japan's most globally exposed cyclical industry.

What does this imply in terms of investors' outlook on the world? First, let's examine some facts: The world has the capacity to produce 73 million automobiles a year. Current global demand is running at 50 million vehicles. The 32% excess capacity guarantees that no auto manufacturer in the world can make money. Historically, due to mix and regional demand variances, 10% excess capacity was the level at which most companies could make decent operating margins. Thus, either demand for autos has to rise 32% or capacity has to be drastically cut to restore profitability. Unfortunately, every country in the world is engaged in subsidy programs to keep auto makers alive and ensure manufacturing jobs are maintained. Without the creative/destructive capitalist influence to force production cuts, restoring balance will be entirely dependent on rising end-demand.

Japan is in a particularly difficult situation. It produces 10 million autos domestically for a country that only purchases 4 million in a year. Excess production is exported, overwhelmingly to developed countries, with the United States as the major destination. Structurally, this is an unsustainable business model. Long-term demand growth for autos is coming not from Europe or the United States but from developing nations, most notably China. Expensive Japanese cars produced at home are not competitive in the Chinese, Indian, or other emerging economies. Low-cost local production is essential. Thus Japan faces a situation in which it will have to move the production of 50% of its total automobile capacity offshore in the coming years in order to remain competitive in this industry. The economic implications of such a wrenching change and its impact on the auto companies and their supply chain are enormous.

This is what makes the phenomenal performance of the auto companies so interesting. Faced with a long-term structural challenge of such importance, we believe profitability is certain to remain subdued for years to come. Yet, investors seem more intent on the implications of a near-term recovery in demand and production, which will make the magnitude of the losses somewhat less than previously anticipated. But the fact is these companies will remain loss making for a long time, and peak margins are unlikely to exceed 2%. Similar blue-sky investment thinking is being replicated in a number of areas exposed to developed country personal consumption, notably the consumer electronics field.

The concern in the coming quarters is how the market is likely to respond to a recovery that is insufficient to move the auto and electronics industry out of the red. As an example, U.S. auto sales would have to rise 40% for the Japanese makers to become profitable again. While the move in the sector during the first quarter of this year was driven by the hope for a profit recovery, news flow in the coming months will be the catalyst for whether there is any fundamental basis in the hope and hype. Given the sheer volume of recovery necessary to restore profits, it is likely that disappointment will be the outcome. Now that the edifice of a recovery has been established by the market, it is crunch time to determine whether it can be sustained. If the reality is a more prolonged downturn in demand than hoped, the automotive and information technology sectors will suffer, and so too will the Japanese market.

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