



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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Is It Time to Invest in the Japanese Stock Market?

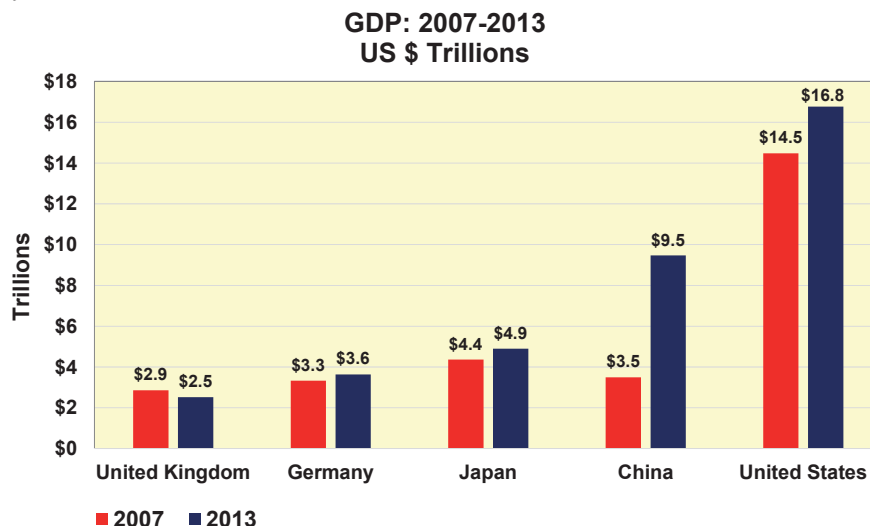
“Once a man’s will is set, he can triumph through any obstacle.”

Shoin Yoshida, Japanese samurai and educator, 1830-1859

Last July, our investment commentary dealt with Europe and the pros and cons of investing in European equities. Many stock market pundits were recommending European stocks last year due to their inexpensive valuations. Our conclusion was that the modest stock market valuation reflected the many challenges facing the European Union and that it would be prudent to avoid most European equities. Most European stock markets did, in fact, decline during the second half of 2014, and they continue to struggle in 2015.

Currently there is a chorus of brokers and investment bankers who are enthusiastic about the Japanese stock market. This is a real change, as Japan has had very serious economic challenges over the past two decades, which is reflected by the decades-long Japanese secular bear market. Having written investment commentaries on Europe, the BRIC countries and Singapore, we thought it would be useful to address Japan – especially in view of the many promising initiatives that Prime Minister Shinzo Abe and his Liberal Democratic Party are undertaking. As with other commentaries about foreign stock markets, this one provides some perspective on Japan’s past and analyzes whether or not it makes sense to invest in the Japanese stock market at this time.

Today, Japan is the world’s third largest economy (second largest until China overtook Japan about five years ago). The chart below shows the size of the world’s five largest economies and their growth since 2007:



Source: International Monetary Fund

Japan's Past

Japan's long history and extraordinarily rich culture necessarily limit our commentary to reviewing events of the recent past as well as outlining the current state of Japan in economic and political terms. In 1600, Tokugawa Iyasu consolidated power at the Battle of Sekigahara and launched the Tokugawa Shogunate, which lasted until 1868. The Tokugawa Shogunate was a feudal, authoritarian and militaristic society. During the Shogunate, the Japanese Emperor was primarily a religious and cultural figurehead. In 1639, the Shogunate ordered that all contact with foreign nations be severely limited. Japan's only regular contact was with China and Korea. Japan was a "closed society." In 1853, U.S. Navy Commodore Matthew Perry sailed a small fleet of steam-powered warships into a harbor near Tokyo and delivered a letter from President Fillmore, demanding a trade treaty between Japan and the U.S. In 1854, the treaty, which granted virtually all of the U.S. demands, was signed and thus began the "opening" of Japan.

Meiji Restoration and Japanese Imperialism 1868-1945

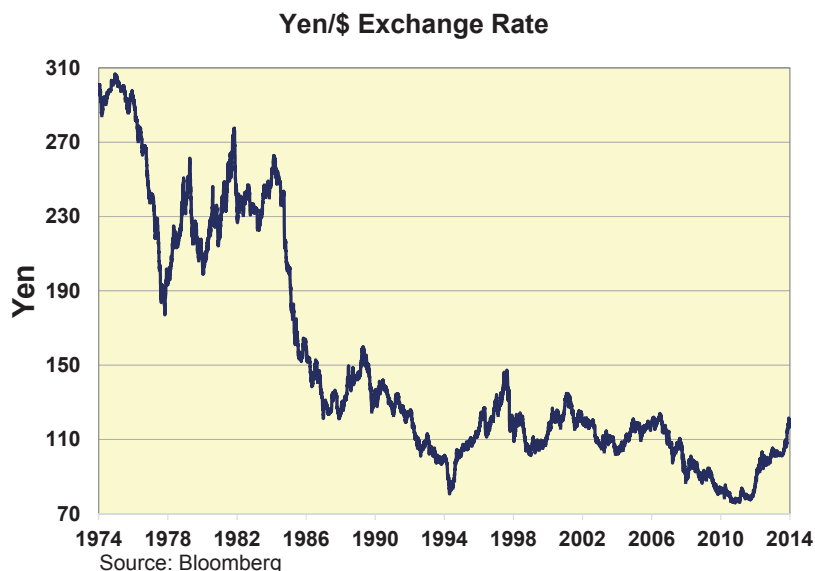
In 1868, the Tokugawa Shogun lost his power, and the Emperor was restored to his supreme position. The Shogun was overthrown by a small number of ambitious, able, patriotic, young samurai, and although the Emperor was "restored" to power, he was expected to take advice from this group of modernizers. During the next 45 years, Japan went through an amazing social, economic, political and military transformation, which was largely peaceful. By the end of this period, Japan had developed a highly-educated population free of former feudal class restrictions, promulgated a constitution and established a Western-style parliament. It had built a rapidly growing industrial base with a modern and effective transportation and communication system. It had a centralized, modern bureaucratic government. And lastly, it had created a very powerful army and navy, as demonstrated by their victory against China in 1894-1895, resulting in Japan's colonizing Korea and Taiwan. Then in 1904, Japan fought Russia, and in three battles, soundly defeated Russia at sea and on land, becoming the first non-Western world power.

In the two decades following World War I, Japan became an East Asian imperial power. With few natural resources, the military-dominated Japanese government sent its army into Manchuria in 1932 to gain more resources. Manchuria became the puppet state, "Manchukuo." In 1937, the Japanese army occupied most of China's coast and then captured Nanking, committing appalling atrocities. The death toll of POWs and civilians at "The Rape of Nanking" is estimated at between 100,000 and 300,000. In December, 1941, feeling stymied by the U.S.'s freezing of Japanese assets in the U.S. and the U.S. embargo on oil exports to Japan, Japan launched a surprise attack at Pearl Harbor and also captured the oil-rich Dutch East Indies. World War II in the Pacific ended in August, 1945 when the U.S. dropped two atomic bombs – one on Hiroshima and one on Nagasaki – at which point Emperor Hirohito, overruling many of his military advisors, surrendered to the Allies unconditionally.

MacArthur and the Japanese Post-War "Economic Miracle"

The American Occupation of Japan lasted from 1945 through 1952. Supreme Allied Commander Douglas MacArthur was the final authority on all decisions during the occupation and rehabilitation

of Japan. There was widespread military, political, economic and social reform at a time when Japan was in flux and most receptive to radical change. A new constitution was passed by the Japanese parliament with many far-reaching changes, including universal women’s suffrage, the renunciation of the right to wage war and the elimination of all non-defensive armed forces. On the economic front, MacArthur promoted land reform, strengthened the capitalism system and broke up the *zaibatsu* – the powerful business conglomerates which controlled large parts of the economy. The impetus of the Japanese “economic miracle” took place in 1950 with the Communist invasion of South Korea, as Japan became the Allied arsenal from which the Korean War was fought. From 1950 until 1990, Japan’s remarkable economic growth transformed it from a country whose industrial strength had been totally destroyed to the world’s second largest economy. The distinguishing characteristics of this “economic miracle” included: the cooperation of manufacturers, suppliers, distributors, and banks in closely knit groups called *keiretsu*; powerful yet responsible trade unions; close interaction with government ministries; and the guarantee of lifetime employment in big corporations and unionized factories. In the West, this came to be known as “Japan Inc.” – a system in which industry was an extension of the government and the leadership elite. There was little surplus capital during this period so that the banks and corporations became highly leveraged. Japan perennially had a large trade surplus and a steadily appreciating currency, and by 1990, Japan had one of the highest per capita GDPs in the world. The Japanese “economic miracle” was the main reason for the remarkable appreciation of the yen, as shown in the chart below:



The 1985-1991 Asset Bubble and the “Lost Decades”

Americans are familiar with asset bubbles, having recently experienced the “housing bubble” which peaked in 2006-2007 and helped lead to the Panic of 2008. The Japanese experienced an even more extreme asset price bubble, which peaked in 1990-1991, leading to almost two decades of economic stagnation. Many will remember the many pundits during the 1980s who forecast that it was only a matter of time until Japan’s GDP would surpass that of the U.S. American high schools and universities introduced courses in Japanese, and U.S. business schools taught their students the supposed keys to Japanese success. But this economic success led to overconfidence in Japan and an overheated economy. Large amounts of capital were borrowed, and banks and corporations became

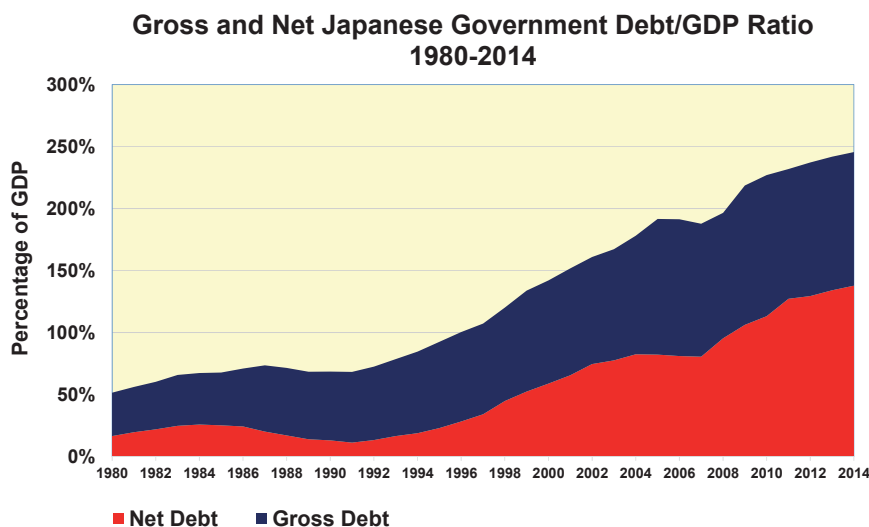
greatly overleveraged. There was rampant stock market and real estate speculation. This led to the rapid acceleration of asset prices, which resulted in an enormous asset bubble. In 1990-1991, the market value of prime Tokyo real estate was 350 times greater than comparable land in Manhattan. There were rumors that the land beneath the Tokyo Imperial Palace was worth more than the value of all California real estate. On December 29, 1989, the Nikkei 225 hit a high of 38,957, having grown six fold in a decade. The chart below chronicles the asset bubble in Japanese stocks and the devastating drop of 81.9% in the Nikkei 225 Index, which bottomed in 2009 at 7,055.



The Balance Sheet Recession

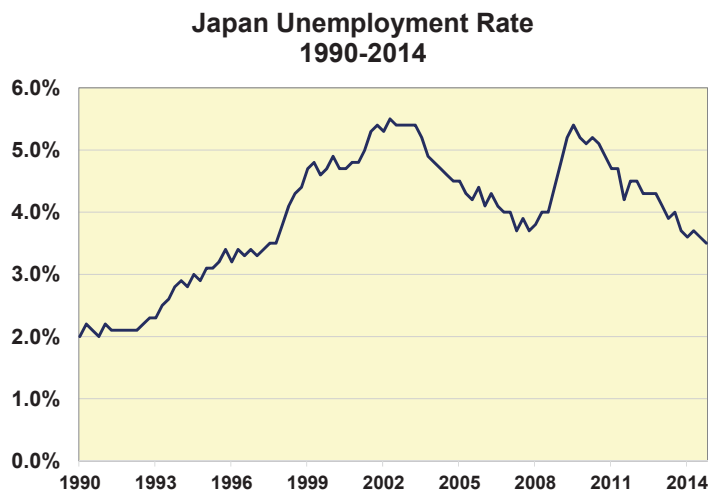
The plummeting prices of real estate and equities resulted in severe financial pressure on the banks, corporations and investors who had borrowed excessively to acquire these assets. In many cases, the loans and other liabilities exceeded the market value of the assets, causing many to be in technical bankruptcy with negative net worth. Most banks had huge amounts of nonperforming loans and assets; these impaired assets often exceeded their capital. On the other hand, most industrial corporations had thriving businesses with strong brands and positive cash flow. What did these institutions and individuals do with their cash flow and savings? They used it to pay down debt, and because of the extreme level of the asset bubble, it took more than a decade to reduce their leverage. This led to what Nomura Economist Richard C. Koo calls “the balance sheet recession” in his influential book, *The Escape from Balance Sheet Recession and the QE Trap*. The rational and exemplary behavior of these overleveraged individuals and corporations caused them to use their savings and corporate cash flow to reduce debt year after year. This, in turn, led to a paucity of capital expenditures and new business initiatives, resulting in very low loan demand. The Bank of Japan has sought to stimulate the economy over the past two decades by increasing the money supply through rock bottom interest rates and providing the banks with abundant liquidity. However, it was difficult to increase the money supply, as borrowers are needed to increase the velocity of money. Japanese banks were unable to find many borrowers – even at near zero interest rates – as most corporations preferred to pay off debt. Once debt was repaid, corporations sought to accumulate large cash balances to ensure they never experienced such financial stress ever again. On a macro level, a high savings

rate often leads to weak aggregate demand in the economy, a lack of growth of the money supply and an absence of capital investment. This can lead to deflation and recession (or even a depression) without fiscal action. In order to prevent this, the Japanese government borrowed year after year, causing its Debt/GDP ratio to reach 245% – the highest by far of any developed nation. The following chart shows the enormous growth in government debt, although the net debt (debt owed to the public) is much lower:



Source: International Monetary Fund

Many politicians and economists have been very critical of Japan’s allegedly profligate borrowing, requiring future generations to pay off the large debts of their parents and grandparents. Richard Koo, however, praises the fiscal action of the Japanese government over the past two decades, as the government borrowing helped to avoid deflation, depression and panic in the wake of the bursting of this potentially disastrous asset bubble in 1990. Remarkably, Japan’s GDP and per capita GDP never declined during this difficult “lost decade” when the damage from the asset bubble was being remediated. Unemployment has also remained low – especially in comparison with Europe and the U.S. The chart below chronicles this achievement:



Source: Japan Ministry of Internal Affairs and Communication

Prime Minister Shinzo Abe

While Japan managed to provide remarkably effective damage control to the economy for the two decades from 1990 through 2010, its economy barely grew at all. The average annual growth rate of Japan's GDP was 0.8% for the 14+ year period from 2000 until now. Government debt climbed every year, deflation was a constant threat, and interest rates were barely positive. One politician emerged to try to get Japan moving again – Shinzo Abe, who quoted the 19th century Japanese samurai and educator, Shoin Yoshida, during a recent press conference: “Once a man's will is set, he can triumph through any obstacle.”

Shinzo Abe is the current Prime Minister of Japan and the President of the Liberal Democratic Party (LDP). Abe is from a politically prominent family. Both his father and his paternal grandfather were politicians, and his maternal grandfather was Prime Minister of Japan from 1957-1960. He grew up in Tokyo and studied political science at Seikei University, graduating in 1977. He later went to America to study public policy at the University of Southern California. He worked briefly in industry at Kobe Steel, leaving the company to work at various positions in the government. He was elected to Parliament in 1993, and was later chief negotiator for the government on behalf of the Japanese families of Japanese abductees taken to North Korea. He was first elected Prime Minister in 2006 but resigned after serving for only one year, when the LDP was caught up in several scandals, causing the LDP to lose control in the Upper House for the first time in 52 years. Abe waited five years and was elected again in 2012 in a landslide election, becoming the first Prime Minister to be re-elected since Shigeru Yoshida, one of the fathers of modern Japan. A month ago, Prime Minister Abe called another general election in order to claim a mandate to support his pro-growth reforms and policies aimed at ending deflation. He won again, and the LDP now holds a 61% majority in Japan's Lower House. Its coalition with the Komeito party gives it a 68% majority, which enables the coalition to override votes in the Upper House of Parliament.

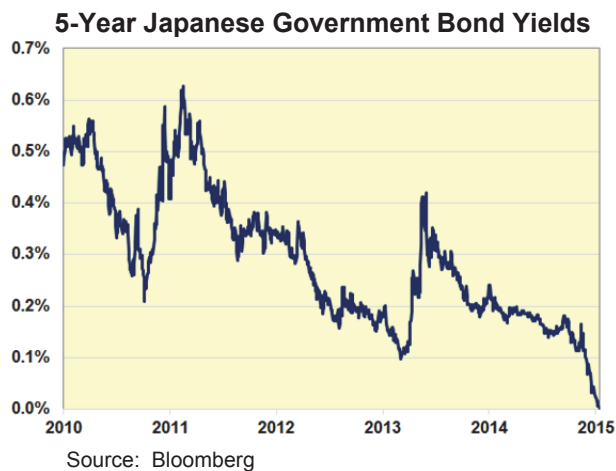
Prime Minister Abe's Three “Arrows”

During his rise to power in the fall of 2012, Abe campaigned on a multi-pronged economic program, nicknamed “Abenomics.” His program is aimed at remedying two decades of economic stagnation and consists of the three major “arrows”:

- Radical monetary expansion through the creation of 60 to 70 trillion yen;
- Fiscal stimulus through a 10 trillion yen (approximately \$100 billion) government spending program to stimulate demand;
- Structural reform including corporate tax cuts, making it easier to lay off workers, agricultural reforms, and even efforts to increase the number of full-time women in the workforce.

Abenomics enjoyed a five-month honeymoon. By late November, 2012, it became clear that Abe was likely to win the election. With the Bank of Japan and the Japanese government poised to provide massive monetary expansion and fiscal stimulus, the markets began to react, and by May 2013, the Nikkei Index had climbed 78%. Simultaneously, the yen had declined from 81 to 103 against the U.S. dollar – a 27% depreciation, which gave a big shot in the arm to Japanese exporters. It appeared as if the Japanese economy would begin to shift into higher gear. However, by

mid-2013, it became clear that most of the stock market and currency moves were due to foreign institutional investors rather than Japanese investors. It turned out that Japanese institutional and retail investors sold equities, and it was foreign investors who provided the buying power to lift the Tokyo stock market. Foreign investors currently own more than 30% of Japanese equities. By mid-2014, despite Prime Minister Abe's expansionary monetary and fiscal policies, the Japanese economy showed little growth. The effort to nudge the inflation rate from zero to 2% has not worked. The private sector has continued to save an aggregate of 7% of GDP annually. The charts below show the yields on the 5-year and 10-year Japanese Government Bond. After a brief climb in yields in 2013, which seemed to foreshadow stronger economic growth, bond yields have continued their decline. As shown below, the 5-year Government Bond is yielding 0%:



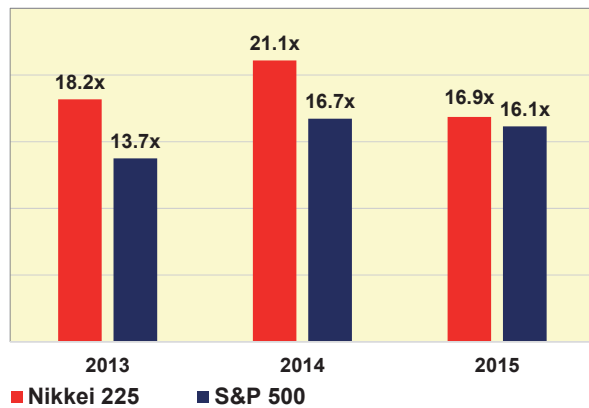
Current State of Play

Abe's first two arrows have been underway for several years. His third arrow of structural reform ran into heavy political opposition in 2014. Efforts to make it easier to lay off workers, changes in subsidies for women staying home, and many other aspects of his program got bogged down. Accordingly, Prime Minister Abe called another election so that if he won, he could claim a mandate to push his program through. He also proposed a delay in raising the consumption tax increase until 2017. Abe won another resounding electoral victory in December, 2014, which should help him implement some of his programs, including a new Stewardship Code for publicly traded companies that emphasizes good corporate governance and higher shareholder returns. An important trend which Abe will not be able to reverse is the decline in population. Japan's population peaked in 2007 with 128 million people and is on a path to decline by about one million people per year. And with one of the highest longevity rates in the world, the average age of the population is increasing. It appears as if immigration is the only solution to this problem, although this is unlikely to occur as the Japanese are very ethnocentric.

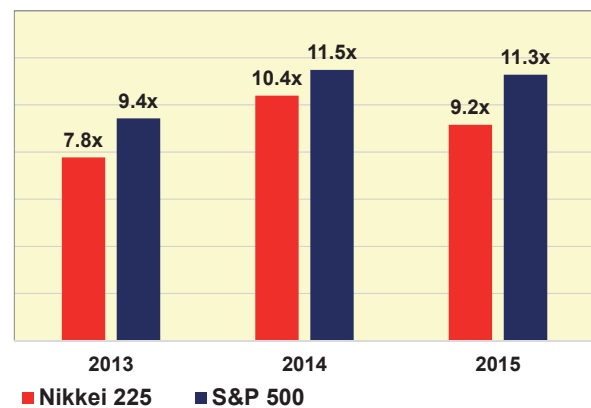
Stock Market Valuation

Before Abe's campaign for Prime Minister in 2012, the Tokyo stock market was quite inexpensive. The Nikkei 225 traded around 8,500; it is now trading around 17,000. The charts on the next page compare the price/earnings and price/cash flow ratios for the Nikkei 225 and the S&P 500. It should be noted that there are certain accounting conventions in Japan which tend to minimize reported earnings somewhat compared with U.S. companies. Price/cash flow ratio comparisons are, for the most part, not affected by these conventions, which is the reason for providing this data:

Price/Earnings Ratios (2013-2015)



Price/Cash Flow Ratios (2013-2015)



Note: P/E Ratios calculated on 12-month forward earnings estimates.
P/CF Ratios calculated on 12-month forward cash flow estimates.

Source: Bloomberg

Weighing the Pros and Cons

The table below outlines both positive reasons for investing and negative reasons for not investing in Japan now:

Pros

- Abe's relentless focus on pro-growth policies
- Fiscal and monetary stimulus
- Introduction of Stewardship Code for corporations
- Oil price drop adds 1%+ to GDP
- Inexpensive stock market valuation
- Govt. pension fund to increase equity allocation by 25%

Cons

- Weak economic growth
- High savings rate, weak demand
- Deflationary environment
- High government Debt/GDP
- Opposition to structural reform
- Serious demographic problem

Conclusion

Japan has come through a potentially devastating asset bubble in remarkably good shape. Although it suffered two "lost decades" with GDP growth of less than 1% annually and was forced to increase its government debt dramatically, Japan managed to remain one of the world's wealthiest countries, maintaining its high per capita GDP level over this difficult period. Now, Prime Minister Abe is pursuing an ambitious growth program with relentless focus, using his "Three Arrows" program. Due to Japan's serious demographic issues and the pattern of robust private sector saving, it is hard to see Japan's GDP growing at the 2-3% pace of the U.S. in the foreseeable future. On balance, however, we believe that the combination of the steep drop in energy prices, the government's fiscal and monetary steps, the increased emphasis on shareholder returns and the inexpensive stock market valuation make it one of the most attractive foreign markets for those investors who want foreign stock market exposure. Due to the possibility of continued yen depreciation, U.S. investors who are attracted to the risk/reward ratio on the Tokyo stock market are well-advised to use ETFs or mutual funds which hedge the yen to the U.S. dollar.

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