HARGREAVEHALE

INVESTMENT BULLETIN

Japan the only land where interest rates do not rise

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The suffering of UK savers continues. Not only are they given no reward for saving but they are actually penalised for putting money on deposit in terms of negative inflation adjusted returns. They are told to have faith in the idea that inflation will fall in the second half of 2011. Fat chance given the way that metals, soft commodities and oils are currently performing.

The devastating impact of rising food prices on the plutocracies of the Middle East has surprised markets, but not yet caused panic. It was fitting that the tinder was a Tunisian trader selling basic foodstuffs from a stall. The disaster scenario of religious fanatics seizing control of Saudi oil supply is still not taken seriously, and given the huge US presence in Saudi it is easy to see why. However, a sharp and sustained rise in the oil price would be extremely serious for stock markets worldwide.

Ignoring for a moment the "Calamity Jane" scenario, UK citizens who have savings to invest have the world as their oyster. After all, UK citizens are free to put their money to work wherever they want. Granted a share certificate is not really what it used to be. If you had decided to back the development of the railways in Victorian England you would have been sent by penny post a beautiful multi coloured engraving of rolling stock, superimposed on your Great Western Railways share certificate. Now it is just a dematerialised line on a Crest holdings report. But although a shareholding is no longer represented by a work of art in the form of a certificate, it does give the investor a piece, big or small, not just in the profits and dividends of a particular company but also in the wider infrastructures, physical, political, fiscal and cultural aspects of the countries in which that company operates.

You can be a retired teacher in Lyme Regis, Dorset, and through the astounding efficiency of the capitalist system you can invest and get dividends from an enterprise in China, Mongolia, Kazakstan, wherever takes your fancy. And the cost of obtaining ownership of such an asset in the form of commissions and stamp duty can be very small. Imagine the sheer aggravation and cost involved in buying another type of asset, such as property in these locations. And if you feel like it, you can sell such an asset and get the money in just three days.

And individuals have an ability they did not possess ten years ago, to get information on such investments via the internet and they get information as opposed to propaganda about countries via instruments like Facebook and Twitter and there is not a lot governments can do about it. Meanwhile the race to create one global exchange accelerates with mergers announced between exchanges in the UK, Canada, Germany and the US in the first six weeks of this year.

As a result, increasingly oddball investments are being opened up. Recent offerings currently on my desk include sovereign bonds in US Dollars on offer from the Republic of Iraq, the Gabonese Republic, the Lebanese Republic, silly examples with minimum sizes largely out of reach of the average investor but interesting yields often over 8% with relatively limited currency risk because of their Dollar status.

Occasionally of course, governments put pressure on the providers and sourcers of information, as the Chinese did last year closing down Google and Facebook. They also control free currency movements between countries, either by dirty floats (China) or interest rates penalties (Brazil). In the UK, who remembers the "Dollar premium", a blunt instrument of the Bank of England to discourage Sterling holders from investing overseas. According to the Centre for Economic Policy research, the incoming government of Mrs Thatcher abolished exchange controls in 1979, not that long ago. With respect to portfolio investment, the controls stipulated that the purchase by UK residents of foreign exchange to invest overseas could only be made from the sale of existing foreign securities or from foreign currency borrowing and as a result foreign currency traded at an implied premium over the official exchange rate which generally exceeded 30% in the period 1974 to abolition in 1979.

So quite recently, within living memory in fact, the Bank of England has been prepared to limit the freedom of UK savers to invest without penalty overseas. Occasionally, in a tight spot, with a budget deficit to finance, with nervous overseas holders of Sterling and a need to encourage investment within the UK, there has been no real alternative. Although a repeat performance is highly unlikely, investors should perhaps remember that existing freedoms are not necessarily guaranteed ad infinitum.

With overseas investments in mind, one big surprise this year has been the performance of the Japanese market. The Nikkei 225 started the year at 10260 and is currently at 10842, a rise of just under 6%. Of course, there have been many false starts and plenty of rallies have petered out in the two decade long fall from the all time high of 39000 recorded on New Years Eve in 1989. At that point famously the Imperial Palace in Toyko was said to be worth more in property terms than the whole state of California.

In the long descent, there have been six rallies that last more than six months and four rallies lasting over a year. There has been a 40% rally, a 50% rally, three rallies of around 60% and even a 140% rally, but all turned out to be rallies in a bear market. What's new?

Well nothing if you believe in a Middle East domino theory which involves the oil price heading north to $150 plus and staying there.

But if you take a less "Calamity Jane" view of markets, and you start looking at comparative world markets, then Japan is starting to look interesting. In macro terms, unlike other emerging markets in the East, such as Indonesia, China and India, Japan only suffers from input cost inflation, as in the West. It does not suffer from demand led inflation. China, India and Indonesia are vulnerable to demand led as well as input led inflation as their consumers start to replicate the behaviour of Western consumers in the 1950's. Hence inflationary pressures are higher and interest rates have to be raised higher. The result is underperformance in stock markets, with the Indian market down 11% in the last three months and the Chinese market down over 20% since the beginning of last year. The contrast with the Japanese market is interesting.

In the West, of course interest rates are also rising but largely only in response to cost push pressures. Consumer demand remains weak, housing markets remain weak, wage pressures remain weak and Central Bankers are still keeping a weather eye on deflation. Hence, the rise in interest rates has been relatively muted and has come about as a result of a minor market led sell off of government bonds rather than, as yet, official government action on interest rates. The pressure on investors is to find somewhere to put money to protect against the alternative of negative interest rates. Hence the somewhat crablike movement in western markets in recent months. In the West inflation is rising off a base of 2%. In Japan inflation is building off an inflation rate of just 0.3 %.

The Japanese of course have been dealing with the problem of low inflation/deflation for decades. They had the crash which we have just experienced some twenty years ago, when property values cratered and bad debts threatened the stability of their financial system and they have been working their way out of it ever since. Progress towards the creation of significant GDP growth has been pitifully slow. Rather unnervingly, almost uniquely amongst far eastern economies, Japan's economic development post 1989 has proved something of a mirror image of post crash Western economies with the possible exception of Germany. If you look at the demographics of an increasingly ageing population combined with subdued consumer demand. If you look at the failure of the banks to lend despite monetary growth, the similarities are striking. It is true that Japan's level of national debt to GDP, some 200%, following years of accruing fiscal deficits as a result of government infrastructure spending is well north of even Greece or Italy. Possibly something of a warning to politicians in Europe and the US labeled as "fiscal deficit deniers".

Years of underperformance and disappointments have taken their toll on Japanese equity valuations. However, in September last year, something strange happened. The historic multiple of the Japanese market fell below that of the US market, an event last seen in 1973. This is particularly interesting in view of the fact that Japanese corporate profit margins have traditionally been between 25% and 30% lower than their global competitors. This has been the result of a combination of factors: limited growth in domestic consumption, an absence of inflation and indeed flirtations with deflation, and falling nominal and real wages. A strong currency also impacted exporters profit margins. Since 1973, the Yen has appreciated from 300 Yen to the Dollar to 82 Yen to the Dollar. What the Japanese economy has really been suffering is the reverse multiplier effect. Lower profit margins, lower tax take, lower real wages, lower consumer demand, deteriorating demographics, etc, etc.

But investors seem happy to look beyond such stark negatives. They even seem happy to ignore the repeated warnings over the stability of the Japanese sovereign debt market. This is in part because the national debt in Japan is mainly financed by domestic savers and therefore not susceptible to the whims of foreign bond investors. But another downgrade in the status of Japanese government debt, which is bound to happen, is not necessarily bad news for Japanese equities.

Sentiment seems to be changing partly as a result of what is happening in other markets. In the West, interest rates are starting to rise in reaction to increasing input prices, and in emerging markets they are rising both because of the combination of rising input prices and growing consumer demand. Japan is sitting somehow in the middle but it is perceived to be more or less the last man standing when it comes to raising interest rates because of very low levels of inflation and decade long flirtations with deflation.

In Japan, the big news is that the Bank of Japan has revised upwards its 2011 inflation forecast. Inflation will be 0.3%, up from the 0.1% previously estimated. In addition, last year for the first time in decades, GDP growth was a positive and forecast growth during 2011 is 3.3%. Higher GDP could well start to generate a virtuous circle of higher tax revenues, higher employment, higher wages and most important corporate margins. This is especially the case, because the Japanese authorities will continue to be very reluctant to raise rates because of the fragility of their bond market. Every 100 basis point change in the weighted average cost of sovereign debt is equal to 25% of the central government's tax revenue. This should mean that the Bank of Japan will prefer to monetise sovereign debt by printing money to buy anything issued. This will prove inflationary which is exactly what Japanese equities need. Add to the pot a weaker Yen as comparative real interest rates rise in other economies, and a positive multiplier effect takes hold. If this starts to happen, the big surprise would probably turn out to be a jump in tax receipts and corporate profitability.

Japan's economy should prove more resistant than most to higher inflation and higher interest rates. In addition, the long decline in the Nikkei has collapsed the value of equities to the point where they look good value. In relation to the US, for example, price to book in Japan is 1.0 times, and in the US is 2.0. Comparitive PER's are 15.9 and 16.0 respectively. In terms of yield, it is 2% in Japan and it is 1.8% in the US.

To obtain a spread of equities we are buying three Investment Trusts, Baillie Gifford Japan, Fidelity Japan Values and JP Morgan Japan. Baillie Gifford and Fidelity Japan both have a concentration on medium and smaller Japanese companies, whilst JP Morgan has a concentration on larger corporates such as Honda, Mitsubishi and Sumitomo. Full details on request.

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