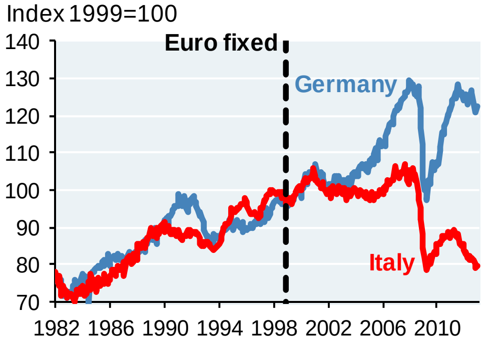
Topics: The possible economic and investment impact of Japan's monetary and fiscal bazooka; and the latest round of historical revisionism in Europe

This week's note focuses on Japan's rising equity markets, but first, a comment on Europe. Jean Claude Juncker, Prime Minister of Luxembourg and former President of the Euro Group, was quoted in Der Spiegel last week as saying that there are disturbing parallels to Europe in 1913, before the First World War, and that "*those who think that the question of war can never be raised in Europe any more may be massively wrong. The demons are not gone, they are only sleeping*." He proceeded to use this as a justification for keeping the Euro and sticking to the austerity program. What should one make of such remarks?

If the Euro makes sense in the long run, it will be because of its economic advantages, not its political ones. I have doubts about the former (see our May 2012 chart on EU economic dispersion vs countries starting with the letter "M"), but time will tell. In any case, using the threat of war as a justification for the Euro is ridiculous. From 1900 to 1945, tens of millions of Europeans were killed in wars with other European countries; practically none[1] have been killed since, and this has nothing to do with Europe using a single currency. The explanations for Europe's demilitarization are complex (the Cold War, the Marshall plan, Germany's demobilization), but history shows that a lasting peace in Europe was won decades before the Euro was introduced. "*Where have all the soldiers gone? The Transformation of Modern Europe*" by Stanford's James Sheehan shows how 1945, rather than 1968, 1989 or 2001, was the turning point for the continent. As a result, comments like Juncker's appear to be part of a Creation Myth advanced by some EU politicians: the idea that European citizens must accept further supranational governance to prevent future conflict.

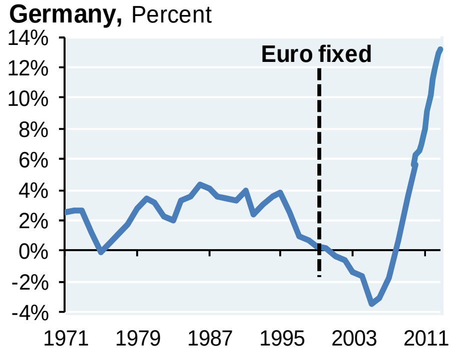
For what it's worth, if there *are* rising regional tensions in Europe, it's not difficult to identify what's causing them. There is a common denominator at work below: the Euro is the primary catalyst for the continent's dislocations, imbalances, and painful adjustments. While the European *Union* has been an anchor for peace, the *Euro* has not. In the end, economics trumps politics.

Germany vs Italy: Industrial Production
Index 1999=100



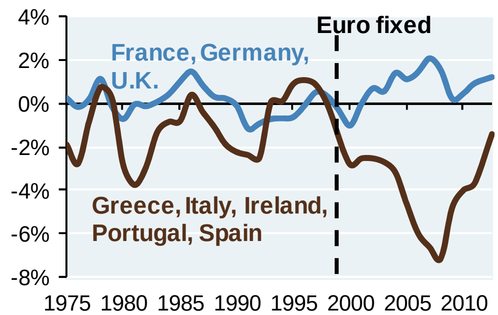
Source: OECD, GaveKal Securities.

Unemployment: Euro Periphery minus Germany, Percent



Source: JPMAM, BoS, BoP, OECD, NSS, IMF.

Current account deficits
Percent of GDP



Source: OECD.

I would downplay for now some of the issues you might read regarding contagion risk from Cyprus, which is a bit of a special case[2]. In the U.S., the private sector is doing OK, with household demand, housing, spending, production and employment all running at a solid pace. **And now, onto Japan, which has registered among the highest equity market gains of the year, particularly for investors that also positioned for the Yen's decline.**

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[1] This number would be 140,000 if casualties resulting from the disintegration of Yugoslavia in the early 1990's were included. The Balkan countries are "European" (they are almost all candidates or potential candidate countries for EU accession), but the disintegration of a multi-ethnic/religious country is not something likely to repeated elsewhere. Another 15,000 were killed in the 1956 Russian-Hungarian conflict, and 5,000 during the 1974 conflict between Turkey and Greece on Cyprus. However, for these purposes, I would not characterize Russia, the North Caucuses or Turkey as "European", despite their membership in the "Council of Europe", an umbrella organization of 47 countries which also includes Azerbaijan and the Ukraine.

[2] Germany's Federal Intelligence Service (the BND) concluded last fall that an aid program for **Cyprus** would benefit certain Russian depositors with billions of dollars in deposits in Cyprus, and that "*Cyprus is a gateway for money laundering activities in the EU*". The politics of the EU seem to require harsher treatment for Cypriot bank depositors (partial confiscation), but I am not so sure this is a paradigm for what will happen elsewhere, and why this would be more of a problem for depositors or financial markets than private sector losses already imposed on Greek bondholders while the ECB was kept whole. The Eurozone makes its idiosyncratic decisions based on different circumstances, and frequently changes its mind; that is the lesson of the last 4 years. Europe's destiny, whatever it is, will likely not be shaped by what happens in Cyprus. The bigger issue to me, as we have shown in recent weeks, is how growth conditions in France, Italy and Spain are weaker than they have been in a century, other than during the deprivations of wartime.

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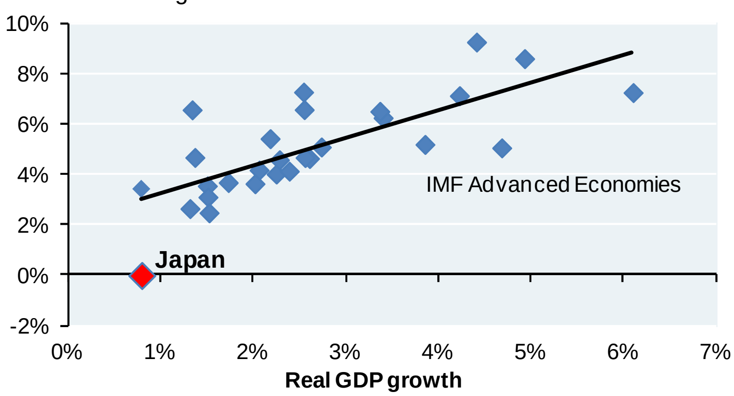
***Desperately Seeking Shinzo*. Pressures from low growth, stagnant profits and lost competitiveness have apparently reached a breaking point not just economically, but politically. The Shinzo Abe Administration differs from its predecessors, and appears intent on breaking the cycle of deflation. As mentioned in our 2013 Outlook, while there are structural problems in Japan, aggressive monetary and fiscal policy could move those issues to the back-burner as far as markets are concerned in 2013. This looks more like a "trade" than a long-term investment, but for investors able to hedge the Yen exposure (given Japan's intention to debase it), Japanese equities may continue to perform well for a while longer, even after the rally since last fall. Like the cicada which lives underground for 17 years and then emerges for a short period above ground, 2013 is a year in the sun for Japanese equities after 2 decades of underperformance.**

Background on the Japanese economy in 5 simple charts

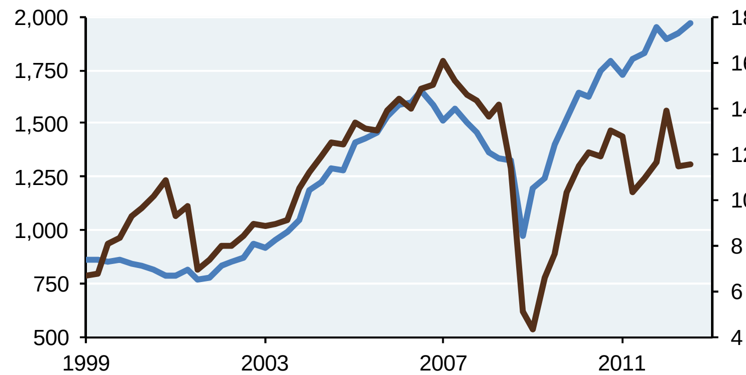
Both nominal and real growth in Japan have stalled since 1990, with Japan exceptionally low in nominal terms. Corporate profits have stagnated as well while the rest of the world has seen corporate profits rebound. Cash earnings by employees have collapsed, and are now back (amazingly) at the same level they were in 1990. For context: in the US, average hourly earnings have *doubled* over the same period. Another sign of pressure: Japan's long-standing trade and current account surpluses which prevailed since 1980 have evaporated. And of course, there is Japan's gargantuan government debt which is over 200% of GDP. If Japan had grown at just 3% (nominal) over the last 20 years, we estimate that its debt ratio would be 130% instead. The surprise to me is it has taken this long for Japan to find the situation intolerable. My guess is that the pressure for change is coming from the corporate sector, rather than from aging households.

Japan growth, 1991-2012
Nominal GDP growth



Source: International Monetary Fund.

US vs. Japan corporate profits
Billions, USD Trillions, JPY

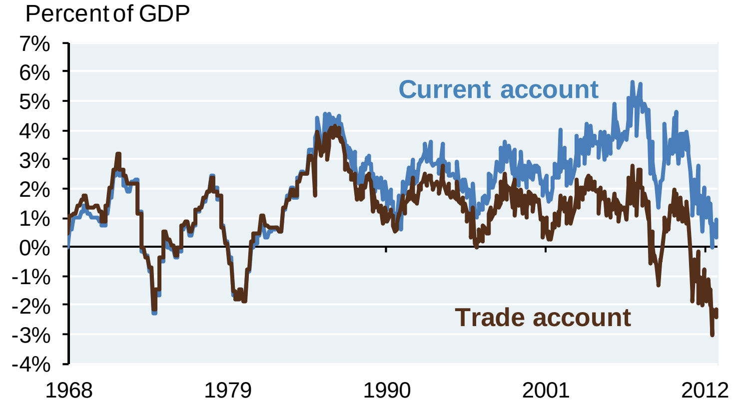


Source: BEA, Japan Ministry of Finance.

Total cash earnings per employee in Japan
Index, 2000 = 100, sa, firms with 5+ employees

Source: Ministry of Health, Labor & Welfare.

Japanese current account and trade balances
Percent of GDP



Source: OECD, Bank of Japan, Ministry of Finance.

Japanese general government debt/GDP (%, IMF)	1990	1992	1994	1996	1998	2000	2002	2004	2006	2008	2010	2012
Actual	67	71	83	99	118	140	164	181	186	192	215	237
If nominal GDP had grown at 3% instead of 0%	67	73	82	94	107	118	128	134	131	126	128	130

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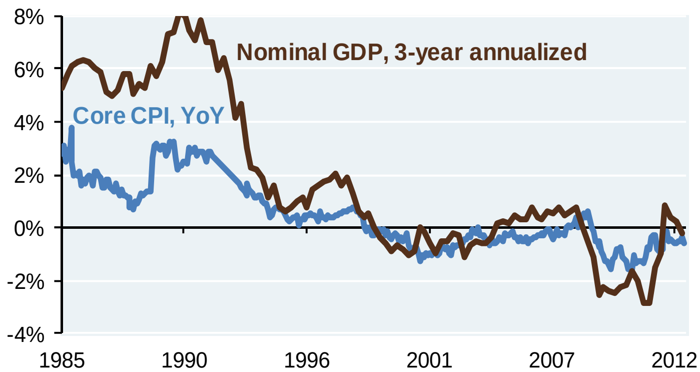
What is Japan planning to do about it?

Shinzo Abe's government intends to ease monetary and fiscal policy until nominal GDP growth hits 3 percent, and until core inflation hits 2 percent. How they will execute the plan is still a mystery: will they run large fiscal deficits and public works projects? Will they buy foreign bonds to weaken the Yen and risk the wrath of the G7? Will they buy risky domestic assets and encourage greater-risk taking by cash-rich Japanese households? Will they adopt massive tax breaks for R&D and capital spending to promote private sector investment? Not clear yet. What we do know is that it may take a LOT of money printing to get the job done, since as shown, it has been 20 years since Japan generated nominal growth and inflation at the target levels.

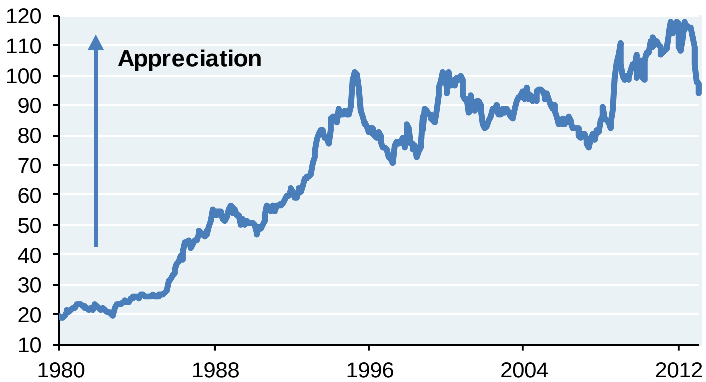
The benefits of announcing the plan helped to weaken Yen/$ from around 80 to the mid-90's. As shown in the second chart, that corresponds to a decline in the trade-weighted Yen as well. The trade-weighted Yen is still 10%-15% higher than it was during prior periods accompanied by consistent trade surpluses.

Japan core CPI and nominal GDP growth rate
Percent change



Source: Ministry of Internal Affairs and Communications, J. P. Morgan Securities LLC, Cabinet Office of Japan. CPI adjusted for changes in tax rates.

Japanese Yen trade weighted index
Index, January 2000 = 100



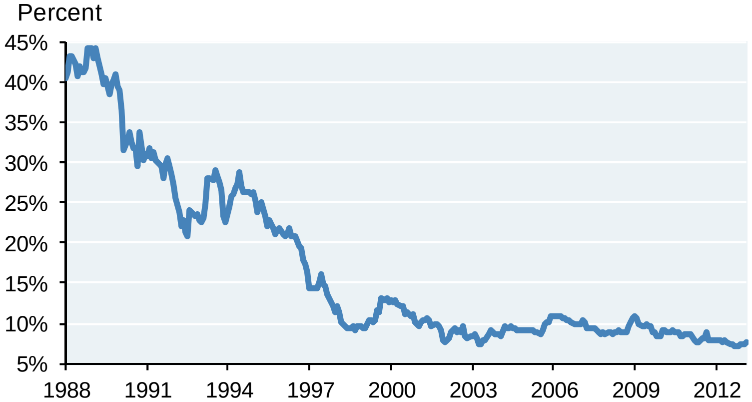
Source: Goldman Sachs & Co., Bloomberg.

We don't know exactly what Japan will do, and there is a chance they will reverse course. However, my sense is that something has changed in Japan's attitude towards deflation, and that they are prepared to take economic and political risk to confront it. The losers might include holders of long-duration Japanese government bonds, *if* the plan entails higher domestic interest rates; but if US-style central bank purchases are used, government bond yields might remain stable. Who holds them? Private sector and quasi-nationalized Japanese banks and insurance companies own 75% of all Japanese government bonds.

What about Japanese equities?

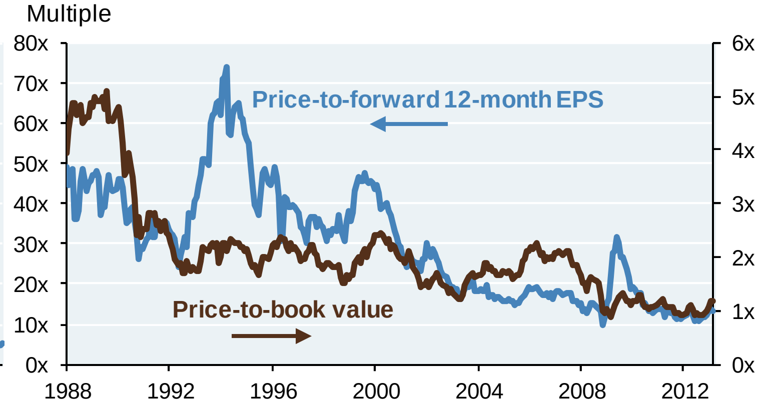
Japan has been on a strange and sad odyssey in global equity markets. Incredibly, Japan used to represent over 40% of the MSCI World Equity Index. Influential books were published on its economic miracle ("*Theory Z*", "*The Art of Japanese Management*", "*The Key to Japan's Competitive Success*", etc) and then the Nikkei sank 65% starting in 1989. At the peak, Japanese equities were trading at 40-70 times earnings; now they are between 10x and 15x. Japan still trades at slightly higher P/E's than other countries, but the margin between them is a fraction of what it once was.

MSCI World Index market cap in Japan
Percent



Source: MSCI, J.P. Morgan Securities LLC.

Valuation of the MSCI Japan Index
Multiple



Source: MSCI, J.P. Morgan Securities LLC.

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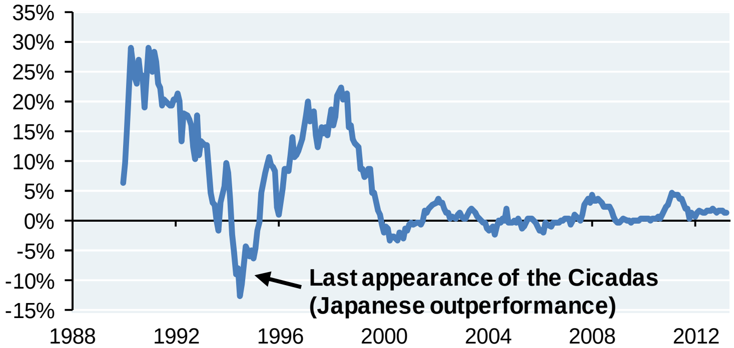
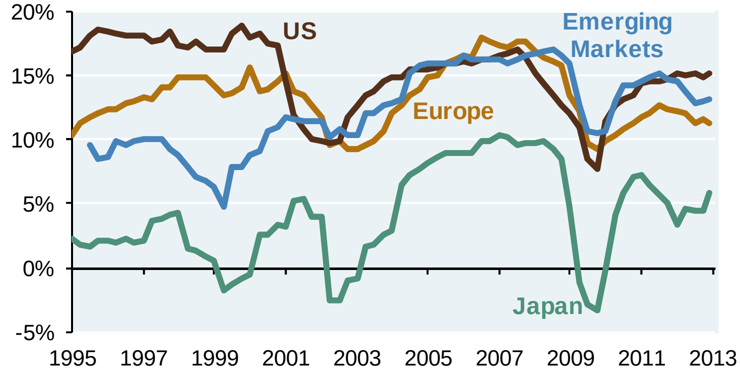
During Japan's descent into deflation, many global equity managers and asset allocators with the flexibility to avoid Japan did exactly that. The first chart below shows the cumulative benefit of not owning any Japanese equities in a global equity portfolio since 1998. This is one of the most consistent regional investment differentials ever seen. While the magnitude of the benefit was somewhat smaller in the 2000's, this is a function of the collapse in Japan's weight in the MSCI index; it still generated consistent portfolio benefits with few lapses. The second chart is an indication of why many investors have been so comfortable underweighting Japan: its corporate sector has inferior margins compared to others.

The benefit of being underweight Japanese equities
Cumulative outperformance of MSCI World ex-Japan vs MSCI World, rolling 2 years



Source: Bloomberg.

Return on Equity
Percent



Source: Datastream.

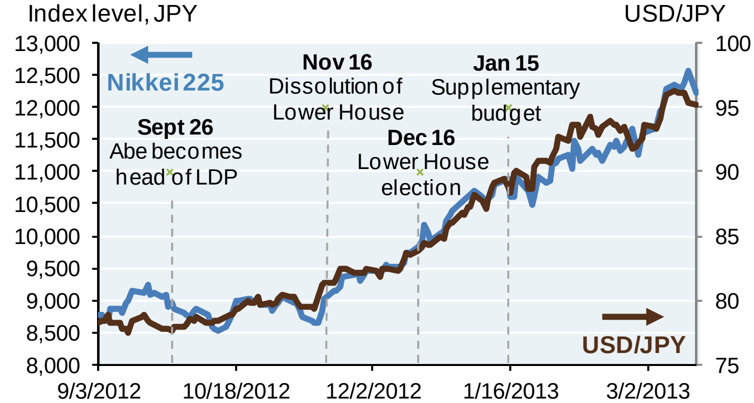
The cicadas emerge
The table below shows the four major equity markets in dollar and local currency terms. I have written before about the benefits of a portfolio tilted to the US and Emerging Markets over Japan and Europe. This has been a consistently positive strategy over the last 20 years, and in particular over the last few years as the financial crisis exposed severe structural problems of Europe. Since last fall, however, while Europe has lagged the US as we expected, the Nikkei has been on a tear as markets anticipate easier financial conditions and shifts in Japanese household and corporate behavior. The Nikkei rose from 9,000 to over 12,500, for a 40%+ return. Unfortunately for non-Yen based investors, more than half of this return was eroded by the decline in the Yen mentioned earlier. The chart below shows how closely the Nikkei's rise and the Yen decline have been linked. **If an investor had purchased Japanese equities and hedged the Yen exposure (by shorting the Yen vs their home currency), returns would be much closer to the Yen returns shown**. This, it seems to me, represents the most sensible strategy for purchasers of Japanese equities.

US Dollar and Local currency total returns by region

	Year to date		2007-2012	
	USD	Local	USD	Local
S&P 500	10.0%	10.0%	15%	15%
MSCI Europe	5.8%	9.2%	-5%	-4%
Euro Stoxx	2.7%	3.8%	-17%	-17%
MSCI Japan	11.5%	22.6%	-22%	-44%
Nikkei	9.0%	20.9%	-7%	-33%
MSCI EM	-1.0%	-0.3%	36%	39%

Source: Bloomberg. Data as of March 15, 2013.

Japanese equities & the Yen since last September
Index level, JPY USD/JPY



Source: Bloomberg, Nomura.

If Japan does continue to modestly pressure the Yen downwards vs its trading partners, it should benefit: Japan has one of the highest sensitivities in the world of export prices to exchange rates. According to a paper from the Federal Reserve in 2007, a 10 percent depreciation of the EU currencies, the Canadian dollar, or the Asian emerging currencies would raise the price of exports from these regions by 3 percent, whereas a similar decline in the nominal effective yen would boost the yen price of Japanese exports by 5 percent. In effect, Japanese companies benefit more from currency devaluation than other regions.

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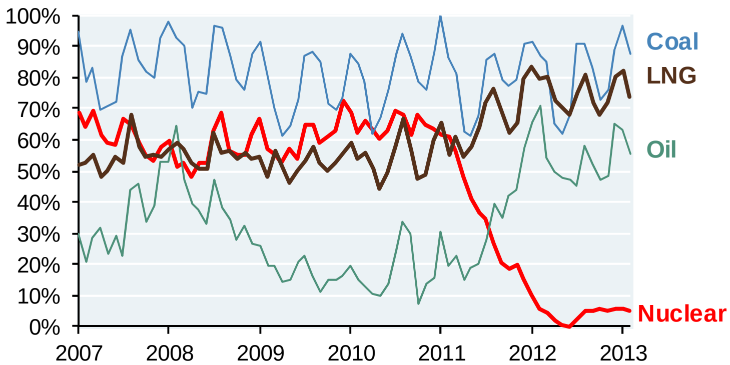
Other long-term factors to keep in mind

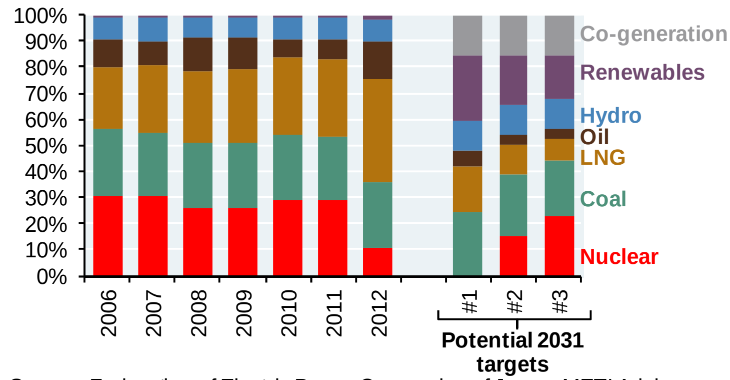
There are well-known structural headwinds that Japan faces as well, such as the world's most unfavorable demographics, and its decision to shut down nuclear power and rely on much more expensive forms of energy. The second chart shows Japan's 2031 power generation targets. Renewable energy (ex-hydro) is estimated to rise from 1.25% to 12%-25%, which is very ambitious once you take into account that offshore wind is the largest projected expected increase in the plan. Offshore wind is substantially costlier than onshore wind; we have seen projects in Europe where the cost of building the *connection* of an offshore wind turbine to the grid is more expensive than building an *entire* brand new combined cycle natural gas plant. Japan has limited experience with either onshore or offshore wind, and something tells me that in a few years, nuclear power will be turned back on so as to maintain reasonable electricity prices for Japan's export sector.

Japan power plant capacity utilization by fuel type
Percent



Source: Federation of Electric Power Companies of Japan 2012 Electricity Review, J.P. Morgan Commodities Research.

Contribution to Japan power generation
Percent

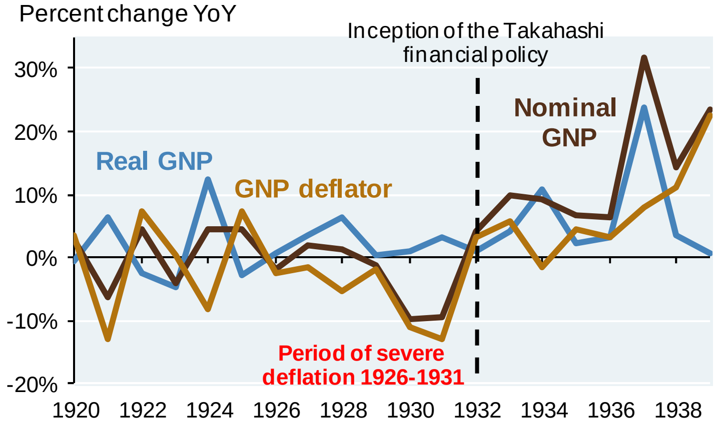


Source: Federation of Electric Power Companies of Japan, METI Advisory Committee.

Conclusion

If investors have the capacity to hedge away Yen exposure, it makes more sense to hold *some* Japanese equities than it has in a long time. The Abe administration appears committed to boosting private sector wages, activity and profits. The Finance Minister has referenced efforts during the 1930's by Finance Minister Takahashi that were ultimately successful in combating deflation (see chart). Takahashi policies included a 40% decline in the Yen, lower tax revenue and a rise in public works spending (note: the only spending Takahashi cut was military spending, which led to his assassination by Japanese military officers in 1936). There are differences in Japan between now and then: Japan's government debt was only 56% in the 1930's. However, the parallels are similar to those drawn by Bernanke when discussing successful stimulus undertaken by President Roosevelt. Many of Japan's structural problems will almost certainly resurface, but in 2013, changing policies may outweigh them in the financial markets. Be prepared to take profits on this position at some point; **cicadas don't live forever**.

The end of Japanese deflation period in the 1930's
Percent change YoY



Source: Nomura, Japan's Economic Planning Agency

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Topics: The possible economic and investment impact of Japan's monetary and fiscal bazooka; and the latest round of historical revisionism in Europe

"*Exchange rate pass-through to export prices: assessing some cross-country evidence*", Vigfusson, Sheets and Gagnon; Federal Reserve Board, June 2007.

"Haven for Oligarchs: Europe's Mounting Reluctance to Bail Out Cyprus", Der Spiegel, January 14, 2013

"*Abenomics and Japan's experience in the 1930s*", Nomura Japanese Economic Insight, February 25, 2013