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JAPANESE EQUITIES AND BULL MARKET ECONOMICS

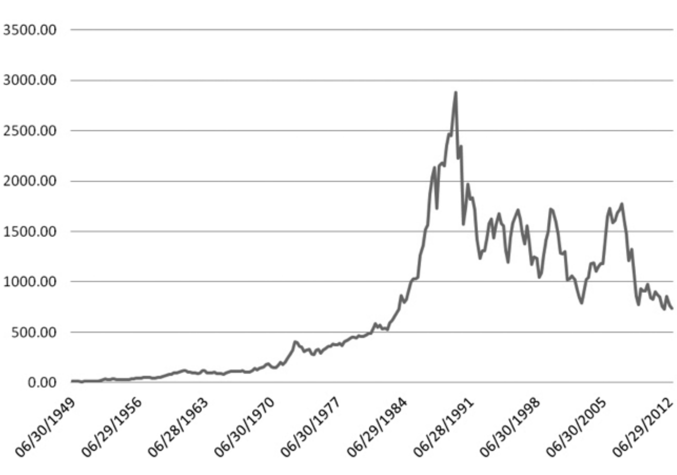
By Steve Scoles

Japan's financial markets are great examples of the kinds of powerful trends that can develop in markets. Japan's broad equity market index, the TOPIX, had a 40-year bull market that saw the index grow almost 30 times in value by the late 1980s. However, since 1989, the TOPIX has lost over 75 percent of its value in a brutal bear market. Furthermore, the index hit a new bear market low in 2012, almost 23 years after its peak.

Moving to fixed income, Japan's bond market has shown a very strong bull market since 1990. Bond prices have risen steadily as 10-year Japanese government bond yields have fallen from 8 percent to less than 1 percent. As I write this article in November of 2012, Japan's 10-year bond futures are just less than their all-time high price.

In my investing career, Japan's recent financial market trends (bear market in equities and bull market in bonds) have been blamed on something specific to the Japanese culture or government policies. However, looking at the last 10

TOPIX Index 1949 to 2012



Source: Bloomberg

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years, North American stock and bond markets have shown many similarities to what Japan has experienced. Perhaps it is now becoming apparent that what has happened to Japan's markets are more due to natural market dynamics than the nation itself.

Before pursuing the future of Japan's financial market performance, we need to look at what some of those natural market dynamics are.

BULL MARKET ECONOMICS – RISING PRICES INCREASE DEMAND

A basic principle of economics is the law of supply and demand. As prices rise, demand drops and supply increases. The price of a product therefore adjusts and eventually settles at the point where supply equals demand.

There are a couple of problems with applying this idea to financial assets. First of all, people do not really demand financial assets. Instead, what they really demand are future investment returns.

Second, future investment returns are a very tricky thing. Often, to figure out what future returns will be, people look to *past* returns. For example, anyone who advises "stocks for the long run" typically highlights stocks' past returns as proof of their future return potential. But note that past returns depend on past *price changes.*

With these two problems, you start to get a circular loop between demand and price. Demand for financial assets depends on future expected returns, which often depends on past returns, which depends on past price changes.

With stocks and bonds, the laws of supply and demand become warped and prone to these positive feedback loops. As prices rise, demand rises, which increase prices further, which then further increases demand, and so on. To put it simply, rising prices creates an increase in demand.

At a moderate level, these positive feedback loops help create powerful financial market trends or bull markets. On an extreme level, you get bubbles. As well, these feedback loops can operate the other way where falling prices reduce demand, creating bear markets.

When it comes to financial markets, these "bull market economics" often overwhelm the normal law of supply and demand.

THE WEAK GRAVITATIONAL PULL OF FUNDAMENTAL VALUES

It is important to note that working as an opposing force to these positive feedback loops for financial asset prices is the gravitational pull of a fundamental value for the asset. The fundamental value is supposed to be the rationally determined price that should be paid for the asset. However, this gravitational pull of fundamental values is often weak for several reasons.

First, when it comes to long-term assets, even just small changes in discount rates and growth rates can result in very different "fundamental" values. Bull markets often are simply the move from the low end of reasonable values to the high end.

Second, as financial speculator George Soros has pointed out, an asset's fundamentals can be influenced by changing asset prices as well. For example, a company's rising stock price can allow the company to use its stock as currency to buy out competitors. So fundamentals are often not simply a given fact, but also change as market prices change.

Third, current fundamentals can be misleading, because it's difficult to imagine how much those fundamentals can change in the future. Not to pick on former U.S. Treasury Secretary Hank Paulson too much, but his quote in July of 2007 that "this is far and away the strongest global economy I've seen in my business lifetime" was not very predictive of where the world economy was going.

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Because of these reasons, fundamental values often only provide a weak gravitational pull on asset prices. However, in any market, there are only so many investors and so much leverage that can be applied to the asset before the bull market ends. Or there are so many people who become negative in a bear market, that there is no one left to be negative. As Soros also points out, what was once self-fulfilling becomes self-defeating.

PSYCHOLOGICAL FACTORS

While fundamental value considerations are not to be ignored, psychological factors can often be more useful in identifying the various stages of bull and bear markets and more predictive of what is going to happen in the future for those markets.

Famous investor, Sir John Templeton, who happened to make a name for himself by investing early in the Japan's last bull market, gave a simple outline of a bull market. He said, "Bull-markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

That's nice advice, but buying at times of pessimism is difficult by definition—you have to be a very rare person and the odds are very small that you will be that person! As well, it takes a lot of experience and a good memory to know what pessimism really looks like.

I would add to Templeton's comments above that bull markets tend to end with sustained optimism and bear markets end with sustained pessimism. As an example of this, *Business Week* had a famous cover story in 1979 highlighting the "Death of Equities." While this is often pointed out as signaling the start of the great bull market in U.S. stocks in the later part of the 20th century, what people miss is that it was almost three years later that the bull market started. On the other side of that bull market, in 1996 and 1997, *Business Week* had cover stories pointing out "Our love Affair with Stocks" and "The New Business Cycle," a few years before the bull market ended.

To combine all of the above comments on bull markets and psychology, I would say bull markets are great, but at times of extreme or sustained market sentiment, it's time to invest in the other direction.

JAPAN EQUITIES TODAY

This brings me to where Japanese equities stand today. The following sample of evidence suggests there is some sustained pessimism towards Japanese equities, which may signal the end of its long bear market and the start of a new bull market.

First, In July of 2011, I noticed a long article in *The New York Times* titled "This Time, Japan's Gloom Runs Deeper." The article highlighted the "… aging population, a lack of jobs for college graduates and persistent deflation." Talking to many people in the investment business, this is very much the strong consensus on Japan's fundamentals. This is a far cry from the view commonly presented in the 1980s of the "Japanese economic miracle."

Second, Tower Watson's recent survey of Japanese pension plan asset allocations have noted a steady decline in allocations to equity assets and within the equity allocation, a steady decline in the allocation to domestic equities. At a recent pension conference it was announced that, "Toyota has moved to get better returns from its domestic equity allocations, shifting 10 billion yen in May away from the long-suffering TOPIX index. …"

Furthermore, I see that Japan's Government Pension Investment Fund, the largest pension fund in the world, has publicly proclaimed it is reducing exposure to domestic equities in favor of international equities.

While on the one hand, it may appear that these large pension plans allocating funds away from traditional Japanese domestic equities may be a bad thing for the asset class, instead, it is likely a good thing. When a large pension plan makes a significant change to its asset allocation, it typically needs the agreement of many parties—consultants, committees, and, in the case of government plans, agreement by government officials. When so many people agree on an investment strategy it can signal the end of a long trend is near. In the case of Japanese equities, this means it is starting to appear that all those who are going to sell have sold, which is what is needed for its bear market to end and a new bull market to begin.

While this is just a sprinkling of evidence around Japanese equities, it seems now is the time to take a good look at them as an investment option. To use a baseball analogy, while there are certainly other bull markets in play currently, Japan equities appear to be one of the few in the on-deck circle.

DISCLAIMER: This article is for informational purposes and is not intended as a recommendation to buy securities. In fact, it is entirely possible that the author has a large position in Japanese equities that he is desperately trying to sell.

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