

GaveKal Ad Hoc Comment

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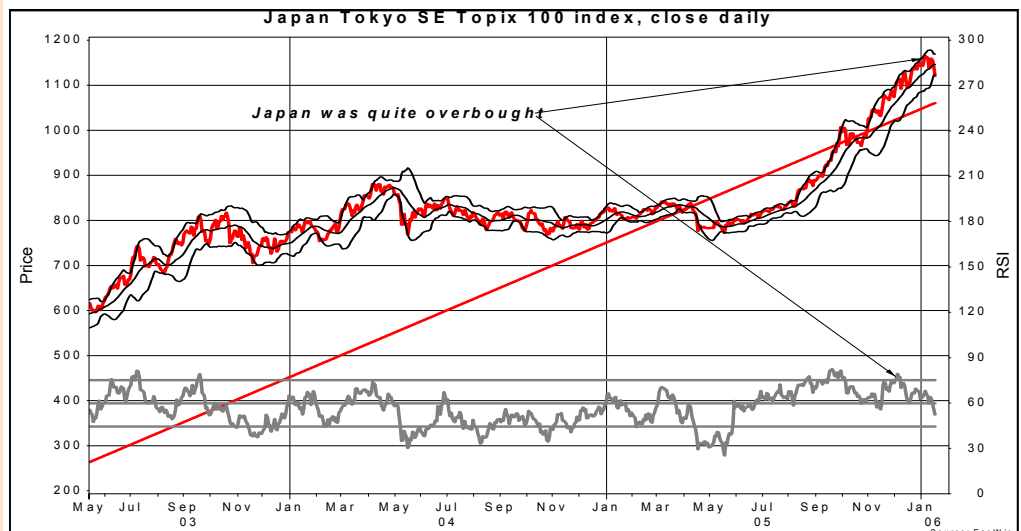
The Japanese Market Sells Off

We concluded the Daily [Checking the Boxes](#) of January 11th by saying: “We have been firm believers of the “Japan is on the mend” story. And we want to remain bullish of the Japanese equity market. But having said that, we must also admit that we have seen the movie of “low money supply growth, falling bank shares” before, and we did not like the ending (it involved us putting our heads in our hands and stating “I am done with Japan”)... So all in all, we are nervous. We are all the more nervous since the Nikkei appears to be at a very important technical juncture; it can either brake its 15 year downtrend...or not! The good news is that we will know soon”.



And here is what we now know: in the past two trading sessions, the Topix has shed -6.7%, the Topix small caps has lost -9.4%, the Jasdq is down -12.6% and the TSE Mothers index (albeit, probably no-one cares...but still) is down a cool -20.7%. This brutal sell-off begs a number of questions, but first and foremost is: why?

The first explanation offered is that Japan was quite seriously overbought, and that a period of consolidation was more than overdue. The fact that this consolidation comes shortly on the heels of the end of the year “window-dressing” period (in which fund managers scramble to buy whatever did well during the year) should also not be a surprise.



Japanese stocks are selling off aggressively. Why?

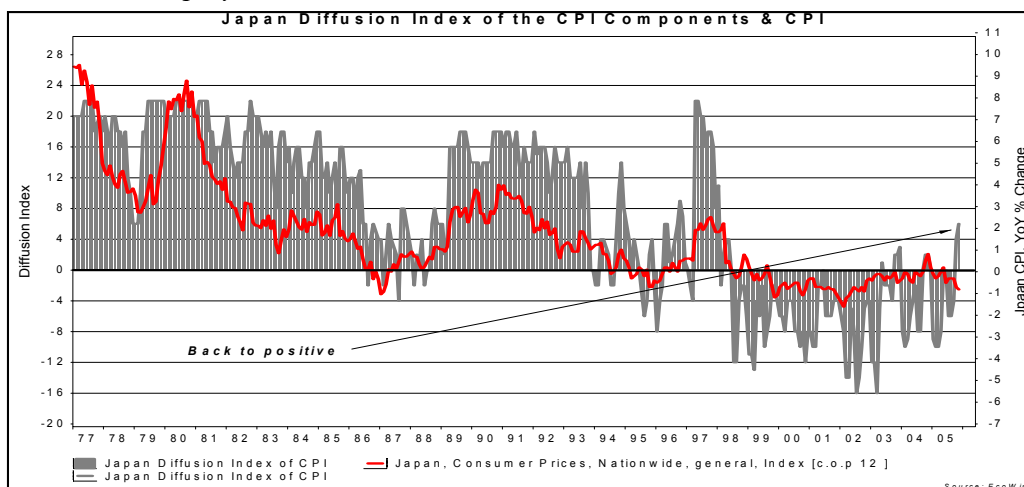
Could it be that the hope of the end of deflation was a chimera?

China seems set to re-export deflation.

The second explanation offered is that Japanese equities have suffered from the one-two punch of the Livedoor investigation and the disappointing Intel numbers. Very frankly, this explanation feels a little weak. Indeed, looking at our screens today, we find that the biggest falls by sector are Securities Brokers (-7.5%), Real Estate (-6.5%), Metals (-6.4%), and Wholesalers (-6%). And the links between any of these industries and either Livedoor or Intel appears pretty strenuous to us. But whatever the reasons, the recent sell-off raises an important question: is the current pull-back simply a healthy correction in a continuing bull market? Or will Japan disappoint yet again?

Concern #1: China is Again Exporting Deflation

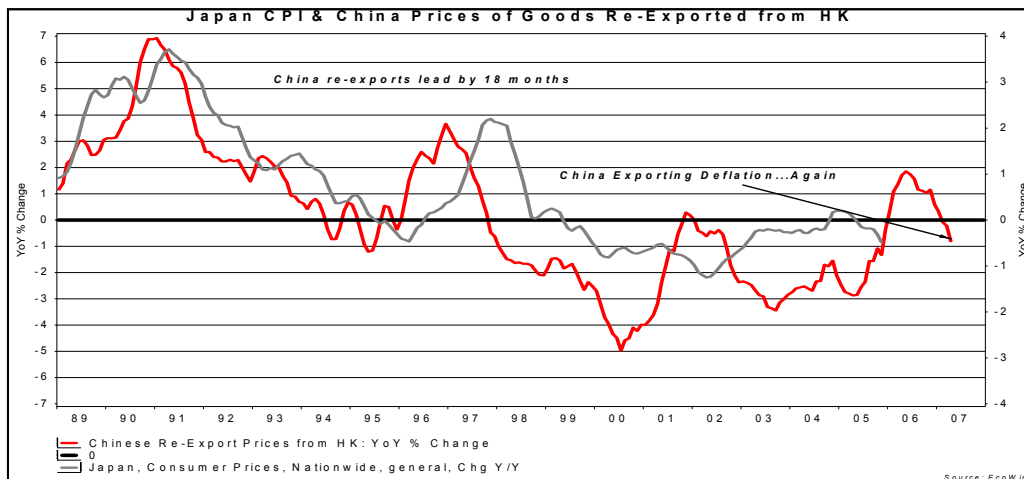
We will not bore our clients by reviewing the damage wrecked by deflation on the Japanese economy, and the Japanese stock market, in the past fifteen years. Suffice to say that, the possibility that Japan might be exiting its deflationary bust environment (see [From Bad Deflation to Good](#), August 2005) was sufficient enough to the send equity markets on a tear.



As illustrated in the above chart, something very odd is happening: while more sectors in the Japanese economy appear to be regaining pricing power (a positive development for stocks), the Japanese CPI index has been trading lower. And frankly, we are at pains to explain the dichotomy.

Staying on the inflation story, another source of concern has emerged: China, which had stopped exporting deflation for a brief period last year, is now back at it. At least, that's what we make of the recent sharp dip in HK re-export prices.

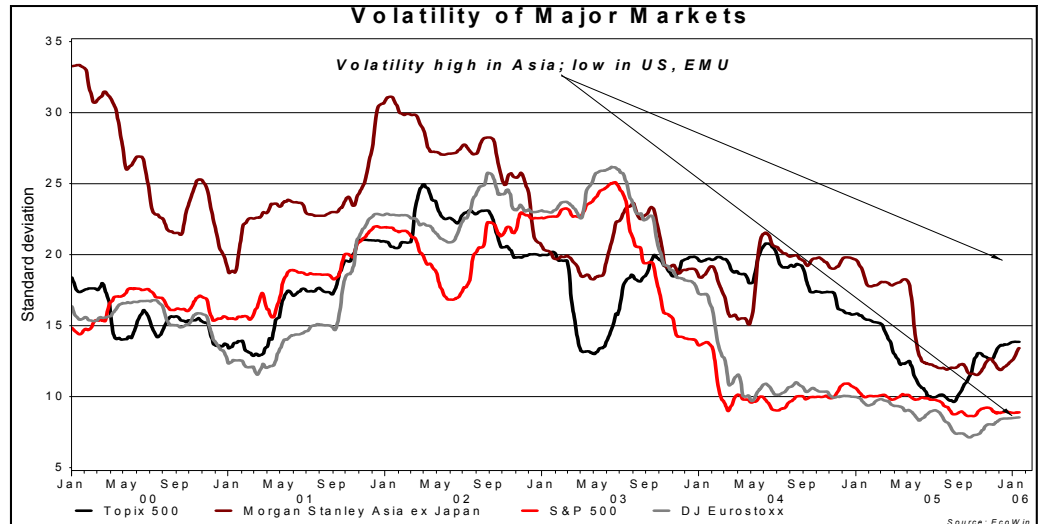
And this leaves us in a bit of quandary. Indeed, the overwhelming impression we have when talking to clients is that most people expect Japan to head out of deflation sometime in the coming year. And Japanese politicians have promised us as much. But is such an expectation reasonable when China is actively exporting deflation? Could the market stand to be disappointed?



Concern #2: Volatility is on the Rise

Another concern on the Japanese stock market is that volatility has recently been rising far more aggressively than in other markets. And frankly, we have a tough time explaining this rise, though we do know one thing: we don't like it much. Indeed, highly volatile markets tend to trade at discounts to stable markets, if for no other reason that investors, like ourselves, tend to like to sleep at night. And owning assets that fluctuate all over the place gets tiresome in a hurry.

The volatility of the Japanese equity market is on the rise. That's not a good thing.



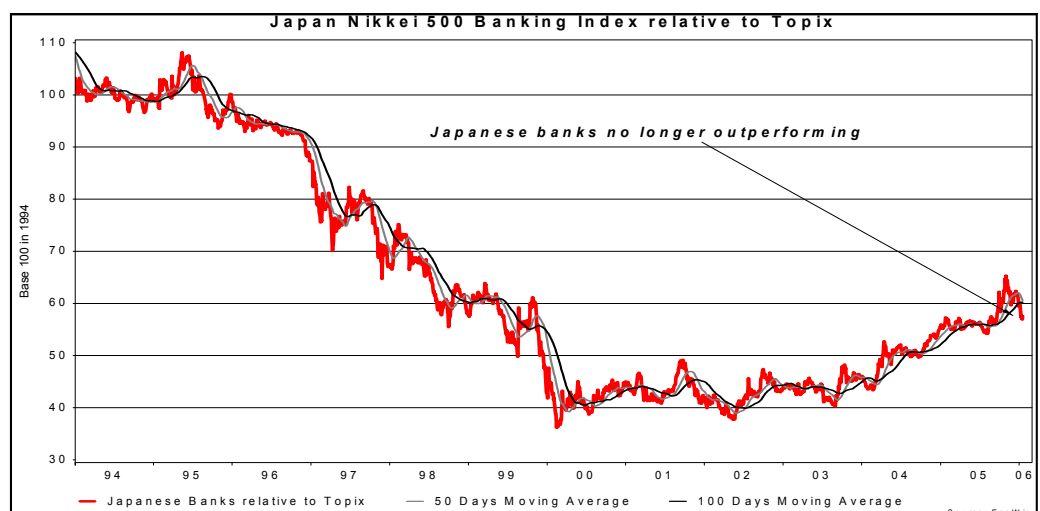
Concern #3: Banks Have Been Underperforming

Since the beginning of the year, we have been highlighting in our Daily Checking the Boxes the worrying underperformance of Japanese Banks, to the growing annoyance of a number of clients who would write to tell us: "let it go-banks as a leading indicator were useful when the economy was in a deflationary bust and the banking system was broken, but now that things are looking better in Japan, looking at the banks is no longer that useful".

A major source of concern has been the under-performance of the banks.

Our reply has been: it's not just in Japan that we look at the relative performance banks. We do it in every market. And whenever we see banks underperforming when long bond yields are falling, regardless of the market, our natural inclination is to pick up our marbles and run away from the playground.

Why? Because if bank stocks underperform while long bond yields are falling, it is likely that banks are not in the midst of expanding their business (or if they are expanding, then they are doing something stupid that the market does not like). Worse yet, when banks underperform while long bond yields fall, it could be a sign that the banks' balance sheets are deteriorating. Either way, we feel it is usually better to step aside.



If global growth slows, how will that impact Japanese equities?

Historically, Japanese equities have been rather cyclical.

Japan's deteriorating terms of trade are also a potential issue.

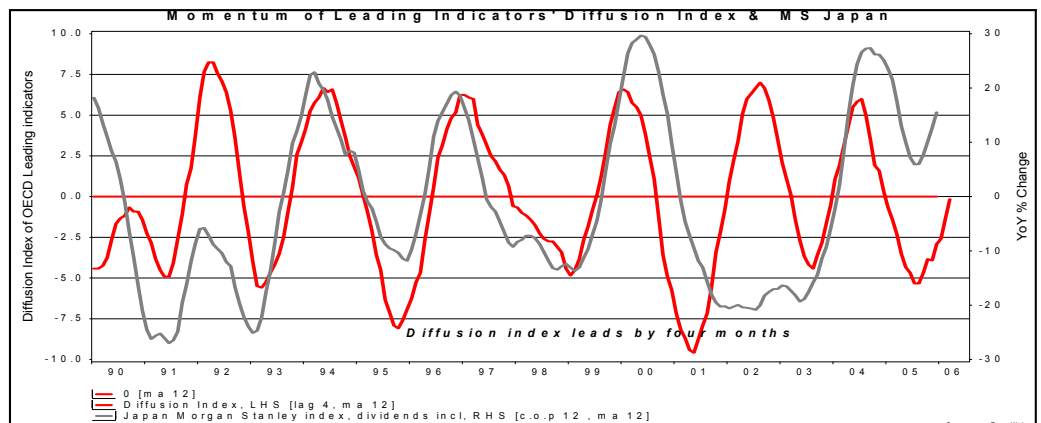
Over the years, we have lost a lot of money investing in Japan. And for all the money we threw down the Japanese well, we came up with one major lesson: don't invest in Japan when the banks are underperforming. And, maybe through sheer stubbornness, we will hold on to that rule until it stops working.

Concern #4: Japanese Equities Tend to Be Quite Cyclical

In our recent [Quarterly Strategy Chart Book](#), we try to prove that the World, and especially the US economy, should go through some kind of mid-cycle slowdown in 2006. In other words, while we remain quite optimistic on the structural side of our economies (see [Our Brave New World](#)), we are concerned about a roll-over in the economic cycle.

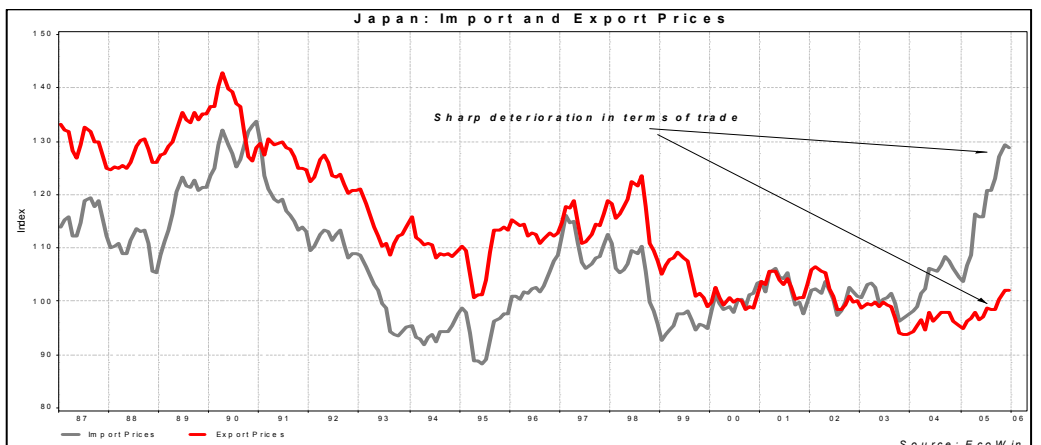
Historically, Japan has been a rather cyclical market, a fact highlighted in the chart below which represents the annual change in our diffusion index of OECD leading indicators and the Japanese stock market. To be sure, most of the economic data around the world (except the United States) in recent weeks has come in rather strong. In fact, even the OECD leading indicators are once again powering ahead. So maybe there is nothing for the Japanese equity market to worry about.

But after the past two day's performance, one is forced to consider the possibility that the Japanese stock market is smelling a rat. And could this rat be the cyclical slowdown that we talked about in our last [Quarterly Strategy Chart Book](#)? We have little doubt that a slowdown in global growth would prove a serious headwind to Japanese stocks.



Concern #5: Deteriorating Terms of Trade

What happens when everything you export (flat screen TVs, automobiles...) keeps falling in prices while everything you import (oil, copper...) keeps going up in price? The answer is simple: a massive deterioration in the terms of trade (visible in the chart below). Deteriorations in terms of trade are, needless to say, highly cyclical events. But nevertheless, Japan has not had to endure anything of the sort for the past twenty years. And at some point, such deterioration is bound to hurt economic activity.

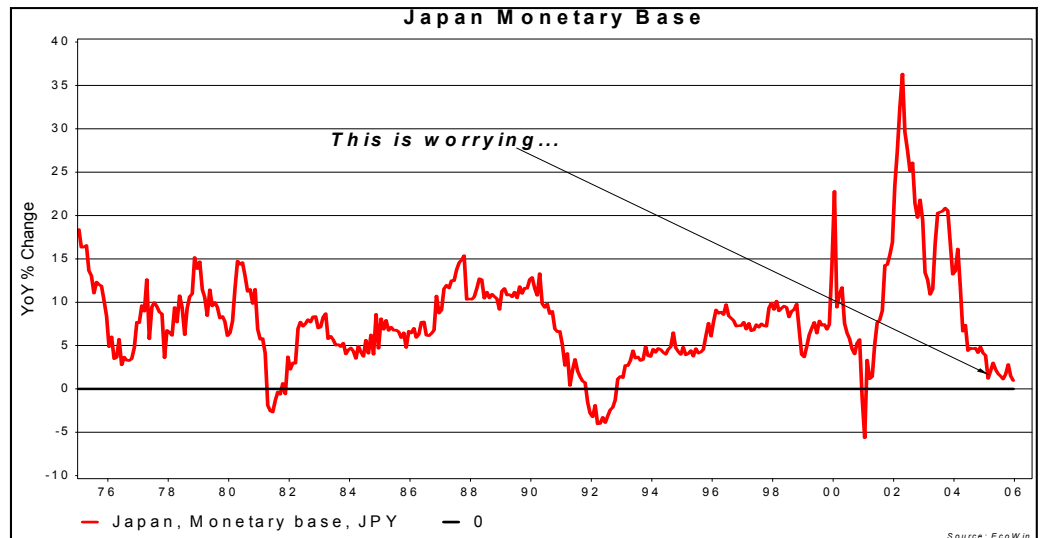


Another concern is the weak money growth prevalent in Japan today.

Concern #6: Low Money Growth

A paper on Japan would not be complete without checking in with our friends at the BoJ to see what they are doing. Or not doing. And today, it unfortunately is more of the latter. As we have been highlighting incessantly in the past month (see our January [Monthly Strategy Review](#)), the growth rate of the Japanese monetary base is now reaching alarmingly low levels.

And as Charles keeps saying, the game is usually simple: one needs to figure out whether there is more money than fools, or more fools than money. We fear that, in Japan, there are today more fools than money. And in those circumstances, fools and their money are soon parted.



Conclusions

Since the beginning of the year, there has been no real bad news out of Japan. The economy seems to be humming along; companies are hiring and building up expansion plans. Consumers are out shopping again... But despite the benign economic environment, Japanese equities have been very volatile, and have started to pull back. Is this new behavior a simple consequence of last year's extremely strong rally? Or is there more at hand? As we tried to highlight above, we can think of a few catalysts which would help bring Japanese stocks lower. But we have a tough time thinking of forthcoming events (a RMB revaluation? A collapse in oil prices?...) which would push Japanese equities higher. Taking some profits (for once!) in Japan does seem to make sense.