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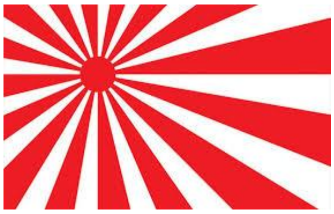


JAPAN

The sun will rise again…

Not so long ago, post-war Japan was talked about in the same reverent tones as China is today. Its economy was the envy of the world; its work ethic and productivity levels were off the scale, and this manufacturing prowess turned its economy into a behemoth, the second largest in the world. Then something unexpected happened, something that hadn't happened since the Great Depression. Prices started falling, right across the board, and kept falling. A long-term deflationary spiral kicked in, and Japan's growth miracle transformed into a case study in 'what-not-to-do' for governments and central banks around the world.

It was a vicious cycle. To tackle falling prices, declining sales, and plunging profits, Japanese corporations were forced to make lay-offs and pay cuts. The 'job-for-life' tradition was disbanded, incomes dropped, and consumers cut back on their spending. Deflation also created a higher real interest rate, which in turn reduced the appetite for capital expenditure and investment. When a country gets trapped in a deflationary cycle, it's very difficult to get out. Like diabetes, it induces other complications and makes the patient worse.

Enter Doctor Abe (aka Prime Minister Shinzo Abe) and his radical expansion plans, including massive levels of QE. Now, after almost two years of intensive care, what was once an economy on life-support is finally starting to show signs of real life. In late June, Abe declared triumphantly that deflation had ended: “Through bold monetary policy, flexible fiscal policy and the growth strategy we have reached a stage where there is no deflation,” he announced.

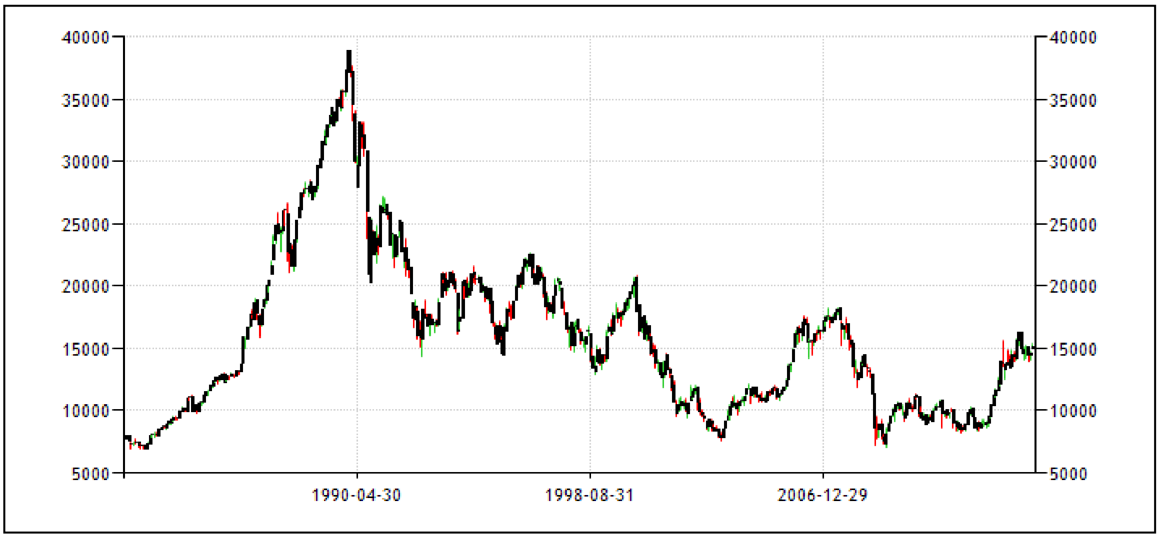
It was a bold call, for growth remains low in Japan, and inflation hasn’t really taken hold either, but it might mark an important turning point. QE will continue to provide a tailwind, and moreover, the charts show that Japanese equities are starting to look attractive for the first time in decades. One step at a time…

The sun will rise again - one step at a time…

‘Four Steps’ to recovery

Source: The Economist, May 2013

1. The big picture



Japan's stock market has been going nowhere for a long, long time. To put things in perspective, when I was head of technical analysis at Dow Jones in London in 1990, the market value of the Japanese stock market was about 50% of the value of all world markets combined. An extraordinary figure even then. (Today the Japanese stock market is worth less than 10% of the world market, while the US is worth around a third.)

2. Drilling down

Recent price action has been more positive. Japan's Nikkei 225 started to climb when Shinzo Abe led the LDP to a landslide victory. Following his command, the Bank of Japan unleashed a torrent of liquidity: almost three times the current pace of the Federal Reserve printing presses. The results have been spectacular: the Nikkei is up 70% since November. (The Yen has also sold off heavily.)

I expect the 30-year low to hold, but remember that Japan is still home to immense volatility. I am targeting a 25% rise over the next 12 months, and higher in the years ahead.

3. Recent action

The “Abe effect” ran out of steam last year, at 16,000, and has been forming a potential ‘rounding top’ – a bearish pattern. It could mean lower prices in the weeks and possibly months ahead. I expect the current trading range to continue to play out over the next few months, but any break of 12,500 would bring the 30-year-low back into play. (Remember this is a highly volatile market.)

That said, I would view future weakness as an opportunity to buy a long-term position in what could be an important secular bottom in the months and years ahead.

4. The relative story

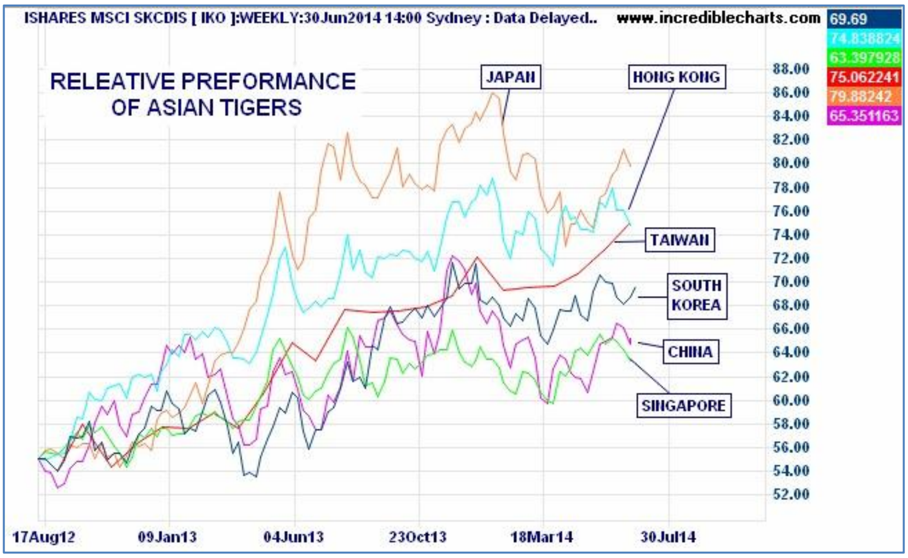


Chart A

&

Chart B

Sometimes it can be useful to look at relative performance - ie. how the Nikkei is faring against other benchmarks.

Chart A shows that Japan has been outperforming the rest of Asia over the last two years. This is positive, and shows that portfolios are being reweighted in response to prime minister Abe's expansion plans.

Chart B shows that Japan is also outperforming the Dow Jones Industrial Average (the US 'supercaps'). This ratio shows a possible change in trend as well, which could provide a strong tailwind for owners of Japanese stocks in the years ahead.

Conclusion:

There's a lot happening in Japan right now. It's an interesting market for economists and market watchers. Abe's aggressive experiment with QE will fill the economic and trading text-books for years to come. We don't yet know how it will play out, of course, but the charts seem to be pointing to a secular market bottom in Japanese equities. Could we go marginally lower? Yes, but the next couple of years should provide an opportunity to buy this market at a level that won't be seen for generations to come.