CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Japan, the Central Banks, and Stock Markets

A startling change has come to Japan since the November election for the lower house of its parliament, which gave Shinzo Abe and his Liberal Democratic Party a large majority. Since then, Mr. Abe has appointed a new head for the central bank (the Bank of Japan), increased government spending substantially, and begun far-reaching structural reform of governmental activities. The Bank of Japan (the BoJ) duly announced a truly enormous program of asset purchases, proportionally much larger than the Federal Reserve's programs. This new dynamism in Japan has had stunning effects on the value of the yen and the Tokyo stock market and has already given a significant lift to Japan's long-dormant economy. The yen has fallen in value against the dollar by more than one fifth in the six months since Abe's election seemed assured; the Nikkei index of Japanese stocks has risen by two thirds in the same period; the first quarter 2013 GDP for Japan rose at an annualized rate of 3.5%.

Recall that Japan's development was extraordinarily robust for decades after World War II as it became one of the world's leading manufacturers of automobiles, electronics, and other industrial equipment. Its stock market and property markets reflected Japan's wealth and success; by the late 1980s, the total value of Japanese stocks exceeded America's. Near the end of 1989, Japan's principal stock market index, the Nikkei 225, stood just under 40,000 and Japan Inc seemed to by buying up America. Then the property markets and stock market collapsed; the economy fell into a series of recessions, and price deflation set in. Last year, China's economy surpassed Japan's as the world's second largest. With its aging population, hostility to outsiders (reflected in a policy of essentially no immigration), and the failure of its Fukushima reactor after the earthquake and tsunami, Japan was moribund. It actions and inactions since 1989 have been studied by prominent economists (including Fed chair Ben Bernanke) as examples of what not to do. Indeed, Shinzo Abe himself, as prime minister a few years ago, was an undistinguished failure.

Does the remarkable new dynamism on display in Japan presage a real change in Japan? Will Tokyo's stock market continue to appreciate? Will Japan's economy grow after its two decades of slumber? Or, more ominously, is this one more important central bank engaged in an unsustainable policy of asset purchases--'quantitative easing'--destined to end very unhappily?

By

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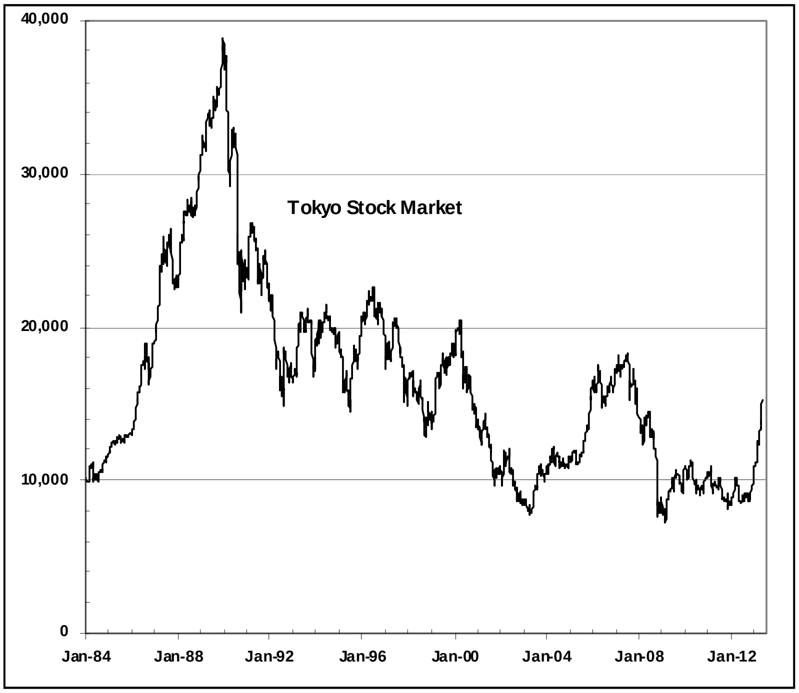
Despite nearly stagnant nominal economic growth since the early 1990s, Japan's mild deflation (i.e., falling prices) actually served to maintain the buying power--a real measure of wealth--of Japanese people. (Two percent deflation and zero percent 'nominal' economic growth means two percent 'real' economic growth.) And, although the yen kept rising in value against all the other

The Tokyo stock market rose enormously in the 1980s, only to begin a long collapse from 39,000 in the Nikkei 225 index in 1989 to 8000 in 2003 and 7000 in 2009. The recent torrid rally has brought the index well above 15,000.

With the yen falling markedly, the reinvigorated corporate sector in Japan may fuel higher stock prices. Core has a meaningful investment in Japanese stocks.

major currencies in the world, Japanese industry adjusted to higher the higher exchange rate by improving efficiencies. Hence, Japan continued to be a formidable export power house all through these recent decades. Perhaps Japan has been jolted into action by the increasingly assertive actions of its gigantic neighbor. Two insignificant islands long claimed by Japan, lying south of Japan in the East China Sea, are the subject of a territorial dispute in which China has taken ever more aggressive and provocative steps. There is a stridently nationalistic tone to Mr. Abe's rhetoric; the interplay between his nationalism and his fiscal, economic and monetary policies is not terribly clear. At all events, Mr. Abe and his policies are very popular and an upcoming election in Japan's upper house of it parliament will give his party a large majority there, enabling the government to enact its legislative agenda without meaningful opposition.



The central banks and the stock market's rally. We may not be able to parse the interplay between Mr. Abe's nationalism and his economic plans, but we can make sense of the interplay between central bank actions and the world-wide stock market rally. The four major central banks of the developed economies, the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan, have at various stages in recent years undertaken ever more aggressive monetary policies, first to lower the risk to the stability of the banking and financial systems, and second to stimulate stagnant economies. The most dramatic has been the recently announced policy of the BoJ of huge asset purchases. Smaller central banks have engaged in their own aggressive asset purchases; JP Morgan reports that one third of advanced country central banks now own equities directly. Recall that most central banks, including our Fed, generally held government securities only until the financial crisis.

With the BoJ announcement, it appears that many investors have finally concluded that, while the central banks continue to be buyers of so many investible assets, stock markets will continue to rise. The stock market advance has been slow and persistent. In the US, it has been supported by continuing growth in corporate profits, modest but real economic growth, marked improvement in the housing sector, decent if unremarkable job growth, and a distinct shrinkage in the federal budget deficit, as tax revenues increase, government spending falls, and Fannie Mae makes a large, one-time dividend payment to the Treasury. As things stand, and despite the big rally in the US over the last six months, valuations are not unusually high. When stock prices are measured against corporate earnings, the rally now is not like 1999 dot-com boom; it is restrained and supported by quite favorable ratios of earnings to prices.

For now, we at Core intend to maintain or build our stock market positions, particularly in Japan and the US, in the equity-oriented portfolios we manage. The bond portion of our portfolios are heavily weighted toward US corporate bonds, including high-yield bonds. We maintain our fairly large position in US dollar denominated emerging market debt, a very fruitful investment we have held for several years.

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