**<u>JAPAN: THE LAND OF THE SETTING SUN</u>**

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"There is a house in New Orleans
They call the Rising Sun
And it's been the ruin of many a poor boy
And God, I know I'm one". "House of the Rising Sun" ("Rising Sun Blues"), sung by The Animals and many others

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## CONCLUSION

In recent months, economic and political excitement within assorted emerging, developing, and frontier nations have entranced most marketplace observers and captured the attention of numerous politicians in the United States and other so-called advanced nations. In contrast, Japan, having once been in the limelight, nowadays stands in the background of the international financial theater. However, Japan currently deserves more of a starring role.

Japan's changing political leadership in late 2012 and the subsequent major new round of substantial monetary laxness encouraged major- and intertwined- Japanese Yen weakness and Japanese equity (Nikkei) strength. The new Japanese policies, the Nikkei's stratospheric rally, and the Yen's rapid bear tumble probably helped to encourage global economic optimism in general as well as rallies in the S+P 500 and many other key world stock marketplaces in particular.

Yet at present, many players nevertheless increasingly take for granted Japan's extraordinary monetary easing actions of early 2013 (and related other parts of "Abenomics") and their marketplace consequences. Clairvoyants likewise currently place comparatively little emphasis on Japan's current sluggish GDP prospects. They also do not underline that both the Japanese Yen and Nikkei apparently entered into a sideways trend beginning around late May 2013.

Of course diverse and entangled variables influence economic levels and trends (and storytelling about them), whether in Japan or elsewhere. But because Japan rather recently ventured on such extraordinary monetary easing, signs of mediocre Japanese economic performance warn that other very lax central bank policies increasingly will have diminished growth benefits as time passes. For example, the International Monetary Fund predicts Japan's calendar 2015 real GDP will increase merely one percent. Japan also has not escaped its gloomy government spending and debt situation. The sideways trends in the Nikkei and Yen arguably reflect such current (potential) Japanese performance.

The recent high in Japanese stocks and bottom in the Yen probably will not be broken by much if at all any time soon. Also, a notable (even if not major) decline in the Nikkei from its recent peak alongside a rally in the Yen relative to its recent low will be a bearish sign for the world economy as well as for the S+P 500 and many other stock marketplaces.

## JAPANESE POLITICS AND ECONOMICS: TAKING IT EASY

On 11/14/12, amidst economic growth worries and deflation fears, Japan called a crucial lower house election. On 12/16/12, the Liberal Democrats won. The incoming Prime Minister, Shinzo Abe, introduced "Abenomics", with its three "arrows" of easy money, flexible fiscal policy, and structural reform. The monetary arrow represents a significant policy development. The Bank of Japan on 1/22/13 unleashed its two percent inflation rate "price stability target". By embracing the two percent level, Japan aligned itself with similar inflation policy goals adopted by the Federal Reserve and European Central Bank. Japan's central bank emphasized its intention to engage in aggressive monetary easing, especially via purchases of financial assets such as JGBs.

Under new Bank of Japan leadership (Governor Kuroda), 4/4/13 brought "Quantitative and Qualitative Monetary Easing" ("QQE"). The Bank pledged to double the monetary base within two years. Thus even more massive easing became policy in Japan, with political and central bank authorities coordinating closely to defeat deflation (create sufficient inflation) and boost growth. Under QQE, central bank sentinels and political (and industrial) players aim for Yen weakness and Nikkei (and other asset) strength. The bank greatly accelerated its bond acquisition, now acquiring JGBs at a Y50 trillion ($485 billion) annual rate. This policy fights to encourage "a further decline in interest rates across the yield curve". Compare the United States Federal Reserve's money printing (quantitative easing) and yield repression programs.

What does the Bank of Japan also say regarding its mammoth money printing exercise? Allegedly, "JGB purchases are executed for the purpose of conducting monetary policy and not for the purpose of financing fiscal deficits." Compare the Federal Reserve's rhetoric.

The Bank of Japan and political leadership remain wedded to their strategies. On 7/21/13, popular and business enthusiasm swept the governing Liberal Democratic Party to victory in Japan's upper house elections. In a Financial Times interview, the central bank Governor proclaimed the Bank will keep its expansive monetary policy in place not only until inflation touches two percent, but also until it stabilizes there. Thus its very lax policy may stay in place longer than just two years (12/13/13, p1).

## <u>JAPANESE YEN AND JAPANESE STOCKS: RECENT TRAVELS</u>

Especially under the new political and central bank leadership, Japanese stocks "in general" and the Yen have sailed together. A slumping Yen encouraged the fierce Nikkei bull charge. Note the timing of key marketplace turns. The Nikkei established an important top on 12/30/13 at 16320. The Yen attained a key low versus the US dollar around Y105.4 on 12/30/13. On 3/7/14, the Yen closed around Y103.3 versus the US dollar, the Nikkei at about 15275.

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| Japanese Yen High or Low Versus the US Dollar (date) | Nikkei Stocks High or Low (date) |
|---|---|
| Various highs Y75.4 (10/31/11), Y77.7 (6/1/12) Y77.2 (9/13/12) and Y79.2 (11/9/12) | Lows 8136 (11/25/11), 8239 (6/4/12); 8619 take-off low (11/13/12) |

[The final high in the Japanese Yen versus US dollar cross rate occurred around when the Japanese lower house election was called, on 11/14/12. The Liberal Democrats triumphed 12/16/12.]

| | |
|---|---|
| Slump from 4/2/13's Y92.6 high | Rally up from 4/5/13's 12831 low |

[Recall 4/4/13's "Quantitative and Qualitative Monetary Easing".]

| | |
|---|---|
| Y103.7 low (5/22/13) | High 15943 (5/23/13) |

| | |
|---|---|
| High Y93.8 (6/13/13) | Low 12415 (6/13/13) |
| Y105.4 low (12/30/13) | High 16320 (12/30/13) |
| Y100.8 high (2/3/14) | Low 13995 (2/4/14) |

What are important percentage rises from the Yen 105.4 low? A five percent appreciation against the US dollar gives Y100.1, 10pc Y94.9, 15pc Y89.6, and 20pc Y84.3. A five percent depreciation relative to Y105.4 equals Y110.7, a ten pc slump gives Y115.9.

Suppose the Nikkei weakens from its 16320 end December 2013 summit. A five percent fall gives about 15505, ten pc 14690, 15pc 13870, and 20pc 13055. A 25pc fall equals 12240, 33pc 10870. A five percent jump over its 16320 high equals 17135; a 10pc advance gives about 17950, close to its 2/26/07 major high at 18300.

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The Japanese Yen versus US dollar cross rate level and trend are monitored closely by Japanese and other international authorities. Many marketplace astronomers in other currencies, debt arenas, and stock fields also study this important currency cross rate. However, the Yen's broad real trade-weighted level and motions (effective exchange rate, "EER", monthly average, 1990=100; Bank of England statistics) are a more comprehensive guide to the Yen "in general" and Japanese official views in regard to it. Analysis of the EER Yen also offers a useful perspective regarding trends in related currency, interest rate, and stock marketplaces.

The Yen attained its all-time EER pinnacle in January 2012 at 185.6. It established its final tops in July/August 2012 at 183.7/183.4.

After "Abenomics" marched on stage, the EER Yen plummeted. Its 141.4 low in May 2013 stumbled 23.8 percent from January 2012's pinnacle. The Yen slump continued. From October 2013's average of 143.2, it slid lower, falling to around 135.4 (December 2013)/135.2 (January 2014). However, it rallied to 137.3 in February 2013. See the 11/4/13 essay, "Currencies: the Waiting Game" for additional details on the EER Yen history and key levels.

## INFLATION PROGRESS, YET MEDIOCRE GROWTH AND STILL MASSIVE DEBT

"You say you got a real solution
Well you know
We'd all love to see the plan." "Revolution", by the Beatles

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In late 2012, significant political change supposedly arrived in Japan. In winter and spring 2013, Prime Minister Abe and the Bank of Japan majestically proclaimed their awesome economic plans, with mammoth money printing being the most noteworthy. Thus the thunder, lightning, and rhetoric of Abenomics struck marketplaces!

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According to the International Monetary Fund's "World Economic Outlook" ("WEO", October 2013, "Statistical Appendix", Table A5), after a long era of generally slight deflation, Japan probably will achieve its two percent inflation target and thereafter. Japanese consumer prices averaged -.1 percent average annual percent change (slight deflation) from 1995-2012. The 2013 level was about unchanged. However, the IMF forecasts inflation to jump to 2.9pc in 2014, remaining just under 2.0pc over the 2015-2018 vista.

What does recent Japanese inflation data display? They indicate progress toward the blessed two percent landmark. May 2013 was the last year-on-year negative CPI at -.3pc year-on-year. The year-on-year rate rose to 1.5pc in November 2013 and 1.8pc in December 2013. In January 2014, Japan's consumer price index slipped .2pc month-on-month, but increased 1.4pc year-on-year. (Japan's Statistics Bureau).

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Unfortunately for Japan, although it has managed to create a bit more inflation and probably significantly reduced deflationary expectations, the nation still seems mired in its slow growth and massive debt situation.

According to the IMF's "World Economic Outlook Update" (1/21/14; Table 1), Japan's 2013 output grew a modest 1.7 percent, up only slightly from 2012's 1.4pc. In 2014, despite Abenomics, real GDP likewise expands only 1.7pc year-on-year. Japan's national sales tax rises from five to eight percent in April 2014. This will blunt growth somewhat. Moreover, despite Abenomic magic (particularly its ongoing marvelous money printing scheme), Japan's 2015 GDP edges up only 1.0pc. Although the January 2014 IMF forecast increased October 2013's forecast for 2014 by .4pc, it cut the 2015 growth estimate by .2pc. As in the case of the US Federal Reserve's glorious quantitative easing programs, one should wonder how much long-run real economic growth derives from Japan's version.

The IMF believes world output will grow from 2013's 3.0pc to 3.7pc in 2014 and 3.9pc in 2015. This modest increase for calendar 2014 and 2015 probably offers little scope for Japan's to surprise viewers with higher GDP growth than the IMF now forecasts.

Suppose Japan's enormous easing (output stimulus) scheme does not push its economy much further forward than the indicated 2015 GDP one percent growth rate (or suppose that the 1.7pc estimate for 2014 is not reached). If so, then how likely is it that the Fed's own ongoing easing (particularly as the tapering program continues) will continue to substantially assist American economic growth (and confidence)?

The IMF forecasts (October WEO) only a slight Japanese output gap as a percent of potential GDP in calendar 2014 and 2015. The gap probably will be merely -.5pc in 2014 and just beneath -.3pc in 2015. This indicates that Japan has little scope to boost GDP from this vantage point. Japan had a gigantic gap in 2009 of -6.7pc (compare the positive .73 in 2007 at the end of the Goldilocks Era). The gap narrowed to -3.6pc in 2011, falling further to an estimated -.9pc in 2013.

Despite the emergence of a trade deficit in the past few years (assisted by high petroleum prices and the consequences of increased petroleum demand due to the nuclear shutdown disaster), Japan still runs a current account surplus. Japan's current account balance as a percent of GDP probably will remain modest (October WEO). Falling from a 4.9pc surplus in 2007, it was 1.2pc in 2013. The IMF predicts 1.7pc in 2014 and 1.9pc in 2015; such levels do not indicate substantial economic growth looms on the horizon.

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From some perspectives, Japan is a creditor rather than a debtor nation. Note its massive holdings of US Treasury securities, for example. And Japanese households and other domestic private sources have long been savers.

However, the national Japanese government debt situation remains alarming, even if the problem has not yet generated widespread national or international panic. Like the Fed's sustained monetary easing schemes, Abenomics has boosted national confidence (and helped to rally stocks) and bought time for a fiscal solution. Yet based on IMF statistics, Abenomics has accomplished little if anything positive on the debt front. Abenomics continues the nation's traditional abnegation of responsible national action on its debt problem. Its fiscal arrow does not aim far.

Though somewhat dated, the IMF's October 2013 "Fiscal Monitor" provides insight. Japan's general government overall balance 2009 through 2013 ranged between -9.3 percent and -10.4pc of GDP, with 2013's a still-gaping -9.5pc (Statistical Table 1). Although its budget deficit falls moderately after 2013, Japan continues to generate large budget shortfalls. The fiscal arrow of Abenomics indeed is flexible (or weak). The IMF forecasts 2014 at -6.8pc, with 2015's -5.7pc and 2016's -5.0pc.

According to Statistical Table 4, Japan's general government gross debt soared from an already lofty 183.0pc of GDP in 2007 to 238.0pc in 2012. Despite Abenomics, the 2013 scene worsened, reaching 243.5pc. The IMF predicts a dark picture for the next few years. The gross debt will remain sky-high at over 242.0pc for the each of the three years 2014-16. Compare Japan's general government debt with that of the G20 advanced nations. The G20 debt level was 78.2pc in 2007, 116.0pc in 2012, 115.4pc in 2013; it declines only slightly in subsequent years, falling to 114.2pc by 2016.

## TURNING POINTS: JAPANESE AND AMERICAN STOCKS

The supply/demand situation for US equities obviously is not the same as for Japanese stocks. Yet from the closing months of the sunny Goldilocks Era to the present, the Japanese and American stock marketplaces often have made important moves in same direction (trend) around the same time. See the table below. Of course the S+P 500 continued to climb above its 2010 and 2011 highs, whereas the Nikkei stayed underneath its April 2010 top (and even lower February 2011 and March 2012 highs) until early 2013. Nevertheless, many important directional moves occurred around the same time.

The sharp rally in the Nikkei that began in late 2012, inspired by Japan's easy money policies, surely was a factor helping to propel the S+P 500 upward. After all, Japan is a major industrial (advanced) nation, and its stock marketplace is substantial and globally-watched.

Consequently, further declines in the Nikkei from its January 2014 peak probably will cast a bearish shadow on the S+P 500 (and European stocks in general as well). In this context, keep in mind the bear trends in emerging marketplace equities "in general" (and commodities in general) since spring 2011. China's stock marketplace remains notably feeble. Conversely, a renewed rally in the Nikkei beyond its January 2014 plateau probably will inspire US equity bulls.

Architects can link many other variables such as US and Japanese  government interest rates, the Japanese Yen/US dollar cross rate, the level of and trend in the broad real US trade-weighted dollar, and commodity patterns (such as in the broad GSCI) to the stock columns below.

| **Japan: Nikkei Stocks (date)** | **US: S+P 500 (date)** |
|---|---|
| Major high 18300 (2/26/07)/18297 (6/20/07) final top 17488 (10/11/07) | Initial highs 1462 (2/22/07) and 1556 (7/16/07) followed by the major peak 1576 (10/11/07) |

[Recall the Yen cross rate low versus the dollar 6/22/07 around Y124.1. Remember the timing of 2007 yield highs in the JGB at 2.00 percent on 6/13/07 and the US Treasury 10 year note on 6/13/07 at 5.32pc. What about the timing of major equity lows in 2003? The S+P 500's final bottom was 3/12/03 at 789, the Nikkei's trough 4/28/03 around 7605.]

| | |
|---|---|
| Final high 14601 (6/6/08) | Final elevation 1440 (5/19/08) |
| Major low 6995 on 10/28/08; 7028 on 3/9/09 | Major low 667 (3/6/09) |
| High 11408 (4/5/10) | High 1220 (4/26/10) |
| Low 8810 (8/27/10) | Low 1040 (8/27/10; low 1011 on 7/1/10. (August is key because QE2 unveiled end August/November) |
| High 10891 (2/17/11) [Japanese earthquake low 8228 on 3/15/11] | High 1344 (2/18/11) |
| Low 8136 (11/25/11) | Low 1075 (10/4/11) |
| High 10255 (3/27/12) | High 1422 (4/2/12) |
| Low 8239 (6/4/12) | Low 1267 (6/4/12) |
| High 9289 (9/19/12) | High 1475 (9/14/12) |
| Low 8629 (11/13/12) | Low 1343 (11/16/12) |
| High 15943 (5/23/13) | High 1687 (5/22/13) |
| Low 12416 (6/13/13) | Low 1560 (6/24/13) |
| High 14953 (7/19/13) | High 1710 (8/2/13) |
| Low 13188 (8/28/13) | Low 1627 (8/28/13) |

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The S+P 500 has advanced to new highs in recent weeks, whereas the Nikkei has not. Perhaps the Nikkei will resume its climb and achieve new highs. Though it is a difficult call, the Nikkei probably will not break its January 2014 height by much if at all in the near future.

In any event, given the timing coincidence of recent years, perhaps at some point these two stock marketplaces will embark on a significant bear move around the same time.

However, might the Nikkei (from what may be a major high in January 2014) already be leading the S+P 500 downward? Perhaps. Marketplace history is not marketplace destiny. However, Japan's major high in 2007 preceded the American pinnacle. The Nikkei's final high at 17488 on 10/11/07 coincided with America's 1576 major peak in October 2011. After the dreadful decline during the worldwide economic crisis, a major low initially occurred in Japan, in late October

2008 (recall the major low in China's Shanghai Composite on 10/28/08 at 1665), a few months before the S+P 500's 3/6/09 major low.

Another marketplace timing note: though history of course does not necessarily repeat itself, remember that the Nikkei's recent high of 12/30/13 occurred right around the calendar date of the all time record pinnacle nearly 25 years before on 12/29/89 at 38957. To what extent does Japan's money printing spectacular (especially its recent round under Abenomics), assisted by longstanding massive deficit spending, evoke memories of the Japanese asset price bubble of a couple of decades ago? Stock watchers also may note that twice the important Nikkei bottom around 8136 on 11/25/11 gives about 16270.

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"US Stocks: Shadows and Signals" (2/3/14) states: "Yet during the darkest days of the worldwide economic crisis of late 2008/early 2009 as well as during the subsequent recovery, Federal Reserve Board easy money policies have played key roles in encouraging bull moves in the S+P 500 (and many other equity playgrounds). Likewise, the elimination of some of these schemes, particularly previous rounds of quantitative easing (money printing), has occurred alongside highs in American stock benchmarks.

What does tapering foreshadow? The Fed's recent decision to reduce (taper) and eventually eliminate the current gigantic round of money printing warns that a notable top is or relatively soon will be in place."

On 12/18/13, the Fed announced its first round of tapering. It heralded a second cut in its securities purchases on 1/29/14. The Nikkei's 12/30/13 summit falls between these dates. The Fed next meets 3/18-19/14. Most observers expect this meeting to further taper the securities acquisition program.

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Suppose China grows less than expected. See "Another Marketplace Tapering Tale: the China Story" (9/9/13) and "Chinese Rates: Opening the Gates" (12/2/13). Such a Chinese deceleration probably will help to slow Japanese (and worldwide) economic growth, with ominous portents for Japanese and American and other stock marketplaces. Incidentally, note the recent squabbles between China and Japan over the ownership of several tiny islands.

Also bear in mind the Chinese renminbi's decline in recent weeks against the US dollar. Suppose an "overall" slump in the renminbi, including against the Japanese Yen, helps to stop the Yen (both on a dollar cross as well as an effective exchange rate basis) from making new lows in its bear move. That in turn would tend to make further climbs in the Nikkei more difficult. In any event, the renminbi's 6.039 high against the dollar occurred 1/14/14, not long after the Nikkei's high on 12/30/13 at 16320 and the Yen's 12/30/13 Y105.4 low against the dollar.

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