Stick with Japan ... it's paying off

Earnings growth of up to 13pc is a strong reason to persevere

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THE truly accomplished global investors succeed because they run the marathon and not the sprint.

Japan's renaissance could only be considered a marathon and best described by the seafaring analogy that a supertanker cannot be turned around on a dime.

The Japanese economy, by any measure, would be considered a supertanker and one that sails the high seas alongside its maritime and economic ally, the US.

Japan still ranks second, after the US, in terms of aggregate wealth per capita and enjoys a greater wealth distribution than any other developed nations reflected in a Gini coefficient (a statistical tool to measure income distribution of a nation's residents) of 63 per cent.

Since writing about Japan and its reform policies stewarded by Japanese Prime Minister Shinzo Abe in this column on April 12 last year ("Positive thinkers stick with Abe"), investments in Japan have been the best performing of all the thematics we have discussed.

With Japanese stocks reaching 7-year highs, coupled with the fact that they have been the best-performing developed market, in US dollar terms, 2015 year-to-date, the question for Australian ultra high net worth (UHNW) investors becomes whether now is the time to exit this race or persevere and seek a "second wind"?

From the perspective of listed companies on Japanese bourses, the fundamentals present a strong argument to remain in the race during 2015.

With reasonable expectations of earnings growth between 12-13 per cent this year, Japan is one of the few markets with positive revisions in earnings-per-share momentum.

Strong earnings growth, an increasing focus on shareholder return, continued monetary policy accommodation and a continued weaker yen, which itself, in turn, supports earnings, all bode well for the global investor seeking portfolio alternatives.

Further to this, an important shift can be witnessed in the graph provided.

So far this year, the MSCI Japan index has risen and this rally occurred despite the yen strengthening against the euro.

This is significant in that it demonstrates a decisive break in the inverse yen-equities correlation, which has broadly applied for more than a decade in the nation of the rising sun.

This shift looks to be partly a function of Japan's rotation from bonds to equities, which was one of the primary goals of the Bank of Japan's bond-buying program, known as "quantitative and qualitative easing" or QQE, which began in April of 2013.

With the open-ended QQE program, BOJ purchases of Japanese government bonds have driven up their prices which, in turn, have compressed these bonds' yield.

With lower yields, asset allocators are prompted to move into riskier assets, thereby driving up the prices of other assets and further compressing yields on private credit.

The wealth effect that this causes, thanks to higher asset prices, then boosts aggregate demand, while the "credit channel effect" — reduced yields in credit markets — lowers financing costs for both companies and households.

This positive scenario supports the reasonable expectation of earnings growth for listed Japanese companies in 2015.

Further still, supported by a competitive yen, the collapse in commodity input costs and a sequential improvement in real wages that feeds into firmer domestic demand was reinforced by the announcement in January that domestic employment had significantly improved, with the job openings-to-applicants ratio reaching its highest levels since 1992.

Improving domestic employment and household wealth in Japan also directly benefits Australia, as we remain one of their key trading partners.

On this, Innes Willox, CEO of Australian Industry Group and Larkin Group Advisory Board member, comments that: "Japan is slowly finding its feet and economically Australia is well placed to develop the relationship for generations to come.

The FTA will provide winners and losers within the Australian economy but overall it gives Australia a chance to build a new economic partnership with one of the region's biggest economies just as it starts to open further to the world."

For Australian businesses and investors alike, one thing is known for certain: that under the fiscal stewardship of Shinzo Abe and the monetary guidance of BOJ chairman Haruhiko Kuroda, Japan will stop at nothing to turn its supertanker away from the path towards continued deflation.

Its unprecedented and unrelenting commitment to "reflation", through asset purchases and other stimuli can mean only one outcome — yen-denominated asset inflation.

Given the recent decoupling of the yen-equities correlation, the savvy global investor should differentiate between those listed entities whose profit growth and share price gains are mainly attributable to foreign exchange movements and those whose profits are increasingly driven by solid fundamentals and highly competitive business models.

UHNW investors have therefore been advised to own Japanese assets that the Central Bank cannot print, namely, equities.

Alps Electric Co. (6770: JP), Seiko Epson (6724: JP) and Makita Corporation (6586: JP) are all worth keeping an eye on this year, to name but a few

All of these are examples of Japanese companies which have overseas sales of at least 15 per cent, price-earning (P/E) ratios of 20 times or lower and have expectations of operating profit growth at least 15 per cent, excluding the effects of foreign exchange.

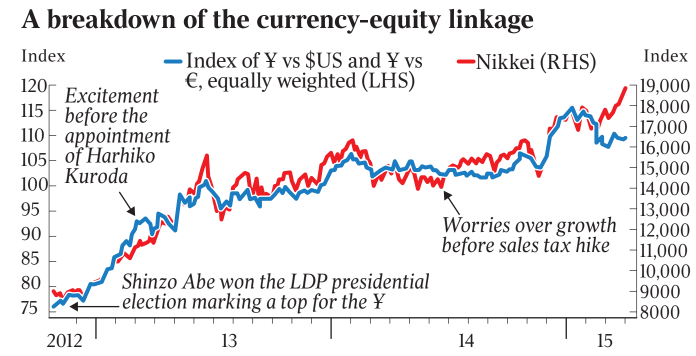
The 17th century Japanese poet Matsuo Bash said: "No matter where your interest lies, you will not be able to accomplish anything unless you bring your deepest devotion to it."

Investing in Japan, without any doubt, requires the deepest of devotion and for those willing to run the course, the greatest of accomplishments may well wait ahead.

Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments www.larkingroup.com.au

Japan's Prime Minister Shinzo Abe, who has overseen successful reform policies AFP

A breakdown of the currency-equity linkage



Source: Gavekal/Macrobound

Don't bet the bank on a rising stockmarket

ROGER MONTGOMERY

THE current boom in share prices is difficult to ignore but caution should always be at the back of every investor's mind.

As a growing band of retirees are forced — by low interest income on their term deposits — into a narrowing band of sufficiently high-quality company shares with stable income, their price-to-earnings ratios are reaching multiples that simply won't be sustainable over the next few years.

It's quite simple really: local interest rates are expected to decline further, and armed with plenty of cash and an understanding of the income required to fund lifestyle and general living expenses in retirement, the biggest cohort of the population is marching headlong into what I believe will be another catastrophe.

Now, I know, in a rising market and with interest rates expected to remain low for some time, I will, like Cassandra, never be believed. It is probably right to dismiss my forecast of impending doom upon the retirement nest eggs of many millions of investor. But the sad truth is that despite decades of experience, those baby boomers have learned little about successfully navigating the market's booms and busts.

Keep these two truisms in mind: first, the stockmarket has never allowed a majority to grow sustainably wealthy at the expense of the minority — it's always been the other way around. Secondly, the stockmarket is merely a transfer mechanism that transfers wealth from those who have no patience to those that do.

What is the action that the majority has commenced? They are being herded into stocks and property by low interest rates. Remember the observation of my friend from Magellan Funds, Hamish Douglass, that it is better to be six months early, than six minutes late.

As interest rates continue to decline, investors searching for income are moving further and further up the risk spectrum. By way of example, A-REITs (real estate investment trusts) now trade at up to 40 per cent over their net tangible assets and such is their popularity that their investment bankers would have no trouble securing billions of fresh equity for them. The only problem is they cannot find assets that stack up.

The enthusiasm for more risk is willingly encouraged by an increasing chorus of advisers, some of whom are now suggesting investors look at the yields available on equities on a 13-month basis! Promoting dividend yields by picking up three dividends over 13 months fails to recognise you have borrowed a dividend from the subsequent year.

Longer term, equity market returns will be determined by two drivers. They are earnings and the P/E ratio investors are willing to pay.

Starting with earnings, there are, in turn, two further drivers. The first is GDP growth and the second is profit margins. GDP growth is driven by changes to the labour force and changes to productivity.

Analysts at Montgomery have discovered that countries responsible for 72 per cent of world GDP growth will see old-age related dependency rates rise significantly, and double in some countries, in the next 20-30 years. Turning to profit margins, the analysts have discovered that profit margins are the highest they have been since 1974, especially for mega-cap companies. These margins cannot increase indefinitely.

Having established that the drivers of corporate earnings — GDP growth and margins — will in future come under pressure, we turn to the other driver of equity market returns, the P/E multiple. One of the major factors driving the multiple investors are willing to pay is interest rates.

As interest rates fall, so do discount rates used to calculate the present values of business cashflows. These have been on a steady decline since 1981.

Given risk-free rates cannot fall below zero, the 30-year tailwind that has helped boost stockmarket returns might now be ending. Investors believe that rising interest rates will be required before a stockmarket correction follows. I am not sure that we need rates to actually rise. You see, this time around, low rates have driven a stampede into alternative assets with higher yields. When those yields cease being higher, because shares have been pushed up too far, and/or the stampede ends, asset prices will stop rising ... and that might be all that is required to see the gains reverse.

Roger Montgomery is the founder and CIO at The Montgomery Fund.

S&P/ASX 200 index, past year

Beware the small caps that shoot themselves in the feet with clangers

RICHARD HEMMING
UNDER THE RADAR

WHAT a difference a week makes, or a few days in this case. On the second last day of the reporting season, LogiCamms delivered a first-half profit result that ticked all the boxes and led to a 15 per cent spike in its shares to as high as 85c.

But now its shares are back where they started after the company, three days later and citing "personal reasons", said its managing director, Matt Adamo, would resign immediately to be replaced by Steve Banning. The odd thing here is that Banning was the CEO before Adamo; now Banning is back again!

Then there was the medical science company SDI, which also delivered a strong interim profit result, but still its stock got hammered 26 per cent in the wake of a "trading update" delivered just three days before the result. This is from a company whose board includes a self-described "investment relations consultant".

I got in contact with the CFO at SDI, John Siaviero, who said: "In hindsight we shouldn't have done that (offering a trading update just before a result). It was a board decision."

Separately, mobile technology firm eServGlobal's share price cratered after it announced its Paris-based chief executive Paulo Montessori was "stepping down with immediate effect" without any explanation.

There were more, and there will be more.

Small listed companies that are not used to being in the public spotlight are more prone to deliver clangers that leave investors unsure as to whether there are real problems that are unseen ... but could literally explode.

Do the big falls represent a buying opportunity?

When there are big announcements like this, it's not necessarily a public relations problem. All companies lose key executives at one time or another. But it isn't good enough for anyone but the guy up the top to respond to concerns. At times like this investors need to see leadership.

Until I see that sort of leadership we would be very cautious in recommending a stock to our subscribers. The question therefore, is whether or not you should sell?

The companies above all have strong balance sheets. LogiCamms actually has $23 million in cash.

Based on the last published information, Logicamm, SDI and EServeGlobal were all producing growing profits. So do the executives know something we don't? If they do, then all the other directors have a responsibility to tell us.

There is enough litigation to ensure that they are mindful of their responsibilities. One of our top performing stocks is Bentham IMF, which funds class actions, and right now is reportedly funding one against deeply troubled skills training group Vocation.

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