Kimura Dreamvisor Newsletter Summary 24th of July

American Investors have entered ‘reverse earnings’ market mood.

The reverse curve of long/short interest rate and defensive stocks relationship.

Japanese ZIRP was terminated as BOJ and Japanese government signaled the end of deflation era based on economic and earnings forecasts.
However the market seems to ignore such statements. Earnings are strong, however foreigners are sidelined and deep pocket Japanese domestic investors seem to be fully booked with large pubic subscriptions. Buyers level get thinner and Japanese individuals, burdened with margin calls selling plus Softbank group related equities crash, melted away.

It has been repeated that the main reason behind foreigner’s lack of buying activity is foreign stock markets fall due to increased geopolitical risk, but I feel this risk is quite limited. Japanese people looking at the news of Beirut bombing and increased tensions in the Middle East think about some kind of 5th Middle East war .However looking at oil and gold price movement’s conflict extension seems highly improbable.

The FOMC 8th of August committee is certainly an important event but most US institutional investors have already discounted this, it is not any more a major issue. Even if rates are raised again this would certainly be the last shot. Current market consensus is that the next rate rise will take place in September after what rate tightening cycle would nearly be over (this translate into5,5 % FF rate by September end).Should economy show further weakness then target would be lowered at 4,25 %, in both cases the current calendar year scenario won’t change much.

More important are the long term rates. US 10 years TB yield went down from 5,3 % to 5,02% around June. Discounting august FF rate increase Long/short term rates reverse curve expanded (steepening yield curve) but this is standard discounting of economic slowdown, said in other words this translate in a bearish view of companies’ earnings.

For the April -June quarter US earnings registered a 13 % YoY increase but stocks did not reflect this double digit growth. Rather NASDAQ registered a new low for the current fiscal year and cyclical stocks were sold off. On the reverse defensive stocks like pharmaceuticals or utilities were bought. Long term rates and companies earnings show a typical ‘reverse earnings’ pattern.

In a typical reverse earnings market cycle, stocks are depressed to discount bad earnings and economic slowdown. However US short term rates have not yet reached their ceiling nor has economic cycle peaked yet. The economic expansion phase has been unusually long but veteran investors opened early the advance forecast race.

Barron’s is suggesting buying the blue chips.

Among the American investors I know profile varies a lot but all are seasoned professionals. Their persuasion power is high and a majority is going for the ‘reverse earnings’ scenario. This may also be true of European investors. <u>But for those looking solely at the Japanese stock market,</u> rates have just started to trend upward and we are in a ‘upside earnings’ cycle where it pays to buy stocks which earnings improvement is above rates increase. Certainly not a bearish mood market.

US long term rates suggest a totally different pattern. The lowest yield on 10 years TB was 3,1% in June 2003.The yield went up to June 06 for three years in a row reaching 5,25 %. The US market has experienced a typical economic, rate, stock prices cycle reaching a peak in May 06 (for earnings). From that point the market entered a bearish phase led by earnings downside revisions.

Another factor to explain the bearish market is the US 4 year’s cycle pattern according to which a low is reached in the second half of mid-election years. The scale of the cycle varies according to years but is extremely significant for US market. Anyway for this particular cycle correlation between earnings, economy and stock prices was not that high.

US Barron’s last week edition published an article stressing that it was optimum timing to buy 10 blue chips companies. GE (Per 16x),Home depot (Per 11x), Dow Chemical (Per 8x), Wal Mart (Per 15x), Nestle (Per 13x), Chevron (Per 8x), Cisco Systems (Per 16x), Lehman Brothers (Per 9x), News Corp, Vodaphone (Per 10x), that’s Barron’s so at 5 % long term rate level those stocks must undoubtedly be attractive long term investment targets.

For Japan I could easily build a long list of Japanese stocks trading at less than 15x average Per. Even discounting the inherent risk with a 6-7% yield this compares favorably with bonds.

It is nearly impossible to secure a proper income from bonds or savings in Japan with long bond yield at only 1,8 %. Based on such an idea it won't be long before Japanese Asset Managers launch 'low Per large caps equities package 'investment trusts.